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THE LAW OF DISPROPORTIONATE GAS SALES*

David E. Pierce**

I. INTRODUCTION

Whenever more than one person owns the right to market gas from a well, the potential for disproportionate gas sales exists. Although often characterized as a "gas balancing" problem, the term "gas balancing" refers to the menu of equitable techniques for dealing with disproportionate gas sales. This Article focuses on the basic issue of whether one working interest owner can ever lawfully market more than their share of the gas being produced. Presumably B will continue marketing gas from the well; indeed, B in most cases will be contractually obligated to third parties (their lessor and gas purchasers) to do so.

The question arises as to whether B can lawfully market gas from the well. If so, it then becomes necessary to determine the rights and obligations of the affected parties and how these rights and obligations should be administered. These are the questions that the law of disproportionate gas sales seeks to answer.

1. For example, assume A and B each own 50% of the working interest in a gas well located in Section 30. Their respective interests may be the product of voluntary pooling, forced pooling, leasing undivided mineral interests, or assignment. Regardless of how their ownership interests were created, each party has elected to separately market their proportionate share of gas produced from the well. Something happens and A is unable to market its gas. Perhaps A's contract has terminated; perhaps A has a dispute with its gas purchaser; perhaps A, or A's purchaser, is unable to obtain pipeline capacity to ship A's gas to the purchaser's delivery point, or possibly A thinks that the current market price for gas is too low. This raises the issue of the relative rights of A and B when A fails to market its 50% share of the gas being produced. Presumably B will continue marketing gas from the well; indeed, B in most cases will be contractually obligated to third parties (their lessor and gas purchasers) to do so.

2. See infra text accompanying notes 142-151 (discussing different approaches to gas balancing).

3. For purposes of this Article, the term "working interest owner" includes any person who

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proportionate share of the gas stream. Depending upon how this basic issue is resolved, the parties may or may not need to address gas balancing issues. Resolution of this issue can also impact the relative rights of the lessor and lessee under various clauses of the oil and gas lease, such as the habendum clause and the royalty clause. Other non-working interest owners, such as owners of nonparticipating royalty and overriding royalty interests, will also be affected by the administration of disproportionate gas sales.

This Article explores the conceptual basis for evaluating disproportionate gas sale problems under commonly encountered legal relationships. These problems are examined in the context of:

1. Working interest owners who are common law cotenants.
2. Working interest owners developing the property pursuant to an operating agreement.
3. Working interest owners developing the property pursuant to a pooling order.
4. Working interest owners marketing gas under title 52, sections

has a right to enter and develop the property for oil and gas. This would include an unleased mineral interest owner.

4. If the disproportionate sale was unlawful, the party selling more than their share of the gas stream will be subject to tort and, depending upon the agreements between the parties, contract liability. If the disproportionate sale was lawful, the court will have the opportunity to consider equitable techniques for protecting the interests of each party, such as some form of gas balancing.

5. See D. Pierce, Kansas Oil and Gas Handbook § 17.17 (1989). As used in this article, “operating agreement” refers to the contract entered into by the working interest owners to coordinate development of the property. The operating agreement designates an “operator” and specifies each working interest owner’s rights and obligations throughout the development and production process. Anytime there is multiple ownership of the working interest, or the potential for multiple ownership, the working interest owners will normally enter into an operating agreement, often called a “joint operating agreement” or simply “JOA.” Id.

6. See Martin, The Gas Balancing Agreement: What, When, Why and How, 36 Rocky Mt. Min. L. Inst. 13-1 (1990) (pre-print edition) [hereinafter Martin]. Professor Patrick H. Martin suggests that one way to avoid the disproportionate sales issue is to have the state oil and gas conservation commission specifically address the issue in their pooling orders. The pooling order would authorize disproportionate sales and provide for equitable techniques to ultimately bring the parties into balance. Professor Martin explained the pooling order approach, stating:

[When you apply for a pooling order, you request a gas balancing paragraph as part of the order. The paragraph would spell out the manner in which balancing would take place. Such an order could allow and require the operator to market all production from the unit unless the parties have entered into a gas balancing agreement. Once the order is entered, the operator will be able to market the production without a non-marketer coming back and revoking the authorization. The non-operator cannot complain if he had an opportunity to assume responsibility for marketing his own share of gas. Since it is an order of the agency, the operator is likely to gain some immunity from liability, and disputes arising from the order would probably come under the jurisdiction of the agency. The agency could periodically review the actions of the parties under the order and order cash balancing should it be appropriate. Likewise, the agency could provide a mechanism for payment of royalty should that be necessary to protect the correlative rights of any party.]

Id. at 49-50.
541-547 of the Oklahoma Statutes.\textsuperscript{7}

The goal of this Article is to offer attorneys and judges a logical approach to evaluating disproportionate sale problems.\textsuperscript{8}

II. IDENTIFYING COTENANT AND COTENANT-LIKE RELATIONSHIPS

The first task in evaluating a disproportionate sales problem is to identify the precise nature of the relationships that exist between the working interest owners.\textsuperscript{9} This requires an examination of all conveyances and contracts affecting the working interest owners. Conveyances affecting the parties should be examined to determine whether a common law cotenancy relationship exists. Often some, but not all, of the parties will have a cotenant relationship. For example, the well may be located on a pooled unit consisting of all of Section 30. \(A\) and \(B\) each own an undivided 50\% interest in all the minerals in the North Half of Section 30. \(C\) owns all the minerals in the South Half. \(A\) and \(B\) are cotenants of the minerals in the North Half, but they are not cotenants as to \(C\), nor as to any interest they may have under a pooling order or agreement covering the South Half.\textsuperscript{10}

After evaluating conveyances between the parties, contracts between the parties must be evaluated. The parties may have entered into pooling agreements, unitization agreements, operating agreements, gas balancing agreements, processing agreements, division orders, and gas sales agreements which can impact their relationships and their ability to meet their relational obligations to one another. If all the working interest owners have specifically agreed how disproportionate sales will be handled, their


\textsuperscript{8} The "logic" of the analysis should never lose sight of the realities of gas marketing and the practical needs of the gas industry.

\textsuperscript{9} Courts may decide not to attach any significance to the relationship, but this should be an issue which is identified and addressed by the court. For example, if the court finds that the common law cotenancy relationship has been modified or displaced by a subsequent agreement between the parties, the court should note this and articulate how the contract affects the relationship.

\textsuperscript{10} \textit{See infra} text accompanying notes 16-25.
agreement should govern their relative rights. However, agreements entered into among the working interest owners cannot affect the rights of persons who are not parties to the agreements. Persons who would not be subject to agreements among the working interest owners would include nonparticipating royalty owners, royalty owners, and other owners of rights to production carved out of the oil and gas lease prior to the agreements. The rights of these parties will be determined by the agreements they signed or accepted: the oil and gas lease, the royalty deed, or an assignment.


When working interest owners enter into an operating agreement they often prepare a gas balancing agreement to address the rights and obligations of each party when they make disproportionate gas sales. Typically the agreement will permit the producing party to take and market the full gas stream for their own account until the non-taking party is able, or decides, to commence or resume taking gas. A record of imbalances is maintained. Generally, the non-taking party will be entitled to makeup the imbalance by taking their proportionate share of gas, plus a share of the other party's gas (usually not to exceed 50% of the other party's share of the gas stream) until the gas account is balanced. If the reservoir is depleted before balancing in kind is accomplished, the parties will account to one another through 'cash balancing.'

Id.

13. There are now four versions of the "Model Form Operating Agreement." Development agreements entered into prior to 1978 will usually employ the "Ross-Martin" Form 610 "Model Form Operating Agreement—1956" [hereinafter 56 Form]. Development agreements entered into from 1978 through 1982 will probably use the "A.A.P.L. Form 610 — 1977 Model Form Operating Agreement" [hereinafter 77 Form]. Development agreements entered into after 1982 will probably use the "A.A.P.L. Form 610 — 1982 Model Form Operating Agreement" [hereinafter 82 Form]. Development agreements entered into from and after 1990 will probably use the "A.A.P.L. Form 610 — 1989 Model Form Operating Agreement" [hereinafter 89 Form].

The time periods are only rough approximations. Often a developer will not change to a new form of agreement for many years, and will elect instead to use an earlier version with the alterations and additions they have developed through experience with the form. In addition to the Model Forms, there is also the occasional custom-made operating agreement. These are often encountered when the well is being operated by a promoter with passive working interest investors. Offshore operations are often conducted under company-generated operating agreement forms.

14. The efforts of David L. Motloch, and the Rocky Mountain Mineral Law Foundation committee which he chairs, have resulted in a model form gas balancing agreement for use, as "Exhibit E," with the joint operating agreement. See Motloch, Rocky Mountain Mineral Law Foundation Form 6 Balancing Agreement, 2 ROCKY MTN. MIN. L. FOUND. 10-1 (paper ten (10) of the Institute on the Oil and Gas Joint Operating Agreement, discussing the committee's model form gas balancing agreement).
Therefore, the dispute must be resolved by evaluating less targeted documents such as the operating agreement and pooling agreement. All of these agreements must be examined to discover whether they contain any express guidance regarding disproportionate sales; usually they do not. Even though these less targeted agreements fail to address the issue directly, they may disclose cotenant or cotenant-like relationships which can be helpful, and perhaps determinative, in evaluating disproportionate sales issues.

A. Common Law Cotenancy

The most pertinent common law analogy which courts are likely to employ in evaluating disproportionate gas sales problems is cotenancy. Although the analogy may often be far from perfect, it offers the court a logical starting point for its analysis. Therefore, once it is determined how the properties have been assembled, the next step is to identify whether an actual cotenancy exists between any of the parties. For example, assume A owns all the minerals in the South Half of Section 30. B and C each own an undivided 50% of the minerals in the North Half of Section 30. A leases to X, B leases to Y, and C leases to Z. Y and Z are "common law cotenants" of the working interest in the North Half of Section 30. X is not a common law cotenant of any party. However, X may, under certain circumstances, become a "contractual cotenant" or a "statutory cotenant." If we assume conservation regulations limit Section 30 to one gas well, the interests of X, Y, and Z must be combined in some fashion for development. Depending upon the terms of any voluntary pooling agreement and joint operating agreement, and the state

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15. See Martin, supra note 6 at 13-14. Professor Martin argues that in most situations balancing disputes can be resolved as a matter of contract interpretation (the operating agreement) or statutory construction (pooling statutes and orders), without resorting to strained cotenancy analogies. Id.

16. The phrase "common law cotenant" is used to distinguish a cotenancy created by concurrent ownership of an estate in land from cotenant-like relationships created by contract or statute. However, rights under a common law cotenancy can be altered by contract or statute; making it indistinguishable, for practical purposes, from a contractual or statutory cotenancy.

17. The phrase "contractual cotenant" refers to any cotenant-like relationship created by a contract. The most common form of contractual cotenant is created by an operating agreement between working interest owners.

where Section 30 is located, a cotenancy-like relationship among X, and Y and Z, may be created.

If the parties have a common law cotenancy relationship, in a majority of jurisdictions any cotenant can develop the property and produce the oil and gas without the consent of the other cotenants. The key element of a common law cotenancy is the "unity of possession," i.e., the right of each cotenant to occupy the entire undivided interest in the property. Each cotenant has a right to immediate, but non-exclusive, possession of the property. Therefore, if X conveys to W an undivided interest in X's lease covering the South Half of Section 30, X and W will each have the non-exclusive right to develop the South Half. As to the leasehold rights in the South Half, X and W become common law cotenants.

The only limitation on a cotenant's right to extract minerals is the obligation to ultimately "account" to non-producing cotenants for their share of net profits. When dealing with extraction of a mineral from an estate held in cotenancy, the extracted mineral is owned solely by the mining cotenant. Removal and sale of minerals by the producing cotenant does not constitute conversion or actionable waste.

19. See, e.g., Cox v. Davidson, 397 S.W.2d 200 (Tex. 1965). See generally 2 H. Williams & C. Meyers, Oil and Gas Law, § 502, at 573 (1989). The most notable exception to the majority rule is Louisiana. Id. at 576-76.3. See also infra text accompanying notes 68-71.


22. E.g., Prairie Oil & Gas Co. v. Allen, 2 F.2d 566 (8th Cir. 1924). The court, applying Oklahoma law, held that the non-producing cotenant is entitled to an accounting from the producing cotenant for her proportionate share of "the market value of the oil produced less the reasonable and necessary expense of developing, extracting and marketing the same." Id. at 574.

Another obligation of the cotenant would be to permit other cotenants to exercise their concurrent right to develop the minerals. Each cotenant extracting minerals would then have an obligation to account for any net profits to all other cotenants. See, e.g., Compton v. People's Gas Co., 75 Kan. 572, 89 P. 1039 (1907).


[I]n the absence of statute or agreement, or a repudiation of the cotenancy, there simply is no basis for allowing one cotenant in real property to recover damages from another cotenant for conversion of natural gas that is produced from land and reduced to personal property.

Id.

The Supreme Court of Oklahoma adopted a similar approach in rejecting a conversion claim in Anderson v. Dyco Petroleum Corp., 782 P.2d 1367, 1371-72 (Okla. 1989). However, it is doubtful the parties in Anderson were actually common law cotenants. See infra text accompanying notes 26-32.
right to an accounting, common law cotenants also enjoy another basic cotenancy right: the right to end the cotenancy through partition.\(^{24}\) Therefore, the common law arsenal of cotenant remedies includes an accounting for net profits and the ability to end the cotenancy by partition.\(^{25}\)

The reported cases have failed to clearly distinguish between the common law cotenancy and cotenant-like relationships created by contract or statute.\(^{26}\) For example, in \textit{Anderson v. Dyco Petroleum Corp.},\(^{27}\) the court considered whether Dyco, and Dyco's gas purchasers, were liable for the conversion of gas belonging to other working interest owners in the well. The complaining working interest owners were not marketing gas from the well and Dyco was selling more than its 47% share of the well's production. Dyco's gas purchasers refused to buy gas from the complaining working interest owners.\(^{28}\) The \textit{Anderson} court did not indicate whether any of the parties are lessees or assignees of undivided mineral or leasehold interests, nor did they reveal the existence of any operating agreement, pooling agreement, pooling order, or statute that would create a cotenant-like relationship. Without disclosing the source of the relationship, the court concluded:

Under Oklahoma law Appellants [Anderson] and the other working interest owners in the well [including Dyco] are tenants in common. As cotenants each is entitled to market production from the well and the sale of gas to a purchaser by one or more cotenants without consent of other cotenants is lawful. Under ordinary circumstances it does not involve tortious conduct, i.e. conversion, on the part of either the purchaser or on the part of the working interest seller because each

\(^{24}\) See, e.g., Mulsow v. Gerber Energy Corp., 237 Kan. 58, 697 P.2d 1269 (1985); Moseley v. Hearrell, 141 Tex. 280, 171 S.W.2d 337 (1943). This is the basic common law cotenancy right that will often be modified by contract, statute, or administrative order. See Martin, supra note 6, at 5-6, 8.

\(^{25}\) For an interesting case addressing a request for an accounting and partition, see White v. Smyth, 147 Tex. 272, 214 S.W.2d 967 (1948). \textit{White} is discussed in Kuntz, supra note 23, at 13-9 to 13-10.

\(^{26}\) Anderson v. Dyco Petroleum Corp., 782 P.2d 1367 (Okla. 1989) (court does not attempt to identify the source of the cotenant relationship); Teel v. Public Service Co. of Oklahoma, 767 P.2d 391 (Okla. 1985), as corrected, (1986), reh'g granted and opinion amended, (1987), reh'g denied, (1989) (court finds that the parties are common law cotenants but fails to apply common law cotenancy concepts to the dispute); United Petroleum Exploration v. Premier Resources, 511 F. Supp. 127 (W.D. Okla. 1980) (suggesting the parties were not common law cotenants and that their respective rights were governed by a pooling statute and their operating agreement); Beren v. Harper Oil Company, 546 P.2d 1356 (Okla. Ct. App.), as corrected on limited grant of cert., reh'g denied, (1975) (suggesting that the parties were not common law cotenants; instead, their respective rights were governed by their operating agreement and industry trade usages).

\(^{27}\) 782 P.2d 1367 (Okla. 1989).

\(^{28}\) \textit{Id.} at 1369.
A cotenant has the right to develop the property and market production under the common law.29

The court cited De Mik v. Cargill,30 Moody v. Wagner,31 and Mullins v. Ward,32 to support its conclusions. Each of these cases concerned the rights of common law cotenants.

In the recently mandated case of Teel v. Public Service Co. of Oklahoma,33 the court acknowledged that the parties were common law cotenants. Teel had entered into farmout agreements with Siegfried, Siegfried, Inc., and Collins (the "operators"). The operators complied with the terms of the farmout agreements and Teel assigned them undivided interests in the farmout properties. Some of the wells were subject to an operating agreement, while others were not.34 The operators then entered into a gas sales contract with Transok. Upon pay-out, under the farmout agreement, Teel apparently exercised an option to convert his non-operating interest into an undivided working interest in the farmout properties, thereby becoming a cotenant in the working interest with the operators. Teel refused to sell his share of the gas to Transok and later revoked the operators' authority to market his gas to Transok. Transok was aware of Teel's actions but continued, at the operators' request, to credit Teel's account with a proportionate share of the gas proceeds from the operators' gas sales.35

Teel brought suit contending Transok and Public Service Company of Oklahoma ("PSO")36 had converted Teel's gas. The alleged act of conversion occurred when Transok purported to buy Teel's portion of the gas stream with notice that Teel had revoked the operators' authority to market gas to Transok. Since Transok purchased the entire gas stream tendered by the operators who were the other cotenants in the well, it is difficult to understand how Transok could be held liable for conversion. Teel's claim was more properly against his cotenant operators for an accounting. Transok may have credited a share of the production to Teel on their books, but this could have been corrected once the rights of Teel and the other cotenants were determined.

29. Id. at 1371-72.
34. Id. at 394.
35. Id.
36. Id. (Transok had assigned its contract to PSO).
The Oklahoma Supreme Court held that Transok converted Teel's gas by purchasing it after receiving notice that Teel had revoked the operators' right to market gas to Transok. However, Teel could not revoke the right of the other cotenants to market the full gas stream. Teel's indication to the operators that he wanted his gas to stay in the ground should not alter the ability of the other cotenants to pass title to the entire gas stream to Transok. Nor should Transok's accounting entries affect Teel's rights against the producing cotenants. The court apparently confused Teel's situation with one where, for example, Teel tells the operators to deliver Teel's share of the gas to purchaser X, and the operators instead deliver it to Transok, which takes the gas knowing that the operators had been instructed to deliver it to purchaser X. In the situation before the court, Teel effectively said to his cotenants, "you take all of the gas now, I'll take mine when I can get a better price."

Although the court recognized that Teel and the operators were common law cotenants, it failed to apply basic cotenant concepts to Teel's claim. Most of what the court said about cotenants failed to support its conclusion. For example, the court stated:

The owners of undivided interest[s] in oil and gas rights are tenants in common. Each of the cotenants may develop the common property but not to the exclusion of the other cotenants. When gas is discovered by one cotenant, the cotenant may deduct the necessary expenses of developing, extracting, and marketing; but an accounting must be made to the other cotenants for the pro rata share of the production. A tenant in common may lease his/her interest in production without the consent of other cotenants, but in the absence of an express agreement, one cotenant is not an agent of the other. A gas sales contract executed by a cotenant is limited to his/her interest.

The court relied on the concept that the operators lacked authority to sell Teel's gas. If one accepts this premise, then Transok could not have purchased any gas belonging to Teel; all the gas Transok purchased belonged to the operators. Should one inquire as to where Teel's gas is, the answer is that it is in the ground, awaiting marketing by Teel. Certain erroneous findings by the trial court apparently derailed the Supreme Court's analysis. The Teel court discussed the trial court's findings that: "[T]he purchasers took delivery of Teel's gas which was produced by the

37. Id. at 393, 397.
38. Id. at 396.
operators”, and “[T]he operator had bought and sold Teel’s gas to Transok and PSO.”

The court relied upon these findings to support its holding that:

in the presence of notice that the non-contracting cotenant has revoked the operator’s right to sell, failure of a purchaser to account to each working interest owner for his/her pro rata share of the proceeds subjects the purchasers to the same liability as the operator and the purchaser may become a converter of the property.

If Transok was subject to the “same liability as the operator”, then it had no liability, since the operator had authority to deliver the entire gas stream to Transok. The operator had an obligation to account to Teel, but that did not affect title to the production purchased by Transok. Teel successfully turned a simple accounting claim against his cotenants into a conversion claim against Transok. The dissent in Teel suggested that the proper resolution of Teel’s claim would: “[P]ermit Teel to recover by way of ‘balancing’. . . .” However, a rare unanimous Oklahoma Supreme Court, in Anderson v. Dyco Petroleum Corp., limited Teel to situations where “a purchaser purports to buy gas of an owner from an operator which is not authorized to deliver it.”

It appears that after Anderson, the Oklahoma Supreme Court has chosen to deal with all disproportionate sales issues as though the parties were common law cotenants. However, the Oklahoma courts will have to supplement their common law cotenancy approach by considering the impact of any agreements between the parties, as well as applicable statutes, regulations, and Corporation Commission orders.

B. The Contractual Cotenancy

Contracts between working interest owners may alter their common law cotenant rights. If the parties are not cotenants, contracts between them may create cotenant-like rights and obligations. Although pooling agreements may create cotenant-like relationships, the contract that will most often impact or create the relationship is the operating agreement.

39. Id. at 397.
40. Id.
41. Id. at 399 (Summers, J. dissenting) (quoting Beren v. Harper Oil Co., 546 P.2d 1356 (Okla. Ct. App.), as corrected on limited grant of cert., reh’g granted, (1975)).
42. 782 P.2d 1367 (Okla. 1989).
43. Id. at 1372. This was not actually the situation in Teel, because the operators were authorized, by the law of cotenancy, to deliver the gas; they just couldn’t force a current sale of Teel’s proportionate share of the gas.
44. 782 P.2d 1367 (Okla. 1989).
Each of the four form operating agreements, i.e., the 56 Form, 77 Form, 82 Form, and the 89 Form, provide for a contractual cotenancy with regard to production from a defined "unit" or "contract" area. The contractual cotenancy is created by the "ownership clause" of the operating agreement. The ownership clause of each form agreement provides:

56 FORM

4. Exhibit "A" lists all of the parties, and their respective percentage or fractional interests under this agreement. Unless changed by other provisions, all costs and liabilities incurred in operations under this contract shall be borne and paid, and all equipment and material acquired in operations on the Unit Area shall be owned, by the parties as their interests are given in Exhibit "A". All production of oil and gas from the Unit Area, subject to the payment of lessor's royalties, shall also be owned by the parties in the same manner. . . .

77 FORM

Exhibit "A" lists all of the parties and their respective percentage or fractional interests under this agreement. Unless changed by other provisions, all costs and liabilities incurred in operations under this agreement shall be borne and paid, and all equipment and material acquired in operations on the Contract Area shall be owned by the parties as their interests are shown in Exhibit "A". All production of oil and gas from the Contract Area, subject to payment of lessor's royalties which will be borne by the Joint Account, shall also be owned by the parties in the same manner during the term hereof; provided, however, this shall not be deemed an assignment or cross-assignment of interests covered hereby.

82 FORM

Unless changed by other provisions, all costs and liabilities incurred in

45. See description of each form supra note 13.
46. The reference to "unit area" in the 56 Form, and the references to "contract area" in the 77, 82, and 89 Forms, all are essentially defined to include:
[A]ll of the lands, Oil and Gas Leases and/or Oil and Gas Interests intended to be developed and operated for Oil and Gas purposes under this agreement. Such lands, Oil and Gas Leases and Oil and Gas Interests are described in Exhibit 'A'. This language is quoted from Article I., Section C. of the 89 Form, which is substantially similar to the 56, 77, and 82 Form definitions.
47. 56 Form, supra note 13, § 4, at 2-3 (emphasis supplied).
48. 77 Form, supra note 13, Art. III, § B, at 2 (emphasis supplied).
operations under this agreement shall be borne and paid, and all equip-
ment and materials acquired in operations on the Contract Area shall
be owned, by the parties as their interests are set forth in Exhibit “A”.
In the same manner, the parties shall also own all production of oil and
gas from the Contract Area subject to the payment of royalties to the
extent of ______ which shall be borne as hereinafter set forth. . . .

Nothing contained in this Article III.B. shall be deemed an assignment
or cross-assignment of interests covered hereby.49

89 FORM

Unless changed by other provisions, all costs and liabilities incurred in
operations under this agreement shall be borne and paid, and all equip-
ment and materials acquired in operations on the Contract Area shall
be owned, by the parties as their interests are set forth in Exhibit “A”.
In the same manner, the parties shall also own all production of Oil and
Gas from the Contract Area subject however, to the payment of roy-
ties and other burdens on production as described hereafter. . . .

Nothing contained in this Article III.B. shall be deemed an assignment
or cross-assignment of interests covered hereby, and in the event two or
more parties contribute to this agreement jointly owned Leases, the par-
ties’ undivided interests in said Leaseholds shall be deemed separate
leasehold interests for the purposes of this agreement.50

Each of these forms contemplates an Exhibit “A” which describes
the properties contributed by each party and lists each party’s percentage
interest in the unit or contract area. For example, assume the contract
area is Section 30 consisting of 640 acres. Using our previous hypotheti-
cal, assume X owned the leasehold rights to the South Half of Section 30
and assigned an undivided one-half interest in its lease to W. Recall that
Y and Z each have a lease from cotenant mineral interest owners who
each owned an undivided one-half interest in the North Half of Section
30. Therefore, X and W are common law cotenants and Y and Z are
common law cotenants. X and W are not common law cotenants to Y
and Z. However, the ownership clause of the various operating agree-
ments creates a contractual cotenancy between each party having an in-
terest in Section 30. The Exhibit “A” would indicate that W, X, Y, and
Z are each entitled to a 25% ownership interest in the unit or contract
area.

Under all the operating agreement forms each party in this example
owns 25% of all production from the unit area. As the court in Reserve

49. 82 Form, supra note 13, Art. III, § B, at 2 (emphasis supplied).
50. 89 Form, supra note 13, Art. III, § B, at 2 (emphasis supplied).
Oil, Inc. v. Dixon\textsuperscript{51} noted: "The contract [56 Form] vests ownership of the oil and gas produced from the wells in the parties in the same percentage that they own interests in the well."\textsuperscript{52} Professor Kuntz has analyzed the effect of the ownership clause, noting that:

The ownership provision has the literal effect of making the owners cotenants in the oil or gas produced. According to the strict rules of conversion, an owner selling the entire stream for its own benefit would be liable for conversion of the gas owned by other parties.\textsuperscript{53}

Arguably the ownership clause gives each working interest owner an undivided interest in each molecule of gas produced. Professor Kuntz has indicated that this would give rise to a conversion claim whenever less than all of the working interest owners were marketing their shares of the gas stream. It is arguable, however, that the rights of these contractual cotenants are similar to their common law counterparts. Therefore, if $W$, $X$, and $Y$ are unable, or unwilling, to currently market their share of the gas stream, then $Z$, who has developed a market, should be able to sell the full stream without risking conversion. Otherwise, $Z$ could not develop its 25\% interest in the gas. So long as $Z$ stands ready to account for 75\% of the gas stream it is marketing, the other parties have no valid complaint.\textsuperscript{54} The Oklahoma Supreme Court seems to have adopted this approach in Anderson v. Dyco Petroleum Corp.,\textsuperscript{55} but the opinion did not indicate whether the parties had an operating agreement or were common law cotenants.\textsuperscript{56}

1. Cross-Conveyance

In Gillring Oil Co. v. Hughes\textsuperscript{57} the court held that the ownership clause of the 56 Form operating agreement creates a cross-conveyance of rights in property covered by the agreement.\textsuperscript{58} Therefore, each working interest owner becomes a common law cotenant with the other working interest owners. By signing the operating agreement, $W$ is deemed to

\begin{footnotes}
\item 51. 711 F.2d 951 (10th Cir. 1983).
\item 52. Id. at 952.
\item 53. Kuntz, supra note 23, at 13-17.
\item 54. See Kuntz, supra note 23, at 13-17 to 13-18. Professor Kuntz suggests such a result can be obtained by giving effect to the provision, found in all the operating agreement forms, authorizing each party to take their gas in kind. Id.
\item 55. 782 P.2d 1367 (Okla. 1989).
\item 56. Id. at 1371. The court noted that "[u]nder Oklahoma law Appellants and the other working interest owners in the well are tenants in common." However, the court did not indicate the source of their cotenant relationship. Id. See supra text accompanying notes 26-29.
\item 58. Id. at 876.
\end{footnotes}
have assigned $X$, $Y$, and $Z$ each an undivided 25% interest in $W$'s 25% unit area working interest. Similarly, $X$, $Y$, and $Z$ have each assigned to $W$ an undivided 25% in their respective 25% unit area working interests. Professor Smith has commented on the impact of a cross-conveyance, stating:

If such an estate [tenancy in common] has been created, no single co-owner has the right to appropriate all of the production for himself. Even though a mining cotenant informs the other cotenants that he is extracting only his own share of the minerals, he is treated as a matter of law as operating the mine or the oil and gas well on behalf of all cotenants. The production is owned proportionately by all of the cotenants, who have a right to insist upon their proportionate share of net profits.

The parties to the operating agreement, through the ownership clause, effectively become common law cotenants. Professor Smith has also suggested that the impact of the cotenancy theory may extend beyond mere accounting rights:

It also requires non-operator participation in take-or-pay settlements and automatically assures non-marketing co-owners a right to share proportionately in any payments made thereunder. Future contracts cannot exclude their interests unless they elect to be excluded.

It is arguable whether these results must necessarily flow from a common law cotenancy. Although the cotenancy may, by the contract, extend to the molecules of gas produced, this does not require a departure from the traditional rules governing cotenants in the underlying interest in land from which the production emanates. Courts could still permit a marketing cotenant to enter into their own gas contracts and take, for their own account, more than their proportionate share of the gas stream. However, the marketing cotenant must be prepared to both account to and permit the other cotenants to take or market their respective shares of the gas stream. The Oklahoma Supreme Court adopted this approach in Anderson v. Dyco Petroleum Corp. by holding that Dyco, owning 47% of the gas stream, could market more than their 47% share and sell the gas for their own account to selected gas purchasers.

60. Id. at 12-15.
61. Id.
63. Id. at 1371.
The court characterized Dyco and the non-marketing working interest owners as "tenants in common." The remedy for the non-marketing cotenants is to seek an accounting or pursue common law gas balancing rights, such as balancing in kind and periodic cash balancing.

2. Cross-Conveyance and the 77, 82, and 89 Forms

Under the 77, 82, and 89 Forms of operating agreement there is express language disclaiming a cross-conveyance (denoted in the forms as "cross-assignment") between the parties to the agreement. However, if the parties were common law cotenants coming into the operating agreement, such as W and X, and Y and Z, the agreement might not affect their common law relationships. The 89 Form addresses this issue by providing that:

[IN the event two or more parties contribute to this agreement jointly owned Leases, the parties’ undivided interests in said Leaseholds shall be deemed separate leasehold interests for the purposes of this agreement.]

The apparent intent of this provision is to ensure that all the parties are on an equal footing under the operating agreement. Therefore, if Z is marketing all the gas from the contract area for its own account, the 89 Form would make the accounting and balancing rights of W and X identical to those of Y (who is a common law cotenant of Z). The provision also seems to eliminate a common law cotenant's right to seek partition. This supplements the existing provisions in the form agreements which expressly restrict a cotenant’s right to partition.

C. The Statutory Cotenancy

Statutes can create a cotenant-like relationship between working interest owners. The most likely source of such a statute would be a state's pooling laws. There may also exist special purpose statutes designed to address specific problems associated with gas production. Such statutes

64. Id.
65. Id. at 1373.
66. 89 Form, supra note 13, Art. III, § B, at 2 (emphasis supplied).
67. For example, the 77 Form provides that:

If permitted by the laws of the state or states in which the property covered hereby is located, each party hereto owning an undivided interest in the Contract Area waives any and all rights it may have to partition and have set aside to it in severalty its undivided interest therein.

77 Form, supra note 13, Art. VIII, § F, at 12. Identical provisions are found in the 82 and 89 Forms. 82 Form, supra note 13, Art. VIII, § E, at 12; 89 Form, supra note 13, Art. VIII, § E, at 15.
can create new rights; they can also define and modify existing common law and contractual cotenancy rights.

1. Pooling Statutes: Louisiana

In *Amoco Production Co. v. Thompson* the court noted that under Louisiana law, owners in “indivision” (the civil law analogue of a common law cotenancy) cannot develop the property held in indivision unless all cotenants consent. The court found that “gas produced from a compulsory unit initially is owned in indivision;” therefore, it was proper to apply the “molecular” theory of ownership to the produced gas. Under the Louisiana forced pooling statutes separate tracts within the pooled area are converted into “a common interest with regard to the development of the unit and the drilling of the well.” Therefore, the molecular theory of ownership in indivision applies to gas produced from a force-pooled unit.

The *Thompson* court had to determine the validity of an order issued by Professor Patrick Martin, then Commissioner Martin, which in effect partitioned ownership in gas produced from a force pooled unit. The order permitted each interest owner to market their gas in kind and to sell, for their own account, the entire production stream when other owners failed to take or market their proportionate shares of gas. The court affirmed the position taken by Commissioner Martin, holding that the Commissioner of Conservation has the statutory authority to effect a partition by authorizing interest owners to take their share of gas in

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69. Id. at 386. Contrary to the Louisiana rule, in Kansas, Oklahoma, Texas, and most other producing states, any cotenant can mine minerals from land held in cotenancy without the consent of the other cotenants. See supra text accompanying notes 19-21.
70. Thompson, 516 So.2d at 387.
71. Id. at 383.
72. Id. at 389-90. Commissioner Martin’s solution to the cotenancy problem is indicated by the following portion of his order:

Any owner who wishes to market his share of production from a unit well may do so with balancing to be done on a volumetric basis if he presently cannot, or does not choose to, sell his gas. Any such owner can make his own sale at his own price or make up the gas in kind later. If the owner does not elect to market his own gas, then he should not feel harmed if the unit operator is authorized to market separately the gas attributable to that non-operator’s interest with accounting to be made on the basis of that separate sale. The non-selling owner does not have a right to share in the selling owner’s contract, though he does have a right to an accounting in cash or kind for his share of the unit production.

*Id.* at 390. The court, commenting on Commissioner Martin’s order, stated that: “The practical effect of this order was to allow the marketing owners to take their shares in kind (sole ownership), both prospectively and retroactively. This had the legal effect of converting ownership in indivision into sole ownership and effected a partition.” *Id.*
kind.\textsuperscript{73} Regarding balancing problems when one interest owner takes more than their share of the gas stream, the court stated that:

It is implicit in the obligation of the Commissioner to issue orders affording each owner the right to recover his just and equitable share, that the Commissioner can order an accounting in kind for balancing purposes or an accounting in cash (if such is the only available practical relief).\textsuperscript{74}

2. Special Purpose Statutes: Oklahoma

Title 52, sections 541-547 of the Oklahoma Statutes,\textsuperscript{75} commonly known as “House Bill 1221” and also as the “Sweetheart Gas Act,” took effect May 3, 1983 and applies to the distribution of production proceeds received on or after that date.\textsuperscript{76} The Act was intended to ensure every owner in a well has the opportunity to currently market their proportionate share of gas whenever gas is marketed from the well. As the Oklahoma Supreme Court observed in \textit{Seal v. Corporation Commission}:\textsuperscript{77}

In our opinion unless all owners in a well have equal opportunity to sell gas from the well, they are not afforded the opportunity to produce their just and equitable share of the gas. The purpose of the Act is to afford this opportunity.\textsuperscript{78}

This equal opportunity is provided through two procedures: (1) When initial production is obtained, the operator is obligated to market each owner's ratable share of production from the well; this is accomplished through a notice and election procedure specified in section 542B of the Act.\textsuperscript{79} (2) After production from the well begins, any owner obtaining a contract to sell gas from the well must give written notice of the contract terms to all owners in the well who do not have a contract.\textsuperscript{80} Each party without a contract then has the option to share in the proceeds from gas sales under any contract covering production from the well.\textsuperscript{81}

\textsuperscript{73} \textit{Id.} at 392-93.
\textsuperscript{74} \textit{Id.} at 394.
\textsuperscript{75} \textit{OKLA. STAT.} tit. 52, §§ 541-547 (Supp. 1990).
\textsuperscript{77} \textit{Id.}
\textsuperscript{78} \textit{Id.} at 288; \textit{OKLA. STAT.} tit. 52, § 541 (Supp. 1990) (each interest owner in well producing gas afforded “an equal opportunity to extract their fair share of gas . . . .”).
\textsuperscript{79} \textit{OKLA. STAT.} tit. 52, § 542B (Supp. 1990).
\textsuperscript{80} \textit{Id.} § 543B.
\textsuperscript{81} \textit{Id.} § 543A.
The operation of the Act contemplates that the operator and owners, both with and without contracts, will follow the notice, offer, and election procedures specified in the Act. Most of the current balancing cases will require courts to determine each party's respective rights and obligations when the procedural requirements of the Act have been ignored. This becomes a difficult task when it is realized that the Act preserves to each interest owner a high degree of discretion concerning the marketing of their share of production.

The Act merely provides a marketing option for owners without a gas contract; the owner can elect not to market their gas. The Act is replete with statements regarding an owner's "opportunity" to market or share in proceeds. Although any interest owner can effectively elect to leave their gas in the ground, the Act provides for current marketing of each owner's gas, unless they affirmatively indicate they do not want to participate in current sales. Section 544 of the Act provides, in part: "[t]he amount of gas produced daily, irrespective of the owner producing, belongs to, is owned by, and shall inure to the benefit of each owner in the well in proportion to each owner's interest in the well." This essentially creates a statutory cotenancy in gas produced from a particular well, supporting each interest owner's right to share in production proceeds. In *Energy Search Petroleum, Inc. v. Amoco Production Co.*, the court cited section 544 for the proposition that:

As tenants in common on the subject leases, the parties own a pro-rata share of each 'molecule' of gas that comes out of a well. 52 O.S. § 544. Failure to pay for gas taken by an operator from a well where the operator is a tenant in common amounts to conversion on the part of the operator.

It is arguable whether merely producing gas subject to section 544 could result in conversion. It is the statutory cotenant's failure to account to the other statutory cotenants that gives rise to a cause of action;

82. After studying Oklahoma oil and gas law for the past decade, I have determined why everyone refers to certain statutes by their legislative bill designation: they desire to treat statutes such as "House Bill 1221" and "Senate Bill 160" as though they were never enacted. Wishful thinking, but not much of a defense when someone decides to enforce the strictures of the statute.


86. *Id.* at 1.
not the act of production.\textsuperscript{87} Section 544 creates the statutory cotenancy to provide parties with the opportunity to currently market their gas. Therefore, if the non-marketing party fails to either timely assert the right to share in proceeds,\textsuperscript{88} or to take their proportionate share of the gas, a court should rely upon equitable balancing remedies instead of treble damages\textsuperscript{89} and conversion.

In \textit{Energy Search}, the court held that production by a party under a contract, occurring when there was no “split connection” on the well, constitutes a conversion and a violation of section 544, which entitles the non-marketing party to treble damages under section 547.\textsuperscript{90} In \textit{Energy Search}, as with \textit{Amoco Production Co. v. Thompson},\textsuperscript{91} the court failed to recognize that multiple parties can market gas from a well without a split connection.\textsuperscript{92} For example, \( X \) could be marketing half of the gas stream

\begin{verbatim}
\textsuperscript{87} Id. (emphasis supplied). The obligations to “account” and “compensate”, measured by common law cotenancy standards, may be satisfied by a subsequent balancing. The critical issue becomes timing, i.e., whether the accounting must take place on the basis of a specific time period such as daily, monthly, or yearly. \textit{See infra} text accompanying notes 142-144.

\textsuperscript{88} The statutes require that the operator and parties with a contract initially notify other owners in the well of the opportunity to market their gas or share in production proceeds. \textit{See OKLA. STAT. tit. 52, § 543B (Supp. 1990)}. However, failing to adhere to such a notice requirement should not automatically impose liability on the contracted party, particularly when the non-contracted party fails to timely assert their rights under the statutes.

\textsuperscript{89} \textit{Id.} § 547 provides in part:

\begin{quote}
The Corporation Commission is herein empowered to promulgate rules and regulations ... including the power to establish and enforce penalties for violations thereof ... Such power shall not preclude the remedies available through the district courts as provided by existing law nor preclude the right, herewith granted, of any owner who is injured in business or property by any other owner in the well by reason of any action in violation of the provisions of this act to sue in the courts of this state and to recover threefold the damages so sustained, the costs of the suit, and reasonable attorneys' fees to be fixed by the court.
\end{quote}

\textit{Id.} (emphasis supplied).


\textsuperscript{92} The \textit{Energy Search} court stated: “Without a split connection any theory of over-production is not applicable.” and “Where, as here, the split connection has been removed, there is no other way for Energy to sell its gas. Thus, the operator (Amoco) must account and pay for all gas disposed of at the rate they were compensated.” \textit{Id.} at 3,4. The \textit{Thompson} court stated:

\begin{quote}
It is obvious that, if individual owners are allowed to take (partition) the gas in kind, some form of balancing is required. Two owners cannot take gas from one well at the same time, unless the connection to the well is split streamed. Thus, a party who wishes to take his gas in kind must be allowed, absent split streaming, to appropriate 100% of the unit gas
\end{quote}
\end{verbatim}
at the wellhead to Natural Gas Pipeline Company and Y could be marketing, simultaneously, the other half of the gas stream to a factory in Illinois using Natural's transportation services. The lack of a "split connection" seemed to influence the Energy Search court in finding Amoco liable for treble damages under the Act.\textsuperscript{93} Treble damages should be awarded when the Act has been violated, but only then if the non-marketing party can demonstrate they have been "injured" by the violation. The Energy Search court's rationale was questionable. It is doubtful, after the Oklahoma Supreme Court's decision in Anderson v. Dyco Petroleum Corp.,\textsuperscript{94} that sections 544 and 547 will be given such a restrictive interpretation.

Although the Anderson\textsuperscript{95} court held that a cotenant can market gas without the consent of other cotenants in the well,\textsuperscript{96} they expressly avoided addressing the impact of section 544 on their holding.\textsuperscript{97} The plaintiffs apparently decided, for tactical reasons, to abandon their claims under sections 541-547.\textsuperscript{98} However, since the terms of section 544 are self-executing, it seems the court should have addressed the statute in defining basic cotenancy rights to gas produced in Oklahoma. After May 2, 1983, any gas produced from a well in Oklahoma "belongs to, is owned by, and shall inure to the benefit of each owner in the well in proportion to each owner's interest in the well."\textsuperscript{99} This is a rule of property which must now be applied to any disproportionate gas sale situation.

However, this does not mean that the court must employ a conversion analysis merely because the parties own a proportionate share of each gas molecule being produced. The section 544 ownership provision can be equated to the ownership clause of the operating agreement.\textsuperscript{100} Other language in section 544 acknowledges that one party may be producing and marketing more than their share of the gas stream. The first sentence provides, in part: "[A]n owner of a well producing natural or casinghead gas may produce daily from the well that amount of gas production for a certain period of time. Each owner taking in kind has the same right to get his share of the production this way.

\textit{Id.} at 393.
\textsuperscript{93} \textit{Energy Search}, No. 87-C-375-E at 3, 4.
\textsuperscript{94} 782 P.2d 1367 (Okla. 1989).
\textsuperscript{95} \textit{Id.}
\textsuperscript{96} \textit{Id.} at 1371-72.
\textsuperscript{97} \textit{Id.} at 1379.
\textsuperscript{98} \textit{Id.} at 1369, 1379.
\textsuperscript{99} OKLA. STAT. tit. 52, § 544 (Supp. 1990).
\textsuperscript{100} \textit{See supra} text accompanying notes 47-56; \textit{see infra} text accompanying notes 115-121.
which may be *lawfully produced* therefrom."\(^{101}\) Production is not limited by *ownership*; it is limited only by what can be extracted under the pertinent statutes and regulations.\(^{102}\) The final two sentences of the section, by imposing an obligation to account and compensate non-marketing parties, acknowledge that certain owners will be routinely producing more than their proportionate share of the gas stream. Section 542D expressly states: "Nothing in this act shall be construed to . . . prevent any owner . . . from taking their share of production in kind or separately disposing of their share."\(^{103}\)

It appears that the Oklahoma Legislature intended to preserve the ability of each party to market more than their share of the gas stream so long as the marketing parties account for disproportionate sales and provide the non-marketing parties with an opportunity to participate in current sales. If a party declines to participate in current sales, the marketing party can sell the full gas stream without committing a tort or violating the Act. The remedy of the non-marketing party is to seek an accounting or participate in some form of gas balancing. This brings the analysis full circle back to *Anderson v. Dyco Petroleum Corp.*\(^{104}\) Even if the *Anderson* court had applied section 544 in evaluating the ownership rights of the parties, the result should be the same, because the same analysis should be used. In fact, section 544 should make the analysis easier, since Oklahoma courts will always be dealing with a statutory cotenancy.\(^{105}\) Although marketing parties can still be liable for violating specific statutory requirements, the mere production of gas will not be a conversion or a violation of the Act. Production of a disproportionate share will give rise to an obligation to account and compensate. However, the approaches to accounting and compensation should be identical to the approaches suggested by the court in *Anderson* for use among what the court characterizes as "tenants in common."\(^{106}\) Although a non-marketing party's basic right to revenue sharing under the Act must be recognized, the *Anderson* analysis should be used where all parties

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102. For example, *Id.* § 29, which provides in part:

> Every . . . person . . . is hereby prohibited from taking more than fifty percent (50%) of the daily natural flow of any gas well or wells unless, for good cause shown under the exigencies of the particular case, the Corporation Commission shall establish a different percentage under the prescribed rules and regulations therefor.

*Id.*

103. *Id.* § 542D.
104. 782 P.2d 1367 (Okla. 1989).
105. However, the statutory cotenancy may be modified by contract.
have let the well flow without implementing or asserting rights under the Act. This would prevent interest owners from using the Act for strategic "hindsight" gas marketing.

III. THE RIGHT TO TAKE IN KIND

Although tax considerations are at the origin of the right to take in kind, it is doubtful the right would be jettisoned if the tax motivation was removed. With the availability of new gas marketing opportunities, it is doubtful that lessees with a competitive edge will be willing to turn over marketing activities to a well operator. Nor will such lessees be willing to share their marketing prowess with others. If anything, the desire to seek out and exploit new markets on an individual basis will be a growing trend as the gas marketing infrastructure develops. Even if the lessee does not feel creative, their lessor and the implied covenant to market will require their active participation and, perhaps, experimentation. Gas marketing is the area where the entrepreneurial spirit will flourish in the years to come. The right to take gas in kind plays a major role in any viable marketing scenario.

A. Right to Take in Kind Absent an Operating Agreement

As noted in Section II of this Article, the right to take in kind, absent specific authorization in an operating agreement, depends upon a state's approach to the law of cotenancy. Even in states such as Louisiana, where cotenancy rules prohibit taking in kind, forced pooling or some other regulatory or statutory right may permit the parties to take in kind. Most courts acknowledge that the efficient development of mineral resources will be impaired if a right to take in kind is not recognized.

B. Right to Take in Kind Under the Operating Agreement

All of the model form operating agreements authorize each working interest owner to take their share of oil and gas production in kind. The relevant portion of the clause in each form agreement provides:

108. See supra text accompanying notes 16-25.
109. See supra text accompanying notes 68-74.
56 Form

Each party shall take in kind or separately dispose of its proportionate share of all oil and gas produced from the Unit Area . . . Any extra expenditure incurred in the taking in kind or separate disposition by any party of its proportionate share of the production shall be borne by such party. 111

77 Form

Each party shall have the right to take in kind or separately dispose of its proportionate share of all oil and gas produced from the Contract Area . . . Any extra expenditure incurred in the taking in kind or separate disposition by any party of its proportionate share of the production shall be borne by such party. Any party taking its share of production in kind shall be required to pay for only its proportionate share of such part of Operator's surface facilities which it uses. 112

82 Form

Each party shall take in kind or separately dispose of its proportionate share of all oil and gas produced from the Contract Area . . . Any extra expenditure incurred in the taking in kind or separate disposition by any party of its proportionate share of the production shall be borne by such party. Any party taking its share of production in kind shall be required to pay for only its proportionate share of such part of Operator's surface facilities which it uses. 113

89 Form

Each party shall take in kind or separately dispose of its proportionate share of all Oil and Gas produced from the Contract Area . . . Any extra expenditure incurred in the taking in kind or separate disposition by any party of its proportionate share of the production shall be borne by such party. Any party taking its share of production in kind shall be required to pay for only its proportionate share of such part of Operator's surface facilities which it uses. 114

111. 56 Form, supra note 13, § 13, at 6 (emphasis supplied).
112. 77 Form, supra note 13, Art. VI, § C, at 6-7 (emphasis supplied). Note that the 77 Form states each party shall have the "right" to take in kind. The 56, 82, and 89 Forms all state each party "shall" take in kind.
113. 82 Form, supra note 13, Art. VI, § C, at 7-8 (emphasis supplied) (the language is the same whether or not there is a gas balancing agreement).
114. 89 Form, supra note 13, Art. VI, § G, at 11 (emphasis supplied) (the language is the same whether or not there is a gas balancing agreement).
1. Taking in Kind and the Ownership Clause

As noted in Section II of this Article, the ownership clause creates a contractual cotenancy in all production from the unit or contract area.\(^\text{115}\) However, the ownership clause must be read in conjunction with each party's right to take their share of production in kind. A logical reading of these clauses should permit each party, as a contractual cotenant, to market their share of production plus any other production that is not being marketed by a cotenant. The producing cotenant would be obligated to account to the non-marketing cotenants and be ready to surrender their share of the gas stream when they decide to commence marketing. Professor Smith has adopted a similar view, noting that:

\[\text{[E]ven when the parties are actually tenants in common, there appears to be no reason why they cannot contractually modify their common law rights and obligations; and they would seem to have done so by the language of Article VI.B. It expressly authorizes each party to take his share in kind and separately dispose of that share. If this language means anything at all, it must mean that each party has a contractual right to partition out his share of production in kind without any concurrent obligation to account to the other parties for part of the sales price.} \^\text{116}\]

Professor Kuntz has acknowledged the importance of the right to take in kind, but noted the "ingenuity of counsel" in the contract interpretation process could result in varying interpretations.\(^\text{117}\) He suggested how a court might give both clauses effect. First, each party could market their proportionate share of gas under the take-in-kind clause. Second, the ownership clause would require each party to account to all other cotenants for a proportionate share of the sales proceeds.\(^\text{118}\) This would achieve a result similar to that mandated by sections 541-547 of the Oklahoma Statutes.\(^\text{119}\) Considering the Oklahoma Supreme Court's opinion in Anderson v. Dyco Petroleum Corp.,\(^\text{120}\) it seems likely that Oklahoma courts will give the take-in-kind clause priority over the ownership clause.

Professor Martin has taken the view that the ownership clause merely states: "the overall quantum of production to which an owner is entitled and is not an expression of the character of ownership of each

\(^{115}\) See supra text accompanying notes 45-56.
\(^{116}\) Smith, supra note 59, at 12-16.
\(^{117}\) Kuntz, supra note 23, at 13-18.
\(^{118}\) Kuntz, supra note 23, at 13-18.
\(^{120}\) 782 P.2d 1367 (Okla. 1989).
molecule produced, i.e. a tenancy in common.” 121 Under Professor Martin’s approach the take-in-kind provision would govern and the ownership clause would serve merely as a statement of the parties’ respective shares in the contract area covered by the operating agreement.

2. Facilities and Notices

Each operating agreement form requires the interest owner to pay for any additional costs needed to separately market their share of gas. 122 This would include such items as additional metering equipment and connections. In the 77, 82, and 89 Forms the interest owner who takes in kind need not pay for any part of the operator’s surface facilities when used solely to market gas belonging to the other interest owners. 123 If part of the operator’s facilities are used by the interest owner, they need only pay for the proportionate share of the facilities which they actually use. 124 With the advent of open access transportation, taking in kind will often be merely a matter of communication as opposed to the construction of separate facilities.

Prior to the 89 Form, there were no stated notice provisions concerning when a party could either commence or terminate taking in kind. The 89 Form requires the interest owner to give the operator written notice at least ten days before taking in kind commences. 125 The 89 Form also requires that:

All parties shall give timely written notice to Operator of their Gas marketing arrangements for the following month, excluding price, and shall notify Operator immediately in the event of a change in such arrangements. Operator shall maintain records of all marketing arrangements, and of volumes actually sold or transported, which

121. Martin, supra note 6, at 13. In explaining his interpretive approach, Professor Martin stated:

[S]everal courts have recognized that balancing in kind is an industry custom; a reading of the joint operating agreement that the ownership paragraph relates to overall quantum produced from the Contract Area and not to the character of that ownership nor to a duty of any seller to account to all owners for sales is in accord with the custom and reflects that understanding of the function of the take-in-kind provision of the joint operating agreement. This reading harmonizes the different provisions of the joint operating agreement, and one need not resort to the law of cotenancy for further guidance or for confusion. That is to say, the ‘ownership’ clause of the joint operating agreement provides the quantum each party is entitled to take when there is production but, in light of the right of each to take in kind, it does not provide the nature of the ownership of each molecule.

Id. at 13-14.

122. See supra text accompanying notes 111-114.

123. See supra text accompanying notes 112-114.

124. See supra text accompanying notes 112-114.

125. 89 Form, supra note 13, Art. VI, § G, at 11.
IV. OPERATOR'S RIGHTS WHEN A PARTY DOES NOT TAKE IN KIND

Up to this point the focus has been on matters which define an operator's ability to take the gas and market it as their own. This section addresses the other alternatives given the operator under the commonly used forms of operating agreement.

A. Operator's Options for Dealing with Non-Operator Gas

One option for the operator is to simply market all the gas produced from the well for its own account until the other non-operators commence taking their respective shares. The operator's right to take unmarketed gas in kind is the option addressed in previous sections of this Article. Each operating agreement form also gives the operator a limited option to either purchase a non-operator's gas, or act as the non-operator's marketing agent and sell the gas, for the non-operator's account, to a purchaser. The relevant portion of the clause in each form agreement provides:

56 FORM

In the event any party shall fail to make the arrangements necessary to take in kind or separately dispose of its proportionate share of the oil and gas produced from the Unit Area, Operator shall have the right, subject to revocation at will by the party owning it, but not the obligation, to purchase such oil and gas or sell it to others for the time being, at not less than the market price prevailing in the area, which shall in no event be less than the price Operator receives for its portion of the oil and gas produced from the Unit Area. Any such purchase or sale by Operator shall be subject always to the right of the owner of the production to exercise at any time its right to take in kind, or separately dispose of, its share of all oil and gas not previously delivered to a purchaser. Notwithstanding the foregoing, Operator shall not make a sale into interstate commerce of any other party's share of gas production without first giving such other party sixty (60) days notice of such intended sale. 127

126. 89 Form, supra note 13, Art. VI, § G, at 11.
127. 56 Form, supra note 13, § 13, at 7.
DISPROPORTIONATE GAS SALES

77 FORM

In the event any party shall fail to make the arrangements necessary to take in kind or separately dispose of its proportionate share of the oil and gas produced from the Contract Area, Operator shall have the right, subject to the revocation at will by the party owning it, but not the obligation, to purchase such oil and gas or sell it to others at any time and from time to time, for the account of the non-taking party at the best price obtainable in the area for such production. Any such purchase or sale by Operator shall be subject always to the right of the owner of the production to exercise at any time its right to take in kind, or separately dispose of, its share of all oil and gas not previously delivered to a purchaser. Any purchase or sale by Operator of any other party’s share of oil and gas shall be only for such reasonable periods of time as are consistent with the minimum needs of the industry under the particular circumstances, but in no event for a period in excess of one (1) year. Notwithstanding the foregoing, Operator shall not make a sale, including one into interstate commerce, of any other party’s share of gas production without first giving such other party thirty (30) days notice of such intended sale.

In the event one or more parties’ separate disposition of its share of the gas causes split-stream deliveries to separate pipelines and/or deliveries which on a day-to-day basis for any reason are not exactly equal to a party’s respective proportionate share of total gas sales to be allocated to it, the balancing or accounting between the respective accounts of the parties shall be in accordance with any Gas Balancing Agreement between the parties hereto, whether such Agreement is attached as Exhibit “E”, or is a separate Agreement.128

82 FORM

In the event any party shall fail to make the arrangements necessary to take in kind or separately dispose of its proportionate share of the oil and gas produced from the Contract Area, Operator shall have the right, subject to the revocation at will by the party owning it, but not the obligation, to purchase such oil and gas or sell it to others at any time and from time to time, for the account of the non-taking party at the best price obtainable in the area for such production. Any such purchase or sale by Operator shall be subject always to the right of the owner of the production to exercise at any time its right to take in kind, or separately dispose of, its share of all oil and gas not previously delivered to a purchaser. Any purchase or sale by Operator of any other party’s share of oil and gas shall be only for such reasonable

128. 77 Form, supra note 13, Art.VI., § C, at 7.
periods of time as are consistent with the minimum needs of the industry under the particular circumstances, but in no event for a period in excess of one (1) year. Notwithstanding the foregoing, Operator shall not make a sale, including one into interstate commerce, of any other party's share of gas production without first giving such other party thirty (30) days notice of such intended sale.129

89 FORM

If any party fails to make the arrangements necessary to take in kind or separately dispose of its proportionate share of the Oil and/or Gas produced from the Contract Area, Operator shall have the right, subject to the revocation at will by the party owning it, but not the obligation, to purchase such Oil and/or Gas or sell it to others at any time and from time to time, for the account of the non-taking party. Any such purchase or sale by Operator may be terminated by Operator upon at least ten (10) days written notice to the owner of said production and shall be subject always to the right of the owner of the production upon at least ten (10) days written notice to Operator to exercise its right to take in kind, or separately dispose of, its share of all Oil and/or Gas not previously delivered to a purchaser; provided, however, that the effective date of any such revocation may be deferred at Operator's election for a period not to exceed ninety (90) days if Operator has committed such production to a purchase contract having a term extending beyond such ten (10)-day period. Any purchase or sale by Operator of any other party's share of Oil and/or Gas shall be only for such reasonable periods of time as are consistent with the minimum needs of the industry under the particular circumstances, but in no event for a period in excess of one (1) year. . . . Any such sale by Operator shall be in a manner commercially reasonable under the circumstances, but Operator shall have no duty to share any existing market or transportation arrangement or to obtain a price or transportation fee equal to that received under any existing market or transportation arrangement. The sale or delivery by Operator of a non-taking party's share of production under the terms of any existing contract of Operator shall not give the non-taking party any interest in or make the non-taking party a party to said contract. No purchase of Oil and Gas and no sale of Gas shall be made by Operator without first giving the non-taking party ten days written notice of such intended purchase or sale and the price to be paid or the pricing basis to be used. Operator shall give notice to all parties of the first sale of Gas from any well under this Agreement.

All parties shall give timely written notice to Operator of their Gas marketing arrangements for the following month, excluding price.

129. 82 Form, supra note 13, Art. VI, § C, at 8 alternate (language from subsection labelled "Option 2: No gas balancing agreement").
and shall notify Operator immediately in the event of a change in such arrangements. Operator shall maintain records of all marketing arrangements, and of volumes actually sold or transported, which records shall be made available to Non-Operators upon reasonable request.130

1. Purchase of Non-Operator Gas

Each form operating agreement gives the operator the option to purchase any non-operator's share of production. However, the operator's purchase option is subject to the non-operator's right to take the gas in kind at any time. The 89 Form, for the first time, places some modest limits on the non-operator's immediate right to take in kind. The non-operator must give the operator at least ten days written notice before they commence taking in kind. However, if the operator has committed the non-operator's gas to a sales contract extending beyond the ten day notice period, the operator can defer the non-operator's right to take in kind for up to ninety days.131 This 90-day provision apparently applies both to operator purchases of the non-operator's gas, as well as to situations in which the operator is acting as the non-operator's marketing agent.

Any purchase or sale by the operator of a non-operator's gas can be "only for such reasonable periods of time as are consistent with the minimum needs of the industry under the particular circumstances."132 In no event can the operator purchase or sell the gas for a period longer than one year. However, this would not prevent the parties from entering into a separate gas sales contract to govern operator purchases or a separate marketing agreement concerning sales on the non-operator's behalf.

Under the 56 Form the operator must purchase or sell a non-operator's gas at "not less than the market price prevailing in the area, which shall in no event be less than the price which Operator receives for its portion of the oil and gas."133 The 77 and 82 Forms require payment of

130. 89 Form, supra note 13, Art. VI, § G, at 11 (emphasis supplied) (language from subsection labelled "Option 2: No gas balancing agreement).
131. 89 Form, supra note 13, Art. VI, § G, at 11 (language from subsection labelled "Option 2: No gas balancing agreement.
132. 89 Form, supra note 13, Art. VI, § G, at 11 (language from subsection labelled "Option 2: No gas balancing agreement). This same restriction is also found in the 77 and 82 forms.
133. 56 Form, supra note 13, § 13, at 7. This provision places the operator at a disadvantage. If the operator markets the non-operator's gas under the operator's existing contract, to the extent that the current market price exceeds the contract price, the operator must account at the market price. If current market prices fall below the contract price, the operator must account at their contract price.
the "best price obtainable in the area for such production." The 89 Form substantially changes the prior forms by requiring the operator to act in a "manner commercially reasonable under the circumstances" when entering into a "sale" of a non-operator's gas. The new provision specifically relieves the operator from any obligation to "share any existing market or transportation arrangement or to obtain a price or transportation fee equal to that received under any existing market or transportation arrangement." This new provision also states that a sale or delivery of non-operator gas under the operator's existing contracts will not give the non-operator any interest in the operator's contract.

It is not clear whether these provisions will be applied to an operator purchase, as distinguished from a sale, of non-operator gas. Arguably, "any such sale by Operator" would include a sale to the operator as well as a sale to a third party purchaser. In any case, before the operator can purchase or sell the non-operator's gas, the operator must give the non-operator ten days written notice of the proposed transaction including the price or pricing formula.

2. Marketing Non-Operator Gas

The operator's sale of non-operator gas is governed by the same procedural limitations as is the purchase of non-operator gas. The major distinction is the substantive difference in the relationship between the operator and non-operator. If the operator is marketing gas on behalf of the non-operators, the operator functions as their marketing "agent." This agency relationship can give rise to fiduciary obligations related to the marketing function. Although the 89 Form has attempted to narrow the scope of the operator's duties in such a relationship, residual fiduciary obligations remain in areas not expressly defined or limited by the operating agreement. These obligations could include claims to take-or-pay benefits under operator contracts, especially under the 56, 77, and 82 forms.

After analyzing the operator's options under the 56, 77, and 82

134. 77 Form, supra note 13, Art. VI, § C, at 7; 82 Form, supra note 13, Art. VI, § C, at 8.
135. 89 Form, supra note 13, Art. VI, § G, at 11.
136. 89 Form, supra note 13, Art. VI, § G, at 11.
137. 89 Form, supra note 13, Art. VI, § G, at 11.
138. See generally Smith, supra note 59, at 12-5.
139. Smith, supra note 59, at 12-6 to 12-11.
forms, Professor Smith has suggested that: “Purchase of the nonoperators' gas is the alternative which provides the best legal safeguards for the operator who sells the entire production of a gas well.”

Professor Smith concluded his analysis by offering the following advice:

The financial benefit received by an operator who opts to sell gas solely on his own behalf may be offset by the uncertainty of the rights of the non-marketing non-operators. They may be subjected to costly litigation even if they ultimately prevail in a suit seeking to force an immediate accounting for gas sales. A purchase of the non-operators' gas, especially if accomplished through a separate instrument and accompanied by full disclosure, should clearly establish the rights of the parties and significantly reduce the likelihood of costly litigation.

Professor Smith's suggestion avoids the fiduciary trappings of a marketing agent and frees the parties from the uncertainty of future accounting and gas balancing equities. It also provides a basis for current accounting to royalty owners.

B. "Accounting" for Disproportionate Sales

Assuming the parties have run the conversion gauntlet by establishing their right to currently take, or not take, production from a well, they will be ready to "account" for the imbalance. An issue to initially address is timing. If a party is entitled to an accounting on a daily, weekly, or monthly basis, the parties are essentially treated as though the marketing parties are selling for every interest owner. If the non-marketing party dislike the price or terms being obtained by the marketing parties, this approach would be unacceptable to the non-marketing party. If the non-marketing party is able to freely enter and exit the contracts of the marketing parties, this approach would be unacceptable to the marketing parties.

However, if the marketing party has the right to market all of the production stream, the proper timing of an accounting should be when there is a change in the parties' relative marketing status. For example,

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140. Smith, supra note 59, at 12-17.
141. Smith, supra note 59, at 12-17.
142. See, e.g., Teel v. Public Service Co. of Oklahoma, 767 P.2d 391 (Okla. 1985), as corrected, (1986), reh'g granted and opinion amended, (1987), reh'g denied, (1989) (Teel, not satisfied with the price and other contract terms offered by the operators' gas purchaser, did not want to market his proportionate share of the gas stream at that time).
143. This is one of the major criticisms of the revenue sharing rights created by OKLA. STAT. tit. 52, §§ 541-547 (Supp. 1990). See Hoefling, Gas Balancing Problems in a Deregulated Market: Changes and Possible Solutions Under Oklahoma Law, 25 Tulsa L. J. 63, 88-89 (1989) [hereinafter Hoefling].
has been marketing all the gas from a well in which \( W, Y, \) and \( Z \) own undivided interests. If \( W \) subsequently commences taking their gas in kind, or otherwise marketing their share, this would be a logical time to trigger a balancing between \( X \) and \( W \). It may also be an appropriate time to balance with \( Y \) and \( Z \); particularly since \( W \) may commence selling a proportionate share of the gas stream attributable to \( Y \) and \( Z \). If the parties are unable to agree, the initial trip to court over a balancing matter should resolve the timing issue, at least until the parties' positions significantly change.

An equally difficult question is the basis for adjusting each party's rights with regard to balancing. The issue is whether to follow a strict common law accounting for a proportionate share of net profits or seek to enforce industry custom as an adjunct to the operating agreement and request balancing in kind, or cash. Each party will naturally follow the approach that will net them the greatest recovery. The balancing jurisprudence to date can be summarized as follows: Courts will try to identify the problems and motivations of the parties, evaluate how their action or inaction has impacted each party, and arrive at a remedy the court thinks is fair under the circumstances.\(^{144}\) Precedent is of little value; the equities are adjusted on a case-by-case basis.

Perhaps the most significant development in this area is that courts will recognize any form of balancing as a remedy for what are essentially cotenant accounting problems. The Oklahoma Supreme Court, in Anderson v. Dyco Petroleum Corp.,\(^{145}\) observed that:

The law has been settled for some time that a producing cotenant must account to a non-producing cotenant for the market value of the production less any reasonable and necessary expenses of developing, extracting and marketing. Further, certain practices of the industry have been acknowledged by the courts to remedy situations like that apparently existent here where only certain working interest owners have sold production. These practices involve balancing in kind the production from the well by allowing cotenants like Appellants the opportunity to market gas from the well (i.e. taking a certain percentage of an overproduced party's gas until any imbalance in the cotenant's takes from the well are made up), by periodic cash balancing whereby under-


\(^{145}\) 782 P.2d 1367 (Okla. 1989).
produced cotenants receive cash from producing cotenants in proportion to their respective interests and cash balancing upon any particular gas reservoir's depletion. Instead of bringing an action for accounting or relying on one of the potential solutions set forth above, Appellants sought instead to turn what should have been largely an equitable proceeding into a tortious one not sanctioned by Oklahoma law.\footnote{146}

It was not necessary for the Anderson court to evaluate the proper form of balancing or accounting,\footnote{147} they merely concluded that the under-produced cotenants did not have any conversion claim against the over-produced cotenants. An issue not yet addressed by the courts is whether the cotenant can insist upon an accounting for net profits instead of any balancing remedy created by industry custom. Although some courts treat balancing as merely a partition action,\footnote{148} the form operating agreements prohibit partition of the underlying property interest. However, the right to take in kind would seem to override any challenge that a division of production, as opposed to the underlying property interest from which the production emanates, is restricted by the partition clause of the operating agreements. If the balancing remedy is chosen, the parties must be prepared to convince the court that one form of balancing under the circumstances is more equitable than another form. Regardless of what several courts and commentators say, balancing in kind is not the preferred method for resolving gas imbalances.\footnote{149} The preferred

\footnotetext{146}{Id. at 1373.}  
\footnotetext{147}{Id. at 1373 n.18. The court stated: "On the instant record we have no reason to and do not express any view as to which method of balancing might be appropriate in this case." Id. (citing United and Beren).}  
\footnotetext{148}{E.g., Amoco Prod. Co. v. Thompson, 516 So.2d 376 (La. Ct. App. 1987), writ denied, 520 So.2d 118 (La. 1988).}  
\footnotetext{149}{Although there are many cases which say balancing in kind is the preferred method, the method chosen is governed by its fairness to the parties under the circumstances. See, e.g., Beren v. Harper Oil Company, 546 P.2d 1356 (Okla. Ct. App.) (court applies cash balancing), as corrected on limited grant of cert., appeal after remand, (1975); United Petroleum Exploration v. Premier Resources, 511 F.Supp. 127 (W.D. Okla. 1980) (court applies cash balancing, while recognizing that balancing in kind is the preferred method but excepting where equity dictates); Pogo Producing Co. v. Shell Offshore, Inc., Civil Action No. 88-1405, 12 (E.D. La. April 17, 1989) (minute entry granting dismissal), aff'd, 898 F.2d 1064, 1067 (5th Cir. 1990) (although balancing in kind may be the "preferred method," circumstances may exist which make balancing in kind "inequitable"). An exception to this observation may be Louisiana where balancing in kind is viewed as an act of partition. See Thompson, 516 So.2d at 376.}  

Professor Martin would refine my observation that taking in kind is not the preferred method for resolving gas imbalances:

I think it would be more accurate to state that the industry custom and practice has been for working interest owners to balance in kind, and when the courts have been asked to resolve differences over balancing, the courts have used a standard of fairness to determine if the industry custom should be applied to a given set of circumstances.

\footnote{Martin, supra note 6, at 17 n.59.}
method is whatever a court thinks is fair under the circumstances.\textsuperscript{150} As with any other difficult and fact-sensitive issue, a court's analysis and conclusions will sometimes be questionable.\textsuperscript{151}

V. DISPORPORTIONATE SALES AND NON-WORKING INTEREST OWNERS

The rights of non-working interest owners, such as lessors, nonparticipating royalty interest owners, and owners of nonoperating interests under an oil and gas lease, will be determined by the agreements which created their rights, and, in some cases, by statute.\textsuperscript{152} Agreements to which they are typically not a party, such as the operating and gas balancing agreements, cannot affect their rights.\textsuperscript{153} A marketing program agreed to by the working interest owners is not binding upon the non-working interest owners unless their consent is obtained. Likewise, a marketing program that develops by default is not binding upon the non-working interest owners. Therefore, the marketing regime for purposes of paying non-working interest owners may be significantly different from the marketing regime pursued, either through agreement or default, by the working interest owners.

A. The Lessor’s Marketing Regime

The marketing regime between the lessor and lessee is defined by the oil and gas lease. In all cases the royalty clause plays a major role; in many cases the pooling clause impacts the analysis. Although the specific terms of the lease will ultimately govern, consider the following commonly encountered lease provisions:

\begin{itemize}
  \item[150.] The concept is often referred to as “equitable gas balancing.” See, e.g., Pogo Producing, Civil Action No. 88-1405, at 8 (characterizing equitable gas balancing by three methods depending on circumstances: (1) balancing in kind; (2) periodic cash balancing, and (3) cash balancing upon reservoir depletion).
  \item[151.] See generally Hoefling, supra note 143, at 72-78 (criticizing the United decision as not being faithful to Beren).
  \item[152.] See, e.g., OKLA. STAT. tit. 52, § 87.1 (Supp. 1989). The parties’ rights may also be affected by a pooling order issued by an administrative agency. See generally Martin, supra note 6, at 26.
  \item[153.] An exception to this rule would be interests carved out of the oil and gas lease after the agreement at issue took effect. However, interests carved out of the mineral interest, whether before or after the lessee enters into the operating or balancing agreements, will be subject only to the terms of the oil and gas lease.
\end{itemize}
ROYALTY CLAUSE

3. The royalties to be paid by lessee are: (b) on gas, including casing-head gas and all gaseous substances, produced from said land and sold or used off the premises or in the manufacture of gasoline or other products therefrom, the market value at the mouth of the well of one-eighth of the gas so sold or used, provided that on gas sold at the wells the royalty shall be one-eighth of the amount realized from such sale.

POOLING CLAUSE

5. Lessee is hereby granted the right to pool . . . the leased premises. . . . The entire acreage pooled into a gas unit shall be treated for all purposes, except the payment of royalties on production from the pooled unit, as if it were included in this lease. In lieu of the royalties herein provided, lessor shall receive on production from the unit so pooled only such portion of the royalty stipulated herein as the amount of his acreage placed in the unit or his royalty interest therein on an acreage basis bears to the total acreage so pooled in the particular unit involved.

Assuming there has been no pooling, the royalty clause requires payment of a royalty on production "sold or used." Although some commentators suggest the right to payment may be affected by the "market value" or "proceeds" (amount realized) language, in most situations, it should not matter. The principal inquiry should be whether there has been production of gas. The market value/proceeds inquiry will only be relevant for determining the basis for calculating royalty once the basic right to payment is established.

Unless the well is shut in, gas is being marketed from the property, and is being "sold or used." This would apparently trigger a right to a current payment of royalty on any gas removed from the premises, regardless of which working interest owner was doing the marketing. This approach is supported by recent cases denying lessors the right to share in take-or-pay payments under gas purchase contracts. For example, consider the difficulty a lessee would have explaining to a royalty owner...
why they are not entitled to share in take-or-pay payments, while at the same time denying them any right to currently receive a royalty on gas produced by the other working interest owners. The royalty owner has been told to read *Diamond Shamrock Exploration Corp. v. Hodel*\(^{158}\) in response to their request to share in take-or-pay payments received by their lessee. Upon reading this case, they learn that royalty is due only when gas is produced and sold from the leased land. The royalty owner then asks the lessee for royalty on gas that is being produced from either the “leased land”, or land pooled with the leased land. The lessee admits that gas is being produced and sold from the leased land, but they assert it is not the lessee’s gas; the lessee’s gas, and the royalty owner’s gas, is still in the ground. The lessee explains that the reason for this is their gas purchaser had refused to take any gas because of a pricing and take-or-pay dispute under the lessee’s gas sales contract. According to the lessee, those problems have now been solved, because the lessee has been paid $10,000,000, none of which is subject to the royalty clause. The gas sales contract was subsequently terminated, by mutual agreement — of the lessee and gas purchaser. However, for two years, other parties have marketed all the gas produced from the well, and the lessor has received no royalty.\(^{159}\)

The royalty owner is understandably not impressed by the lessee’s “my gas, your gas, their gas” explanation. Nor is the royalty owner impressed by the operating agreement, and perhaps even the gas balancing agreement, that the lessee produces for the royalty owner’s inspection. The royalty owner’s response in each case is properly: “These are not my agreements; I didn’t sign them.” The royalty owner may decide to pursue alternative courses of action. First, they can treat the lessee’s gas as having been produced. In this situation, the royalty owner has an argument that gas has been produced and sold, and by the terms of its oil and gas lease the lessee owes them a royalty, regardless of any collateral agreements the lessee may have with third parties.

An alternative course of action would be for the lessor to “agree” with the lessee: “Yes, my gas is in the ground, and has been there, essentially shut-in and without any production for over a year, and you haven’t timely paid the required shut-in royalty.” The lessee will respond by referencing the habendum clause of the oil and gas lease and will note

\(^{158}\) 853 F.2d 1159 (5th Cir. 1988).

that other parties have produced over 10 million cubic feet of gas each day from the well. In some states, particularly New Mexico, this assertion may not be a defense.\textsuperscript{160} Pooling statutes in some states, such as Oklahoma,\textsuperscript{161} resolve the problem by requiring all parties marketing from a force-pooled unit to account to each royalty owner.\textsuperscript{162} This issue remains largely undecided in the other producing states.\textsuperscript{163}

If the leased land has been pooled pursuant to a pooling clause, the lessor can often make out an even stronger case for receiving a royalty on all production from the pooled unit. Most pooling clauses contain the stock language that the lessor will be paid a royalty “on production from the unit,” reduced proportionately to account for their surface acreage contribution to the unit.\textsuperscript{164} Royalty owners will generally have a compelling argument for the current payment of royalty regardless of which party is marketing gas. Their right to be paid royalty should not be affected by any difficulty in calculating the basis for payment.

Determining the basis for paying royalty seems difficult at first glance. For example, the problem arises as to how to calculate the amount of royalty due when the party contractually bound to pay the royalty has not marketed any gas. The issue becomes whether the non-marketing party would pay royalty based upon the sales proceeds obtained by one or more of the marketing parties; also, the problem of what would happen if the non-marketing party made up the underproduction at either a higher or lower sales price would have to be considered. Perhaps the best way to deal with these issues is to calculate royalty based upon the sales made by the marketing parties. If this price is not representative of that which a prudent operator would obtain under its implied marketing obligations, the lessor could challenge the lessee's failure to actively market the gas. An alternative approach, if royalty is based upon “market value,” is to pay the lessor the current market value regardless of what the marketing parties receive for their gas. Such an approach could also be used if a marketing party is getting above-market

\textsuperscript{160} See Greer v. Salmon, 82 N.M. 245, 479 P.2d 294 (1970) (rejecting the argument that the capability of production satisfied the habendum clause, the court held that the shut-in royalty clause was a condition which had to be satisfied to save the lease from termination).

\textsuperscript{161} OKLA. STAT. tit. 52, § 87.1 (Supp. 1990).

\textsuperscript{162} See Shell Oil Co. v. Corporation Comm'n, 389 P.2d 951 (Okla. 1964) (known as the “Blanchard” case; the court adopted the “weighted average” approach to the royalty payment problem).


\textsuperscript{164} See supra text accompanying note 155.
prices, in which the non-marketing lessee is unable to share. Calculating market value may be difficult, but not impossible; it should be an easier task today with the advent of a spot market for gas.

Another difficult issue is whether an “advance” royalty paid to the lessor by their non-marketing lessee can be credited against royalty otherwise due on gas taken by the lessee to balance in kind. The lessee will claim that they merely made advance payments of royalty on gas which they would produce in the future; lessors may not see it that way. Even if the lessor is given the benefit of any price differences between gas produced by the marketing parties and gas subsequently taken in kind by the lessee, a literal reading of the royalty clause would require payment of royalty on all gas produced, regardless of its designation as make-up gas. This would create a strong incentive for a cash balancing approach, instead of any form of balancing in kind.

The marketing party also has royalty problems; the issue is whether the marketing party should either pay royalty based upon the entire gas stream they sell, or pay as though they are only marketing their proportionate share of the gas stream. Once again the lease contract will determine the parties’ rights. If the lessee is crediting all of the gas sales proceeds to its account, it will be difficult to argue the gas has not been “sold or used” by the lessee. The asymmetrical treatment of royalty among marketing and non-marketing parties is the result of asymmetrical contractual obligations created by the oil and gas lease, operating agreement, and gas balancing agreement. Courts can either attempt to equitably harmonize the agreements, or enforce them individually without regard to the new realities of the marketing side of the gas industry. In the past, courts have pursued different paths in this area.165

B. The Marketing Regimes for other Non-Working Interest Owners

The analysis for other non-working interest owners, such as nonparticipating royalty interest owners and overriding royalty interest owners, should be identical to that used in the lessor case. The document creating the interest will define the rights of the parties; this assumes that the

165. For example, when dealing with the market value royalty issue, Texas and Kansas have enforced the royalty clause without regard for the marketing realities of the gas industry. In contrast, Oklahoma and Louisiana have adopted rules which took account of the long-term gas contract as the primary means for marketing gas. Compare Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866 (Tex. 1968) and Lightcap v. Mobil Oil Corp., 221 Kan. 448, 562 P.2d 1, cert. denied, 434 U.S. 876 (1977) with Tara Petroleum Corp. v. Hughey, 630 P.2d 1269 (Okla. 1981) and Henry v. Ballard & Cordell Corp., 418 So.2d 1334 (La. 1982).
base document has not been modified by subsequent agreements, statutes, or regulatory action. As with the oil and gas lease, it remains to be seen whether the courts will try to reconcile the express terms of the document creating the interest with the marketing realities confronting the working interest owners.

VI. CONCLUSION

The principles which apply to the resolution of cotenancy disputes have been evolving since 1285. However, it is still unclear how courts will apply these principles to resolve gas balancing problems. Although carefully classifying the property interest is an important part of any balancing analysis, it is equally important to ascertain how contracts between the parties and statutory considerations effect the underlying relationship. Regardless of the technical origin of the working interest owners' relationship, courts should recognize the practical realities of gas marketing, and avoid applying conversion principles to police the relationship. Instead, courts should realize that disproportionate sales are a necessary adjunct of gas marketing, and adopt an analysis that will permit maximum production of wells at all times, regardless of the marketing problems of individual working interest owners. The interests of non-marketing parties can be protected by applying cotenant accounting concepts and gas balancing. The final analysis will usually be one of judicial conscience: the equities will determine how disproportionate sales problems are resolved between working interest owners. It remains to be seen whether this judicial conscience will play a role when defining the rights of lessors, nonparticipating royalty owners, and others merely having a right to share in production.

166. Subsequent agreements might include division orders, pooling agreements, or an agreement to be bound by the terms of an operating agreement or balancing agreement. The ability to use division orders to patch up problems created by an oil and gas lease has been severely restricted in many states by either legislative or judicial action. See Pierce, Resolving Division Order Disputes: A Conceptual Approach, 35 Rocky Mtn. Min. L. Inst. 16-1, 16-38 to 16-41 (1989).

167. See supra text accompanying notes 164-65.
