WHITHER "SURROUNDING CIRCUMSTANCES"?

Contract interpretation after *Barrow-Shaver v. Carrizo.*

WRITTEN BY **T. RAY GUY**

The trial of a contract interpretation dispute usually follows a familiar pattern. The lawyers argue as to—and present evidence concerning—whether the contract is ambiguous, which is a question of law for the judge to decide.[1] If he or she determines that the language is *not* ambiguous, its construction becomes another question of law, again for the court,[2] and parol or extrinsic evidence[3] is not admissible to vary or contradict its written terms.[4] On the other hand, if the court determines that the contract *is* ambiguous, its interpretation becomes a question for the jury, and the parties are allowed to introduce extrinsic evidence for the jury's consideration. Such proof can, and often does, include evidence of the circumstances under which the contract was negotiated and executed.[5]

But such surrounding-circumstances evidence is also useful, and (within limitations) admissible, at the early stage when the court is determining *whether* the contract is ambiguous,[6] and thereafter—unlike other forms of extrinsic evidence, and again with limitations as described below—when the court takes on the tack of interpreting a contract that it has concluded is unambiguous. It's these usages of surrounding-circumstances evidence—"susceptible to confusion and inconsistency …"[7]—that were at issue in *Barrow-Shaver Resources Co. v. Carrizo Oil & Gas, Inc.*,[8] in which the parties argued over proof of the circumstances surrounding negotiation of a farmout agreement.

The Contract Interpretation Issues in *Barrow-Shaver v. Carrizo*

Mineral lessee Carrizo Oil & Gas ("Carrizo") farmed its lease out to Barrow-Shaver Resources ("BSR"). An early draft of the farmout prepared by Carrizo required Carrizo's consent for any assignment but provided that such consent "shall not be unreasonably withheld." Carrizo struck the latter clause from a later draft; the final agreement did not limit Carrizo's ability to withhold consent.

BSR received an offer of $27.69 million to assign the farmout. Carrizo refused to consent, offering instead to sell the lease for $5 million. The farmout expired, and BSR sued Carrizo for breach of contract, fraud, and tortious interference.

At trial, the parties offered conflicting evidence of surrounding circumstances. Carrizo pointed to the pre-execution negotiations, specifically the deleted language, to support its claim of an unconditional right to withhold consent. Both parties tendered expert testimony as to industry custom. BSR's expert opined as to factors justifying or constraining consent and that Carrizo's demand of $5 million contravened industry practice; Carrizo's expert testified that industry custom did not require a reason for withholding consent.

The trial court, applying the parol evidence rule, excluded evidence of negotiations and prior drafts but did allow testimony of industry custom. Finding the consent provision ambiguous, the court put its interpretation to the jury with an instruction concerning industry custom and expectations. The jury found that Carrizo failed to comply with the agreement and awarded BSR $27.69 million, and the court entered judgment for BSR in that amount. The court of appeals reversed and rendered judgment for Carrizo.[9]

The Texas Supreme Court affirmed the rendition of a take-nothing judgment. Before the court, both parties had contended that the farmout was unambiguous. Justice Paul W. Green, writing for the five-justice majority, agreed. Justice Eva Guzman (joined by Chief Justice Nathan L. Hecht and Justice Brett Busby) concurred and dissented. Justice Jeffrey S. Boyd dissented. All members of the court credited evidence of surrounding circumstances but disagreed as to *which* such evidence was admissible, and for what purposes, and on what grounds. The justices' conflicting opinions turned on differing views of whether the proffered evidence (negotiations and prior drafts, and industry custom) properly informed, or instead impermissibly contradicted, the express language of the farmout.

What are the constraints on the use of surrounding-circumstances evidence when the judge is deciding ambiguity, or subsequently construing a contract deemed unambiguous, and how did *Barrow-Shaver* deal with those constraints?

1. The Evidence Must Be "Objective in Nature"

One key requirement is that the evidence must be "objective in nature."[10] Some of the "objectively determinable factors"[11] recognized in recent Supreme Court decisions include:

- the existence of an attorney-client relationship;[12]
- arbitration industry norms when an arbitration agreement was executed;[13] and
- the manner in which insurance contracts were negotiated in the London market.[14]

"Objective," in this context, seems to mean "undisputed" or at least "not subject to dispute."[15] The evidence credited by the *Barrow-Shaver* majority included that the parties were

"sophisticated oil and gas entities," each with experienced representatives who exchanged multiple drafts, and that each was represented by counsel—"circumstances establish[ing] that the consent-to-assign provision was a bargained-for exchange."[16] On the other hand, the evidence of industry custom was disputed, supported on each side by conflicting expert testimony.[17]

2. The Evidence Must Not Contravene the Writing

The competing opinions in *Barrow-Shaver* demonstrate what seems to be the usual issue: whether the proffered surrounding-circumstances evidence contradicts the printed language or instead sheds light on its meaning. For example, in an insurance coverage dispute, the Supreme Court held evidence of trade usage, prior dealings, and prior negotiations inadmissible because the policy unequivocally precluded coverage.[18] Disagreement as to whether evidence was consistent with or contradictory to the meaning of the language has divided the court in several recent decisions on the issue.[19]

Consistent with this history, the *Barrow-Shaver* outcome turned on the majority's conclusion that evidence of prior negotiations and industry custom was inadmissible because, in its view, the consent-to-assign provision was clear on its face. Green wrote that the "… terms of the agreement make clear that Carrizo has no obligation and its right to withhold consent is thus unrestricted…;"[20] thus evidence of negotiations and drafts was inadmissible[21] (even though the deleted language would have supported the court's interpretation), as was evidence of industry custom and usage.[22] The dissenting justices disagreed. Guzman (joined by Hecht and Busby) found no inconsistency between the language and a requirement of reasonableness because "the jury found reasonableness [was] baked into the contract language through trade custom and usage …."[23] Boyd implicitly found the provision ambiguous, given his statement that at a new trial "… the jury must decide the breach-of-contract claim …,"[24] and would have remanded for a new trial with the jury allowed to hear both types of surrounding-circumstances evidence: "Just as Barrow-Shaver could rely on extrinsic surrounding-circumstances evidence of industry custom to explain or supplement the parties' written contract, Carrizo could rely on extrinsic surrounding-circumstances evidence of the parties' negotiations and draft agreements to establish that the parties did not intend to incorporate that industry custom in their contract."[25]

3. Surrounding-circumstances Evidence Cannot Be Used to Create *an Ambiguity but Can Reveal the Existence of a Latent Ambiguity*

Evidence of surrounding circumstances cannot *create* an ambiguity where the language is otherwise clear.[26] However, an ambiguity may be "latent," with ambiguity coming to light when apparently clear language is applied to the subject matter.[27] So the court may consider evidence of circumstances in determining whether a contract that on its face is *not* ambiguous, actually contains an ambiguity.[28] For example, the court found a latent ambiguity where a settlement agreement specifically mentioned two pending lawsuits and provided that "all related claims and controversies" between the parties were settled.[29] While the agreement seemed unambiguous, extrinsic evidence revealed the existence of a third case, requiring a factual determination whether the parties intended that it also be resolved.[30]

As a side note: Disagreement over interpretation doesn't necessarily mean that the contract is ambiguous.[31] Since "unclear" doesn't necessarily mean "ambiguous," evidence of circumstances can furnish clarity in otherwise-obscure language. So it's at least theoretically possible that a provision in a contract is unambiguous but its meansing is disputed—and that, with other extrinsic evidence inadmissible, evidence of circumstances will win the day.

An Important Tool for the Trial Advocate

To reiterate: Once the court has found that the contract is ambiguous, parol evidence—including circumstances—is admissible and properly considered by the jury.[32] But persuasive presentation of evidence is just as important when the court is considering the question of ambiguity, or interpreting unambiguous language, as when the jury is asked to construe ambiguous language. Setting the background for your client's execution of the disputed contract—whether with evidence of the parties' prior relationship, their negotiations and drafts, industry custom, or otherwise—can go a long way toward making the trial judge comfortable issuing the rulings you seek. **TBJ**

NOTES

1. *Nat. Union Fire Ins. Co. of Pittsburgh, Pa., v. CBI Industries, Inc.,* 907 S.W.2d 517, 520 (Tex. 1995).
2. *City of Pinehurst v. Spooner Addition Water Co.,* 432 S.W.2d 515, 518 (Tex. 1968).
3. Though "parol evidence" is commonly understood to mean *oral* evidence— "… that which is given by word of mouth … given by witnesses in court …," Black's Law Dictionary (6th Ed. 1990)—in practice courts often fail to distinguish oral parol evidence from other forms of extrinsic evidence. *See, e.g., Houston Exploration Co. v. Wellington Underwriting Agencies, Ltd.,* 352 S.W.3d 462, 469 (Tex. 2011) ("The stricken [from a policy form] language is parol evidence …"); *Sun Oil Co. (Del.) v. Madeley,* 626 S.W.2d. 726, 731 (Tex. 1981) "[T]he parol evidence rule circumscribes the use of extrinsic evidence.").
4. *Lewis v. East Texas Finance Co.,* 136 Tex. 149, 146 S.W.2d 977, 980 (1941).
5. *Miller v. Gray,* 149 S.W.2d 582, 583 (Tex. 1941) (evidence of custom admissible to explain an ambiguous contract).
6. *See, e.g., Nat. Union Fire*, 907 S.W.2d at 520 ("Whether a contract is ambiguous is a question of law for the court to decide by looking at the contract as a whole *in light of the circumstances present when the contract was entered*" (emphasis added); *City of Pinehurst,* 432 S.W.2d at 519.
7. *URI, Inc. v. Kleberg Cty.,* 543 S.W.3d 755, 757 (Tex. 2018) (Guzman, J.).
8. 590 S.W.3d 471 (Tex. 2019).
9. Holding (among other things) that the prior drafts and negotiations were not barred by the parol evidence rule; that the drafts established that the farmout was not (as contended by BSR) silent on the issue of consent, but instead unambiguously gave unfettered discretion to deny consent; and therefore that the interpretation of the farmout should not have been submitted to the jury. *Carrizo Oil & Gas, Inc. v. Barrow-Shaver Resources Co.,* 516 S.W.3d 89, 97 (Tex. App.—Tyler 2017), *aff'd,* 590 S.W.3d 471 (Tex. 2019).
10. *URI,* 543 S.W.3d at 768.
11. *Houston Exploration Co.,* 352 S.W.3d at 469.

12. *Anglo-Dutch Petroleum Int'l, Inc. v. Greenberg Peden, P.C.,* 352 S.W.3d 445, 450 (2011).
13. *Americo Life, Inc. v. Myer,* 440 S.W.3d 18, 22-24 (Tex. 2014).
14. Including the practice of striking from multipart forms coverage rejected during the negotiations. *Houston Exploration,* 352 S.W.3d at 469-472.
15. Decades ago the Supreme Court held that "[E]ven in those cases of ambiguous instruments, if the parol evidence is undisputed as to the circumstances, the construction is yet a question of law for the court." *Brown v. Payne,* 142 Tex. 102, 176 S.W.2d 306 (1943).
16. *Barrow-Shaver,* 590 S.W.3d at 484.
17. In that instance, if both sides' expert testimony had met the appropriate gatekeeper standards and the contract language hadn't rendered such evidence unnecessary, it would seem that the interpretation of the contract would indeed have been for the jury, with an instruction allowing the jury to determine industry custom and practice. In its brief on the merits in the Supreme Court, BSR contended that, "[W]hen industry usage is disputed, it must be decided by the jury *before* the court decides if a contract is ambiguous. Until words are construed as those in the industry would understand them, judges cannot tell whether a contract is ambiguous or not." (Emphasis in original.) Such an allocation of the decision-making would seem to require a hybrid, bifurcated trial, in which the jury is asked to determine industry usage; the trial judge then decides whether that usage renders the contract ambiguous and the trial continues toward a second jury charge for consideration of whatever fact issues remain.
18. *Nat. Union Fire,* 907 S.W.2d at 521.
19. *Americo, supra* n. 12; *Anglo-Dutch, supra* n. 12; *Houston Exploration, supra* n. 3.
20. 590 S.W.3d at 482. The path to that conclusion was a bit indirect: the farmout agreement was silent as to grounds for withholding consent; a contract must address all material terms with a certain degree of specificity, but a term that is immaterial may not be supplemented or given further precision; the primary purpose of a farmout agreement is the obligation to drill, and therefore a consent-to-assign provision is not material; thus "… the agreement's purported silence as to when consent may be withheld is of no legal consequence and needs no supplement to aid its interpretation." *Id.*
21. "Here, evidence of the parties' substantive negotiations directly relates to the creation of the parties' unambiguous agreement. Therefore, the parol evidence rule bars consideration of evidence of the parties' substantive negotiations of the consent-to-assign provision." *Id.* at 483.
22. "To supplement so clear and easily understood a provision containing 'express written consent' with extrinsic evidence … would make almost every term, word, or phrase in an agreement, and any obligation not in an agreement, susceptible to litigation and ultimately a jury determination based on competing expert testimony, regardless of clarity." *Id.* at 486.
23. *Id.* at 502-03.
24. *Id.* at 517.
25. *Id.*
26. *Cmty. Health Sys. Prof'l Servs. Corp. v. Hansen,* 525 S.W.3d 671, 688 (Tex. 2017).
27. *Nat. Union Fire,* 907 S.W.2d at 520.
28. *Id.* ("The [latent] ambiguity must become evident when the contract is read in the context of the surrounding circumstances …").
29. *Gallagher Headquarters Ranch Development, Ltd. v. City of San Antonio,* 303 S.W.3d 700 (Tex. 2010).
30. *Id.* at 702. The court has also noted, as a "classic example" of a latent ambiguity, a contract calling for goods to be delivered to "the green house on Pecan Street," where there were in fact two green houses on Pecan Street. *URI,* 543 S.W.2d at 765-66; *Nat. Union Fire,* 907 S.W.2d at 520 n. 4.
31. *Sun Oil v. Madeley,* 626 S.W.2d at 727. "Lack of clarity does not create an ambiguity …."
32. The Texas Pattern Jury Charges specify the following language for inclusion in an instruction to be given to a jury being asked to determine whether a party complied with an ambiguous agreement: "You must decide its meaning by determining the intent of the parties at the time of the agreement. *Consider all the facts and circumstances surrounding the making of the agreement* …." PJC 101.8, Texas Pattern Jury Charges—Contracts (emphasis added).

T. RAY GUY
is a member of Frost Brown Todd and resident in its Dallas office. He is certified in civil trial law by the Texas Board of Legal Specialization and is a panelist with the American Arbitration Association.

Seeking Nominations

DEADLINE: January 15, 2021

For more information on the nominations process, visit www.txbf.org or call the TXBF office at (512) 480-8000.

Terry Lee Grantham Memorial Award

Dan Rugeley Price Memorial Award

Gregory S. Coleman Outstanding Appellate Lawyer Award

Lola Wright Foundation Award

Outstanding 50 Year Lawyer Award

Outstanding Law Review Article Award

Ronald D. Secrest Outstanding Trial Lawyer Award

Samuel Pessarra Outstanding Jurist Award