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The Renaissance of *Law* in the *Law of* Oil and Gas: The Contract Dimension [reprint, first published 2004]

David E. Pierce

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THE RENAISSANCE OF *LAW* IN THE *LAW OF* OIL AND GAS: THE CONTRACT DIMENSION[*] [reprint, first published 2004]

DAVID E. PIERCE[**]

Table of Contents

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** Professor of Law, Washburn University School of Law.

I. Introduction

After twenty years of scholarly inquiry into the discipline we call "oil and gas" law, it appears many of the flaws associated with this "specialized" body of law relate to its "special" status. Jurisprudential flaws have developed as courts depart from basic contract, property, or tort law in pursuit of "oil and gas law" concepts. The phenomenon is not limited to oil and gas law but can occur in any "law of" setting. For example, consider the debate presently occurring over the extent to which contract law will govern the *law of* electronic commerce.[1] At least with electronic commerce a conscious debate is taking place over whether there is a need to avoid or change basic contract law principles to accommodate particular types of transactions.[2] It appears such a debate never took place with regard to many basic "oil and gas law" principles. This article is designed to trigger such a debate by analyzing recent judicial approaches to recognizing and applying "implied covenants" under the oil and gas lease. By comparing the experience and outcomes under the oil and gas rule with the outcome under a contract law analysis, it should be possible to evaluate whether a specialized "oil and gas" rule is necessary or advisable.

II. Judicial Reluctance to Apply Basic Legal Concepts

Once the law associated with an industry is able to anoint itself with "law of" status, courts become gun-shy at applying basic principles of contract, property, and tort law to the industry's problems. They proceed gingerly with their legal analysis, careful to pay homage to the special "law

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1. Judge Easterbrook, in *Hill v. Gateway 2000, Inc.*, 105 F.3d 1147 (7th Cir. 1997), *cert. denied*, 522 U.S. 808 (1997), takes an accommodating approach toward computer marketing practices, arguably at the expense of traditional contract principles. Judge Easterbrook's "law of" approach can be contrasted with Judge Vratil's approach in *Klocek v. Gateway, Inc.*, 104 F. Supp. 2d 1332 (D. Kan. 2000), where she refuses to disregard basic contract doctrine to accommodate Gateway's mass marketing techniques.

2. Witness the American Law Institute's rejection of the final draft of the proposed Article 2B to the *Uniform Commercial Code* and the National Conference of Commissioners on Uniform State Laws' adoption of the *Uniform Computer Information Transfer Act. See generally* Symposium, *Perspectives on the Uniform Laws Revision Process*, 52 HASTINGS L.J. 603 (2001).

of" principles, lest they be chided for their lack of insight into the unique, often complex, analysis that has been applied by others. This is particularly the case with oil and gas law which has been blessed with three highly influential multi-volume treatises,[3] two "oil and gas law" casebooks,[4] many single-topic treatises,[5] several regional oil and gas works,[6] and three major organizations dedicated to assisting the rest of the world in understanding what we are talking about.[7] Courts often preface their analysis of an oil and gas problem with an observation acknowledging, sometimes grudgingly, sometimes apologetically, that it is governed by "oil and gas law." It is as though the court is about to leave the world of law and enter into the nether world of quasi-law. A recent example from Kansas is found in Justice Six's

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3. EUGENE KUNTZ, A TREATISE ON THE LAW OF OIL AND GAS (1987). First published in 1904, this is a seven-volume treatise currently maintained by Professors Owen L. Anderson, Ernest E. Smith, David E. Pierce, and John S. Lowe. HOWARD R. WILLIAMS & CHARLES J. MEYERS, OIL & GAS LAW (2001). This eight-volume treatise, commonly known as "Williams & Meyers on Oil & Gas Law," is now updated and revised by Professors Patrick H. Martin and Bruce M. Kramer; volume 8 of the treatise is also published separately as WILLIAMS & MEYERS MANUAL OF OIL AND GAS TERMS (10th ed. 1997). W.L. SUMMERS, THE LAW OF OIL AND GAS (1954). First published in 1927, this eight volume treatise is now maintained by Professor John S. Lowe. Three significant single-volume oil and gas works include: RICHARD W. HEMINGWAY, THE LAW OF OIL AND GAS (3d ed. 1991); JOHN S. LOWE, OIL AND GAS LAW IN A NUTSHELL (4th ed. 2002); ROBERT E. SULLIVAN, HANDBOOK OF OIL AND GAS LAW (1955).

4. JOHN S. LOWE ET AL., CASES AND MATERIALS ON OIL AND GAS LAW (4th ed. 2002); RICHARD C. MAXWELL ET AL., OIL AND GAS CASES AND MATERIALS (7th ed. 2002).

5. *E.g.*, BRUCE M. KRAMER & PATRICK H. MARTIN, THE LAW OF POOLING AND UNITIZATION (3d ed. 2002).

6. *E.g.*, DAVID E. PIERCE, KANSAS OIL AND GAS HANDBOOK (1986).

7. The Center for American and International Law (formerly the Southwestern Legal Foundation) publishes the annual proceedings of the Institute on Oil and Gas Law and Taxation, which currently consists of a fifty-three-volume reference work. Their web address is http:// www.cailaw.org/iel. The Rocky Mountain Mineral Law Foundation publishes the annual proceedings of the Rocky Mountain Mineral Law Institute, which currently consists of a forty-eight-volume reference work. The Foundation also conducts several special institutes that focus on discrete topics, such as the "Special Institute on Private Oil and Gas Royalties." The Foundation's publications can be accessed in hard copy or by CD Rom, which provides various search capabilities. Their web address is http://www.rmmlf.org. The Energy and Mineral Law Foundation (formerly the Eastern Mineral Law Foundation) publishes the annual proceedings of the Eastern Mineral Law Institute, which currently consists of a twenty-three-volume reference work. Their web address is http://www.emlf.org. Each of these nonprofit organizations is dedicated to providing education concerning legal issues associated with the mineral and energy industries.

opinion for the court in *Smith v. Amoco Production Co.*,[8] where he begins his analysis with the statement,

> *We identify the unique character of oil and gas jurisprudence as the cardinal thread in our analysis* of the statute of limitations question. Implied covenants in oil and gas leases and government regulation of the gas industry have historically been litigated, discussed in texts, and debated by scholars. One result has been the development of a body of law that recognizes implied covenants in an oil and gas lease as either implied in fact or implied in law.[9]

However, as noted in the following section, the court ultimately applies basic contract law principles and effectively addresses one of the most complex "oil and gas law" issues in a fair and efficient manner—relying, to a large extent, on basic contract principles.

III. The Oil and Gas Lease and the Law of *Implied Covenants*

A. Professor Merrill's "Oil and Gas Law" Analysis

1. Implying Obligations to Get the Lessor a Better Deal

The best example of the modern disconnect between contract law and oil and gas law is the so-called "law of" implied covenants. We owe much of the credit, or blame, for this disconnect to Professor Maurice Merrill who, in 1926, published the first edition of his work: *The Law Relating to Covenants Implied in Oil and Gas Leases.*[10] Much of Professor Merrill's work was influenced by his underlying belief that the oil and gas lease, as written, was an unfair bargain that needed to be mitigated by courts implying contract terms as a matter of law.[11] The ultimate goal was to get

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8. 31 P.3d 255 (Kan. 2001).

9. *Id.* at 264 (emphasis added).

10. MAURICE H. MERRILL, THE LAW RELATING TO COVENANTS IMPLIED IN OIL AND GAS LEASES (1926) (2d ed. 1940 & Supp. 1964). It would surely be a matter of personal delight to Professor Merrill that over seventy-five years after he first published his work on implied covenants, courts, litigants, and scholars are still actively debating his theories.

11. Professor Merrill stated his basic rationale for implied covenants:

> In the first place, it is to be noted that the landowner, the lessor, is, in almost every case, a private individual of limited financial capacity, generally a farmer. The expense and uncertainty involved in the search for and exploitation of oil and gas render it impossible for him to develop his lands himself. . . .
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> . . . .
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> . . . But, may not the lessor protect himself by the insertion of general

the lessor a better bargain than the express terms of the lease would otherwise allow. He made no excuses for his willingness to ride roughshod over the law of contract: "Of course, the implied covenant is a fiction, used like other fictions by the law in order to achieve a desirable result. . . . The obligations are imposed, not by the agreement of the parties, but by operation of law."[12] In his treatise, Professor Merrill advocates a "radical" departure from basic contract and property law concepts to create a special body of "oil and gas law" to protect lessors:

> May there not be, *in the conditions peculiar to the oil and gas industry and to the leases executed for the purposes of that industry*, circumstances affecting the relation of "lessor" and "lessee" which justify the somewhat radical departures from ordinary rules which have characterized the decisions upon the implication of covenants?[13]

> covenants for exploration, development, operation and protection, similar to those which the courts imply? The answer to this objection is twofold: In the first place, the leases are not drawn by the lessor, nor *de novo* for each transaction. They are taken upon standard forms, prepared by the lessees or with a view to their special interests. If special terms are to be inserted, they must be demanded by the lessor. But the ordinary lessor, not versed in the peculiarities of oil and gas, nor yet in the rules of law which govern the liabilities of lessees, may not know what clauses are necessary for his protection, nor how to draw them if he knew of their necessity. . . . Since the lease is prepared by the lessee or from the point of view of his interests, since the lessor does not ordinarily know what provisions are necessary for enforcing the operations the promise of which is held out to him by the lease, and since the utter impossibility of foreseeing all of the conditions which may surround the lease in the future cuts off all chance of phrasing express provisions to meet the demands of these conditions, the lessor's opportunity to protect himself by exact stipulation is illusory. It must be borne in mind that lessor and lessee do not usually deal on an equal footing, as two business men contracting at arms length. The lessor is ordinarily of limited education and business experience, unfamiliar with the subject-matter of the lease. The parties do not, by mutual negotiation, arrive at an agreement as to terms, the result of which is embodied in a written instrument whose language is an [sic] much that of one party as of the other. The lessee comes armed with a printed form, the product of legal and business experience, and gives the lessor the chance of accepting that or nothing. It is idle to suggest that the lessor can afford himself any adequate protection through haggling over terms.

MERRILL, *supra* note 10, at 466, 467–68 (2d ed. 1940).

12. *Id.* at 27.
13. *Id.* at 465 (emphasis added).

Litigants are presently using Professor Merrill's implied covenant theory in an effort to improve the lessor's position under the royalty clause of the oil and gas lease. For example, the lessors in *Yzaguirre v. KCS Resources, Inc.*[14] asserted their lessee had an implied obligation "to obtain the best price available for the benefit of the royalty owner"[15] relying upon the theory that "the entire body of implied covenant law has been aimed at . . . making sure the royalty owner gets the best deal."[16] In *Smith v. Amoco Production Co.*[17] the plaintiffs also put forth a "best price" theory and argued "it is illogical to say that the express royalty provisions override the lessee's implied duties."[18] "They reason that setting aside a duty to obtain the best price possible eliminates the duty of good faith and fair dealing and the implied covenant to market."[19] In a recent article, written by a prominent lawyer who represents royalty owners in class actions, the "best deal" theory is taken even further by advocating what the author calls the "mutual benefit implied covenant."[20] His "mutual benefit implied covenant" is designed to get the lessor not only the "best deal" under the oil and gas

14. 53 S.W.3d 368 (Tex. 2001).

15. *Id.* at 373.

16. *Id.* at 374 (quoting Royalty Owners at oral argument). The Texas Supreme Court rejected the lessors' "best deal" argument relying upon the express "market value" basis for calculating royalty and declining to "rewrite this lease's plain terms to give the Royalty Owners the benefit of a bargain they never made." *Id.*

17. 31 P.3d 255 (Kan. 2001).

18. *Id.* at 270. This suggests, incorrectly, that the "implied" can somehow override that which is "express" in the contract. Although this may be the impact when the covenant is implied *in law*, note that it is plaintiff's counsel who is also arguing the covenant is implied *in fact*.

19. *Id.* The Kansas Supreme Court rejected this argument noting under prior law "the lessee has an obligation to market the produced minerals at reasonable terms within a reasonable time following production." *Id.* at 271.

20. John Burritt McArthur, *The Mutual Benefit Implied Covenant for Oil and Gas Royalty Owners*, 41 NAT. RESOURCES J. 795 (2001). Another reason counsel for lessors like the "implied" covenant concept is it provides them with a theory that directs the court's attention away from individual contract rights towards generic concepts of what might be "more fair" if the parties were starting anew—unburdened by things like existing contract language. This is critical for the new breed of entrepreneurial counsel seeking their next class action investment opportunity. Because there are often significant substantive differences among oil and gas contracts, the implied covenant theory is often employed to try to homogenize the contracts into one obligation and to try and satisfy the requirements for class action treatment. This process of contract homogenization typically results in the taking away of contract rights from some and conferring new rights on others. This appears to be one area where the procedural expediency of the class action is achieved only by altering the substantive rights of the parties subject to the class action.

lease, but also the best deal under any other venture the lessor may be able to associate with the oil or gas that is extracted from the leased land. His opening statement and foundational premise are pure Merrill: "One of the best-settled rules in oil and gas law is that courts give royalty owners extra contract protection in order to equalize the balance of power between the royalty owner and the lessee, which usually is an operating oil and gas company."[21]

Although Merrill's theory has had some impact on courts,[22] only the Colorado Supreme Court,[23] to date, appears to have adopted wholesale the Merrill approach to lease interpretation, or anti-interpretation.[24] The Kansas Supreme Court, in *Smith v. Amoco Production Co.*, commented on the lack of judicial support for Professor Merrill's theory:

> Professor Merrill is the advocate for the implied in law approach. . . .
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> . . . .
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> The *Indian Territory* court observed in 1941 that it had found no support for Professor Merrill's implied in law doctrine in the adjudicated cases. Sixty years later, based on the briefing here, we share the same observation. We choose to join Oklahoma, Texas, and Montana in holding that the covenants are implied in fact.[25]

2. Evaluating the Underlying Premises for Professor Merrill's Theory

Professor Merrill's perceived need for "oil and gas law" to rescue lessors from their oil and gas lease bargains can be summarized as follows: (1) Lessors are generally less sophisticated than lessees concerning oil and gas

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21. *Id.* at 797.

22. *E.g.*, Gilmore v. Superior Oil Co., 388 P.2d 602, 607 (Kan. 1964) (quoting Professor Merrill's version of the marketable product rule).

23. Rogers v. Westerman Farm Co., 29 P.3d 887 (Colo. 2001). Although the West Virginia Supreme Court came to a Rogers-like conclusion in *Wellman v. Energy Resources, Inc.*, 557 S.E.2d 254 (W. Va. 2001), the decision is of limited value because the court did not have to address the impact of the "at the well" or "market value" language of the oil and gas lease. *See* David E. Pierce, *Recent Developments in Nonregulatory Oil and Gas Law: Unfinished Business*, 53 INST. ON OIL & GAS L. & TAX'N 3-1, 3-27 to 3-28 (2002) [hereinafter *Unfinished Business*] (discussing the *Wellman* case).

24. The *Rogers* case and its use of Professor Merrill's analysis are discussed in David E. Pierce, *Exploring the Jurisprudential Underpinnings of the Implied Covenant to Market*, 48 ROCKY MTN. MIN. L. INST. 10-1 (2002) [hereinafter *Jurisprudential Underpinnings*].

25. Smith v. Amoco Prod. Co., 31 P.3d 255, 268 (Kan. 2001) (citation omitted).

development and legal issues; (2) lessees generally begin the negotiating process by tendering a printed form of oil and gas lease; (3) the form contains provisions generally favorable to the lessee; and (4) lessors often do not negotiate the lease terms.[26] These same observations could be made about many typical contracting situations; but courts have not abandoned basic contract law principles when there is inequality of sophistication or bargaining power.

Even in the oil and gas context courts have been unwilling to openly redraft the oil and gas lease to benefit the lessor. For example, in the leading case on implied covenants the Eighth Circuit in *Brewster v. Lanyon Zinc Co.*[27] interpreted an oil and gas lease that expressly gave the lessee a period of five years in which to decide whether it would drill a well on the property. When the lessor sought to attack the lease because no well had been drilled during the first four years, the court responded by quoting the following statement by the Kansas Supreme Court in *Rose v. Lanyon Zinc Co.*,[28]

> "If plaintiffs should desire to contract for an immediate exploration, they must have that right; and if they should desire to give an oil or gas company five years in which to sink a well, upon a consideration satisfactory to themselves, and as the result of negotiations free from imposition and fraud, they must have that right. But, having deliberately made a contract of the latter description, *they have no right to call upon a court to declare that it is the other kind, merely because generally it might seem to be better for farmers* not to incumber their lands with mineral leases, giving a long time for exploration, *or because generally* such leases do contemplate that forfeiture shall follow a failure to explore at once."[29]

In refusing to modify the express terms of the oil and gas lease, the court in *Brewster*, quoting from Justice Story's *Equity Jurisprudence*, observed,

> "[E]very person who is not from his peculiar condition or circumstances under disability is entitled to dispose of his property in such manner and upon such terms as he chooses; and

26. *See supra* note 11 and accompanying text.
27. 140 F. 801 (8th Cir. 1905).
28. 74 P. 625 (Kan. 1903).
29. *Brewster*, 140 F. at 808 (quoting Justice Burch, writing for the court in Rose v. Lanyon Zinc Co., 74 P. 625, 628 (1903)) (emphasis added).

> whether his bargains are wise and discreet, or profitable or unprofitable, or otherwise, are considerations, not for courts of justice, but for the party himself to deliberate upon."[30]

Although Professor Merrill's observations concerning the leasing process may be accurate in some cases,[31] they will not be accurate in many cases. For example, what if the landowner is represented by counsel knowledgeable in "oil and gas law"? What if the landowner entering into the oil and gas lease is in fact a sophisticated oil and gas developer who negotiated the lease terms, which are contained in a customized document, with provisions uniquely beneficial to the land-owner/lessor? Professor Merrill responded to this situation in the 1964 Supplement to his treatise:

> Obviously, the implied covenant doctrine is not rendered inapplicable merely because in a particular instance the factors which justify its imposition as an incident of the relation do not exist.[32] *It would impede the administration of justice if the courts were required in each case to embark upon a calculation of the relative knowledge and of the bargaining power of the parties.* Thus the doctrine applies though the lessor is the government or a large corporation.[33]

Professor Merrill would place ease of administration, to achieve his goals, above giving effect to the individual contract of the parties. Basic public policy favoring freedom of contract, and the protection of private property—in this case contract rights are the price Professor Merrill is willing to pay, in the "oil and gas" context, to provide the lessor with a better deal.

Professor Merrill's premise that oil and gas leases are some sort of adhesion contract is also false. Although it is true that oil and gas leases

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30. *Id.* at 806 (quoting JOSEPH STORY, 1 COMMENTARIES ON EQUITY JURISPRUDENCE § 244, 239–40 (12th ed. 1877)).

31. I would submit that *timing* of the leasing transaction often has a lot to do with whether the lessor will drive a harder bargain for their land. Those who lease first often accept the lessee's offered terms. Those who delay often gain insight from those who have gone before them while competition for leases generally increases for those not willing to accept the first offer. Also, the existence of prior development in the area being leased can be a big factor. Second and third generation development of an area frequently produces a corps of savvy landowners schooled through past experiences that were either good, or bad.

32. If Professor Merrill's implied-in-law covenant is based upon the existence of certain inequities, why should it be applied if those inequities do not exist?

33. MERRILL, *supra* note 10, at 227 (Supp. 1964) (emphasis added).

create a standard relationship, have their own unique structure and terminology,[34] and are frequently presented to lessors using form documents, the relative circumstances of the contracting parties often defy classification as an adhesion contract. For example, it is the prospective lessor, as the owner of the minerals, who has the "take-it-or-leave-it" power over the transaction. They cannot be compelled to lease their land on terms demanded by the lessee. In any event, lessees rarely present their offers to lease on a take-it-or-leave-it basis. Frequently there are other lessees in the area willing to negotiate.[35] However, the same lessees are not going to negotiate against themselves if the landowner accepts the offered deal. This is not all that different from a sale of real estate. If the buyer doesn't offer less money, the seller will get their price.

From my independent analysis, the prototypical leasing transaction Professor Merrill uses to justify judicial intervention is not, in fact, the typical situation. On several occasions I have had the opportunity to conduct empirical research that involved analyzing either a sampling of oil and gas leases held by a lessee in a county or state, or all the oil and gas leases used by a lessee in a single field. For example, I designed and conducted a study of oil and gas leases used by the Union Pacific Resources

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34. As I have written previously,

> The development of oil and gas in America is accomplished through a standard relationship created by documents called oil and gas leases. It has become axiomatic there is no such thing as a standard oil and gas lease *form*, such as a "Producers 88." However, even though the terms of the documents are seldom similar, the general structure of the legal relationships they create are typically identical.

David E. Pierce, *Rethinking the Oil and Gas Lease*, 22 TULSA L.J. 445, 445–46 (1987) (emphasis added). The "standard relationship" consists of a grant of the right to develop the leased land for a specified period of time that can be extended indefinitely by production. *Id.* Failure to obtain production from the leased land causes the lease to expire. *Id.* In the event production is obtained, the lessor will be compensated by a royalty associated with the volume and value of production from the leased land. *Id.* at 446 n.3.

35. The current flurry of leasing for coalbed methane development in Eastern Kansas provides an interesting laboratory for evaluating leasing practices. One of my Contracts students indicated her father had been approached by a developer wanting a lease on his land. I suggested he might just tell them "no" to start the "negotiations." He told them "no" on Friday and they came back on Sunday offering to lease for twice the previously offered bonus and asking what they could do to make the deal acceptable. The various developers seeking leases have been very willing to negotiate land use, financial, and other terms of the leases—but you have to ask. Like any other contracting party, they don't negotiate against themselves.

Company (UPRC) throughout the state of Texas.[36] The study was introduced as evidence in a class certification hearing in *Union Pacific Resources Group, Inc. v. Neinast.*[37] The data consisted of a random sample of 980 oil and gas leases from a total of 26,000 leases encompassing 30,000 individual royalty owners. After reading and analyzing the 980 oil and gas leases, I found that

> [t]here is a considerable level of contractual diversity among the leases sampled in my study. The vast majority of the documents indicate they were the product of active negotiation between the lessor (or the lessor's legal counsel or other representative) and the lessee. This conclusion is based upon the royalty fraction typically being in excess of l/8th and the primary term being for something less than 10 years.[38] For example, of the leases sampled, 212 provided for a l/8th royalty; the remaining 768 provided for a royalty in excess of l/8th. My conclusion is also based upon frequent modifications to the lease form either by adding-to or striking-out language, or by the incorporation of special terms attached as an addendum or exhibit to the lease form. The frequency of individually negotiated leases in the sample makes it very likely additional royalty obligation variations would be found in leases that were not part of the sample.[39]

Even if one accepts Professor Merrill's premise that the oil and gas lease is an adhesion contract, this is simply the beginning of the analysis, not the end. Adhesion contracts are enforceable like any other contract. The "contract law" test used to identify the unenforceable adhesion contract is unconscionability.

36. The study did not include leases used by UPRC in Crockett County or Sutton County, Texas.

37. 67 S.W.3d 275 (Tex. App. 2001) (reversing trial court's certification of class and ordering class decertified).

38. Ten years was the lease primary term printed in most of the lease forms.

39. Report of David E. Pierce, Neinast v. Union Pac. Res. Group, Inc., No. 32,040, District Court of Washington County, Texas, 1–2 (2001) (Professor Pierce was called as an expert witness on behalf of the Union Pacific Resources Company in this action.).

B. The "Contract Law" Response to Professor Merrill's Concerns

1. Unconscionability

The "contract law" response to unfair bargains has been the unconscionability analysis. However, Professor Merrill would not rely on an unconscionability analysis because it is not intended to cause a "disturbance of allocation of risks because of superior bargaining power."[40] In most cases an unconscionability analysis would not provide the court with an opportunity to add obligations to the oil and gas lease. The unconscionability analysis actually protects freedom of contract by imposing a principled analysis on when and how courts can go about modifying contracts. For example, the official comment to U.C.C. § 2-302 provides, in part,

> This section is intended to make it possible for the courts to police explicitly against the contracts or clauses which they find to be unconscionable. In the past such policing has been accomplished by adverse construction of language, by manipulation of the rules of offer and acceptance or by determinations that the clause is contrary to public policy or to the dominant purpose of the contract. This section is intended to allow the court to pass directly on the unconscionability of the contract or particular clause therein and to make a conclusion of law as to its unconscionability.[41]

Although the oil and gas lease is not subject to Article 2 of the *Uniform Commercial Code*,[42] the parallel provision of the *Restatement (Second) of Contracts*[43] would apply to oil and gas leases. The commentary to the *Restatement (Second) of Contracts* § 208 adopts comment observations to U.C.C. § 2-302 and adds, "Particularly in the case of standardized agreements, the rule of this Section permits the court to pass directly on the

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40. UNIFORM COMMERCIAL CODE § 2-302 cmt. 1 (1977) [hereinafter U.C.C.] (citation omitted) ("The principle is one of the prevention of oppression and unfair surprise and not of disturbance of allocation of risks because of superior bargaining power.").

41. *Id.*

42. The oil and gas lease is not a "contract for sale of minerals" to be removed by the lessor. *Id.* § 2-107(1). The comment to section 2-107 would place the oil and gas lease in the category of "contracts affecting land" subject to the law governing land contracts. *Id.* § 2-107 cmt. 1.

43. RESTATEMENT (SECOND) OF CONTRACTS § 208 (1981).

unconscionability of the contract or clause rather than to avoid unconscionable results by interpretation."[44]

Because the unconscionability analysis has proven to be demanding in practice[45] there is a risk courts may revert to many of the interpretive devices the analysis was designed to avoid.[46] It is ironic that introducing a principled analysis to avoid the use of less principled techniques sometimes causes the less principled interpretive devices to proliferate. For example, if a court desires an outcome that cannot be achieved by applying an unconscionability analysis, it may simply choose to rely upon an interpretive rule that will get it where it believes the equities lead. The most common counter-unconscionability analysis interpretive device used by courts is, "[I]n interpreting leases like those in this case, we are mindful of the generally accepted rule that oil and gas leases are strictly construed against the lessee in favor of the lessor."[47] Technically this is a rule of "construction" that should be applied only if the contract has first been deemed "ambiguous."[48]

However, like so many canons of construction, courts tend to use them when they support the desired outcome even though there may be no need

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44. *Id.* at cmt. a.

45. Courts have been reluctant to use unconscionability and have generally limited it to the most egregious of factual situations. Professors White and Summers provide the following assessment of the doctrine: "As preamble let us lay out the battlefield upon which the 2-302 battles are fought. Most who assert 2-302 and most who have used it successfully in reported cases have been consumers. Most of these successful consumer litigants have been poor or otherwise disadvantaged." JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE 154 (5th ed. 2000).

46. I refer to this in another writing as a "circular unconscionability/interpretive analysis." *Jurisprudential Underpinnings*, *supra* note 24, at 10-9.

47. Rogers v. Westerman Farm Co., 29 P.3d 887, 901 (Colo. 2001).

48. Professor Farnsworth has commented on this rule of construction:

> An especially common example [of a rule of construction] is the rule that if language supplied by one party is reasonably susceptible to two interpretations, one of which favors each party, the one that is less favorable to the party that supplied the language is preferred. Such interpretation *contra proferentem* ("against the profferer") is often rationalized on the ground that the party against whom it operates had the possibility of drafting the language so as to avoid the dispute . . . . Although the *contra proferentem* rule may encourage care in the drafting of contracts, it can scarcely be said to be designed to ascertain the meanings attached by the parties. *It is not applicable if the language is unambiguous and it is often denigrated as a rule of "last resort."*

E. ALLEN FARNSWORTH, CONTRACTS 473–74 (3d ed. 1999) (emphasis added).

to resolve an ambiguity, or even a need to interpret the express terms of the contract.[49]

An example of this misuse of the "interpret against the lessee" canon is a pair of cases, *Gilmore v. Superior Oil Co.*[50] and *Schupbach v. Continental Oil Co.*,[51] where the court interpreted leases requiring a royalty based upon "1/8 of the proceeds of the sale thereof *at the mouth of the well*."[52] In each case the court determined the leases contained "ambiguities" and interpreted them "in favor of the lessor and against the lessee."[53] The end result of the court's "interpretation" and "construction" was to nullify the "at the mouth of the well" language so the lessee could not deduct compression costs to transport gas from the "mouth of the well" to an interstate pipeline located on the leased premises. Justice Fontron revealed his view of the court's strained analysis stating,

> I find it extremely difficult to accept the rationale of *Gilmore v. Superior Oil Co.* It offends my sense of logic to say that the market value of gas at the mouth of the well is the price for which the gas is ultimately sold after having been so processed that it has become marketable. I would consider that market value of gas at the well would be that amount for which it could be sold, after deducting such reasonable expense as was required to render it saleable.[54]

The Kansas Supreme Court, when presented with the *Gilmorel Schupbach* ambiguity argument in *Stemberger v. Marathon Oil Co.*[55] rejected it stating,

> The relevant portion of the lease provision governing in this action provides that Marathon will pay royalties of one-eighth (1/8) of the market price at the well for gas sold or used. The lease provision is silent as to deductions. Stemberger argues that the lease is ambiguous and therefore must be construed in her favor to preclude the deductions made by Marathon . . . .

49. *See generally* Bruce M. Kramer, *The Sisyphean Task of Interpreting Mineral Deeds and Leases: An Encyclopedia of Canons of Construction*, 24 TEX. TECH L. REV. 1, 103–08 (1993).
50. 388 P.2d 602 (Kan. 1964).
51. 394 P.2d 1 (Kan. 1964).
52. *Schupbach*, 394 P.2d at 2 (emphasis added); *Gilmore*, 388 P.2d at 605.
53. *Schupbach*, 394 P.2d at 4; *Gilmore*, 388 P.2d at 605.
54. *Schupbach*, 394 P.2d at 6 (Fontron, J., concurring) (citation omitted).
55. 894 P.2d 788 (Kan. 1995).

> Stemberger correctly states that ambiguities in an oil and gas lease are to be construed in favor of the lessor. See *Gilmore v. Superior Oil Co.* Here, however, the lease is not ambiguous. The lease's silence on the issue of post-production deductions does not make the lease ambiguous. The lease clearly specifies that royalties are to be paid based on "market price at the well."[56]

This suggests that the compression cost rulings in *Gilmore* and *Schupbach* should be limited to those particular cases in which the court found, and then resolved, ambiguities in the oil and gas leases.[57] This provides an inherent limitation on any doctrinal damage done by courts seeking to do equity in a particular case; by purporting to resolve an ambiguity in a particular contract, the case should have little precedential effect.

Another risk to an unconscionability analysis is that courts will manipulate the basic elements of unconscionability to achieve a desired outcome. An example of a court's failure to apply the temporal aspect of the unconscionability test is *Kansas Baptist Convention v. Mesa Operating Ltd.*[58] The *Restatement* and the *Uniform Commercial Code* each stress the term at issue must be evaluated "at the time the contract is made."[59] Professors White and Summers note, "That it appears unconscionable at the time of performance is irrelevant. The test is not by hindsight."[60]

The court's analysis and discussion in *Kansas Baptist Convention* is unique because it not only abuses basic unconscionability principles, but also manages to misapply "good faith" and "implied covenant" principles all in pursuit of an apparent "oil and gas law" solution to the Convention's lack of foresight. At the heart of this case is the Convention's 1952 decision to enter into a combination gas development and sales contract. The contract was the product of negotiation in which the Convention's attorney sought and obtained concessions from Mesa's predecessor in interest. The structure of the deal was designed to accommodate limitations on the Convention's ability to lease the land. The hindsight problem was pretty simple: development and operation costs increased, but the Convention had agreed to a fixed-price of 10¢/Mcf for its share of the gas. At the time the

56. *Id.* at 794 (citation omitted).

57. David E. Pierce, *Developments in Nonregulatory Oil and Gas Law: The Continuing Search for Analytical Foundations*, 47 INST. ON OIL & GAS L. & TAX'N 1-1, 1-43 (1996).

58. 864 P.2d 204 (Kan. 1993).

59. RESTATEMENT (SECOND) OF CONTRACTS, *supra* note 43, § 208; U.C.C., *supra* note 40, § 2-302(1).

60. WHITE & SUMMERS, *supra* note 45, at 154.

Convention entered into the gas sales contract gas prices were approximately 5.5¢/Mcf. As the lawsuit unfolded in 1988 the market price for gas was around $1.52/Mcf.[61]

When Mesa elected to drill another well under the contract in 1988, the practical effect would be to consume, for the indefinite future, all of the Convention's gas sales revenue to pay for its share of the new well drilling costs. The Convention alleged Mesa acted in bad faith when it elected to drill the 1988 well that put the Convention in a negative income position. Under the contract Mesa was given the following right,

> It [Mesa] shall drill such additional well or wells on the Unitized Area as it should deem necessary from time to time and shall pay and discharge all costs and expenses incurred and shall charge the other parties hereto their proportionate share upon the cost and expense basis provided for in the schedule of accounting . . . . The judgment and discretion of [Mesa] exercised in good faith and without negligence shall be the limit of its liability to the other parties hereto for any act done or omitted to be done in good faith in the performance of any of the provisions of this agreement.[62]

Therefore, the sole issue should have been whether Mesa acted in good faith when it decided to drill the 1988 well. It would appear that even if Mesa breached this obligation, the most it could be assessed in damages would be denial of the ability to recoup any of the 1988 well costs from the Convention.[63] However, it would appear under either a subjective or objective good faith standard, Mesa could establish valid reasons why it would legitimately want to drill the 1988 well. Mesa's conduct could have been evaluated by asking whether a reasonable person, without considering the Convention's unique situation, would have drilled the well. There does not seem to be any legitimate reason to restrain the rights of Mesa and the other parties merely because drilling the well would have an adverse impact on the Convention's revenue stream. The Convention's problem was the product of entering into what turned out to be a poor contract.[64]

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61. *Kan. Baptist Convention*, 864 P.2d at 207–08.

62. *Id.* at 213.

63. This is where the court's use of unconscionability, under any set of circumstances, gives the Convention a windfall by voiding the 10¢/Mcf gas contract instead of calculating normal breach of contract damages. *See infra* text accompanying notes 123–25.

64. Actually the Convention's total net revenue from its interest was very close to the amount predicted by its attorney in 1953 when they negotiated the contract. Kan. Baptist

The court stated, "The present case involves an overreaching lessee."[65] Although Mesa and the Convention were not in an oil and gas lease relationship, the court felt compelled to discuss implied lease covenant case law.[66] The court, however, ultimately settled on unconscionability as the governing theory stating, "The parties made this contract in 1952, and we are only providing a remedy where subsequent changes not reasonably foreseeable by the parties have rendered the contract unconscionable under present circumstances."[67] This is not an unconscionability analysis. There is no procedural unconscionability; there is no substantive unconscionability. The "overreaching" by Mesa, according to the court, was that the Convention guessed wrong on the future price of gas and drilling costs. Since these "subsequent changes" were not "reasonably foreseeable," somehow Mesa is responsible. What we have is an impracticability case that was not pursued as such because it was evident the Convention assumed the risk of just these sorts of "subsequent changes" by entering into an open-ended drilling cost obligation to be paid from fixed-price gas revenues.

The court remanded the case to the district court to "fashion a remedy modifying the contract in light of the changed circumstances that have rendered the contract unconscionable."[68] The trial court responded by "reforming" the contract to relieve the Convention from the fixed-price provisions of the contract.[69] However, the real winner in this case was not the Convention. The party that brought the case was Hugoton Energy Corporation. Hugoton Energy, relying no doubt upon the sanctity of contracts, purchased the Convention's interest for $15,000, apparently thinking it was not worth much, other than litigation value, because of the 10¢/Mcf gas contract. When it became apparent it would sue Mesa, Hugoton Energy reconveyed 10% of the interest it had purchased from the Convention and brought suit on its own behalf and in the name of the

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Convention v. Mesa Operating Ltd., 898 P.2d 1131, 1138 (Kan. 1995) [hereinafter *Kan. Baptist Convention II*] (appeal following remand).

65. *Kan. Baptist Convention*, 864 P.2d at 213. The "over-reaching," according to the court, occurred when "Mesa commenced to drill the third well on May 25, 1988." *Id.* at 218.

66. The court devotes several pages to the law of implied covenants in oil and gas leases as background discussion; the concepts are never directly applied. *Id.* at 211–13. Presumably the court was ultimately trying to articulate a "prudent operator" standard to evaluate Mesa's decision to drill the 1988 well.

67. *Id.* at 218.

68. *Id.* at 220.

69. *Kan. Baptist Convention II*, 898 P.2d at 1137.

Convention.[70] After the litigation, Hugoton Energy's $15,000 investment was worth approximately $1.9 million under the reformed terms of the contract.[71] I wonder if Justice Allegrucci, who wrote the opinion for the court, would find the Convention was again the victim of "subsequent changes not reasonably foreseeable by the parties [the court reforming a fixed-price contract]" which have "rendered the contract [to sell their interest for $15,000] unconscionable under present circumstances [when the interest has a present value of $1.9 million]."[72] I would submit that under the court's seriously flawed unconscionability analysis the Convention's agreement to sell a $1.9 million asset for $15,000 is unconscionable and should be "reformed" to whatever the Kansas Supreme Court thinks Hugoton Energy should make on its lawsuit investment.

Kansas Baptist Convention illustrates how a doctrine designed to promote freedom of contract can be distorted and abused to engage in the same sort of judicial redrafting and reallocation of wealth the unconscionability doctrine was designed to avoid. Clearly, the court engaged in a fundamental "disturbance of allocation of risks" between the parties, which the unconscionability analysis was designed to avoid instead of promote.[73]

2. The Proper Role of "Implied Covenants"

The Kansas Supreme Court, in *Smith v. Amoco Production Co.*,[74] identified the two polar jurisprudential roles of "implied covenants" stating,

> A contract implied in fact is one "inferred from the facts and circumstances of the case" but which is "not formally or explicitly stated in words." It is the product of agreement, although it is not expressed in words. A contract implied in law does not rest on

70. *Kan. Baptist Convention*, 864 P.2d at 208.

71. *Kan. Baptist Convention II*, 898 P.2d at 1138.

72. *Kan. Baptist Convention*, 864 P.2d at 218. Counsel for Mesa noted that Hugoton Energy would receive a 12,000% return on its investment. *Kan. Baptist Convention II*, 898 P.2d at 1141.

73. This case also illustrates that often the problem is not manipulating the *law of* oil and gas to achieve a desired outcome. Any body of law, including contract law, can be manipulated. However, it is often easier to detect departures from the law of contract, particularly when many of the oil and gas law concepts have been specifically developed to accommodate judicial manipulation.

74. 31 P.3d 255 (Kan. 2001).

> actual agreement. It is a legal fiction created by courts to ensure justice or to prevent unjust enrichment.[75]

After evaluating case law and Professor Merrill's implied-in-law approach to implied covenants, the court concluded, "We choose to join Oklahoma, Texas, and Montana in holding that the covenants [implied in oil and gas leases] are implied in fact."[76] This means that before a covenant can be implied, the court must determine, from the express terms of the oil and gas lease, whether it is "necessary."

Under a contract law analysis a covenant will be implied only when it is necessary to give full effect to the parties' express agreement in which a term has been omitted. Therefore, the express terms of the agreement determine whether an additional term is necessary to make the contract complete. To determine if the agreement is incomplete, it must first be interpreted. Only after meaning has been ascribed to the express terms can it be determined whether an omission exists. Upon interpretation, the express terms may resolve the issue and eliminate the need for an implied term. For example, in Kansas, courts have defined the term "market value" in the oil and gas lease as requiring a royalty reflecting: (1) "value or price at the current rate prevailing when the gas is delivered"[77] and (2) the value or price being a "price which would be paid by a willing buyer to a willing seller in a free market."[78] Therefore, the obligation to pay a royalty of one-eighth of the "market value" needs no interpretation. There is nothing missing;[79] there is no omitted term to be supplied by implication.

The Texas Supreme Court,[80] in *Yzaguirre v. KCS Resources, Inc.*,[81] refused to consider any sort of implied covenant "[b]ecause the lease

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75. *Id.* at 265 (citations omitted).

76. *Id.* at 268.

77. Holmes v. Kewanee Oil Co., 664 P.2d 1335, 1339 (Kan. 1983).

78. *Id.* at 1341 (quoting Lightcap v. Mobil Oil Corp., 562 P.2d 1, Syl. 4 (Kan. 1977)).

79. However, the inquiry will also require that we ascertain "where" the market value of the production will be determined. This is typically addressed by other express terms of the lease that specify a valuation location, such as: *at the* well, *at the* mouth of the well, *at the* tailgate of a processing plant, *at the* outlet of the separator, *at the* connection of the flow line to the gathering system, *at the* gathering system connection to an intrastate or interstate pipeline.

80. Texas defines "market value" in a manner similar to Kansas. Exxon Corp. v. Middleton, 613 S.W.2d 240 (Tex. 1981); Tex. Oil & Gas Corp. v. Vela, 429 S.W.2d 866 (Tex. 1968). *See generally* David E. Pierce, *Royalty Calculation in a Restructured Gas Market*, 13 E. MIN. L. INST. 18-1, 18-15 to 18-19 (1992) [hereinafter *Royalty Calculation*].

81. 53 S.W.3d 368 (Tex. 2001).

provides an objective basis for calculating royalties."[82] The analysis that has developed in Texas to evaluate the "need" for resorting to implied covenants was summarized by the court in *HECI Exploration Co. v. Neel*[83] to include the following,

> A covenant will not be implied unless it appears from the express terms of the contract that "it was so clearly within the contemplation of the parties that they deemed it unnecessary to express it," and therefore they omitted to do so, or "it must appear that it is necessary to infer such a covenant in order to effectuate the full purpose of the contract as a whole as gathered from the written instrument." A court cannot imply a covenant to achieve what it believes to be a fair contract or to remedy an unwise or improvident contract . . . .[84]

This is a classic statement of the "implied-in-fact" covenant analysis.

If, after applying the analysis, the court finds something is missing, it will proceed to the second step of the implied-in-fact analysis and fashion an implied covenant that is fully consistent with the express terms of the contract. For example, the Eighth Circuit in *Brewster v. Lanyon Zinc Co.* illustrates this step of the analysis stating,

> It is conceded, as indeed it must be, that the lease contains no express stipulation as to what, if anything, should be done in the way of searching for and producing oil or gas after the first five years; but it does not follow from this that it is silent on the subject, or that the matter is left absolutely to the will of the lessee. Whatever is implied in a contract is as effectual as what is expressed. Implication is but another name for intention, and if it arises from the language of the contract when considered in its entirety, and is not gathered from the mere expectations of one or both of the parties, it is controlling.[85]

The court proceeded to fashion an implied obligation to further develop the leased lands in a manner complimenting, instead of negating or altering, the express terms of the oil and gas lease.

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82. *Id.* at 374.
83. 982 S.W.2d 881 (Tex. 1998).
84. *Id.* at 888–89 (quoting Danciger Oil & Ref. Co. v. Powell, 154 S.W.2d 632, 635 (Tex. 1941)) (citation omitted).
85. 140 F. 801, 809 (8th Cir. 1905).

3. The Proper Role of "Good Faith"

Good faith is an interpretive device that can impose limitations on a party's discretion when, in the context of the express contract terms, limitations are appropriate. However, the express terms of the contract define the nature and scope of the obligation to perform and enforce the contract in good faith. For example, termination of a contract, without cause, may be acceptable if the express terms of the contract are followed, regardless of the hardship it may impose on the other party. This was the situation in *St. Catherine Hospital of Garden City v. Rodriguez*[86] where the contract between the hospital and its radiology services provider stated, "'[T]his contract may be terminated by [appellee or appellant] *at any time, without cause, by giving written notice of such termination to the other party not less than ninety (90) days prior to the selected termination date.*'"[87] When the Hospital followed the terms of the contract and terminated following the notice period, Rodriguez sued asserting the termination had been a breach of the hospital's duty of good faith and fair dealing. Rejecting Rodriguez's argument, the court noted,

> The problem with Dr. Rodriguez' breach of contract cause of action is that the Hospital terminated the agreement precisely within the terms of the parties' agreement . . . .
>
> There are explicit clauses in some agreements that, in effect, eliminate any implication of good faith and fair dealing. For instance, when an agreement permits a termination, *without cause*, by the giving of 90 days' notice, the parties ought to be bound by this agreement. From the date the agreement was signed to the date termination was given, Dr. Rodriguez was well aware that the Hospital could terminate his agreement at any time without cause by giving him 90 days' notice. If no cause was necessary, then it is largely irrelevant whether the Hospital acted in good faith or bad faith. It was not required to have a valid or fair reason to terminate. The only requirement was the giving of 90 days' written notice. To hold that the right to terminate *without cause* can only be exercised in good faith simply rewrites the agreement of the parties.[88]

86. 971 P.2d 754 (Kan. Ct. App. 1998).
87. *Id.* at 756.
88. *Id.*

St. Catherine merely illustrates the basic rule that the express terms of the contract can be sufficiently clear so that interpretation is unnecessary. Of course, if the clear, express terms create a fundamentally unfair situation, or otherwise violate public policy, unconscionability and other policing devices are available to protect the contracting party. But these are not interpretive issues.

The "duty of good faith and fair dealing" is defined by the express terms of the contract. For example, the *Restatement* provides, "Every contract imposes upon each party a duty of good faith and fair dealing *in its performance and its enforcement.*"[89] The *Uniform Commercial Code* uses similar language.[90] As the UCC comment indicates,

> This section does not support an independent cause of action for failure to perform or enforce in good faith. Rather, this section means that a failure to perform or enforce, in good faith, *a specific duty or obligation under the contract*, constitutes a breach of that contract or makes unavailable, under the particular circumstances, a remedial right or power. This distinction makes it clear that the doctrine of good faith *merely directs a court towards interpreting contracts* within the commercial context in which they are created, performed, and enforced, and *does not create a separate duty of fairness and reasonableness which can be independently breached.*[91]

To the extent the term at issue is self-defining on the range of acceptable conduct, a good faith analysis is not required. For example, the obligation to pay a market value royalty is self-defining.

IV. Interpreting the Oil and Gas Lease "Contract"

Oil and gas disputes can often be effectively resolved by first defining the true nature of the interpretive problem. Does the problem relate to an *omitted term* or the *meaning* of a term or terms present in the contract? Implied covenant analysis is typically associated with the omitted term problem while a good faith analysis can be triggered by a meaning problem. However, courts have, under the rubric of "oil and gas law," tried to apply an omitted term/implied covenant analysis to situations that may require a simple meaning analysis or a good faith analysis. Therefore, the first task is

89. RESTATEMENT (SECOND) OF CONTRACTS, *supra* note 43, § 205 (emphasis added).
90. U.C.C., *supra* note 40, § 1-203 (1977).
91. *Id.* § 1-203 cmt. (emphasis added).

to define the nature of the problem: is there really a missing term, or are we merely trying to define the meaning of a term?

A. Is Something Really Missing?

If implied covenants are viewed as being implied-in-*law*, something will be missing in the oil and gas lease whenever judicial intervention is desired to adjust the equities of the situation.[92] If implied covenants are implied-in-*fact*, then often they will not be needed because the express terms of the contract adequately define the rights and obligations of the parties. Also, if the rights and obligations of the parties are not fully defined, but the problem is not an absence of terms but the meaning of a term, then an additional covenant, under an implied-in-fact analysis, would be unnecessary. However, to understand why arguments over terms and meaning will continue, at least with regard to the calculation of royalty, one must understand the royalty value theorem.

1. The Royalty Value Theorem

The royalty value theorem recognizes the inherent conflict between lessor and lessee when the lessor is compensated through a fixed fraction of the value of oil and gas. The theorem provides, "When compensation under a contract is based upon a set percentage of the value of something, there will be a tendency by each party to either minimize or maximize the value."[93] To understand how the theorem works in practice, the physical and economic facts regarding the production and marketing of oil and gas must be recognized. First, oil and gas tend to increase in value as they move downstream from the point of production. Second, much of the increase in value can be attributed to costs associated with transporting, treating, aggregating, packaging, and marketing the production. The resulting downstream value of the production consists of two components: (1) the enhanced value associated with the actual investments in the production; and (2) the enhanced value of the production in its current form and location.

The theorem recognizes that lessors will seek to maximize the value of their fraction of royalty by arguing for a valuation point as far removed

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92. *See generally Jurisprudential Underpinnings*, *supra* note 24.

93. David E. Pierce, *What's Behind the Valuation Controversy Anyway?*, *in* FEDERAL & INDIAN OIL & GAS ROYALTY VALUATION & MANAGEMENT III, 1-1 (Rocky Mtn. Min. L. Found. 2000) (original statement of the theorem); David E. Pierce, *The Royalty Value Theorem and the Legal Calculus of Post-Extraction Costs,* 23 ENERGY MIN. L. INST. ch. 6 (2003) (expanded discussion of the royalty value theorem).

from the point of production as possible.[94] Lessees, in turn, will argue for a valuation point at the moment the oil and gas is extracted from the ground. The lessee is often aided by express contract language specifying a royalty equal to either a share of the "oil" when produced or a share of the value of "gas" calculated "at the well" or "at the mouth of the well."[95] This language suggests, in seemingly clear terms, that the valuation for royalty purposes should take place at or near the point of extraction. The lessor's task will be to argue for additional implied terms regarding where the calculation should be made because the express terms thwart their desire for a fraction of the greater downstream value.

An excellent example of the confusion caused by the "oil and gas law" approach to interpreting the lease contract is *Stemberger v. Marathon Oil Co.*,[96] where the court acknowledged the express terms of the contract resolved the issue, but felt compelled to pay homage to the presumed existence of an implied covenant to market. The royalty value theorem was in full force in *Stemberger*: the express terms of the lease required a fractional royalty on "the market price at the well."[97] The lessee transported

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94. As I have noted previously,

> In most cases, if production is obtained from the leased land, the royalty will become the primary source of landowner compensation under the leasing transaction. Once the oil and gas lease is entered into, and production has been obtained, there are only two ways a lessor can maximize his royalty income: (1) increase the *volume* of production; (2) increase the *value* of production. The situs of the lessor's volume- and value-enhancing efforts is often a courthouse.

David E. Pierce, *The Missing Link in Royalty Analysis: An Essay on Resolving Value-Based Royalty Disputes*, 5 TEX. WESLEYAN L. REV. 185, 185 (1999) [hereinafter *Missing Link*] (emphasis added).

95. For example, the AAPL Form 675 Oil and Gas Lease provides the following,

> 3. The royalties to be paid by Lessee are as follows: On oil, one-eighth of that produced and saved from said land, *the same to be delivered at the wells or to the credit of Lessor into the pipe line to which the wells may be connected.* Lessee shall have the option to purchase any royalty oil in its possession, paying the market price therefor prevailing for the field where produced on the date of purchase. On gas, including casinghead gas, condensate or other gaseous substances, produced from said land and sold or used off the premises or for the extraction of gasoline or other products therefrom, the *market value at the well* of one-eighth of the gas so sold or used, provided that on gas *sold at the wells* the royalty shall be one-eighth of the amount realized from such sale.

EUGENE O. KUNTZ, ET AL., FORMS MANUAL TO ACCOMPANY CASES AND MATERIALS ON OIL AND GAS LAW 12 (3d ed. 1998) (emphasis added).

96. 894 P.2d 788 (Kan. 1995).

97. *Id.* at 792. This was a class action that included overriding royalty interests and lessors in several states. In an apparent attempt to keep a class together at all costs, the

the gas downstream from the well where it was sold. The lessee sought to pay royalty based upon the downstream price minus the cost of moving the gas from the well to the downstream sales point. The lessor argued royalty was due on the downstream price, without any deduction for costs to move the gas to the sales point. In the first twelve pages of the court's opinion, under the heading "PIPELINE FROM WELL," the court applies a basic contract analysis and arrives at an accurate conclusion. However, in order to justify applying Kansas law to resolve the rights of all members in the class, the court's opinion, under the heading "CONFLICT OF LAWS," in the next five pages, applies an "oil and gas law" analysis that introduces the implied covenant to interpret what the court has already concluded was clear, express contract language.

In its "first" opinion[98] the court in *Stemberger* held that

> *Scott*, *Voshell*, and *Molter* are dispositive of the issue in this case. These cases clearly show that where royalties are based on market price "at the well," or where the lessee receives his or her share of the oil or gas "at the well," the lessee must bear a proportionate share of the expenses in transporting the gas or oil to a distant market.[99]

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plaintiffs stipulated with the defendant that "the rights of all parties should be construed according to the language of the gas royalty clause in Stemberger's lease." *Id.* Unfortunately for members of the class, the class representative, Stemberger, had a royalty clause that was among the least favorable for making its case. *Id.* With this stipulation the express terms of the other class members were swept away and replaced with the following: "one-eighth (1/8), at the market price at the well, (but, as to gas sold by lessee, in no event more than one-eighth (1/8) of the proceeds received by lessee from such sales) . . . ." *Id.*

98. *Id.* at 794 (the portion of the opinion entitled "PIPELINE FROM WELL").

99. *Id.* at 796. *See also* Scott v. Steinberger, 213 P. 646 (Kan. 1923). The *Scott* case concerned a downstream sale of gas for 15¢ per thousand cubic feet ("Mcf") from which the lessee deducted 7¢/Mcf to account for the cost of moving the gas from the wellhead to the point of sale. *Id.* at 647. The lessee paid the lessor its one-eighth royalty using the resulting 8¢/Mcf figure. *Id.* The lessor argued they were entitled to one-eighth of 15¢/Mcf instead of the one-eighth of 8¢ they received. *Id.* In *Stemberger* the court described the holding in *Scott*,

> This court determined the parties contemplated that the market price of the gas should be determined at the place where the wells were connected with the pipeline and not at some distant market where the gas might be sold. Thus, where the price of the gas was to be determined at the well, royalties were to be paid at a rate of 8 cents per MCF, the reasonable value of the gas at the field.

The court held that the lease was clear regarding the location at which royalty must be calculated: "at the well" as opposed to a location that is not "at the well." This simply gave effect to the express terms of the contract.

As an introduction to its "second" opinion,[100] the court observed, "The lessee has the duty to produce a marketable product, and the lessee alone bears the expense in making the product marketable."[101] If the court was able to resolve the interpretive problem using the *express* covenant to value royalty "at the well," there would be no need to resort to *implied* covenants. This is where "oil and gas law" begins to negate sound "contract law" analysis. This is also where the court starts to flounder as it seeks to harmonize the "oil and gas" law of Kansas, Oklahoma, and Texas to justify its choice of law conclusions. However, the court returned to the express terms of the lease under the heading "REASONABLENESS OF DEDUCTIONS,"[102] noting that

> [t]his case turns on the fact that the royalty was to be paid based on "market price at the well" and the gas was marketable at the well, but there was no market at the well. The parties in this case dispute Marathon's deduction of transportation expenses, but there has been no evidence or finding as to what the market price at the well was. Because sale occurred away from the well or the lease premises, we assume that royalties were paid based on the market price at a distant market rather than market price at the well. *Amicus* API seems to recognize this. API suggests that this court should remand the case to the district court "to determine the 'market price at the well' by determining the reasonable cost to transport the gas from the wellhead to the point where it could be sold off the lease under circumstances where no market existed at the well and the lessee had to build its own connecting pipeline." Marathon disagrees with API and argues that remand is not appropriate because the parties have not requested it and

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Stemberger, 894 P.2d at 795. The *Voshell* and *Molter* cases addressed similar issues concerning the downstream marketing of oil. Molter v. Lewis, 134 P.2d 404 (Kan. 1943); Voshell v. Indian Territory Illuminating Oil Co., 19 P.2d 456 (Kan. 1933).

100. *Stemberger*, 894 P.2d at 800 (the portion of the opinion titled "CONFLICT OF LAWS").

101. *Id.* at 799.

102. *Id.* at 805.

> because the only evidence presented was that the amount deducted was reasonable.[103]

Although the lessee was successful at focusing the court on the express terms of the lease, the lessors were also successful at getting the court to assume an implied covenant analysis was required, even though the question could be fully answered by interpreting the express "at the well" language. The problem here concerned the *meaning* of the express terms "at the well"; it had nothing to do with a missing term. The terms were there, the court just had to apply them—as it clearly did in its "first" *Stemberger* opinion.

2. The Scope of the Contractual Relationship

To maximize royalty under the royalty value theorem, lessors will seek to expand the scope of the oil and gas lease relationship to include enterprises the lessee may engage in downstream of the leased premises. This is often attempted by characterizing the oil and gas lease as some sort of "cooperative venture" or "joint enterprise."[104] The lessor seeks to have its royalty rights follow the production as it moves downstream from the leased premises because it will generally increase in value as it moves further away from where it was extracted. The most common problem the lessor encounters in its quest for downstream value is the express language of the lease indicating royalty is to be determined at or near the point where the oil or gas is extracted.

Even absent the commonly encountered "at the well" language, the entire oil and gas lease is structured around a relationship that begins, and ends, at the leased land.[105] For example, the granting clause grants the lessee rights to explore, develop, and produce from, *the leased land.* The duration of the

103. *Id.* at 806. The author was one of the attorneys representing the American Petroleum Institute that participated in *Stemberger* by filing an amicus brief on appeal. *Id.* at 788. My main contribution to the analysis was that nobody, on either side of the case, had addressed the real issue: since the lease requires a royalty based upon "market price at the well," the focus of the trial should be on answering the single question: what is the market price of gas at the well? If the amount paid as royalty was less than that number, the lessee breached its contract; if the amount paid was equal to or greater than that number, the contract was not breached. This is simply an application of the express terms of the contract, which is all that should have been required under the facts of this case.

104. *See generally* McArthur, *supra* note 20, at 834–37.

105. *See generally Missing Link*, *supra* note 94; David E. Pierce, *Incorporating a Century of Oil and Gas Jurisprudence into the "Modern" Oil and Gas Lease*, 33 WASHBURN L.J. 786, 819–28 (1994).

lease will continue only so long as there is production from *the leased land.* Activities to extend the lease beyond the stated term must take place on *the leased land.* Royalty is generated only from production that is obtained from *the leased land.* The lessee will argue that the scope of the relationship is defined by the leased land so that whatever business activities the lessee engages in away from the leased land are independent from its lease obligations.

The basic issue is when, during the life of the lease, does the lease cease to govern a barrel of *extracted* oil or a thousand cubic feet of *extracted* gas? The lessee would argue, under a lease providing for a royalty on gas, that the lease relationship, as to any extracted gas, ends when the gas is extracted. At this point the surrounding facts will determine the parties' rights in the extracted gas. For example, if it is used to support lease operations, there may be no royalty due on the extracted gas.[106] If it is "sold at the wells," a royalty equal to one-eighth of the sales proceeds may be due.[107] If it is not sold at the well, and not used to support lease operations, a royalty equal to one-eighth of the market value of the gas may be due.[108] In each situation, nothing remains to be done by the lessee but apply the terms of the lease contract to identify the royalty that is due. The lessee's obligation is complete at the time the gas is extracted. As to the extracted gas, the lessee should be able to take it and do what they please without concern for its prior association with an oil and gas lease.

This is another area where the express covenants of the lease limit the scope of the parties' relationship and implied covenants are being used by the lessor to try and expand the limits. The lessor response has been to argue the lessee, in addition to its express obligations, has an implied obligation to "market." "Market," being a rather imprecise term, introduces an opportunity for "interpretation." However, note that in this case the implied covenant is being used to obscure what is otherwise pretty clear express language. What necessitates implying the marketing obligation

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106. For example, the lease might provide, "Lessee shall have free use of oil, gas and water from said land . . . for all operations hereunder, and the royalty on oil and gas shall be computed after deducting any so used." AAPL Form 675 Oil and Gas Lease 1 3, *reproduced in* KUNTZ, *supra* note 95, at 12.

107. For example, the AAPL Form 675 Oil and Gas Lease states, "provided that on gas *sold at the wells* the royalty shall be one-eighth of the amount realized from such sale." *Id.* (emphasis added).

108. For example, the AAPL Form 675 Oil and Gas Lease states, "On gas . . . produced from said land and *sold or used off the premises or for the extraction of gasoline or other products therefrom*, the market value at the well of one-eighth of the gas so sold or used . . . ." *Id.* (emphasis added).

when the rights of the parties can be ascertained using the express terms of the lease? Where is the omitted term in this situation? The completeness of the royalty obligation may depend upon whether the implied covenant is characterized as implied-in-law as opposed to implied-in-fact. If the covenant is implied-in-law, the agreement is presumably not complete until it meets the court's view of what is "fair." Under a properly applied implied-in-fact analysis an additional covenant in many cases will be unnecessary. Most situations are merely an issue of the "meaning" of the term.

B. Is it a "Meaning" Problem?

The *law of* oil and gas has frequently caused courts to evaluate situations applying the wrong analysis. This is where a "contract law" approach can be particularly revealing and useful in identifying the true nature of the task before the court: is it an omitted term problem or a meaning problem? If it is an omitted term problem, the court will often need to apply an implied covenant analysis. However, if the problem is determining the "meaning" or operation of an "open" term, a good faith analysis will often be required. The influence of "oil and gas law," and the "law of" implied covenants, has caused courts to apply an implied covenant analysis to all problems—even "meaning" problems where a good faith analysis is the appropriate response. For example, one of the leading Texas "implied marketing covenant" cases is really a "good faith" case.

In *Amoco Production Co. v. First Baptist Church of Pyote*,[109] the royalty clause provided that Amoco would pay its lessor a share of "the amount realized from such sale" of the gas production.[110] Amoco entered into a gas contract to sell gas from the leased land at a price approximately one-half the price others were selling their gas for at the time.[111] This seemingly odd behavior by Amoco was understandable because it had several other leases in the field, where the gas had been dedicated to the same purchaser under prior contracts at 17¢/Mcf, and the purchaser agreed to increase the contract price for this dedicated gas from 17¢ to 70¢.[112] The trade-off, however, was that Amoco would dedicate additional acreage, including plaintiff's leased land, to the gas purchaser at a price of 70¢/Mcf when the going price was in the range of $1.40/Mcf. The lessor sued Amoco and the court began its opinion stating, "This case involves the issue of an implied covenant to

109. 579 S.W.2d 280 (Tex. App. 1979).

110. *Id.* at 288.

111. It appears Amoco agreed to sell gas from the leased land for about 70¢/Mcf when others were able to obtain contracts to sell at approximately $1.40/Mcf. *Id.* at 282–83.

112. *Id.*

market natural gas at fair market value under a lease which provides for a royalty based upon the amount realized from the sale of such gas."[113]

What is the "omitted term" that necessitates implying a term? The problem appears to be interpreting the lessee's obligations when it has agreed to pay its lessor a fraction of "the amount realized" under the lease. This is a "meaning" problem, not an omitted term problem. The real issue is, because the lessee has the ability to unilaterally impact "the amount realized," what sort of restraints, if any, should be placed on the lessee to ensure the intent of the parties is fulfilled? Although the court purported to apply an implied covenant analysis, it stated, "We conclude there is an implied covenant to exercise good faith in the marketing of gas, and particularly so where the interests of the lessor and lessee are not identical."[114] This appears to be more of a "good faith" analysis instead of an "implied covenant" analysis.[115] The Supreme Court, in refusing the application for writ of error, commented on the Court of Appeals' good faith analysis stating,

> It is implicit in the court's reasoning that there was evidence of a breach of the covenant to market in good faith in Amoco's marketing of the lessors' gas at a rate substantially lower than market value, where by doing so Amoco was able to obtain for itself the collateral benefit of increasing the price for gas from its other previously dedicated leases from third parties.[116]

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113. *Id.* at 282.

114. *Id.* at 285.

115. Dissenting Justice Preslar picked up on the good faith analysis stating,

> We do not need to discuss or determine whether the failure "to act in good faith" is sufficient legal excuse to overcome the express contractual terms because it is evident from the record that there is no proof of any such failure to act in good faith. As is seen, the only "proof" is that Appellant sold its gas for less than others sold theirs. Obviously, this is not enough to sustain the judgment. Otherwise, all who have contracted for less than the top price paid by others are in default under their oil and gas lease regardless of reasons for entering such contract other than price.

Id. at 290 (Preslar, C.J., dissenting).

116. Amoco Prod. Co. v. First Baptist Church of Pyote, 611 S.W.2d 610, 610 (Tex. 1980). The court cautioned,

> However, this holding should *not* be interpreted as implying an absolute duty to sell gas at a market value under a "proceeds" royalty clause. The parties can draft either a "market value" or a "proceeds" royalty provision, and their intent will be followed by the courts. Although, in a proper factual setting, failure to sell at market value may be relevant evidence of a breach of the covenant to

In many instances, determining the meaning of a term will not require a good faith analysis. For example, when the lease requires payment of a fraction of "market value" as a royalty, the lessee has no discretion or any ability to manipulate the situation.[117] This raises an issue under many leases that contain optional royalty provisions allowing the lessee to pay the lessor based on "proceeds" or "amount realized" if the gas is "sold at the well," or the "market value" if the gas is "used" or otherwise not "sold at the well."[118] The court in *Yzaguirre v. KCS Resources, Inc.* alluded to the issue, but was not required to address it, suggesting in any event there was a good faith basis for KCS' off-lease marketing.[119] This presents an interesting question regarding the express terms of the lease: (1) was the option designed to provide the lessee a "right" to market the extracted gas in any manner it desires[120]—so long as the lessor receives royalty based upon either what the lessee gets for the gas when sold at the well or the market value, at the well, of gas used or marketed off the lease? or (2) was the option designed to impose an "obligation" on the lessee to dispose of gas so as to maximize the net return to the lessor—depending upon the unique analysis a particular jurisdiction uses to define market value?[121] Without

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> market in good faith, it is merely probative and not conclusive.

Id.

117. *E.g.*, Yzaguirre v. KCS Res., Inc., 53 S.W.3d 368 (Tex. 2001).

118. For example, the AAPL Form 675 Oil and Gas Lease provides,

> 3. The royalties to be paid by Lessee are as follows: . . . . On gas, including casinghead gas, condensate or other gaseous substances, produced from said land and *sold or used off the premises or for the extraction of gasoline or other products therefrom*, the *market value at the well* of one-eighth of the gas so sold or used, provided that on gas *sold at the wells* the royalty shall be one-eighth of *the amount realized* from such sale.

KUNTZ, *supra* note 95, at 12 (emphasis added).

119. *Yzaguirre*, 53 S.W.3d at 374 n.3. The court identified the issue stating,

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

Id.

120. This argument would seem to be particularly strong where the lessee has the option to "use" the gas and not market it at all.

121. For example, does the court calculate "market value" at the time the gas is extracted or at the time the gas sales contract was entered into by the lessee? *Royalty Calculation*,

addressing the issue directly, the Kansas Supreme Court and others have assumed the option is a "right" the lessee can exercise without regard for its impact on the royalty calculation.[122]

Lessees will seek to address this issue as one of interpreting the "meaning" of the royalty clause. Lessors will argue for an implied covenant analysis that requires the lessee to take whatever action is required to get the lessor the best deal. However, the problem will probably be resolved by applying the express terms of the lease supplemented by a good faith analysis for cases like *Amoco Production Co. v. First Baptist Church of Pyote.*[123]

C. "Contract" Damages or "Punishment" Damages?

We have already seen, in the *Kansas Baptist Convention* case,[124] an example where the court granted a party "punishment" damages instead of "contract" damages. Although the court was responding to what it thought was Mesa's bad faith in imposing the costs of a third well against the Convention's revenue stream, instead of merely eliminating the offending costs,[125] the court modified the underlying contract and took away $1.9 million in value from Mesa and gave it to the Convention and Hugoton Energy Corporation.[126] As in the *Kansas Baptist Convention* case, a sure sign a court has departed from contract principles into the unprincipled realm of "equity" is when the damages sought have no relationship to a

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supra note 80, at 18-22 to 18-34 (discussing the various approaches to defining "market value").

122. The courts have generally sought to ascertain, as a matter of fact, how the gas is being marketed and then merely applied the appropriate portion of the royalty clause to compensate the lessor. *E.g.*, Waechter v. Amoco Prod. Co., 537 P.2d 228, 247–48 (Kan. 1975) (giving effect to Amoco's sale of gathering system that changed point of sale from an off-lease "market value" to an on-lease "proceeds" transaction under the oil and gas lease).

123. *See Unfinished Business*, *supra* note 23, at 3-8 to 3-10.

124. Kan. Baptist Convention v. Mesa Operating Ltd., 864 P.2d 204 (Kan. 1993).

125. The costs would have amounted to $54,375 (5/16 x $174,100). *Id.* at 207.

126. The injustice in this after-the-fact modification of the contract is that Mesa, when it acquired its contract rights in 1969, most likely valued its predecessor's contract rights as though it would have the opportunity to purchase 5/16ths of the gas for 10¢/Mcf. *Id.* at 206–07. The facts are clear that this was the basis on which Hugoton Energy and the Convention entered into their contract that valued the same rights in 1988 at $15,000. *Id.* at 208. The market had already valued the contract, *as written*, at $15,000. *Id. As re-written* by the court, its value increased to $1.9 million—all based upon Mesa's attempt to recoup $54,375. Of course, this also means Mesa's value in the contract decreased by $1.9 million because of its breach. These "equitable" punitive damages for breach of contract are thirty-one times the actual damages allegedly suffered by the Convention and Hugoton Energy.

breach of the underlying contract. One of the first principles we discuss in my Contracts course is that "the law is concerned mainly with *relief* of *promisees* to *redress breach* and not with *punishment* of *promisors* to *compel performance*."[127] This principle should be used to evaluate whether the plaintiff's damage theory is contract-based or the product of an attempt to confuse the issue in hopes of finding a sympathetic judge, juror, or justice.

In the royalty arena, the best examples of plaintiffs seeking "punishment" damages for a breach of contract are in the "affiliate transaction" cases. The real contractual goal of the lessor in these cases is to obtain a royalty on values downstream from the well—even though their lease provides for an "at the well" royalty value. The lessor faces an immediate interpretive problem because in many jurisdictions, like Kansas and Texas, the courts will give effect to the express "at the well" language in the lease contract.[128] Today it is common practice for a producing company to sell its production to an affiliated marketing company which aggregates, packages, and markets the gas downstream from the well.[129] The producing company will pay royalty based upon what it receives from the marketing company.[130] The lessor will attack this transaction, asserting the affiliate transaction has cut the lessor out of value it was entitled to. This value was instead transferred to the producing company's affiliated marketing company. The key issue is determining what the lessor "was entitled to."

If the lease provides for a gas royalty based upon "market value at the well," the issue will be what was the market value of the gas, *at the well.* Assume the lessee pays the lessor based upon a $1.00/Mcf value. If lessor contests this payment, and it is ultimately held the "market value at the well" was $1.05/Mcf instead of $1.00, the lessor's contract damages will be $0.05/Mcf. This is a classic contract damages model: contract price – price paid = damages. However, the lessor will be entitled to damages only if the amount paid is less than the market value *at the well.* Recognizing this dilemma, counsel for lessors have started to argue that since the lessee has sold the gas to their affiliate, the court should disregard the corporate separateness of the producing and marketing companies and look only to

127. E. ALLEN FARNSWORTH ET AL., CONTRACTS CASES AND MATERIALS 1 (6th ed. 2001).

128. *E.g.*, Stemberger v. Marathon Oil Co., 894 P.2d 788, 794 (Kan. 1995); Judice v. Mewboume Oil Co., 939 S.W.2d 133, 135 (Tex. 1996).

129. *See generally* Judith M. Matlock, *Payment of Gas Royalties in Affiliate Transactions*, 48 INST. ON OIL & GAS L. & TAX'N 9-1 (1997).

130. This amount will typically be based upon a recognized area index price which generally equates to the current market value of the gas as produced.

the value obtained from the sale *by the marketing company* to an unaffiliated third party. By modifying their damages request, they are able to obtain the downstream value they would otherwise be denied under their contract. The fact they seek to obscure is that the basis for their complaint is still breach of contract: did they receive market value *at the well* for their gas? To the extent a court uses the sale by the affiliated marketing company to define the "contract price," it is disregarding the "market value at the well" contractual limitation on the lessor's royalty.

An artful statement of the lessor's damage theory is provided by an attorney that has made the argument on several occasions:

> Although couched under the duty to market or something based on lease terms, the true issue is again the narrower mutual benefit issue.[131] These cases rarely claim that a higher price was available than the price the lessee actually received when it or its affiliate resold the gas.[132] Nor do they seek a full review of market values.[133] The royalty owners are not contesting the operator's marketing diligence. They just want equal treatment by sharing the price received, directly or indirectly.[134]
>
> Nor should these royalty owners need to prove that the price the lessee ultimately did receive in third-party sales was the comparable market value in the field.[135] What they are saying is that diligence in getting the best price requires at least the efforts that their own lessee thought best for its own production;[136] presumably it did act prudently in getting the price it did;[137] but

131. This means do not look at the express lease terms, or the implied covenant to market, because there will often be something there that causes a problem, such as "at the well" or "market value" language.

132. This is because the price already represents a downstream value that is obtained by the marketing affiliate, which often includes aggregating, packaging, and marketing expenses, including expenses associated with moving the gas from the wellhead to the point of sale by the marketing affiliate to an unaffiliated third party.

133. The reason they do not is that "a full review of market values" would consider the appropriate location for determining the value, which will often be "at the well."

134. They just want royalty based upon a value "*not* at the well" instead of "at the well."

135. Because if you did, you would realize the third-party sale included downstream values, which should not be included to determine "at the well" values.

136. But the lessee is not limited in any way to an "at the well" value.

137. Often the "lessee selection" argument will be made by lessor's counsel. For example,

> Yet part of the lessee's promise is that it will make its expertise available to the royalty owners. The obligation to share fully should not be lessened if the

> it has to share that price.[138] The lessee got a separate benefit[139] and should have to disgorge the portion attributable to its royalty owners' share.[140]

Note that in this situation lessor's counsel is arguing his permutation of "oil and gas law" in hopes a court will explore the current fairness of the proposed *new* agreement instead of evaluating the conscionability of the contract.[141] Applying "contract law" to the situation will often cause the case to fold when the express lease terms require a wellhead valuation for royalty.

V. Conclusions

The dynamics of the oil and gas lease, and the evolution of the *law of* oil and gas, provide a jurisprudential laboratory to evaluate why and how courts react to situations they believe require their equitable intervention. After a century of oil and gas litigation, we can see courts vacillating between "contract law" and "oil and gas law," depending upon their willingness to give effect to the express terms of the oil and gas lease contract. Courts faithful to contract law enforce the lease contract as

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> lessee's efforts can produce a better than average return. *If the lessee is a large, experienced marketer, its expertise will be precisely why landowners want to sign up with it.* It cannot avoid this obligation just by donning a new set of corporate colors.

McArthur, *supra* note 20, at 817 (emphasis added). The argument is unconvincing for several reasons. Often the party that obtains the lease from the lessor never develops the leased land. The vast majority of leases contain a broad assignment clause, and it is common to have the lease assigned several times before it is possessed by the party that ultimately develops the leased land. Frequently, the lease will be assigned many times after the property is developed. Also, a lessor should not be concerned with a lessee's downstream marketing capabilities when they are expressly limited to a royalty on values at the most "upstream" point in the gas marketing chain: "at the well." In any event, if a lessee is held to have an implied marketing obligation, the lessee's performance will be measured by what a hypothetical prudent operator owning the single lease would have done under all the circumstances. *Jurisprudential Underpinnings*, *supra* note 24, at 10-12 to 10-14 (discussing the prudent operator standard).

138. This is the real rub that goes to the heart of the "implied-in-law/lessor best-deal" analysis versus the "implied-in-fact/what does the contract require" analysis.

139. The benefit is derived from the lessee's ownership of the gas and ability to do things with the gas after the lease relationship has run its course regarding the extracted gas.

140. McArthur, *supra* note 20, at 865. The royalty owner's "share" is often defined as an amount of money equal to the market value of the gas "at the well."

141. This contract is the "old" agreement.

written; courts seeking to mitigate the express terms of the lease contract resort to implied covenants and other interpretive devices to avoid giving effect to the contract the parties made. Often this is masked by purporting to invoke "oil and gas law" to resolve the issue.

If you accept the premise that the oil and gas lease is an adhesion contract, then it is highly likely that the express terms of the resulting bargain—the contract—have been designed to maximize the lessee's interests. Therefore, if a court wants to avoid sticky language like "market value" and "at the well," it will need to employ a theory that gets them away from the contract where the court's interpretive license can operate. This is where the law of implied covenants comes into the picture, with Professor Merrill as the chief artist.

It is possible that counsel representing lessors and lessees are missing the real issue that drives courts in this area: Is *the lease contract* at issue in fact the product of an unfair bargain?[142] For counsel representing lessees in Colorado, their task may be to debunk, with evidence at trial, the underlying premises used by the Colorado Supreme Court to apply their implied-in-law approach to the oil and gas lease.[143] The task for counsel representing lessors in jurisdictions like Kansas and Texas will be more difficult. They will have to prove, with evidence at trial, that an unfair bargaining situation existed and resulted in the express lease terms the lessee is seeking to enforce.[144]

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142. This will present a problem for the class action procedural device since inquiry into issues such as unconscionability requires a highly factual lessor-by-lessor analysis. For example, there will be a temporal variance in the inquiry because the conscionability of the bargain must be evaluated "at the time it was made." U.C.C., *supra* note 40, § 2-302(1). It is not unusual to encounter leases in a single field, or even a single well, that may have been entered into decades apart. Similarly, an unconscionability analysis requires that "the parties shall be afforded a reasonable opportunity to present evidence as to its commercial setting, purpose and effect." *Id.* § 2-302(2). The *Restatement* contemplates a similar inquiry, "The determination that a contract or term is or is not unconscionable is made in light of its setting, purpose and effect. Relevant factors include weaknesses in the contracting process like those involved in more specific rules as to contractual capacity, fraud, and other invalidating causes . . . ." RESTATEMENT (SECOND) OF CONTRACTS, *supra* note 43, § 208 cmt. a.

143. The Colorado Supreme Court, like Professor Merrill, bases its interpretation of the oil and gas lease on the premise that the "standard" oil and gas lease is unfair to the lessor and therefore requires judicial intervention to rewrite the contract to make it fair, or more fair. Rogers v. Westerman Farm Co., 29 P.3d 887, 899 (Colo. 2001); *Jurisprudential Underpinnings*, *supra* note 24, at 10-16 to 10-20.

144. The Colorado Supreme Court criticizes the Kansas Supreme Court's interpretation of the term "at the well" noting: "the Kansas Supreme Court concluded that the lease was

"Oil and gas law," in the vast majority of cases, should merely be a chronicle of how contract, property, and tort have been applied to problems encountered by the oil and gas industry. An "oil and gas" contract should be treated no differently from any other type of contract.[145] If a court decides to treat it differently, it should explain why. As noted in this article, courts that stray from basic contract law principles are often adjusting the contract to favor the lessor. However, instead of employing the appropriate contract analysis, such as unconscionability, they justify their intervention as the application of "oil and gas law." Currently, oil and gas law is undergoing a tug-of-war between those desiring to engage in a broad equitable re-ordering of the oil and gas bargain[146] and those desiring to apply traditional contract doctrine to preserve the parties' private ordering.[147] There are many in-between that usually end up applying contract doctrine after wading through a morass of "oil and gas law."[148] I predict the jurisprudence in this area will be significantly improved with a revival of the application of basic contract law to oil and gas problems; a revival which some courts are pursuing and one I believe will result in a renaissance *of law* in the *law of* oil and gas.

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not ambiguous, and that the language at issue specifically provided the point of valuation for the royalty payments." *Rogers*, 29 P.3d at 899 (referring to the Kansas court's analysis in Stemberger v. Marathon Oil Co., 894 P.2d 788 (Kan. 1995)). However, the Colorado Supreme Court also criticized the Colorado Court of Appeals for finding "that the 'at the well' provisions must be given *some* meaning." *Rogers*, 29 P.3d at 899 (emphasis added). In jurisdictions willing to give meaning to the express terms of the contract, the lessor will have to establish a legal basis for disregarding the contract, such as unconscionability. If the court will not accommodate the lessor through benevolent interpretation, then the lessor will need to provide the court with a doctrinal basis for avoiding the express terms of the contract.

145. As with any contract, the unique attributes of the industry can be accommodated, when appropriate, through interpretive concepts such as "usage" or "usage of trade." *See generally* RESTATEMENT (SECOND) OF CONTRACTS, *supra* note 43, §§ 219–223.

146. For example, the Colorado Supreme Court demonstrated this re-ordering in its opinion, *Rogers v. Westerman Farm Co.*, 29 P.3d 887 (Colo. 2001).

147. For example, the Texas Supreme Court demonstrated traditional contract interpretation in its opinion, *Yzaguirre v. KCS Resources, Inc.*, 53 S.W.3d 368 (Tex. 2001).

148. The Kansas Supreme Court exemplified this approach in its opinions in *Stemberger v. Marathon Oil Co.*, 894 P.2d 788 (Kan. 1995) and *Smith v. Amoco Production Co.*, 31 P.3d 255 (Kan. 2001).