IN THE CLASSROOM:
Drafting a Better Preferential Right to Purchase Clause
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I. Introduction

When I received Harry Sullivan’s call for articles, I thought IEL members might be interested in what is going on in the classroom regarding the teaching of oil and gas law. I am sharing one of the drafting exercises the students in my Advanced Oil and Gas Law course completed this semester. The Advanced course introduces students to issues associated with assignments, farmouts, operating agreements, purchase and sale agreements, and midstream agreements. It also allows students to develop their legal drafting skills through a number of drafting exercises.

II. The Preferential Right to Purchase Drafting Exercise

In studying the operating agreement, students were introduced to the preferential right to purchase clause found at ARTICLE VIII., § F. of the A.A.P.L. Form 610 – 1989 Model Form Operating Agreement. This exercise was designed to learn many of the problems associated with the clause and how to address them through drafting.

Students were informed that the client wanted to maximize its ownership in any oil and gas properties it may own. One way to do this is with a preferential right to purchase clause that creates opportunities for the client to acquire additional interests in properties covered by an operating agreement.

To test each student’s ability to contractually address complex situations, the clauses they drafted had to include: (1) a preferential right triggered by non-sales transactions in addition to sales transactions; (2) a duration limitation to avoid rule against perpetuities issues; (3) a general perpetuities and restraint on alienation savings clause; and (4) a liquidated damages clause.
As their first step in the drafting process, students prepared a memorandum of law that surveyed commentary and case law on the Model Form clause and on preferential right to purchase clauses in general. This exposed numerous interpretive and administrative issues associated with the clause. First, the events that trigger the clause should be clearly defined. For example, the imprecise “desire to sell” trigger in the Model Form creates problems. What is meant by a “desire” to sell? Contract law is designed around “offer” and “acceptance,” not “desire.” After studying this issue, the class decided to have the triggering event for a sale be a signed contract between the seller and buyer, with the closing subject to the express condition of non-exercise of the preferential right. The existing Model Form also tries to list information to be provided to the party holding the right. By using a signed contract as the triggering event, all the information requirements can be met by providing the right holder with a complete copy of the contract.

By triggering the preferential right through non-sale transactions, students were forced to come up with some sort of valuation mechanism to put a number on the transaction. Other common problems students identified included: (1) dealing with transfers to a mortgagee or other secured party; (2) transfers of stock designed to avoid the preferential right using the “Texas two-step” maneuver; (3) transfers among parties to the operating agreement; (4) creation and transfer of “new” interests, such as an overriding royalty; (5) package sales; and (6) non-cash transactions.

Students also learned about the law of “options.” Once a transfer triggers a party’s preferential right, it becomes an “option” to purchase. After researching the law of options students recognized that a common problem is determining whether a party’s actions were sufficient to exercise the option. The students decided that a simple objective indication that “I am exercising my option,” should be all that is required. At that point in time, they become bound to complete the deal. The more steps built into the process, the more likely someone will argue the option was not exercised.

Because there are often many parties to an operating agreement, the students also had to administer multiple parties with preferential rights. The Model Form states: “if this optional right is exercised, the purchasing parties shall share the purchased interest in the proportions that the interest of each bears to the total interest of all purchasing parties.” I suggested that when addressing this issue, students may want to consider the drafting technique of using an example to illustrate the math involved. An interpretive issue with the Model Form is whether it is possible for a party to elect to only purchase their proportionate Contract Area share. The answer I believe is “no” but the language in the existing clause is not clear. If someone exercises their preferential right, even though they only own a 1% interest in the leases, they must be prepared to purchase the entire interest. Students were asked to clarify, in their clauses, that this would be the result.

III. A Structured Approach to Drafting
Students learn a structured approach to drafting. First, they learn to look at any forms as the last step of the process, never the first. I find that if they begin with a form, it will invariably channel their analysis to end up with a document that looks remarkably similar to the form. Forms should be used as a checklist only after the student has drafted his or her own document. They can be used to see if someone (typically the anonymous creator of the form) has an approach or a clause that needs to be considered. It is impossible, at the beginning of the process, to intelligently evaluate whether a form is proper or complete.

Therefore, the first step is for students to gain knowledge about the task and related issues. They do this by: (1) understanding the client’s goals and what the client needs to accomplish its goals; (2) studying the nature of the transactions required to accomplish client goals; (3) reviewing relevant commentary and case law that impacts the types of documents required to complete the required transactions. The goal is to conduct basic legal analysis and research to learn as much as possible about the transaction and the documents required to accomplish the transaction. I discuss this process in: David E. Pierce, Professional Responsibility and the Transactional Lawyer: The Drafting Context, 57 ROCKY MTN. MIN. L. INST. 19-1 (2011). In this exercise, and other exercises throughout the course, students are learning, applying, and practicing the process I describe in the article. Lawyers should know as much about the relevant facts and law when drafting a document as they would if drafting an appellate brief.

The students were aided by many excellent articles, written by practitioners, noting problems associated with preferential rights to purchase. Students also studied the major cases. For example, they learned about the Texas two-step corporate transfer maneuver upheld in Tenneco Inc. v. Enterprise Products Co., 925 S.W.2d 640 (Tex. 1996). Beyond the specifics of the preferential right to purchase clause, they revisited old favorites, such as the rule against perpetuities and the level of drafting precision required to create a defensible liquidated damages clause -- as demonstrated most recently by FPL Energy, LLC v. TXU Portfolio Management Co., 426 S.W.3d 59 (Tex. 2014).

Once the students had assembled all this knowledge, the next task was to put it into action with words on paper. The assignment required students to prepare a replacement for ARTICLE VIII., § F., of the 1989 Model Form Operating Agreement. This required that they ensure the structure and terminology of the clause meshed with that of the Model Form.

IV. The New, Improved Preferential Right to Purchase Clause

Applying the parameters established for this exercise, below is a sample of the sort of provisions students drafted. Although no student work incorporated all these elements, the clause combines the students’ collective wisdom. We offer it for your consideration and use, realizing that it is highly unlikely that all these terms would survive the negotiation process. However, the students, through their research and understanding of the common problems associated with such a clause, would be able to
engage in a principled discussion of why each provision was selected. That is one of the ultimate goals of the drafting process, whether drafting the document yourself, or reviewing one provided by the other party’s counsel: understand the function, purpose, and effect of every word, sentence, paragraph, and section of a document – and the document itself.

A.A.P.L. FORM 610 – 1989 MODEL FORM OPERATING AGREEMENT, at page 15, delete lines 33 to 45 and replace it with the following under the heading: “F. Preferential Right to Purchase:”

F. Preferential Right to Purchase:

The parties shall each have a preferential right to purchase any interest in the Contract Area that a party seeks to transfer.

1. Interests Covered by the Preferential Right.

This preferential right to purchase applies to a transfer of an interest in the Operating Agreement or an interest in the Contract Area, to include any interest created out of a covered interest, including, for example, an overriding royalty.

2. Transfers Burdened by the Preferential Right.

a. Transfer by Sale. If a party seeks to transfer any interest by sale, the contract to sell will contain language similar to the following:

“The property being sold is burdened by a preferential right to purchase created by an Operating Agreement. The Seller’s obligation to sell under this sales agreement is conditional upon this contract being first presented to the other parties to the Operating Agreement and the non-exercise of all preferential rights to purchase. If any party to the Operating Agreement elects to exercise its preferential right to purchase, Seller and Buyer will be relieved of all obligations under this sales agreement and any advance payment as earnest money will be returned to the party making the payment.”

b. Non-Sale Transfers. If a party’s interest is transferred by gift, inheritance, involuntary transfer, or any other transfer without consideration, the transfer will be subject to this preferential right to purchase.

c. Transfer as Security. No preferential right to purchase will be triggered by the creation of a mortgage or other secured position in a party’s interest in the Contract Area. However, any secured position that is granted will be subject to a preferential right to purchase the burdened interest in the event the secured party seeks to foreclose or otherwise apply the party’s interest in the Contract Area to fulfill a secured obligation. Once the secured party initiates action against the party’s interest as collateral for its
debt, the interest will be valued following the procedures in § 3.b. of this clause, with the creditor tendering a good faith estimate of the current market value of the interest, and the party with the option electing whether to accept the tendered number or pursue the appraisal process. The accrual and exercise of option rights will be governed by § 3 of this clause. If a party elects to exercise its option, the debtor party, and the secured party, will convey all their rights in the interest to the electing party free of all liens and encumbrances and, following the conveyance, the debtor party and the secured party will look solely to the purchase price proceeds as collateral. Any party exercising its option to purchase will pay their portion of the purchase price to the secured party. The secured party will be responsible for determining any amount due the debtor party.

d. **Transfer of Stock.** A transfer of stock or other evidence of ownership or control in an entity will be considered a transfer when the primary asset owned by the entity is a Party’s interest in the Contract Area.

e. **Artifice Transfers.** The parties will act in good faith and avoid employing any artifice, such as strategic stock and asset transfers or a credit or security arrangement, designed to negate, impair, or make it more difficult to administer, the preferential rights created by this § F. When an issue arises concerning the application or scope of a party’s right of first refusal, the presumption will be in favor of protecting the efficacy of the party’s right.

f. **Transfer to Another Party to the Operating Agreement.** A transfer under § F. includes a transfer from any party to the Operating Agreement to any other party to the Operating Agreement.

3. **Administration of the Right Once Triggered.**

a. **Transfer by Sale.** When a party enters into a signed contract to sell its interest in the Contract Area, it will immediately provide all other parties with a complete copy of the contract using the mailing, fax, or e-mail address listed at Exhibit A to this Operating Agreement. Upon receiving a complete copy of the contract, the party will have an option to purchase beginning as of 12:01 a.m. local Houston, Texas time on the day following the day the contract was received.

b. **Transfers Without a Contract to Sell.** When a party transfers ownership or control over its interest in the Contract Area by any means other than a sale of the interest, it will immediately provide all other parties with a description of the transfer and the party’s good faith estimate of the current market value of the interest being transferred. This information will be provided to the other parties using the mailing, fax, or e-mail address listed at Exhibit A to this Operating Agreement. Any party may choose to accept the estimate and if so, the party will have an option to purchase beginning as of 12:01 a.m. local Houston, Texas time on the day following the day the estimate was received. Any party may refuse to accept the estimate and, within the time allowed to exercise its option, request a neutral appraisal of the interest. The affected parties will attempt to agree upon the selection of an appraiser. If they are unable to agree, they will
seek the assistance of a judge having jurisdiction to select the appraiser. Upon delivery of the purchase value by the selected appraiser, the affected party will have an option to purchase, at the appraised value, beginning as of 12:01 a.m. local Houston, Texas time on the day following the day the appraisal establishing the purchase value was received by the party.

In the event any party elects to purchase based upon the transferring party’s good faith estimate, the purchasing party’s interests under § 3.d. will be valued using the estimate number. Any party that elects to purchase following an appraisal will acquire its interests under § 3.d. using the appraisal number.

Any transfer will be made without warranty but with the benefit of any after-acquired title the transferor may obtain in the transferred interest.

c. **Exercise of the Option to Purchase.** Once an option to purchase is created by a transfer, the option must be exercised on or before 5:00 p.m. local Houston, Texas time on the tenth calendar day following the day on which the option was created. The option can be exercised by notifying the transferring party using the mailing, fax, or e-mail address listed at Exhibit A to this Operating Agreement. Notice will be effective upon placing it with the U.S. Mail or a commercial delivery service such as Federal Express, or upon sending notice by fax or e-mail, so long as the act occurs prior to the end of the option period. The notice exercising the option need not be in any particular form so long as it conveys the message the party is electing to exercise its option to purchase.

d. **Exercise of the Option by More Than One Party.** If only one party elects to exercise its option to purchase under this preferential right, it will be obligated to purchase the entire interest being transferred. If more than one party elects to exercise its option to purchase, then each electing party will be obligated to purchase its proportionate share of the interest as determined by considering its proportionate interest in the Contract Area compared to the proportionate interest of all parties who elect to purchase. For example, if Party A, owning a 10% interest in the Contract Area, and Party B, owning a 25% interest, are the only parties electing to exercise their preferential rights to purchase, A will be obligated to purchase 10/35ths of the interest and B 25/35ths. The party seeking to transfer its interest that triggers the preferential right has no preferential right to purchase the interest.

4. **No Package Sales.** No party will combine for sale its interest in the Contract Area with any other property.

5. **Cash Sales Only.** Any transfer by sale will be for cash only.

6. **Rule Against Perpetuities and Restraints on Alienation.**

   a. **Duration Limit.** Unless terminated sooner by the terms of this Operating Agreement, the preferential right created by this clause will terminate 20 years following
the last to die of all past and present (as of the date of this Operating Agreement) Presidents of the United States of America who are alive on the date this Operating Agreement takes effect.

b. **Duration Savings Clause.** If any provision of this § F. is found to violate the rule against perpetuities or the rule against unreasonable restraints on alienation, the parties intend that a court reform the offending provision to avoid the violation while providing for the maximum lawful duration.

7. **Liquidated Damages, Injunctive Relief, Attorney Fees.**

a. **Liquidated Damages.** The parties recognize it is highly speculative and difficult to determine what the damages would be if a party failed to honor its obligations under this § F. The potential value of the interests involved is unknown, the value of a lost opportunity to acquire an interest at some time in the indefinite future is unknown. The value of a larger consolidated interest through the exercise of a preferential right to purchase is unknown. The value of any interest, and a lost opportunity to acquire the interest, will be impacted by future development, unknown geological factors, future oil prices, future gas prices, and a host of business factors that cannot be predicted with any degree of accuracy.

Recognizing the inherent uncertainty associated with determining damages, and desiring to avoid the costs associated with determining damages through litigation, the parties agree that if a transferring party violates this § F., and its interest is transferred to a third party, the parties entitled to a preferential right to purchase will be entitled to liquidated damages equal to the fair market value of the transferred interest, at the time of transfer.

If there are more than one party entitled to a preferential right to purchase, they will share in the liquidated damages in proportion to their interest in the Contract Area as though all parties exercised their preferential right to purchase under § 3.d. of this clause. The parties believe this is the best way to estimate damages in the event of a breach that results in the interest being transferred to a third party without providing the other parties with the opportunity to exercise their rights as stated in this § F. The parties further believe this approach comports with principles of compensation as a reasonable forecast of just compensation for the harm caused by a breach the parties agree is incapable or difficult of estimation.

b. **Injunctive Relief.** If a party’s rights under this § F. are violated, the party may elect, when they deem it feasible and appropriate, to seek injunctive relief to prevent or undo a transfer that has taken place.

c. **Attorney Fees.** If a party pursues court action to recover damages or obtain injunctive relief, and the other party is found to have violated the terms of this § F., the party will be entitled, in addition to any other remedy, to its reasonable attorney fees incurred to enforce its rights.
8. **Continuing Obligation.** The preferential right to purchase created by this § F. is a continuing obligation that arises every time an interest is transferred.