Oil and Gas: Watts v. Atlantic Richfield Co.: Lessor's Distant Beacon of Hope—Will Oklahoma See It?

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Oil and Gas: Watts v. Atlantic Richfield Co.: Lessor's Distant Beacon of Hope — Will Oklahoma See It?

I. Introduction

Take-or-pay gas contracts between natural gas producers and pipeline companies are a dynamic issue in the field of oil and gas law. Such contracts sparked exponential litigation between gas producers and pipeline companies when diminished demand for gas deteriorated the market in the early 1980s. Pipeline companies could neither take nor pay for the gas for which they had bargained. Litigation on the pipeline/producer contracts ignited further disputes between royalty owners and their producers as the royalty owners sought their share of the revenues derived from the leases, i.e., the take-or-pay proceeds or settlements.

In Roye Realty & Developing, Inc. v. Watson, Oklahoma's first case addressing the rights of the lessors to take-or-pay settlement proceeds, the Oklahoma Supreme Court decided that lessors do not share in such payments. This decision deprived Oklahoma land owners of hundreds of millions of dollars in royalties on income derived from their land. The decision also yielded precedent which is confusing and ill-prepared to address the rights of the relevant parties in the inevitable future litigation.

This note compares the reasoning of the Tenth Circuit Court of Appeals in Watts v. Atlantic Richfield Co. with the Oklahoma Supreme Court's reasoning in Roye. In Watts, the Tenth Circuit decided an issue closely related to take-or-pay settlement proceeds based on Oklahoma law. The Watts reasoning highlights the weaknesses of Roye and demonstrates the need for Roye to be strictly limited to the facts of the case. Royalty law that adequately protects the rights of all relevant parties to the oil and gas lease must be established. In the interest of justice, the confusion of Roye should quietly pass into history and an improved line of reasoning should be adopted.

Part II of this note reviews the relevant oil and gas industry background and the countervailing lines of reasoning which jurisdictions have applied to take-or-pay royalty disputes. Specifically, the "plain terms" reasoning applied in Roye will be compared with the "cooperative venture" theory set forth by Professor Thomas Harrell. While plain terms jurisdictions apply a four corners approach to royalty

3. 949 P.2d 1208 (Okla. 1996). For an informative discussion of this decision, the surrounding issues and a summary of other jurisdictions' handling of those issues, see James Muenker, Oil and Gas: Roye Realty & Developing v. Watson — An Answer to the Take-or-Pay Royalty Issue in Oklahoma or Simply More Confusion?, 49 OKLA. L. REV. 751 (1996).
4. See Roye, 949 P.2d at 1217.
5. 115 F.3d 785 (10th 1997).
6. See Thomas A. Harrell, Developments in Non-Regulatory Oil & Gas Law, 30 INST. ON OIL &
clause analysis, those jurisdictions that use the cooperative venture theory take the intent of the parties into consideration when analyzing lease agreements. The narrowly divided Roye court denied Oklahoma lessors any share of take-or-pay settlement proceeds based on a plain terms approach to contract interpretation. In contrast, the cooperative venture theory holds that lessors and lessees enter into lease agreements for the purpose of sharing jointly in all of the economic benefits derived from the leased land. The partners in the joint venture simply divide all revenues arising from their joint operation in the proportion described in the royalty clause of their lease.

Part III explores the Watts decision. The Watts holding allows royalty owners the opportunity to seek their due share of settlement proceeds received by their lessees when those proceeds are derived from litigation of other than the take-or-pay variety. Watts preserves the rights of Oklahoma lessors to many royalties, in contrast to Roye, which apparently would have rendered lessors unable to claim royalty on much of the revenues derived from their leases.

Though it may lead to further litigation on the subject, application of Watts offers Oklahoma lessors hope that their contractual expectations will be satisfied. Part IV of this note will analyze the application of Watts. The Watts holding, if adopted in Oklahoma, will undoubtedly play a role in future related issues. It remains to be seen, however, whether the Oklahoma Supreme Court will accept the reasoning of the Tenth Circuit, which chose to distinguish Roye.

II. Background
A. Take-or-Pay History

From the late 1930s to the early 1980s, natural gas producers and pipeline companies had incentive to enter into long-term, take-or-pay sales contracts. By the mid-1980s, an excess supply of natural gas left the pipeline companies locked

7. See Roye, 949 P.2d at 1217.
8. See Harrell, supra note 6, at 334.
9. See id.
10. See infra notes 121-24 and accompanying text.
11. Under the terms of such contracts, pipeline companies are required to take either a specified minimum amount of gas, or to pay for that amount if it is not taken. See 8 HOWARD R. WILLIAMS & CHARLES J. MEYERS, OIL AND GAS LAW 1099 (1996). This arrangement was mutually beneficial to both the producer and the pipeline company. The contract gave the producer incentive to explore for and to develop natural gas reservoirs, and it also guaranteed the pipeline companies the supply of gas needed to service their customers.
12. Prompted by the natural gas shortages of the 1970s, the federal government began to regulate the gas market. The Natural Gas Policy Act of 1978, 15 U.S.C. §§ 3301-3432 (1994), spawned increased exploration for natural gas by establishing price ceilings for gas sales which essentially eliminated all price competition. In order to meet anticipated long-term gas shortages, producers entered the long-term, take-or-pay contracts. Pipeline companies were similarly encouraged to enter such contracts as they allowed the pipeline companies to minimize the risk of demand fluctuations. See Lowe, supra note 1, at 225-28.
into long-term, high-priced, take-or-pay contracts, the maintenance of which was not economically feasible.\textsuperscript{13} In turn, this market failure led to breach of the long-term, take-or-pay contracts between producers and pipeline companies. The pipelines were unable to take the gas or pay the massive fees which grew out of the long-term agreements because their liability often surpassed their net worth.

Pipeline companies unsuccessfully asserted various legal defenses in their attempts to avoid the massive contractual liability owed to their gas producers.\textsuperscript{14} Rather than force the pipeline companies into bankruptcy, the producers settled their claims for a fraction of the amount owed\textsuperscript{15} and negotiated new sales contracts with the purchasers.\textsuperscript{16} Even so, the amount of the settlements totaled in the billions industry-wide. Naturally, lessors sought their royalty share of those billions.

Disputes between producers and pipeline companies sparked a litigious chain reaction which has not yet run its course. Initially, the producers sued their various pipeline companies to recover damages for breach of their take-or-pay contracts. Subsequently, the various lessors took action to recover their royalty share of the proceeds from the agreements between the producers and the pipelines.

Similar litigation will inevitably follow. Currently, gas is priced and sold under a variety of contracts that involve payments that, like take-or-pay payments, are not direct payments for produced gas. A variety of marketing fees called "producer demand charges"\textsuperscript{17} are collected by lessees. These payments, however, often carry a label other than "production." As a result, lessors may not receive royalties on these revenues in jurisdictions which follow the four corners approach to contract interpretation. Because "producer demand charges" were not explicitly mentioned in the lease arrangements, a plain terms jurisdiction will not recognize such revenues as royalty-producing. Given the monetary magnitude of these issues, debate is sure to follow as lessors seek to share, through royalties, in the economic benefits derived from their land. It remains to be seen whether lessors will be allowed to claim a share of such proceeds in Oklahoma.

\begin{itemize}
\item \textsuperscript{13} See Bruce M. Kramer, \textit{Liability to Royalty Owners for Proceeds From Take-or-Pay and Settlement Payments}, 15 E. Min. L. Found. \textit{§} 14.01 (1994).
\item \textsuperscript{14} Estimates of the total of the actual liability incurred by pipeline companies are in the neighborhood of $60 billion to $70 billion. \textit{See} Lowe, \textit{ supra} note 1, at 227.
\item \textsuperscript{15} Estimates of the total pipeline settlement costs are in the neighborhood of $12 billion to $15 billion. \textit{See id.}
\item \textsuperscript{16} The concurrence of settling the breached contracts (often for pennies on the dollar) and renegotiating contracts at the same time offered producers, at the least, an opportunity to structure the pair of dealings in a manner which favored themselves over the royalty owners; given the billions of dollars in lost revenues from the settlements with the pipelines, producers certainly had the incentive to favor themselves. Producers may have been encouraged to negotiate a low sale price for gas in the new contracts in exchange for an increased settlement in the take-or-pay dispute, realizing that the settlement proceeds may not be subject to royalties while the sale of the gas surely would be.
\item \textsuperscript{17} Demand charges, including take-or-pay payments, are payments made to producers for standing ready to supply gas to sales customers. \textit{See} Howard R. Williams \& Charles J. Meyers, \textit{Manual of Oil and Gas Terms} 273 (9th ed. 1994).
\end{itemize}
B. The Evolution of the Case Law

As lessors began to claim their share of take-or-pay proceeds, the course of litigation took two distinct paths based on the relevant jurisdiction's method of interpreting the contracts involved. One jurisdictional approach has come to be known as "plain terms." Courts in these jurisdictions attempt to give effect to the plain language of the lease unless those terms are ambiguous. The second jurisdictional approach requires analysis beyond the language of the lease to determine the intent of the parties. These jurisdictions have come to be known as "cooperative venture" jurisdictions.

1. Plain Terms Reasoning

Two primary reasons are commonly given to justify denial of royalty under the plain terms approach: (1) a legal definition of "production" which requires actual physical severance of minerals from the ground, and (2) a four corners approach to contract interpretation. When the legal definition of production requires physical extraction of minerals from the ground, a royalty clause premised on "production" cannot be triggered by take-or-pay proceeds because such payments are made in lieu of production. Reading the royalty clause to require actual physical extraction, therefore, is consistent with a four corners interpretation.

These two reasons were used to deny lessors a claim to take-or-pay proceeds in Diamond Shamrock Exploration Co. v. Hodel. This early take-or-pay decision by the United States Court of Appeals for the Fifth Circuit dramatically impacted the course of take-or-pay litigation. Diamond Shamrock set the stage for royalty owner and producer arguments regarding royalty payments on take-or-pay proceeds.

In Diamond Shamrock, the lessor (the United States Government) claimed a share of the take-or-pay payments made to its lessees. The lease in Diamond Shamrock was a standard "production" lease which required royalties on "production saved, removed or sold from the leased area." The controversy in Diamond Shamrock turned on the contract definition of "production." The court determined that absent ambiguity, the plain meaning of the contract provisions must control. The court found the meaning of "production" in several federal statutes. Interpreting the statutory language, the Fifth Circuit found

18. "Cooperative venture" is the term used by Professor Harrell to describe the relationship between lessee and lessor. See Harrell, supra note 6, at 334.
19. 853 F.2d 1159 (5th Cir. 1988).
20. Diamond Shamrock addressed the issue of take-or-pay payments, while Roye and Watts address take-or-pay settlement proceeds. The distinction is not insignificant, but it was the reasoning of the Diamond Shamrock court that profoundly impacted the market. The Diamond Shamrock court reasoned that take-or-pay payments are made in lieu of production and, therefore, do not trigger royalties on a "production"-based lease. See id. at 1165.
21. See id. at 1162.
22. Id. at 1161 (emphasis added).
23. Id. at 1165-66.
24. See id. at 1168.
25. See id. at 1161-66. The Diamond Shamrock court interpreted the Outer Continental Shelf Lands
the plain meaning of "production" to require the actual physical extraction of minerals from the ground. Because the royalty clause was premised on "production," no royalty would be triggered unless and until the gas was actually extracted from the ground. Take-or-pay payments, the court reasoned, are payments made in lieu of production, while royalties are payable only on actual production. The court further stated that take-or-pay proceeds were not part of the price paid for gas, but compensation to the producer for the risks of development.

Texas courts have maintained strict adherence to a four corners reading of Texas' legal definition of production. In *Killam Oil Co. v. Bruni*, the Texas Court of Appeals interpreted a royalty clause, similar to that in *Diamond Shamrock*, to require actual severance of the minerals from the ground before royalty becomes due. The *Killam* court relied upon the established definition of "production" in Texas which requires the physical extraction of the minerals from the ground. The *Killam* court reasoned that the lessor's chosen language in the lease "unambiguously limited its right to royalty payments only from gas actually extracted from the land." This holding has been reaffirmed in several Texas cases.

Oklahoma decided its take-or-pay royalty rights precedent in 1996 with *Roye* and established itself as a "plain terms" jurisdiction when the Oklahoma Supreme Court ruled that the express terms of the lease agreement determine the outcome of disputes over take-or-pay settlement proceeds. In denial of Oklahoma's established definition of "production," however, the *Roye* court decided that take-or-pay settlement proceeds are not for production, and therefore are not royalty bearing.

In *Roye*, the lessors sought royalties on the settlement proceeds from take-or-pay litigation between their lessee and purchaser. That settlement resulted in a renegotiated contract between the producer and pipeline company. The Oklahoma Supreme Court denied the lessors an opportunity to seek such royalties, overruling

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26. See *Diamond Shamrock*, 853 F.2d at 1168.
27. See id. at 1165.
28. See id.
29. See id. at 1167-68.
31. See id. at 267.
32. Id. at 268.
the appellate court and affirming the trial court's grant of summary judgment in favor of the lessors. The Roye court held that lessors are not entitled to a share of take-or-pay settlement proceeds unless "clear language" in the lease provides for such an arrangement. The Roye court reasoned that because the royalty clause limited royalty payments to substances "produced," and because take-or-pay settlement proceeds were not for actual production, the plain terms of the contract precluded royalties on such proceeds.

The United States Court of Appeals for the Tenth Circuit addressed the issue of lessors' rights to take-or-pay settlement proceeds in Harvey E. Yates Co. v. Powell. The lease in Yates was similar to that in Diamond Shamrock. The Yates court found the plain meaning of "production," as established in New Mexico statutes, to require actual physical extraction of the minerals from the ground. The Yates court, however, decided that a material issue of fact must be answered: whether the settlement proceeds at issue are attributable, in any part, to a price adjustment for the actual production of gas. This price adjustment issue was not addressed by the Roye court, but plays a central role in Watts.

Recently, the United States Court of Appeals for the Sixth Circuit addressed the take-or-pay issue in In re Century Offshore Management Corp, a case that is factually similar to Diamond Shamrock. At issue were the United States Government's rights, as lessor, to proceeds from the settlement of a take-or-pay contract. The relevant lease was the standard "production"-type, and "production" was defined by federal statute.

The Century Offshore court clarified the holding in Diamond Shamrock, finding that royalties must be paid on settlement proceeds when they are significantly related to production. The Sixth Circuit stated that courts must determine whether a sufficient "nexus" exists between production and payment to trigger the royalty clause of the lease. The Century Offshore court found the settlement payments at issue akin to "advanced payments" for gas, and thus tied such payments to future actual extraction. Royalties on such payments are only due when the specific gas which repays the advanced payment actually is produced. This opinion comes closer to

36. See Roye, 949 P.2d at 1212.
37. See id. The Roye court cited Walden v. Potts, 152 P.2d 923 (Okla. 1944), as authority for its chosen definition without making any reference to the cases since Walden which make it clear that Oklahoma "production" is merely the discovery of oil or gas in paying quantities. For a critical discussion on the Roye court's use of authority, see Muenker, supra note 3, at 763.
38. 98 F.3d 1222 (10th Cir. 1996).
40. See id. at 1230.
41. See id. at 1235.
42. 111 F.3d 443 (6th Cir. 1997).
43. See supra note 32 and accompanying text.
44. See Century Offshore, 111 F.3d at 449.
45. See id. at 450.
46. See id.
47. See id.
allowing lessors an opportunity to claim their share of royalties, but does not come as close as the "cooperative venture" approach.\textsuperscript{48}

2. Cooperative Venture Reasoning

The second jurisdictional path follows the cooperative venture concept established by Professor Thomas Harrell.\textsuperscript{49} Professor Harrell's view considers the language of the royalty clause to express the general expectations of the parties involved.\textsuperscript{50} The terms of oil and gas leases are not designed with the intent or capability of expressly accommodating every possible scenario which may arise between the parties. Some interpretation and ascertainment of the parties' objectives based upon surrounding circumstances is necessary to determine the proper intent.

Under the cooperative venture theory, lessors and lessees form a partnership to accomplish that which neither is able to do alone — exploit the natural resources of various reserves. The lessor owns the mineral rights, but lacks the ability to capitalize thereon. The lessee has the expertise and money to extract the minerals, but lacks access to the land. The two must form an association in which they are able to share proportionately in both the risks and benefits of the venture.

In \textit{Frey v. Amoco Production Co.},\textsuperscript{51} the Louisiana Supreme Court applied the Harrell view and found royalties to be owed on take-or-pay payments. Under Louisiana law,\textsuperscript{52} the lessor has a proportional interest in all of the economic benefits derived from the minerals extracted pursuant to the lease unless such benefits were expressly negated in the language of the lease.\textsuperscript{53} The \textit{Frey} court stated that:

\begin{quote}
[A]ny determination of the market value of the gas which . . . permits either the lessor or the lessee to receive a part of the gross revenues from the property greater than the fractional division contemplated by the lease, should be considered inherently contrary to the basic nature of the lease and be sustained only in the clearest of cases.\textsuperscript{54}
\end{quote}

This formula for determining the interests of the parties can be easily applied to any incoming revenues. The complex determination of whether revenues relate to production or what portion of the revenues so relate need not be made. All revenues

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\textsuperscript{48} It should be noted that there can be no "nexus" between production and payment unless the producer renegotiates a new sales contract with the same purchaser. The producer, therefore, can eliminate all obligation by settling the claim with its purchaser and then re-selling to a new purchaser.  
\textsuperscript{49} See supra note 6 and accompanying text.  
\textsuperscript{50} See supra note 6 and accompanying text.  
\textsuperscript{51} 603 So. 2d 166 (La. 1992).  
\textsuperscript{52} The \textit{Frey} court answered a question certified by the Fifth Circuit Court of Appeals: Whether under Louisiana law and the facts concerning the Lease executed by Amoco and Frey, the Lease's clause that provides Frey a "royalty on gas sold by the Lessee of one-fifth (1/5) of the amount realized at the well from such sales" requires Amoco to pay Frey a royalty share of the take-or-pay payments that Amoco earns as a result of having executed the Lease and under the terms of a gas sales contract with a pipeline-purchaser. \textit{Id.} at 170.  
\textsuperscript{53} See id. at 178.  
\textsuperscript{54} Id. at 173-74.
derived from the lease are divided between the partners according to the agreed proportion in the royalty clause. This simplicity and flexibility should serve to relieve both the parties and the courts of the burden of future litigation while honoring the reasonable expectations of lessors and lessees.

The United States Court of Appeals for the Eighth Circuit followed the cooperative venture reasoning in *Klein v. Jones.* Royalty owners in *Klein* sought a share of take-or-pay proceeds based on an unjust enrichment theory. The *Klein* court agreed that equity mandated intervention. Applying Harrell's cooperative venture theory, the Eighth Circuit allowed royalty owners to claim their share of the settlement proceeds. The comparative venture/plain terms dichotomy was reexamined outside the context of take-or-pay settlement proceeds by the Tenth Circuit in 1997.

*III. Watts v. Atlantic Richfield Company*

A. Case History

Several lessors of oil and gas leases brought a diversity action in the United States District Court for the Eastern District of Oklahoma against their lessee, Atlantic Richfield Company (ARCO). The dispute arose from lease agreements for mineral interests in the Wilburton Field in Latimer County, Oklahoma. The suit followed the settlement of a dispute between ARCO and the purchaser with whom ARCO had a long term gas purchase agreement, the Arkansas Louisiana Gas Company (Arkla). Arkla breached its long term purchase agreement with ARCO, claiming that the gas produced by ARCO was of lesser quality than that bargained for in the contract. Arkla settled that dispute paying ARCO valuable consideration in the form of both cash and non-cash items.

Some of the cash proceeds received by ARCO in the settlement of the ARCO/Arkla dispute constituted payment for gas which was subsequently taken by Arkla (i.e., recouped takes). Royalties were paid on this gas. The lessors argued that the recouped gas, all gas taken by Arkla in the past, and all future takes may have been sold or will be sold to Arkla at a "bought-down" price. The lessors sought royalty payments on the settlement revenues based on breach of the contractual duty to pay royalties. The lessors claimed that the settlement proceeds

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55. 980 F.2d 521 (8th Cir. 1992).
56. *See id.* at 525-31.
57. *See id.* at 528-31.
58. 115 F.3d 785 (10th Cir. 1997).
59. *See id.* at 788.
60. *See id.*
61. *See id.*
62. *See id.* at 789.
63. *See id.* at 792.
64. *See id.*
65. Lessors sought recovery of royalties based on six theories: (1) breach of contractual duty to pay royalties, (2) breach of the implied covenant to market, (3) breach of fiduciary duty, (4) constructive fraud, (5) breach of the duty of good faith, and (6) civil conspiracy. *See id.* at 789. The breach of the contractual duty to pay royalties was the focus of the *Watts* court's analysis.
constituted consideration for compromises in both price and take quantities. ARCO refused to tender royalties to the lessors on any of the remaining proceeds, claiming that the settlement revenues were not for actual production.\footnote{See id. ARCO and Arkla had been involved in other litigation pertaining to a Louisiana lease and settled both litigation together. See id. The settlement agreement was somewhat complicated with some of the exchanges in the form of non-cash consideration. See id. at 789.}

The district court granted summary judgment to ARCO based on \textit{Roye}.\footnote{See id. at 790.} The district court analogized these settlement payments to take-or-pay settlement proceeds, and therefore applied the same denial of rights to the lessors as the \textit{Roye} court.\footnote{\textit{Watts} was decided based upon Oklahoma law.} Because the relevant leases did not explicitly require royalties to be paid on settlement proceeds and because the payments were not for the actual production and sale of gas, the lessors were not allowed to claim royalties.\footnote{See \textit{Watts}, 115 F.3d at 790-91.}

\textbf{B. Decision}

The United States Court of Appeals for the Tenth Circuit reversed summary judgment and remanded the case for the determination of a material issue of fact: whether the settlement consideration paid to ARCO constitutes payment, at least in part, for gas actually produced and sold, or whether it constitutes payment for something other than the production and sale of gas.\footnote{See id. at 794.} The lessors argued that settlement proceeds must be for the production of gas because: (1) the only thing that ARCO provides to Arkla according to the relevant settlement agreement is the production of gas; and (2) Arkla would not make a payment without getting something in return.\footnote{See id. at 790.}

Basing their decision on Oklahoma law, the Tenth Circuit held that the district court erred in concluding as a matter of law that the settlement proceeds between ARCO and Arkla were to be treated like nonrecoupable take-or-pay payments.\footnote{See id. at 791.} The Tenth Circuit cleared the summary judgment hurdle by making a critical distinction that the district court neglected to make. The Tenth Circuit found that the settlement proceeds at issue in \textit{Watts} were not the same as take-or-pay settlement proceeds and should not be treated as such.\footnote{See id. at 791.} The fact that take-or-pay settlement proceeds are not royalty bearing does not mean that all proceeds arising from the settlement and

\begin{itemize}
  \item \textit{Watts} court stated: "[W]e hold that the district court erred in concluding that the proceeds in this case should be treated like non-recoupable take-or-pay settlements." \textit{Id.} While take-or-pay settlement proceeds are specifically for nonproduction, \textit{see} Roye Realty & Developing, Inc. \textit{v. Watson}, 949 P.2d 1208, 1216 (Okla. 1996); Harvey E. Yates Co. \textit{v. Powell}, 98 F.3d 1222, 1236 (10th Cir. 1996) (reh'g denied Nov. 13, 1996); Diamond Shamrock Exploration Co. \textit{v. Hodel}, 853 F.2d 1159, 1167-68 (5th Cir. 1988), and are not subject to royalties, as the result of the \textit{Roye} decision, where royalties are contractually premised on "production," other settlement proceeds may in fact constitute consideration for production and may therefore be royalty-bearing. \textit{See Watts}, 115 F.3d at 792.
\end{itemize}
negotiation of a gas contract are non-royalty bearing. In the case of settlement proceeds other than those resulting from take-or-pay litigation, the nature of the consideration must be determined.

With this determination, the Watts court noted that an actual or patent price reduction is not the triggering mechanism which indicates the duty to pay royalties or the measurement for such royalties. Instead, any agreement made by the lessee which compromises its rights to pursue a higher price for the gas in exchange for a lump sum payment implicates the duty to pay royalties even if the price prior to settlement and the price after settlement are the same.

IV. Analysis
A. The Distinction Between Roye and Watts

Roye was a critical decision in Oklahoma oil and gas law on a burgeoning issue which previously had not been addressed in that jurisdiction. For reasons not specified in the decision itself, the settlement between the pipeline and producer in Roye was kept "confidential." The royalty owners were not allowed to discover the terms of that agreement during suit against their lessee. This secrecy highlights the producers' ability to disguise proceeds which in fact constitute a buy-down on the renegotiated gas sales contract between the producer and pipeline, preventing the lessor from discovering the foul. With the settlement negotiations kept secret, lessors are denied access to the evidence of the buy-down.

The Roye decision was not in accordance with Oklahoma precedent and threatened to deprive Oklahoma land owners of their present and future interests in oil and gas leases. This decision is difficult to reconcile with prior case law. Oklahoma precedent indicates a method of interpreting oil and gas leases much like that of Louisiana and Arkansas, both of which have explicitly adopted the cooperative venture line of reasoning. This method is manifested in Tara Petroleum Corp. v. Hughey. In Tara, the Oklahoma Supreme Court looked beyond the plain meaning of the words "market price" in a gas lease. The Tara court determined that "necessity of the market" mandated an alternate interpretation of "market price" contrary to its plain meaning. The Tara court made this finding based on fairness

74. See Watts, 115 F.3d at 791.
75. See id. at 794.
76. See id. at 793.
77. See id.
78. See Roye, 949 P.2d at 1211.
79. Amicus curiae for the lessors in Roye argued that the settlement proceeds are royalty bearing because they are a "marketing substitute," and, therefore, constitute monies paid for the gas.
80. See supra note 34 and accompanying text.
82. See id. at 1273.
83. See id.
to the producer.\textsuperscript{84} The \textit{Roye} court, oddly, made no mention of this case, and dismissed the \textit{Tara} approach in favor of a plain terms approach.\textsuperscript{85}

Even assuming the legitimacy of Oklahoma's adoption of a plain terms approach, one would expect Oklahoma courts to find the plain meaning of "production" to be in accordance with Oklahoma precedent. The Oklahoma Supreme Court has defined "production" as merely the capability of producing minerals in paying quantities, not actual extraction of the minerals from the ground.\textsuperscript{86} This view is in contradiction to the majority view which requires actual production of the minerals. Again, the \textit{Roye} court made no mention of Oklahoma's definition in finding production to require the actual physical extraction of the minerals from the ground.

The \textit{Roye} holding was not explained well by the court and the decision remains unexplainable. The \textit{Roye} court's errors worked an injustice upon Oklahoma gas lessors and cost them hundreds of millions of dollars, collectively, in lost royalty. The Tenth Circuit Court of Appeals took a step toward correcting Oklahoma precedent in \textit{Watts}. In \textit{Watts}, the Tenth Circuit interpreted Oklahoma law as it would apply to oil and gas lease matters that were related to take-or-pay proceeds or settlements rather than the take-or-pay settlement proceeds themselves.\textsuperscript{87}

The only significant difference between the facts of \textit{Roye} and \textit{Watts} is the nature of the proceeds at issue. In \textit{Roye}, the court addressed take-or-pay settlement proceeds. In \textit{Watts}, the Tenth Circuit dealt with the lessors' right to share in the settlement proceeds of a long-term take contract disputed on grounds other than the take-or-pay nature — the difference being the nature of the claim between the producer and pipeline company. While the distinction is subtle, the implication of the \textit{Watts} holding is that \textit{Roye} is limited to take-or-pay settlement cases and that there still exists hope for the lessors in Oklahoma to assert their rights to the future economic benefits of the lease.\textsuperscript{88} The blow to lessors' royalty rights dealt by the \textit{Roye} court, therefore, may have been remedied by the distinction made by the Tenth Circuit in \textit{Watts}.

B. Limitations of the Watts Court

The \textit{Watts} court applied the three guiding principles established in \textit{Harvey E. Yates v. Powell}\textsuperscript{89} to determine whether royalties were due on the settlement proceeds at

\begin{flushright}
84. See id.
85. Prior to \textit{Roye}, several commentators predicted that Oklahoma would adopt the cooperative venture approach. See Randy King, Royalty Owner Claims to Take-or-Pay Payments Under the Implied Covenant to Market and the Duty of Good Faith and Fair Dealing, 33 S. Tex. L.J. 801 (1992); see also, Lowe, supra note 1.
86. See supra note 35.
87. The issue of take-or-pay settlement proceeds had already been settled in Oklahoma by the \textit{Roye} decision.
88. In fact, the \textit{Roye} court explicitly noted that it was limited in its decision to the facts before it. See Roye, 949 P.2d at 1216.
89. 98 F.3d 1222 (10th Cir. 1996). \textit{Yates} was a Tenth Circuit case based on New Mexico law which dealt with a similar issue as that in \textit{Watts}. Specifically, the relevant issue was whether lessors are entitled to royalties on cash payments from gas purchasers to lessees in settlement of take-or-pay disputes. See id. at 1226.
\end{flushright}
issue. According to the first principle, no royalties are due on the relevant leases unless and until gas is actually physically extracted from the ground. This principle is the product of those jurisdictions which legally define "production" to require actual physical extraction of minerals from the ground. Where the legal definition of "production" is such, requiring extraction of the minerals can be justified. Such a reading is in accordance with a four corners approach to contract interpretation.

The Roye court defined "production" to require actual physical extraction of the minerals from the ground. Oklahoma, though, has no such legal definition of production. By fashioning this unprecedented definition, the Roye court crippled Oklahoma lessors in their ability to claim due royalties by depriving them of the benefit of the true plain meaning of "production." Because Watts was decided based on Oklahoma law, the Tenth Circuit was bound by this principle as the result of Roye.

Although Watts ultimately allowed the lessors an opportunity to make a claim, the Watts holding is, nevertheless, limited by this production principle. There must be a subsequent extraction of gas from the ground and a sale of that gas to the purchaser from whom the settlement or other proceeds are received to require royalties. If a producer settles a dispute with one purchaser and then negotiates a new sales contract with a different pipeline company, then the lessor has no claim to royalty because no "nexus" will exist between the production and sale to trigger the debt. Only when the producer continues to sell gas to the same purchaser can a connection be found between revenues and actual production. Thus to some extent, the production principle restricts Oklahoma lessors' rights to those situations in which producers and pipeline companies maintain an ongoing relationship.

The second Yates principle holds that nonrecoupable proceeds received by the producer as settlement of a breach of the take-or-pay provision of the supply contract are not royalty bearing. Such proceeds are specifically for nonproduction, and are therefore contrary to a royalty clause which requires actual production. The implicit nonproduction quality of such payments breaks the nexus between production and payment. The Roye holding is also premised on this principle. The inherent nonproduction quality of the nonrecoupable payments is the reason that the Roye court granted summary judgment to the lessee.

In Century Offshore, however, the Sixth Circuit Court of Appeals limited this principle to payments in settlement of debt which accrued under a take-or-pay contract as the result of the purchaser's failure to take. Though basing its decision on Diamond Shamrock, the Century Offshore court came to a conclusion opposite of that

90. See Watts, 115 F.3d at 792. The relevant lease was a standard "production"-type lease like that in Roye.
91. See Roye, 949 P.2d at 1216.
92. See supra note 35.
93. The "nexus" requirement was articulated in In re Century Offshore Management Corp., 111 F.3d 443 (6th Cir. 1997), but the concept is implicit in the production principle of Yates. Without a connection to actual production, no royalty is due.
94. See Watts, 115 F.3d at 792.
95. See id.
made in *Diamond Shamrock*. The *Century Offshore* court found a link between the proceeds of the settlement and the sale of gas.96 This link triggered royalties.97 The Sixth Circuit found that there was no inherent nonproduction quality to the proceeds at issue in *Century Offshore*.

The difference between the cases is the nature of the settlement proceeds at issue. In *Diamond Shamrock*, the producer settled with the pipeline company on debt accrued due to a failure to take the minimum quantity of gas required by the contract. In *Century Offshore*, the pipeline did not have accrued debt to the producer.98 Instead, the pipeline paid the producer $12,250,000 to buy out the existing sales contract and negotiate a new agreement.99

The *Century Offshore* decision, therefore, would limit the second *Yates* principle to debt accrued from the failure to take on a take-or-pay contract. Only such accrued debt has the implicit nonproduction quality which breaks the nexus between production and payment. In *Century Offshore*, the Sixth Circuit found a nexus to exist when the pipeline paid the lump sum payment simply in order to renegotiate its take-or-pay agreement.100 This restriction is important to lessors because it minimizes the instances in which they will be denied their royalty share of the proceeds derived from their leases.

The third *Yates* principle provides that any portion of the settlement proceeds which constitute a "buy-down" of the contractually owed price of gas is royalty bearing when such gas is actually produced and taken at the bought-down price.101 Only the amount of such proceeds that reflects a fair apportionment of the price adjustment payment over the purchases affected by that price adjustment is royalty bearing.102 This "buy-down" theory was precisely the argument of the lessors in *Roye*, which the court found inapplicable to take-or-pay settlement proceeds.103 This principle leads to the necessary inquiry into the nature of non-take-or-pay settlement proceeds. This inquiry takes the case beyond summary judgment. When a producer trades valuable consideration for a reduced price on the gas actually produced, then royalties are not only owed on the sale of gas at the bought-down rate, but also on a commensurate portion of the consideration which gave effect to that lower price.104 Such proceeds are not payments for nonproduction; rather, they are for actual production.105

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96. *See Century Offshore*, 111 F.3d at 449.
97. *See id.*
98. *See id.* at 447.
99. *See id.*
100. *See id.* at 448.
101. *See Watts*, 115 F.3d at 792.
102. *See id.*
104. *See Watts*, 115 F.3d at 792.
105. This relationship between the settlement proceeds and the renegotiated price is the "nexus" described by the *Century Offshore* court. *See Century Offshore*, 111 F.3d at 448-49.
Applying the three guiding principles of *Yates*, the *Watts* court found that gas had actually been extracted from the ground. In this regard, the *Watts* court referred to the gas taken by Arkla since the settlement of the ARCO/Arkla dispute. This subsequent taking is the gas at the heart of the issue and the taking of which clears the *Watts* lessors of summary judgment under the first of the *Yates* principles. Because there was a continuing sales relationship after the settlement between the producer and pipeline, and because no facts before the court indicated the proceeds to be limited to accrued failure to take debt, summary judgment was inappropriate in *Watts*.

The *Yates* principles, as applied in the *Watts* decision, offer Oklahoma lessors hope of a legitimate claim to the proceeds of their leases in the future. Denied this hope are take-or-pay proceeds, which have been precluded by *Roye*. In all other cases, an inquiry must be made whether the settlement proceeds constitute consideration for gas purchased at a bought-down price or whether the proceeds account for price reductions attributable to future production under the renegotiated contract. Applying *Watts*, if any agreement by a producer compromises its right to pursue a higher price for the gas in exchange for valuable consideration, then that compromise triggers a duty to pay royalties. Whatever settlement consideration the lessee receives in that compromise is a component of the true price paid for the gas, and is therefore royalty bearing. A refusal on the part of the lessee to pay such royalties would result in a windfall for the lessee. The nature of the settlement proceeds, therefore, created an issue of material fact that precluded summary judgment and offered lessors their deserved day in court.

107. See id. at 792.
108. According to *Yates*, without actual production, summary judgment for the lessee would have been appropriate. See id.
109. See id.
110. See id. at 793.
111. See id.
112. See id. The *Watts* court illustrated this windfall by the following hypothetical:

Suppose that a purchaser is obligated to take 1,000,000 units of gas at $4.00 per unit payable in two equal installments of $2 million. Upon receiving the first 500,000 units, the purchaser unilaterally reduces the price to $3.00 per unit (claiming that the gas is of substandard quality) and remits payment of only $1.5 million. In response, the producer files a lawsuit for $1 million, the amount due on the past price deficiency and the anticipated future shortfall. Instead of litigating the gas quality issue, the parties agree to settle their dispute. In exchange for a one-time lump sum payment of $500,000, the producer agrees to forgive the past price deficiency and to accept the lower price of only $3.00 per unit for future production. In this situation, there has been no "buy down" (i.e., actual price reduction). The pre-settlement price and the post-settlement price are both $3.00 per unit. Despite the absence of a price reduction, however, the lump sum payment still constitutes proceeds from the sale of gas because it represents a component of the true price paid for both past and future production under the supply contract. No one would dispute, therefore, that the royalty owners are entitled to their royalty share of the lump sum payment.

Id. (emphasis supplied).
C. Implications of the Distinction

The Watts decision may suffer great difficulty in its application, despite being more legally sound than the holding in Roye. Rather than finding as a matter of law that the settlement proceeds were not bargained for in the royalty clause of the lease simply because such explicit language was absent, the Watts court recognized the danger of such a hasty conclusion113 and found that a material issue of fact existed in the determination of the nature of the proceeds.114 The Watts court noted that producers cannot escape their duty to pay royalties to lessors by "disguising" revenues as consideration for something other than the sale of gas.115

Watts recognized that lessees have the ability to structure proceeds of settlements in ways that effectively deny the lessors their due royalty.116 The Roye court failed to make this observation with regard to take-or-pay settlements. The distinction the Tenth Circuit made in Watts regarding the nature of the settlement proceeds at issue is critical to the determination of lessors' rights in future related litigation.

It is important to address this issue because several other economic benefits derived from the lease are either currently at issue or will be in the near future. For example, the Federal Energy Regulatory Commission (FERC) authorizes interstate pipelines to charge their customers certain demand charges117 and other marketing fees that may eventually be passed to producers in one form or another. Gas inventory charges are one such demand charge to gas customers made by the pipeline to the producer for standing ready to supply gas to their customers.118 Reservation fees are also charged to gas customers to guarantee service.119 It seems more than likely that royalty owners will look for a share of these proceeds as they are passed along to their partners.

Absent the distinction made by the Watts court, the Roye precedent may apply to all settlement proceeds and to a variety of other price-disguising payments for both oil and gas. Under Roye, lessees can structure settlements and other economic benefits derived from the lease as something other than production, and can therefore manipulate the appearance of consideration to their advantage so as to minimize royalty obligations to their lessors.120

D. The Application of Watts

Under Watts, lessors have the opportunity to stake their claim to the various economic benefits which arise out of the mineral leases. The Watts court noted that the reasoning of the case is not limited to actual "buy-down" agreements, but

113. See supra note 110.
114. See Watts, 115 F.3d at 794.
115. See id.
116. See id. at 792.
118. See id. at 451; see also id. at 543 (giving a definition of "inventory reserve charge").
119. See id.
120. See supra note 110.
"extends to any settlement in which a producer receives consideration for compromising its pricing claim . . ." It would seem that demand charges and any other marketing fees passed along to producers will play some role in the pricing of gas. It is unlikely that pipeline companies will be willing to pass along any economic benefits to lessees without receiving something in return. That something must be the gas produced.

This method of determining the proper apportionment of the revenues derived from the lease is not as simple as the cooperative venture method, but it is significantly better for lessors than holding that the absence of specific language in the lease leads to an absence of rights regarding the object of such language. The cooperative venture theory applies uniformly to all economic benefits derived from the lease, regardless of how such proceeds are labeled. Each partner takes his portion of all proceeds in accordance with the lease agreement. The Watts reasoning applies to future issues in a more complicated manner. Applying the Watts reasoning will likely result in even more litigation over issues such as what constitutes consideration for pricing compromises and the identification of the portion of the revenues that actually account for such a compromise. Regardless of the complexity, lessors now have an opportunity to address those issues which they did not, or could not, have incorporated in the lease.

Computing damages through the inquiry mandated by Watts will necessarily entail a great deal of litigation and difficulty. Such difficulty was encountered by the lessor in Piney Woods Country Life Sch. v. Shell Oil Co. In Piney Woods, a Mississippi district court had to make a determination of the meaning of "market value" of gas. Upon finally concluding that "market value" referred to the spot-market value, the Piney Woods court attempted to measure the damages. This measurement was very complex, as it required the determination of the spot-market price of gas of similar quality and sold in similar quantities at the time each sale of gas was made. In the end, the Piney Woods court found many of the lessor's measures of those factors to be "speculative at best." The lessors were allowed partial recovery after more than twenty years of litigation.

A determination of the issue identified by Watts will be similarly complex and speculative. Any time that economic benefits flow to the lessee, as in the case of settlement proceeds, a determination will have to be made as to what portion of those proceeds accounts for a price compromise and what portion accounts for other economic factors. Alternatively, a determination of how much actual "buy-down" occurred may be established by comparing the price paid for gas and the price that would have been received absent the disputed proceeds. Either way, significant difficulties are encountered that make the process costly and imprecise.

121. Watts, 115 F.3d at 793.
125. This is similar to the Piney Woods evaluation. The lessor would essentially have to establish the market value of the gas by demonstrating similar sales of like quality gas in similar quantities.
V. Conclusion

From the lessors' perspective, Oklahoma oil and gas law is grim. The Roye decision has rendered lessors helpless in their attempt to claim their full share of the economic benefits of their leases. Roye, and its abomination of Oklahoma law, eliminated any possible claim by lessors to the billions of dollars worth of take-or-pay settlement proceeds recovered by producers since the 1980s.

The future of Oklahoma oil and gas law is, as yet, uncertain. The best solution to the Roye dilemma would be to overrule the case altogether and to adopt a new line of reasoning which is based on Oklahoma "production" and Oklahoma contract interpretation. The Frey reasoning would be ideal. This cooperative venture theory would allow the intent of the parties to guide the outcome of the decisions, while still allowing for the application of Oklahoma "production" in the interpretation of the royalty clause.

Watts offers promise to lessors that their rights to future economic benefits of their leases will be supported by the courts. The Tenth Circuit attempted to interpret Oklahoma state law in Watts as it would apply to settlement proceeds of a non-take-or-pay nature. This distinction is crucial to the future rights of Oklahoma lessors, but it remains to be seen whether Oklahoma will adopt this new line of reasoning.

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