RECENT DEVELOPMENTS IN NONREGULATORY OIL AND GAS LAW: UNFINISHED BUSINESS

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CHAPTER 3

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SYNOPSIS

§ 3.01. Introduction.

Cases decided during 2001 remind us how dynamic, and static, the law can be concerning the discipline we call oil and gas law. This article discusses recent developments and highlights some of the unfinished business in nonregulatory oil and gas law. Many of the cases examined in this article merely confirm what we have known for years; others challenge our understanding of what we thought was the law. Nowhere have the static, the dynamic, and the unfinished business been better portrayed than in the interpretation of the royalty clause.

§ 3.02. Interpreting the Royalty Clause.

[1] Texas: It Means What It Says.

[a] "Market Value" Means Market Value.

The Texas Supreme Court's holding in *Yzaguirre v. KCS Resources, Inc.*[1] should come as no surprise to the oil and gas community. The case represents a straight-forward application of lease interpretation principles and implied covenant analysis. The court in *Yzaguirre* had to determine whether its *Vela/Middleton*[2] market value royalty rule was a two-way street: Would it apply when it did not net the lessor a greater royalty than he would receive under a proceeds calculation? The question posed in *Yzaguirre* was the same as that posed in *Vela* and *Middleton*: Does the lessee's gas contract matter when the oil and gas lease provides for a royalty share of the "market value" of the gas produced? The answer in *Vela* and *Middleton* was "No"; the answer in *Yzaguirre* was "No." Unlike a proceeds royalty, which

[1] 53 S.W.3d 368 (Tex. 2001).

[2] Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866 (Tex. 1968); Exxon Corp. v. Middleton, 613 S.W.2d 240 (Tex. 1981). The court in *Yzaguirre* summarized its *Vela* holding, and the issue presently before it, as follows:

> When royalty payments are based on market value under an oil and gas lease in Texas, the lessee owes royalty based on the price of gas on the open market, even though the gas was actually sold for less than this price under a long-term sales contract. . . . In this case, we must decide whether the open-market price is still the correct measure under such a lease when the lessee sells the gas for *more* than market value under a long-term sales contract.

requires reference to a gas sales transaction to calculate the royalty due, a market value royalty is a self-contained "objective basis for calculating royalties that is independent of the price the lessee actually obtains . . . ."[3]

Timing is often everything in contracting for long-term gas sales. In 1979, KCS Resources, Inc., entered into a twenty-year gas sales contract with Tennessee Gas Pipeline Co. that provided for what would prove to be very favorable gas prices. The oil and gas lease between KCS and its lessor, Mr. Yzaguirre, provided for an "amount realized" royalty if gas was sold at the wells and a "market value" royalty if sold off the leased premises.[4] The gas sale took place at a processing plant several miles from the leased land and therefore triggered the market value royalty measure. Ultimately, the pricing provisions in the gas sales contract with Tennessee resulted in prices that far exceeded the market value of the gas when it was produced.[5]

[b] Express "Market Value" Covenant Eliminated Need for Implied Covenant to Market.

In an effort to construe the phrase "market value" in their favor, the lessors resorted to an unsuccessful argument previously advanced by the *Vela/Middleton* lessees: that market value merely means the lessees can deduct the costs they incur to obtain the off-lease proceeds.[6] After rejecting this express covenant approach, the lessors turned to an implied covenant argument, relying on the implied

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[3] *Yzaguirre*, 53 S.W.3d at 374.

[4] The royalty clause for each lease at issue stated:

> The royalties to be paid by Lessee are: . . . on gas, including casinghead gas or other gaseous substance, produced from said land and sold or used off the premises or for the extraction of gasoline or other product 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. . . .

Id. at 372.

[5] *Id.* at 370.

[6] The court observed:

> The Royalty Owners claim that the distinction between these types of royalties ["market value" and "amount realized"] lies in what costs are deducted before calculating the royalty, not in the rate on which the royalty is based. In their view, both amount-realized and market-value royalties start with the price the producer actually receives for the gas, with the difference being that the lessee subtracts transportation costs from the proceeds before paying market-value royalty.

Id. at 372. What goes around comes around.

covenant to reasonably market. The lessors asserted their lessee had an implied obligation "to obtain the best price available for the benefit of the royalty owner"[7] on the underlying theory that "the entire body of implied covenant law has been aimed at . . . making sure the royalty owner gets the best deal."[8] The court rejected the lessors' implied covenant theory because the lease provided an express basis for calculating the royalty due—market value. The court concluded that lessors under a market value royalty clause, in any event, need no protection from lessee self-dealing because they will always receive a royalty based on the market value of the gas produced.[9] Therefore, if the lessors have been paid a royalty based on current market values, they have received the benefit of their bargain as expressed in the royalty clause of their lease, and the court would "not now rewrite this lease's plain terms to give the Royalty Owners the benefit of a bargain they never made."[10]

[c] What About *Cabot Corp. v. Brown*?

The Texas Supreme Court in *Cabot Corp. v. Brown*[11] considered the implied covenant to market in conjunction with an express market value royalty clause, a provision the court held had been modified by a division order. In the course of its opinion the court observed:

> Included within the covenant to manage and administer the lease is the duty to reasonably market the oil and gas produced from the premises. . . . This duty is also two-pronged: the lessee must market the production with due diligence and obtain the best price reasonably possible. *Under a gas royalty clause providing for royalties based on market value, the lessee has an obligation to obtain the best current price reasonably available.*[12]

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[7] *Id.* at 373.

[8] *Id.* at 374.

[9] The contractual obligation to pay royalty based upon market value eliminates the need for any special judicial intervention regarding the value component of the royalty equation. The court observed:

> Because the lease provides an objective basis for calculating royalties that is independent of the price the lessee actually obtains, the lessor does not need the protection of an implied covenant. Depending on future market behavior, this may be financially beneficial to the lessor, as it was in *Vela*, or it may be less advantageous, as here. In either event, the parties have received the benefit of their bargain.

Id. at 374.

[10] *Id.*

[11] 754 S.W.2d 104 (Tex. 1987).

[12] *Id.* at 106 (emphasis added).

This quoted language has been relied upon by lessors for the proposition that a lessee has the obligation to pay royalty on "the best price reasonably possible" under a market value royalty clause.[13] The court in *Yzaguirre* explained its *Cabot Corp.* language by noting that the case was about division orders, and the quoted language was dicta because the court did not consider whether the implied covenant required the lessee to pay royalty based on best available price.[14]

However, there is a more logical explanation for the statement in *Cabot Corp.,* which recognizes a role, albeit at the time a declining role, for the implied covenant to market under a market value royalty clause. In *First National Bank of Weatherford v. Exxon Corp.,*[15] the court indicated it would consider the "legal" quality of gas when determining whether sales were comparable for market value royalty purposes. This meant that the legal classification of the well from which the gas is produced becomes critical since it will create a market value ceiling.[16] To the extent the lessee has an opportunity to control this ceiling, it may give rise to implied obligations to pursue whatever regulatory classifications, or reclassifications, a prudent operator would pursue under the circumstances.[17] For example, if the lessee

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[13] A prominent champion of this view is Professor Weaver. *See* Jacqueline Lang Weaver, *When Express Clauses Bar Implied Covenants, Especially in Natural Gas Marketing Scenarios,* 37 Natural Resources J. 490, 522–26 (1997). A literal interpretation of the statement that "the lessee has an obligation to obtain the best current price reasonably available" under a market value royalty clause would focus on the word "current" and merely be a statement of the basic market value royalty rule: the lessee must strive to obtain the current value for the production without regard for what it may have obtained under a prior gas contract. The court also noted that this language was taken from a quotation by Professor Hemingway which actually reads: "the best current *market* price reasonably available." *Yzaguirre,* 534 S.W.3d at 374 (emphasis by the court).

[14] *Yzaguirre,* 53 S.W.3d at 374.

[15] 622 S.W.2d 80, 82 (Tex. 1981).

[16] This was a major difference between the market value approach in Texas and that in Kansas. Although both states equated market value to what a willing buyer would pay a willing seller for the gas when it was extracted, Kansas did not limit market value by its "legal" classification. For example, in *Matzen v. Cities Service Oil Co.* the Kansas Supreme Court held:

> The age of the well or the contract of sale matters not to the landowner whose gas is being produced and whose reserves are being reduced, or to the producer or the consumer, who are concerned only with quality and quantity, not origin. . . .
>
> We . . . hold that quality, as that term is used in defining comparable sales, does not include the 'legal characteristics' of the gas resulting from 'vintaging.' Quality consists of the inherent properties of the gas—BTU content, pressure, and the like.

Matzen v. Cities Serv. Oil Co., 667 P.2d 337 (Kan. 1983).

[17] *See generally* Jacqueline Lang Weaver, *Implied Covenants in Oil and Gas Law Under Federal Energy Price Regulations,* 34 Vand. L. Rev. 1473 (1981).

had the ability to qualify gas for an intrastate price of $1.35/Mcf, but instead qualified the gas for an interstate price of $0.80/Mcf, the lessor might have an implied covenant claim that the market value ceiling should be $1.35/Mcf instead of $0.80/Mcf. Within this limited context, the *Cabot Corp. v. Brown* statement makes sense.

[d] Evidence of Market Value.

The lessors in *Yzaguirre* sought to offer expert testimony that the Tennessee long-term gas sales contract was evidence of market value. They argued that the price the producer actually receives under a gas sales contract is always relevant to prove market value. The court rejected this argument, holding that a 1979 gas contract, with price provisions unrelated to the current value of gas as it is produced, is not evidence of market value.[18] To the extent the evidence is not relevant to ascertaining "the prevailing market price at the time of delivery" it should not be considered by the court. However, it is conceivable that a long-term gas contract, with a flexible pricing mechanism that tracks current gas values, could be relevant evidence. The issue will be the extent to which the pricing provisions of the contract effectively reflect current gas market values.

[e] Royalty Calculation Dispute Not an Action for Recovery of Real Property for Venue Purposes.

In *Yzaguirre*, the lessees commenced suit for a declaratory judgment on the market value royalty calculation issue in Dallas County although the leased land was located in Zapata County. The lessors argued that venue was mandatory in Zapata County under the 1995 version of Section 15.011 of the Texas Civil Practice and Remedies Code, which provided: "Actions for recovery of real property or an estate or interest in real property, for partition of real property, to remove encumbrances from the title to real property, or to quiet title to real property shall be brought in the county in which all or a part of the property is located."[19] Noting that "ownership" of the property was not in dispute, but rather the lessee's obligations under the terms of the oil and gas lease, the court held the mandatory venue provisions of Section 15.011 did not apply and venue in Dallas County was proper.[20]

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[18] *Yzaguirre*, 53 S.W.3d at 374–75.
[19] *Id.* at 371.
[20] *Id.*

[f] Unfinished Business in Texas.

Although the *Yzaguirre* opinion provides useful guidance on several royalty clause issues, the court noted two issues it did not have to address in this case. The first issue concerned the dual gas royalty provisions found in so many oil and gas leases. The leases at issue in *Yzaguirre* provided for a royalty on gas "sold or used off the premises or for the extraction of gasoline or other product therefrom, the market value at the well" and for gas "sold at the wells . . . the amount realized from such sale . . . ."[21] Since the lessee, particularly in today's gas market, often has the discretion to market either "at the well" or "off the premises," is there any limitation on the lessee when deciding how to exercise its discretion?

The court in *Yzaguirre* identified the issue as follows:

> The Royalty Owners do not argue that KCS breached the covenant to market reasonably by selling the gas away from the leased property in order to reduce royalties it owed to the Royalty Owners. Although the leases' bifurcated royalty clause would have based royalties on actual proceeds if the sales had occurred at the well, KCS agreed to off-premises sales in the 1979 GPA [gas purchase agreement], long before it could have known the GPA price would exceed the market price of gas.[22]

The lessor's response to the court's observation would be that the lessee has an obligation to seek an amendment to the gas sales contract that would change the point of sale to trigger the "amount realized" portion of the royalty clause so the lessor can maximize its royalty income. The lessor would argue further that surely the gas purchaser would have been willing to change the point of sale if the lessee would adjust the contract price downward a little. The final piece of the argument would be that but for the lessee's selfishness and desire to maximize its return under the gas contract, it could have made arrangements to allow the lessor to claim a share of the proceeds instead of being limited to a market value royalty.

The lessee's response to the lessor's argument would be to first note that this is not a fiduciary relationship and the lessee is not obligated to subordinate its interests to those of the lessor, particularly with regard to basic financial terms of the lease. The lessee would argue

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[21] *Id.* at 372.

[22] *Id.* at 374 n.3.

that the express terms of the lease give it the freedom to structure sales in any manner it desires even though a particular structure, under certain circumstances, might prove more beneficial to the lessor. Finally, the lessee would note that the net effect of the clause is to ensure that the lessor either gets paid on the same basis the lessee is paid, or market value, which may, under *Vela/Yzaguirre*, be more or less than what the lessee is receiving under a contract, but in any event, a fair reflection of the value of the gas at the time it is produced.

In the cases to date, the courts have assumed that if the sale was in fact structured as an on-lease or off-lease transaction, the lessee-chosen sales structure would be determinative.[23] The only instances where courts have refused to follow the lessee's structuring of the sale is when the apparent structure is not in accord with the facts. For example, in *Piney Woods Country Life School v. Shell Oil Co.*,[24] the gas sales contract stated that title to the gas passed to the purchaser at the wellhead, but in fact, the lessee retained possession and the risk-of-loss until the gas was delivered to the purchaser's facility, which was located off the leased premises. The court held that this was in fact an off-lease sale triggering the market value provisions of the royalty clause.[25] A closer case is *Matzen v. Cities Service Oil Co.*, where a lessee that also owned the gathering system was held to have maintained possession and ownership of the gas until it was delivered to the gas purchaser, even though the gas sales contract provided for metering of the gas at the wellhead.[26] In 1986, after reviewing the *Waechter*, *Matzen*, and other Kansas market value royalty cases, the author offered the following observation to the practicing bar:

> The court's approach to determining the point of sale in *Matzen* and *Waechter* offers the lessee, in cooperation with his gas purchaser, a way to control the effect of a *Waechter* lease. By carefully designating, in the gas purchase agreement, the point of sale and transfer of ownership from lessee to purchaser, the lessee can control

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[23] For example, in Waechter v. Amoco Production Co., 537 P.2d 228 (Kan. 1975), the lessee sold its gathering system, which connected all its wells to a central delivery point, to Cities Service Gas Co., the gas purchaser. This changed the point of sale and transfer of title from an off-lease location to on-lease locations. The court recognized the change in the structure of the sale from a market value (off-lease) royalty obligation to a proceeds (on-lease) royalty obligation. *Id.* at 247–48.

[24] 726 F.2d 225 (5th Cir. 1984), *cert. denied*, 417 U.S. 1005 (1985).

[25] *Id.* at 233.

[26] 667 P.2d 337, 348 (Kan. 1983).

whether royalty will be valued according to proceeds or market value.[27]

So long as the selected structure is factually real and not merely apparent, such facts should be what determine the lessee's royalty obligations when the lease contains varying royalty valuation standards depending upon whether the sale takes place on-lease or off-lease.

The second item of unfinished business concerns the 1991 Texas division order statute, which defines "market value" to mean "the amount realized at the mouth of the well by the seller of such production in an arm's-length transaction."[28] The court in *Yzaguirre* was not required to address the potential impact of this statute but observed: "The Royalty Owners point out that the statute is consistent with their argument, but they do not argue that it controls our analysis of their 1973 leases."[29] However, the context of the statutory language,[30] and legislative purpose, should logically be limited to instances in which a postenactment *division order* uses the statutory terms instead of imposing a statutory meaning on terms used in oil and gas *leases*. It is highly unlikely that the Texas Legislature intended to go down the path of mandating a private *statutory* oil and gas lease.

[g] Unfinished Business in Other States.

The *Yzaguirre* holding should be readily transferrable to other states that equate market value with what a willing buyer pays a willing seller for gas at the time it is extracted from the ground. Kansas addressed the *Yzaguirre* issue indirectly in *Holmes v. Kewanee Oil Co.*,[31] in which the court held the lessee was obligated to pay gas royalty on higher current market values instead of the lessee's contract price. Although the court calculated damages using the highest regulated price available in the county, it refused to apply the price prospectively, noting the market price might fluctuate in the future.[32] Under the facts, it appears the fluctuation the court was considering would be a loss of value compared to the sales it relied upon to establish current market value.[33] The court in *Piney Woods Country Life School*

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[27] David E. Pierce, Kansas Oil and Gas Handbook § 9.50, at 9–71 (1986).

[28] Tex. Nat. Res. Code Ann. § 91.402(i) (Vernon 1994).

[29] *Yzaguirre*, 53 S.W.3d at 372 n.2.

[30] For example, the statute speaks in terms of using a *division order* "to clarify royalty settlement terms in the oil and gas lease . . . ." Tex. Nat. Res. Code Ann. § 91.402(i) (Vernon 1994).

[31] 664 P.2d 1335 (Kan. 1983).

[32] *Id.* at 1342.

[33] *See* David E. Pierce, *Royalty Calculation in a Restructured Gas Market*, 13 E. Min. L. Found. 18-1, 18-32 to 18-33 (1992).

v. Shell Oil Co.[34] also assumed the market value royalty rule would be a two-way street. After commenting on the *Vela* approach to the market value royalty issue, the court stated: "If the price of gas declines, a market value royalty clause would benefit a lessee who has contracted to sell gas at a favorable price."[35]

However, the real unfinished business in this area probably does not concern the market value royalty states, where the rules have proven durable with time and changes in the gas market. Instead, the major issue will be whether the "market value equals proceeds" states, such as Oklahoma,[36] Louisiana,[37] and Arkansas,[38] will continue to apply a rule grounded on facts that no longer exist. The underlying factual premise of the market-value-equals-proceeds rule was that lessees, burdened with the obligation to market gas, had no choice but to enter into long-term contracts with pricing provisions that rarely tracked the market value of gas as it was extracted. Now that the underlying factual premise is no longer true, and lessees have choices, is the rule still necessary? This author predicts that Oklahoma may reexamine its approach to the issue. Since Louisiana and Arkansas have somewhat broader and differing jurisprudential approaches to the issue, the author predicts they will focus on other rationales for retaining their existing approaches to the issue.[39]

[2] Colorado: It Means What *The Court* Says It Means.

[a] The Colorado Marketable Product Rule: An Illogical Application of a Logical Rule or the Logical Application of an Illogical Rule?

When presenting the recent developments lecture during the Forty-Seventh Institute, the author discussed what was described as "The 'Marketable Product' Game" and took the opportunity to note: "The notoriously malleable concept of 'marketable product,' when joined with general notions of lessee implied marketing obligations, can be used as a false analytical tool to arrive at about any conclusion a court

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[34] 726 F.2d 225 (5th Cir. 1984), *cert. denied*, 417 U.S. 1005 (1985).

[35] *Id.* at 236 n.14.

[36] Tara Petroleum Corp. v. Hughey, 630 P.2d 1269 (Okla. 1981).

[37] Henry v. Ballard & Cordell Corp., 418 So. 2d 1334 (La. 1982).

[38] Hillard v. Stephens, 637 S.W.2d 581 (Ark. 1982).

[39] *See generally* David E. Pierce, *Royalty Calculation in a Restructured Gas Market*, 13 E. Min. L. Found. 18-1, 18-9 to 18-15, 18-19 to 18–22 (1992).

desires."[40] The Supreme Court of Colorado took this concept to a new level in *Rogers v. Westerman Farm Co.*[41] and proved it can play the Marketable Product Game totally unencumbered by any external restraints—such as contract language! The *Rogers* case raises the basic issue of whether the marketable product analysis offers a workable, principled basis for the proper calculation of royalty.

In *Rogers,* the court fashions the rules that will be applied in Colorado to determine when gas becomes a "marketable product." The rules are designed to: (1) define what the lessee must do to fulfill its implied obligation to market gas; and (2) identify expenses that can be deducted to calculate royalty. However, the court's apparent jurisprudential goal is to nullify express "at the well" lease language to push royalty valuation away from the point of production downstream to the point where the gas is delivered to an interstate pipeline. The *Rogers* approach is unique because it elevates a court-made set of marketing rules above the terms of the oil and gas lease and effectively eliminates the prudent operator standard commonly used to evaluate compliance with implied lease covenants. The court goes beyond contract interpretation and pursues its own notion of what the lessor/lessee relationship should be under the vast majority of oil and gas leases. It is judicial contract-making, or remaking, at its best, or worst.

The dispute in *Rogers* is fairly typical. The lessors sued alleging they had not been paid the correct royalty. The leases all provided for either a proceeds or market value royalty measure, each in any event to be calculated "at the well."[42] The lessees marketed gas in three ways: (1) delivering it in kind to the lessor; (2) selling it at the well, on the leased premises; and (3) selling it downstream, off of the leased premises, after it had been gathered, compressed, dehydrated, and delivered to an interstate pipeline.[43] Although some of the

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[40] David E. Pierce, *Developments in Nonregulatory Oil and Gas Law: The Continuing Search for Analytical Foundations*, 47 Oil & Gas Inst. 1-1, 1-43—1-44 (Matthew Bender 1996).

[41] 29 P.3d 887 (Colo. 2001).

[42] The court observed: "The leases all provide, with some variation, for royalties to be paid based on the gas 'at the well' or 'at the mouth of the well.' " Rogers v. Westerman, 29 P.3d 887, 891 (Colo. 2001).

[43] *Rogers*, 29 P.3d at 891. The court described the structure of the sales transactions as follows:

> The amendments resulted in the buyer contracting with another company, usually Yuma Gathering System, who would perform gathering, compression, and dehydration of the gas, and transport the processed gas directly to the buyer at the interstate pipeline.

transactions were with affiliated entities, many were arm's-length transactions with nonaffiliated purchasers. The court's analysis and holdings in this opinion do not depend upon the affiliated status of the parties. The court found the parties were in agreement that the gas, as it emerged from the wellhead, was "sweet and dry" and had been used "in its natural state from the well for many years, both by local consumers and by the lessors in lieu of royalty payments."[44]

Not so typical was the underlying theory advocated by the lessors, which consisted of the following elements: First, the lessee has an implied covenant to market gas. Second, to fulfill this implied obligation the lessee must produce a "marketable product." Third, to have a marketable product it must be of a saleable quality, *and* the lessee must take it downstream from the lease to a place where numerous buyers and sellers can interact, which in this case, the lessors contended, was where the gathering system interconnected with an interstate pipeline. Fourth, the lessee must affirmatively incur and bear all costs associated with moving the gas from the wellhead to the interstate pipeline. Prior to *Rogers,* the marketable product rule had been limited to an inquiry of whether the gas was of such a quality that it could either be sold to a purchaser or used. The plaintiffs in *Rogers* had to pursue this more aggressive version of the marketable product rule because their gas had, in fact, been marketed for years at the wellhead.[45] Under the Kansas[46] and Oklahoma[47] versions of

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> Finally, the record reflects other contracts which were entered into between the lessees and Yuma Gathering System, which provided for the sale of gas directly to Yuma Gathering System. Under these contracts, Yuma Gathering System would receive the gas directly from the lessees, process the gas, and subsequently sell the gas to a third party at the interstate pipeline.

Id. at 893.

[44] *Id.* at 892.

[45] The court noted that "initially most of the contracts, which were executed in the 1970's between the lessees and the gas companies that bought the gas, provided for the gas to be sold at the wellhead, with the buyer of the gas undertaking the performance of the gathering, compression, and dehydration necessary for the gas to subsequently enter the pipeline." Rogers, 29 P.3d at 893. During the 1970s regulatory era, the lessee in most cases could not have elected to gather, compress, and dehydrate its own gas. Instead, it sold the gas for what it could get from the pipeline company that operated the gathering facilities as part of its other transportation facilities. The gas sales in this case also reflect the changes in pipeline regulation that took place during the 1980s. As the court observed:

> In the late 1980s and early 1990s, a number of the contracts were amended to provide for sale of the gas away from the well, in addition to continued provisions for the sale of the gas at the well. In general, these amended contracts provided for an alternate point of sale,

the marketable product rule, the gas would have been a marketable product at the well and the lessors would have had no case.[48]

[b] Step One: Nullify Express References to "At the Well" and "Market Value."

The lessors found a sympathetic Colorado Supreme Court willing to assist them in "interpreting" their oil and gas leases to allow them to participate, risk-free, in the lessees' postlease investments and businesses. The first step in the lessor's interpretive process was to nullify the express terms of the oil and gas lease, particularly any language that might indicate royalty should be calculated "at the well." The court in *Rogers* accomplishes this first task by holding that the "'at the well' language is silent with respect to allocation of costs."[49] Although the "at the well" language did not expressly state that costs of compression, dehydration, and transportation could be deducted, the court failed to give the language any meaning even though it expressly, and clearly, addressed the "location" requirement the court added to its marketable product rule.

> usually directly to an interconnection point of a gathering system and the buyer's pipeline. Under these amendments, the gas was sold to the buyer, with the point of delivery being a gathering system, instead of at the well.

Id. at 893.

[46] In Sternberger v. Marathon Oil Co., 894 P.2d 788 (Kan. 1995), the Kansas Supreme Court held that gas could be "marketable" at a particular location even though no buyers were taking gas at that location. The court noted: "[T]here is no evidence in this case that the gas produced by Marathon was not marketable at the mouth of the well other than the lack of a purchaser at that location." *Id.* at 799. Therefore, the court was concerned with the inherent quality of the gas as something that could be sold at the well had the seller desired to enter into a wellhead transaction. The court held:

> In the case before us, the gas is marketable at the well. The problem is there is no market at the well, and in that instance we hold the lessor must bear a proportionate share of the reasonable cost of transporting the marketable gas to its point of sale.

Id. at 800.

[47] In Mittelstaedt v. Santa Fe Minerals, Inc., 954 P.2d 1203 (Okla. 1998), the Oklahoma Supreme Court declared: "The lessee has a duty to provide a marketable product available to market at the wellhead or leased premises." 954 P.2d at 1208. The court concluded: "When the gas is shown by the lessee to be in a marketable form at the well the royalty owner may be charged a proportionate expense of transporting that gas to the point of purchase." *Id.* Therefore, under the Oklahoma version of the marketable product rule, the lessee has a duty to seek out a market at the well. If the gas is in a saleable form at the well, a wellhead sale will complete the lessee's royalty obligations.

[48] This would have also been consistent with the Colorado Supreme Court's prior holding in Garman v. Conoco, Inc., 886 P.2d 652 (Colo. 1994).

[49] *Rogers*, 29 P.3d at 896.

The court next has to nullify the references to "market value" and "market price" because, as noted in *Yzaguirre*, such express terms provide a stand-alone, objective basis for calculating royalty without reference to the deduction of costs.[50] The crude analytical process the court employs to ensure that every reference to market value and market price is ambiguous reveals little about contract interpretation but much about the court's hostility towards the oil and gas lease.[51] The court begins its analysis with the statement: "Notwithstanding an initial misleading appearance that the lease language provides for allocation of costs, it is apparent that when scrutinized in depth, each lease clause provision inadequately addresses allocation of costs."[52] It concludes its analysis finding that nothing contained in the express terms of the royalty clause, other than the fraction, provides any guidance on how royalty should be calculated. This, of course, is the predicate for the all-important step two—resort to an implied covenant to market.[53]

[c] Step Two: *Imply* How Royalty Should Be Calculated.

Now that the lease is "silent" regarding the calculation of royalty, *the court* can fill in the gaps with obligations *it* implies. The court expands on the marketable product rule it adopted in *Garman v. Conoco, Inc.*[54] by adding to the quality requirement a "commercial marketplace" requirement.[55] Although the quality of the gas is such that it can be marketed at the well, and is in fact marketed at the well, such a sale can now constitute a violation of Colorado's implied covenant to market. All gas in Colorado must be sold in a "commercial marketplace." The court describes its new marketable product rule as follows:

> In defining whether gas is marketable, there are two factors to consider, condition and location.[56] First, we must look to whether

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[50] The court simply determines the market value of the gas when it is produced and uses that number to calculate the lessor's royalty.

[51] The court addresses the market value lease language at pages 896 to 898 of the *Rogers* opinion. *Rogers*, 29 P.3d at 896–98.

[52] *Id.* at 897.

[53] "[W]e conclude that because the leases are silent, we must look to the implied covenant to market . . . ." *Id.* at 902.

[54] 886 P.2d 652 (Colo. 1994).

[55] "[W]e believe that the more accurate definition of marketability includes both a reference to the physical condition of the gas, as well as the ability for the gas to be sold in a commercial marketplace." *Rogers*, 29 P.3d at 903.

[56] Even though "location" is now a major component of the Colorado marketing analysis,

> the gas is in a marketable condition, that is, in the physical condition where it is acceptable to be bought and sold in a commercial marketplace. Second, we must look to location, that is, the commercial marketplace, to determine whether the gas is commercially saleable in the oil and gas marketplace.[57]

In the court's examples and citations, it suggests the commercial marketplace might be at the point where the gas enters a pipeline; under the *Rogers* facts that would be the interstate pipeline, not the gathering system that ultimately delivers the gas to the interstate pipeline.[58] However, the court notes that the "commercial marketplace" issue is, in every case, "a question of fact."[59]

[d] Step Three: Eliminate the Prudent Operator Standard so the New Rule Is a Rule of Law, Not Fact.

The court's holding in *Rogers* creates a *judicial* covenant to market, not an implied covenant to market. The "implied" is merely a jurisprudential vehicle for the court to impose its view of how gas royalties should be calculated in Colorado. The judicial nature of the covenant is revealed by the absence of a prudent operator component. For example, under the implied covenant to protect against drainage, the obligation arises out of the nature of the lease and the absence of express lease language addressing the issue. However, compliance with the obligation is an issue of fact that employs a prudent operator analysis. In *Rogers,* the court defines the marketing obligation as a

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the court did not consider any of the location language in the oil and gas leases, which expressly provided for payment of royalty "at the well." Although the court went to great lengths to hold that "at the well" was silent regarding the deduction of costs, it did not revisit the language to determine whether it offered any guidance regarding the "location" where royalty should be determined. Of course, had the court done this, it would have eliminated the need for its implied covenant/location analysis. It will be interesting to see whether a jury will be allowed to consider evidence regarding "at the well" when they apply the new marketable product rule. Although the court has made it clear that quality and location are issues of fact for the jury, the court also referred to the trial court's ruling that "determined that the leases were silent regarding allocation of costs, and therefore, no testimony or evidence should be presented to the jury regarding the lease language." *Rogers*, 29 P.3d at 894. The court of appeals affirmed this ruling. *Id.* at 895. Does this mean that in subsequent actions when the issue of fact is the "location" of a commercial marketplace, required by the oil and gas lease, that a lessee will be unable to refer to "at the well" as used in the lease?

[57] *Id.* at 905.

[58] *Id.* at 905 ("It may be, for all intents and purposes, that gas has reached the first-marketable product status when it is in the physical condition and location to enter the pipeline.").

[59] *Id.* at 905–06.

matter of law: Do whatever is necessary to get the gas to a downstream commercial marketplace. The factual inquiry to which the court alludes only relates to determining whether, under the circumstances, the obligation was fulfilled: Did the lessee sell at the required downstream commercial marketplace? For example, it does not address whether a lessee would be acting as a prudent operator by selling the gas at the well. This does not matter because the court holds in *Rogers* that the lessee must sell at what is ultimately held to be the commercial marketplace. If the lessee does not do so, there is no inquiry as to why it did not, or whether it was prudent. Instead, the inquiry will be as to the difference in the price the lessee obtained versus the price it could have obtained at the commercial marketplace the jury subsequently identifies, no doubt with assistance from "the penetrating vision of hindsight."[60]

The judicial law-making aspect of the rule is revealed by the absence of any sort of prudent operator standard to determine whether a sale at the well is a breach of contract. There apparently is no prudent operator flexibility whether a lessee would choose to sell at the well or downstream of the well. If it is not sold at what is ultimately determined to be the "commercial marketplace," it is a breach of contract. The commercial marketplace requirement is not the result of an express lease clause or a traditional implied covenant under the prudent operator standard, it is a rule of law adopted by the Colorado Supreme Court to enhance the position of all lessors under the vast majority of oil and gas leases that currently exist in the state.

[3] Kansas: Jurisprudential Foundations for the Implied Covenant to Market.

It is most fitting that the Kansas Supreme Court's opinion in *Smith v. Amoco Production Co.*[61] should be decided immediately after the Texas Supreme Court's *Yzaguirre* decision and the Colorado Supreme Court's decision in *Rogers*. The *Smith* case offers a jurisprudential explanation for the radically different approaches pursued by the courts in *Yzaguirre* and *Rogers*. The Kansas Supreme Court also applies its analysis to perhaps the most difficult implied marketing covenant problem to date: the Federal Energy Regulatory Commission (FERC)

[60] This is one of Professor Lowe's favorite sayings.

[61] 31 P.3d 255 (Kan. 2001).

Order No. 451 prudent operator "damned-if-you-do and damned-if-you-don't" issue.

Amoco Production Company owned interests in oil and gas leases that were subject to a gas sales contract with Williams Natural Gas Company. The contract had been entered into by the predecessors of Amoco and Williams in 1950 and, following various amendments, covered 600,000 acres of leased land in the Kansas Hugoton gas field.[62] Although the contract required Williams to pay "the highest price authorized by law" for the gas it took, Williams had no take-or-pay or other minimum take obligation.[63] During all relevant time periods, Williams had more gas under contract than it could resell. Therefore, Williams would most likely take gas under contracts that contained a take-or-pay obligation or which had sales prices below current market prices.

As would be expected with any gas contract dating back to 1950, the Amoco/Williams gas sales contract covered many different "vintages" of gas based upon the date each well was drilled. After the Natural Gas Policy Act of 1978 (NGPA) took effect, each well covered by the contract received an NGPA "maximum lawful price" classification. Many of the "old" wells received classifications under NGPA Section 104, which provided for some of the lowest gas prices. Wells drilled more recently received higher price classifications under NGPA Section 103. Wells unable to produce above a specified quantity of gas were classified as "stripper" wells and qualified for one of the highest price classifications under NGPA Section 108.[64] During the relevant time frames involved in this case, gas could be sold for $0.57/MMBtu (Section 104 gas), $3.46/MMBtu (Section 103 gas), or $5.76/MMBtu (Section 108 gas), depending upon the wellbore from which it was produced. Although the gas was from the same reservoir and had the same intrinsic value, the price could range from $.57 to $5.76 through the wonders of government regulation.

Beginning in the mid-1980s, the FERC became disillusioned with the wonders of federal gas price regulation and began the process of replacing government-established prices with market-driven alternatives. One of FERC's initiatives in this regard was FERC Order No.

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[62] Smith v. Amoco Prod. Co., 31 P.3d 255, 259 (Kan. 2001).

[63] *Id.* Williams "only had the obligation to take gas from the Amoco leases ratably and ratably as it took gas from other producers in the Hugoton/Panoma fields." *Id.* at 260–61.

[64] *Id.* at 259–60.

451.[65] As noted by the court in *Smith*, "FERC adopted Order 451 to resolve pricing distortions that had resulted from the NGPA's pricing structure."[66] The goal of Order No. 451 was to provide a process by which gas producers and gas purchasers could renegotiate their long-term contracts that provided for gas prices that were either substantially above or below current market prices. For example, the district court in *Smith* had found the market price for gas was $1.29/MMBtu at a time when Amoco was obligated to sell gas to Williams for as little as $0.57/MMBtu and Williams was obligated to buy gas from Amoco for as much as $5.76/MMBtu.[67]

The basic problem for Amoco was that the FERC placed the Order No. 451 renegotiation trigger with producers. Using the current market price of $1.29/MMBtu as the practical renegotiation benchmark, if Amoco failed to pull the trigger in a timely manner, its $.57/MMBtu royalty owners would complain to the tune of $.72/MMBtu ($1.29—$0.57).[68] However, if Amoco pulled the trigger, its royalty owners entitled to gas prices in excess of $1.29/MMBtu would complain.[69]

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[65] Ceiling Prices; Old Gas Pricing Structure, Order No. 451, FERC Reg. Preambles 1986-1990 ¶ 30,701 (1986), 51 Fed. Reg. 22,168 (June 18, 1986), *modified*, Order No. 451-A, FERC Reg. Preambles ¶ 30,720 (1986), 51 Fed. Reg. 46,762 (Dec. 24, 1986), *modified further*, Order No. 451-B, FERC Reg. Preambles ¶ 30,748 (1987), 52 Fed. Reg. 21,669 (June 9, 1987).

[66] *Smith*, 31 P.3d at 272.

[67] *Id.* at 261.

[68] This assumes these royalty owners were being paid on a "proceeds" basis instead of a "market value" basis. Under Kansas law, what the lessee receives under its gas contract should not matter since its royalty entitlement is a share of the current market value of the gas when produced. However, even the market value royalty owner will be concerned with the volume issues. If Amoco had an opportunity to terminate the Williams contract and thereby increase the volume of gas produced from its lease, the royalty owner may choose to complain, particularly if hindsight reveals gas prices were favorable when the wells were not producing at full capacity. Also, since the Order No. 451 "alternative maximum price" at this time was $2.86/MMBtu, if the purchaser agreed to pay $2.86/MMBtu, the producer could not terminate the contract with regard to its lower-priced gas.

[69] Amoco's dilemma matrix would look as follows:

Gas Classification	Unregulated (Market Prices)	NGPA § 104	NGPA § 103	NGPA § 108
Prices on Trigger Date	$1.29	$0.57	$3.46	$5.76
Impact on Lessor (assuming they are paid on a proceeds basis)	$1.29 No impact under market value royalty clause.	$0.72+ Increase.	$2.17− Decrease.	$4.47− Decrease.

When Amoco pulled the trigger on June 8, 1989, it was sued by the *Youngren* class[70] of royalty owners for failing to act sooner.[71] The *Smith* class sued, asserting Amoco should never have triggered the Order No. 451 renegotiation process.[72] Their theory was that Amoco breached its implied covenant to market.[73] The first issue the court addressed was the appropriate statute of limitations, which depended upon whether the plaintiffs' implied covenant theory was implied in law or implied in fact.

[a] "Implied in Law" or "Implied in Fact"?

Justice Six, writing for the court in *Smith*, described the distinction between covenants implied in fact and implied in law as follows:

> A contract implied in fact is one "inferred from the facts and circumstances of the case" but which is "not formally or explicitly stated in words." . . . It is the product of agreement, although it is not expressed in words. . . . A contract implied in law does not rest on actual agreement. It is a legal fiction created by the courts to ensure justice or to prevent unjust enrichment.[74]

The precise issue before the court was whether the implied covenant to market was an action "upon any agreement, contract or promise in writing" or an action "upon contracts, obligations or liabilities expressed or implied but not in writing."[75] If the marketing obligation is found to be one in writing, Section 60-511 of the Kansas Statutes Annotated establishes a five-year statute of limitations.[76] If found to

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[70] As the court noted:

> This action [*Smith v. Amoco*], filed in Finney County on August 11, 1993, was consolidated with Youngren v. Amoco, Case No. 89 CV 22, and transferred to Stevens County. In *Youngren*, royalty owners with leases in the Hugoton area whose old gas sold for the low maximum lawful prices sued Amoco for failing to invoke Order 451 sooner (to increase the price of gas produced by their leases). *Youngren* was settled.

Smith, 31 P.3d at 262–63.

[71] The district court found: "FERC Order 451 became effective January 23, 1987." and "Between late 1987 and early 1988, almost all of the major suppliers of gas to Williams had invoked Order 451, and those suppliers thereby terminated whatever purchase contracts they had with Williams." *Id.* at 260.

[72] *Id.* at 258.

[73] *Id.*

[74] *Id.* at 265.

[75] *Id.* at 264.

[76] Kan. Stat. Ann. § 60-511(1) (Supp. 2001).

be an obligation "not in writing," then the three-year statute of limitations in Section 60-512, Kansas Statutes Annotated, will be applicable.[77] The court held that the implied covenant to market is implied in fact in Kansas, and therefore, the five-year statute of limitations should be applied.[78]

Justice Six surveyed the commentary regarding whether implied covenants are implied in fact or implied in law. Commentators who conclude that covenants are implied in law can be placed into two general categories: (1) commentators who attempt to explain what the courts have done and (2) commentators who personally believe the oil and gas relationship is unfair and should be redefined by the courts. Professor Kuntz would fall into the first category;[79] Professor Merrill in the second.[80]

[b] The *Smith* Jurisprudential Explanation for the Outcomes in *Yzaguirre* and *Rogers*.

The Kansas Supreme Court's implied covenant analysis in *Smith* provides a useful jurisprudential explanation for how the implied marketing covenant issues were addressed by the Texas Supreme Court in *Yzaguirre* and by the Colorado Supreme Court in *Rogers*. The court's holding and analysis in *Yzaguirre* is representative of an implied-in-fact approach to the oil and gas lease relationship. The court began its analysis by focusing on the express terms of the oil and gas lease to determine whether they addressed the matter at issue. Since

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[77] Kan. Stat. Ann. § 60-512(1) (Supp. 2001).

[78] *Smith*, 31 P.3d at 258. After considering the approaches followed by courts and noted by commentators, Justice Six concluded his analysis noting:

> The *Indian Territory* court observed in 1941 that it had found no support for Professor Merrill's implied in law doctrine in the adjudicated cases. . . . Sixty years later, based on the briefing here, we share the same observation. We choose to join Oklahoma, Texas, and Montana in holding that the covenants are implied in fact.

Id. at 268.

[79] 5 Eugene Kuntz, *A Treatise on the Law of Oil and Gas* § 54.3 (1991).

[80] Maurice H. Merrill, *The Law Relating to Covenants Implied in Oil and Gas Leases* § 221 (2d ed. 1940) (hereafter cited as "Merrill"). After examining the lessor's inferior bargaining position, Professor Merrill poses the following rhetorical questions:

> Is it not the real basis of the doctrine of implied covenants in oil and gas leases to be found in a theory of enforcing that conduct which, under the circumstances, fair dealing between lessor and lessee fairly demands that the latter pursue? Do not the conditions which have been reviewed justify the judicial imposition of that standard of conduct upon the lessee?

Merrill, § 221 at 469.

they did, the court's implied covenant analysis was complete. If the express lease terms had not addressed the issue, the court would imply a covenant only to the extent necessary to address the issue and only to the extent that what was implied was consistent with the express terms of the oil and gas lease. Quoting from *Danciger Oil & Refining Co. v. Powell*, the court noted: " '[T]he written instrument is presumed to embody their entire contract, and the court should not read into the instrument additional provisions unless this be necessary to effectuate the intention of the parties as disclosed by the contract as a whole.' "[81]

In contrast, the lessors in *Yzaguirre* put forth an implied-in-law argument: " '[T]he entire body of implied covenant law has been aimed at . . . making sure the royalty owner gets the best deal.' "[82] The court disagreed, holding: "We will not now rewrite this lease's plain terms to give the Royalty Owners the benefit of a bargain they never made."[83] However, the Colorado Supreme Court in *Rogers* was willing to rewrite the "lease's plain terms to give the Royalty Owners the benefit of a bargain they never made": a lease without "at the well" language or any other language that would suggest royalties should be calculated at the point where oil or gas is produced. The jurisprudential explanation for the court's action in *Rogers* is that the implied covenant to market is implied in law to make the lease fair, or "more" fair. Recall the Kansas Supreme Court described the implied-in-law contract as an obligation that "does not rest on actual agreement";[84] instead, "[i]t is a legal fiction created by the courts to ensure justice or to prevent unjust enrichment."[85] As noted previously, the Colorado Supreme Court went to great lengths to eliminate the "actual agreement" between the parties by finding just about every provision of the royalty clause to be hopelessly unclear.[86] However, this does not explain why the court believed "justice" required such action or why creating new implied obligations was necessary to "prevent unjust enrichment."

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[81] *Yzaguirre*, 53 S.W.3d at 373. The Kansas Supreme Court, in *Smith*, cited *Danciger* for the proposition that "covenants will be implied in fact when necessary to give effect to the actual intention of the parties, as reflected by the contract . . . ." *Smith*, 31 P.3d at 265.

[82] *Yzaguirre*, 53 S.W.3d at 374.

[83] *Id.*

[84] *Smith*, 31 P.3d at 265.

[85] *Id.*

[86] *Rogers*, 29 P.3d at 897–98.

In what appears to be more akin to unconscionability analysis than to contract interpretation, the court in *Rogers* revealed its general hostility toward the oil and gas lease as written, and oil and gas lessees in general. The following observations made by the court, as a prelude to its implied covenant analysis, reveal why it departs from the parties' contract and embarks on a mission to achieve "justice" and "prevent unjust enrichment":

1. "[L]essees, to avoid alerting lessors of their motives, have intentionally used 'at the well' language to avoid directly stating their objectives in sharing costs."[87]

2. "[I]n interpreting leases like those in this case, we are mindful of the generally accepted rule that oil and gas leases are strictly construed against the lessee in favor of the lessor."[88]

3. "This rule [strict construction against lessee] is generally based on the recognition that the bargaining power between a lessor and lessee is similar to that historically found between an insurance company and its customers. . . . Thus, the parties are in similar unequal positions."[89]

4. "[L]essors are not usually familiar with the law related to oil and gas leases, while lessees, through experience drafting and litigating leases, generally are."[90]

Therefore, the court held that the express terms of the oil and gas leases offered no insight into how royalties should be calculated because, as the court assumed, all lessees use leases that hide the operative language from their lessors, lessors have no bargaining power, and lessors do not know the law. The court's response was not to declare the oil and gas lease unconscionable, but rather to "interpret" a better deal for the lessor using the implied covenant to market and a marketable product analysis. The precise scope of the court's marketable product rule will be governed by what the court perceives is necessary to prevent unjust enrichment under its view of the oil and gas lease and the parties to the lease. This is that implied-in-law rationale for implied covenants that Professor Merrill advocated, which apparently had no explicit judicial support until the *Rogers* decision.[91]

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[87] *Id.* at 899.

[88] *Id.* at 901.

[89] *Id.* at 902.

[90] *Id.*

[91] *See above* N.78, where Justice Six of the Kansas Supreme Court, without the benefit of the *Rogers* decision at the time, comments on the lack of authority for Professor Merrill's implied-in-law approach to implied covenants.

[c] An Implied-in-Fact Marketing Covenant Analysis: Kansas Gets It Right.

Justice Six, writing for the Kansas Supreme Court in *Smith*, noted:

> [W]e may be the first appellate court to be presented with the type of lessor royalty owner claims asserted here, i.e., breach of the implied covenant to market arising in a factual setting under the Natural Gas Policy Act (NGPA), where the Federal Energy Regulatory Commission's (FERC) Order No. 451 had been invoked by the lessee.[92]

As a preliminary matter, the court assumed Amoco's implied marketing covenant obligations had to be evaluated as though Amoco had a single lease, without regard for its collateral interests associated with other leases or contracts. The court referred to this single-lease analysis as the "independent duty principle" and explained it as follows:

> Amoco admits that its obligations as lessee apply independently to each lease. The independent duty principle is applied to prevent Amoco from making the management of a given lease dependent upon the management of another lease. . . .
>
> . . . .
>
> . . . When negotiating with Williams Natural Gas under good-faith negotiating provisions, Amoco had a marketing duty to each of its lessors.[93]

Amoco's Order No. 451 dilemma was caused, in part, by the fact that it had leases covering 600,000 acres under a single gas contract that in conjunction with the NGPA, provided for the payment of a range of prices depending upon the attributes of the well from which the gas was produced. If Amoco had an independent duty to each lessor to maximize his lease benefits, and the FERC gave Amoco the power under Order No. 451 to increase, and at the same time decrease, lease benefits for its various lessors, it would seem Amoco was in an impossible situation. The very same action Amoco had to pursue to satisfy its implied covenant obligations to Lessor A would breach its obligations to Lessor B. Also, since Amoco was given the power to either trigger or not trigger the process, doing nothing was not an option since inaction would negatively impact some of its lessors.

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[92] *Smith*, 31 P.3d at 257.

[93] *Id.* at 272.

However, as the court noted, the issue was not simply determining what action would maximize a lessor's position, but rather, what a prudent operator would do under the circumstances.[94] In this regard, the court refused to adopt the lessors' "best price" implied covenant argument. It is revealing that the lessors contended: "[I]t is illogical to say that the expressed royalty provisions override the lessee's implied duties."[95] These were the same lessors who had just convinced the court that the implied covenant to market was implied in fact and not in law. If implied in fact, then the existence and scope of the implied must be defined by the expressed. The lessee responded with the argument that the express market value and proceeds provisions of the leases eliminated the need for any implied covenant; this was the same lessee that convinced the trial judge the implied covenant to market was implied in law and not in fact. The court did not address either party's argument directly but instead turned to the prudent operator standard to sort out the issues, noting Amoco was required "to use due diligence to market the gas it produced within a reasonable time and at a reasonable price."[96]

First, Amoco's position as a "common lessee" would not result in "automatic liability under its implied covenant to market as a reasonably prudent operator."[97] Instead, the trial court must engage in a "fact-specific approach" that considers, in light of the regulatory environment faced by Amoco, whether it acted as a prudent operator.[98] Among the relevant facts should be the Amoco/Williams gas contract and Williams' ability to minimize the gas it would purchase. As found by the trial court:

> "Williams controlled the right to purchase all of Amoco's gas under the 1950 contract . . . ."[99]
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> "Williams was not required to purchase any certain quantity of gas."[100]
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> "Williams shut in Amoco's Hugoton/Panoma gas field, taking only minimal amounts of gas each month from each lease,"[101] and

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[94] "Amoco's implied covenant to market pricing obligation, under the facts here, is contained within its duty to act at all times as a reasonably prudent operator." *Id.* at 272.

[95] *Id.* at 270.

[96] *Id.* at 272.

[97] *Id.* at 273.

[98] *Id.*

[99] *Id.* at 260.

[100] *Id.*

[101] *Id.* at 261.

> "There was no market in the free market for any gas priced at the maximum lawful price of section 103 and section 108 gas between August, 1990, and December 31, 1992. It was simply too high for anyone to pay when there was an abundance of cheaper gas in the market place."[102]

A high contract price for gas means very little if the purchaser is not obligated to take gas the wells are capable of currently producing. Collateral concerns regarding the rule of capture, drainage, and the present value of money must be weighed against the prospect of receiving an above-market price for small quantities of gas.

The lessee's obligations must also be considered in the specific context of "the purpose of Order 451,"[103] which, the court noted, was to "bring some rationality to natural gas pricing."[104] Therefore, the trial judge must balance the "regulatory background and national policy reflected under the NGPA and the purpose of FERC's Order 451"[105] against "any conflict of interest" Amoco might have in pursuing a course of action primarily to maximize its own interests to the detriment of its lessor.[106] The "regulatory background" is not defined by the court, but presumably would include the long-term gas contract, the subsequent splintering of "gas" into NGPA pricing categories, the intervention of public policies designed to allow market forces to determine the price of gas, and the unique impact Order No. 451 had on the Amoco contract, particularly the failure of increased prices imposed by Order No. 451 to cause Williams to terminate its hold on Amoco's gas supplies.[107]

In a final acknowledgment that the implied covenant to market is part of the oil and gas lease contract, the court reminded the trial judge

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[102] *Id.* at 262.

[103] *Id.* at 273.

[104] *Id.*

[105] *Id.*

[106] The court noted that "Amoco should not be allowed to manipulate the procedure to receive undue benefit for itself." *Id.* at 273.

[107] The trial judge noted the unique interaction between the Amoco/Williams contract and the Order No. 451 process:

> FERC Order No. 451 had the effect of allowing some producers to obtain the release of gas otherwise dedicated to interstate sales without the voluntary agreement of the purchaser.
>
> But Order 451 did not have this effect on the Amoco Williams 1950 contract, because under the terms of that contract Williams was not required to purchase any certain quantity of gas.

Id. at 260.

that the lessors have the burden of proof and must present expert testimony to establish a breach of contract.[108] The expert testimony must identify " 'what an experienced operator of ordinary prudence would do under the same or similar circumstances, having due regard for the interest of both [lessor and lessee].' " The inquiry is a question of fact considering "the facts as they existed at the time Amoco took the action complained of."[109] A final comparison of these issues with the *Rogers* implied-in-law approach further illustrates how fundamentally different the Kansas/Texas approach is from the Colorado approach. In *Rogers*, the issue was not whether the lessee acted in a prudent manner in pursuing its marketing program, but rather "[t]he determination as to when gas is marketable . . . ."[110]

[4] West Virginia: Embraces Marketable Product Concepts.

In *Wellman v. Energy Resources, Inc.*,[111] the West Virginia Supreme Court applied marketable product concepts to determine whether Energy Resources had properly deducted sums from gas sales proceeds it obtained from its gas purchaser, Mountaineer Gas Company. The case is peculiar because Mountaineer paid Energy Resources $2.22/Mcf for the gas, Energy Resources calculated the Wellmans' royalty using $0.87/Mcf, and apparently offered no explanation other than that "it was entitled to deduct certain expenses from the amounts received . . . before calculating the Wellman's royalty."[112] The court found: "Energy Resources, Inc., introduced no evidence whatsoever to show that the costs were actually incurred or that they were reasonable."[113] However, the court used the opportunity to discuss when costs would be deductible if the appropriate evidence were presented.

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[108] *Id.* at 273.

[109] *Id.* The Kansas Supreme Court has always been careful to avoid second-guessing lessees after the fact. Quoting from a prior case, the court reasoned: " 'It is not the place of courts, or lessors, to examine in hindsight the business decisions of a gas producer.' " *Id.* at 271.

[110] *Rogers*, 29 P.3d at 912. The court noted: "The commercial market and the condition of the gas dictates the marketability of the gas, *not the independent actions of a particular lessee*." *Id.* at 909. Under a prudent operator standard the "independent actions of a particular lessee" would have to be evaluated in light of what a prudent operator would have done under the circumstances. This suggests that what the court calls an implied covenant analysis is merely the creation of its own marketing rules.

[111] 557 S.E.2d 254 (W. Va. 2001).

[112] *Id.* at 263.

[113] *Id.* at 265.

The oil and gas lease provided for a royalty on "gas is sold by the Lessee . . . one-eighth (1/8) of the proceeds from the sale of gas as such at the mouth of the well . . . ."[114] The court, viewing the Colorado (*Garman v. Conoco, Inc.*), Kansas, and Oklahoma approaches as persuasive, adopted the following rule:

> [I]f an oil and gas lease provides for a royalty based on proceeds received by the lessee, unless the lease provides otherwise, the lessee must bear all costs incurred in exploring for, producing, marketing, and transporting the product to the point of sale.[115]

The court noted that the phrase, " 'at the mouth of the well,'. . . might be language indicating that the parties intended that the Wellmans, as lessors, would bear part of the costs of transporting the gas from the wellhead to the point of sale . . . ."[116] However, the court held the issue was moot in this case because Energy Resources failed to offer any evidence that such postwellhead costs were incurred. The court also noted that a different rule might be applicable for leases that provided for a market value measure.[117]

§ 3.03. Defining the Duration of the Oil and Gas Lease.

[1] The Habendum Clause.

The oil and gas lease in *Ridenour v. Herrington*[118] contained a common form of habendum clause that provided for a secondary term "as long thereafter as oil, gas or other mineral is produced from said land."[119] However, the lease also stated: "Cessation of paying production after the primary term for a period of sixty days shall cause this lease to terminate."[120] The lessee argued that a prudent operator would continue to operate the lease, and therefore, he must be allowed a reasonable period of time in which to regain profitable production. However, the court ruled that prudent operator and reasonable time concepts were not applicable because the lease defined the relevant time frame as "[c]essation of paying production . . . for a period of sixty days . . . ." The evidence indicated there had been a total

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[114] *Id.* at 258.
[115] *Id.* at 265.
[116] *Id.* at 265.
[117] *Id.* at 264 n.3.
[118] 47 S.W.3d 117 (Tex. App.—Waco 2001).
[119] Ridenour v. Herrington, 47 S.W.3d 117, 120 (Tex. App.—Waco 2001).
[120] *Id.*

cessation of production from the lease for a period of six months.[121] The court held that the lease had terminated automatically after sixty days without regard for the reasonableness of the operator's actions.[122]

[2] Temporary Cessation Doctrine: Defining "or the Like."

A litigation cottage industry has arisen in recent years, built around finding historical lapses in production that can be used to establish automatic termination of the oil and gas lease. This litigation exists because of the unique interaction of the special limitation created by the lease habendum clause and the lack of an effective statute of limitations on the determination of title. *Krabbe v. Anadarko Petroleum Corp.*[123] is an example of this trend: a trial in 1999 over cessations that occurred thirteen and fourteen years before in 1985 and 1986.[124] The lease in *Krabbe* would continue "so long as oil or natural gas is produced" and did not contain a cessation of production *clause*. Therefore, cessations of production would be governed by the cessation of production *doctrine,* which provides:

> [T]he automatic termination rule is relaxed if the lessee can prove that the cessation of production was temporary and is due to sudden stoppage of the well, some mechanical breakdown of the equipment used in connection therewith "or the like." . . . The lessee is entitled to a reasonable time in which to remedy the cause of the temporary cessation and resume production. . . . What constitutes a reasonable time depends on the facts of each case. . . . The lessee must act with diligence in obtaining renewed production. . . . The burden is on the lessee to prove that the cessation in production fell within the temporary cessation doctrine.[125]

The issue in *Krabbe* concerned the scope of "or the like," used to refer to excusable cessation events other than a "sudden stoppage of the well" or "some mechanical breakdown of the equipment" associated with the well. The lessor did not dispute that the cessations were temporary or that the lessee regained production within a reasonable time; instead, the lessor contended the events giving rise to the cessation—gas marketing disputes and processing plant improvements—were not proper cessation excuses. The lessee had two gas

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121 *Id.* at 122.
122 *Id.*
123 46 S.W.3d 308 (Tex. App.—Amarillo 2001).
124 Krabbe v. Anadarko Petroleum Corp., 46 S.W.3d 308, 311 (Tex. App.—Amarillo 2001).
125 *Id.* at 315–16.

wells producing on the leased land, but production from the wells was sold under two separate gas contracts into separate gas gathering systems that delivered gas to the Turkey Creek processing plant. Production from either well would maintain the lease in effect. Production from one well was stopped for nineteen months because the lessee and its gas purchaser were engaged in a contract dispute that included a trip to court. During this nineteen-month period, production from the second well was stopped for ninety-two days in 1985 and sixty-one days in 1986. The ninety-two-day interruption was the result of "mechanical work . . . performed at the Turkey Creek Plant, including overhauling compressors, installing a high-pressure inlet gas scrubber, replacing header piping, and improving the emergency shutdown system."[126] The sixty-one-day interruption was apparently for scheduled maintenance of the Turkey Creek Plant.[127]

The lessor attempted to link the two cessation events to limit the Turkey Creek Plant shut-down excuse, because of the gas contract litigation, by asserting in effect: But for the lessee's gas contract problems, the first well would not have been shut in, and therefore, there would have been no need to rely on production, and an excused cessation, from the second well. The court did not accept this invitation to link the two events and instead applied the cessation doctrine to the Turkey Creek Plant shut-down that precipitated the issue.[128] The lessor contended its lessee should have constructed a new pipeline to bypass the Turkey Creek Plant, so when the plant was shut down for maintenance, production from the well would not have been interrupted. The lessor also argued the plant shutdowns, being "foreseeable, avoidable, non-physical, marketing problems," should not be covered by the temporary cessation doctrine. The lessor's final argument was that the doctrine should not be applied to events that occur beyond the point where the gas is sold, and therefore, since the gas was sold at the well, events downstream at the plant could not be considered.[129] Rejecting each of the lessor's arguments, the court held that the Turkey Creek Plant shut-down was "the like" type of event that would trigger the temporary cessation doctrine.[130]

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[126] *Id.* at 312.

[127] *Id.* at 312–13.

[128] However, had the plant shut-down not been an excused event, the lessee's argument would have been that the prior contract dispute provided an excuse.

[129] *Krabbe*, 46 S.W.3d at 314.

[130] *Id.* at 318.

[3] Temporary Cessation Doctrine: Deliberate Termination.

Guinn Investments, Inc. v. Ridge Oil Co.[131] considers whether the temporary cessation doctrine can apply if the lessee deliberately interrupts production for ninety days with the intent to terminate the oil and gas lease. One might wonder how this issue could arise. Guinn and Ridge each owned the oil and gas leasehold estate on separate but adjoining tracts of land subject to a single oil and gas lease that would continue "as long . . . as oil or gas . . . is produced from said land . . . ." The well on the Guinn tract ceased producing in 1950, but the lease was maintained by production from the Ridge tract until December 1, 1997, when "Woodward, Ridge's vice president, ordered an employee to turn off the electricity to the two wells on the Ridge tract."[132] On January 13, 1998, Woodward sent letters to the mineral interest owners of the leased land explaining that Ridge was terminating the existing leases by shutting in the wells for ninety days because Ridge desired to obtain new leases on the land. The new leases were obtained, and on March 3, 1998, Ridge hit the switch and resumed production. Guinn was upset and sued, asserting that the lease was still in effect because the cessation was temporary and that Ridge was liable for fraud and tortious interference with Guinn's lease contract.

The court held the lease had terminated because the temporary cessation doctrine does not apply to a lessee who voluntarily ceases production with the intent to terminate its lease.[133] The court rejected Guinn's fraud claim because Ridge at no time made any representations to Guinn, fraudulent or otherwise.[134] The court also rejected Guinn's tortious interference claim because Guinn's contract with its lessors had terminated on December 1 leaving nothing to be interfered with when Ridge contacted the lessors the following January.[135]

[4] Temporary Cessation Doctrine: Fact Issues and Remedies.

A dispute over a three-year cessation of production from 1987 through 1990 subsequently revealed an additional interruption from

[131] Case No. 2-00-055-CV, 2001 WL 253430 (Tex. App.—Fort Worth, Mar. 15, 2001) (not released for publication).

[132] *Id.* at *1.

[133] *Id.* at *4.

[134] *Id.* at *5–6.

[135] *Id.* at *7.

November 1979 through April 1980. In *Bryan v. Big Two Mile Gas Co.*[136] a jury found that the lease had terminated in 1979 because the lessee failed to prove the interruption qualified under the temporary cessation doctrine. In reviewing the jury's findings, the West Virginia Supreme Court found: "There was substantial evidence from which the jury could find that BTM could have replaced any malfunctioning equipment in 1979–80 in a matter of days; and that in 1987-90 BTM could have pursued another market for gas in a much more timely fashion."[137]

The court described the temporary cessation doctrine as follows:

> The essence of this doctrine is that where a temporary cessation in production is genuinely necessary to accomplish necessary maintenance, repairs, or replacements, or to deal with the unexpected temporary loss of a market, the cessation is excusable and will not result in the termination of a mineral lease, so long as the lessee is diligent in accomplishing the maintenance, repairs, replacements, or marketing.[138]

Application of the doctrine is an issue of fact that requires examination of the reasons for the cessation, its duration, and the actions of the lessee in responding to it.[139] The jury relied on the lessee's meter records to establish the 1979 cessation; the lessee did not dispute the 1987 cessation.

After holding that the lease terminated in 1979, the trial court held that the lessor was entitled to a "reasonable royalty" of one-eighth,[140] characterizing the lessee as a holdover tenant.[141] The Supreme Court rejected this analysis and instead characterized the lessee as a trespasser, stating:

> [W]here a mineral lease has automatically terminated due to an unexcused period of cessation of production by the lessee, and mineral production is subsequently resumed by the former lessee without the informed and knowing agreement by the mineral owner to a renewal of the lease and the resumption of production, the

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[136] Case No. 29641, 2001 W. Va. LEXIS 190 (W. Va. Dec. 11, 2001).

[137] *Id.* at *20.

[138] *Id.* at *17-18.

[139] *Id.* at *18.

[140] The royalty provided for in the terminated oil and gas lease was "1 cent for every thousand cubic feet of gas produced from the well." *Id.* at *6.

[141] *Id.* at *27-28.

> former lessee is a trespasser with regard to mineral production subsequent to the lease's termination, and the mineral owner may recover in damages from the former lessee the actual value of the minerals removed after the lease's termination with no deduction for the cost of producing unless the former lessee shows that the renewal of production was the result of innocent conduct on his part.[142]

The court concluded that the lessee's possession of the lease following the 1979 cessation was not "willful," but possession following the 1987 cessation was "willful." Although the court did not use the terminology, it in essence held that the 1979 cessation resulted in a "good faith" trespass, and the 1987 cessation resulted in a "bad faith" trespass. The measure of damages associated with the nonwillful (good faith) trespass is the value of the gas produced less the actual, reasonable costs of production.[143] The measure of damages associated with the willful (bad faith) trespass is the value of the production without any deduction of production costs.[144]

[5] Resurrecting the Lease Through Revivor.

In *Natural Gas Pipeline Co. of America v. Law*,[145] the lessors sued, asserting their lease terminated due to cessations of production in August 1959, July 1960, June and July 1961, September 1963, and July and August 1964.[146] The trial court concluded that the lease had terminated and awarded damages.[147] The court of appeals reversed, holding a 1979 family settlement agreement among descendants of the original lessors had revived the terminated lease.[148] The court primarily relied on the following revivor language:

> WITNESSETH that one Mary Haas, who died, intestate, in Jo Daviess County, Illinois, in 1939 was the owner of mineral rights

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[142] *Id.* at *28. The court noted, however, "that a landowner's ability to recover such trespass damages is obviously subject to all other applicable principles and doctrines of law, such as the statute of limitations, unjust enrichment, election of remedies, and estoppel." *Id.* at *28 n.8.

[143] The court cautioned the trial court against "creative accounting" to mitigate the impact on the trespassing lessee by noting: "costs . . . must be objectively reasonable operating costs that were actually incurred in the operation of the well in question and should be determined according to the principle that any reasonable doubt as to the proper nature and measure of such costs is to be resolved in favor of the mineral owner, as opposed to the trespasser." *Id.* at *31.

[144] *Id.* at *30.

[145] 65 S.W.3d 121 (Tex. App.—Amarillo 2001).

[146] *Id.* at 123.

[147] *Id.*

[148] *Id.* at 129.

on Section 30, in Block P Mc, and Section 18 in Block 26, EL & RR Survey in Moore County, Texas, *now subject* to an oil and gas lease *in favor of Natural Gas Pipeline Company of America, Lease # 8070-O & G, known as Mary Haas #1 and # 3*; . . .[149]

The court noted that the statement was not an inadvertent reference to the lease,[150] but rather, a deliberate attempt to set out the current state of affairs among all the parties as of December 28, 1979. The court also found "*now* subject to" significant to indicate that the parties, as of 1979, believed the lease was in force. The land impacted was clearly identified, and the lease and the producing wells on the lease were all identified. Under these facts, the court held that the document revived the lease "as a matter of law."[151]

This is a situation where the same "history" that allowed the plaintiff to terminate the lease also provided the defendant with a complete defense. This author predicts that courts may be more inclined to find revivor from historical facts because of the perceived inequity of a lawsuit in 2002 to terminate a lease for events in 1960 to which neither party paid any attention at the time. This may be the case particularly where it is difficult or impossible for a lessee to explain an interruption in production that took place ten, twenty, thirty, or more years ago, often with an equally large number of intervening owners. Courts may be willing to "revive" theories such as revivor to deal with problems that the statute of limitations or laches would normally address.

§ 3.04. Surface Owner Issues.

[1] Oklahoma: Surface Damages Act Prohibits Entry Without Surface Owner Agreement or Request for Appraisers.

Anadarko Petroleum Corporation had a lease on land that it entered to drill a well. Unable to come to an agreement with the surface owners regarding surface damages, Anadarko filed a petition requesting the appointment of appraisers eight business days after it entered the land

[149] *Id.* at 124 (emphasis by the court).

[150] The court observed: "[T]he agreement is a formal document, which appears to have been professionally prepared and after it was signed, was recorded in the deed records of Moore County." *Id.* at 125-26. The goal with this statement was apparently to distinguish the situation from routine statements commonly contained in division orders.

[151] *Id.* at 126.

with equipment. In *Sanford v. Anadarko Petroleum Corp.*,[152] the court affirmed the award of treble damages against Anadarko for failing to request appraisers before it entered the property. The relevant statute required: "Any operator who willfully and knowingly fails to keep posted the required bond or who fails to notify the surface owner, prior to entering, or fails to come to an agreement and does not ask the court for appraisers, shall pay, at the direction of the court, treble damages to the surface owner."[153] Anadarko argued that "prior to entering" applied only to the bond and notification requirements and not the agreement or appraiser requirements.[154]

Construing the statute in conjunction with the other provisions of the Act and its underlying purpose, the court concluded that the statute had to be interpreted to prohibit any entry by the lessee until either the landowner and lessee reached an agreement, or in the event they were unable to agree, a petition was filed to appoint appraisers. As the court noted:

> Once it is clear the operator and surface owner cannot agree, the court's supervision becomes necessary. This procedure protects the interests of those who own the right to produce oil and gas, by allowing the drilling to proceed. It also protects the surface owners' interests, by having court-appointed appraisers determine a fair amount of compensation, with approval by the court. This procedure is commenced by filing a petition. This is what Anadarko failed to do. Allowing the operator to proceed, without first filing the petition, destroys the balancing of interests this Act was designed to accomplish.[155]

Apparently, Anadarko proceeded to drill because of the availability of equipment.[156] The cost for its early entry was treble surface damages.

[2] Louisiana: Surface Owner Third Party Beneficiary of Surface Damage Covenant in Oil and Gas Lease.

Another contemporary litigation cottage industry is the suit by the current property owner for environmental damage to the property since

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[152] 32 P.3d 218 (Okla. App. 2001).
[153] Okla. Stat. tit. 52, § 318.9 (1991).
[154] Sanford v. Anadarko Petroleum Corp., 32 P.3d 218, 219 (Okla. App. 2001).
[155] *Id.* at 220.
[156] *Id.*

the inception of the oil and gas industry. These cases are well suited for contingent fee financing because of the potentially enormous damages in the event a court allows the cost to remediate the land as a measure of damages.[157] In *Hazelwood Farm, Inc. v. Liberty Oil and Gas Corp.*,[158] the court considered preliminary issues in a suit by a surface owner against defendants, who "at various times since 1926, operated oil and gas wells on the Property pursuant to the rights granted to the lessee and its assignees under [an August 10, 1926, oil and gas lease] . . . ."[159] The cause of action, as described by the court, alleged:

> [D]amages for environmental contamination and other damages that the Defendants' oil operations have caused to the surface and subsurface of the Property. The Defendants' operations included the construction of numerous earthen pits, including a twelve-acre evaporation pond in which Hazelwood alleges that the Defendants dumped oil, grease, salt water, and other hazardous and/or toxic oil production waste. As a result of such operations, Hazelwood asserts that the surface, surface soils, and groundwater on and beneath the Property have become contaminated with hazardous and toxic wastes consisting of oil and grease, heavy metals, chlorides, and other by-products and constituents of oil and gas production. Hazelwood also shows evidence that the Property is contaminated with radioactive materials and asserts that the Defendants failed to properly plug and abandon wells there.[160]

The issue before the court was whether the surface owner could pursue a contract claim against the defendants based on a covenant contained in the oil and gas lease between the mineral interest owners and the lessees. The surface owner was not a party to the lease. The covenant provided:

> The use of the surface of the land is granted only for the purposes hereof. Grantee shall be responsible for all damages caused by his operations.[161]

The surface owner contended it could enforce the covenant as a third party beneficiary. The court of appeals agreed that a surface owner

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[157] However, there is no requirement that the injured landowner use any of the damage award to remediate the property.

[158] 790 So. 2d 93 (La. App. 2001).

[159] *Id.* at 95.

[160] *Id.* at 95–96.

[161] *Id.* at 99.

could be a beneficiary of a "stipulation *pour autrui*" in an oil and gas lease and held the facts in this case supported such a finding.[162]

Under Louisiana law, stipulations in a contract benefitting a third party "are favored."[163] To determine whether a contract provides for a stipulation *pour autrui,* the primary factor is whether there is a legal relationship between the promisee and the third party that creates an obligation that will be discharged by performance of the promisor's covenant. Although the court did not discuss its application of this requirement, the analysis would most likely be as follows: The legal relationship of mineral owner and surface owner imposes obligations on the mineral owner to limit its use and disruption of the surface; to discharge this obligation, the mineral owner required its oil and gas lessee to "be responsible for all damages caused by his operations;" such a covenant protects the mineral owner from possible liability and otherwise provides him with a benefit by fostering harmonious relations between the competing estates.

[3] Texas: Reining in the Surface Damage Cottage Industry.

In *Senn v. Texaco, Inc.*,[164] the surface owners brought suit against past and present oil and gas lessees for damages associated with oil and gas drilling and production activities, including contamination of the aquifer underlying their land. On June 5, 1997, the owners of the land conveyed the surface estate to the plaintiffs by deed that expressly excluded any warranty or representation concerning the environmental condition of the land.[165] Texaco had leased the land in 1948 and assigned all its rights to Apache Corporation in 1995. Exxon Mobil Corporation also leased part of the land in 1948 and assigned all its rights to Primrose Operating Company in 1992. Apache assigned its rights to CK Oil Properties on June 1, 1997, and retained rights to certain deep formations that had not been developed. Texaco, Exxon, and Apache challenged the plaintiffs' standing to sue them as prior owners of the property.[166]

Holding the plaintiffs lacked standing to pursue prior owners, the court stated "a cause of action for injury to real property is a personal

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[162] *Id.* at 100.
[163] *Id.*
[164] 55 S.W.3d 222 (Tex. App.—Eastland 2001).
[165] *Id.* at 224–25.
[166] *Id.* at 225.

right which belongs to the person who owns the property at the time of the injury."[167] The court held the discovery rule and similar statute of limitations concepts are not relevant when the issue is standing: "Without the breach of a legal right belonging to the plaintiff, no cause of action can accrue to his benefit."[168] The court articulated the policy behind this rule as follows:

> The discovery rule cannot work to transfer the ownership of a cause of action from one person to another simply because the second person claims to have discovered the injury. . . . It lends certainty to transactions involving real property by producing clearly defined rights and liabilities.[169]

The court concluded by noting that the plaintiffs could have avoided their standing problem by obtaining a specific assignment of the prior owner's possible causes of action when they purchased the land.[170] Are they still available for transfer?

§ 3.05. Conveyancing Issues.

[1] Undivided Mineral Interest in Granite Dominates the Surface.

Wilderness Cove, Ltd. v. Cold Spring Granite Co.[171] serves as a reminder that severed mineral interests can create real problems for a surface owner because severance of the mineral, absent express limiting language in the conveyance, includes the right to make reasonable use of the surface to mine the mineral. In *Wilderness Cove,* an 1890 deed from owners of an undivided one-half fee interest in the land conveyed "all of our interest in and to the Granite on the . . . land together with the necessary right of way to the extent of our interest in the same for constructing a Rail Road and for quarrying and handling the said Granite."[172] This interest is now owned by Cold Spring Granite; the remaining one-half interest in the granite and all other surface and mineral rights to the property are owned by Wilderness Cove. On July 12, 2000, Wilderness Cove purchased the

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[167] *Id.*
[168] *Id.* at 226.
[169] *Id.*
[170] *Id.*
[171] 62 S.W.3d 844 (Tex. App.—Austin 2001).
[172] *Id.* at 845-46.

property, thirty acres of which fronts on Lake LBJ, for residential development.[173]

Wilderness Cove, no doubt seeking to avoid paying Cold Spring Granite to acquire its inchoate surface use rights, asked the court to hold that Cold Spring Granite's rights were limited to a share of the profits from the sale of granite when, and if, Wilderness Cove elected to mine the granite. The court rejected this argument, holding that Cold Spring Granite owned the granite *in situ* as a mineral estate, which is the dominant estate giving it the right "to make necessary and reasonable use of the surface to remove the minerals."[174] The court also held that these basic mineral ownership rights are not diminished because Cold Spring Granite owned an undivided interest in the granite as a cotenant with Wilderness Cove.[175]

[2] Twenty-Nine Years of Receiving Royalties and Paying Taxes and What Do You Get? Not Adverse Possession.

Cornelius thought he had inherited the oil and gas mineral estate from his mother when she died in 1966, and for twenty-nine years he received production proceeds under a lease his mother had granted in 1945. It was later found that his mother had conveyed the mineral estate to her brother, James Tarpley, who also died in 1966. The Moody Bible Institute of Chicago claimed title to the minerals through a conveyance from Tarpley's heirs.

In *Cornelius v. Moody Bible Institute of Chicago*,[176] the court had to determine whether the receipt of production proceeds and the payment of taxes on the production proceeds would constitute adverse possession of the minerals. Holding such acts insufficient as a matter of law, the court noted the fundamental adverse possession inquiry: Did the claimant's actions put the record title owner on notice of the adverse claim? Typically, this will require the claimant to drill a well on the land and produce minerals for the statutory period. In *dicta,* the court also noted that the activity must take place physically on the land being claimed; merely pooling it with other lands where the activity takes place is not adequate notice.[177]

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[173] *Id.*
[174] *Id.* at 849.
[175] *Id.* at 850-51.
[176] 18 P.3d 1081 (Okla. App. 2001).
[177] *Id.* at 1084.

[3] What Goes Around Comes Around: The Irony of After-Acquired Title.

Grantor ("A" below) owned one-half of the minerals in a tract of land from which the following mineral interest conveyances were made in the order indicated:

1: 1/3 from A to B (this left A with 1/6: 1/2-1/3 = 1/6).

2: 1/4 from A to C (this was an over-conveyance by 1/12: 1/4-1/6).

3: 1/8 from C to A (this was a reconveyance to A).

4: 3/8 from A and B to D (with A's contribution intended to be 1/8).

Depending upon the interest owned by A at the time of conveyance No. 4, A either contributed 1/8 of the mineral interest or 1/24. The difference depends on what C owned following conveyance No. 3. Following conveyance No. 3, did the 1/12 necessary to satisfy the shortage under conveyance No. 2 automatically vest in C under the after-acquired title doctrine? If so, that means all A had when conveyance No. 4 took place was a 1/24 mineral interest, and therefore, the remaining 8/24 to satisfy the 3/8 conveyance to D must come out of B's mineral ownership.

In *Mack Oil Co. v. Garvin*,[178] the Oklahoma Supreme Court held the after-acquired title doctrine would apply to the reconveyance to A by the previously shorted grantee B. Therefore, when B reconveyed 1/8 to A, the 1/12 necessary to make B whole from conveyance No. 2 immediately passed through A to B. The court noted that the after-acquired title doctrine is applicable "no matter what conduit or circuity of conveyancing the title may pass through in returning to the grantor."[179]

§ 3.06. Oil and Gas Contracts Issues.

[1] Some Basics: When Does an Agreement Become a Contract?

In *Encina Partnership v. COREnergy, L.L.C.*,[180] a landman acting on behalf of COREnergy negotiated a seismic permit with Encina

[178] 39 P.3d 775 (Okla. 2001).
[179] *Id.* at 779.
[180] 50 S.W.3d 66 (Tex. App.—Corpus Christi 2001).

Partnership with the understanding COREnergy would pay Encina a total of $197,240 for the permit by conditional drafts, which stated: "On approval of seismic permit or lease described hereon and on approval of title to same by drawee not later than 3 days after the arrival of this draft at collecting bank."[181] The procedure followed by COREnergy was to have a landman negotiate the seismic permit with the landowner. Once they were in agreement, the landowner would sign the permit, and the landman would issue COREnergy's draft for the negotiated permit fee. However, the draft would be paid only if COREnergy accepted the negotiated permit.[182]

COREnergy refused to pay the Encina permit drafts one day after they were issued.[183] Encina sued asserting fraud and breach of contract. The court held that the language on the face of the drafts made COREnergy's approval of the seismic permit a condition precedent to the formation of a contract.[184] Because COREnergy refused to approve the permit, which was one of the conditions precedent, there was no contract between the parties. Perhaps a more accurate description of the parties' contract status is that at the point in time when the landowner signed the permit and received the conditional draft, the landowner had merely made an offer to COREnergy, which created in COREnergy a power of acceptance. Until COREnergy signified its acceptance by paying the drafts, either party would be free to walk—Encina by revoking its offer, COREnergy by rejecting Encina's offer. The court's characterization of the situation as a "condition precedent to the formation of the contract" accurately describes the transaction from COREnergy's position, but it does not make it clear that Encina was also under no contractual obligation until COREnergy acted in accordance with the terms of its conditional draft.

This is one area where a simple mutual assent analysis may be more useful than a condition precedent form of analysis. This is particularly the case where the "condition" is the equivalent of acceptance. In this case, the "condition" was "approval of seismic permit . . . ." That sounds a lot like "Do I want to accept their offer?" The condition analysis is more appropriate when the approving party has limited its freedom of action in some meaningful way. For example, if the condition is "marketable title," the parties are bound at the time the

[181] *Id.* at 69.
[182] *Id.* at 67.
[183] *Id.* at 68.
[184] *Id.* at 69.

draft is issued, and the issuing party will be discharged from its contractual obligations only in the event title is not marketable. The broad condition language in the *Encina* case was more akin to a "home office approval" clause where a company's employees and contractors are sent forth to solicit offers for the decision makers to accept or reject at the home office.

[2] The Clause Gas Processors Love and Producers Hate: The Economic-Out Clause.

Most gas processing agreements have some form of "economic-out" clause that allows the processor to cease taking gas from a producer if it becomes "uneconomic" to process. The clause is the product of an industry that operates on a margin defined by the cost of its input, natural gas, and the value of its output, liquids and residue gas. However, there are two general categories of "processors": those that primarily seek to separate hydrocarbon liquids from the gas stream and those that primarily seek to treat the gas. In *Redman Energy Corp. v. Koch Midstream Services Co.*,[185] the producer and processor entered into a Gas Processing Agreement to process "sour gas" containing corrosive hydrogen sulfide. In fact, the gas was so corrosive it ate up the gathering line the processor used to convey the gas from the producer's wellhead to its processing facility.[186] Replacement of this gathering line was the focus of the parties' dispute.

When the processor discovered problems with the gathering line, it had to shut in the producer's well connected to the gathering line. In assessing its options, the processor determined either a new gathering line would need to be installed or a line could be run to another well on an adjacent property.[187] However, the processor determined it would not be economic for it to pursue either option alone so it proposed sharing the costs for any new gathering line equally with the producer.[188] The parties' Gas Processing Agreement provided:

> In the event Gas from the lease . . . is or becomes insufficient in volume or liquefiable hydrocarbon content, *or becomes uneconomical for processing*, the Processor reserves the right to submit to

[185] 45 S.W.3d 341 (Tex. App.—Texarkana 2001).
[186] *Id.* at 343.
[187] *Id.*
[188] *Id.* at 347.

> Producer an alternate processing proposal. Producer shall notify Processor of its acceptance or rejection of the alternate processing proposal within thirty days of its receipt of same.
>
> Should Producer accept the alternate processing proposal, the terms of such proposal shall become effective on the first day of the month following such election.
>
> Should Producer reject such alternate proposal or fail to advise Processor of its election within the thirty day period described above, this agreement shall be terminated on the first day of the month following the end of such thirty day period.[189]

The producer sued the processor asserting the cost associated with replacing the gathering line was not covered by the economic-out clause because it was not "processing."[190] The court examined the entire agreement and identified several provisions that indicated "the parties intended that the gathering of the gas from the well in order to process it at the processing plant would be an integral part of the processing, not a separate and distinct function."[191] The court held that costs associated with the gathering line could be considered by the processor in evaluating the processing economics associated with the producer's gas. Even if processing includes gathering, the producer argued the processor had failed to trigger the procedures set forth in the economic-out clause.[192] The court held that the evidence at trial indicated the processor had properly triggered the economic-out clause and because the producer failed to respond within the specified time, the processing agreement was terminated.[193]

[3] Lack of Specific Volume Limitations Gave Rise to "Best Efforts" Obligations.

In *Aquila Southwest Pipeline, Inc. v. Harmony Exploration, Inc.*,[194] producer Harmony entered into a contract granting Aquila the exclusive right to purchase all of Harmony's casinghead gas from specified wells. The revenue Harmony would receive from the agreement was based on a percent of the proceeds Aquila obtained when it sold the

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189 *Id.* at 343–44 (emphasis by the court).
190 *Id.* at 345.
191 *Id.* at 346.
192 *Id.* at 346–47.
193 *Id.* at 347.
194 48 S.W.3d 225 (Tex. App.—San Antonio 2001).

processed gas liquids and residue gas. Initially, the liquids recovery efficiency was from ninety to ninety-five percent with the bulk of the revenue proceeds generated by the sale of liquids.[195] Harmony presented evidence to show that Aquila, in an effort to contract for processing services with as many producers as possible, began taking more gas than it could process.[196] This resulted in bypassing much of the gas around the overloaded processing plant, thereby reducing the liquids recovery efficiency to forty-three percent for some products.[197] This resulted in reduced revenue to Harmony and other producers.[198]

Harmony argued that Aquila had an obligation to use its "best efforts" to take and process Harmony's gas, an obligation it breached when it contracted for subsequent volumes that adversely impacted Harmony. The court held that the Harmony/Aquila contract was a gas purchase and processing contract, which constituted a sale of goods governed by Article 2 of the Uniform Commercial Code (UCC).[199] Since it was a sale of goods, the court considered the application of Section 2-306(b) of the UCC, which stated: "A lawful agreement by

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[195] *Id.* at 237.

[196] The court found the evidence indicated:

> Beginning in 1992, Aquila began an aggressive campaign to connect as many volumes as possible into their system, thereby making Aquila the premier Austin Chalk gatherer. . . . Rather than restrict its buyers or new gas into its system, Aquila began to utilize a segment of pipe (originally designed for emergencies) to allow all excess volumes to bypass the plants and go straight into the sales line at the plant's tailgate. Aquila began bypassing approximately 20% of its gas, but later bypassed as high as 50% of the gas it received.

Id. at 237.

[197] *Id.* at 238.

[198] Aquila's contract with Harmony was entered into on May 1, 1991; the aggressive addition of production began in 1992. The court noted:

> Because Aquila possessed the exclusive right to process Harmony's gas, Aquila determined the value Harmony received for its gas. Although title to the gas passed at the wellhead, the price that Harmony was paid for its gas was not calculated at the point of passage of title. The actual price Harmony received for the sale of gas depended upon whether Aquila fulfilled its obligation to process gas beyond the point of delivery. As a result, the 'best efforts' obligation of section 2.306(b) applied to the 1991 contract.

Id. at 235.

[199] The court did not engage in any sort of predominant factor analysis to determine whether the agreement was primarily for a service with an incidental sale of goods or primarily a sale of goods with processing as the incidental component. The court simply concluded: "Unlike the gas processing-only contract in Conoco, the gas purchase and processing contract in the instant case requires Aquila to both purchase and process Harmony's gas." *Id.* at 234.

either the seller or the buyer for exclusive dealing in the kind of goods concerned imposes unless otherwise agreed an obligation by the seller to use best efforts to supply the goods and by the buyer to use best efforts to promote their sale."[200] First, the court found the Harmony/Aquila contract was "for exclusive dealing in the kind of goods concerned" because Aquila had the exclusive right to buy Harmony's gas, and Harmony could have the gas processed only by Aquila.[201] Second, the court found the "unless otherwise agreed" portion of Section 2-306(b) was not applicable so Aquila had an obligation to "use best efforts to promote their sale."[202] The court upheld the jury's verdict that Aquila failed to use its best efforts to process Harmony's gas.[203]

Although the court quoted portions of the contract that seemed to give Aquila discretion in how it processed gas,[204] the jury and court apparently did not believe the language was strong enough to override

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200 *See* Tex. Bus. & Com. Code Ann. § 2.306(b) (Vernon 1994).

201 *Aquila*, 48 S.W.3d at 235.

202 "[T]he parties did not agree in the contract to modify or waive the best efforts provision required by section 2.306(b)." *Id.* at 235.

203 *Id.* at 240. The jury and court rejected Aquila's argument that an "emergency" bypass provision of the contract applied to the situation. *Id.* at 238. The jury and court were also influenced by Aquila's failure to try to take and process gas behind the plant ratably. *Id.* at 238–39. This is not surprising since the plant was dealing with casinghead gas where bypassing would be preferable to shutting in oil production. Arguably, by forcing all parties to share in the missed processing opportunity through bypassing gas, a ratable allocation of the burden was achieved. However, it would not account for the differing obligations Aquila might have to a party contracting in 1991 as compared to a party contracting in say 1993, when it had already exceeded its processing plant capacity. These issues, of course, could easily have been provided for in the contract by Aquila's stating that it had the right to contract for additional gas supplies, which might exceed its processing capacity and require bypass. Harmony, being expressly alerted to such a possibility, could have demanded a right to release its gas in the event the bypass situation, or processing efficiencies, became unacceptable.

204 For example, the court noted the following provisions:

> The parties expressly recognize that Buyer's obligations to take pursuant to the rules or otherwise shall be subject to the ability of Buyer's facilities to handle all gas connected thereto, lessening or fluctuating demand for gas on Buyer's or its resale purchaser's system, the location on Buyer's system of gas supplies and demand, and any other valid reason such as force majeure, whether or not of a kind herein mentioned.
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> . . . .
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> In the event any of Buyer's facilities are of insufficient capacity to handle all of the gas connected thereto, Buyer shall be obligated only to take gas ratably from all leases and/or wells delivering into such facilities.

Id. at 231–32.

the best efforts obligation to take. Perhaps a major factor was the lack of any contractual right for Harmony to seek out other arrangements if Aquila was unable to efficiently process Harmony's gas. Often gas processing agreements will give the producer the right to have its gas released from the contract if it is not processed. The predominant sales component of the Aquila contract, coupled with a bypassing of production instead of a cessation of production, perhaps explains why the contract did not have such a provision and why, even if it did, it might not have been applicable to a mere bypass situation. The court used the implied best efforts obligation to add symmetry to a contract that obligated Harmony to give all of its gas to Aquila and gave Aquila the exclusive right to purchase and process Harmony's gas without any express obligation to do so.

[4] Pooling Equals Agreement Not to Partition.

In *MCEN 1996 Partnership v. Glassell*,[205] several production units were formed using pooling agreements. The court observed that in Texas, entering into a pooling agreement results in a cross-conveyance of the mineral interests encompassed by the agreement. As cotenants, the parties to the pooling agreement have the right to seek a partition of their undivided interests. However, their partition rights can be waived by contract.[206] Shortly after MCEN acquired an interest in the pooled units, it filed suit to partition the units by sale. The trial court denied partition holding there was an express agreement among the parties not to partition the pooled units.[207]

On appeal, the court examined each of the pooling agreements and found they all had language indicating that the pooling would be effective so long as production continued from the pooled unit.[208] Some of the agreements also provided for termination before production ceased only if all the affected parties agreed.[209] One set of agreements was to continue "pursuant and under the terms and provisions of the oil and gas leases relating and pertaining to each

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[205] 42 S.W.3d 262 (Tex. App.—Corpus Christi 2001).

[206] *Id.* at 263.

[207] *Id.*

[208] For example, the following language was held to be sufficient to prevent partition: "[The pooled unit] will remain in effect . . . so long thereafter as there is a well within the pooled area capable of producing gas . . . ." *Id.* at 264.

[209] For example: "The unit created hereunder may be dissolved at any time . . . by an instrument executed by Lessees . . . provided the mineral and royalty owners under the leases included within the pooled unit have previously consented in writing to such dissolution." *Id.* at 264.

unit created hereby . . . pooled, combined and unitized for the purpose of producing gas from the Edwards Lime Reservoir . . . ."[210] The court held this was express language limiting partition stating:

> Under the terms of the declaration, the unit will exist as long as the pooled leases exist. By entering into the agreement to unitize, the parties agreed to maintain the unit as a whole while the underlying leases were in effect. The declaration contains an agreement not to partition.[211]

Although the contract language on which the court focused did not "expressly" state: "[T]he parties waive the right to partition," the language nevertheless constituted an express indication that partition was not compatible with the pooled relationship and defined the period in which partition would be restricted.

[5] Revisiting a Perennial Contest: "I'm Operator, You're Not."

The court in *Stable Energy, L.P. v. Kachina Oil & Gas, Inc.*[212] sets the stage noting: "In the following years, the title of 'operator' changed hands several times and eventually became the focal point of the parties' dispute."[213] CRB Oil & Gas was designated the operator of a well in 1980. In 1983, CRB subcontracted with K-N Operating to operate the well. Although CRB owned an interest in the contract area covering the well, K-N did not. After CRB filed for bankruptcy, the trustee in bankruptcy filed a Form P-4 with the Texas Railroad Commission designating K-N as the operator. In 1990, K-N filed a Form P-4 designating its affiliate, MGN Oil & Gas Corporation, as operator. In 1991, MGN changed its name to Kachina Oil & Gas, Inc. At no time did MGN or Kachina own an interest in the contract area covering the well. In 1989, Stable Energy, L.P., acquired its interest in the contract area, and in 1992, Kachina sent an authorization for expenditure (AFE) to all working interest owners in the contract area proposing to work over the well.

Since 1983, Kachina and its predecessors had operated the well under a joint operating agreement (JOA) that governed the rights and obligations of the working interest owners in the contract area. The

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[210] *Id.* at 264.
[211] *Id.* at 265.
[212] 52 S.W.3d 327 (Tex. App.—Austin 2001).
[213] *Id.* at 329.

JOA provided that if the operator proposed an operation by issuing an AFE, parties who elected not to participate would relinquish their interests pursuant to JOA article VI.B.2. which stated:

> *Upon commencement of operations* for the . . . reworking . . . of any such well by Consenting Parties . . . each Non-Consenting Party shall be deemed to have relinquished to Consenting Parties . . . all of such Non-Consenting Party's interest in the well and share of production therefrom.[214]

When Kachina proposed the workover, Stable, owning thirty-three percent of the well, agreed to participate, and also tendered its check to purchase a twenty-eight percent interest owned by Nonconsenting Parties.[215] The contest began when Kachina informed Stable it did not know how to apply Stable's payment because Stable was in default on its joint interest billings for the well. Stable responded by assigning a one percent interest in the well to its affiliate, Anchor Operating Company.[216] Stable asserted it held an operator vote between itself and Anchor, as purported owners of sixty-one percent of the well, and elected Anchor as the operator. Anchor then cut the locks on the gate to the well, took possession of the well, and began workover operations on the well that were more extensive than those proposed in the Kachina AFE. At this point, Kachina withdrew its workover AFE.[217] Stable then filed suit seeking an accounting and declaratory judgment that Anchor was the operator.

The court held there were several problems with Stable's position. First, it never became a majority owner in the well because it never acquired the twenty-eight percent ownership interest of the Nonconsenting Parties. Stable contended it acquired this interest when it tendered its check to Kachina. However, the court held the JOA provided the transfer would only occur "[u]pon commencement of operations . . . ."[218] Therefore, at the time Stable purported to hold an operator vote, it only owned a thirty-three percent interest in the contract area. Also, no operations were ever commenced under the Kachina AFE because it was withdrawn when Anchor took over the well. The court held that the Anchor operations could not satisfy the Kachina AFE because they were fundamentally different from what

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[214] *Id.* at 332 (emphasis by the court).
[215] *Id.* at 330.
[216] *Id.* at 333.
[217] *Id.* at 330.
[218] *Id.* at 331–32.

was described in the Kachina AFE, and no attempt was made to issue a new AFE as required by the JOA.[219]

Stable sought to bolster Anchor's position as operator by attacking the legitimacy of Kachina's operator status. Stable noted that Kachina did not own an interest in the contract area as required by the JOA. The court responded to this argument stating:

> Stable correctly contends that Kachina was vulnerable to being replaced by a successor operator because, at the time of Anchor's alleged election, Kachina did not own a working interest in the well. The JOA provides that operators "shall be selected from the parties owning an interest in the Contract Area." Because Kachina was not a partial owner, Article V.B.1 of the JOA would have allowed the parties to replace Kachina with a successor operator: "If Operator . . . *no longer owns an interest in the Contract Area* . . . it shall cease to be Operator without any action by Non Operator, *except the selection of a successor*."[220]

The court did not have to address the precise operation of Article V.B.1. because it concluded that at no time did Stable own the majority interest necessary to elect Anchor as operator.[221]

Stable also sought reimbursement of $33,500 Anchor had spent reworking the well under theories of unjust enrichment and promissory estoppel. The court rejected recovery under the unjust enrichment theory because no evidence was presented to establish the reasonable value of the benefit allegedly conferred on the working interest owners.[222] Rejecting the promissory estoppel theory, the court held there was no promise to transfer nonconsenting interests to Stable upon tender of payment. The JOA provided that Stable "had a duty to be familiar with its terms, including the relinquishment clause";[223] thus, Stable's rights in this area were governed by the express terms of the JOA. The court concluded, noting: "If an alleged promise is part of

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[219] The court found that the workover activities of Anchor were "substantially different" from those described in Kachina's AFE. The JOA relinquishment provisions were never triggered because the working interest owners never had notice or an opportunity to consider the operations undertaken by Anchor. The court noted that Article VI.B. of the JOA required that operations be preceded by an AFE describing the operations and soliciting their approval. *Id.* at 332.

[220] *Id.* at 334 (emphasis by the court).

[221] The court observed: "Any vulnerability in Kachina's position was immaterial because Stable and Anchor did not have the majority interest required to elect a successor without the consent of the other parties." *Id.* at 334.

[222] *Id.* at 335–36.

[223] *Id.* at 336.

a valid contract, the promisee cannot disregard the contract and sue for reliance damages under the doctrine of promissory estoppel."[224]

§ 3.07. Oil and Gas Litigation Issues.

[1] Judicial Ascertainment Clause: If I Sue My Lessee and "Win," Do I "Lose"?

In *Wellman v. Energy Resources, Inc.*,[225] the West Virginia Supreme Court held that a common form of "judicial ascertainment clause" violated public policy and was therefore void. The clause at issue was in an oil and gas lease and provided:

> This lease shall never be forfeited or terminated for failure of Lessee to perform in whole or in part any of its express or implied covenants, conditions or obligations until it shall have been first finally judicially determined that such failure exists, and Lessee shall have been given a reasonable time after such final determination within which to comply with any such covenants, conditions or obligations.[226]

The court noted public policy promoting "economy of judicial effort," the concept "that one should not have to undergo repeated litigation over the same matter" and that "the purpose of the legal system is to provide final resolution of legal controversies and not to provide a device to enable one party to grind another down through repetitious litigation until the other submits."[227] The court therefore held "that 'judicial ascertainment' clauses in oil and gas leases in West Virginia are void under the public policy of this State . . . ."[228]

[2] Presuit Notice and Cure Clause: Court Ignores Express Terms.

In *Niemeyer v. Tana Oil and Gas Corp.*,[229] the oil and gas lease between the parties provided:

> In the event lessor considers that lessee has not complied with all its obligations hereunder, both express and implied, lessor shall

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[224] *Id.*
[225] 557 S.E.2d 254 (W. Va. 2001).
[226] *Id.* at 258.
[227] *Id.* at 261.
[228] *Id.* at 261-62.
[229] 39 S.W.3d 380 (Tex. App.—Austin 2001).

> notify lessee in writing, setting out specifically in what respects lessee has breached this contract. Lessee shall then have sixty (60) days after receipt of said notice within which to meet or commence to meet all or any part of the breaches alleged by lessor. The service of said notice shall be precedent to the bringing of any action by lessor on said lease for any cause, and no such action shall be brought until the lapse of sixty (60) days after service of such notice on Lessee.[230]

The lessee argued that the lessor had breached the lease by failing to comply with the notice and cure clause prior to filing suit for an alleged underpayment of royalty. Relying on the Texas Supreme Court's analysis in *Texas Oil & Gas Corp. v. Vela*,[231] the court held the notice requirement only applied to actions seeking cancellation as opposed to damages.[232]

Although the court's holding may be consistent with *Vela*, it is not consistent with the express terms of the notice and cure clause, which clearly applied to the lessor's suit seeking damages for an alleged breach of express and implied covenants. In *Vela,* the court applied a clause with language very similar to the one in the *Niemeyer* case. However, the issue in *Vela* was whether the notice had to be given before damages for drainage could begin accruing under the oil and gas lease. The court in *Vela* held:

> Provisions of this nature are included in the lease primarily to protect the lessee against a forfeiture for breach of some express or implied obligation. The parties could not have intended that the lessor would be forever barred from recovering damages sustained prior to the giving notice, and we hold that the first two sentences quoted above apply only to actions to cancel the lease and not to suits for damages.[233]

It does not appear that the notice and cure provision was ever intended to delay the accrual of damages or a cause of action. Instead, it was intended to provide a procedure to try to mediate the dispute before the inertia of litigation would take hold. For example, in the royalty setting, the notice would not create any sort of limitation on the recovery of underpaid royalties accruing prior to the notice, but it

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230 *Id.* at 388.

231 429 S.W.2d 866, 874–75 (Tex. 1968).

232 *Niemeyer*, 39 S.W.3d at 388.

233 Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 875 (Tex. 1968).

would give the lessee time to focus on the issue and either pay what the lessor asserts is due or articulate, in an effort to settle the matter, its rationale for not paying the amount claimed. Once the notice is given and the cure period has passed, if the lessor is not satisfied with the lessee's response, the lessor can proceed to court, and if it establishes liability, recover whatever damages it can prove.

In an effort to limit the scope of the clause, the court in *Vela* identified its purpose as merely to provide the lessee with time to prepare its defense, and therefore, failing to comply with the clause would merely be grounds for abating the suit so the lessee could prepare.[234] In light of modern pleading and procedure rules, this rationale is unconvincing. The purpose of the clause should be better understood today with the strong public, judicial, executive, and legislative preference for alternative dispute resolution. The notice and cure clause merely requires the lessor to give the lessee advance notice of a claimed breach of its contract so the lessee can have a specified period of time in which to try to cure a default. Although this places a modest contractual limitation on a party's ability to immediately file suit, it is arguable that this clause, unlike the judicial ascertainment clause struck down in *Wellman*,[235] actually promotes a well recognized public policy favoring presuit mediation of disputes.

[3] Texas Further Defines Scope of Discovery Rule in Oil and Gas Litigation.

In *Wagner & Brown, Ltd. v. Horwood*,[236] the lessors sued their lessee alleging the lessee had improperly deducted gathering and compression charges in calculating the lessors' royalty. The lessors sought damages for periods prior to the applicable four-year statute of limitations, asserting the discovery rule had deferred accrual of the cause of action until the lessors were aware of the facts giving rise to their claim. They contended that the nature of their injury was both "inherently undiscoverable" and "objectively verifiable."[237] Addressing only the "inherently undiscoverable" requirement, the Texas Supreme Court held:

> [W]e cannot say that injuries caused by excessive or improper charges resulting in the underpayment of royalties are inherently

[234] *Id.*
[235] 557 S.E.2d 254 (W. Va. 2001).
[236] 58 S.W.3d 732 (Tex. 2001).
[237] *Id.* at 734.

> undiscoverable. Horwood and Glass's [the lessors] injury is the type that could have been discovered with reasonable diligence; therefore the discovery rule does not apply to defer accrual of their claims.[238]

The court addressed the issues by first noting that an injury is "inherently undiscoverable" when it is unlikely to be discovered by a diligent claimant within the prescribed limitations period. The focus is not on the *injured party*, but rather on the *injury* to determine whether, "on a categorical basis," it is something that would be generally discoverable employing reasonable diligence.[239]

Applying this analysis to the injury category of underpayment of royalty, the court expanded on its analysis in *HECI Exploration Co. v. Neel*[240] stating:

> As royalty owners, Horwood and Glass have "some obligation to exercise reasonable diligence in protecting their interests." . . . . Royalty owners may not rely on implied covenants to "dispense with the need . . . to exercise due diligence in enforcing their contractual rights." [A] royalty owner should exercise due diligence to determine whether charges made against royalty payments are proper and reasonable.[241]

The court indicated that the lessor could have turned to the lessee, the party providing the gas gathering and compression services, and the gas purchaser for information concerning the postproduction charges.[242] The court rejected the lessors' argument that information about the injury must be available from a public source.[243] The court also observed that "those who receive statements listing fees charged should be alerted to the need to perform additional investigation to protect their interests."[244] This imposes a general obligation on the lessor to ask questions in an effort to go behind the statements received to ascertain whether they are being properly paid.

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238 *Id.* at 737.

239 *Id.* at 734–45.

240 982 S.W.2d 881 (Tex. 1998).

241 *Wagner & Brown*, 58 S.W.3d at 736.

242 *Id.* at 736–37.

243 *Id.* at 736.

244 *Id.* at 737. One of the lessors had hired a consultant in 1982 to investigate the fees charged and using the statements and other information was of the opinion the lessor had been overcharged. *Id.*

[4] Class or No Class? The *Hankins/Neinast* Royalty Payment Class Certification Cases.

During 2001, two Texas intermediate appellate courts arrived at opposite conclusions regarding the propriety of litigating royalty underpayment claims as a class action.[245] The El Paso Court of Appeals, in *Union Pacific Resources Group, Inc. v. Hankins*,[246] held that the district court acted properly in certifying the class. The Houston Court of Appeals in *Union Pacific Resources Group, Inc. v. Neinast*,[247] held that the district court abused its discretion in certifying the class and ordered the class decertified. Although the *Hankins* case limited the proposed class to defined royalty owners covering land in Crockett County, Texas, and the *Neinast* case included defined royalty owners within the State of Texas, except Crockett and Sutton Counties, the geographic scope of the proposed classes was not the issue. The issue concerned the unifying principle on which the plaintiffs were relying to avoid considering the express terms of the individual leases.

In each case, the plaintiffs relied upon the "implied covenant to manage and administer the leases" as the unifying principle that would make resolving the disputes as a class action appropriate. The focus of the lessors' complaint was a sale by the Union Pacific producing entity to an affiliated Union Pacific marketing entity. The lessors were seeking to obtain royalties based on the prices for which the marketing entity sold the gas at a marketing point downstream of the wells as opposed to the prices the producing entity received, which reflected gas values further upstream. The basic issue was whether royalty should be calculated at or near the well or at some point downstream of the well, and once this issue was resolved, whether the amount paid, considering the appropriate location, complied with the lease terms. The plaintiffs contended that the express lease terms were not relevant to this inquiry because the lessee had breached its implied covenant

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[245] The author was an expert witness in both cases on behalf of Union Pacific Resources Group, Inc. where his role was to design and conduct a study of the oil and gas leases and other relevant contracts involved in the litigation. The basic allegation in each case was that all royalty owners in the putative class had not been paid the royalty they were due. Therefore, the author examined the oil and gas leases to identify lease terms relevant to the allegations. Once the relevant lease terms were identified, the author performed a comparative analysis to identify the level of similarity and diversity among the separate contractual obligations encompassed by the plaintiffs' desired class of royalty owners.

[246] 51 S.W.3d 741 (Tex. App.—El Paso 2001).

[247] 67 S.W.3d 275 (Tex. App.—Houston 2001).

to market as to all the lessors by failing to pay royalty using the downstream gas values.

Although the court in *Hankins* refused to consider the impact of *Yzaguirre v. KCS Resources, Inc.*[248] on its analysis, contending it went to the merits of the claims or defenses, the court did accept, as a matter of law, the following concepts:

> Included in the covenant to manage and administer the lease is the duty to reasonably market the oil and gas produced from the premises. Under this implied obligation, the lessee must market the production with due diligence and obtain the best price reasonably possible. Where a royalty clause provides for royalties based on market value, the lessee has an obligation to obtain the best current price reasonably obtainable. . . .
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> Here, although the individual amounts of royalties due may vary among the class members, the conduct of UPRG, the issues regarding UPRG's transactions with its affiliates, and the resulting diminished royalties are pertinent to all class members. Moreover, the issue of whether appellants breached the implied covenant to market would apply equally.[249]

It is interesting that the court would refuse to consider principles established in *Yzaguirre* but then accept as determinative principles that had been expressly rejected by *Yzaguirre*. Throughout the court's analysis of the class certification issues, it adopted the plaintiffs' unifying legal principle of a "breach of the implied covenant to market . . . even though . . . the leases have different express terms."[250]

As in *Hankins*, the court in *Neinast* found: "Predominance in this case hinges on whether the trial court properly implied a covenant to reasonably market the gas in every lease at issue in the class."[251] Relying on *Yzaguirre* and other Texas Supreme Court cases, the court noted that a covenant will be "implied" only to the extent it is necessary and consistent with the express terms of the lease.[252] This means the court must examine the individual oil and gas leases to ascertain whether an implied covenant is necessary and if so, the resulting content of the implied covenant as defined by the express

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[248] 53 S.W.3d 368 (Tex. 2001).
[249] *Hankins*, 51 S.W.3d at 751.
[250] *Id.* at 752.
[251] 67 S.W.3d 275, 281 (Tex. App.—Houston 2001).
[252] *Id.* at 283.

terms of the lease.[253] As the court observed, a random sample of 1,000 leases gathered from the 26,000-lease universe, "yielded 150 variations concerning there rights and duties."[254] Therefore, resolving the rights of the putative class based on the contractual relations between the proposed class representatives and the lessee could result in hundreds of situations where the lessee, or lessor, was entitled to more or less favorable treatment because of the express terms of the contract. The court also noted that once the extent of any necessary implied covenant is defined, the prudent operator standard must still be applied to determine whether the implied covenant was breached. The prudent operator analysis requires that the court identify what a "reasonably prudent operator under the same or similar circumstances"[255] would do. The court noted that such an inquiry "necessarily contemplates a fact-specific, location-by-location inquiry for each lease."[256]

Justice Cohen in his dissenting opinion accuses the majority of resolving the merits against the plaintiffs, asserting: "It holds that none of the leases contains that implied covenant because, as a matter of law, that implied covenant does not exist."[257] Clearly that is not what the majority did. The court did reject the trial court's assertion[258] that all of the leases contained the same implied covenant as a matter of law, regardless of what the express lease terms provided. However, the thrust of the majority's analysis is that the trial court must define and evaluate the issues to be decided against the appropriate legal context. Justice Cohen does not really dispute this; he is just arguing for application of a different legal context. The majority does not evaluate or define the parties' rights under a lease; the court is merely instructing the trial judge that the terms of the contract must be considered in any litigation regarding the parties' rights under the contract—a novel thought the Texas Supreme Court seems to keep trying to impress upon us in its decisions.

[5] Industry Custom and Usage Evidence: Powerful Stuff.

In *Mescalero Energy, Inc. v. Underwriters Indemnity General Agency, Inc.*,[259] the trial court had granted the insurance company

[253] *Id.* at 282.
[254] *Id.* at 279.
[255] *Id.* at 284.
[256] *Id.*
[257] *Id.*
[258] The approach of the trial judge in *Neinast* was identical to the approach of the court in *Hankins*.
[259] 56 S.W.3d 313 (Tex. App.—Houston 2001).

summary judgment, holding that the Austin Chalk was a single "formation" as the term was used in a policy excluding coverage for an underground blowout that did not impact "two or more separate formations . . . ."[260] The court relied on the Williams & Meyers *Manual of Oil and Gas Terms*, which defined "formation" as follows:

> A succession of sedimentary beds that were deposited continuously and under the same general conditions. It may consist of one type of rock or of alterations of types. An individual bed or group of beds distinct in character from the rest of the formation and persisting over a large area is called a "member" of the formation. Formations are usually named for the town or area in which they were first recognized and described, often at a place where the formation outcrops. *For example, the Austin chalk formation outcrops at Austin, Texas.*[261]

Although the court noted that the Texas Supreme Court had referred to this definition in another case, it had been adopted neither as the court's definition nor as the sole definition of the term "formation."[262] What the court found persuasive though was the Texas Supreme Court's willingness to look to extrinsic evidence, such as a dictionary of industry terms, to determine the commonly understood meaning of an industry term. The court noted that this extrinsic evidence could be obtained from a dictionary or through other sources, including expert testimony.[263]

The issue in the *Mescalero* case was whether an affidavit of the insured's expert witness, advancing a theory that the Austin Chalk comprises many "formations" as that term is used by the industry,[264] created an issue of material fact that would preclude summary judgment. Ultimately, the court held that the insured's affidavit indicated the term "formation" was ambiguous, and therefore, the trial court erred in granting summary judgment to the insurance company.[265] In arriving at this conclusion, the court stated that extrinsic evidence is admissible to interpret a contract to ascertain whether it

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[260] *Id.* at 315-16.

[261] *Id.* at 318 (emphasis by the court) (quoting from Howard R. Williams and Charles J. Meyers, Manual of Oil and Gas Terms 559 (9th ed. 1994).

[262] *Id.* at 323.

[263] *Id.*

[264] The insured's expert defined formation as " '[a]ny mappable, separate, self contained pressure unit within a geological interval.' " *Id.* at 319.

[265] *Id.* at 325.

is ambiguous,[266] and the extrinsic evidence can be in the form of affidavit testimony by an expert witness.[267] The final issue addressed by the court was whether the affidavit of the insured's expert was inadequate as a mere conclusory statement that failed to reveal the basis for the expert's opinions.[268] The court held that the opinion was based on the expert's review of relevant documents in the litigation and his expertise as a petroleum engineer. The court also noted that the other party elected not to depose the witness to explore the basis for his proposed definition, nor had that party sought to challenge him or his work as being unreliable under *Daubert*. The court concluded stating:

> We find that Davenport's [the insured's expert witness's] assertion that a "formation" should be interpreted as he defines it in his affidavit, supported by his unimpeached qualifications, is sufficient to defeat summary judgment and establish a reasonable definition of a "formation" for this case. We conclude the policy is ambiguous.[269]

This holding probably has more than mere procedural benefits for the insured because the court, in introducing the case, stated: "For insurance policies in particular, however, we construe the policy against the insurer when ambiguous policy terms permit more than one interpretation, especially when the policy terms exclude or limit coverage."[270] The task for the insurance company's counsel upon remand will be to identify the precise basis for the opinions of the insured's expert and then test him through rigorous cross-examination[271] and by offering its own rebuttal evidence on the issue.

§ 3.08. Conclusion.

As this article reveals, the recent developments during 2001 have been dominated by royalty litigation, but the courts have also been addressing other interesting issues regarding oil and gas contracts and

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[266] *Id.* at 320. "In particular, a specialized industry or trade term may require extrinsic evidence of the commonly understood meaning of the term within a particular industry." *Id.*

[267] *Id.* at 323.

[268] Justice Taft, in a dissenting opinion, stated he would affirm the trial court's judgment because the affidavit of the insured's expert did not disclose his basis and reasoning for concluding that his definition of "formation" should be considered. *Id.* at 325–26.

[269] *Id.* at 325.

[270] *Id.* at 319.

[271] *Id.* at 325.

conveyancing. Perhaps the most significant future developments, the "unfinished business," will be determining whether litigants can use the class action device to homogenize oil and gas contracts to create the critical mass plaintiffs' counsel require to invest in royalty and other oil and gas litigation.