§ 14.01. Introduction.

The natural gas industry in the pre-1990's period was predicated on the role of the pipeline as a merchant, not merely a transporter of natural gas. In many cases, pipelines executed gas purchase contracts with lessee/producers that were lengthy in duration and contained take-or-pay provisions committing the pipeline to pay for gas which it did not physically take.\(^{(1)}\)

Pipeline purchasers were caught in the natural gas price bubble of the 1980's, which restricted their ability to sell gas to end users at prices that would cover their purchase price from producers.\(^{(2)}\)

Pipelines therefore became obligated under their take-or-pay clauses to pay for gas they did not want. This, in turn, led to pipelines refusing to either take or pay for natural gas.\(^{(3)}\)

Producers quite naturally claimed that the pipelines were contractually liable for their take-or-pay obligations.\(^{(4)}\)

In the ensuing years, many pipelines and producers either settled or litigated these claims, which in most cases led to the payment of substantial sums of monies to the producers.\(^{(5)}\)

Williams and Meyers define a take-or-pay clause as follows:

A clause in a gas purchase contract requiring the purchaser to take, or failing to take, to pay for the minimum annual contract volume of gas which the producer-seller has available for delivery. Under such clause the purchaser usually has the right to take the gas paid for (but undelivered) in succeeding years.\(^{(6)}\)

The continued inclusion of this reasonably simple clause was based on a reasonably simple premises: energy prices would continue to rise as shortages in supply would continue into the indefinite future.\(^{(7)}\)
Unfortunately, the rising price scenario was displaced by an oversupply of natural gas characterized as the "natural gas bubble," which led to a sharp decline in energy prices generally and natural gas prices specifically. Thus pipelines were in the embarrassing position of agreeing to buy gas at a high price but unable to sell it except at a much lower price.\(^{(8)}\)

Pipeline breaches of take-or-pay provisions led to massive payments being made to producers in the late 1980's. The "million dollar" question was whether the royalty owners would share in these payments, be they the result of a settlement agreement or a court judgment.

In analyzing this question, it is helpful to break down the payment into its component parts in order to determine whether a royalty payment is due with respect to each such component. Two active practitioners in the field have suggested that a take-or-pay settlement can be composed of the following four parts:

1) Payments to settle past pricing disputes attributable to prior production.

2) Payments to settle past take-or-pay obligations not attributable to past production. This component can further be subdivided into payments which are recoupable from future production and payments which are not so recoupable.

3) Contract buydown payments whereby the producer receives a lump sum payment to amend the contract to reduce the price on future gas purchases and, in some cases, to also reduce the purchaser's required takes.

4) Contract buyout payments whereby the producer receives a lump sum payment to terminate the contract. As a result, the gas is freed of any obligation to the purchaser and thus will be sold to different purchasers.\(^{(9)}\)

An interesting issue is whether the royalty owner is entitled to notice of the contents of the agreement for purposes of determining whether royalty is to be owed. For example, payments under component 1 above relating to prior production would clearly be royalty-bearing. Payments relating to components 3 and 4, on the other hand, raise both royalty clause interpretation issues as well as implied covenant to market issues. In any event, it is likely that the characterization placed on the settlement by the lessee and the pipeline/purchaser would probably not be binding on the lessor who was likely not to be a party to either the contract or the settlement agreement.\(^{(10)}\)


Wyoming was the first state to decide at the appellate level the merits of a royalty owner's claim to a share of take-or-pay monies received by a producer from a pipeline for gas that was not taken.\(^{(11)}\)

In \textit{State v. Pennzoil Co.},\(^{(12)}\) two state lessees had entered into a gas purchase contract with Colorado Interstate Gas (CIG). The contract contained a take-or-pay clause with a five-year make up period being given CIG to take the gas paid for but not taken.\(^{(13)}\)

CIG was also required to pay the difference between the price it paid under its take-or-pay obligation and the price ultimately received when the gas was actually taken. Pennzoil refused to pay the state a royalty on the monies it received for gas not taken by CIG.
The state royalty clause provided as follows:

The royalties to be paid by lessee are: . . . (ii) on gas, including casinghead gas or other hydrocarbon substance, produced from said land saved and sold or used off the premises or in the manufacture of gasoline or other products therefrom, the market value at the well of one-eighth of the gas so sold or used provided that on gas sold at the wells the royalty shall be one-eighth of the amount realized from such sale. (14)

The state's position was that the take-or-pay payments were essentially advance payments for future production. The Wyoming Supreme Court three years earlier had determined that advance payments for uranium that had not been produced or marketed were royalty-bearing. (15)

The royalty in the earlier case was to be paid on uranium that was "mined and produced." In Pennzoil, royalty was to be paid on oil or gas that was "produced and saved or sold."

The court initially determined that the language of the royalty clause was not ambiguous, defeating the State's claim that the terms "produced" and "sold" were ambiguous. Instead the court relied on two different approaches to buttress its conclusion that production as used in the state's oil and gas lease form meant a physical severance from the ground. The first approach is basically a plain meaning approach: language will be given its plain meaning unless the parties express an intent to give it a different meaning. To the court, production clearly meant a physical severance from the ground in the absence of express language to the contrary. (16)

The second approach was to use some canons of construction to defeat the state's claim that the parties intended the state to share in all of the economic benefits that flow from the leasing transaction. Here the primary canon used was that documents should be construed against the scrivener, which in this case was the state. (17)

The actual production and sale of the hydrocarbons was considered a condition precedent to the royalty obligation; since the payments were not for hydrocarbons produced and sold, the state was not entitled to share in the proceeds.


In the mid-1980's the Federal Government as lessor of both onshore and off-shore oil and gas leases sought royalty on take-or-pay or settlement proceeds received by its lessees. In two separate cases, filed in two different districts in Louisiana, the courts reached two contradictory results. The Fifth Circuit, however, resolved the conflict when it jointly heard the two cases and rendered its decision in Diamond Shamrock Exploration Co. v. Hodel. (18)

In the lease involved in the Mesa case, the royalty clause required Mesa to pay the United States 1/6 in amount or value of "production saved, removed or sold from the leased area." (19)

Mesa had executed a gas purchase contract with Tennessee Gas Pipeline, which had a take-or-pay clause. Mesa tendered royalty to the U.S. on all gas actually taken by Tennessee, but did not tender any royalty on the payments made for gas not taken. Under the gas purchase contract, Tennessee had a seven-year make-up period for the gas not taken. The district court judge had found that the take-or-pay clause was designed in part to provide a steady cash flow to the producer. The monies paid for gas not taken were not paid for gas that had been produced. Therefore the royalty obligation was not triggered.
The Diamond Shamrock royalty clauses were similar to the Mesa clauses. The district court judge, however, found that the term "production" should be expansively defined based on the Outer Continental Shelf Lands Act's definition. (20)

The Act defines production as:

those activities which take place after the successful completion of any means for the removal of minerals, including such removal, field operations, transfer of minerals to shore, operation monitoring, maintenance, and work-over drilling. (21)

Since the take-or-pay payments compensate the producer for its monitoring, maintenance and other activities, the payments were for "production" and therefore royalty was owed.

The lease form authorized the Secretary to establish by regulation "reasonable minimum values" which would serve as the basis for royalty payments. The applicable regulations purported to establish a floor for the value for royalty payment purposes, by providing that "under no circumstances shall the value of production be less than the gross proceeds accruing to the lessee from the disposition of the produced substances . . . ." (22)

Extrapolating from the gross proceeds language, the Secretary argued that take-or-pay payments were part of the proceeds from the federal oil and gas lease. Therefore they were part of the value for which royalty payments must be made.

The Fifth Circuit rejected the Secretary's argument. It initially refused to apply the Act's expansive definition of production to the royalty clauses of the federal oil and gas lease. Production, according to the court, only means the physical severance of the hydrocarbons from the ground. (23)

The court then created a strawman by dealing with the problem of make-up gas. Most gas purchase contracts with take-or-pay clauses have make-up take provisions. These provisions ordinarily give the pipeline/purchaser several years to take the gas not previously taken but paid for, as well as providing for price adjustments should the value of the gas either increase or decrease from the level at which the take-or-pay payments were made. (24)

The court seemed unduly concerned that if adjustments were made, the lessee would either owe further royalty monies or would be entitled to a refund should the price be lowered. While the statute of limitations might prevent a refund suit, this was irrelevant in determining whether or not the leasehold royalty clause and the regulations required the payment of royalty on take-or-pay or settlement monies. (25)

Perhaps the key to the Fifth Circuit's analysis was its determination that take-or-pay payments were not payments for the "sale of gas." Instead, they were negotiated to provide a steady source of revenue to the producers to help them cover their investment, operations and maintenance. While fitting within the statutory definition of the term production, the Fifth Circuit found that these expenditures would be incurred whether or not a sale of hydrocarbons was ever consummated. Without such a sale, the royalty owner, whose interest was essentially risk-free, should not share in the benefits received by the risk-taker where there had been no physical severance from the ground.

While both Diamond Shamrock and Pennzoil reached the same conclusion, the Wyoming Supreme Court's inability to clearly overrule Cheyenne Mining and the Fifth Circuit's treatment of the OCS regulations left the door open for further litigation on this issue. In addition, both decisions affected governmental oil and
gas leases where the lessee was not the drafter of the lease. Furthermore, neither action dealt with settlement payments where it was possible to allege a breach of the implied covenant to market. These issues were raised in the next round of litigation affecting the major oil and gas producing states of the Gulf Coast region.

§ 14.03. The Plain Meaning Approach.

In a series of decisions rendered by two courts of appeal in Texas, royalty owners were denied a share of the take-or-pay or settlement proceeds based on a plain meaning approach to the royalty clause. The first of these cases, *Killam Oil Co. v. Bruni*, presents a classic fact situation. The Bruni Trust executed a 3800-acre lease to Killam and Hurd. Several producing wells were drilled and a gas purchase contract was consummated with United Texas Transmission Co. (UTTCO). The gas purchase contract contained a take-or-pay clause. There was no mention of a make-up provision although that factor did not enter into the court's decision. UTTCO breached its take-or-pay obligation and eventually settled with the two lessees with a payment of approximately $6.8 million.

The trial court granted the royalty owner's motion for summary judgment.

The court approached the issue as a simple case of construing a written instrument. It applied the traditional Texas principles and canons of construction, relying in large part on the express language of the royalty clause. It likewise found the royalty clause language unambiguous so that extrinsic evidence or other factors could not be admitted to ascertain the intent of the parties.

The key to the court's analysis was a rigorous look at the royalty clause to determine what events triggered the royalty payment obligation.

The two key terms that needed to be defined were "produced" and "sold." If the gas was neither produced nor sold there would be no royalty payment obligation. The court began its analysis with a look at the term "production" as it occurs in the habendum clause. For habendum clause purposes, production has been defined as "the actual physical extraction of the mineral from the soil." But the habendum clause and the royalty clause serve different functions. The former denotes the limitation which will automatically terminate the lease, while the latter describes the basic consideration which supports the conveyance of the mineral estate to the lessee.

The court therefore went on to analyze two further cases where the term production is defined. In *Exxon Corp. v. Middleton*, the issue was whether the lessee was obligated to pay market value or proceeds royalty on gas that was sold pursuant to a long term gas purchase contract.

The court there applied a literal or plain meaning approach to resolving that issue, concluding that the gas was produced and sold not when the gas purchase contract was executed but when the gas was physically severed and delivered to the gas purchaser. It should be noted that a number of jurisdictions, including Arkansas, Louisiana, and Oklahoma take a different view regarding when the gas is sold under a long term contract. While the approach taken as to when gas is produced and sold may not be critical to a determination of whether royalty is owed on take-or-pay or settlement monies, the *Middleton* holding clearly supports the *Bruni* decision.
Perhaps even more critical to the court's view was its analysis of *Monsanto Co. v. Tyrrell.*

*Tyrrell,* however, involved a very atypical oil and gas lease.

Tyrrell, the lessor, was to receive a 30% royalty upon initial production. After Monsanto, the lessee, had recouped from its 70% of production all of its drilling and production costs, the royalty would increase to 50%. Monsanto entered into a gas purchase contract which provided for an advance payment being made prior to the achievement of actual production. The payment was to be recouped from actual production, measured at 30% of the value of the gas produced and delivered to the pipeline. Tyrrell argued that advance payment was "recovery from production" under the lease and therefore would count in determining when payout had occurred.

In the context of this peculiar royalty provision, the court relied on habendum clause cases to determine that production means "the actual physical extraction of the mineral from the soil." Since the payments were not for gas actually delivered to the pipeline, they were not included in the amounts that were to be calculated to determine whether payout had been reached.

The *Tyrrell* court's rationale for requiring actual production was that to treat the advance payment otherwise would shift the entire burden of drilling and equipping the well to Monsanto. As others have argued, however, determining when there is production, and when there is a payment in advance of production, are two separate questions.

The lessee and the purchaser cannot set the time for payment that would deleteriously impact the rights of the royalty owner to recoup her royalty share. If the royalty owner can show, as in *Cheyenne Mining* and *Frey,* that the payments reflect a present sale at a future date of the production, royalty should be paid.

The *Bruni* analysis was also followed in *Mandell v. Hamman Oil & Refining Co.*

The royalty clause provided that for gas the royalty owner was to receive "1/4 of 8/8ths (one-fourth of eight-eighths) of all produced . . . ."

There was also a provision allowing the royalty owner to take his share of gas in kind, should he so elect. The lease also required the lessee to make best efforts to sell the gas and encouraged the lessee when contracting with purchasers to include a "favored nations" pricing provision so that the lessors would receive the benefit of the highest-priced gas purchase contract executed by the pipeline/purchaser.

The lease also gave the lessors the right to receive a copy of any gas purchase contract with the right to approve of the contract or take in kind.

A producing gas well was drilled and the lessee executed a long term gas purchase contract with Tennessee Gas Pipeline Co. The royalty owners were eventually given a copy of the contract, but neither approved it nor elected to take in kind as required under the lease. The contract had a take-or-pay provision requiring Tennessee to take or pay for 85% of the well's deliverability. Tennessee refused to take or pay in the third year of the contract. Eventually, Tennessee agreed to settle the take-or-pay litigation for $8,000,000. The settlement called for the lessee to assign its working interest in the lease to Tennessee. The jury allocated $6.5 million of the settlement to the value of the working interest, $626,000 to take-or-pay damages, and $874,000 to drainage and reduced price damages. Royalty was owed on the $874,000 but not on the remainder of the settlement.
Mandell tried to use his leasehold right to take in kind to argue that when Hamman sold the gas, they were selling Mandell's gas. The court rejected this claim because under the lease Mandell had an option to take his gas in kind, an option that had not been exercised at the time of the settlement agreement. Their interest was merely an economic interest in the value of production, not a corporeal interest in the hydrocarbons in the ground.

The court was quite brief in its rejection of the Mandell's claim that royalty was owed on any take-or-pay or settlement payment. Relying on Bruni, the court likewise concluded that royalties were owed on production, which required a physical severance from the ground. The court characterized the take-or-pay agreement as an allocation of risk between natural gas producers and purchasers. That function is distinct from an advance payment for production or as an intrinsic part of the value of the gas that is actually produced and sold. Here Tennessee's payments, except for the $874,000, were not based on gas that had been produced.\(^\text{(46)}\)

The Texas approach taken in Mandell and Bruni is consistent with the state's approach to interpreting oil and gas leases in general, and royalty clauses specifically. Extrinsic evidence and factors are not usually admitted to interpret a written instrument and the courts adhere to the plain meaning approach, especially as to terms of art.\(^\text{(47)}\)

This approach does not allow for the consideration of the "practical realities" of the industry to affect the court's interpretation of unambiguous lease language.\(^\text{(48)}\)

Thus in the market value/proceeds situation, Texas adhered to the view that the two terms were not the same and that a market value royalty clause required the lessee to pay royalty on the current market value of the hydrocarbons regardless of the proceeds it was receiving pursuant to its sales contract.\(^\text{(49)}\)

This view is also consistent with the two central themes of Middleton. The first is that gas sold under a gas purchase contract is sold when it is physically produced. The second is that the terms of the gas purchase contract cannot affect the royalty obligation created in the lease. Here the parties specified that royalty would be due upon a particular event — production. As defined by the court, production is the physical severance of the hydrocarbons and without such a severance no royalty obligation is incurred.\(^\text{(50)}\)

**§ 14.04. The Cooperation Principle.**

Various commentators have argued that one of the bases for the implication of covenants in the lessor/lessee relationship is the contractual principle of cooperation.\(^\text{(51)}\)

The principle has been extended to cover more than the classic implied covenants.\(^\text{(52)}\)

This cooperation principle, as well as a predilection to look beyond the express terms of the written instrument, has led the Louisiana and Arkansas Supreme Courts to find that royalty was payable upon the receipt of take-or-pay or settlement monies by the lessee.

In Frey v. Amoco Production Co.,\(^\text{(53)}\) the Louisiana Supreme Court answered the following question certified to it by the Fifth Circuit Court of Appeals:

Whether under Louisiana law and the facts concerning the Lease executed by Amoco and Frey, the Lease's clause that provides Frey a "royalty on gas sold by the Lessee of one-fifth (1/5) of the amount realized at the well from such sales" requires Amoco to pay Frey a royalty share of the take-or-pay payments that Amoco
earns as a result of having executed the Lease and under the terms of a gas sales contract with a pipeline-purchaser.\(^{54}\)

The facts in *Frey* are slightly different than the other royalty on take-or-pay cases. While the leasehold royalty clause used the term "produced and saved" to describe when oil royalty was due, the gas royalty clause did not contain such a term. Instead gas royalty was due when it was either "used" or "sold."\(^{55}\)

Amoco and Columbia Gas Transmission had executed a gas purchase contract with a take-or-pay clause. Columbia breached its contractual obligations and eventually settled Amoco's claims for $66.5 million. Columbia and Amoco allocated $45.6 million as recoupable take-or-pay payments and $20.9 million as non-recoupable take-or-pay payments.\(^{56}\)

The court could have limited its decision to its interpretation of the particular royalty clause used, which, insofar as gas production was concerned, did not use the term "produced." The court did note that where the gas was in fact sold, the settlement monies could be considered part of the total price paid for the gas that was sold. In addition, where a proceeds royalty clause was involved, the court concluded that settlement monies for gas actually produced had to be considered part of the proceeds.\(^{57}\)

The court noted that a sale, not production, was the triggering event for royalty on gas:

The Frey-Amoco Lease explicitly predicates Amoco's obligation to pay royalty on the sale of gas. In contrast, royalty on oil . . . is triggered by production. The discrepancy in "triggering" events is indicative of the physical and economic dissimilarity between oil and gas . . . . Moreover, the variance of language supports Frey's contention [that] production is not a prerequisite to a sale.\(^{58}\)

If the opinion were limited to this rationale, states such as Arkansas and Oklahoma which would base royalty valuation of gas based on the price payable under the gas purchase contract, might reach a similar result if the gas royalty clause did not use the term "produced" as its triggering event.

But the Louisiana Supreme Court, consistent with its earlier decisions, looked well beyond the leasehold language to determine whether royalties were owed on take-or-pay or settlement monies.\(^{59}\)

In looking at extra-lease factors, the court tries to divine the general intent of the parties when they executed the lease. Instead of focusing on the express language of the royalty clause to ascertain the parties' specific intent, the Louisiana court explores the global relationship between a lessor and a lessee. The lease is treated as a cooperative venture between the parties whereby the lessee contributes the capital and the expertise in exchange for the right to develop the lessor's minerals.\(^{60}\)

This allows the court to make an expansive reading of the royalty clause. Benefits which flow from the leasing transaction must be shared between the lessee and the lessor. To allow the lessee to keep the entire benefits is to encourage opportunistic behavior on behalf of the lessee to structure settlements in a way that would be deleterious to the royalty owner's interest.\(^{61}\)

If the lessor had not executed the lease giving the lessee the right to drill for, and produce, natural gas, the lessee would not be receiving the benefits of the take-or-pay clause. Because of this cooperative venture, it would be grossly unfair to allow one party to retain all of the benefits where without the other party, there would have been none of those benefits inuring to the lessee.

While there is some language in *Frey* which suggests that it would be limited to Louisiana because of the
court's reliance on several provisions of the Mineral Code, the Eighth Circuit in *Klein v. Jones* reached a similar result applying Arkansas law. While the facts are somewhat complex, the royalty owners were suing Jones and McCoy and Arkla after Arkla had made substantial payments to Jones and McCoy to settle take-or-pay claims. (63)

Unlike the *Frey* royalty clauses, many of the leases used the word "produced" in the gas royalty clause. (64)

Thus the court had to overcome the argument that the payments were not for gas that was ever produced.

The plaintiffs made several novel arguments. They first claimed that the lessees had breached a general duty of fair dealing that arose from the lessor-lessee relationship. (65)

The court rejected the notion that there was a fiduciary relationship between lessor and lessee but the lessee's actions were to be judged under the traditional reasonable and prudent operator standard. The lessee's efforts to liquidate their claims against the purchaser were reasonable and prudent and thus there was no breach of any general duty of fair dealing. (66)

The court likewise rejected the royalty owners claim that they were third-party beneficiaries under the gas purchase contract. As merely incidental beneficiaries, the royalty owners had no standing to claim any of the benefits of the gas purchase contract. (67)

Likewise the court dismissed the plaintiffs' claim that Jones and McCoy had tortiously interfered with a contractual relationship.

But the court did find that plaintiffs had stated a cause of action under the general rubric of "unjust enrichment." (68)

As with *Frey*, the unjust enrichment rationale requires the court to consider extra-lease factors as it attempts to interpret the royalty clause. Arkansas, like Louisiana, employed "market realities" to reach the conclusion that market value and amount realized lease language meant the same thing if the lessee executed an arms-length long term gas purchase contract. (69)

This predisposition to consider extrinsic factors when combined with a sense of equity led the Eighth Circuit to agree with *Frey* that royalty was owed on take-or-pay or settlement monies. (70)

It also based its argument on a generalized cooperation principle that governs the lessor-lessee relationship. (71)

It likewise rejected any attempt to ascertain the specific intent of the parties when they negotiated the lease with its royalty clause language. Essentially the court viewed the payments to the royalty owners as a fair distribution of the mutual benefits that arise from the leasing transaction. (72)

It also emphasized the inherent unfairness of allowing either the lessor or the lessee to "receive a part of the gross revenues from the property greater than the fractional division contemplated by the lease . . . ." (73)

The *Frey/Klein* approach is consistent with each state's treatment of other royalty issues in general and the market value/proceeds issue specifically. Extrinsic evidence, industry practice, market realities, notions of fairness are all included in the calculus of decision-making. The courts admit that they are not seeking to determine the specific intent of the parties as it relates to the royalty clause. Instead, the general intent, as
reflected in the cooperation principle should guide the courts in their interpretive process. Once the cooperation principle is applied, the outcome appears certain: the royalty owner should share in any of the economic benefits that flow from a gas purchase contract, including take-or-pay monies.

§ 14.05. The Implied Marketing Covenant.

Within the panoply of implied covenants, the implied marketing covenant has been the least litigated and least written about over the years.\(^{(74)}\)

The traditional elements of a cause of action for breach of the marketing covenant are 1) discovery of hydrocarbons on the premises; 2) failure to market the discovered hydrocarbons; 3) ability to market the hydrocarbons if the lessee's action complied with the relevant standard of conduct; and 4) damages proximately caused by the lessee's failure to act in the prescribed manner.\(^{(75)}\)

In addition to the actual marketing of the product, the implied marketing covenant has been expanded to require the lessee to obtain the best price and terms reasonably available.\(^{(76)}\)

The covenant ostensibly applies to settlement agreements whereby the interests of the lessor and the lessee might diverge. Professor Richard Pierce, early in the debate over royalty owners' rights to share in settlement monies, posited two situations where the interests of the lessor and lessee would conflict. The first arises where the lessee accepts a lump sum payment in exchange for a change in the make-up schedule or a lowering of future prices. The second arises where there is a global settlement that involves more than one lessor and the rights of various lessors are affected in different ways.\(^{(77)}\)

While several of the major decisions discuss the implied marketing covenant and its application to take-or-pay and settlement payments, none have held that a breach of the implied marketing covenant has occurred. In *Hurd Enterprises, Ltd. v. Bruni*,\(^{(78)}\) the marketing covenant issue was center-stage in the bifurcation of the *Bruni* case. The jury had found that the lessee had not failed to reasonably market the gas by either agreeing to the gas purchase contract amendments which lowered the price and by settling the contract claims as they had.\(^{(79)}\)

The jury, however, did find that the lessee had breached a general duty of good faith and fair dealing in the way it structured the settlement agreement. While there is an inconsistency between these two jury responses to the special issues, the court of appeals resolved that conflict by inferring that the jury had applied two different standards of conduct to the two different special issues. The appropriate standard of conduct to comply with the marketing covenant is the reasonable and prudent operator standard.\(^{(80)}\)

The duty of good faith and fair dealing is a different standard, as it by definition involves a subjective, as well as an objective, analysis of the lessee's actions. The court rejected the implication of a general covenant of good faith and fair dealing, or a higher fiduciary standard of conduct, in the absence of some proof of a special or confidential relationship between the lessor and lessee.\(^{(81)}\)

The facts indicated that the lessor was a knowledgeable oil and gas owner who negotiated all of its leases. Under those circumstances there would be no confidential or special relationship merely because the lessee and lessor had executed a lease. Therefore, the jury verdict that a duty of good faith and fair dealing had been violated would have to be overturned.

A total rejection of the application of the implied marketing covenant to most take-or-pay or settlement
actions by lessors was summarily adopted by the court in Mandell.

After denying royalty on take-or-pay or settlement monies because no physical severance had occurred, the court dealt with the royalty owner's claim that the settlement agreement violated the marketing covenant in a similar manner. The court recognized the marketing covenant but then went on to conclude that marketing entails production and the take-or-pay liability and its ensuing liability was for gas that was not produced. Without production there are no marketing covenant duties.\(^{(83)}\)

The court stated:

\[
\text{Take or pay is not a benefit that appellants received via execution of the lease . . . and does not flow from the marketing covenant of the lease. Hamman was required to obtain for appellants only benefits received that were related to the sale of gas that had been produced.}^{(84)}
\]

As noted above, the classic elements of the marketing covenant cause of action do not require physical severance, they merely require the discovery of hydrocarbons and a failure to market where a market is available. The court's summary dismissal of the marketing covenant claim is disturbing as it suggests that if a party enters into a contract for the sale of hydrocarbons at below market level prices, the lessor has no cause of action until the gas is actually delivered and paid for.\(^{(85)}\)

The implied marketing covenant was also discussed in Frey, although it was not critical to the court's decision. In Louisiana the implied covenants do not arise out of the cooperation principle or the need to prevent opportunistic behavior in relational contracts.\(^{(86)}\)

Instead, the duty to act as a reasonable and prudent operator arises out of Article 122 of the Mineral Code,\(^{(87)}\) which creates an obligation for lessees to act as "good administrators."\(^{(88)}\)

The actions of the lessee in settling the dispute and lowering the price of the gas that was dedicated to the contract met the marketing covenant standard, because to demand complete performance of the contract would have undoubtedly led to the pipeline's insolvency and injured both the lessor's and lessee's interests.\(^{(89)}\)

The court, however, suggests that the lessee's benefits, which flow from its continuing duty to market the gas at the best price and terms available, should not solely be retained by the lessee. The lessee must share the benefit with the lessor when all the lessee is doing is complying with its leasehold obligations.\(^{(90)}\)

\section*{§ 14.06 Conclusion.}

As with other royalty issues,\(^{(91)}\) there is a sharp division between the states on how to deal with take-or-pay or settlement monies. The present division on this issue, however, can be explained by the jurisdictions' general views on oil and gas lease interpretation issues. Texas has always been committed to a literal interpretation of oil and gas leases, with little extrinsic evidence being admissible to ascertain the meaning of the language used in the lease. Therefore it is not surprising that where leases require the production of gas before a royalty payment is triggered, payments made to a lessee for the non-production of gas is not royalty-bearing. Likewise, the Texas interpretation of when gas is sold supports its position that until physical delivery, no sale occurs.

On the other hand, Arkansas and Louisiana have been much more willing to allow extrinsic factors to color
their interpretation of oil and gas leases. Consistent with their use of "market realities" to interpret the market value/proceeds dichotomy, these two states similarly allow extrinsic factors to color their interpretation of the royalty clause as it relates to take-or-pay payments. Adopting a broader cooperation principle, Arkansas and Louisiana want the lessor/lessee relationship to be a closer one so that the lessee who receives benefits from the existence of the lease will have to share those benefits with the non-risk-bearing royalty owner. There are some dangers in this approach, given the traditional allocation of risk between the royalty and working interest owners. This "activist" approach is obviously a two-edged sword. In the case of the market value/proceeds issue, the lessees were able to use extrinsic factors to reap a benefit while in the take-or-pay arena the lessors were able to use extrinsic factors to reap a similar benefit. Because so much reliance is placed on extrinsic factors, uncertainty will be created which will add to the costs of oil and gas development.

The implied marketing covenant clearly has a place in take-or-pay or settlement payment disputes. The Mandell conclusion that no marketing duties arise until there is a physical severance flies in the face of the history of the marketing covenant. With a duty to market, however, comes the reality of the new gas market. As Frey accurately pointed out, a lessee is under a duty to market, but if the pipeline/purchaser is unwilling or unable to take under the terms of the existing contract, is not the lessee under a duty to renegotiate a new contract with new terms that will hopefully benefit both the lessor and the lessee in the long run? These issues are best left to the jury who can decide whether the renegotiation process takes into account the interests of both the lessor and the lessee where there is a strong potential for a divergence of interests.

1. For a description of take-or-pay clauses and natural gas purchase contracts, see generally 4 Howard R. Williams & Charles J. Meyers, Oil & Gas Law § 724.5 (1992); Thomas G. Johnson, "Natural Gas Sales Contracts," 34 Inst. on Oil & Gas L. & Tax'n 83, 108-111 (1983); Bruce M. Kramer, "Royalty Obligations Under the Gun Ð The Effect of Take-or-Pay Clauses on the Duty to Make Royalty Payments," 39 Inst. on Oil & Gas L. & Tax'n 5-1, 5-3 to 5-5 (1988).


3. For an excellent review of the problems facing the natural gas industry in the early 1980's, see Richard J. Pierce, Jr., "Lessor/Lessee Relations in a Turbulent Gas Market," 38 Inst. on Oil & Gas L. & Tax'n 8-1 (1987).


5. Michael P. Pearson & Richard D. Watt, "To Share or Not to Share: Royalty Obligations Arising out of Take-or-Pay or Similar Gas Contract Litigation," 42 Inst. on Oil & Gas L. & Tax'n 14-1 (1991)(hereinafter Pearson & Watt). With few exceptions, the defenses proffered by the pipelines were rejected by the court.

6 8 Williams & Meyers, supra note 1, at 1233 A typical take-or-pay clause is as follows:

Buyer agrees to purchase and receive from Seller or to pay for if available but not taken, a quantity of gas equal to the sum of the Daily Contract Quantities herein specified. . . The Daily Contract Quantity shall be the daily rate of production equal to seventy-five percent (75%) of the Delivery Capacity of each well. . ." Medina, et al., supra note 4, at 187.

7 There was litigation regarding a take-or-pay provision in a gas purchase contract in 1950. United Carbon Co. v. Monroe, 92 F. Supp. 460 (W. D. La. 1950), aff'd, 196 F.2d 455 (5th Cir. 1952). See generally Kramer, supra note 1, at 5-3 to 5-4.

8 McArthur, supra note 2, at 361-63; Pearson & Watt, supra note 5, at 14-9 to 14-11. The pipelines in 1989 were claiming in reports to the Federal Energy Regulatory Commission that $44 billion of take-or-pay liability had already been settled. 54 Fed. Reg. 52,356 (1989) (Table 5).


10 Piney Woods Country Life School v. Shell Oil Co., 726 F.2d 225 (5th Cir. 1984); Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866 (Tex. 1968).


14. 752 P.2d at 976 (emphasis omitted). The royalty provision also had a favored nations clause which required its lessee to pay royalties on the same basis as those received by the United States for production from federal leases in the same field. *Id.*


16. *See generally* Union Oil Co. of Calif. v. Touchet, 86 So. 2d 50 (La. 1956); Monsanto Co. v. Tyrrell, 537 S.W.2d 135 (Tex. Civ. App. Ñ Houston [14th Dist.] 1976, writ ref'd n.r.e.).

17. The court concluded: "If there were any arguable ambiguity in this aspect of the lease, any doubt would have to be resolved against the Board as the drafter of the lease." 752 P.2d at 979 (citations omitted).

18. Diamond Shamrock Exploration Co. v. Hodel, 853 F.2d 1159 (5th Cir. 1988). The other case was styled *Hodel v. Mesa Petroleum Co.* and the district court opinion was not officially reported. *See generally* Kramer, *supra* note 1, at 5-15 to 5-18.

19. 853 F.2d at 1161.


21. *Id.*

22. 853 F.2d at 1164-65 (citing 30 C.F.R. § 206.150); in current regulation, present at 30 C.F.R. § 206.152(h).
24. See generally Johnson, supra note 1, at 110-11.

25. The court hypothesized that with a seven-year make-up period and a two-year statute of limitations on claims arising from royalty checks, the producers would be barred from seeking refunds. 853 F.2d at 1166. Certainly payments could be made conditioned upon ultimate settlement, and it would appear much more likely that the United States would be a "solvent" defendant rather than an individual royalty owner.


27. Killiam Oil Co. v. Bruni, 806 S.W.2d 264.

28. 806 S.W.2d at 265.

29. Id. at 265-66. The court also severed the royalty owner's claim that the implied covenant to market had also been breached. Those issues were decided in Hurd Enterprises, Ltd. v. Bruni, 828 S.W.2d 101 and discussed in detail infra at text accompanying notes 76-78.

30. The court applied several canons of construction. The court was to determine the intention of the parties as expressed in the written instrument. Extrinsic evidence was not to be used unless the instrument was ambiguous and the instrument was to be construed against the royalty owners who drafted it. 806 S.W.2d at 266-67. See generally Bruce M. Kramer, "The Sisyphean Task of Interpreting Mineral Deeds and Leases: An Encyclopedia of Canons of Construction," 24 Tex. Tech L. Rev. 1 (1993)(hereinafter Kramer, Sisyphean).

31. The lease contained a reasonably standard gas royalty provision:

The royalties (b) on gas, including casinghead gas and all gaseous substances, produced from said
land and sold or used off the premises or in the manufacture of gasoline or other product therefrom, the market value at the mouth of the well of one-eighth of the gas so sold or used provided that on gas sold at the wells the royalty shall be one-eighth of the amount realized . . . .

806 S.W.2d at 266 (emphasis omitted).

32. 806 S.W.2d at 267 (citing Gulf Oil Corp. v. Reid, 337 S.W.2d 267 [Tex. 1960]; Rogers v. Osborn, 261 S.W.2d 311 [Tex. 1953]).


40. 537 S.W.2d at 137.

41. See generally Buie, supra note 26, for a forceful argument of why settlement and take-or-pay monies should be treated as royalty bearing because they are in effect advance payments for production.

43. *Id.* at 153.

44. *Id.* at 156.

45. *Id.* at 165. The lessee had tendered a $10,000 payment, while the jury found that the royalty owner was entitled to $18,892. *Id.*

46. The categorization that the lessee and the pipeline/purchaser place on the settlement monies would obviously not be binding on the royalty owner. See Piney Woods Country Life School v. Shell Oil Co., 726 F.2d 225 (5th Cir. 1984). In this case there was conflicting expert testimony regarding the allocation of the settlement monies. The jury obviously believed the experts for the lessees who assigned a value to the leasehold reserves of $6.5 million. 822 S.W.2d at 165.

47. See generally Kramer, *Sisyphean*, supra note 30.


50. 613 S.W.2d at 244.


53. Frey v. Amoco Production Co., 603 So. 2d 166 (La. 1992). Frey had an interesting procedural history. In two separate cases, the United States District Court for the Eastern District of Louisiana found that no royalty was owed on take-or-pay payments. 708 F. Supp. 783 (E.D. La. 1989), 741 F. Supp. 601 (E. D. La. 1990). The Fifth Circuit initially affirmed in part and reversed and remanded in part with a concurring opinion. 943 F.2d 578 (5th Cir. 1991). The same panel, however, withdrew its opinion and certified a question to the Louisiana Supreme Court. 951 F.2d 67 (5th Cir. 1992).

54. 951 F.2d at 68.

55. The royalty clause provided in part:

the royalties to be paid by Lessee are: (a) on oil . . . one-fifth (1/5) of that produced and saved from the land . . .; (b) on gas, one-fifth (1/5) of the market value at the well of the gas used by Lessee in operations not connected with the land leased. . .; the royalty on gas sold by the Lessee to be one-fifth (1/5) of the amount realized at the well from such sales; (c) one-fifth (1/5) of the market value at the mouth of the well of gas used by Lessee in manufacturing gasoline or other byproducts. . .

603 So. 2d at 169 (n.3).

56. 603 So. 2d at 170 (n.5). Columbia retained the right to recoup the entire $45.6 million in make-up gas. At the time of the litigation, it had taken sufficient quantities of make-up gas for which royalty had been paid. Likewise royalty had been paid on a $280.2 million allocation for past and future price deficiencies. Id.

57. 603 So. 2d at 179-80.

58. 603 So. 2d at 179. This analysis is somewhat inconsistent with Henry, 418 So. 2d 1334, which did not treat the difference between the terms "market value" and "amount realized" as creating a different valuation standard for gas royalty.

Arkla was a major lessee in the Arkoma Basin when it agreed to sell to a Jones and McCoy controlled corporation (Arkoma) one-half of its leasehold interests. Arkoma then executed a gas purchase contract with Arkla which contained a take-or-pay clause and a reasonably high sales price. Arkla eventually breached the gas purchase contract and as part of the settlement essentially purchased the Jones and McCoy leasehold interests.

Although many leases were involved, the basic royalty provision which the court was interpreting stated as follows:

Lessee shall pay Lessor as royalty on gas . . . and other gaseous substance produced from said land and sold or used by Lessee off of the land . . ., the market value at the mouth of the wells of one-eighth (1/8) of such products so sold or used. On all gas . . . sold at the wells by the Lessee the royalty shall be one-eighth (1/8) of the amount realized by such sales.


The court identified three factors which "cry out" for equity intervention: 1) Congress in regulating the market for natural gas never concerned itself with the interests of the royalty owners; 2) The regulatory scheme distorted the marketplace through its vintaging and different rate categories; and 3) The lessee's interest diverged from the royalty owners when they were purchased by Arkla, the pipeline/purchaser. 980 F.2d at 527.

The cooperation principle argument is at odds with the court's rejection of the fiduciary relationship and the implied duty of good faith and fair dealing. See supra text accompanying note 65.

980 F.2d at 529.

Id. at 531 quoting from Henry v. Ballard & Cordell Corp., 418 So. 2d 1334, 1338 (n. 10) (La. 1982) (quoting Thomas A. Harrell, "Developments in Non-Regulatory Oil & Gas Law," 30 Inst. on Oil & Gas L. & Tax'n 311, 336 (1979)).


Kramer & Pearson, supra note 74, at 794. See also 5 Williams & Meyers, supra note 2, § 855.


Richard J. Pierce, Jr., "Lessor/Lessee Relations in a Turbulent Gas Market," 38 Inst. on Oil & Gas L. & Tax'n 8-1, 8-15 to 8-25 (1987). See also Kramer, supra note 1 at 5-30 to 5-33.


Id. at 104.
There is some dispute as to whether a different standard should apply in marketing covenant cases because it involves a business judgment made by the lessee. Kramer & Pearson, supra note 73, at 809-822. The court did note, however, that the implied marketing covenant imposes a duty "to market the production with due diligence and obtain the best price reasonably possible." 828 S.W.2d at 107-08 (citing Cabot Corp. v. Brown, 754 S.W.2d 104, 106 (Tex. 1987)).

This analysis ignores the long standing use of the implied marketing covenant to deal with either the failure to market gas or an unreasonable delay in the marketing of gas. Kramer & Pearson, supra note 73, at 794-95.

Author's note: I would think that the lessor could bring an immediate action for breach of the covenant and seek damages for the difference in price between what a reasonable and prudent operator would have received and what the imprudent operator actually received, discounted to present value. The lessor would, of course, have the burden of proof on the damages issue, including proving how much and when the gas would be sold.

The court stated:
We recognize the virtually perfect alignment of interests existing among the lessee, lessors, and society regarding certain limited aspects of the lease, including resolution of the pipeline-purchaser's financial inability to comply with the take-or-pay provisions in the long term gas contract. . . . More specifically, were a producer to force a pipeline-purchaser to comply with the long-term gas contract, despite the decline in price and market, it is not unlikely the pipeline would be faced with insurmountable financial problems and, eventually, forced into insolvency. . . . A financially insolvent pipeline will not purchase any gas, and a royalty interest is worthless if no gas is sold.

Id. at 181 (citation and emphasis omitted).

90. In Klein, the Eighth Circuit did not get to the merits of the implied marketing covenant claim because the trial court found the action barred by limitations. The trial court had also found that were it not for limitations, the royalty owners had stated a valid claim for breach of the implied marketing covenant. The Eighth Circuit also recognized that Arkansas has adopted the implied marketing covenant and uses a reasonable and prudent operator standard to judge the conduct of the lessee. It disagreed, however, with the application of the statute of limitations, and reinstated the cause of action. 980 F.2d at 532 (citing Amoco Prod. Co. v. Ware, 602 S.W.2d 620, 624 (Ark. 1980)).

91. See generally Kramer, Royalty Interests, supra note 34.