Oil and Gas: Roye Realty v. Watson: Are Royalties Owed on All Take-or-Pay Settlements in Oklahoma?

Beverly M. Barrett
Oil and Gas: *Royer Realty v. Watson*: Are Royalties Owed on All Take-or-Pay Settlements in Oklahoma?

I. Introduction

Throughout the 1970s and early 1980s, agreements by purchasers of gas to take minimum quantities over a specified time or to make minimum periodic payments to a gas producer, even though no gas is actually taken by the purchaser, were commonly used in Oklahoma and other gas-producing states. These agreements, typically called "take-or-pay" agreements, have been the subject of numerous lawsuits. The issue to be discussed in this note concerns whether royalties are due under typical oil and gas leases, in the absence of production, on payments in settlement of take-or-pay claims when they are received by a producer.

Specifically, this note will examine a recent Oklahoma Court of Appeals case, *Royer Realty v. Watson*, in which the court held in a broad, sweeping opinion that royalties must be paid on take-or-pay payments which do not involve production, including those made in settlement of take-or-pay litigation and those made as consideration for so-called contract "buy-outs" or "buy-downs," when gas purchasers and producers agree to release obligations or lower contract prices to better approximate existing market rates.

*Royer Realty* is a case of first impression in Oklahoma and the issue it presents is one of enormous importance to both Oklahoma producers and royalty owners. In light of the current attention and concern given to this issue, parts I through V of this note will review previous case law and the historical developments leading up to the *Royer Realty* decision. Part VI will examine the various arguments available to the producer-seller (or lessee) involved in a take-or-pay dispute, and part VII will deal with the arguments of the royalty interest owner (or lessor) who

1. A "take-or-pay" provision requires a purchaser to take a specified amount of gas during each contract period or pay for that quantity even if not taken in full. See Diamond Shamrock Exploration Co. v. Hodel, 853 F.2d 1159, 1161 (5th Cir. 1988); HOWARD R. WILLIAMS & CHARLES J. MEYERS, MANUAL OF OIL AND GAS TERMS 1233 (1991). An example of an actual take-or-pay provision may be found in Wagner & Brown v. ANR, 837 F.2d 199 (5th Cir. 1988).

2. The focus of this note will not be on the royalty treatment of a typical take-or-pay payment or settlement followed by the taking of make-up gas as addressed in William H. White, *The Right To Recover Royalties on Natural Gas Take-or-Pay Settlements*, 41 OKLA. L. REV. 663 (1988).


4. A contract "buy-out" has been defined by the Oklahoma Tax Commission as a payment to terminate a gas sale agreement. General Counsel, Okla. Tax Comm'n, General Position Statement on the Application of § 1009(g) to Take-or-Pay Settlement Proceeds (Feb. 7, 1990).

5. The Oklahoma Tax Commission defines a contract "buy-down" as a payment to modify the gas sale agreement. Id.

6. Presently, the producer involved in *Royer Realty* is seeking petition for review by the Oklahoma Supreme Court. Amicus curiae briefs have been filed by, among others, the Oklahoma Mineral Owners Association, and the National Association of Royalty Owners (royalty owners' group), and the Oklahoma Independent Petroleum Association (producers' group).
seeks royalties on the payments in settlement of take-or-pay litigation. Finally, part VIII of this note will present what is believed to be the correct approach that should be followed in the State of Oklahoma.

II. Development of Take-or-Pay Litigation

The demand for natural gas is cyclical and is dependent upon weather and economic conditions. Further, exploration efforts are extremely expensive and risky and may not be pursued if gas sale opportunities are uncertain. Therefore, producers often seek to obtain promises from their pipeline purchasers in a take-or-pay provision that they will either "take" certain minimum amounts of gas or "pay" the producer for the amounts not taken.7 Usually, a buyer has a period of time in which to make up any deficiencies in gas which should have been taken earlier but was not. This is called a "recoupment" or "make-up" provision, and when delivered the gas is called "recoupment gas" or "make-up gas."8 A make-up provision may require the buyer to pay any increase in the price of gas that may have occurred between the earlier take-or-pay payments and the actual taking of the gas.9 It is well accepted that royalties are payable on take-or-pay payments when make-up gas is delivered.10

Take-or-pay payments compensate the producer-seller for being willing and able to provide a certain amount of gas and are intended to assure him of a minimal cash flow. The payments also provide the pipeline-buyer flexibility in the amount of gas taken in order to control gas reserves to meet their needs in the absence of an open market for natural gas.11 Both producers and pipelines miscalculated in negotiating take-or-pay clauses during the gas shortages of the 1970s and 1980s. When gas demand and prices declined dramatically, gas purchasers faced take-or-pay liabilities totaling billions of dollars.12 When many gas purchasers simply refused to take or to pay, many producers filed suit. Others amended their gas contracts.13 Many lawsuits and threatened lawsuits were settled.14 Many take-or-pay claims have, from the 1980s to the present, been settled for either lump-sum payments or through

7. White, supra note 2, at 663.
8. Diamond Shamrock, 853 F.2d at 1161.
10. A typical royalty clause provides for payment when there is production. Diamond Shamrock, 853 F.2d at 1161.
12. White, supra note 2, at 664.
13. Id.
14. Id. At the time, the Federal Energy Regulatory Commission (FERC) took several actions which reduced the ability of pipelines to force their customers to buy minimum amounts of gas while permitting their customers to acquire cheaper gas, which placed the pipeline companies in the position of being liable to producers, without compensating rights against their customers. The FERC's answer to the problems thus created was to suggest that the pipeline companies "vigorously renegotiate" their problem contracts with producers, while the FERC retained the right to itself outlaw problem provisions if renegotiations were not successful. See WILLIAM D. WATSON, THE GAS SELLER'S COMPANION: A PRACTICAL GUIDE TO GAS CONTRACTS 4-5 (1992).
renegotiations for contract buy-outs or buy-downs, without any actual delivery of
gas.\textsuperscript{15} Since many of these settlements involve no actual gas production, lessees
and royalty owners alike were unsure of whether royalties were payable under oil
and gas leases which appear to call for royalties when gas is "produced." Therefore,
the issue of royalty obligation is of utmost importance. \textit{Roye Realty} is the first
Oklahoma appellate decision to address this novel question of law.

\section*{III. Take-or-Pay Settlements}

In \textit{Mesa Petroleum Co. v. U.S. Department of Interior},\textsuperscript{16} the royalty clause at
issue required the lessee "to pay the Lessor a royalty of 16 2/3 percent in amount
or value of production saved, removed, or sold from the leased area."\textsuperscript{17} The gas
contract under which the lessee sold the gas had a minimum take-or-pay provision
with a seven-year make-up clause. After take-or-pay payments were made, some,
but not all, make-up gas credit was taken by the purchaser. The federal government,
as lessor, demanded royalty "on the unrecouped deficiency." The lessee argued that
royalty was due only on "production" under the royalty clause. The lessee also
relied on the language of an existing regulation stating that "under no circumstances
shall the value of production be less than the gross proceeds accruing to the lessee
from the disposition of the produced substances."\textsuperscript{18} The Federal District Court for
the Western District of Louisiana concluded that, given the fact that there had been
no production, under the language contained in the leases in question, the
government "has no statutory, regulatory, or contractual authority to collect royalties
on take-or-pay payments."\textsuperscript{19} \textit{Mesa} was consolidated on appeal with a similar case
involving Diamond Shamrock Exploration Co., resulting in the Fifth Circuit Court
of Appeals opinion in \textit{Diamond Shamrock Exploration Co. v. Hodel}\textsuperscript{20} which
represents the majority view regarding take-or-pay payments.

In the case involving Diamond Shamrock Exploration Co., a lessee of federal
acreage received payment pursuant to a take-or-pay clause in its gas sales contract
with the pipeline-purchaser.\textsuperscript{21} The issue was whether royalty was due on the
payment when the take-or-pay payment is received, even though the gas had not
actually been produced and taken. In each case consolidated on appeal, the contract
with the pipeline included a take-or-pay provision requiring the purchaser to take
a specified amount of gas during each contract year or pay for that quantity even
if not taken in full, and a make-up provision. The lessees in each case failed to pay
royalties on take-or-pay payments unless make-up gas had actually been taken.

\textsuperscript{15} See Associated Gas Distrib. v. FERC, 824 F.2d 981 (D.C. Cir. 1987); American Gas Ass'n v.
FERC, 888 F.2d 136 (D.C. Cir. 1989); Associated Gas Distrib. v. FERC, 893 F.2d 349 (D.C. Cir.
1989).

\textsuperscript{16} 647 F. Supp. 1350 (W.D. La. 1986).

\textsuperscript{17} \textit{Id}. at 1353.

\textsuperscript{18} 30 C.F.R. § 206.150 (1987).

\textsuperscript{19} \textit{Mesa Petroleum Co.}, 647 F. Supp. at 1353.

\textsuperscript{20} 853 F.2d 1159 (5th Cir. 1988).

\textsuperscript{21} The oil and gas lease in question provided for royalty on "crude oil, condensate, and natural gas
liquids produced on such lease." \textit{Id}. at 1163.
The Fifth Circuit Court of Appeals held that royalties are not due on "value in the abstract," but only on the value of "production saved, removed or sold from the leased property." Consequently, the Fifth Circuit held that royalties are only owed when there is actual production — a severance of minerals from the formation. The court stated that to reach any other conclusion would lead to absurd results. The federal government, as lessor, was certainly entitled to its proportionate share of the fair market value of what turns out to be the actual make-up gas. But, the court reasoned that if the lessee-producer was forced to pay royalties when the take-or-pay payment is made, it would then have to pay additional royalty due on any increased fair market value at the time make-up gas is taken. Conversely, the court reasoned, if the price of gas drops, the purchaser could be due a refund and, if the producer had already paid royalties, it would be placed in the position of having to seek refunds from the royalty owners. The court observed that uncertainties would result in any case where royalties are payable on the fair market value of gas, and a take-or-pay payment is made but no gas is taken. With no production there is nothing to value.

The Fifth Circuit Court of Appeals held in Diamond Shamrock that take-or-pay payments are not payments for the sale of gas, but instead are payments for the pipeline purchaser's failure to purchase gas. The take-or-pay obligation ensures to the producer a continuous source of revenue to cover investment, operations, and maintenance which will continue to be incurred, regardless of whether the purchaser takes any gas. The take-or-pay payment is not intended to be a payment for gas and is not part of the price of gas until it is applied to actual make-up gas at the time of sale. Thus, the court held that no royalty is due on take-or-pay payments unless and until gas is actually produced and taken from the ground.

The view set forth in Diamond Shamrock has been upheld in several recent cases. In Killam Oil Co. v. Bruni, the San Antonio Division of the Texas Court of Appeals held that, absent production, no royalty is due on settlement proceeds resulting from a breach of a take-or-pay provision in a gas purchase contract. The court held that under a standard oil and gas lease, take-or-pay payments do not constitute a price paid for unproduced gas and do not have the effect of increasing

22. Id. at 1165.  
23. Id.  
24. Id.  
25. Id.  
26. Id. at 1166.  
27. Id.  
28. Id.  
29. Id. at 1167.  
30. Id.  
31. Id.  
32. Id. at 1168.  
33. Id.  
35. Id. at 267.
the price paid for gas that was previously taken. The court held that these take-or-pay payments are made when gas is not produced, and as such, bear no royalty. The Killam Oil court followed the definition of "production" set forth in Diamond Shamrock, i.e., that of actual production when the severance of minerals from the formation occurs.

This definition of production is also found in Wyoming v. Pennzoil Co. The Supreme Court of Wyoming held that royalty owners are not entitled, absent production, to royalty on take-or-pay payments received by the lessee in a lease that only provides for a royalty interest in the lessee's "production." The court held that "production" as used in a royalty clause of an oil and gas lease requires severance of minerals from the ground and that royalties are due "only upon physical extraction of the gas from the leased tract." The court recognized that the parties could have included a provision requiring royalty on the proceeds of take-or-pay payments. But absent such a provision, there is nothing in the lease to indicate that such royalty payments are required.

In Hurd Enterprises, Ltd. v. Bruni, a royalty owner brought an action against a lessee to recover royalties on proceeds of the lessee's settlement with a gas purchaser for the purchaser's breach of a take-or-pay provision in the lessee's gas contract. The lease provided that the royalty owner was to receive a one-eighth royalty "if and when oil and gas was produced." Shortly after the gas contract was signed, the gas market collapsed and the purchaser was buying only five percent of the contract amount and refused to pay for the gas not taken. The lessee negotiated a cash settlement and dismissed legal action against the gas purchaser. The trial court concluded as a matter of law that the gas royalty clause was applicable to the settlement payments and rendered judgment for the royalty owner.

The Texas Court of Appeals, however, upheld Killam Oil and decided that royalty owners are not entitled to royalties on the settlement proceeds arising from the take-

36. Id. at 268.
37. Id.
38. Id. at 267 (quoting Diamond Shamrock, 853 P.2d at 1165).
40. Id. at 981.
41. Id. at 979-80.
42. Id. at 981-82.
43. Id. at 982.
45. In the Hurd lease, the royalty clause was as follows:
   The royalties to be paid by the lessee are . . . (b) on gas, including casinghead gas and
   all gaseous substance, produced from said land and sold or used off the premises or in the
   manufacture of gasoline or other products therefrom, the market value at the mouth of the
   well of one-eighth of the gas so sold or used provided that on the wells the royalty shall
   be one-eighth of the amount realized from such sale.
46. Id. at 106.
or-pay provisions.\textsuperscript{47} The \textit{Hurd Enterprises} court followed the "law of the case" doctrine. Under this doctrine, questions of law decided on appeal to a court of last resort will govern the case throughout its subsequent stages.\textsuperscript{48} Therefore, following the precedent set in \textit{Killam Oil}, the \textit{Hurd Enterprises} court held that, absent a specific provision in a gas lease for royalties on lessee's take-or-pay settlements, a gas royalty owner is not entitled to royalties on the lessee's proceeds from the settlement of a dispute arising from a gas purchaser's breach of a take-or-pay provision in a gas contract between a lessee and a purchaser.\textsuperscript{49} This rule applies even when the settlement terminates the purchaser's recoupment rights.\textsuperscript{50}

The minority view regarding take-or-pay settlements is found in \textit{Frey v. Amoco Production Co.}\textsuperscript{51} In \textit{Frey}, Frederick J. Frey and other owners of gas royalty interests under a mineral lease commenced suit against Amoco Production Company (Amoco), their lessee, to recover a royalty share of the proceeds received by Amoco in settlement of take-or-pay litigation. The applicable oil and gas lease provided for a "royalty on gas sold by the Lessee [of] one-fifth (1/5) of the amount realized at the well from such sales."\textsuperscript{52} The district court judge granted partial summary judgment after trial in favor of Amoco, following the reasoning of \textit{Diamond Shamrock}. The district court determined that the sale of gas cannot occur absent physical production and severance of the gas. Thus, the district court followed the majority view that take-or-pay payments do not constitute part of the sale price of natural gas and the lessee is not required to pay royalties on take-or-pay proceeds.\textsuperscript{53}

Frey appealed to the United States Court of Appeals for the Fifth Circuit. The Court of Appeals decided that take-or-pay payments are a part of the "amount realized" from the sale of gas under the lease, and thus such payments, received by the lessee in settlement of the take-or-pay dispute with its pipeline purchaser for gas not taken, are subject to the lessor's royalty.\textsuperscript{54} On Petition for Rehearing, the Court of Appeals withdrew a portion of its opinion and certified the question regarding Frey's entitlement to a royalty interest on the proceeds of the take-or-pay settlement to the Louisiana Supreme Court. This issue was one of first impression in the state of Louisiana.

The \textit{Frey} court, like the Oklahoma Court of Appeals in \textit{Roye Realty}, examined the basic purpose of an oil and gas lease. The court stated that it was cognizant that the terms of a mineral lease are not intended to accommodate every eventuality.\textsuperscript{55}

\begin{itemize}
  \item \textsuperscript{47} Id. at 105 (citing \textit{Killam Oil Co. v. Bruni}, 806 S.W.2d 264, 268 (Tex. Ct. App. 1991)).
  \item \textsuperscript{48} Id. at 106 n.7.
  \item \textsuperscript{49} Id.
  \item \textsuperscript{50} Id. at 106 n.8.
  \item \textsuperscript{51} 603 So. 2d 166, 168 n.3 (La. 1992).
  \item \textsuperscript{52} Id. at 169 n.3. This royalty provision differs significantly from those in Diamond Shamrock Exploration Co. v. Hodel, 853 F.2d 1159 (5th Cir. 1988), \textit{Hurd Enters. Ltd. v. Bruni}, 828 S.W.2d 101 (Tex. Ct. App. 1992), and \textit{Killam Oil Co. v. Bruni}, 806 S.W.2d 264 (Tex. Ct. App. 1991), each of which referred to "production."
  \item \textsuperscript{54} \textit{Frey v. Amoco Prod. Co.}, 943 F.2d 578, 580-84 (5th Cir. 1991).
  \item \textsuperscript{55} \textit{Frey}, 603 So. 2d at 173.
\end{itemize}
The court reasoned that the parties likely did not contemplate that the producers would receive take-or-pay payments in settlement of gas contract litigation. Thus, the court looked

not at the parties' intent to provide expressly for take-or-pay payments, but rather at the parties' general intent in entering an oil and gas lease, viz., the lessor supplies the land and the lessee the capital and expertise necessary to develop the land for the mutual benefit of both parties.\(^56\)

The *Frey* court stated that an ambiguity in a royalty provision could not be resolved without consideration of the practical and economic realities of the oil and gas industry at the time the leases were negotiated, including the obligations of the lessee to market the gas at the best possible price at the time the leases were made.\(^57\) In light of this rule, the court concluded that a royalty clause in an oil and gas lease is rendered meaningless when the lessee receives a higher percentage of the gross revenues generated by the leased property than contemplated by the lease.\(^58\) An economic benefit accruing from the leased land which is not expressly excluded by the lease and is generated solely by virtue of that lease is to be shared between the lessor and lessee in the fractional division contemplated by the lease.\(^59\)

The court in *Frey* discussed the implied duty to market. It held that a mineral lessee is not under a fiduciary obligation to his lessor, but is bound to perform the contract in good faith and to develop and operate the property leased as "a reasonably prudent operator" for the mutual benefit of himself and his lessor.\(^60\) The court recognized that a lessee who failed to execute a take-or-pay clause in long-term gas contract with a pipeline purchaser would likely be deemed to have acted imprudently.\(^61\) Further, a producer who fails to renegotiate a long-term gas contract in the face of the pipeline's financial inability to perform fully under the contract, given the decline in demand and the rise in producer-pipeline litigation, would also likely be deemed to have acted imprudently.\(^62\) Because the duty to market is a continuing one, the court determined that Amoco should not be able to enjoy the benefits of the settlement while refusing to share the benefits with *Frey*.\(^63\) Otherwise, "lessees would have an incentive to compromise volume prices under their contracts or settlements with pipelines in exchange for favorable take-or-pay terms."\(^64\)

The court concluded in *Frey* that the take-or-pay payments made to Amoco in settlement of the take-or-pay litigation formed part of the "amount realized" by Amoco from the sale of gas and are subject to the lessor's royalty clause in favor

\(^{56}\) *Id.*
\(^{57}\) *Id.* (quoting Henry v. Ballard & Cordell Corp., 418 So. 2d 1334, 1337-38 (La. 1982)).
\(^{58}\) *Id.* at 174.
\(^{59}\) *Id.*
\(^{60}\) *Id.*
\(^{61}\) *Id.* at 176.
\(^{62}\) *Id.*
\(^{63}\) *Id.* at 181.
\(^{64}\) *Id.* at 182 (quoting Frey v. Amoco Production Co., 943 F.2d 578, 585 (5th Cir. 1991)).
of Frey. The "amount realized" by Amoco was interpreted to include both the total price paid by the pipeline-purchaser for the natural gas delivered, and the "economic benefits" derived from the lease. The court held that the take-or-pay payments are a part of the price paid to Amoco by the pipeline-purchaser for the gas actually delivered under the gas contract. The court held that the take-or-pay proceeds constitute economic benefits which are derivative of Amoco's right to develop and explore the leased property.

The Frey court held that the price of gas taken under the contract includes not only the contract price paid per unit of gas delivered, but also the sums paid in the form of take-or-pay payments made in settlement of the take-or-pay litigation. This is due to the fact that the producer is willing to negotiate a lower price in exchange for the guarantee the pipeline will either take or pay for a specific minimum quantity of natural gas, effectively lowering the price the producer charges the pipeline per unit of gas. Consequently, the price of gas and the royalty owed thereon would be higher absent the take-or-pay provision. "Failure to characterize these payments as part of the total price paid for gas sold under the contract is to disregard the obvious economic considerations underlying the take-or-pay clause." Also, the court reasoned that retention by Amoco of the entire take-or-pay payment would permit Amoco to receive a part of the gross revenues from the property greater than the fractional division contemplated by the lease.

The Louisiana Supreme Court recognized in Frey that contrary results have been reached in other federal and state courts. The court attempted to reconcile this by stressing that the mineral law of Louisiana evolved not from common law, but from the Louisiana Civil Code, and that this was not the first time the court declined to follow a majority view. Therefore, it can be argued that Frey is only influential in the State of Louisiana and should not be given much weight by the Oklahoma courts.

The Louisiana Supreme Court also distinguished Diamond Shamrock by noting that in that case the federal court applied federal law to a federal offshore lease expressing the lessee's royalty obligation as a fraction of the "amount or value of production saved, removed, or sold." The royalty clause involved in Frey did not involve a federal lease and provided royalty on "gas sold by the Lessee of 1/5 of the amount realized." Significantly, there was no express referral to "production."

65. Id. at 178.
66. Id.
67. Id.
68. Id. at 180.
69. Id.
70. Id.
71. Id.
72. Id. at 181.
73. Id. at 182. The Supreme Court of Louisiana recognized that it declined to follow the majority view set forth in Henry v. Ballard & Cordell Corp., 418 So. 2d 1334 (La. 1982).
74. Frey, 603 So. 2d at 178 (quoting Diamond Shamrock, 853 F.2d at 1163).
75. Id. at 169.
IV. Contract Buy-Outs and Buy-Downs

In Gerald J. W. Bos & Co. v. Harkins & Co., the Fifth Circuit Court of Appeals held that payments under a settlement in cancellation of a take-or-pay gas contract, a contract buy-out, are not subject to royalties. In Harkins the owner of a royalty interest in a force-pooled gas unit brought suit against the operator of the unit and the gas pipeline company, after cancellation of the take-or-pay contract between the operator and the pipeline company. The owner alleged that the operator breached its fiduciary duty to royalty owners by canceling the contract. The Fifth Circuit Court held that under Mississippi law, an owner of a royalty interest in a force-pooled gas unit was a mere incidental beneficiary that had no rights under a long-term, take-or-pay contract. Thus, the court held that no royalties were due on amounts received as a result of the contract buy-out.

V. Roye Realty & Developing, Inc. v. Watson

Roye Realty & Developing, Inc. v. Watson involved an action by R.D. and Dorothy Watson, mineral lessors, who claimed that they were entitled to a share in a settlement between their lessee-producer, Roye Realty and Development Co. (Roye), and Arkansas Louisiana Gas Company (Arkla), a gas purchaser. The Watsons contended that the "take-or-pay" provision in the gas purchase contract entitled them to a share in the settlement based on the royalty provisions in the leases held by Roye and the purchase contract between Roye and Arkla. Although they were not parties to the gas purchase contract or settlement in question, the Watsons contended that they were third-party beneficiaries of both. Roye and Arkla admitted that the Watsons were entitled to be paid a royalty on gas produced and sold. Roye and Arkla denied, however, that they had any liability to the Watsons for Arkla's failure to purchase gas and the consequent take-or-pay liability. The trial court granted summary judgment in favor of Roye and Arkla and the Watsons appealed.

The Oklahoma Court of Appeals stated that oil and gas lessees have an implied duty to market oil and gas that is within the "production capability" of the lessee. The court determined that this duty to market is intended to insure that lessors, such

76. 883 F.2d 379 (5th Cir. 1989).
77. Id. at 382.
78. Forced pooling, or compulsory pooling, operates under the idea that excessive drilling is wasteful, but that all owners are entitled to a fair chance to recover hydrocarbons. Rather than deny owners the right to drill, compulsory pooling requires owners within a designated area to pool their interests together to achieve benefits from a single well. See generally 6 Howard R. Williams & Charles J. Meyers, Oil and Gas Law § 905, at 13 (1987).
79. Harkins, 883 F.2d at 382.
80. Id.
82. Id. slip op. at 2.
as the Watsons, realize the benefit of their royalty.83 The court reasoned that the take-or-pay clause allows a lessee to receive value for the exercise of its rights over oil and gas within its production capability and to "market" the oil and gas without severance or sale.84 Thus, the court stated that the take-or-pay arrangement allows the purchaser to refuse oil and gas that would otherwise generate a royalty by being severed and sold.85

The Oklahoma Court of Appeals held that by either receiving payment for the severance and taking of oil and gas by a purchaser or by granting a right to refuse to take oil and gas that the purchaser was obliged to take, a lessee markets the oil and gas.86 The court held that the lessee thus incurs liability to pay the lessor a royalty on the revenue generated from the marketing.87 The Oklahoma Court of Appeals reversed the trial court's granting of a summary judgment in favor of Roye and Arkla as premature.88 The Watsons were held to be entitled to recognition of their royalty interest in the payments received in connection with the marketing of gas.89 This broad holding implies that royalties must be paid not only when oil and gas is actually produced, but any time money changes hands between a producer and a gas purchaser, whether it be pursuant to a take-or-pay payment, a settlement made in compromise thereof, or a contract buy-out.

The Oklahoma Court of Appeals cited no authority in support of its sweeping opinion in Roye Realty. Therefore, the possible arguments that could be set forth by producers and royalty interest owners and the authority that could be cited in support for these arguments must be examined. This is important because the Oklahoma Court of Appeals opinion offers little guidance in cases that do not exactly mirror the facts of Roye Realty.

VI. Producer Arguments Against a Royalty Obligation

Producers have a number of arguments supporting their position that royalty owners should be denied a royalty interest in take-or-pay payments and settlements. These include (1) arguments focusing on the actual language in the lease; (2) the fact that express language controls over implied covenants; and (3) the argument that the payment does not involve the sale of gas. In addition there are practical arguments in the producer's favor.

A. The Producer's Emphasis on the Definition of Royalty Interest and Production

A royalty interest is defined as "the landowner's share of production, free of expenses of production."90 Producers may argue that the term "royalty" only

83. Id.
84. Id.
85. Id.
86. Id.
87. Id.
88. Id.
89. Id.
90. 8 Williams & Meyers, supra note 78, § 856.
includes "a right to share in oil and gas if and when produced." Therefore, if a royalty is related to the concept of production, then the controlling term in this issue is "production." The lessors in Roye Realty entered into standard oil and gas leases which limited the producer's obligation to pay royalties for gas produced and sold from the leased premises.\footnote{Actually there were two oil and gas leases involved in this case. The exact royalty clauses were not quoted in the Roye Realty decision which indicates that the court of appeals apparently gives no weight to the parties' agreement. A copy of the leases have been obtained from counsel of record, however, and they provided for royalties on gas "produced, saved and sold," and "produced and sold," respectively. These are similar to the example of a typical gas royalty provision found in 3 WILLIAMS & MEYERS, supra note 78, § 643.2, at 525-26 (1986).} In order to be entitled to a royalty, the lessor must show that payments received by the lessee are for gas produced and sold.\footnote{Diamond Shamrock, 853 F.2d at 1167-68; see also Kaiser Francis Oil Co. v. Producer's Gas Co., 870 F.2d 563, 570 (10th Cir. 1989).} In such a royalty clause, as a precondition of sale, the oil and gas must be physically removed from the ground.\footnote{See Golsen v. ONG Western, Inc., 756 P.2d 1209, 1216-18 (Okla. 1988); 52 OKLA. STAT. ANN. § 570.2 (West 1994). This definition of production is also utilized by the Texas courts in Monsanto Co. v. Tyrrell, 537 S.W.2d 135, 137 (Tex. Civ. App. 1976). In Monsanto it was concluded that under Texas law the term "production" was unambiguous and required the "actual physical extraction of the mineral from the soil." Id.} In fact, the oil and gas industry and most courts define production in terms of physical severance of the minerals from the ground. When a pipeline makes take-or-pay payments, unless recoupment gas is physically taken, there is no production and thus no royalty owed. Obviously it would be easier to seek royalty payments under a royalty clause in which the terms "produced" or "production" are not used.\footnote{Kramer, supra note 9, at 5.24-25.} 

B. Producer's Argument That Express Language Controls

Another compelling argument available to the producer is that a royalty owner is free to require that the lease provide specifically that royalties are to be paid on take-or-pay payments for gas not taken. Absent an express provision in the lease to this effect, however, royalties should not be due until after the production of the gas.\footnote{Id. at 5.21. Alternatively, the royalty clause could simply provide for the payment of royalty on any payment received by the lessee, whether or not it involved the actual production or sale of gas.} A fundamental precept of contract law in Oklahoma is that the law will not make a better contract than the parties themselves entered into. The judicial function of the court is to enforce the contract as it is written.\footnote{Mandell v. Hamman Oil & Ref. Co., 822 S.W.2d 153 (Tex. Ct. App. 1991), rek'd denied, No: 01-90-00950-CV (Tex. Dec. 19, 1991), error denied, No. 01-90-00950-CV (Tex. July 1, 1992).} Under this argument, the Oklahoma Court of Appeals has superimposed its own royalty obligation that is in direct conflict with the clear, unambiguous language of the lease, and has essentially rewritten the lease.

Producers may also argue that the Oklahoma Court of Appeals in Roye Realty ignored the express language limiting the royalty obligation to payments for gas produced and sold and instead created an expanded version of the implied duty to
market gas. Under this reasoning, the court created a new implied obligation to share in payments not attributable to gas production or sales. But a written contract should control over conflicting implied terms. Also, it has been established in Oklahoma that parties may expressly limit the effect of any implied obligation.

C. Producer's Argument That a Take-or-Pay Payment Is Not a Payment for Gas

Yet another argument available to the producer is that a take-or-pay payment is not the payment for gas, but is a commercial benefit for the producer to create a minimum cash flow for the ongoing capital and operational costs that are incurred, even when the purchaser fails to take any gas. The purpose of the take-or-pay clause is to shield the producer from adverse market fluctuations and encourage investment for exploration and development of oil and gas reserves. Royalties are arguably not owed on such payments because they involve a sale of assets other than natural gas. Under this approach, to hold otherwise is to deny the lessee the benefit of his bargain and entirely rewrite the oil and gas lease.

Producers may also argue that take-or-pay clauses are simply intended to apportion the risks of natural gas production and sales between the buyer and the seller. The producer bears the risk of production, and take-or-pay payments are intended to compensate the producer for the risks associated therewith. To hold otherwise would permit the lessor to be compensated for risks he never intended to assume — he executed the lease to reap the benefits of royalties without having to shoulder the risks of exploration, production and development.

D. Practical Arguments Against Royalty Obligation

Purchasers who make take-or-pay payments may have the right to demand make-up gas and the royalty paid on the make-up gas is usually determined by the market value of the gas at the time the make-up gas is taken. If the market value of the

100. Eugene O. Klintz, A TREATISE ON THE LAW OF OIL AND GAS § 60.2 (1991) ("The parties may insert express provisions in the oil and gas lease which are inconsistent with and supersede any implied obligation . . . .").
101. A take-or-pay payment is not for purchase of gas but is intended as compensation to the producer for dedicating gas and standing ready to deliver. Golson v. ONG Western, Inc., 756 P.2d 1209 (Okla. 1988).
102. White, supra note 2, at 668.
103. Hurd Enterprises, Ltd. v. Bruni, 828 S.W.2d 101, 110 n.2 (Tex. Ct. App. 1992) ("Because take-or-pay provisions are intended to apportion the risks of natural gas production, it follows that the benefits from those provisions should not be shared by royalty owners. Royalty owners are allowed to reap the benefits through royalty payments without having to shoulder the associated risks of exploration, production, and development.") (quoting Walter Cardwell, Do Producers Owe Royalty on Take-or-Pay Settlements? at S-7 (State Bar of Texas Advanced Oil, Gas, and Mineral Law Course 1991))
104. Diamond Shamrock, 853 F.2d at 1167.
105. Id. at 1166.
gas is higher at the time the purchaser elects to take make-up gas than when the take-or-pay payment was made, a royalty based on the increased price is due from the producer. The producer must make a second royalty payment on the difference between the market value at the time of the make-up gas and the take-or-pay payment. Thus, the producer will have to make two separate royalty payments to satisfy its royalty obligation. Similarly, if the market value falls from the time the take-or-pay payment is made and the time make-up gas is taken, the producer might have to give the purchaser a refund on part of his take-or-pay payment.106

This gives rise to a troubling problem with requiring royalties on take-or-pay payments when no production is involved. How does one establish the value of the royalties owed? The Oklahoma Court of Appeals in Roye Realty suggested that royalties should be owed in any instance of payment by a gas purchaser to a producer, whether the payment is for the severance and taking of oil and gas by the purchaser, or for granting the purchaser the right not to have to take the oil and gas.107 However, in many take-or-pay disputes, the contract is "bought out" or renegotiated, or "bought down."108 The decision by the Oklahoma Court of Appeals failed to even consider the underlying settlement agreement. The decision in Roye Realty also failed to distinguish among the various types of settlements, such as contract buy-downs, contract buy-outs, payments for accrued take-or-pay, present payments with future make-up rights, and any combination of these types.109 In fact, the Roye Realty opinion was rendered without the benefit of knowing the actual type of settlement entered into by the parties. Producers therefore could argue that there must be a careful analysis of each type of settlement in light of Oklahoma law and the lease language at issue before there can be a determination of whether royalties are due.

VII. Royalty Owner Arguments

Royalty interest owners will, of course, agree with the Oklahoma Court of Appeals' decision in Roye Realty, since it held that the lessor has a royalty interest in any and all payments received in connection with the marketing of gas from the leased premises. Although the opinion in Roye Realty sets forth no basis for the court's holding, there are certainly available arguments. Producers may owe royalties to royalty owners upon the receipt of take-or-pay payments under several theories. The most convincing arguments in favor of the royalty owner center around (1) the implied covenant to market and the reasonably prudent operator standard; (2) the argument that take-or-pay payments are simply a marketing substitute; (3) the theory of unjust enrichment and constructive trust; (4) the theory

106. Id.; White, supra note 2, at 670. If a take-or-pay dispute involves several wells, each having different royalty owners, any method of allocating the settlement benefits will no doubt be questioned as arbitrary by at least some of the owners.
108. White, supra note 2, at 670.
that the lessor acts as a third-party beneficiary; and (5) the theory that an alternate interpretation of the term "production" should be followed in Oklahoma.

A. Royalty Owner's Emphasis on the Implied Duty to Market

An argument available to royalty owners is that the relationship between a lessor and a lessee demands that the lessor share in the benefits derived from the exploration and the development of minerals since the lessor contemplated such a benefit when he granted the rights conferred upon the lessee in the oil and gas lease. Under this theory, the issue of whether the lessor should share in take-or-pay payments or settlements was arguably not contemplated by the parties at the time they entered into the lease agreement. Thus, the basic intent of the parties should be examined rather than looking for an express intent regarding take-or-pay payment. If this is the case, royalty owners may argue that the Oklahoma Court of Appeals did not rewrite the clause in Roye Realty, but rather the court simply gave recognition to the covenants implied in law to promote the special relationship between the parties and preclude any disproportionate benefit to the lessee at the expense of the lessor.

Consistent with this is the argument that the implied duty to market mandates that the lessor share in all payments derived from the marketing of gas from the leased premises. The covenant is implied in order to carry out the intentions of the parties and to insure a course of fair dealing between the parties. The implied duty to market goes to the very purpose of the oil and gas lease.

In McVicker v. Horn Robinson & Nathan, the Oklahoma Supreme Court held that "the fact that the lessee has at one time invested money in it [the lease] certainly would not warrant his holding it indefinitely without development, marketing, or payment of rentals for its future speculative value." The McVicker court held that if a lessee cannot market the oil and gas, there is no benefit to the lessor and there is no purpose to be served under the terms of the lease. The duty to market contemplates the mutual benefit of the lessor and lessee.

111. The implied covenant is a fiction used by the law in order to achieve a desirable result. An implied covenant's terms have not been agreed upon by the parties consciously, and it is possible the parties never even directed their attention to the matter. "The obligations are imposed, not by agreement of the parties, but by operation of law." See Maurice H. Merrill, The Law Relating to Covenants Implied in Oil and Gas Leases 27-28 (2nd ed. 1940); 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, 195 (1976).
112. The implied duty to market requires the lessee, once production is established, to diligently market that production. Strange v. Hicks, 188 P. 347 (Okla. 1920).
114. Id. at 416.
115. Id. It has been stated that in an oil and gas lease, "[t]he lessor provides the land, the lessee provides the capital and expertise, and both share, in some proportion, the product or value derived therefrom." Fredrick R. Parker, Jr., The Lessor's Royalty and Take-or-Pay Payments and Settlements Under Gas Sales Contracts in Louisiana, 47 LA. L. REV. 589, 596 (1987).
The lessee has the implied obligation to operate the lease as a "reasonably prudent operator," meaning that he must have in his mind not only his interests, but also the interests of his lessee to promote mutual advantage and profit.\textsuperscript{117} The implied covenant to market requires the lessee to use due diligence and obtain the best price reasonably available.\textsuperscript{118} Therefore, royalty owners can argue that where the sale price would have been higher without a take-or-pay provision in the lease, a producer may not enjoy any benefit associated with his inclusion of such a provision in his gas sale contract, but refuse to share these benefits with the lessor.\textsuperscript{119} When the lessors no longer have a representative dealing at arms-length with a purchasing pipeline, courts will intervene to enforce the implied covenant obligating the lessee to market.\textsuperscript{120}

B. Take-or-Pay as a Marketing Substitute

Royalty owners will no doubt agree with the holding in \textit{Roye Realty} that the take-or-pay clause demonstrates that a lessee can receive value for the exercise of its rights over the oil and gas without actual severance.\textsuperscript{121} Since the lessee has a duty to market gas,\textsuperscript{122} it may be argued that the take-or-pay arrangement is simply a marketing substitute or alternative to an actual severance and sale.\textsuperscript{123} The theory is that, by receiving payment, whether it be for the severance and taking of gas by a purchaser, or for granting a right to refuse to take the gas, the lessee "markets" the gas.\textsuperscript{124} If this is true, the royalty owner may argue that the lessee also incurs liability to pay the lessor a royalty on the revenue generated from this marketing.\textsuperscript{125}

In a take-or-pay arrangement, a purchaser may make a take-or-pay payment and refuse to take gas that would otherwise be subject to severance and sale. Often, by putting off the sale of the gas, the lessor runs the risk that the demand for the gas will fall and that pipelines will be unable to meet their obligations.\textsuperscript{126} Further,

\textsuperscript{117} KUNTZ, \textit{supra} note 100, § 60.3. The standard of performance uniformly required of the lessee to comply with his implied duty to market oil or gas is the prudent operator standard under which the lessee is required to exercise reasonable diligence or the degree of diligence that would be exercised by an ordinary prudent operator having regard for the interests of both the lessor and lessee.

\textsuperscript{118} MERRILL, \textit{supra} note 111, at 212-13 ("[D]iligence in marketing should include the duty to realize the highest price obtainable by the exercise of reasonable effort. If proper effort has been made or if the record clearly demonstrates that effort would be ineffectual, the covenant is satisfied.").


\textsuperscript{120} \textit{See} Klein v. Jones, 980 F.2d 521, 532 (8th Cir. 1992).


\textsuperscript{122} \textit{Id.}, slip op. at 3; Frey, 603 So. 2d at 175; KUNTZ, \textit{supra} note 100, § 60.1.

\textsuperscript{123} Roye Realty, No. 76,848, slip op. at 2.

\textsuperscript{124} \textit{Id.}

\textsuperscript{125} \textit{Id.}

\textsuperscript{126} "The terms of the lease contemplate action and diligence on the part of the lessee." Martin, \textit{supra} note 111, at 200. "Encompassed within the lessee's duty to market diligently is the obligation to obtain the best price reasonably possible." Frey v. Amoco Prod. Co., 603 So. 2d 166, 175 (La. 1992). However, the Oklahoma Court of Appeals in \textit{Roye Realty} indicated that a lessee must market whenever the ability to market exists: "In Oklahoma, oil and gas lessees have an implied duty to market the oil and gas that is within the 'production' capability of the lessee." Roye Realty, No. 76,848, slip op. at 3.
although the gas is not sold, by leaving it in the ground, the gas becomes vulnerable to drainage and reduction in reservoir pressure and could be worth less than if the gas was sold in the present market.  Royalty owners may also argue that, during periods when no gas is taken and prices are rising, the lessor's inability to enjoy the higher prices must be compensated by the sharing of damages or other benefits received by the lessee from the purchaser in the take-or-pay clause.

C. Royalties Owed Under a Constructive Trust Theory in Order to Avoid Unjust Enrichment

Although the issue of whether a lessor should share in take-or-pay payments or settlements was not contemplated by the parties at the time they entered into the lease agreement, an argument can be made that the lessor should be paid a royalty if the failure to do so would result in the lessee being unjustly enriched. A party may recover on a theory of unjust enrichment only if there is an enrichment of another coupled with a resulting injustice.

The proper basis for imposing a constructive trust is to prevent unjust enrichment. Arguably, the producer holds the royalty owner's share of any take-or-pay benefits under a constructive trust for the royalty owner. However, the performance required of a lessee under a lease is not measured by a fiduciary standard, and the lease by itself does not cause the lessee to become a trustee for the lessor for any special trust or confidence placed in the lessee.

D. Royalty Owner's Argument that the Lessor Is a Third-Party Beneficiary

A royalty owner may argue that his relationship with the lessee is governed by more than just the lease, and that the gas sales agreement is also important. In analyzing whether a gas sale agreement constitutes a third-party beneficiary contract in favor of the lessor, the lessee may argue that one must consider that "the lessee entered into the gas contract at least, in part, to discharge its lease obligations to the

(emphasis added).

127. If operations do not proceed with reasonable diligence, and drainage occurs, the lessor loses both royalties and his contingent interest in the gas drained. Martin, supra note 111, at 200. Gas is treated as being marketed for purposes of other clauses in a lease, such as those which require minimum payments to the lessor when no sales are occurring, when the lessee enters into a take-or-pay contract and no gas is being taken. KUNTZ, supra note 100, § 60.3. If this is the case, the lessee may argue that he should be entitled to all of the benefits of the take-or-pay clause.

128. "The cooperative venture between lessor and lessee [requires] the lessee to market the gas to secure the maximum benefit possible for both parties." David E. Pierce, Developments in Nonregulatory Oil and Gas Law: Relationships, Contracts, Torts and the Basics, 41 INST. ON OIL & GAS L. & TAX'N § 1.07[1], at 1-72 (1990) (citing Henry v. Ballard & Cordell Corp., 418 So. 2d 1334, 1337 (La. 1982)). "When an outside business motivation for acting, in what would otherwise be a foolish manner, can be identified, the lessee is probably pursuing its interests at the expense of the royalty owner." Pierce, supra, at 1-79; KUNTZ, supra note 100, § 60.3, at 137-38.


132. KUNTZ, supra note 100, § 59.3.
lessor. . . [indicating that] the gas contract was entered into for the benefit of the lessor as well as the lessee."

Although it never discusses the subject further, the Oklahoma Court of Appeals in Roye Reality noted, prior to ruling in their favor, that the royalty owners "contend that they are third-party beneficiaries" of both the gas contract and the lessee's settlement agreement with the gas purchaser. Similarly, it is noted that, while the Louisiana Supreme Court in Frey determined that "[a] mineral lessee is not under a fiduciary obligation to his lessor," he nevertheless "is bound to perform the contract in good faith and . . . as a reasonably prudent operator for the mutual benefit of himself and his lessor." The royalty owners argument is, therefore, not without basis.

E. Royalty Owner's Argument for an Alternate View of Production

Royalty owners may stress that there are different interpretations of "production" as applied to the different clauses in an oil and gas lease. The definition of the term "production" does not always require the physical act of marketing the products. Instead, in many jurisdictions the discovery of gas capable of being produced in paying quantities is sufficient for the purposes of a habendum clause, governing the term of the lease. In Oklahoma, "production" under the habendum clause may mean that the gas has been located underground and is capable of being produced, but has not necessarily been brought to the surface for sale or marketing. Therefore, under at least one provision in the lease, the term "production" does not require the physical removal of the gas from the ground.

Royalty owners, therefore, may assert an argument that in states that follow such a definition applicable to the habendum clause, production under other provisions in the lease should also have a meaning that does not require the physical severance of gas. But, this argument would not be applicable in states such as Texas, which treats the term "production" in a habendum clause as requiring both discovery and actual marketing. Also, this argument does not carry much weight in the

133. Pierce, supra note 128, at 1-75.
136. It must be noted that, although there may be arguments present to support an oil and gas lessor receiving third party beneficiary rights under a gas sales agreement, most courts do not advocate a fiduciary, "highest good faith," or "utmost good faith" standard in any oil and gas implied covenant case. "Unless the lease document itself creates in law a trust, or unless a relationship of trust and confidence necessarily results from the lessor-lessee relationship, the standard of conduct of the lessee cannot be appropriately categorized as fiduciary." Hurd Enterprises, Ltd. v. Bruni, 828 S.W.2d 101, 108 (Tex. Ct. App. 1992).
137. The purpose of a habendum clause is to establish the duration of the interest granted, which normally involves actual production to extend a lease past its primary term. See 2 Kuntz, supra note 100, § 26.1, at 318; 4 id. § 46.4(e), at 24.
140. Kramer, supra note 9, at 5.26.
141. Id.
context of the Royle Realty facts, since a basic landowner's royalty clause, and not an habendum clause, is at issue. Therefore, the producer's strongest argument is still that the standard industry definition of production requires actual physical severance of the oil and gas from the ground. 142

F. Practical Arguments in Favor of Royalties Being Owed

Royalty owners have an argument that Oklahoma courts need not set out separate and distinct rules depending on the type of settlement such as a contract buy-down, contract buy-out, a payment for accrued take-or-pay, or present payments with future make-up rights. Instead, an argument exists that the type of settlement is irrelevant since the intent of the parties was that the royalty owner would share in the benefits derived from the development of the leased premises. Under this theory, if a distinction is made between certain types of settlements where producers are allowed to retain all of one type of settlement payment, but share with royalty owners in another type of settlement payment, producers would have an artificial incentive to maximize the lump-sum settlement and minimize the future prices. 143

Another argument that can be asserted is that, if the gas purchase contract entitles the producer to retain take-or-pay proceeds even though the pipeline never makes up the gas paid for, such proceeds have had the practical effect of increasing the price paid for gas actually produced, and the lessor should be entitled to a royalty on these proceeds once the make-up right has terminated. 144 Additionally, the royalty owner might not have an opportunity to claim part of the settlement if the settlement terminates the pipeline's right to make-up gas applicable to the period covered by the settlement. Once the gas is produced, a new sales contract, which establishes a price significantly lower than the price provided for by the take-or-pay clause in dispute, may be entered into. 145

The problem is that these arguments appear to rely on fictions which exist only to justify a desired result. The intent of the parties is best described in the oil and gas lease, and current payments have nothing to do with the price of previously produced gas. Further, there is no guarantee that prices will always be lower under new gas sale agreements.

VIII. The Correct Approach

Although numerous arguments exist both for and against mandatory payments, the correct approach to the problem of whether, in the absence of production, royalties are due on take-or-pay payments is the majority view set out in Diamond Shamrock, Killam Oil, and Harkins. 146 The logic of these opinions centers around

142. This argument was persuasive in Diamond Shamrock Exploration Co. v. Hodel, 853 F.2d 1159 (5th Cir. 1988), and Killam Oil Co. v. Bluni, 806 S.W.2d 264, 267 (Tex. Ct. App. 1992).
145. Id.
146. Diamond Shamrock, 853 F.2d at 1159; Killam Oil Co., 806 S.W.2d at 267; Gerald J.W. Bos
the idea that royalties are due only when gas is actually produced and sold, and not before. In most instances, the parties in an oil and gas lease have agreed that royalties are to be paid on the sale proceeds of production. In the majority of jurisdictions, the common industry definition of "production" requires the minerals to be physically severed from the ground. In the take-or-pay settlement situation, the payments do not involve the actual production of oil and gas, and thus royalties should not be incurred. A The Oklahoma Court of Appeals decision in Roye Realty is in direct conflict with Oklahoma Supreme Court decisions and industry standards defining "production" and "sale."

In Roye Realty, the royalty owner's strongest argument is that royalties are due under the implied duty to market. However, it must be remembered that the royalty clause in Roye Realty expressly stipulated that royalty was to be paid for gas "produced and sold" or used off the premises. B It is significant that the royalty clause involved in Frey, the primary support for the royalty owner's argument, did not contain the express requirement of "production." There is a strong argument that the use of Frey as support for royalties in Roye Realty is inadequate or inappropriate since the wording of the royalty clauses contained in the Frey and Roye Realty leases are so dissimilar. Express provisions in the lease should be given deference over implied covenants and the courts should not engage in rewriting provisions in a lease that were entered into at arm's length negotiation and in good faith by competent parties. The implied duty to market gas will be applicable when the lessee actually produces the gas, and at that time the lessor will be paid his royalty.

Also, the argument presented in Roye Realty that a take-or-pay arrangement is a marketing substitute is a fiction. A take-or-pay arrangement may be a substitute for the pipeline-purchaser's obligation to buy gas, but in reality this is not marketing at all. C No gas is sold when there is only a take-or-pay settlement. The royalty owners can argue that royalties should be incurred on payments made in settlement of take-or-pay litigation since the lessor runs the risk that demand will fall (and consequently the gas will be worth less) by putting off the sale of gas. However, the opposite could also be true — demand could rise and the lessor could receive the benefit of higher prices. For this reason, the Roye Realty rule is too broad. The courts must be able to examine the unique facts present in each case involving a take-or-pay arrangement in order to determine if royalties are owed.

The weakest arguments in favor of royalty owners are that royalties should be paid under unjust enrichment, constructive trust, or third-party beneficiary theories. Arguably, there is no unjust enrichment since take-or-pay payments are to comen-


\* 147. It is becoming well accepted that royalties are not payable upon the receipt of take-or-pay payments, but rather when the applicable make-up gas is taken. See White, supra note 2, at 663. Why, then, should royalties be payable upon a settlement which involves no production? Further, if royalties are owed, producers might be less motivated to settle.


\* 149. Treating a take-or-pay payment as production would affect other clauses in the lease. Would such a payment extend the term of a lease which otherwise would expire in the absence of production in paying quantities?
sate the producer-seller for being willing and able to provide a certain amount of gas and provide him with cash to cover continuing operation costs. Without these payments, the producer would be financially unable to explore for or continue production. The take-or-pay arrangement also benefits the pipeline-purchaser by giving it flexibility in the amount of gas taken and the ability to control gas reserves. In most instances, the producer and the purchaser probably do not consider the royalty owner to be a benefactor under their agreement. And, according to Eugene Kuntz, in his A Treatise on the Law of Oil and Gas, the lease by itself does not cause the lessee to become a trustee; if only the lease is considered, his performance is not measured by a fiduciary standard.\textsuperscript{150}

Still, the royalty owners may argue that the intent of the parties when entering a take-or-pay arrangement was that the royalty owner would share in all benefits derived by the lessee under the arrangement. The express provisions in the lease, however, show that the parties bargained for royalty only when there is production. Arguably, the courts should not infer that the intent of the parties is directly contrary to the express provisions in the lease. If the parties intended that royalties be paid on take-or-pay payments or payments in settlement of take-or-pay litigation, they could have expressly provided so in the royalty clause.

The most striking problem with the Oklahoma Court of Appeals opinion in \textit{Roye Realty} is that its simple approach to the problem establishes a new, overly broad policy applicable to all take-or-pay settlements, without consideration to any of the unique facts which exist under the various disputes involved, and without consideration of the underlying lease and settlement agreement. With the explosion of take-or-pay litigation which occurred in the 1980s that led to many types of settlements between producers and pipelines, the \textit{Roye Realty} decision will have a tremendous impact in Oklahoma. Other cases with these unique and complex questions of law will surely follow \textit{Roye Reality}. Therefore, it is necessary that the Oklahoma courts deal with the matter in an orderly fashion, and distinguish between the various types of take-or-pay disputes and settlements. Many take-or-pay disputes result in the renegotiation of a contract, or a contract buy-out rather than a cash settlement. The computation of royalties in these situations would be difficult, if not impossible. Yet the broad mandate of \textit{Roye Reality} fails to provide for a careful analysis of each type of settlement with consideration of the language in the lease. Instead, \textit{Roye Realty} provides that the receipt by the producer of any type of payment in lieu of take-or-pay litigation is an act of "marketing" the gas and a liability for royalties is incurred. This approach simply cannot be justified under every fact situation.

\textbf{IX. Conclusion}

The Oklahoma Supreme Court has the opportunity to enable the law pertaining to royalty obligations under take-or-pay settlements to be developed in an orderly fashion. The Oklahoma Court of Appeals decision in \textit{Roye Realty}\textsuperscript{151} was ill-

\textsuperscript{150} Kuntz, supra note 100, § 59.3.

conceived and lacked a basis in traditional oil and gas law. If left intact, future cases involving different royalty clauses and significant facts may not be fairly considered. Thus, the opinion would create more problems than it would solve. The Oklahoma Supreme Court should, at the very least, require that applicable facts in *Roye Realty* be developed. If the settlement in the case involved no production which can fairly be attributed to the settlement payment, the court should rule that no royalties are owed.

*Beverly M. Barrett*