BEVERIDGE & DIAMOND PC

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MEMORANDUM

FROM: Beveridge & Diamond, P.C.
Peter J. Schaumberg

RE: Analysis of H.R. 6

On January 18, 2007, the House of Representatives passed H.R. 6. We were asked to review Title II of that bill, entitled the "Royalty Relief for American Consumers Act of 2007," to identify and evaluate potential legal issues that would be presented if Congress were to enact H.R. 6 into law. Because this bill raises so many significant and complex legal issues, for convenience we are including herein a brief summary of the problems H.R. 6 raises and a synopsis of our legal conclusions. Attachment A is our complete legal review of the issues that would be presented if H.R. 6 were enacted.

Background

In 1995, Congress passed the Outer Continental Shelf Deep Water Royalty Relief Act ("DWRRA"). Section 302 of the DWRRA amended the Outer Continental Shelf Lands Act ("OCSLA") to provide royalty relief authority for deep water leases issued before the date of enactment. Section 302 includes a so-called "price threshold." If average market prices in a calendar year exceed a prescribed level ($34.92 per barrel of oil and $4.36 per million Btu of natural gas in 2005), the qualifying lease loses its royalty relief and must pay royalty on production that calendar year. This price threshold only applies to royalty relief for Pre-Act leases under Section 302.

A different provision of the DWRRA, Section 304, required the Minerals Management Service ("MMS") to provide royalty relief for new leases in certain deep water areas of the Gulf of Mexico issued in lease sales from 1996-2000. For these leases, Congress required MMS to grant royalty suspension volumes of 17.5 million barrels of oil equivalent for leases in 200-400 meters of water, 52.5 million barrels in 400-800 meters of water, and 87.5 million barrels in water depths greater than 800 meters. Importantly, Section 304 of the DWRRA does not include a price threshold provision. MMS also did not include a price threshold provision in the regulations implementing Section 304. MMS did, however, include a price threshold (equivalent in its terms to the Section 302 price threshold) as an addendum to the leases issued in 1996, 1997, and 2000. However, MMS did not include any price threshold provisions in the 1998/1999 leases. Therefore, under the applicable statutes, regulations and lease terms, the 1998/1999 lessees only begin to pay royalties on oil and gas production from their leases once the applicable royalty suspension volume is exhausted. At this time, only about 20 of the 1032 originally-issued 1998/1999 leases are producing.

Some of the 1998/1999 lessees voluntarily agreed to amend their leases to include a price threshold provision. Title II of H.R. 6 would compel the remaining lessees to relinquish their existing benefit of royalty-free suspension volumes by imposing the substantial penalty of precluding them from ever acquiring another OCS lease. Under Section 204(a) of H.R. 6, MMS may not allow a 1998/1999 lessee to participate in a new Gulf of Mexico OCS lease sale unless the lessee agrees to amend all of its 1998/1999 leases to include a price threshold, <u>or</u> the lessee agrees to pay a "conservation of resources" fee ($9 per barrel or $1.25 per mmBtu of gas, adjusted for inflation) for all of its 1998/1999 leases in any calendar year when average market prices are above the price threshold. In any event, the "conservation of resources" fee is mandatory for production from any lease without a price threshold. Section 204(c) would apply the same bar to acquiring any existing OCS Gulf of Mexico lease. Co-lessees may decide separately to agree to a price threshold and avoid the bar on leasing, but similar authority is not included for separately agreeing to pay the fee.

In addition, Section 204 of H.R. 6 requires a second "conservation of resources" fee. The annual fee of $3.75 per acre, adjusted for inflation, would be assessed on all non-producing OCS leases in the Gulf of Mexico, not just the 1998/1999 leases. This fee would be in addition to the per acre annual rental a lessee of a non-producing lease must pay under the terms of its lease to keep its lease in effect during the primary term.

Legal Issues Presented by H.R.6

If H.R. 6 becomes law, the 1998/1999 lessees could seek judicial review of Congress' authority to impose these new requirements. Retroactive application of H.R. 6's requirements would raise numerous complex issues including, but not limited to, breach of contract, unlawful takings, bill of attainder, and denial of equal protection and due process under the Fifth Amendment to the U.S. Constitution. It is also possible that prospective lessees would seek an injunction against holding lease sales during the pendency of such litigation. Using the traditional equitable principle of irreparable harm, a court would likely grant the injunction because it would be highly prejudicial to bar dozens of prospective lessees from new lease sales while they litigate the lawfulness of the H.R. 6 leasing ban. Further, as Assistant Secretary of the Interior Allred recently explained to Congress, a three year delay in lease sales could significantly reduce production over ten years by 1.6 billion barrels of oil equivalent and cost the U.S. Treasury $13 billion in bonus and royalty revenues.

Because of the above-described effects, H.R. 6 squarely presents many serious legal issues, including:

Breach of contract -- Recent court decisions clearly establish that new lease obligations imposed by legislation enacted after the lease is issued and not expressly contemplated therein constitutes a material breach of contract. The obligations Section 204 would impose on the 1998/1999 lessees suffer from the same legal deficiency. As a result of this repudiation of the 1998/1999 leases, the lessees would be entitled to restitution or other damages. Since the effect of the $3.75 "conservation of resources" fee applicable to all non-producing Gulf of Mexico OCS leases is simply to increase the annual lease rental in contravention of OCSLA and the lease terms, the same breach of contract analysis would find that fee to be unlawful;

Unlawful taking -- The DWRRA royalty suspension volumes effectively convey to the lessee the royalty interest usually held by the lessor, but only until the royalty suspension volumes are exhausted. By requiring the 1998/1999 lessees either to accept a price threshold or agree to pay the fee, H.R. 6 results in a taking of this entire property interest from the lessee without just compensation in violation of the Fifth Amendment to the U.S. Constitution;

Equal protection -- Requiring only the class of 1998/1999 lessees to pay additional royalties/fees or be deprived of participation in OCS lease sales, when there is no legitimate government interest furthered by such restriction other than forcing these lessees to shoulder an additional financial burden not currently required under their lawful leases, amounts to discrimination and a denial of equal protection under the Fifth Amendment;

Bill of attainder -- Singling out and punishing a select, "easily ascertainable" number of lessees who have committed no offense and caused no harm raises concerns that H.R. 6 may qualify as a bill of attainder in violation of the Constitution; and

Due process concerns -- Laws like H.R. 6 with retroactive effect are disfavored, and in this situation amount to a violation of the lessees' due process rights under the Fifth Amendment.

The attached memorandum provides a complete and detailed analysis of the DWRRA, the provisions of Title II of H.R. 6 as passed by the House, and the full range of potential legal challenges presented by H.R. 6.

ATTACHMENT A: SIGNIFICANT LEGAL ISSUES PRESENTED BY H.R. 6

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I. SUMMARY

On January 18, 2007, the House of Representatives passed H.R. 6. Title II of that bill, which would be entitled the "Royalty Relief for American Consumers Act of 2007," addresses royalty and other revenue issues related to federal Outer Continental Shelf ("OCS") oil & gas leases.

During the period between 1996 and 2000, the Minerals Management Service ("MMS," the agency within the U.S. Department of the Interior ("DOI") responsible for oil & gas leasing on the OCS) issued oil & gas leases in deep water portions of the Gulf of Mexico with a congressionally-mandated provision that provides royalty relief for prescribed volumes of oil and gas production as a financial incentive to encourage expensive deep water production. Under the Outer Continental Shelf Deep Water Royalty Relief Act, Pub. L. No. 104-58 ("DWRRA"), Congress granted lessees between 17.5 and 87.5 million barrels of oil equivalent free of royalty, depending on water depth. Once the so-called "royalty suspension volume" is produced, the lessee thereafter is required to pay royalty on its production.[1]

For DWRRA leases issued during 1996, 1997, and 2000, MMS included a provision that terminates the royalty relief for any volumes of oil and gas produced when market prices exceed a prescribed average dollar amount for a calendar year.[2] MMS was not statutorily-required to

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[1] The royalty rate applicable to deep water OCS leases issued during this period is 12.5 percent of the amount or value of production.

[2] In 2004, the price thresholds were $33.90 for oil and $4.24 for gas. In 2005, the price thresholds were $34.92 for oil and $4.36 for gas.

include this so-called "price threshold" provision in these leases. And, MMS did not include any price threshold provision in leases issued in 1998 and 1999.

Market prices for both oil and gas have exceeded the price threshold since calendar year 2004. Consequently, the 1998/1999 lessees pay no royalty until they exhaust their royalty suspension volumes, unless market prices fall below price thresholds for a calendar year.

When news of the omission of the price thresholds was publicized in 2006, some members of Congress expressed a desire to "fix the problem." Late in 2006, some of the 1998/1999 lessees voluntarily agreed to amend their leases to include a prospective price threshold provision. H.R. 6 is an attempt by the House to compel the remaining lessees to do the same. Under this bill, 1998/1999 lessees would be barred from participating in future OCS lease sales, or acquiring any existing OCS leases, unless they either agree to amend their leases and include a price threshold, or, instead, agree to pay a mandatory "conservation of resources" fee of $9.00 per barrel of oil or $1.25 per million Btu of gas, the equivalent of the royalty that would be due on a barrel of oil with a market price of $72 or natural gas with a market price of $10 per million Btu. H.R. 6 also would impose an additional "conservation of resources" fee of $3.75 per acre for every non-producing lease on the Gulf of Mexico OCS, not just the 1998/1999 leases.

The retroactive application of H.R. 6 to the 1998/1999 leases and non-producing leases potentially gives rise to breach of contract claims, unlawful takings claims, denial of due process and equal protection under the Fifth Amendment to the U.S. Constitution, and the likelihood of preliminary injunctive relief. As discussed below in Section IV, these legal concerns are so significant that if H.R. 6 were approved by the Senate and enacted into law, the courts likely would find the legislation to be unlawful on a number of grounds. More importantly, H.R. 6 bars dozens of existing OCS oil and gas lessees from future lease sales unless they either "renegotiate" to include a price threshold or agree to pay a fee that is the equivalent of a royalty. Because of the substantial legal and financial issues surrounding H.R. 6, if this law were to be enacted, companies could ask a court to enjoin the Gulf of Mexico OCS lease sales they are excluded from until they obtain a final judicial resolution of their claims.

Using the traditional equitable principle of irreparable harm,[3] a court likely would grant the injunction for two main reasons. First, MMS could not "undo" lease sales after the fact and take leases away from the successful bidders if the 1998/1999 lessees' judicial challenge to the H.R. 6 lease sale ban was successful. Second, MMS is about to begin leasing under a new five-year plan. Just over two months ago, Congress enacted the Gulf of Mexico Energy Security Act of 2006, Pub. L. No. 109-432, opening to leasing highly prospective, but previously off limits, areas of the Gulf of Mexico. Section 103 of the new law directs the MMS to lease the so-called 181 Area "as soon as practicable, but not later than 1 year, after the date of enactment of this Act." It also directs the MMS to lease the so-called 181 South Area "as soon as practicable after the date of enactment of this Act." It would be highly prejudicial to bar dozens of prospective lessees from the lease sales for these new areas while they litigate the lawfulness of the H.R. 6 leasing ban. And although this factor would not weigh heavily in a motion for injunctive relief, the ban also might be costly to the Treasury since reduced competition could result in lower bonus bids for the leases.

[3] See *infra* at 38-39.

The resolution of complex litigation challenging H.R. 6, including appeals, easily could take three to four years. The consequences of such an extended delay in holding OCS lease sales would negatively impact the U.S. Treasury in terms of delay in receiving billions of dollars in bonus and royalty revenues and the Nation by further undermining our domestic energy security. See U.S. Dept. of Interior, Allred Asks Congress for Additional Tools to Resolve Royalty Issue on 1998-1999 Leases in Gulf of Mexico, http://www.mms.gov/ooc/press/2007/pressdoi0118.htm (last visited February 28, 2007) (regarding January 18, 2007 testimony of Interior Assistant Secretary Allred before Congress. Assistant Secretary Allred stated that "[i]f an affected company went to court and a judge were to enjoin future lease issuance, the resulting impacts would be significant. A 3-year delay, for example, could reduce production over 10 years by 1.6 billion barrels of oil equivalent and cumulative revenue by $13 billion.").

II. BACKGROUND: STATUTORY BASIS FOR DEEPWATER ROYALTY RELIEF

In 1995, Congress passed the DWRRA. The two most significant provisions of this law, Sections 302 and 304, provide authority for MMS to grant royalty relief for OCS leases. One of the provisions of Section 302, currently codified at 43 U.S.C. § 1337(a)(3)(C), provides opportunities for royalty relief for "new production" from leases in deep water (water depths of 200 meters or greater) in defined areas of the Gulf of Mexico that already were in existence on November 28, 1995, the date of enactment of the DWRRA. MMS regulations at 30 C.F.R. Part 203 provide details on how MMS will implement the royalty relief authority for these "Pre-Act" leases.

Also, Section 302 amends the Outer Continental Shelf Lands Act , 43 U.S.C. §§ 1331-1356a ("OCSLA"), for deep water royalty relief by including a price threshold provision. 43

U.S.C. § 1337(a)(3)(C)(v) and (vi) (for oil and natural gas, respectively). In any calendar year when the average daily market price for the year exceeds the price threshold, $34.92 per barrel for oil and $4.36 per million Btu for gas for calendar year 2005,[4] the royalty relief is suspended for volumes produced in that year. The text of the DWRRA price threshold provisions states expressly that they apply only to royalty suspension volumes for Pre-Act leases under Section 302, 43 U.S.C. § 1337(a)(3)(C). Both price threshold clauses begin as follows: "During the production of volumes determined pursuant to clause (ii) or (iii) of this subparagraph...." These clauses in turn relate only to the leases covered by clause (i) of that subparagraph: "any lease or unit in existence on [November 28, 1995]...", *i.e.*, the Pre-Act leases. The limitations on applicability of this section could not be more plain.

Under Section 302 and the MMS regulations at 30 C.F.R. § 203.78(c), the volumes produced in any year when the price thresholds apply count against the royalty suspension volumes. Thus, for example, all volumes of oil and gas produced in 2005 reduce the royalty suspension volume available for a lease. The royalty suspension volumes under Section 302 are not automatic. The statute provides that upon application of the lessee, the MMS must determine "whether new production from such lease or unit would be economic in the absence of the relief from the requirement to pay royalties...." 43 U.S.C. § 1337(a)(3)(C)(ii). If the MMS cannot make this finding in favor of the lessee, then the lessee receives no relief. Id. If the lessee's deep water lease qualifies for relief, then Section 302 prescribes the minimum amounts of royalty relief that apply.

[4] MMS publishes the price thresholds applicable for each calendar year at http://www.mms.gov.

Section 304 of the DWRRA required MMS to provide royalty suspension volumes for new deep water leases in defined areas of the Gulf of Mexico issued in lease sales for five years after the date of enactment. The volumes that Congress required to be royalty free for lease sales from 1996-2000 were: 17.5 million barrels of oil equivalent for leases in water depths of 200 to 400 meters; 52.5 million barrels of oil equivalent for leases in water depths of 400 to 800 meters; and 87.5 million barrels of oil equivalent for leases deeper than 800 meters.[5]

In contrast to Section 302, royalty relief for new deep water leases under Section 304 is automatic; *i.e.*, there is no application requirement for the lessee to demonstrate economic need as with Section 302. Importantly, Section 304 does not include any statutory price threshold provisions or references to other price threshold provisions in the DWRRA or OCSLA. Further, the MMS did not promulgate regulatory price thresholds when it issued its regulations at 30 C.F.R. Part 260 implementing this authority. See also Royalty Relief for New Leases in Deep Water, 63 Fed. Reg. 2,626 (Final rule Jan. 16, 1998); Deepwater Royalty Relief for New Leases, 61 Fed. Reg. 12,022 (Interim final rule Mar. 25, 1996). For leases issued pursuant to lease sales in 1996 and 1997, MMS included a price threshold provision as an addendum to the lease, thereby making the price threshold a term of the lease. The lease provision is functionally identical in its terms to the price threshold provision applicable to Pre-Act leases under Section 302. However, for lease sales held in 1998 and 1999, MMS did not include the price threshold

[5] Section 304 may be found in the Pocket Part of Title 43 of the U.S. Code Annotated in the "Historical and Statutory Notes" section.

addendum in the leases.[6] The addendum was included again for leases issued in the 2000 lease sales.

Therefore, under the applicable statutory authority, regulations, and lease terms, the 1998/1999 lessees currently are entitled to produce the full royalty suspension volume applicable to their leases under DWRRA Section 304, ranging from 17.5 to 87.5 million barrels of oil equivalent, without any requirement to pay a royalty on that production. MMS issued 1032 deep water leases in 1998 and 1999, 526 of which are actively engaged in exploration or development. Only about 20 of these leases currently are producing.[7]

In late 2006, six companies with 1998/1999 leases agreed to amend their leases to include a price threshold term. U.S. Dept. of Interior, DOI Signs Agreement with Oil and Gas Companies on 1998/1999 Leases, http://www.gomr.mms.gov/homepg/whatsnew/newsreal/2006/061214.pdf (last visited February 28, 2007). The leases that are subject to these agreements comprise only a portion of the 1998/1999 leases.

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[6] The reasons for the absence of price thresholds in the 1998/1999 leases are beyond the scope of this analysis. For a review of that issue, see Investigative Report On the Lack of Price Thresholds in Gulf of Mexico Oil and Gas Leases, *available at* http://www.doioig.gov/upload/MMS%20ROI%20REDACTED.txt (issued by the Inspector General of DOI in January 2007) (last visited February 28, 2007).

[7] Marc Humphries, *Royalty Relief for U.S. Deepwater Oil and Gas Leases*, 2 Congressional Research Service Report 6 (2007).

III. OVERVIEW OF TITLE II OF H.R. 6

On January 18, 2007, the House of Representatives passed H.R. 6, which would impose significant new burdens on Gulf of Mexico lessees, particularly those who hold DWRRA leases issued in 1998 and 1999 that currently are not subject to price thresholds. Before addressing the legal issues raised by H.R. 6, we review Section 204 of that bill which creates the aforementioned burdens.

A. Section 204(a) Bars Lessees That Have Not Amended Their 1998 and 1999 Leases or Agreed to Pay the Conservation of Resources Fee From Participating in New Lease Sales

Paragraph (a) of this section effectively would coerce lessees of 1998/1999 leases to relinquish their existing benefit of royalty-free suspension volumes by precluding their ability ever to participate in future lease sales. Under this paragraph, MMS may not issue a new Gulf of Mexico OCS lease to any person, defined in subparagraph (a)(2) as a lessee of a 1998/1999 lease[8] or anyone who has any "direct or indirect interest in, or who derives a benefit from" any such lease,[9] **unless**:

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[8] While subparagraph (a)(2) refers to a "lessee that holds a covered lease," for all practical purposes, as discussed below, this describes only the 1998/1999 lessees. This includes current lessees of 1998/1999 leases at the time of a post-enactment OCS Gulf of Mexico lease sale as well as a person who holds a 1998/1999 lease on the date of enactment of H.R. 6 and later transfers it. Therefore, if H.R. 6 hypothetically is enacted on June 1, 2007, and if you had a 1998/1999 lease that you transferred with production on or after October 1, 2006 (the date the conservation of resources fees are effective under Section 204(b)), you would be barred from future lease sales unless you (or your transferee) paid the conservation of resources fees due from October 1 to the date of transfer.

[9] Application of the new lease ban/fee payment obligation to persons other than the lessee is particularly harsh. For example, if you are an overriding interest holder on 1998/1999 Lease A, that interest alone is sufficient to bring you within the description of "person" in Section 204(a)(2). Although Section 204(a) is not particularly clear, it would appear that even if you come within the definition of "person," you only would be barred from leasing if you are a

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-- the person "renegotiates"[10] all of its 1998/1999 leases to include a price threshold that is equal to or less than the price threshold in Section 302 of the DWRRA, 43 U.S.C. § 1337(a)(3)(C);[11] **or**

-- the person pays, or enters into an agreement to pay,[12] the conservation of resources fee established under Section 204(b) for all of its 1998/1999 lease production in any year when the average market price for oil exceeds $34.73 per barrel or the average market price for gas exceeds $4.34 per million Btu, adjusted for inflation.[13] That fee is $9.00 per barrel of oil produced or $1.25 per million Btu of natural gas, adjusted for inflation.

Importantly, a person is barred from future Gulf of Mexico lease sales unless they accept the price threshold or agree to pay the fee for all of the 1998/1999 leases for which they are lessee of record, including non-producing leases. Further, under Section 204(a)(3), if there are

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(Continued …)
lessee of 1998/1999 leases and you fail to either "renegotiate" or agree to pay the fee on all of those leases.

[10] Use of the term "renegotiate" in H.R. 6 is a misnomer. Following an OCS lease sale, the successful bidder is presented with a standard form lease with MMS-drafted addenda. The lessee has no opportunity to modify the terms that are presented. Thus, the leases effectively never were "negotiated" in the first instance, and therefore, H.R. 6 simply compels an amendment of the lease.

[11] This is the price threshold that is applicable to leases issued before November 28, 1995.

[12] Under section 204(a)(1)(B)(ii), if a lessee holds a non-producing 1998/1999 lease, and therefore, no conservation of resource fee yet is due to be paid under subparagraph (i), the lessee would be barred from participating in new lease sales unless the lessee first enters into an agreement with MMS to pay the fees once production commences.

[13] Effectively, the same price thresholds are contained in the lease addenda to the 1996, 1997, and 2000 leases.

multiple lessees, each lessee may enter into a separate agreement with the MMS for its proportionate share of the lease interest. Thus, if Lessee X agrees to "renegotiate" for its 20 percent interest, it would not be subject to the new leasing bar even if the 80 percent owner, Lessee Y, were unwilling to agree. Subparagraph (a)(3) does not allow the same option to agree to pay the conservation of resources fee by each co-lessee.

B. Section 204(b) Imposes Conservation of Resources Fees for Producing DWRRA Leases Not Subject to Price Thresholds and Non-Producing Leases

Section 204(b) establishes two conservation of resources fees. The Secretary of the Interior is required to issue a rule within 60 days of the enactment of H.R. 6 establishing a conservation of resources fee for producing federal oil & gas leases in the Gulf of Mexico (subparagraph (b)(1)(A)) and a separate fee for non-producing federal Gulf of Mexico leases (subparagraph (b)(1)(B)).

Subparagraph (b)(2) provides that the fee "shall apply" to any producing, "covered leases," which, as explained below, essentially are the 1998/1999 leases. The fee is statutorily set at \$9.00 per barrel of oil and \$1.25 per million Btu of natural gas, adjusted for inflation, and is retroactive to October 1, 2006. This fee is mandatory, but does not apply to any lease that is subject to a price threshold provision because it would not be a "covered lease." Thus, if a lessee of a 1998/1999 lease agrees to "renegotiate" its lease to include a price threshold, that lessee's proportionate share of lease production would not be subject to the fee. Also, the fee would not be applicable to production in any calendar year when average market prices are below the price thresholds, which are set at \$34.73 and \$4.34 for oil and gas, respectively, in 2005 dollars. These price thresholds are almost the same as the DWRRA Section 302 price thresholds.

As discussed above, the congressionally-prescribed royalty suspension volumes in Section 304 of the DWRRA are 17.5 million to 87.5 million barrels of oil equivalent, depending upon water depths. Using the prescribed royalty suspension volumes for the different water depths and the $9.00 fee (before any inflation adjustment), if market prices remain above the price threshold the 1998/1999 lessees would be required to pay conservation of resources fees totaling either $157.5 million, $472.5 million, or $787.5 million <u>for each lease</u>![14]

Subparagraph (b)(3) sets the non-producing lease conservation of resources fee at $3.75 per acre per year, adjusted for inflation.[15] This fee too is retroactive to October 1, 2006. OCS leases generally range from 2500 to 5,760 acres,[16] so the annual cost to lessees of this provision would be between $9,375 and $21,600 per lease.

C. Section 204(c) Bars Lessees From Obtaining Any Existing OCS Leases if Their DWRRA Leases are Not Subject to Price Thresholds or if the Lessees Have Not Agreed to Pay the Conservation of Resources Fee

We explained above that Section 204(a) would bar a lessee of a 1998/1999 lease from participating in lease sales for new Gulf of Mexico OCS leases unless the lessee either "renegotiated" its lease to include a price threshold or agreed to pay the conservation of resources fee on its production. Although the wording is difficult to follow, Section 204(c)

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[14] While the amount of royalties each 1998/1999 lessee would have to pay if it agreed to "renegotiate" each of its leases to include a price threshold would vary depending on the market price of oil and gas, the order of magnitude would be about 20 percent less than these totals if the average market price were $58.00 per barrel until the royalty suspension volume is exhausted.

[15] Because the leases are not producing oil and gas, royalty is not an issue. Non-producing leases are subject to payment of an annual per acre rental prescribed in the lease which lessees must pay to hold the lease.

[16] *See* Humphries *supra* at 7, n.7.

appears to prohibit a lessee of a 1998/1999 lease from obtaining "any other lease for the production of oil or natural gas in the Gulf of Mexico...," unless the lessee "renegotiates" its lease to include a price threshold or agrees to pay the conservation of resources fee for its production. Thus, this subsection together with Section 204(a) has the following effect: if a lessee of a 1998/1999 lease is unwilling either to amend <u>all</u> of its 1998/1999 leases to include a price threshold or to pay the conservation of resources fee for <u>all</u> of its 1998/1999 leases, it never can acquire another interest in a new <u>or</u> existing Gulf of Mexico lease. We even read the language of section 204(c) as prohibiting the lessee from merging with, or acquiring, another company that holds Gulf of Mexico lease interests, since the subsection prohibits obtaining by "sale *or other transfer*" the economic benefit of any other lease. Therefore, this provision would have the secondary impact of influencing otherwise reasonable business transactions.

D. Under Section 204(d) a "Covered Lease" is a DWRRA Lease Issued in 1998 or 1999

This subsection contains definitions. The term "covered lease" is defined as a lease issued under Section 304 of the DWRRA, and therefore, subject to the congressionally-mandated royalty suspension volumes ranging from 17.5 to 87.5 million barrels of oil equivalent per lease, which does not have a price threshold equal to or less than the price thresholds described in 43 U.S.C. § 1337 (a)(3)(C) (applicable to DWRRA Section 302 Pre-Act leases). This description includes all of the 1998/1999 Section 304 leases that we have been referring to in this memorandum, and currently includes no other leases.

IV. SIGNIFICANT LEGAL ISSUES PRESENTED BY H.R. 6[17]

A. Background

In Section II of this memorandum we explain that currently there is no statute, regulation, or lease term that imposes a price threshold on the DWRRA-prescribed royalty suspension volumes for the 1998/1999 leases. Thus, these lessees only begin to pay royalty once the full royalty suspension volume is produced. Section III of this memorandum explains that the principal purpose of Section 204 of H.R. 6 is to address the lack of price thresholds in the 1998/1999 leases and to compel the 1998/1999 lessees to accept price threshold provisions or agree to pay a fee on production or be barred from obtaining any new OCS leases.

In our view, Congress' approach in H.R. 6 is subject to the same legal infirmities as a direct imposition of price thresholds or a fee. First, under the terms of H.R. 6 as currently written, there effectively is no choice for the lessees because the conservation of resources fee on producing leases is <u>mandatory</u> for 1998/1999 leases without price thresholds. As explained above, Section 204(b)(1)(A) directs the Secretary of the Interior, by rule, to establish a conservation of resources fee for producing leases in the Gulf of Mexico. Section 204(b)(2) then provides as follows:

> (2) PRODUCING LEASE FEE TERMS--The fee
>
> under paragraph (1)(A)--

[17] Our references to H.R. 6 are meant to be to whatever version of this bill eventually may be enacted following Senate consideration. Obviously, until such time H.R. 6 has no legal effect.

> (A) subject to subparagraph (C) [a price threshold], shall apply to covered leases that are producing leases; (emphasis added).

Section 204(b)(2)(A). The next subparagraph then fixes the fee at $9/barrel and $1.25/mmBtu. Since the 1998/1999 leases are covered leases (except for any lessees who agree to "renegotiate"--they are not subject to the fee), there is no question that Section 204 requires payment of the fee when these leases begin producing (unless prices fall below the price threshold). Therefore, producing lessees would be subject to the fee immediately. Moreover, it really is not a meaningful choice for a 1998/1999 lessee to elect not to agree to pay the fee now for its non-producing leases, and immediately be barred from receiving any new leases, when the lessee likely will have to pay the fee anyway once production begins.[18]

Second, the "choice" that Section 204 purportedly provides is illusory. If your options are either to "renegotiate"/agree to pay the fee or accept the gradual, but inevitable, demise of your OCS development and production livelihood, that is no choice at all.

Even the floor debate in the House of Representatives over H.R. 6 reflects an understanding that the 1998/1999 lessees effectively are given no choice but to "renegotiate" or pay the fee. Congressman Rahall plainly stated that: "The bill would establish thresholds in the 1998-1999 leases for royalty relief." 153 CONG. REC. H699 (daily ed. Jan. 18, 2007). Congressman Goodlatte remarked that "[w]e are persecuting an industry and the people employed in that industry domestically." Id. at H709. Congressman Conaway perhaps stated it

[18] As noted above, only about 20 of the 1998/1999 leases are currently producing. Therefore, the lessees of the remaining leases would be required to "renegotiate" or agree to pay the fee before those leases go into production or they would be barred from the next lease sale (and any assignments of any OCS lease) immediately following the date of enactment.

most succinctly in a remark after H.R. 6 was approved: "This is only happening because this law is, in effect, a gun held at the head of these lease owners to come in and renegotiate." Id. at H748. Under similar circumstances, courts long have recognized that one who is faced with a "Hobson's choice" really has no choice at all. United States v. Bethlehem Steel, 315 U.S. 298, 331 (1942) ("They had no choice in view of the circumstances which subordinated them and by which they were governed....").

We will now examine the various legal issues that H.R. 6 raises since it effectively imposes price thresholds on the 1998/1999 leases. These include breach of contract, a taking in violation of the Fifth Amendment, and other constitutional issues such as equal protection, bill of attainder, and due process.

B. Discussion of Legal Issues Presented by H.R. 6

1. The New Lease Obligations Imposed on Existing Leases Under H.R. 6 are in Breach of the Lease Contracts

An OCS oil and gas lease is a contract between the United States and the lessee and is governed by the same legal principles as any other contract. See E. Kuntz, OIL AND GAS LAW 107 (1986); Hunthauser Holdings, LLC v. Loesch, 2003 U.S. Dist. LEXIS 14428 at *16-17 (D. Kan. May 1, 2003). As explained in the preceding sections, since H.R. 6 would substantially alter the terms of the agreement between the lessee and the United States, the first inquiry is whether the effective imposition of a price threshold or fee on the 1998/1999 leases constitutes a breach of those contracts.

More than a century ago, the Supreme Court held that Congress cannot deprive a party with which it contracts "of the fruits actually reduced to possession of contracts lawfully made." Sinking-Fund Cases, 99 U.S. 700, 720 (1879). Two recent Supreme Court cases, United States

v. Winstar Corp., 518 U.S. 839 (1996), and Mobil Oil Exploration & Producing SE, Inc. v. United States, 530 U.S. 604 (2000), elaborate on this principle by finding that the government may incur liability for damages if legislation materially affects performance of an existing government contract. See also First Nationwide Bank, First Gibraltar Holdings, Inc. v. United States, 431 F.3d 1342, 1351 (Fed. Cir. 2005) (stating that "[w]hen the government as contracting party makes a promise in exchange for a benefit, it is bound by mutual obligations, as any party to a contract is bound," and therefore, the United States is liable for retroactively abrogating an existing contract). The holdings of Winstar, Mobil Oil, and their progeny support the conclusion that the passage and implementation of H.R. 6 gives rise to liability on the part of the government for breach of the 1998/1999 leases.

At issue in both Winstar and Mobil Oil was the enforceability of contracts between the government and participants in a regulated industry. The Winstar litigation stems from the savings & loan crisis of the 1980s, during which time the government provided incentives to induce healthy thrifts to merge with failing thrifts. The Winstar plaintiffs entered into contracts with government agencies to govern such mergers. The contracts provided that the plaintiffs could count supervisory goodwill and capital credits toward their regulatory capital requirements. Several years later, Congress passed a law canceling these incentives. As a result, many thrifts, including the plaintiffs, fell out of compliance with their regulatory capital requirements and were seized by thrift regulators. The plaintiffs filed suit and the Court of Federal Claims ruled in their favor, finding that the government (1) breached its contractual obligations to permit plaintiffs to count supervisory goodwill and capital credits toward their regulatory capital requirements, and (2) was liable for damages as a result thereof. Both the Federal Circuit and the Supreme Court affirmed the decision of the Court of Federal Claims.

In related litigation stemming from the savings & loan crisis of the 1980s, the Federal Circuit recently held in two cases that the government, in passing legislation directed at existing contracts and retroactively abrogating provisions therein, violated the implied covenant of good faith and fair dealing. In Centex Corp. v. United States, 395 F.3d 1283 (Fed. Cir. 2005) and First Nationwide Bank, plaintiffs alleged that legislation passed in 1993 breached certain contracts they entered into with the government in the 1980s. The plaintiffs asserted that the 1993 legislation changed the tax laws to abrogate tax benefits to which the plaintiffs were entitled at the time they entered into the contracts and that the law specifically targeted the benefits they enjoyed under the contract. In both cases, the Court of Federal Claims and the Federal Circuit agreed that under the pre-1993 tax laws, the plaintiffs were entitled to the tax benefits in question and that the legislative abrogation of those benefits breached the government's implied covenant of good faith and fair dealing under the contract.

In Mobil Oil, the Court examined the effect of the Outer Banks Protection Act ("OBPA") on certain OCS oil and gas leases off the Outer Banks of North Carolina. Under OCSLA, prior to drilling lessees must, among other things, submit an Exploration Plan ("EP") that MMS must approve within 30 days after submittal. 43 U.S.C. § 1340(c)(1). Two days before the Mobil Oil plaintiffs submitted their EP in August 1990, Congress enacted the OBPA prohibiting approval of plaintiffs' EP until MMS completed additional environmental studies, which would be in 1991 at the earliest. In light of the new OBPA-imposed procedures, the agency directed suspension of the leases.

The Mobil Oil plaintiffs eventually filed suit in the Court of Federal Claims, asserting that the delays in approving its EP's resulting from the OBPA, which was enacted after the leases were issued, constituted a breach of contract. In an 8-1 decision the Supreme Court upheld the decision in favor of the plaintiffs, finding that the leases at issue were not subject to the requirements of post-lease legislation such as the OBPA. Specifically, the Court focused on standard OCS lease language which incorporated statutes and regulations into the leases. The Court held that while the lease language specifically incorporated OCSLA,[19] existing OCSLA regulations and certain future OCSLA regulations, new statutes and regulations were implicitly excluded from similar treatment. Without such a limitation, the Court reasoned that the lease contract essentially is illusory.[20] Accordingly, the Court concluded that subjecting the plaintiffs' leases to the additional requirements for EP's imposed by the OBPA was a breach of contract. The Court went on to hold that the breach of the lease terms was substantial, thereby constituting a material breach that amounted to a repudiation, and ordered the government to pay $158 million, the price of the bonus bids paid by the plaintiffs for their leases, as restitution.

The Court of Federal Claims recently had an opportunity to consider application of the Mobil Oil breach of contract analysis to a matter again involving OCS leases. Amber Resources v. United States, 68 Fed. Cl. 535 (2005). In this case, lessees requested suspensions of their OCS

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[19] The leases also specifically incorporated the Department of Energy Organization Act, but that statute was not relevant to the litigation.

[20] "Hence, these provisions mean the contracts are not subject to future regulations promulgated under other statutes, such as new statutes like OBPA. Without some contractual provision limiting the Government's power to impose new and different requirements, the companies would have spent $158 million to buy next to nothing." Mobil Oil, 530 U.S. at 616.

leases offshore of California under applicable provisions of OCSLA and MMS regulations. When MMS granted the suspensions, the State of California sued claiming that MMS could not do so unless it made a consistency determination as required under the Coastal Zone Management Act, 16 U.S.C. §§ 1451-1465 ("CZMA"). This became an issue because 1990 amendments to the CZMA changed the scope of federal agency activities that were subject to consistency review. After the Northern District of California ruled that the 1990 amendments to the CZMA now subjected these suspension requests to CZMA consistency,[21] the lessees filed the Amber case.

The plaintiffs claimed that the additional procedural requirements for consistency determinations required by the 1990 CZMA amendments, which post-dated all the leases, constituted a breach of contract. Applying the Mobil Oil analysis, the Court of Federal Claims concluded that the additional procedural requirements imposed by the post-lease CZMA amendments constituted a total breach of the contracts. Moreover, even though the CZMA was incorporated in the leases by Section 1, the court reasoned that only the provisions of that law in effect at the time of lease issuance, and not post-lease amendments to the CZMA, were covered by that section. The Court of Federal Claims awarded plaintiffs in excess of $1 billion.

The 1998/1999 leases include basically the same language as the leases issued in Mobil Oil and Amber Resources regarding the application of future laws and regulations. For example, Lease OCS-G 21374, issued to Kerr-McGee Oil & Gas Corporation with an effective date of November 1, 1999, provides:

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[21] California v. Norton, 150 F. Supp. 2d 1046 (N.D. Cal. 2001), aff'd, 311 F. 3d 1162 (9th Cir. 2002).

> Sec. 1. Statutes and Regulations. This lease is issued pursuant to the Outer Continental Shelf Lands Act of August 7, 1953, 67 Stat. 462; 43 U.S.C. 1331 et seq., as amended (92 Stat. 629), (hereinafter called the "Act"). The lease is issued subject to the Act; all regulations issued pursuant to the Act and in existence upon the Effective Date of this lease; all regulations issued pursuant to the statute in the future which provide for the prevention of waste and conservation of the natural resources of the Outer Continental Shelf and the protection of correlative rights therein; and all other applicable statutes and regulations.

Therefore, just like the leases at issue in Mobil Oil, this lease is subject to OCSLA; all regulations issued pursuant to OCSLA in existence on the lease effective date; all future regulations issued pursuant to OCSLA that provide for the prevention of waste and conservation of resources; and all other applicable statutes and regulations. And like the OBPA, H.R. 6 and any regulations issued thereunder are not subject to OCSLA or regulations issued pursuant to OCSLA, and therefore, could only be incorporated into the 1998/1999 leases through the catchall "all other applicable statutes and regulations" clause. The Supreme Court in Mobil Oil held that the catchall clause could not be construed to include post-lease legislation since such a construction would render the contract illusory. Thus, pursuant to Mobil Oil, being issued after the 1998/1999 leases were executed, H.R. 6 is subject to the same legal defects as the OBPA.

Moreover, like the OBPA, H.R. 6 would create a material breach. As we explained above in Section IV.A, the lessees effectively have no choice under H.R. 6 but to "renegotiate" their leases to include a price threshold or agree to pay a new fee to avoid a permanent bar from all future OCS lease sales and assignments. Accordingly, in our view, H.R. 6 should be viewed the same as a direct requirement for a price threshold or a new fee, which for the reasons discussed above at 13-14, would be such a significant new financial obligation as to constitute a material breach of contract.

Further, Section 204(b)(3) of H.R. 6, which establishes a new annual $3.75 per acre conservation of resources fee for all non-producing OCS oil and gas leases in the Gulf of Mexico, not just the 1998/1999 leases, would constitute a breach of the rental terms of the leases as well as a violation of OCSLA.[22] OCSLA provides that "[a]n oil and gas lease...shall...contain such rental and other provisions as the Secretary may prescribe <u>at the time of offering the area for lease</u>." 43 U.S.C. § 1337(b)(6) (emphasis added). The 1998/1999 leases contain a provision fixing the rental payments at various amounts established in the Final Notice of Lease Sale, generally not in excess of $9.00 per acre. H.R. 6, however, effectively would unilaterally raise the per acre rental fee for nonproducing leases in breach of the lease provisions setting the rental rate and in violation of OCSLA.

While this new fee is styled a conservation of resources fee, it is indistinguishable from an increased lease rental fee.[23] The conservation of resources fee, like the rental, is a per acre fee paid annually by a leaseholder before the lease goes into production. H.R. 6 §§ 204(b)(1)(B); (b)(3). Therefore, under H.R. 6, Congress simply has increased the rental fee in contravention of the lease terms and OCSLA provision quoted above which required in unambiguous terms that the rental be set at the time the lease is issued. Accordingly, under standard contract principles

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[22] The MMS is required by H.R. 6 to promulgate a regulation implementing the fee within 60 days of the enactment of H.R. 6, but the annual fee is set in H.R. 6 at $3.75 per acre (in 2005 dollars).

[23] A rental fee is a per acre fee paid annually as an obligation to hold a lease before it goes into production. <u>See</u>, <u>e.g.</u>, Williams & Myers, 8 MANUAL OF OIL AND GAS TERMS (definition of rent).

and Mobil Oil, there is no question that the establishment of this new fee by H.R. 6 supports a claim for breach of all the non-producing Gulf of Mexico leases.

Finally, application of both of the H.R. 6 conservation of resource fees to existing leases would also be a breach of the implied covenant of good faith and fair dealing. In First Nationwide Bank, described above, the court explained that when the United States enters into contracts it is subject to this covenant which "imposes obligations on both contracting parties that include the duty not to interfere with the other party's performance and not to act so as to destroy the reasonable expectations of the other party regarding the fruits of the contract." 431 F.3d at 1349. Like the legislation at issue in First Nationwide Bank, H.R. 6 would deprive the 1998/1999 lessees of the fruits of their leases, namely, royalty relief without price thresholds. Accordingly, H.R. 6 would subject the government to a claim for breach of the implied covenant of good faith and fair dealing inherent in the 1998/1999 leases.

2. H.R. 6 Results in a Taking of the Lessees' Property Interests Without Just Compensation

The Fifth Amendment provides, in pertinent part, "nor shall private property be taken for public use, without just compensation." U.S. Const. amend. V. To succeed on a takings claim a plaintiff must establish (a) the existence of a protected property interest, and (b) that a compensable taking of that interest has occurred. Maritrans, Inc. v. United States, 342 F.3d 1344, 1351 (Fed. Cir. 2003).

The 1998/1999 leaseholders possess several different types of property interests by virtue of the lease and the statutes incorporated therein. Identifying which of these property interests H.R. 6 impacts is a crucial first step in a takings analysis. We think H.R. 6 impacts the lessees' royalty interest in the following manner. When a lease is issued, the lessor conveys the working interest in the lease and retains the royalty interest. The practical effect of the DWRRA's statutory grant of royalty suspension volumes, however, was to convey the royalty interest to the 1998/1999 lessees until the royalty suspension volumes are exhausted.

H.R. 6 requires the 1998/1999 lessees either to "renegotiate" a price threshold or agree to pay the fee in lieu of the royalty, which in effect forces the lessees to pay royalty on their production. Consequently, H.R. 6 would take back from 1998/1999 lessees the royalty interest in the first 17.5 million to 87.5 million barrels of oil equivalent, depending on the water depth. The remaining question is whether a royalty interest is a protected property interest.

It is a well-established principle that the royalty interest in oil and gas leases is a property interest.[24] At the time the 1998/1999 leases were executed, and so long as the minerals are not yet produced, the royalty interests effectively retained by the lessees under the DWRRA are

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> [24] A royalty interest is commonly defined as a right to a fractional share of the oil produced from the leased land. Royalties for oil have long been created by lease of land or mineral fee interest for oil purposes. Three distinct kinds of legal interests in the land and the oil contained therein are merged in the lessor: 1) the lessor's interest in the surface; 2) a reversionary interest in the oil remaining in the ground, contingent upon the termination of the lease; and 3) the right to receive royalties and/or rent under the lease. It is this last type of interest that is at issue in this case, *i.e.*, the Government's interest in its royalty valuation of oil produced by Shell Exploration under the California leases.
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> It is hornbook law that the lessor's interest in royalties under an oil lease may be both accrued and unaccrued. Traditionally, courts have viewed unaccrued royalties, *i.e.*, royalties to be paid from future production under a mineral lease, as real property interests retained by the lessor. However, royalties which have accrued from the production and severance of oil from the land have been generally regarded by courts as personal property.

Shell Oil Co. v. Babbitt, 920 F. Supp. 559, 564-65 (D. Del. 1996) (internal citations omitted).

unaccrued, and thus, real property interests. Even if the royalties had accrued, however, and were considered personal property, the takings analysis would not change. Real property interests and personal property both are protected property interests for takings purposes. Adams v. United States, 391 F.3d 1212, 1224 (Fed. Cir. 2004). Accordingly, the 1998/1999 lessees possess a protected property interest.

Federal courts recognize three types of takings challenges: regulatory takings, which challenge a government restriction on property use; physical takings, which challenge a physical invasion of property by the government; and exaction takings, which challenge conditions on development approvals taking the form of physical dedications or monetary impact fees. See Lingle v. Chevron U.S.A. Inc., 544 U.S. 528, 548 (2005). A takings challenge to H.R. 6 would be analyzed under a regulatory takings analysis, as H.R. 6 is a government restriction on property and is neither a physical invasion of property nor a physical dedication and does not provide for a monetary impact fee.

To determine whether a regulatory taking has occurred, courts utilize a two-tiered approach often referred to as the Lucas/Penn Central test. In Lucas v. South Carolina Coastal Council, the Supreme Court laid out the categorical rule that a government regulation that completely eliminates the economic use and value of real property is a *per se* taking. 505 U.S. 1003 (1992). If, however, there is not a total taking, courts employ the multifactor balancing test announced in Penn Central Transp. Co. v. New York City, 438 U.S. 104 (1978). Although our preliminary analysis leads us to conclude that H.R. 6 would likely be construed to eliminate completely the economic use and value of the 1998/1999 DWRRA royalty suspension volumes and thus would constitute a *per se* taking under Lucas, we also describe below the applicable analysis under the Penn Central test.

Under Lucas, a government regulation that completely eliminates the economic use and value of real property is a *per se* taking. H.R. 6 would arguably effect such a *per se* taking. As discussed above, the DWRRA effectively conveyed to the 1998/1999 lessees the royalty interest in the production of oil and gas up to the amount of the royalty suspension volume. At the time the 1998/1999 leaseholders executed their leases, and until there is production, the royalty interest has not yet accrued, and thus, under the law would be considered a real property interest. See Shell, 920 F. Supp. at 564-65. H.R. 6, however, would take away in its entirety the royalty interest in the production of oil and gas that the DWRRA granted to the 1998/1999 lessees. In other words, H.R. 6 (a government regulation) would take away entirely (would completely eliminate the economic use and value) the royalty interest (real property interest) granted to the 1998/1999 lessees, and thus, would constitute a *per se* taking. Moreover, even if the 1998/1999 lessees' royalty interest were classified as a personal property interest, the Federal Circuit recently applied Lucas in this context. Maritrans, 342 F.3d at 1352-53 (Fed. Cir. 2003).[25]

Because a court would likely construe H.R. 6 as a categorical taking under Lucas, the court would not need to proceed with an analysis under Penn Central. Nonetheless, a brief

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[25] In Maritrans, the Federal Circuit analyzed whether the regulation at issue deprived the plaintiffs completely of the economic use and value of their cognizable property interest in tank barges, concluding that it did not. While no other court has applied Lucas to personal property, Maritrans is controlling precedent in the Federal Circuit. Thus, even if the court determined that the royalty interest was a personal property interest, the court could still find that H.R. 6 constitutes a categorical, or *per se*, taking of that property under Lucas for the reasons set forth above.

review of the Penn Central test demonstrates that even if H.R. 6 were not construed as a categorical taking, it would still likely be construed as a taking under the Penn Central balancing test.

Under the Penn Central test the government action must be examined for (1) economic impact on the property owner; (2) degree of interference with the owner's reasonable investment-backed expectations, and (3) its character. 438 U.S. at 124. With regard to the economic impact, courts have never stated that a particular amount of impact is necessary to find a taking, or that below a certain degree of impact a taking is precluded. See, e.g., Cienega Gardens v. U.S., 331 F.3d 1319, 1345 (Fed. Cir. 2003). The only guidance here is that the impact must be severe. See, e.g., Tahoe-Sierra Preservation Council v. Tahoe Regional Planning, 535 U.S. 302, 322 n. 17 (2002); Animas Valley Sand & Gravel, Inc. v. Bd. of County Comm'rs, 38 P.3d 59, 67 (Col. 2001). Here, H.R. 6 would require the 1998/1999 lessees to pay hundreds of millions of dollars or be barred from all future lease sales. As such, the leaseholders have a compelling argument that the economic impact of H.R. 6 would be severe.

The second factor is often analyzed under a two-step approach: (1) does the property owner have actual investment-backed expectations, and (2) were those expectations reasonable. Cienega Gardens, 331 F.3d at 1346. Section 304 of the DWRRA effectively gave the lessees the royalty interest in specified amounts of produced oil and gas. Further, the lessees' expectations that they held this royalty interest were reasonable because (a) Section 304 of the DWRRA, which governs the 1998/1999 leases, did not require price thresholds; (b) MMS did not promulgate a regulatory price threshold; and (c) price thresholds in the 1996 and 1997 leases were addendums and not part of the boilerplate language of the leases.

The third factor analyzes the character of the government action at issue, and courts often balance the public interest advanced by the government measure against the burden on the property owner. See Keystone Bituminous Coal Ass'n v. DeBenedictis, 480 U.S. 470, 488, 492 (1987). Here, the public interest advanced by H.R. 6, the recoupment of money,[26] does not fit within the category of interests that courts consider worthy so as to avoid finding a taking, such as measures to address war, emergencies, or national security. See, e.g., United States v. Central Eureka Mining Co., 357 U.S. 155, 168 (1958) (temporary wartime shutdown of gold mines not a taking, since "[w]ar...demands the strict regulation of nearly all resources"); Block v. Hirsch, 256 U.S. 135, 157 (1920) (wartime rent controls not a taking, in part because "[a] limit in time, to tide over a passing trouble, well may justify a law that could not be upheld as a permanent change"). On the other hand, as discussed above, the burden imposed by H.R. 6 on the 1998/1999 lessees is severe.

3. Other Constitutional Issues

In addition to the legal issues noted above, the various requirements of H.R. 6 may run afoul of other provisions of the United States Constitution. In particular, the entity-specific, punitive, and retroactive nature reflected in the bill's current provisions may implicate equal

[26] While H.R. 6 states that the purpose of the bill is to provide for less reliance on foreign oil and more support for alternative energy, for the reasons discussed *infra* at 29-30, it is unclear how the lease restrictions would further these purposes. Accordingly, we view the "public interest" at issue as the recoupment of lost royalties. See 153 CONG. REC. H684 (daily ed., Jan. 18, 2007) (statement of Rep. Markey) ("Mr. Speaker, this bill today is a historic bill. What it is going to do is to reclaim billions of dollars, the GAO says upwards of $10 billion, which will then be moved over from unnecessary tax breaks and royalty relief for oil and gas companies, and moved over to a Strategic Renewable and Energy Efficiency Reserve....").

protection and due process concerns under the Fifth Amendment[27] and bill of attainder protections. Federal courts are sensitive to laws that single out particular entities or groups for disparate treatment, discriminatory burdens, or special punishment. Such scrutiny is heightened when the articulated purposes and probable effectiveness of the legislation may be deemed illegitimate, irrational, and/or arbitrary. Unless indicated otherwise, the constitutional issues raised here apply to the facets of H.R. 6 noted above, <u>except</u> for the $3.75 per acre conservation fee applicable to all non-producing leases.[28]

a. Requiring Only the Class of 1998/1999 Lessees to Pay Additional Royalties/Fees or be Deprived of Participation in OCS Lease Sales, Without a Legitimate Government Interest Furthered by the Restriction, Amounts to a Denial of Equal Protection

Under the Fifth Amendment, Congress may not deprive a person of equal protection of the laws.[29] As a general rule, similarly situated persons may not be intentionally treated differently, unless "it bears a rational relation to some legitimate end." <u>Romer v. Evans</u>, 517 U.S. 620, 631 (1996); <u>Village of Willowbrook v. Olech</u>, 528 U.S. 562, 564 (2000). Even though H.R. 6 does not implicate a judicially-recognized suspect class (*e.g.*, race, alienage) or a fundamental right (*e.g.*, voting), it may constitute "invidious discrimination," to which courts pay

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[27] The Fifth Amendment is also the source of the takings proscriptions discussed immediately above; these concerns are not repeated here.

[28] This fee also poses separate legal problems, as discussed in the breach of contract analysis above.

[29] While the guaranty of equal protection is set forth in the Fourteenth Amendment, the due process guaranty of the Fifth Amendment provides the same protections for federal legislation. <u>Hampton v. Mow Sun Wong</u>, 426 U.S. 88 (1976). Thus, as discussed further below, the "rational basis" tests applied for equal protection and due process analyses are identical. Also, corporations are considered "persons" entitled to equal protection and due process. <u>Grosjean v. Am. Press</u>, 297 U.S. 233, 244 (1936).

careful attention. Richardson v. Belcher, 404 U.S. 78 (1971). Congress cannot claim a legitimate interest in discriminating against a disfavored group, and courts will always examine the relationship between a classification and Congress' purported goals. Romer, 517 U.S. at 632-33; Department of Agriculture v. Moreno, 413 U.S. 528, 534 (1973).

H.R. 6 indisputably treats similarly situated lessees differently by singling out certain oil and gas lessees as subject to the requirement to "renegotiate" a price threshold or pay a fee on production. While not so blatant as to denote the 1998/1999 lessees by name, the classification is so specific that it applies to this discrete group. Courts will hence examine the discrepancy of conditions imposed on the 1998/1999 lessee class relative to the broader class affected by the statute (all OCS Gulf of Mexico lessees). The clear result of H.R. 6 is that only 1998/1999 lessees must pay a royalty or fee on their production not currently required by their leases. Further, other lessees may freely bid on new leases and transfer existing ones, while 1998/1999 lessees may not if they choose not to "renegotiate" or agree to pay the fee. Such a distinction among similarly situated lessees also is unprecedented. See Romer, 517 U.S. at 631 ("Discriminations of an unusual character especially suggest careful consideration to determine whether they are obnoxious to the Equal Protection clause.").

As explained earlier, it is also unclear from the face of the statute and the limited legislative history what legitimate government interest is furthered by the lessee classification in H.R. 6 other than an intention to extract hundreds of millions of dollars from lessees who happen to legally possess leases without price thresholds. Cf. Romer, 517 U.S. at 634 (finding violation of equal protection where the terms of state constitutional amendment were "so far removed" from its justifications, and "raise[d] the inevitable inference that it is born of animosity toward the class that it affects").

It is a well-established principle that persons cannot be subjected to special obligations or burdens from which other persons practicing the same business or calling are exempt; this is unconstitutional discrimination. See, e.g., Mayflower Farms v. Ten Eyck, 297 U.S. 266 (1936); Metro. Life Ins. Co. v. Ward, 470 U.S. 869 (1985). While funding alternative energy may be a legitimate goal of H.R. 6, imposing the burden of funding that program only on 1998/1999 lessees by inflicting new royalty or fee obligations appears to be evidence of the burden's own discriminatory intent. "A classification of persons undertaken for its own sake is something the Equal Protection Clause does not permit." Romer, 520 U.S. at 635; Willowbrook, 528 U.S. at 563 (finding classification was designed to "get" plaintiff).

b. Singling Out and Punishing a Lessee Whose Only "Offense" is to Possess DWRRA Leases That are Not Subject to Price Thresholds May Constitute an Unconstitutional Bill of Attainder

By imposing significant new financial burdens and exclusions from leasing on a select, "easily ascertainable" number of lessees, H.R. 6 may qualify as an impermissible bill of attainder. U.S. Const. Art. I, § 9, cl. 3 provides simply: "No Bill of Attainder or ex post facto Law shall be passed." Bills of attainder are essentially legislatively-imposed sanctions "aimed particularly at...an identifiable entity, intending to punish it." Communist Party U.S.A. v. Subversive Act. Cont. Bd. (SACB), 367 U.S. 1, 82 (1961). This doctrine reflects two key constitutional principles: punishment should not be imposed absent violations of existing law (see next Section below), and the judicial branch rather than Congress should make such individualized assessments. See Lovett, 328 U.S. 303, 316-17 (1946).

The Supreme Court has recognized that "[l]egislative acts, no matter what their form, that apply either to named individuals or to easily ascertainable members of a group in such a way as to inflict punishment on them without a judicial trial are bills of attainder prohibited by the Constitution." Lovett, 328 U.S. at 315. Courts therefore focus on three distinct factors, all of which H.R. 6 arguably satisfies: specificity, punishment, and no judicial trial. See Garner v. U.S. Dept. of Labor, 221 F.3d 822, 826-27 (5th Cir. 2000) (citing Sel. Serv. Sys. v. Minn. PIRG, 468 U.S. 841, 847(1984)). With regard to specificity, as noted in the equal protection discussion above,[30] H.R. 6 specifically singles out a discrete number of lessees, *i.e.*, those with royalty relief but without price thresholds in their leases.[31] While specificity alone is insufficient for a bill of attainder, "narrow application of a statute to a specific person or class of persons raises suspicion, because the Bill of Attainder Clause is principally concerned with the *singling out* of an individual for legislatively prescribed punishment." Foretich v. United States, 351 F.3d 1198, 1224 (D.C. Cir. 2003). H.R. 6 is particularly problematic given that it makes this individualized judgment on its face. See United States v. Brown, 381 U.S. 437, 453-54 (1965); Blawis v. Bolin, 358 F. Supp. 349 (D. Ariz. 1973).

Further, H.R. 6 effectively punishes its singled out lessees. Courts generally engage in three inquiries--historical, functional, and motivational--in determining whether a statute

[30] Bill of attainder analysis involves similar factors as equal protection and due process (e.g., classifications, retroactivity), but is a distinct, more restrictive inquiry undertaken by courts. See Nixon v. Adm'r of General Servs., 433 U.S. 425, 471 (1977).

[31] The fact that the lessees are defined by specific lease date rather than by name still renders them "easily ascertainable." See Lovett, 328 U.S. at 315; Seariver Mar. Fin. Holdings v. Mineta, 309 F.3d 662, 670 (9th Cir. 2002) (citation omitted).

imposes "punishment." Sel. Serv., 468 U.S. at 852; Consol. Edison Co. of N.Y., Inc. v. Pataki, 292 F.3d 338 (2d Cir. 2002) ("Con Ed") (finding Bill of Attainder Clause applies to corporations and permanently enjoining enforcement of law barring utility from passing on costs to ratepayers, on bill of attainder and equal protection grounds). Regarding the "historical" punishment inquiry, courts have expanded traditional concepts to include economic injury, finding it necessary to "respond to attempts by contemporary legislatures to punish individuals in new and heretofore unforeseen ways." See Con Ed, 292 F.3d at 348, 351.[32] Whether losing future bidding opportunities or facing higher production fees, 1998/1999 lessees undoubtedly face at least economic punishment under H.R. 6. Further, the "punitive confiscation of property [, and prohibition of] designated individuals or groups from participation in specified employments or vocations" may be "punitive *per se*."[33] Con Ed, 292 F.3d at 351 (citations omitted); Sel. Serv., 468 U.S. at 852. Finally, even carefully crafted "conditional" penalties may qualify as punitive for bill of attainder purposes, whether retrospective or prospective. See Cummings v. Mo., 71 U.S. 277, 324 (1867). This is particularly true in the context of H.R. 6, where the condition itself (amendment of lease terms) is part of the penalty, the burdens may

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[32] "It is undisputed that Con Ed would have been allowed to pass through to ratepayers the costs of covering power demand while replacing the generators during a scheduled outage. What, then, we must ask, other than punishment can justify forcing Con Ed to absorb those same costs after the accidental outage? Neither of the legitimate purposes set out above -- prevention of harm to ratepayers and deterrence of inefficient, monopolistic conduct -- can justify preventing Con Ed from passing these costs along to ratepayers." Con Ed, 292 F.3d at 353-54.

[33] As noted above, the 1998/1999 lessees' royalty rights under their lawful leases are property rights, effectively taken by the Hobson's choice presented by H.R. 6. In addition, H.R. 6 may be punitive *per se* since selection of any option either forces the 1998/1999 lessees to pay hundreds of millions of dollars (seriously devaluing their leases and damaging their business prospects) or bars their pursuit of offshore oil and gas exploration and production.

severely threaten an affected entity's survival, and the affected entities have not agreed to the burdens in advance.[34] Thus, H.R. 6 likely satisfies the first "historical" inquiry.

The "functional" factor then examines whether, given the "type and severity of burdens imposed," the statute still reasonably furthers non-punitive legislative purposes. See Nixon, 433 U.S. at 475. As examined above, H.R. 6 presents no "wholly non-punitive purpose to justify" the selective burdens on 1998/1999 lessees. See Con Ed, 292 F.3d at 351. Here, the punitive fees or loss of opportunities and property rights are unrelated to the 1998/1999 lessees' fitness to produce offshore oil and gas, implying that they are punitive and irrational. Compare Seariver, 309 F.3d at 666 (upholding exclusion of prior oil-leaking vessel from Prince William Sound to limit potential for additional spills in the area).

The "motivational" factor of punishment looks to "unmistakable evidence of punitive intent" on the legislature's part in enacting the statute. Flemming, 363 U.S. at 619. Courts look first to the legislative history. Garner, 221 F.3d at 827. The available legislative record makes it clear that H.R. 6's intent is punitive. See Section IV.A above. Courts also can discern a "punitive design" from the face of the statute or the lack of a rational basis. See Flemming , 363 U.S. at 617. As previously noted, H.R. 6 on its face arguably imposes punishment on a select few and may fail a rational basis review.

Finally, as discussed in the suspension and debarment section below, H.R. 6 evidently provides no judicial process to safeguard against an improper legislative judgment of guilt. For

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[34] Compare SBC Communs. v. FCC, 154 F.3d 226, 244, 247 (5th Cir. 1998) (reversing lower court's finding of bill of attainder, given plaintiffs' prior support of legislation and lack of any "victim" of Congress).

the above reasons, there is a substantial argument that H.R. 6 is an unconstitutional bill of attainder.

c. H.R. 6 Imposes Unique and Unfair Burdens That May Violate Due Process

i. *Retroactivity: Bills Like H.R. 6 With Retroactive Effect are Disfavored and May Violate the Due Process Rights of 1998/1999 Lessees*

H.R. 6 may violate due process because, rather than limiting future rights, it retroactively takes away existing rights to royalty relief vested in the 1998/1999 leases. Because H.R. 6 would modify the terms of existing leases by effectively imposing a price threshold or agreement to pay a fee where none exists now, it has retroactive effect. While the lease obligations and fees are technically imposed going forward, H.R. 6 directly impacts the leases themselves and disturbs the rights and conditions attached when they were granted between 1998 and 1999.

"[R]etroactivity is not favored in the law." Landgraf v. Usi Film Prods., 511 U.S. 244, 264 (1994).[35] Because it disturbs "legitimate expectations and settled transactions," courts will find that "retroactive legislation violates the Fifth Amendment unless it is justified as a rational measure." Seariver, 309 F.3d at 678 (citing Usery v. Turner Elkhorn Mining, 428 U.S. 1, 17 (1976)); General Motors Corp. v. Romein, 503 U.S. 181, 191 (1992). In conducting a retroactivity analysis, courts consider "(1) whether Congress clearly expressed its intent that the statute apply retroactively, and if so, (2) whether the statute is justified by a rational legislative

[35] Applying this principle, several states, including Colorado, Georgia, Louisiana, Missouri, New Hampshire, Ohio, Tennessee, and Texas, have gone beyond the U.S. Constitution and prohibited outright all "retroactive" or "retrospective" laws.

purpose."[36] Seariver, 309 F.3d at 678 (citations omitted). Indeed, courts may even apply a more stringent rationality requirement for retroactive legislation. See Pension Ben. Guar. Corp. v. R.A. Gray & Co., 467 U.S. 717, 730 (1984). While Congress may allocate economic rights and burdens generally, "[i]t does not follow, however, that what Congress can legislate prospectively it can legislate retrospectively. The retrospective aspects of legislation, as well as the prospective aspects, must meet the test of due process, and the justifications for the latter may not suffice for the former." Id. As detailed in the bill of attainder section above, punitive purposes such as "deterrence" and "blameworthiness" for statutes aimed at particular persons cannot survive rational basis review. See Seariver, 309 F.3d at 668.

Applying the two-step analysis above, H.R. 6 would expressly congressionally authorize retrospective applicability. As discussed above, H.R. 6 principally applies only to 1998/1999 leases executed under the DWRRA. Nevertheless, as a retrospective statute, it may still fail a due process rational basis review.[37]

Further, H.R. 6 contrasts with other types of retrospective legislation that legitimately "draws upon antecedent facts for its operations" in order to impose a burden on an industry or individuals to remediate their wrongful actions. Regions Hosp. v. Shalala, 522 U.S. 448

[36] Retroactive laws most often trigger substantive due process concerns, and hence require the same minimum "rational basis" scrutiny as Fifth Amendment equal protection challenges. That is, because H.R. 6 does not implicate fundamental rights and likely does not "shock the conscience" (*e.g.*, voting or child-rearing issues), courts similarly look to whether the law is rationally related to a legitimate governmental interest. See Valot v. SE Local Sch. Dist. Bd. of Educ., 107 F.3d 1220 (6th Cir. 1997).

[37] Again, the reasons and analysis are identical to the equal protection context above, and for sake of brevity are not repeated here. See *supra* at 28-30, n.29.

(1998).[38] In such situations, Congress responded to some tangible harm previously engendered by those at whom the legislation is targeted, rather than categorically "impos[ing] that obligation automatically on a legislatively defined class of persons." United States v. Monsanto, 858 F.2d 160, 175 (4th Cir. 1988). Indeed, as discussed above, H.R. 6 identifies no harm attributable to the 1998/1999 lessees that would warrant and rationally relate to the measures imposed by H.R. 6, so as to classify them as remedial rather than punitive.

ii. *H.R. 6 Strays From Fair and Acceptable Procedures in Comparable Suspension and Debarment Settings*

If a 1998/1999 lessee does not "renegotiate" its leases to include a price threshold or agree to pay a fee, its subsequent bar from future bidding operates analogously to suspension and debarment in the government contracts context. Whereas the latter process contains certain procedural safeguards before an entity is barred from participating in future government contracts, the automatic bar in H.R. 6 lacks such measures and therefore may invoke due process concerns. See Matthews v. Eldridge, 424 U.S. 319, 333 (1976) (stating that the "fundamental requirement" of procedural due process is "the opportunity to be heard at a meaningful time and in a meaningful manner."). Specifically, suspension and debarment is legitimate because it generally is limited in time and only implicates deserving wrongdoers. These principles do not apply to H.R. 6, which threatens a perpetual bar against 1998/1999 lessees that have done nothing wrong.

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[38] Compare Usery, 428 U.S. at 18 (upholding "rational measure to spread the costs of the employees' disabilities to those who have profited from the fruits of their labor - the operators and the coal consumers"); Monsanto, 858 F.2d at 173 (finding CERCLA not improperly retroactive or punitive since it only requires restitution of responsible cleanup costs).

While the right to bid on government contracts is admittedly not a recognized vested property interest, courts have required certain minimum procedures before related royalty (discussed in the takings section above) and occupational rights deserving of due process protection are taken away. See Bruns v. Nat'l Credit Union Admin., 122 F.3d 1251 (9th Cir. 1997); Trifax Corp. v. Dist. of Columbia, 314 F.3d 641, 643 (D.C. Cir. 2003). Since H.R. 6 could take away a vested royalty interest or ultimately harm a lessee's business, and thus could impinge on the rights discussed above, some minimal due process safeguards are required. As H.R. 6 does not contain these safeguards, it may be unconstitutional.

Typically, debarments are imposed for cause, *i.e.*, when a particular contractor or licensee has committed fraud or another violation, or when it has violated the terms of its contract, permit, license, etc. See, e.g., Burke v. United States EPA, 127 F. Supp. 2d 235 (D.D.C. 2001). Yet even these debarments are remedial and may not be punitive. See id. No one has suggested that the lessees impacted by H.R. 6 have committed any wrongdoing. Therefore, there can be no remedial purpose ascribed to H.R. 6.

Furthermore, even where a wrong has occurred, government regulations and decisions often impose a limited time period commensurate with the offense, such as three to five years, rather than perpetual debarment. See, e.g., id.; Textor v. Cheney, 757 F. Supp. 51 (D. Colo 1991); Leslie & Elliot Co. v. Garrett, 732 F. Supp. 191 (D. Colo. 1990). H.R. 6, in contrast, would permanently bar 1998/1999 lessees from future bidding and from receiving other existing leases.

Finally, at least minimum procedural due process, including notice and a hearing, are afforded those faced with debarment. See Trifax, 314 F.3d at 643; Transco Security, Inc. v.

Freeman, 639 F.2d 318, 321 (6th Cir.1981); Bank of Jackson County v. Cherry, 980 F.2d 1362, 1369 (11th Cir. 1993) (rejecting federal agency attempt to use its farm loan guaranty program as a lever to force resolution of a private dispute). The affected lessees have obviously been afforded no such hearing prior to potentially having their valid property and liberty interests taken away by H.R. 6.

V. CONCLUSION

Given the various legal issues and infirmities in H.R. 6 illustrated above, any plaintiff desiring to challenge the law, either on its face or as applied, may pursue various avenues of legal relief, including but not limited to money damages and declaratory and injunctive relief. Various legal claims could perhaps be brought in one consolidated lawsuit, but more likely in separate actions due to jurisdictional concerns.

A breach of contract challenge to H.R. 6 would give rise to significant damages, including: (1) the amount of royalties or fees that a lessee would be required to pay as a result of renegotiating its lease to include a price threshold or agreeing to pay the fee; (2) the diminution in value of leases caused by loss of royalty relief due to H.R. 6; (3) the annual $3.75 per acre conservation of resources fee assessed on all non-producing Gulf of Mexico OCS leases; and (4) the opportunity for restitution of the bonus bids paid for any of the 1998/1999 leases not in production after H.R. 6 is enacted. In addition, declaratory and injunctive relief against enforcement of H.R. 6 based on takings and other constitutional claims outlined above could be sought.

Finally, on a short term basis, as previously noted, there are good grounds for seeking a preliminary injunction to stop new OCS Gulf of Mexico lease sales from occurring while the

1998/1999 lessees challenge the government's right to exclude them from such sales. In granting a preliminary injunction, courts balance factors including irreparable harm, likelihood of success on the merits, relative benefits and burdens from an injunction, and the public interest. See Speaks v. Kruse, 445 F.3d 396, 399-400 (5th Cir. 2006); Serono Lab. v. Shalala, 158 F.3d 1313, 1317-18 (D.C. Cir. 1998). Since the exclusionary burden that may fall on 1998/1999 lessees is particularly severe and serious legal questions are posed as detailed above, a court would likely grant a preliminary injunction.