NOTE

MOBIL OIL EXPLORATION & PRODUCING SOUTHEAST, INC. v. UNITED STATES

I. INTRODUCTION

Does the United States government breach a contractual obligation concerning advanced payments for offshore leases when it enacts legislation, not contemplated in the original contract? This unforeseen legislation created enhanced regulatory obstacles to explore and develop the leased land. This was the issue the United States Supreme Court dealt with in *Mobil Oil Exploration & Producing Southeast, Inc. v. United States.*[1]

The government has dual obligations when it enters into a contract with a private party. First, it assumes the role of a private party and negotiates the contract for its own benefit. Second, the government has a responsibility to act in the best interest of the public and enact legislation in the best interest of the public.[2] This requires a precarious balancing act.

The *Mobil/Marathon* case clarifies two issues regarding government contracts. First, when the government enters into a contract with a private party, it is bound by basic contractual principles. Second, the government is free to pass legislation, but is liable if that legislation substantially breaches certain contracts.

This note examines the impact of the *Mobil/Marathon* case on future governmental contracts. Section II examines the regulatory background surrounding this situation. Section III reviews the United States Court of Federal Claims' decision, including an analysis of the sovereign acts and unmistakability doctrines. The appellate court's reversal of the claims court is covered in Section IV. Section V deals with the Supreme Court's contractual analysis of the situation. Finally, Section VI discusses possible consequences of the United States Supreme Court's decision.

Understanding the *Mobil/Marathon* cases requires an understanding of the factual background that surrounded this unique situation.

II. FACTUAL/REGULATORY BACKGROUND

In 1953, the Outer Continental Shelf Lands Act (OSCLA) was passed, giving the federal government jurisdiction over oil and gas development on the outer continental shelf.[3] The OSCLA allows the Secretary of Interior

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1. Mobil Oil Exploration & Producing Southeast, Inc. v. United States, 530 U.S. 604, 120 S. Ct. 2423 (2000).

2. Mark T. Cramer, *Contracts Written in Stone: An Examination of United States v. Winstar Corp.*, 25 PEPP. L. REV, 567, 568-70 (1997).

3. 43 U.S.C. §1331 (1994).

to sell exploration, development, and production leases through a competitive bidding process. Additionally, the OSCLA gives the Secretary oversight and approval power over exploration plans. The Coastal Zone Management Act (CZMA) gives states impacted by oil exploration the right to review and approve or deny exploration plans, and is closely tied to the Outer Banks Protection Act.[4] These two pieces of legislation were the basis under which these oil companies planned to obtain and develop offshore leases.[5]

During the early 1980s, the Department of Interior sold fifty-three leases to various oil companies, including Conoco, Mobil, and Marathon.[6] These leases gave the oil companies the right to develop resources in various locations, including off the coast of North Carolina. The $158 million dollars that Mobil and Marathon paid for the leases could ultimately be a good investment for the oil companies, because experts estimate that a large percentage of natural gas and oil reserves lie under the submerged lands of the Outer Continental Shelf.[7]

Once the leases were obtained, a Plan of Exploration (POE) was to be submitted for approval by the Secretary of Interior and to the impacted states (North Carolina). These oil companies combined their leases into one exploratory well off the coast of Cape Hatteras, called the Manteo Unit. This well was supervised by a subsidiary of Mobil, and then the POE was submitted to the Department of Interior and North Carolina, as required by the OSCLA.[8]

North Carolina had objected to any development off of its coast for a number of years. In July of 1989, North Carolina entered into a Memorandum of Understanding (MOU) with both the oil companies and the Department of Interior, which required additional environmental impact studies.[9] While this second environmental study was proceeding, the oil companies continued to follow the regulatory requirements of the OSCLA and the CZMA by obtaining several other required permits.[10] In June 1990, the MOU environmental report determined that the Manteo Unit POE would not significantly impair the environment. On July 17, 1990, North Carolina opposed the CZMA certification.[11] At this point one of two things could happen, exploration and development could be halted indefinitely or the Secretary of Commerce could override North Carolina's objection. However, prior to any further action by any of the parties in-

4. 16 U.S.C. §1451 (1994).

5. Conoco v. United States, 35 Fed. Cl. 309, 314-15 (1996).

6. *Id.* at 316.

7. Edward A. Fitzgerald, *Conoco Inc. v. United States: Sovereign Authority Undermined by Contractual Obligations on the Outer Continental Shelf*, 27 PUB. CONT. L.J. 755 (1998).

8. *Conoco*, 35 Fed. Cl. at 318.

9. Marathon Oil Co. and Mobil Oil Exploration & Producing Southeast v. United States, 177 F.3d 1331, 1334 (1999).

10. The oil companies obtained a National Pollution Discharge Elimination System Permit (NPDES) from the Environmental Protection Agency (EPA). *Marathon*, 177 F.3d at 1334.

11. *Id.* at 1335.

volved, Congress passed the Outer Banks Protection Act (OBPA) in August of 1990, which increased environmental regulatory requirements before exploration could begin.[12]

The OBPA initially stopped all exploration and development off the coast of North Carolina for forty-five days.[13] The Secretary of Interior was prohibited from approving any exploration plans until an Environmental Sciences Review Panel (ESRP) verified that the plan met the requirements of the OSCLA. Then the Secretary of Interior was to report to Congress that he had sufficient information to make OCSLA-required decisions.[14] The oil companies continued to push their plan of exploration in spite of the newly enacted legislation.

Mobil/Marathon submitted a final plan of exploration on August 20, 1990, which was again rejected by North Carolina. The oil companies then followed the administrative procedure in appealing North Carolina's objection to their plan in January 1992, the Secretary of Interior told Mobil that their POE met all applicable requirements. However, it would not be approved until the additional OBPA requirements were met.[15]

Mobil and Marathon joined a number of other oil companies in bringing a suit in United States Court of Federal Claims, which ruled in their favor.[16]

III. FEDERAL CLAIMS COURT RULING

The court of federal claims held that the government had materially breached the lease contracts.[17] The terms of the contracts are crucial in understanding this case, as well as understanding the rights and privileges of the lessee.[18] Section 1 of the lease makes it applicable to the OSCLA and all regulations issued under that act. This section also subject the lease to "all regulations issued pursuant to the statute in the future which provide for the prevention of waste and conservation of natural resources. . . ."[19] This clause is significant in that it refers to future legislation under the OSCLA, not future legislation generally.

Mobil/Marathon argued that they paid hundreds of millions of dollars for the right and opportunity to explore and develop offshore lands owned by the federal government and that the enactment of the OBPA materially breached these rights. This newly enacted legislation interfered with their ability to gain the benefit of their leases based on the Secretary of Interior's refusal to consider their exploration plans in good faith.[20]

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12. *Marathon*, 177 F.3d at 1335.
13. *Id.* at 1335.
14. *Marathon*, 177 F.3d at 1335.
15. *Id.*
16. *Conoco*, 35 Fed. Cl. at 323.
17. *Marathon*, 177 F.3d 1331.
18. *Conoco*, 35 Fed. Cl. at 317.
19. *Id.* at 317.
20. *Conoco*, 35 Fed. Cl. at 317.

The government contends that the original leases did not grant Mobil/Marathon "an absolute right to explore or develop the areas subject to the leases."[21] The government's argument was that the leases were subject to various federal requirements before any exploration could begin and that simply because a company has a lease, it is not guaranteed that it will be able to obtain any of the permits required for exploration.[22]

The claims court analyzed the plain meaning of the contract's language in deciding what the parties intended. The fact that some statutes and regulations were specifically included meant that others were excluded. The court read the language "all other applicable statutes and regulations"[23] to include only current regulations. The drafters of the contract explicitly made the leases subject to specific regulations, such as the OCSLA when it stated "regulations issued pursuant to the statue in the future,"[24] however, it said nothing about future legislation.[25] The court reviewed the lease contracts using the objective test of what a reasonable similarly situated person would have believed the contract to include.[26] The languages of the lease contracts were intended to allow the oil companies a fair shot at exploration and development based on known statutes and regulations. Thus, the court believed that if the government wanted the lease contracts subject to new regulatory legislation, it should have expressly included them in the terms of the lease.[27]

The federal court of claims disposed of two other issues. The sovereign acts doctrine and the doctrine of unmistakability.

The sovereign acts doctrine deals with the tension of the government as both a sovereign and as a contractual party.[28] This doctrine arises anytime the United States government enters into a contract with a private entity: "It is a well-settled point of law that the sovereignty acts doctrine is included as an inherent term, which is expressed or implied in every public contract."[29] When the government's obligations as a sovereign and as a contractual party are inconsistent, a certain amount of tension is created.[30] It is a fact that the government must enter into a variety of private contracts to accomplish certain objectives, such as building airplanes. However, the government as a sovereign must not refrain from passing legislation benefiting the pubic for fear of breaching a specific contract.

21. *Id.* at 320.

22. *Conoco*, 35 Fed. Cl. at 320.

23. *Id.* at 322.

24. *Conoco*, 35 Fed. Cl. at 322.

25. *Id.* at 322.

26. *Conoco*, 35 Fed. Cl. at 322.

27. *Id.* at 322.

28. *Conoco*, 35 Fed. Cl. at 334; *see also* Hughes Communications Galaxy v. United States, 998 F.2d 953, 958 (1993).

29. *Hughes Communications*, 998 F.2d at 958.

30. *Id.* at 958.

The government is shielded by the sovereign act doctrine when it passes laws in the best interest of the general public, which incidentally impact certain government contracts.[31] However, when the government passes legislation narrow in scope and specifically aimed at a certain class of people, the sovereign acts doctrine is not applicable,[32] because the legislation is not passed in the best interest of the general public.[33]

The court of claims looked at the scope of the OBPA and its application in deciding if it was general or specific in nature.[34] The court reasoned that the law was specific in its application, because the general public was not directly impacted by the legislation.[35] The court stated that: "the OBPA affected the public welfare incidentally at most."[36] The court viewed this statute as specific in nature despite the fact that the OBPA was an environmental statute aimed at protecting the coastal areas of the United States.

The unmistakability doctrine was the other issue the federal court of claims disposed of. This doctrine states that the federal government does not waive its sovereign powers or immunity in a contract, unless it is done in clear and unmistakable terms.[37]

The court in this instance believed that the government had the knowledge and ability to expressly make the contracts subject to future legislation, and refrained from putting any such clauses in the contract.[38]

Finally, the claims court relied on a contemporary Supreme Court case, *United States v. Winstar*,[39] in determining the impact of the enactment of the OBPA on the lease contracts. The issue in *Winstar* was the amount of liability the government bears when it breaches a contract based on subsequently enacted legislation.[40] The court viewed its decision in *Conoco* as a validation of the *Winstar* decision, in ruling that the federal government should be treated as a private party in contractual issues.

The claims court also analysed whether restitution of the lessees' upfront cash payments and annual rentals should be offset by any benefit they obtained before the OBPA was passed. The court held that there was no identifiable benefit and awarded the oil companies $156 million for their advanced lease payments, but refused to return their annual rental payments.[41]

31. *Conoco*, 35 Fed. Cl. at 335-36.
32. *Id.* at 335.
33. *Conoco*, 35 Fed. Cl. at 335.
34. *Id.*
35. *Conoco*, 35 Fed. Cl. at 335.
36. *Id.* at 336.
37. *Conoco*, 35 Fed. Cl. at 335.
38. *Id.* at 323.
39. United States v. Winstar, 116 S. Ct. 2432 (1996).
40. *Conoco*, 35 Fed. Cl. at 332.
41. *Marathon*, 177 F.3d 1331, 1336-37 (1996).

IV. FEDERAL APPEALS COURT

The government appealed the decision of the United State Court of Federal Claims to the United States Court of Appeals for the Federal Circuit. In *Marathon Oil Co. and Mobil Oil Exploration and Producing Southeast, Inc. v. United States*, the court reversed the court of claims and held that the government's enactment of the OBPA, was not the cause of the oil companies failure to obtain the requisite permits to explore its lease holdings.[42]

The court began its analysis with the terms of the lease contracts, which the court of claims viewed as the determinative issue. The court of claims viewed the language in the contract which stated "all other applicable statutes and regulations," but did not include any future legislation.[43] The court of appeals disagreed with the court of claims and gave this issue little attention.[44] The appellate court believed that the lease's provisions were conditioned on the lessee's ability to obtain the appropriate regulatory permits, stating:[45]

> Under the circumstances of this case, to treat Marathon's failure to obtain the necessary approvals and permits for exploratory activity as a breach of contract by the Government would be to eviscerate these salutary protections of the nation's fragile coastal lands and waters. . . .[46]

The fact that North Carolina refused to approve the POE, because these oil companies did not provide adequate information concerning CZMA consistency certification, was the cause of their inability to begin exploration.[47] Under this analysis the leases were stopped before the OBPA had any impact on them.

Ultimately, the court of appeals viewed this situation as one in which the large oil companies, as experienced and sophisticated contractual parties, assumed a certain amount of risk in return for priority in the development of oil and gas leases.[48] This risk appears in various forms, including that the company may not be able to obtain the proper federal and state permits. Other forms of risk appear when development of the resources is no longer cost effective as a result of weather problems, special equipment needs and/or malfunctions.[49]

The split between the court of claims and the court of appeals ultimately resulted in a petition for certiorari before the United States Supreme Court.

42. *Id.* at 1340.
43. *Marathon*, 177 F.3d at 1337.
44. *Id.* at 1337.
45. *Marathon*, 177 F.3d at 1337.
46. *Id.* at 1338.
47. *Marathon*, 177 F.3d at 1337.
48. *Id.* at 1339-40.
49. *Marathon*, 177 F.3d at 1339-40.

V. THE UNITED STATES SUPREME COURT

In *Mobil Oil Exploration and Producing Southeast, Inc. v. United States*, the Supreme Court held that the government materially breached the lease contracts with Marathon and Mobil Oil.[50] The court believed that the lease agreements did not subject them to any future regulations not expressly put into the terms of the contract. The language of the contract included "all other applicable . . . regulations."[51] The Supreme Court interpreted this language to include current and not future regulations. The Court ordered the government to pay restitution to the companies for the breach of the contract.[52]

In its analysis, the Supreme Court narrowed the issue to the common law of contracts. "A contracting party is entitled to restitution if the other party 'substantially' breached a contract or communicated its intent to do so."[53] The Court cited *Winstar*[54] in support of its holding that the government was bound by the same terms as a private individual or company: "When the United States enters into contract relations its rights and duties are governed generally by the law applied to contracts between private individuals."[55] Repudiation is a statement by one party to the other of their intent to breach the contract, and such a breach would result in damages.[56] Total breach is when the value of the contract is impaired to the extent that damages are recoverable based on the remaining performance of the contract.[57]

The Court found that the various contract provisions subjected the leases to: (1) section 302 and 303 of the Department of Energy Organization Act, (2) OCSLA, (3) regulations issued to the statute an in existence upon the effective date of the contract, (4) all regulations issued pursuant to such statute in the future which provided for the prevention of waste and under the OCSLA, and (5) "all other applicable statutes and regulations."[58] The Supreme Court read the plain language of the contract in much the same manner as the court of claims, and limited it to the legislation existing at the time the contract was created.

The Court believed that the Secretary of Interior's refusal to approve the oil company's POE based on the passage of the OBPA was a repudiation that substantially breached the lease contract. In a letter to the Governor of North Carolina, the Interior Department wrote: "Because we have found that Mobil's Plan fully complies with the law and will have only negligible effect on the environment, we are not authorized to disprove the

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50. *Mobil,* 120 S. Ct 2437-38.
51. *Id.* at 2428.
52. *Mobil,* 120 S. Ct. at 2428.
53. *Id.* at 2423.
54. *Winstar,* 116 S. Ct. 2432.
55. *Id.*
56. *Winstar,* 116 S. Ct. 2432.
57. *Mobil,* 120 S. Ct. at 2429.
58. *Id.* at 2433.

Plan or require its modification."[59] In this statement, the government acknowledges that Mobil/Marathon has successfully complied with the required regulations and complied with the relevant provisions of the contract. On September 28, 1996, the Regional Director of the Department of Interior wrote to North Carolina's governor stating that the "Outer Banks Protection Act (OBPA) of 1990 . . . prohibits the approval of any Exploration Plan at this time."[60] The letter further stated that the POE would remain on file until the OBPA requirements were met.[61] Clearly, the court viewed the passage of the OBPA as changing the nature of the contract: "[We] do not say that the changes made by the statue were unjustified. We say only that they were change of a kind that the contract did not foresee."[62] This statement is the "smoking gun" that helped the oil companies make their case. To a certain extent the Supreme Court believed that the government should have shifted the risk of future legislation by stating so in the contract in explicit terms.

The government argues that any violation of the terms of the contract did not amount to a material breach,[63] because the delay in consideration of the POE was not essential to the agreement.[64] The court of appeals disagreed and viewed the lease contracts as giving the oil companies a right and "opportunity" to explore and develop lands under current statutory rules and procedures.[65] This opportunity included "timely and fair consideration of a submitted Exploration Plan . . .,"[66] which the government did not provide.

The government stated that the oil companies waived their opportunity to restitution by urging that the government perform the contract.[67] The Supreme Court was not convinced by the government's argument because they did not believe that the companies got a fair opportunity to have their exploration plan considered.[68] "The performance question, however, is not just about what the oil companies did or requested, but also about what they actually received from the Government."[69] The government did not perform under the provisions of the contract, because they refused to approve the companies' plans based on the passage of the OBPA.

59. *Mobil*, 120 S. Ct. at 2431.
60. *Id.* at 2432.
61. *Mobil*, 120 S. Ct. at 2432.
62. *Id.* at 2436.
63. *Mobil*, 120 S. Ct. at 2436.
64. *Id.*
65. *Mobil* 120 S. Ct. at 2436.
66. *Id.* at 2436. The delay after OBPA's passage was four years.
67. *Mobil*, 120 S. Ct. at 2437.
68. *Id.*
69. *Mobil*, 120 S. Ct. at 2437.

The government stated that repudiation of the contract did not damage the companies, because they could not have met all of the original statutory requirements.[70] According to the government, the oil companies' POE did not meet CZMA guidelines and, thus, was doomed before the OBAP was enacted, resulting in no damages.[71] However, damages are not being sought, rather refund of advanced payments. Mobil/Marathon should have been afforded the opportunity to see if their plans would have been approved according to the original contracts because "the Government repudiated the lease contracts, the law entitles the companies to that restitution whether the contracts would, or would not, ultimately have produced a financial gain. . . ."[72] The companies knew the risk inherent in contracts such as these, however, they had only assumed these risks based on the terms in the original contract.

VI. CONCLUSION

The United States Supreme Court clarified certain principles concerning private individuals and government contracts. First, the government is bound by basic contract principles when it enters into a contract for economic benefit. Second, government contracts will now contain express language limiting the government's liability for the enactment of future legislation. Third, the government is free to pass legislation; however, it may be liable if that legislation substantially breaches certain individual contracts.

The Supreme Court's decision in *Mobil Oil Exploration & Producing Southeast v. United States*[73] appears to be a very pro private business decision. Companies entering into contracts with the government know what to expect if problems arise with the contract. A decision against Mobil/Marathon may have resulted in a chilling effect on companies entering into contracts with the government, especially in areas highly regulated and rapidly changing.

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70. *Id.* at 2437.
71. *Mobil*, 120 S. Ct. at 2437.
72. *Mobil*, 120 S. Ct. at 2437.
73. *Id.*