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THE 1990 NELPI ENERGY LAW ESSAY

**LESSEE DUTIES AND LESSOR RIGHTS IN GAS
CONTRACTING UNDER THE IMPLIED
MARKETING COVENANT OF OIL, GAS, AND
MINERAL LEASES***

Roger D. Williams†

I. INTRODUCTION

The domestic gas market underwent radical changes in the 1980's, especially in the area of gas purchase contracts.¹ Interstate gas pipeline companies began adjusting contracting practices to meet the often divergent objectives of their customers: downstream purchasers desire a reliable source of gas to satisfy peak demands over the long term, yet they want contract flexibility to avail themselves of more favorable near-term gas prices dictated by market forces.² Recent gas purchase contracts often contain price redetermination clauses and are generally of much shorter duration than older long-term contracts,³ forcing gas producers and lessees to negotiate more frequently for the sale of natural gas.⁴

This changed gas contracting environment is primarily a product of de-evolution in the gas regulatory scheme. The phased return to a partially free market in the gas industry under the Natural Gas Policy Act of 1978 (NGPA)⁵ is eliminating the traditional method of marketing gas,

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1. Pearson & Dancy, *Negotiating and Renegotiating the Gas Contract: Producer Duties to Third Parties*, 56 OKLA. B.J. 2181, 2181 (1985).

2. Interview with John C. Griffin, Assistant Secretary for Southern Natural Gas Co., Birmingham, Alabama (Sept. 21, 1989).

3. Pearson & Dancy, *supra* note 1, at 2181.

4. Pearson & Dancy, *supra* note 1, at 2182.

5. 15 U.S.C. §§ 3301-3432 (1988).

developed under the Natural Gas Act of 1938 (NGA).⁶

Historically, gas pipeline companies acted as purchasers, transporters, and marketers of gas. They would execute long-term purchase contracts with gas producers, usually for a flat price, or with only nominal price escalations over the contract term.⁷ A lessee-producer, by executing a long-term contract, typically satisfied its lease marketing obligations for the duration of the contract term. Pipeline companies, via "take-or-pay" clauses, often guaranteed to take a minimum daily or monthly quantity of gas, or pay the producer its equivalent price.⁸ The pipelines therefore accepted the risks of transporting gas and handling day-to-day market fluctuations based on end-users' needs. In exchange for these "middleman" services, pipeline companies profited from built-in economies of scale.

This historical gas contracting pattern began to change in the early 1980's. A drilling boom in the oil and gas industry, fueled in part by the NGPA's move toward a free gas market, combined with consumer conservation efforts, quickly led to a situation of gas oversupply. Gas prices fell and long-term contract "take-or-pay" provisions became a major liability to pipeline companies who could not take and sell even their minimum gas contract volumes.⁹ The pipelines therefore began concentrating more on their role as transporters, while leaving the marketing or merchant function to others.¹⁰ The outcome is a change from traditional long-term sales to pipeline companies to short-term direct sales to gas marketing companies and gas brokers or consumers, often with primary terms of only thirty days.¹¹

The purpose of this Article is to examine lessee duties and lessor rights under the implied marketing covenant of oil and gas leases, specifically as they relate to gas contracting, and to assess the applicability of established common-law principles to the new generation of gas contracts. Whereas under traditional long-term contracts a lessee could be relatively unconcerned about subsequent marketing duties owed lessors,

6. 15 U.S.C. §§ 717-717w (1988).

7. See, e.g., *Pineywoods Country Life School v. Shell Oil Co.*, 539 F. Supp. 957, 975 (S.D. Miss. 1982), *aff'd in part, rev'd in part*, 726 F.2d 225 (5th Cir. 1984), *cert. denied*, 471 U.S. 1005 (1985).

8. See 4 H. WILLIAMS & MEYERS, OIL AND GAS LAW § 724.5 (1989) [hereinafter OIL AND GAS LAW].

9. See, e.g., SONAT, INC., 1988 ANNUAL REPORT 22 (1989).

10. R. LUETTGEN, *Drafting Natural Gas Contracts after Order 436: The Producer's Perspective*, NATURAL RESOURCES, ENERGY, AND ENVIRONMENTAL LAW SECTION MONOGRAPH SERIES (ABA) No. 11, at 1 (1989).

11. Pearson & Dancy, *supra* note 1, at 2181.

in today's gas market "contracting activities which do not consider the obligations to the parties could result in the producer being held liable for damages for breach of the implied covenant to market the gas."¹² Potential liability may also arise under Federal Energy Regulatory Commission (FERC) orders designed to promote a free market for gas.¹³ Finally, rules of law developed in litigation of long-term gas contracts may be no longer relevant or may be more stringently applied, as contracting frequency increases, exposing lessees to potentially greater liability.

II. ORIGIN OF THE IMPLIED MARKETING COVENANT

The relationship between lessor and lessee in the development of oil, gas, and mineral leases has been the subject of extensive litigation throughout the history of oil and gas development. Judicial resolution of disputes has affected lessor-lessee rights and obligations in two very significant ways: First, highly complex and technical lease provisions (which generally tend to favor lessees) have evolved specifically delineating lessor rights and lessee obligations. A second, counterbalancing effect of judicial intervention in oil and gas leasing has been the development of the law of implied covenants.

Because the highly complex nature of the lease contract, in many situations, leases predominantly have become adhesion contracts. This inequity results because most landowners possess very little knowledge of oil and gas operations and possess relatively minor bargaining power in negotiating lease terms. Large-scale landowners and corporate owners of vast mineral interests, such as paper companies with extensive timber and mineral holdings, usually retain experienced legal counsel to prepare and negotiate oil and gas leases. But the majority of smaller land and mineral interest owners typically acquiesce to the oil company's or landman's lease form and terms. Should a conflict arise, the smaller mineral interest owner will likely be dismayed to learn the disputed lease provision has a prior judicial stamp of approval.

The creation of implied covenants, however, offsets the unequal bargaining power of the lessee. Historically, oil and gas leases have been intentionally silent as to important lessor rights and lessee obligations

12. Pearson & Dancy, *supra* note 1, at 2181.

13. See Pierce, *Lessor/Lessee Relations in a Turbulent Gas Market*, 38 INST. ON OIL & GAS L. & TAX'N § 8.04 (1987) (under FERC Order No. 451, lessee may be liable to either of two lessors, one with a low vintage/low price contract and the other with a multi-vintage/higher price contract, whether electing or not electing to renegotiate the lower price contract).

after oil and gas is first discovered.¹⁴ In part due to the adhesive nature of the leases, and in part due to the principle of cooperation,¹⁵ courts have incorporated implied covenants into leases.¹⁶ Implied covenants may be viewed as obligations derived by implication from the lease, whether implied in fact based on the intention of the parties,¹⁷ or implied in law to do justice.¹⁸

Pertinent to the development of implied covenants is the implied marketing covenant, now recognized as an accepted tenet of oil and gas law.¹⁹ The implied marketing covenant requires a lessee to use due diligence to market products capable of being produced from the leasehold once they have been discovered.²⁰ While inconsistent lease provisions may displace implied covenants,²¹ absent such provisions an implied covenant to market arises under any lease in which royalty is based on value.²²

The implied covenant to market has become the basis for determining rights of lessors and obligations of lessees in gas contracting. In assessing these rights and obligations, one must keep in mind that marketing gas is more difficult than marketing oil or other liquid products, primarily because of the required transportation infrastructure and the impracticability of above-ground storage. To evaluate whether a

14. See 5 OIL AND GAS LAW § 801 *supra* note 8.

15. *Id.* Prof. Williams and Dean Meyers state that "[t]he principle of cooperation requires that parties to a contract cooperate in order to carry out the purposes of the agreement. It is based upon both the reasonable expectations of the parties when they enter into an agreement and ethical concepts of conduct." *Id.* § 802.1, at 9.

16. See *Wolfe v. Texas Co.*, 83 F.2d 425 (10th Cir.), *cert. denied*, 299 U.S. 553 (1936); *Iams v. Carnegie Natural Gas*, 194 Pa. 72, 45 A. 54 (1899).

17. See, e.g., Walker, *The Nature of the Property Interests Created by an Oil and Gas Lease in Texas*, 11 TEX. L. REV. 399, 402 (1933).

18. M. MERRILL, COVENANTS IMPLIED IN OIL AND GAS LEASES, §§ 7, 220 (2d ed. 1940 & Supp. 1964).

19. 34 ROCKY MTN. MIN. L. INST. § 15.03[3] (1988).

20. *Craig v. Champlin Petroleum Co.*, 435 F.2d 933, 938 (10th Cir. 1971); *Wolfe v. Texas Co.*, 83 F.2d 425 (10th Cir.), *cert. denied*, 299 U.S. 553 (1936); 5 OIL AND GAS LAW, *supra* note 8, § 853, at 389.

21. 5 OIL AND GAS LAW, *supra* note 8, § 858, at 418.

22. 5 OIL AND GAS LAW, *supra* note 8, § 853, at 389. Professor Williams and Dean Meyers suggest that the implied covenant to market also arises under leases providing for royalty payable in kind because "the typical lessor lacks both the experience and facilities to dispose of the [products] . . ." 5 OIL AND GAS LAW, *supra* note 8, § 853, at 394. Practically speaking, however, the lessor is usually given the option to take royalty in value or in kind. The lessor who decides to take royalty in kind, therefore, does so with full knowledge that it must provide necessary facilities to take the products, and that this action releases the lessee from any express or implied duty to market the lessor's royalty share of production. This Article adopts the view that the implied covenant to market arises only where a lessor receives royalty in value.

lessee has breached its marketing duties, several factors need to be considered. They include the availability of a market,²³ availability of marketing facilities (treating and processing plants), the pressure and quality of gas, and the prevailing gas market price if a price exists.²⁴

III. PRUDENT OPERATOR STANDARD AND LESSEE DUTIES IN MARKETING

Courts in most states apply the prudent operator standard to determine whether a lessee has breached an implied covenant, including the implied covenant to market.²⁵ The prudent operator standard has been stated as “[w]hatever, in the circumstances, would be reasonably expected of operators of ordinary prudence, having regard to the interest of both lessor and lessee”²⁶ It is an objective standard, analogous to the reasonable person standard of negligence law.²⁷

Courts impose various duties upon lessees under the implied marketing covenant based on the prudent operator standard. Depending on the facts and circumstances, a lessee must fulfill certain obligations when marketing a lessor’s royalty share of gas. This section examines four possible duties which courts may impose on prudent operators or lessees. Although often treated as separate and distinct standards, in reality these duties are simply manifestations of the general duty to market. The four standards include the duty to market in good faith, the duty to act as a fiduciary, the duty to contract at arm’s length, and the duty to obtain the highest price in gas contracting.²⁸

A. *Duty to Market in Good Faith*

Courts appear to focus primarily on the good-faith aspect of marketing when deciding whether a lessee has breached the implied covenant to market, particularly in the area of gas contracting. Good faith is a lower,

23. The availability of a market includes such factors as the demand for gas, distance to existing pipelines and distribution networks, and the relative cost of extending pipelines to the field. See 5 OIL AND GAS LAW, *supra* note 8, § 855, at 400.

24. See 2 W. SUMMERS, THE LAW OF OIL AND GAS § 415 (1954); 5 OIL AND GAS LAW, *supra* note 8, § 853, at 389; H. WILLIAMS & C. MEYERS, OIL AND GAS TERMS 546-47 (7th ed. 1987) [hereinafter OIL AND GAS TERMS].

25. See *Tidelands Royalty B Corp. v. Gulf Oil Corp.*, 611 F. Supp. 795, 801 (N.D. Tex. 1985); 5 OIL AND GAS LAW, *supra* note 8, § 806.3, at 35, § 856.3, at 407.

26. *Brewster v. Lanyon Zinc Co.*, 140 F. 801, 814 (8th Cir. 1905).

27. 5 OIL AND GAS LAW, *supra* note 8, § 806.3, at 42.

28. Section IV addresses another potential duty of a prudent operator under the implied marketing covenant, that of renegotiating existing gas contracts.

subjective standard, which differs from the prudent operator standard.²⁹ Good faith implies that a lessee has not acted fraudulently or dishonestly in the exercise of its business judgment.³⁰ In marketing, good faith implies that a lessee has not gained selfish advantage at the lessor's expense.³¹ In essence, the standard of good faith is subsumed in the prudent operator standard.³²

The leading case dealing with breach of the implied covenant to market in good faith is *Amoco Production Co. v. First Baptist Church of Pyote*.³³ In this case, the lessee, Amoco, committed the plaintiff-lessor's gas to a sales contract on terms substantially lower than terms for which gas was then being sold to other purchasers from the same well.³⁴ Amoco made this commitment by amending an existing gas contract covering other Amoco leases in the unit with lessors other than the plaintiffs.³⁵ By doing so, Amoco obtained the collateral benefit of a four-fold increase in price for the other lessors' gas previously committed to the contract.³⁶ The court held that Amoco breached its implied covenant by failing to exercise good faith in marketing the plaintiff-lessor's gas at fair market value under a lease providing for royalty based on proceeds.³⁷ The court stated, "justice toward the lessor would seem to require that he

29. Martin, *A Modern Look at Implied Covenants to Explore, Develop, and Market under Mineral Leases*, 27 INST. ON OIL & GAS L. & TAX'N 177 (1976). The difference between good faith and the normal prudent operator test is that even though a lessee believes it acted in good faith and there is a reasonable basis for this belief, a jury may still find the lessee failed to act as a prudent operator. *Id.* at 199.

30. See 5 OIL AND GAS LAW, *supra* note 8, § 806.2, at 31-32 (quoting *Brewster v. Lanyon Zinc Co.*, 140 F. 801 (8th Cir. 1905)). See also *infra* notes 78-79 and accompanying text.

31. 5 OIL AND GAS LAW, *supra* note 8, § 807, at 49.

32. Some courts have held that there is an implied covenant of good faith and fair dealing in every contract. See *Triangle Mining Co. v. Stauffer Chem. Co.*, 753 F.2d 734 (9th Cir. 1985); *Candelaria Indus., Inc. v. Occidental Petroleum Corp.*, 662 F. Supp. 1002, 1010 (D. Nev. 1987) (court's statement of subsequent proceedings).

33. 579 S.W.2d 280 (Tex. Civ. App.—El Paso 1979), *writ ref'd n.r.e. per curiam*, 611 S.W.2d 610 (Tex. 1980).

34. *Id.* at 282-83.

35. *Id.*

36. *Id.* at 183.

37. *Id.* at 284-87. Most oil and gas leases provide for gas royalties to be paid on either "proceeds" from the sale of gas, computed at the mouth of the well, or "market value" at the mouth of the well. The "proceeds" clause applies when a lessee makes a wellhead sale of gas. The market value provision is usually applicable whenever gas is used by the lessee off the leased premises or in the manufacture of gasoline or other liquid products. The purpose of the "market value" clause is to ensure that the lessor receives royalties based on fair market price, and not at some artificial price determined by the lessee, whenever the lessee does not truly sell the gas stream, but uses it for fuel off the leased premises or as a raw material to make more valuable products. See 3 OIL AND GAS LAW, *supra* note 8, §§ 650-6.504.

should receive the same return as those who had leased to other operators"³⁸ In effect, the court found that Amoco's self-dealing was "using" the plaintiff-lessor's gas within the spirit of the market value royalty clause,³⁹ but failing to pay true market value. The Texas Court of Appeals further explained the duty to market in good faith in *El Paso Natural Gas v. American Petrofina*.⁴⁰ Citing *Amoco*, the court stated that "the duty to market in good faith is based on the assumption that the operator [or lessee] is marketing something that belongs to the [lessor]."⁴¹ It is a breach of good faith for the lessee to retain some benefit that should rightfully be included in the benefit obtained for the lessor.

Whether an operator has marketed gas prudently and in good faith is a factual issue for the trier of fact to evaluate in light of the circumstances existing at the time marketing occurred. The Tenth Circuit Court of Appeals so held in *Greenshields v. Warren Petroleum Corp.*,⁴² a case in which a lessor claimed that lessees and plant operators in Oklahoma's Ringwood Field entered into unconscionable, confiscatory, and unreasonable gas purchase contracts. Lessee Warren Petroleum had several oil wells in the field that produced casinghead gas.⁴³ At the time, casinghead gas was an unwanted by-product of more valuable oil production.⁴⁴ Producers typically wasted the gas by venting, or allowing it to escape into the atmosphere, although the practice was illegal.⁴⁵ Faced with the possibility of a complete field shutdown by the Oklahoma Corporation Commission if venting of gas continued,⁴⁶ lessee Warren Petroleum approached several companies who reputedly had the financial capacity to build gathering and marketing facilities, and proposed to sell the gas to them.⁴⁷ Although neither Warren nor the potential gas marketers thought the project financially sound, Oklahoma Natural Gas Co., a public utility, agreed to build the necessary facilities and market the

38. *Amoco*, 579 S.W.2d at 285 (quoting COVENANTS IMPLIED IN OIL AND GAS LEASES, *supra* note 18, § 84, at 212-14).

39. See *supra* note 30.

40. 733 S.W.2d 541 (Tex. App.—Houston [1st Dist.] 1986, writ ref'd n.r.e.).

41. *Id.* at 550.

42. 248 F.2d 61 (10th Cir.), *cert. denied*, 355 U.S. 907 (1957).

43. *Id.* at 65-66. Casinghead gas is gas produced along with oil from oil wells. Typically, oil is a more desired product. Casinghead gas may be separated from the oil in a primary separator, or taken directly from the annular space between the casing and tubing string of the well. OIL AND GAS TERMS, *supra* note 24, at 120.

44. *Greenshields*, 248 F.2d at 66.

45. *Id.*

46. The Oklahoma Corporation Commission had the power to order a complete shutdown of wells venting gas in order to prevent waste. OKLA. STAT. tit. 52, §§ 236-238 (1950).

47. *Greenshields*, 248 F.2d at 66.

gas.⁴⁸ Warren contracted to sell the gas to Oklahoma Natural at one and one-half to two and one-half cents per Mcf.⁴⁹

The basis of the plaintiff-lessor's claim was that Oklahoma Natural paid ten cents per Mcf for "pipeline-quality gas" elsewhere in the state of Oklahoma.⁵⁰ The trial court, however, found that the low price for Ringwood Field gas was justified.⁵¹ The gas was produced at low pressure and had to be treated for removal of liquid components and compressed to higher pressure in order to transport it to market via high pressure pipeline.⁵² Therefore, the court of appeals affirmed the trial court's finding that the lessees acted in good faith and used due diligence in marketing the gas.⁵³ The court stated that such a finding must be explored by considering the circumstances existing at the time of marketing.⁵⁴ It seemed apparent to the court that the lessees could not have obtained more favorable terms. The court further stated:

The mere fact that, due to the quality of the gas and the necessity for obtaining an immediate market for gas then being wasted, the purchasers were in an excellent position to bargain for a low purchase price cannot create a situation where the lessees would be liable to suit by the lessors whether they entered the only available contract or refused to enter it, provided they used diligence in promoting the lessors' interests.⁵⁵

The *Amoco* and *Greenshields* decisions thus provide important, basic boundaries for defining and evaluating lessee duties and lessor rights in gas contracting. A lessee has a duty to use good faith and due diligence in marketing the lessor's gas in the manner of a reasonably prudent operator. Good faith and due diligence will be evaluated in light of circumstances existing at the time of marketing. A key factor in this analysis is whether the lessee obtained some collateral benefit for itself at the lessor's expense. Also, the fact that a lessee faced difficulty in marketing, due to poor gas quality or even general market forces, standing alone, will not

48. *Id.*

49. *Id.* at 66 n.3. "Mcf" denotes 1000 cubic feet, the common measurement unit of gas in the oil and gas industry, usually measured at a standard pressure and temperature datum. See OIL AND GAS TERMS, *supra* note 24, at 552.

50. *Id.* at 68. Pipeline-quality gas "has sufficient pressure to enter the high pressure lines of the purchaser for distribution to its customers without further compression and which is sufficiently dry so that the liquid hydrocarbons therefrom will not drop out in the transmission lines." OIL AND GAS TERMS, *supra* note 24, at 720 (citing *Greenshields*).

51. *Greenshields*, 248 F.2d at 66.

52. *Id.* at 68.

53. *Id.* 67.

54. *Id.* at 67.

55. *Id.* at 69.

subject the lessee to liability so long as the lessee used diligence to market the gas.

B. *Duty to Act as Fiduciary*

The implied marketing covenant does not impose upon a lessee a fiduciary duty to the lessor.⁵⁶ In *El Paso Natural Gas Co. v. American Petrofina Co. of Texas*,⁵⁷ the defendants had assigned several leases to El Paso Natural Gas Company, retaining overriding royalty interests in the leases. El Paso drilled and produced wells on the leases for many years, paying overriding royalties in accordance with the terms of lease assignments, styled "Gas Lease-Sales Agreements" (GLA's). El Paso also operated other leases in the area. A key provision in the defendants' GLA's, negotiated prior to enactment of the NGPA in 1978, required El Paso to pay overriding royalties upon the highest amount for which El Paso could lawfully sell gas produced from any of its leases. By the early 1980's, El Paso was paying overriding royalties to the defendants at the maximum price fixed by section 102 of the NGPA.⁵⁸ This price was up to four times the maximum price El Paso could charge for gas sold from the defendants' GLA leases.⁵⁹ In some cases, El Paso was paying more in overriding royalties for GLA leases than it actually received from gas sales.

Because of the unprofitability of the GLA leases, El Paso tendered reassignments of the leases to the defendants pursuant to express unprofitability clauses in the GLA's. When all of the defendants refused to accept El Paso's tenders, El Paso filed for a declaratory judgment as to its rights and duties under the GLA's, and sought monetary damages. The defendants pleaded affirmative defenses, and also sought a declaratory judgment of their rights in the lease assignments. Basically, the defendants claimed that El Paso breached the implied covenant to market gas in good faith by not selling gas produced from the GLA wells "for a sufficient price to prevent the wells from being unprofitable and, therefore, reassignable."⁶⁰

56. *Craig v. Champlin Petroleum Co.*, 435 F.2d 933, 938 (10th Cir. 1971). See *Townsend v. Creekmore-Rooney Co.*, 332 P.2d 35, 38 (Okla. 1958).

57. 733 S.W.2d 541 (Tex. App.—Houston 1986, writ ref'd n.r.e.).

58. The NGPA established eight different categories of gas production and fixed maximum lawful prices for the "first sale" of gas in each category. 15 U.S.C. §§ 3301-3432 (1982). Section 102 established ceiling prices for "new natural gas," as defined in the act. *Id.* § 3312(c).

59. Almost all of El Paso's GLA wells were either NGPA Section 103 or Section 104 wells. *El Paso Natural Gas Co.*, 733 S.W.2d at 546.

60. *Id.* at 550.

The court held that El Paso did not owe the defendants any implied duty as to the amount for which it actually sold their production, since El Paso paid overriding royalties on an independently established higher price. A working interest owner is not under an obligation to market gas for a sufficient price to keep a lease assignment in effect when the alternative is to return 100% of the gas to the royalty owners.⁶¹ In dicta, the court went on to say that “[i]f there were an implied duty to market in good faith, it did not create a fiduciary duty on El Paso by which it was obligated to subordinate its own interests to those of the defendants.”⁶² This reasoning should logically also apply to lessee-lessor relationships since they are essentially the same as that of assignee-assignor in *El Paso Natural Gas*.

A lessee may therefore diligently promote its own interests in marketing gas, without fear of being held to a fiduciary standard of conduct, so long as the lessor's interests coincide with the lessee's. However, where a lessee's interests are not aligned with those of its lessor, as where a lessee sells gas to an affiliate or to a wholly or partially owned subsidiary, the lessee may be held to a stricter standard than the prudent operator standard. In this situation “the court may be more willing to ‘second guess’ the marketing decisions of the lessee.”⁶³ Stated another way, courts will be more likely to strictly scrutinize a lessee's intent and motive in gas contracting when the lessee's interests are antagonistic to those of its lessor.⁶⁴ Often, this is referred to as a duty to contract at arm's length.

C. *Duty to Contract at Arm's Length*

Arguably, all gas purchase contracts should be negotiated at arm's length. Under the implied marketing covenant, this may be viewed as another aspect of a prudent operator's obligations; however, it becomes an explicit duty where a lessee contracts with a subsidiary or affiliated company, or where a lessee's interests are otherwise antagonistic to those of its lessor. The obvious problem is one of collusion⁶⁵ on price and

61. *Id.*

62. *Id.*

63. Pearson & Dancy, *supra* note 1, at 2183.

64. Pearson & Dancy suggest six different situations where antagonism between lessee and lessor may arise, three of which are directly related to gas contracting. Pearson & Dancy, *supra* note 1, at 2182.

65. Collusion is not necessarily limited to dealings between a lessee and its affiliated or subsidiary companies, but may arise between independent entities. In the latter case, a lessor may bring a cause of action under the implied covenant to market just as with the former; however, allegations of

terms, with the lessee attempting to pay gas royalties under the "proceeds" royalty clause to the detriment of the lessor.⁶⁶ A lessee typically claims that it is only obligated to pay royalties on the proceeds of its contract (which are usually below market value), whereas the lessor claims it is entitled to royalties under the "market value" royalty clause based on gas market price at the time the gas is sold.

In the leading case of *Tyson v. Surf Oil Co.*,⁶⁷ a lessee sold gas to three affiliated companies at one cent per Mcf, while the market price was four cents per Mcf. The Louisiana Supreme Court found that the principal of the lessee, Mr. C. M. Leonard, was the "moving spirit" of all three affiliated companies, and that he fixed the price which the affiliated companies would pay for the gas.⁶⁸ Therefore, the court held that the plaintiff-lessors were entitled to fair market value for the gas at the well because they did not consent to the gas sales price.

The *Tyson* court imposed a stricter standard upon the lessee, a standard which requires a lessee to obtain the lessor's approval of the gas sales price whenever contracting with an affiliate or subsidiary. Failure to obtain the lessor's approval is apparently *prima facie* evidence of failing to contract at arm's length, at least in the context of lessee-affiliate gas contracting in Louisiana.

More recently, Texas courts have been willing to adopt a less strict standard than that of *Tyson*. In *Texas Oil & Gas Corp. v. Hagen*,⁶⁹ several royalty owners brought an action against their gas lessee based on breach of contract, failure to market gas with good faith and reasonable diligence, and fraud by misrepresentation and concealment. Texas Oil & Gas (TXO) contracted to sell the plaintiffs' royalty share of gas to Delhi Pipeline Company, TXO's wholly owned subsidiary. Delhi transported the gas to a central dehydration facility in the field, then transported the gas seven and one-half miles to a gas treating plant. After treating, Delhi transported the gas to two end-line users fifty and one hundred miles away. These end-line users paid fifteen cents per Mcf more than the price provided in the TXO-Delhi contract. TXO paid the plaintiffs royalties based on the lower-price in the TXO-Delhi contract.

collusion or fraud should be pleaded in order for the court to apply a stricter level of review as to the intent and motives of the lessee. See *infra* notes 67-80 and accompanying text.

66. See *supra* notes 33-39 and accompanying text.

67. 196 So. 336 (1940).

68. *Tyson*, 196 So. at 339.

69. 683 S.W.2d 24 (Tex. App.—Texarkana 1984), *case settled, judgment set aside*, 760 S.W.2d 960 (Tex. 1988).

The plaintiffs claimed that because Delhi was a subsidiary of TXO, gas was not actually sold at the wells, but "sold or used off the premises" by TXO. Based on proof that the subsidiary was merely the alter ego of its parent company, the court disregarded the purported sale of gas at the wells and found that the true sale was off the premises. The court found the evidence insufficient to create a presumption of arm's-length contracting and held that the sale of gas by the lessee to its wholly owned subsidiary was a sham. Therefore, the market value royalty clause was operative, and not the proceeds royalty clause.⁷⁰

Although the *Hagen* court found the gas contract to be a sham, it did acknowledge that, under proper circumstances, a presumption of arm's-length contracting could be sustained:

The mere fact that a subsidiary is wholly owned by the parent and there is an identity of management does not justify disregarding the corporate entity of the subsidiary, but where management and operations are assimilated to the extent that the subsidiary is simply a name or a conduit through which the parent conducts its business, the corporate fiction may be disregarded in order to prevent fraud and injustice.⁷¹

Even though the judgment in *Hagen* was set aside by the Texas Supreme Court based on a settlement reached by the parties,⁷² and therefore has no precedential value, it is still illustrative of the recent intellectual climate of the Texas Court of Appeals.

The proper circumstances alluded to in *Hagen* were in fact presented to the Texas Court of Appeals two years later in *Parker v. TXO Production Corp.*⁷³ *Parker* involved a suit by royalty owners for breach of the implied covenant to market gas in good faith. The lessee sold gas to its wholly owned subsidiary at ninety-five percent of market value, deducting five percent for compression charges, even though other prospective purchasers made no similar deduction.⁷⁴ The court held there was no basis for piercing the lessee's corporate veil to determine if the sale was a sham.⁷⁵ Therefore, if contract gas sales price is found to be

70. See *supra* note 37.

71. *Hagen*, 683 S.W.2d at 28 (citing *Gentry v. Credit Plan Corp. of Houston*, 528 S.W.2d 571 (Tex. 1975), and *Bell Oil & Gas Co. v. Allied Chem. Corp.* 431 S.W.2d 336 (Tex. 1968)).

72. 760 S.W.2d 960 (Tex. 1988).

73. 716 S.W.2d 644 (Tex. App.—Corpus Christi 1986, no writ).

74. *Id.* at 645. "The court indicates that factors other than price can validly be considered in determining whether gas has been properly marketed." Smith, *Developments in Nonregulatory Oil and Gas Law*, 38 INST. ON OIL & GAS L. & TAX'N § 1.03[1][c][i], at 1-30 (1987). See discussion concerning price in gas marketing, *infra*, Part III, Subpart D.

75. *Parker*, 716 S.W.2d at 647-48.

“close” to its market value price at the time the contract was negotiated, the court will presume the contract was negotiated at arm’s length and the “proceeds” gas royalty clause will be operative.

The stricter standard of arm’s-length contracting has also been called a standard of “highest good faith.” In *Le Cuno Oil Co. v. Smith*,⁷⁶ gas lessors brought suit against lessee-assignee Le Cuno for an accounting of receipts for the sale of gas at the wellhead. Le Cuno, which also owned the gas gathering system, took custody of gas at the wellhead, processed it, and sold it to interstate gas pipeline companies. The court noted that Le Cuno, as producer, could have contracted with Le Cuno, as gatherer, to effectively set gas prices.⁷⁷ Because Le Cuno accounted to its lessors based on wellhead price, it was required to “exercise the highest good faith in any contract it entered disposing of the royalty owners’ gas.”⁷⁸ But finding that Le Cuno’s sales to the interstate pipelines were bona fide arm’s-length transactions, the court held that Le Cuno satisfied the highest good faith standard.⁷⁹

Apparently, the *Le Cuno* court would impose an arm’s-length or highest good faith standard on all wellhead gas sales where the lessee, or its subsidiary or affiliate, owns or operates downstream gathering, treating, or pipeline facilities. Under these circumstances, if a lessor challenges a wellhead gas sale as being below market value, the court will presume that the gas contract between a lessee and its subsidiary or affiliate is not at arm’s length. The burden of proof will shift to the lessee to show by circumstantial evidence that its gas contract price was close to market value at the time the contract was executed.

D. *Duty to Obtain Best Price in Gas Contracting - Lessee’s Exercise of Good Business Judgment*

Under the implied marketing covenant, courts generally have given deference to the business judgment of a lessee in marketing gas. For example, in *Gazin v. Pan American Petroleum Corp.*,⁸⁰ the Oklahoma Supreme Court held that a lessee exercised reasonable diligence in obtaining a satisfactory market for gas within a reasonable time even though a less satisfactory market was available three and one-half years

76. 306 S.W.2d 190 (Tex. Civ. App.—Texarkana 1957, writ ref’d n.r.e.), cert. denied, 356 U.S. 974 (1958).

77. *Id.* at 192.

78. *Id.*

79. *Id.* at 192-93.

80. 367 P.2d 1010 (Okla. 1962).

earlier. The lessee gambled by drilling additional wells, proving up more reserves, in order to secure a gas contract with better prices and terms.⁸¹

The Fourth Circuit Court of Appeals reached an opposite conclusion in *Hutchinson v. McCue*.⁸² The court disagreed with the lessee's business judgment in suspending deliveries to an existing gas market in an effort to obtain a better price. The court may have been influenced by the fact that gas was already being sold in an existing market, and that the lessor had a vested interest in the continuation of those sales as a third-party beneficiary to an existing contract.⁸³

Gazin and *Hutchinson* illustrate the dilemma facing lessees who are forced to choose between contracting to sell gas for a presently available low price, or withholding their gas in anticipation of receiving a higher price later.⁸⁴ Commentators have clouded lessees' business decisions by stating that a lessee owes a duty to its lessor to obtain the best price and terms possible for gas.⁸⁵

Several courts have examined the relationship between lessee and lessor in the context of whether a lessee has a duty to obtain the best price and terms when entering into gas contracts. For example, in *Amoco Production Co. v. First Baptist Church of Pyote*,⁸⁶ the court reviewed several authorities who advocated a duty under the implied marketing covenant for a lessee to obtain the highest price available when marketing gas. While the court's opinion gives tacit approval to this view, the court did not expressly endorse it.

Some opinions have been cited as creating a duty for a lessee to obtain the highest price available when marketing gas, but a closer examination of these opinions and the authorities upon which they rely indicates otherwise. For example, the Oklahoma Supreme Court in *Johnson*

81. *Id.* at 1011.

82. 101 F.2d 111 (4th Cir.), *cert. denied*, 308 U.S. 564 (1939).

83. See *infra* Part V for a discussion of lessors' rights as third-party beneficiaries to gas contracts.

84. See Discussion Notes, 16 Oil & Gas Rep. 1014 (1962).

85. See, e.g., COVENANTS IMPLIED IN OIL AND GAS LEASES, *supra* note 18, § 84, at 212-14 ("the concept of diligence in marketing should include the duty to realize the highest price obtainable by the exercise of reasonable effort"); Martin, *supra* note 29, at 191 (there is a duty owed by lessee to obtain the best price possible for gas); Siefkin, *Rights of Lessor and Lessee with Respect to Sale of Gas and as to Gas Royalty Provisions*, 4 INST. ON OIL & GAS L. & TAX'N 181, 182 (1953) (implied obligation to market probably requires the lessee to secure the highest price reasonably obtainable).

86. 579 S.W.2d 280 (Tex. Civ. App.—El Paso 1979), *writ ref'd n.r.e. per curiam*, 611 S.W. 2d 610 (Tex. 1980).

*v. Jernigan*⁸⁷ stated that “[t]he lessee is obligated to develop the commodity he has found so that it will bring the highest possible market value,”⁸⁸ citing the opinion in *Harding v. Cameron*.⁸⁹ The *Harding* court had stated that “[a]n implied duty or obligation was imposed by law . . . to obtain a market for the gas at the best price obtainable,”⁹⁰ citing as authority for this statement the decisions of *Gazin v. Pan American Petroleum Corp.*⁹¹ and *Townsend v. Creekmore-Rooney Co.*⁹² Neither *Gazin* nor *Townsend*, however, directly support the *Harding* statement.

The *Harding* court apparently read *Gazin* as saying that the lessee did not breach its implied covenant to market by waiting three and one-half years to enter into a gas purchase contract because the covenant included the obligation to market gas at the best possible price obtainable. But in *Gazin* the lessee’s diligence in drilling additional wells while seeking better contract terms appears to be the basis for the court’s decision.⁹³ *Townsend* only supports that an implied covenant to market exists, not that it requires marketing at the highest price possible. Searching the “chain of title” for the *Johnson* and *Harding* opinions, therefore, reveals very little support for a “duty” to market gas at the best price and terms available.

More recently in *Barby v. Cabot Corp.*,⁹⁴ the Oklahoma Supreme Court expressly stated that “[u]nder Oklahoma law a producer has a duty to market the gas produced from a well and to obtain the best price and terms available,”⁹⁵ citing their decision in *Tara Petroleum Corp. v. Hughey*.⁹⁶ This statement represents an expansive interpretation of *Tara Petroleum*. The *Tara Petroleum* court did not hold that a lessee has a duty to obtain the best price in marketing gas, but that best price is prima facie satisfaction of the lessee’s royalty obligation under a “market value” royalty clause.⁹⁷

Gas contract price and terms were also at issue in *Piney Woods*

87. 475 P.2d 396 (Okla. 1970).

88. *Id.* at 399.

89. 220 F. Supp. 466 (W.D. Okla. 1963).

90. *Id.* at 470.

91. 367 P.2d 1010 (Okla. 1961).

92. 358 P.2d 1103 (Okla. 1960).

93. *See supra* notes 80-81 and accompanying text.

94. 550 F. Supp. 188 (W.D. Okla. 1981). *Barby* involved a claim that a lessee breached its implied covenant to market by waiting fourteen months after expiration of an existing gas contract before executing a new contract. The court held that the plaintiffs failed to meet their burden of proof in showing that the lessee was dilatory in renegotiating the expired contract. *Id.* at 191.

95. *Id.* at 190.

96. 630 P.2d 1269 (Okla. 1981).

97. *See id.* at 1273.

*Country Life School v. Shell Oil Co.*⁹⁸ Plaintiff-lessors charged lessee, Shell, with failure to fulfill its obligation to market gas because Shell did not procure a price renegotiation clause in one of two gas sales contracts. The first or "base" contract was executed in 1971 at a price of fifty-three cents per Mcf, escalating three percent per year.⁹⁹ The second or "excess" contract was negotiated and executed one year later at a price of forty-five cents per Mcf, escalating one percent per year.¹⁰⁰ The excess contract also contained an "area FPC clause" which provided that Shell would receive the Federal Power Commission's prescribed ceiling rate for comparable gas sales in the area if that rate was higher than the contract rate. At the time of trial, gas was being sold for sixty-three cents per Mcf under the base contract but for \$1.63 per Mcf under the excess contract due to the area FPC clause.¹⁰¹ The lessors objected to the absence of a similar clause in the base contract.

The court found that at the time Shell negotiated the base contract, gas was customarily being sold under long-term contracts at fixed prices with minimal price escalation clauses.¹⁰² Therefore, the court held that Shell did not breach its implied duty to market.¹⁰³ The fortuitous price increase in the excess contract resulting from the area FPC clause was immaterial, especially since the initial price and escalation rate of the base contract were higher than in the excess contract.

According to testimony of Shell's regional marketing manager, when negotiations initially began prices offered in the interstate market were generally equal to, or slightly greater than, those found in the intrastate market.¹⁰⁴ But intrastate gas sales yielded a higher present value than interstate sales because the Federal Power Commission did not regulate production volumes.¹⁰⁵ Shell therefore committed its gas to the intrastate market early in the marketing process.

The district court did not address the reasonableness of Shell's decision to commit its gas to the intrastate market at a lower price than the interstate market probably because the price for intrastate sales was

98. 726 F.2d 225 (5th Cir. 1984), *cert. denied*, 471 U.S. 1005 (1985).

99. *Id.* at 229. The "base" contract covered sales of gas up to a maximum of 46,667 Mcf per day. *Id.*

100. *Id.* The "excess" contract covered sales of gas produced by Shell in excess of the amount committed under the base contract. *See id.*

101. *Piney Woods Country Life School v. Shell Oil Co.*, 539 F. Supp. 957, 965-69.

102. *Id.* at 975.

103. *Id.*

104. *Id.* at 966.

105. Shell's marketing occurred during the early 1970's, prior to enactment of the NGPA. Under the NGA, only interstate gas sales were regulated. 15 U.S.C. § 717(b) (1982).

higher by the time the base and excess contracts were executed. The Fifth Circuit Court of Appeals, in affirming the district court's decision, impliedly acknowledged that a prudent operator or lessee does not have to market gas at the highest price obtainable, but may consider all relevant factors. Instead of accepting the terms of the base contract, the court stated, "Shell might . . . have accepted a lower initial price but reserved the opportunity to redetermine the price at later intervals Shell's decision was not a breach of the lease-created covenant to market, since the choice of the [base] contract was a prudent and reasonable one."¹⁰⁶

Piney Woods illustrates an important facet of gas contracting, often overlooked in the best-price-and-terms debate. A gas contract is not a simple, single-purchase transaction where a known commodity is sold to the highest bidder. Many complex, interrelated factors weigh heavily in a lessee's marketing decisions, which arguably should enter into a court's determination of whether a lessee breached its implied covenant to market where a lessee contracts to sell gas for less than "best" price. Courts need to take a flexible approach in reviewing a lessee's business judgment. Depending on business climate, market factors, and regulatory constraints, a lessee may attempt to negotiate a gas contract which yields the highest present value, the highest actual value, or some optimization of the two. Initial price is only one factor to be considered. With the current trend toward contracts of much shorter duration, however, price may be the most important criterion.

IV. DUTY TO RENEGOTIATE GAS CONTRACTS

This section analyzes whether a duty exists for a lessee to renegotiate gas contracts by considering two basic questions. First, does a general duty exist for a lessee-seller to renegotiate an existing, unexpired contract with a gas purchaser whenever changed circumstances make performance of the contract harsh or unreasonable? Second, whether or not a general duty exists, does the implied marketing covenant impose a duty upon a lessee to use due diligence, in the manner of a reasonably prudent operator, to renegotiate an existing, unexpired gas contract when it would be advantageous to the lessor's interests?

106. *Piney Woods*, 726 F.2d at 237.

A. *Lessee's General Duty to Renegotiate a Gas Contract with the Gas Purchaser*

The parties to a contract are best able to assign and allocate risks during contract formation. Contract renegotiation therefore represents a reallocation of contract risks. However, where the parties expressly or implicitly allocate risks associated with foreseeable contingencies in the contract, courts will normally enforce the contract and will not later intervene to reallocate risks, unless failure to do so causes an unconscionable result.

In a fixed-price gas contract, the parties assign the risk of market price increases to the lessee-seller and the risk of market price decreases to the gas purchaser.¹⁰⁷ The assignment of risk to a lessee-seller is comparatively less where the gas contract places a floor under price but allows for price escalation,¹⁰⁸ but the parties nevertheless explicitly allocate risks. If a lessee-seller incorrectly forecasts future gas market changes and finds itself locked into a disadvantageous contract, it cannot complain that the contract is unconscionable. All that can be said is that an undesirable outcome has occurred in a risk-oriented business.¹⁰⁹ In this situation a lessee-seller may attempt to assert the doctrines of impossibility or impracticability; however, these are "devices for shifting risk in accordance with the parties' presumed intentions, which are to minimize the costs of contract performance, one of which is the disutility created by risk[.] [T]hey have no place when the contract explicitly assigns a particular risk to one party or the other."¹¹⁰

There is, therefore, no general duty for a lessee-seller or a gas purchaser to renegotiate an *existing* gas contract when a contingency related to an explicitly assigned risk occurs. On the other hand, the implied marketing covenant does impose a duty upon a lessee to renegotiate where a gas contract has *expired*. For example, in *Barby v. Cabot Corp.*,¹¹¹ the court held that a lessee breached its marketing duty by failing to renegotiate an expired gas contract for twenty-one months. In *Amoco Production Co. v. First Baptist Church of Pyote*,¹¹² the court imposed a duty on a lessee to renegotiate an expired gas contract at a higher

107. See *Northern Ind. Pub. Serv. Co. v. Carbon County Coal Co.*, 799 F.2d 265 (7th Cir. 1986).

108. See *id.* at 278.

109. See *id.*

110. *Id.*

111. 550 F. Supp. 188 (W.D. Okla. 1981).

112. 579 S.W.2d 280 (Tex. Civ. App.—El Paso 1979), *writ ref'd n.r.e. per curiam*, 611 S.W.2d 610 (Tex. 1980).

price than that obtained by the lessee. The nature of the duty to renegotiate expired contracts is in fact nearly identical with the original duty to market gas upon first discovery of commercial production. However, as the decision in *Barby* suggests, courts may be less tolerant of time elapsed in renegotiation settings.¹¹³

The existence of a duty to renegotiate expired gas contracts does not create nor impose a similar duty upon a lessee to renegotiate *existing, unexpired* contracts, even if the lessee later negotiates contracts for the sale of other lessors' gas on more favorable terms. Subsequently-negotiated contracts could possibly be on less favorable terms, but a lessor would assuredly not argue that its lessee would have a duty to renegotiate the gas contract in this situation.

While a lessee may desire to renegotiate its gas purchase contract after learning of more favorable terms in later contracts its purchaser negotiates with other parties, the lessee has no implied duty to do so apart from an express renegotiation clause. Conversely, and perhaps more importantly, the gas purchaser has no duty to renegotiate the original contract with the lessee-seller, absent an express renegotiation clause or a judicially-mandated reformation.

B. *Lessee's Duty Under the Implied Marketing Covenant to Use Due Diligence to Renegotiate a Gas Contract*

An appropriate standard of review for gas contracting, as set forth in *Tara Petroleum Corp. v. Hughey*,¹¹⁴ is that a gas contract is not unreasonable if fair and representative of other contracts negotiated at the time in the field. A lessor, therefore, cannot complain that its lessee is in breach of any lease obligation for failure to renegotiate a reasonable and fair contract, even though it appears unreasonable and harsh based on later, higher-priced contracts.¹¹⁵

Given that a lessee has no general duty to renegotiate a gas contract,

113. *Cf. Gazin v. Pan Am. Petroleum Corp.*, 367 P.2d 1010 (Okla. 1962) (3-1/2 years reasonable time to market newly discovered gas). See *supra* notes 80-81 and accompanying text.

114. 630 P.2d 1269 (Okla. 1981).

115. A claim of "harshness" in gas contracting between a lessee and gas purchaser, based on later unforeseen changes, has been reviewed but not accepted by at least one court, calling it a claim for "imprevision." "This essentially French doctrine . . . permits judicial reformation of contracts whenever a drastic change in circumstances renders performance for one of the parties harsh . . ." *Hanover Petroleum Corp. v. Tenneco Inc.*, 521 So. 2d 1234 (La. Ct. App. 1988). See Litvinoff, *Force Majeure, Failure of Cause and Theorie De L'Imprevision: Louisiana Law and Beyond*, 46 LA. L. REV. 1 (1985).

it would be illogical to imply a duty to use due diligence to do so whenever a lessor learns that some other mineral interest owner is getting a better bargain. Further, what would be the gas purchaser's incentive to renegotiate prices upward? What consideration would a lessee-seller provide to obtain a higher-priced contract? When a lessee renegotiates for higher prices by compromising prices or terms under other contracts, he breaches the implied marketing covenant as related to other lessors.¹¹⁶

An allegation that a lessee failed to use due diligence in renegotiating an existing, fixed-price gas contract, where market prices have increased substantially, could possibly be viewed as a claim for breach of the implied marketing covenant since the lessee failed to include a "price renegotiation clause" in the contract. However, in *Piney Woods Country Life School v. Shell Oil Co.*,¹¹⁷ the court held otherwise. The court found that the lessee executed gas contracts for the best available prices *at the time*, fulfilling its implied marketing duties.¹¹⁸ Courts have consistently refused to allow lessors to use hindsight in attacking gas contracts which were reasonable when originally executed.

V. LESSOR RIGHTS IN GAS CONTRACTING: THE LESSOR AS THIRD-PARTY BENEFICIARY

A review of lessee duties and lessor rights under the implied marketing covenant would not be complete without a brief discussion of what appears to be an emerging basis for closer scrutiny of a lessee's gas contracting activities. Although a lessee is not under a duty to renegotiate a gas contract at the bidding of its lessor, the lessee may have a duty to obtain lessor approval where the lessee chooses to renegotiate an existing valid gas contract. This possible duty may arise under a third-party beneficiary theory:

A third party beneficiary is one for whose benefit a promise is made in a contract, but who is not a party to the contract. Royalty and overriding royalty owners may be considered third party beneficiaries to a gas contract as they receive revenues and benefits predicated on the contract, but are not actually parties to it.¹¹⁹

In effect, once a lessee enters into a gas contract with a purchaser,

116. See *supra* notes 33-39 and accompanying text.

117. 726 F.2d 225 (5th Cir. 1984), *cert. denied*, 471 U.S. 1005 (1985).

118. Where a lessee does fail to include a price renegotiation clause *and* contracts for less than the best available price, a lessor may have a stronger argument for breach of the implied marketing covenant. See *supra* Part III, Subpart D.

119. Pearson & Dancy, *supra* note 1, at 2185 (footnote omitted).

the lessor becomes a creditor beneficiary¹²⁰ ("The royalty obligation on the sale of gas thus creates a contractual debtor/creditor relationship between the lessor and lessee.")¹²¹ After the beneficiary's rights vest, the contracting parties may need the beneficiary's approval to modify the contract.¹²²

Logically, no lessor would object if the lessee renegotiates more favorable prices and terms, but during periods of low demand and over-supply, the normally coincident interests of lessee and lessor may diverge.

In some instances, the [lessee] may want to maximize its cash flow to service its bank debt and pay operating expenses, thereby stabilizing its financial position. The maximization of cash flow may come through spot market sales at prices which may be considered below market value if compared to the prices obtained under long term contracts negotiated in better markets.

The lessor may not have a coinciding interest in maximizing cash flow, and instead may desire to maximize the total returns from his royalty and mineral interest.¹²³

A more predominant scenario, precipitated by the "gas bubble" and downturn in gas prices in the early 1980's, is that pipelines and other gas purchasers have refused to honor their contracts unless producers agreed to lower prices and substantial modification of take-or-pay provisions.¹²⁴ Professor Richard Pierce has categorized four responses a lessee might make in this context:¹²⁵ (1) a lessee may accede to the purchaser's demand in order to maintain some gas sales and cash flow, and to avoid potential shut-in problems; (2) a lessee may hold out for a period of time for more favorable terms and a possible settlement bonus; (3) a lessee, in addition to holding out for more favorable terms and a possible settlement bonus, may obtain the collateral benefit of raising the contract price applicable to a different source of supply; and, (4) a lessee may litigate to a final judicial resolution of compensatory and/or exemplary damages, as well as a declaratory judgment requiring future contract compliance. While many cases between lessee-producers and gas purchasers have

120. Pearson & Dancy, *supra* note 1, at 2186. A creditor beneficiary is a person, not a party to a contract between promisor and promisee, to whom the promisee owes a duty. The promisee acts as a conduit, i.e., the promisor's performance on the contract flows through the promisee to benefit the promisee's creditor.

121. Pearson & Dancy, *supra* note 1, at 2182.

122. See Pearson & Dancy, *supra* note 1, at 2186.

123. Pearson & Dancy, *supra* note 1, at 2185.

124. Pierce, *supra* note 13, § 8.03.

125. Pierce, *supra* note 13, § 8.03[1]-[4].

been resolved,¹²⁶ suits between lessors and lessees are likely germinating in this litigiously fertile soil.

Whether a lessee chooses (for business reasons) or "elects" (based on a purchaser's anticipatory breach) to renegotiate an existing valid gas contract, the lessee may have a duty to inform or obtain lessor approval.¹²⁷ A very serious problem, however, is that a lessor whose financial goals differ from those of its lessee will have no incentive to approve a proffered renegotiated contract. Or an unsophisticated lessor may be bewildered at the lessee's request for approval, having never been privy to the original contract. At the other extreme, a sophisticated lessor may play a "hold up game" with its lessee to exact a substantial "approval bonus" for agreeing not to sue for breach of contract under the implied marketing covenant.

Clearly, a lessee needs some latitude to exercise good business judgment in marketing, especially in the current environment. Judicial expansion and clarification of third-party beneficiary principles, as applied to implied marketing obligations, appears to be inevitable, and will likely occur as more frequently negotiated short-term gas contracts are litigated. The same principles, however, should apply to contract renegotiations as apply to original contract negotiations.

A lessee does not stand as a fiduciary to its lessor and is not required to subordinate its interests to those of its lessor.¹²⁸ If a lessee is held to a standard of good faith and reasonable prudence in exercising its business judgment when negotiating an original gas contract without obtaining lessor approval, a lessee should be held to the same standard and have the right to renegotiate its gas contract, when necessary in its business judgment, without the burdensome and potentially complicated task of obtaining lessor approval.

VI. CONCLUSION

The new gas contracting environment will certainly influence evaluation of lessee duties and lessor rights under the implied marketing covenant, but clearly some principles of established law will not change. For

126. See, e.g., *Hanover Petroleum Corp. v. Tenneco Inc.*, 521 So. 2d 1234 (La. Ct. App. 1988); *Universal Resources Corp. v. Panhandle Eastern Pipeline Co.*, 813 F.2d 77 (5th Cir. 1987). Cf. *Northern Ind. Pub. Serv. Co. v. Carbon County Coal Co.*, 799 F.2d 265 (7th Cir. 1986).

127. *Pearson & Dancy*, *supra* note 1, at 2188. Cf. *Tyson v. Surf Oil Co.*, 195 La. 248, 196 So. 336 (1940) (gas sold by lessee to affiliate for less than market price without lessor consent; price not binding on lessor).

128. See *supra* Part III, Subpart B.

example, the standard of review of a lessee's marketing activities will inevitably remain the same; a lessee has a duty to use good faith and due diligence in marketing its lessor's gas in the manner of a reasonably prudent operator. Circumstances existing at the time of marketing should continue to be relevant. Also, courts will still consider lessee dealings with affiliates or subsidiaries as warranting stricter scrutiny of marketing activities.

The trend to shorter-term, direct sales gas contracts, however, will likely cause more stringent evaluation of whether a lessee contracted for the best or highest possible price. With the proliferation of gas contract brokers (both pipeline-affiliated brokers and independent brokers) the gas market may begin to resemble other commodities markets. Growing "spot market" sales already evidence this trend. Price may indeed become the most important factor in determining whether a lessee has acted prudently in marketing gas.

In one sense, increased contracting frequency may subject lessees to greater liability under the implied marketing covenant, not only because of the number of contracts negotiated, but also because of the potential for courts to reconsider the relationship of lessee to lessor. Arguably, a typical lessor's knowledge of gas contracting and bargaining power is even less in today's market. Whereas a lessor may have been willing to attempt to market its royalty share of gas for a long-term sale by seeking professional counsel, a typical lessor in today's market does not have the resources to effectively market its gas on a short-term or frequent basis.¹²⁹ More than ever, a lessor must rely on its lessee's business judgment and marketing acumen. A lessee essentially acts as the lessor's agent in this setting, creating a stronger argument for a relationship of trust.

On the other hand, greater contracting frequency may reduce lessee liability for breach of the implied marketing covenant in some situations. Because the contract term is much shorter, the potential compensatory damages for breach will be limited, that is, if the questionable contract represents only a temporary aberration. If the parties roll over the contracts month-to-month, however, they may establish a pattern of conduct, subjecting the lessee to greater liability and possibly even punitive damages.

129. It is possible that gas brokers and marketers may fill the gap for lessors in this area. However, brokerage services are normally performed for a fee. Lessors may prefer to allow their lessees to market gas, since marketing costs are often absorbed into a lessee's overhead and not deducted from royalty.

Short-term, frequent gas contracts may lessen some traditional concerns about seller-purchaser relationships and allocation of risks. In the past a lessee might have acquiesced to certain contract terms in hopes of establishing a better working relationship with a major gas pipeline-purchaser. The relationship between producer and seller was often confrontational, with the long-term arrangement usually benefitting one party at the expense of the other party over the contract's duration.¹³⁰ Lessees also faced potential liability for errors in judgment in negotiating contract terms and allocating risks. In a free market where gas is sold on a short-term basis, however, the focus shifts to buying and selling the commodity at market prices. The emphasis on maintaining long-term relationships and drafting contracts to cover all possible contingencies is no longer necessary.

Overall, the relaxed regulatory scheme and the move toward a free gas market, with its attendant impact on gas contracting, should prove beneficial to both lessor and lessee. Gas market prices and gas price futures may become topics of household conversation, much the same as oil prices, and gas prices may be listed in the financial sections of daily newspapers. Lessors may find they will be much more informed as to their lessees' marketing activities by matching royalty payments with published gas prices for the corresponding period of production. Lessees may find they are less vulnerable to litigation since the complexities and risks of gas contracting are apparently minimized in a competitive, short-term market. If this is truly the result, then lessees may channel their energies into more worthwhile endeavors—exploring for more oil, gas and mineral resources.

130. R. LUETTGEN, *supra* note 10, at 32-33.