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BEATTY & WOZNIAK, P.C.
ENERGY IN THE LAW

We say again—"Seller Beware"…
Another chapter in the case of Pennaco Energy

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Following up the Beatty & Wozniak December 2015 Newsletter article "Seller Beware" (summarizing *Pennaco Energy Inc. v. KD Co. LLC*, 2015 WY 152, hereinafter referred to as "Pennaco I"), a new Wyoming Supreme Court decision is a chilling reminder to sellers of oil and gas properties to be sure that all liabilities in all associated contracts are assigned to the purchaser. *Pennaco Energy, Inc. v. Sorenson*, 2016 WY 34 ("Pennaco II"), decided March 11, 2016, involves similar issues as Pennaco I, with many of the same parties and basic facts. However, the court's new analysis offers more discussion of the contrasting contract provisions that attempt to transfer liability.

As in Pennaco I, the surface agreement in Pennaco II did not contain an exculpatory clause applicable in case of assignment. Thus, the controlling issue was whether the relationship established under the surface agreement between Pennaco and the landowner was primarily contractual, or whether it was based on privity of estate and created a covenant running with the land. If it was primarily contractual, the Court reasoned that the landowner expected the liabilities under the agreement to be fulfilled by the operator with which it had contracted. As in Pennaco I, the court found that the obligations under the surface agreement were not covenants running with the land, therefore the duties of the operator were not assignable without a novation from the landowner.

Background:

Pennaco acquired interests in oil and gas leases underlying Sorenson's ranch, which mineral rights were owned by Sorenson and multiple other parties. Sorenson and Pennaco then entered into a surface damage and use agreement (the "Agreement"), the stated purpose of which was to give the parties a "firm understanding as to what damages will be payable in the event of development of the lands". The rights granted to Pennaco were separate from and in addition to the rights to reasonable use of the surface Pennaco held under the oil and gas leases. Pennaco agreed to make certain annual payments to compensate Sorenson for the use of his land and any damage thereto "until such time as the property is restored and reclaimed."

In 2009, Pennaco notified Sorenson that they were shutting in wells on the Sorenson Ranch, but in 2010 Pennaco *sold* its rights to the oil and gas leases, as well as the surface damage and use agreements. The rights under these agreements were ultimately assigned to High Plains Gas.

After the sale, Pennaco did not pay annual payments or reclaim any of Sorenson's land as required under the Agreement, and Sorenson subsequently filed suit to collect payments due and enforce the reclamation obligations.

Pennaco moved for summary judgment and argued that the exculpatory clause in the oil and gas lease, which read, "If all or any part of this lease is assigned, no leasehold owner shall be liable for any act or omission of any other leasehold owner" was incorporated into the Agreement and Pennaco was no longer liable to the landowner. Pennaco alternatively argued that any obligations in the Agreement were covenants running with the ownership of the leasehold estate, and therefore all obligations passed to the assignee.

The district court denied the motion for summary judgment and concluded that Pennaco retained all legal liability under the Agreement. The jury trial therefore only focused on the amount of damages owed by Pennaco, and the jury found very favorably for the landowner, awarding over $1M in damages. Sorenson was also awarded just under $333,000 in attorneys' fees.

Issues Addressed:

Did the Agreement create covenants running with the land, or did it create only contractual obligations? The court found, as in Pennaco I, that the obligations under the Agreement were contractual, and therefore subject to analysis under contract law. Using the four corners rule, the court found the Agreement required Pennaco to perform certain obligations until operations have ceased and the lands are reclaimed.

The court further found that the exculpatory clause in the oil and gas lease was not incorporated into the Agreement. The Agreement referred to the oil and gas lease, but did not specifically state that the oil and gas lease was incorporated by reference. The court ruled that a simple reference to the lease was not enough. Instead, the court found that drafters of agreements need to use language showing clear intent to incorporate all or part of its terms and conditions. The exculpatory clause in the oil and gas lease was effective to relieve Pennaco of obligations only under the lease itself, and not the Agreement.

The court also rejected Pennaco's argument that surface agreements are categorically different than oil and gas leases and such that the same contract principles do not apply.

Also notable was the court's award of attorneys' fees. The landowner in Pennaco II retained his attorney under a contingent fee arrangement. While the total fees determined at the attorney's hourly rate would have been just under $125,000, the court in Pennaco II affirmed the lower court's finding that a 2.5 times multiplier was warranted under the circumstances.

Conclusion:

When selling assets and assigning the associated contracts, each individual contract should be examined for exculpatory clauses as well as assignability. If contracts do not contain an exculpatory clause relieving an assignor of obligations upon assignment, the best option is to obtain a novation from the party under the contract to whom the obligation is owed (in this case, the landowner Sorenson). This ensures that the party can only enforce contract rights against the new owner of the properties.

Additionally, while exculpatory clauses are virtually standard in oil and gas leases, operators should ensure all contracts ancillary to the oil and gas lease contain appropriate exculpatory language or that they characterize the agreements as covenants running with the land.

For more information regarding exculpatory clauses and the *Pennaco* decisions, please contact Betsy Odell or Nicol Kramer.