



Is A Gas Purchase Agreement Subject to UCC Section 2-306?

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Synopsis

Table listing sections 18.01 through 18.06 with corresponding page numbers: Introduction (557), The Lenape Decisions (558), The First Opinion Concludes that the Contract Is an Output Contract Subject to Strict Quantity Restrictions Under UCC 2-306 (560), Why the First Opinion Is in Error (567), Why the Second Opinion Is Right (571), Conclusion (578).

§ 18.01. Introduction.

In Lenape Resources Corp. v. Tennessee Gas Pipeline Co., a case of first impression in which more than 50 amicus briefs and letters were filed, the Supreme Court of Texas considered whether a gas purchase contract which required the Buyer to take or pay for 85 percent of Seller’s delivery capacity was an output contract, and whether delivery under that contract was subject to the proportionality restrictions imposed by Uniform Commercial Code (UCC) Section 2-306. In its first unreleased opinion (the “First Opinion”)<sup>1</sup> the court found the contract to be an output contract subject to UCC 2-306. In its second as yet unreleased opinion (the “Second Opinion”),<sup>2</sup> the court reversed itself and held, five to four, that the contract

1 Lenape Resources Corp. v. Tennessee Gas Pipeline Co., 38 Tex. S. Ct. J. 1124 (1995); 1995 WL 453266. Readers can request a copy of the “First Opinion” from the author, as it is no longer available on WESTLAW.

2 1996 WL 185352, 39 Tex. S. Ct. J. 496, 925 S.W.2d 565 (Tex. 1996)(reh’g denied 1996).

was neither an output contract nor subject to the delivery restrictions in UCC 2-306.

This chapter surveys the important *Lenape* decisions. Then it explains why the court's flirtation with applying UCC 2-306 to take-or-pay gas contracts was ill conceived. Next, it discusses the correct result reached in the court's second decision. Finally, it explores the effect of applying UCC Section 2-306 in the gas industry in the Appalachian Basin.

### § 18.02. The *Lenape* Decisions.

In 1979, when gas supplies were scarce and prices regulated, predecessors to Lenape Resources Company (Sellers)<sup>3</sup> entered into a 20 year gas purchase contract<sup>4</sup> with Tennessee Gas Pipeline Company (Buyer), committing for sale to Buyer all gas produced from certain described reserves in Zapata County, Texas. In addition to a clause requiring the Buyer to take or pay for 85 percent of Seller's delivery capacity,<sup>5</sup> the contract also contained an escalating price clause for deregulated gas.

At the time of contract formation, a time when the Buyer needed all the gas it could purchase and prices were predicted to rise, one well was producing on the dedicated acreage.<sup>6</sup> Shortly after the execution of the

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<sup>3</sup> 925 S.W.2d at 567. The Sellers under the contract at the time of the litigation included producers in addition to *Lenape*, presumably as a result of a farmout and subsequent assignment.

<sup>4</sup> The contract is often referred to as the "GPA."

<sup>5</sup> Relevant portions of the contract as they appear in the second opinion at 925 S.W.2d at 565, at page 569 follow:

3. Quantity:

(a) Seller agrees to sell and deliver to Buyer, and Buyer agrees to purchase and receive, or pay for if available and not taken, Seller's pro rata part of the following quantities of gas produced from the committed reserves:

(ii) A quantity of gas well gas equal to eighty-five percent (85%) of Seller's delivery capacity. Delivery capacity is defined in section 1(f) of the GPA as: Seller's pro rata part of the average amount of gas well gas per day which can be efficiently withdrawn from the wells on the lease(s) in the course of a delivery capacity test conducted as provided in section 3(f) hereof under applicable rules and regulations and in accordance with prudent operating practices, the production from which is covered by this Agreement and which is available for delivery . . . .

<sup>6</sup> *Id.* at 567.