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# THE IMPLIED MARKETING COVENANT IN OIL AND GAS LEASES: SOME NEEDED CHANGES FOR THE 80's

*Bruce M. Kramer\** &  
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## I. INTRODUCTION

In recent years the demand for natural gas has resembled the trek of an amusement park roller coaster—lots of ups and downs. In the mid to late 1970's the nation experienced an energy shortage upon which President Carter declared the "moral equivalent of war."<sup>1</sup> In an attempt to combat the shortages Congress passed the Natural Gas Policy Act of 1978 (NGPA).<sup>2</sup> At the heart of the NGPA is a pricing structure which places a significant burden on producers in the form of costly (in both time and money) administrative requirements.<sup>3</sup> The normal market place incentive to seek higher maximum prices under various NGPA formulae is diluted by the tremendous bureaucratic and administrative transaction costs.<sup>4</sup> The lessee is therefore "encouraged" by the high transaction costs to accept the first classification for his wells and

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1. The Energy Problem, President's Address to the Nation, 1 Pub. Papers 656 (April 18, 1977).

2. 15 U.S.C. §§ 3301-3432 (1982).

3. 15 U.S.C. §§ 3311-3348 (1982). The NGPA has been deemed "the most complicated and ambiguous statute ever enacted." Moody & Garten, *The Natural Gas Policy of 1978: Analysis and Overview*, 25 Rocky Mtn. Min. L. Inst. 2-1 (1979). This criticism is especially true of the pricing provisions. For a discussion of these provisions see *Id.* at 2-13 to 2-48. The large expense of compliance with the administrative requirements is detailed in *Oil & Gas J.* 207 (Nov. 19, 1979). The president of Sun Gas Co. reported that, in the past year, his company had "filed 4,500 pounds of paper to receive price determinations for 1,500 producing wells." *Id.* Forty-two employees were added to handle the deluge of paperwork and it was estimated that the cost of administration was 1.5 million dollars.

4. For a detailed discussion of the regulatory scheme relating to the natural gas industry, see R. Pierce, *Natural Gas Regulation Handbook* (1980 & Supp. 1982).

gas products. This complacency is exacerbated by the recent decrease in demand for natural gas.<sup>5</sup>

Following a period of governmental policies aimed at stimulating drilling and production in the mid to late 1970's, producers of natural gas experienced a prolonged downturn in demand which has continued to date.<sup>6</sup> In 1984 it was estimated that the surplus of natural gas in the United States has now reached seven trillion cubic feet per year. This surplus represented about thirty percent of the nation's productive capacity.<sup>7</sup> The forecast for 1986 reflects a deliverability surplus in excess of four trillion cubic feet.<sup>8</sup> A natural effect of this current glut is that an increasing number of wells are being shut-in.<sup>9</sup> On those wells not shut-in, producers find that they are often unable to market the permitted levels of production.<sup>10</sup> In either situation, shut-in or marketing of only a percentage of production, lessors are unlikely to receive the royalty payments they expect. It is probable that the above-described scenario will precipitate an increase in litigation predicated on the lessee's duty to market natural gas which has been discovered on the leasehold.<sup>11</sup> This article, anticipating such an increase, attempts to review the lessee's obligation under the implied covenant to market.

## II. THE APPLICATION OF THE IMPLIED COVENANT TO MARKET

### *Development of Implied Covenants Generally*

One of the most distinctive features of oil and gas leases is the almost total absence in the ordinary type of lease of express

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5. Hagar & Smith, *Lingering U.S. Gas Surplus Predicted*, *Oil & Gas J.* 32 (Jan. 2, 1984). This article compiles the results of a survey taken of natural gas producers throughout the lower forty-eight states. See also *AGA: Gas Surplus to Remain Price Rein*, *Oil & Gas J.* 52-53 (Jan. 6, 1986).

6. W. Legg, *Natural Gas Producers/Purchasers Interface: Current Status 1-2* (Unpublished Manuscript: presented to the Mineral Law section of the Oklahoma Bar Association November, 1983). The author notes several factors which contributed to the decline in demand for natural gas: (1) the length and depth of the recession in the early 1980s, (2) decreases in the use of natural gas by the ailing anhydrous ammonia manufacturing industry, (3) restrictions in the use of natural gas in federal legislation which encouraged the use of alternative energy sources, (4) conservation measures, (5) unusually warm winters, and (6) competition caused by lower crude oil prices. *Id.* See Hagar & Smith, *supra* note 5, at 32-33.

7. Hagar & Smith, *supra* note 5, at 32.

8. *AGA: Gas Surplus to Remain Price Rein*, *Oil & Gas J.* at 52 (Jan. 6 1986).

9. Hagar & Smith, *supra* note 5, at 32. The sixty-three producers responding to the survey reported that forty-six percent of their combined productive capacity of 3.7 billion cubic feet per day was shut-in. *Id.* See also W. Legg, *supra* note 5, at 4 (author notes that many wells completed when demand was high have been shut-in).

10. W. Legg, *supra* note 5, at 4.

11. Weaver, *Implied Covenants in Oil and Gas Law Under Federal Energy Price Regulation*, 34 *Vand. L. Rev.* 1473, 1510 (1981).

clauses protecting the royalty interest of the lessor. It is doubtful if any other character of legal instrument can be found in which one of the parties has so much potentially at stake with so little express contractual protection.<sup>12</sup>

As noted in the above passage, oil and gas lease forms have traditionally not contained provisions which set out the duties a lessee owes his lessor. Thus, a lease will generally be silent as to the lessee's duty to, among other things, drill offset wells, develop the leasehold, protect against drainage, or market the minerals discovered on the leasehold.<sup>13</sup> In the absence of such provisions, however, courts have been willing to find implied covenants which require the lessee to perform such duties or suffer the consequences of breach.<sup>14</sup>

Implied covenants in oil and gas leases originated at the turn of the century.<sup>15</sup> In 1905, the landmark case of *Brewster v. Lanyon Zinc Co.*<sup>16</sup> was decided. In *Brewster* the Eighth Circuit stated that where a lease contains no express provisions regarding the lessee's duty to develop the lease, it does not follow that the decision as to how to develop the lease is left solely to the lessee. Rather, the lessee's duty to develop "arises from the language of the contract when considered in its entirety

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12. Walker, *The Nature of the Property Interests Created by an Oil and Gas Lease In Texas*, 11 *Tex. L. Rev.* 399 (1933).

13. See R. Hemingway, *The Law of Oil and Gas* 411-12 (2d ed. 1983); M. Merrill, *Covenants Implied In Oil and Gas Leases* 19-20 (2d ed. 1940); 5 H. Williams & C. Meyers, *Oil and Gas Law* § 801 (1983). Various reasons have been given for the general absence of express provisions in oil and gas leases.

The absence of such express covenants is not due to the unwillingness of the lessee to contract expressly with reference to these matters, but is based upon the fact that conditions differ so radically in different oil and gas fields . . . that it is for all practical purposes impossible to express in the lease the lessee's obligations concerning these matters. Leases are almost invariably acquired prior to the discovery and development of the pool and before a thorough knowledge of its characteristics is obtainable.

Pressler, *Implied Covenants in Oil and Gas Leases*, 18 *Miss. L.J.* 402, 405 (1947).

14. The most often cited authority on implied covenants and their development is M. Merrill, *supra* note 13. For a more recent treatment see 5 H. Williams & C. Meyers, *supra* note 13, at §§ 801-804.

15. One of the earliest reported cases is *Stoddard v. Emery*, 128 Pa. 436, 18 A. 339 (1889). In that case the court stated: "Had there been nothing said in the contract [on the duty to drill additional wells] there would of course have arisen an implication that the property should be developed reasonably . . ." *Id.* at 436, 18 A. at 339.

16. 140 F. 801 (8th Cir. 1905). *Brewster* is referred to as the most cited and quoted opinion in the area of implied covenants. 5 H. Williams & C. Meyers, *supra* note 13, at § 802. Modern courts continue to cite it with approval. See, e.g., *Mitchell v. Amerada Hess Corp.*, 638 P.2d 441, 449 (Okla. 1981).

17. *Brewster*, 140 F. at 809.

The *Brewster* rationale is based on the court's interpretation of the intent of the parties.<sup>18</sup> Over the years, however, courts have implied covenants on other grounds,<sup>19</sup> including public policy<sup>20</sup> and general principles of equity.<sup>21</sup>

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18. The intent theory can be considered a smaller component of the broad duty of cooperation imposed upon the lessor and lessee. See *Western Natural Gas Co. v. Cities Service Gas Co.*, 507 P.2d 1236, 1241 (Okla. 1972); 5 H. Williams & C. Meyers, *supra* note 13, at § 802.1. Cf. *Wood v. Lucy, Lady Duff-Gordon*, 222 N.Y. 88, 118 N.E. 214 (1917). "Without an implied promise, the transaction cannot have such business 'efficacy, as both parties must have intended that all events it should have.'" *Id.* at 91, 118 N.E. at 215. See also, Meyers, *The Effect of Express Provisions in an Oil and Gas Lease on Implied Obligations*, 14 *Inst. Min. L.* 90, 90-92.

In applying the marketing covenant, courts have stated that the royalty clause, when considered in light of the exclusive right to develop held by the lessee, reveals an agreement, albeit a silent one, that the gas discovered will be marketed. See *Iams v. Carnegie Natural Gas*, 144 Pa. 72, 72-73, 45 A. 54, 54-55 (1899); *Munsey v. Marnet Oil & Gas Co.*, 199 S.W. 686, 689 (Tex. Civ. App. Dallas 1917), *rev'd on other grounds*, 113 Tex. 212, 254 S.W. 311 (1918). This reasoning is especially valid where, as is most often the case, the lessor's only long term remuneration is a share of the minerals marketed from the leasehold. See, e.g., *Benedum-Trees Oil Co. v. Davis*, 107 F.2d 981, 985 (6th Cir. 1939), *cert. denied*, 310 U.S. 634 (1940); *Wolf v. Texas Co.*, 83 F.2d 425, 432 (10th Cir. 1936).

19. As a general rule, the bases for each of the implied covenants may be the same. *M. Merrill*, *supra* note 13, at 186. See also *Howerton v. Kansas Natural Gas Co.*, 81 Kan. 553, 560, 106 P. 47, 50 (there is little difference between implied drilling covenant and implied marketing covenant), *modified*, 83 Kan. 367, 108 P. 813 (1910).

20. This basis has most often been applied to the development and exploration covenants. See *Superior Oil Co. v. Devon Corp.*, 604 F.2d 1063 (8th Cir. 1979), where the court, in cancelling a lease for lack of development, noted:

[A]t this particular point in time the public interest in encouraging the prudent development of oil and gas is particularly important. The development of domestic sources of oil will reduce the amount of oil which has to be imported and will thereby redound to the national interest by helping to reduce the deficit trade balance and to render the nation less susceptible to economic dislocations arising from political disturbances in foreign oil producing nations.

*Id.* at 1069. See also 5 H. Williams & C. Meyers, *supra* note 13, at § 802.2; Martin, *A Modern Look at Implied Covenants to Explore, Develop and Market Under Mineral Leases*, 27 *Inst. Oil & Gas L. & Tax'n* 177, 205 (1976) (author suggesting courts consider public policy in applying implied covenants). But cf. *Weaver*, *supra* note 11, at 1492 (author cautions that use of public policy rationale may ignore bargained for expectations of parties).

21. Accord *Martin*, *supra* note 20, at 198. See *Darr v. Eldridge*, 66 N.M. 260, 263, 346 P.2d 1041, 1044 (1959). Courts which apply the duty to market on equitable principles reason that such a duty must be implied to protect the lessor from the inequality of bargaining power and control over marketing that exists between lessor and lessee. See, e.g., *Ferguson v. Gulf Oil Corp.*, 192 Okla. 355, 358, 137 P.2d 940, 943 (1943). Similarly, equitable principles might be applied to prevent the lessee from speculating at the lessor's expense. See, e.g., *Benedum-Trees Oil Co. v. Davis*, 107 F.2d 981, 985 (6th Cir. 1939), *cert. denied*, 310 U.S. 634 (1940); *Warfield Natural Gas Co. v. Allen*, 59 S.W.2d 534, 537 (Ky. 1933); *Reynolds v. White Plains Oil & Gas Co.*, 199 Ky. 243, 246, 250 S.W. 975, 976 (1923).

*Historical Development of the Marketing Covenant*<sup>22</sup>

One of the recognized but little discussed implied covenants relates to the lessee's duty to market the product discovered on the leasehold. The marketing covenant applies equally to oil and gas; however, as a practical matter, it is rarely applied to the production of oil.<sup>23</sup> As with most implied covenants, the marketing covenant arises even though under most conditions or circumstances both the lessor and lessee share a common interest in marketing the minerals discovered. However, where circumstances occur which make the marketing of the product detrimental to the lessee's best interest, disputes will arise.<sup>24</sup> It is because of these

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22. While other commentators present variations, the list of implied covenants put forth by Professor Hemingway is generally accepted.

- A. Implied covenants to develop the lease.
  - 1. Drilling an initial well.
  - 2. Developing the lease upon production.
- B. Implied covenants of protection.
  - 1. Protecting against drainage.
  - 2. Abstaining from depreciation of the lessor's interest.
- C. Implied covenants relating to management and administration of the lease.
  - 1. Produce and market.
  - 2. Operate with reasonable care.
  - 3. Use of modern methods of production and development.
  - 4. Seek favorable administrative action.

R. Hemingway, *supra* note 13, at 411. See also M. Merrill, *supra* note 13, at 23; Walker, *supra* note 12, at 401; 5 H. Williams & C. Meyers, *supra* note 13, at § 804 (each setting out similar list of implied covenants).

23. *Cole Petroleum Co. v. United States Gas & Oil Co.*, 121 Tex. 59, 63, 41 S.W.2d 414, 416 (1931); Siefkin, *Rights of Lessor and Lessee With Respect to Sale of Gas and As To Gas Royalty Provisions*, 4 *Inst. Oil & Gas L. & Tax'n* 181, 182 (1953). "Oil is of such a nature that it need not be transported to a market through a pipeline, but may be taken from the ground and stored in tanks to await shipment by rail or truck to an ever-ready market." 2 W. Summers, *The Law of Oil and Gas*, 222-23 (1959). See also 5 H. Williams & C. Meyers, *supra* note 13, at § 853 (stating reasons why duty to market generally applies to gas wells).

24. Donahoe, *Implied Covenants In Oil and Gas Leases and Conservation Practice*, 33 *Inst. Oil & Gas L. & Tax'n* 97 (1982). "The relationship between lessor and lessee . . . is a complex one of mutual interest mingled with antagonism." *Id.* at 98. Consider the following areas where the lessor's and lessee's interests may not be aligned:

- 1. There may be no available market, thus the lessee has little incentive to attempt to find a market.
- 2. The lessee, a user of gas, may want to hold a lease so as to guarantee a continued long term supply.
- 3. The lessee may be financially unable to construct facilities necessary to market the product.
- 4. The lessee may feel that, given the present market, the steps necessary to market the product are not economically feasible.
- 5. The lessee may desire to drill a deeper well in search of more marketable gas, or, in the alternative, oil.
- 6. The lessee may be satisfied with a profitable contract and, despite the lessor's urging, fail to seek a more favorable contract.

potentially conflicting situations that the implied covenant to market was developed.

The basic principles underlying the implied covenant to market were elucidated in 1899 by the Pennsylvania Supreme Court in *Iams v. Carnegie Natural Gas*.<sup>25</sup> The case also is illustrative of the early marketing covenant cases which dealt not with a fractional royalty but with a flat rate sum to be paid if gas was found and marketed. The basic problems that have confronted all courts dealing with the marketing covenant are reflected in *Iams*. For example, the court had to determine the standard of conduct to govern the lessee's activities under the lease.<sup>26</sup> It concluded that once the marketing duty was triggered by the finding of gas in sufficient quantities "[t]he tenant [lessee] was then under an obligation to operate for the common good of both parties."<sup>27</sup>

The *Iams* court also impliedly discussed the allocation of the burden of proof on the issue of proving a violation of the marketing covenant. In this case the plaintiff/lessor presented evidence of the defendant/lessee's failure to market the gas which had been found in quantities sufficient to justify marketing. The burden of presenting evidence then shifted to the lessee to "show some good reason for not having done so."<sup>28</sup> In this case the jury did not accept the lessee's rebuttal testimony and held for the lessor.<sup>29</sup>

The parameters of the implied covenant were developed more fully in *Howerton v. Kansas Natural Gas Co.*<sup>30</sup> As with *Iams*, the court was dealing with a fixed sum royalty for gas. However, there was no express covenant to market the gas if sufficient quantities were found.<sup>31</sup> The court nonetheless found that an implied covenant to market existed based on the implied intent of the parties in agreeing to the lease with a royalty provision. The marketing covenant springs forth from the nature of the leasehold transaction whereby the lessor's major benefits only arise upon the marketing of any discovered mineral.<sup>32</sup> The court

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25. 194 Pa. 72, 45 A. 54 (1899). This case involved an express covenant to market gas if it was found in "sufficient quantities." *Id.* at 72, 45 A. at 54.

26. *Id.* at 72, 45 A. at 54. See also, *Howerton v. Kansas Natural Gas Co.*, 31 Kan. 553, 106 P. 47 (1910), *McGraw Oil & Gas v. Kennedy*, 65 W. Va. 595, 64 S.E. 1027 (1909).

27. *Iams v. Carnegie Natural Gas*, 194 Pa. 72, 45 A. 54 (1899) (quoting *Glasgow v. Chartiers Oil Co.*, 152 Pa. 48, 25 A. 232 (1892)).

28. *Id.* at 75, 45 A. at 55.

29. The remedy in cases involving a flat sum royalty would be a money judgment for the unpaid sum plus interest. Cancellation should not be available. 5 H. Williams & C. Meyers, *supra* note 13, at § 853.

30. 81 Kan. 553, 106 P. 47 (1910).

31. *Id.* at 557, 106 P. at 48. There was an express covenant to provide the lessee with gas for domestic purposes if sufficient quantities were found. The lessee was in compliance with this free use covenant. *Id.*

32. See *supra* note 18.

did not discuss the relevant standard to judge the lessee's conduct because there was a total absence of any effort to market the discovered gas.

The court also differed from *Iams* in the remedy given to the lessor. Although the case involved a fixed sum royalty, the court concluded that there was no adequate remedy at law.<sup>33</sup> Treating the implied covenant as both a condition and a covenant, the court upheld a decree of forfeiture terminating the leasehold estate.<sup>34</sup>

By 1931 the Texas Supreme Court had accepted as a well-established fact the implied covenant to market in the context of an oil and gas lease.<sup>35</sup> The marketing covenant was derived from and considered an essential part of the development covenant, as neither the lessor or lessee gained any advantage from the discovery of hydrocarbons unless those substances were marketed.<sup>36</sup> The covenant to market in the oil and gas lease transaction had its foundation in the earlier hard-rock mineral cases which implied a covenant to market minerals such as coal or sulfur.<sup>37</sup> The implied covenant to market was soon recognized in most oil producing jurisdictions throughout the United States.<sup>38</sup>

### *The Prima Facie Case*

The minimum elements that a lessor must prove to state a cause of action for breach of the implied covenant to market are:

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33. 81 Kan. at 561, 106 P. at 50. The court had eventually determined that the gas was found in sufficient quantities to justify marketing.

34. *Id.* at 563, 100 P. at 50-51. See *infra* note 74 for authority to the contrary. In *Howerton*, given an absence of drainage to other leases it is difficult to support the court's conclusion that a money damage recovery for the amount of the unpaid fixed sum royalty, with interest, would not have adequately compensated the lessor for the breach of the implied covenant to market.

35. *Cole Petroleum Co. v. United States Gas & Oil Co.*, 121 Tex. 59, 41 S.W.2d 414 (1931).

36. *Id.* at 63, 41 S.W.2d at 416. As in *Iams* the court based its decision on an express covenant although it repeated on several occasions that the duty to market would exist outside of any express covenant. *Id.* at 66, 41 S.W.2d at 416-17.

37. *Id.* at 66, 41 S.W.2d at 416-17 (citing *Benavides v. Hunt*, 79 Tex. 394, 15 S.W. 396 (1981) (sulfur lease)). In contrast to *Iams* where money damages were a sufficient remedy, the court in *Cole Petroleum* cancelled the lease because a specific leasehold provision stipulated forfeiture of the assigned estate for any breach of an express or implied covenant. 121 Tex. at 66, 41 S.W.2d at 417.

38. See, e.g., *Wolfe v. Prairie Oil & Gas Co.*, 83 F.2d 434, 437 (10th Cir. 1936); *Peoples Gas Co. v. Dean*, 193 F. 938, 942 (8th Cir. 1911); *Howerton v. Kansas Natural Gas Co.*, 81 Kan. 553, 556, 106 P. 47, 49 (1910); *Carroll Gas & Oil Co. v. Skaggs*, 231 Ky. 284, 288, 21 S.W.2d. 445, 447 (Ky. Ct. App. 1929); *Hutchinson v. Atlas Oil Co.*, 148 La. 540, 87 So. 265 (1921); *Berthelote v. Loy Oil Co.*, 95 Mont. 434, 442, 28 P.2d 187, 191-92 (1933); *Masterson v. Amarillo Oil Co.*, 253 S.W. 908, 914 (Tex. Civ. App. Amarillo 1923) (writ *dism'd*); *Pryor Mountain Oil & Gas Co. v. Cross*, 31 Wyo. 9, 12, 222 P. 570, 572 (1924). See generally *W. Summers*, *supra* note 23 at 582-95; *5 H. Williams & C. Meyers*, *supra* note 13, at §§ 853-858.3; *Walker*, *supra* note 12, at 437-41 (each discussing the marketing covenant).



1. Discovery of hydrocarbons on the premises;
2. Failure to market the discovered hydrocarbons;
3. Ability to market the hydrocarbons if the lessee's actions complied with the relevant standard of conduct, and;
4. Damages proximately caused by the lessee's failure to act in the prescribed manner.<sup>39</sup>

Once these requirements have been met, a remedy is available.<sup>40</sup>

The initial requirement that hydrocarbons be discovered on the premises is axiomatic. Clearly one must have a product to market before a duty to market will arise. However, as in *Iams* and *Howerton*, a factual issue may arise as to whether the hydrocarbons have been discovered in "sufficient quantities."<sup>41</sup>

The second element required to establish a cause of action for breach of the marketing duty requires the lessor to prove that a market exists. Markets only exist if there is a willing buyer as well as a willing seller.<sup>42</sup>

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39. Accord, 5 H. Williams & C. Meyers, *supra* note 13, at § 855; Weaver, *supra* note 11, at 1513.

In addition to these traditional elements of the implied covenant to market, recent cases have dealt with different duties that may arise in today's oil and gas patch. For example in *Texas Oil & Gas Co. v. Hagen*, 683 S.W.2d 24 (Tex. App. 1984), the court suggests that the lessee owes the lessor the duty to disclose the fact that the sale of gas is to a subsidiary corporation of the lessee who in turn is selling to a third party at a higher rate. The duty to disclose might arise in the context of a division order or the contract for sale where self-dealing is involved.

Although it is not mentioned, one could infer from the court's decision in *Diamond Shamrock Corp. v. Harris*, 681 S.W.2d 317 (Ark. 1984), that where a producer has committed the reserves in an area to a purchaser and then negotiated a proceeds lease with a lessor for on-leasehold sales, an implied marketing covenant obligation would arise so that a subsequent royalty owner could receive market value based royalties in the absence of disclosure by the lessee that he would be bound to accept the proceeds of the gas purchase contract previously negotiated. The result can be best explained on a duty to disclose rationale since there would normally be no requirement that a lessee disclose prior agreements with third parties to lessors or lessor assignees as was the case in *Harris*. If the covenant to market existed when the lease was being negotiated then a duty to disclose the marketing obligations of the lessee and how they would impact the royalty clause might be implied and the leasehold terms ignored.

40. Available remedies may include absolute cancellation, conditional cancellation, or damages. For a general discussion of available remedies see 4 E. Kuntz, *Oil and Gas* 128-34, (1978); 5 H. Williams & C. Meyers, *supra* note 13, at 416.2-416.6. See *infra* text accompanying notes 214-32.

41. See *infra* note 142. This issue may be subsumed in the broad context of the lessee's standard of conduct. Under no standard would the lessee be required to market such small quantities of gas as would make marketing impractical or inefficient.

42. *Craig v. Champlin Petroleum Corp.*, 435 F.2d 933 (10th Cir. 1971). The court concluded there must first be an "opportunity for selling the commodity . . . that is the existence of a commercial demand for the same." *Id.* at 936 (quoting *Replogle v. Indian Territory Illuminating Co.*, 193 Okla. 361, 366, 143 P.2d 1002, 1007 (1943)).

Thus, notwithstanding the fact that commercial quantities of oil and gas have been discovered, there is no breach of the marketing covenant unless it is shown that an actual market existed.<sup>43</sup> It is clear, however, that the lessee must undertake diligent efforts to secure a buyer if none are readily available.<sup>44</sup> Often it is apparent that the lessee has done little if anything regarding the marketing of the gas.

Although rarely discussed, the rules allocating the burden of proof and burden of going forward in the context of the marketing duty are very important.<sup>45</sup> In *Craig v. Champlin Petroleum Co.* the allocation of the burden to the lessor to prove the existence of a market for the gas was undoubtedly a critical factor in the Tenth Circuit's reversal of the trial court's finding that a market existed.<sup>46</sup> In one recent case, a federal district court held that under Oklahoma law the burden of proof was on the lessor to show a breach of the marketing covenant.<sup>47</sup> However, it cited an Oklahoma Supreme Court decision that dealt not with the implied covenant to market but with the issue of what royalties are owed under a "market price" royalty clause.<sup>48</sup>

In *Iams*, one of the first marketing covenant cases, the Pennsylvania Supreme Court seemingly shifted the burden of proof to the lessee once the lessor had proven discovery of hydrocarbons and a total failure to market.<sup>49</sup> Montana also places the burden on the lessee to establish

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43. See *Bristol v. Colorado Oil & Gas Corp.*, 225 F.2d 894, 897 (10th Cir. 1944); *Townsend v. Creekmore-Rooney Co.*, 358 P.2d 1103, 1107 (Okla. 1960); *Morgan v. Houston Oil Co. of Texas*, 84 S.W.2d 312, 313 (Tex. Civ. App. San Antonio 1935) (writ dismissed). In each of these cases the courts found no breach of the duty to market because no market demand existed. The absence of a market may also exist for other reasons. For example, the distance from the well to a pipeline willing to accept the product may be substantial, *Bristol*, 225 F.2d at 897; there may be insufficient pressure at the wellhead, *McVicker v. Horn, Robinson & Nathan*, 322 P.2d 410, 414-15 (Okla. 1958); or there may be impurities in the product, *Risinger v. Arkansas-Louisiana Gas Co.*, 198 La. 101, 104, 3 So. 2d 389, 292-94 (1941). The lease may, however, terminate under the *habendum* clause. See *infra* notes 62-84 and accompanying text.

44. *Craig v. Champlin Petroleum Co.*, 435 F.2d 933, 938 (10th Cir. 1971). The court stated that even though it appeared that no market existed, the lessee must use "normal procedures and practices of the existing industry" in attempting to secure a market. *Id.* See, e.g., *Howerton v. Kansas Natural Gas Co.*, 81 Kan. 553, 106 P. 47 (1910); *Hutchinson v. Atlas Oil Co.*, 148 La. 540, 87 So. 265 (1921).

45. Professors Williams and Meyers assert that the lack of discussion of burden of proof issues indicates judicial approval of the usual allocation of the burden to the lessor/plaintiff. 5 H. Williams & C. Meyers, *supra* note 13, at § 856.

46. 435 F.2d 933, 936-37 (10th Cir. 1971). There was conflicting evidence at trial about the marketability of the gas because of pipeline unavailability, lack of sufficient revenues and processing plant capacity.

47. *Barby v. Cabot Corp.*, 550 F. Supp. 188, 190 (W.D. Okla. 1981).

48. *Id.* at 190 (citing *Tara Petroleum Corp. v. Hughey*, 630 P.2d 1269 (Okla. 1981)).

49. 194 Pa. 72, 74; 45 A. 54, 55 (1899). The court approved a jury instruction requiring the lessee to "show some good reason for not [marketing]" once the lessor had shown that gas was discovered in sufficient quantities.

reasonable diligence in the marketing of the gas in order to avoid a decree of cancellation.<sup>50</sup> The burden of going forward may also shift to the lessee where there are extraordinary circumstances such as a very lengthy time period between discovery and marketing.<sup>51</sup> Finally, the burden may shift if the plaintiff is able to make a prima facie showing of drainage, especially where the lessee is conducting the drainage operations.<sup>52</sup>

The third element requires a showing that had the lessee complied with the applicable standard of conduct, the hydrocarbons would have been marketed. Thus the lessor must prove, even in the absence of any marketing activity, that had the lessee attempted to market he would have succeeded.<sup>53</sup> For the modern cases involving not a total lack of marketing but a lack of effective or competent marketing, the lessor must show that a better deal could have been made.<sup>54</sup>

Finally, the lessor must prove that he has been damaged by the breach of the marketing covenant. In the older cases involving a fixed sum royalty, the lessor could not state a cause of action for breach of the implied covenant to market if the lessee had paid or tendered the fixed sum.<sup>55</sup> An illustrative case showing the burden of proof necessary to sustain an action for damages is *Carroll Gas & Oil Co. v. Skaggs*,<sup>56</sup> in which the court found that statistical and geological certainty were not required.<sup>57</sup> The result was simplified by the lessor's ability to show loss of hydrocarbons by drainage to adjacent leaseholds. This allowed the court to grant the lessor lost royalties as the proper measure of damages.<sup>58</sup>

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50. *Severson v. Barstow*, 103 Mont. 526, 532, 63 P.2d 1022, 1024 (1936); *Berthelote v. Loy Oil Co.*, 95 Mont. 434, 28 P.2d 187 (1933).

51. *Bristol v. Colorado Oil & Gas Corp.*, 225 F.2d 894 (10th Cir. 1944). The tenth circuit concluded that "[nine and one-half years] is inordinately long and undoubtedly places the burden upon the lessees to excuse the delay." *Id.* at 897.

52. See, e.g., *Dixon v. Anadarko Prod. Co.*, 505 P.2d 1227, 1230 (Okla. 1972); *Haken v. Harper Oil Co.*, 600 P.2d 1237, 1240 (Okla. Ct. App. 1979).

53. *Carroll Gas & Oil Co. v. Skaggs*, 231 Ky. 284, 287, 21 S.W.2d 445, 448 (1929). 5 H. Williams & C. Meyers, *supra* note 13, at § 855. A different rule should apply in cases where the lack of marketing effects the habendum clause and not the marketing covenant. See text accompanying *infra* notes 75 to 85.

54. See, e.g., *Gazin v. Pan American Petroleum Corp.*, 367 P.2d 1010 (Okla. 1961).

55. *Hurst v. Petroleum Exploration, Inc.*, 221 Ky. 786, 299 S.W. 954 (1927); *McGraw Oil & Gas Co. v. Kennedy*, 65 W.Va. 595, 64 S.E. 1027 (1909).

56. 231 Ky. 284, 21 S.W.2d 445 (1929).

57. *Id.* at 291, 21 S.W.2d at 448-49. Plaintiff was able to show the amount of potential daily gross and net production as well as the price of similar gas in the area. He was also able to prove the loss of some of that gas through drainage.

58. *Id.* at 292, 21 S.W.2d at 448-49. The lessor had also sought and received the remedy of cancellation so that he was not able to recover damages for the gas still in the ground. *Id.* A recovery of interest on the unpaid royalty, had the gas been properly

The burden of proof of the damage element of the cause of action is clearly on the plaintiff.<sup>59</sup>

### III. SPECIAL CIRCUMSTANCES WHICH AFFECT THE DUTY TO MARKET

The implied covenant to market, unlike most of the other implied covenants, arises under a variety of circumstances. This has had an impact on the way courts view and analyze the component parts of the covenant. Circumstances such as the relation of marketing to the obligations under the habendum clause, the existence or non-existence of a shut-in gas royalty clause, and the problem with constantly changing regulated or unregulated markets for natural gas all create some difficult conceptual issues for the courts to resolve.<sup>60</sup>

#### *Expiration of the Lease Under the Habendum Clause*

The typical oil and gas lease provides that the lease shall extend throughout the primary term "and so long thereafter as oil or gas or other hydrocarbon substances are produced in paying quantities."<sup>61</sup> Thus it is clear that the lease may terminate by its own terms if there is no actual production in paying quantities on or before the final day of the primary term.<sup>62</sup> However, because of the various meanings given the word "produced," this is not always the case. A dichotomy is found in the construction of the term "produced" which creates substantial confusion in discerning between cancellation for breach of the implied covenant to market and termination of the lease under the habendum clause for failure to produce in paying quantities.<sup>63</sup> The dichotomy, and its affect on the marketing covenant, is best exemplified by the differing views taken by two major producing states—Texas and Oklahoma.

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marketed, still might have been appropriate.

59. *Id.*

60. See *infra* text accompanying notes 193-98. These circumstances are in addition to the normal difficulties of proof that accompany an allegation that a lessee has breached the marketing covenant. Problems relating to existence or non-existence of gathering lines, processing plants and potential markets are all an "intrinsic" part of the cause of action.

61. See, e.g., the lease form at 7 H. Williams & C. Meyers, *supra* note 13, at § 699.1. The requirements of "paying quantities" exists absent express statement. *Stewart v. Amerada Hess Corp.*, 604 P.2d 854, 857 (Okla. 1979); *Gulf Oil Corp. v. Reid*, 161 Tex. 51, 54, 337 S.W.2d 267, 269 (1960).

62. See, e.g., *Reid*, 161 Tex. at 54-55, 337 S.W.2d at 269-70. Various "savings" clauses could extend the life of the lease into the secondary term without production. See generally, R. Hemingway, *supra*, note 13, at § 853.4.

63. See 5 H. Williams & C. Meyers, *supra* note 13, at 394. See also *Reid*, 161 Tex. at 54, 337 S.W.2d at 269. "An oil and gas lease . . . [creates] a determinable fee in the land which terminates upon the happening of the events upon which it is limited."

*The Texas View — Production in Paying Quantities Requires Discovery and Marketing of Commercial Quantities After the End of the Primary Term*

It is well established in Texas law that the devotion of the leased premises to the exploration, development, and production of minerals creates a special limitation on the lessee's estate.<sup>64</sup> Thus, absent a savings clause of some type,<sup>65</sup> a lease terminates at the end of the primary term if minerals are not being produced and marketed in paying quantities.<sup>66</sup> The Texas view is exemplified by *Gulf Oil Corp. v. Reid*.<sup>67</sup> In *Reid* the parties executed a mineral lease containing a five year primary term on December 9, 1943. The lessee began drilling a well a few days prior to the end of the primary term and completed the well on January 18, 1949. At that time the lessee tendered shut-in payments to the lessor. The payments were refused. The lessee contracted for the sale of the gas production on June 7, 1949, and gathering lines were connected some four months later. From that time until the time of trial, gas was being produced and marketed in paying quantities.<sup>68</sup> The lessor sued for cancellation of the lease. In granting the lessor's request the court stated:

[N]o matter how great the potential production may be or how many million cubic feet of gas may have been flared there would be no production or production in paying quantities unless there was an available market . . . . [T]he fact that there is no available market is not an excuse for failure to produce, and the lease terminates unless some other provision will keep it in force.<sup>69</sup>

Therefore, as with fee simple determinables, the leasehold interest is automatically terminated if the requisite condition is not met. Under the Texas approach, that condition requires the lessee to both discover and market the hydrocarbons in order to extend the leasehold estate into the secondary term.

*The Oklahoma View — Discovery of Commercial Quantities During the Primary Term Temporarily Extends the Lease Into the Secondary Term*

The Oklahoma position was initially proposed by the Tenth Circuit in *Bristol v. Colorado Oil & Gas Corp.*<sup>70</sup> In *Bristol*, a well capable of

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64. Walker, *supra* note 12, at 408; *Reid*, 161 Tex. at 54, 337 S.W.2d at 269.

65. Typical clauses which may, notwithstanding the absence of production in paying quantities, propel the lease into the secondary term are discussed at R. Hemingway, *supra* note 13, at 304-334. They include the shut-in royalty clause, the commencement clause, the dry hole clause, and the continuous operations clause.

66. *Freeman v. Magnolia Petroleum Co.*, 141 Tex. 274, 278, 171 S.W.2d 339, 341-42 (1943).

67. 161 Tex. 51, 337 S.W.2d 267 (1960).

68. *Id.* at 53, 337 S.W.2d at 268.

69. *Id.* at 55, 337 S.W.2d at 270.

70. 225 F.2d 894 (10th Cir. 1955). At the time the tenth circuit decided the *Bristol*

producing in paying quantities was completed within the primary term. However, because of the poor quality of the product and the absence of pipeline facilities, the well was capped for over seven years beyond the end of the primary term.<sup>71</sup> The court, while noting that the rule may differ in other jurisdictions, stated:

[T]his lease is an Oklahoma contract, and . . . under Oklahoma law, actual production within the definite term of the lease is not a condition precedent to extension of the lease beyond its definite term . . . . [T]he lessee has a reasonable time to market the gas after discovery and expiration of the definite term of the lease.<sup>72</sup>

As the Oklahoma courts have solidified their positions, they have specifically rejected the application of the Texas view that the habendum clause creates an estate analogous to the common law fee simple determinable estate.<sup>73</sup> The Oklahoma interpretation of the habendum clause is grounded upon a general statutory provision requiring the courts to avoid forfeiture on equitable principles.<sup>74</sup>

#### *Significance of the Distinction*

As can be discerned from the above discussion, the dichotomy centers around the interpretation of the word "production" as used in the lease. Clearly, Oklahoma courts view production as not including actual marketing. Rather, the duty to market arises solely from an express or implied covenant.<sup>75</sup> Texas courts, on the other hand, construe production

case, it had already been rebuffed once in its attempt to interpret habendum clauses as only requiring discovery and not marketing prior to the end of the primary term. In interpreting a Kansas lease, the court in *Christianson v. Champlin Refining Co.*, 169 F.2d 207 (10th Cir. 1948), similarly held that only discovery is required. In *Tate v. Stanolind Oil & Gas Co.*, 172 Kan. 351, 240 P.2d 465 (1952) the Kansas Supreme Court disagreed and maintained the rule requiring both discovery and marketing. The Oklahoma Supreme Court did not endorse the *Bristol* approach until 1958 when it decided *McVicker v. Horn, Robinson & Nathan*, 322 P.2d 410 (Okla. 1958). See *infra* note 75.

71. *Bristol*, 225 F. 2d 894, 895 (10th Cir. 1955). Gas was eventually marketed seven years and nine months after the end of the primary term. This was nine and one-half years after the successful completion of the well. *Id.*

72. *Id.* at 896.

73. *Stewart v. Amerada Hess Corp.*, 604 P.2d 854, 858 (Okla. 1979).

74. Okla Stat. tit. 23, § 2 (1981).

75. See *Flag Oil Corp. v. King Resources Co.*, 494 P.2d 322, 325 (Okla. 1972); *Townsend v. Creekmore-Rooney Co.*, 358 P.2d 1103, 1106-07 (Okla. 1960); *McVicker v. Horn, Robinson, & Nathan*, 322 P.2d 410, 412-14 (Okla. 1958). In *McVicker* the court discussed the meaning of "production" as used in Oklahoma oil and gas leases. To say that *marketing* during the primary term of the lease is essential to its extension beyond said term, *unless the lease contains additional provisions indicating a contrary intent*, is to not only ignore the distinction between producing and marketing . . . but it also ignores the difference between express and implied

as not merely requiring a duty to market, but the reality of a sale of the discovered hydrocarbons.<sup>76</sup> Thus, in Oklahoma and the states following its interpretation, the habendum clause is satisfied by discovery and diligent efforts to market hydrocarbons from the property.<sup>77</sup> The view followed by Texas and other states, however, requires actual production (including marketing) in paying quantities.<sup>78</sup>

There are two categories of marketing covenant cases; one dealing with a total absence of marketing and the second dealing with the second-guessing of a consummated marketing transaction. In Texas-type jurisdictions the first category of suits would be impossible unless there was a shut-in royalty or other savings clause in the lease.<sup>79</sup> The second-category of litigation can occur as long as marketing in paying quantities is carried on.<sup>80</sup>

On the other hand, in Oklahoma-type jurisdictions total failure to market suits can be brought in either the primary or secondary term regardless of the inclusion of a shut-in gas royalty provision.<sup>81</sup> However,

terms in lease contracts.

*McVicker*, 322 P.2d at 413. Accord *Stewart v. Amerada Hess Corp.*, 604 P.2d 854 (Okla. 1979); *Gard v. Kaiser*, 582 P.2d 1311, 1313 (Okla. 1978).

76. This interpretation was plainly stated in *Stanolind Oil & Gas Co. v. Barnhill*, 107 S.W.2d 746 (Tex. Civ. App. Amarillo 1937) (writ ref'd). In that case the lessee shut in a well capable of producing seven million cubic feet per day. However, the court noted that the lease "did not provide that it should remain in force and effect for five years, and as long thereafter as there may be prospects of a market for the product . . ." Id. at 749. Accord *Cox v. Miller*, 184 S.W.2d 323, 327-29 (Tex. Civ. App. Eastland 1944) (writ ref'd).

77. Principal support for the Oklahoma view is found in Montana, West Virginia, and Wyoming. See, e.g., *Fey v. A.A. Oil Corp.*, 129 Mont. 300, 321, 285 P.2d 578, 587-88 (1955); *Ohio Fuel Oil Co. v. Greenleaf*, 84 W. Va. 67, 76-77, 99 S.E. 274, 278 (1919); *Pryor Mountain Oil & Gas Co. v. Cross*, 31 Wyo. 9, 17, 222 P. 570, 573 (1924).

78. The Oklahoma view has been rejected by most producing states. See, e.g., *Tate v. Stanolind Oil & Gas Co.*, 172 Kan. 351, 240 P.2d 465 (1952). "[A]n habendum clause . . . requires actual production during the primary term as distinct from mere exploration or discovery." Id. at 354-55, 240 P.2d at 468. Accord *Landry v. Flaitz*, 245 La. 223, 232-22, 157 So. 2d 892, 895 (1963); *Jones Land Grant, Inc. v. Ringle Dev. Co.*, 56 N.M. 101, 106, 240 P.2d 850, 853 (1952).

79. See, e.g., *Landry*, 245 La. at 238, 152 So.2d at 895-97. In *Landry* the court declared the lease terminated "by its term[s]" for failure of the lessees to establish actual production in paying quantities before the final day of the primary term. Id. The lease may be kept alive, however, by meeting the requirements of other leasehold savings provisions or by having another producing well located on the leasehold premises.

80. See, e.g., *Craig v. Champlin Petroleum Co.*, 435 F.2d 933 (10th Cir. 1971); *Amoco Prod. Co. v. First Baptist Church*, 579 S.W.2d 280 (Tex. Civ. App. El Paso 1979), aff'd per curiam, 611 S.W.2d 610 (Tx. 1980).

81. See *Christian*, 506 P.2d at 1347. "After the mineral is discovered the lessee is required to use reasonable diligence . . . [in] marketing the product within a reasonable time. Failure to do so will result in termination of the lease under the habendum clause after the expiration of the primary term." Accord *Bristol*, 225 F.2d at 897.

because of the almost universal inclusion of shut-in gas royalty provisions in many widely used lease forms in all states,<sup>82</sup> the distinction may be illusory. An issue that remains to be resolved is whether the duty to market should differ depending on whether the alleged breach occurs while the lessor is receiving shut-in royalty payments.<sup>83</sup> A related issue concerns the impact that the potential remedy has on the duty to market. In Oklahoma-type jurisdictions, breach of the marketing covenant in the secondary term will cause a termination of the lease because the habendum clause has been violated.<sup>84</sup> In Texas-type jurisdictions, breaches may lead to termination but in certain circumstances can be limited to only a recovery of monetary damages.<sup>85</sup>

#### *Effect of Shut-In Royalty Provisions In the Lease*

The effect of shut-in royalty provisions on the implied covenant to market is an actual but as yet unanswered issue affecting the marketing covenant in the secondary term. Where a lessee completes a gas well capable of producing in paying quantities but is unable to achieve actual production because of the absence of a market, the lease may be preserved beyond the primary term by payment of shut-in royalties pursuant to an appropriate leasehold provision. Again, however, a distinction must be made between the states which interpret "production" to include the duty to market (the Texas view) and those which hold that commercial discovery is equivalent to production (the Oklahoma view).

In states following the Texas view, the timely payment of shut-in royalties serves an independent and distinct purpose—extension of the lease to the secondary term in the absence of actual production. Such a savings clause is necessary because, as was noted previously,<sup>86</sup> the fact

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82. The 1981 American Association Petroleum Landmen approved model lease forms for Arkansas, Colorado, Kansas, Oklahoma, and Texas all include shut-in gas royalty provisions.

83. No Oklahoma decision has terminated a lease for failure to market gas in the secondary term but *dictum* in *Stewart v. Amerada Hess Corp.*, 604 P.2d 854, 858 (Okla. 1979) supports the proposition that if the lessee breached his duty and could not raise other equitable considerations, a decree of cancellation would be proper. Failure to do so will result in termination of the lease under the habendum clause after the expiration of the primary term. Accord *Bristol*, 225 F.2d at 897.

84. Damages may be the sole remedy available if the lease does not have specific forfeiture provisions. *Cole Petroleum Co. v. United States Gas & Oil Co.*, 121 Tex. 59, 41 S.W.2d 414 (1931); *Guleke v. Humble Oil & Refining Co.*, 126 S.W.2d 38 (Tex. Civ. App. 1939).

85. See *Freeman v. Magnolia Petroleum Co.*, 141 Tex. 274, 278-79, 171 S.W.2d 339, 341-42; *Stanolind Oil & Gas Co. v. Barnhill*, 107 S.W.2d 746, 749 (Tex. Civ. App. Amarillo 1937) (writ ref'd).

86. See text accompanying *supra* notes 64 to 69.



that there is no available market does not excuse the failure to produce. In order to keep the lease alive in such a situation a savings clause is necessary. The shut-in royalty clause is such a provision.<sup>87</sup>

There is a paucity of cases dealing directly with the issue of the relationship between the shut-in royalty clauses and the implied covenant to market. There is clearly no case which stands for the proposition that the existence of such a shut-in clause would preclude the existence of an implied covenant to market during the secondary term of a lease.<sup>88</sup> This position is consistent with the view that the purpose of the shut-in clause is to act as a general savings provision which propels a lease into the secondary term where actual marketing of the gas is unachievable at the end of the primary term.<sup>89</sup> The interaction of the shut-in royalty clause and the implied covenant to market has created some confusion, a confusion which is exacerbated when the habendum clause issue is added to the mixture. A series of Louisiana cases, for example, reflect the court's inability to sort out the related but distinct problems of how the payment of shut-in royalties effects the lessee's obligation to market gas in either the primary or secondary term of the leasehold estate.

In *Risinger v. Arkansas-Louisiana Gas Co.*,<sup>90</sup> the Louisiana Supreme Court was faced with a lessor's argument that the lessee should be forced to forfeit the leasehold estate for shutting in a well capable of producing marketable quantities of gas. The lease had provided for the payment of shut-in royalties, and those payments had been tendered by the lessee but refused by the lessor. The primary term of the lease had not expired. Without clearly identifying that there was an implied covenant to market, the court discussed at some length the obligation of a lessee to market gas from wells which are shut-in and for which the lessee is already receiving shut-in gas royalties.<sup>91</sup> Unless a duty to find a market existed, notwithstanding an express obligation to keep the lease

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87. See *Reid*, 161 Tex. at 56, 337 S.W.2d at 271. "The provision in the lease for payment of 'shut-in' royalty is to provide for just that eventuality, namely, where gas has been discovered in paying quantities, but a market is lacking." States following the Texas view include: Kansas, *Elliott v. Crystal Springs Oil Co.*, 106 Kan. 248, 252, 187 P. 692, 694 (1920); Louisiana, *Davis v. Laster*, 242 La. 735, 746, 138 So. 2d 558, 562 (1962); and New Mexico, *Greer v. Salmon*, 82 N.M. 245, 250, 479 P.2d 294, 298-99 (1970). See generally 4 E. Kuntz, *supra* note 40, at 8-12 (discussing both Texas and Oklahoma views); 5 H. Williams & C. Meyers, *supra* note 13, at §§ 853-855.

88. See generally 5 H. Williams & C. Meyers, *supra* note 13, at § 858.1. But cf. *Gazin v. Pan American Petroleum Corp.*, 367 P.2d 1010 (Okla. 1961), discussed *infra* text accompanying notes 116-19.

89. 5 H. Williams & C. Meyers, *supra* note 13, at § 854.

90. 198 La. 101, 3 So. 2d 289 (1941).

91. *Id.* at 110-13, 3 So. 2d at 292-93. The facts showed that the well was shut-in because of a high salt water content which would have required additional processing prior to entry into a nearby pipeline. *Id.* at 106-08, 3 So. 2d at 191-92.

alive merely by the payment of \$200 per annum, the court's discussion was unnecessary. The court also concluded that the lessee must engage in reasonable efforts to actually market the gas and pay the agreed-upon royalty based upon the price or market value of the gas so marketed.<sup>92</sup> Although the court never clearly identified this duty as being based on an implied covenant to market which was not effected by the express covenant to pay shut-in royalties, that rationale is the one most often attributed to the holding in *Risinger*.<sup>93</sup>

After a twenty-year hiatus, the Louisiana Supreme Court was again confronted with an implied covenant to market allegation. Again, however, the court did not clearly identify it as a separate covenant. The court continued to submerge the marketing obligation into either the development or good faith operations covenants. In *Lelong v. Richardson*,<sup>94</sup> the lessor sought a decree of cancellation of a lease upon which the lessee had drilled two gas wells, both of which had been shut-in. The primary term of the lease had expired, but the lessee had tendered to the lessor the shut-in royalties which were provided for in the lease.<sup>95</sup> The court's opinion is somewhat perplexing because it merges the implied marketing and development covenants.<sup>96</sup> The decision clearly follows the *Risinger* rationale—that the payment of shut-in royalties does not extinguish the lessee's duty to continue to seek a market for the discovered natural gas. The fact that the lease was in the secondary term was not relevant to the marketing obligation because it was being kept alive by the shut-in payments.

However, the court then cites with approval the two Tenth Circuit cases which espouse the Oklahoma-type definition of a habendum clause,<sup>97</sup> even though Louisiana is generally thought of as a Texas-type jurisdiction requiring actual or constructive production at the end of the primary

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92. The lessee conceded that they could not pay the \$200 royalty indefinitely without making reasonable and diligent efforts to market the product. *Id.* at 110, 3 So. 2d at 292.

Unless the court perceived that there was a continuing duty to exercise diligent efforts notwithstanding the payment of the royalty due there was no need to discuss the efforts of the lessee to find a market. *Id.* at 106-12, 3 So. 2d at 291-93.

93. 5 H. Williams & C. Meyers, *supra* note 13, at 421. The court also noted that failing to make a proper payment would not terminate the lease, while also noting that failing to meet the duty to market would support at least a conditional cancellation or forfeiture of the lease. 198 La. at 105, 116, 3 So. 2d at 291, 294.

94. 126 So. 2d 819 (La. App. 2d Cir. 1961).

95. *Id.* at 821-22.

96. *Id.* at 829. The court at one point said the issue is whether or not the payment of shut-in royalties keeps the lease alive in the secondary term but then in the next paragraph returns to the issue of the lessee's duty to adequately develop the leasehold as being a determinative question that must be answered. *Id.* at 830.

97. *Christianson v. Champlin Refining Co.*, 169 F.2d 207 (10th Cir. 1948); *Bristol v. Colorado Oil & Gas Corp.*, 225 F.2d 894 (10th Cir. 1955).

term in order for the leasehold estate to continue into the secondary term.<sup>98</sup> Notwithstanding the unexplained adherence to the *Bristol* rationale, the court concluded, again by inference, that payment of shut-in royalties will not hold a lease forever, even though the terms of the lease might be so interpreted. As with the *Risinger* opinion, the court imposes on the lessee a duty to seek a market for the shut-in gas. In doing so, however, the court raises the spectre of a potential conflict between the habendum and covenant obligations by imposing some type of absolute time-limit before which the lease will be cancelled notwithstanding the payment of shut-in royalties.<sup>99</sup> Under a pure covenant analysis requiring the lessee to exercise due diligence, one could posit a set of circumstances where no market could exist for a lengthy period of time and the lessee would not have breached his obligations under a marketing covenant. But under the court's language in *Lelong*, the combination of habendum and shut-in royalty clauses might require actual marketing within a reasonable time after discovery even if marketing is actually impossible.<sup>100</sup>

Finally, in *Davis v. Laster*,<sup>101</sup> the Louisiana Supreme Court discussed the good faith efforts of the lessee to market the shut-in gas during the secondary term, notwithstanding the fact that the shut-in royalties had been paid to the lessor.<sup>102</sup> If the implied covenant to market did not continue to impose a duty upon the lessee after the payment of shut-in royalties, the court would not have needed to discuss, at some length, the actual attempts at marketing and development which the lessee had engaged in.<sup>103</sup>

Although one might expect a different treatment of the shut-in royalty clause problem in Oklahoma-type jurisdictions, such has not

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98. *Lelong*, 126 So. 2d at 826-29 (citing Moses, Problems in Connection with Shut-in Gas Royalty Provisions in Oil and Gas Leases, 23 Tul. L. Rev. 374 (1949)), for the proposition that discovery *and* marketing is required to propel a lease into the secondary term in the absence of a shut-in royalty clause. *Lelong*, 126 So. 2d at 826-27. See also, *Smith v. Sun Oil Co.*, 172 La. 655, 135 So. 15 (1931).

99. *Lelong*, 126 So. 2d at 828. The court also suggests that the length of time that is determined to be reasonable may depend upon the amount that is being paid to the lessor under the shut-in royalty clause. If the shut-in clause and the implied covenant to market are treated independently the amount paid is irrelevant to answering the question of whether the lessee had acted reasonably and diligently in his search for a market for the shut-in gas.

100. *Id.* at 828-29. See also Moses, Problems in Connection with Shut-In Gas Royalty Provisions in Oil and Gas Leases: Part II, 27 Tul. L. Rev. 478 (1953).

101. 242 La. 735, 138 So. 2d 558 (1962).

102. *Id.* at 754, 138 So.2d at 564. The court also more clearly adopted a Texas-type approach to the issue of applying the habendum clause, *Id.* at 757-58, 138 So. 2d at 565, throwing into some doubt the *Lelong* court's approval of the *Bristol* and *Christianson* holdings.

103. *Id.* at 739, 757, 138 So. 2d at 559-60, 565.

been the case. *Gard v. Kaiser*<sup>104</sup> is representative of the Oklahoma view of shut-in royalty payments. In that case the lessor brought an action for cancellation of the lease on the ground that the lessee failed to pay shut-in royalties after expiration of the primary term. Gas had previously been marketed from the lease but marketing had temporarily ceased.<sup>105</sup> The Oklahoma Supreme Court, after stating that in Oklahoma immediate marketing is not required to satisfy the habendum clause, noted that a shut-in royalty clause is not necessary to extend the lease beyond the primary term once a commercial well has been completed. Rather, the lease is extended with or without payment of shut-in royalties but is subject to forfeiture for breach of the marketing covenant.<sup>106</sup> Even in states following the Oklahoma view, however, leases which provide for payment of shut-in royalties can stipulate that payment will not hold the lease open beyond a specified date.<sup>107</sup>

The question still remains: What effect does the acceptance of shut-in royalty payments have on the implied covenant to market? In states following the Texas view, it would appear that the acceptance of shut-in royalty payments does not extinguish the duty to market. However, this issue has only been directly addressed by one court. In *Pray v. Premier Petroleum, Inc.*,<sup>108</sup> the Kansas Supreme Court stated that "the fact [that] the lease is held by payment of shut-in gas royalties does not excuse the lessee from his duty to diligently search for a market and to otherwise conduct himself as a reasonable and prudent lessee . . . ." <sup>109</sup> This position is supported by the commentators.<sup>110</sup>

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104. 582 P.2d 1311 (Okla. 1978).

105. *Id.* at 1312. Marketing had ceased for a period of three years for lack of adequate wellhead pressure. In the interim the lessee had applied for, and eventually received, a release of the gas sales contract from the Federal Power Commission. A new contract was negotiated and marketing was resumed after the addition of a compressor.

106. That is, the lessee must act with diligence in seeking a market. *Id.* at 1313 (citing 4 E. Kuntz, *supra* note 40, at 9).

107. For a lesson on how *not* to draft such a provision see *Flag Oil Corp. v. King Resources Co.*, 494 P.2d 322 (Okla. 1972). For a discussion of why shut-in clauses should still be inserted in leases executed in states following the Oklahoma view see Discussion Notes, 41 Oil & Gas Rep. 553 (1972). See also Moses, *supra* note 100 at 482 (noting the Louisiana practice of placing a five year limit on shut-in royalty payments).

108. 233 Kan. 351, 662 P.2d 255 (1983).

109. *Id.* at 354, 662 P.2d at 258. Kansas is a Texas view state. See *Elliott v. Crystal Springs Oil Co.*, 106 Kan. 248, 252, 187 P. 692, 694 (1920).

110. 5 H. Williams & C. Meyers, *supra* note 13, at § 858. Masterson has a similar view. "A complete answer to the argument that a shut-in clause is unfair to the lessor because it would allow the lessee to hold a lease forever without producing is that the lessee owes a duty to be diligent in searching for a market." Masterson, *The Shut-In Royalty Clause in an Oil and Gas Lease*, 4 Rocky Mtn. Min. L. Inst. 315, 330 (1958). Cf. *Risinger v. Arkansas-Louisiana Gas Co.*, 198 La. 101, 3 So. 2d 289 (1941); *Lelong v. Richardson*, 126 So. 2d 819 (La. App. 2d Cir. 1961) (supporting by implication the above stated commentators).

The Louisiana approach makes it even clearer that the duty to market continues into the secondary term along with the payment of shut-in gas royalties.<sup>111</sup> The approach taken, which includes in the reasonableness and diligence formula the amount and duration of the royalty payments, properly balances the interests of the lessor and the lessee.<sup>112</sup> It removes much of the incentive of the lessee to delay marketing for speculative purposes because the time limit will decrease or increase depending on the size of his out-of-pocket expenses. The one problem that remains unsolved is that delay in marketing the discovered gas may often inure to the lessor and lessee's benefit (as well as the public's) depending on the extant market for gas.<sup>113</sup>

Although the evidence is contradictory, it would appear that states following the Oklahoma view would also hold that the acceptance of shut-in payments does not effect the implied duty to market. In *Gard v. Kaiser*,<sup>114</sup> the Oklahoma Supreme Court, quoting Professor Kuntz, stated the Oklahoma rule. The court noted that "[t]he lease is extended with or without the shut-in gas royalty clause, *subject to forfeiture for failure to comply with the implied obligation to market the product.*"<sup>115</sup> This statement, however, contradicts an earlier decision by the same court. In *Gazin v. Pan American Petroleum Corp.*,<sup>116</sup> the court stated that "it is clear that the lessors may waive their right to demand production or marketing by accepting delay rentals during the primary term of the lease . . . ." <sup>117</sup> Thus, the three year period for which the lessors in *Gazin* accepted delay rentals were not considered in determining whether marketing had ceased for an unreasonable length of time.<sup>118</sup> As Williams and Meyers suggest, if acceptance of delay rentals circumvents

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111. See *supra* text accompanying notes 90-103.

112. But cf., Martin, *supra* note, 20 at 205-07, where the author suggests that public policy, if included in the implied covenant formula, might favor later rather than earlier marketing.

113. Martin, *supra* note 20.

114. 582 P.2d 1311 (Okla. 1978).

115. *Id.* at 1313 (citing 4 E. Kuntz, *supra* note 40, at 9) (emphasis added). The court later stated that "shut-in gas provisions are not to be construed as limitations or conditions which would affect termination of the leases." *Gard*, 582 P.2d at 1314-15.

116. 367 P.2d 1010 (Okla. 1961).

117. *Id.* at 1011-12. In *Gazin* the lessee, in October of 1956, completed a well capable of producing twenty million cubic feet of gas per day. A contract was offered in which the purchaser would pay ten cents per thousand cubic feet of gas "as and when needed." *Id.* at 1011. A more favorable contract, calling for fifteen cents per thousand cubic feet, with the purchaser obligated to "take or pay" for five percent of the established reserves, was entered into in April of 1960. In the interim, the lessee, at considerable expense, had acquired some surrounding acreage and built up reserves. *Id.* at 1012-13.

118. *Id.* at 1012.

enforcement of the implied covenant to market, perhaps the same could be said of acceptance of shut-in royalties.<sup>119</sup>

Because of the paucity of cases, the impact of shut-in royalty payments on the implied marketing covenant will continue to be a matter of academic debate and speculation.<sup>120</sup> The better view is that acceptance of shut-in royalty payments should not totally extinguish the lessee's duty to market. However, the authors suggest that there might be some good reasons for treating Texas and Oklahoma type jurisdictions differently. In Texas-type jurisdictions payment of shut-in royalties in the secondary term is mandatory if the lease is to be kept alive. The payment should be treated solely as a means of satisfying the *habendum* clause requirement. As noted earlier, however, the amount and duration of the payments should be included in determining the reasonableness of the lessee's actions in order to avoid delays prompted by market speculation.

In Oklahoma-type jurisdictions, however, payment of shut-in royalties is not needed to satisfy the *habendum* clause requirements which propel the lease into the secondary term. Therefore the lessee is paying the lessor a royalty which, unless tied to the marketing covenant, has no function. Thus, payment of such a royalty should be treated as an express covenant relating to the marketing of gas. However, the mere existence of a shut-in royalty provision should not *ipso facto* extinguish the implied covenant to market. It should at least place a heavier burden on the lessor to show that the lessee is failing to market the gas for

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119. 5 H. Williams & C. Meyers, *supra* note 13, at § 858.2 n.4.

120. See, e.g., 5 H. Williams & C. Meyers, *supra* note 13, at § 854; Martin, *supra* note 20; Weaver, *supra* note 11. Consider *Bristol v. Colorado Oil & Gas Corp.*, 225 F.2d 894 (10th Cir. 1955). In that case the lessee was unable to market the gas for over seven years beyond the end of the primary term. Bristol, one of several lessors, accepted shut-in payments until the year before a pipeline connection was made. However, unlike his co-lessors, Bristol had not signed a shut-in agreement. *Id.* at 895. Bristol brought suit for cancellation, alleging that the lessee had breached the implied marketing covenant. In denying the cancellation of the lease, the court stated:

[W]hile the acceptance of these payments without signing the shut-in agreements *may not* operate strictly as an estoppel or waiver of their rights to insist upon a breach, it is proper, we think, to consider it in the light of all of the other facts and circumstances in the determination of the ultimate question of prudent operation in the light of time and effort.

*Id.* at 898 (emphasis added). Did acceptance of the shut-in royalties "not operate strictly as an estoppel" because there was no executed agreement, or was the court making a general statement that acceptance of shut-in payments, even if pursuant to an executed agreement, can never preclude implication of the marketing covenant?

But see *supra* note 107. It is likely that many of the lease forms in Oklahoma will retain a shut-in royalty clause. For example, the three American Association of Petroleum Landmen oil and gas lease forms in use in 1981 all contained a shut-in gas royalty provision.

speculative purposes only. Absent conditions showing substantially unequal bargaining positions, fraud, or coercion, the payment of shut-in royalties in Oklahoma-type jurisdictions should give the lessee greater freedom to delay the marketing of the gas.

### *Presence of Express Lease Clauses*

As noted previously,<sup>121</sup> there is a noticeable absence of express provisions in oil and gas leases. However, as with other implied covenants, the parties to a lease may agree to certain express provisions which are inconsistent with, and thereby alter, the duty to market.<sup>122</sup> The strength of this principle was tested in *Gex v. Texas Co.*<sup>123</sup> In *Gex* the lessor alleged that the lessee sold the gas derived from the leased premises at well below the then existing market price. The lease in question contained a provision that the lessee "shall never be under obligation to drill or mine for oil or gas or other minerals, but that such mining or drilling, both before and after production, shall be wholly at the option of said grantee."<sup>124</sup> The court noted that because a duty to market is implied from the express duty to develop and produce, the parties had, "by eliminating any implied covenant or obligation to develop and produce, preclude[d] any implied covenant to market."<sup>125</sup>

A similar principle was enunciated by the tenth circuit in *Brimmer v. Union Oil Co. of California*,<sup>126</sup> wherein the court stated that "[a]n express covenant upon a given subject, deliberately entered into without fraud or mutual mistake, excludes the possibility of an implied covenant of a different or contradictory nature."<sup>127</sup> Therefore, it is clear that by executing an express agreement which addresses the lessee's duty to

121. See supra notes 13-24 and accompanying text.

122. For a general discussion of the effect express provisions have on the implied duty to market see 4 E. Kuntz, supra note 40, at 123-25; 5 H. Williams & C. Meyers, supra note 13, at §§ 857-858.3. The effect express lease clauses have on the implied covenants is dealt with by statute in Louisiana. See La. R.S. 31:122 (1975). "Parties may stipulate what shall constitute reasonably prudent conduct on part of the lessee." Id.

123. 337 S.W.2d 820 (Tex. Civ. App. Amarillo 1960) (writ ref'd n.r.e.).

124. Id. at 822. The court found that a subsequent amendment to the original lease was not controlling to the issue. Id.

125. Id. at 825-26. The *Gex* decision has been soundly criticized by the commentators. See, e.g., 5 H. Williams & C. Meyers, supra note 13, at § 858.3.

126. 81 F.2d 437 (10th Cir.), cert. denied, 298 U.S. 668 (1936).

127. *Brimmer*, 31 F.2d at 440. In *Brimmer* the parties agreed that the lessee would build a pipeline when production of five thousand barrels per day could be sold at a minimum price of one dollar per barrel. The plaintiff sued for breach of the marketing covenant, alleging that, although the full five thousand barrels could not be sold at one dollar or more each, the price was such that a profit could be made by the lessee. Id. at 440.

market, the parties may alter the standard of conduct by which the lessee is to be judged.<sup>128</sup>

#### THE APPLICABLE STANDARD OF CONDUCT

##### *Development of a Standard of Conduct*

Once it has been determined that an implied covenant applies to a given lease in a specified situation, the question arises as to what standard of conduct the lessee's actions are to be judged by. In order to establish a cause of action for breach of any implied covenant, the lessor must prove that the lessee has breached the applicable standard.<sup>129</sup> Over the years, courts have employed various standards of conduct to review lessee's conduct.<sup>130</sup>

Early courts accepted the view that a lessee who acted in good faith could not be guilty of breaching the implied covenants.<sup>131</sup> In *Young v. Forest Oil Co.*,<sup>132</sup> the Pennsylvania Supreme Court, in deciding whether to order the cancellation of a lease on which the lessee had expended substantial amounts of money, stated that a lessee is entitled to follow his "judgment." If that is exercised in good faith, a different opinion by the lessor, or the experts, or the court, or all combined, is of "no consequence" and will, therefore, not support the forfeiture of the lease.<sup>133</sup> Subsequent courts, however, began to move away from the good faith standard and gravitate towards a more objective test of the lessee's conduct. Courts which began this trend often seemed to apply both an objective and subjective standard;<sup>134</sup> however, the objective standard has

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128. As parties to oil and gas leases become more sophisticated more express clauses may be included so as to effect the implied covenant to market. Such clauses could deal with issues relating to federal or state regulatory matters, the acceptable price and terms in a gas purchase contract, processing plants, or pipeline construction. The large number of reported opinions dealing with the various implied covenants, however, probably illustrates the difficulty of adding express covenants to leases which have traditionally eschewed such detail. See *supra* note 12.

129. See *supra* note 39.

130. See generally 5 H. Williams & C. Meyers, *supra* note 13, at § 807 (discussing various standards of conduct).

131. See, e.g., *Kellar v. Craig*, 126 F. 630, 633 (4th Cir. 1903); *Young v. Forest Oil Co.*, 194 Pa. 243, 250, 45 A. 121, 122 (1899).

132. 194 Pa. 243, 45 A. 121 (1899).

133. *Id.* at 250, 45 A. at 122. Accord *Kellar*, 126 F. at 633. In *Kellar* the court stated that "the lessee or his assigns are permitted to determine the character of the work to be done, and such ascertainment . . . , in the absence of fraud, disposes of the question."

134. See, e.g., *Manhattan Oil Co. v. Carrell*, 164 Ind. 526, 532, 73 N.E. 1084, 1086 (1905) (requiring lessee to act "in good faith upon sound business principles"); *Grass v. Big Creek Dev. Co.*, 75 W. Va. 719, 725-26, 84 S.E. 750, 753-54 (1915) (seemingly proposing conflicting tests).



now become the one by which the lessees are judged. This standard was articulated in *Brewster v. Lanyon Zinc Co.*<sup>135</sup>

The object of the operations being to obtain a benefit or profit for both lessor and lessee, it seems obvious, in the absence of some stipulation to that effect, that neither is made the arbiter of the extent to which or the diligence with which the operator shall proceed, and both are bound by the standard of what is reasonable . . . . There can, therefore, be a breach of the covenant for exercise of reasonable diligence, though the lessee not be guilty of fraud or bad faith . . . . Whatever, in the circumstances, would be reasonably expected of operators of ordinary prudence is what is required.<sup>136</sup>

This standard is known as the reasonably prudent operator standard, and has been accepted by modern courts as "an essential part of every implied covenant."<sup>137</sup>

#### *Application of the Reasonably Prudent Operator Standard to the Implied Marketing Covenant*

Although courts often use language which implies the application of a good faith standard,<sup>138</sup> modern courts, in reviewing the lessee's marketing efforts, have generally applied the reasonably prudent operator standard.<sup>139</sup> Absent an express agreement altering the marketing duty,<sup>140</sup> neither the lessee nor the lessor determine the duties owed under the marketing covenant.<sup>141</sup> Instead, the decision turns on the facts, circumstances, and practical considerations presented in each case.<sup>142</sup> Therefore, the lessee in any given case is compared to a hypothetical reasonable person engaged in oil and gas operations. Under such an objective

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135. 140 F. 801 (8th Cir. 1905).

136. *Id.* at 814. The *Brewster* court expressly rejected the good faith test. *Id.* at 813.

137. *Amoco Prod. Co. v. Alexander*, 622 S.W.2d 563, 568 (Tex. 1981).

138. See, e.g., *Bristol v. Colorado Oil & Gas Corp.*, 225 F.2d 894 (10th Cir. 1955). "In determining whether the lease has been forfeited for breach of the covenant to market, equity 'will impose a rigid standard of good faith on part of the lessee', measured in each case not only by the lapse of time but the diligence of the operator as well." *Id.* at 897 (quoting *Phillips Petroleum v. Peterson*, 218 F.2d 926 (10th Cir. 1954)); *Waechter v. Amoco Prod. Co.* 217 Kan. 489, 510, 537 P.2d 228, 248 (1975).

139. See, e.g., *Sword v. Rains*, 575 F.2d 810, 813 (10th Cir. 1978); *Nordan-Lawton Oil & Gas Corp. of Texas v. Miller*, 276 F. Supp. 16, 18 (W.D. La. 1967); *Eggleston v. McCasland*, 98 F. Supp. 693, 695 (E.D. Okla. 1951).

140. See *supra* notes 121-128 and accompanying text.

141. *Brewster*, 140 F. at 814.

142. *Bristol v. Colorado Oil & Gas Corp.*, 225 F.2d 894, 897 (10th Cir. 1955). Accord *Spiller v. Massey & Moore*, 406 P.2d 467, 471-72 (Okla. 1965); *Clifton v. Koontz*, 160 Tex. 82, 89, 325 S.W.2d 684, 691 (1959).

standard, the lessee cannot justify his wrongful act or omission on the grounds that his course of action was reasonable based on circumstances peculiar to himself.<sup>143</sup> Rather, the lessee's marketing activities are compared to those that would have been carried on by a reasonably prudent operator under similar circumstances.<sup>144</sup> Where it is found that the lessee failed to meet this standard of conduct he will be liable for breach of the implied marketing covenant.<sup>145</sup>

#### THE VIABILITY OF THE REASONABLY PRUDENT OPERATOR STANDARD AS APPLIED TO THE IMPLIED MARKETING COVENANT

As the implied marketing covenant approaches its one hundredth year of existence, it has, according to some commentators, begun to show its age.<sup>146</sup> Accordingly, a debate has arisen as to the proper standard of conduct by which a lessee's marketing activities should be judged. Given the expected increase in the number of lawsuits seeking cancellation for breach of the implied marketing covenant,<sup>147</sup> this debate takes on added importance. This section will consider the current practice of using the reasonably prudent operator standard to judge a lessee's marketing activities.

#### *The Setting for the Debate*

A review of the litigation based on the implied marketing covenant reveals that the controversy generally arises in one of two situations. Historically, marketing covenant cases have arisen when the diligence of the lessee in obtaining a first purchaser has been questioned by the lessor. That is, whether the lessee has been timely in obtaining a market.<sup>148</sup> In such a situation the central issue to be decided, assuming damages

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143. Accord 2 W. Summers, *supra* note 23, at 589-92; 5 H. Williams & C. Meyers, *supra* note 13, at § 806.3.

144. *Bristol*, 225 F.2d 897; *Peoples Gas Co. v. Dean*, 193 F. 938, 942 (8th Cir. 1911); *Pray v. Premier Petroleum, Inc.*, 233 Kan. 351, 355, 662 P.2d 255, 258 (1983); *Carroll Gas & Oil Co. v. Skaggs*, 231 Ky. 284, 287, 21 S.W.2d 445, 447 (Ky. Ct. App. 1929); *Berthelote v. Loy Oil Co.*, 95 Mont. 434, 449, 28 P.2d 187, 191-92 (1933); *Masterson v. Amarillo Oil Co.*, 253 S.W. 908, 914 (Tex. Civ. App. Amarillo 1923) (writ *dism'd*); *Pryor Mountain Oil & Gas Co. v. Cross*, 31 Wyo. 9, 106, 222 P. 570 (1924).

145. For a discussion of the remedies available for breach of the marketing covenant see *infra* text accompanying notes 214-32. See also 4 E. Kuntz, *supra* note 40, at 128-34; 5 H. Williams & C. Meyers, *supra* note 13, at § 857.

146. See, e.g., *Martin*, *supra* note 20, at 190-93, 188-205; 5 H. Williams & C. Meyers, *supra* note 13, at § 856.3. But see *Weaver*, *supra* note 11, at 1515-19 (rebutting the arguments made by the above cited authors).

147. See *supra* notes 4-9 and accompanying text.

148. See, e.g., *Bristol v. Colorado Oil & Gas Corp.*, 225 F.2d 894, 897 (10th Cir. 1955); *Christianson v. Champlin Ref. Co.*, 169 F.2d 207, 209 (10th Cir. 1948); *McVicker v. Horn, Robinson & Nathan*, 322 P.2d 410, 413 (Okla. 1958).

and an available market, is whether the lessee has breached the applicable standard of conduct.<sup>149</sup>

The second setting under which marketing covenant cases may arise is when the lessor is unsatisfied with the lessee's choice of available markets.<sup>150</sup> In such a factual setting the initial question may be whether the lessee has secured the best price available.<sup>151</sup> An answer to this query does not, however, resolve the issue of whether or not the marketing covenant has been breached.<sup>152</sup> Again, the central issue in this situation is the lessee's compliance with the applicable standard of conduct.

*Judicial Response: The Need for Conceptual Clarity*

Several recent cases illustrate the difficult time the courts have had trying to enunciate clear and concise principles in applying the prudent operator standard to the marketing covenant situation. In *Young v. Dixie Oil Co.*,<sup>153</sup> a lessor sought to void two leases based on the lessee's

149. "[T]he component duty to market must be tempered by the rule of reason and prudence." *Bristol*, 225 F.2d at 897. For a discussion of the elements in a cause of action for breach of the marketing covenant, see *supra* notes 39-59 and accompanying text.

150. See, e.g., *Gazin v. Pan American Petroleum Corp.*, 367 P.2d 1010, 1012-13 (Okla. 1961); *Young v. West Edmond Hunton Lime Unit*, 275 P.2d 304, 310 (Okla. 1954); *Amoco Prod. Co. v. First Baptist Church*, 579 S.W.2d 280, 284-88 (Tex. Civ. App. El Paso 1979), writ ref'd n.r.e. per curiam, 611 S.W.2d 610 (Tex. 1980).

151. It is well established that a lessee has a duty to secure the highest price obtainable for gas being marketed. *Craig v. Champlin Ref. Co.*, 435 F.2d 933, 939 (10th Cir. 1971); *Greenshields v. Warren Petroleum Corp.*, 248 F.2d 61, 69 (10th Cir.), cert. denied, 355 U.S. 907 (1957); *Piney Woods Country Life School v. Shell Oil Co.*, 539 F. Supp. 957, 975 (S.D. Miss. 1982) aff'd in part and rev'd in part on other grounds, 726 F.2d 225 (5th Cir. 1984); *Harding v. Cameron*, 220 F. Supp. 466, 470 (W.D. Okla. 1963); *Waechter v. Amoco Prod. Co.*, 217 Kan. 489, 533, 537 P.2d 228, 264 (1975) (Schroeder, J., dissenting); *Johnson v. Jernigan*, 475 P.2d 396, 399 (Okla. 1970); *Amoco Prod. Co. v. First Baptist Church*, 579 S.W.2d 280, 285 (Tex. Civ. App. El Paso 1979), writ ref'd n.r.e. per curiam, 611 S.W. 2d 610 (Tex. 1980); *Martin*, *supra* note 20, at 191, n.52; *M. Merrill*, *supra* note 13, at 213; *Siefkin*, *supra* note 23, at 182.

152. This principle was emphasized by the Texas Supreme Court in *Amoco*, 611 S.W.2d at 610. The court stated that, while it found no reversible error in the lower court's finding that the lessee had breached the duty to market by selling gas at "substantially lower than market value",

[t]his holding should *not* be interpreted as implying an absolute duty to sell gas at market value under a "proceeds" royalty clause . . . . Although, in a proper factual setting, failure to sell at market value may be relevant evidence of a breach of the covenant to market in good faith, it is merely probative and is not conclusive.

*Id.*

The fact that the lessee has obtained less than the best price, even absent a finding of breach of the implied marketing covenant does, however, give the lessor a cause of action for recovery of the price differential. *Craig v. Champlin Petroleum Co.*, 300 F. Supp. 119, 125 (W.D. Okla. 1969), rev'd on other grounds, 435 F.2d 933 (10th Cir. 1971).

153. 647 S.W.2d 235 (Tenn. Ct. App. 1982).

failure to market gas, notwithstanding the lessee's payment of the applicable shut-in royalty.<sup>154</sup> While clearly accepting the principle that an implied covenant to market exists, the court never stated the applicable standard of conduct that governs the lessee's actions.<sup>155</sup> The only announced standard of conduct in *Young* to judge the lessee's activities was the command to "act diligently."<sup>156</sup> The court also pointed out that the marketing covenant requires a continuing effort on behalf of the operator to market the gas. In this case the court concluded that the lessee's activities, notwithstanding the lack of marketing up to the time of trial, had been sufficient to meet the "diligence" standard. However, the court hinted that future delays may not be tolerated because a third well had been drilled. The court specifically noted that future delays in marketing might justify a later court finding that a breach had occurred.<sup>157</sup>

The confusion engendered by the imposition of the marketing covenant on the lessee is typified by the recent case of *Amoco Production Co. v. First Baptist Church*.<sup>158</sup> The facts illustrate the trend involving marketing covenant cases which "second guess" a lessee's decision to enter into a new or amended gas purchase contract which the lessor believes is not the best deal available.<sup>159</sup>

In *Amoco Production*, the dispute concerned a lessee's decision to dedicate the lessor's gas wells under a particular long term gas purchase contract which did not contain a price redetermination clause. Other wells in the same field were covered by different contracts with other

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154. *Id.* at 236. The court mistakenly called the shut-in royalty payment a "rental," possibly because the amount paid was based on the delay rental figures. Both leases were beyond the primary term.

155. *Id.* at 237. Professor Martin has noted that many of the marketing covenant cases do not explicitly embrace the "prudent operator" standard taking into account the interests of both the lessor and lessee. Martin, *supra* note 20, at 191.

156. 647 S.W.2d at 237. The court did use a "due diligence" standard, citing *Waddle v. Lucky Strike Oil Co., Inc.*, 551 S.W.2d 323 (Tenn. 1977). The evidence was apparently in conflict, but the court concluded that insufficient capacity of the individual wells in conjunction with the lack of a nearby pipeline proved that the operator was acting diligently.

157. *Young*, 647 S.W.2d at 237-38. The court suggests that with three shut-in wells sufficient quantities of gas were present to justify the expense of constructing the needed pipeline.

158. 579 S.W.2d 280 (Tex. Civ. App. El Paso 1979), writ *ref'd n.r.e. per curiam*, 611 S.W.2d 610 (Tex. 1980).

159. See, e.g., *Barby v. Cabot Corp.*, 550 F. Supp. 188 (W.D. Okla. 1981); *Piney Woods Country Life School v. Shell Oil Co.*, 539 F. Supp. 957 (S.D. Miss. 1982), *aff'd in part and rev'd in part on other grounds*, 726 F.2d 225 (5th Cir. 1984); *Greenshields v. Warren Petroleum Corp.*, 248 F.2d 61 (10th Cir.), *cert denied*, 355 U.S. 907 (1957).

purchasers which allowed for significantly higher prices in later years.<sup>160</sup> The court had no difficulty concluding that the implied covenant to market imposed some duty on the lessee to reasonably renegotiate the expired gas purchase contract. However, translating that duty into an articulated standard of care presented a more formidable task.<sup>161</sup>

The court began its analysis by embracing a "good faith" standard applicable to the lessee's conduct in marketing the gas and a "really good faith" standard for situations in which the interests of the lessor and lessee diverge.<sup>162</sup> The court also included the traditional "prudent operator" standard, taking into account the interests of both the lessor and lessee.<sup>163</sup> Added to the melange is the concept of due or reasonable diligence which is defined as seeking the "highest price obtainable."<sup>164</sup>

All of these standards require different kinds of proof. A lessee who honestly but mistakenly or negligently thinks he has secured the best price obtainable would meet the good faith standard but would probably not meet the prudent operator or due diligence standard. The good faith standard in the absence of self-dealing would seemingly require proof of the lessee's subjective state of mind. In *Amoco Production*, the court measured the lessee's conduct by the existence of comparable sales made contemporaneously by the lessee and other operators in the relevant field. Which of the standards should apply in the marketing covenant situation is not made clear.<sup>165</sup> However, in an unusual per curiam refusal of the writ, the Texas Supreme Court seemingly embraced the good faith standard but added a caveat that no absolute duty to

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160. *Amoco*, 579 S.W.2d at 282-83. At the end of the period in question Amoco was receiving up to \$1.95/MCF from some of its gas purchases in the same field while plaintiff's gas was being sold at only \$.72/MCF. Prior to the 1975 contract gas from the lessor's well was sold to four different purchasers. After the 1975 contract all of the gas was sold to one purchaser at the reduced price.

161. *Amoco* 579 S.W.2d at 284-85. The court mysteriously discusses at great length the standard of care that governs the lessee's exercise of the pooling power, notwithstanding the fact that the plaintiffs did not challenge the creation of the pooled unit in this case. Even there, however, the court described the pooling power as being governed by the "utmost good faith standard," the "fairness" standard, and the "good faith" standard, taking into account the lessor's and lessee's intent standard. The only rule that is clearly made by the court is that the lessee is not held to a "fiduciary" standard. *Amoco*, 579 S.W.2d at 284-85 (citing *Pritchett v. Forest Oil Corp.*, 535 S.W.2d 708 (Tex. Civ. App. El Paso 1976)) (writ ref'd n.r.e.); 4 E, Kuntz, *supra* note 40, at 219.

162. The court says: "We conclude there is an implied covenant to exercise good faith in the marketing of gas, and particularly so where the interests of the lessor and lessee are not identical." *Id.* at 285. See also Martin, *supra* note 20, at 191.

163. *Amoco*, 579 S.W.2d at 285 (citing 2 Summers, *supra* note 23, at 641).

164. *Amoco*, 579 S.W.2d at 285 (citing M. Merrill, *supra* note 13, at 212-14).

165. *Amoco*, 579 S.W.2d at 287-88.

sell at market value will always exist, especially if the lease contains a "proceeds" rather than a "market value" royalty clause.<sup>166</sup>

While several state court decisions have had difficulty choosing the appropriate standard to apply, two recent federal decisions applying Oklahoma<sup>167</sup> and Mississippi<sup>168</sup> law clearly laid out the applicable rule. In *Barby v. Cabot Corp.*,<sup>169</sup> the court held that the lessee is under a duty "to obtain the best price and terms available."<sup>170</sup> The burden of proof was placed on the lessor to show that the lessee violated the duty,<sup>171</sup> and the court applied a due diligence or prudent operator standard. In this case a twenty-two month delay in negotiating an expired gas purchase contract was held to violate the prudent operator standard.<sup>172</sup>

In *Piney Woods Country Life School v. Shell Oil Co.*,<sup>173</sup> the court utilized the prudent operator or due diligence standard in assessing the actions of the lessee to initially market the newly-discovered gas. The court clearly set out the elements of the prudent operator standard, including the due care and diligence duty which must be exercised with

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166. *Amoco Prod. Co. v. First Baptist Church*, 611 S.W.2d 610 (Tex. 1980). Both the *per curiam* Supreme Court opinion and the Court of Civil Appeals decision leave open a very difficult issue, namely, the effect of the nature of the royalty clause on the implied covenant to market. Amoco argued that because "proceeds" royalties were to be paid, they were under no duty to sell at the best price available, 579 S.W.2d at 286-87. This argument was rejected by the Court of Civil Appeals but revived by the *per curiam* opinion of the Supreme Court. 611 S.W.2d at 610. See also, *Phillips Petroleum Co. v. Johnson*, 155 F.2d 185 (5th Cir. 1946). The duty to receive the highest price obtainable should clearly attach to a "proceeds" royalty because in the "market value" royalty situation the lessor is entitled to receive royalty on the market value regardless of the price for which the lessee sells the gas. Therefore the lessor would not suffer any loss by an undervalued sale. See generally, Harrell, *Recent Developments in Nonregulatory Oil and Gas Law, Inst. Oil & Gas L. & Tax'n* 327 (1980). Professor Harrell notes the inconsistency or incapability of the implied covenant to market and a market value royalty clause as it is applied in *Texas Oil & Gas Corp. v. Vela*, 429 S.W.2d 866 (Tex. 1968). Harrell, *supra* at 328-30.

167. *Barby v. Cabot Corp.*, 550 F. Supp. 188 (W.D. Okla. 1981).

168. *Piney Woods Country Life School v. Shell Oil Co.*, 539 F. Supp. 957 (S.D. Miss. 1982), *aff'd in part and rev'd in part on other grounds*, 726 F.2d 225 (5th Cir. 1984).

169. 550 F. Supp. 188 (W.D. Okla. 1981).

170. *Id.* at 190 (citing *Tara Petroleum Corp. v. Hughey*, 630 P.2d 1269 (Okla. 1981)).

171. *Id.* The court's job was made easier in that in an earlier unpublished opinion the court had held that the lessee had been dilatory in renegotiating the same gas purchase contract. The delay in renegotiating the new gas purchase contract was some twenty-two months after the expiration of the old contract.

172. *Id.* This is to be compared with the nine-year delay in the initial marketing of the gas that was held to be acceptable in *Bristol v. Colorado Oil & Gas Corp.* 225 F.2d 894 (10th Cir. 1955).

173. 539 F.Supp. 957 (S.D. Miss. 1982).

“due regard to the interests of both lessor and lessee.”<sup>174</sup> After taking a “hard look” at the facts and circumstances surrounding the negotiations and signing of the gas purchase contract, the court concluded that the lessee had acted as a prudent operator in obtaining the best prices and terms available.<sup>175</sup> Unlike the lessee in *Amoco Production*, the lessee here had bargained for the best terms and price available at the time of the contract. Thus, *Piney Woods* represents adherence to the prudent operator standard, but with a close examination of the lessee’s actions.

### *The Problem of Self-Dealing: Red Flags for the Court*

As with the implied covenant to prevent drainage, the problem of self-dealing with marketing seemingly alerts a court to a heightened sense of review regardless of the court’s stated standard of conduct.<sup>176</sup> In *Texas Oil & Gas Corp. v. Hagen*,<sup>177</sup> the court was influenced by what it deemed to be self-dealing between the lessee and a wholly owned subsidiary who purchased the gas for resale to third parties.<sup>178</sup> While the court reiterated the *First Baptist Church* standard of conduct, “highest good faith” or “best of good faith,”<sup>179</sup> the fact that there was self-dealing presents a prima facie case of violating the standard.<sup>180</sup> The

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174. 539 F. Supp. at 973-74. For other cases embracing the prudent operator standard see, *Craig v. Champlin Petroleum Co.* 300 F. Supp. 119 (W.D. Okla. 1969), aff’d, 421 F.2d 236 (10th Cir. 1970); *Nordan-Lawton Oil & Gas Corp. of Texas v. Miller*, 272 F. Supp. 125 (W.D. La. 1967); *Harding v. Cameron*, 220 F. Supp. 466 (W.D. Okla. 1963); *Southwest Gas Prod. Co. v. Seale*, 191 So. 2d 115, 119-20 (Miss. 1966).

175. *Piney Woods*, 539 F. Supp. at 74-5. The court distinguished both *Amoco Prod. Co. v. First Baptist Church*, 579 S.W.2d 280, and *Craig v. Champlin Petroleum Co.*, 300 F. Supp. 119 (W.D. Okla. 1969), concluding that in both of those cases the lessees had not exercised due diligence in securing the highest price obtainable.

176. See 5 H. Williams & C. Meyers, supra note 13, at § 824.

177. 683 S.W.2d 24 (Tex. App. Texarkana 1984).

178. *Id.* at 27-28. *Texas Oil and Gas (TXO)* as lessee sold the gas to *Delhi Pipeline*, a wholly-owned subsidiary, who then processed it and sold it to third parties at prices which exceeded by \$.15/MCF the price contained in the sale from TXO to Delhi. A division order was signed by the lessors agreeing to be bound by the Delhi-TXO contract. The lease provided for market value royalties for gas sold or used off of the premises. *Id.* at 27 n.1.

179. *Id.* at 29. The court also cited *Le Cuno Oil Co. v. Smith*, 306 S.W.2d 190 (Tex. Civ. App. Texarkana 1957), writ ref’d n.r.e., cert. denied, 356 U.S. 974 (1958), and *Greenshields v. Warren Petroleum Corp.*, 248 F.2d 61 (10th Cir.), cert. denied, 355 U.S. 907 (1957) as grounds for this highest good faith standard. The court infers that a trust or confidential relationship is created which might lead to fiduciary obligations, as was suggested by the Texas Supreme Court in *Manges v. Guerra*, 673 S.W.2d 180 (Tex. 1984) (as it applies to the exercise of the pooling power).

180. 683 S.W.2d at 29. The court also noted the failure of TXO to disclose to the lessor its relationship with Delhi and the resale contracts as the basis for finding fraudulent

court did not lessen the burden on the plaintiff, nor did it shift the burden of proof once the self-dealing has been shown, but the presence of the "sham" sale to the subsidiary clearly effected the court's decision to find a breach of the implied marketing covenant.<sup>181</sup>

### *The Commentators' Review: Three Discordant Analyses*

In the recent past, commentators have suggested three standards by which the lessee's marketing activities should be judged.<sup>182</sup> A review of these three analyses will serve as a basis for the standard proposed by the authors.

#### *Professor Martin's View: The Good Faith Standard*

Professor Martin has forcefully argued that, in reviewing the lessee's marketing activities, courts should return to a good faith standard.<sup>183</sup> Martin contends that the prudent operator standard should be modified in recognition of the fact that "the corporate lessee today has responsibilities in national energy development and environmental protection that often require it to consider the long term consequences of its actions without regard to short-term profit . . . ."<sup>184</sup> As he correctly notes, the lessee's duty to obtain the highest price may force gas into the intrastate market notwithstanding the existence of a greater interstate use.<sup>185</sup> Similarly, he contends that by promoting production and not conservation, the implied covenant to market has thwarted the proper functioning of market mechanisms and thus has ill-served the nation.<sup>186</sup> Professor Martin suggests that the lessee should be held to the same standard of conduct

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misrepresentations. This was critical because the jury awarded punitive damages which can only be recovered if a tort is proven, not merely for breach of an implied covenant. The court talks about the lessee being in a confidential relationship with the lessor and states that full disclosure is required to avoid a finding of bad faith or overreaching. Whether full disclosure is required in cases only where there is self-dealing or in all cases is not discussed by the court.

181. *Id.* at 28. The court found that TXO had not made any affirmative misrepresentations of fact in the division order but the court nonetheless found a breach of contract because of the nature of the "sham" transaction. The court looked askance at a sale which was designed to make the proceeds standard, rather than the market value standard, apply to the royalties on gas, when third parties were apparently ready and willing to purchase the gas off of the premises for a price higher than that designated in the self-dealing contract between Delhi and TXO.

182. Martin, *supra* note 20, at 190-93, 198-205; Weaver, *supra* note 11, at 1515-20; 5 H. Williams & C. Meyers, *supra* note 13, at § 856.3.

183. Martin, *supra* note 20, at 198-205.

184. *Id.* at 177.

185. Martin, *supra* note 20, at 192-3.

186. *Id.* at 203-04.



by which corporate officers and directors are generally held.<sup>187</sup> Thus, he concludes:

It is my proposal that the prudent operator standard be modified to give due regard to the fact that the lessee must often act upon its perceptions of its duties under express and implied governmental policies and public opinion . . . . [T]he proper test is whether the lessee has acted in good faith and had a reasonable basis for its judgment. This is the truer test of the prudent operator.<sup>188</sup>

*Williams' and Meyers' View: The Fluctuating Standard*

Although the bases for their opinion is somewhat different, Williams and Meyers propose that the lessee be judged by a standard of conduct which "approaches a good faith test."<sup>189</sup> Unlike Martin, however, they propose a fluctuating standard. Where the interests of the lessor and lessee are aligned, Williams and Meyers propose that "[t]he greatest possible leeway should be indulged the lessee in his decision about marketing gas . . . ."<sup>190</sup> Where the lessor's and lessee's interests are not aligned, the authors suggest that closer supervision of the lessee's business judgment is necessary.<sup>191</sup> Williams and Meyers suggest a dual standard because of the potential harm which may be caused by excessive judicial supervision. They assume that, in the typical marketing covenant case, the interests of the lessee and lessor are aligned. The authors fear that scrutiny of lessees' actions by judges or juries, in view of after acquired knowledge, will encourage operators "to take the least hazardous and perhaps least profitable course of action."<sup>192</sup>

*Professor Weaver's View: The Reasonable Prudent Operator Standard*

Unlike the views of the commentators discussed in the two preceding sections, Professor Weaver advocates future adherence to the reasonable prudent operator standard.<sup>193</sup> Weaver acknowledges that federal pricing regulations along with the costly filing requirements of the NGPA<sup>194</sup>

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187. *Id.* at 204.

188. *Id.* at 205.

189. 5 H. Williams & C. Meyers, *supra* note 13, at 412.

190. *Id.* at 411.

191. *Id.* For examples of instances where the interests of the lessor and lessee are not aligned, see *supra* note 24.

192. 5 H. Williams & C. Meyers, *supra* note 13, at § 856.3.

193. Weaver, *supra* note 11, at 1510-19.

194. See *supra* note 3.

complicate the duty to market and may result in increased litigation of that covenant,<sup>195</sup> however, she sees no need to change the current standard. Rather, she favors a reasonable prudent operator standard which, when properly applied, allows the lessee to exercise his business judgment when choosing among reasonable alternatives.<sup>196</sup> Professor Weaver sees little basis for the fear that courts will, in judging the lessee's marketing activities, fail to consider the present state of the natural gas industry.<sup>197</sup> She concludes that "[a] good faith subjective standard . . . invites the needless opportunity to abuse the rational basis of the doctrine of implied covenants by allowing lessors' royalties to be determined by apparently sincere, but nonetheless negligent, efforts of lessees."<sup>198</sup>

#### *A Fluctuating Standard: The Better View*

Our civilization is still in a middle state, scarcely beast, in that it is no longer wholly guided by instinct; scarcely human in that it is not yet wholly guided by reason.

Theodore Driesser

While each of the commentators whose views were discussed in the preceding sections propose various standards, it is apparent that at least two see a need for courts to closely consider the facts and circumstances surrounding a lessee's marketing decision before finding a breach of the applicable standard of conduct.<sup>199</sup> The recent fluctuations in supply and demand for natural gas, along with the complex pricing system integrated into the NGPA, make this need even more acute. Recognizing this need, courts have rightfully begun to consider the above factors when rendering decisions.<sup>200</sup> The recognition of these factors is merely a nuance which reflects an awareness of changing market conditions and public policy. As Justice Holmes noted:

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195. Professor Weaver states that "the implied covenant to market . . . may well experience a revival because of the importance and difficulty of correctly pricing oil and gas under the federal regulations." Weaver, *supra* note 11, at 1510.

196. *Id.* at 1516.

197. *Id.* at 1515-16.

198. *Id.* at 1517.

199. See, e.g., *Piney Woods Country Life School v. Shell Oil Co.*, 539 F. Supp. 957 (S.D. Miss. 1982), *aff'd in part and rev'd in part on other grounds*, 726 F.2d 225 (5th Cir. 1984).

200. See, e.g., *Sword v. Rains*, 575 F.2d 810, 814 (10th Cir. 1978) (court noted "chaotic and uncertain market conditions" resulting from court case which cast cloud over applicable provision of NGPA); *Superior Oil Co. v. Devon Corp.*, 604 F.2d 1063, 1069 (8th Cir. 1979) (court noted need to encourage domestic development through application of covenant to further develop). Neither of these cases was a marketing covenant case. See also, *Weymouth v. Colorado Interstate Gas Co.*, 367 F.2d 84 (5th Cir. 1966).

Every important principle which is developed in litigation is in fact and at bottom the result of more or less definitely understood views of public policy . . . the unconscious result of instinctive preferences and inarticulate convictions, but none the less traceable to views of public policy in the last analysis. And as the law is administered by able and experienced men . . . it will be found that, when ancient rules maintain themselves . . . new reasons more fitted to the time have been found for them, and that they gradually receive a new content, and at last a new form, from the grounds to which they have been transplanted.<sup>201</sup>

It is in this light that a subtle alteration of the lessee's marketing duty is proposed. Even though a court can take a "hard look" at the facts, it can still give deference to the ultimate marketing decision. In determining whether the lessee has performed as a reasonably prudent operator, taking into account the interests of both the lessor and lessee, the court can and should give due deference to the lessee's business judgment to market the gas.<sup>202</sup> Each of the standards proposed in the preceding sections recognizes the need to give deference to the lessee's judgment. In fact, the variable in each proposed standard is the degree of deference which should be given. In the authors' opinion the standard proposed by Professors Williams and Meyers grants the lessee the correct amount of deference.

The standard proposed by Professor Martin, on the other hand, allows the lessee an excessive amount of deference. It is illogical to allow the lessee to escape liability on a claim alleging breach of the implied marketing covenant merely by asserting that his error, though significant, was made in good faith. To allow such a standard of review places an unreasonable burden upon the lessor to rebut the lessee's state of mind in all but those cases where the lessee has acted with gross ignorance or a grievous mistake in judgment.<sup>203</sup> This is not to say that Professor Martin's suggestions are without merit. Indeed, as suggested previously, some degree of subjectiveness should necessarily be present to prevent courts from arbitrarily interfering with the business judgment of the lessee.<sup>204</sup> This is certainly the case in the law of corporations, where it has been stated that "[i]t is too well settled to admit of

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201. O. Holmes, *The Common Law* 32 (1963).

202. Cf. *Amoco Prod. Co. v. Ware*, 269 Ark. 313, 319, 602 S.W.2d 620, 623 (1980). This proposed alteration closely tracks the language in *Ware*. That case, however, was not a marketing covenant case.

203. Cf. 17 Am. Jur.2d *Contracts* § 371 (1964) (obligee not liable for error due to honest mistake in judgment absent gross ignorance).

204. Martin, *supra* note 20, at 201-02.

controversy that ordinarily neither the directors nor the other officers of a corporation are liable for mere mistakes or errors of judgment, either of law or fact."<sup>205</sup> That is, directors should be allowed to take chances so long as there is no evidence of self dealing, overreaching, fraud, or bad faith.<sup>206</sup>

The same could be said of an operator/lessee. In the normal situation the interests of the lessor and lessee are aligned. Both parties share an interest in securing a contract as soon as possible on the best available terms. To allow the trier of fact to second guess the business judgment of the lessee in such a situation serves only one purpose: it promotes conservatism.<sup>207</sup>

For these reasons the fluctuating standard proposed by Williams and Meyers appears to be the most viable standard of conduct by which to review a lessee's marketing activity. Where the interests of the lessor and lessee are aligned, the country is ill-served by courts or juries who, in light of knowledge acquired after the lessee's decision, second guess the business judgment of the lessee. This is especially true in light of the complex federal regulatory scheme and the instability of the market. This does not mean, however, that the lessor should be left with the burden of proving bad faith. Rather, the lessee should have the burden of establishing that his actions were taken in good faith.<sup>208</sup> Assuming a *prima facie* case of good faith is shown, the burden should shift to the lessor to rebut the proof set forth.

Where the interests of the lessee and lessor are not aligned, the application of the higher standard of conduct is justified. This principle is well established in the law of corporations. In *Lewis v. S.L. & E., Inc.*,<sup>209</sup> the court noted that "the business judgment rule presupposes that the directors have no conflict of interest. When a shareholder attacks a transaction in which the directors have an interest other than as directors of the corporation, the directors may not escape review of the merits of the transaction."<sup>210</sup> This principle is also well established in

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205. 3A W. Fletcher, *Cyclopedia of the Law of Private Corporations* § 1039 (perm. ed. 1975); H. Henn & J. Alexander, *Laws of Corporations* § 242 (1983).

206. See, e.g., *Panter v. Marshall Field & Co.*, 646 F.2d 271, 296 (7th Cir.), cert. denied, 454 U.S. 1092 (1981); *Galef v. Alexander*, 615 F.2d 51, 57 (2d Cir. 1980); *Lewis v. Anderson*, 615 F.2d 778, 781-83 (9th Cir. 1979), cert. denied, 449 U.S. 869 (1980); *Maher v. Zapata Corp.*, 490 F. Supp. 348, 351-54 (S.D. Tex. 1980) (each adopting business judgment rule).

207. 5 H. Williams & C. Meyers, *supra* note 13, at § 856.3.

208. Accord *Martin*, *supra* note 20, at 202. "Once the lessee has established that [he] . . . is acting in good faith (i.e., not in the deliberate disregard of the lessor's interest) and that there is a reasonable basis for [his] . . . belief," the lessee's interest should not be subordinated to those of the lessor.

209. 629 F.2d 764 (2d Cir. 1980).

210. *Id.* at 769. Accord *Treadway Co. v. Care Corp.*, 638 F.2d 357, 382 (2d Cir. 1980).

oil and gas law<sup>211</sup> and could easily be engrafted onto the standard of conduct used to judge a lessee's marketing activities. In addition to a sliding scale of deference, the authors believe that a sliding scale standard of proof should be applied in marketing covenant cases. The function of having a higher standard is to allocate the risks of an erroneous judgment between the litigants.<sup>212</sup> Where litigation is especially fact-focused, the standard of proof "instructs the fact finder concerning the degree of confidence our society thinks he should have in the correctness of factual conclusions for a particular type of adjudication."<sup>213</sup> In cases where there is no conflict of interest between the lessor and lessee, the lessor should have to prove by "clear and convincing evidence" that the lessee has breached the prudent operator standard. However, where the interests of the lessor and lessee diverge the standard should be lowered to the normal civil standard of the "preponderance of the evidence." In cases where it is clear that there is lessee self-dealing, as with the so-called "fraudulent drainage" cases, the authors suggest that after the lessor has shown a prima facie case of self-dealing, the burden should shift to the lessee to show by a preponderance of the evidence that he has met the prudent operator standard.

The combination of substantial deference and the clear and convincing standard of proof should eliminate frivolous litigation brought by disgruntled lessors who, with the benefit of hindsight, are second-guessing a marketing decision made by a lessee. But it will encourage litigation where evidence of self-dealing or conflicts of interests are provable. This strikes a proper balance of the competing values that are a necessary consequence of the implied covenant to market.

Thus, it would be stated that when a lessor attacks a transaction in which the lessee has an interest other than that as operator of the leasehold, the lessee may not escape review of the facts, circumstances, and practical exigencies of the transaction. Such a standard would retain the reasonably prudent operator test which generally places the initial burden of proof on the lessor.

#### REMEDIES

The two most prevalent remedies available to a lessor upon a showing of a breach of the marketing covenant are damages and cancellation.<sup>214</sup>

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211. See, e.g., *Craig v. Champlin Petroleum Co.*, 300 F. Supp. 119, 125 (W.D. Okla. 1969); *Harding v. Cameron*, 220 F. Supp. 466, 471 (W.D. Okla. 1963); *Young v. West Edmond Hunton Lime Unit*, 275 P.2d 304, 309 (Okla. 1954). *Accord*, *Amoco Prod. Co. v. First Baptist Church*, 579 S.W.2d 280, 285 (Tex. Civ. App. El Paso 1979), writ ref'd n.r.e. per curiam, 611 S.W. 2d 610 (Tex. 1980).

212. *Colorado v. New Mexico*, 104 S. Ct. 2433, 2438 (1984). See also *Addington v. Texas*, 441 U.S. 418, 423-25, 99 S. Ct. 1804, 1807-08 (1979).

213. 104 S. Ct. at 2438 (citing *In re Winship*, 397 U.S. 358, 370 (1970) (Harlan, J. concurring)).

214. If the breach of the marketing covenant is also a lack of production under the

An initial issue that must be resolved is whether the damage and cancellation remedies are cumulative or mutually exclusive. The leading case which supports the view that the remedies are cumulative is *Carroll Gas & Oil Co. v. Skaggs*.<sup>215</sup> The cumulative recovery is based on the theory that damages are necessary to recoup the losses suffered by the lessee's past failure to market, while cancellation of the lease is necessary in order to prevent future damages by the lessee.<sup>216</sup> There is nothing inconsistent in pleading and proving both damages and cancellation or forfeiture of the lease.<sup>217</sup>

There are, however, several cases which hold that in the absence of an express forfeiture provision in the lease, the sole remedy available for breach of the marketing covenant is damages.<sup>218</sup> In *Guleke v. Humble Oil & Refining Co.*,<sup>219</sup> the court stated that a breach of an implied covenant relating to development of the premises, including the covenant to diligently market gas, will not sustain an equitable suit for forfeiture.<sup>220</sup> This was *dictum* because the court had previously concluded that the three month delay between discovery and marketing was not a breach of the implied covenant to market.

In cases involving a failure to initially market the gas, the leading commentators have long argued for a remedy which prevents the lessor from reaping a double recovery.<sup>221</sup> The courts, however, have uniformly rejected the remedy of interest on the late royalties and have instead granted the full amount of royalties which would have been paid had marketing been achieved with due diligence.<sup>222</sup> Nonetheless, several de-

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*habendum* clause, then the remedy will automatically be cancellation in Texas-type jurisdiction and will most likely be cancellation even in Oklahoma-type jurisdictions. 4 E. Kuntz, *supra* note 40, at 131-2.

215. 231 Ky. 284, 21 S.W.2d 445 (1929).

216. *Id.* at 292, 21 S.W.2d at 449-50.

217. *Id.* at 292, 21 S.W.2d at 449-50.

218. *Guleke v. Humble Oil & Refining Co.*, 126 S.W.2d 38 (Tex. Civ. App. Amarillo 1939); *Howerton v. Kansas Natural Gas Co.*, 81 Kan. 553, 106 P. 47, on rehearing, 82 Kan. 367, 108 P. 813 (1910).

219. 126 S.W.2d 38 (Tex. Civ. App. Amarillo 1939). The general rule in Texas for the development covenant is that damages must be shown by the lessor to be inadequate before an absolute or conditional decree of cancellation will be granted. *Slaughter v. Cities Services Oil Co.*, 660 S.W.2d 860 (Tex. App. 1983).

220. *Guleke*, 126 S.W.2d at 40 (citing *Jacobs v. Robinson*, 241 S.W. 241 (Tex. Civ. App. Dallas 1922), *aff'd*, 113 Tex 231, 254 S.W. 309 (1923)); *Grubb v. McAfee*, 109 Tex. 527, 212 S.W. 464 (1919); *Cheek v. Metzger*, 116 Tex. 356, 291 S.W. 860 (1927); *Cole Petroleum Co. v. United States Gas & Oil Co.* 121 Tex: 59, 41 S.W.2d 414 (1931).

221. 5 H. Williams & Meyers, *supra* note 13, at § 857; 4 E. Kuntz *supra* note 40, at 130.31; *Martin*, *supra* note 20, at 184 n. 31.

222. See, e.g., *Carroll Gas & Oil Co. v. Skaggs*, 231 Ky. 284, 291, 21 S.W.2d 445, 448 (1929); *Cotiga Dev. Co. v. United Fuel Gas Co.*, 147 W. Va. 484, 128 S.E.2d 626 (1962). In a recent case involving the lessee's loss of access to his well caused by wrongful acts committed by another operator, the Kansas Supreme Court impliedly adopted a

cisions have prevented a double recovery by providing some type of credit or accounting for royalties already paid when the gas is actually marketed.<sup>223</sup>

The recent marketing covenant cases which deal with renegotiated or poorly negotiated gas purchase contracts have uniformly given the lessor damages when a breach has been found. One of the essential elements in this type of case is the showing by the lessor that a better deal was available at the time the contract was entered into. In *Amoco Production*, the lessor was able to show several other contemporaneous gas purchase contracts with better pricing provisions. Damages were therefore easy to measure by merely computing the price differential between the other contracts, and the lessor's contract.<sup>224</sup> Similarly, in *Barby*, where damages were caused by the unreasonable delay in renegotiating an expired contract, the damages were the difference between what was paid under the old contract, during the period of unnecessary delay, and the prices in the renegotiated contract.<sup>225</sup>

The availability of total or conditional cancellation or forfeiture of the lease as a remedy is intertwined with the habendum clause/marketing covenant relationship.<sup>226</sup> In marketing cases which deal with a total failure to market the product, one has to identify whether or not the jurisdiction follows the Texas or Oklahoma approach in interpreting the habendum clause. In Texas-type jurisdictions, the absence of marketing in the secondary term automatically terminates the lease in the absence of other savings provisions.<sup>227</sup> But if the lease is being held in the secondary term by payment of shut-in royalties, should a lessor be allowed to cancel the lease for a lessor's failure to market? The *Guleke* opinion would apparently only allow the lessor to recover damages. The earlier cases dealing with fixed sum royalties, which can be analogized to the shut-in payments, also limit the recovery to damages for breach of the

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variant of the interest rule when it overturned a damage verdict for the amount of the lost oil and held instead that the lessee was only entitled to recover for the delay in recovery. Since there was no evidence as to the damages caused by the delay, e.g., interest on the amount of delayed, but still recoverable oil, the lessee had not sustained his burden of proof on the damages issue. *Mai v. Youtsey*, 231 Kan. 419, 646 P.2d 475 (1982).

223. See e.g., *Cotiga Dev. Co. v. United Fuel Gas Co.*, 147 W. Va. 484, 1285 S.E.2d 2626 (1962); *Texas Pacific Coal & Oil Co. v. Barker*, 117 Tex. 418, 6 S.W.2d 1031 (1928). Professor Kuntz believes that this measure of damages is most appropriate in the marketing covenant situation. 4 E. Kuntz, *supra* note 40, at 131.

224. *Amoco Prod. Co. v. First Baptist Church*, 579 S.W.2d 280, 282-83 (Tex. Civ. App. El. Paso 1979), writ *ref'd n.r.e. per curiam*, 611 S.W.2d 610 (Tex. 1980).

225. *Barby v. Cabot Corp.*, 550 F. Supp. 188 (W.D. Okla. 1981).

226. See generally, *Williams & Goodwin, Forfeiture of Lease for Failure to Market Gas*, 46 W. Va. L.Q. 271 (1940).

227. See *supra* text accompanying notes 64-68.

marketing covenant.<sup>228</sup> If the marketing covenant is not extinguished by the payment of shut-in royalties, the lessor should be allowed to seek a total cancellation of the lease if he can prove that the lessee has breached his duty to initially market the discovered gas.<sup>229</sup>

In Oklahoma-type jurisdictions, it is clear that cancellation or forfeiture must be available, otherwise the lessee can keep a lease alive perpetually by the payment of damages without ever having to market the discovered gas. In many Oklahoma cases cancellation is perceived to be an available remedy, but equitable defenses will be available which limit the courts' use of that remedy.<sup>230</sup> However, many of the equitable considerations that may be raised by the lessee will be the same considerations used to prove that he acted as a reasonably prudent operator. Therefore, if it is determined that a breach of the covenant has occurred, courts should not hesitate to cancel the lease in its entirety.

For breaches of the marketing covenant that are essentially challenges to the reasonableness of the actual marketing decision, the authors suggest that only "under extraordinary circumstances"<sup>231</sup> should the lessor be entitled to a decree of cancellation. In these cases damages are readily ascertainable. Moreover, the cancellation remedy would be too harsh a penalty for a mistake in business judgment.<sup>232</sup> However, in cases where the lessor can show self-dealing or fraud, cancellation would be an appropriate remedy in order to "punish" the wrong-doer.

#### CONCLUSION

The implied marketing covenant arose to resolve some of the conflicts which arise between the lessor and lessee after a commercial well has

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228. *Guleke*, 126 S.W.2d 38 (Tex. Civ. App. Amarillo 1930); *Howerton v. Kansas Natural Gas Co.*, 81 Kan. 553, 106 P. 47, on rehearing, 82 Kan. 367, 108 P. 813 (1910). See also, *Hurst v. Petroleum Exploration, Inc.*, 221 Ky. 786, 299 S.W. 954 (1927); *McGraw Oil & Gas Co. v. Kennedy*, 65 W. Va. 595, 64 S.E. 1027 (1909).

229. Professors Williams & Meyers cogently argue that total cancellation is appropriate in marketing covenant cases, rejecting the conditional and partial cancellation decrees usually found in exploration and development cases. 5 H. Williams & C. Meyers, *supra* note 13, at § 857.

230. See, e.g., *Townsend v. Creekmore-Rooney Co.*, 332 P.2d 35 (Okla. 1958); *Strange v. Hicks*, 78 Okla. 1, 188 P. 347 (1920). See also, *Severson v. Barstow*, 103 Mont. 526, 63 P.2d 1022 (1936); *Berthelote v. Loy Oil Co.*, 95 Mont. 434, 28 P.2d 187 (1933); *Pryor Mountain Oil & Gas Co. v. Cross*, 31 Wyo. 9, 222 P. 570 (1924).

231. *W. T. Waggoner Estate v. Sigler Oil Co.*, 118 Tex. 509, 518, 19 S.W.2d 27, 29 (1929). See also, *Slaughter v. Cities Service Oil Co.*, 660 S.W.2d 860 (Tex. Ct. App. Amarillo 1983), *Wes-Tex Land Co. v. Simmons*, 566 S.W.2d 719, 722 (Tex. Civ. App. Eastland 1978) (writ ref'd n.r.e.); *Guinn v. Clay*, 324 S.W.2d 254, 255 (Tex. Civ. App. 1959) (error ref'd n.r.e).

232. See, e.g., *Barby v. Cabot Corp.*, 550 F. Supp. 188 (W.D. Okla. 1981); *Amoco Prod. Co. v. First Baptist Church*, 579 S.W.2d 280 (Tex. Civ. App. El Paso 1979), writ ref'd n.r.e. per curiam, 611 S.W.2d 610 (Tex. 1980).



been completed. Through nearly one hundred years of use, the covenant has been adapted to meet the complexities presented by the changing industry. Recent developments may soon effectuate increased use of the covenant, thus necessitating a reevaluation of the implied marketing covenant. In light of the increased pressures placed upon the lessee by federal regulations and the downturn in demand, any reevaluation should focus on the standard of conduct and standard of proof by which a lessee's marketing activities are to be judged. More specifically, the continued viability of the reasonably prudent operator standard should be reviewed.

The case law reveals that actions grounded on the implied marketing covenant are decided after the trier of fact considers the circumstances and practical exigencies of the case. So too should the covenant itself be reviewed. Such analysis reveals that in those instances where the parties to a lease share a common interest in production, the lessee should be allowed to exercise his business judgment without fear of being second guessed by judge or jury. The increase of the standard of proof to a "clear and convincing" evidence level achieves a compromise with which both lessors and operators can live.