

RECENT DEVELOPMENTS IN TEXAS, UNITED STATES, AND INTERNATIONAL ENERGY LAW

EDITED BY AUDREY HARE

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I. INTRODUCTION

The *Recent Developments in Texas, United States, and International Energy Law* section consists of selected cases and brief discussions of legislation and regulations related to energy law.¹ Part II focuses on developments in Texas energy law. This part includes an article on recent developments in onshore joint operating agreements and case summaries in Texas oil and gas law. Part III explores developments in United States energy law. This part includes an article on developments in the choice of law on the Outer Continental Shelf, a discussion of FERC's interim rules for natural gas pipelines, and case summaries in United States oil and gas law. Part IV addresses international developments in energy law. This part presents developments in Russia's antimonopoly law and Islamic financing in Saudi Arabia.

1. The content of the *Recent Developments* section is provided for general information purposes only. The TEXAS JOURNAL OF OIL, GAS, AND ENERGY LAW is not responsible for the accuracy or completeness of the case summaries provided in this section. The short articles may serve as a useful beginning point in the legal research process, but are not a substitute for primary research of the laws of the jurisdiction discussed.

II. RECENT DEVELOPMENTS IN TEXAS ENERGY LAW

A. CURRENT ISSUES WITH THE ONSHORE JOINT OPERATING AGREEMENT

JENNIFER A. POWIS*

1. Introduction

An update on any legal issues affecting onshore joint operating agreements (JOAs) would not be complete if it ignored the long-standing controversy revolving around an operator's duty to the non-operator. The first part of this article addresses the impact of the exculpatory clause on an operator's obligations under the standard onshore JOA. The second part addresses the recent Supreme Court opinion in *Seagull Energy E & P, Inc. v. Eland Energy, Inc.*² While *Seagull* interprets an offshore operating agreement, its holding may very well apply to assignments under the 1982 JOA.

2. The Exculpatory Clause

a. Introduction

The exculpatory clause found in the American Association of Petroleum Landmen's (AAPL) 1989 JOA states:

[Operator] shall be the Operator of the Contract Area, and shall conduct and direct and have full control of all operations on the Contract Area as permitted and required by, and within the limits of this agreement. In its performance of services hereunder for the Non-Operators, Operator shall be an independent contractor not subject to the control or direction of the Non-Operators except as to the type of operation to be undertaken in accordance with the election procedures contained in this agreement. Operator shall not be deemed, or hold itself out as, the agent of the Non-Operators with authority to bind them to any obligation or liability assumed or incurred by Operator as to any third party. Operator shall conduct its activities under this agreement as a reasonable prudent operator,

* Jennifer A. Powis is an associate at Baker Botts LLP. This paper is a revised version of a paper originally presented by Kathy Silver at the Energy Law Institute for Attorneys and Landmen, September 7-8, 2006, in Houston, Texas.

2. 207 S.W.3d 342 (Tex. 2006).

in a good and workmanlike manner, with due diligence and dispatch, in accordance with good oilfield practice, and in compliance with applicable law and regulation, but in no event shall it have any liability as Operator to the other parties for losses sustained or liabilities incurred except such as may result from gross negligence or willful misconduct.³

The exculpatory clause in Article V.A. of the AAPL 1982 JOA states:

[Operator] shall be the Operator of the Contract Area, and shall conduct and direct and have full control of all operations on the Contract Area as permitted and required by, and within the limits of this agreement. It shall conduct all such operations in a good and workmanlike manner, but it shall have no liability as Operator to the other parties for losses sustained or liabilities incurred, except such as may result from gross negligence and willful misconduct.⁴

Thus, the exculpatory clause in the JOA establishes the standard of care (i.e., operations must be conducted in a good and workmanlike manner), but if the operator falls short of this standard, the operator shall be liable only for gross negligence or willful misconduct.

As demonstrated by the broad liability-limiting language adopted in the 1989 version, the JOA attempts to limit the operator's exposure to acts of gross negligence and willful misconduct in any activity undertaken by the operator. While this broad reading initially gained momentum in a Fifth Circuit Court of Appeals case,⁵ Texas courts are dramatically limiting the provision's applicability. The cases discussed below do not exhaust the subject but do represent the spectrum of authority for the two extremes.

b. *Stine v. Marathon Oil Co.*

In *Stine v. Marathon Oil Co.*, the Fifth Circuit held that the exculpatory clause shields an operator from liability for *any act taken in its capacity as operator* unless the conduct involved gross negligence or willful misconduct.⁶ The court found that the protection extended even to the "various administrative and accounting duties, including the recovery of costs under the authority of the JOA."⁷ Further, the court found that

3. AAPL, FORM 610-1989 MODEL FORM OPERATING AGREEMENT, Art. V.A. Designation and Responsibilities of Operator, *reprinted in* ANDREW DERMAN, THE NEW AND IMPROVED 1989 JOINT OPERATING AGREEMENT: A WORKING MANUAL 28 (1991) [hereinafter AAPL, FORM 610-1989 MODEL FORM OPERATING AGREEMENT].

4. AAPL, FORM 610-1982 MODEL FORM OPERATING AGREEMENT, *reprinted in* STATE BAR OF TEXAS INSTITUTE, OIL AND GAS LAW: FOR LEGAL ASSISTANTS AND ATTORNEYS F-19 (1984).

5. *Stine v. Marathon Oil Co.*, 976 F.2d 254 (5th Cir. 1992).

6. *Id.* at 261.

7. *Id.*

the exculpatory clause even limited liability for acts performed as operator “under the authority of the JOA that amount to tortious interference with contracts with third parties.”⁸ Thus, in *Stine*, the Fifth Circuit found the exculpatory clause of the JOA to be extremely broad.

i. Factual Background

Non-party Internorth, Inc., farmed out approximately 60,000 acres of a leasehold interest to the Stines (“Stine”) in Concho and Menard counties in Texas. With Internorth’s consent, Stine then assigned a portion of his interest under the farmout agreement to Marathon Oil Company (“Marathon”). Marathon and Stine entered into a “letter agreement” and a JOA memorializing their agreement that Stine would drill three exploratory wells. The letter agreement authorized Marathon to take over as operator of the farmout acreage after the first three wells were complete. Only one of the three wells produced. Marathon took over as operator, drilled two more dry holes, and then proposed to plug and abandon all the dry wells. Stine objected to plugging the wells because he wanted them tested for oil in shallower formations; however, Stine did not take over the wells. Marathon proceeded to plug and abandon them.

Stine owed Marathon certain costs for his share of the drilling and operating expenses. Marathon sued Stine, and others, to collect the operating expenses. Stine counterclaimed, arguing that Marathon failed to turn over the wells to him, damaged the wellbores by plugging, failed to timely complete other wells in formations that later proved productive, and refused to share information as required by the JOA. In addition, after paying the amount owed in full, Stine further alleged that Marathon overcharged him for the operating expenses and tortiously interfered with a gas contract.

Marathon admitted to overcharging Stine, but disputed the remaining claims. Moreover, Marathon argued that the exculpatory clause precluded any finding of liability, for both operational and contractual issues, unless Stine showed that Marathon’s actions were grossly negligent or willful.

ii. Case Holding

The JOA between Stine and Marathon included the exculpatory clause from the AAPL 1982 JOA. The Fifth Circuit was presented with three different interpretations for this exculpatory clause. First, Stine argued that the clause should be limited to physical acts by the operator within the geographic limit of the contract area. Second, the district court held

8. *Id.*

that the clause should apply only to acts that were “unique to the operator under the contract.”⁹ Third, Marathon, and an amicus brief by the Texas Mid-Continent Oil & Gas Association, argued that the operator should be “protected from [all] liability in connection with any act done under the color of the JOA, both torts and breaches of contract.”¹⁰

The Fifth Circuit adopted Marathon’s reasoning and found that the exculpatory clause of the JOA excused Marathon from “any liability for any act taken in its capacity ‘as Operator’ if authorized by the JOA,” except for actions that were grossly negligent or done willfully.¹¹ The court further stated that this limitation on liability extended to various administrative and accounting duties.¹²

In part, the court relied on the following language from the well-known article by Professor Ernest E. Smith, *Duties and Obligations Owed by an Operator to Nonoperators, Investors, and Other Interest Owners*:

The more serious question is the effect of the remaining language of Art. V [which] state[s] that the operator shall have no liability to the other parties for losses sustained or liabilities incurred, “except such as may result from gross negligence or willful misconduct.” Thus the operator is not liable to the nonoperators for injury caused by the operator’s ordinary negligence. . . . Such clauses do not, of course, purport to authorize the operator to act in a negligent manner. They do however, purport to exculpate the operator from liability for negligent injury to the joint property and partially indemnify him against liability for negligent injury to third parties. Under Art. V., the operator would not be liable to the nonoperators if his negligent drilling resulted in the well blowing out. . . .

Does the language of Art. V. . . . also relieve the operator from liability for conduct which is in breach of specific provisions of the operating agreement? . . . The history of the language used in the model forms suggests that it does.¹³

The court also relied on earlier Texas cases, including a Dallas Court of Appeals opinion in which the court found that the “failure to send supplemental AFE’s [Authorization For Expenditure] was not gross negligence.”¹⁴ The Fifth Circuit stated that the Dallas Court of Appeals “clearly [implied] that the operator’s acts in accounting for and billing

9. *Id.* at 259.

10. *Id.*

11. *Id.* at 261.

12. *See id.* at 260.

13. 32 ROCKY MTN. MIN. L. INST. 12-1, 12-30 (1986).

14. *Stine*, 976 F.2d at 260 (discussing *Argos Res. v. May Petroleum, Inc.*, 693 S.W.2d 663 (Tex. App.—Dallas 1985, writ ref’d n.r.e.)).

drilling costs under the operating agreement are subject to the protection of the exculpatory clause.”¹⁵

Relying on these authorities, the Fifth Circuit found that Marathon was “not liable for any action taken in connection with the completion, testing or turnover, or [sic] any well drilled under the provisions of the JOA unless Stine [could] prove that Marathon’s actions were grossly negligent or willful.”¹⁶ Further, the court found that the exculpatory clause even limited liability for acts performed as operator “under the authority of the JOA that amount to tortious interference with contracts with third parties.”¹⁷

c. Abraxas Petroleum Corp. v. Hornburg

In *Abraxas Petroleum Corp. v. Hornburg*, the court held that the “exculpatory clause is limited to claims based upon an allegation that [the Operator] failed to act as a reasonably prudent operator and does not apply to a claim that it breached the JOA.”¹⁸

i. Factual Background

Abraxas Petroleum Corporation (“Abraxas”) was a new operator for the Cleo Smith lease, located in Stonewall County, Texas. Although the wells had produced for more than four decades, a few months after Abraxas took control of operations, oil production decreased and operating expenses escalated. Abraxas issued an Authorization for Expenditure (AFE) describing the workover procedures that it believed were necessary to restore the wells. None of the individual jobs for the wells exceeded \$30,000 (under the JOA, jobs exceeding this amount required the operator to issue an AFE), but Abraxas bundled all the proposed work into one AFE totaling approximately \$44,000. The working interest owners did not consent to the procedures. Of the proposed workover operations, Abraxas actually performed only one small project at a cost of approximately \$7,500 and did not notify any of the working interest owners that it had decided not to complete the proposed operations. Abraxas then made the decision to shut down full operations and produce only one barrel of oil per day to hold the lease.

The working interest owners brought suit, alleging, in part, that sending the AFE letter was a breach of contract because the procedures were repairs, as opposed to a rework, and therefore were not subject to the consent/nonconsent elections. The JOA in *Abraxas* included the

15. *Id.*

16. *Id.* at 261.

17. *Id.*

18. 20 S.W.3d 741, 759 (Tex. App.—El Paso 2000, no pet.).

exculpatory clause from the AAPL 1982 JOA. Abraxas argued that the exculpatory clause protected it from liability for the breach of contract claim. The working interest owners countered that the exculpatory clause applied only to “causes of action arising from lease operations and does not apply to the operator’s breach of contract.”¹⁹

ii. Case Holding

The court held that the exculpatory clause does not apply to all claims and specifically not to the breach of contract claim at issue.²⁰

We first find that the exculpatory clause is unambiguous, and therefore, we will construe it as a matter of law. As some evidence that the parties did not intend that the exculpatory clause apply to any and all claims, we note that the exculpatory clause is found in an article which concerns the operator’s authority to conduct operations in the contract area. More significantly, the operator’s limitation of liability is linked directly to imposition of the duty to act as a reasonably prudent operator, which strictly concerns the manner in which the operator conducts drilling operations on the lease. Accordingly, we conclude that the exculpatory clause is limited to claims based upon an allegation that Abraxas failed to act as a reasonably prudent operator and does not apply to a claim that it breached the JOA.²¹

Noticeably absent from the court’s opinion is any discussion of *Stine* or the Texas cases *Stine* used in support of its holding.²²

d. IP Petroleum Co. v. Wevanco Energy, L.L.C.

In *IP Petroleum Co. v. Wevanco Energy L.L.C.*, the appellate court reversed and rendered judgment in a case where the jury found gross negligence and/or willful misconduct.²³ While the court held that the exculpatory clause limited IP’s liability because plaintiffs “alleged that IP failed to conduct operations in [a] good and workmanlike manner and failed to act as a reasonably prudent operator,” it also held that there was no evidence of such conduct.²⁴

19. *Id.* at 759.

20. *Id.*

21. *Id.*

22. The court did not need to address Abraxas’s argument in the alternative that the evidence presented at trial was not legally or factually sufficient to sustain a willful misconduct or gross negligence finding.

23. 116 S.W.3d 888 (Tex. App.—Houston [1st Dist.] 2003, pet. denied).

24. *Id.* at 895-96.

i. Factual Background

Non-working interest owners brought suit against IP as the operator of a wildcat well, claiming that IP failed to drill the well properly.²⁵ The JOA between the parties included the exculpatory clause from the AAPL 1982 JOA.²⁶ At trial, the jury found that IP's alleged failure to drill to a sufficient depth was the result of gross negligence or willful misconduct.²⁷ IP appealed, claiming that the evidence presented at trial did not support the jury's finding.²⁸ The non-working interest owners argued that there was sufficient evidence of gross negligence or willful misconduct, but even if there was not sufficient evidence, no finding of gross negligence or willful misconduct was required because the claim was for breach of contract and therefore not covered by the exculpatory clause.²⁹

ii. Case Holding

The court easily distinguished the holding in *Abraxas* and found that this was precisely the type of suit for which the exculpatory clause was intended to limit liability.³⁰ Plaintiffs alleged that IP failed to conduct itself in a good and workmanlike manner when it drilled the wildcat well.³¹ Because the claim was based on the standard of care to which the exculpatory clause applied, the court found that IP could be liable only for actions constituting gross negligence or willful misconduct.³² Although the jury answered the question affirmatively, the court found there was no evidence meeting this standard and reversed and rendered judgment.³³

3. Post-Assignment Liability for Operating Expenses

In *Seagull Energy E & P, Inc. v. Eland Energy, Inc.*, the court held that an assignor under a standard form JOA will most likely be liable for operating costs post-assignment.³⁴ The court based this holding on Texas contract law, which "generally provides that an assignor's contractual obligations survive assignment unless the contract expressly provides otherwise or the assignor obtains an express release."³⁵ While *Seagull* interpreted an offshore JOA, its holding and reasoning will most likely apply to the AAPL 1982 JOA, which is completely silent on the issue of

25. *Id.* at 894.

26. *See id.* at 894-95.

27. *Id.* at 894.

28. *Id.*

29. *Id.* at 895.

30. *Id.* at 895-96.

31. *Id.* at 895.

32. *Id.* at 897.

33. *Id.*

34. 207 S.W.3d 342, 347 (Tex. 2006).

35. *Id.* at 345.

post-assignment liability for operating costs. It may also apply to the AAPL 1989 JOA, which addresses, in part, this issue.

a. Case Summary

Seagull Energy E & P, Inc. (“Seagull”) was operator of two offshore oil and gas leases in the Gulf of Mexico.³⁶ Eland Energy, Inc. (“Eland”) owned a small working interest and was a non-operator under the JOAs at issue.³⁷ The JOAs were “essentially the same” and provided that Eland was to share in the cost of operations and remit payment to Seagull, the operator, in proportion to its respective interest.³⁸ After two years, Eland sold its interest in the leases to Nor-Tex Gas Corporation (“Nor-Tex”) and assigned Nor-Tex its rights and obligations under the operating agreements.³⁹ When Nor-Tex defaulted, Seagull sued both Nor-Tex and Eland to recover the outstanding costs of operation under the JOA.⁴⁰ Eland argued that the assignment of its obligations under the JOA to Nor-Tex relieved it of this duty and that therefore Eland could not be held responsible for costs associated with operations conducted after the assignment.⁴¹

The Supreme Court held that Eland was liable.⁴² Neither party argued that the JOA language should be construed as ambiguous.⁴³ The Court’s primary concern was to “give effect to the intent of the parties as that intent is expressed in the contract.”⁴⁴ Because the operating agreement “simply [did] not explain the consequences of an assignment of a working interest to a third party,” the Court looked to general rules of contract construction.⁴⁵ The general rule provides that a party who assigns contractual rights and duties to a third party remains liable unless expressly or impliedly released by the other party to the contract.⁴⁶ Thus, Eland still owed Seagull for its proportionate share of the operating costs.

b. Possible Effect on Onshore JOAs

While the offshore JOA at issue in *Seagull* did not provide for the rights and obligations of an assignor, the 1989 onshore JOA expressly addresses this topic:

36. *Id.* at 344.

37. *Id.*

38. *Id.*

39. *Id.*

40. *Id.*

41. *Id.* at 345.

42. *Id.* at 347.

43. *Id.* at 345.

44. *Id.*

45. *Id.* at 346.

46. *Id.* at 347.

No assignment or other disposition of interest by a party shall relieve such party of obligations previously incurred by such party hereunder with respect to the interest transferred, including without limitation the obligation of a party to pay all costs attributable to an operation conducted hereunder in which such party has agreed to participate prior to making such assignment, and the lien and security interest granted by Article VII.B. shall continue to burden the interest transferred to secure payment of any such obligations.⁴⁷

Under the AAPL 1989 JOA, an assignor will be obligated for operating costs that the “party has agreed to participate [in] prior to making” the assignment.⁴⁸ Arguably, *Seagull*’s holding that the assignor is liable for operating costs unless released by the operator could still apply. While the AAPL 1989 JOA at least discusses the issue, it does not address costs after the assignment.

Like the offshore JOA in *Seagull*, the AAPL 1982 JOA is silent on this issue. Because the Court applied general contract law, the legal analysis and reasoning found in *Seagull* will most likely apply to the AAPL 1982 JOA. Thus, companies may wish to amend their AAPL 1982 JOAs to address post-assignment liability for operating expenses.

4. Conclusion

While parties to a JOA may assume that operating “in accordance with good oilfield practice” is enough to insulate them from liability, the above cases represent the overarching principle that a Texas court will apply principles of contract law in determining liability under a JOA. When a question relating to the construction of a contract is presented, the court will closely examine the wording of the JOA and give effect to all the provisions so that none are rendered meaningless. In this light, a company must adequately protect itself from liability by adapting the JOA to its own use, rather than just accepting the model form contract.

47. AAPL, FORM 610-1989 MODEL FORM OPERATING AGREEMENT, *supra* note 3, Art. VIII.D. (Assignment; Maintenance of Uniform Interest).

48. *Id.*

B. TEXAS OIL AND GAS CASE SUMMARIES

THOMPSON AND KNIGHT LLP*

Fordoche Inc. v. Texaco Inc., 463 F.3d 388 (5th Cir. 2006).

In this significant Louisiana case, the central issue was whether the operator under four joint operating agreements performed its obligations in good faith as required by the preferential right or right of first refusal (“ROFR”) clauses. The defendant, Texaco Exploration and Production, Inc. (“Texaco”), planned to sell its interests affected by the four operating agreements to a third party as part of a larger sales area, which included leases in several areas of the state of Louisiana. The ROFR clauses of the operating agreements required Texaco to first offer the plaintiffs, who were also parties to the operating agreements, the same interest on the same terms as that of the contemplated sale to the third party. Texaco sent the plaintiffs letters notifying them of its planned package sale and calling on them to exercise their preferential rights elections. The plaintiffs questioned whether the letters amounted to a good faith offer to sell the identical type and quantity of property rights being offered to the third party and whether the offer was for a fairly allocated amount of the package sale price. The plaintiffs alleged that Texaco did not respond with satisfactory answers to their requests for information. Texaco contended that its initial letters fulfilled its obligations under the ROFR provisions and that the plaintiffs did not request additional explanation of the offer. Following Texaco’s sale of its entire interests to the third party, the plaintiffs brought this suit against Texaco for failure to comply in good faith with the ROFR clauses. Texaco filed a motion for summary judgment dismissing the plaintiffs’ claims. The district court granted the motion, and the plaintiffs appealed this decision to the Fifth Circuit.

Upon *de novo* review of the record, the Fifth Circuit found that genuine issues of material fact existed and, thus, reversed the district

* These case summaries were originally prepared by Thompson & Knight LLP attorneys for the OIL, GAS AND ENERGY RESOURCES LAW SECTION REPORT, a quarterly publication of the State Bar of Texas. These summaries are provided to the TEXAS JOURNAL OF OIL, GAS, AND ENERGY LAW and do not constitute legal advice. Not all of the attorneys who prepared the case summaries are board certified in oil, gas, and mineral law.

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court's grant of summary judgment in favor of Texaco. The court found that the evidence presented could reasonably suggest that Texaco may have breached (1) its obligations under the ROFR clauses and (2) its duty to act in good faith with respect to performance of those obligations.

First, the Fifth Circuit found that Texaco violated one of the operating agreements, referred to as the "1962 JOA," because it did not offer the entirety of its interest in the property affected by the operating agreement to the plaintiffs and, thereafter, sold the entirety to the third-party buyer. Texaco's offer letter for the 1962 JOA interests listed eleven properties that were excluded from the plaintiffs' ROFR. The court found that the language in the ROFR clause of the 1962 JOA clearly and unambiguously provided that the ROFR extended to all of each party's property interests affected by the operating agreement.

The ROFR clause was identical in the other three operating agreements and limited the ROFR to the sale of interest in "unitized substances," which was defined in the agreements as "all gas and condensate in and which may be produced and saved" from the specific unit to which the operating agreement applies. Texaco argued that it only had a duty to offer its interest in the unitized substances and was not obligated to offer the plaintiffs its interest in the tangible assets associated with unit drilling and production. The Fifth Circuit disagreed after reviewing provisions in the operating agreements that mandated that the parties also owned the wells, property, and equipment acquired under the operating agreement. Accordingly, the court concluded that Texaco was not authorized to sell the entirety of the tangible assets because all of the working interest owners held an indivisible interest in those tangible assets and the assets were not just Texaco's to sell.

In addition, the Fifth Circuit found that Texaco's offer letters were ambiguous and did not particularly describe the property interests for sale. As a result, the court held that it could not determine as a matter of law that Texaco complied with the ROFR clauses. Further, the Fifth Circuit concluded that Texaco did not make an offer to the plaintiffs on the same terms that it made to the third party. Texaco sold the entirety of its interest to the third party at the same price offered to the plaintiffs for just its working interest. The offer to sell to the plaintiffs did not include production facilities and other tangible assets. In other words, the sales price to the plaintiffs was higher than the sales price offered to the third-party buyer, because the offer to the plaintiffs included fewer assets.

Finally, Article 1759 of the Louisiana Civil Code expressly provides that good faith is a requirement of every contract or agreement. The Fifth Circuit found that there were several implications of bad faith by Texaco in the record, including implications that Texaco falsely inflated the purchase price quoted to the plaintiffs and that Texaco made

misrepresentations to the plaintiffs regarding its claims to full ownership of the surface rights and intangible property.

Barnes v. Dominion Oklahoma Texas Exploration & Prod., Inc. (in re *Moose Oil & Gas Co.*), 347 B.R. 868 (Bankr. S. D. Tex. 2006)

In this case, landowner Doris Barnes (“Barnes”), who had executed a mineral lease, filed an adversary complaint against O. Lee Tawes III (“Tawes”) and Marlin Data Research (“MDR”) for royalties on mineral production. Two issues were presented in this case: (1) whether, under a joint operating agreement, working interest owners are under privity of contract or privity of estate with a royalty owner and (2) whether consenting parties under a joint operating agreement are liable for royalties owed by non-consenting parties.

Barnes executed an oil, gas, and mineral lease in favor of American Exploration Company (“American”). American’s interest was conveyed to Dominion Oklahoma Texas Exploration & Production, Inc. (“Dominion”). Moose Oil & Gas Co. (“Moose”) leased adjacent land and assigned some of its leasehold interest to Tawes and other parties (herein called “Moose Assignees”). Dominion, Moose, and the Moose Assignees entered into a Working Interest Unit Agreement and Joint Operating Agreement to create four producing wells in the “Baker Unit.” Barnes’s property was included in the Baker Unit. With respect to two of the wells covered by the JOA (the “non-consent wells”), Moose and the Moose Assignees, including Tawes, were consenting parties to drill the non-consent wells and Dominion was a non-consenting party. Under the terms of the JOA, consenting parties were responsible for the expenses of drilling the wells and for payment of royalties due with respect to leases contributed to the unit by non-consenting parties.

On February 13, 2002, MDR and Tawes purchased, at foreclosure sale, Moose’s interest in the Baker Unit, including its interest in the non-consent wells. Production from the non-consent wells was suspended after February 2002. Proceeds accumulated to that date were held in a Royalty Suspense Account and in a Working Interest Suspense Account. Barnes contended that she was entitled to recover from both Tawes and MDR all unpaid royalties from the non-consent wells.

As to the first issue listed above, the court held that Tawes and MDR were not in privity of contract with Barnes under the lease; likewise, there was no privity of estate prior to February 2002. The court based its conclusion on the fact that Barnes did not produce any evidence that Tawes and MDR had assumed the Barnes lease. Accordingly, the court reasoned that Tawes and MDR were merely working interest owners, liable only on their contracts as of the date that they signed same or

succeeded to the interest of a predecessor. Further, the court noted that under Texas law, because Tawes and MDR acquired Moose's interest subsequent to the severance of the minerals for which royalties were due, there was no basis for imposing liability on Tawes and MDR for the payment of royalties merely as Moose's successors. Additionally, the court observed that because under Texas law a working interest owner is not a "first purchaser" of production, the royalties at issue were personalty and no longer an encumbrance on real property when acquired by MDR and Tawes.

As to the second issue, however, the court found that under Texas law Barnes was a third-party beneficiary of the working interest owners. Thus, Tawes, as a consenting party under the JOA, must pay royalties owed by the non-consenting party lessee. Further, noting that the JOA did not limit the liability of the consenting parties to their percentage working interest, the court held that Tawes was liable for all of Barnes's unpaid royalty from the non-consent wells.

In summary, the court concluded that neither Tawes nor MDR was in privity of contract or privity of estate with Barnes prior to February 2002. Nonetheless, Tawes was liable to Barnes as a third-party beneficiary for the royalties due from production from the non-consent wells prior to February 2002. However, because MDR was not a Moose Assignee, MDR did not share such liability.

Compton v. Plains Mktg., LP (in re *Tri-Union Dev. Corp.*), 349 B.R. 145 (Bankr. S.D. Tex. 2006)

In this case, the bankruptcy court considered an adversary action by a Chapter 11 trustee to recover an alleged preferential transfer made by Tri-Union Development Corporation ("Tri-Union"), an oil seller to Plains Marketing, LP ("Plains"). The central issue in this case was whether the prepetition transfer made by Tri-Union was made in the ordinary course of business for purposes of the buyer's ordinary course of business defense to a preferential transfer claim, even though the circumstances of the payment were unique. The court held that the transfer in question qualified as a transfer in the ordinary course of business because the length of the transaction was typical, the amount paid was not at odds with the expected amount of oil to be purchased, and there were no unusual or coercive collection activities.

In 2001, Plains began purchasing oil from Tri-Union's EI-277 well. Delivery was typically made via a third-party gathering system. Every month, Tri-Union would provide Plains with an estimate of the number of barrels it expected to deliver. On the tenth working day of each month,

Plains would close the books on the previous month's production. Usually, before the books were closed, the third party would deliver "run tickets" to Tri-Union, detailing the number of barrels actually delivered to Plains. Plains always made payment on the twentieth calendar day of each month. Often, adjustments to the estimates were not resolved before the payment date. This led to a system of constant reconciliations between Tri-Union and Plains.

On August 13, 2003, Plains initiated a direct deposit to pay Tri-Union \$93,384.50, based upon Tri-Union's estimated delivery of 3100 barrels of oil to be delivered to Plains. On August 18, 2003, Tri-Union notified Plains that the EI-277 well was shut in and would not be producing until further notice. Typically, the overpayment would have been credited against future balances, but because no future production was expected, Tri-Union wired the \$93,384.50 to Plains on October 16, 2003. Tri-Union declared bankruptcy on October 20, 2003.

The trustee of the Tri-Union Class 4A Creditors' Trust alleged that the October 16 transfer was avoidable under 11 U.S.C. § 547(b), which allows a trustee to avoid a transfer made within 90 days before the filing of the bankruptcy petition. Plains asserted the affirmative defense of 11 U.S.C. § 547(c)(2), which states that a transfer made within the ordinary course of business may not be avoided. A creditor asserting this defense must prove that the transfer was (1) in payment of a debt incurred in the ordinary course of business of the debtor and the transferee, (2) made in the ordinary course of business of the debtor and the transferee, and (3) made according to ordinary business terms. Plains also asserted the affirmative defense of constructive trust.

First, the court considered whether a one-time event can qualify as being within the ordinary course of business between two parties. The court answered this question in the affirmative, noting that "an appropriate ordinary course analysis requires a recognition that a variety of events in the course of the parties' business may be found ordinary, even though these events never occurred in the parties' history."

Next, the court considered whether the particular transfer at issue could be considered ordinary. In its analysis, the court relied upon other cases that examined parties' conduct in determining whether they did anything unusual with respect to a transfer. In particular, the court considered the following factors: (a) whether the amount or form of tender differed from past practices, (b) whether the creditor engaged in any unusual collection activity, and (c) the circumstances under which the payment was made.

The court concluded that Plains had proven all of the statutory elements of the affirmative defense. The length of time that the transaction required appeared to be typical. Further, there was no

evidence that the amount paid was at odds with the expected number of barrels to be purchased. Likewise, the payment arrangements appeared to be typical within the industry. Most important, there was no unusual collection activity.

The court rejected Plains's argument that the \$93,348.50 was held by Tri-Union in constructive trust for Plains because, under the circumstances, the equities did not weigh in favor of creating the judicial fiction of a constructive trust. Even though Plains paid "gratuitous sums" to Tri-Union, the Plains system of accounting, and not Tri-Union, was the cause of the mistake.

Chesapeake Operating, Inc. v. Denson, 201 S.W.3d 369 (Tex. App.—Amarillo 2006, no pet. h.)

This case involved a dispute between a royalty owner and the lessee/operator over a division order executed by their predecessors-in-interest. At issue was how occupation or production taxes were to be borne by the parties. The division order addressed the issue and provided that, to the extent the division order covered matters not included in the subject lease, it would constitute an amendment of such lease. Neither party contended that the pertinent provision in the division order was ambiguous or that it was not made a part of the subject lease. The trial court entered judgment in favor of the royalty owner, declared the rights of the parties under the division order, and awarded damages.

On appeal, the court stated that because neither party contended that the division order was ambiguous, its construction involved a question of law. Next, the court discussed the pertinent provision and interpreted it in favor of the royalty owner's position with respect to how occupation or production taxes were to be borne between the parties, and the discussion and interpretation of this unusual provision is unique to this case. However, the court also addressed the lessee/operator's contentions that, at the time the division order was signed, only "producers" were obligated to pay such taxes and royalty owners were not "producers"—such contention being contrasted with current statutory requirements that provide royalty owners are among those responsible for assuring payment of such taxes. The court acknowledged these statutory changes, but stated that they did not relieve the court from attempting to enforce the original intent of the parties to the division order, and that such changes cannot operate retroactively to deny individuals their previously vested rights. Given the preexisting contractual arrangement with respect to the bearing of taxes, the court felt that the subsequent statutory changes had no effect upon the agreement in the division order with respect to the sharing of taxes.

The lessee/operator also contended in the alternative that any tax for which the royalty owner was statutorily responsible automatically became a new tax and that, under the pertinent provision in the division order, the parties agreed to pay their pro rata share of all new taxes. In response to these contentions, the court again discussed and interpreted the pertinent provision insofar as it dealt with any tax increase or new tax and concluded that the wording in the division order did not support the contentions of the lessee/operator.

In summary, the court stated that the trial court interpreted the pertinent provision in the division order in a manner that effectuated the agreement of the parties with respect to the bearing of occupation or production taxes, and affirmed the trial court's judgment in that regard. The remainder of the case dealt with modification of the wording of the judgment of the trial court. Among other things, such judgment purported to affect certain non-litigants with respect to the bearing of these taxes. The court stated that a trial court lacks jurisdiction to enter judgment for a non-litigant, and that to do so constitutes fundamental error on its part if the error is apparent from the face of the record. Accordingly, the court modified the judgment of the trial court to clarify that it was binding only on the litigants and to correct certain other errors so that the judgment would comport with the pleadings as required by TEX. R. CIV. P. 301.

EOG Resources, Inc. v. Wagner & Brown, LTD, 202 S.W.3d 338 (Tex. App.—Corpus Christi 2006, no pet. h.)

The central oil and gas legal issue in this case was whether the reference to “100 feet below the deepest producing interval as obtained in the test well” in a farmout agreement and its related correction assignment refers to 100 feet below the geological formation being produced in the test well, regardless of the subsurface depths of such geological formation, or only 100 feet below the specific subsurface depths of the producing interval being produced in the test well.

In 1984, Longhorn Oil and Gas Company (“Longhorn”), predecessor in interest to Wagner & Brown, Ltd. (“W&B”), executed a farmout agreement to REH Energy, Inc. (“REH”), predecessor in interest to EOG Resources, Inc. (“EOG”). Under the farmout agreement, REH could earn an assignment of a portion of Longhorn's interest in certain leases. To earn an interest in such leases, REH's obligation included drilling a test well.

The farmout agreement provided that the assignment to REH would be limited in depth to “100 feet below the deepest producing interval as

obtained in the test well.” REH drilled a successful test well and earned an assignment of the interest in the leases as provided in the farmout agreement.

On September 11, 2002, subsequent to the acquisition of Longhorn by W&B and the acquisition of REH by EOG, the parties executed a correction assignment in order to correct previous assignments to REH related to the farmout agreement. The correction assignment adopted language identical to that in the farmout agreement and defined EOG’s interest under the correction assignment as covering “[A]ll depths from the surface of the ground down to 100 feet below the deepest producing interval as obtained in the [test well] as seen at a measured depth of 9,679 feet to 9,729 feet subsurface.”

In a suit for declaratory judgment, the trial court granted W&B’s motion for summary judgment, declaring that the correction assignment “did not enlarge or alter the rights owned by the parties and that the interest of EOG Resources, Inc. under such correction assignment is limited to those depths lying between the surface and subsurface depth of 9,829 feet in the properties covered thereby.”

On appeal, both parties argued that the phrase “deepest producing interval as obtained in the test well” is unambiguous, although each put forth a different construction of the phrase. EOG contended that “deepest producing interval” referred to the formation from which the test well first established production, at whatever depth such interval is found. According to EOG, the test well’s deepest producing interval was in the subsurface geological formation known as the Morris Sand and, thus, such assignment followed the formation to its deepest depth, plus 100 feet. However, the appellate court agreed with the trial court in favor of W&B.

Noting that the correction assignment specifically contains the qualifying language “deepest producing interval *as obtained in the test well*” (emphasis added), the court stated that no other language in the farmout agreement indicated the parties’ intent to convey interests according to a variable depth that depended upon where a “producing interval” might be at any location in the lease.

The court also noted that, had the parties intended otherwise, there was readily available alternative language or terms that could have clearly expressed any intent to expand “producing intervals obtained in the test well” to encompass the depth of the entire Morris Sand formation lying under the leased property. Such available terms include the words “formation,” “horizon,” “field,” “reservoir,” or “stratigraphic layer,” but the parties did not elect to use these terms in their farmout agreement or correction assignment.

Apache Corp. v. Dynegy Midstream Services, LP, 214 S.W.3d 554 (Tex. App.—Houston [14th Dist.] 2006, pet. filed)

The primary issue in this case was the interpretation of natural gas contract provisions relating to payments for residue gas, marketing fees, and interaffiliate sales.

Apache owned several oil and gas wells in West Texas and New Mexico. Apache's predecessors contracted with the predecessors of Versado and Dynegy (collectively "Versado") to process the gas from the wells. As a result of the contracts, Versado was required to pay Apache a percentage of the proceeds it realized from the sale of liquid hydrocarbons and residue gas.

Following an audit by Apache of Versado's payments, Apache sued Versado for breach of contract and for violations of the New Mexico Unfair Practices Act. Apache alleged that Versado wrongfully withheld proceeds by deducting "unaccounted-for gas" in its calculations of residue gas. Apache also alleged that Versado breached the contracts by charging excessive marketing fees and engaging in interaffiliate sales. The jury found that Versado breached the contracts by failing to pay Apache \$1,508,678 for unaccounted-for gas, as well as for charging \$158,000 in excessive marketing fees. The trial court, however, granted Versado's motion for judgment notwithstanding the verdict and disregarded the jury's verdict. Apache appealed.

The contracts at issue in this case provided that Apache was to be paid for residue gas as a percentage of the "net proceeds f.o.b. the Plant tailgate" and defined residue gas as the quantity of gas that remains after the liquid hydrocarbon products are extracted and the fuel, flared, or lost gas is deducted. In that regard, the appellate court determined that the contracts were unambiguous. Versado argued that unaccounted-for gas fell into one of the three categories of deductions but that it was incapable of measurement. The appellate court disagreed and found that no language in the contracts permitted Versado to deduct unaccounted-for gas for purposes of calculating residue gas. It held that the trial court erred in disregarding the jury's answer on this issue.

An amicus curiae brief was filed by the Texas Pipeline Association, which alleged that its members have entered contracts similar to the ones at issue. The association expressed concern "with the premise that a party can acquire a producer's interest in a gas purchase contract executed many years prior to the acquisition, and attempt to cause a retroactive interpretation of that contract based on the allegation that the contract does not comport with the parties' intent." The appellate court responded that its opinion did not attempt to retroactively interpret a contract,

noting that, if the association's members comply with the terms of their respective contracts, the court's opinion will not affect interpretation of those contracts.

With regard to excessive marketing fees, Apache argued on appeal that Versado sold liquid hydrocarbons to its affiliates at an artificially depressed price, because it deducted a marketing fee from the weighted average sales price. Although the contracts permitted Versado to deduct costs from the sales price of liquid hydrocarbons, Apache contended that Versado incurred no marketing fee because Versado sold the liquid hydrocarbons to its affiliates; thus, it should not be permitted to deduct a fee from the sales price. Strictly interpreting the contracts, the appellate court found no evidence that Versado charged Apache a marketing fee and held that judgment notwithstanding the verdict was proper on such issue. Instead, the evidence revealed that Versado paid a marketing fee to its affiliates under contracts to which Apache was not a party.

Apache also contended that the trial court erred in granting Versado's motion for partial summary judgment on Apache's claim for breach of contract regarding interaffiliate sales. In such regard, Apache claimed that Versado engaged in sham transactions in which it sold residue gas at below-market prices to affiliates that resold the gas for a higher price; therefore, according to Apache, the best possible price was not being obtained for Apache. Apache contended that the Uniform Commercial Code ("UCC") requires Versado to perform the contract in good faith, and, accordingly, obtain the best possible price for the gas.

The appellate court found that the contracts did not require Versado to sell Apache's products to unaffiliated third parties or to obtain the best possible price. The contracts simply required Versado to pay Apache a percentage of the proceeds. The appellate court stated that the duty of good faith imposed by the UCC is aimed at requiring parties to perform their contractual promises. In the absence of a specific duty or obligation in the contract to which the good-faith standard can be applied, the UCC obligation of good faith will not support a claim for damages. Because the contracts did not require Versado to market the gas to non-affiliates or to obtain the best possible price, the appellate court held that the UCC good-faith standard did not apply and summary judgment in favor of Versado was proper on such issue.

Versado filed a cross-appeal challenging the trial court's judgment that declared Apache was entitled to future payments for liquid condensate from the operation of compressors at two of Versado's facilities. Versado previously had converted such facilities from processing plants to booster stations and contended that no payments to Apache were required on the liquids collected at such locations. The appellate court held that the plain language of the contracts did not support the trial court's declaratory

judgment. The contracts defined “liquid hydrocarbon products” as all hydrocarbons “delivered to, and processed, or extracted at the Plant.” A “Plant” was defined as the facility in which gas is processed. Payment under the contracts was required only for liquid hydrocarbons “saved and sold at the Plant.” Because the two facilities at issue were now booster stations and no longer fell under the contractual definition of “Plant,” Apache was not entitled to future payments on such liquids.

Prior to litigation, Versado voluntarily paid Apache \$338,599.47 for liquids removed at the two booster stations. At trial, Versado claimed Apache had been unjustly enriched by the payment and sought reimbursement. The jury found that Apache did not wrongfully retain the payment. On appeal, Versado argued that because the contracts did not provide for payments on the liquids from these facilities, the evidence was insufficient to support the jury’s answer. However, the appellate court cited the “voluntary-payment rule,” and stated that, because Versado did not claim the payment was made under duress or protest, or that the payment was obtained through fraud or coercion, Apache properly asserted the voluntary-payment rule as a defense to Versado’s claim of unjust enrichment, and there was sufficient evidence to support the jury’s answer in that respect.

Morrison v. Robinson, No. 10-05-00321-CV, 2006 Tex. App. LEXIS 7905 (Tex. App.—Waco Aug. 30, 2006, pet. denied)

The central issue considered in this case was, where a single deed conveyed the interest of two different owners, whether an ambiguity in one grantor’s granting clause and reservation could create an ambiguity in the other grantor’s granting clause and reservation. The court of appeals held that such an ambiguity can exist.

Morrison and her sister-in-law, Barbara Evans, each owned an undivided one-half interest in 87.36 acres in Robertson County, Texas. In a single deed prepared by Morrison’s attorney, Morrison and Evans conveyed their interests in the surface estate to Robinson, with each grantor reserving, by separate reservations, the mineral estate. Shortly after the deed was executed, the minerals under the 87.36-acre tract were leased and a dispute arose between Morrison and Robinson as to what portion of the minerals each party owned. Robinson filed for a declaratory judgment against Morrison, who answered and filed a counterclaim for declaratory judgment and to quiet title. The trial court granted summary judgment in favor of Robinson. The appellate court reversed.

On appeal, Morrison argued that the mineral reservation in her deed was ambiguous, thereby creating a fact issue as to the parties' intent and rendering summary judgment improper. The court noted that for an ambiguity to exist in the deed, there must be more than one reasonable interpretation of Morrison's mineral reservation. Accordingly, the court examined Morrison's reservation, which provided:

SAVE AND EXCEPT and there is hereby reserved for Grantor, Charlise Northcutt Morrison, and her heirs, administrators, successors or assigns, an undivided one-half (A 1/2) interest of the oil, gas and other minerals produced with the oil and gas now owned by Charlise Northcutt Morrison that are in and under the property and may be produced from it[.]

Robinson argued that the express wording of the reservation operated to reserve unto Morrison an undivided one-quarter mineral interest. The court agreed, stating that it is reasonable to read Morrison's reservation with an emphasis on the words "now owned" and conclude that Morrison intended to convey a one-fourth mineral interest, or one-half of her one-half mineral interest.

Morrison, however, argued that her reservation must be harmonized with Evans's reservation, which provided:

SAVE AND EXCEPT and there is hereby reserved for Grantor, Barbara Morrison Evans and her heirs, administrators, successors or assigns, for a period until June 11, 2000, an undivided one-half (A 1/2) interest of the oil and gas and other minerals produced with the oil and gas now owned by Barbara Morrison Evans, that are in and under the property and that may be produced from it[.]

On June 11, 2000, an undivided one-fourth (A 1/4) interest of the total mineral estate shall pass to and be owned by Grantees, their heirs and assigns. It is the intent of the Grantor Barbara Morrison Evans and the Grantee James E. Robinson and Charles Owen Robinson, that as of June 11, 2000 that Barbara Morrison Evans, her heirs and assigns shall own an undivided one-fourth (A 1/4) of the oil, gas and other minerals and James E. Robinson and Charles Owen Robinson and their heirs and assigns shall own an undivided one-fourth (A 1/4) of the total oil, gas and mineral estate.

Morrison argued that the meaning of the "now owned by" in her reservation is revealed by the additional language contained in Evans's reservation, and that the last sentence in Evans's reservation indicates that both reservations intended for the grantors to initially retain their undivided one-half mineral interest. Thus, Morrison claimed that, because the language in Evans's reservation clearly reflected the parties' intent that Evans retain her undivided one-half mineral interest until

June 11, 2000, the only reasonable construction of Morrison's reservation is that, likewise, she would retain her undivided one-half mineral interest.

The court acknowledged that it is a question of law as to whether an instrument is ambiguous and that such a question must be decided by examining the instrument as a whole in light of the circumstances existing at the time the instrument was executed. Thus, the court held that, because the wording of Morrison's reservation was substantially identical to Evans's reservation, and due to the additional language in Evans's reservation, *both* Morrison's and Robinson's interpretations of Morrison's reservation were reasonable. Because the deed was reasonably susceptible to more than one meaning, the court held the deed to be ambiguous and found summary judgment was improper.

Chief Justice Gray, in his dissenting opinion, argued that Morrison's reservation was not ambiguous on its face and that Robinson's interpretation of Morrison's reservation constituted the only proper interpretation of the deed. Pointing out that there is no precedent for the court's holding that the language used by one independent grantor in a deed can create an ambiguity in the otherwise unambiguous language used by another independent grantor, the dissent reasoned that the deed in question was from two different grantors owning two different estates; accordingly, each grantor's conveyance should stand on its own.

Sanchez v. Duke Energy Field Services, Inc., No. 04-05-00926-CV, 2006 Tex. App. LEXIS 7947 (Tex. App.—San Antonio Sept. 6, 2006, pet. denied) (mem. op.)

This case involves a dispute over the interpretation of two pipeline easements entered into in 1998 between Sanchez, as grantor, and Duke Energy Field Services, Inc. ("Duke"), as grantee. One pipeline was a 4½ inch line, and the other was a 12¾ inch line. Under the terms of the pipeline easements, Duke agreed to release all existing easements it held on Sanchez's land, with the exception of a specifically described gas pipeline easement, and to remove all pipelines associated with the released easements. Each of the easements also contained a provision requiring Duke to pay additional consideration to Sanchez in the amount of \$0.25 for each lineal foot of Duke's pipelines located on Sanchez's premises. Duke was to make such payment to Sanchez upon execution of the easements and annually thereafter.

After the easements were executed, Duke paid Sanchez an amount equal to \$0.25 times the total length of the following pipelines under Sanchez's property: (1) the 4½ inch pipeline, (2) the 12¾ inch pipeline, and (3) the gas pipeline that was specifically excluded from the general release in the pipeline easements. Sanchez accepted such payment and a

similar payment on the first anniversary of the easements in 1999. Although Duke submitted the same annual payment from 2000 forward, Sanchez did not cash such subsequent checks. In 2002, Sanchez sued Duke, seeking a declaratory judgment that (a) Duke owned additional pipelines under Sanchez's land pursuant to a general conveyance under which Duke purchased the Seeligson Gas Processing Plant from various Mobil entities, and (b) because the additional consideration language was in both easements, Duke owed Sanchez two annual payments of the same amount, one payment in satisfaction of the additional consideration clause in the 4½ inch pipeline easement and the other payment in satisfaction of the additional consideration clause in the 12¾ inch pipeline easement. The trial court granted a summary judgment in favor of Duke on both issues, and Sanchez appealed.

In connection with the first issue, the court of appeals found that the conveyances executed in connection with Duke's purchase of the Seeligson Gas Processing Plant clearly excluded from the transaction the pipelines that Sanchez had contended were acquired by Duke in conjunction with that transaction.

As to the second issue, the court of appeals stated that it must construe the two pipeline easements, which were executed at the same time and as part of the same transaction, together. Although an identical provision for additional consideration appeared in both easements, the court found that the payment was unambiguously intended to be an annual payment based on the total amount of lineal feet of pipeline that Duke owned on Sanchez's land. Accordingly, the court held that, as a matter of law, the existence of the clause in each easement did not obligate Duke to make two identical payments to Sanchez.

The court of appeals affirmed the trial court's judgment in favor of Duke.

Cudd Pressure Control, Inc. v. Sonat Exploration Co., 202 S.W.3d 901 (Tex. App.—Texarkana 2006, no pet.)

This case addresses choice-of-law for indemnification in a well drilling operation. Sonat Exploration Company ("Sonat") was the operator of a high-pressure gas well in Bryceland, Louisiana, and hired Cudd Pressure Control, Inc. ("Cudd") to work on the well. They entered into a Master Service Agreement under which they agreed to indemnify each other and provide insurance for claims brought by their employees. The well blew out, and four Cudd employees were killed. The families of the employees filed tort lawsuits in Texas. Sonat settled all of the tort claims.

Sonat then sued Cudd to obtain indemnity for the settlements. At trial, judgment was entered against Cudd. Cudd appealed, contending that the trial court had incorrectly applied the governing Texas statute on oil field indemnity agreements and that the evidence was inadequate to show that mutuality of agreement existed or to prove, as required by statute, the amount of insurance coverage for indemnity that Sonat itself had acquired.

A critical issue in the trial was whether Texas or Louisiana law should apply to the action. The trial court applied Texas law. Cudd agreed not to appeal the choice of law issue. Lumbermens Mutual Casualty Company, the company that was Cudd's excess insurer, however, intervened and appealed the trial court's choice-of law ruling.

The Master Service Agreement did not contain a choice of law provision. The agreement, however, did specify certain controlling indemnity law and statutes in the event a well was drilled in either Louisiana or Texas. The parties had agreed that for operations in Texas the provisions of Chapter 127 of the Texas Civil Practice and Remedies Code would apply. Because Louisiana law is different from Texas law on the issue of oil field indemnity, the parties provided for a similar scenario in the event a well was drilled in Louisiana. In Louisiana, the courts have recognized that the only effective way to obtain indemnity in oil well drilling operations is through the indemnitee's purchasing and paying for insurance and becoming an additional insured under the contractor's insurance. The Master Service Agreement provided an authorization for Cudd, in return for payment of the applicable premium by Sonat, to name Sonat as an additional insured. This procedure was predicated on work performed "in the State of Louisiana." The appellate court found these provisions established that indemnity rights in Texas and Louisiana "were tethered to the state where the well was drilled."

The appellate court found that Louisiana had a substantial relationship to the parties and the transaction because the well site where the accident occurred is located in Louisiana. The court further found that application of Louisiana law was not contrary to a fundamental policy of Texas, because each of the two states had a similar purpose in their indemnity laws: "to restrict abusive indemnity practices in well drilling operations."

The court reversed the judgment of the trial court and remanded the case for further proceedings.

Reiland v. Patrick Thomas Properties, Inc., 213 S.W.3d 431 (Tex. App.—Houston [1st Dist.] 2006, no pet.)

This action resulted from an appeal of a trial court decision holding that a certain right of first refusal (“ROFR”) was a valid and enforceable conveyance of real property. The ROFR referred to a tract of land described as being “3.0152 acres adjoining on the east side that certain 1.9854 acre tract conveyed by Leonard Bythel Weis and wife, Marjorie K. Weis, to Beverly Faulkner, Trustee on or about February 18, 1977.” The tract was further identified as “being 3.0152 acres in the William Walters Survey, Abstract 851, Harris County, Texas.”

The ROFR was granted to Beverly Faulkner (“Faulkner”) in 1977 by Leonard and Marjorie Weis. In 1999, the subject tract was conveyed to Michael F. Reiland (“Reiland”) and then, in 2004, Patrick Thomas Properties, Inc. (“PTP”) acquired the ROFR from Faulkner. Faulkner and PTP were unaware of the sale to Reiland. Upon discovery of the prior sale to Reiland, PTP sued Reiland and claimed to be “ready, willing and able to comply” with the terms to purchase said land, pursuant to the terms and provisions of the ROFR. PTP argued that, if it had been properly notified of the pending sale, it would have exercised its option. At trial, PTP was granted partial summary judgment. The court held the legal description in the ROFR to be adequate as a matter of law.

On appeal, Reiland asserted that the ROFR was void because (1) the description contained therein was legally inadequate, and (2) it contained an artificial price cap that operated as an unreasonable restraint on alienation. As a result of the court’s ruling on the first issue, the second issue herein was not addressed.

The primary question in this case was whether the description of the subject tract as set out in the ROFR met the requirements of the Statute of Frauds. The court repeated the well-settled rule that a “writing must furnish within itself or by reference to some other existing writing, the means by which the land to be conveyed may be identified with reasonable certainty.” Also, it has been held that if a description contains enough information to allow a person familiar with the area to locate the premises with reasonable certainty, it is sufficient to satisfy the Statute of Frauds; however, even if “the record leaves little doubt that the parties knew and understood what property was intended to be conveyed . . . the knowledge and intent of the parties will not give validity to the contract and neither will a plat made from extrinsic evidence.”

The trial court noted that PTP hired a surveyor, who indicated that he was able to locate the property because the ROFR referred to a deed that involved the same parties (i.e., Weis and Faulkner). The surveyor then reviewed the records of Harris County, Texas, and found that there was only one other tract of real property that had been owned by Weis and was later conveyed to Faulkner. Therefore, the surveyor determined that the deed he located had to be the 1.984-acre tract referenced in the

description set forth in the ROFR; thus, according to the ROFR, the subject tract was determined to be adjacent to the property that was conveyed in such deed. The surveyor then located another deed in which a third party conveyed the same property to Reiland and, in that deed, said tract was described by metes and bounds. Thus, the surveyor determined that the property described by metes and bounds was the same tract described in the ROFR.

Reiland argued that the ROFR was defective because (a) there was nothing in the description that would allow an individual to identify the 3.0152-acre tract with reasonable certainty and (b) the document wholly failed to define the size, shape, or boundaries of the land to which it related. The court agreed.

As noted, on behalf of PTP, a surveyor was able to locate the property on the ground and to make a plat of its location that was introduced into evidence. However, the court held that the rule for admissibility of extrinsic evidence to aid in descriptions is that a “resort to extrinsic evidence . . . is not for the purpose of supplying the location of description of the land, but only for the purpose of identifying it with reasonable certainty from the data in the memorandum.”

The court held that, within the ROFR, there was nothing to indicate the shape of the block or the courses and lengths of its border lines or those of the 3.0152 acres. Further, PTP provided a copy of a metes and bounds description of the property that was created when same was surveyed in 1999. However, the court held such evidence was inadmissible because there was no reference to such survey in the description.

The court held that the ROFR contained an inadequate land description and, thus, violated the Statute of Frauds. The judgment of the trial court was reversed and title awarded to Reiland.

III. RECENT DEVELOPMENTS IN UNITED STATES ENERGY LAW

A. CHOICE OF LAW ON THE OUTER CONTINENTAL SHELF AND TEXACO EXPLORATION & PRODUCTION, INC. V. AMCLYDE ENGINEERED PRODUCTS COMPANY

WALTER R. MAYER*

The choice of law for events, contracts, and commerce that relate to efforts to procure resources from the Outer Continental Shelf has been a decades-long struggle for lawyers and courts. In 1953, the Outer Continental Shelf Lands Act (OCSLA) attempted to clarify the issue by declaring that the fixed structures on the Outer Continental Shelf were to be considered federal enclaves that borrowed the nearest state's law on many substantive issues.⁴⁹ This statutory language and the case law that later developed work relatively well with regard to events and contracts that deal solely with fixed offshore platforms.⁵⁰ However, difficulty arises when the facts take a stroll even slightly off of a fixed platform and start to involve drilling vessels or vessels that construct or service fixed platforms. The interaction between OCSLA and events or contracts that would naturally be maritime in nature has proven to be a puzzle not easily resolved.

The issue is important because the choice of law can have a substantial effect on the outcome of a case and can determine the recovery rights of the plaintiff and the enforceability of risk-shifting clauses among the defendants.⁵¹ The importance of this area of law is highlighted by the level of deepwater commerce that is expected to occur in the near future. One forecast has estimated that global deepwater expenditures will exceed \$80 billion between 2007 and 2011.⁵²

* Walter R. Mayer is an associate at Vinson & Elkins, L.L.P., in Houston, Texas. Mr. Mayer's practice focuses on litigation related to energy and offshore construction. Mr. Mayer is a graduate of Boston College (B.S. 1998) and the University of Virginia School of Law (J.D. 2001).

49. 43 U.S.C. § 1333 (2006).

50. The Fifth Circuit has generally held that contracts for offshore drilling on the Outer Continental Shelf that deal with either a fixed platform or no vessel at all are not maritime contracts. *Laredo Offshore Constructors, Inc. v. Hunt Oil Co.*, 754 F.2d 1223, 1231 (5th Cir. 1985); *Hodgen v. Forest Oil Corp.*, 87 F.3d 1512, 1525 (5th Cir. 1996); *Wagner v. McDermott, Inc.*, 79 F.3d 20, 22 (5th Cir. 1996); *Fontenot v. Dual Drilling Co.*, 179 F.3d 969, 976-77 (5th Cir. 1999); *Snyder Oil Corp. v. Samedan Oil Corp.*, 208 F.3d 521, 523 (5th Cir. 2000).

51. One particular choice-of-law issue is the application or avoidance of the anti-indemnity statutes under Texas and Louisiana law. TEX. CIV. PRAC. & REM. CODE ANN. § 127.003 (2006); LA. REV. STAT. ANN. § 9:2780 (2007).

52. *Deepwater Market Healthy but Issues Just Around the Corner*, DEEPWATER INT'L,

A body of precedent has developed that supports the position that when OCSLA applies but maritime law would also naturally apply to the event or contract in the absence of the Act, then maritime law controls instead of the nearest state's law.⁵³ However, in *Texaco Exploration & Prod. v. AmClyde*, the Fifth Circuit announced an opinion that seems to be a break from that precedent.⁵⁴ This decision could have a significant effect on the scope of the application of maritime law on the Outer Continental Shelf. In short, the opinion seems to substantially shrink the scope of the application of maritime law to operations related to the procurement of resources from the Outer Continental Shelf.

This article first summarizes the law regarding the choice of law under OCSLA and then follows with a discussion of the facts and relevant decisions of the *AmClyde* opinion. Because the *AmClyde* opinion was not created in a vacuum, the article next discusses both the case law that *AmClyde* arguably breaks from and the cases that may have provided some notice that such an opinion would eventually be written. The article concludes with a discussion of the subsequent *Biagas* opinion out of the Eastern District of Louisiana, which limits the application of *AmClyde* to its facts.

1. Territorial Limits of State and Federal Submerged Lands Rights

The threshold issue for a choice-of-law analysis for offshore work is whether the event took place on (or the scope of the contract in question contemplates a location in) territorial state waters or on the Outer Continental Shelf. Choice of law within state waters will be controlled by the choice of law of the particular state or maritime law if it applies to the facts. The choice-of-law analysis for certain events or contracts related to the procurement of resources from the Outer Continental Shelf will be controlled by OCSLA.

In 1953, the Submerged Lands Act granted a quitclaim to the coastal states that included the submerged land and resources of up to three nautical miles or up to nine nautical miles in the Gulf of Mexico, if a state could demonstrate a larger claim prior to the date when the state joined the Union.⁵⁵ Several lawsuits were inevitably filed in which the coastal

October 16, 2006 (citing report from Infield Energy Data Analysts titled *Global Perspective Deep & Ultra-deepwater Market Update Report 2007-2011*). The article also quotes Dr. Roger Night from Infield Data Analysts as stating, "No player in the 21st Century offshore oil and gas industry that wants to be successful can ignore deepwater." *Id.*

53. See, e.g., *Laredo Offshore Constructors, Inc. v. Hunt Oil Co.*, 754 F.2d 1223 (5th Cir. 1985); *Rodrigue v. Aetna Cas. & Sur. Co.*, 395 U.S. 352 (1969); *Kimble v. Noble Drilling Corp.*, 416 F.2d 847, 850 (5th Cir. 1969).

54. 448 F.3d 760 (5th Cir. 2006), cert. denied, 127 S.Ct. 670 (2006).

55. 43 U.S.C. § 1312 (2006). The three nautical miles threshold is a measurement from antiquity based on the outer distance of a cannonball shot. M. Benjamin Cowan, *Venue for Offshore Environmental Crimes: The Seaward Limits of the Federal Judicial Districts*, 49 VAND.

states attempted to establish a right to more than three nautical miles.⁵⁶ After decades of controversy and court battles between the coastal states and the federal government, the Supreme Court of the United States accepted the claim of nine nautical miles by Texas and Florida and rejected the rest.⁵⁷ The federal claim includes the balance of the Continental Shelf (given the name the “Outer Continental Shelf”), which starts at the edge of the state waters and extends 200 to 350 miles from the shore.⁵⁸

2. Choice of Law and Choice-of-Law Clauses on the Outer Continental Shelf: OCSLA

The choice-of-law analysis for a dispute located on the Outer Continental Shelf starts with OCSLA. OCSLA was signed into law by President Eisenhower on August 7, 1953.⁵⁹ Only three months later, the first law review article written about the new Act was authored by future secretary of state Warren M. Christopher, then a fourth-year associate at O’Melveny & Myers in Los Angeles.⁶⁰ According to Christopher, the full scope and weight of OCSLA was not appreciated at the time.⁶¹ It had been passed “almost unnoticed” and overshadowed by the Submerged Lands Act and the fatal illness of Senator Robert A. Taft.⁶²

The OCSLA was a land and resource grab of about 261,000 square miles (an area larger than France) by the federal government.⁶³ The

L. REV. 825, 838-39 (1996) (tracing the three nautical mile rule to a 1793 letter from Thomas Jefferson and the 1702 writings of Cornelius van Bynkershoek referencing a rule originating in 1610).

56. *United States v. Louisiana*, 363 U.S. 1 (1960); *United States v. Florida*, 363 U.S. 121 (1960); *United States v. Maine*, 420 U.S. 515 (1975).

57. *United States v. Louisiana*, 363 U.S. 1 (1960); *United States v. Florida*, 363 U.S. 121 (1960); *United States v. Maine*, 420 U.S. 515 (1975). However, the Minerals Management Service does allow Louisiana’s claim of three “imperial nautical miles,” which are 6080.2 feet each. Mineral Management Service, Outer Continental Shelf – Definition, <http://www.mms.gov/aboutmms/ocsdef.htm> (last visited Apr. 15, 2007).

58. The Minerals Management Service defines the outer limit of the Outer Continental Shelf as follows: “The seaward limit is defined as the farthest of 200 nautical miles seaward of the baseline from which the breadth of the territorial sea is measured or, if the continental shelf can be shown to exceed 200 nautical miles, a distance not greater than a line 100 nautical miles from the 2,500-meter isobath or a line 350 nautical miles from the baseline. Outer Continental Shelf limits greater than 200 nautical miles but less than either the 2,500 meter isobath plus 100 nautical miles or 350 nautical miles are defined by a line 60 nautical miles seaward of the foot of the continental slope or by a line seaward of the foot of the continental slope connecting points where the sediment thickness divided by the distance to the foot of the slope equals 0.01, whichever is farthest.” Mineral Management Service, *supra* note 57.

59. Outer Continental Shelf Lands Act, Ch. 345, 67 Stat. 462 (1953) (codified as amended at 43 U.S.C. § 1333 (2006)).

60. Warren M. Christopher, *The Outer Continental Shelf Lands Act: Key to a New Frontier*, 6 STAN. L. REV. 23, 23 & n.2 (1953).

61. *Id.* at 23-24.

62. *Id.*

63. *Id.* at 23 (citing S. Rep. No. 411, 83d Cong., 1st Sess. 5 (1953)). The propriety and validity of OCSLA under International Law are beyond the scope of this paper.

stated purpose of OCSLA was “[t]o provide for the jurisdiction of the United States over the submerged lands of the outer Continental Shelf, and to authorize the Secretary of the Interior to lease such lands for certain purposes.”⁶⁴ Professor Harold F. Clark from Columbia University indicated the importance of OCSLA when he stated before the Senate Interior and Insular Affairs Committee in 1953 that the mineral resources and food potential of the area made this declaration of jurisdiction more important to the United States than the Louisiana Purchase.⁶⁵

a. Enforcement of a Choice-of-Law Clause Under OCSLA

OCSLA, if applicable, creates its own choice-of-law rules that trumps any contractual choice-of-law clause in a contract.⁶⁶ The Fifth Circuit has held that if OCSLA applies, then OCSLA’s choice-of-law rules will void the application of a contractual choice-of-law clause.⁶⁷

b. Choice of Law Under OCSLA

OCSLA provides the choice-of-law analysis for certain locations. If OCSLA applies, it establishes that the applicable situs is a federal enclave.⁶⁸ The general rule is that the statute will borrow and apply the law of the “adjacent state”⁶⁹ unless general maritime law naturally applies on its own.⁷⁰ The Fifth Circuit has held that for the adjacent state’s law to apply as “surrogate federal law,” a three-pronged test must be applied:

- (1) The controversy must arise on a situs covered by OCSLA;
- (2) Federal maritime law must not apply of its own force; and
- (3) The state law must not be inconsistent with Federal law.⁷¹

i. First Prong: OCSLA Situs?

64. Outer Continental Shelf Lands Act, Ch. 345, 67 Stat. 462 (1953) (codified as amended at 43 U.S.C. § 1333 (2006)).

65. Christopher, *supra* note 60, at 23 (citing Statement of Dr. Harold F. Clark, Professor in Charge of Educational Economics at Columbia University, Hearings before Senate Interior and Insular Affairs Committee on S.J. Res. 13 and Other Bills, 83d Cong., 1st Sess. 354 (1953)).

66. *Roberts v. Energy Dev. Corp.*, 104 F.3d 782, 786 (5th Cir. 1997) (OCSLA “essentially acts as a choice-of-law provision trump card”).

67. *Union Texas Petroleum v. PLT Eng’g, Inc.*, 895 F.2d 1043, 1050 (5th Cir. 1990) (“We find it beyond any doubt that OCSLA is itself a Congressionally mandated choice of law provision requiring that the substantive law of the adjacent state is to apply even in the presence of a choice of law provision in the contract to the contrary”).

68. 43 U.S.C. § 1333 (2006).

69. While this language has not been frequently tested in the courts, the area where a particular adjacent state’s law would apply is defined by OCSLA as “the area of the State if its boundaries were extended seaward to the outer margin of the outer Continental Shelf.” 43 U.S.C. § 1333(a)(2)(A). *See also* *Reeves v. B&S Welding*, 897 F.2d 178 (5th Cir. 1990); *Snyder Oil Corp. v. Samedan Oil Corp.*, 208 F.3d 521 (5th Cir. 2000).

70. *E.g.*, *PLT*, 875 F.2d 1047.

71. *Id.*; *Demette v. Falcon Drilling Co.*, 280 F.3d 492, 497 (5th Cir. 2002).

The Fifth Circuit has held that the following three sites satisfy OCSLA's situs requirement:

- (1) the subsoil and seabed of the OCS;
- (2) any artificial island, installation, or other device if (a) it is permanently or temporarily attached to the seabed of the OCS, and (b) it has been erected on the seabed of the OCS, and (c) its presence on the OCS is to explore for, develop, or produce resources from the OCS;
- (3) any artificial island, installation, or other device if (a) it is permanently or temporarily attached to the seabed of the OCS, and (b) it is not a ship or vessel, and (c) its presence on the OCS is to transport resources from the OCS.⁷²

ii. Second Prong: Does Maritime Law Apply of Its Own Force?

It is the continued role and viability of this second prong that is one of the subjects of the *AmClyde* opinion. Described herein is the law as it exists while the full effect of *AmClyde* is being determined.

The choice-of-law analysis implicated by contracts in the offshore setting typically require the parties to address the threshold issue of what law would "naturally" govern the contract, before addressing contractual or statutorily imposed choice-of-law provisions. So, the question under this second prong is whether federal maritime law applies of its own force. In other words, "in the context of oil and gas exploration on the Outer Continental Shelf, admiralty jurisdiction and maritime law will only apply if the case has a sufficient maritime nexus wholly apart from the situs of the relevant structure in navigable waters."⁷³ The Fifth Circuit has held that in the context of contract disputes, the application of maritime law is precluded by OCSLA "except in those cases where the subject matter of the controversy bears the type of significant relationship to traditional maritime activities necessary to invoke admiralty jurisdiction."⁷⁴

The application of maritime law has been described as a two-part test of "(1) location and (2) connection with maritime activity."⁷⁵ The connection test itself involves two questions, "(1) whether the type of incident involved has the potential to disrupt maritime commerce and (2)

72. *Diamond Offshore Co. v. A & B Builders, Inc.*, 302 F.3d 531, 541-42 (5th Cir. 2002) (interpreting 43 U.S.C. § 1333(a)(1)); *Demette*, 280 F.3d at 497.

73. *Laredo Offshore Constructors Inc. v. Hunt Oil Co.*, 754 F.2d 1223, 1230 (5th Cir. 1985).

74. *Laredo*, 754 F.2d at 1231 (citing *Rodrigue v. Aetna Cas. & Sur. Co.*, 395 U.S. 352 (1969) and *Kimble v. Noble Drilling Corp.*, 416 F.2d 847, 850 (5th Cir. 1969)). See also *PLT*, 895 F.2d at 1048.

75. *Texaco Exploration & Prod. v. AmClyde Eng'd Prods. Co.*, 448 F.3d 760, 770 (5th Cir. 2006).

whether the general character of the activity giving rise to the incident shows a substantial relationship to traditional maritime activity.”⁷⁶

The Fifth Circuit has described the specific issue of whether a contract is a maritime contract as another two-part inquiry. First, the court considers the contract’s “historical treatment in the jurisprudence,” and second, the specific facts of the case.⁷⁷ The fact-based inquiry is guided by six factors (called the Davis factors) with a personal injury tort slant:

- (1) What does the specific work order in effect at the time of the injury provide?
- (2) What work did the crew assigned under the work order actually do?
- (3) Was the crew assigned to do work aboard a vessel in navigable waters?
- (4) To what extent did the work being done relate to the mission of the vessel?
- (5) What was the principal work of the injured worker?
- (6) What work was the injured worker actually doing at the time of the injury?⁷⁸

iii. Third Prong: State Law Not Inconsistent with Federal Law?

This prong relates to the question of whether there are any applicable state laws that would conflict with federal laws. The analysis is on a case-by-case basis.⁷⁹

3. *AmClyde Factual and Procedural Background*

The *AmClyde* case is based on an accident during the construction of the Petronius offshore drilling platform in 1998.⁸⁰ The Petronius project was a \$400 million venture for deepwater drilling to develop oil and gas resources from the Viosca Knoll Block 786 of the Outer Continental Shelf.⁸¹ The platform was located in the Gulf of Mexico off the coast of Alabama and Louisiana.⁸² When completed, the Petronius platform was

76. *Id.* at 770-71 (citing *Jerome B. Grubert, Inc. v. Great Lakes Dredge & Dock Co.*, 513 U.S. 527, 534 (1995)).

77. *Demette*, 280 F.3d at 500 (citing *Davis & Sons, Inc. v. Gulf Oil Corp.*, 919 F.2d 313, 315 (5th Cir. 1990)).

78. *Id.* at 501.

79. The Fifth Circuit has stated that Texas Oilfield Anti-Indemnity Act and the similar Louisiana Oilfield Indemnity Act are not inconsistent with federal law. *Hodgen v. Forest Oil Corp.*, 87 F.3d 1512, 1528 (5th Cir. 1996) (LOIA); *Campbell v. Sonat Offshore Drilling, Inc.*, 979 F.2d 1115, 1126 (5th Cir. 1992) (Texas law).

80. *AmClyde*, 448 F.3d at 765.

81. *Id.*

82. *Id.*

to be capable of producing 60,000 barrels of oil and 100 million cubic feet of natural gas per day.⁸³

During the construction, a derrick barge called the DB-50 was using its crane to transfer a part of one of the decks, called the South Deck Module, from a materials barge to its own deck for transportation and installation as part of the platform.⁸⁴ The materials barge was about 1,500 feet from the platform.⁸⁵ During the transfer, either the crane or a load line failed.⁸⁶ The failure caused the entire South Deck Module to fall to the ocean floor and delayed the project for fifteen months.⁸⁷

Texaco Exploration & Production Company, Inc. and Marathon Oil Company (collectively "Texaco"), as the leaseholders to the Viosca Knoll Block 786, sued AmClyde Engineered Products Company, Inc., as the successor in interest to the manufacturer of the crane.⁸⁸

Texaco's construction contract for the Petronius platform was with J. Ray McDermott, Inc.⁸⁹ In order to complete the construction, McDermott chartered and operated the DB-50 from the owner, J. Ray McDermott International Vessels, Ltd. (JRMIV).⁹⁰ Texaco did not engage in litigation with McDermott because the construction contract had an arbitration clause.⁹¹

Building Risk Underwriters paid Texaco more than \$72 million under a builder's risk policy and brought a subrogation suit against AmClyde, JRMIV, and the DB-50, in rem, for losses other than those associated with delayed production.⁹² Underwriters did not sue McDermott because they were named as an additional insured.⁹³

The trial court in the Eastern District of Louisiana found that OCSLA did not apply.⁹⁴ However, the court did find that maritime law applied to this dispute regarding the transfer of cargo between two vessels and granted a motion to strike Texaco's jury demand because maritime law extinguished the right.⁹⁵ The trial court granted summary judgment to AmClyde on the subrogation claim, as it found that AmClyde was an additional insured.⁹⁶

83. *Id.*

84. *Id.*; Petition for a Writ of Certiorari at 2, *AmClyde*, 127 S.Ct. at 670 (U.S. Sept. 19, 2006) (No. 06-409).

85. *AmClyde*, 448 F.3d at 766.

86. *Id.* at 765.

87. *Id.*

88. *Id.*

89. *Id.*

90. *Id.* at 765-66.

91. *Id.*

92. *Id.*

93. *Id.* at 766-67.

94. *Id.* at 767.

95. *Id.*

96. *Id.*

A bench trial on Texaco's products liability claim took place over seven weeks and twenty-four trial days.⁹⁷ The trial court found that Texaco had failed to sustain its burden of proof with respect to the liability of all defendants, except that JRMIV was liable to Texaco and Underwriters for the unseaworthiness of the DB-50, and, in the alternative, McDermott's negligence with regard to the care and inspection of the wire was a superseding cause.⁹⁸ The court later vacated its liability findings and entered summary judgment for JRMIV on a finding that JRMIV was an additional insured or, in the alternative, McDermott was a bareboat charter, precluding liability to JRMIV for unseaworthiness.⁹⁹

4. *The Appeal to the Fifth Circuit*

Both Texaco and Underwriters appealed.¹⁰⁰ The assigned panel was Chief Judge Jones, Judge Jolly, and Judge DeMoss.¹⁰¹ The opinion was drafted by Judge DeMoss.¹⁰² Although the incident occurred more than 1,500 feet from the Petronius Platform, the Fifth Circuit held that OCSLA applied.¹⁰³ The court was influenced by OCSLA's specific reference to "platform construction" in its definition of "development."¹⁰⁴

Although no party disputed the natural application of maritime law to the facts, the Fifth Circuit *sua sponte* found that "Texaco's complaint . . . arises not from traditionally maritime activities but from the development of the resources of the Outer Continental Shelf."¹⁰⁵ The Fifth Circuit thus held that maritime law does not apply, even though the damage in question dealt with the transfer of cargo between two vessels, because the event was in furtherance of efforts to develop resources on the Outer Continental Shelf. The Fifth Circuit seemingly has concluded that the development of resources on the Outer Continental Shelf prevents any finding that there may be a connection to traditional maritime activity. Based on a finding that maritime law did not apply, the Fifth Circuit remanded the case back to the trial court to allow the court to consider the effect of a proper jury demand.¹⁰⁶

The full effect of this opinion is still developing. *AmClyde* could eventually be read to substantially minimize the application of the second

97. *Id.*; Petition for a Writ of Certiorari, *supra* note 84, at 2.

98. *AmClyde*, 448 F.3d at 767.

99. *Id.*

100. *Id.* at 768.

101. *Id.* at 764.

102. *Id.*

103. *Id.* at 768; Petition for a Writ of Certiorari, *supra* note 84, at 2.

104. *AmClyde*, 448 F.3d at 768 (citing 43 U.S.C. § 1331(l)).

105. Petition for a Writ of Certiorari, *supra* note 84, at 2-3.

106. *AmClyde*, 448 F.3d at 775.

prong of OCSLA choice-of-law analysis. If activities that seem rather “salty” are no longer to be considered maritime if they happen to occur in the furtherance of the procurement of resources from the Outer Continental Shelf, then the likelihood of maritime law applying on its own to an OCSLA situs is greatly diminished.¹⁰⁷

5. *AmClyde and the Benefit of Hindsight*

A review of the case law related to the difficult area of work on the Outer Continental Shelf that involves drilling vessels or vessels constructing or providing services to vessels leading up to the *AmClyde* opinion reveals that (1) the effect of the opinion on certain precedent still needs resolution and (2) there were some clues that such a decision would be coming.

a. Precedent

Although the Fifth Circuit stated that there is nothing maritime about the development of the resources of the Outer Continental Shelf, some earlier Fifth Circuit opinions have applied maritime law to such development. In *Demette v. Falcon Drilling Co.*, the Fifth Circuit dealt with a choice-of-law dispute regarding an indemnity clause in a “Services and Drilling Master Contract” after an injury to a worker on a jack-up rig on the Outer Continental Shelf.¹⁰⁸ The injured worker was an employee of a contractor that signed the Master Contract to provide casing services to the rig.¹⁰⁹ The injured worker sued a contractor other than his employer, and the other contractor sued the injured worker’s employer seeking indemnity under the Master Contract.¹¹⁰ The enforceability of the indemnity turned on whether the Master Contract was controlled by Louisiana law or maritime law by operation of OCSLA.¹¹¹ The Fifth Circuit held that the jack-up rig was a vessel even when jacked up out of the water.¹¹² The Fifth Circuit further held that maritime law and not Louisiana law applied to the contract to provide casing services by operation of OCSLA.¹¹³

107. The opinion raises the further question as to whether the same development activities and contracts are to be considered maritime if they are in state waters but are to be considered to be controlled by state law if they are in the waters over the federal Outer Continental Shelf. In this situation, the federal enclave would be more likely to apply state law than the state itself.

108. 280 F.3d 492, 494-95 (5th Cir. 2002).

109. *Id.* “Casing” was defined by the Fifth Circuit as “an activity performed during the drilling for oil, whether onshore or offshore; it involves the welding together and hammering of pipe into the subsurface of the earth to create a permanent construction.” *Id.* (quoting *Campbell v. Sonat Offshore Drilling, Inc.*, 979 F.2d 1118, n. 2 (5th Cir. 1992)).

110. *Id.*

111. *Id.* at 494.

112. *Id.* at 498, n. 18.

113. *Id.* at 500-01.

Other Fifth Circuit cases have also held, in seeming conflict with *AmClyde*, that contracts and activities in furtherance of the development of resources on the Outer Continental Shelf are to be controlled by maritime law and not state law under OCSLA. *Campbell v. Sonat Offshore Drilling, Inc.*, dealt with an employee who was allegedly injured while transferring from a transport vessel to the drilling vessel.¹¹⁴ The Fifth Circuit held that maritime law controlled the enforcement of the indemnity clause in the contract, which was to provide casing services to an offshore drilling operation on a drilling vessel on the Outer Continental Shelf.¹¹⁵ In *Dupont v. Sandefer Oil & Gas, Inc.*, the Fifth Circuit dealt with an indemnity dispute related to the injury of an employee on a jack-up drilling rig who was engaged in work related to completing a well on the Outer Continental Shelf. The court held that a contract for the drilling services on the Outer Continental Shelf that required the provision and equipment of a vessel was controlled by maritime law.¹¹⁶ In *Smith v. Penrod Drilling Corp.*, the Fifth Circuit dealt with a case based on the injury of a worker while he was standing on fencing on a fixed platform on the Outer Continental Shelf and reaching for a safety valve assembly on a neighboring jack-up barge.¹¹⁷ The Fifth Circuit found that the indemnity language in the drilling contract was controlled by maritime law because the contract contemplated the use of a vessel in its workover services.¹¹⁸

The holding in *AmClyde* is also difficult to reconcile with the Supreme Court's opinion in *Grubart, Inc. v. Great Lakes Dredge and Dock Co.*, where maritime law was found to apply to a case related to a marine contractor engaged in construction work on the Chicago River from a barge.¹¹⁹

b. Sources and Indicators of the *AmClyde* Opinion

The *Demette* case described above is interesting because the author of the *AmClyde* opinion, Judge DeMoss, drafted a well-crafted dissent to the majority opinion that provides some additional insight.¹²⁰ The dissent provides some indication that Judge DeMoss wanted to limit or prevent the application of maritime law to operations on the Outer Continental Shelf.¹²¹ A substantial portion of the dissent by Judge DeMoss argues that

114. 979 F.2d 1115, 1117-18 (5th Cir. 1992), *superseded by statute on other grounds*, Texas Oilfield Anti-Indemnity Act, 1989 Tex. Sess. Law Serv. 1102 (West), *as recognized in* Greene's Pressure Testing & Rentals, Inc. v. Flournoy Drilling Co., 113 F.3d 47 (5th Cir. 1997).

115. *Id.* at 1118.

116. 963 F.2d 60, 61-62 (5th Cir. 1992).

117. 960 F.2d 456, 458 (5th Cir. 1992).

118. *Id.* at 459-61.

119. 513 U.S. 527 (1995).

120. *Demette*, 280 F.3d at 504 (DeMoss, J., dissenting).

121. *Id.*

maritime law should not apply to jack-up rigs used to develop resources from the Outer Continental Shelf.¹²² Judge DeMoss referred to *Rodrigue v. Aetna Casualty & Surety Co.* and the statutory history of OCSLA to support three principles: (1) “Structures placed on Outer Continental Shelf for the purpose of exploring for, developing, removing, and transmitting resources therefrom are not vessels”; (2) “Congress decided that maritime law does not apply to these structures”; and (3) “The laws of the State of Louisiana will apply to activities on these structures to the extent that such state laws are not inconsistent with other federal laws.”¹²³ The dissent includes language that resembles the *AmClyde* opinion: “The special purpose of a jack-up rig, which is drilling for oil and gas, has nothing to do with traditional maritime activities or interests.”¹²⁴ The *AmClyde* opinion may be considered a second bite at the apple in an attempt to limit the application of maritime law to the Outer Continental Shelf.

The dissent also provides evidence that a motivating factor for the *AmClyde* opinion may have been an effort to marginalize the need to deal with the confusing case law regarding the line between those situations on the Outer Continental Shelf that are maritime and those that are not. Judge DeMoss concludes that “from and after the 1978 Amendments to OCSLA all of our Circuit case law purporting to draw tortuous and complicated distinctions as to what is and what is not a vessel are just so much sound and fury signifying nothing”¹²⁵ DeMoss ends his dissent with a plea for en banc consideration: “An en banc reconsideration of the enigmas raised here in this case . . . would be a first step in bringing greater uniformity and predictability to the law applicable to the development of these increasingly critical natural resources.”¹²⁶ Less than a year before the *AmClyde* opinion, Chief Judge Jones, who joined the *AmClyde* opinion, also expressed frustration with the current state of the law on the line between maritime and non-maritime disputes:

This appeal requires us to sort once more through the authorities distinguishing maritime and non-maritime contracts in the offshore exploration and production industry. As is typical, the final result turns on a minute parsing of facts. Whether this is the soundest jurisprudential approach may be doubted, inasmuch as it creates uncertainty, spawns litigation, and hinders rational calculation of costs and risks by companies participating in the industry.

122. *Id.* at 504-18.

123. *Id.* at 504-06 (citing *Rodrigue v. Aetna Cas. & Sur. Co.*, 395 U.S. 352 (1969), and the Outer Continental Shelf Lands Act, 43 U.S.C. § 1333(a)(1)).

124. *Id.* at 509.

125. *Id.* at 516.

126. *Id.* at 518-19.

Nevertheless, we are bound by the approach this court has followed for more than two decades.¹²⁷

Dissatisfaction with the current state of the law on this issue by the Fifth Circuit is not new. The Fifth Circuit has previously stated, “Whether a contract is or is not maritime in nature is a quotidian issue whose resolution is governed by no broad rubric discernible from the numerous decided cases.”¹²⁸ These quotes indicate that one intent behind the *AmClyde* decision may have been a desire to simplify the choice-of-law analysis by marginalizing the application of maritime law.

6. Reaction to *AmClyde*: Biagas

The reaction from the court that has addressed the issue most directly has been to limit *AmClyde* to its facts. A district court in the Eastern District of Louisiana dealt with a suit related to the injury of a roustabout on a supply vessel in *Biagas v. Hornbeck Offshore Servs., L.L.C.*¹²⁹ The supply vessel was to help move a separator unit from one part of the same Petronius platform on the Outer Continental Shelf as in *AmClyde* to another location on the platform.¹³⁰ After the separator unit was back-loaded onto the supply vessel, the vessel moved away from the platform.¹³¹ The court accepted as true the plaintiff’s allegation that the vessel had moved away to allow a helicopter landing, was not moored, and was essentially “standing-by.”¹³² The separator unit then allegedly slid and pinned the plaintiff roustabout.¹³³ The court distinguished *AmClyde* and held that maritime law controlled because “the offloading of the [separator] unit from the fixed platform had ended and the equipment had been placed on the deck of a vessel. After the unit had been placed on the deck of the vessel, the vessel maneuvered some distance away from the platform.”¹³⁴ The court stated that the vessel was engaged in the traditional maritime activity of “the stowage of cargo being transported aboard a vessel.”¹³⁵

Thus, even though the vessel was standing by ready to continue its work on the same platform as in *AmClyde*, the court held that the work was maritime because it had, at the time of the incident, moved away from the platform and was waiting. As the vessels and cargo at issue in *AmClyde* were 1,500 feet away from the Petronius platform, the only

127. *Hoda v. Rowan Co.*, 419 F.3d 379, 380 (5th Cir. 2005).

128. *Davis & Sons, Inc. v. Gulf Oil Corp.*, 919 F.2d 313, 313 (5th Cir. 1991).

129. No. 04-1164, 2006 WL 2228952, at *1-3 (E.D. La. Aug. 3, 2006).

130. *Id.*

131. *Id.* at *1.

132. *Id.* at *1 n.1.

133. *Id.* at *1.

134. *Id.* at *3.

135. *Id.*

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distinction is that the cargo in *AmClyde* was being lifted between the decks of two vessels at the time of the incident, while the cargo in *Biagas* was standing-by. A clear rule in this area may be better than a rule that lacks predictability, even if not everyone likes the rule. However, the *Biagas* decision and the precedent discussed herein demonstrate that momentum and expectations can create a reaction that causes confusion and different, but not more consistent, lines being drawn by the developing case law.

B. REVERSAL OF FERC'S STANDARDS OF CONDUCT FOR TRANSMISSION PROVIDERS AS THEY APPLY TO NATURAL GAS PIPELINE COMPANIES

DANIEL W. SANBORN*

The Federal Energy Regulatory Commission (FERC) has long regulated the relationship between transmission providers¹³⁶ and their marketing affiliates.¹³⁷ Starting in November 2003, FERC promulgated new standards of conduct for transmission providers to (1) create unified and consistent standards of conduct for interstate natural gas pipelines and electric utility providers and (2) greatly expand the scope of the

* Daniel Sanborn is an associate at Vinson & Elkins L.L.P. in Houston. His practice focuses on FERC energy regulation and transactional matters related to oil, natural gas, and LNG assets. He has counseled and continues to counsel a number of clients on compliance with FERC's standards of conduct for transmission providers. Mr. Sanborn received his J.D. from the University of Texas and was admitted to the Texas Bar in 2001. This article is provided for general information purposes only, does not constitute legal advice, and expresses only the views of the author, and not those of any other person or entity.

136. FERC's regulations define a "transmission provider" as (1) a public utility that owns, operates, or controls facilities used for the transmission of electricity in interstate commerce or (2) an interstate natural gas pipeline that transports natural gas for others pursuant to a Section 7 certificate of public convenience and necessity under the Natural Gas Act, 15 U.S.C. § 717(f)(c) (2000), Section 311 authorization under the Natural Gas Policy Act of 1978, 15 U.S.C. § 3372(a) (2000), or a Section 284.221 blanket certificate under 18 C.F.R. § 284.221. 18 C.F.R. § 358.3(a) (2007). A transmission provider does not include a natural gas storage provider that is authorized to charge market-based rates and is not interconnected with the jurisdictional facilities of any affiliated interstate natural gas pipeline, has no exclusive franchise area, no captive rate payers, and no market power. *Id.* § 358.3(a)(3).

137. FERC promulgated its initial rules regulating the relationship between natural gas pipelines and their marketing affiliates on June 1, 1988. *Inquiry Into Alleged Anticompetitive Practices Related to Marketing Affiliates of Interstate Pipelines*, Order No. 497, [Regs. Preambles 1986-90] F.E.R.C. Stats. & Regs. ¶ 30,820 (1988), *order on reh'g*, Order No. 497-A, [Regs. Preambles 1986-90] F.E.R.C. Stats. & Regs. ¶ 30,868 (1989), *order extending sunset date*, Order No. 497-B, [Regs. Preambles 1986-90] F.E.R.C. Stats. & Regs. ¶ 30,908 (1990), *order extending sunset date*, Order No. 497-C, [Regs. Preambles 1991-96] F.E.R.C. Stats. & Regs. ¶ 30,934 (1991), *reh'g denied*, 58 F.E.R.C. ¶ 61,139 (1992), *aff'd in part and remanded in part sub nom.*, *Tenneco Gas v. FERC*, 969 F.2d 1187 (D.C. Cir. 1992), *order on remand and extending sunset date*, Order No. 497-D, [Regs. Preambles 1991-96] F.E.R.C. Stats. & Regs. ¶ 30,958 (1992), *order on reh'g and extending sunset date*, Order No. 497-E, [Regs. Preambles 1991-96] F.E.R.C. Stats. & Regs. ¶ 30,987 (1993), *order denying reh'g and granting clarification*, Order No. 497-F, 66 F.E.R.C. ¶ 61,347 (1994), *order extending sunset date*, Order No. 497-G, [Regs. Preambles 1991-96] F.E.R.C. Stats. & Regs. ¶ 30,996 (1994) [hereinafter Order No. 497]. FERC promulgated its initial rules regulating the relationship between interstate electric utilities and their marketing affiliates on April 24, 1996. *Open Access Same-Time Information System (Formerly Real-Time Information Network) and Standards of Conduct*, Order No. 889, [Regs. Preambles 1991-96] F.E.R.C. Stats. & Regs. ¶ 31,035 (1996), *order on reh'g*, Order No. 889-A, [Regs. Preambles 1996-00] F.E.R.C. Stats. & Regs. ¶ 31,049 (1997), *reh'g denied*, 81 F.E.R.C. ¶ 61,253 (1997) [hereinafter Order No. 889]. Order No. 497 and Order No. 889 are referred to collectively herein as the "Marketing Affiliate Rules." The term "marketing affiliate," though its definition has undergone some recent changes, as will be discussed in this article, refers generally to an affiliated entity that sells natural gas, other than from its own supply, or electricity in U.S. energy markets. An "affiliate" is another person or functional unit that controls, is controlled by, or is under common control with such person. 18 C.F.R. § 358.3(b) (2007). A voting interest of 10 percent or more creates a rebuttable presumption of control. 18 C.F.R. § 358.3(c) (2007).

affiliate relationships regulated to include interactions between a transmission provider and certain of its non-marketing affiliates, known as energy affiliates.¹³⁸ Representatives of the natural gas pipeline industry, but none from the electric utility industry, challenged FERC's authority to extend its regulation of affiliate relationships beyond marketing affiliates.¹³⁹ In response to those appeals, the D.C. Circuit recently overturned FERC's standards of conduct for transmission providers as they apply to natural gas pipeline companies.¹⁴⁰ FERC has subsequently issued interim standards of conduct¹⁴¹ and initiated a rulemaking process¹⁴² to establish permanent affiliate rules for interstate natural gas pipelines and to consider changes to the affiliate rules applicable to electric utilities.¹⁴³ From a regulatory compliance perspective, there are important differences for interstate natural gas pipeline companies and their affiliates between the requirements of the Energy Affiliate Rules and FERC's Interim Rules.

1. *The Energy Affiliate Rules*

Prior to FERC's adoption of the Energy Affiliate Rules, FERC regulated the interactions between a transmission provider and those marketing affiliates that conducted business with the transmission provider. Under FERC's Marketing Affiliate Rules applicable to interstate natural gas pipeline companies, such companies were required to (1) equally apply the provisions of their FERC gas tariffs, including discounts granted, to all shippers; (2) refrain from disclosing to a marketing affiliate information received from non-affiliated shippers; (3) contemporaneously disclose to all existing and potential shippers any gas transportation, sales, or marketing information provided to a marketing affiliate; (4) separate, to the maximum extent possible,¹⁴⁴ the pipeline's

138. *Standards of Conduct for Transmission Providers*, Order No. 2004, [Regs. Preambles 2001-05] F.E.R.C. Stats. & Regs. ¶ 31,155 (2003), *order on reh'g*, Order No. 2004-A, [Regs. Preambles 2001-05] F.E.R.C. Stats. & Regs. ¶ 31,161 (2004), *order on reh'g*, Order No. 2004-B, [Regs. Preambles 2001-05] F.E.R.C. Stats. & Regs. ¶ 31,166 (2004), *order on reh'g*, Order No. 2004-C, 109 F.E.R.C. ¶ 61,325 (2004), *order on reh'g*, Order No. 2004-D, 110 F.E.R.C. ¶ 61,320 (2005) [hereinafter Energy Affiliate Rules].

139. *National Fuel Gas Supply Corp. v. FERC*, 468 F.3d 831 (D.C. Cir. 2006).

140. *See id.* at 845.

141. *Standards of Conduct for Transmission Providers*, Order No. 690, 118 F.E.R.C. ¶ 61,012 at P 15, *order on clarification and reh'g*, Order No. 690-A, 118 F.E.R.C. ¶ 61,229 (2007) Order Nos. 690 and 690-A are referred to collectively herein as the "Interim Rules."

142. *See Notice of Proposed Rulemaking*, 118 F.E.R.C. ¶ 61,031 (2007) [hereinafter *NOPR*].

143. Though the Energy Affiliate Rules applied to both electric utility and natural gas pipeline transmission providers, because no electric utilities petitioned for review of the Energy Affiliate Rules, those rules continue to apply in their entirety to electric utility transmission providers. *See National Fuel Gas Supply Corp. v. FERC*, 468 F.3d at 845. This article will therefore focus on the application of FERC's affiliate regulations to natural gas pipeline companies and the changes that have occurred with respect to those entities under FERC's Interim Rules.

144. This independent functioning requirement was implemented not as a mandate that the

operating employees from the operating employees of the marketing affiliate; (5) file and update with FERC a list of operating employees and facilities shared with a marketing affiliate; and (6) maintain a log of all requests for transportation service made by affiliated marketers or in which an affiliated marketer was involved.¹⁴⁵ These requirements only applied to marketing affiliates with which an interstate natural gas pipeline conducted transportation transactions.¹⁴⁶ The Marketing Affiliate Rules did not apply to affiliated producers, gatherers or processors selling gas solely from their own production, gathering, or processing facilities; affiliated local distribution companies (LDCs) and intrastate pipelines making only on-system sales; and interstate pipelines making sales pursuant to a Section 284.224 blanket certificate under 18 C.F.R. § 284.224 (2007).¹⁴⁷

Starting in November 2003, however, FERC significantly revised and expanded its standards of conduct for transmission providers to apply to all affiliates of a transmission provider, including affiliated producers, gatherers, processors, LDCs, and intrastate pipelines, that (1) engage in or are involved in transmission transactions in U.S. markets, (2) manage or control transmission capacity of a transmission provider in U.S. markets, (3) buy, sell, trade, or administer natural gas or electric energy in U.S. markets, or (4) engage in financial transactions related to the sale or transmission of natural gas or electric energy in U.S. markets.¹⁴⁸ The Energy Affiliate Rules applied to all such affiliated entities (including marketing affiliates), even if such affiliates did not conduct transportation transactions with the affiliated interstate natural gas pipeline.

Under FERC's Energy Affiliate Rules, natural gas pipeline transmission providers were required to (1) separate their transmission

marketing function of a natural gas pipeline company be forced to move to a company and location entirely separate from the transmission function, but that access to the space and information of the transmission function be controlled such that the marketing function would not have access to the space and information of the transmission function. *See* Order No. 497, *supra* note 137, at 31,142.

145. *Id.* at 31,133-147.

146. Order No. 497-A, *supra* note 137, at 31,591.

147. *Id.* at 31,591-92.

148. 18 C.F.R. § 358.3(d) (2006). The rules excluded from the definition of an energy affiliate (1) a foreign affiliate that does not participate in U.S. energy markets; (2) an affiliated transmission provider; (3) a holding, parent, or service company that does not engage in energy or natural gas commodity transactions or is not involved in transmission transactions, unless it is a transmission provider, in U.S. energy markets; (4) an affiliate that purchases natural gas or energy solely for its own consumption; (5) a state-regulated LDC that acquires interstate transmission capacity to purchase and resell gas only for on-system sales and does not engage in any of the other energy affiliate activities, except to the limited extent necessary to support on-system sales and to engage in de minimus sales necessary to remain in balance under applicable pipeline tariff requirements; and (6) a gatherer, processor, Hinshaw pipeline or an intrastate pipeline that does not engage in any of the energy affiliate activities, other than making incidental purchases or sales of de minimus volumes of natural gas to remain in balance under applicable pipeline tariff requirements. *Id.*

function employees and transmission system information from the operating employees of their marketing and energy affiliates;¹⁴⁹ (2) prohibit the disclosure of their transmission system information and information about their non-affiliate shippers (including the “no-conduit” rule) to a marketing or energy affiliate;¹⁵⁰ (3) post on their website the names of their energy and marketing affiliates, shared facilities, comprehensive organizational charts, notice of employee transfers to an affiliate, and written procedures for compliance with the rules;¹⁵¹ (4) train certain employees, including those employees shared with a marketing or energy affiliate, on compliance with the rules;¹⁵² (5) designate a Chief Compliance Officer;¹⁵³ (6) strictly enforce the tariff provisions that do not provide for discretion and equally apply all tariff provisions that do allow for discretion;¹⁵⁴ (7) maintain a written log of all exercises of discretion under their tariffs;¹⁵⁵ and (8) post all offers of a discount once they became contractually binding.¹⁵⁶

2. *National Fuel Gas Supply Corp. v. FERC*

Several entities, including National Fuel Gas Supply Corporation and the Interstate Natural Gas Association of America (INGAA), petitioned the D.C. Circuit for review of the Energy Affiliate Rules promulgated by FERC.¹⁵⁷ Those entities challenged several key aspects of the rules:

(1) the extension of FERC’s affiliate regulations to non-marketing affiliates;

(2) the extension of FERC’s affiliate regulations to entities that do not hold or control capacity on their affiliated gas pipelines;

(3) the favorable exemption from the application of the Energy Affiliate Rules of LDCs that make only on-system sales as compared to producers, gatherers, and processors that likewise make only on-system sales;

(4) the prohibitions against a transmission provider sharing certain risk-management employees and lawyers with its marketing and energy affiliates; and

149. 18 C.F.R. § 358.4(a) (2006). In particular, while a natural gas pipeline company was permitted to share support employees and officers and directors with a marketing or energy affiliate under certain circumstances, *see* Order 2004-A, *supra* note 138, at PP 145-46; Order 2004-B, *supra* note 138, at P 57, the pipeline could not share risk-management employees assessing the creditworthiness of individual shippers or lawyers who participated in transmission policy or tariff implementation decisions, *see* Order 2004-B, *supra* note 138, at PP 68, 74-75.

150. 18 C.F.R. § 358.5(a)-(b) (2006).

151. *Id.* § 358.4(b)-(c) (2006).

152. *Id.* § 358.4(e) (2006).

153. *Id.*

154. *Id.* § 358.5(c) (2006).

155. *Id.*

156. *Id.* § 358.5(d) (2006).

157. *National Fuel Gas Supply Corp. v. FERC*, 468 F.3d 831 (D.C. Cir. 2006).

(5) the requirement that transmission providers maintain a log of all exercises of discretion under their FERC tariff.¹⁵⁸

In *National Fuel Gas Supply Corp. v. FERC*, the court held that “FERC cannot impede vertical integration between a pipeline and its affiliates without adequate justification.”¹⁵⁹ In *Tenneco Gas v. FERC*, the Court had previously upheld FERC’s adoption of its Marketing Affiliate Rules as they applied to natural gas pipelines because the court concluded that FERC had presented “both (i) a plausible theoretical threat of anti-competitive information-sharing between pipelines and their marketing affiliates and (ii) vast record evidence of abuse.”¹⁶⁰ Applying that same standard to its review of FERC’s adoption of the Energy Affiliate Rules, the Court found that FERC “has provided no evidence of a real problem with respect to pipelines’ relationships with non-marketing affiliates,” and that the record did not contain any “complaints from competitors of pipelines’ non-marketing affiliates.”¹⁶¹ As a result, the Court vacated the Energy Affiliate Rules as they applied to natural gas pipelines and remanded to FERC the issue of what, if any, standards of conduct should apply to interstate natural gas pipelines.¹⁶²

3. FERC’s Interim Standards of Conduct for Interstate Natural Gas Pipelines

In promulgating the Energy Affiliate Rules, FERC repealed the Marketing Affiliate Rules applicable to natural gas pipelines.¹⁶³ Once the Energy Affiliate Rules were vacated in *National Fuel Gas Supply Corp. v. FERC* with respect to natural gas pipelines, there were no longer any affiliate standards of conduct applicable to natural gas pipelines. On remand, FERC chose to address the absence of such rules by issuing, without notice or comment, interim rules governing the relationship between a natural gas pipeline and its marketing affiliates.¹⁶⁴ These Interim Rules modify FERC’s current standards of conduct for transmission providers as they apply to interstate natural gas pipelines, and are to remain in effect until a final rule is adopted in response to the notice of a proposed rulemaking¹⁶⁵ issued on January 18, 2007, in FERC Docket No. RM07-1-000.¹⁶⁶

158. See *National Fuel Gas Supply Corp.*, 468 F.3d at 839.

159. *Id.* at 840 (citing its prior decision in *Tenneco Gas v. FERC*, 969 F.2d 1187, 1199 (D.C. Cir. 1992)).

160. *Id.* at 840.

161. *Id.* at 841.

162. *Id.* at 845.

163. See Order 2004, *supra* note 138, at P 175.

164. Order No. 690, *supra* note 141; Order No. 690-A, *supra* note 141.

165. See *NOPR*, *supra* note 142.

166. Order No. 690, *supra* note 141, at P 9.

The Interim Rules differ significantly from the Energy Affiliate Rules. First, under the Interim Rules an interstate pipeline's interactions with its affiliated producers, gathers, processors, LDCs, or intrastate pipelines (who do not also qualify as marketing affiliates) are not regulated.¹⁶⁷ Instead, only the relationship between a natural gas pipeline and a marketing affiliate that conducts transportation transactions on such affiliated pipeline is regulated under the standards of conduct resulting from the Interim Rules.¹⁶⁸

Second, the Interim Rules narrow the definition of marketing or brokering natural gas to include only a sale of natural gas by a seller that is (1) not an interstate pipeline, (2) not selling gas solely from its own production, gathering or processing facilities, or (3) not an intrastate natural gas pipeline or LDC making solely on-system sales.¹⁶⁹ Consequently, in terms of natural gas, the current standards of conduct for transmission providers apply only to the relationship between a natural gas pipeline and an affiliate, other than an interstate gas pipeline, that sells natural gas acquired from another party in a U.S. market.

Third, the Interim Rules render inapplicable to natural gas pipelines the prohibition against sharing with a marketing affiliate risk-management employees that engage in transmission functions, sales, or commodity functions.¹⁷⁰ In doing so, however, the Interim Rules also remove the affirmative statement in the standards of conduct that risk-management employees can be shared.¹⁷¹ FERC declined to provide further guidance on this issue in Order 690-A.¹⁷² Under FERC's prior Marketing Affiliate Rules for natural gas pipelines, the pipeline was permitted to share a risk-management employee with a marketing affiliate unless that employee assessed the creditworthiness of transmission customers.¹⁷³ In the absence of further clarification from FERC, that would appear to be the governing standard for determining whether a particular risk-management employee can be shared between a natural gas pipeline and a marketing affiliate.

Fourth, under the Interim Rules natural gas pipelines no longer have to maintain and post a written log of all acts of discretion exercised (whether granting or denying a request) under their FERC gas tariff. Instead, the Interim Rules require only that the pipeline maintain a

167. *Id.* at P 17.

168. Order No. 690-A, *supra* note 141 at P 2.

169. Order No. 690, *supra* note 141 at P 18.

170. *Id.* at P 20.

171. See 18 C.F.R. § 358.4(a)(6) (2007) ("Transmission Providers are permitted to share risk-management employees that are not engaged in Transmission Functions or sales or commodity Functions with their Marketing and Energy Affiliates. This provision does not apply to natural gas transmission providers.").

172. See Order No. 690-A, *supra* note 141 at P 15.

173. *Vector Pipeline, L.P.*, 97 F.E.R.C. ¶ 61,085 (2001).

written log of granted waivers of tariff provisions and provide that log to any person within 24 hours of a request.¹⁷⁴

Finally, the Interim Rules change the point at which new natural gas pipelines become subject to the standards of conduct. Under the Energy Affiliate Rules, natural gas pipelines became subject to the standards of conduct “when [they began] soliciting business or negotiating.”¹⁷⁵ Under the Interim Rules, however, natural gas pipelines are not required to observe the standards of conduct “until they commence transportation transactions with their marketing affiliates.”¹⁷⁶ Under its Marketing Affiliate Rules, FERC found “transportation transactions” to mean both direct transportation on its line¹⁷⁷ and indirect transportation through displacement¹⁷⁸ of the gas to an affiliated marketer. It remains to be seen whether FERC will continue to apply this interpretation of “transportation transactions” under the Interim Rules.

All of the remaining provisions of the Energy Affiliate Rules (e.g., the separation-of-functions requirements, the prohibitions against information sharing, the posting requirements, the designation of a Chief Compliance Officer, the maintenance of written compliance procedures, the limitations on employee transfers, the employee training requirements, and the equal-treatment-of-shipper requirements) remain applicable to natural gas pipelines with respect to their interactions with their marketing affiliates that conduct transactions on their pipeline.¹⁷⁹ Likewise, any waivers or exemptions from the Energy Affiliate Rules granted to a natural gas pipeline by FERC remain valid with respect to its interactions with those marketing affiliates.¹⁸⁰

4. *Beyond the Interim Rules*

The Notice of Proposed Rule Making (NOPR) issued on January 18, 2007, in FERC Docket No. RM07-1-000 seeks comment on how to make permanent the changes made to the standards of conduct by the Interim Rules.¹⁸¹ Depending on the comments received, FERC could change the provisions ultimately adopted as the permanent final rule. However, it does not appear that FERC will attempt to re-promulgate the expansive Energy Affiliate Rules with respect to natural gas pipelines in the final

174. Order 690, *supra* note 141, at P 22.

175. Order No. 2004-C, *supra* note 138, at P 46.

176. Order No. 690, *supra* note 141, at P 26.

177. See *National Fuel Gas Supply Corp.*, 64 F.E.R.C. ¶ 61,192, at 62,582 (1993).

178. See *Tuscarora Gas Transmission Co.*, 94 F.E.R.C. ¶ 61,325, at 62,211 (2001) (“because Sierra Pacific’s off system sales are made possible by displacement (increasing shipments) on Tuscarora, Sierra Pacific conducts transportation transactions on Tuscarora within the meaning of the marketing affiliate rules”).

179. *Id.* at P 15.

180. *Id.* at P 16.

181. *NOPR*, *supra* note 142.

rule. FERC has not attempted to provide the justification required by *National Fuel Gas Supply Corp. v. FERC* for such an expansion of its standards of conduct, nor has it proposed such an expansion of its standards of conduct.¹⁸²

FERC has nevertheless proposed in the NOPR to expand the definition of marketing, sales, or brokering to include entities that manage or control transmission capacity, such as asset managers (those who manage or control gas or electric assets, including a transmission customer's capacity) or agents (those authorized to act on behalf of a transmission customer with respect to transmission-related activities such as nominations, scheduling, and billing).¹⁸³ If adopted, this would greatly expand the scope of affiliates deemed marketing affiliates under the standards of conduct for transmission providers.

The NOPR also seeks comments on whether the standards of conduct applicable to electric utilities should be revised to reflect the same scope of applicability as currently exists under the Interim Rules for natural gas pipelines, and on how to do so while still maintaining the necessary customer protections.¹⁸⁴ In a press release issued by FERC Chairman Joseph T. Kelliher contemporaneously with the issuance of the NOPR, Chairman Kelliher expressed a continued preference for "establishing consistency between application of rules to natural gas pipelines and electric utilities."¹⁸⁵ He explained, "If there was no more record evidence of abuse involving electric utility non-marketing affiliates than there was for pipeline affiliates, the unavoidable conclusion appears to be that the foundation of the expanded Standards of Conduct rule is fundamentally flawed. However, since there was no judicial challenge to the rule in this respect, we have the discretion to enforce a rule that may be arbitrary and capricious in its formation. I, for one, do not know why we would choose to do so."¹⁸⁶

The Interim Rules will be in effect until a final order is issued by FERC in Docket No. RM07-1-000. Such a final order is not likely to be issued before this summer.¹⁸⁷

182. See *Open Commission Meeting State of Chairman Joseph T. Kelliher*, Docket No. RM07-1-000 at 2 (Jan. 18, 2007) ("Today, we decline to justify application of the expanded scope of the Standards of Conduct rule to natural gas pipelines, and propose instead to narrow application to marketing affiliates, consistent with the interim rule.").

183. *NOPR*, *supra* note 142, at P 21.

184. See, e.g., *id.* at PP 11-13.

185. *Open Commission Meeting State of Chairman Joseph T. Kelliher*, *supra* note 182, at 2.

186. *Id.*

187. Initial comments in response to the NOPR were filed on March 30, 2007. Reply comments are due April 30, 2007. There are no statutory or regulatory deadlines for when a final order must be issued.

IV. RECENT DEVELOPMENTS IN INTERNATIONAL ENERGY LAW

A. RUSSIA'S NEW ANTIMONOPOLY LAW: CHALLENGES AND CHANGES TO ACQUISITIONS IN RUSSIA'S OIL AND GAS INDUSTRY

BYRON C. ROMAIN* AND MAXIM SCHERBAKOV**

1. Introduction

The end of the Soviet Union brought an unprecedented amount of liberty to the acquisition of oil and gas assets located in the territory of the Russian Federation, whether in whole or in part, by international oil and gas companies (IOCs).¹⁸⁸ This freedom of acquisition continued through the currency and economic crises that befell the Russian Federation in 1998. Over the last several years, however, oil prices have been bullish, reaching highs above \$78 per barrel of crude oil—well above the \$11 per barrel of crude oil seen toward the end of the 1990s. The apparent sustained increase in the price of crude oil, combined with relative instability in other areas of the world, has focused foreign (e.g., non-Russian) attention and investment back on oil and gas industry of the Russian Federation.

Many IOCs considering an investment in the Russian oil and gas industry fail to adequately consider Russia's antimonopoly laws. This failure on the part of the IOCs is due in part to the lack of clarity in the previous antimonopoly law¹⁸⁹ and the different rules and regulations that had formerly existed for transactions on the financial markets.¹⁹⁰ The

* Byron C. Romain is a Moscow-based attorney in Baker Botts LLP's global projects group. He represents clients in a wide variety of matters within the finance and energy sectors.

** Maxim Scherbakov is a Russian qualified associate formerly practicing in the Moscow office of Baker Botts LLP. His main areas of practice are antitrust and competition, joint ventures and cross-border transactions.

188. For the avoidance of doubt, IOCs, as defined and utilized here, do not include Russian entities or Russian-controlled entities.

189. See *Vedomosti S'ezda Narodnykh Deputatov RSFSR i Verkhovnogo Soveta RSFSR O konkurentsii i ogranichenii monopolisticheskoi deyatelnosti na tovarnykh rinkah* [Ved. RSFSR] [Bulletin of the Congress of People's Deputies of the Russian Soviet Federal Socialist Republic and Supreme Council of the RSFSR on Competition and Restriction of Monopoly Activity on Commodity Markets], 1991, No. 948-1, (Russ) [hereinafter *Previous Antimonopoly Law*] (including additions and amendments of June 24, 1992, May 25, 1995, May 6, 1998, January 2, 2000, December 30, 2001, March 21 and October 9, 2002, March 7, 2005, February 2, 2006). Note the age of the law, the era in which it was passed, and the numerous amendments thereto.

190. See the previous financial markets antimonopoly law, *Sobranie Zakonodatel'stva Rossiiskoi Federatsii O zashite konkurentsii na rinke finansovih yslug* [SZ RF] [Russian Federation Collection of Legislation on Protection of Competition in the Financial Services Market], 1999, No. 117, (Russ.).

Russian Federation recently took steps to remedy the aforementioned defects with the enactment of Federal Law No. 135-FZ of July 26, 2006, on Protection of Competition (New Antimonopoly Law), which came into force on October 27, 2006.¹⁹¹ The New Antimonopoly Law, and the change in focus from small and medium-sized transactions (of which there were numerous) to large-sized transactions,¹⁹² form the cornerstone of Russia's antimonopoly enforcement efforts. Prior to the entry into force of the New Antimonopoly Law, efforts by the Federal Antimonopoly Service of the Russian Federation (FAS), the agency charged with overseeing compliance and enforcing antimonopoly regulations, to prevent antimonopolistic acts in the Russian oil and gas industry were largely ineffective. The enforcement ability of FAS has been, however, notably strengthened by the New Antimonopoly Law.

This article sets forth in outline form the key provisions of the New Antimonopoly Law as it applies to the acquisition by entities¹⁹³ of oil and gas assets located on the territory of the Russian Federation. In particular, this article focuses on the acquisitions of shares or other interests¹⁹⁴ of entities that hold an exploration or production license, or of a parent of such entity (Transactions). This paper will not focus on other methods of control that may be regulated by the New Antimonopoly Law.

2. *The Extraterritorial Concept*

Under the Previous Antimonopoly Law, it was unclear whether Transactions that took place between entities located outside of the Russian Federation, but that concerned oil and gas assets in the Russian Federation, were subject to approval by FAS, because the main criterion for consideration by the Previous Antimonopoly Law was whether a Transaction leads or may lead to the limitation of competition in the Russian Federation.¹⁹⁵ The New Antimonopoly Law clarifies this by explicitly introducing additional criteria that strengthen the concept of

191. *Sobranie Zakonodatel'stva Rossiiskoi Federatsii O zashite konkurentsii* [SZ RF] [Russian Federation Collection of Legislation on Protection of Competition], 2006, No. 135-FZ, (Russ.) [hereinafter New Antimonopoly Law].

192. This refocus of energies is one of the main priorities declared for the new legislation.

193. "Entities" in this context refers to those legal persons, not including natural persons, holding an exploration and/or production license for oil/gas.

194. As in most jurisdictions, there are different types of legal entities in the Russian Federation that can hold a license. Depending on the type of entity utilized (e.g., joint stock company or limited liability company), owners may hold shares (joint stock company) or an interest (limited liability company). The transferability of shares, as well as liabilities and rights, differs in accordance with the laws governing the types of entities. For the remainder of this paper, unless the context requires otherwise, "shares" and "interest" may be used interchangeably, with no distinction being provided as to the form of the entity.

195. See Previous Antimonopoly Law, *supra* note 189.

extraterritoriality. Transactions which meet the aforementioned criteria, which is interpreted broadly by FAS, and are made in respect of:

- (i) assets located in the Russian Federation;
- (ii) shares or participatory interest in a Russian entity; or
- (iii) rights relating to a Russian entity (not including non-profit organizations);

fall under the scope of the New Antimonopoly Law.

While the above may seem quite limiting, FAS has interpreted¹⁹⁶ it to include Transactions that occur outside the Russian Federation but that affect the ultimate ownership or control of an entity, whether Russian or not, holding assets in the Russian Federation, regardless of the layers of entities in between, and which leads or may lead to the limitation of competition in the Russian Federation. A qualifying Transaction requires either (1) prior consent of FAS for the Transaction or (2) notification of the Transaction submitted to FAS after the Transaction is completed.¹⁹⁷ Whether a Transaction requires “prior consent” or “notification”—both of which are terms of art, with differing burdens—is discussed in section 3 below, as are exclusions based on the value of a Transaction.¹⁹⁸

3. *New Thresholds for Transactions*

Once it is certain (or reasonably can be assumed due to commercial considerations) that a Transaction requires FAS approval, the party seeking such approval must decide whether “notification” after completion of the Transaction or “prior consent” for the Transaction is appropriate,¹⁹⁹ or whether the Transaction does not require FAS approval because the monetary value of the Transaction or the ownership interest acquired falls below the limits set by the New Antimonopoly Law.

a. Notification

Notification is the less onerous of the two approvals. When a Transaction requires notification, an “interested party” submits to FAS,

196. Federal Antimonopoly Service, *FAS of Russia is publishing answers to questions in relation to the federal law on the “Protection of Competition,”* dated 19 March 2007, available at <http://www.fas.gov.ru/answers/11675.shtml> (last visited Jun. 5, 2007).

197. New Antimonopoly Law, *supra* note 191, art. 3(2).

198. While certain Transactions do not require FAS approval, acquisitions by IOCs of oil and gas assets in the Russian Federation are often not eligible for such exclusions as the value of such Transactions generally exceeds the monetary limits set by law.

199. The seller and buyer involved in the transaction may jointly make a decision as to the type of application needed for FAS’s approval; however, only one “interested” party submits an application for approval of a Transaction. New Antimonopoly Law, *supra* note 191, art. 32. These approval concepts are not new; they existed in the Previous Antimonopoly Law as well.

no later than forty-five days after the date of the Transaction, the details of the Transaction.²⁰⁰ Notification is appropriate when:²⁰¹

- (i) (a) the total value of the assets of the acquirer and the acquirer's group of persons,²⁰² plus the total value of assets of the target (e.g., the entity being acquired) and the target's group, is equal to or greater than \$7.7 million but less than \$115 million; or
(b) the gross revenue received from the sale of commodities during the previous calendar year by the acquirer and the acquirer's group, plus the gross revenue received from the sale of commodities during the previous calendar year of the target and the target's group, is equal to or greater than \$7.7 million²⁰³ but less than \$115 million;²⁰⁴ and
- (ii) the total value of the assets of the target and the target's group is equal to or greater than \$1.2 million but less than \$5.8 million; or
- (iii) the acquirer, the acquirer's group, the target or the target's group is listed on FAS's "Register of Legal Entities Holding More than 35% of a Particular Federal Commodities Market." (Register).²⁰⁵

and one of the ownership thresholds set out below in sub-section c "Ownership Thresholds" applies.

Should lower limits set forth in (i) and (ii) above not be exceeded, or should any of the parties involved not be listed in the Register, FAS approval is not required. However, should the upper limits set forth in (i) and (ii) above be exceeded, then the Transaction may require the prior consent of FAS as set forth below.

b. Prior Consent

By its very nature—consent obtained beforehand as opposed to notification after the fact—prior consent is the more onerous FAS approval. To obtain prior consent, an interested party must submit an application to FAS seeking antimonopoly approval for the Transaction, including a lengthy list of information about the commercial aspects of the Transaction, the target, the seller, the purchaser, and their respective

200. New Antimonopoly Law, *supra* note 191, art. 30.

201. *Id.*

202. The definition of "group of persons" is set forth by the New Antimonopoly Law, *supra* note 191, art. 9. A "group of persons" can be loosely understood to mean affiliates in which at least 50 percent identical ownership/control is present, whether parent or subsidiary, including links via natural persons or family members.

203. The U.S. dollar figures set forth in this article are approximations. The actual legal amounts are generally set forth in Russian rubles, the official currency of the Russian Federation.

204. New Antimonopoly Law, *supra* note 191, art. 30(1)(5).

205. The Register is available, in Russian, at the FAS's Home Page, <http://www.fas.gov.ru/competition/454.shtml>.

groups. By law, FAS has thirty days to consider an application and issue its decision,²⁰⁶ subject to an extension period.²⁰⁷ Prior consent is appropriate when:²⁰⁸

- (i) (a) the total value of assets of the acquirer and the acquirer's group, plus the total value of assets of the target and the target's group, is greater than \$115 million; or
(b) the gross revenue received from the sale of commodities during the previous calendar year by the acquirer and the acquirer's group, plus the gross revenue received from the sale of commodities during the previous calendar year by the target and the target's group, is greater than \$230 million; and
- (ii) the total value of assets of the target and the target's group is greater than \$5.8 million; or
- (iii) the acquirer, the acquirer's group, the target or the target's group is listed on the Register,

And one of the ownership thresholds set out below in sub-section c "Ownership Thresholds" applies.

It is unlikely that any acquisition of oil and gas assets in the Russian Federation by a major or mid-major IOC would not trigger the prior consent requirement. Consider: at the end of 2005, Chevron had total assets of \$125,833 million²⁰⁹ and ExxonMobil had total assets of \$208,335 million;²¹⁰ a larger independent like Anadarko had \$1,022 million in net revenues from the sale of production.²¹¹

Although it has not yet ever been used, there is a potential exception to the prior consent requirement when a Transaction does exceed the thresholds discussed above. The New Antimonopoly Law stipulates that the President or the Government of the Russian Federation may exempt a Transaction by issuing an act of government.²¹²

206. New Antimonopoly Law, *supra* note 191, art. 33(1).

207. *Id.* art. 33(3). FAS may unilaterally extend the time period for consideration for up to two months should additional information on the transaction is needed or because FAS requires more time to consider the proposed transaction. Should FAS exercise such right, FAS is obliged to publish on its official website information or other actions in regards to the transaction. In practice, FAS often exceeds the thirty day period without exercising its extension right, partly because of its large caseload and partly because of the lack of penalty for exceeding such thirty day period.

208. *Id.* art. 28(1).

209. CHEVRON CORP., 2005 ANNUAL REPORT, FINANCIAL HIGHLIGHTS (2005), available at <http://www.chevron.com/investor/annual/2005/financials.asp>.

210. EXXONMOBIL CORP., EXXONMOBIL 2005 FINANCIAL AND OPERATING OVERVIEW (2005), available at <http://ccbn.mobular.net/ccbn/7/1532/1692/>.

211. ANADARKO CORP., ANADARKO 2005 ANNUAL REPORT (2005), available at http://www.anadarko.com/PDF/APC_05Annual.pdf.

212. New Antimonopoly Law, *supra* note 191, art. 27(2). At this time we are unaware of any such acts being issued. Thus the scope and the type of transaction that may be exempted, if any, is speculative. The phrase "Government of the Russian Federation" refers to an act signed by the Prime Minister.

c. Ownership Threshold

Notification and prior consent, in addition to the valuation thresholds set forth in subsections a and b above, also require certain ownership thresholds be met before they are triggered. The ownership thresholds, which are percentage-based and dependent on the type of entity involved are as follows:

- (i) acquisition of the rights to voting shares in a joint stock company when the acquirer would then possess more than 25% of the voting shares;²¹³
- (ii) acquisition of voting shares in a joint stock company when the acquirer already possesses at least 25% but no more than 50% of the voting shares and would, after the Transaction, possess more than 50% of the voting shares;²¹⁴
- (iii) acquisition of voting shares in a joint stock company when the acquirer already possesses at least 50% but no more than 75% of the voting shares and would, after the Transaction, possess more than 75% of the voting shares;²¹⁵
- (iv) acquisition of membership interest in a limited liability company when the acquirer would then possess more than one third of the membership interest;²¹⁶
- (v) acquisition of membership interest in a limited liability company when the acquirer already possesses at least one third but no more than 50% of the membership interest and would, after the Transaction, possess more than 50% of the membership interest;²¹⁷
- (vi) acquisition of membership interest in a limited liability company when the acquirer already possesses at least 50% but no more than two-thirds of the membership interest and would, after the Transaction, possess more than two-thirds of the membership interest;²¹⁸
- (vii) acquisition of at least 20% of the target's assets (as per balance sheet);²¹⁹ or
- (viii) acquisition of the right to direct the business activities or exercise the executive functions of the target.²²⁰

213. New Antimonopoly Law, *supra* note 191, art. 28(1)(1).

214. *Id.* art. 28(1)(4).

215. *Id.* art. 28(1)(6).

216. *Id.* art. 28(1)(2).

217. *Id.* art. 28(1)(3).

218. *Id.* art. 28(1)(5).

219. *Id.* art. 28(1)(7).

220. *Id.* art. 28(1)(8).

4. *Applicability to Intra-Group Transactions*

A significant change in the New Antimonopoly Law has been the easing of restrictions on intra-group transactions. Previously, all Transactions that were covered, either by subject matter or value, under Russia's antimonopoly legislation, required FAS approval. There was no legal distinction made for a Transaction between unrelated parties or a Transaction between related parties (e.g., a parent and its subsidiary)—they both required FAS approval. As it is not uncommon for IOCs to utilize various subsidiaries and holding companies for economic efficiency and legal protection, in practice any transaction by an IOC that involved oil and gas assets in the Russian Federation had to be approved by FAS. The New Antimonopoly Law has modified this by requiring notification only for intra-group transactions.²²¹ There are, of course, certain limitations as follows:

- (i) the parties to the Transaction all belong to the same group;²²²
- (ii) the party making the application must provide to FAS, at least one month in advance of the Transaction, a list of all the entities in the group and the basis for the inclusion (e.g., common ownership or control) of all such entities on the list (the “group list”);²²³ and
- (iii) the entities on the group list did not change from the time the group list was provided through the date of the Transaction.²²⁴

FAS has ten days from the date of receipt of an intra-group notification to either (1) post the group list on its website for public comment²²⁵ or (2) notify the applicant that any of (i) through (iii) above has not been complied with or the format of the group list was not prepared in compliance with the requirements promulgated by FAS.²²⁶ While an intra-group transaction may be attractive in its relative ease when compared to prior consent, an IOC must determine its comfort with the possible disclosure of its affiliates and subsidiaries, and their ownership structure. In addition, all other notification requirements apply to intra-group Transactions.²²⁷

221. New Antimonopoly Law, *supra* note 191, art. 31(1).

222. *Id.* art. 31(1)(1).

223. *Id.* art. 31(1)(2).

224. *Id.* art. 31(1)(3).

225. *Id.* art. 31(2)(1).

226. *Id.* art. 31(2)(2).

227. *Id.* art. 31(3).

5. Possible Penalties for Antimonopoly Violations

Violations of the New Antimonopoly Law can trigger a range of administrative, criminal, and civil penalties, both for an IOC and for its managers as well. These penalties include:

- (i) liquidation of an entity;²²⁸
- (ii) forced reorganization of an entity (e.g., the spin-off of some of the entity's business units or complete disintegration of the entity);²²⁹
- (iii) voiding the Transaction;²³⁰
- (iv) an economic benefit penalty (e.g., all ill-gotten proceeds must be paid into Russia's federal budget);²³¹
- (v) various administrative fines;²³² and
- (vi) the disqualification of the managers held liable for the antimonopoly violations as managers.²³³

6. Conclusion

The New Antimonopoly Law has both clarified and expanded the reach of Russia's antimonopoly regime. An IOC considering an acquisition of an entity holding oil and gas assets in the Russian Federation must not assume that offshore transaction do not subject it or a Transaction to FAS scrutiny. Due to the possible complications of failing to obtain proper FAS approval, and in light of the public scrutiny that foreign ownership of Russian oil and gas assets can sometimes bring, IOCs are advised to adhere to the New Antimonopoly Law as closely as is legally possible.

228. *Id.* arts. 34(1) and (3).

229. *Id.*

230. *Id.* arts. 34(2), (4), (5), and (6).

231. *Id.* art. 23(1)(2)(J).

232. *See* Kodeks RF ob Administrativnykh Pravonarusheniakh [KOAP] [Code of Administrative Violations], 2001, No. 195-FZ (Russ.) arts. 3(5), 14(31)-(33), 19(5)(2), 19(8). Non-compliance with FAS requirements can result in fines for natural persons up to ~\$377, and fines for legal persons up to ~\$18,860. As of May 12, 2007, new sections were added to the Code of Administrative Violations that add significant new penalties for violations of Russia's antimonopoly laws. These new penalties, which are proceeds-based and therefore have no numerical cap, are as follows: for abuse of dominant position, up to 1/50 of the net proceeds of the violator and the violator's group of persons for the year preceding the date of the violation; for anticompetitive agreements or actions, up to 15/100 of the net proceeds of the violator gained on the market where the violation occurred during the year preceding the date of the violation; and for actions which constitute unfair competition, up to 15/100 of the net proceeds of the violator gained on the market where the violation occurred during the year preceding the date of violation.

233. *See Id.*, art. 19(5)(2).

B. CHALLENGES IN STRUCTURING NON-RECOURSE ISLAMIC FINANCING FOR ENERGY PROJECTS IN SAUDI ARABIA

NABIL A. ISSA* AND PATRICK F. CAMPOS**

With oil prices reaching record highs over the last few years, a number of the Gulf Cooperation Council (GCC) countries have used their profits both to diversify their economies and to further invest in oil and gas projects, including related industrial projects, such as refineries and petrochemical plants. Many of these energy projects are partly owned by leading foreign energy companies that provide technology and are normally off-takers for the products created by the joint venture project companies. Engineering, procurement, and construction (EPC) costs for energy projects, however, have risen rapidly,²³⁴ and most foreign joint venture parties are eager to structure the financing for such projects so as to keep the debt off-balance-sheet and non-recourse for the parent sponsors. Local governmental bodies are also increasingly reluctant to fund the cost of such energy projects.

Concurrent with the boom in large-scale energy projects in the GCC, the region has witnessed a dramatic increase in the number of local parties who are interested in financing such projects in a *Shari'ah*-compliant manner,²³⁵ or at least ensuring that one or more tranches of financing are provided on a *Shari'ah*-compliant basis. Sponsors who wish to structure the financing of an energy project in a *Shari'ah*-compliant manner not only seek to finance their investments in ways that do not involve the payment of interest/*riba*²³⁶ but also look to abide by other

* Nabil A. Issa is a senior associate based in the Dubai and affiliated Riyadh office of King & Spalding LLP. Mr. Issa's practice focuses on banking and financing matters, with a special focus on *Shari'ah*-compliant structures. He was recognized in the 2006 and 2007 editions of Chambers Global *The World's Leading Lawyers*. Mr. Issa graduated from the University of California, San Diego (B.A.), the University of Pennsylvania (J.D. and Graduate Certificate in Middle Eastern and Islamic Law), and was a Fulbright Scholar at U.A.E. University.

** Patrick F. Campos is a senior associate based in the Dubai office of King & Spalding LLP. His practice focuses on finance and project development. Mr. Campos was recognized in the 2007 edition of Chambers Global *The World's Leading Lawyers*. Mr. Campos is a graduate of Arizona State University (B.A.) and Georgetown University Law Center (J.D.).

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234. Victoria Robson, *Marginal Returns: International Banks Continue to Wrestle for a Stake in Deals, Despite Ever-Thinning Margins, in What Looks Set to Be Another Boom Year for Project Finance*, MIDDLE EAST ECON. DIG., Mar. 23, 2007, at 39, 40.

235. Victoria Robson, *Financing Turns Compliant: Sharia-Compliant Project Finance Is Beginning to Take Off but Stumbling Blocks Remain for Those Entering the Market*, MIDDLE EAST ECON. DIG., Mar. 23, 2007, at 48, 48.

236. *Riba* literally means "increase." The *Qur'an* provides that "Allah has permitted trade and forbidden *riba*." *Qur'an* 2:275.

underlying *Shari'ah* requirements.²³⁷ Sponsors who anticipate that they may float all or a portion of such an energy project to the public in the region are also discovering that, if the project is financed in a *Shari'ah*-compliant manner, the general public's interest in investing in the project is greatly enhanced.²³⁸ In addition, the size of the required financing of many energy projects is such that the conventional lenders are unable or unwilling to fund the entire amount of the financing, while Islamic financial institutions are eager for opportunities to finance productive assets, as they generally cannot invest in purely financial assets.

In order to structure a financing in Saudi Arabia, it is critical for lenders to have a basic understanding of the *Shari'ah* as applied in Saudi Arabia. The fundamental law of the Kingdom of Saudi Arabia is the Holy *Qur'an* and the teachings and traditions (*hadith*) of the Prophet Mohammed.²³⁹ Saudi Arabia, however, has promulgated a number of regulations recently, partly as an overall process of increasing the transparency of its regulations and partly in an accelerated manner to fulfill certain requirements of the World Trade Organization in connection with its bid for accession.²⁴⁰ While the *Shari'ah* is the *law* in Saudi Arabia, man-made rules are considered *regulations* that must not conflict with the *Shari'ah*.

This article will provide a brief overview of some of the challenges faced by lenders looking to finance energy projects in Saudi Arabia, particularly on a *Shari'ah*-compliant basis. We include some of the methods we have developed over the last few years while advising lenders and sponsors of such projects who are seeking to mitigate those risks. The first section of this article discusses some of the most common forms of *Shari'ah*-compliant financing structures utilized to finance energy projects in Saudi Arabia. The second section focuses on the issues faced by lenders to energy projects in Saudi Arabia, regardless of whether such financing is provided on a *Shari'ah*-compliant basis.

237. Among other factors, a *Shari'ah*-compliant transaction must also not (i) include the sale of a forbidden product (e.g., alcohol, drugs, pornography, pork, etc.) or (ii) contain an "unacceptable level of risk," also known as *gharar* (i.e., the Prophet is believed to have forbidden the sale of dates on a tree before such dates were ripe because of the risk that they may become insect-infested prior to becoming ripe).

238. Robson, *supra* note 235.

239. Royal Decree No. A/90 dated 23/08/1412 H. ("Basic Law").

240. See Nabil A. Issa, *Middle East: Petroleum Provisions of Iraq's New Constitution and the Admission of Saudi Arabia to the WTO*, 1 TEX. J. OF OIL, GAS, AND ENERGY L., 162, 166 (2006); Jim Phipps et al., *Middle Eastern Law*, 40 INT'L LAW. 597, 597 (2006).

1. *Shari'ah-Compliant Financing Structures and Considerations in any Shari'ah-Compliant Financing*²⁴¹

a. The *Ijara wa Iqtina* Structure

An *ijara* is a type of lease that has elements of an operating lease and a financing lease. The lenders either take actual or contractual ownership of the asset and lease it back to the project company. At the end of the term of the *ijara*, the asset is sold, usually pursuant to a separate agreement, back to the project company for a nominal amount. Yet the *ijara*, to be *Shari'ah*-compliant, must allocate to the property owner, rather than the Islamic investor, certain responsibilities that are considered to flow from the ownership of the concerned asset. In a sense, *Shari'ah* principles seek to ensure that there is a fair and proper allocation of responsibilities between the landlord and the tenant. For example, an *ijara* contract should impose on the owner the responsibility for major maintenance and structural repairs of the leased asset. In addition, responsibility for property damage insurance should be allocated to the lender, as landlord, rather than the borrower, as tenant. These responsibilities create potential exposure on the part of the lenders to certain liabilities that conventional lenders would eschew, and contractual mechanisms must be implemented to reconfigure the allocation of such risks. To this end, a special purpose company (SPV) is at times used to own the asset rather than the actual project company; the SPV then enters into a sublease with the actual borrower. In Saudi Arabia, the use of an SPV to act as lessor, however, could potentially lead to Saudi Arabia's Banking Dispute Committee refusing to take jurisdiction of the matter, if none of the parties to the dispute is a local or international lender. We believe it is critical to work with SAMA²⁴² in structuring *ijara* financings using an SPV.

The *ijara* structure is normally used when an asset is in existence, such as in connection with the refinancing of an energy project. *Shari'ah* boards have, however, approved the use of the *ijara* structure for the financing of projects to be constructed through the use of forward leases with the requirement that monies be returned in the event the project is not constructed.

241. Portions of the discussion on *Shari'ah*-compliant structures earlier appeared in the newsletter of the Association of Foreign Investors in Real Estate. Amin Husain, Nabil Issa & Fadi Mudarres, *Foreign Real Estate Investment in the US and Europe: Some Considerations and Structures for Middle Eastern Investors*, AFIRE NEWS, Mar./Apr. 2007, at 18, available at <http://www.afire.org/newsletter/2007/mideast.pdf>.

242. SAMA is the Saudi Arabian Monetary Agency, which is the central bank of Saudi Arabia. The Banking Dispute Committee does not have jurisdiction to hear a dispute if none of the parties to the dispute is a lender in a dispute of a banking nature.

b. The *Istisna'-Ijara* Structure

A modification of the *ijara* structure is the *istisna'-ijara* structure. The *istisna'-ijara* structure is primarily utilized for projects that involve the financing of assets to be constructed. The *istisna'* involves the sale of assets to be constructed in accordance with certain specifications and for a specific determined price. Once the construction phase of a project is complete, an *ijara* is utilized for the repayment of the amounts borrowed. Because the *Shari'ah* generally prohibits rent payments for an asset until it has actual economic value, the *ijara* is used for only those portions of the asset that acquire economic value as they become available during the construction of the project.

c. The *Murabaha* Structure

In some instances, a *murabaha* structure has been used to finance the acquisition of existing assets. A *murabaha* is a cost-plus financing, involving the purchase of an asset by the financial institution, which could be an Islamic financial institution, and the immediate resale of the asset to the borrower on deferred payment terms at cost, plus an agreed profit.

The total purchase price of the asset is generally paid in installments over an agreed period of time. Although the *murabaha* structure has the advantage of placing title to the property in the hands of the borrower, prepayment restrictions and pricing constraints have limited the use of this structure.

One of the most popular forms of *Shari'ah*-compliant financing is the use of working capital or commodity *murabahas* (*tawarooq*). Amounts are lent to a project through the use of separate *murabahas* for the acquisition by the lender, acting as the agent of the borrower, of amounts of commodity equal in value to the principal amount required, the immediate resale to the project company at the purchase price of such commodity, plus an agreed profit, and the immediate resale to the original seller of the commodity (normally for the price at which the original seller sold the commodity to the lender, plus a small transaction fee, which is passed on to the borrower). The profit portion owed to the lender is then in addition to the amounts lent to the project company for the construction and/or operation of such project. While this form of Islamic financing is widely utilized, it has been criticized by certain Islamic financial institutions, and borrowers in the GCC are increasingly opting for other forms of *Shari'ah*-compliant financing.

d. The *Musharaka* Structure

The word *musharaka* means “sharing” and describes joint business enterprises in which the partners share the profit or loss of the venture. In

general, there is no guaranteed rate of return on such investments. *Musharaka* structures have been used in various joint ventures in connection with project financings in Saudi Arabia. In effect, the lenders enter into a contractual joint venture with the borrower for the purpose of developing the project. The lenders acquire a majority interest in the *musharaka* and provide the bulk of the funds to the venture. A diminishing *musharaka* structure was utilized in the project financing of the Al Waha Petrochemical Company in Jubail.²⁴³ A diminishing *musharaka*, for example, is typically used to reduce the ownership share of the lenders as amounts owed are paid to the lenders.²⁴⁴

e. The *Sukuk* Structure

A number of energy projects in the GCC are now being partially or completely financed through the use of *sukuk*.²⁴⁵ *Sukuk* holders have undivided beneficial ownership interests in the asset underlying the *sukuk*. *Sukuk* are arguably analogous to US Trust Certificates and provide holders regular payments that are often benchmarked to LIBOR. It is now possible to obtain rated *sukuk*, and a number of *sukuk* in the region are redeemable in the event the concerned project company floats its shares within a certain number of years from the issuance of the *sukuk*. The assets from which the *sukuk* holders are generating profits must be *Shari'ah*-compliant. In Saudi Arabia, an obstacle to utilizing *sukuk* has been that a Saudi Arabian limited liability company (LLC) cannot issue debt instruments or securities, including *sukuk*. This has resulted in the need to issue the *sukuk* by utilizing offshore SPVs as the Ministry of Commerce & Industry has not been willing to sanction the creation of an SPV as a joint stock company for the issuance of *sukuk*. An offshore SPV results in a 5% withholding tax on payments made to the SPV and precludes a listing on Saudi Arabia's Tadawul. Certain joint stock companies, however, have been able to issue *sukuk* in Saudi Arabia and create an LLC as an SPV for the purpose of receiving payments from the joint stock company's subsidiaries on behalf of the *suk* holders. Despite the difficulties in structuring *sukuk* in Saudi Arabia, *sukuk* tranches in project financings of energy projects are widely expected to grow in popularity over the next few years in the GCC.

243. See Mohamed Hamra-Krouha, *Saudi Innovation*, 26 INT'L FIN. L. REV., Jan. 2007, at 46.

244. We note the diminishing *musharaka* structure was initially created as a tax-driven structure in the United Kingdom for *Shari'ah*-compliant real estate financings. The use of this structure in Saudi Arabia must be carefully considered by the sponsors and lenders to a project.

245. We note that it has been announced that the two joint venture refineries being developed by Saudi Aramco with ConocoPhillips and with Total may be partly financed with *sukuk*, and Abu Dhabi's TAQA Group has announced it will partly finance future energy projects with *sukuk*.

f. Other Considerations in *Shari'ah*-compliant Financing

In addition to understanding the basic forms of *Shari'ah*-compliant financing, it is also important to recognize that the *Shari'ah* Boards of the concerned financial institutions are a critical component of all *Shari'ah*-compliant financings. Most *Shari'ah* scholars have reviewed and approved transactions using the foregoing structures and others (e.g., *mudarabas*, *wakalas*, etc.). *Shari'ah* scholars, however, do not always take the same approach to all issues, with the result that structural details or contractual provisions that are acceptable to one *Shari'ah* scholar may be unacceptable to another *Shari'ah* scholar. It is therefore helpful, when proposing investment structures to a *Shari'ah* scholar, to learn in advance the position that that particular *Shari'ah* scholar takes on various issues. It should also be noted that there are a limited number of *Shari'ah* scholars who are recognized as experts in their field and who are fluent in English.

Moreover, if one or more tranches of financing are to be provided on a *Shari'ah*-compliant basis, then a separate asset will need to be identified, as most *Shari'ah* Boards will not approve as *Shari'ah*-compliant the financing of an asset that is also being conventionally financed. Normally, however, there is an inter-creditor agreement between the conventional lenders and the *Shari'ah*-compliant lenders by which the amounts of any recovery in a default situation are shared on a *pari-passu* basis.

We note that a common objection to the form of *Shari'ah*-compliant financings is that the lenders often use the same inter-bank offering rates (e.g., LIBOR) as a benchmark to calculate the profit being generated. Therefore, the argument is advanced that a *Shari'ah*-compliant financing is simply interest-based financing but using a different means of charging interest by using terms in Arabic. It is critical to understand that, when structuring a *Shari'ah*-compliant financing, form is important. In addition, the various *Shari'ah*-compliant structures require the financing party to act as a lessor, a partner, or a party selling a product rather than a lender of funds. The *Shari'ah* was never meant to deprive business people from making a profit, but does aim to prevent lending that exploits the borrower or is usurious. Also, using a benchmark such as LIBOR to price a *Shariah*-compliant financing is not in itself wrong. For example, a steak that is slaughtered in a manner that is considered *halal*, or kosher, may taste and cost exactly the same as a steak that is produced through the slaughter of a cow that is not done in a manner that is *halal*, or kosher. However, for the believer, the method in which that cow was slaughtered will determine whether or not such believer may consume that steak. Similarly, it is important to appreciate and understand that the structuring of a financing in a *Shari'ah*-compliant manner is of great

importance to a borrower who does not wish to engage in conventional financing.

2. Specific Challenges in Structuring a Financing in Saudi Arabia

A number of challenges exist in structuring a financing in Saudi Arabia, particularly the concept of “security” and the means of “perfecting” and enforcing security interests in Saudi Arabia, which differ from those of most Western jurisdictions. Under the *Shari’ah*, a security interest may be perfected only through possession. Thus, a pledge of an object (e.g., a vehicle or jewelry) as security for a loan will be recognized so long as the lender maintains possession of the object. This becomes much more difficult with respect to certain types of property that are the object of financings, including immovable property such as real estate or fixtures on the land. We note that the term for pledge (*rahn*) is used interchangeably for both real property (mortgages) and personal property.

a. Rahn

Lenders normally wish to obtain a *rahn* of the real estate, movable property of the project company and the facility to be constructed for use by the project company. Below is a brief discussion of each type of asset.

i. Real Estate/Immovables

There does not yet exist in Saudi Arabia a central registry for the recordation of real estate title deeds.²⁴⁶ Title to real estate is manifested in a title deed issued by a Public Notary. To create a valid mortgage interest in real property in Saudi Arabia, the lender or other security holder and the owner must enter into a separate pledge agreement, the full text of which is then recorded on the title deed to the real property by the Public Notary, and then the title deed is given to the mortgagee. Recordation of the *rahn* on the title deed and possession of the title deed by the mortgagee has been held by the *Shari’ah* courts generally to constitute constructive possession of the real property itself, making the pledge valid under the *Shari’ah*.²⁴⁷

246. Royal Decree No. M/6 dated 11/2/1423 H. (24 April 2002) (the “Real Property Regulations”), provides that a new real property register will be created in Saudi Arabia in which rights and interests in real property will be recorded. While the implementing regulations for the Real Property Registration Regulations have been issued by the Minister of Justice, Decision No. 4497 dated 14/6/1425 H. (31 July 2004), the real property register has not yet been established.

247. We note, however, that such rulings are not binding upon Saudi Arabian judges in subsequent proceedings.

While it was once the practice to record the liens of banks or other lenders on the real estate title deeds, the Ministry of Justice stopped this practice about twenty years ago on the ground that most of these liens represented interest-bearing transactions repugnant to Islam. Lenders attempted to skirt this issue at first by appointing individual employees of the lender as nominees under the *rahn* recorded on the title deed. Over time, however, the Public Notaries refused to record such liens as well, making it difficult to use real estate as collateral security for loan transactions from commercial banks. A notable exception to this is the Saudi Industrial Development Fund (SIDF) (discussed below), which routinely registers valid mortgage interests against real estate and improvements, including improvements constructed on leased land in Saudi Arabia's industrial cities.

When possible, lenders will take an assignment of the lease from the relevant industrial city in Saudi Arabia, such as the Royal Commission of Jubail and Yanbu. Such assignment should include the improvements made on the leased land. Also, because the SIDF takes a first-priority mortgage over the lease and improvements, it is often possible for other lenders to enter into a intercreditor agreement with the SIDF that provides that, in a foreclosure situation following an event of default, after the assets have been sold by the SIDF the remaining amounts will be paid over to the commercial lenders after the SIDF has received all amounts owed to it.

ii. Movable

In a project financing, the lenders normally wish to take a mortgage over all the movables that belong to the project company. The Commercial Mortgage Regulations²⁴⁸ establish a statutory framework applicable to mortgages over movable property. However, the governmental bodies that are tasked with recording the *rahn* on the title do not yet have a mechanism for recording such *rahn*. For example, the *muroor* (motor vehicle department) does not yet have a system for recording a *rahn* on the *istimara* (title deed) of vehicles. The Commercial Mortgage Regulations provide that, for *rahn* taken in accordance with the steps of the Commercial Mortgage Regulations, the lender(s), in an event of default situation, must provide the defaulting borrower a notice of such default and a period of time within which to rectify the default. If the default is not corrected within the agreed time frame, an application

248. Royal Decree No. M/75 dated 21/11/1424 H. (27 February 2004), *supplemented by* Decision No. 6320 dated 18/6/1425 H., published in *Umm Al Qura* edition no. 4016 (October 29, 2004) (consisting of implementing regulations issued by the Minister of Commerce and Industry).

is made to the Board of Grievances to conduct an auction sale of the movables that are subject to the *rahn*.

iii. After-Acquired Property

Assets, or *marhoun*, under the *Shari'ah* must be something that can be validly sold. Therefore, any *marhoun* subject to a *rahn* must (i) be in existence at time of execution of the *rahn*, (ii) have a quantifiable value and (iii) be saleable and deliverable.²⁴⁹ The definition of *marhoun* creates a problem in terms of after-acquired property. This can be addressed in a financing through regular updates of the schedule of *marhoun*/assets in the security agreement prior to each draw on a facility to ensure that the concerned *marhoun* is covered by the security agreement.²⁵⁰

We have developed a form of security agreement for Saudi Arabia that utilizes the *rahn-adl* structure, in which the *adl* is akin to the Western concept of a trustee over the assets. This is supported by a "Deed of Possession" in which the schedules from the Security Agreement are duplicated (and, as with the Security Agreement, updated regularly), thus creating a form of "constructive possession" of the assets and subjecting them to a *rahn*. Each type of asset in a financing needs to be analyzed and a determination made as to the best method under local law to subject such asset(s) to a *rahn*. While the *rahn-adl* concept has not been tested before local courts, to our knowledge, such structure has been utilized in other project financings in Saudi Arabia.

b. Assignment of Contract Proceeds

It is possible to assign contract proceeds and other intangible rights under the *Shari'ah*, subject, however, to the caveat that it is not possible to "perfect" such assignments through recordation with a central registry. Instead, borrowers in Saudi Arabia are often asked to assign specific contract proceeds, with an acknowledgment from the payor that the assignment shall remain in effect until the assignee consents to any transfer or termination of the assignment.

Under *Shari'ah* precepts as applied in Saudi Arabia, however, unilateral assignments are not effective. In order to create an effective assignment of a contract of the relevant project company and/or contractual obligations of counterparties thereto, such counterparties must be given notice of the assignment and must consent to the assignment. Thus, an assignment of amounts owed to a project company

249. Michael McMillen, *Islamic Shari'ah-Compliant Project Finance: Collateral Security and Finance Structure Case Studies*, 24 FORDHAM INT'L L.J. 1184, 1220.

250. *Id.*

to the lenders must include a written consent of such assignment by the payor(s) in order to be a perfected interest.

c. Power of Attorney

Lenders to projects in Saudi Arabia often rely on a “*wakala*” or a power of attorney given to a designee of the lenders in order to exercise certain “step-in rights” in an event of default scenario. However, it is critical to note that powers of attorney in Saudi Arabia are revocable, even if the power of attorney is characterized on its face and in the security documents as an “irrevocable” power of attorney. We note that certain schools/*maddhabs* of *Shari’ah* provide an exception to the general rule that a power of attorney is revocable, if it is coupled with an interest of a third party, and this third party relies on its irrevocability. The lenders will still be taking a risk when using this mechanism, however, as there is debate among lawyers and commentators as to whether this exception exists. The “irrevocable” power of attorney is likely also to be more enforceable if its duration is limited to a certain specified period of time (usually a limited period of time beyond the base tenor of the financing). In order to protect against the revocation of a power of attorney granting step-in rights, lenders often include a liquidated damages provision in the concerned security agreement that is triggered upon premature revocation. In our experience, liquidated damages have been enforced by the local courts as long as the liquidated damages approximate the actual damages and are not drafted as excessive financial penalties for non-performance.²⁵¹

d. Pledge of Interests in a Saudi LLC

A Saudi LLC, the corporate form most often utilized for Saudi Arabian joint venture entities that are partly foreign owned, does not issue share certificates. This has presented difficulties in raising non-recourse project financing for Saudi LLCs to the extent that there are no share certificates of the project company that can be pledged to the lenders. The problem arises from the requirement under Saudi Arabian law noted above and based upon the *Shari’ah* principle that any security interest, in order to be valid, must be reduced to actual or constructive possession of the subject of the pledge given. In the absence of a share certificate that can be physically delivered to the lenders or even annotated, the pledge of interests in a Saudi LLC is not enforceable under local law. Accordingly, there is no generally effective direct means

251. A Fatwa from Sheikh Abdulaziz bin Baz in the form of Resolution No. 25 dated 21/08/1394 H. permits penalty clauses in agreements as long as such is meant to encourage adherence to a contract as opposed to a “financial threat” to the counterparty.

by which shareholders may pledge their interests in a Saudi LLC to a lender or any other party. To get around this, lenders will often require sponsors to form SPVs in offshore jurisdictions (e.g., the Cayman Islands or elsewhere) to serve as the actual shareholders in the Saudi project company, as the shares of such SPVs may be more readily pledged to the lenders as additional security for their loans. The lenders can then take security over the second-tier shares, the shares of the offshore companies established by the sponsors to hold their shares in the project company.

One potential obstacle to this sort of arrangement is that the Saudi Department of Zakat and Income Taxation (DZIT) generally does not treat as “Saudi” the interests of a Saudi Arabian individual or entity in a non-Saudi offshore company, thereby subjecting the non-Saudi company to income taxation on profits flowing from the project company at a 20 percent flat tax rate—even if the capital is truly Saudi in nature (unless the SPV is incorporated in a GCC jurisdiction such as Bahrain and is wholly owned by GCC nationals). By contrast, a Saudi individual or entity generally pays *zakat* at the rate of 2.5 percent of net profits. Moreover, payment made by a Saudi party (whether for services or dividends) to the offshore entity would be subject to a Saudi withholding tax at rates of between 5 percent and 20 percent of the gross amount, depending on the nature of the payment.

We understand that certain local partners in energy projects, such as Saudi Aramco, have not previously agreed to the use of such an offshore structure in joint venture projects sited in Saudi Arabia in which such entities have an interest and, for practical and political reasons, may not be amenable to this sort of offshore ownership structure. We also note that Saudi Arabian joint stock companies do have certificated shares that may be pledged to local lenders. However, the time required to form a joint stock company involving foreign shareholders (as well as the requirement that such companies have a minimum of five shareholders) often dissuades sponsors from using this structure.

e. Fuel Supply

Many energy projects rely on a commitment by the Ministry of Petroleum or other appropriate governmental department or ministry to provide a certain amount and quality of fuel over an agreed period of time and pursuant to a predetermined pricing structure to justify the cost of such energy projects.²⁵² Lenders will normally wish to see that the feedstock supply is guaranteed. Therefore, the subject of the damages

252. The cost of petroleum-based feedstock is currently considerably less than that available outside Saudi Arabia. This has been a critical aspect of making many energy projects “bankable” in Saudi Arabia. See Issa, *supra* note 240, at 167 (discussing pricing of feed stock for petrochemical projects in Saudi Arabia).

payable in the event that the fuel is not supplied is an issue that lenders expect will be addressed in any fuel supply agreement. A related issue is whether the project company will have a priority allocation if there is a shortage of the appropriate level and quality of such fuel available in Saudi Arabia.

f. Take Or Pay Arrangements

Take or pay arrangements are unusual in Saudi Arabia, and it is not clear if such arrangements are enforceable.

g. Insurance

The ability of an energy project to obtain insurance for sabotage or terrorism is often an issue of great concern in Saudi Arabia. While local insurers are increasingly willing to provide partial cover for this risk, insurance to cover the entire cost of such projects has generally not been available. It also should be noted that under the *Shari'ah*, conventional insurance contracts (as opposed to the *Shari'ah*-compliant *takaful* insurance structures) may be viewed as void on the grounds that they involve elements of *gharar* (risk or speculation).

h. Environmental Law

Lenders are increasingly concerned that energy projects are in compliance with the relevant environmental regulations in Saudi Arabia. The Public Environmental Law creates a regulatory framework for the development and enforcement of environmental rules.²⁵³ The implementing regulations require that the appropriate licensing authority mandate an applicant for a project that may have a negative effect on the environment to submit an environmental impact report as part of the feasibility study for the project for which approval is being sought.²⁵⁴

i. Floating Charge/Set-Off Rights

The concept of a floating charge over accounts does not exist in Saudi Arabia. Therefore, lenders normally require that certain project accounts be maintained in an account in a jurisdiction in which the lenders can take a floating charge over the account (e.g., England or New York). Lenders will likely require that proceeds generated from offshore offtake agreements be deposited directly into certain offshore accounts subject to such floating charges.

253. Royal Decree No. M/34 dated 28/07/1422 H.

254. Minister of Defense Resolution No. 1/1/4/5/1/924 dated 3/8/1424 H., amended by Minister of Defense and Aviation Resolution No. 1/1/4/2391 dated 8/5/1426 H.

However, this mechanism is often impractical where onshore (Saudi Arabian) counterparties are reluctant to pay into an offshore account. In these instances, lenders have employed “cash sweep” mechanisms to move cash from an onshore account of the borrower to an offshore account subject to a floating charge. This can be accomplished by creating a segregated onshore account and contracting with the deposit bank to permit a representative of the lender to manage or direct disbursements from the onshore account.

Offshore lenders will typically also require set-off rights with respect to project accounts held with them. The rights of banks in Saudi Arabia to set-off are generally broad. Lenders must ensure that such rights are provided for in the loan documentation. Absent such agreement, the lenders would require a court order before exercising any claimed set-off rights.

j. Saudi Industrial Development Fund

The SIDF is a Saudi Arabian governmental entity with a mandate to provide financial assistance through soft term loans to sponsors of certain types of industrial projects in Saudi Arabia.

SIDF lending²⁵⁵ is currently limited to SR 600 million per project, which can be a small amount in comparison to the size of the current mega projects in the energy sector of Saudi Arabia.²⁵⁶ This can be increased to SR 1.2 billion if a project can be licensed as two or more separate projects. We understand that the SIDF has even lent up to SR 2 billion where a project consists of more than two separate projects and such projects are financially independent of each other. SIDF funding is not available for certain types of energy projects that do not “manufacture” a new product (e.g., refineries and power plants). SIDF funding, however, has been a critical component in the financing of petrochemical facilities and other heavy industrial activities in Saudi Arabia.

Commercial lenders are sometimes uncomfortable with the terms of the loans provided by the SIDF, as the SIDF requires a first-priority mortgage over all assets of a project company to which it lends, even if its portion of the loan is considerably smaller than the overall financing

255. In the authors' experience, SIDF applies a front-end one-time evaluation charge (on approved loans only) to cover its costs of studying and evaluating the application (approximately an amount equal to 6 percent of the entire loan), and follow-up costs are billed once every six months during the relationship of the project (calculated on an annual basis of .75 percent to 1 percent of the loan amount in lieu of interest).

256. The official limit is SR 400 million, *see* Saudi Industrial Development Fund, FAQ, <http://www.sidf.gov.sa/english/FAQ/> (last visited Jun. 4, 2007). However, based on the authors' experience and communications with SIDF personnel, SR 600 million is the limit used in practice.

provided by commercial lenders, export credit agencies, etc. Moreover, the SIDF is the only entity in Saudi Arabia currently permitted to register a full commercial property mortgage (and, thus, perfect its security interests), which requires commercial lenders to create a “springing” collateral security interest that essentially comes into existence only upon receipt by the SIDF of all amounts owed to it by the project company.

k. Promissory/Order Notes

The Negotiable Instruments Office (NIO) has jurisdiction over actions, matters, and disputes involving negotiable instruments, such as promissory notes, which, for reasons relating to *Shari'ah* precepts, we typically recharacterize as “order notes.” In the context of such disputes, the NIO has jurisdiction superior to that of the Banking Disputes Committee. Actions before the NIO are normally resolved in less time than those before the Banking Disputes Committee and, as order notes are generally enforceable in Saudi Arabia on their face, lenders often require the borrower to deliver an order note for the full amount of the loan, in addition to an order note evidencing the amount of commission/interest owed. In the event a lender cannot enforce the interest provisions of the loan for reasons of *Shari'ah* interpretation, lenders normally protect themselves by having an order note that is only for the amount of the principal and, thus, is untainted by interest.

l. Tax Gross-Up Provision

Companies in Saudi Arabia are required to pay a withholding tax of 5 percent of the profits/interest on a loan charged to them by a foreign lender. We note that foreign lenders typically require borrowers to gross up any payments to account for such tax. Companies in Saudi Arabia must also consider the possibility of such tax being introduced at a future point if a loan that originally included only Saudi lenders is syndicated to include foreign lenders. Lenders look to restrict the ability of borrowers to block syndication to non-Saudi financial institutions on the basis of increased costs attributable to withholding tax.

m. Islamic Financing

Interestingly, while *Shari'ah* is the fundamental law of Saudi Arabia, most financings in Saudi Arabia traditionally involved conventional financing. Therefore, some of the modes of Islamic financing raise questions as to their enforceability in Saudi Arabia. For example, questions have been raised regarding the use of an “*ijara*,” because of the possibility that a tribunal in Saudi Arabia will determine that the *ijara* payments made under an agreement to a financial institution are higher

than “market rents” and may decide that the lessee should not pay any amounts above market rents.²⁵⁷ While we believe this type of concern can be easily addressed by simply indicating in the *ijara* that this is a form of *Shari’ah*-compliant financing (*ijara wa iqtina*) and providing for the jurisdiction of the Banking Disputes Committee, we understand that lenders have raised concerns about the ability to utilize certain *Shari’ah*-compliant structures for proposed financings in Saudi Arabia. It is important that time be spent ensuring that the *Shari’ah*-compliant tranche of any financing meets the requirements of the relevant *Shari’ah* Boards and provides a structure that the *Shari’ah*-compliant lenders believe will be enforceable in Saudi Arabia. Therefore, it is critical to work with counsel that regularly interacts with the leading *Shari’ah* Board members and scholars, including members of such counsel who regularly work on *Shari’ah*-compliant products and are fluent in Arabic, to more easily interact with those members of the relevant *Shari’ah* Boards who are not proficient in English.

n. Dispute Resolution

i. Issues in Relation to Governmental or Quasi-Governmental Entity as a Guarantor

In the event that a governmental entity or quasi-governmental entity (e.g., Saudi Aramco, SABIC, etc.) is providing any type of guarantee (e.g., cost overrun or completion guarantees are common even in non-recourse financings), lenders may be concerned that such governmental or quasi-governmental entity may not be in a position to agree to arbitration whether in or outside of Saudi Arabia, as may be contemplated in the event of a dispute under such guarantees. Under Article 3 of the Arbitration Regulations,²⁵⁸ governmental departments may not resort to arbitration to settle their disputes with third parties except after approval of the President of the Council of Ministers, unless this ruling is amended by a resolution from the Council of Ministers. Also, Council of Ministers Resolution No. 58 dated 17/01/1383 H. provides that governmental departments may not agree to a foreign arbitration clause in their contracts. Lenders may request confirmation from such governmental or quasi-governmental entity that it either has obtained the required permission or is not a governmental department and does not require such permission.

Also, as in the case with foreign arbitration, a Saudi governmental department may not agree to a contract that provides for governing law

257. See Hamra-Krouha, *supra* note 243.

258. Royal Decree No. M/46 dated 12/07/1403 (“Arbitration Regulations”).

other than the laws and regulations of Saudi Arabia.²⁵⁹ The standard-form government contract provides for Saudi Arabian governing law and jurisdiction of disputes before the Board of Grievances.

ii. Enforcement of a Foreign Arbitral Award or Judgment Against the Project Company

Offshore lenders will likely be concerned about the ability to enforce a foreign judgment or arbitral award against the concerned project company. In order to enforce a judgment of a court in a foreign jurisdiction in Saudi Arabia, such judgment must be submitted to the Board of Grievances, which would have the discretion to enforce all of such judgment or such part thereof to the extent it is not inconsistent with Saudi Arabia's laws or regulations. In considering a request to enforce a foreign judgment or arbitral award, the Board of Grievances would ordinarily require the party seeking enforcement to demonstrate (i) either that Saudi Arabia and the country in which such foreign judgment was issued are parties to a bilateral or multilateral agreement for the reciprocal enforcement of judgments or, in the absence of such agreement, that such country would recognize and enforce a Saudi Arabian judgment in the same manner as a domestic judgment; (ii) that the Saudi Arabian judgment debtor was accorded due process in the foreign proceeding, including due notice and the opportunity to appear in and defend itself in such proceeding; (iii) that such foreign judgment is final in the country where it was issued; and (iv) that such foreign judgment contains nothing that contravenes the *Shari'ah* or the public policy of Saudi Arabia.

The Board of Grievances may refuse to enforce a foreign judgment if a final judgment has been rendered by a Saudi Arabian court or other adjudicatory authority in proceedings between the same litigants and involving the same subject matter, or if an action was commenced before a Saudi Arabian court or other adjudicatory authority between the same litigants and involving the same subject matter prior to the commencement of the proceeding in the country where the foreign judgment was issued, and the decision of the Saudi Arabian court or other adjudicatory authority is still pending. In the event that such foreign judgment were not enforced in whole or in part under the aforementioned procedures, the judgment creditor could proceed by way of a new proceeding instituted in Saudi Arabia before the appropriate court or other adjudicatory authority and the outcome of such proceeding

²⁵⁹. Art. 3 of Council of Ministers' Resolution No. 58 dated 17/01/1383 H. (approx. 10 June 1963).

would be governed in all respects by Saudi Arabia's laws, regulations, and procedure.

With respect to the enforcement of foreign arbitral awards, Saudi Arabia is a party to the Convention on Recognition and Enforcement of Foreign Arbitral Awards (the New York Convention).²⁶⁰ Saudi Arabia has, however, invoked the reciprocity reservation of the New York Convention, which permits a signatory state to limit its recognition and enforcement of arbitral awards to awards rendered in the territory of another signatory state. In order to enforce in Saudi Arabia an arbitral award obtained in a foreign arbitral proceeding, such award must be submitted to the Board of Grievances. To the best of our knowledge, the Board of Grievances has not yet acted in connection with any request to enforce a foreign arbitral award, whether pursuant to the terms of the New York Convention or otherwise, without relitigating at least a portion of such matters.

While we are not aware of the Board of Grievances enforcing a foreign judgment or arbitral award rendered outside the GCC without relitigation of the matter, we are aware of arbitral awards and judgments being enforced from jurisdictions in the GCC (e.g., Bahrain).

iii. Banking Disputes Committee

Foreign lenders should take comfort in their ability to file a suit before the Banking Disputes Committee in Saudi Arabia. The Banking Disputes Committee has jurisdiction over matters and disputes involving lenders (including foreign lenders) and their customers—that is, “settling” disputes between banks and their customers “in accordance with the agreements concluded between them.” Under the regulations governing the Banking Disputes Committee, all disputes between banks and their customers (other than those involving negotiable instruments) are to be referred in the first instance to the Banking Disputes Committee. Unlike other tribunals in Saudi Arabia, we understand that the Banking Disputes Committee regularly enforces “interest” or profit provisions in financing agreements. Also, we are aware that the Saudi Arabian Monetary Agency has advised certain lenders in Saudi Arabia that decisions from the Banking Disputes Committee should be treated as final decisions that are not subject to appeal.

iv. Step-In Rights/Process for Enforcing the Rights of Lenders

A judicially directed sale of the *marhoun* at the request of the lenders is required in order to foreclose on collateral. If the proceeds of the sale

260. Royal Decree No. M/11 dated 16/07/1414 H.

are less than the debt secured by the *rahn*, the lender would have the right to share with other creditors. We note that the right of lenders to occupy, use, and operate *marhoun* subject to a *rahn* is far from bulletproof, although, in representations of lenders to entities in Saudi Arabia, we have typically used the *wakala*/power-of-attorney structure described above in this note. Accordingly, lenders would normally prefer to sell the *marhoun* and apply the proceeds of the sale to the debt owed. The sale of such *marhoun* is normally conducted as an auction sale. Some lenders prefer to take title to the assets rather than attempt to obtain a *rahn*. Many lenders, however, are reluctant to take title for reasons such as potential liability concerns by being the owners of the *marhoun*.

3. Conclusion

The willingness of lenders to provide *Shari'ah*-compliant financing with longer tenures, pricing that is competitive with conventional banks, and the growing number of lenders and lawyers who understand and are able to utilize a number of different *Shari'ah*-compliant structures has made this type of financing attractive to sponsors of energy projects, particularly in a jurisdiction such as Saudi Arabia.

There are a number of challenges in structuring a non-recourse financing for an energy project in Saudi Arabia, particularly if the project is financed 100 percent on a *Shari'ah*-compliant basis or includes tranches of *Shari'ah*-compliant finance. However, the fact that such projects are being closed and include both local and international lenders indicates that, with appropriate structuring, non-recourse financings on a *Shari'ah*-compliant basis are possible in Saudi Arabia.