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Arthur J. Wright

Carla J. Sharpe

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DIRECT GAS SALES: ROYALTY PROBLEMS FOR THE PRODUCER

ARTHUR J. WRIGHT* & CARLA J. SHARPE**

As anyone familiar with the natural gas industry knows, the past few years have brought tremendous changes. Beginning with passage of the Natural Gas Policy Act (NGPA) in 1978,1 Congress, the Federal Energy Regulatory Commission (FERC), and our courts have struggled, and continue to struggle, to replace strict governmental regulation of the industry with a free market where competitive behavior can flourish. One result of the changes has been the advent of sales by producers of natural gas directly to end users, distributors or marketers thereof, without an intermediate purchase by a pipeline, i.e., a "direct sale."

Direct sales by producers differ from "traditional" producer sales to pipeline purchasers in several respects. Direct sale contracts are typically for short terms (month-to-month) with market sensitive prices set by negotiations between the parties. Direct sales are usually specific as to a quantity of gas to be sold within a specified time frame rather than being tied, as traditional sales have been, to the life of a specific source. However, even though the direct sale contract is specific as to quantity, it is also frequently "interruptible," meaning there is no firm obligation to sell gas and, accordingly, no provision for penalty if either party fails to perform.

In a nutshell, producer direct sales became possible and attractive as a result of FERC's initiatives in the 1980s. First, FERC encouraged restructuring of traditional producer-pipeline-consumer relations, resulting in large quantities of gas becoming suddenly free from regulatory structures (special marketing programs, blanket certificate programs, and ultimately Order No. 451).2 Then, with Order No. 436,3 which was later vacated4 but ultimately revised and readopted in Order No. 500,5 FERC virtually mandated pipelines to provide "open access" transportation. This placed most interstate pipelines in the role of transporter rather than merchant. With

* Vice-President-Legal, Delhi Gas Pipeline Corporation, Dallas, Texas. J.D., 1971, University of Texas; B.A., 1968, Tulane University. The author's prior publications include Contractual Issues in Marketing Natural Gas, 36 ROCKY MTN. MIN. L. INST. 16-1 (1990).

a burgeoning reduction in takes by traditional pipelines under existing contracts, a volatile spot market emerged and the direct sales route was obvious.6

While the direct sales route is undoubtedly attractive to the producer because of the ready availability of sales today, it brings with it responsibilities and problems never before faced by the producer. Interruption of takes may be more frequent if transportation by a pipeline becomes unavailable. Short notice arrangements for additional sales may become necessary when an end user's demand increases. Also, some traditional pipeline functions such as measurement, billing, and control of flow may become the producer's responsibility.7 Not only do these new problems exist, but also an age-old one remains and is accentuated. By embarking on a path of direct sales, a producer is setting forth into uncharted seas regarding the extent of his duties of royalty payments to his mineral owners.

This royalty problem often stems from the mechanism commonly used by the producer to conduct his direct marketing activities — the marketing affiliate. The producer establishes an affiliated, but separate, company to conduct all necessary marketing activities, including marketing for third parties if the producer so desires. The use of a marketing affiliate by the producer is attractive for at least two reasons. First, the marketing affiliate can be used by the producer to "capture margin"; thus, the producer avoids sharing some of the sale proceeds with his royalty owners. Second, the marketing affiliate can be used by the producer to conveniently "capture costs" of marketing, therefore allowing the producer to deduct costs from the sale proceeds payable to royalty owners and other working interest owners in a specific well.

The legal analysis of the producer's obligations to his royalty owners has always been complex. The value or price the royalty is to be based on is seldom easily determined, as evidenced by the great number of royalty owner lawsuits brought against producers. Also, the producer's use of a marketing affiliate for direct sales creates another layer of complexity in that legal analysis. Does that "layer" insulate the producer from liability for a breach of any of his duties to his royalty owner or enable him to capture margin in his affiliate? The premise of these authors is that it does not.

The producer's liability to his royalty owners is, of course, determined in large part by the terms and provisions of the oil and gas lease between them, with the producer's liability to pay monies to that royalty owner being set by the royalty clause of the lease. The royalty clause establishes the benefit to inure to the mineral owner in the event of extraction and production of the covered minerals by his lessee. In addition to the royalty clause, however, the producer faces yet another liability to the royalty owner, one not specifically found in the lease: the implied


7. See generally Hollis, supra note 6; Wright, supra note 6.
duty to market the gas produced. This article will address the relationship of the various types of gas royalty clauses to the implied duty to market production when the producer chooses to "direct market" his gas through use of a marketing affiliate. Further addressed are the resulting problems he may face when he does so — problems even more complex and possibly insurmountable than those encountered by producers in the past.

I. Royalty Clauses

There are several varieties of royalty clauses found in oil and gas leases today. Therefore, any analysis of the legal problems associated with direct marketing must begin with a determination of what type of royalty clause is in the lease at issue. Royalty clauses for the production of gas occasionally provide for fixed dollar amounts or for delivery of gas "in kind" in satisfaction of the lessee's royalty obligation. More typically, however, gas royalty clauses, unlike oil royalty clauses, require the payment of money to the lessor. There are three types of gas royalty clauses: the market value clause, the proceeds clause, and the hybrid clause. The clauses are so named because the amount of any payment is determined either by the market value of the gas, by the proceeds of the sale of the gas, or by a combination of the market value and proceeds — the "hybrid" royalty clause.9

A. The Market Value Royalty Clause

The typical "market value" gas royalty clause requires payment of royalties based on the market value or market price of the gas as determined at the wellhead.10 Such market value or market price11 is generally defined as that price a willing buyer would pay a willing seller in a free market — "the price property would bring when it is offered for sale by one who desires, but is not obligated to sell, and is bought by one who is under no necessity of buying it." Market value is, therefore, a question of fact.

Determination of market value is not an easy task, as courts who have struggled with the issue would attest. In Piney Woods Country Life School v. Shell Oil

8. For a discussion of fixed and "in kind" royalty clauses, see 3 EUGENE O. KUNTZ, LAW OF OIL AND GAS §§ 40.2, 40.3 (1989).
9. The hybrid royalty clause typically calls for payment of proceeds for gas sold at the wellhead and market value for gas sold or used elsewhere. See, e.g., Exxon Corp. v. Middleton, 613 S.W.2d 240 (Tex. 1981).
10. For examples of how the market value royalty clause is used, see TXO v. Vela, 429 S.W.2d 866, 868 (Tex. 1968) (holding that lessee must "pay to lessor, as royalty for gas . . . while the same is being sold or used off of the premises, one-eighth of the market price at the wells of the amount so sold or used"); Piney Woods Country Life Sch. v. Shell Oil Co., 726 F.2d 225, 228 (5th Cir. 1984) (holding that lessee must pay "on gas . . . produced from said land and sold or used, the market value at the well of one-eighth of the gas so sold or used . . . "); cert. denied, 471 U.S. 1005 (1985).
11. The terms "market value" and "market price" are, for all practical purposes, interchangeable. See, e.g., Arkansas Natural Gas Co. v. Sartor, 78 F.2d 924, 927 (5th Cir. 1935), cert. denied, 296 U.S. 635 (1936). But see Shamrock Oil & Gas Corp. v. Coffee, 140 F.2d 409 (5th Cir.), cert. denied, 321 U.S. 620 (1944). For the remainder of this article, the term "market value" will be used.
12. Middleton, 613 S.W.2d at 246.
Co.,¹³ the Fifth Circuit stated, "The only general rule that emerges . . . is that the method of proof varies with the facts of each particular case."¹⁴ There may be substantial differences in the market value of gas even from leaseholds in the same general area caused by such variations as the quality or pressure of the gas, the availability and expense of gathering and operating plant facilities.¹⁵ Of course, differences in judicial opinion exist. Courts in some jurisdictions have found that under certain circumstances the contract price for gas sold at the wellhead on the then-current, open, and competitive market establishes market price, while other jurisdictions disagree.¹⁶ There is widespread agreement, however, that courts may determine market value of gas, as they often do, using evidence of sales of gas "comparable in time, quality and availability to marketing outlets."¹⁷ The court in Exxon v. Middleton¹⁸ explained "comparable sales" further:

Sales comparable in time occur under contracts executed contemporaneously with the sale of the gas in question. Sales comparable in quality are those of similar physical properties such as sweet, sour, or casinghead gas. Quality also involves the legal characteristics of the

14. Id. at 238; see also Pinney Woods Country Life Sch. v. Shell Oil Co., 905 F.2d 840 (5th Cir. 1990). Some general propositions have, however, been established regarding market value royalty clauses. See, e.g., Phillips Petroleum Co. v. Ochsner, 146 F.2d 138, 141 (5th Cir. 1944) (holding that evidence of the value of the gas for purposes other than that for which it is to be used is not admissible for a determination of market value of the gas as actually used); Phillips Petroleum Co. v. Bynum, 155 F.2d 196, 198 (5th Cir.) (stating that when it is impossible to ascertain market value, royalty may be based on the actual or intrinsic value of the gas), cert. denied, 329 U.S. 714 (1946); Sartor v. United Carbon Co., 163 So. 103, 104 (1935) (holding that market value is not measured by the general market price of gas in a county but by gas comparable in quality, pressure, etc.); Foster v. Atlantic Ref. Co., 329 F.2d 485, 488 (5th Cir. 1964) (holding that evidence of prices paid under long term gas purchase contracts is not admissible to prove "value" for royalty clause purposes); see also 3 Howard R. Williams, OIL AND GAS LAW § 650.2 (1992).
15. See Williams, supra note 14, § 650.2.
16. In Oklahoma and Louisiana, where the lessee enters into a long term gas purchase contract at arm's length, the price set by that contract will be the market price. See, e.g., Tara Petroleum Corp. v. Hughey, 630 P.2d 1269, 1273 (Okla. 1981); Hillard v. Stephens, 793 P.2d 189 (8th Cir. 1986); Henry v. Ballard & Cordell Corp., 418 So. 2d 1334 (La. 1982).

However, Texas, Kansas, and Montana disagree that the price for a long term gas purchase contract, entered into at arm's length, is the market price. For example, in TXO v. Vela, 429 S.W.2d 866 (Tex. 1968), and Exxon Corp. v. Middleton, 613 S.W.2d 240 (Tex. 1981), the court determined that market price "means the prevailing market price at the time of the sale or use" and that gas marketed under long term contracts is sold or used not when the contracts are entered into but when it is delivered to the purchaser. Thus "the contract price . . . is not necessarily the market price . . . " Vela, 429 S.W.2d at 871; see also Lightcap v. Mobil Oil Corp., 562 P.2d 1 (Kan. 1977), cert. denied, 434 U.S. 876 (1978); Montana Power Co. v. Kravik, 586 P.2d 298 (Mont. 1978).

The issue of precisely when market value is determined is beyond the scope of this article. For these purposes, this article will focus on the one generally agreed to method for determining market value and the method applicable to most direct sales which are made on a monthly basis: comparable sales.
17. Vela, 429 S.W.2d at 872; see also Bowers v. Phillips Petroleum Co., 692 F.2d 1015 (5th Cir. 1982); Exxon Corp. v. Middleton, 613 S.W.2d 240 (Tex. 1981).
18. 613 S.W.2d 240 (Tex. 1981).
gas; that is, whether it is sold in a regulated or unregulated market, or in one particular category of a regulated market.\(^9\)

The Middleton court also stated, "Sales comparable in quantity are those of similar volumes to the gas in question. To be comparable, the sales must be made from an area with marketing outlets similar to the gas in question."\(^20\) As the court in Piney Woods notes, however, "[c]ompletely comparable sales are not likely to be found" due to the wide range of factors that may affect the price of natural gas.\(^21\) Therefore, comparability is a matter left to the court's discretion.\(^22\)

The market value royalty clause typically requires an evaluation of sales by other parties (not of sales by the producer in question) to establish comparable sales and market value. Thus, in most cases, whether the producer is participating in a direct sale of his gas should be irrelevant. However, it is important to note that ultimately in Piney Woods, the court determined the comparable sales evidence to be "unsuitable under the particular facts," finally turning to the "actual-sales-price-less-costs method"\(^23\) and a scrutinization of the producer's sales activity. In Piney Woods, the court applied the same analysis regarding proceeds royalty clauses and, therefore, essentially converted a market value royalty clause to a proceeds clause. Thus, where comparable sales do not exist or are deemed by the court to be unsuitable evidence of market value, as was the case in Piney Woods, the producer's actual sales may become relevant. Also, like the proceeds royalty clause, the market value clause will, when applicable, permit deduction of expenses required to market the gas off the premises.\(^24\) (Such expenses, and specifically whether direct marketing expenses are deductible, will be discussed in connection with the proceeds royalty clause.) Thus, in some instances, the producer's sales activity may be relevant even when a market value royalty clause is the subject of the litigation. The producer's sales activity is very relevant when considering the second type of royalty clause, the proceeds royalty clause.

B. The Proceeds Royalty Clause

The typical "proceeds" gas royalty clause requires payment of royalties based on the proceeds acquired by the lessee upon sale of the gas.\(^25\) Presumably, an

\(^9\) Id. at 246. The states are not in agreement whether such "legal" characteristics of the gas are a component of "quality" of the gas for purposes of determining market value. See, e.g., Matzen v. Cities Serv. Oil Co., 667 P.2d 337 (Kan. 1983); Holmes v. Kewanee Oil Co., 664 P.2d 1335 (Kan. 1983), cert. denied, 474 U.S. 953 (1985).

\(^20\) Middleton, 613 S.W.2d at 246-47.

\(^21\) Piney Woods, 726 F.2d at 239 (emphasis added).

\(^22\) For an excellent discussion of determining market value, including methods other than use of comparable sales, see KUNTZ, supra note 8, § 40.4.

\(^23\) Piney Woods, 905 F.2d at 845.

\(^24\) Market value of the gas at the wellhead when sold off the premises is "the market value of the gas where sold, less the reasonable cost of transporting the gas to the market and the processing necessary to make it marketable." TXO v. Hagen, 683 S.W.2d 24, 28 (Tex. Ct. App. 1984), aff'd, 31 Tex. Sup. Ct. J. 140 (1987), withdrawn, 760 S.W.2d 960 (Tex. 1988).

\(^25\) For examples of the "proceeds" royalty clause, see Warfield Nat'l Gas Co. v. Allen, 88 S.W.2d
efficient market establishes a market value at the wellhead which takes into account expenses necessary to make the gas marketable. "Proceeds" for these purposes is generally defined as that money lawfully obtained and retained from the sale of gas.\(^{26}\) Further, for these purposes, courts usually restrict the lessee's liability to "net" proceeds, being " gross proceeds" less "reasonable expenses related directly to the costs and charges of gathering, processing and marketing the gas."\(^{27}\) Thus, evidence of the market value of the gas is generally irrelevant. With the proceeds royalty clause, courts struggle with different evidentiary matters than they do with market value clauses. For example, what, if any, expenses and costs are deductible from those proceeds prior to a payment of the lessee's royalty obligation?

While the producer is bound by the duty to market the gas he produces, the question of which party should bear related costs often remains to be answered. Traditionally, the producer pays all costs of exploration and production of gas. This includes the costs of geophysical surveys of drilling, testing, completing and reworking the well, and of secondary recovery.\(^{28}\) The producer's duty is to produce a product at the wellbore, and, therefore, all associated costs are borne by him. Costs which are incurred subsequent to production and which are necessary to create a marketable product are generally shared proportionately by the royalty owner and the producer where, as is typical, the royalty is payable at the well.\(^{29}\) Such post-production costs include gross production and severance taxes; transportation charges or other expenses incurred in conveying the minerals produced from the wellhead to the place where a buyer takes possession thereof; and expenses of treatment required to make the gas marketable, such as dehydration, purification, and processing.\(^{30}\) There is no consensus among the various states whether the costs of compression are shared.\(^{31}\)

It has not yet been decided whether the producer's direct sales costs, including costs associated with his marketing affiliate, may be included as shared post-production

\(989\) (Ky. 1935) (requiring "the lessee to pay for each gas well from the time and while the gas is marketed the sum of one-eighth of proceeds received from the sale thereof, payable each three months"); Matzen v. Hugoton Prod. Co., 321 P.2d 576, 578 (Kan. 1958) (requiring the lessee to pay lessor "one-eighth of the proceeds from the sale of the gas").

26. The term "proceeds" itself implies a sale. Where there are no proceeds, as when gas is used in plant operations or exchanged, royalty will be based on fair or market value. See Lightcap v. Mobil Oil Corp., 562 P.2d 1 (Kan. 1977), cert. denied, 434 U.S. 876 (1978); Matzen v. Cities Serv. Oil Co., 667 P.2d 337 (Kan. 1983). See generally Phillips Petroleum Co. v. Johnson, 155 F.2d 185 (5th Cir.), cert. denied 329 U.S. 730 (1946); Phillips Petroleum Co. v. Record, 146 P.2d 485 (5th Cir. 1944).


28. See Williams, supra note 14, § 645.1.

29. Matzen, 321 P.2d at 581-84; Piney Woods, 726 F.2d at 228.

30. See Williams, supra note 14, § 645.2. There is no consensus whether the cost of separators and the expense of measurement for royalty purposes are to be shared burdens. Id. § 645.3.

31. See Wood v. TXO, 854 P.2d 880 (Okla. 1992). Oklahoma, Kansas, and Arkansas do not allow a producer to deduct compression costs from his royalty payments because, these states argue, installation of compression is a necessary expense in the process of making the gas marketable. Schupbach v. Continental Oil Co., 394 P.2d 1 (Kan. 1964). Louisiana and Texas, on the other hand, represent the majority opinion that compression costs are properly deductible because they are post-production costs necessary to move produced gas from the wellhead to the purchaser's pipeline. Martin v. Glass, 571 F. Supp. 1406 (N.D. Tex. 1983) aff'd, 736 F.2d 1524 (5th Cir. 1984).
costs. However, based on cases decided regarding other post-production services which enhance the value of the gas, such costs arguably should be included. Marketing costs of a third party not affiliated with the producer would normally be considered to be post-production services and deductible under a proceeds royalty clause. The counterpoint to this view is that traditionally the costs which are derived from the producer's in-house marketing efforts have not been deducted from the royalty owner's share of the proceeds of production. Given eighty years or more of industry interpretation that in-house marketing costs are not deductible, it is doubtful that a producer could suddenly change his practice and deduct the burgeoning costs associated with the large marketing departments so many producers have established.

However, the deductibility of in-house marketing expenses remains a matter to be determined by litigation. In any event, when a proceeds royalty clause is controlling, the producer's methods of marketing the gas are relevant in determining his royalty liability. As will be seen, courts will carefully scrutinize those marketing practices, particularly when an affiliate of the producer is involved in that marketing.

II. The Implied Duty to Market

As noted above, the producer is bound not only by the express terms of his oil and gas lease, but also by covenants implied therein. The Texas Supreme Court has noted that the implied obligations are as important as the lease terms themselves; "implied obligations are as much a part of the lease and are just as binding as though . . . expressed." The lessee's implied duties have been given various definitions but are traditionally divided into the four phases of operation: exploration, development, production (including marketing), and protection against drainage. Today, the covenant which is the subject of this article, the implied covenant to market, is widely recognized. Addressing the lessee's marketing obligation to the royalty owner under both market value and proceeds gas royalty clauses, the court in Craig v. Champlin Petroleum Co. said,

32. The doctrine of implied covenants "is designed to determine what constitutes fair and reasonable dealing between any lessor and his lessee in the implementation of their general intention that the lessee is to develop the leased premises for their mutual advantage." See Kuntz, supra note 8, § 54.3.


34. See Maurice H. Merrill, THE LAW RELATING TO COVENANTS IMPLIED IN OIL AND GAS LEASES § 4 (2d ed. 1940). Merrill describes the lessee's implied duties as (1) the implied covenant to drill an exploratory well; (2) the implied covenant to drill additional wells; (3) the implied covenant for diligent and proper operation of the wells and for marketing the product, oil or gas is discovered in paying quantities; and (4) the implied covenant to protect against drainage by wells on adjoining lands. Id.

35. See Howard R. Williams & Charles J. Meyers, OIL AND GAS LAW § 804 (1964); Kuntz, supra note 8, § 55.1.

The defendant, Champlin Petroleum Company, as lessee under oil and gas leases . . . has an implied duty and obligation in the exercise of reasonable diligence, as a prudent operator, with due regard for the interest of both lessor and lessee, to obtain a market for the gas produced . . . at a prevailing market price . . . ."37

Thus, the structure of the producer's marketing efforts and the calculation of royalties due his royalty owners will be tested not only by the language of his oil and gas lease, but by the implied covenant to market production.

The implied covenant to market is generally viewed as "two-pronged: the lessee must market the production with due diligence and obtain the best price reasonably possible."38 In so doing, the "standard of care applied to test [his] performance . . . is that of a reasonably prudent operator under the same or similar circumstances."39 In other words, the producer must act as a reasonably prudent operator would in marketing his production, including due diligence to obtain the best possible terms for the sale.40 And in some jurisdictions, under a market value royalty clause, the producer must obtain the best current price reasonably obtainable.41 Such broad language, implying a continuing obligation of the producer to obtain the highest price objectively possible for gas he produces, can, as will be discussed, cause significant problems for the producer upon a court's review of his marketing efforts.

The implied duty to market may have a significant effect on a proceeds royalty clause. As discussed above, under a proceeds clause, the royalty owner is entitled only to his share of the producer's sale proceeds. However, those proceeds may be deemed inadequate, entitling the royalty owner to relief, if the producer has breached his implied duty to market production. In Amoco Production Company v. First Baptist Church of Pyote,42 the court concluded that the lessee must "act fairly and in good faith with regard to the interest of a lessor of a mineral interest."43 In First Baptist Church, the lessee entered into a long-term contract with a purchaser to sell gas produced from the plaintiff royalty owners' well at approximately one-half the amount at which gas was then being sold to other purchasers from the same well, and with no right to a future price redetermination. At the same time, and from the same purchaser,

37. Id. at 125.
38. Cabot, 754 S.W.2d at 106; Weymouth v. Colorado Interstate Gas Co., 367 F.2d 84 (5th Cir. 1966); Bristol v. Colorado Oil & Gas Corp., 225 F.2d 894 (10th Cir. 1955); Molter v. Lewis, 134 P.2d 404 (Kan. 1943); Strange v. Hicks, 188 P. 347 (Okla. 1920). The prudent operator standard is statutory in Louisiana. LA. REV. STAT. ANN. § 31-122 (West 1988).
41. Cabot, 754 S.W.2d at 106.
42. 579 S.W.2d 280 (Tex. Civ. App. 1979), writ ref'd n.r.e. per curiam, 611 S.W.2d 610 (Tex. 1980).
43. Id. at 284.
Amoco received an upgrade on a low, fixed-price contract involving production from leases other than those covering the plaintiffs' mineral interest. The court concluded that Amoco breached its duty to market the gas in spite of the fact that the plaintiffs had signed division orders.44

The First Baptist Church court went further to find that the lessee will be held to stricter scrutiny of his marketing performance when the interests of the lessor and lessee are not identical.45 The First Baptist Church court quotes Professors' Williams and Meyers:

The greatest possible leeway should be indulged the lessee in his decisions about marketing gas, assuming no conflict of interest between lessor and lessee. Ordinarily the interests of the lessor and lessee will coincide; the lessee will have everything to gain and nothing to lose by selling the product. Where the interests of the two diverge and the lessee lacks incentive to market gas, closer supervision of his business judgment will be necessary.46

Professors Williams and Meyers go on to say in that section that "whatever shortcomings in lessee's conduct may be revealed by hindsight, the covenant is not breached if, at the time, an ordinary prudent operator might have followed such a line of action."47 The Professors admonish courts to exercise restraint in "second-guessing" the lessee's marketing decisions, warning that "scrutiny of the lessee's actions by judges (or, worse, juries) in the light of after-acquired knowledge will tend to encourage the operator to take the least hazardous and perhaps least profitable course of action."48

Of course, a producer does not undertake management and development of property for the sole benefit of his lessor. Courts recognize this and the substantial burden borne by the producer and will not require him to subordinate his interest to that of his lessor so long as the interests of the two coincide.49 But where the court perceives a conflict, it will jealously defend the rights of the lessor.50 In First Baptist Church, that

44. Amoco asserted that it was protected from liability because the royalty owners had signed division orders requiring payments based on "net proceeds at the wells." The court said, however, that a division order "does not purport to relieve the lessee from its duty to exercise good faith in obtaining market value for gas sold," its main purpose being protection of a purchaser of production in making distribution of payment. The division order does "not diminish the duty owed to [the] royalty owners." First Baptist Church, 579 S.W.2d at 288.

45. Id. at 285.
46. Id. at 286 (quoting WILLIAMS & MEYERS, supra note 35, § 856.3).
47. See WILLIAMS & MEYERS, supra note 35, § 856.3.
48. Id.
49. Id.
50. See, e.g., TXO v. Hagen, 683 S.W.2d 24 (Tex. Ct. App. 1984), aff'd, 31 Tex. Sup. Ct. J. 140 (1987), withdrawn, 760 S.W.2d 960 (Tex. 1988); TXO v. Parker, 716 S.W.2d 644 (Tex. App. 1986); Amoco Prod. Co. v. Underwood, 558 S.W.2d 509 (Tex. Civ. App. 1977). In a recent case, Hurd Enter., Ltd. v. Bruni, 828 S.W.2d 101 (Tex. Ct. App. 1992), the Texas Court of Appeals considered whether there was a breach by a producer as to his royalty owners of the duty of good faith and fair dealing with respect to marketing obligations. The court held that a "confidential relationship [a special relationship of trust and confidence] must exist to give rise to the duty of good faith and fair dealing." Id. at 112. Because there was no evidence that the relationship between the parties was any more than that of
conflict existed because the potential price for gas produced under one lease was traded to upgrade the price under another. Thus, there was a clear conflict between the interest of the royalty owner and the producer, resulting in a lower royalty check being mailed to the plaintiffs — a result the court found unacceptable.

One other aspect of the reasonably prudent operator standard that can cause significant problems for the producer interested in direct sales is the concept that each royalty owner must be treated as though he is his producer's only lessor. In *Amoco Production Co. v. Alexander*, the court considered a producer's implied obligation to protect his lessor's field from local drainage. There, royalty owners in a water-drive field brought suit against Amoco, a common lessee in the field, for breach of contract, alleging failure to protect the plaintiffs' lease from drainage, tort damages, and "intentional acts and omissions" undertaken to increase Amoco's production from other "updip" leases. The Alexanders' lease was updip. Amoco had increased production on its updip leases, causing updip leases, including the Alexander lease, to "water out" sooner than they otherwise would.

In considering Amoco's actions, the court, as is typical, held Amoco to the reasonably prudent operator standard of conduct. However, the court went on to hold that the said standard "is not to be reduced to" any one lessor simply because the producer "has other lessors in the same field." As for the plaintiffs, the producer had the duty to do whatever a reasonably prudent operator would do if the [plaintiffs] were *its only lessor* in the field. Explaining, the court said:

The conflicts of interest of Amoco, as a common lessee, cause us concern. The Alexander leases provided for 1/6th royalty while Amoco's updip leases provided for 1/8th royalty. There is no economic incentive for Amoco to increase production on the Alexander lease because it will eventually recover the Alexanders' oil updip.

... These conflicts would not occur if Amoco was not a common lessee (lessee common to updip and updip lessors). If the Alexanders were the only Amoco lessor, their interests would more nearly coincide.

The court therefore held that the "reasonably prudent operator standard is not to be reduced to the Alexanders because Amoco had other lessors in the same field. Amoco's status as a common lessee does not affect its liability to the Alexanders." In sum, case law regarding the implied covenant to market production provides much ammunition to royalty owners in their battles with producers. Not only will the producer be held to strict scrutiny when his interests do not coincide with those of his lessor, but that lessor will be viewed by a reviewing court as the producer's only lessor, even where that producer is a common lessee with many lessors in a given area. Such

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lessor/lessee, and was "purely a business relationship," no confidential relationship and therefore no duty of good faith and fair dealing existed. *Id.* at 111.

51. 622 S.W.2d 563 (Tex. 1981).
52. *Id.* at 569.
53. *Id.* at 570 (emphasis added).
54. *Id.* at 569.
55. *Id.*
broad, sweeping statements by courts serve only to spawn litigation and confusion, as illustrated infra.

III. Recent Cases Regarding the Implied Marketing Covenant

Two recent cases highlight the problems that can occur when the implied marketing cases have discussed are applied to actual situations involving marketing gas. In Shelton v. Exxon Corporation, the U.S. district court found that Exxon "breached its duty . . . to prudently market gas under market value clause of gas leases." Exxon had classified the gas produced from wells in which the plaintiffs had a royalty interest as section 109 gas. Exxon argued that because the price of such gas was limited by the NGPA section 109, the market value of the gas for royalty purposes was the section 109 price. At that time, it was clear under applicable Texas law that the market value of gas for purposes of a market value royalty clause could not exceed its regulated price. The plaintiffs argued that prior to 1978, the effective date of the NGPA, Exxon should have dedicated the plaintiffs' gas to new contracts which would have qualified it under section 105(b)(2) of the NGPA and, accordingly, a higher regulated price and higher royalty. The plaintiffs urged that Exxon's failure to do so was a clear breach of the implied covenant to prudently market the gas.

Exxon had marketed and sold the plaintiffs' gas under long-term "corporate warranty" contracts which required Exxon to sell a specified volume of gas, regardless of the source, for the term of the contract. Exxon argued that it could not market the plaintiffs' gas other than under the warranty contracts because the gas was being "effectively committed or dedicated" to those contracts. The court rejected Exxon's argument, holding that Exxon was legally free to commit the plaintiffs' gas to the contracts proposed by the plaintiffs because corporate warranty contracts do not "designate the origin of gas to be supplied"; in other words, specific gas is never dedicated to such a contract. Exxon also argued that the corporate warranty contracts were not imprudent marketing when the contracts were first executed. However, the court said that that question was not the issue; rather, "[t]he real issue is whether it was imprudent for Exxon to continue marketing the [plaintiffs'] gas as it previously had."

Exxon argued that it acted as a reasonably prudent operator in originally entering into the warranty contracts and that it was not imprudent for it to continue to do so even after passage of the NGPA. Further, once the market had changed, a reasonable

57.  ld. at 545.
58.  Id.
59.  ld.; see also First Nat'l Bank v. Exxon Corp., 622 S.W.2d 80, 81 (Tex. 1981) (holding that under a "market value" lease, market value cannot exceed the regulated price).
60.  "Warranty contracts" are distinguishable from "dedication contracts" wherein the seller only obligates itself to sell whatever gas is producible from the wells or leases which are specifically dedicated to the contract for its term. See Gulf Oil Corp. v. Federal Power Comm'n, 563 F.2d 588 (3d Cir. 1977), cert. denied, 434 U.S. 1062 (1978).
62.  Id.
63.  ld. at 547 (emphasis added).
prudent operator "would not have entered into the contracts in question because it would have been costly to use high-priced gas purchased on the open market to fulfill its corporate warranty contracts in order to allow the [plaintiffs'] gas to be sold at market value." The court agreed with Exxon that the duty owed by it was that of a reasonable prudent operator under the same or similar circumstances. However, it rejected Exxon's arguments, stating that such "outside costs," ones that "arise from Exxon's overall, company-wide marketing plan and represent risks inherent to long-term corporate warranty contracts," should not be included as "factors in deciding what a reasonable, prudent operator would do to market the gas."

The court found that Exxon's commitment of the plaintiffs' gas to low-priced warranty contracts subordinated the rights of the royalty interest owners to Exxon's own financial gain, that gain being "its interest in fulfilling its corporate warranties without having to purchase gas on the open market." The Shelton court picked up on the sweeping generalization in Alexander which, in its simplest form, held that the lessee's duty is to do that which would be done by a reasonable, prudent operator holding only the lease in question. The Shelton court agreed by saying,

[T]he reasonable, prudent operator standard should not be reduced as to the plaintiffs because Exxon has corporate warranty contracts legally unrelated to the [plaintiffs'] leases.

. . . Exxon was required to market the [plaintiffs'] gas in the manner reasonably most profitable for the mineral interest owners. . . . [They] can not be penalized for Exxon's inability to back its corporate warranty contracts. . . . Nor should they suffer for Exxon's failure to take the regulatory environment into account in marketing the gas. . . . Since the marketing scheme was Exxon's own, Exxon is at risk when the prudence of the scheme is judged.

The Shelton decision unquestionably conflicts with one common thread of legal analysis running through the "implied duty to market" cases: that so long as a conflict of interest does not exist between the lessor and the lessee, the court should not subject the lessee's reasonable judgment to hindsight. In Shelton, there was in reality no conflict between the lessor and lessee. At the time Exxon made sales under the corporate warranty contracts in question, Exxon received seven-eighths of the price and the royalty owners correspondingly received one-eighth. Such sales were then one of the best ways to market gas, being a way to pin down for a long period of time what was then a high price in the intrastate market. Thus, the plaintiffs had benefitted from

64. Id. at 548.
65. Id. at 546.
66. Id. at 549.
67. Amoco, 622 S.W.2d at 563.
68. Shelton, 719 F. Supp. at 549 (emphasis added). The Shelton court also relied on Freeport Sulphur Co. v. American Sulphur Royalty for the proposition that "supply and demand forces external to the lease and created, at least in part, by the operator did not affect the implied duty to operate." Freeport Sulphur Co. v. American Sulphur Royalty, 6 S.W.2d 1039, 1044 (Tex. 1928); see also Amoco Prod. Co. v. Alexander, 622 S.W.2d 563 (Tex. 1981).
the contracts in their early years when they were economically attractive. For a long period of time, the royalty owners received the benefits of having their gas marketed under the warranty contracts. But as the gas market changed, especially with the passage of NGPA, the long-term warranty contracts became low-priced contracts. Exxon argued that it was imprudent not to know that such a result would ensue when it entered into the contracts, and only hindsight and the passage of NGPA showed Exxon's action to be a mistake. However, the royalty owners were permitted to abandon that method of marketing when it later worked to their detriment, the court deeming it to be, in effect, unreasonable and imprudent operation.69

The authors feel that the Shelton decision is subject to criticism because it constitutes the type of second-guessing which should be avoided by the courts. Recall the statement in First Baptist Church from Professors Williams and Meyers that "[t]he greatest possible leeway should be indulged the lessee in his decisions about marketing gas . . . ."70 Recall also the professors' position that whatever shortcomings in the lessee's conduct that may be revealed by hindsight, the covenant to market is breached only when the lessee does not act as a reasonable prudent operator at the time in question.71 In addition, the Shelton court's reasoning that Exxon had the duty to obtain the best current price as if the plaintiffs' gas was the only gas Exxon was marketing would apply whether the gas was dedicated to Exxon's sales contract or not.72 If it were dedicated, the court could simply say such long-term dedication was an imprudent subjection of the lessor's interest to that of the lessee. As previously stated, Exxon made a reasonable marketing decision with regard to marketing plaintiffs' gas. For many years that marketing resulted in the plaintiffs obtaining the highest price available. By second-guessing Exxon's decision, the Shelton court gave the royalty owner the best of all possible worlds — the highest price when Exxon guessed correctly in its marketing efforts and damages for breach of the implied marketing covenant when Exxon's decisions did not result in the highest price. If the plaintiffs' gas had been dedicated, a court could also say the dedication was not in the plaintiffs' best interest and did not result in the highest possible price. Despite the language in Amoco and Shelton, in many states dedication to a contract will not insulate a lessee from its duty under the implied marketing covenant to obtain the then current highest possible price.

Robbins v. Chevron U.S.A.73 is also important to producers because it reflects how hostile local courts can be towards producers. The facts of the case are critical to show this degree of hostility. This litigation involved a "take or pay" contract originally entered into between a producer and a pipeline in 1960. This story is fairly typical of the scenario which occurred time and time again during the 1980s as producers and pipelines with such contracts dealt with collapsing resale prices. The contract was renegotiated in 1978 to extend its term for ten years and to escalate the purchase price

69. Shelton, 719 F. Supp. at 547.
70. First Baptist Church, 579 S.W.2d at 286.
71. See Williams & Meyers, supra note 35, § 856.3.
of the gas in stages to ultimately the highest price then being paid by three different pipeline purchasers in an eight-county area. At the time of the amendment, the price was $0.205 per MCF. By 1982, it had risen to $3.27 per MMBtu but was capped at $2.289 by a Kansas pricing statute. That statute expired in 1984. The purchaser then tried unsuccessfully to renegotiate the contract and continued to pay $2.289 per MMBtu as opposed to the $3.56 contract price urged by the producer, Chevron.

Finally, because of the pricing dispute, Chevron shut the wells in from September 1985 until October 1, 1987, during which time it made shut-in royalty payments. In February 1987, Chevron sued its purchaser for alleged breach of contract and in October, began selling the gas on the spot market. In July 1988, the royalty owners brought suit to cancel their leases "alleging that in 1978 Chevron breached its implied obligation to market their gas by extending the gas purchase contract ... and by the lack of sales" during the shut-in period. They moved for summary judgment in October 1988, seeking cancellation of Chevron's leases. The trial court granted the motion in December 1988 based on what it perceived to be a breach of the implied marketing covenant - the 1978 contract amendment. The court deemed the leases canceled as of October 1985 when the wells were shut in and ordered an accounting for all production after that time.

To these authors, this case highlights the hostility producers encounter in local trial courts when royalty owners file suit against them. Fortunately for Chevron, the Kansas Supreme Court had no hesitation in overturning the trial court's summary judgment, noting that Chevron's conduct should not be judged on the basis of "hindsight" but upon what an experienced operator of reasonable prudence would have done under the facts existing at the time.\textsuperscript{74} The court felt that the 1978 amendment was not "patently imprudent;"\textsuperscript{75} pursuant to the amendment, the contract price increased dramatically during a time when gas was in short supply and prices were rising. Certainly, in regard to the pricing issue, individuals active in the industry, unless they are paid to be testifying experts for royalty owners, would not see anything imprudent in Chevron's acts, especially so imprudent as to justify summary judgment. Also, in regard to Chevron's handling of the take-or-pay dispute, many producers were slow to assert their rights under take-or-pay contracts and only reluctantly brought suit. To grant a royalty owner summary judgment without expert testimony on the issue and without listening to Chevron's explanations for its actions itself is an example of imprudence on the part of the trial court.

The reception by Chevron at the trial court level exemplifies the problems producers often face in rural courts.\textsuperscript{76} The hostility of the local court in \textit{Chevron} is further

\textsuperscript{74} \textit{Chevron}, 785 P.2d at 1016.

\textsuperscript{75} \textit{Id.}, at 1015.

\textsuperscript{76} Trial courts have historically been hostile to producers in favor of royalty owners. See, e.g., Sun Exploration Co. v. Jackson, 783 S.W.2d 202 (Tex. 1988) (finding that all 12 of the plaintiffs were related to the judge at least by consanguinity in the fourth degree and one of their attorneys who attended the trial was the judge's first cousin). In \textit{Sun}, the trial court granted the plaintiff's request for lease cancellation for breach of the covenant to explore a highly unusual remedy especially in view of the fact that the covenant was not recognized in Texas. Can anyone, other than the Texas Supreme Court, honestly believe that a judge will give an even break to an oil company over friends or relatives whom
shown by the fact that the trial court canceled the leases for the breach of the implied marketing covenant. The act of cancellation, as noted by the Kansas Supreme Court, is not favored by the courts and it clearly cautioned the trial court in this regard. The *Chevron* case reflects the reality that the first time the producer receives a remotely objective review of his actions may likely be at the appellate level, where significant findings of fact may be established against him by a judge or jury. This hostility must be recognized by counsel when providing advice to producers regarding their royalty payments when they are directly marketing gas.

**IV. Methods of Attacking Direct Sales**

The royalty owner's first step in attacking direct sales is to determine the type of royalty clause in the lease. Does his lease contain a market value clause, a proceeds clause or a hybrid, simply a combination of the two? He must further determine what economic forces likely motivated his producer and, of course, whether the producer maintains other leases in the royalty owner's unit or adjoining areas. Also, he needs to compare his sales prices to other prices in the area by the same producer and third parties. Finally, he should determine whether his producer's sales activities are part of a company-wide marketing program involving a marketing affiliate and, if so, when and why that program was implemented.

**A. Capture of Margin or Costs in Affiliate**

There are a variety of ways a royalty owner can attack the direct sales by his producer where the producer captures margin or costs in a marketing affiliate. If a proceeds lease is involved, and where the producer is using a marketing affiliate, the royalty owner can argue that there has been a breach in the implied covenant to market because the proceeds received were too low and there is an inherent conflict of interest as set forth in *Amoco v. Alexander.* In the alternative, he can argue that the sale between the affiliates was a sham. In regard to the sale to an affiliate, the royalty owner need only highlight the fact that closer scrutiny is appropriate because the interests of the lessor and lessee clearly diverge.

If a market value lease is involved, the royalty owner can attack the sale with evidence of comparable sales in the area and actual expenses. Whether these expenses were paid to an affiliate of the producer or to a third party should be irrelevant to the analysis. However, if a valid justification exists for direct sales, any costs paid to entities not affiliated with the producer should pass judicial scrutiny.

Another way to attack sales to a marketing affiliate not related to the implied covenant, when margin or costs are captured in the affiliate, is to claim that the sale was a sham or a fraud and that the real price was the price received by the affiliate. It is interesting to note that when dealing with sales between affiliates, it is not usually necessary to show intentional fraud as a prerequisite to disregarding the corporate

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he knew from childhood, with whom he goes to church every Sunday, with whom the very fabric of his life is indelibly intertwined?

77. See *supra* text accompanying notes 51-55.
entity. Most state courts have held that "it is sufficient if recognizing the separate corporate existence would bring about an inequitable result," such "unfairness" constituting constructive fraud."

B. Low Sales Price

The implied marketing covenant can also be used to challenge direct sales which result in a low price being received for the gas even when a marketing affiliate is not involved. When a marketing affiliate is not used, the challenge is based on the implied marketing covenant under a proceeds lease or under a market value lease in the event there are no comparable sales (and thus a review of actual sales price less the deduction of expenses to make the gas marketable and to transport to market is warranted). In such challenges, there are three potential claims whereby the royalty owner could request the trier of fact to substitute his own judgment for or "second guess" the producer: First, the use of traditional marketing efforts rather than utilizing brokers, a marketing entity or other special marketing efforts; second, questioning the producer's direct marketing efforts because of the failure to spot market when long term prices are low or vice versa, or the failure to market gas to the highest or best price and market; and finally, improper aggregation or dilution of markets, (see example for improperly allocating prime markets) by inclusion of third parties' gas or other production not from that particular royalty owner's land; for example, the aggregation of production on different pipelines.

A royalty owner's methods of attack described in the first and second claims above are both based on the use of experts to detail the producer's marketing efforts as being grossly deficient. If the producer markets directly to a pipeline, an expert can be used to regale a jury with the producer's ineptitude in not marketing gas directly to end markets. Similarly, experts can be retained to attack the producer for not marketing gas on the east coast where the price was higher than on the west coast, where the producer actually sells the gas. The same type of criticism can be leveled against spot


There were new standards set by the Texas legislature in 1989, which provided that a shareholder has no liability for a corporation's obligations with respect to any contractual obligation of the corporation on the basis of actual or constructive fraud or sham, unless the obligee demonstrates that the holder, owner, or subscriber caused the corporation to be used for the purpose of perpetrating and did perpetrate an actual fraud on the obligee, primarily for the direct personal benefit of the holder, owner, or subscriber. However, the legislature did not address or limit the disregard of the corporate fiction "where the corporate fiction is resorted to as a means of evading an existing legal obligation" or "a corporation is organized and operated as a mere tool or business conduit of another corporation." Castleberry, 721 S.W.2d at 272; see also Tex. Bus. Corp. Act Ann. art. 2.21 (West 1980 & Supp. 1993).

sales versus long term sales. Experts, like lawyers, can always be found to say what the client wants them to say. An example of the problems associated with aggregating or diluting markets by attributing gas sales back to a particular lessee can best be illustrated by utilizing the following factual situation: a $3.00 market is directly accessed via pipeline (a) from five of producer's wells (the A wells). This is a 10 MMBtu day market with each of the five wells producing 2MM day. This market can also be accessed from the same producer's gas from another series of wells (the B wells) with different royalty owners by transporting gas first through pipeline (b), then to pipeline (c). The first set of royalty owners will be referred to as royalty owners A and the second set of royalty owners as royalty owners B.

The following drawing represents the foregoing factual situation:

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"B" WELLs  "A" WELLs
       ↓               ↓
       ↓               ↓
PIPELINE "B"   PIPELINE "A"
       ↓               ↓
$1.40 MARKET   PREMIUM
               $3.00 MARKET
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The producer pays royalty to royalty owners A based on the $3.00 price and pays royalty to royalty owners B based on sales to the $1.40 market. Royalty owners B sue the producer for breach of the implied marketing covenant. They cite *Cabot Corp. v. Brown* for the proposition that the producer has the duty to his royalty owner to obtain the best price reasonably possible. Based on this case, the royalty owners argue that they should have a share of the $3.00 market because their gas is accessible to it. Such a price would be the best price reasonably available and, as royalty owners, they should be treated as if they were the only lessors of their lessee's gas. Therefore, they should at least be given proportionate access to the $3.00 market and their proportionate share for royalty purposes. Based on the cited cases, the royalty owners should have a strong chance of success.

As a variation to the foregoing, the producer, concerned about the royalty owners B's suit, decides to include that volume in the premium sale (though the gas does not actually flow that way) by accounting adjustments. Therefore, a fictitious aggregation occurs where the productions from wells A and wells B are added together. As a result,

80. 754 S.W.2d 104, 106 (Tex. 1987). See *supra* text accompanying notes 34-41.
some of the royalty owners A's gas is displaced into the lower-priced spot market, their royalty check is lowered, and the royalty owners in the B wells will receive a higher check.

However, if the gas is aggregated in that fashion, royalty owners A could sue on the same grounds for the breach of the implied marketing covenant, arguing they should be treated as though theirs was the producer's only gas. They would cite the Alexander case for the simple assertion that each royalty owner must be treated as if he were the producer's only royalty owner. In fact, they have a very appealing and strong argument because only their gas actually flowed to the market, they are directly connected to the high price market, and the production from their wells is sufficient to satisfy that market in its entirety. Royalty owners A have an even stronger argument for not aggregating their gas to satisfy the high-price market with gas from the wells in which royalty owners B have an economic interest.

A variation of the foregoing scenario could be that the A wells had only sufficient production from the producer's interest in those wells to satisfy half of the $3.00 premium market. However, third-party gas from those wells could satisfy the remainder of the market. The producer, hoping to create the aura of an independent marketing affiliate and also hoping to market third-party gas for a profit through its marketing affiliate, sells the third-party gas into the premium market and retains a percentage of the third party's sale price as its fee. The gas from the B wells is sold into the low-priced market. The producer's use of a marketing affiliate to directly market such gas from the A wells to the premium market, without any use of the gas from royalty owners B to satisfy the market, creates the conflict situation discovered in Alexander. There is a clear conflict — especially when the producer receives a fee or retains a margin for marketing the third parties' gas. The producer is permitting third party gas to be sold into the high priced market instead of satisfying it from his own production on pipelines A and B. To these authors, this variation creates a clear violation of the implied marketing covenant.

As noted herein, there is much support for the lenient view that a producer's actions when selling gas should not be subject to a stringent review because that producer has common interests with his royalty owners to obtain the highest price reasonably obtainable. However, even under the more charitable view represented by the Chevron case, a producer's action is subject to a strict review where there is a conflict between those interests. Clearly, the act of marketing a third party's gas creates a conflict situation, exacerbated by the collection of a fee. A royalty owner has a very strong argument that the implied marketing covenant has been breached when a producer subordinates the royalty owner's interest in having his gas marketed to that of an unrelated third party.

C. Gas Futures Contracts

Gas futures contracts present a more difficult analytical review than does the typical gas sales arrangement. However, existing case law does provide support for a

81. See supra text accompanying notes 51-55.
82. Id.
83. For an excellent discussion of gas futures contracts, see Mark E. Haedicke, Contracts for the
royalty owner claiming the profits from future trades backed up by the producer's production. Whether the producer uses the traditional futures contract or a variation, such as a forward contract or swap, the principal arguments the royalty owner can marshall are the same. In *Frey v. Amoco Production Co.*, the court noted that the "amount realized" upon which royalty was to be paid included "the economic benefits" derived from the lessee's right to develop and explore, a right conferred by the lease. If take-or-pay proceeds constitute economic benefits which are derivative of a producer's right to develop and explore the leased property, are not the profits generated by a producer's utilization of futures contracts (contracts covered by its production) economic benefits derived in part from the royalty owner's production? Certainly, in Louisiana at least, an "amount realized" lease permits the royalty owner to seek the "sum total, the whole or the final effect of the economic benefits . . . of the rights granted by the synallagmatic contract of lease." Texas courts also recognize the conveyance of substantial benefits on the lessee and third parties to the detriment of royalty owners as a breach of the implied covenant to market gas. Also, the Arkansas Supreme Court in *Klein v. Jones* recently stated that because oil and gas leases are to be construed in favor of the lessor, that oil and gas leases are a "cooperative venture" to develop the minerals for the mutual benefit of both parties. In *Klein*, the court held that each party should receive its fractional division of the gross revenue as contemplated by the lease. The court, citing *Amoco*, said that all benefits grounded on the existence of a lease must be shared in accordance with the lessee's division of gross revenue, and the lessee may not recoup a substantial benefit from a lease that is purportedly unrelated to the production of gas.

The sweeping statements seen in *Frey, Amoco*, and *Klein* regarding the correct interpretation of the intent and purpose of the gas royalty clause provide ample legal support for a royalty owner to seek the economic benefits his producer derives from covered futures trading. However, it will be difficult for a royalty owner to quantify those benefits in a manner that would justify a court awarding him monetary damages with legal certainty. Moreover, a royalty owner will have difficulty bringing implied covenant cases because it will normally be very difficult for him to show that his specific lease conveyed the economic benefit derived from the futures trade, and even more difficult to show the extent of such benefit. The royalty owner could only show the fact that the producer had actual production which enabled him to trade in the futures market with relative safety and that the production was generally related to the

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84. Id. at 316-23.
85. 603 So. 2d 166 (La. 1992).
86. Id. at 179-80.
87. Id. at 180.
88. Id.
89. *First Baptist Church*, 579 S.W.2d at 287.
90. 980 F.2d 521 (8th Cir. 1992).
91. Id. at 531.
92. Id. at 532.
93. Id.
producer's ability to produce gas from the royalty owner's and others' wells. However, absent the tying of the futures arrangement to production from a specific area or lease, such generalities appear tenuous at best as support for a claim for damages. A royalty owner could retain an expert witness to either theoretically trace the gas molecules from the royalty owner's well or to perform mathematical calculations to show the proportional contribution the royalty owner's well theoretically made to the particular futures transaction. Although, whether a court would accept such a nebulous manner of proving and quantifying "economic benefit" derived at the royalty owner's expense is doubtful.

An example of two futures trades which illustrate the potential royalty claims associated with futures transactions are as follows:

In January, the producer, who is a "natural long," sells the right to sell August gas at $1.70. The volume optioned is equal to one-half his expected production for that month. In June, the futures price for August has dropped to $1.25. The producer closes out the August trade at a net profit of $5,000,000 and sells his August production in August at a $1.17. In February, the producer sells the same right for one-half of his September production at $1.68. Due to war in the Middle East and a volcanic eruption on a small island in the Pacific, causing an August snowfall in the Midwest, the gas futures price for September soar to $3.75. To avoid a major book loss, the producer elects to deliver his gas pursuant to the futures contract at $1.70, creating a lost opportunity cost of $17,000,000.

In the first instance, is not the $5,000,000 an economic benefit as described in Klein? Would the producer have gambled without the knowledge that his losses would be limited because of his ability to deliver or sell the equivalent volume of gas to satisfy his market? In the case of the second trade, market value was clearly not obtained for the gas. Further, even if a proceeds lease was involved, because of the existence of a clear conflict of interest, this transaction cannot survive the close scrutiny called for in First Baptist Church.

Conclusion

The application of the implied marketing covenant to the direct marketing efforts of a producer is an area where old principles have yet to be applied to a new methodology of marketing gas. It is the authors' opinion that certain well-worn shibboleths — such as the idea that the producer has the duty "to obtain the best price reasonably possible" or the duty "to operate the lease in dispute as if it were his only lease" — interfere with a thoughtful and correct analysis of the producer's duty under the implied marketing covenant. The real duty is that the producer should market the royalty owner's gas as he would his own with the plan of obtaining the best possible price. The concept that he must obtain "the best price" leads to second-guessing at trial by a royalty owner's experts and a court.\footnote{Often commentators and courts talk about the duty to obtain the "best price" and overlook the "reasonable" portion of the standard. See Patrick H. Martin, A Modern Look at Implied Covenants to Explore, Develop and Market Under Mineral Leases, 27 INST. ON OIL & GAS L. & TAX'N 177, 191 (1976); see also Holmes v. Kewaunee Oil Co., 664 P.2d 1335 (Kan. 1983), cert. denied, 474 U.S. 953} So long as the producer receives seven-
eighths of the proceeds, he has all the incentive in the world to get the "best" price. The proper statement of the lessee's duty under the implied marketing covenant is that he should "realize the highest price obtainable by reasonable effort." There is more than a semantic difference between requiring a producer to obtain the "best price reasonably possible" and requiring the producer to use "reasonable efforts" or to use the same efforts as a reasonable prudent operator under the same or similar circumstances. His standard of care should be only that of an "ordinary prudent operator under the same or similar circumstances." However, it does not mean that that price must be the "best" in absolute terms. A reasonable prudent operator does not always obtain the "best price" despite his efforts to do so. So long as the producer makes reasonable efforts to market his gas, his attempts should not be second-guessed unless there is a clear conflict of interest, as was the case in First Baptist Church, or his actions demonstrate clear ineptitude or negligence. The kind of clear ineptitude or negligence that should be necessary to trigger a breach of an implied covenant can be seen in Waseco Chemical Supply Co. v. Bayou State Oil Corp.

In such cases, the actions of the producer should be closely scrutinized. Examples of such conflicts are detailed herein in the discussion relative to the producer's use of a marketing affiliate to market a third party's gas or when any margin is retained in the producer's affiliate. But as noted in TXO v. Parker, even where a conflict exists, sales to an affiliate below "market price" can be justified by unique circumstances, such as the quality of the gas.

In addition to the implied marketing covenant, the sale to the marketing affiliate can be attacked as being a sham or fraud as in Castleberry. This challenge should find especially fertile ground in Texas.

Finally, the authors do not believe that internal marketing costs are properly captured by producers and deducted from the royalty owner's share of production proceeds. Such practice is not justifiable in view of past practices and performance under the royalty clause in oil and gas leases and is a conflict of interest under the implied marketing covenant.

(1985). The issue is not that the price in question is the best available or better prices are available; the issue is, did the lessee use reasonable efforts?

95. First Baptist Church, 579 S.W.2d at 285 (quoting MERRILL, supra note 34, at 212-14).
96. Cabot, 754 S.W.2d at 106.
98. See supra note 79.