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MARKET VALUE AND LONG-TERM PURCHASE CONTRACTS: *TARA PETROLEUM CORPORATION v. HUGHEY*

I. INTRODUCTION

The recent Oklahoma Supreme Court decision in *Tara Petroleum Corp. v. Hughey*[1] introduced common sense into the controversy over the meaning of the term "market price" in gas leases. Ignoring substantial case law to the contrary in other jurisdictions, the court held that the term "market price," under certain circumstances, was the contract price at which the lessee sold the gas.[2] Therefore, if the lease calls for gas royalty based on the market price at the well, and the producer has entered into a long-term, arm's length, good faith gas purchase contract at the best price available at the time, that contract price is the market price.[3]

Normally, oil and gas leases provide that the lessor will receive a royalty based on either the market price or the proceeds.[4] Courts have generally held that where royalties are based on "proceeds," proceeds are defined in terms of the lessee's revenues. Where the royalty is based on the "market price," however, it has been held that the market price is the prevailing price at any given time for which gas could be sold, regardless of the lessor's commitment to a long-term purchase contract.[5] *Tara* represents the first time that the meaning of "market price" as it relates to royalties has been addressed in Oklahoma.[6]

An understanding of the background of this controversy is critical to a realization of the importance of the *Tara* decision. In the early

1. 630 P.2d 1269 (Okla. 1981).
2. *Id.* at 1272.
3. *Id.* at 1273.
4. *See generally* Fischl, *Ascertaining the Value or Price of Gas for Purposes of the Royalty Clause*, 21 OKLA. L. REV. 22 (1968). Market value refers to the current prevailing price; proceeds refers to the amount received upon sale by the lessee.
5. J.M. Huber Corp. v. Denman, 367 F.2d 104 (5th Cir. 1966); Foster v. Atlantic Ref. Co., 329 F.2d 485 (5th Cir. 1964); Lightcap v. Mobil Oil Corp., 221 Kan. 448, 562 P.2d 1, *cert. denied*, 434 U.S. 876 (1977); Montana Power Co. v. Kravlik, 586 P.2d 298 (Mont. 1978); Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866 (Tex. 1968).
6. The Oklahoma Supreme Court addressed a related issue in Apache Gas Products Corp. v. Oklahoma Tax Comm'n, 509 P.2d 109 (Okla. 1973), where it held that, for the purpose of gross production tax computation, the market price is the contract price. See notes 23-29 *infra* and accompanying text.

days of the gas industry, gas was viewed as little more than a waste product.[7] For this reason, and because of the costs of gas production, it was frequently necessary for producers to enter long-term contracts in order to sell the gas.[8] These contracts usually called for a fixed price to be paid during the term of the agreement with no provisions for future price escalations. It was not possible for the parties to foresee the dramatic changes that would occur in the price of gas. The lessor receiving a royalty based upon the contract price often became disgruntled because lessors who had negotiated leases later in time when gas prices were higher were receiving substantially higher royalties.[9]

In response to the concerns of the lessor, some jurisdictions have awarded increased royalties.[10] These decisions have largely ignored the producer who was locked into a fixed revenue by his long-term contract and thus forced to use a larger and larger share of his income to satisfy the lessor's demand for royalties. The *Tara* decision marks a departure from this trend and recognizes the realities of the gas industry.[11]

An analysis of the underlying policies of *Tara* and the manner in which the *Tara* rule differs from prior decisions indicates that *Tara* provides an equitable solution for both parties.[12]

II. STATEMENT OF THE CASE

Tara presents a typical fact situation. The lessors brought suit for additional royalties against the original lessee, the first purchaser, and the producer.[13] The lessors had executed the original lease to Tara Pe-

7. *See, e.g.*, Morris, *The Gas Royalty Clause—What is the Market Value?*, 25TH INST. ON OIL & GAS L. & TAX 63 (1974); Exxon Corp. v. Middleton, 571 S.W.2d 349, 352 (Tex. Civ. App. 1978), *modified*, 613 S.W.2d 240, *rehearing*, 619 S.W.2d 477 (1981).

8. *See* Apache Gas Products Corp. v. Oklahoma Tax Comm'n, 509 P.2d 109, 112 (Okla. 1973); Exxon Corp. v. Middleton, 571 S.W.2d 349, 352 (Tex. Civ. App. 1978), *modified*, 613 S.W.2d 240, *rehearing*, 619 S.W.2d 477 (1981).

9. 630 P.2d 1269, 1272 (Okla. 1981).

10. J.M. Huber Corp. v. Denman, 367 F.2d 104, 109 (5th Cir. 1966) (royalties based on the theoretical transaction between the supposed free buyer and seller rather than the actual transaction); Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 871 (Tex. 1968) (royalties based on the prevailing market price at the time of the sale which was the time of delivery); Exxon Corp. v. Middleton, 571 S.W.2d 349, 360 (Tex. Civ. App. 1978), *modified*, 613 S.W.2d 240, *rehearing*, 619 S.W.2d 477 (1981) (royalties based on several factors including comparable sales and expert testimony regarding average price corroborated by comparable sales).

11. The same month the Third Circuit of the Court of Appeals of Louisiana reached a similar conclusion by way of a different analysis. See *infra* notes 77-91 and accompanying text.

12. An in-depth discussion of the various methods employed by other jurisdictions to calculate royalties is beyond the scope of this Note. See *supra* note 10.

13. 630 P.2d 1269 at 1272. See *infra* note 18.

troleum in 1973. Through a series of assignments Tara Petroleum assigned the lease to Wilcoy Petroleum.[14] Wilcoy successfully drilled a producing gas well on the property in February of 1976 and that same month entered into a gas purchase contract with Jarrett Oil Company. This contract was for two years and extended automatically from year to year thereafter unless terminated on the anniversary date upon ninety days notice by either party.[15]

The royalties during the first two years were paid by Jarrett to the lessors based upon the contract price. During the contract period Jarrett resold the gas to El Paso Natural Gas Company by a contract which called for the price to be the ceiling price allowed by the Federal Power Commission,[16] rather than a fixed price. Five months after Jarrett began purchasing from Wilcoy, the FPC substantially raised the ceiling price, enabling Jarrett to receive far more from El Paso Natural Gas than the 31 cents or 32 cents per mcf it was paying Wilcoy under the gas purchase contract.[17] The lessors brought suit alleging underpayment of royalties.[18] The District Court of Greer County awarded the lessor additional royalties of $18,000 from Tara Petroleum and Jarrett.[19] It is from this judgment that Tara Petroleum and Jarrett appealed.

The lessors based their claim for higher royalties on the following market price royalty clause:

[T]he said lessee covenants and agrees . . . . To pay lessor for

14. *Id.* at 1271. Tara retained an override of 1/8th royalty of 7/8th working interest and the right to purchase any gas at 3¢ per mcf. An override is defined as a given percentage of the gross production payable to someone other than the lessor. It is generally applied to such a fractional interest in the production of oil and gas as is created from the lessee's estate. La Laguna Ranch Co. v. Dodge, 114 P.2d 351 (1941). In Oklahoma an override has been defined as a percentage carved out of the lessee's working interest free and clear of production expenses. De Mik v. Cargill, 485 P.2d 229, 232 (Okla. 1971).

15. 630 P.2d at 1271. The contract between Jarrett and Wilcoy was in effect from March 1976 through February 1978. By this time gas prices had significantly risen. Although the contract called for the seller, Wilcoy, to pay all royalties and overrides, the actual payments were made by the buyer Jarrett. This fact was considered insignificant by the court because such practices are common in the industry. *Id.* at 1276.

16. The Federal Power Commission (FPC) sets ceiling prices in an effort to regulate the interstate gas market pursuant to the Natural Gas Act (NGA), 15 U.S.C. §§ 717-717w (1976). See *infra* note 71 and accompanying text.

17. The price during this period went to nearly $1.30 per mcf. 630 P.2d at 1271. Mcf refers to thousand cubic feet and is the standard unit for measuring the value of natural gas.

18. *Id.* at 1269. Suit was brought against Tara Petroleum, Jarrett, Wilcoy, Brown, Pugh, Steelman and Howard. Steelman and Howard aided Wilcoy financially. One defendant, Falcon Oil & Gas Co., was dismissed from the suit. All but one of the original lessors dismissed their actions.

19. *Id.* at 1272 (holding for the producers Wilcoy, Brown, Pugh, Steelman and Howard).

> gas of whatsoever nature and kind produced and sold or used off the premises, or used in the manufacture of any products therefrom, one-eighth (1/8) *at the market price at the well* for the gas sold, used off the premises, or in the manufacture of products therefrom, said payments to be made monthly . . . .[20]

On appeal the meaning of the term "market price" in the royalty clause and the amount of royalty for the two year period from 1976 to 1978 were at issue. The case raised the question of whether royalty based upon "market price" is to be calculated from the prevailing market rate in the field, or, as the lessee argued, on the contract price.[21]

III. THE DEVELOPMENT OF THE MARKET VALUE CONTROVERSY

Although the issue has been decided in many jurisdictions,[22] *Tara* represents Oklahoma's first opportunity to deal with the market price clause. In *Apache Gas Products Corp. v. Oklahoma Tax Commission*[23] the Oklahoma Supreme Court was faced with a related issue: whether gross production tax was to be paid based upon the prevailing market price or upon the contract price.[24] The court, in interpreting Oklahoma's Gross Production Tax Code,[25] held that "the Commission should apply the gross production tax to the gross proceeds realized by each producer from his individual sales contracts, except where the conditions under which a particular contract was entered into were such as not to reflect arm's length bargaining . . . ."[26]

The Tax Commission had urged the court to interpret the statute to base the tax due on the prevailing value of the gas. The court rejected this argument, stating that the Commission did not have the right to collect taxes based on the current value. The court stated that the statute was to be interpreted in light of such realities as the neces-

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20. *Id.* (emphasis by the court).

21. *Id.*

22. *See* Henry v. Ballard & Cordell Corp., 401 So. 2d 600 (La. Ct. App. 1981) and cases cited in note 5 *supra*.

23. 509 P.2d 109 (Okla. 1973).

24. *Id.* at 116.

25. OKLA. STAT. tit. 68 § 1009(f) (1971) which states in part:

> In case . . . gas . . . is sold under circumstances where the sale price does not represent the cash price thereof prevailing for . . . gas . . . of like kind, character or quality in the field from which such product is produced, the Tax Commission may require the said tax to [be] paid upon the basis of the prevailing price then being paid at the time of production thereof in said field for . . . gas . . . of like kind, quality and character.

26. 509 P.2d at 116.

sity for long-term sales contracts.[27] The statute must be interpreted to permit the Commission to require the tax to be paid on the basis of prevailing prices only in cases where the prices already paid are less than the prevailing prices at the time for which the sales prices were contracted.[28] The *Apache Gas* rule suggested that the Oklahoma Court might not follow the decisions of other jurisdictions in interpreting the market price clause.[29] It was not until *Tara*, however, that the court had the opportunity to extend its approach in *Apache Gas* to the market price controversy as it pertained to gas royalties.

One of the early cases from another jurisdiction was *Foster v. Atlantic Refining Co*.[30] *Foster* is not, however, typical of the decisions on the market price issue because it involved a lease which contained the phrase "at the market price therefor prevailing for the field where produced *when run*."[31] The lessee, Atlantic, had entered a long-term gas sales contract under which it received less than the prevailing market price. The lessor sued, claiming that the royalties based upon the contract price did not reflect the market price when run.[32] Even disregarding the fact that the contract price was below the prevailing market price, in light of the words "when run," the decision in favor of the lessor seems justifiable. The words "when run" refer to a specific time when the royalties are to be measured and can hardly be interpreted differently. The court stated, "It [Atlantic] made the gas sales contract with full knowledge of this obligation and did nothing to protect itself against increases in price."[33] As one author indicated, the impact of the *Foster* decision on lessees was expected to be slight.[34] The *Foster* lease was not typical, and it appeared that a different result would be obtained if the court had considered the standard lease.[35]

Another case where special terminology governed the result is *J. M. Huber Corp. v. Denman*.[36] *Huber* involved a gas purchase contract which the lessee was required to obtain as a prerequisite to obtaining the lease. The lease called for royalties based upon the market price,

27. *Id.* at 113.
28. *Id.*
29. *See* Ashabranner, *The Oil and Gas Lease Royalty Clause—One-Eighth of What?*, 20 ROCKY MTN. MIN. L. INST. 163, 184 (1975).
30. 329 F.2d 485 (5th Cir. 1964).
31. *Id.* at 488 (emphasis added).
32. *Id.*
33. *Id.* at 489.
34. *See* Ashabranner, *supra* note 29, at 178.
35. *Id.*
36. 367 F.2d 104 (5th Cir. 1966).

"but in no event shall the price be computed at less than four cents per thousand cubic feet."[37]

The lessee negotiated a contract calling for payment of 3-1/2 cents per mcf until 1945 and for 4 cents thereafter. The contract was renegotiated in 1961 for a price of 11 cents per mcf. The lessee paid royalties based on 4 cents rather than the contract price of 3-1/2 cents. After the contract was renegotiated, he paid royalty based upon the 11 cents contract price. The lessor brought suit to increase the royalties to the prevailing current market price. Although the lessee argued that it was forced into the long-term contract by the lessor and that the lessor should be aware that the contract was designed to cover the term of the lease, the court decided that, in determining market value, it would look at the theoretical transactions between the supposed free buyer and seller.[38] Furthermore, the court stated that "the construction put on the contract by responsible action of the parties is frequently the best revelation of its purpose."[39] Because the lessee paid royalties based upon the 4 cents floor price of the lease rather than the contract price of 3-1/2 cents, and because earlier in the negotiations the parties had rejected a "proceeds" clause,[40] it was clear that the parties did not intend that royalties be based upon the contract price.[41]

The same year a Texas case, *Texas Oil & Gas Corp. v. Vela*,[42] dealt with the market value issue. In *Vela* the lease called for royalty to be paid based on 1/8th of the market price at the wells of the amount sold if the gas was sold or used off the premises; or 1/8th of the market value on the gas if used for the manufacture of gasoline, and, finally, if sold by the lessee, 1/8th of the proceeds.[43] Two years after the lease was executed, the lessees entered into long-term gas purchase contracts for the gas. The contracts, which were to run the entire life of the lease,

37. *Id.* at 107 n.4.

38. *Id.* at 109. It was decided that in the case of a market value lease, the court would not examine the "particular transaction but [would look at] the theoretical one between the supposed free seller vis-à-vis the contemporary free buyer dealing freely at arm's length supposedly in relation to property which neither will ever own, buy or sell." *Id.*

39. *Id.*

40. *Id.*

41. *See id.* Almost from the inception of the lease the royalties paid did not conform to the contract price. This was strong evidence that the parties never intended for the contract price to prevail. *See* Morris, *supra* note 7, at 71. However, in Henry v. Ballard & Cordell Corp., 401 So. 2d 600 (La. Ct. App. 1981), the fact that the lessor had accepted without objection the payments which were based on the contract price for seventeen years was evidence that the parties did intend for the contract price to prevail. *Id.* at 606-07.

42. 429 S.W.2d 866 (Tex. 1968).

43. *Id.* at 870-71.

called for a price of 2.3 cents per mcf. The court recognized that these contracts were made in good faith and that they represented the best available deal that could be made at the time.[44] However, in 1960 gas purchase contracts were executed at a price of 16 cents per mcf. The lessor brought suit in that year seeking royalties based upon these higher prices.

The court interpreted the lease strictly,[45] stating, "they [the parties] stipulated in plain terms that the lessee would pay one-eighth of the market price at the well of all gas sold or used off the premises. This clearly means the prevailing market price at the time of the sale or use."[46] Furthermore, as the time of the sale was defined as the time of delivery,[47] the ruling allowed the lessors to receive royalties based on the prevailing price at the time of delivery. The majority relied heavily on the *Foster* decision.[48] Because the *Foster* decision was based upon the term "when run"[49] and there was no such term in the *Vela* lease, the *Vela* decision has been criticized for its reliance on *Foster*.[50]

The rule in Texas was further developed in *Exxon Corp. v. Butler*[51] and *Exxon Corp. v. Middleton*.[52] The *Butler* decision primarily reiterated the court's approach in *Vela*.[53] In *Middleton* the court reaffirmed the *Vela* decision that the market value means the prevailing market value at the time of the sale and that the sale occurs at the time of delivery.[54] In addition, although the court in *Vela* had acknowl-

44. *Id.* at 870. The trial court's finding of good faith was not attacked.

45. *Id.* at 871.

46. *Id.* The court was unsympathetic with the lessee's argument, reasoning that they could have agreed that the royalty should be a fraction of the amount realized by the lessee from its sale.

47. *Id.* It was decided that royalties were to be measured from prevailing market prices at the time of the sale. The court then stated that gas was not sold at the time of the contract but rather at the time of delivery to the purchaser. *Id.*

48. *Id.* The court relied on the statement in *Foster* that Atlantic's inability to make a contract with an escalation provision was beside the point. "It [Atlantic] made the gas sales contract with full knowledge of this obligation [to pay royalties] and did nothing to protect itself. . . ." *Id.* The *Foster* court stated, "the fact that increases in market prices have made the lease obligation financially burdensome is no defense." *Id.*

49. 329 F.2d at 488. See *supra* note 31 and accompanying text.

50. *See, e.g.*, Texas Oil & Gas Corp. v. Vela, 429 S.W.2d at 880 (dissenting opinion); Morris, *supra* note 7 at 75; Note, *The Market Value Controversy*: Exxon v. Middleton, 16 TULSA L.J. 559, 560 (1981).

51. 585 S.W.2d 881 (Tex. Civ. App. 1979), *appeal dismissed*, 619 S.W.2d 399 (1981).

52. 571 S.W.2d 349 (Tex. Civ. App. 1978), *modified*, 613 S.W.2d 240, *rehearing*, 619 S.W.2d 477 (1981).

53. 585 S.W.2d at 884. The court affirmed the court of civil appeals which stated that market value means the "prevailing market value at the time of the sale, and the sale occurs at the time of delivery to the purchaser." *Id.* See *supra* note 47 and accompanying text.

54. 571 S.W.2d at 357.

edged the comparable sales test,[55] *Middleton* enlarged upon the *Vela* holding.[56]

In *Middleton* the court, considering the factors identified in *Vela*,[57] arrived at several conclusions. First, the relevant market area is the field in which the gas was produced.[58] Second, market price is to be determined by reference to comparable sales.[59] Third, the price under long term purchase contracts is not necessarily the market price, but may be considered along with evidence of comparable sales.[60] Finally, the mathematical average of all the prices paid in the field is not the final answer to determining the market value. It appears, however, that an expert opinion on the average price paid in the field which is corroborated by comparable sales may afford a basis for determining market value.[61] As a result of *Middleton* lessees have been subject to increasingly higher ratios of their revenue going to satisfy royalty claims of lessors.

Also of interest are the Kansas Supreme Court decisions in *Waechter v. Amoco Production Co.*[62] and *Lightcap v. Mobil Oil Corp.*[63] The *Waechter* case, decided in 1975, involved a fairly typical lease which calls for royalties based upon the proceeds if sold at the well, or based on the market value at the well if marketed off the leased premises.[64] The court rejected the argument that proceeds and market value

55. In *Vela* the court based its definition of comparable sales on that stated in Phillips Petroleum Co. v. Bynum, 155 F.2d 1961 (5th Cir. 1946) that comparable sales are those which are "comparable in time, quantity, quality, and availability of [marketing] outlets." 571 S.W.2d at 358. One author has stated that the omission of the term quantity from the comparable sales test in *Vela* is immaterial. *See* Note, *Evidence Admissible to Determine Market Value of Gas for Royalty Purposes: The* Vela *Rationale Affirmed by* Exxon Corp. v. Middleton, 17 HOUSTON L. REV. 1047, 1052 n.23 (1980).

56. *See* Note, *The Market Value Controversy*: Exxon Corp. v. Middleton, 16 TULSA L.J. 550, 552 (1981).

57. 571 S.W.2d at 360. The court stated that under *Vela* there were four factors to consider in "determining the market value of gas: (1) the relevant marketing area is the field in which the gas is produced; (2) [a] reasonably prudent operator, in the exercise of good faith, may be required to enter into a long term contract (however, such gas purchase contract between lessee and a third party is not necessarily the 'market price' . . .); (3) the comparable sales to be considered are those comparable in time, quantity, quality and availability of marketing outlets; and (4) the 'average price' method is not conclusive of market price but is more than a scintilla of evidence which, along with corroboration of *comparable* sales from the field, will support a trier of facts finding as to market value." *Id.*

58. *Id.*

59. *Id. See supra* note 55 and accompanying text.

60. *Id.* at 360.

61. *See id.*

62. 217 Kan. 489, 537 P.2d 228 (1975).

63. 221 Kan. 448, 562 P.2d 1, *cert. denied*, 434 U.S. 876 (1977).

64. 217 Kan. at —, 537 P.2d at 231.

were intended to be synonymous.[65] But, the court concluded that all the leases involved in the case were ones in which the gas was sold at the well and were therefore "proceeds" leases.[66] In other words, royalties were to be calculated on the proceeds obtained from the sale. The court thus ruled in favor of the lessee by arbitrarily categorizing the leases regardless of their terms. There were over 48 leases with various types of clauses, and the dissent argued that it was improper to label them all proceeds leases.[67] The dissenting opinion advocated use of the intent of the parties and criticized the majority's use of the term "proceeds" out of context:[68] "To ascertain the intention of the parties . . . use of the words 'gas marketed', 'market value', and 'sold' cannot be ignored."[69] Although the majority held for the lessees, the rationale was so weak that it was of little significance.

Lightcap represents a further extension of the rule defining market value introduced in *Waechter*, bringing Kansas into line with those jurisdictions holding against the lessee. In *Lightcap* the producer contracted for a fixed price for a specified time and thereafter for a "fair, just and reasonable price."[70] Furthermore, any dispute over the price after the specified time was to be resolved by arbitration. The contract called for the dedication of the entire natural gas production to interstate markets, thus introducing the additional factor of Federal Power Commission (FPC) regulation.[71] When the arbitrated rates were sub-

65. *Id.* at —, 537 P.2d at 249. The court stated: "Nor can we say the parties used the term 'proceeds' and 'market value' as equivalents in the royalty clauses . . . . The term 'proceeds' was used only in context with the phrase 'if sold at the well' while the term 'market value' was used in the alternative phrase 'or if marketed by lessee off the leased premises'." *Id.*

66. *Id.* (the justices agreed the royalty should be one-eighth of the proceeds if sold at the well).

67. *Id.* at —, 537 P.2d at 256. The dissent argued for construing the lease against the lessee on the theory that the lessee had prepared an ambiguous lease.

68. *Id.* ("the single word 'proceeds' is lifted out of context from the clause and is said to control without regard to any other language in the clause") (Schroedter, J., dissenting).

69. *Id.* at 257.

70. 221 Kan. at —, 562 P.2d at 4.

71. The Federal Power Commission (FPC) is empowered to set ceiling prices for gas in accordance with the Natural Gas Act (NGA), 15 U.S.C. §§ 717-717w (1976). The issue of whether the FPC has jurisdiction over the royalty owner was addressed in Mobil Oil Corp. v. FPC, 463 F.2d 256 (D.C. Cir. 1971). In *Mobil*, the court held that the FPC did not have jurisdiction over the royalty owner or over a dispute between a royalty owner and his producer over the amount of royalties to be paid because royalty owners are not natural gas companies under the NGA. *Id.* at 259. In *Lightcap*, the court reviewed the decision in *Mobil* and decided that jurisdiction over disputes between royalty owners and lessees was not with the FPC but rather with the courts. The court went on to hold that the existence of federal regulation over the rates which a producer may receive is not an obstacle to the fixing of some higher rate as the market value of gas for the purposes of computing royalties. 221 Kan. at —, 562 P.2d at 11.

It was necessary as a preliminary matter for the court to establish its jurisdiction over the

mitted to the FPC, they were only partially approved and were adjusted downward. The producer paid royalties based on this FPC approved price, and the royalty owners brought suit seeking royalties based upon the arbitrated prices.

The court in *Lightcap* rejected the producer's argument that royalties should either be based on the contract price or the FPC approved price.[72] In doing so, the court ruled that the existence of federal regulations fixing the maximum rates a gas producer might receive from its purchaser is no obstacle to the fixing of a higher rate as the market value of gas it sells for the purpose of computing royalties under the lease.[73] The court stated that a market value lease calls for payment based on the theoretical free market value without regard to governmental regulations.[74]

The *Lightcap* decision has been criticized for its reliance on the intent of the parties in the face of unforeseen circumstances such as changes in FPC regulations.[75] The holding appears to require a lessee to foresee the changes in FPC price ceilings. Unlike *Waechter* the court in *Lightcap* dealt with market value leases, yet what "market price" is and what is required to prove it were not decided.[76]

A recent Louisiana case, *Henry v. Ballard & Cordell Corp.*,[77] is significant for its use of the rules of construction to determine the intent of the parties and its conclusion that the intent of the parties is that royalties be fixed and certain. In *Henry* the lessees had paid royalties based

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dispute in light of the holding in *Mobil*. See note 71 *supra* and accompanying text. Commenting on *Mobil*, Commissioner Foth stated, "the end result was that *Mobil v. FPC* left it open to the courts . . . to determine lease controversies between royalty owners [and] lessees." 221 Kan. at —, 562 P.2d at 6.

72. 221 Kan. at —, 562 P.2d at 5 (royalty owners argued that the arbitrated price was the market value).

73. *Id.* at —, 562 P.2d at 8.

74. *Id.* at —, 562 P.2d at 11.

75. *Id.* at —, 562 P.2d at 9. The dissent in *Waechter* had argued for construction against the lessee. See note 67 supra and accompanying text. In *Lightcap*, the court, reflecting on the Waechter dissent, stated that ambiguous instruments are to be construed strictly against their draftsmen. Furthermore, in the case of oil and gas leases this normally means against the lessee and in favor of the lessor.

76. *Id.* at —, 562 P.2d at 30-31 (dissenting opinion). Justice Fromme stated:

> The majority opinion completely disregards the question of what evidence may be necessary to establish a market price. There was no evidence of market price in the record of this case except the FPC ceiling price. . . . In the present case the lessors argue that certain aborted arbitrated figures on reasonable value somehow establish "market price at the well." Not so.

Id. at —, 562 P.2d at 30-31.

77. 401 So. 2d 600 (La. Ct. App. 1981).

on the amounts received under a twenty year purchase contract.[78] For seventeen years the lessors had accepted royalty payments from the lessees without objection, but in 1979 the lessors filed suit demanding that the lessees pay royalties based upon the current value of gas.[79]

The district court defined market value in its ordinary sense to mean the price which a thing might be expected to bring if offered for sale in the market[80] and concluded that, since natural gas cannot be sold until it is delivered, the market value of gas sold obviously means the current market value.[81] The district court relied upon the rules of construction that the clear language of the contract must be enforced and that in case of ambiguity a contract must be construed against the party who prepared it.[82]

The court of appeals concluded that the district court's reliance on these rules was misplaced.[83] Since there was no evidence that the lessee had prepared the lease, construction against the lessee on that basis was erroneous.[84] Furthermore, because the court found that the intent of the parties was ascertainable, such a construction was unnecessary.[85]

In determining the intent of the parties the court considered two factors. First, for seventeen years the lessor had never objected to the method of payment by the lessee. The court stated that this "long-standing acquiescence" by the lessor was sufficient in itself to determine that the parties had intended the market value to mean the amount realized.[86] Second, expert testimony about the origin of the

78. *Id.* at 601.

79. *Id.*

80. *Id.* at 603.

81. *Id.* The district court reasoned that the sale of minerals still in the ground is not a sale. Gas becomes subject to sale only after it is reduced to possession. Only then can market value be determined. In reversing the district court the court of appeals held that this was not the intent of the agreement. *Id.* at 604.

82. *Id.* at 606. The district court relied upon three rules of construction. First, the contract is the law between the parties. Second, the clear language of the contract is to be enforced. Third, an ambiguous instrument is to be construed against the preparer. The court of appeals recognized all three as valid construction rules, but regarded the latter two as not pertinent.

83. *Id.*

84. *Id.* The court stated:

> By its use of the ambiguity rule, it appears that the trial court found the leases ambiguous and construed them against the defendants-lessees on the assumption that the lessees prepared the leases. There was no evidence presented from which the court could reasonably have concluded that the lessees in these cases had prepared the leases.

Id.

85. *Id.* The court stated, "Even if we assume that the lessees did not prepare these leases, however, we are bound, first, to ascertain the common intention of the parties . . . rather than to adhere to the literal sense of the terms." *Id.*

86. *Id.*

market value clause indicated that, historically, market value clauses were designed to protect the lessee. Because of the expense involved in bringing gas to the market, the clause was developed to provide for royalties based upon the market value of the gas at the well rather than the point of sale where the price was higher.[87]

According to the leases, royalties for gas sold at the well were to be based upon the amount realized.[88] Clearly this was meant to be the contract price. However, the court also held that the clause calling for royalties based on market value for gas sold off the premises should be interpreted similarly.[89] The court stated that "since the parties clearly intended for the royalties to be certain and fixed in one instance, we think the only reasonable interpretation of the . . . lease royalty clauses is that the parties intended for the royalties to be certain and fixed in both instances."[90] Therefore, the lessor was to receive the current market value at the time the gas was committed to the purchaser, the time of the contract.[91]

It is clear that, with the exception of Louisiana, the decisions have been unsympathetic to the lessee's situation. In view of the decision in *Apache Gas*, it was speculated that Oklahoma might not follow those other jurisdictions but would define market price as based upon the contract price.[92] It was not until the *Tara* decision that this speculation was confirmed.

IV. THE DECISION IN *TARA PETROLEUM CORP. V. HUGHEY*

The decision in *Tara* follows logically from that in *Apache Gas*. In *Tara* the lessors claimed that their royalty should be measured by the price the ultimate purchaser, El Paso Gas, was paying the first purchaser, Jarrett, rather than that which Jarrett was paying the lessee, Wilcoy, because the ultimate purchaser's price better represented the market price.[93] In light of decisions such as *Vela* and *Lightcap* the lessor's argument had validity. But the court in *Tara* held that the les-

87. *Id.* at 607.

88. *Id.* at 608. There was no dispute among the parties that the amount realized meant the contract price.

89. *Id.* The court stated, "In light of this clear intent [that the amount realized was the contract price], and after considering the testimony of Mr. Bolton . . . we conclude that in the other instance [i.e. for gas sold off the premises] the parties to . . . the leases intended for the lessor's royalties to be tied to the gas sales contract." *Id.*

90. *Id.*

91. *Id.*

92. Ashabranner, *supra* note 29, at 184-85.

93. 630 P.2d at 1272.

sors were entitled to royalties based only upon the contract executed between the lessee and the first purchaser. As to the contrary authority from other jurisdictions, the court stated that "by and large, the results in those cases have been criticized."[94]

One of the key elements of the decision in *Tara* was the recognition of the realities of the gas industry first mentioned in *Apache Gas*.[95] Two of the major factors relied upon by the court were the necessity for long-term contracts and the lessee's duty to market.[96] In fact, the court credits the existence of such royalty disputes to the necessity that the lessee enter long-term contracts in order to sell the gas.[97] Certainly, as gas prices increase, lessors with more recent leases, and therefore more recent purchase contracts, receive higher royalties than those with older leases. The court recognized that this phenomenon appears unfair at first glance.[98] But the court also believed that lessors and lessees know and consider the necessity of these long-term contracts when they negotiate their leases.[99] Most importantly, it is fundamentally unfair to the producer to hold him to the long-term purchase contract, thus limiting his revenue, while insisting that he pay higher and higher royalties out of this fixed revenue.[100] The court used the following scenario to make the point clear:

> Under their contract the producers received 32¢ per mcf the first year. The royalty share of that amount, one-eighth, is 4¢. Yet by the end of the first year the first purchaser, Jarrett, was receiving nearly $1.28 for the gas. One eighth of the $1.28 is 16¢. So if royalty were measured by the price El Paso Natural Gas paid Jarrett, the lessors' royalty would have quadrupled in one year to one half of the producers' revenues. And all the while, of course, the producers' revenue per mcf remained constant.[101]

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94. 630 P.2d at 1273. The decision in Henry v. Ballard & Cordell Corp., 401 So. 2d at 600, was issued the same month and presumably was not available to the Oklahoma court.

95. 509 P.2d at 112 ("[i]t has never been suggested that long term contracts . . . are unnecessary").

96. 630 P.2d at 1272 ("[t]he kind of dispute we have before us today arises because lessees, in order to market gas, must ordinarily enter into long-term gas purchase contracts"). *See* notes 102 & 104 *infra* and accompanying text.

97. 630 P.2d at 1272.

98. *Id.* ("As the current price of gas increases, lessors with more recent leases, more recent wells, and more recent gas purchase contracts receive royalty on higher prices than their counterparts with older production. Understandably this seems unfair to the lessors.")

99. *Id.* at 1273.

100. *Id.*

101. *Id.* The court went on to state that this would not be fair to the producers: "We do not

A second factor in the decision is the lessee's duty to market.[102] It is, indeed, this duty that has helped to create the controversy, for it is the duty to market which dictates the use of long-term contracts.[103] As one author quoted in the decision stated:

> Add to this well-known reality of the business [long term contracts] the lessee's implied convenant obligation to market with dispatch, and in the opinion of the writer the ambiguity should be resolved in favor of the lessee as a matter of law, with inquiry restricted to whether the sale was a reasonable contract when made.[104]

Acknowledging the necessity for long-term contracts, the court concluded that "as long as our law recognizes long-term gas purchase contracts as binding in the face of escalating prices, the law should not penalize the producer who was forced into the contract in large measure by his duty to the lessor."[105]

But the *Tara* decision should not be taken to mean that the market price will, at all times and in all situations, be the contract price. Under the decision in *Tara*, as long as the gas purchase contract was entered into at arm's-length, and in good faith "with the best price and term available to the producer at the time,"[106] and as long as the lease royalty clause is based on market price at the well, then the market price is the contract price.[107] The court went on to state that if the contract was not reasonable when entered, or if it was not a fair and representative contract at the time in the field, the lessee has then failed to discharge his duty to market the gas and a different result would obtain.[108] The decision places on the lessor the burden of proving that the gas

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believe that the lessors . . . or . . . the assignee-producers ever contemplated that the lessors' royalty could be half of what the producers received for the gas." *Id.*

102. *Id.* ("[o]nce a producing well is drilled a producer has a duty to market the gas").

103. Long-term contracts have been recognized as a necessity in the industry due to the lessee's duty to market. Natural gas, unlike oil, normally is not produced and then stored to await sale. Because of this, it is difficult to measure its value at the time it is actually produced. *See* 509 P.2d at 113. Long term contracts are necessary to meet financing, construction, and operational costs of production. *See The Market Value Controversy*, *supra* note 50. The court in Exxon Corp. v. Middleton cited two reasons why long term contracts have been so prevalent. First, a substantial financial investment was involved in producing gas from the well and getting it to the eventual user. Producers would not be likely to make such an investment without some assurance that the gas would be purchased. Second, gas is normally used as quickly as it is produced. 571 S.W.2d at 352.

104. 630 P.2d at 1273-74 (quoting from 3A W. SUMMERS, OIL & GAS § 589 (2d ed. W. Flittie Supp. 1980)).

105. 630 P.2d at 1274.

106. *Id.* at 1273 (citations omitted).

107. *Id.*

108. *Id.* at 1274.

purchase contract was unreasonable.[109] Therefore, for the lessor to obtain a royalty based upon something higher than the contract price, he must prove that the gas purchase contract which his lessee entered out of his duty to market the gas was unreasonable or not at the best price obtainable.[110] Even though the situations in which a lessee would enter into an unreasonable contract would be few,[111] the lessor does have the opportunity of showing that the contract was not sufficient to meet the duty to market.[112]

The court in *Tara* concluded that the burden of proof thus imposed upon the lessor was not met.[113] The court also denied the plaintiff's equitable argument that Tara and Jarrett should not be enriched to the detriment of the royalty owners.[114] The producers and the lessors had joined and filed one brief as appellees and argued that Tara and Jarrett were jointly owned and subject to the control of two men.[115] The court expressed its opinion that care should be taken to prevent lessors from being deprived of royalties or defrauded by lessees entering into illusory or collusive assignments or purchase contracts.[116] Furthermore, the court stated that where a lessee "is paying royalty on one price, but on resale a related entity is obtaining a higher price, the lessors are entitled to their royalty share of a higher price. The key element is common control of the two entities."[117] But here common control was never shown, and the equitable argument was therefore

109. *Id.* ("[t]he burden of proving that a gas purchase contract was unfair or unreasonable at the time it was entered into is on the lessor seeking additional royalty").

110. *Id.*

111. *Id.* ("[q]uite naturally lessors want to receive as much royalty as possible, but lessees in their own interest seek as good a price as they can get for gas").

112. *Id.* The lessor must show that the contract was not reasonable when entered into and that, therefore, the lessee has not met his duty to market. For a discussion of the duty of the lessee to market gas, see E. KUNTZ, A TREATISE ON THE LAW OF OIL & GAS 320 (1967). The duty was reaffirmed in the *Tara* decision. *See supra* notes 96 & 102 and accompanying text.

113. 630 P.2d at 1274. The court stated:

> In this case there is no hint that the contract was unfair or unreasonable. . . . The producers made the best deal they could to market the gas. The price they negotiated was the highest being paid in the field at the time. . . . Of course the producers were themselves concerned with making the best deal possible, but they acted in good faith and represented their lessors well. . . . And they did not themselves profit in any way from the increases in gas prices. Under these circumstances we hold that the "market price" . . . is the same as the "contract price" of the gas purchase contract.

Id.

114. *Id.* at 1275.

115. The two men were Joe Bob Brown and Dean McNaughton. Joe Bob Brown is not related to the producer Coy Brown.

116. 630 P.2d at 1275.

117. *Id.*

denied.[118]

The lessors argued that even if Tara and Jarrett were not under common control, the court should ignore their separate legal existence.[119] In such cases involving independent third parties, to receive a higher royalty, the lessor must establish that the separate corporate existence was designed to perpetrate a fraud or that one of the two entities is organized so that its affairs are conducted merely as an instrumentality of the other.[120]

The lessor, and the producers who joined him on appeal, failed to establish common control of Tara and Jarrett.[121] Furthermore, the added burden which arises when a contract is negotiated with a third party was not met.[122] The court, therefore, rejected the plaintiff's and producer's argument and reversed the judgments against both Tara Petroleum and Jarrett.[123]

V. ANALYSIS

The controversy over the definition of market price and market value is not new. The argument that is often made by the lessor is that he should receive a royalty based upon the actual worth of the gas. Central to the argument that market price is the contract price, however, is the contention that the courts must respond to the realities of the industry.[124] That the lessor feels cheated when he sees other royalty owners receiving higher royalties because their leases were negotiated

118. *Id.* The record showed that at the time Tara received the original lease and when it assigned it to Coy Brown, Joe Bob Brown and Dean McNaughton each owned 50% of Tara. Furthermore, at the time of trial (March 1979) Brown owned all of Tara and was President of both Tara and Jarrett. However there was no indication of the ownership of Jarrett and the court refused to speculate about its ownership.

119. *Id.* Because there was no showing of common control of the two organizations, Tara and Jarrett were assumed to be separate and independent. In order for the lessor to receive higher royalties, it would have to be shown that their separate existence was a sham.

120. *Id.*

121. *See* note 118 *supra* and accompanying text.

122. 630 P.2d at 1276 ("[t]here is no indication that the producers ever acted under the direction or influence of either Tara or Jarrett. And the fact that Jarrett made the royalty payments for the producers—a common practice in the industry—is not significant").

123. *Id.*

124. The realities of the industry, such as the duty to market and the necessity of long term contracts, have been recognized previously in Oklahoma. *See supra* note 105 and accompanying text. The same factors, although recognized in *Vela*, have been minimized as the courts in other jurisdictions have reasoned that a lessee's failure to protect himself adequately in these contracts was no defense. 429 S.W.2d at 871. However, the decision in *Henry* was based primarily on the facts of the case which indicated that the parties had agreed on the contract price as the relevant measure of market value for more than three-fourths of the lease period. 401 So. 2d at 607.

when prices were higher is understandable.[125] However, to hold for the lessor and against the lessee for that reason works an injustice to the lessee.

The lessee has a duty to market the gas, and in this duty he is often forced to enter long-term contracts. Because it is in the lessee's interest to obtain the best possible price, gas purchase contracts generally reflect the best agreement that can be made.[126] The lessor generally knows that the lessee will have to enter a long term contract and that his revenues will be limited.[127] If the lessee has made a good faith effort and has reached the best agreement he can, it seems unjust to consider his contract binding yet, also, to require him to pay increasing royalties.[128]

The facts in *Tara* permit the assumption that the contract was made at arm's-length.[129] The contract which Jarrett entered into to purchase the gas from Wilcoy was neither unfair nor unreasonable. The result obtained seems clearly correct. Indeed, the court in *Tara* stated that, "if it is not at a minimum fair and representative of other contracts negotiated at the time in the field, then a different result obtains."[130] The decision does not extend to every situation. The contract price will not prevail in situations where the contract was unreasonable. But if the contract were reasonable, as it generally is, then fairness would call for the market price to be the same as the contract price. That in hindsight the contract might not appear the best that could have been made, especially in light of ever-rising prices, is irrelevant. The standard to be applied under *Tara* is whether the contract was reasonable at the time it was negotiated.[131]

As one author discussed, many courts have resolved ambiguities in oil and gas leases in favor of the lessor.[132] This rule of construction has

125. 630 P.2d at 1272. *See supra* note 98 and accompanying text.

126. *Id. See supra* note 102 and accompanying text.

127. *Id.* at 1273 ("lessors and lessees know and consider [the necessity for long-term contracts] when they negotiate oil and gas leases"). Similarly, in *Henry* the court noted that "It strains the imagination to conclude that the parties intended for the royalties to be at all times uncertain and subject to change, rather than determinable from the terms of the gas sales contract." 401 So. 2d at 608.

128. *Id.* at 1273.

129. *Id.* at 1274. Similarly, in *Henry* the court found: "There was no dispute that negotiations between Ballard & Cordell and American Louisiana [the purchaser] were conducted in good faith and at arm's length and that the resulting contract was very favorable to both the [lessors] as well as [lessees]." *Id.* In this regard the court concluded that the price was as good or better than comparable sales at that time and that the price escalation clause was among the best contained in any such sales. 401 So. 2d at 605.

130. 630 P.2d at 1274.

131. *Id.*

132. *See* Fischl, *supra* note 4, at 36.

been criticized as having no real foundation.[133] The court in *Tara* shows sympathy for this position when quoting Summers: "[I]n the opinion of this writer the ambiguity should be resolved in favor of the lessee as a matter of law . . . ."[134] In *Henry* the court rejected the rule that an ambiguous lease should be construed against its drafter, the lessee. Because there was no evidence that the lessee had prepared the lease, construction against the lessee on that basis was found to be erroneous.[135]

The decision in *Tara* is ultimately more fair than that of other jurisdictions.[136] It is more closely in line with the contemplated results of both parties when they entered the lease. As the court remarked, surely the lessor never expected that his royalty could be half of what the producer received for the gas.[137] That this rule is advantageous and fair to the lessee is obvious. But at the same time it does not create an undue hardship on the lessor, because he receives the benefit of the agreement which he made with the lessee.

The decisions in other jurisdictions which allow for royalties based upon the prevailing market price create a better situation for the lessor, but they are catastrophic to the lessee. They allow the lessor to receive a higher and higher percentage of the fixed revenue of the lessee. This result cannot be justified as within the intentions of the parties when they negotiated the lease.[138] One author speculated that a lessor under these decisions could be forced to pay a royalty higher than the amount of revenue he receives through the contract. In such an instance the lease would no longer be producing in paying quantities, and the lessee might also be subject to losing his lease.[139] This author concludes that "it seems inappropriate to measure the lessee's obligation in hind-sight

133. *Id.*

134. 630 P.2d at 1273.

135. 401 So. 2d at 606.

136. *See supra* note 10 and accompanying text; Lightcap v. Mobil Oil Corp., 221 Kan. 448, —, 562 P.2d 1, 9-11, *cert. denied*, 434 U.S. 876 (1977); Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866 (Tex. 1968).

137. 630 P.2d at 1273. *See* note 101 *supra* and accompanying text.

138. *See* Morris, *supra* note 7, in which Dean Morris stated:

> It is probably not correct to say in construing the royalty clause that the lessor and lessee *in fact intended* "market price" to mean what it was construed to mean in *Vela*; neither would it be correct to say that they *in fact intended* "market price" to mean that price which the lessee was able to obtain in a long term gas sales contract. . . . It is . . . more nearly correct to say that by construing "market price" to mean that price which the lessee is able to obtain by using his best business judgment is a construction which is likely to be in accord with the *probable intention of the average lessor and lessee.*

Id. at 78 (emphasis in original).

139. *Id.* at 81.

by substituting new found business judgment in the light of gas prices which are high because of an energy shortage."[140]

Not only is *Tara* supportable for the policy reasons mentioned, it is directly in line with the only other Oklahoma case dealing with the market price of gas.[141] *Apache Gas*, decided in 1973, was chiefly concerned with construction of Oklahoma's Gross Production Tax Code.[142] In *Apache Gas*, the plaintiffs brought suit against the Oklahoma Tax Commission to recover taxes paid under protest. The court, in holding for the plaintiffs, indicated that the Commission does not have the right to place the same gross value on the gas purchased under earlier contracts as a larger volume of gas purchased under more recent ones. The Commission may require taxes based on the prevailing market only "*where the prices (already) paid are less than the prices that prevailed in the field at the time . . . .*"[143] The court held, therefore, that if the contract price was the best price obtainable for gas in the field at that time, then the contract price is the market price for purposes of tax liability.[144]

Finally, the *Tara* decision sets a clear standard for future cases in Oklahoma. Unlike the decisions in other jurisdictions such as *Lightcap*, the *Tara* holding is unambiguous and is not subject to distinction based on minor differences in lease terminology. *Tara* makes it clear that the market price is the contract price except where the contract does not reflect the best terms available at the time. With the decision firmly established, predictability as to the effect of market price clauses in leases becomes possible.

VI. CONCLUSION

The decision in *Tara* is clearly the better rule. The results in other jurisdictions are unsupportable in light of the realities of the gas industry. Not only is *Tara* consistent with *Apache Gas*, on balance its rule is fair to both parties. It avoids the injustice of having a lessee pay an increasing amount in royalties while being limited in his revenues by the long-term contract which he negotiated primarily out of his duty to the royalty owner. The decision is consistent with the intent of both parties. *Tara* and *Henry* make it clear that it is possible to determine

140. *Id.* at 83.
141. 509 P.2d at 109.
142. *See supra* note 25 and accompanying text.
143. 509 P.2d at 113 (emphasis in the original).
144. *Id.* at 113.

that intent, and to construe a lease against the lessee merely because he is presumed to be the drafter is erroneous in such instances. Where the evidence indicates that the lessee made a good faith effort to obtain the best deal possible, logic and fairness demand that market value, for purposes of determining gas royalty payments, be interpreted to mean the contract price rather than the prevailing market price.

Charles Bretton Crane