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John Burritt McArthur

THE TAKE-OR-PAY CRISIS: DIAGNOSIS, TREATMENT, AND CURE FOR IMMORALITY IN THE MARKETPLACE

JOHN BURRITT McARTHUR*

* B.A., Brown University, 1975; M.A. (Economics), University of Connecticut, 1978; J.D., University of Texas, 1984.

A substantial part of the author's recent practice has involved representing producers in take-or-pay lawsuits. In addition to working as one of TransAmerican's counsel in the lawsuit against El Paso Natural Gas described *infra* note 5, Mr. McArthur has handled lawsuits against Transwestern, ANR, CIG, and Tennessee Gas Pipeline.

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Large interstate pipelines traditionally bought most of the nation's gas. The pipelines are among the largest and wealthiest companies in the United States. They buy the gas at the wellhead, ship it hundreds or thousands of miles to market, and resell it to utilities, factories, and other consumers. When the pipelines signed contracts with "take-or-pay" clauses, they promised to take and pay for fixed amounts of gas, or to prepay for this gas even if they did not want to take it until later. This article is about the "take-or-pay" promises that have long been a part of contracts to buy natural gas in the United States, and how our system of contract law has failed to prevent the pipelines that made those promises from breaking their word.

In the early 1980s, the price of gas fell sharply and unexpectedly. In response, pipeline after pipeline decided, after careful planning and deliberation, to ignore their take-or-pay obligations. They replaced the high-priced gas they had contracted to buy with the cheapest gas available in the market and breached their contract obligations. The contagion swept through the industry as prices continued to fall. "Contract cure," "contract abrogation," "emergency gas purchase program" —each pipeline has its own euphemism for its policy decision to dishonor its contracts. Thousands of contracts have been abandoned, billions of dollars of gas lies unpurchased, and well after well has been shut-in.

Pipelines are monopolists in their major markets. That is why Congress has regulated them since 1938. Pipelines expected their market power to immunize them from the effects of contract abandonment. Accordingly, they showed no mercy as market prices dropped below the prices in their take-or-pay contracts. They forced producers to choose between years of grueling litigation and accepting terms of surrender in the guise of contract renegotiation.

Sadly, the pipelines' gamble largely has paid off. The great majority of take-or-pay disputes have been settled on terms extremely favorable to the pipelines. Pipelines have bought off the bulk of their contract obligations for less than twenty cents on the dollar.[1] This one-sided result, an extraordinarily one-sided result for cases in which there generally is no serious issue of liability, is proof of the pipelines' continuing market power.[2]

This article first discusses why the pipelines' "legal" defenses do not excuse their take-or-pay obligations. It is not even a close question. Pipelines pretend that take-or-pay contracts are complex and subject to numerous factually intensive defenses, but they take this position only to avoid summary judgment. The article then discusses how to expose pipelines to damages beyond the ordinary contract remedy of actual damages and low pre-judgment interest. Only by posing a risk of damages beyond ordinary contract damages can producers hope to stop the pipelines' strategic breaches of contract. Finally, the last section explains why neither FERC,[3] Congress, nor the courts should act to restrict or void take-or-pay obligations. Producers have already absorbed the bulk of the falling prices, even though this was the risk that the pipelines, not the producers, promised to assume. Producers should not have to bear any more of the loss.

Proper resolution of the take-or-pay crisis is a vital concern for many reasons. One reason, of course, is the amount of money at stake. Pipelines are trying to avoid enormous debts. In just some of the cases that have

1. *See* Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, 54 Fed. Reg. 52,344, 52,356-57 & Table 5 (1989). Approximately $44 billion in liability has settled for an average of 18.67 cents on the dollar.

2. *See* Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, 55 Fed. Reg. 6605, 6611 (1990).

3. "FERC" is the acronym for the Federal Energy Regulatory Commission.

been tried, producers have received judgments of $620 million;[4] $610 million;[5] $412 million;[6] $108 million;[7] $65 million;[8] and $50 million.[9] These are among the largest judgments ever awarded by American courts.[10] Filings with the FERC suggest that much of the problem may have passed, but at least some large cases remain to be tried.[11] And the cases tried are only the tip of the iceberg. A much larger group of disputes did not even reach the courts. By 1989, pipelines had already reported to FERC that $44 *billion* of past and future take-or-pay liability had been settled.[12]

The financial impact of the disputes extends far beyond pipelines and producers. Royalty owners,[13] the "working interest" owners in the wells,

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4. Kimball v. Tenneco, Inc., No. 27,880-S (Tex. Dist. Ct. Dec. 1, 1988). Tenneco settled the *Kimball* case within a few weeks.

The verdict in *Kimball* awarded a variety of overlapping damages. The settlement of the case occurred before the court entered judgment setting out the exact amount of Tenneco's liability. Both published reports at the time of the verdict and discussions with counsel for Kimball in the case indicate that the likely judgment was somewhere between $620 million and $900 million.

5. El Paso Natural Gas Co. v. TransAmerican Natural Gas Corp., No. 85-09329 (Tex. Dist. Ct. May 24, 1988). The El Paso damage model included large volumes of "incentive priced" section 107(c)(5) gas that also qualified for a lower section 102 price. The United States Supreme Court's holding in FERC v. Martin Exploration, 486 U.S. 204, 209 (1988), that "dually qualified gas" which qualified for at least one deregulated category was to be priced at the deregulated price led the trial court to order a $140,800,215.36 remittitur, reducing the judgment to $480,309,341.34, plus almost $2 million in attorneys' fees and what was already more than a year's post-judgment interest. The case settled soon after the appeal was argued in the Texas Court of Appeals.

6. The jury in Colorado Interstate Gas v. Natural Gas Pipeline Co., 661 F. Supp. 1448 (D. Wyo. 1987), *aff'd in part and rev'd in part*, 885 F.2d 683 (10th Cir. 1989), awarded $724,033,361 on overlapping claims for breach of contract, tortious interference, and attempted monopolization. The court reduced the award to $412,237,972 to eliminate alleged errors and the overlap in damages. *Id.* The court of appeals gave the judgment a bigger shave by cutting out all but the tortious interference claim, a claim on which the jury had awarded $16,017,678 in actual damages. *Id.* at 1457.

7. Texas Crude Inc. v. Delhi Gas Pipeline Corp., No. 85-7-450 (Tex. Dist. Ct. Aug. 14, 1986).

8. Challenger Minerals v. Sonat, No. 84-C-357-E (N.D. Okla. Sept. 9, 1986). Like many of the other major take-or-pay cases, *Challenger Minerals* settled not long after judgment was entered.

9. Forest Oil Corp. v. Oneok, Inc., No. C-84-197 (Tex. Dist. Ct. May 30, 1984).

10. In 1988 the take-or-pay verdicts against Tenneco and El Paso for at least $620 million and $615 million, respectively, were more than the ten largest jury verdicts combined as listed in the ABA's *Litigation* magazine. *Compare Litigation* 45-51 (Mar. 1989).

11. For instance, ANR Pipeline, which has been the most successful of the pipelines in avoiding liability, still faces an appeal to defend its judgment in a major case brought by the producer Tex Dyco. Telephone Interview with Robert Pezold, Attorney for Tex Dyco (Jan. 15, 1992). Challenger Minerals is still waiting to try a $200 million case against Transco Energy Co. *Take-or-Pay Litigators Shift Focus*, TEX. LAW., Apr. 20, 1992, at 5.

12. *See* 54 Fed. Reg. at 52,356 Table 5. As the conspicuous absence of major oil companies as take-or-pay plaintiffs shows, and most take-or-pay lawyers know, a perhaps even larger amount in dispute was resolved by renegotiation without such public notice.

While it is speculation to try to explain why privately-owned independent companies have attempted to pursue take-or-pay cases most aggressively and major oil companies seem to have resolved most of their differences, one explanation may be that the majors are conservative corporations that put a much higher value on their ongoing business relationship with pipelines than do the independents. The other class of silently renegotiated cases that have largely vanished are the small, resourceless producers who had to surrender to pipeline terms without a fight in the early days of take-or-pay disputes.

13. The early law on whether royalty owners are entitled to share in take-or-pay prepayments favors producers. Royalties typically are payable on gas "produced." In the first two major decisions, a Texas Court of Appeals and the Fifth Circuit have held that royalty owners do not have a right

producers of every size and shape, taxpayers in gas producing states, all have their futures tied to the enforceability of take-or-pay contracts. The coerced settlements have littered the natural gas landscape with the dashed hopes and expectations of landowners, farmers, small oil companies, and every other imaginable kind of working interest and royalty owner. These are the real victims of the take-or-pay crisis, along with the gas producing states and their citizens who have lost millions of dollars in tax revenue because of these unlawful schemes. The costs do not stop there. When the contracts are enforced, the gas costs head upstream. Some or all of the billion-dollar liabilities will be absorbed by utilities, industrial users, and other consumers after what are certain to be bitter and acrimonious hearings before FERC.[14] The victims are *not* the pipelines, which bullied their way through the years of decline in the natural gas marketplace.

A full understanding of take-or-pay issues will be vital to the courts of appeals that must continue to pass on the FERC orders that have brought competition to the monopolistic markets of gas transportation and resale. These reviewing courts have frequently ignored FERC's fully supported finding that producers have already borne most of the burden of market decline. These courts have remanded all but one of FERC's orders to reconsider FERC's failure to act on the take-or-pay "problem."[15] The same courts presumably may shift their hostility to pipelines as the judges begin to review FERC decisions about passing through take-or-pay costs to the gas purchasers at the pipeline outlets.

The take-or-pay crisis speaks poorly about our system of contract law. The fact that pipelines have felt free to disregard their contracts and

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to part of take-or-pay settlements because there is no production. Killam Oil Co. v. Bruni, 806 S.W.2d 264, 266-68 (Tex. Ct. App. 1991); Diamond Shamrock v. Hodel, 853 F.2d 1159, 1165-68 (5th Cir. 1988). One problem with this result is that it can create an incentive for the producer and pipeline to settle by splitting the monies that would be due to the royalty owner had the contract been performed and the gas produced, in essence funding a settlement by cutting out the royalty owner. The Fifth Circuit Court of Appeals has permitted recovery under a contract that keyed royalties to the "amount realized at the well from such sales," rather than production. Frey v. Amoco, 943 F.2d 578, 581 (5th Cir. 1991).

A second question is whether the royalty owner should be able to argue that when the gas is produced and sold, even if under another contract, the earlier prepayment should somehow be allocated to the gas price at that time. The Fifth Circuit apparently sidestepped these issues in its own mind by holding that the take-or-pay payments "are not . . . payments for the sale of gas," *Diamond Shamrock*, 853 F.2d at 1167, but rather purely compensation to the producer for the risks of development. This is an extraordinarily myopic view of a payment that varies directly with the amount of gas producible for the pipeline and it ignores the fact that the pipeline's intent in making the payment is to reserve certain amounts of gas for production. For a thorough discussion of many of the issues that surround the question of royalty payments on take-or-pay contracts, see White, *The Right to Recover Royalties on Natural Gas Take-or-Pay Settlements*, 41 OKLA. L. REV. 663 (1988).

14. One factor in judging the prudency of settlements and buyouts will be, of course, whether or not the underlying obligation would have been enforced if the pipeline had fought it in litigation. Indeed, the vigor with which some pipelines pursue frivolous defenses makes one wonder whether they had not decided it was safer to litigate and lose, and then try to pass on the costs, rather than settle and risk having consumer groups challenge the amount of the settlement as imprudent.

15. See *infra* notes 161-227 and accompanying text for a discussion of the ongoing conflict between FERC and the courts of appeals.

that producers have settled these cases, cases with very little doubt about pipeline liability, for less than twenty cents on the dollar shows something is wrong. Much of the blame lies with pipeline monopoly power, but not all. A large part of the blame must be traced to the failure of courts to grant, or producer lawyers to seek, summary judgment early enough to prevent producers from being worn down by years of litigation. It is not a record to be proud of. The courts must do better. Lawyers must do better.

As Congress and FERC transform the gas market into a competitive, deregulated market, the price for gas should be set by freely negotiated private contracts, not by government fiat. Producers will have to be willing to risk hundreds of millions of dollars exploring for new supplies. They will have little incentive to do so if they cannot rely on pipelines and other customers to honor contract promises to pay for whatever gas is discovered. While pricing terms may be sharply different than in the past, take-or-pay contracts will remain a necessary part of the gas business. It is accordingly important that these contracts be free to function as designed and that the courts protect these promises.

I. THE TAKE-OR-PAY PROMISE

The standard take-or-pay clause can be as plain, brief, and unambiguous as this:

> Subject to the terms and provisions hereof, Seller agrees to sell and deliver to Buyer and Buyer agrees to purchase and receive from Seller, or if available and not taken, pay for that quantity of pipeline gas [an agreed amount of gas] . . . .[16]

That is all there is to the take-or-pay commitment. The buyer warrants to pay for a set amount of gas without regard for whether it will want or need the gas or be able to resell it when payment comes due. The buyer signs a guarantee of performance. The seller commits to supply the agreed volumes of gas. If the buyer decides not to take any gas, it still has to pay by making a "prepayment," which gives it a right to "makeup" the gas by taking it in future years.[17]

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16. 4 H. Williams, Oil and Gas Law § 724.5, at 660-61 (1991).

17. Take-or-pay clauses can vary depending on how long the pipeline has to "make up" the untaken gas for which it has made a "prepayment," how the take quantity is measured (for instance, by a percentage of estimated total reserves or a percentage of measured well deliverability), and whether the prepayment has to be refunded if the pipeline fails to make up its gas in the prescribed period.

The right to "make-up" gas is simply the right to receive in a specified future period the gas paid for in today's "prepayment." The "prepayment" is a payment today for gas to be received at the later date. *See generally* H. Williams, *supra* note 16, at 659-65.

Some take-or-pay quantities were set at a percentage of total estimated lifetime reserves for a well. Others require a pipeline to buy a fixed percentage, often eighty percent or ninety percent, of a well's measured annual delivery capacity. Turner, *Natural Gas-Impact of Deregulation of Sales Contracts*, 29 Rocky Mtn. Min. L. Inst. 501, 522 (1983).

Since 1967, when it issued Order 334, FERC has required producers to allow the pipelines at least five years to make-up any prepaid gas. *See* 18 C.F.R. § 154.103 (1987). FERC has not required a refund to a pipeline if it does not make up the gas.

This is a straightforward allocation of market risk. Fixing risk is, of course, the reason to have contracts in the first place. There is nothing mysterious or complex about the take-or-pay bargain. Spotting the issue is easy: whether the pipeline must pay for the gas even though its own market has declined. Market decline is the very risk the buyer assumed with its take-or-pay promises. If the price for natural gas falls and the buyer doesn't want high-priced contract gas, under the terms of a take-or-pay promise, it still has to pay. That single principle should control ninety-five percent of take-or-pay cases.

Take-or-pay promises, when enforced, limit the power of the interstate pipelines. The pipeline market has ideal characteristics for monopolization: high barriers to entry but economies of scale.[18] Pipeline monopolies go back to the early days of the industry. Studies by the Federal Trade Commission in the late 1920s and early 1930s showed that pipeline power was severely concentrated.[19] Many producers had to sell their gas to one pipeline or not at all. Pipelines could buy gas when demand was good, "shut-in" producer's wells and take no gas when demand fell. Exploration companies had no assurance they would ever recover their costs. Even if they discovered large supplies of gas, they could not force the nearby pipeline to buy the gas.[20]

The problem of pipeline monopoly power led Congress to pass the Natural Gas Act of 1938 ("NGA"), which gave the Federal Power Commission ("FPC") the power to regulate the pipelines' transportation rates and make sure they are "just and reasonable."[21] In the 1954 *Phillips* decision, the Supreme Court expanded the Act's reach by deciding that

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18. This was the reasoning behind regulation of the industry. A. TUSSING & C. BARLOW, THE NATURAL GAS INDUSTRY 228 (1984). The economics will be different in some circumstances. For instance, if there are only one or two sellers in a very large gas field, a pipeline trying to enter the market may be able to price competitively if promised a long-term contract over which it can amortize the cost of building the pipeline. Even then the existing pipeline has the economic advantage of already sunk costs. To match its economics, the new pipeline would have to be sufficiently more efficient to have its pipeline costs not exceed the existing pipeline's cost of servicing its loan. Or, of course, the new pipeline may trade lower profits for the chance to enter the field.

Economics of scale may taper off once the pipeline market exceeds the size of the largest pipeline. *See* A. KAHN, THE ECONOMICS OF REGULATION 153 & nn.109-10 (1988). For an argument that increases in the size of the market for gas as well as the number of pipelines casts doubt on the scope of continuing pipeline monopoly power, see Pierce, *Reconsidering the Roles of Regulation and Competition in the Natural Gas Industry*, 97 HARV. L. REV. 345, 352-53 & n.37 (1983). In contrast, FERC has found that pipelines *do* retain substantial monopoly power. The ease with which pipelines have demanded and received one-sided settlements seems to support that finding. *See infra* notes 192-94 and accompanying text.

It takes a lot of money to build a pipeline, but less to operate it. If a company that has already built its pipeline is threatened with competition, it can drop prices just far enough to deter any new entrant. It would still be sure to recover at least the variable cost of shipping gas. The existing pipeline that can spread its costs among its customers can almost always offer cheaper service than a new pipeline that would have to charge high prices to service new or uncommitted customers and pay for new construction costs.

19. Federal Trade Comm'n, Utility Corps., S. Doc. No. 92, 70th Cong., 1st Sess. (1928).

20. *See* Johnson, *Natural Gas Sales Contracts*, 34 INST. ON OIL & GAS L. & TAX'N 83, 108-09 (1983).

21. 15 U.S.C. § 717c (1982). Congress referred to its reliance on the FPC's work in the NGA itself. *Id.* § 717(a).

Congress intended to regulate gas purchase prices as well as transportation prices.[22] Federally regulated prices, however, did not ensure that pipelines would have to buy gas, whatever its price. Prices were regulated but sales were not guaranteed. Thus, federal regulation of wellhead prices did not shield the producers from the pipelines' power. Producers still bore all the risks of discovering, producing, and selling because the pipelines could just stop buying gas during periods of low resale prices. The take-or-pay clause should protect a producer from these problems. When included in a contract, the take-or-pay promise guarantees that the pipeline will pay even for gas it does not want to take, whether because of declining sales or any other reason.

The common focus on the hard time pipelines are having ignores half of the take-or-pay bargain. Pipelines never mention the many dry holes and what they cost producers, or the ongoing operating expenses that must be paid regardless of whether a pipeline takes any gas. These costs are the producer's *quid pro quo* for the pipeline's promise to absorb the market risk of reselling the gas. The Fifth Circuit put it well when it explained the mutuality in the take-or-pay promise:

> The purpose of the take-or-pay clause is to apportion the risks of natural gas production and sales between the buyer and seller. The seller bears the risk of production. To compensate seller for that risk, buyer agrees to take, or pay for if not taken, a minimum quantity of gas. The buyer bears the risk of market demand. The take-or-pay clause ensures that if the demand for gas goes down, seller will still receive the price for the Contract Quantity delivered each year.[23]

All the fuss is about this simple, fair, and well-understood bargain.[24] Take-or-pay clauses have been understood and enforced for decades.[25] They are standard contract terms in the natural gas industry. Along with the price, the take-or-pay section is one of the few parts of a gas purchase agreement that is certain to have been the subject of real negotiation. It is a promise perfectly well understood by both sides to the contract. Contrary to what most pipeline lawyers say, it does not take any kind

22. Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672 (1954). For 25 years the Act was interpreted not to include power to regulate the "wellhead" prices pipelines paid to producers, but just power to regulate the rates pipelines charged their customers at the other end of the pipeline. In 1954, the Supreme Court reversed this long-standing interpretation and decided that the NGA did indeed require the FPC to regulate producer prices as well as pipeline prices and make sure that producer wellhead prices were also just and reasonable. *Id.* at 683-84.

23. Universal Resources Corp. v. Panhandle E. Pipe Line Co., 813 F.2d 77, 80 (5th Cir. 1987). "Take-or-pay contracts are standard in the industry. . . . The take-or-pay option is commonly given in gas contracts because of the cyclical nature of the demand for gas." PGC Pipeline v. Louisiana Intrastate Gas, 791 F.2d 338, 341 (5th Cir. 1986).

24. It behooves the pipeline, of course, to pretend the opposite. *See* Goldsmith, *Defense Perspectives on Take-or-Pay Litigation: Trying the Real Issue*, lecture at 28th Regulatory Conference (May 17, 1989), *reprinted in* PROCEEDINGS OF THE 28TH REGULATORY CONFERENCE 191 (1989) (bemoaning that take-or-pay is complex litigation).

25. *See* Northern Natural Gas Co. v. Republic Natural Gas Co., 172 Kan. 450, 241 P.2d 708 (1952). Take-or-pay clauses are also commonly used in other industries. *See* Arbaugh, *Take-or-Pay Clauses Revisited: Pandora's Box Reopened*, 5 E. MINN. L. REV. 11-1, 11-6 to -7 (1984).

of expert, much less a John Maynard Keynes or Milton Friedman, to figure out how a take-or-pay contract works.

II. FALLING GAS PRICES IN THE MID-1980s CAUSE THE TAKE-OR-PAY CRISIS

A take-or-pay clause is, of course, just a contract mechanism. It only works if producers have the bargaining power to require it in their contracts. The roots of today's take-or-pay problems lie in the late 1970s and early 1980s, when the demand for gas rose to the point that pipelines had to offer take-or-pay commitments if they wanted to acquire new gas supplies. Many pipelines ran out of gas during the energy crisis of the early 1970s and were fiercely criticized by their customers and by government regulators for not having enough gas. Regulated *interstate* gas prices fell below prices in the unregulated *intrastate* market, where producers naturally chose to sell their gas, and gas was therefore scarce in the interstate market. Pipelines had to offer high prices and agree to take most of a producer's gas if they wanted to acquire new gas supplies.

The Natural Gas Policy Act of 1978 ("NGPA") was supposed to cure this market distortion. Congress designed the NGPA to bring interstate gas prices up to the level of intrastate prices and ultimately to create a unified, competitive, deregulated market.[26] When the NGPA was passed, pipelines did not have the incentive to be truly concerned about gas prices. Prices were commonly expected to rise and the pipelines were primarily under pressure to secure stable supplies, not to find low-priced gas. Pipelines were insulated from the market because FERC allowed them to "pass through" *all* prudent gas costs to their customers. Their customers were billed based on an average of their gas costs, so the cost of expensive gas would be spread among all their customers. This pricing, generally known as the pipeline's "WACOG"[27] price, left the pipelines even more secure about buying additional gas at very high prices. The high-priced gas would be averaged with the pipeline's cheaper gas and its single weighted gas price might remain fairly competitive.[28]

The NGPA caused a rush to enter new natural gas contracts. Pipelines bid against each other to lock up new natural gas supplies before prices rose further. The major pipelines entered contracts for expensive incentive-priced gas with very high take requirements, often seventy percent or eighty percent or more of the producer's delivery capacity.[29] In this sellers'

26. The NGPA was designed to increase the price of interstate gas to levels competitive with intrastate gas, put a ceiling on intrastate prices, and then gradually decontrol gas prices. *See generally* Note, *Legislative History of the Natural Gas Policy Act: Title I*, 59 TEX. L. REV. 101, 106-19 (1980).

27. Weighted average cost of gas.

28. A description of the functions and shortfalls of federally regulated gas prices can be found in Pierce, *supra* note 18, at 348-52, 359-65.

29. Although each pipeline has its own version of what happened, a representative description can be found in Tennessee Gas' rendition in Day v. Tenneco, 696 F. Supp. 233, 235 (S.D. Miss. 1988).

market, pipeline after pipeline took extraordinary risks by promising to buy this gas in long-term, twenty year contracts with rigid high prices. The new contracts routinely called for payment of the "maximum lawful price" during regulation and the average of the highest prices in the surrounding area after deregulation, with the regulated price often serving as a price floor if prices fell. Pipelines redoubled their efforts to sign new contracts because they feared a price "fly-up" when many categories of gas would be deregulated on January 1, 1985.[30]

The pipelines badly misread their market. In the early 1980s an economic

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30. Although this Article is not about gas prices, an intricate and complex area of oil and gas law, the take-or-pay crisis would not exist if all gas purchase agreements had market responsive pricing that let pipelines reduce the prices they pay as the prices fall in the resale market. Instead, the standard contracts entered in the late '70s and early '80s generally provide for payment of the "maximum lawful price" while the price was regulated, and often provide that the price should continue to escalate on the same basis after deregulation. Prices in all of the major NGPA categories—sections 102, 103, and 107—have been at levels far above the spot market price because of the prolonged recession in the gas industry.

The Supreme Court threw one wrench in the works when it held in FERC v. Martin Exploration Management Co., 486 U.S. 204, 210-11 (1988), that gas which fit into more than one of the regulated categories would be treated as deregulated if even one of the pricing categories was deregulated. Thus, for instance, gas that was still regulated section 107 gas but also deregulated section 102 gas after January 1, 1985, would be priced under whatever the contract terms were for deregulated gas.

The deregulated price will be whatever the contract says it should be. If the contract is silent, section 2-305 of the Uniform Commercial Code empowers the courts to imply a reasonable, market-based price. (This is a major change from the common law, which would have rendered these contracts void). An unusual problem has arisen in contracts that did not specify a price on deregulation, or that provided some kind of price redetermination mechanism but where no one redetermined. Producers argue that the regulated price remains in effect until redetermination occurs. Pipelines argue that they only have to pay a lower reasonable market price in the absence of any contract price until there is a redetermination. Some contracts solve this problem by providing for a price floor, so that price can never fall, by saying that the last regulated price stays in effect, or by making the regulated price the "contract price," implying that the price should continue. Other contracts are silent. The courts addressing these issues have reached differing opinions on whether the regulated price continues, although the differences are largely based on differences in the contract language. *Cf.* Prenalta Corp. v. CIG, No. C89-1010-B, slip op. at 7-8 (D. Wyo. Aug. 11, 1989) (regulated price provisions did not apply after deregulation, turning to open price term of Commercial Code), *rev'd in part*, 944 F.2d 677 (10th Cir. 1991) (remanding cases because of factual questions over defenses and effect of voluntary payment of above-market prize); CIG v. Martin Exploration, No. 85-CV0399, slip op. at 2 (Colo. Dist. Ct. Dec. 19, 1988) ("no longer existed an applicable effective regulated price" after deregulation); Abby Corp. v. CIG, No. 85-C-233, slip op. at 1-4 (Wyo. Dist. Ct. Nov. 14, 1986) (imposing Commercial Code's "commercially reasonable price" in absence of redetermination); Kennedy & Mitchell, Inc. v. CIG, No. C-86-30, slip op. 2-4 (June 5, 1987) (price was "reasonable price at time of delivery" in absence of redetermination); Samson Resources Co. v. BASF Corp., No. 87-C-809-B (N.D. Okla. June 1, 1990) (reasonable price terms will apply in absence of deregulation) *with* Williams Natural Gas Co. v. Uma Oil Co., No. 85-N-631, transcript at 22, 35-36 (D. Colo. Feb. 13, 1990) (regulated price governed even after deregulation); Samson Resources Co. v. Northern Natural Gas, No. 85-C-74-E, slip op. at 12-13 (N.D. Okla. Sept. 15, 1987) (regulated price provision served as base price that continued to escalate after deregulation); Jeffrey v. KN Energy, No. 83-K-1876, slip op. at 6 (D. Colo. Nov. 7, 1986) (regulated price became new contract price that continued to increase after deregulation).

The *Williams* decision is unusual because it conflicts with a prior decision by a different judge in the same case. *See, e.g.*, Northwest Cent. Pipeline Corp. v. Mesa Petroleum Co., 723 F. Supp. 1410, 1413 (D. Colo. 1989) (regulated price only applies if FERC exercises its pricing jurisdiction, which it does not after deregulation), *apparently reversed sub nom.* Williams Natural Gas Co. v. Uma Oil Co., No. 85-N-631 (D. Colo. Feb. 13, 1990). Except for this reversal, the other cases can be harmonized through detailed analysis of the differences in the contract language.

downturn and rising gas prices caused industrial users to switch to other fuels. Commercial and residential demand fell as these users turned to conservation. The divisions within OPEC caused the worldwide price of oil to fall and spurred fuel-switching from gas to oil. Unusually mild winters and hydroelectric competition further reduced demand.[31] At the same time, the NGPA's incentive prices and expectations of future price increases had worked as planned to increase the supply of gas. In textbook fashion, falling demand and rising supply combined to sharply lower the price.[32] Within a few years, pipelines could buy new gas quite cheaply, but they were still saddled with their high-priced, long-term contracts.

Pipelines reacted to their declining market in the same way. First they reduced the prices they paid for gas if their contracts permitted, cut back on purchases of new supplies, and renegotiated existing contracts to get lower prices whenever possible. As the prices continued to decline, however, virtually every major interstate pipeline decided that it would rather break the law than pay the price of its contract promises. By mid-1985, FERC was able to identify fourteen major interstate pipelines that had claimed *force majeure* and stopped performing their take-or-pay contracts.[33] FERC's list was incomplete. In September 1985, for instance, El Paso Natural Gas Company, which was not on FERC's list but until quite recently was one of America's largest pipelines by sales, began circulating what would become monthly *force majeure* letters to its producers in which it claimed to be excused from buying much of its committed gas supply.[34]

By the early to the mid-1980s, pipeline after pipeline had self-righteously proclaimed that some combination of ordinary market factors, like bad weather, competition from oil and other fuels, increased gas supply, conservation, expansion of nuclear or hydroelectric power, and rising gas imports, had so reduced demand and market prices that they were "unable" to buy the gas they had under contract.[35] Within a year or two,

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31. *See* Order 380, Elimination of Variable Costs From Certain Natural Gas Pipeline Minimum Commodity Bill Provisions, 49 Fed. Reg. 22,778, 22,781 (1984) [hereinafter Order 380].

32. *See id.*

33. *See* Order 436, Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, 50 Fed. Reg. 42,408, at 42,418 (1985) [hereinafter Order 436].

34. Letter on file with *New Mexico Law Review.*

35. Even a quick look at the kind of arguments made by many pipelines would suggest grave cause for doubt. One reason is that the same pipelines repeat exactly the same defenses, word for word, without any showing of how those defenses relate to the facts of the case. They discuss such factors as weather and increased supply or falling demand without giving any specifics at all. And they plead an unbelievable number of defenses. For instance, El Paso Natural Gas routinely answers lawsuits by pleading failure of conditions precedent, violation of state allowable limits, violation of some federal duty to buy gas at the lowest price (without citing any statute or regulation), frustration of purpose, mutual mistake, some theory of intervening cause, violation of public policy, violation of state market demand orders, void as a penalty, unconscionability, impracticability, and *force majeure*. *See* Plaintiff's Fourth Amended Original Petition, El Paso Natural Gas Co. v. GHR Energy Corp., No. 85-09329 (Tex. Dist. Ct. Aug. 25, 1987).

Some of El Paso's objections are as silly as to complain that its purpose of obtaining gas for resale "in accordance with normal market demands and at reasonable prices" has been violated, preventing El Paso from getting "a reasonable rate of return and retention of its customers"; that each pipeline was enmeshed in a wave of litigation that tested these defenses.

III. THE COMMON PIPELINE DEFENSES ARE JUST VARIATIONS ON THE THEME THAT PERFORMANCE HAS BECOME UNPROFITABLE

Lawyers are trained to think conservatively and to avoid making blanket predictions about groups of cases.[36] The reason for caution is obvious. Even small differences in fact can often alter the outcome of a case. Take-or-pay cases should be an exception, however, because the pipelines' defenses are frivolous as a matter of law in the great majority of these cases. These are cases that should be decided on summary judgment.

The determinative fact of each take-or-pay case, the contract itself, is standard throughout the natural gas industry. There are only a handful of exceptions to the normal language. The standard contract is enforceable as a matter of law because it plainly, unambiguously puts the risk of falling prices on the buyer pipeline. As a general matter, "[t]he terms of the take-or-pay clause are unambiguous, common to the gas industry,

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the parties expected "the continued existence of intense competition for gas supplies" and that "world oil prices and natural gas prices would continue to escalate at comparable levels"; that the take-or-pay provision would have "unjustifiable detrimental effects upon El Paso"; and that the contract would be a penalty because it would force El Paso "to pay for a minimum quantity of gas even though not actually taken and received." *Id.* at ¶¶ 8-11. In other words, El Paso says it believes in a fairy-tale world in which no one ever loses money on a contract. To compound the litany, top company officers solemnly sign affidavits stating that the principle purpose of El Paso's take-or-pay contracts was to buy gas that could be resold at "a reasonable rate of return" and that both parties assumed El Paso "would desire to take the daily contract quantity" throughout the contract's life. *See* Answer of El Paso Natural Gas Co. to Defendant's Motion for Summary Judgment, Holland Affidavit, El Paso Natural Gas Co. v. GHR Energy Corp. No. 85-09329 ¶¶ 12, 13 (Oct. 1, 1986). All this is, of course, nonsense. There would not be a take-or-pay clause if both sides to the contract made these kinds of assumptions.

Tenneco, in addition to pleading that no well drilled after the day it signed its contract is ever subject to its promises, also routinely pleads such defenses as violation of federal law, *force majeure*, mutual mistake, commercial impracticability, frustration of purpose, penalty, and unconscionability. These were among the defenses plead by Tennessee Gas Pipeline Transmission Company in its losing $600 million lawsuit. *See* Defendants' Second Amended Answer, Kimball v. Tenneco, No. 27,880-S (Tex. Dist. Ct. June 3, 1988). A quite similar list of *force majeure*, commercial impracticability, "imprecision," mistake and error, and failure of cause or consideration were rejected in the Hanover Petroleum Corp. v. Tenneco, Inc., 521 So. 2d 1234 (Ct. App.), *cert. denied*, 526 So. 2d 800 (La. 1988) discussed *infra* at notes 43-52 and accompanying text. This lineup is strikingly similar to Panhandle Eastern's grab bag, in which rummage around defenses were included like the unconstitutionality of the NGPA, violations of state law, liquidated damages, penalties, failure of conditions precedent, frustration of purpose, mutual mistake, and impossibility. *See* Universal Resources Corp. v. Panhandle E. Pipe Line Co., No. CA3-85-0723-R (N.D. Tex. April 1, 1986). Then here comes Enron Corporation: violation of state conservation laws, violation of federal public policy, penalty, unenforceable liquidated damages, unconscionability, mistake, frustration, impossibility, *force majeure*, and primary jurisdiction in FERC. Resources Inv. Corp. v. Enron Corp., 669 F. Supp. 1038 (D. Colo. 1987). And so on, and so on, and so on.

The lack of substance in these defenses becomes even more glaring when one pipeline's excuses are compared with another. But for slight changes in wording, the defenses are the same. Indeed, discovery usually reveals each pipeline keeping careful track of the excuses used by its fellow pipelines and their success. It is these boilerplate, much-copied defenses that spawned the take-or-pay crisis.

36. Lawyers' ethical rules strongly discourage such talk, talk which might dispel some of the mystery about the law but of course reduce the need for fee-paying clients to seek individual consultation. Take-or-pay cases, however, should be an exception. These cases can be discussed as a class because the material facts are almost always the same.

and fully enforceable."[37] Nor are there significant differences from pipeline to pipeline over their alleged defenses. These companies and their lawyers try out the same tired, conclusory arguments as they try to wriggle out of their promises. It is an extraordinary spectacle as pipeline lawyer after pipeline lawyer foists defenses that have already been rejected on each new court. Whether boilerplate allegations about FERC orders and a falling market can defeat unambiguous contract promises is a question that can almost always be answered as a matter of law. And the unambiguous answer, of course, is no.[38]

This section takes a close look at the pipelines' defenses to show why the courts should disregard the pipeline excuses. Most courts have found that these contracts by their very language compel rejection of the pipeline defenses. The main defenses have been addressed by appellate decisions in each of the four major gas producing states, Texas, Louisiana, Oklahoma, and New Mexico.[39] In each state, the highest court to reach the issue has held as a matter of law that the verbiage served up by pipeline lawyers is not enough to defeat a normal take-or-pay contract.[40] These

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37. Universal Resources Corp. v. Panhandle E. Pipe Line Co., 813 F.2d 77, 80 (5th Cir. 1987); *see, e.g.*, Transcontinental Pipe Line v. State Oil & Gas Bd., 474 U.S. 409, 412-13 (1986).

38. Although the courts have become quite strict in sanctioning frivolous pleading in other areas of the law, they have been inexplicably lax with pipeline lawyers. The defenses are limitless. It matters not that the pipelines have lost these arguments, even on summary judgment, many times before. *No one* believes that take-or-pay contracts are unenforceable for so many reasons. It defies imagination that any contract, and most of these are form contracts drafted by the pipelines, could be unenforceable for dozens of reasons. Were a contract truly deficient on so many grounds, it would be a permanent object of wonder to lawyers and students of the law throughout the country.

39. These four states were, in this order, the top gas producers in the United States in each year from 1980 to 1987. Information drawn from Bureau of Mines and Energy Information Administration, courtesy of Micronomics (on file with New Mexico Law Review).

40. The development of the law shown by these high courts was strongly influenced by three earlier trial court decisions: (1) Challenger Minerals, Inc. v. Sonat, No. 84-C-357-E (N.D. Okla. Sept. 9, 1986) (opinion by Judge Ellison), now withdrawn as settled; (2) Kaiser-Francis Oil Co. v. Producers Gas Co., No. 83-C-400-B (N.D. Okla. June 19, 1985) (opinion by Judge Brett), *aff'd*, 870 F.2d 563 (10th Cir. 1989); and (3) Universal Resources Corp. v. Panhandle Eastern Pipe Line Co., No. CA3-85-0723-R (N.D. Tex. April 1, 1986) (opinion by Judge Buchmeyer), *aff'd*, 813 F.2d 77 (5th Cir. 1987). Two of these courts granted summary judgment for producers, the other awarded $68 million to the producer after a trial to the court. Each decision was clear, emphatic, and favored the producer, and all have helped persuade appellate courts of the appropriateness of summary disposition of take-or-pay cases.

The Oklahoma Supreme Court issued the strongest of the appellate decisions in Golsen v. ONG Western, Inc., 756 P.2d 1209 (Okla. 1988). *Golsen* was quickly followed by a Tenth Circuit decision applying the *Golsen* rule, Kaiser-Francis Oil Co. v. Producers Gas Co., 870 F.2d 563 (10th Cir. 1989). In Texas, both the Fifth Circuit, in Universal Resources Corp. v. Panhandle E. Pipe Line Co., 813 F.2d 77 (5th Cir. 1987), and the First Court of Appeals, in Valero Transmission Co. v. Mitchell Energy Corp., 743 S.W.2d 658 (Tex. App. 1987), have soundly rejected market decline as an excuse for not performing a take-or-pay obligation. The New Mexico Supreme Court curtly affirmed a trial court summary judgment striking the bombastic defenses of El Paso Natural Gas Company in Hartman v. El Paso Natural Gas Co., 107 N.M. 679, 763 P.2d 1144 (1988). And the highest court in Louisiana yet to face these issues affirmed a summary judgment striking Tenneco's equally vacuous contract avoidance scheme in Hanover Petroleum Corp. v. Tenneco, 521 So. 2d 1234 (Ct. App.), *cert. denied*, 526 So. 2d 800 (La. 1988).

Producers can and should lean heavily on rules of construction in the quest for summary judgment. One axiom is that every part of a contract should be given some meaning. *See, e.g.*, RESTATEMENT (SECOND) OF CONTRACTS § 203(a) (1981). In contrast, under the standard pipeline interpretation, the *force majeure* clause is to be given an extraordinary, bloated meaning but the specific, narrow take-opinions form a compact body of governing law that should produce summary disposition of pipeline defenses,[41] but trial courts continue to let meritless cases go to the jury. A few recent victories and half-victories by ANR Pipeline in suits over its nonstandard contract language have encouraged some pipelines to falsely suggest that the tide has turned and that valid defenses of *force majeure* and impracticability exist after all. This Section shows why these suggestions are false.

The pipeline defenses are discussed in order of their importance. The number one defense, "*force majeure*," is a contract-based defense that relies on occurrence of one of a written list of events to excuse performance. A second defense, commercial impracticability, has attracted substantial scholarly interest and enjoyed one recent conspicuous success. After discussing these two defenses, this Section analyzes the other defenses in which the pipelines round out their pleadings: violation of public policy, mutual mistake, frustration of purpose, illegality under state law, penalty, unconscionability, failure of conditions precedent, and failure to mitigate.

A. *Market Decline Will Rarely Be an Event of Force Majeure*

Virtually every gas purchase contract contains a "*force majeure*" paragraph that excuses performance if certain events occur. One of the

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or-pay promise itself is written out of the contract. In reality, narrow, specific promises like the take-or-pay promise should get greater weight than general language (like "events" beyond a party's control that might excuse performance). *See id.* § 203(c). Another rule of construction is that all parts of the contract have to be harmonized, the contract must be construed as a whole. *Id.* § 202(2). The *force majeure* language must be harmonized with the take-or-pay clause. Obviously those clauses are not harmonized if falling prices let the pipeline escape the take-or-pay promise, or if problems in the resale market do the same. Another principle that will help most producers is that ambiguous contracts are construed against their drafters. *Id.* § 206. Most of the take-or-pay contracts are form contracts taken from the pipelines' files, so any ambiguity should be construed against them.

Unfortunately, the arcane jargon of the law seems to conspire against summary judgment. Lawyers are trained to automatically pigeon-hole certain defenses as factual, particularly when a respected lawyer wearing a straight face recites a long list of supposedly material disputed facts. We too readily assume there must be a fact dispute hidden somewhere. When numerous defenses are pled, including defenses that in most cases do raise fact questions, courts often get lost. Pipeline lawyers drone on and on about the alleged fact disputes about *force majeure*, impracticability, and so on. As a practical matter, it is all too easy for many courts to believe that these lawyers would not be arguing that fact questions exist unless that were so. The reassurance of the Rules of Professional Responsibility, which deems that every client deserves zealous representation right up to the edge of the law, too often induces a studied forgetfulness that these are frivolous defenses.

41. Until the late-1980s, there were virtually no recent appellate decisions construing take-or-pay contracts. Plaintiffs had to rely on copies of unpublished trial court opinions, particularly the first three cases cited in footnote 40. As in most new fields of practice, an internal network developed among lawyers who exchanged cases as they came out. This law was gathered in what was and remains the only comprehensive take-or-pay article, Medina, McKenzie, & Daniel, *Take Or Litigate: Enforcing the Plain Meaning of the Take-or-Pay Clause in Natural Gas Contracts*, 40 ARK. L. REV. 185 (1987), *updated in* Medina, *A Report From the Battle Zone; The Take-or-Pay Wars*, 58 OKLA. B.J. 2554 (1987), and Medina, *The Take-or-Pay Wars: A Further Status Report*, 41 OKLA. L. REV. 381 (1988); *see also* Medina, *Take-or-Pay Oklahoma Style*, 60 OKLA. B.J. 705 (1989).

This article does not try to summarize all decisions in each area of take-or-pay litigation. The issuance of binding appellate decisions in this now mature area of law means that lawyers no longer need to wade through all the lower court opinions to find binding authority. This article focuses on the major appellate decisions, plus trial court decisions when important for illustrative purposes.

events listed is almost always the catch-all "events beyond the control of the party claiming *force majeure*." Some *force majeure* provisions also excuse a party if a "failure of markets" or "failure of demand" occurs. The *force majeure* paragraph usually specifies that a failure of markets or demand or any other *force majeure* event must make a party "unable" to perform before it is excused.

As discussed below, pipelines argue that "dramatic" and "unforeseeable" market changes and recent FERC regulations are, separately or in combination, events beyond their control that make them "unable" to buy gas. Although at first blush the "market collapse" arguments sound as if they raise material fact disputes,[42] the defense should not often survive summary judgment. There are three basic reasons why the *force majeure* defense is not valid here. First, market changes and shifting government regulations are the risks assumed by the buyer in a take-or-pay contract. Second, these events have not made pipelines "unable" to perform. Third, the pipelines have not taken all, or often any, reasonable steps to resume performing. In addition, many pipelines fail to give proper notice and so have forfeited their right to hide behind their *force majeure* clause.

1. Market Decline is a Foreseeable Risk Assumed By the Buyer, Not an Event of Force Majeure

Pipelines argue that the falling market and recent FERC orders are events beyond their control. They claim that these events caused market prices to decline to the point that a "cause-beyond-our-control" event of *force majeure* exists. As a result, the pipelines say they should be excused because they cannot resell the gas they promised to buy. The courts have properly rejected this argument. If market decline like this is *force majeure*, producers might just as well never have bothered to sign these contracts in the first place because the pipelines would be free to stop buying gas whenever it became unprofitable to do so.

Most courts quickly agree that this ordinary market risk of falling prices does not excuse performance. The Louisiana Court of Appeals rejected such a *force majeure* defense when Tenneco raised it in *Hanover Petroleum Corp. v. Tenneco, Inc.*[43] Tenneco argued that an economic recession, the NGPA's pricing scheme,[44] falling prices, a mild winter, and an increase in gas supply activated its *force majeure* contract provision of "any other causes, whether of the kind herein enumerated or otherwise, not reasonably within the control of the party claiming suspension."[45] Using this excuse, Tenneco stopped taking Hanover's gas and, of course, never issued a prepayment check.

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42. Why did prices or demand fall, how was the pipeline's market affected, whose gas is now being bought, what has happened to the market price, etc.

43. 521 So. 2d 1234 (Ct. App.), *cert. denied*, 526 So. 2d 800 (La. 1988).

44. A new regulatory "scheme" enacted three years *before* Tenneco signed its contract with Hanover.

45. *Hanover Petroleum*, 521 So. 2d at 1237.

Tenneco's gambit did not persuade the trial judge or the Louisiana Court of Appeals. The court of appeals quoted with approval an earlier case that rejected the same arguments when raised by Transcontinental Gas Pipeline. As that judge had commented, "shifting supply and demand and changing governmental regulations *are normal factors considered in any business transaction.*"[46] The pipeline offering to take-or-pay for set amounts of gas knows that these factors change all the time.[47] If these fluctuations excused performance, take-or-pay contracts would never be enforceable.[48] To avoid this result, the court read the *force majeure* clause to fit with the rest of the contract, including the take-or-pay clause, and interpreted *force majeure* to *not* excuse specific promises made elsewhere in the contract. Because the contract "clearly and unambiguously states . . . [that] the defendant assumes the market risks," these same risks could not be events "contemplated by the *force majeure*" escape valve.[49]

The *Hanover Petroleum* analysis is correct.[50] Market change, even when partially caused by regulatory orders, was a known, existing risk assumed

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46. *Id.* at 1238 (quoting Preston Oil Co. v. Transcontinental Gas Pipeline Oil Corp., No. 294,491 (La. 19th Jud. Dist. Dec. 1986)) (emphasis added).

47. *Id.*

48. As the court said in *Hanover Petroleum*:

> These three factual defenses [increased supply capacity, reduced demand, and fundamentally changed governmental regulations] certainly do not constitute the same type of catastrophic events enumerated in the first part of the '*force majeure*' article. Although these are forces or events beyond the defendant's control, no court has ever brought them within the ambit of the *force majeure* defense.
>
> The defendant would have the court interpret the clause 'whether of the kind herein enumerated or otherwise' . . . to mean any other cause *whatsoever* beyond the control of the defendant in addition to the specifically named ones. If this interpretation were correct, the contract would state that either party could escape responsibility if events beyond the party's control made performance either difficult or unprofitable. . . . However, a party would never sign a contract, if this interpretation were correct, because the remainder of the contract would become meaningless.

Id.

49. *Id.* One problem with Tenneco's argument, as with most pipeline defenses, was its hopeless vagueness. The court understood the amorphousness of letting Tenneco promise to shield Hanover Petroleum from market decline by offering a take-or-pay promise when it wanted to sign up Hanover's gas, but then stop taking gas or making prepayments if prices fell sharply. Such a construction, it agreed, gave the court "absolutely no criteria" to judge when falling prices or changes in governmental regulations activated *force majeure*. *Id.* at 1239. No one would know when market risks were sufficiently pronounced to excuse Tenneco's performance, unless Tenneco was excused whenever it chose not to perform. The contract simply was not written in such a one-sided way.

50. The Mississippi federal trial court applied the same kind of analysis in Day v. Tenneco, Inc., 696 F. Supp. 233 (S.D. Miss. 1988). In words that could have been stolen from Transco's catechism, Tennessee Gas Pipeline, a division of Tenneco, Inc., had complained that "recent changes in the market for natural gas had been so dramatic and unexpected that the take-or-pay clauses in Day's contract should not be enforceable. . . . [T]he unexpected collapse in oil and gas prices and certain changes in federal regulations regarding the sale of gas to consumers combine to make the take-or-pay clauses unfair." *Id.* at 234. Or, more fairly put, Tennessee Gas made some mistakes in its long-term planning. Tennessee's revisionism extended so far that it even argued, apparently without blushing, that when the contract was entered it was "generally assumed at the time that the demand for and the price of gas would remain constant or rise *throughout the century*." *Id.* at 235 (emphasis added). Had this been true, of course, no one would have had much need for a take-or-pay clause. Tennessee Gas complained that it only signed the contract on the theory that

by the pipelines when they entered their gas purchase agreements. The natural gas market is volatile, like other commodity markets. Weather, switching to other fuels, changes in demand or supply, and the other factors which the pipelines cite as *force majeure* are constantly working to cause often sharp changes in price. The natural gas market is even more fickle than many commodity markets because prices and marketability depend upon FERC and state utility regulations. A small change in regulatory approach can produce a new pricing structure. Regulations setting gas prices have changed repeatedly, dramatically, and unpredictably over the past fifty years.[51] For instance, the price for gas trebled in the few years before Congress passed the NGPA and then increased several fold as a result of the NGPA.[52]

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the gas would remain at a competitive price and be marketable.

Even though both the contract and Mississippi's statutory *force majeure* provision included causes beyond the control of the parties, the court held that market collapse and changes in regulation were not *force majeure* within the meaning of the statutory or contractual defense. *Id.* at 235-36. It saw the basic illogic of excusing performance when the "very reason for entering the take-or-pay contracts was to insure payment to the producer in the event of substantial change in the marketplace. Defendants willingly accepted that risk. The fact that the unexpected happened does not excuse performance. Defendants accepted the risk and lost." *Id.* at 236. In passing, the court noted that market-out clauses had not been placed in this contract. *Id.*

Even though Tennessee Gas had offered "extensive evidence" to show that the market collapse was not foreseeable, the Mississippi court was right in finding that the risk was foreseeable enough to have been assumed by the buyer and the mutual allocation of risk should be enforced. Tennessee's allegations that market decline and an inability to resell take-or-pay gas at a profit was unforeseeable, like the similar allegations of other pipelines, brings it right up to the edge of perjury. Pipelines continually say that they never *expected* to be unable to resell the gas at a profit. The parties to take-or-pay contracts may both have *expected* and *hoped* that prices would increase, with the market remaining firm for the gas, but the fact remains that the producer had the foresight to require take-or-pay protection just in case the market declined so severely that the pipeline would not buy enough gas over the course of a year. The possible market problem, whose risks the pipeline expressly accepted, was foreseen to be so severe that the pipeline was given five years to make up the gas. Tenneco may not have *expected* the decline that occurred and have projected something better, but anyone who is literate and *compos mentis* can understand that this was the risk it was taking under the take-or-pay provision.

Tennessee Gas also complained that the pipelines "had to accept producers' terms . . . ," *id.* at 236, as if it had some kind of duress defense. The *Day* contracts had been signed between 1979 and 1984. The pipelines were under severe competitive pressure when buying gas in the late '70s and early '80s, but when a billion dollar pipeline freely and voluntarily decides to buy gas supplies rather than risk running short in a tight market, that is not duress or compulsion.

51. After the *Phillips* decision in 1954, FERC tried setting individual cost-based rates, switched in the sixties to equally unsuccessful area rate pricing, and then was preempted by the NGPA's pricing categories. *See* Ceiling Prices; Old Gas Pricing Structure, 51 Fed. Reg. 22,168, 22,172-76 (1986). Pipelines could also get their cue on the instability of regulated prices from the oil industry, which was subject to emergency price controls in the seventies and then rapidly deregulated. Pipelines knew this when they signed their gas contracts. Pipelines study the gas market constantly because they know they assumed the risk of market decline, including decline caused by changing government regulations. Every pipeline has a marketing or planning department whose purpose is to analyze market fluctuations and their effect on price. Every pipeline has a staff whose job is to study, predict, and influence the course of government regulations. A pipeline's annual plan and other marketing documents invariably reveal a company that constantly measures the very market changes that it now claims are unforeseeable. It is the pipeline that has always sold gas in the markets whose decline it bemoans. It is the pipeline that is an expert in this market. It is the pipeline that has long understood its risks. And it is the pipeline, not the producer, that is ideally situated to adjust its purchasing practices to accommodate the resale market.

52. Information drawn from Twentieth Century Fund, courtesy of Micronomics (information on file with New Mexico Law Review).

When the pipeline promises in such a market to pay even if it may not want to take gas, it knows its demand may fall and its ability to resell change but that it will still have to take-or-pay for the gas. That is the risk of a take-or-pay promise. If, to the contrary, both pipelines and producers had expected the demand for gas to always remain high, the producer would not have needed the assurance that the pipeline would take-or-pay and the promise would have no value.

A seemingly more plausible *force majeure* defense, and a harder case, arises when the parties agree to list "failure of markets" as an event of *force majeure*. Yet the result should be no different in these cases. The Oklahoma Supreme Court dealt with a "failure of markets" clause in *Golsen v. ONG Western, Inc.*,[53] the most thoroughly reasoned and important take-or-pay decision to date. The *Golsen force majeure* clause included not only the catch-all causes beyond the control of the parties, but also "failure of gas supply or markets."[54] *Golsen*'s trial court had decided, after a bench trial, that declining market demand and the pipeline's inability to resell Golsen's gas *at a profit* were each sufficient reasons to trigger the failure-of-markets *force majeure* clause. Both this holding and its reasoning were emphatically reversed by the Oklahoma Supreme Court.

The justices first rejected ONG's purported defense of "inability to sell gas at a profit." Citing an early Oklahoma Supreme Court case for the bedrock common law principle that performance is not excused just because it has become more difficult or expensive,[55] the court noted that the Uniform Commercial Code ("Code") codified the same principle in its measure of damages. Financial disappointment or loss could hardly be a defense by itself when the Code's measure of damages is fixed by the difference between contract and market prices; this measure of damages forces the buyer to pay more than the market will bear.[56] The availability of a lower market price is of course the very reason that a breach and damages are likely to arise in the first place.[57] And the Code's section on impracticability states, and only pipelines could profess surprise at the principle, that "increased costs alone" cannot excuse performance and "[n]either is a rise or collapse in the market in itself a justification, for that is exactly the type of business risk for which business contracts made at fixed prices are intended to cover."[58]

Next came ONG's theory that a "failure of markets," an event not listed as a defense in standard *force majeure* clauses but included in ONG's contract, was proven by the 28.4% decline in ONG's sales. The

53. 756 P.2d 1209 (Okla. 1988).
54. *Id.* at 1211.
55. *Id.* at 1212.
56. *Id.*
57. If the contract price always equaled the market price, few pipelines would risk incurring liability by not buying gas that they can pass on at cost, even if they might maximize profits by buying someone else's cheaper gas.
58. *Golsen*, 756 P.2d at 1213 (citing 12A OKLA. STAT. § 2-615, cmt. 4 (1981) and RESTATEMENT (FIRST) OF CONTRACTS § 455)).

court found that ONG's lost sales, based on a decline in demand for gas at the price ONG paid Golsen, was not a "failure" of markets. Golsen and ONG had a thirty-page contract that was permeated by "the general purpose or intent . . . to arrange the purchase and sale of gas."[59] ONG's argument that a partial failure of demand by ONG's customers at ONG's preferred price absolved ONG from all responsibility for buying gas would "eliminate the requirement to pay for gas not taken as a practical matter, for any contract amount not taken would be the result of a partial failure of demand."[60]

Not only had ONG agreed to take Golsen's gas, but ONG made this promise in a contract that contained intricate price provisions spelling out who bore the effect of every possible rise or fall in price.[61] Letting ONG off the hook just because of three words in the *force majeure* clause on one page would defeat the purpose of the intricate price provisions.

> To allow *force majeure* to excuse performance under the contract clause containing the phrase "failure of markets" is to ignore these long and detailed arrangements as well as the extensive take-or-pay provision in favor of an interpretation of a short phrase in a contractual provision broadly denoting supervening impossibility. *Such a construction allows three isolated words to alter the entire character of a lengthy and detailed contract which provides for the exact situation herein encountered in this cause and that is the deregulation of gas price.* To allow this phrase to negate the lengthy major provisions of the contract places undue influence on a tenuous construction of two extracted portions of the *force majeure* clause. . . . Suspension of the obligation to take-or-pay for gas in the event of a partial failure of the market is contrary to the general purpose of the contract, and indeed, applying the phrase literally would transform the contract to another creature entirely.[62]

Most take-or-pay contracts contain similarly detailed language in their price provisions part of the contract, which generally allocates the burden of price changes rather than the take-or-pay section.[63]

59. *Id.*

60. *Id.*

61. For instance, Golsen was entitled to collect the maximum lawful regulated price while regulated prices were in effect, but with a price ceiling set at the NGPA section 102 gas price. *Id.* After deregulation, the contract provided a detailed formula to calculate a new price using the average of the three highest prices in certain counties. *Id.* These and other pricing provisions were so important that they took up five pages of the contract.

62. *Id.* at 1214 (emphasis added).

63. Ironically, in contract language totally ignored by *Golsen*'s many critics, Golsen had given ONG other relief from the market decline it feared. For instance, if during regulation a well qualified as a "stripper" well or otherwise might receive a high incentive price, ONG had a unilateral right to stop buying that well's gas and release the well from the contract unless a mutually agreed price was negotiated. *Id.* at 1213. If FERC or some state agency prevented ONG from passing through its full gas cost to its customers, Golsen had to refund the amount that could not be collected. *Id.* at 1213-14. And after deregulation, if ONG did not like the redetermined price, ONG had full discretion to propose an alternative price that it was willing to pay and to terminate the contract if Golsen did not accept ONG's new, preferred price. *Id.* at 1213. These provisions would

What is perhaps the most common way of reading *Golsen* is the wrong way. Many people seem to read *Golsen*'s holding to be that a market decline defense is necessarily inconsistent with any take-or-pay promise and that the defense therefore can always be disregarded. The pipelines were quick to attack the opinion on this basis, saying that the Oklahoma justices had simply ignored the market decline portion of ONG's *force majeure* clause.[64]

These readers have not read *Golsen* carefully. Although the court suggested that a market based defense generally is inconsistent with the take-or-pay promise,[65] the real basis for its decision was the court's distinction between a *failure* of markets and mere falling market demand. The distinction is explained in a footnote in which the court observed that "[t]he lack of *market demand* as distinguished from *absolute demand* is a function of price, although the trial court treated these items separately."[66] Thus the court held, quite correctly, that ONG's market must fail, not just decline—that there must be a failure of demand, not just no demand at a profitable price, for a "failure" of markets to occur.

Golsen's facts show perfectly well why this is the only fair reading of "failure of markets." ONG stopped buying contract quantities of gas in 1982. ONG had introduced evidence at trial that it lost some sales, but it did not prove that it had lost its market. The trial record showed that ONG's sales had indeed declined, falling 26.4% between 1981 and

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absorb the bulk of any strain caused by the declining market about which ONG complained. In addition, ONG had all of the 15-year contract term to make up gas for which it prepaid and would be reimbursed for any prepayments if the contract expired or reserves ran out before ONG had completed its "make-up." *Id.* at 1210. The contract could hardly have given ONG more protection to choose the price it liked and the time when taking its gas would be the most beneficial.

Even more significant than whether these clauses did or did not give ONG price relief is the fact that they were in the contract at all. As the court observed, it is inappropriate to call the effects of deregulation unforeseeable when the contract has a specific price clause for deregulation. *Id.* at 1213.

64. One of ANR Pipeline's lawyers led the attack by dashing off a letter to each justice of the Oklahoma Supreme Court. In addition to accusing them of "intellectually dishonest decision-making," he continued that "the majority's reasoning is the same as pretending that the parties who negotiated at arms-length never agreed to add the words 'failure of gas supply or markets' to their contract." Letter to the justices of the Oklahoma Supreme Court (Mar. 18, 1988).

65. Such a holding would of course be wrong. ANR's lawyer is correct that ONG and Golsen were free to limit their promises any way they want. They could have agreed that any decline in sales would excuse performance, even if this made the take-or-pay promise meaningless. They did agree to include "failure of markets" in their definition of *force majeure*, and calling this clause "three isolated words" does not alter the fact that Golsen agreed to put the three isolated words in its *force majeure* clause. Nor are the three words totally incompatible with a take-or-pay promise even if market decline is a defense. There could still be occasions when prepayments would be required even if a decline in demand occurred. For instance, ONG would be prevented from substituting cheaper gas for Golsen's gas and not prepaying if gas supplies increased, while demand stayed the same, or if demand increased. Nonetheless, the parties did not agree that falling prices, rather than a failed market, excused ONG and there was no reason why ONG should get *force majeure* relief for that reason. Indeed, the price mechanism in the contract actually gave ONG a break if prices fell. *See supra* notes 61-63 and accompanying text.

66. *Golsen*, 756 P.2d at 1213 n.2 (emphasis added).

1983, from 363 bcf to 267 bcf, but its revenues had only fallen 4.8%.[67] ONG's 1981 revenue was $965,889,000, its 1983 revenue only slightly less at $919,298,000.[68] The unit price for ONG's gas *continued to increase as it had in every year since 1975.*[69]

ONG was not a company *in extremis.* In 1984 ONG's sales rose again and its revenues passed the $1,000,000,000 mark for the first time and reached $1,024,018,000.[70] Total gas sales in 1984 were the highest in Oklahoma history.[71] Not surprisingly, ONG's 1982, 1983, and 1984 10-K reports, in which it was required by the federal law to describe all material financial information, made no mention of any market failure.[72] None had occurred. Indeed, between 1982 and 1984, the years of ONG's alleged market suffering and its inability to buy gas, ONG, the company claiming that it did not have enough room for Golsen's gas, spent $140 million to acquire new gas reserves.[73]

ONG's real argument, which worked its way into the trial court's findings, was that there was no resale market for Golsen's gas at the section 102 price ONG was required to pay Golsen to buy the gas.[74] Frustration with the gas resale market has nothing to do with failure of markets. If ONG refused to absorb some of its own gas costs to stay competitive, say by taking some or all of the $140 million it had used to buy new reserves and instead reducing the price at which it resold gas, that was a problem of ONG's own making, not a failure of its markets.[75]

The result should be the same, and the pipeline not excused, even if "failure of demand," rather than just "failure of markets," is a defined event of *force majeure.* Just before the Oklahoma Supreme Court decided *Golsen,* a federal trial court in Oklahoma applied a *force majeure* clause

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67. Brief for Appellant at 9, Golsen v. ONG Western, Inc., 756 P.2d 1209 (Okla. 1988) (No. 65833).

68. *Id.*; *see also Golsen*, 756 P.2d at 1212.

69. Brief for Appellant at 9-10, *Golsen*, 756 P.2d 1209 (Okla. 1988).

70. *Id.* at 9.

71. *Id.* at 13.

72. *Id.* at 14.

73. *Id.* at 16 n.4.

74. *Id.* at 13-14 (citing Finding of Fact ¶ 14, *Golsen v. ONG Western, Inc.*, 756 P.2d 1209 (Okla. 1988) (No. 65833)).

75. There is another reason why ONG should have lost. The evidence does not suggest any way that market changes left ONG unable to perform. As in most *force majeure* clauses, a failure of markets was no defense unless it left ONG "unable" to perform. The inability to perform section of the *force majeure* clause is quoted at *Golsen*, 756 P.2d at 1210. Holding that ONG did not meet this burden would have been a quick, easy way to reverse the trial court. Merely losing profits is not an inability to perform, any more than having to borrow to make a car or house payment excuses obligations under a car loan or home loan. ONG's slight reduction in revenue was not translated into any evidence that it could not buy Golsen's gas. Thus even had a true failure of markets occurred, ONG still had failed to meet its related burden of showing that it had become unable to perform. The burden of proving inability to perform is discussed in more detail in the next section. *See infra* notes 90-101 and accompanying text.

that included a "partial or entire failure of gas supply or demand."[76] In *Kaiser-Francis Oil Co. v. Producers Gas Co.*,[77] Producer's Gas Company ("PGC"), the pipeline, had argued that "failure of demand" meant its obligation was excused whenever "the demand for gas sharply decreased, with a corresponding decrease in the resale price of gas that PGC was obligated to take or pay for under the contracts."[78] The trial court and the Tenth Circuit disagreed. Looking at the contract as a whole, the trial court decided that such a reading would

> render the take or pay provisions of the contracts virtually useless, allowing PGC to claim a *force majeure* situation at any time it is faced with an over supply or a drop in the price of natural gas. If this had been the intent of the parties, a market out or price redetermination clause should have been included in the contracts. A *force majeure* clause is not a substitute for those types of clauses and thus provides no defense for PGC.[79]

Demand had to fail, not just fall.

The Tenth Circuit affirmed *Kaiser-Francis* after the *Golsen* opinion came down, citing *Golsen* as authority but adding in its own words that "PGC's interpretation of the *force majeure* provision is antithetical to the take-or-pay provision."[80] PGC's theory would have left it free to take gas when it could resell the gas at a profit, but shut in the wells during any drop in demand in the twenty-year life of the contract. The Tenth Circuit correctly held that "[s]uch a one-sided interpretation is suspect."[81] The interpretation is actually much more than "suspect." It would void the buyer's basic obligation under the contract. A contract is not a one-way street. If prices stayed down, PGC might never have bought gas again, yet Kaiser-Francis would have to keep its gas supply available just in case PGC changed its mind.

Even a quick look at standard take-or-pay contracts, most of which do not include "failure of demand or market" as *force majeure*, confirms the correctness of the decision to enforce these contracts as a matter of law. Inability to resell gas at a profit does not excuse a buyer from

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76. Kaiser-Francis Oil Co. v. Producer's Gas Co., 870 F.2d 563, 565 n.1 (10th Cir. 1989). The third case in the trilogy of influential early trial decisions, the *Challenger Minerals* decision reached the same result in reliance on *Kaiser-Francis*. Challenger Minerals, Inc. v. Sanot, No. 84-C-357-E (N.D. Okla. Sept. 9, 1986). The rule is the same in Texas, in which an intermediate court of appeals has held that a falling gas market is no defense because "an economic downturn in the market for a product is not such an unforeseeable occurrence that would justify application of the force majeure provision, and a contractual obligation cannot be avoided simply because performance has become more economically burdensome than a party anticipated." Valero Transmission Co. v. Mitchell Energy Corp., 743 S.W.2d 658, 663 (Tex. Ct. App. 1987).

77. 870 F.2d 563 (10th Cir. 1989).

78. *Id.* at 566.

79. Order Granting Partial Summary Judgment at 7, Kaiser-Francis Oil Co. v. Producer's Gas Co., No. 83-C-400-B (N.D. Okla. June 19, 1985).

80. *Kaiser-Francis*, 870 F.2d at 566.

81. *Id.*

honoring a contract in which it expressly undertook to provide guaranteed payments to the seller. The annual take-or-pay obligation shows that the parties foresaw, even if they may not have expected or desired it, the possibility of a market decline so severe that the pipeline might not want to take enough gas for periods of a year or more. The five-year minimum make-up provision required by FERC underscores this basic assumption that severe market decline can occur, even if it is not expected to occur.[82]

The Oklahoma Supreme Court correctly emphasized the fact that the possibility of severe price changes is reflected a second time in the kind of pricing terms that show up in these contracts. Many take-or-pay contracts contain incentive prices that were far above the market price even on the day the contract was signed.[83] The gas sold under those contracts was always bought "at a loss" and was never likely to have been resold at its cost, but apparently fit the pipeline's business planning anyway. Other contracts have periodic, usually annual, price redetermination, sometimes coupled with an "economic out" clause which lets the pipeline terminate the contract if it doesn't like the price, or a "market out" clause which lets the pipeline reduce the price it pays as the market changes.[84] Some have "FERC-out" clauses, requiring refunds of costs that cannot be included in the pipeline's rate base.[85] These price terms most clearly reflect the intent that the pipeline will bear the burden of changes in the resale price. The price terms provide a structure to allocate changes in price, changes that might cause the contract price to end up far above the going rate in the resale market at the other end of the pipeline. The pricing terms confirm that such a danger, the risk of not being able to resell the gas at its price, is well known from the beginning.

Some courts still believe they see material fact disputes that require a jury to decide *force majeure* defenses, but their opinions invariably give only cursory review to the *force majeure* clause and lack thoughtful consideration of how that clause fits into the general purposes of a take-or-pay contract. The decisions are not examples of reasoned decision-making. For instance, in *Exxon Corp. v. Columbia Gas Transmission*,[86] Columbia Gas alleged that such events as an "abnormally mild winter" and "severe economic recession," as well as its alleged inability to resell its gas at its high cost, were causes beyond its control and therefore *force majeure*.[87] The court announced summarily, without analyzing the

82. As the court in *Golsen* noted, the measure of damages for breach or repudiation, the difference between the contract price and some lower market value, is itself predicated on the assumption that the buyer must perform even if at a loss, as are the Code's sections on impracticability. *Golsen*, 756 P.2d at 1212-13.

83. *See* Williams Natural Gas Co. v. FERC, 943 F.2d 1320, 1337 (D.C. Cir. 1991) (pointing out that incentive prize must be judged for reasonableness at time contract was made).

84. 4 H. WILLIAMS, *supra* note 16, § 726, at 758-61; Johnson, *supra* note 20, at 104-05.

85. 4 H. WILLIAMS, *supra* note 16, § 726, at 758-61; Johnson, *supra* note 20, at 103-04.

86. 624 F. Supp. 610 (W.D. La. 1985).

87. *Id.* at 612.

contract's terms or its purpose, that it "is clear to this Court that there exists a very real question of fact as to whether Columbia has actually been rendered unable to perform, and whether the events cited by Columbia are encompassed by the force majeure clause of the contracts in question."[88] The court did not bother to identify specifically even one of these fact questions. *Columbia Gas* is an example of a court taking the easier path of abdicating its duty to weed out frivolous claims and instead throwing everything to the jury, without the hard but necessary analysis needed to see whether summary judgment is proper. Other courts have also followed the path of simply declaring events like changed federal regulations as *force majeure*, without any discussion of why.[89]

2. Pipelines Are Not "Unable" to Perform Just Because They Cannot Resell Gas at a Profit

Even if an event of *force majeure* occurs, most contracts do not excuse performance unless the *force majeure* occurrence in some way makes the pipeline unable to perform.[90] Some courts treat the question of whether an event is one of *force majeure* and whether it has an effect that excuses performance as the same, but they are actually two separate barriers the pipeline must overcome if it is to be excused and each ordinarily requires quite different proof.[91]

Too much ink has been wasted in a debate on whether a *force majeure* clause must forbid performance, leave a pipeline unable to perform, or merely affect performance, and what the difference between these standards could be. A few contracts say clearly that the event must "prohibit" or "prevent" performance to be an excuse. Many others state that the pipeline must become "unable" to perform before it is excused.[92] Pipelines argue that being "unable" to perform requires only a showing that

88. *Id.*

89. *E.g.*, Resources Inv. Corp. v. Enron Corp., 669 F. Supp. 1038, 1043 (D. Colo. 1987); NGPL v. Anschutz Corp., Cause No. 85-L-3446 (E.D. Ill. Nov. 17, 1987) (citing other cases).

90. To give an easy example, even if "fire" is an event of *force majeure*, a fire in the pipeline's employee parking lot still does not excuse it from buying gas at wells hundreds of miles away.

91. *See, e.g.*, Atlantic Richfield Co. (ARCO) v. ANR Pipeline Co., 768 S.W.2d 777, 781 (Tex. Ct. App. 1989) (holding Order 380 an event of *force majeure* as a matter of law, but leaving open as a jury question whether Order 380 left ANR unable to perform).

92. A variety of the standard *force majeure* provisions are listed in 4 H. Williams, *supra* note 16, at § 733. In a thoroughly reasoned decision involving a coal take-or-pay contract, Judge Posner analyzed a *force majeure* clause that included government orders that "wholly or partly *prevent*" the buyer from using the coal. Northern Indiana Pub. Serv. Co. (NIPSCO) v. Carbon County Coal, 799 F.2d 265, 274 (7th Cir. 1986) (emphasis added). Most take-or-pay contracts do not contain quite this strong language.

Wheeling Valley Coal Corp. v. Mead, 186 F.2d 219 (4th Cir. 1950), is a case often cited for the proposition that events of *force majeure* must "prevent" performance, rather than merely make a pipeline somehow unable to perform, for them to be a defense. *Wheeling* actually supports the opposite view. The contract in *Wheeling* expressly said that the events must "prevent" performance, *id.* at 221, as was the case in *NIPSCO*. Thus, these cases can be distinguished from contracts that do not use the word "prevent" and presumably the difference in meaning must be given at least some effect. Contracts with lesser language should impose a lesser burden.

performance has become more difficult, not that it is directly prohibited. Obviously were this correct and an event had to merely "affect" performance, and if any cause beyond the pipeline's control can be an event of *force majeure*, the pipeline would never have to buy gas it could not resell at a profit. All risk would fall back to the producer and the take-or-pay clause would become a nullity.

Although the cases rarely address precisely how much less of an effect is required to prove the excuse of "inability" to perform rather than being "prevented" from performing, the courts have made it clear that the financial "inability" the pipelines are talking about is not a *force majeure* excuse under either standard. What pipelines are complaining about is that they can't resell contract gas at a profit and they don't want to pay for their economic miscalculation. As the *Golsen* court put it emphatically, an inability to resell at a profit is not *force majeure*.[93]

The debate over whether performance must be prohibited, rather than the pipeline merely becoming financially "unable," is purely academic. The reason is that no pipeline has yet shown that it is financially unable to buy the gas it refuses to buy. Jurors who have to pay their bills, and pay them on time, will have no trouble seeing through the charade. Most pipelines remain profitable. They have renegotiated the majority of their high-priced contracts for pennies on the dollar. At the same time, they are enjoying new profits during their supposed time of trouble from transporting other companies' gas. Pipelines have more than enough cash to honor the contracts that are not renegotiated. This is why pipelines fight desperately to keep their profits, revenues, and other financial information from the jury.

The best reading of a take-or-pay promise is that financial inability

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93. Golsen v. ONG Western Inc., 756 P.2d 1209, 1212 (Okla. 1988). This basic common law rule is incorporated into the Uniform Commercial Code as well as the RESTATEMENT (SECOND) OF CONTRACTS. U.C.C. § 2-615, comment 4 (1991); RESTATEMENT (SECOND) OF CONTRACTS § 455 (1990).

One of the few cases to discuss the meaning of "unable," International Minerals & Chem. Corp. v. Llano, Inc., 770 F.2d 879 (10th Cir. 1985), does so in a different context than *force majeure*, but it provides no support for the pipelines' arguments even though it is one of their favorite authorities. In *Llano*, the buyer waived its right to claim *force majeure* by failing to give adequate notice. *Id.* at 886. The issue of whether Llano was unable to perform came up again, however, under the buyer's claims of impracticability and under a contract provision which said that if the buyer was "unable" to receive gas because of events beyond its reasonable control, adjustments would be made in the minimum bill. *Id.* at 885. The Tenth Circuit therefore analyzed in some detail what "unable" meant in the contract.

The court first held that unable could not mean impossibility, because the buyer could always take gas, even if it had to vent the gas in the air. *Id.* at 886. The court understandably refused to require economic waste by making the buyer purchase gas it could never use. The court therefore defined "unable" to mean impracticable as that term is defined under New Mexico common law and the Uniform Commercial Code. The common law permitted an impracticability defense only if an unanticipated circumstance made performance of the contract promise "vitally different" from what both parties *should have* contemplated. *Id.* The buyer in *Llano*, a mine and processing facility, was excused under this provision because there was no "technically suitable way" for it to comply with unexpected changes in New Mexico environmental regulations without shutting down its plant. *Id.* at 887. In contrast, the pipelines are technically equipped to continue taking all the gas just as they have always done so in the past.

cannot be a defense in any event. The pipeline's promise is a *guarantee* of a fixed stream of revenue. It binds itself to pay a certain amount of money, an amount that will be set by measuring the volume of the producer's gas. Had pipelines guaranteed payment on a note, they would be laughed out of court if they asked to be excused because they had run out of money or because they had lost the money they had borrowed, *i.e.*, the benefit they had received, when they expected to make profits on it instead. Yet that is the pipelines' complaint. They guaranteed payments because they expected to make money selling producers gas, and the world hasn't turned out as they expected. Contracts are enforced all the time even if they disappoint one of their parties.

If the pipeline could argue financial inability at all, of course, its "inability" to perform the individual contract should be tested against its overall financial assets. The issue is not how much a pipeline would lose if it had to resell a given producer's gas. The pipelines intended all along to combine their gas costs into a single weighted average cost of gas, which is the price they are allowed to bill their customers.[94] They only entered high-priced contracts in the first place because they calculated that this gas was affordable when averaged with their other, lower gas costs. The gas in the high-priced contracts never could have been resold at its cost. When a pipeline complains that open access and the competitive market have reduced its ability to buy some producer's high-priced gas, the jury is entitled to look at the pipeline's overall financial situation. Jurors are entitled to consider the increased revenues that the pipeline has earned by transporting open-access gas owned by others, its continuing revenue from the fixed demand charges left intact by FERC's Order 380, and the profits it makes by reselling other, cheaper gas.

The loudly proclaimed inability to perform is virtually never grounded in reality. In *Golsen*, for instance, ONG claimed to be "unable" to perform even though its profits were increasing, its revenues had barely fallen off, and it had enough money to spend $140 million on new gas reserves in one year alone.[95] The many varieties of the "unable" to

94. For a discussion of the distortion caused by this weighted pricing mechanism, see Pierce, *supra* note 18, at 362-63.

95. *See supra* notes 67-75 & accompanying text. In ANR's case ANR bought less than contract quantities from companies like ARCO as early as 1983. In a trial against ARCO in 1987, ANR showed the jury a huge colored chart which indicated that its annual sales had fallen from 600 billion cubic feet to 200 cubic feet between 1984 and 1987. These charts, as well as ARCO's excluded charts showing ANR's not only continuing but *increasing* profitability, are reproduced at the back of ARCO's brief on appeal. ARCO Brief, *infra* note 98, app. *Compare* Plaintiff's Exhibits 116-20 *with* Defendant's Exhibits 2-33A. For that reason, ANR claimed to be unable to pay for $40 million of ARCO's gas. At the same time, ANR persuaded the trial judge to hide all information of its financial condition from the jury. The evidence the jury was forbidden to see would have shown that ANR received a fixed capacity charge of $280 million each year, every year, from its biggest customer. ARCO Brief, *infra* note 98, at 41-43. Other evidence excluded by the judge showed that ANR's "gross cash flow," its income after deduction of costs and taxes, was *$231* million in 1983, *$388* million in 1984, *$353* million in 1985, and *$328* million in 1986. *Id.* at app. Plaintiff's

perform argument boil down to the claim that a pipeline is unable to perform if it cannot resell all the gas at a profit. This problem, if it exists, is irrelevant to the take-or-pay contract. The pipeline receives the gas and takes title at the wellhead or at some point of delivery close to the wellhead. After that, what it does with the gas is its own business. Regulations that affect its ability to sell the gas at the profit it seeks hundreds or thousands of miles away have nothing to do with the pipeline's ability to take or to pay for the gas except, perhaps, in the extreme case where the pipeline cannot sell the gas at any price and runs out of room to store gas. Even in these circumstances, the fact that the take-or-pay promise is an alternative obligation comes into play. Whether or not the pipeline can take the gas has nothing to do with its ability to pay. When it made the alternative take-or-pay promise, it accepted the risk that it might have to prepay and later be unable to make up the gas.[96] That is its risk, not the producer's. The standard contract contains no guarantees about what the pipeline can do in the markets where it resells its gas. What price it gets thousands of miles away, what profits it receives, what steps it takes to market, what regulations it encounters; none of these factors condition the obligation to buy gas at the wellhead. Pipelines and producers are not partners or joint venturers. The producer gets none of the pipeline's profit in good years. The take-or-pay contract provides no reason for it to bear the pipeline's losses in bad years.

The "unable to perform" argument has an even deeper factual flaw. It cannot be squared with the fact that pipelines, which do business in a sheltered regulatory market, are given rates designed to permit a positive return on most of their costs. The market does not set their rate of return, FERC does. FERC has let pipelines recover 100 percent of the carrying costs for any prepayments they make.[97] The pipelines can sit back and decide when the market will be best able to absorb their gas. Furthermore, FERC lets them directly bill *all* of their fixed costs, including fixed operating and carrying costs, and forces their customers to pay these costs even if they buy no gas.[98] FERC has helped guarantee that pipelines will be able to makeup the gas by requiring every producer to offer at least a five-year make-up period.[99] It has provided a new opportunity to recover gas costs by letting pipelines spread their gas costs

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Exhibit 117. ANR sent approximately $200 million or more annually in dividends upstream to its parent, the Coastal Corporation, from 1984 to 1986, an amount almost three times the annual dividends from 1981 to 1983. *Id.* at 43 & app. Plaintiff's Exhibit 117. ANR's return on capital and common equity increased sharply from 1983 to 1984-1986. *Id.* ANR became more profitable after "*force majeure*" occurred. In short, the take-or-pay "crisis" was the best thing that ever happened to ANR Pipeline.

96. Lone Star Gas Co. v. McCarthy, 605 S.W.2d 653, 656-67 (Tex. Ct. App. 1980).

97. *E.g.*, Order 380, *supra* note 31, at 22,780 n.16, 22,785 (1984).

98. ANR Pipeline, for instance, collected $280 million a year from one of its customers even if it sold no gas. Brief of Appellant, at 41-44, Atlantic Richfield Co. v. ANR Pipeline Co., 768 S.W.2d 777, 780 (Tex. Ct. App. 1989) [hereinafter ARCO Brief].

99. 18 C.F.R. § 154.103 (1991).

over their transportation services. And when the pipeline buys and takes gas, it can include all prudently incurred gas costs in its rates.[100] FERC even tried to guarantee pipelines that they would not be stuck with all of their gas costs by providing that if they did not expect to recover their full gas costs when they resell their gas, FERC would guarantee recovery of up to fifty percent of these costs through a fixed surcharge if the pipelines absorb the rest.[101] At a minimum, a pipeline will be substantially protected if it prepays, waits until the point in the next five years when it has the best chance of recovering the majority of its gas costs, and with perhaps some reduction in price, so that it may have to absorb some of its gas cost, takes and sells the makeup gas.

These guarantees of pipeline cost recovery could not contrast more sharply with the exposure of the gas producer, who must rely on its take-or-pay contract and that contract alone to guarantee recovery of the high costs of exploring and producing natural gas. No government regulator protects producers from pipelines that refuse to pay. The producer has to rely on the courts and the law. If they falter, there will be no relief.

3. Pipelines Have Not Taken Diligent Steps to Perform

The third broad reason why the changes in today's increasingly competitive market do not support a *force majeure* defense is that *force majeure* clauses impose a duty on the pipelines, as the parties claiming the defense, to take *all* reasonable, diligent steps to perform. Even if the take-or-pay promise did not allocate market risks to the pipeline and even if a pipeline truly became unable to pay for the gas at some point, most could not meet the burden of showing that they took all steps necessary to perform. A party seeking excuse still must show that "it tried to overcome the results of the events' occurrences by doing everything within its control to prevent or minimize the event's occurrence and its effects."[102]

Most pipelines take no serious steps to perform. Poor mouthing their financial condition, urging producers to commiserate by giving up contract rights, and then sitting back in the bad times and banking substantial profits is not a diligent effort to perform. Nor is it diligent to refuse to take gas without making all reasonable efforts to build or lease storage for gas that cannot be sold today; to extend low-priced long-term contracts, enter new contracts, and buy up cheap gas on the spot market when that cheap gas displaces more expensive gas they were already

100. While many pipeline officers will lie about gas contracts and some of their litigation strategies are just dumb, few are dumb enough to jeopardize recovery of their gas costs by claiming that their purchases were imprudent.

101. *See infra* text accompanying notes 186-232.

102. Gulf Oil Corp. v. FERC, 706 F.2d 444, 454 (3d Cir. 1983), *cert. denied*, 464 U.S. 1038 (1984).

obligated to buy; to waste money drilling new wells on the pipeline's own acreage and that of affiliates when it cannot take gas it already has under contract; or to refuse to take gas that could be sold if the pipeline absorbed part of the gas cost or made its takes during the make-up period.

A contract is a serious obligation. By fixing future patterns of behavior, the parties guarantee each other's performance even if they later want to do something else. No one would go to the trouble and expense of negotiating a written contract if the contract could be dropped unless both sides always continued to agree that the contract had remained a good deal.

4. Pipelines Must Give Specific, Timely Notice of *Force Majeure*

Producers should always check to make sure that the pipeline gave prompt, detailed notice of the facts supporting its claim of *force majeure*. To protect against whimsical declarations of *force majeure*, most *force majeure* clauses require that notice be given "immediately" or "as soon as possible." Moreover, the party claiming *force majeure* must give full particulars of the cause of *force majeure* or the pipeline will waive its right to claim the excuse.[103] Pipelines generally had legal advice as they schemed to break their contracts, and so were careful to give some notice, but the boilerplate, conclusory assertions that are standard in *force majeure* letters should be analyzed to see if the notice came soon enough and was detailed enough to satisfy contract requirements. *Force majeure* letters often just reference generalities like recession, increased gas supply and competition, and a handful of federal regulatory orders and then happily announce that the pipeline is excused but with a reminder that the producer had better not sell its gas to anyone else, just in case the pipeline changes its mind. Conspicuously absent are any facts about how much gas customers bought in the pipeline's resale market, *i.e.*, whether demand really declined, why the pipeline can't absorb some gas cost and still resell the producer's gas at competitive prices, the steps the pipeline has taken to try to sell the gas, and why the pipeline can't just prepay for the gas and take it later, an alternative under which FERC *guarantees* the pipeline's right to pass through the carrying cost of the prepayment. Producers should focus carefully on the timing and adequacy of the pipeline's notice. This may be a quick way to short-circuit some *force majeure* defenses.

5. The Exception That Proves The Rule: *ARCO v. ANR, Dyco v. ANR*, and the Other ANR Cases

Even though the law is clear that no *force majeure* defense arises just because prices have fallen, courts have had difficulty with a series of

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103. This happened to the buyer in International Minerals & Chemical Corp. v. Llano, Inc., 770 F.2d 879, 885 (10th Cir. 1985).

cases involving ANR Pipeline Company. ANR has won two major cases at trial using the *force majeure* defense. Contrary to what many pipelines and their lawyers suggest, the ANR cases, right or wrong, do not have much precedential value. The standard ANR contract contains two provisions that differ dramatically from standard *force majeure* language: (1) the *force majeure* clause lists "any act or omission including failure to take gas of a purchaser of substantial quantities of gas from Buyer which is excused by any event or occurrence of the character herein defined as constituting force majeure," and (2) on any day when deliveries or takes are "affected" by *force majeure*, the contract quantity is deemed to be "the actual volume delivered and purchased on each such day."[104]

The lead ANR case is *Atlantic Richfield (ARCO) v. ANR Pipeline Co.*[105] ANR traditionally sold most of its gas to one customer, Michigan Consolidated Gas Company ("MichCon"), which until recently had owned ANR. ANR had "minimum bill contracts" which required MichCon to pay for minimum amounts of gas whether it took that gas or not. In 1985, FERC voided such minimum bills in Order 380 because FERC found them to be unjust and reasonable under the Natural Gas Act. Freed of its contract obligation to make minimum payments by Order 380, MichCon reduced its annual purchases from ANR by 210 billion cubic feet.[106]

As MichCon's purchases fell, ANR shifted its misfortune right back onto ARCO. ANR told ARCO that Order 380 and ANR's falling sales made ANR "unable" to buy ARCO's gas. ANR called MichCon's declining purchases an event of *force majeure*. In fact, in the years that followed when ANR refused to buy over $40 million of gas it should have bought from ARCO, ANR still demanded and received a fixed capacity charge called a "demand charge" from MichCon of more than $280 million a year.[107] In 1985, the year Order 380 took effect, ANR had after-tax income of $285 million and it sent more than $200 million upstream to its corporate parent, the Coastal Corporation.[108] In spite of this enormous profitability, ANR maintained that it was unable to buy ARCO's gas.

104. Atlantic Richfield Co. (ARCO) v. ANR Pipeline Co., 768 S.W.2d 777, 780 (Tx. Ct. App. 1989).

105. 768 S.W.2d 777 (Tx. Ct. App. 1989).

106. *Id.* at 781 & n.1.

107. *See supra* note 98.

108. *Id.* In a great leap of faith, the same Coastal Corporation whose subsidiary ANR was suing to void its take-or-pay obligations on the grounds that market changes made them unenforceable had brought suit through another subsidiary, Colorado Interstate Gas ("CIG"), suing a reluctant buyer in Wyoming federal court when the buyer refused to buy CIG's gas. The buyer defended on *force majeure* grounds. Rejecting those arguments in that case, CIG won a judgment of almost $400 million. *See supra* note 6. CIG, the company saying that take-or-pay contracts are enforceable, and ANR, the company abandoning millions of dollars in debts because it claimed they aren't, are so close that they share the same general counsel and other officers. Coastal sits at the top of the two companies and rakes in the increased profits that are the reward for refusing to take-or-pay for gas.

At trial, ANR was allowed to show the jury huge colored charts tracking its falling sales. The pipeline argued that if this supposed event of *force majeure* affected its ability to perform even a small amount, it was excused from all performance and the daily, required contract quantities were reduced to any amount it desired to take.[109] After painting ANR as a victim by showing the jury the charts of ANR's declining sales, ANR persuaded the court to exclude ARCO's countervailing proof that ANR had remained hugely profitable and proof of the fixed $280 million demand charge ANR received each year like clockwork from MichCon. This evidence, of course, would have shown the jury that ANR was fully able to perform the ARCO contract.

Adding to these errors, the court followed ANR's invitation and instructed the jury that ARCO, as the party claiming damages, "had the duty to take all reasonable steps to try to mitigate, reduce, and alleviate its claimed losses."[110] As ARCO correctly pointed out, its gas was dedicated to ANR and could not be sold to anyone else without ANR's permission and FERC's approval.[111] The Court gave no indication what business this pure question of law had being put before the jury. With his foot in this door, ANR's counsel told the jury

> There has been no effort, zero effort on the part of the plaintiffs to mitigate anything. And, that is the legal duty that the court is instructing you with respect to [in instruction no. 2] and if they haven't done it, you know, bye-bye birdie.[112]

Then, after the jury heard detailed evidence that the course of conduct on both sides had been to interpret the contract *ARCO*'s way, the court instructed the jury that it could only consider the contract "as written," and not this course of conduct, in reaching its verdict. Yet, although both sides agreed that the contracts were unambiguous, the court refused to tell the jury what they meant. Not surprisingly, the jury that was deprived of its right to see the most probative evidence that ANR could indeed fully perform its contract and was at the same time subjected to ANR's contract distortions, all without correction by the court, found for ANR.[113]

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109. By this self-indulgent theory, of course, MichCon could have cut back its purchases from ANR by one percent yet ANR could have refused to take 100% of ARCO's gas and been fully exonerated. Worse yet, ANR would keep control over the fate of ARCO's gas and could require ARCO to stand ready to deliver gas at any time, not selling it to anyone else, yet arbitrarily refuse to take or pay for gas for the entire remaining contract term if ANR so chose. This is not a contract.

110. ARCO Brief, *supra* note 98, at 37, citing TR 3764.

111. *Id.* at 37.

112. *Id.* at 38 (quoting SF 2202).

113. ANR indulged in other prejudicial conduct. For instance, its lead attorney brought astronaut Gene Ciernan to the closing argument and began by noting that the astronaut was his friend. *Id.* at 49. The lawyer urged the jury to act on regional prejudice, calling ARCO some 49ers in from out of state looking for a strike. *Id.* at 48. Among the worst of ANR's efforts at prejudice was counsel's surprise use on closing argument of blown up pictures of ARCO's witnesses, with partly

The Texas Court of Appeals affirmed the judgment for ANR by summarily pronouncing that Order 380 was an event of *force majeure*.[114] It then held that the trial court correctly let the jury decide if ANR had become "unable" to perform, the question on which the jury had found for ANR, without having heard one iota of evidence about ANR's ample financial ability. And, on the mitigation issue, the court found that it "doubt[ed] this instruction was appropriate under the facts of this case," but it "cannot understand how reversible error was committed in view of the failure of the jury to find liability."[115] The court said that the instruction concerned only the amount of damages, not liability.

The appellate court did agree with ARCO that the trial court, not the jury, should have construed the contracts, but it affirmed an instruction that merely told the jury that it might "consider and apply all of the terms and provisions of the contracts as written," without giving the jury a clue as to what the contracts meant, and that kept the jury from considering the parties' prior course of conduct.[116] As its apparent justification, the court cited the provisions of the Commercial Code that exclude prior dealings if they are inconsistent with the contract's terms. The court never discussed any of ARCO's evidence, however, and so gave no indication why ARCO's course of performance evidence was or might be inconsistent with the contract's language. Finally, the court affirmed the exclusion of evidence of the hundreds of millions of dollars that ANR received as the demand charge from MichCon, as well as evidence that Order 380 coincided with increased profitability for ANR.[117] The only reason given for affirming exclusion of this evidence was that it was "not relevant to the stated question."[118] The court did not identify the "stated question," which it must have felt was whether ANR could take, not pay for, ARCO's gas. The court provided no explanation for the counter-intuitive result that evidence of profits and financial ability

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unadmitted deposition or trial excerpts in large letters beneath the picture. The pictures were appended to ARCO's brief. PX 136, 130, 135, 138, 131, 137 (attached to back of ARCO Brief). ARCO objected vigorously, but the court of appeals overruled this point because ARCO did not give the trial court "proof . . . supporting its present contention that the statement attributed to each witness was not based upon testimony." 768 S.W.2d at 785. That obviously is an impossible burden that no counsel could bear. To be presented at the end of a trial with quotes taken out of context or from depositions, and to have to prove that these statements were never introduced anywhere in a many-thousand-page transcript, would limit the practice of law to lawyers with photographic memories (and calm wits). Nothing in the Texas rules before or since indicates that such surprise and unfair surprise tactics could be countenanced in the interest of justice or anything else.

114. Atlantic Richfield Co. (ARCO) v. ANR Pipeline Co., 768 S.W.2d 777, 781 (Tx. Ct. App. 1989).

115. *Id.* at 784.

116. *Id.* at 783.

117. The court did let the jury learn that ANR still received a demand charge, but there was no way the jury could determine how this evidence bore on ANR's ability to perform without knowing how *much* the annual charge was.

118. *Id.* at 784.

could ever be irrelevant in a case about pipeline's ability to pay for gas.[119]

The *ARCO* decision is wrong on the merits for many reasons. A number of the errors are obvious. As the court of appeals agreed, it is the trial court's duty to interpret unambiguous contract language. The failure to instruct the jury on the contract language left ANR free to make several clearly erroneous arguments. First, ANR took the position that whenever any substantial decline in takes of one of its major customers occurred, ANR could reduce its takes by *any* amount it wanted, even if only a "teeny weeny" bit of *force majeure* occurred.[120] Not only does this reading let ANR turn temporary misfortune into permanent absolution, but it ignores the other parts of the *force majeure* clause. For instance, ANR is required to remedy any cause of suspension "so far as possible with reasonable dispatch." If ANR is really only a "teeny weeny" bit unable to take-or-pay, it still must take or pay for all the gas it can "as far as possible." And it must do all it can to go back to business.

Under ANR's theory, in contrast, it had no obligation to do anything to take any gas no matter how minor the event of *force majeure*. ANR's exculpatory theory also writes out of the contract the language that if a party is rendered unable "wholly *or in part* to perform an obligation, . . . *such* obligation or condition shall be suspended . . ."[121] (*i.e.*, the total *or partial* obligation) while the *force majeure* cause exists. Under ANR's interpretation, even if a party is only partly, even only infinitesimally, unable to perform, the entire obligation will be suspended if ANR chooses not to perform.[122] Further, the language of the paragraph reducing "affected" takes to the amount actually taken on days of *force majeure* itself suggests that there must be a relationship between the *force majeure* event and the amount taken, a result defeated by ANR's theory. And, as at least one court has pointed out, ANR's reading that it can reduce the amount taken to *any* amount at all is inconsistent with the ANR contract requirement that a party will not be excused unless it is rendered "unable" to take the gas it will not take.[123]

The trial judge's failure to properly instruct the jury injected a second

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119. Nor did the court mention ANR's ridiculing ARCO for being an out-of-state corporation and other improper jury arguments. *See supra* note 113. ARCO Brief, *supra* note 98, at 47-49.

120. *See* Brief for Appellee at 12-16, *ARCO*, 768 S.W.2d at 780 [hereinafter ANR Brief].

121. *ARCO*, 768 S.W.2d at 789 (emphasis added).

122. *See supra* note 102 and accompanying text.

123. In a decision that thus far stands on its own, the Michigan federal trial court in ANR Pipeline Co. v. Devon Energy Corp., No. G86-1123 CA (W.D. Mich. Feb. 1, 1989) (order denying defendant's motion for partial summary judgment), found ANR's contract ambiguous because of the conflict between these two provisions. *See id.* at 10-11. At a minimum, if courts will not reject ANR's contract argument as a matter of law, they should find the contract ambiguous and let the jury consider all surrounding evidence of intent and course of performance, evidence that the trial judge excluded in the *ARCO*. At best for ANR, the conflict between the reduction-in-takes language and the requirement that ANR be unable to perform makes the contract ambiguous.

error when ANR's counsel argued that the requirement of "inability" to perform did not apply to specifically listed events of *force majeure*, like MichCon's failure to take.[124] ANR's novel theory was that if a specifically described event of *force majeure* like government regulation occurred, the pipeline was automatically off the hook. Only if ANR relied on an unlisted "cause beyond its control" did it have to prove inability to perform. The jury could have believed that ANR did not have to prove inability to perform. ANR made this argument even though its contract could not state more clearly that a party must be "unable to perform" to claim benefit from any *force majeure* event.[125]

These two reversible errors were compounded when the court refused to let the jury know that ANR could easily have afforded to buy ARCO's gas. Take-or-pay is an *alternative* obligation.[126] ANR had the burden of proving that it could not take ARCO's gas or make a prepayment. ANR was given full latitude to woo the jury with charts of its declining sales, but the jury was not allowed to see proof that these declining sales had not left ANR unable to pay. ANR's income increased during much of the time it claimed to be "unable" to buy gas. Maybe ANR would not take the gas, but it certainly could pay for the gas. By excluding proof of ANR's finances, the trial court excluded the most directly probative evidence of ANR's ability to perform. This trial was not fought on a level playing field. Faced with the drastic decline in sales shown by ANR's charts and allowed no evidence of the true fact that ANR had not been hurt financially, the jury not surprisingly found for ANR.[127]

By refusing to interpret the contract, allowing ANR to sponsor its distorted revisions of the contract's language, preventing the jury from considering the financial evidence of ANR's ability to perform, letting ANR argue mitigation when ARCO had no such duty, and preventing the jury from giving any weight to ANR's course of performance, the trial court helped give ANR the win it got. The result shows why courts, not juries, should decide unambiguous questions of law.[128] Clear and

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124. *See* ARCO Brief, *supra* note 98, at 18-21.

125. Apparently even ANR's "grammarian" admitted that the inability requirement applied to the entire *force majeure* clause. *Id.* at 20. The court let ANR put on the stand an English professor, who quickly admitted she had no experience or knowledge about customs in the natural gas industry, and had her opine freely on the grammatical meaning of parts of ANR's *force majeure* clause. The result is a new category of contracts, ones which the parties stipulate are so clear as to be unambiguous but which to ANR are so ambiguous as to require an expert grammarian to help the jury figure out what they mean.

126. *See, e.g.*, Golsen v. ONG Western, Inc., 756 P.2d 1209, 1215 (Okla. 1988).

127. And a final error, of course, was ANR's arguing that the slightest failure by ARCO to mitigate, when ARCO in fact had no obligation to mitigate, was "bye bye birdie."

128. Some of the other ANR courts have also left peculiar questions open for the jury. For instance, the courts in Dyco Petroleum Corp. v. ANR Pipeline Co., No. 867-C-1097 (N.D. Okla. Nov. 2, 1987) and Hamilton Bros. Oil Co. v. ANR Pipeline Co., No. CIV-88-132-A (W.D. Okla. Feb. 20, 1989), viewed it as a fact question whether ANR would be allowed, under federal regulations, to reduce the price it charged *its customers* below the price that ANR paid for the gas it was reselling. In fact, not only has FERC gone out of its way to encourage pipelines to do just that,

unambiguous contracts quickly become unclear and unpredictable when a party is allowed to bombard the jury with its after-the-fact interpretation of a contract that it now wishes that it never entered.[129]

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showing that there is no possible legal impediment to this conduct, but the question of whether federal regulations prohibit such conduct is a question of law. In Order 380, FERC actually told ANR that FERC would act quickly to help pipelines reduce their rates. Order 380, 49 Fed. Reg. 31,259, 31,274 & n.41 (1984) [hereinafter Order 380A]; *see also id.* at 31,273 nn.32-38 (observing with approval that some pipelines had cut rates by reducing margins to increase sales).

The experience of the past few years is that pipelines have no difficulty finding experts willing to propound theories of what government regulators will do that bear no likeness whatsoever to the government regulations. It is for impartial judges, not paid experts, to decide the meaning of controlling laws and regulations.

129. The mischief wrought by *ARCO* was repeated in the next big ANR case, one including the producer Dyco Petroleum. *See* Dyco Petroleum Corp. v. ANR Pipeline Co., No. 867-C-1097 (N.D. Okla. Nov. 2, 1987). Like the *ARCO* court, the *Dyco* trial court found as a matter of law that Order 380 was an event of *force majeure*, leaving only the question of ANR's "inability" to perform to the jury. The issue submitted to the jury on the *force majeure* read as follows:

> INTERROGATORY NO. 3: FORCE MAJEURE
>
> On all claims for breach of contract after June 1, 1985 ANR asserts the affirmative defense of "*force majeure.*" Under this defense it is claimed that following ANR's declaration of *force majeure*, effective June 1, 1985, ANR was rendered unable, fully or in part to perform or comply with the contract obligations of each gas purchase contract.
>
> (a) Do you find, from a preponderance of the evidence, that ANR was rendered unable wholly or in part to take its system-wide contract obligation of gas purchases from its contract producers due to the event of *force majeure* (that is, the failure of ANR's customers to take gas which was excused by Federal Energy Regulatory Commission Order 380)?

Dyco Petroleum Corp. v. ANR Pipeline Co., No. 867-C-1097 Verdict (N.D. Okla. Feb. 5, 1990).

Worse, the court instructed the jury that if there was any *force majeure* event, there was no prepayment obligation, no obligation to pay for gas not delivered. This came up in an instruction styled "EFFECT OF FORCE MAJEURE." The instruction read as follows:

> You are instructed that the quantity provisions in all but five of the contracts, that is, Contract Nos. 3, 9, 15, 20, and 37, provide that the deliveries or takes are affected by *force majeure* and the volume of gas delivered is less than the otherwise applicable DCQ, then the DCQ is deemed to be the volume actually delivered.
>
> In other words, if a party is in *force majeure*, there is no obligation to take or pay for more than is actually delivered.
>
> As to Contract Nos. 3, 9, 15, 20, and 37 which do not contain the specific quantity provision, if you find that a usage of trade has been established that when a party is in *force majeure*, it is excused from both the obligation to take and the obligation to pay, then you shall find that ANR is properly excused from both obligations.

This error was reinforced when the jury was again told that under the normal contract language there was no obligation to prepay for any gas not taken, and asked whether a usage of trade extended to the five contracts that did not have such *force majeure* language. *Id.* Interrogatory No. 5. Even these errors were overshadowed by the error in instructing the jury on the meaning of "unable." The court defined "unable" as meaning "that, in light of reasonable business practices, it is impracticable to perform such obligation." *Id.* "UNABLE"—DEFINED. In the impracticability definition, the court then instructed the jury that "whether performance has been rendered impracticable is whether the cost of performance has in fact become so excessive and unreasonable that the failure to excuse performance would result in grave injustice." *Id.*

One interesting part of the case, in spite of the many errors, was that the court did instruct the jury that it had to find *system-wide force majeure* for ANR to be excused. Thus even if ANR was able to perform this contract, it would still be excused if it could not perform its group of contracts. One problem with this instruction, or one of the problems, is that the court did not let the jury see what ANR had done with its other contracts, including those in which it had settled

Just days after the ARCO jury reached its verdict, a representative of ANR's parent company told the press that the ARCO result "will have widespread impact on similar cases between pipelines and producers."[130] Other pipelines with standard take-or-pay clauses immediately chimed in that Order 380 was a defense for them too.[131] In fact, even were *ARCO* the finest product of American jurisprudence since John Marshall sat on the Supreme Court, the opinion still would not be controlling authority for most take-or-pay cases. Very few take-or-pay contracts have similar *force majeure* language. ANR itself distinguished other take-or-pay cases in ANR's appellate brief as ones in which the parties "failed to specifically define *force majeure* in their contracts" and argued that "the uniqueness of each contract makes it impossible to make sweeping generalizations about these cases."[132] Then ANR described its own contract as one that had "unique" contract provisions and therefore could not be read against take-or-pay precedent.[133]

ANR told the truth when it said that its contract was different from other take-or-pay contracts. Most take-or-pay contracts do not list a decline in takes, even if by a major pipeline customer, as an event of *force majeure*. The whole point of the take-or-pay promise is just the opposite: to prevent a pipeline from shutting off the flow of revenue

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or coerced renegotiations. Telephone conversation with Robert Pezold, attorney for Dyco (Jan. 15, 1992). Thus, the jury had no basis to perform this analysis.

True to form, the court also excluded all evidence of ANR's overall financial ability. *Id.* Once again, the jury trying to decide whether the cost of performance had become excessive or unreasonable was robbed of its right to see the basic financial information. That would be the first data anyone with common sense would require to make this decision.

130. *ANR Pipeline Exonerated*, Houston Chronicle, Aug. 3, 1987, § 2, at 2, col. 4.

131. For instance, El Paso Natural Gas Company, in a case in which its *force majeure* defense had been stricken on summary judgment and it had then lost more than half a billion dollars in a jury trial, received the *ARCO* opinion just before filing its reply brief. Suddenly it dawned on El Paso, which had been distinguishing all other take-or-pay cases by arguing that El Paso's contract was "unique," that here was controlling authority. El Paso decided that its contract was not so unique after all. *ARCO* became "the most pertinent Texas *force majeure*/governmental regulation case decided to date . . . ," one that "obliterated [TransAmerican's] position even while it was preparing its Appellee's Brief." Appellant's Reply Brief at 40. El Paso Natural Gas Co. v. TransAmerican Natural Gas Co., No. 01-88-0847-CV (Tex. Ct. App. 1989). The *ARCO* holding was miraculously transformed into "[t]he almost foregone conclusion in *ARCO* that the same governmental regulation upon which El Paso relies (Order 380, 49 Fed. Reg. 22,778 (1984)) rendered the producer here 'unable' to buy." *Id.* at 42. El Paso's eight different sets of lawyers put their names on its brief representing this to the Texas Court of Appeals. Somehow they and El Paso forgot to mention that El Paso's contract did not have any of the "unique" exculpatory language on which ANR relied and, worse, that El Paso *supported* Order 380, Order 380-A, 49 Fed. Reg. 31,259, at 31,265 (1984), telling the FERC that passing the order would *improve* El Paso's competitive position. If candor was not enough, El Paso's support for Order 380 was sufficient to bar its reliance on the Order. *See* TEX. BUS. & COM. CODE ANN. § 2.615, comment 10 (party claiming excuse cannot rely on government order that it induced).

132. ANR correctly stressed below and on appeal that its contract was different from standard industry contracts and, less correctly, that the court of appeals could therefore safely disregard the overwhelming bulk of take-or-pay authority, all of which held that market changes are no defense to the take-or-pay promise. ANR Brief, *supra* note 120, at 9. ARCO provided the court of appeals with seven pages describing the basic take-or-pay authorities and discussing them in detail.

133. *See id.* at 12.

because it misjudges its resale market and may lose money if it has to honor its promises to buy gas. Nor do standard take-or-pay contracts have ANR's provision that if an event of *force majeure* "affects" deliveries or takes at all, the contract quantity will be reduced to whatever amount is actually delivered. The standard contract language requires instead that the pipeline fully prove that it is unable to take.[134] Even if rightly decided, therefore, *ARCO* does not signify a major change in take-or-pay law.

B. Government Regulations Are Not Force Majeure

A number of pipelines narrow their *force majeure* defenses to focus on government regulations, rather than market decline generally. "Regulation by governmental authority," "interruption by government regulation," or similar language about government orders is usually a defined event of *force majeure.*[135] Pipelines point to recent FERC orders, particularly Orders 380, 436, 451, and 500, and claim them as events of *force majeure.* A few pipelines claim that these orders directly prohibit them from buying gas under their contracts. They speculate about an implied federal "duty" that invalidates their obligation to buy all but the cheapest gas they can find. Pipelines that are not as aggressive admit that they are not really forbidden to honor their contracts, but they still argue that recent FERC orders have so revolutionized their market that the effect of these orders is to make them "unable" to perform, even if the orders do not expressly prohibit performance.

The argument that FERC has done anything to excuse take-or-pay obligations or to victimize pipelines is frivolous. It is not an arguable reading or a good faith extension of FERC orders, nor a position that can be reached from ignorance or careless analysis. The defense is a bad faith argument, deserving the same treatment courts mete out to other bad faith arguments. Three major flaws in the argument exist. First, FERC has said, time and again, exactly the opposite; it will not and has not relieved pipelines of their take-or-pay obligations and is not creating a framework for contract abrogation.[136] FERC's orders are clear and unambiguous on this point and there is no fact issue here, nothing for a jury to hear or decide.

Second, pipeline reliance on FERC orders as a disturbing event that should entitle them to *force majeure* relief is in error because FERC has

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134. The contract between Golsen and ONG contained the same failure-of-takes language disputed in *ARCO. See* Golsen v. ONG Western, Inc., 756 P.2d 1209, 1211 (Okla. 1989). However, none of the opinions or briefs suggest that ONG, an intrastate pipeline, had lost any sales because of Order 380. ONG apparently did not even try to raise a defense under the substantial-reduction-in-takes part of its *force majeure* clause. Thus, a pipeline may have the ANR contract language but not be affected by Order 380, and thus lack the factual predicate for the ANR defense.

135. A separate clause ordinarily makes the contract subject to all valid regulations of government bodies with authority, but this language was originally designed to show that the contracts are enforceable in spite of changing regulations, rather than unenforceable because of them. H. WILLIAMS, *supra* note 16, § 734, at 801-02.

136. *See infra* notes 146-51, 173-75 and accompanying text.

carefully and deliberately crafted a system to help pipelines perform their remaining take-or-pay obligations.[137] FERC orders have carefully reiterated that *all* prudently incurred gas costs can be included in the pipelines' rates.[138] Prepayments will be treated as a fixed portion of the rates charged until the gas is taken.[139] In the wake of Orders 380 and 436, which reduced pipeline monopoly power in both the transportation and gas resale markets, FERC in Order 500 gave pipelines added assistance in passing through their gas costs and in settling take-or-pay claims.[140]

Third, the strident criticism that pipelines level at these FERC orders obscures the fact that each order is based on a finding that pipelines continue to wield monopoly power in their purchasing and transportation markets and that new regulations are needed to lessen that power.[141] Congress designed the NGPA to inject competitive pricing into natural gas markets.[142] FERC is merely implementing that congressional will after making repeated findings that the pipelines' markets have remained uncompetitive. Pipelines have too much power, not too little. Pipelines are not innocent victims of a federal agency run amuck.

1. Order 380

The first order pipelines cite as *force majeure* is Order 380. Order 380 was a major effort to inject market forces into the pipeline workplace. To this end, FERC voided the "minimum bill" provisions that pipelines had used to make their customers pay a fixed charge for gas, whether or not the customers took any gas.[143] FERC found that such minimum bills were unjust and unreasonable barriers to competition.[144] Order 380 was designed to force competition in the resale gas market.[145]

The pipelines complained bitterly that minimum bills were their guar-

137. *See infra* notes 186-87 and accompanying text.
138. *See infra* notes 152-53 and accompanying text.
139. *Id.*
140. *See infra* notes 186-87 and accompanying text.
141. *See infra* notes 161-62, 168-70 and accompanying text.
142. *See supra* note 26 and accompanying text.
143. Order 380, 49 Fed. Reg. at 22,781-83 (1984).
144. *Id.*
145. *E.g.*, Order 500-I, 55 Fed. Reg. 6605, at 6619-20 (1990). Pipelines traditionally billed their customers both a "demand" charge that covered most of their costs for pipeline capacity and gas availability, and a "commodity" charge, part of which covered any fixed costs not included in the demand charge and the rest of which was a variable charge for the cost of gas. Minimum bills did not include any make-up rights; pipeline customers had no right to make up gas not taken when the payments were made. The commodity charge became an increasing percentage of the total bill to the customer as the cost of gas increased. Order 380, 49 Fed. Reg. at 22,781 n.17 (1984) (ten cents per mcf gas cost was 40% of gas price in 1955; $3.08 per mcf gas cost was 75% of gas price in 1983). In hearings on Order 380, FERC found that the fixed "minimum bill" charge for the gas itself, which customers had to pay even if they didn't take the gas, was an unjust and unreasonable barrier to competition and was therefore void under the Natural Gas Act. Minimum bills were unreasonable both because they allowed a pipeline to bill customers for gas costs the pipeline might never incur, and because the fixed payments insulated pipelines from pressure to minimize gas costs. *Id.* at 22,781-83.

antee that they could recover all prudent gas costs from their customers. Those customers in turn benefitted from the stable supply of gas committed under the take-or-pay contracts. Pipelines argued that FERC could not fairly void minimum bills if it left the pipelines saddled with their corresponding take-or-pay obligations to producers. This argument, of course, is a variation on the theme that pipelines now raise in court: that Order 380's termination of minimum bills removed the framework for take-or-pay payments, made it impossible for pipelines to buy gas they allegedly could no longer resell, and so constituted an event of *force majeure*.

FERC disagreed with the argument that minimum commodity bills were necessary to recover take-or-pay costs.[146] To the contrary, it found that "there is no clear nexus between a pipeline's annual take-or-pay obligations and its minimum commodity bills to its customers."[147] "[The] incurrence of take-or-pay is not necessarily related to whether or not a customer takes gas at minimum commodity bill levels."[148]

Voiding the pipelines' minimum bills with their resale customers did not logically require giving the pipelines take-or-pay relief against producers for a number of reasons. First, a pipeline might not incur any take-or-pay costs when a customer's takes fell below minimum bill levels.[149] Second, even if the pipeline did incur some liability, there was no showing that minimum bills allocated the take-or-pay costs to the customers for whose benefit the pipeline had incurred these obligations.[150] Finally, unlike minimum bills, take-or-pay payments simply represented a prepayment for gas that could be made up later. As FERC noted in a footnote, it was not aware of any pipeline that had ever lost the right to make up gas.[151]

There is a fourth reason why the minimum bills cannot fairly be equated with take-or-pay obligations. Unlike producers, the pipelines still operate in an artificially protected environment. As FERC noted in the first pages of Order 380, the pipelines' fixed costs, those for building the pipeline and having capacity available when needed, were already covered in the demand charge and fixed cost component of minimum bills.[152] Pipelines are regulated monopolies that recover these fixed costs by administrative fiat. FERC left those charges alone in Order 380: FERC was careful to reassure the pipelines that they would be able to recover

146. Order 380, 49 Fed. Reg. at 22,781-82.
147. *Id.* at 22,787.
148. *Id.* at 22,788.
149. *Id.* at 22,787-88.
150. A pipeline might buy expensive gas to meet the winter demand of a local distribution company, for instance, but spread the added cost of that gas to industrial users who but for the minimum bill would have switched to oil or spot market purchases, rather than pay this premium price to the pipeline.
151. Order 380, 49 Fed. Reg. at 22,787 n.46; *accord id.* at 22,787.
152. *Id.* at 22,779.

the carrying costs for gas prepayments, as well as pass on prudently incurred gas costs, when they sold their gas.[153]

The minimum bills struck down in Order 380 cannot be compared fairly with the take-or-pay contracts. Had FERC voided take-or-pay contracts as the pipelines requested, many producers would be left with no assurance of compensation for the tremendous costs of drilling and exploring for gas, for holding acreage with cash payments, and for operating the wells and keeping them ready to produce if the pipelines ever ask to have the gas turned back on. The producers' market is not regulated. Producers do not have a government agency to guarantee their costs. The prices they get in today's market often will not repay their expenses if their take-or-pay contracts are voided. Many producers drilled very expensive wells solely in reliance on the pipelines' promises to buy whatever gas was discovered. It was the pipelines, not the producers, who agreed to bear the risk of reselling this gas. FERC correctly saw no reason to relieve the pipelines of the burden they knowingly assumed.[154]

The finding in Order 380 that minimum bills are not necessarily related to take-or-pay obligations has been described by FERC as a finding of "legislative," not "adjudicative" fact, and so one not automatically binding on a pipeline in civil litigation.[155] Nor does FERC's refusal to void take-or-pay contracts or otherwise alter them necessarily prohibit a pipeline from arguing that the "effects" of the Order are *force majeure* under its contract.[156] Nonetheless, FERC's assurances that pipelines will be able to recover all prudently incurred gas carrying costs, and its invitation to pipelines to apply for a waiver if they can show the Order should not apply to them, should establish as a matter of law that Order 380 and any falling sales it causes do not of themselves constitute *force*

153. Order 380-A, 49 Fed. Reg. 31,259, 31,262 (1984); Order 380, 49 Fed. Reg. at 22,780 & n.16. The "principal" amount of the prepayment can then be recovered, as long as it was prudently incurred, when the pipeline takes gas and resells it. *Id.* at 22,780 n.16.

154. Lawyers should be embarrassed that pipeline counsel continue to argue that Order 380 prohibited take-or-pay contracts or imposed some duty to breach those contracts. FERC said over and over that it was not addressing the take-or-pay issue and did not intend to abrogate these contracts. The pipelines' compensation for take-or-pay prepayments or settlements will be handled in individual pipeline rate cases. Order 380, 49 Fed. Reg. at 22,788. It was "simply not essential that the take-or-pay issues be resolved" in Order 380. Order 380-A, 49 Fed. Reg. 31,259, 31,265 (1984). "The purpose of the rule is not to reduce or eliminate take-or-pay obligations . . . ." *Id.*

In a barely veiled warning to the pipelines, FERC noted that there was a serious question as to whether the Commission even had jurisdiction to change prices in pipeline/producer contracts, should it want to do so. *Id.* The NGPA removed FERC's jurisdiction over wellhead contracts, presumably taking with it the power to act on these contracts. These provisions apply only to NGPA contracts, so the Commission still would have jurisdiction over NGA contracts. FERC has consistently held that it would be unlawfully discriminating for it to take action against NGA contracts alone. The District of Columbia Circuit Court of Appeals has affirmed FERC's finding that it does not have jurisdiction to act on the price terms of NGPA contracts. American Gas Ass'n v. FERC, 912 F.2d 1496, 1505-06 (D.C. Cir. 1990).

155. Order 380-D, 29 FERC ¶¶ 61,689, 61,689 (1984) (citing K. DAVIS, ADMINISTRATIVE LAW ¶ 15.03, at 296 (1972)).

156. *Cf.* Associated Gas Distrib. v. FERC, 824 F.2d 981, 1026 n.29 (D.C. Cir.), *cert. denied*, 485 U.S. 1006 (1987) (quoting FERC's position that nothing in Order 436 "is intended to abridge the rights and obligations regarding take-or-pay liabilities under contracts between those pipelines and their suppliers, including any right to raise *force majeure* as a defense in an appropriate case.").

majeure. Even if a pipeline cannot take the gas today, it still can prepay, recover the carrying costs, and will have at least five years to makeup the gas. A pipeline cannot prove inability without buying the gas and trying to recover its costs as FERC has suggested, and perhaps absorbing some of the costs itself. If it fails to make this effort, it has not taken the diligent steps to perform required before it can claim *force majeure*.

Many of the pipeline's legal arguments are attempts to reargue the merits of Order 380, with which they disagree. They are too late. Jurisdiction over FERC orders lies with the first federal court to be reached by an appeal.[157] Order 380 was affirmed by the District of Columbia Court of Appeals in *Wisconsin Gas Co. v. FERC*.[158] The federal appeals court agreed with the Commission that take-or-pay obligations were not so "inextricably" related to minimum bills that they had to be acted upon together.[159] It accepted the findings that minimum bills would not necessarily have *any* effect on take-or-pay exposure and that the pipelines could later makeup any gas for which they prepaid, exactly what FERC had found.[160] Pipelines did not get what they wanted in Order 380, but they are now bound by its terms.

2. Orders 436, 500, and 528

FERC's rulings in the Order 436-500 sequence are the most important proof of why FERC orders cannot excuse pipelines' private contract obligations. Order 436 was issued after FERC found that pipelines were continuing to use their monopoly power to prevent price competition in their resale markets, even though FERC had voided minimum bills in order to foster such competition.[161] The pipelines did not have to ship anybody else's gas, so they could use their control over transportation to limit the gas being sold in the resale market. The pipeline's customer no longer had a minimum purchase requirement, but the customer also lacked any other source for gas but the pipeline. To remedy this problem, FERC required any pipeline that wanted prompt approval to ship *anyone* else's gas to ship the gas for all comers on an equal, non-discriminatory basis.[162]

The District of Columbia Court of Appeals quickly reversed Order 436, saying that FERC had not provided a reasoned explanation for its refusal to also provide take-or-pay relief. Responding with Order 500, FERC reaffirmed its position that take-or-pay contracts did not need regulatory action.[163] FERC made specific findings that such relief was not needed and that private negotiations had resolved most of the take-

157. 15 U.S.C. § 3413(b)(4)(B) (1982).
158. 770 F.2d 1144 (D.C. Cir. 1985), *cert. denied*, 476 U.S. 1114 (1986).
159. *Id.* at 1159-60.
160. *Id.* at 1160.
161. *See infra* notes 168-79 and accompanying text.
162. *Id.*
163. *See infra* notes 186-218 and accompanying text.

or-pay problem.[164] The District of Columbia Circuit, although hostile to FERC's refusal to act on take-or-pay contracts, did not overturn this finding. Thus, Order 500 should spell the end to pipeline arguments about FERC orders creating some kind of defense to take-or-pay performance.

a. Order 436

Order 436 was FERC's second major effort to force competition into the gas industry.[165] The order grew out of a series of cases in which the District of Columbia had three times struck down FERC's approval of "special marketing programs,"[166] and from FERC's continuing effort to implement the NGPA's removal of restrictions on wellhead price controls.[167] FERC noted that the rationale for pipelines, unlike producers, was their remaining market of continuing regulation power.[168] Although the NGPA's removal of wellhead price controls had done much to increase competition, pipelines were refusing to transport gas for other purchasers on a non-discriminatory basis.[169] This use of pipeline monopoly power to refuse transportation was the barrier to competition that Order 436 was designed to remedy.[170]

In Order 436, FERC made pipelines who wanted prompt regulatory permission to sell their excess pipeline capacity to other gas purchasers, including, for instance, shipping a producer's gas directly to market in an effort to settle take-or-pay claims, become "open access" shippers. Instead of the forbidden special marketing programs, an open access pipeline had to ship all sellers' gas on an equal, first-come-first-served, nondiscriminatory basis. Approval to ship other sellers' gas traditionally had involved a lengthy certification process. The carrot to pipelines was that FERC agreed to cut that process short for open access pipelines.[171]

164. *Id.*

165. The first was Order 380.

166. Maryland People's Counsel v. FERC, 761 F.2d 768 (D.C. Cir. 1985) (MPC I); Maryland People's Counsel v. FERC, 761 F.2d 780 (D.C. Cir. 1985) (MPC II); Maryland People's Counsel v. FERC, 768 F.2d 450 (D.C. Cir. 1985) (MPC III).

167. *See* Order 436, 50 Fed. Reg. 42,408, 42,409 (1985).

168. *Id.* at 42,418.

169. *Id.* at 42,420-21.

170. *See id.* at 42,411.

171. Order 436 actually included several steps designed to speed up the conversion of pipelines to open access. Pipelines seeking a certificate to offer transportation services were required to do so on a "stand alone" basis, not tying transportation any longer to other services like gas sales. They had to apply for a "blanket" transportation certificate that would open their pipeline to all customers, not just some selected sellers, to get the benefit of expedited treatment. *Id.* at 42,424-25. Customers who had paid fixed demand charges could convert from fixed "firm" sales, once a guaranty of certain sales for the pipeline, to fixed transportation charges. *Id.* at 42,425-26. Pipelines were given the right to expedite the abandonment of natural gas contracts, a bone to them to facilitate settlements, if they wanted to open their system to open access transportation. *Id.* at 42,465-66. FERC had found that pipelines' offering special transportation services on a selective basis had operated as a discriminatory preference. Order 436, in fact, arose because some pipelines had been trying to settle their take-or-pay disputes by offering producers special deals to ship their gas at lower rates in return for take-or-pay releases. The District of Columbia Circuit had found this practice unreasonably discriminatory and prohibited under the Natural Gas Act. *See* cases cited *supra* note 166. FERC responded with Order 436, trying to force competition onto the pipelines across the board.

The effect of Order 436 was to "unbundle" the pipeline's job as a transporter from its job as a gas merchant. By requiring nondiscriminatory access, FERC prevented pipelines from using their monopoly in gas transportation to extort contract concessions from producers who had no other way to ship their gas to market. Now producers would be free to weigh the prices they were offered by the pipeline against the prices they could get if they kept the gas and sold it directly to end-users at the other end of the pipeline. Producers were guaranteed that they could shop for the best price because the pipeline could not discriminate in its transportation charges. At the same time, gas consumers could come to the wellhead and bargain against the pipeline as buyers of gas. Competition was enhanced at both ends of the pipeline—where gas was purchased at the wellhead, and where gas was resold at the pipeline outlet.[172]

Order 436 says, just as clearly as Order 380, that pipelines do not deserve relief from take-or-pay obligations. The pipelines had asked FERC to issue scheduling orders which would tell pipelines whose gas to purchase and insulate them from lawsuits by the producers whose gas was not purchased. The Commission said point blank that it would not so abrogate private contracts, nor would it create a framework for unilateral contract abrogation by the pipelines.[173] To make sure the message got through,

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172. To strike another blow for competition, FERC gave pipeline customers the option to reduce the "firm" demand charges they had agreed to pay for pipeline capacity or to convert them to a right to call on similar amounts of "firm" transportation. Order 436, 50 Fed. Reg. at 42,425-26. For a fairly succinct summary of contract demand reduction and conversion, see Associated Gas Distrib. v. FERC, 824 F.2d 981, 1013 (D.C. Cir. 1987).

Order 436 would have had limited effect if major pipeline customers, particularly the local distribution companies, still had to pay the fixed contract demands whether they wanted gas or not. These companies would have little incentive to buy cheaper gas if they still had to pay the high contract demand charges on top of the gas price. To let these companies gradually reduce their contract quantities, or to convert it to a fixed obligation to transport gas, would free them up to buy gas directly from purchasers who competed with the pipelines. The requirement that open access be nondiscriminatory would prevent the pipelines from then charging such high transportation rates for those sales that the distribution company had to keep coming back to the pipeline. Contract demand reduction and conversion, like open access, would help let the pipeline and other buyers compete together in the market for gas at the wellhead, and let the pipeline and other producers compete together as sellers at the pipeline outlet. FERC's requirement of nondiscriminatory transportation services and the alteration in the contract demand mechanism attacked the pipelines' monopoly power in transportation at both ends of the pipeline.

173. [T]he 'cut-back' plan approach would involve the Commission ultimately in many aspects of natural gas production decisions. It would substitute the Commission's judgment for that of the commercial parties on such issues as which supplies of gas should be taken by a pipeline in managing its portfolio of gas purchase agreements.

> . . . [T]he cut-back approach would lay the predicate for pipelines to assert to producers that supervening governmental actions relieved the purchasers of all liability for breach of contracts that would otherwise exist. It would thus also raise extremely serious questions regarding the ability of private parties in the gas production industry to rely on private contracts as a tool for structuring basic economic relationships.
>
> The potential effect of the Commission pursuing this option thus could well have been, by essentially a stroke of the pen, to void thousands of gas purchase agreements nationwide and to declare worthless some seven billion dollars worth of contract damage claims which producers might otherwise pursue against interstate purchasers. *Neither the legal nor the factual basis for potentially voiding billions of dollars in*

"the Commission reiterate[d] that the final rule does not override contracts."[174] FERC even said it twice. It "is not in this rule in any way whatsoever affecting the contractual rights and obligations of parties under producer/pipeline contracts."[175]

FERC again noted that it would continue to protect recovery of pipeline gas costs. The NGPA had deprived the Commission of power to deny pipeline requests to recover gas costs unless there was "fraud and abuse or similar grounds."[176] This sheltered market is still far from a truly competitive market and its risks. Pipelines remain beneficiaries of government protection.[177]

Order 436 did leave some pipelines unable to recover part of their costs.[178] Nonetheless, FERC confirmed its guarantee of many pipeline costs and created the open access certification that has opened up a whole new market in transporting other peoples' gas. FERC will let pipelines recover their gas costs through the profits they earn in this new transportation service.[179] Falling gas sales can be offset by increasing

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> *freely negotiated contracts was made clear in the filings made with the Commission.* In addition, a determination that effectively abrogated non-NGA-jurisdictional wellhead contracts would run directly counter to the Congressional directives in the NGPA that progressively removed federal regulation of producer/pipeline transactions, and which expressly allowed the free operation of those contracts where below any applicable maximum lawful prices prescribed by statute. *See* NGPA § 101B(b)(9). *See also* NGPA § 601(c). Accordingly, the Commission has declined to pursue this path.
>
> *Moreover, the Commission has sought to make it crystal clear that* NOWHERE in the final rules, . . . has the Commission abrogated any contracts nor created a regulatory framework predicated on any unilateral contract abrogation.

Order 436, 50 Fed. Reg. at 42,423-24 (emphasis added).

174. Order 436, 50 Fed. Reg. at 42,440.

175. *Id.* at 42,443. The Commission reminded pipelines that Congress had withdrawn FERC's jurisdiction over NGPA wellhead prices, the prices that most producers charge pipelines. *See, e.g., id.* Congress deregulated producer activity but not the pipelines because the producers' market did not pose the risk of monopoly that remains in the pipeline market: "Congress concluded that gas production was sufficiently competitive to remove regulation, [but] the control which interstate pipelines exercised over transportation still conferred on them the same kind of market power over their customers as had existed at the time of enactment of the NGA." *Id.* at 42,418. Congress decided to let the market take care of prices in producer contracts, so the pipelines need not bother looking to federal regulators for relief from the contracts that they freely entered. Congress stripped FERC of any authority to redo those bargains.

176. *Id.*

177. Ironically, FERC had considered offering the pipelines even more protection. One of the proposals in Order 436, part B, had been to provide a "safe harbor" guaranteeing pass through of the costs of buying out take-or-pay contracts by certain dates. Most commentators, including pipelines, opposed this solution because they feared that such a clear guarantee of cost recovery would encourage producers to raise the price of take-or-pay settlements (if pipelines were guaranteed recovery, producers would have no reason to compromise), and the Commission decided to retain its recently issued April 10, 1985 Statement of Policy and Interpretive Rule. *See generally*, Order 436, section IV B, especially 50 Fed. Reg. at 42,462-63. The Statement generally allowed pipelines to include all prudently incurred buyout costs in their rates but contained no guarantees of recovery. Statement of Policy and Interpretative Rule, 50 Fed. Reg. 16,076 (1985) (codified in 18 C.F.R. § 2.76 (1991)).

178. They still had to sell their gas at prices that let them recover their approved rates and they had to absorb whatever gas costs they could not persuade their customers to buy.

179. *See* Order 436, 50 Fed. Reg. at 42,440-42.

revenues and profits from gas transportation. There was no showing that the pipelines needed more relief.

b. Remand of Order 436

On appeal of Order 436, the District of Columbia Court of Appeals left unturned FERC's finding that pipeline exploitation of their monopoly power to refuse open access transportation was discriminatory and prevented full competition.[180] The court upheld most of the order, including the steps to "unbundle" the pipeline transportation and merchant roles.[181]

The court of appeals split with FERC, however, on its refusal to order take-or-pay relief. The court viewed the issue as who among the various parties in the industry should bear the costs of high prices and takes in a fallen market. The court felt that Order 436, whose open access provisions would bring low-priced gas to pipeline customers, let customers off the hook and made it likelier that the pipelines alone would bear most of these costs.[182] Order 436 took away pipeline leverage by letting a customer simply shift to lower-priced gas and leave the few remaining customers, who for whatever reason could not shift, with high-priced gas.[183] Given these possibilities, the court decided that FERC had failed to give a reasoned explanation for its inaction on take-or-pay contracts.[184]

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180. Associated Gas Distrib. v. FERC, 824 F.2d 981, 994 (D.C. Cir. 1987). The court of appeals also left standing the Commission's basic finding that "a prevailing pipeline practice, particularly their general refusal to transport gas for third parties where to do so would displace their own sales, has caused serious market distortions," and was unduly discriminatory under the Natural Gas Act. *Id.* at 993. Even more significantly, the court affirmed FERC's general authority to remedy this monopoly practice by ordering open access. A fundamental goal of both the NGPA and the NGA was to protect consumers from pipeline monopoly power. *Id.* at 995, 1001-03. The pipelines failed to show any barrier to FERC's "devising rules [to] remedy [the] lack of competition" and to subject pipelines to market forces. *Id.* at 1001. Just as significantly, the court upheld FERC's finding that FERC in principle could attack the fixed contract demand provisions in pipeline contracts as themselves a reflection of pipeline monopoly power, a distortion that would not exist without pipeline market restraints. *Id.* at 1017. The Court discussed with seeming approval FERC's refusal to enter an order of priority that would tell pipelines which contracts they had to perform, knowing that such a step would "essentially substitute FERC price controls for the wellhead market, a move clearly forbidden by the NGPA." *Id.* at 1022 n.26.

181. *Id.* at 1009.

182. *Id.* at 1021.

183. *Id.* at 1023.

184. *Id.* at 1025. The court did not challenge FERC's estimate that $7 billion of liability had been settled for twenty cents on the dollar. Instead the court argued that the fact of such skewed settlements still did not answer the pipeline complaint that they were hurt by Order 436, had no practical choice but to opt for open access, and were losing their markets to sell gas without appropriate relief from their take-or-pay obligation. *Id.* at 1023. The court believed FERC had exaggerated the pipelines' ability to pass through gas costs. It feared that customers would use the contract demand mechanism to convert to transportation services or simply eliminate their liability. *Id.* at 1025-26. FERC should have given more consideration to conditioning producer access to transportation on some take-or-pay relief, remembering that such conditioned access was not the same as contract abrogation. *Id.* at 1027. Further, FERC's failure to act on high-priced Natural Gas Act gas, which remained within its jurisdiction, on the premise that this was only a small amount of gas, was remanded because there was no finding on just how much gas still fell under the Natural Gas Act. *Id.* Finally, the court reiterated that FERC did have authority to condition open access on take-or-pay relief and that such relief would not be discriminatory, as these were the very contracts that were the source of the problem. *Id.* at 1029.

The court knew it had no authority to usurp the fact finding role Congress gave to FERC. Even without a basis to overturn FERC's findings about the effectiveness of private contract renegotiation, the *Associated Gas Distributors* opinion nonetheless reeked of hostility toward FERC's finding that take-or-pay relief was not needed.[185]

c. Order 500

On remand, FERC replaced Order 436 with Order 500. FERC once again refused to do anything to take-or-pay contracts. At the invitation of the District of Columbia Circuit, however, FERC gave the pipelines two major weapons to help resolve their take-or-pay problems. First, pipelines were allowed to use a volume credit to offset that volume of take-or-pay liability if a producer wanted to ship any gas on the pipeline system.[186] Second, to help the pipeline pass on its remaining costs to its resale customers, FERC created a crediting mechanism under which a pipeline could pass through twenty-five percent to fifty percent of its settlement or buyout costs as a fixed charge, as long as it was willing to absorb the same percentage of these costs itself. All remaining gas costs would still be included in the pipeline's filed rates if prudently incurred and passed back to the extent that customers would buy the gas at the pipelines' rates.[187]

Although FERC gave the pipelines these two major sources of relief, it refused to act on take-or-pay contracts. All the Commission would do was study the problem further:

> The rule adopted here is intended to be in effect for an interim period while the Commission studies the issues related to contract demand adjustments and the build-up of take-or-pay liability under producer/pipeline contracts, which formed the basis for the Court's remand in the *AGD* decision.[188]

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185. Pipelines subjected to Order 436 were likened to a condemned man given "the choice between the noose and the firing squad." *Id.* at 1024. The court piously said that it was not telling FERC to grant take-or-pay relief (in fact, the court knew it lacked the power to make this determination for itself, although it dearly wished to do so), but it castigated FERC for its "seeming blindness to the possible impact of Order 436 on take-or-pay liability, and its tendency to elevate into affirmative benefits what are at best palliatives, [which] seemed impossible to square with the requirement of reasoned decisionmaking." *Id.* at 1025. Pipelines were described as caught in the middle, having entered their contracts when they were pressured to get a higher supply of gas but now being abruptly subject to the "downside risk[s]" of the market. *Id.* at 1027. The factual basis for inaction on take-or-pay was "utterly Panglossian." *Id.* at 1030. FERC was sent back to make amends for its "insouciance on take-or-pay," a problem that "taints the package." *Id.* at 1044. With pointed language like this, the Commission could hardly have been reassured by the dictum that while FERC had to "more convincingly address" the take-or-pay issues, it was not being told what to do. *Id.* Concurring and dissenting Judge Mikva went further and urged his fellow panelists to tell FERC that its inaction "should not be tolerated on remand." *Id.* at 1045 (Mikva, J., concurring and dissenting).

186. *E.g.*, Order 500, *Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, 52 Fed. Reg. 30,334, 30,337-38 (1987).

187. *Id.* at 30,341-46.

188. *Id.* at 30,350.

d. Order 500-H

Two years later, the District of Columbia Circuit remanded Order 500. The primary reason for remand was that after two years, FERC still had done nothing to take-or-pay contracts and had not explained why not.[189] Responding with Order 500-H, FERC explained in great detail why it saw no reason to grant take-or-pay relief. Although Orders 380 and 436 had attacked pipeline monopoly power that stood as a barrier to competition, a major purpose of Order 500 was to give the pipelines more power.[190] "The primary purpose of crediting was to give pipelines additional bargaining power to negotiate reasonable settlements of their take-or-pay contracts."[191] The buyout provisions similarly gave pipelines some added leverage in their efforts to pass through their costs to consumers.

The main reason FERC would do nothing more for the pipelines was that they had been successful in using their market power to reduce their liability. By the end of 1988, as much as ninety-five percent of take-or-pay liability had been resolved.[192] Pipelines had settled $16 billion in past claims and $28 billion in future exposure, a total of $44 billion in obligations, by paying just $8.2 billion, approximately 18.6 cents on the dollar.[193] This was clear proof that private contract renegotiation was working and needed no help.[194]

FERC found such private restructuring preferable to a regulatory solution. The whole point of the NGPA had been to leave the price of new gas to the marketplace.[195] Settlements were preferable to FERC action.[196] There were other signs, in addition to the mere volume of take-or-pay settlements, that the switch to a competitive market was working. While direct sales by pipelines were falling, and with them gas prices, their transportation of other sellers' gas had gone up.[197] Total gas shipped was increasing.[198] After January 1987, take-or-pay exposure began to

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189. American Gas Ass'n v. FERC, 888 F.2d 136, 147, 152-53 (D.C. Cir. 1989). The Order was also remanded on the narrow technical grounds that FERC had failed to explain the authority on which the crediting mechanism was based, *id.* at 148, its refusal to review the basis for the Contract Demand reduction, *id.* at 150, and its failure to provide an adequate reason for the requirement of having buyouts or settlements completed by March 31, 1989. *Id.* at 151.

190. Order 500-H, 54 Fed. Reg. 52,344, 52,358 (1989).

191. *Id.*

192. *Id.* at 52,353 & n.76.

193. *Id.* at 52,356 Table 5.

194. *See id.* at 52,358-59. The settlement ratios were particularly impressive given the fact that the courts have routinely enforced these contracts. Settling a case of likely liability for twenty cents on the dollar is no mean feat and is certainly one measure of the pipeline's continuing market power.

The Interstate Natural Gas Association of America ("INGAA") claimed that settlement costs had risen to thirty-nine cents on the dollar in 1989, up from eleven cents in 1985, but FERC found that the INGAA numbers failed to account for the future liability foregone in the later settlements and so overstated how much pipelines were paying producers. *Id.* at 52,364.

195. *Id.* at 52,365.

196. *Id.* at 52,370.

197. *Id.* at 52,353-54 & Table 3, 52,382 n.214.

198. *Id.*

plummet even though pipeline sales were also falling; price renegotiation was working.[199] Another reason for inaction was that pipelines had already received tremendous assistance, one that the market would never provide, under the pass through mechanism. As FERC noted, the recovery of production costs through a fixed charge "is an extraordinary mechanism which the Commission has rarely permitted."[200]

With all this help, the pipelines were hardly in a position to complain. All parties were bearing some of the burden of the market decline. The producer's burden, taking less than twenty cents on the dollar, was obvious. Of the gas costs remaining, pipelines had chosen to absorb 39.3% of the buyout costs, passing on the same amount as fixed costs and trying to pass through the rest under their variable rates.[201] This was in line with FERC's view that all parties should bear some of the burden of the market decline. Thus, FERC refused to find take-or-pay clauses unjust and unreasonable, to require market-out pricing in these contracts, or to take other steps to defeat contract obligations.[202]

FERC emphasized the unfairness of any kind of contract abrogation. Take-or-pay clauses serve important purposes. They are a "legitimate, bargained-for-risk allocation mechanism [that] requires pipelines and their customers to compensate the producer in part for the risks the producer incurs in making substantial investments in order to meet the supply needs of these pipelines and their customers."[203] Elimination of these clauses, even if only in jurisdictional contracts, would mean "the producer no longer had any contractual assurance of some minimum level of income where the original bargain between the producer and pipeline had contemplated some level of assured income."[204] Contract provisions providing this kind of minimum guarantee are reasonable, and FERC could not attack them under its authority to strike unjust and unreasonable contract terms. FERC's answer to the pipelines, and to the Court of Appeals, could hardly have been clearer. New take-or-pay relief is not needed.

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199. *Id.* at 52,353. FERC made the findings the District of Columbia court had requested on NGPA jurisdictional gas, and found that changing the price terms in these contracts would be counterproductive. Although almost half of the take-or-pay exposure reported by the end of 1986 was for such jurisdictional gas, *id.* at 52,368, FERC did not believe that taking action under these contracts could be effective. FERC could do little about the price for such gas because Congress had deemed all NGPA prices below "maximum lawful price" levels at the regulated price ceiling as just and reasonable. *Id.* at 52,367-68. FERC reaffirmed its belief that the NGPA deprived it of any authority to change the freely negotiated terms of NGPA contracts, *id.* at 52,365-68, and held that this partial relief could discourage full restructuring of pipeline/producer contracts. *Id.* at 52,369. Such an "uneven" resolution of the take-or-pay problem, and its inequitable effects, would be inconsistent with having all parties bear part of the burden of falling prices. *Id.*

200. *Id.* at 52,387.

201. *Id.* at 52,357.

202. *See, e.g., id.* at 52,386-87. There are signs that Congress is quite happy with the compromise between regulatory directive and unimpeded market forces. Notably, the House Report on the Natural Gas Decontrol Act discussed FERC's open access revisions with approval. H.R. Rep. No. 39, 101st Cong., 1st Sess. 5-6 (1989). Congress likes what FERC is doing.

203. Order 500-H, 54 Fed. Reg. at 52,349.

204. *Id.* at 52,369.

e. Order 500-I

Order 500-I was issued to respond to a barrage of requests for rehearing that followed Order 500-H. In Order 500-I, FERC reaffirmed Order 500-H in all significant respects.[205]

Pipelines met Order 500-H with a frontal assault on FERC's finding that producers had made significant take-or-pay concessions. Pipelines argued that producers had not made significant concessions in settling their cases. Their argument was that a take-or-pay clause and a prepayment really just serve to ensure producers that they will have the benefit of pipeline money until the gas is taken, that the producer's only real benefit is therefore the interest on the money from the time of the prepayment until the time that the pipeline would have bought the gas anyway, and that 18.6 cents on the dollar fully compensated producers for the loss of interest so that the producers had not given up anything.[206]

FERC properly made short shrift of this argument. First, it noted that pipelines might not make up the gas, in which case the producer had a contract right to both a prepayment and to sell the gas to someone else.[207] Second, the pipelines' late, untimely settlements did not compensate the producer for the late payment of their money.[208] Third, and most fundamentally, the pipelines ignored the often vast difference between the price the producer had a right to get under the take-or-pay contract and the below-market price at which it would have to sell its gas.[209] FERC noted again that the fact that these cases, which "in all likelihood would have resulted in a judgment for producers," were nonetheless settled was a good sign of the pipelines' continuing bargaining power and of the effectiveness of FERC's Order 500 relief.[210] The Commission reaffirmed its belief that it had no jurisdiction to act over gas deregulated under the NGPA, and that acting just on jurisdictional contracts would be both unfair and ineffective.[211]

In the discussion of its inaction on jurisdictional gas, FERC explained more broadly why it would not attack take-or-pay contracts. Contract abrogation was an "extreme measure." It would require FERC to find take-or-pay provisions unjust and unreasonable and then affirmatively specify what provisions *were* reasonable. Such increasing government involvement would reverse the direction of the past two decades in which "the industry has just gone through the process of getting the government out of controlling wellhead contracts."[212] The market distortions caused

205. To add to FERC's headaches, in the interim the District of Columbia Circuit reversed FERC's method of passing through the fixed buyout costs as a violation of the filed rate doctrine. Associated Gas Distrib. v. FERC, 893 F.2d 349 (D.C. Cir. 1989). The effects of that order are currently being handled in individual pass-through proceedings.

206. *See, e.g.*, Order 500-I, 55 Fed. Reg. 6605, 6606 (1990) (summarizing pipelines' arguments).

207. *Id.* at 6607.

208. *Id.*

209. *Id.* at 6607-08.

210. *See id.* at 6607-11.

211. *Id.* at 6615-20.

212. *Id.* at 6619.

by prior regulations gave no cause for optimism that FERC would be competent to declare what was and was not a proper contract clause. "The parties are in a much better place themselves to refashion their contractual and commercial relationships."[213]

FERC felt that all parts of the industry had, and should have, suffered from the falling market. Pipelines were of course absorbing part of take-or-pay settlements, while producers were giving up some of the high prices in their contracts.[214] The concessions of the various parties were "an equitable resolution of the take-or-pay problem."[215] Payment of the 18.6 cents on the dollar "reasonably reimburse[s] producers for their lost opportunity to invest the money which the pipelines were contractually required to pay under the take-or-pay clause, but did not."[216] Falling prices proved the success of open-access in leading to a competitive market.[217] While there might not be a perfect solution to market decline, FERC put its resolution forward as the best decision in the public interest.[218]

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213. *Id.*
214. *Id.* at 6607-08.
215. *Id.* at 6611.
216. *Id.* at 6607.
217. *Id.* at 6631.
218. In fact, while FERC could not have made a clearer and more persuasive case that pipelines did not need relief, it understated the suffering imposed on producers. Producers giving up an average of more than eighty cents on the dollar are absorbing the lion's share of the falling market. Assume a pipeline is obligated to buy 1,000 mcf of gas in 1990 at four dollars/mcf. It settles for eighty cents/mcf, or a little better than the average 18.6 cents. The producer resells the gas at an "optimistic" market price of $1.50. The producer has received $2.30 instead of four dollars/mcf, a loss of $1.70/mcf, and much of that has come late. The pipeline then decides to pass through fifty percent of its costs as a fixed charged, imposed on its transportation through put, and absorbs fifty percent, or forty cents. The pipeline has paid a fourty cent penalty for its take-or-pay contracts. The consumers for whom the gas was purchased have paid a 40 cent penalty. The producer has paid $1.70, or almost twice the combined burden on the pipeline and consumer. This example will frequently understate the burden on the producer as the contract price is significantly higher than four dollars under many of these contracts, and the forfeited eighty-percent-plus settlement is a correspondingly greater loss.

Usually the settlement comes several years after the payment should have been made, so it in no sense compensates the producer for lost interest. Further, gas that is priced at the section 102 level or the section 107 level may be several times the market place. There is no way around it. However the dispute over how much of take-or-pay settlement costs should be passed through is resolved, producers will already have borne the brunt of the falling market. They have suffered the very injury that pipelines promised to protect them from in their take-or-pay contracts. There is no basis to give pipelines relief from these contracts.

A fourth order that pipelines have claimed voids or supersedes their contract obligations is the now reversed Order 451, which raised price ceilings on certain "old" gas and gave buyers and sellers some new rights to renegotiate contracts for this gas. Order 451, *Ceiling Prices, Old Gas Pricing Structure*, 51 Fed. Reg. 22,168 (1986). This Order is even more remote to the real issues of take-or-pay litigation. Prior to the Order, gas from wells that had begun production before the NGPA took effect could be subject to any one of sixteen separate and low price ceilings. Order 451 raised these ceilings, which FERC found to be unjust and unreasonable. (The Order affected not only gas dedicated to interstate commerce the day before the NGPA was enacted (section 104 gas), but also certain other flowing gas sold under "rollover" contracts, contracts that had expired of their own terms (section 106 gas). For a summary of Order 451's provisions, see *id.* at 22,177-78.

FERC raised the ceiling prices for this gas because it found that the artificially low prices for these categories of gas had caused drilling to collapse, with the stark result that new exploration

f. American Gas Association v. FERC

At long last, the District of Columbia Circuit affirmed FERC's determination that additional regulatory action is not needed on take-or-pay contracts. In *American Gas Ass'n v. FERC*,[219] the District of Columbia Court of Appeals affirmed FERC's finding that take-or-pay action was not needed. Perhaps because FERC had at least twice explained why in

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had not replaced gas reserves consumed in any year from 1978 to 1984. *Id.* at 22,172-77. Order 451 imposed an elaborate set of procedures under which parties to contracts for old gas with indefinite price escalators could renegotiate their price up to a new price ceiling, which was set at the estimated replacement cost for the gas. *See generally id.* at 22,177-78. Producers were given the right to abandon the old contracts and sell to other buyers if the pipeline would not match any price the producers nominated below the ceiling price, and producers got the right to insist that the pipeline transport this gas. To prevent the producers from trying to renegotiate only their low-price contracts, the pipelines got the right to open negotiations on all contracts if the producer asked to reset any prices and the right to abandon the contracts if the parties did not reach agreement. To ensure market stability, the pipelines' firm sales customers were given the right to bid for the gas if the pipeline did not in order to protect their supply. Producers in contracts without indefinite price escalator were stuck with their old prices. *Id.*

The Fifth Circuit reversed Order 451 and remanded it to FERC. Mobil Oil Exploration & Producing Southeast, Inc. v. FERC, 885 F.2d 209 (5th Cir. 1989), *rev'd*, 111 S. Ct. 615 (1991). The Supreme Court has now reinstated Order 451. FERC made it quite clear that the Order was not to be used to abrogate contracts. True to form, pipelines complained about Order 451 just as they had Orders 380 and 436. They told FERC that the Order would inevitably increase their prices and insisted that FERC address the supposed distortions caused by high-priced gas under other contracts. The Commission found that exactly the opposite was true. Low prices for old gas had artificially limited drilling, distorted the market, and forced pipelines to buy too much high-priced gas because this was the only gas on the market. Somewhat paradoxically, raising the price for old gas to its marginal replacement cost would bring more moderately priced gas onto the market and lead to a lower cost mix of gas overall. Order 451, 51 Fed. Reg., at 22,197. The Commission's predictions relied heavily on the effects of competitiveness in the producer market. *Id.* at 22,171, 22,183, 22,186, 22,195. As new supplies of medium priced gas appeared, FERC believed that producers of high priced gas would see the demand for their reserves disappear and have to lower prices if they wanted to preserve their sales of uncontracted gas. *Id.* at 22,194-197. The evidence did not show any need for relief from take-or-pay contracts. *Id.* at 22,183. The Commission reaffirmed "its position that problem contracts are primarily a matter for resolution between the parties involved." *Id.*

Like the District of Columbia Circuit Court of Appeals when it considered Orders 436 and 500, the Fifth Circuit could not resist trying its hand at administrative fact finding when it reviewed Order 451. The court left FERC's findings that old ceiling prices were causing market distortions alone, *Mobil*, 885 F.2d at 218, but it held that FERC had no authority to alter the price ceilings and had not justified its action on abandonment. *Id.* at 218-23. It remanded to FERC for a fuller consideration of whether FERC had authority to enter the relief issued. *Id.* at 226. Even though there was no proper factual record before the court on this issue and the court had *no* authority to make findings on the need for take-or-pay relief, the court nonetheless noted that take-or-pay contracts "potentially threatened [pipelines'] very existence as public utilities," *id.* at 223, and found inaction on such contracts arbitrary and unreasonable. *Id.* at 224.

Judge Brown, dissenting, understandably found this requirement of take-or-pay action "the most startling part of the Court's opinion." *Id.* at 234 (Brown, J., dissenting). Not only did FERC not have to solve all problems in a single order, any more than any administrative agency would have to do so, but Order 451 gave the pipelines substantial leverage by letting them force renegotiation of all contracts, if the producer wanted to renegotiate any contracts, and to terminate obligations under old contracts. *Id.* at 235. Orders 500-H and 500-I have now resoundingly explained why no action is needed. They should remain the law of the land unless and until Congress decides otherwise.

The Supreme Court had no trouble rejecting the Fifth Circuit's foray into factfinding as it reversed that court's appellate decision and reinstated Order 451. The reversal came with reminders of the deference due to FERC and chastisement of the fifth circuit for having "overshot the mark" in its criticisms of FERC. *Mobile*, 111 S. Ct. at 627-28.

219. 912 F.2d 1496 (D.C. Cir. 1990), *cert. denied*, 111 S. Ct. 957 (1991).

great detail (in Orders 500-H and 500-I), the court was careful about the standard of review. The court noted early on that its review of the administrative decision not to act was "quite limited in scope," requiring it only to determine that the Commission had considered all relevant factors.[220]

The court agreed with FERC on several grounds. First, in a ruling of great significance, it agreed that FERC did not have jurisdiction to alter the price or non-price terms of "non-jurisdictional" or post-NGA contracts.[221] More fundamentally, the court found that FERC had considered all relevant factors in deciding not to require changes in take-or-pay contracts. Far from describing those contracts as imposing penalties, the court noted that the provisions "are primarily contract authorizations of a kind of specific performance for the seller."[222] Adopting proposals like mandatory market-out, forcing producers to lower their prices according to some unknown standard, would violate Congress' decision to declare NGPA prices automatically just and reasonable. Even more significantly, the court reviewed without protest the Commission's view that take-or-pay provisions "have a legitimate role in pipeline/producer contracts."[223] As it noted:

> Not to do so would seem to condemn long-term gas purchase contracts to extinction. They would be virtually meaningless with no remedy, and it is not clear that take-or-pay is much more draconian than ordinary contract damages, as the forced purchaser can take and resell at a loss.[224]

Further, the court said that "[t]he Commission saw the clauses as assuring the producer some minimum level of revenue to cover operating expenses and debt."[225] While the court did not fully agree with the Commission's figures on the amount of settlements reached through private renegotiation, it did accept the finding that significant settlements have been reached and that the private marketplace seems to be working to foster renegotiation.[226] As the court summed up, "We have no basis whatever

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220. *Id.* at 1504-05.

221. *Id.* at 1505-07; *see also* Pennzoil Co. v. FERC, 645 F.2d 360 (5th Cir. 1981), *cert. denied*, 454 U.S. 1142 (1982); Turner, *supra* note 17, at 518, 542 ("The legislative history clearly evidences that Congress did not intend for the FERC to impose itself upon contracts."). If Congress decided to change its mind and invalidate take-or-pay clauses in NGPA contracts, it would face the constitutional question of whether it could do this under the dying but not wholly dead impairment of contracts clause or the due process clause. *But see* LIBRARY OF CONGRESS, CONGRESSIONAL RESEARCH SERVICE, THE CONSTITUTIONALITY OF ABROGATION OF NATURAL GAS WELLHEAD PURCHASE CONTRACTS (1983) (authored by Robert D. Poling) (arguing that Congress has power to impose at least some retroactive abrogation); *accord* Arbaugh, *supra* note 25, at 11-62-70.

222. American Gas Ass'n v. FERC, 912 F.2d at 1507.

223. *Id.* at 1508.

224. *Id.*

225. *Id.*

226. *Id.* at 1509. The court stumbled a bit over FERC's assumption that future liabilities as well as past liabilities were being settled for 18.6 cents on the dollar. It claimed that FERC's calculation of future liabilities was not explained and could hardly be fully precise as it necessarily depended on an assumed level of future sales. *Id.* The court went on, however, to note that the Commission

for forcing the Commission into interference with thousands of contracts, in the form either of generic rules or interminable case-by-case decisions, which in either event would be only dimly related to the price difficulty that is the core of the pipelines' problem and is plainly off the Commissions' reservation."[227]

g. Order 528

FERC recently changed the Order 500 crediting mechanism again, but it left intact the general principle that it will provide relief for the pipelines. Responding to an appellate decision that struck down FERC's method of allocating the fixed charge for the gas purchase deficiency,[228] FERC reopened the volume crediting mechanism to negotiation between the parties but also confirmed the viability of Order 500's crediting principles. FERC left existing settlement agreements intact.[229] While FERC required pipelines to submit new pass-through proposals, it held that without agreement between pipelines and producers, the Commission would continue to require a pipeline to absorb the same amount of costs as it was currently absorbing.[230] FERC also expressly confirmed that pipelines could use any combination of the previous Order 500 mechanisms in negotiating a new allocation method.[231] While pipelines may no longer be able to insist that customers accept the automatic pass-through provision of Order 500, the tenor of Order 528 indicates that the Commission will continue to provide significant relief to the pipelines.[232]

3. These FERC Orders Do Not Excuse Performance

This review of FERC orders reveals why pipelines carefully avoid citing any specific language in the orders. The pipelines assert generally that FERC has somehow prohibited them from buying high-priced gas. Yet,

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was not using the number as an exact number but rather as a "general confirmation of the proposition that the crediting mechanism and other factors would force the producers to assume a significant share of the sunk costs arising from actions taken long ago in the expectation of continued high prices." *Id.*

227. *Id.*

228. In Associated Gas Distributor v. FERC, 893 F.2d 349 (D.C. Cir. 1989) (AGD II), the District of Columbia Circuit held that FERC's "purchase deficiency" method of allocating the fixed cost portion of take-or-pay costs, under which some of those costs could be imposed on parties who purchased no gas, violated the filed rate doctrine. *Id.* at 354-57. The filed rate doctrine limits pipelines to charging rates only for service during the period of the charge. *See* Order 528, *infra* note 229, at 3 n.4. *See generally* Arkansas La. Gas Co. v. Hall, 453 U.S. 571, 578 (1981) (filed rate doctrine bars FERC from retroactive rate adjustments).

229. Order 528, *Order on Remand Staying Collection of Take-or-Pay Fixed Charges and Directing Filing of Revised Tariff Provisions* (Nov. 1, 1990) at 6 & 9.

230. "Thus, absent agreement with its customers and all other affected parties, the Commission will continue to require absorption as provided in Order No. 500 and the cases decided after No. 500. Therefore, absent agreement, a pipeline must continue to absorb the same amounts of its take-or-pay settlement costs as it is currently absorbing under its existing pass through mechanism." *Id.* at 15.

231. *Id.* at 19 n.3.

232. FERC expressly stated that pipelines must absorb "a significant portion of the costs," *id.* at 15, but it was careful to say that costs "must be spread as broadly as possible throughout the industry," *id.* at 13. These are the same principles that produced Order 500 in the first place.

FERC has not done so. FERC has said it will not break the ties of private take-or-pay contracts. FERC is not in the business of renegotiating private contracts. None of its orders absolve pipelines of their contract promises or prohibits performance. FERC has refused to abrogate these contracts in language that leaves no room to argue that some "good faith extension of existing law" could transmute FERC's orders into a ban on take-or-pay contracts.[233]

The idea that FERC has done anything to outlaw take-or-pay promises is even more preposterous given the fact that the very problem Order 500 is designed to solve is how to help pipelines recover the cost of *enforceable* take-or-pay contracts. Had FERC voided these contracts, Order 500's elaborate buyout and crediting mechanisms would not be needed. Nor would pipelines spend so much time petitioning FERC for relief, if existing orders already gave them that relief.[234]

It is true that FERC may prohibit some pipelines from recovering part of their gas costs if their contracting practices were "imprudent." Imprudence is very hard to show. The pipeline must be guilty of "fraud, abuse, or similar grounds."[235] Even if a pipeline urges its own imprudence during a take-or-pay case, however, prospective imprudence should not create a take-or-pay defense. What recovery FERC might deny a pipeline in the future is purely speculative. Furthermore, the imprudency argument

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233. Had FERC taken it upon itself to announce such a duty, its orders would have been preempted by the NGPA for all gas committed or dedicated to interstate commerce after November 9, 1978, the effective date of the NGPA. Congress withdrew FERC's jurisdiction over pricing under such contracts, except for its jurisdiction to see that the price for this gas complied with the NGPA's ceiling prices during regulation. *See generally American Gas Ass'n*, 912 F.2d at 1506-07. In addition, the NGPA provides that *any* gas priced at or below the regulated ceiling prices shall be deemed "just and reasonable." *Id.* at 1507. This clear statutory mandate would prevent FERC from directly voiding even earlier NGA gas if priced at NGPA ceiling prices. *Id.* at 1505-06.

234. In fact, FERC has long acknowledged the validity and enforceability of take-or-pay promises. Even before Orders 380, 436, 451, and 500, the Commission had established a presumption that prices under contracts with takes of seventy-five percent or less entered after December 23, 1982 could be passed through to customers. Statement of Policy, FERC Stat. & Regs. 30,410 (1982). This Statement of Policy made it clear that even contracts with high percentages would be protected in contracts entered before December 23, 1982. *Id.* More than fifteen years before that, FERC had mandated that if producers extracted a take-or-pay concession, they had to allow the pipelines a minimum five-year period to make-up the gas. Order 334, codified in 18 C.F.R. § 154.103 (1987). More recently, FERC has held that prepayments do not violate NGPA ceiling prices, even if the pipeline would be unable to later make-up the gas, because prepayments are not payments for gas delivered. FERC order of July 14, 1988, at 5. The pipelines had argued that the per-MCF cost of prepayments should be added to the price they were paying for gas they took, thus producing a price greatly over the NGPA ceiling price. However silly this argument, under which a pipeline could have agreed to make a prepayment and then immediately claimed that the prepayment itself was an overcharge and therefore void, one pipeline persuaded the Fifth Circuit to stay a take-or-pay case and refer this issue to FERC. Wagner & Brown v. ANR Pipeline Co., 837 F.2d 199 (5th Cir. 1988). FERC quickly dismissed the argument. The Commission relied heavily on the obvious fact that gas purchase contracts had been standard for many years before the NGPA was passed (yet Congress gave no indication that it intended to invalidate such standard contract devices), and on the fact that the NGPA was enacted "in the context of prevailing practices." FERC Order of July 14, 1988, at 6-7. Another sign of congressional approval or at least acquiescence in the use of take-or-pay contracts is Congress' failure to pass any of the many bills introduced to limit or invalidate those clauses. For a sample list of these bills in the mid-1980s, see Arbaugh, *supra* note 25, at 11-56-61. FERC has not invalidated take-or-pay contracts in any way, shape, or form.

235. 15 U.S.C. § 3431(c)(2) (1982).

ignores the alternative nature of the pay obligation. Few producers ultimately care if their pipeline takes gas and resells it. That is not their problem. The possibility that a pipeline may not take or make-up its gas is inherent in the take-or-pay obligation.[236] The fact that some gas costs, some fraction of a pipeline's total gas cost, may not be passed through if the pipeline does opt to take the gas does not make the pipeline "unable" to pay. Indeed, FERC has noted with approval that some pipelines have cut margins and borne some of the cost of their high-priced purchases.[237] Many remedies are available to the pipeline, the most obvious being absorbing some of those costs themselves, storing

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236. Lone Star Gas Co. v. McCarthy, 605 S.W.2d 653, 656-57 (Tex. Civ. App. 1980).

237. As FERC told ANR Pipeline which had argued in Order 380 that pipelines were not allowed cut prices, ANR's "premise is incorrect." Order 380-A, 49 Fed. Reg. 31,259, 31,274 (1984). FERC noted that it had approved a reduction in rates filed by United Pipeline in less than thirty days. *E.g.*, *id.* at 31,273 (noting with approval that among "innovative and creative responses" to take-or-pay problems was pipeline action to "cut their rates by reducing their margins in order to increase sales."). The irony in ANR's request was that ANR had no intention of reducing its rates. ANR continued to pretend that it had no take-or-pay problems at all. Some pipelines have unabashedly argued that they are subject to a "least cost" duty, notwithstanding the absence of any statute, regulation, or order saying so, because FERC can prevent them from passing high gas costs through to their customers. They use this excuse to stop buying all high-priced contract gas. They point out that the NGPA gives the Commission the power to stop pipelines from recovering gas costs under the fraud and abuse standard. As support, they generally reference a well publicized case involving Columbia Gas Distribution Company. Office of Consumers' Counsel v. FERC, 783 F.2d 206 (D.C. Cir. 1986).

Office of Consumers' Counsel does not give any reason to breach take-or-pay contracts. In fact, the case proves the sharp limits of any "least cost duty." The District of Columbia Circuit affirmed FERC's finding that a pipeline had to be guilty of "reckless disregard" of its general duty to minimize costs before FERC could deny pass-through of gas costs. *Id.* at 218. Imprudence is not enough to show fraud or abuse. *Id.* at 220. The court stressed that the standard to deny pass through had to be set high because Congress did not want FERC to use its power over rates to indirectly regulate the prices that Congress had removed from FERC jurisdiction, which is exactly what the pipelines are asking. *Id.* at 221. Such action by FERC would defeat Congress' goal of leaving these contracts to the interplay of market forces, a goal evidenced when Congress removed FERC's direct jurisdiction over producer prices in the NGPA. Least cost arguments really propose a new form of price regulation, a fantasy borne of the pipelines' wildest imaginings in which the ceiling price for gas falls with the lowest priced gas available in the spot market.

Office of Consumers' Counsel does acknowledge the unexceptional principle that pipelines have a broad duty to minimize costs, *id.*, but it does not say that pipelines have a right to breach existing contracts every time cheaper gas comes along. To the contrary, Columbia's existing high-priced contracts were treated as binding obligations. *Id.* at 229. The enforceability of these contracts was the reason Columbia had a problem recovering its costs. The question was how far Columbia's costs could exceed the market—how inefficiently Columbia had to have bargained—before Columbia would be denied its right to pass through 100% of those costs. Moreover, the appellate court did not even decide that Columbia's costs were in fact excessive, but remanded that question to the FERC for further reconsideration. *Id.*

Office of Consumers' Counsel said absolutely nothing about the imprudency or likely imprudency of *any* pipeline except Columbia Gas Distribution Company and it did not even decide the imprudency of Columbia's purchases. Exactly the same contract terms might be prudent for other pipelines with lower costs, a greater need for gas, or higher prices but lower take requirements. *Id.* at 230. Prudency "is individual to each pipeline . . ." Order 380-A, 49 Fed. Reg. at 31,268. Columbia, for instance, had bought gas at incentive prices with eighty-five percent or ninety percent takes, even after it foresaw an oversupply in its system. *Office of Consumers' Counsel*, 783 F.2d at 227. Most pipelines will adamantly insist that their purchases were prudent when made, necessary to supply their systems, and remain prudent today. And, in fact, it is probably true that few pipelines made the same mistakes that Columbia made. If the pipeline denies imprudency, of course, that should be the end of the argument.

gas to see if prices go up, or paying and hoping that if price rises over the make-up period their purchases may not seem so imprudent.

In any event, of course, all FERC would do to punish imprudent purchases is deny the pipeline recovery of the imprudent part of gas costs. The speculative possibility that some part of a pipeline's gas costs might not be recovered is no justification for pipelines to assert that they are freed from obligation to honor all of their take-or-pay promises. If a pipeline established its imprudency, if FERC denied pass through, and if this were an event of *force majeure*, *force majeure* would still only cover the "part" of performance rendered unable.[238]

To the extent that pipelines are entitled to take-or-pay relief when they cannot recover their gas costs, the custom is to say so in their contract. Ordinarily, even FERC's denial of cost pass-through "does not modify the contract between the pipeline and the producer."[239] A number of gas purchase agreements contain "FERC-out" clauses, which require the producer to refund the part of its gas costs that FERC excludes from the pipeline's rate base. It seems unlikely that parties who had agreed to specific price relief based on FERC action would also have intended that the *force majeure* clause would suspend their contract based on market difficulties. Parties would not so carefully agree upon the specific relief should FERC deny their pass-through if they also intended a broader, unwritten excuse from all performance just because the market would not let the pipeline recover its approved gas costs.

With a FERC-out clause, the pipeline's relief is much more limited than the total exculpation demanded. Not only does the pipeline avoid only the disallowed costs, but they get relief only to the extent of costs not included in their rate base, not all costs they cannot recover in today's market. Even the FERC-out clause does not guarantee the pipeline that it can refuse to buy all gas that cannot be resold at a profit. And without a FERC-out clause, of course, the naked promise to take-or-pay without any restriction for market conditions displays a clear intent to leave the marketing burden and risk on the pipeline.[240]

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238. The unusual idea that a pipeline can unilaterally cancel its obligations under some least cost or prudency duty is also absurd because, had the pipelines' promises been subject to this condition, most of the contracts would have violated that duty from their inception. Most contracts still in dispute have above-market pricing terms which the pipelines offered in order to round out their gas supply. The gas was priced above the market price, and above the pipeline's weighted average gas costs, on the day the contracts were entered and has always remained so. If those pipelines truly believe that they violated a least cost duty and entered these contracts as part of a fraudulent purchasing scheme, the producer can add a claim for fraudulent inducement to its lawsuit. If the pipeline's promise to pay was part of such a fraudulent scheme, it was a false promise intended to induce reliance that succeeded and the producer should recover for the injury of entering this fraudulent contract.

239. Order 500-H, 54 Fed. Reg. 52,344, 52,367 (1989).

240. Some pipeline officers will testify they are not allowed to lower the price rates and absorb part of their gas costs. This is nonsense. FERC has urged just that. What is true is that the pipelines cannot absorb some of their gas costs and earn the same rate of return otherwise allowed by FERC. They and their shareholders would have to pay for their bad business decisions, just as in every other corporation in the country.

It is questionable whether a FERC-out clause should come into play at all in a case of imprudence.

The word from FERC is simple. FERC has stated again and again that take-or-pay contracts create very real obligations. The Commission has made other changes specifically designed to ease the burden of performance in today's market. In view of FERC's clear and unambiguous denial of relief, pipeline attorneys who still argue that there is some regulatory prohibition would do well to worry a little bit less about their accumulating fee, a little more about their obligations under Rule 11 or the analogous state disciplinary rule.

C. *State Regulatory Defenses Are Usually Preempted*

Pipelines have hidden behind state as well as federal regulations. The production of natural gas is subject to many kinds of state regulation. Most prominent are "ratable-take" statutes that make pipelines buy all gas offered in certain areas on equivalent terms and market demand regulations that limit the amount of gas produced from a well by tying production to some measure of demand, supposedly in order to avoid economic waste. States enforce market demand regulations by setting well "allowables," the amount of gas that they allow a well or field to produce in a given year. Pipelines often seek refuge from their promises by arguing that one kind of state regulation or another won't let them honor their contracts. This is not so.

Most take-or-pay cases concern gas sold in interstate commerce. It is now established beyond all possibility of dispute that ratable take statutes cannot defeat, limit, or condition a pipeline's promises to buy interstate gas. The Supreme Court has said this three times, most recently in a unanimous March 1989 decision.[241] States cannot tell purchasers of in-

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It is one thing for FERC to, for instance, impose a price ceiling on costs that can be passed through if it decides that certain costs have become unjust and unreasonable. But if a plaintiff is committing fraud in its purchasing practices, and some part of those costs are disallowed as a result, making the producer refund those costs makes the producer the sole victim of the pipeline's fraud. This is grossly unfair when the producer had no way of policing the pipeline's purchasing practices and relied on the pipeline's promise to pay regardless of demand. No public policy is served by expanding the type of legitimate government regulation that activates a FERC-out clause to include fraud or reckless disregard in purchasing.

241. Northwest Cent. Pipeline Corp. v. State Corp. Comm'n, 489 U.S. 493 (1989). The Supreme Court first decided this issue more than 25 years ago in Northern Natural Gas Co. v. State Corp. Commission, 372 U.S. 84 (1963). Kansas had a ratable take statute that forbade "inequitable or unfair" taking or "unreasonable discrimination . . . in favor of or against any producer . . . ." *Id.* at 88. The Kansas Corporation Commission had issued an order requiring all purchasers, including Northern which was hooked up to 11,000 wells in Kansas' Hugoton field, to buy gas from all wells in a "common source of supply . . . in substantially the same proportionate status as to [overproducers or underproducers]." *Id.* at 86 n.1. In other words, Northern had to buy about the same portion of gas from everybody in the same field, whether it had a contract with them or not.

Northern argued that this order gave it two bad choices. Either Northern had to buy gas it did not want or need from producers not under contract, thus keeping their production ratable with the producers under contract, or Northern had to lower takes under its contracts with take-or-pay obligations and so breach those contracts. *Id.* at 89. Northern predicted that either option would increase its costs, the first because Northern would have to pay for extra gas that it could not sell and did not want to buy, the second because Northern would have to break its contract obligations and suffer the resulting liability. *Id.* at 99 & n.1 (Harlan, J., joined by Stewart and Goldberg, JJ., terstate gas where to buy gas or dictate the terms of purchase because

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dissenting). Northern argued that the price increases that inevitably would follow from compliance with the Kansas ratable take order invaded the Federal Power Commission's ("FPC") preemptive jurisdiction to determine interstate pipeline rates. *Id.* at 99.

The United States Supreme Court agreed that Kansas could not regulate Northern's purchases. The Court found that state regulatory orders "directed" at purchasers "could seriously impair the Federal Commission's authority to regulate the intricate relationship between the purchasers' cost structures and eventual costs to wholesale customers who sell to consumers in other States." *Id.* at 92. Either direct or indirect state regulation of interstate gas prices would violate the Natural Gas Act's regulatory scheme. *Id.* at 91. Congress' determination to control these interstate prices was strong enough to bar regulations like the Kansas statute even if they raised only "the imminent possibility of collision" with federal goals, apparently without any finding of actual "collision." *Id.* at 92.

The Court emphasized that the defect of the statute was its focus on purchasers:

> The danger of interference with the federal regulatory scheme arises *because these orders are unmistakably and unambiguously directed at purchasers who take gas in Kansas for resale after transportation in interstate commerce.* In effect, these orders shift to the shoulders of interstate purchasers the burden of performing the complex task of balancing the output of thousands of natural gas wells within the State, . . . a task which would otherwise presumably be the State Commission's.

Id. (emphasis added). At the same time, the Supreme Court carefully protected Kansas' power to regulate producers. It cited a raft of precedents establishing beyond doubt that the states have full power to allocate scarce resources. All the Court decided was the *very* limited question of "whether the Constitution sanctions *the particular means chosen by Kansas* to exercise the conceded power if those means threaten effectuation of the federal regulatory scheme." *Id.* at 93 (emphasis added). Going even further, the Supreme Court cited another group of cases upholding the states' power to control production and described the difference between those cases and the Kansas ratable take statute as a "significant distinction, which bears directly upon the constitutional consequences, between conservation measures aimed directly at interstate purchasers and wholesalers for resale, and those aimed at producers and production." *Id.* at 94. At the time, however, little attention was paid to the Court's narrow emphasis that the defect in the statute was that Kansas "aimed" its regulation directly at purchasers rather than producers.

The dissenters joined the FPC in urging a remand to Kansas state court to see if the effect of the Kansas order would be to abrogate take-or-pay contracts like the one in *Northern*. *Id.* at 98-99 (Harlan, J., joined by Stewart and Goldberg, JJ., dissenting). The three dissenters correctly pointed out that any gas Northern was required to buy under Kansas' regulation probably would be cheaper than the gas it was currently buying. If so, compliance would have *reduced* Northern's gas cost, a result that the dissenters pointed out was wholly consistent with the NGA. *Id.* at 105.

More than fifteen years later, Mississippi tested *Northern*'s vitality by applying Mississippi's ratable take statute to interstate purchases. The Mississippi State Oil and Gas Board ordered Tenneco to buy gas from Coastal Corporation and other gas producers in a field where Tenneco had some gas contracts, but none with Coastal or these other producers. Transcontinental Gas Pipe Line Corp. v. State Oil & Gas Bd., 474 U.S. 409, 414 (1986). Mississippi tried to escape *Northern* by reasoning that as Congress had now withdrawn FERC jurisdiction over certain gas prices by passing the NGPA, it had reopened interstate wellhead prices to state control. *Id.* at 422. (Mississippi apparently forgetting the adage that fools rush in where wise men fear to tread.).

In *Transcontinental Gas Pipe*, a 5 to 4 majority of the Supreme Court rejected Mississippi's attempt to overturn *Northern*. Instead, the Court found the NGPA just as comprehensive a regulation of interstate gas markets as the NGA. Congress restored interstate gas sales to free market forces, but deregulated gas "is still a subject of deep federal concern." *Id.* In fact, the NGPA actually *extended* federal pricing controls for a time by giving FERC jurisdiction over intrastate as well as interstate gas prices. *Id.* at 421. Mississippi's ratable take statute violated the NGPA for the same reason that the Kansas statute had violated the NGA: the regulations would force a buyer to take gas from everybody, including noncontract gas, or breach its own contracts by not taking contract gas. In either event Mississippi would have increased by regulatory fiat the cost of gas which Congress wanted left to the free market. *Id.* at 418-19.

The four dissenters in the *Transcontinental* decision included Justices Rehnquist and O'Connor, two conservative jurists whose power has grown with the addition of Justices Scalia, Kennedy, and Souter to the Court. The split was not wholly ideological, though. Chief Justice Burger was in the majority and Justice Stevens was a dissenter. Any possibility that a now more conservative Court

Congress has preempted this field of regulation and left it to the marketplace.

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would reverse *Transcontinental*, however, was put to rest in Northwest Central Pipeline Corp. v. State Corp. Commission, a 1989 case that also emerged from the Hugoton field in Kansas. 489 U.S. 493 (1989). In *Northwest Central* a unanimous Court, lead by Justice Brennan, affirmed the *Transcontinental* rule that states cannot regulate purchases of interstate gas. For purposes of today's take-or-pay litigation, state ratable take defenses are no defense at all to an interstate contract. Courts should summarily dismiss any efforts by the states to impose such requirements on interstate gas purchasers. *See, e.g.*, ANR v. Corporation Comm'n, 860 F.2d 1571, 1580-82 (10th Cir. 1988), *cert. denied*, 490 U.S. 1051, 109 S. Ct. 1967 (1989).

Northwest Central did not leave the law unchanged. The Court strongly affirmed the power of states to affect prices, *if* through regulations directed at producers rather than purchasers. A Kansas "market demand" order was the primary concern in *Northwest Central.* The regulation was addressed to producers, not purchasers. Kansas let producers flow gas only if it could be produced without waste, to satisfy market demand, and so that each lease would ultimately produce the gas underlying the lease area. *Northwest Cent. Pipeline Corp.*, 489 U.S. at 498. The State Commission implemented its order by setting amounts each well could produce. These production quotas were known as "allowables," as they are elsewhere. *Id.* at 499. Purchasers who did not buy the full allowable for a given year had traditionally been allowed credits so they could buy that gas in later years. *Id.* at 502.

Kansas' liberal crediting policy, which allowed pipelines to make up allowable gas at virtually any time in the future, caused great imbalances in the Hugoton field. *Id.* at 501. Much of the Hugoton gas in the ground was dedicated to a handful of major interstate pipelines under old, low-priced contracts that had no minimum takes. The pipelines treated the gas like long-term assets. They saved it. They bought other gas under contracts with take obligations and kept their cheap Hugoton gas in the ground for future profit taking, to sell if prices rose and profits would be highest. *Id.* at 501-02. Other buyers bought all the gas they could get, creating an imbalance between their wells and the pipelines'. To cure the imbalance, the Kansas Corporation Commission issued an order shortening the time in which a purchaser would be allowed to make up their untaken gas. The pipelines would have to buy this cheap gas now or lose their right to produce it forever. *Id.* at 503-05.

This dry problem gave the Supreme Court a chance to rechart the *Northern* and *Transco* terrain. The new Kansas order obviously had a direct impact on purchasers, even though its terms were directed at producers. Indeed, the Supreme Court described the order as "[d]esigned as a counterweight to market, contractual, and regulatory forces that have led interstate pipelines to cut back purchases from Kansas-Hugoton producers . . . ." *Id.* at 497. The Court nonetheless found that this order was permitted because it was directed at producers. The Natural Gas Act by its terms reserved "the production or gathering of natural gas" to the states. *Id.* at 507 (citing NGA § 1B, 15 U.S.C. § 717(b) (1938)). These terms were "sufficient in themselves to reserve to the states" the power to regulate rates of production. *Id.* at 510. The Court found support in the NGA's legislative history for its position that the Act did not deprive the states of their power to regulate production. *Id.* at 510-14. Both *Northern* and *Transco* were distinguished because they struck down orders directed at purchasers, in particular the interstate pipelines whose operations Congress had kept for federal regulation. *Id.* at 514. Although Kansas' regulation had "some impact on the purchasing decisions and hence costs of interstate pipelines," *id.* at 516, the Court would not allow this possibility to nullify what it considered to be the clear intent of the NGA. *Id.* at 518.

Northwest Central is one of the finer examples of a distinction without a difference. In *Northern* and *Transco*, the Supreme Court found state ratable take statutes preempted because of the theoretical possibility of "collision" with federal pricing policies. In *Northwest Central*, the Court refused to find preemption, even though the state regulations almost certainly would affect interstate prices, because there was no *direct* conflict between the two.

The *Northern* dissenters were certainly correct when they argued that whether regulations were directed at producers or purchasers "should not be allowed to obscure their true nature." *Northern Natural Gas*, 372 U.S. at 100. Exactly the same limitations that are forbidden in a preempted ratable take statute, one rendered unenforceable because of its "aim" at purchasers, can be implemented by merely switching one word and "aiming" the statute at producers and requiring ratable production rather than ratable purchases. However arbitrary this distinction, it is as much good law as any recent 9:0 decision.

Fortunately, the distinction is not going to have much impact. The major gas producing states are sufficiently producer-oriented that they are very unlikely to redraft their ratable take statutes

D. *Buying Gas Has Not Become Commercially Impractical*

Commercial impracticability, a favorite pipeline excuse, shares many elements with *force majeure* and often is analyzed with it.[242] Contrary

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to comply with *Northwest Central.* As a practical matter, then, ratable take statutes will remain preempted in cases over interstate contracts, while market demand orders directed at producers will be effective.

It is true that if a contract *is* subject to state production ceilings, it ordinarily reduces the buyer's obligation to the state production ceiling. This limitation is usually spelled out in the clause that defines the take obligation, and it would also follow under standard *force majeure* or government regulation clauses. But, in fact, most statutes regulating production do not cut off the buyer's obligation even if not preempted.

The *Golsen* court thoroughly explained why two kinds of state regulation, conservation laws and a statute prohibiting discrimination against producers, did not reduce take-or-pay obligations. Golsen v. ONG Western, Inc., 756 P.2d 1209 (Okla. 1988). Like most states, Oklahoma has a "market demand" conservation law that prohibits waste. OKLA. STAT. tit. 52, § 86.3 (1981). ONG argued that this statute would be violated if ONG had to take-or-pay for gas that it could not resell at the same price. The court found several reasons why this statute did not limit ONG's duty to take-or-pay. First, the question of physical waste was not raised when all the producer was trying to do was enforce the prepayment provision, not the take provision. *Golsen*, 756 P.2d at 1214. ONG did not have to take any gas, so no gas need be "wasted." Second, even the suggestion of economic waste was inappropriate when ONG had agreed to buy the gas for more than the market price. *Id.* at 1215. As the Court noted, the prohibition against waste was designed to prevent producers from flooding the market with cheap gas. *Id.* at 1216. Golsen had a market for its gas, one embodied in its contract, at an above-market price. ONG made that market when it agreed to buy Golsen's gas. It did not matter whether ONG might have trouble *reselling* the gas at some other point down the line. *Id.* at 1215-16. A statute designed to prevent sales at "sacrifice prices" that might dissipate the state's gas resources should have no concern with sales at an above-market price, whatever happened after that. *Id.* at 1216. The *Kaiser-Francis* court reached the same conclusion that enforcement of a prepayment obligation did not constitute waste, when the gas need not even be produced. Kaiser-Francis Oil Co. v. Producer's Gas Co., No. 83-C-400-B, slip op. at 10 (N.D. Okla. filed June 16, 1986).

ONG also argued that buying from Golsen would violate Oklahoma's common purchaser statute. That statute prohibits a purchaser from discriminating in favor of one purchaser and against other owners in a common source of gas. OKLA. STAT. tit. 52, § 240 (1981). The court found that the common purchaser prohibition had nothing to do with the only relevant question, which was whether Golsen could legally tender the gas. *Id.* at 1218-19. ONG might or might not have to take other producers' gas that it did not want, but that was its problem, not Golsen's. Obviously had this gas been interstate gas, this statute would have been preempted on the authority of *Northwest Central. See id.* at 1219.

The federal judge in *Universal Resources* found an even shorter way to reject the conservation of resources argument. He simply noted that the Oklahoma Corporation Commission is the only authority that can determine if a well is in violation of its regulations. Universal Resources Corp. v. Panhandle E. Pipe Line Co., No. CA3-85-0723-R, slip op. at 4 & n.4, *aff'd*, 813 F.2d 77 (5th Cir. 1987).

A Texas appellate court gave the same correct and brusque treatment to the market demand argument in Valero Transmission Co. v. Mitchell Energy Corp., 743 S.W.2d 658 (Tex. Ct. App. 1987). Rejecting Valero Transmission's arguments that buying Mitchell's gas would violate the Texas market demand order, the court first observed that the Texas Railroad Commission had no authority to abrogate private contracts. *Id.* at 660-61. The Railroad Commission's enabling rules expressly acknowledged that they "should not affect existing contractual rights and obligations between parties." *Id.* at 660 (quoting 12 Tex. Reg. 536 (1987)). Further, even if the Railroad Commission had authority to change contracts, there was evidence that Valero was still able to move most of its gas. *Id.* at 662. Valero had not proven that production would exceed market demand.

Take-or-pay contracts should also survive state "allowable" regulations. Most gas-producing states limit the amount of gas that can be produced from a well by setting an "allowable," a permitted amount of gas. The allowable quantity is often based on the purchaser's nomination of the amount of gas it can sell in the market. This does not mean that the buyer can just reduce its nominations and erase its take-or-pay obligation. Take-or-pay contracts normally require the purchaser to nominate at least as much gas as it is required to buy under the contract. The flaw in the pipeline's position, to its alluring title, however, the doctrine does not let a buyer escape

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when it tries to use these regulations as a defense, is that they invariably can nominate at least the required contract amounts and sell that gas if they will simply lower their price.

A pipeline who refuses to nominate sufficient quantities, even though it can sell the gas at some price, violates its *contractual* obligation to nominate minimum contract quantities of gas. Because allowable regulations are initially based on nominations, but are often adjusted to account for the pattern of actual production, a pipeline could reduce a well's allowable by simply not taking much gas. As the allowable decreases because gas is not being produced, the purchaser then claims that it no longer can take the gas because of the lowered allowable. Not only does this violate the contract obligation, but it can give rise to tort liability. A sophisticated version of this scheme was carried out by El Paso Natural Gas Company, which manipulated its pattern of taking gas throughout New Mexico in order to shut in some of its expensive gas. A New Mexico jury found that El Paso had made its nominations in bad faith, manipulating its purchases to decrease the allowable limit. Hartman v. El Paso Natural Gas Co., 107 N.M. 679, 683, 763 P.2d 1144, 1148 (1988). The court rejected El Paso's argument that the jury's findings defeated the New Mexico regulatory scheme. *Id.* at 686, 763 P.2d at 1151. The thrust of the decision is that a purchaser must obey is contract obligations to the fullest extent permitted by state regulations.

All Valero was arguing in its case wlth Mitchell, for instance, was that Mitchell's gas would cost Valero four dollars a unit to sell when the market price was just two dollars, so "there is no existing market for four dollars gas." *Valero Transmission Co.*, 743 S.W.2d at 661. That resale price problem belongs just to Valero, not to the State of Texas. The market is there, just at a lower price. This is the same silly argument that the *Golsen* court rejected in its *force majeure* discussion. The demand for gas remains. The purchaser may have to take a loss when it *resells* the gas, that's all. Thus even if market demand regulations could preempt contract rights, and even if statutes concerning conservation within the state had anything to do with conditions in the pipelines' resale markets, the fact that pipelines could simply lower their resale prices to move their gas should be an adequate answer to arguments based on statutes concerning the waste.

While most courts have clearly distinguished the purchaser's *contractual* obligation to buy gas and its statutory obligation, not all courts have and those that fail to do so have quickly slid into error. In the worst case, Lively Exploration Co. v. Valero Transmission Co., 751 S.W.2d 649 (Tex. Ct. App. 1988), *appeal dismissed*, 493 U.S. 1065 (1990), a Texas court dumped the entire issue on the jury. Like the *ANR* cases, *Lively* shows plainly how the rule of law is subverted when the interpretation of statutes is treated as a fact question for the jury's consideration. The *Lively* jury instruction said that production which constituted waste was unlawful, that waste included production in excess of market demand, and that market demand "*means that amount of gas needed for current consumption.*" *Id.* at 653 (emphasis added). Valero, the pipeline, flooded the record with testimony that production beyond the small amounts it took would be in excess of its current consumption, and the court let the jury decide the whole mess. *Id.* at 655-56. They not surprisingly found no breach.

The market demand rule should have been irrelevant in *Lively* because it could not affect the private rights of the parties; because enforcement of the take-or-pay provision did not require production in any event, as Valero could have simply prepaid and taken the gas later; and because whether or not Valero could have resold the gas, which was the only complaint Valero had, at the price it paid had nothing to do with economic waste. The court of appeals nonetheless affirmed the judgment on narrow and exceedingly technical grounds. In a hair-splitting distinction, the court narrowed the producer's [Lively's] complaint on appeal to only an objection "that the charge should not have included the rule because it did not relieve Valero of its contractual obligations," not that application of the market demand rule to it was erroneous. *Id.* at 652. The court put great weight on Lively's supposed concession that the evidence on the market demand rule supported the jury's finding that Valero did not fail to take or pay for required contract quantities, *id.* at 656, and the court rejected Lively's point that the rule had no probative value because the market demand rule did not obligate Valero to breach the contract. The court apparently affirmed for the narrow reason that, *given the "concession" that the market demand rule applied to these parties*, there was evidence to support the verdict. *See id.* at 656. Nowhere in the opinion is there any explanation of how the effect of the market demand rule on an unambiguous contract could be a question of fact, rather than the question of law that it really is.

The court of appeals should have decided as a matter of law that the market demand rule did not relieve Valero of its contract obligations. Both the terms of the rule and the specific allowables which the Railroad Commission had imposed would be matters of which the court could and normally would take judicial notice. The meaning of the rule is a basic question of law. None of its obligations merely because a falling market has made them burdensome..

At early common law a contract could be defeated by changed conditions only if performance had become strictly impossible, rather than merely impracticable.[243] Commercial losses, like personal injuries, pretty much lay where they fell. Impossibility has softened as it has turned into commercial impracticability. The softening may reflect the shift away from an undeveloped economy that could not afford to compensate many injuries, whether personal or commercial.[244] True to its roots, however, impracticability still is a defense that rarely excuses contract obligations. Legal impracticability does not exist just because a contract is "impractical" in the lay sense of the word. Instead, the defense has three main requirements: (1) a risk must occur that was not expressly assumed; (2) the occurrence must change a basic assumption in the contract; and (3) great injustice must result if the parties are held to their bargain.[245]

The United States Supreme Court has recognized that economic change alone does not give rise to a commercial impracticability defense. "Economic necessity is not recognized as a commercial impracticability defense to a breach-of-contract claim."[246] Courts traditionally have not permitted fluctuations in price alone to excuse performance.[247]

Commercial impracticability is a statutory defense to a gas purchase agreement, not a contractual defense. In all of the major gas producing

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this raises a fact question. Nothing was left for the jury to do, except to be as confused as Valero could make it when the court shirked its duty of deciding the law. Valero benefitted from the same mischief that is dear to ANR. If the jury is allowed to decide the law, legal rules and plain contract language will be defeated whenever lawyers and their experts can divert the jury's attention from the plain, unambiguous language. The pipeline will maximize confusion as this will maximize its chance for recovery. A legal system in which rules of law are interpreted as facts for the jury has no claim to be a government of laws rather than "people" or, more accurately, jurors.

In cases involving intrastate gas or market demand orders directed at producers, producers have to adjust their damage models to comply with state allowable limits. Many of these allowables are set at 100% of deliverability, however, and damage models projecting past production into the future should pass muster in the assumption that allowable limits are unlikely to change for the worse over the life of the contract.

242. One pipeline lawyer, an in-house lawyer for an ANR affiliate, has accused the courts of "throwing the legal baby out with the bath water" by rejecting such other "commercial" defenses as impracticability and frustration of purpose when it rejects *force majeure*. Goldsmith, *supra* note 24, at 191. ANR received a jury finding of impracticability in Dyco v. ANR, *see supra* notes 128-29, a result that doubtless will lead other pipelines to refocus on this defense.

243. *In re* Westinghouse Elec. Corp. Uranium Contracts Litigation, 517 F. Supp. 440, 451 (E.D. Va. 1981) (common law predecessor doctrine was impossibility "which purported to require a showing of objective or scientific impossibility"), *subsequent history omitted*; Transatlantic Financing Corp. v. United States, 363 F.2d 312, 315-16 (D.C. Cir. 1966).

244. *See* G. GILMORE, DEATH OF CONTRACT 95-96 (1974) (decline of strict contract theory "may be taken as remote reflections of the transition from nineteen century individualism into the welfare state and beyond").

245. Golsen v. ONG Western, Inc., 756 P.2d 1209, 1221 (Okla. 1988).

246. W.R. Grace & Co. v. Local Union 759, 461 U.S. 757, 769 n.12 (1983).

247. *See* Langham-Hill Petroleum, Inc. v. Southern Fuels Co., 813 F.2d 1327, 1330 (4th Cir.), *cert. denied*, 484 U.S. 829 (1987) ("if fixed price contracts can be avoided due to fluctuations in price, then the entire purpose of fixed price contracts, which is to protect both the buyer and the seller from the risks of the market, is defeated"); Monolith Portland Cement Co. v. Douglas Oil Co., 303 F.2d 176, 180 (9th Cir. 1962) ("Appellant's excuse can be no more than its economic dreams did not come true . . . . In our view, stronger language was required to reduce the agreement to a requirements contract. In other words, the clause was no escape for bad economic projecting.").

states except Louisiana, a contract to buy gas is a contract for the sale of goods subject to the Uniform Commercial Code.[248] Section 2-615 of the Code codifies the doctrine of commercial impracticability. The section by its words protects only sellers, but judicial interpretation has extended it to buyers as well.[249] The drafters of section 2-615 were careful to exclude market decline and even market collapse from its reach. As they said, impracticability does not cancel an express assumption of risk. The assumption may be by contract language or by industry custom. "[T]he exemptions of this section do not apply when the contingency in question is sufficiently foreshadowed at the time of contracting to be included among the business risks which are to be fairly regarded as part of the dickered terms, either consciously or as a matter of reasonable, commercial interpretation from the circumstances."[250] The same basic common law rule is set out in the Restatement (Second) of Contracts.[251]

Here both contract language and custom require pipelines to pay even if they do not take. The well understood and only purpose of a take-or-pay clause is to put market risk squarely on the buyer. A contract in which a pipeline promises to pay, even without taking and without any restriction for market conditions, is not based on any assumption that the buyer will want to take, will be able to take, will be able to resell the gas at a profit, or will be able to resell the gas at all.[252] Most courts have summarily held in take-or-pay cases that impracticability cannot excuse performance by events that, like market changes, were

248. Louisiana, as a Code state, does not recognize commercial impracticability. *See* Hanover Petroleum Corp. v. Tenneco, Inc., 521 So. 2d 1234, 1240 (La. Ct. App. 1988).

249. *Golsen*, 756 P.2d at 1221 & n.9. The Code's comment 9 seems to indicate that the Code envisions its applicability to both buyers and sellers. It may be that the reason buyers are not expressly mentioned is that their only obligation is, in general, to pay, and it was assumed to be rare indeed that the buyer would not be able to pay. Northern Ind. Pub. Serv. Co. v. Carbon County Coal Co., 799 F.2d 265, 276-77 (7th Cir. 1986). This argument is less persuasive in states that, like Indiana, have their own official comments which diverge from the Code's. *See id.* at 277. In general, lawyers need to be very careful to make sure that their state has adopted all comments to the Code, as well as the text, before relying on general Code authorities, including the comments.

250. U.C.C. § 2-615, comment 8; for additional authorities, see Challenger Minerals, Inc. v. Southern Natural Gas Co., No. 84-C-357-E, slip op. at 15 (N.D. Okla. filed Sept. 9, 1986).

251. RESTATEMENT (SECOND) OF CONTRACTS, § 261, comment a (1979) (principle of impracticability "yields to a contrary agreement by which a party may assume a greater as well as a lesser obligation"); *id.*, comment b ("[t]he continuation of existing market conditions and of the financial situation of the parties are ordinarily not such assumptions, so that mere market shifts or financial inability do not usually effect discharge . . ."). While government intervention can also be a cause of impracticability, it is subject to similar limitations. Such risks may be assumed, and are no excuse if they merely make performance more burdensome. RESTATEMENT (SECOND) OF CONTRACTS, § 264, comment a (1979) ("With the trend toward greater government regulation, however, parties are increasingly aware of such risks, and a party may undertake a duty that is not discharged by such supervening governmental actions . . ."); *id.*, comment b ("Governmental action that has the indirect effect of making performance more burdensome by, for example, contributing to a scarcity of supply, is governed by the general rule stated in § 261 [market shifts or financial inability do not discharge the obligation]".

252. Challenger Minerals, Inc. v. Sonat, No. 84-C-357-E (N.D. Okla. Sept. 9, 1986) (opinion by Brett, J.); *Golsen*, 756 P.2d at 1222-23. *See generally* Northern Ind. Pub. Serv. Co. v. Carbon County Coal Go., 799 F.2d 265, 278 (7th Cir. 1986).

foreseeable at the time the contracts were entered.[253] These courts quickly point to the comment to section 2-615 which states that neither market collapse nor market decline is a defense to performance unless the contract says so. Yet this kind of market reverse is really all that the pipelines are complaining about.

Challenger Minerals, Inc. v. Sonat[254] offers the best illustration of how a court should cut through the impracticability defense. After a bench trial, the court held that the risk of market fluctuation is "inherently borne by a pipeline" in a take-or-pay contract that lacks a market-out clause.[255] Quoting section 2-615, the court observed that a collapse in the market is "exactly the type of business risk which business contracts made at fixed prices are intended to cover."[256] Pipelines confuse their failure to foresee the exact shape of the market with a failure to understand its risks. "Although the parties may not foresee the precise eventuality claimed to excuse performance, an awareness that the marketplace is in flux and more than usually uncertain is sufficient to indicate that the party to the contract agreeing to be bound to a particular performance assumes the risk within the uncertain area."[257] This is a crucial but often overlooked distinction. Pipelines may have hoped for, expected, or even counted on an increasing gas price, but they nonetheless foresaw the possibility of a lower price and their contracts gave them that risk. Because the take-or-pay clause does give the buyer this risk, the *Challenger Minerals* court made the pipeline do exactly what it promised.

Pipelines tend to focus on a few old impracticability cases in which one court or another excused performance because of intervening government orders or drastic market changes in some other circumstance. In fact, a set of cases stemming from the energy crisis of the early seventies confirms that contracts are *not* rendered voidable by impracticability merely because of rapid market shifts.[258] The few cases that do find a defense tend to involve disruptions caused by war. Those cases merely prove that the doctrine of impracticability is flexible enough to allow courts to alter contracts if necessary to protect basic social concerns.[259] A perennial pipeline favorite, the *Llano* case, is easily distin-

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253. *Challenger Minerals*, No. 84-C-357-E at 15-16 and cases cited therein; Hartman v. El Paso Natural Gas Co., 107 N.M. 679, 680, 763 P.2d 1144, 1145 (1988). *But see* Aluminum Co. of Am. v. Essex Group, Inc., 499 F. Supp. 53, 75-76 (W.D. Pa. 1980) (arguing foreseeability not required). Whatever the correct law on foreseeability, the Code's exclusion of assumed risks as events of impracticability should put an end to this defense in its entirety.

254. No. 84-C-357-E (N.D. Okla. Sept. 9, 1986) (opinion by Brett, J.).

255. *Id.* at 7.

256. *Id.* at 14-15.

257. *Id.* at 15 (citations omitted).

258. *See, e.g.*, Eastern Airlines, Inc. v. Gulf Oil Corp., 415 F. Supp. 429, 437-41 (S.D. Fla. 1975) (energy crisis not failure of presupposed conditions or something that rendered performance impracticable); *see also id.* at 438 (discussing Suez Canal cases that refused to find impracticability in closing of Suez Canal). The *Eastern Airlines* court gave great significance to the fact that they concerned industries with constantly changing regulations, which of course makes them like the natural gas industry. *Id.* at 434.

259. For instance, the Supreme Court, speaking through Justice Holmes, let a ship captain off

guished.[260] New environmental rules forbid the pipeline from using the gas at all. Finally, a case that attempted to expand the doctrine of commercial impracticability and is frequently cited by pipelines, *Aluminum Co. of America v. Essex Group, Inc.*, is a bad case for pipelines because if followed literally it would dictate performance of take-or-pay contracts in today's gas market.[261] None of these cases, unlike today's take-or-pay

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the hook for turning back and not completing his voyage when, three days out, he learned of the imminent start of World War I. The Kronprinzessin Cecilie, 244 U.S. 12 (1917); *accord* The Claveresk, 264 F. 276 (2d Cir. 1920); *see also* Eastern Air Lines, Inc. v. McDonnell Douglas Corp., 532 F.2d 957 (5th Cir. 1976) (priority scheduling due to Vietnam War excused performance under contract and under Defense Production Action).

260. *See supra* note 93.

261. Aluminum Co. of Am. (ALCOA) v. Essex Group Inc., 499 F. Supp. 53 (W.D. Pa. 1980). The reasons pipelines remain irrationally attracted to impracticability as a defense lies in this now much discredited case. Like a bad penny, *ALCOA* turns up in a pipeline brief whenever impracticability appears, which is virtually always. The federal trial judge in this unusual Pennsylvania case decided that impracticability forced him to reform the pricing terms of ALCOA's contract to supply Essex with as much molten aluminum as Essex supplied raw material. Although written to herald a brave new world in contract law, the opinion has rightly been a prophet without honor in its own land and should remain so.

ALCOA has very peculiar facts that would take it about as far as possible from the take-or-pay situation even were it good law, which it is not. To the extent it is relevant, it favors natural gas producers, not the pipelines. In fact, fidelity to *ALCOA's* approach would bind the pipeline to buy all the gas that it promised to buy.

ALCOA is not good precedent for pipelines for many reasons. First, the pricing indicator at issue in *ALCOA* was a complex, weighted price index that had precisely tracked the cost of aluminum for years, but had then unexpectedly lost its accuracy owing to the effect of the energy crisis on electricity costs. *See id.* at 58-59, 63-65. The court believed, apparently without dispute by Essex, that *both* parties had studied the index and understood it to be an accurate way of tracking aluminum costs before making it part of their contract. *Id.* The court viewed the index as an "actuarial prediction," *id.* at 64, one that had ceased to hold true. Most take-or-pay cases, in contrast, either contain pricing terms that still accurately track market changes, or just as carefully omit any tracking and fix all market risks on one party or the other. The buyer just promises to buy a fixed amount at some price. To the extent that some parties agree to a market-out clause, which is designed to vary with market prices, those indexes have worked in this market and the *ALCOA* principle would require the pipelines to buy gas at the market-out price. Take-or-pay contracts contain nothing remotely resembling an agreed-upon price index that has ceased to function.

A second striking difference between *ALCOA* and the relief the pipelines seek is that the *ALCOA* court refused to void the contract. The trial court rejected the cancellation sought by ALCOA and reformed the price instead. *Id.* at 78-80. ALCOA was still stuck making and selling aluminum, but at a market based price. The case does not provide any support for pipeline arguments that courts should void, cancel, or rescind take-or-pay contracts.

Third, *ALCOA* was a case in which the seller's loss was matched by a windfall gain to the buyer. Essex sold the finished aluminum at dramatically inflated profits that increased hand-in-hand with ALCOA's losses. *Id.* at 75. The court was concerned to avoid a windfall gain for either party. *See id.* at 79-80. In the take-or-pay situation, in contrast, the buyer has already paid for many of its sunk gas costs, often costs that could not be justified at market rates, in reliance on the promise of incentive prices. Enforcing the contracts as written guarantees the producer the minimum benefit, regardless of what happens in the market, of his bargain. This expected, bargained-for benefit would be lost by reformation. The producer still might not suffer a loss (that depends on where the reformed price falls in relation to his cost), but it would be deprived of its clear contract expectancy. Making producers who had already drilled their wells at their own expense also bear the market risk the buyer agreed to take would give a windfall gain to the buyer, but impose a windfall loss on the seller without any contractual reason to do so. All this is, of course, quite different from *ALCOA*.

ALCOA is perhaps most undeserving because it is a change in the law that failed. Judge Aldisert obviously felt that long-term, fixed price contracts, with their clear allocation of risks, had to have some limits if they were to retain their utility in a complex economy. "If the law refused an cases, turn on contracts with the express assumption of market risk that can be found in take-or-pay contracts. It is this express assumption of risk that the courts have rightly read as compelling rejection of the impracticability doctrine as a matter of law.[262]

There is no reason to extend the defense of impracticability to these cases. The doctrine was developed to shift the cost of unforeseen changes to whoever could do something about the changes.[263] Pipelines are far better suited to handle the declining resale market than producers. They are the only party with real experience in their customer markets. They have long standing relationships and expertise in dealing with public utilities and state regulators. They are on average much larger than the producers who sell them gas. They are better situated to afford the cost of developing new strategies to fit the changed market. Pipelines have large marketing and regulatory divisions whose sole purpose is to study the market and adjust pipeline purchasing strategies to it. They are already structured to bear the burden of the changes that have occurred.

E. *Hope Springs Eternal: Mutual Mistake, Frustration Of Purpose, Illegality, Penalty, Improper Liquidated Damages, Violation Of Public Policy, Failure Of Conditions Precedent, Unconscionability, Insecurity Of Gas Supply, Failure To Mitigate*

In the hope that the quantity, variety, or ambitiousness of their defenses might convince a court to find a fact question somewhere and thus stave off summary judgment, pipelines invariably add ten or twelve other

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appropriate remedy when a prudently drafted long-term contract goes badly awry, the risks attending such contracts would increase." *Id.* at 89. Aldisert also seems to have felt that it was his duty to protect a corporation from managers who had made a bad mistake, that courts "must consider the fiduciary duty of management and the established practice of risk limitation in interpreting contracts and in the application of contract doctrines such as mistake, frustration, and impracticability. Corporate managers should not gamble with corporate funds." *Id.* at 89-90. And it is impossible to read *ALCOA* without thinking that if corporate managers did gamble and lose, Judge Aldisert thought it was the court's unusual role to step in and save them from their own improvidence.

Fortunately, the good judge's effort to reform the law has failed. Other courts have sharply and properly criticized his judicial legislation. *See* Pierce, *Issues in Gas Contract Litigation*, 35 INST. ON OIL & GAS L. & TAX'N 61, 84 (1984) ("*Alcoa* stands as an island in a sea of contrary decisions"). The most fundamental error in his work, of course, is that a long-term contract cannot function *unless* the parties are free to win big or loose big in their gamble. Any long-term contract that allocates risk creates such exposure. Only the chance for big gains, as well as big losses, can power an economy in which massive capital investment is needed to design and produce new products.

262. The courts do not need to decide how far market decline need go to become severe enough to be impracticable, even had the pipelines not assumed this risk. Enforcing take-or-pay contracts does not threaten grave injustice, the third element of commercial impracticability. Pipelines knew when they entered these contracts that not all of the expensive gas they were buying to fill up their systems could be resold at cost to their customers. They bought this gas only because the price could be absorbed when averaged with the cost of their cheaper gas. These pipelines have now profited by the transportation revenues generated in that new market and it is only fair that they pay the downside expense of the corresponding market change, the increasing competition in sales.

263. Northern Ind. Pub. Serv. Co. v. Carbon County Coal Co., 799 F.2d 265, 278 (7th Cir. 1986). In contrast, for an early argument that courts should adopt a more "middle course" on impracticability, see Tannenbaum, *Commercial Impracticability Under the U.C.C.: Natural Gas Distributors' Vehicle for Excusing Long-Term Requirements Contracts?*, 30 HOUS. L. REV. 771 (1983).

defenses to top off *force majeure* and impracticability. The courts have had little problem rejecting these defenses.

Mutual mistake is almost invariably pled. It is just as invariably wrong. Any "mistake" was the pipeline's unilateral mistake, if it really was so naive, in predicting that it would always want to take the gas, a judgment the producer obviously did not share when it required take-or-pay protection.[264] The take-or-pay promise itself is conclusive proof that any mistake was not mutual.

A related defense is frustration of purpose, which can excuse performance if a party's "principal purpose is substantially frustrated" by an occurrence "the nonoccurrence of which was a basic assumption on which the contract was made. . . ."[265] The doctrine has been narrowly applied, requiring a "virtually catastrophic, wholly unforeseeable event" to occur.[266] A unilateral error in projecting price trends is not frustration of purpose. Further, frustration is not a defense if the contract's "language or the circumstances indicate the contrary."[267] The express assumption

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264. *See, e.g.*, Universal Resources Corp. v. Panhandle E. Pipe Line Co., 813 F.2d 77, 80 n.4 (5th Cir. 1987) ("mutual mistake . . . based on Panhandle's unilateral assumption that it would not have to make present deficiency payments . . . ."). Louisiana, a Code state, has a similar doctrine of mutual or unilateral error, but that doctrine does not apply to what are in essence mistakes "as to the profitability of the contract." Hanover Petroleum Corp. v. Tenneco, Inc., 521 So. 2d 1234, 1240-41 (La. Ct. App. 1988). The mistake must be as to a "basic assumption" of the contract, and generally will not cover market conditions or the financial situation of the parties. RESTATEMENT (SECOND) OF CONTRACTS § 152, comment b (1979). The doctrine does not apply when a party bears the risk of a mistake, *id.* § 154, which is obviously the case for the pipeline under even surface analysis of the take-or-pay clause. Day v. Tenneco, Inc., 696 F. Supp. 233, 236 (S.D. Miss. 1988) ("that defendants' predictions proved inaccurate does not create a mutual mistake"); Resources Inv. Corp. v. Enron Corp., 669 F. Supp. 1038, 1042 (D. Colo. 1987) ("mistaken predictions of future economic conditions, however, will not facilitate relief from contractual obligations"); Exxon Corp. v. Columbia Gas Transmission Corp., 624 F. Supp. 610, 613 (W.D. La. 1985) (that buyers' hopes for marketing gas at profitable levels are dashed is not failure of cause).

One misguided author has tried to put exactly the opposite twist on these facts, arguing that the fact that a gas shortage existed when most take-or-pay contracts were entered is a sign "that the parties did not contemplate a complete reversal of market conditions." Comment, *Take-or-Pay*, *infra* note 266, at 271. This is like arguing that it is already drizzling so it is not going to rain. And, of course, the argument ignores the fact that the take-or-pay remedy is designed to operate if there is a full market reversal.

265. RESTATEMENT (SECOND) OF CONTRACTS § 265 (1979).

266. Challenger Minerals, Inc. v. Sonat, No. 84-C-357-E, slip op. at 17 (N.D. Okla. Sept. 9, 1986). Impracticability, mutual mistake, and frustration of purpose all rest at bottom on the unforeseeability of the market changes. Pierce, *supra* note 18, at 82. This is also a sufficient reason why they should be rejected: these changes were foreseen and that was why take-or-pay clauses were needed.

One author has argued that frustration of purpose "appears to be well-suited to the take-or-pay problem," but he realistically notes that American courts are not likely to agree. Comment, *Take-or-Pay Provisions: Major Problems for the Natural Gas Industry*, 18 ST. MARY L.J. 251, 270 (1986) [hereinafter Comment, *Take-or-Pay*].

267. RESTATEMENT (SECOND) OF CONTRACTS § 265 (1979), comment a (purpose frustrated must "be so completely the basis of the contract that, *as both parties understand*, without it the transaction would make little sense, . . . so severe that it is not fairly to be regarded as within the risks . . . assumed . . .," and must be basic assumption along lines of rule on impracticability, even though foreseeability is not determinative) (emphasis added). *See generally Northern Ind. Pub. Serv. Co.*, 799 F.2d at 276-78 (discussing close relationship among frustration, impracticability, and *force majeure*). One court to leave the door slightly ajar to a frustration defense is the Colorado court in *Resources Investment*, which rejected all economically-based arguments but allowed the pipeline

of the obligation to pay even when the pipeline does not want to take disproves any contention that both sides assumed that the resale market would not decline.

Pipelines argue that performance would be illegal or violate public policy. They claim that making a prepayment for gas they would then decide not to take would violate the NGPA's price ceilings, because the effective price for the token amount of gas they decide to take would, in their theory, have to include both the price for that gas and the prepayment on untaken gas.[268] FERC has now determined conclusively that prepayments are not payments for gas taken and therefore are not to be counted as part of the maximum lawful price.[269] In a related vein, pipelines argue that state or federal court litigation should be stayed until FERC looks directly at the merits of their take-or-pay disputes. This argument is a non-starter. If one thing is clear by now, it is that FERC has washed its hands of these private contract disputes.[270] Even a court that initially referred such cases to FERC changed course once it realized that FERC would sit on the cases for years without taking any action.[271]

The defensive arguments that honoring take-or-pay contracts would violate specific federal or state regulations are discussed in detail in section III above.[272] As shown there, these arguments lack merit. The same is true for purported violations of public policy. Courts look to existing laws and regulations to determine whether such violations exist, and the same reasoning that proves that take-or-pay clauses are not illegal under existing laws protects those contracts from these public policy arguments.[273]

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to argue frustration based on warm weather and new legislation. 669 F. Supp. at 1043. The court did not discuss why the risk of these elements was not allocated to the buyer under the take-or-pay clause or provide any kind of principled reasoning to support its conclusion.

268. In other words, if a pipeline paid two dollars/MMBtu for 1,000 feet of gas, and prepaid but did not take 2,000 more feet of gas at two dollars/MMBtu, it could claim that it was paying six dollars for the 1,000 feet of gas it did take. Under this argument, pipelines could unilaterally make contract performance illegal by making small prepayments but deliberately not taking the gas. If this strategy succeeded, the pipeline would doubtless then offer to buy the same gas from the same producer at a spot market price.

The public policy defense is described in all its glory in Comment, *Take-or-Pay*, *supra* note 266, at 272-78.

269. ANR v. Wagner & Brown, No. GP86-54-000 (July 14, 1988) (order dismissing complaints and denying petitions for declaratory order and expedited rulemaking).

Pipelines tried to get before FERC not because it was a better, wiser, or more just forum, but because the Commission moves slowly. *See* Pierce, *supra* note 18, at 67-68 ("FERC is notoriously slow . . . . Thus, the most important consequence of a holding of primary jurisdiction is lengthy delay of the contract litigation.").

270. *See, e.g.*, Superior Oil Co. v. Transco Energy Co., 616 F. Supp. 98, 101-02 (W.D. La. 1985) (citing FERC Amicus Brief indicating that such questions should not be referred to it); Forest Oil Corp. v. Tenneco, Inc., 622 F. Supp. 152, 155 & nn.1-15 (S.D. Miss. 1985) (citing FERC Associate General Counsel letter that FERC seems to have no jurisdiction over matter and 15 cases in which the same or similar arguments have been rejected).

271. Danden Petroleum, Inc. v. Northern Natural Gas Co., 615 F. Supp. 1093, 1099-1103 (N.D. Tex. 1985).

272. *See supra* notes 135-232 and accompanying text.

273. Universal Resources v. Panhandle E. Pipe Line Co., No. CA3-85-0723-R, slip op. at 4 n.4 (N.D. Tex. filed Apr. 1, 1986) (citing Sid Richardson Carbon & Gasoline Co. v. Internorth, Inc.,

The courts have soundly rejected the argument that prepayments are void as a penalty or as unconscionable liquidated damages. A prepayment is an alternative method of performance, not a measure of damage.[274] As one trial court said in discarding this defense, the promise "is a contractual provision that guides the parties' conduct during the pendency of the contract, not a provision that punishes a party for breaching the contract."[275]

Some pipelines argue that the non-occurrence of market decline is an implied condition precedent to the contract. Implied conditions will not be inferred, however, in areas where the contract speaks clearly, and these contracts unambiguously put the risk of falling demand on the buyer.[276]

Not surprisingly, arguments that take-or-pay clauses are unconscionable have not succeeded. Not only is lost profitability not the same as unconscionability, but the pipeline would have to show that the contract was unconscionable *at the time it was made*, the very time when the pipeline was beating down the door to get at such contracts, not now after the market has turned on it.[277]

A number of pipelines have refused to prepay for gas they obviously do not want by pretending that they are unsure that the gas will remain in the ground to be made up. This argument has been properly rejected because there was no reasonable insecurity and the producer had continued to tender gas for delivery.[278] In such a circumstance, when the pipeline refused to take any gas, the producer was not required to respond to the pipeline's purely hypothetical request for adequate assurance that the gas would still be there if the pipeline ever changed its mind.[279] Take-or-pay contracts vary in how they deal with buyers' becoming unable to take all the make-up gas, either because the contract term is over or the gas runs out, but such risks are not themselves enough to invalidate the contract. The risk of not taking all the gas generally has been one of the risks imposed upon the buyer, who might have to buy the same gas twice if it fails to take all the gas in the make up period.[280] This is a

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595 F. Supp. 497, 500-01 (N.D. Tex. 1984)). As the *Sid Richardson* court said, "[I]t is in the public's best interest to prevent such planned breaches of contract by a utility, such as the Defendant, who could otherwise breach their contracts and then hide behind the Natural Gas Act." *Id.* at 501.

274. Universal Resources Corp. v. Panhandle E. Pipe Line Co., 813 F.2d 77, 80 n.4 (5th Cir. 1987).

275. *Universal Resources*, No. CA3-85-0723-R, slip op. at 5 & nn.5-6; Challenger Minerals v. Sonat, No.84-C-357-E, slip op. at 19 (N.D. Okla. Sept. 9, 1986).

276. *See Universal Resources*, No. CA3-85-0723-R, slip op. at 5 n.7.

277. *See* Resources Inv. Corp. v. Enron Corp., 669 F. Supp. 1038, 1042 (D. Colo. 1987), and cases cited therein.

278. *Universal Resources*, 813 F.2d at 78-80.

279. *Id.* at 79-80.

280. Lone Star Gas Co. v. McCarthy, 605 S.W.2d 653, 656-57 (Tex. Civ. App. 1980). Or pipelines may argue a related defense that the gas does not meet quality specifications, a problem for which most contracts give the producer the right to treat the gas to bring it up to standard. In *Kaiser-Francis*, for instance, PGC argued that Kaiser-Francis' gas no longer met contract specifications. Kaiser-Francis Oil Co. v. Producer's Gas Co., No. 83-C-400-B, slip op. at 6-7 (N.D. Okla. June 19, 1985). The court rejected this argument because Kaiser-Francis had never been given a chance

bargained-for risk and the contract will say so if the parties intend the pipeline to get a refund for a failure of supply.

Pipelines may argue that producers fail to mitigate by not selling any untaken gas on the spot market. There is a catch-22 to the argument. If the producer does sell the gas, the pipeline will turn on it just as quickly and will now say that the gas was committed to the contract, the producer breached the contract by selling the gas to anyone else, and that the producer therefore cannot recover damages for its own breach.[281] The failure-to-mitigate defense should have little place in contracts in which the gas is committed to the buyer,[282] because here the normal remedy will be to require prepayment but to order the producer to hold the make-up gas available. If the producer sues for repudiation, in contrast, the contract is over and the buyer will get a credit for gas at the market price at the time of repudiation, regardless of whether the gas was sold or not.

There are easy answers for most of these defenses. The courts should not let themselves be diverted by pipelines that will plead every frivolous defense possible as long as they are not sanctioned.[283] Courts would never permit such abuse in ordinary cases, and there is no reason to carve out a special "frivolity" exception for take-or-pay cases.

IV. DISCOVERY SHOULD BE DIRECTED AT SUMMARY DISPOSITION AND EVIDENCE OF BAD FAITH

The biggest question in every take-or-pay lawsuit is whether the court will grant summary judgment striking the pipeline's defenses. If so, the

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to treat the gas to conform to the contract and had not raised the same defense to reject the same quality gas owned by others in the well. This proved that Producer's Gas Company's real problem was prices, not gas quality.

Also included in the list of spurious arguments is the pipeline plea that the prepayment is merely an advance on payment for gas that would otherwise be taken, so the producer's only loss or damage is the time value of money, *i.e.*, interest. The argument ignores the fact that the producer can effectively sell the gas twice if the pipeline does not take the gas and that the price the producer can get in the market is rarely even nearly as good as the contract price. Indeed, one purpose of the take-or-pay clause, with its guarantee of periodic payment, is to protect producers from just getting interest. Johnson, *supra* note 20, at 110-11.

281. This is precisely what happened the El Paso Natural Gas lawsuit, discussed *supra* note 5, in which El Paso argued below that it was excused from making any prepayments during the period when TransAmerican sold "El Paso's" gas but that TransAmerican had failed to mitigate because it continued producing gas and drilling wells, and so increased El Paso's liability by increasing contract quantities. The issue was more complicated than in many take-or-pay cases because El Paso only had rights to a portion of the gas, so that holding its gas in the ground would have required TransAmerican to shut in the gas attributable to other interests or to artificially attempt to estimate what total production would have been and to shut in El Paso's fractional interest in that production.

282. Thus in Atlantic Richfield Co. v. ANR Pipeline Co., the court of appeals found that a mitigation issue should not have been submitted to the jury, even though it also found the error harmless. Atlantic Richfield Co. v. ANR Pipeline Co., 768 S.W.2d 777, 784 (Tex. Civ. App. 1989).

283. In a case in which it faced a judgment of over $400 million, for instance, El Paso pled more than a dozen affirmative defenses below, but on appeal raised only one, *force majeure*. Brief of Appellants, El Paso v. TransAmerican, No. 01-88-0847-CV (Tex. Civ. App. 1989). One easy measure of just how frivolous these defenses are is that all but one or two will be dropped when the pipeline drags its case up on appeal.

case will be dramatically shortened and summary judgment on damages should follow quickly. The goal must be to rob the pipeline of the advantage it seeks by being in court—delay. If summary judgment is not granted, the producer will be exposed to all the economic pressure the pipeline can muster as the years of discovery stretch on indefinitely.

Testing liability on summary judgment right after a first wave of discovery should be the producer's goal in every take-or-pay case.[284] The amount of discovery that should be needed to surmount pipeline defenses is surprisingly small for cases with so much at stake. To get summary judgment, producers should focus as early as possible on proving the enforceability of take-or-pay clauses, the pipeline's assuming the risk of market decline, and its full ability to perform. The proof ordinarily will come right out of the mouths of the pipeline's witnesses and from the pipeline's books and records. Such discovery should not be necessary to win summary judgment, but whatever admissions the producer can uncover in pipeline files will underscore the meritlessness of the defenses and may help push cautious judges into granting summary judgment. In addition, the same evidence can help prove repudiation or lay the predicate for punitive damages on common law claims.

One goal is to establish, quickly and cheaply, every way in which the pipeline has treated take-or-pay contracts as enforceable. Many pipelines entered take-or-pay contracts with affiliated companies and honored these contracts, at least initially, even after prices fell. Such evidence confirms there is nothing wrong or against public policy about these contracts and that the pipeline understood that. Discovery into pipeline administrative filings will turn up similar evidence of enforceability. Pipelines will have to argue before FERC and in state utility proceedings that the very contracts they pretend are unenforceable are in fact prudent contracts whose costs must be passed on. These administrative proceedings are fertile sources of pipeline admissions that their take-or-pay contracts are binding and enforceable obligations. Furthermore, pipeline executives who will face prudency review can hardly afford to say that anything in their contracts is imprudent. Top company officers should be forced to discuss the common industry meaning of take-or-pay clauses. Either the witnesses will admit the truth that they knew these clauses allocated the risk of market decline or, if they deny this, leave themselves open to impeachment from expert witnesses and often from their company's early internal documents.

Pipelines would not be recording take-or-pay liabilities on their books if they thought that market decline excused performance. Most pipelines drafted extraordinarily blunt plans tallying their contract obligations, targeting the victims of their systematic breaches, and recording the success of their contract avoidance schemes. Pipelines' files invariably are full of documents discussing how to avoid onerous take-or-pay liabilities,

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284. Another look at the practical aspects of preparing a take-or-pay case is Wawro, *Outline of the Development of a Take-or-Pay Lawsuit*, lecture at 28th Regulatory Conference (May 17, 1989), *reprinted in* Proceedings of the 28th Regulatory Conference 195 (Ia. State May 16-18, 1989).

measuring their exposure, and so on. These documents often contain speculations on likely producer responses to the pipeline's breaches, put a price on anticipated judgments, and plan ways to trick producers into staying out of court. Jurors applying their common sense will catch on quickly when they see these documents.

Producers should look for testimony showing that the pipeline did not really stop paying just because of market decline. One relevant area of discovery is whether a pipeline continued to buy from its affiliates and whether affiliate prices were higher on average than the pipeline's weighted average cost of gas. Executives should be questioned carefully about the decision to stop taking or paying for gas. The decision is rarely made with any analysis of individual contracts and company witnesses normally will be unable to articulate any coherent standard to explain when and why they decided to stop buying the producer's gas, or, for that matter, when they will resume purchases. If the witness answers honestly that his company will resume performance once the market/contract price differential falls to a certain level, the answer will only graphically emphasize that profit, not ability to perform, is the real issue. If he refuses to say when, if ever, performance will resume, his testimony helps to prove a repudiation claim that the pipeline has no intention of honoring the contract.

The producer should demand to see the pipeline's other contracts, particularly contracts with market-out clauses, to prove that the pipeline was fully aware of that simple contract mechanism which would have given it protection against market decline. Pipelines must be asked to produce calculations of delivery obligations under the disputed contract. If they made such calculations, their protestations of no liability become suspect. If not, the failure to take even this minimal step to perform is good evidence of repudiation and bad faith.

The producer should look at any contracts under which the pipeline sells gas. If they have take-or-pay clauses, has the pipeline insisted on performance? Most of the major interstate pipelines do have gas producing affiliates, some of whom have take-or-pay contracts with other buyers. Colorado Interstate Gas, for instance, an affiliate of ANR Pipeline Company, won a $724,033,361 judgment based on a take-or-pay resale contract at the same time that CIG and ANR both were refusing to honor their own take-or-pay contracts.[285]

A very telling test of a pipeline's true beliefs about defenses based on market decline can be made by looking at the pipeline's pre-NGPA performance. Many pipelines bought gas under extremely low-priced contracts entered in the 1950s and 1960s. Producer requests for relief as market prices rose fell on deaf ears. Pipelines sanctimoniously enforced the "sanctity" of these fixed contracts, which benefitted them.[286] Sauce for the goose being sauce for the gander, pipelines can hardly expect

285. *See supra* note 6.
286. *See* Johnson, *supra* note 20, at 96.

any more relief now than they gave earlier just because the shoe is on the other foot.

Another necessary area of discovery is ability to perform. There are usually numerous ways to show that a pipeline has not become unable to perform. Discovery into storage systems may show that the pipeline could take, pay, and store gas it could not economically resell at the moment. A pipeline may be buying gas under other, higher priced contracts. Virtually all pipelines still earn substantial profits, and many are sending millions of dollars upstream to parents or into pipeline expansion projects. Most pipelines have internal plans showing that they believe the gas "bubble" will burst and they soon will need to take the gas they have under contract. If they can take the gas later in the make-up period, obviously they are not "unable" to perform. Furthermore, the largest pipelines are each undertaking ambitious expansion projects in the expectation that the demand for gas will rise dramatically. The fact that pipelines are sufficiently optimistic about the gas business to risk hundreds of millions of dollars on its future is itself persuasive jury evidence that they are not "unable" to perform. Furthermore, the costs of these projects are often buried in their books in ways that let them disguise their real profit from day-to-day operations.

Pipelines frequently try to hide behind their lawyers when asked why they stopped performing. They claim attorney/client privilege or work-product privilege. The law is quite clear that pipelines cannot so shield the origin of their schemes.[287]

Pipeline SEC filings will contain more grist to disprove their *force majeure* defense. Annual 10-K reports and other periodic federal securities reports required of publicly traded companies must contain all material information about the pipeline's financial condition. Filing false statements in these reports gives rise to criminal liability.[288] Although pipelines readily pretend that their markets have been destroyed and they are unable to honor basic contract commitments, none of this most material information

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287. The claim of privilege for contract negotiations or the business decsion to breach should get short shrift. For example, a FERC adminstrative law judge summarily dismissed Transcontinental Gas Pipeline's effort to shield legal advice that went into the negotiation and renegotiation of the disputed contracts. *In re* Transcontinental Gas Pipeline Corp., 38 FERC ¶ 63,042 (Mar. 13, 1987) (order ruling upon issues of attorney/client privilege and attorney work product privilege).

The pipelines' penchant for secrecy, their drive to conceal the true facts of their take-or-pay campaigns, continued even through the recent court of appeals opinion confirming FERC's decision to let pipelines conceal the raw data on settlements filed by the pipelines in Order 500 proceedings. FERC had agreed to allow this ongoing concealment "because of some parties' expressions of concern about the competitive effect of release." *American Gas Ass'n*, 912 F.2d at 1508 n.3. Without such data being made public, of course, the pipelines are free to wage their adversarial battle to persuade regulators and legislators that they are truly victims of today's market without ever giving producers and those interested in truth the chance to examine their numbers and fairly test their arguments. This unjust approach is not surprising, of course, because it is the same approach pipelines take in discovery when their cases hit the courts. They want to argue "inability" to perform but refuse to let the jury see the financial data that would confirm or refute their arguments.

288. *E.g.*, 15 U.S.C. § 78j(b), 78r (1934). *See generally* Mixon, *Take-or-Pay Contracts: Impacts on Financial Statements*, 38 OIL & GAS TAX Q. 595, 596-98 (1990).

shows up in these federal securities reports, the first place it would be were it true.

Pipelines should be asked to calculate the effect of performing their contract obligations on their weighted average cost of gas, a cost that includes many below-market prices. Usually the effect is marginal. The producer should calculate the difference between its price and the weighted price. This is the maximum measure of the pipeline's true exposure, the cost of performance. Most important, the producer should prepare a chart comparing the pipeline's annual profit with the difference between the producer's price and the market price, or the pipeline's weighted gas price. Such a chart emphasizes how easy performance would be. It shows how little the pipeline would lose and how easily it could absorb the loss if it just dropped the price far enough to resell the producer's gas. While the take-or-pay promise should be enforceable even if the pipeline takes a loss, because nothing in a take-or-pay contract guarantees the pipeline a profitable business, evidence that the pipeline can easily absorb any unrecovered gas costs may be the quickest way to disprove assertions of inability to perform.

This is not a lot of discovery. It is extraordinarily little for cases that usually have millions of dollars in dispute. The case should move as follows. The producer files document requests and interrogatories with the complaint. The pipeline refuses to produce virtually everything just mentioned because it does not "specifically" relate to the producer's contract. A month or so will pass before the producer's motion to compel is heard. Any fair court will order production, giving the pipeline thirty days to produce the material. The producer should then depose the half-dozen executives who (1) made the pipeline's policy generally or (2) had something to do with the specific contract. The producer should use the information discovered to file a motion for partial summary judgment on liability. If the motion is granted, the producer should conduct equally focused discovery on damages and decide if it wants to pursue tort claims for punitive damages or just get the quickest final judgment on its contract claim.

V. REMEDIES FOR DELIBERATE CONTRACT BREACH

This section discusses remedies that go beyond the ordinary contract measure of damages, remedies that producers should consider to put added pressure on the pipeline. The most important of these is repudiation. Repudiation would already have proven the surest weapon against pipeline defaults were the Commercial Code more widely studied. The cause of action has many advantages. It locks in the best possible measure of damages short of punitive damages. It shares much of the punch of causes of action that carry punitive damages because the producer can recover more than just the damages it has suffered by time of trial. Better yet, these damages are a matter of right, not something left to the discretion of the jury. And the pipeline is put on notice that it may well not be allowed to stall but then return to business as usual if prices once again rise years later. If a jury finds repudiation, the contract is gone forever and with it the commitment of gas.

After discussing repudiation and a related cause of action, breach of the whole, this section discusses racketeering claims. While the courts have been hostile toward racketeering claims, they fit the system-wide, detailed schemes of the pipelines and bring the added benefit of treble damages. Producers' lawyers should not be afraid to pursue this remedy for violation of their clients' rights just because of judicial hostility to such claims. Next are tort duties of good faith. The expansion of a tort duty of good faith in contract cases has been slowed, but the take-or-pay experience, in which pipelines have deliberately breached contracts in a gamble that they can avoid the full contract measure of damages, provides a good example of why a tort duty of good faith should apply to some sets of facts. Lastly, this section discusses a number of tort claims that may be appropriate, including antitrust claims, negligence, conversion, fraudulent inducement, duress, civil conspiracy, and tortious interference.

A. *Repudiation Is Not Hard to Prove*

Repudiation is a surprisingly simple claim to prove. The most important legal fact about repudiation is that it is defined in the Uniform Commercial Code.[289] The cause of action can be taken directly from the language of the Commercial Code in all states except Louisiana. Although the Code can be interpreted using precedent if necessary, Code-law is not determined by common-law precedent. The reason commercial law was codified was to simplify and improve the amorphous sprawl of the common law, not to add to the confusion. The language of the Code, its purpose, and the comments are designed to and can answer most questions.[290] It is a free-standing body of law and the statute itself, supplemented by the drafters' written comments, should be enough to resolve most disputes.

The common problems with proving repudiation would be solved, and solved easily, if litigators and the courts paid more attention to the language of the Code. The elements of repudiation are described in Section 2.610 and its comments. There are just two. First, there must be an act of repudiation. The act can be an "overt communication of intention" not to perform, an action which makes performance impossible "or demonstrates a clear determination not to perform," or a demand for counterperformance if "under a fair reading it amounts to a statement of intention not to perform except on conditions which go beyond the contract."[291] Second, the repudiation must "substantially impair" the value of the contract. Substantial impairment means that "material inconvenience or injustice will result" if the victim is forced to wait until performance finally comes.[292]

289. U.C.C. § 2-610 (1978).
290. *Id.*
291. *Id.* comments 1-2.
292. *Id.* comment 3.

The myriad contract cure schemes, emergency gas purchasing programs, and other plans to break down producers' rights easily fit this definition of repudiation.[293] Indeed, they should do so as a matter of law. Claims that a gas purchase agreement has become void, ineffective, or is suspended for some indefinite period of time because performance is too costly according to some test that can never be articulated; refusals to buy gas or make prepayments and an inability to say when, if ever, performance will resume; a refusal to prepay without assurance of performance; or offers of performance but only with the added condition of price concessions or take reductions, an indication of intent not to perform except on conditions which go beyond the contract, should each be sufficient to establish repudiation. Furthermore, repudiation automatically results if the plaintiff fails to give adequate assurances of performance within thirty days after receiving a demand for assurance.[294]

In many cases, indeed in most cases, repudiation should be found under these standards as a matter of law. The court should have already held that market decline or inability to sell gas at a profit is not an event of *force majeure*. The Code does not expressly state whether the intent not to perform should be tested by an objective or subjective standard, although proving what "intention" words or acts reveal sounds like a subjective standard. Whether a pipeline gives an adequate assurance after receiving notice of insecurity, though, should be a question of law.[295] So too deciding whether a "fair reading" of a unwillingness to perform unless paid off by price concessions or take reductions is a statement of unwillingness to perform except on conditions that go beyond the contract should be an easy question of law in these cases.

As far as substantial impairment is concerned, the failure to make an annual prepayment, with no indication that other prepayments will be forthcoming—a failure to pay under a contract whose primary purpose and often only obligation for the buyer is to make a payment—should be substantial impairment as a matter of law. After all, the obligation to pay is the buyer's basic contract obligation. In many gas purchase agreements it is all the buyer ever has to do. The seller rarely provides anything other than gas to the buyer, and the buyer really doesn't do anything else other than take gas at the right time, in the right quantities, and pay. Failure to pay in a take-or-pay contract defeats the central purpose of the contract and should automatically satisfy the substantial

293. *But see* Goldsmith, *Defense Perspectives on Take-or-Pay Litigation: Trying the Real Issue*, lecture at 28th Regulatory Conference (May 17, 1989), *reprinted in* Proceedings of the 28th Regulatory Conference 191, 193 (an experienced in-house lawyer at Colorado Interstate Gas who has tried many take-or-pay cases complaining that he spends "in excess of fifty percent of my time defending either repudiation or punitive damage claims and to date not one has survived a directed verdict").

294. U.C.C. § 2-609(1), (4) (1978).

295. At least this should be a question of law in take-or-pay cases. Although adequate assurance is "defined by commercial rather than legal standards," *id* comment 3, a standard that suggests fact issues, the response likely to be forthcoming from a pipeline, which in substance will be that they will buy gas when *force majeure* ceases to exist, should be wrong as a matter of law for the same reason that the pipelines' defenses are wrong as a matter of law.

impairment element. If a court doesn't find substantial impairment as a matter of law, few juries will have trouble seeing that cutting the guaranteed flow of funds, the very thing a take-or-pay contract is designed to provide, greatly exceeds the substantial impairment required to prove repudiation.

The biggest enemy of repudiation at common law was the doctrine of election of remedies. A victimized seller who continued to seek performance or gave the buyer a break by letting it make an occasional purchase affirmed the contract, waived repudiation, and could only recover damages for breach of contract. The victim was supposed to declare repudiation immediately and refuse any later offer by the buyer, even though this conduct might subject the seller itself to damages if it did not prove its repudiation case.

The Code solves this problem. It allows the seller to choose from a variety of remedies, including awaiting performance with or without suspending its own performance and without waiving its right to sue for repudiation.[296] Failure to sue right away is no longer viewed as an election to affirm the contract because the Code encourages parties to wait for performance. Nor, apparently, can it be a waiver. "Inaction and silence by the aggrieved party may leave the matter open *but it cannot be regarded as misleading the repudiating party*."[297] The victim can take his remedies "*at any time*" unless he has done something which "in good faith requires" notification before suing for repudiation.[298] If the victim does wait more than a "reasonable" time before suing, all it loses is the right to recover the damages that could have been avoided by acting sooner.[299] Unlike the victim at common law, who perhaps should more properly be called the victim *of* the common law, a Code victim does not lose its claim for repudiation.[300]

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296. *Id.* § 2-610 (1978).

297. *Id.* comment 4 (emphasis added).

298. *Id.* (emphasis added).

299. *Id.* comment 1.

300. Thus the Code's significance is that it lets the producer wait and see what happens without losing the right to sue for repudiation. What the producer usually sees is a pipeline that continues adamantly to insist that it has no obligation to buy gas and that demands price relief before it will deign to honor its contract promises. A closer case may arise if the pipeline buys some gas but not contract amounts, yet repudiation really should not be much harder to prove in this case. If the pipeline skips a few years of performance but is now back meeting all its obligation, the producer may in fact be limited to past damages because its "positive action" of letting the buyer resume purchases could make it unfair for the producer to declare repudiation, say after an increase in market price, when the producer suddenly wanted out of the contract. In this case, however, the producer will be made whole by past damages, for which it still can sue.

If the pipeline later breaches its obligations again, for instance by playing with takes and buying a little gas here and a little there to avoid repudiation claims but not coming close to contract quantities, and argues that the contract is somehow reinstated, the producer still has two easy responses. First, a producer's accepting a trickle of performance is not an action requiring notification before suing for repudiation if the pipeline has continued to refuse to buy proper contract quantities. Nothing in the charitable act of helping the pipeline try to sell its gas and so mitigate the producer's damages conveys with it a license to repudiate the contract. Second, if the jury believes that the producer should give notice before suing for repudiation after honoring some pipeline purchases, the producer can sue affirmatively for exactly the same damages. It can seek breach of contract

The producer can avoid the danger of reinstatement by conditioning its acceptance of partial performance with a written reservation of the right to sue for repudiation.[301] The Code codifies the reservation of rights doctrine. Many pipelines are tempted to respond to repudiation claims by saying they have "performed" and pointing to some small quiver of performance, like buying a tiny fraction of contract quantities or quantities measured through incomprehensible deliverability tests whose only real purpose is to minimize the take requirement. The reservation of rights doctrine ends all that.

The Code does give pipelines a right to retract their repudiation unless the producer cancels the contract, changes its position, or gives some indication it has accepted the repudiation as final.[302] Suing for repudiation and responding to any partial performance with a reservation of rights should qualify as a clear indication that the repudiation is final. Retraction also must include any assurance demanded, assurances pipelines never give. Indeed, the producer can probably add another good trial exhibit by writing the pipeline to ask it to state, in writing, if it will take-or-pay for the full contract quantities each year in the future, as well as pay for the accumulated deficiency, and when its market-based *force majeure* will end. The pipeline will respond with some legal mumbo jumbo that hedges on performance or hides behinds market conditions

damages for underpurchases until the time the pipeline resumed its purchases and sue for repudiation from the time of renewed purchases at a below contract price (performing but only on conditions that go beyond the contract). The pipeline cannot return to performance with other conditions, such as market-outs, without creating a new repudiation.

U.C.C. § 2-612 (1978) does provide that a party can reinstate a contract if it "accepts a nonconforming installment without seasonal notification of nonconformity," sues only for past performance, or makes a demand for future performance. *Id.* § 2-612(c). Although take-or-pay contracts may not be installment contracts, this section should not apply in any event to a *total* breach like that when the pipeline says that it has *no* obligation in today's market. *See id.* § 2-612 comment 6 (1978) (subsection with reinstatement only "involves merely a defect in one or more installments, as contrasted with the situation where there is a true repudiation within the section on anticipatory repudiation"); *see, e.g.*, Jon-T. Farms, Inc. v. Goodpasture, Inc., 554 S.W.2d 743, 746 (Tex. Civ. App. 1977) ("We doubt that § 2.612(c) was intended to cover a repudiation such as this one. Comment Six to that section states that this provision was not intended to cover true repudiation."); Kunian v. Development Corp. of Am., 165 Conn. 300, 334 A.2d 427 (1973) (reinstatement inapplicable where defendant had repudiated); Cherwell-Ralli, Inc. v. Rytman Grain Co., Inc., 180 Conn. 714, 433 A.2d 984 (1980) (same). Indeed, section 2-612's proviso that suing only for past installments or demanding future performance proves reinstatement is flatly, totally inconsistent with section 2-610's proviso, and encouragement, that the victim of repudiation may "urge retraction" without losing its suit for repudiation if the wrongdoer does not retract. When the pipeline itself is not trying to continue performance, it makes no sense to say the contract has been reinstated.

Using section 2-612 can be a dangerous tactic for the pipeline. If the pipeline wants to argue that the gas purchase agreement is an installment contract, then *any* nonconformity or default in even one installment, a single missed pre-payment, may be a breach of the whole. This breach exposes the pipeline to the same measure of future damages as repudiation, but with even simpler proof than on a repudiation claim. For instance, when El Paso Natural Gas asked the court for a jury instruction on reinstatement in the TransAmerican/El Paso case, pursuant to Section 2-612, TransAmerican then asked and got for a trial amendment to add a claim for breach of the whole. The jury found for TransAmerican, giving it a new, independent basis for $536 million in damages.

301. U.C.C. § 1-207 (1975).

302. *Id.* § 2-611.

that are not defenses in the contract. The court should be able to decide that this continued insistence on terms far beyond the contract is itself further repudiation, not retraction.

B. The Damages For Repudiation

The beauty of repudiation is its measure of damages. The repudiated contract is finished, over forever. The producer's full contract expectancy, often many times the accrued past damages, will be awarded at the time of trial. The great pipeline weapon of delay is gone. Gone, too, is the committed gas. The game of withholding performance until prices rise is defeated because, when prices do rise, the pipeline will have to look elsewhere for its gas supply. Most importantly, the measure of damages is locked in at what normally will be a very high price level.

Code sections 2-708 and 2-273 define the measure of damages. Section 2-708 requires the pipeline to pay the difference between the market price at the time the producer learns of repudiation and the contract price.[303] To measure its damages, all the producer has to do is multiply the various contract quantities, including projected future production, times the difference between the market price fixed at the time it learned of repudiation and the contract price as it changes. For future damages, the payments the pipeline would have been required to make if the contract continued beyond the time of repudiation, the Code equates the market price to the market price when the producer learned of the repudiation.[304] These historical, published gas prices are readily available.[305]

The contract/market price differential sanctions the pipeline by exposing it to the maximum measure of damages for its wrongdoing. Pipelines have chosen to stop buying gas precisely because the market price has fallen so low that the pipelines are unwilling to miss the bargains in the spot market, even though this means breaking existing contract promises.[306] The Code responds by sticking the pipelines with the maximum measure of damages over the remaining years of the contract.[307] The sanction is

303. *Id.* § 2-708.

304. *Id.* § 2-723(a).

305. The parties may have a fact dispute over whether a long-term or short-term price is appropriate, *see* Manchester Pipeline Corp. v. Peoples Natural Gas, 862 F.2d 1439, 1446-48 (10th Cir. 1988) (suggesting that on remand offset price should be long-term market price, not spot market price), but the unavailability of any long-term price can often make that point moot. In today's market, the two are often the same. In addition, as the producer has the right to and, indeed, is encouraged to await pipeline performance even after learning of repudiation, the courts have no business imposing a duty to enter long-term contracts that would preclude acceptance of resumed performance by the defaulting pipeline.

306. Pipelines then complain that the offset market price should not be so low because prices will rise in the future, but that argument just casts added doubt on why they do not perform in the first place when they could just prepay, and take and resell the gas later, if they were right that prices will rise.

307. This price also must be the price prevailing in geographic market, as shown by section 2-723(2), which authorizes use of a different price if market prices at the time and *place* of repudiation are not available. U.C.C. § 2-703(2) and comment.

Some pipelines have argued that they should be allowed to limit their damages to lost profits because the market/contract price over-compensates the producer for its loss. They rely on section a needed deterrent to the pipelines' quest to switch to the cheapest gas sellers.

Proving the future damages component of repudiation damages is harder than proving past damages. The producer needs to have a reservoir engineer, perhaps with the assistance of a geologic expert, estimate future production from existing wells.[308] The estimates of future production can be converted into damages by multiplying the appropriate volumes times the difference between the contract and market price, discounting that sum to the time of trial, and adding pre-judgment interest.

Producers who prove they would have drilled more wells and found more gas had the pipelines not stopped paying can recover damages for

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2-708(b), which lets the *seller* measure its damages by its lost profits *if* section 2-708(a)'s contract/market damage measure is "*inadequate* to put *the seller* in as good a position as performance." *Id.* § 2-708(b) (emphasis added). The comment to section 2-723 says that the contract/market measure is not the exclusive measure of damages "if the circumstances of the case make this necessary."

Section 2-708(b) nowhere suggests that it is intended to be used to limit the remedies available to the victimized seller *i.e.*, to force use of lost profits if this measure would lower damages. The section is remedial, designed to assure full compensation for the victim, not protection for the wrongdoer. It does not say that the repudiating buyer, rather than the victimized seller, can ask for lost profits or other damage measure to avoid the sanctions the Code imposes on the wrongdoer. Section 2-708(b) only suggests lost profits if contract damages are *inadequate* to put the seller in the same position as performance, not if they are overly adequate. The Code's remedies are designed to supplement available relief for the aggrieved, not to reduce it. Section 2-708(a) is mandatory by its terms. It says that the contract/market measure "*is*" the measure of seller's damages unless inadequate. Not one word in the Code suggests that pipelines who ignore their contract obligations until the day of trial can then get up and ask the court to ignore the proscribed measure of damages.

The Fifth Circuit created a new, unsupported meaning for "inadequacy" in Nobs Chem., U.S.A., Inc. v. Koppers Co., 616 F.2d 212, 215 (5th Cir. 1980), where it decided that damages which overcompensate were "inadequate" to put the victim in the same position as performance. *Nobs* and related cases have thus far been limited to jobber or middle-man cases in which the seller had a fixed acquisition cost and selling price, so that his profit would be set no matter what happened in the market. Producers generally take all risks of production and have a profit that varies with drilling costs, and so are not in this position. For a case properly rejecting the *Nobs* reasoning and arguing that a breaching party cannot avoid section 2-723's measure of damages by arguing that it overcompensated a plaintiff, see Trans World Metals, Inc. v. Southwire Co., 769 F.2d 902, 907-09 (2d Cir. 1985). In addition, section 2-723 does not contain any indication that it permits courts to ignore the mandatory language of section 2-708(a), a different Code section. All section 2-723 refers to is the measure of damages "if the circumstances of this case make this necessary." This section is written as part of a discussion of what to do if market price is difficult to prove, and should be read simply to let the parties look further for *evidence of market price* if competent evidence is not readily available under section 2-708(a).

Of course, if the contract/market price is inadequate, the seller clearly is entitled to sue for lost profits. *See* Prenalta Corp. v. Colorado Interstate Gas Co., 944 F.2d 677, 691 (10th Cir. 1991).

308. The producer needs to decide whether to base its estimate of future contract quantities on estimates of future *production* or of future *deliverability tests.* The pipelines were happy to use unprecise tests of delivery obligations in their contracts because they wanted as much gas as they could get their hands on during the boom days of the gas market. The fact that deliverability tests overstate production, because production generally declines over time and so is likely to fall in the test period, was known when the contracts were entered and is not a mutual mistake. Had the pipelines wanted to use actual production and well flow instead of short-term tests, they could easily have done so. Some gas purchase agreements do use percentages of actual production.

An engineer who has calculated the reserves that will be produced from the well can also calculate the likely higher test amounts, but the easiest way to measure contract quantities is to apply the contract's take percentage to estimated actual future production rather than estimated future test results. This approach understates the obligation that would be produced using test results, letting the jury see that the producer is favoring the pipeline with conservative numbers and avoiding often confusing testimony about the mechanics of deliverability tests.

the gas they would have found and sold to the pipeline. For these damages to be recovered, of course, the contract must commit gas from newly discovered wells to the pipeline.[309] One way of proving damages from these undrilled wells is to project that the producer would drill roughly the same number of wells each year with the pipeline's money and had to stop when payment ceased. Experts will have to determine the likely reserves from the new wells. Producers who had not been drilling in recent years because pipelines won't buy their gas often can show that they would have drilled more wells if they were being paid for their gas. In many cases it is likely that existing drilling would have increased, often sharply, as the producer responded to the incentive in high priced gas. The difference between a high contract price and the low and falling market price often makes it economic to focus drilling in areas covered by take-or-pay contracts.[310]

Some pipelines argue that they cannot repudiate as long as they are in court seeking a declaration of their right to not pay. They claim a privilege to breach their contracts as long as they are in court. They think they can avoid the effects of repudiation, causing liability to recede to simple breach of contract, simply by filing suit for a declaratory judgment.

The Code does not create any such "litigation in progress" or "good faith legal dispute" defense. Nor does it reduce the seller's remedy from repudiation damages to just past damages as a reward to a buyer who ties up the producer in years of litigation by raising frivolous defenses. The question for the court or jury is whether the pipeline's words or conduct show "a clear determination not to continue with performance" or to do so "except on conditions which go beyond the contract."[311] Not buying gas because prices fell, or at least not buying unless able to resell it at some unspecified profit, is an attempt to impose a condition that is not in the contract. If the common law ever had a "good faith" excuse, it is excluded by this express definition of repudiation in the

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309. In a creative argument, at least one pipeline has argued that the producer had an obligation to "mitigate" its damages by not drilling any more wells. Brief of Appellant, El Paso Natural Gas Co. v. GHR, No. 01-88-0847-CV, slip op. at 76 (Feb. 23, 1989). El Paso argued that the Code's duty of good faith required TransAmerican to reduce its output in order to "mitigate" damages. *Id.* at 77. The answer to this silly theory is that mitigation does "not require [a party] to impair all his cause of action or to sacrifice a substantial right of its own." LTV Aerospace Corp. v. Bateman, 492 S.W.2d 703, 705 (Tex. Civ. App. 1973). The victim of a contract breach does not have to jettison its contract expectancy in order to placate the contract breacher, not even if the breacher is a pipeline.

310. In one case a producer that had drilled approximately 10 wells a year on the property dedicated to the contract but 70 wells on all its properties proved to the jury's satisfaction that it would have drilled 36 wells a year, half of its operations, on the dedicated property for the remaining contract years because falling prices on other properties had made the dedicated property the producer's most attractive. Future reserves were calculated by multiplying the 36 per year new wells by historical success ratios, per well production, and decline rates, after company and outside experts had testified that this statistical method was an appropriate way to calculate reserves. Brief of Appellee, GHR v. El Paso Natural Gas Co., No. 01-88-0847-CV, slip op. at 66-70 (Feb. 23, 1989).

311. U.C.C. § 2-610 (1978).

Code. We do not want to turn our courts into sanctuaries for corporate law breakers.[312]

Repudiation claims have been too little used.[313] Suing for repudiation is one of the easiest ways to put the pressure back on the pipeline, where it ought to be, by making its exposure go far beyond breach of contract damages. Thus, the claim is one way to fight the enormous economic power of pipelines and better protect the rights of producers.

C. *Breach Of The Whole*

A related Code violation is a "breach of the whole." Ironically, the breach of the whole is a "cleaner" cause of action than repudiation, yet it has been even less used. A "breach of the whole" does not turn on whether a party intends to perform in the future. Instead, it focuses purely on the effect of the default. A breach of the whole is a default in one or more installments in a contract if the default causes "substantial impairment" of the contract.[314] Substantial impairment has the same meaning here as it does in repudiation, material inconvenience or injustice.[315] Whether default on a single installment can substantially impair the value of a contract is a question of fact for the jury.[316] In cases in which the pipeline has taken away the primary benefit of the entire contract, the guaranteed payment, it is hard to believe that juries will have much trouble finding substantial impairment. The jury has found breach of the whole in three substantial cases in which the theory has been used.[317]

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312. Pipelines that persuade a court there is a "good faith" defense may find that they wished they had not. All the major pipelines try to shield their decisions to breach their contracts behind in-house legal advice. Asked how they can say they are acting in "good faith," they say they are acting on advice of counsel but argue that they can't say what that advice is because it is privileged. The *only* way a jury can fairly evaluate the good faith claim, deciding whether the pipeline does believe in good faith that what it is doing is proper, is to see the legal advice that led it to stop performing. Then the pipeline's chief officers and their intent can be tested upon cross-examination. If the pipeline's attorneys have drawn the line in discovery on contract interpretation questions or on why the pipeline stopped paying as privileged, the pipeline should not be able to argue the good faith defense. Alternatively, if it intends to argue the defense, the advice on which it relied needs to produced. If the court won't order production, this is one area where it should be proper to focus argument on the claim of privilege because the jury is entitled to know that the pipeline is afraid to produce the advice on which it is relying.

313. On two occasions when they have gotten to the jury, however, they have led to spectacular results: $536 million in one case and over $600 million in another. These are not windfalls. Both producers had large reserves of untaken gas that generated this kind of loss.

314. U.C.C. § 2.612(c) (1978).

315. *Id.* § 2.610 comment 3.

316. USX Corporation v. Union Pac. Resources Co., 753 S.W.2d 845, 850-51 (Tex. Civ. App. 1988). The Restatement, which has adopted the Code's substantial impairment test, lists the following factors as relevant to determining substantial impairment: (1) whether the victim loses a benefit he reasonably expected; (2) the likelihood the defendant will cure his breach; (3) whether the defendant's conduct is consistent with good faith and fair dealing; and (4) the extent to which further delay would prevent the victim from making substitute arrangements. *See* RESTATEMENT (SECOND) OF CONTRACTS § 243 comment e (1981).

317. The jury that awarded TransAmerican Natural Gas $536 million and some change against El Paso Natural Gas Company found a breach of the whole. The jury that awarded Red Hill its more than $600 million judgment against Tennessee Gas Pipeline found the same. *See supra* notes 4-5. So did a jury in an Oklahoma case for the producer Dyco. Telephone interview with Robert Pezold, attorney for Dyco (Jan. 15, 1992).

D. *Long-Term, System-Wide Contract Abrogation Can Be a Racketeering Violation*

In spite of its broad scope, the civil racketeering statute has not been a real factor in take-or-pay litigation.[318] Even the most aggressive producer attorneys seem to view it as too complex or too unpopular with the courts to be worth the bother.[319] This is a mistake.

RICO is not that complex, even though it contains a few unfamiliar terms. The statute fits like a glove around the organized schemes to defraud hatched by the pipelines. Nor is judicial hostility to RICO, while real, a proper reason for dropping a valid claim. A lawyer's duty runs to his client, not to pleasing judges by avoiding statutes they dislike. Judges have repeatedly grafted creative restrictions onto the statute because they disagree with its purposes, but the United States Supreme Court has repeatedly told them not to do it. Law is made when lawyers press valid claims against a reluctant judiciary.[320] And RICO's automatic treble damages are a suitable way of reminding pipelines that they may lose much more than the cost of their purchase obligation. The only real problem with RICO claims is that Congress is likely to amend the statute to drop treble damages from private suits. Existing claims may well be grandfathered in, however, so RICO claims should be brought now.

There are six elements to a RICO cause of action: (1) a proper plaintiff; (2) a proper defendant; (3) an enterprise; (4) a pattern of racketeering; (5) illegal conduct; and (6) proper injury.[321] The statute has a four-year limitations period.[322] The plaintiff, defendant, and injury elements are easy to prove. Any "person" can sue, including corporations and partnerships.[323] RICO injury is any injury to "business or property."[324] Failure to make payments is a direct business injury, so producers will easily satisfy the injury requirement. The hard questions in fitting what the pipelines have done into a violation of the racketeering statute lie in the

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318. RICO claims have only been used in a handful of take-or-pay cases. In Cayman Exploration Corp. v. United Gas Pipe Line, 873 F.2d 1357 (10th Cir. 1989), the court summarily dismissed RICO claims for want of particularity. In Dyco v. ANR, No. 867-C-1097 (N.D. Okla. Nov. 2, 1987), in contrast, the court denied the pipeline's motion for summary judgment and the case was settled quickly thereafter.

319. Medina, McKenzie & Daniel, *Take or Litigate: Enforcing the Plain Meaning of the Take-or-Pay Clause in Natural Gas Contracts*, 40 ARK. L. REV. 185, 207 n.20 (1986) ("RICO is so complex, its pleading and proof requirements so arcane, and its disfavor with the lower federal courts so widespread, that great caution must be exercised, especially if RICO forms the sole basis for federal jurisdiction.").

320. M. EISENBERG, THE NATURE OF THE COMMON LAW 12-13 (1988).

321. For a still accurate synopsis of the basic elements of RICO, see McArthur & White, *Civil RICO After Sedima: The New Weapon Against Business Fraud*, 23 HOUS. L. REV. 743 (1986).

322. Agency Holding Corp. v. Malley-Duff & Assocs., 483 U.S. 143 (1987).

323. 18 U.S.C. § 1964(c) (1970). So, too, any person can be a defendant. 18 U.S.C. § 1961(3) (1970).

324. *Id.* § 1964(c). There is a budding body of law about whether third-parties, like employees terminated by a producer who have to cut back operations, have standing to sue under RICO. Even though the Supreme Court has said that RICO injury is broader than antitrust injury, these claims likely will fail. The statute does not contain a privity requirement, however, and those who would receive a portion of prepayments or contract payments directly from the pipeline, for instance, royalty owners, might well have standing to sue.

definition of enterprise, the pattern of racketeering, and to a lesser degree proving violation of one of four prohibited courses of conduct.[325]

1. The Enterprise

The first challenge is to find an "enterprise" separate from the defendant. Congress wanted RICO to punish only certain kinds of organized fraud, defined as a "pattern of racketeering," when conducted through or using an "enterprise." The enterprise can be a corporation, partnership, or any informal "association-in-fact" including an illegal combination.[326]

All interstate pipelines are corporations and readily satisfy the enterprise requirement. The rub is that all but one circuit has held that the defendant cannot also be the enterprise if the producer is suing under section 1962(c), the most commonly used RICO provision.[327] The enterprise barrier can easily be avoided if the pipelines used other affiliates to defraud the producer. The gas purchasing company, often the biggest company in a family of companies, signs the contracts with producers. Another corporation, often called a marketing corporation, is set up to buy substitute

325. Whether royalty owners have a right to prepayments, rather than production out of the ground (the common language defining the basis for royalty payments in royalty agreements), is an unsettled issue, although the law is beginning to say that they do not. *See supra* note 12. Obviously the first place to look is the royalty agreement, which may well vary whatever general rule is developed. Attorneys drafting contracts for royalty owners should insist that prepayments are included in the royalty agreement as a basis for royalty payments.

The royalty owner may make other arguments. Buying cheap gas today, but at the same time paying the full contract price for gas that will not be taken until much later, is more expensive than just buying the high-priced gas today. This is particularly true as most contracts require the buyer to pay the full amount of any increase in price between the time of the prepayment and the time of the make up. The pipeline cannot pay a high price today but gamble that if prices go up, the gas will be relatively cheap in the future. But the royalty owner can reasonably argue that the pipeline was almost certain, and far more than more likely than not, to have actually bought gas out of the ground and taken that gas, but for its contract abrogation schemes. In that event, the royalty owner is injured without any question of whether prepayments also give rise to royalty obligations.

326. An "enterprise" includes any "individual" or "corporation," 18 U.S.C. § 1961(4) (1970), and so easily includes the major interstate pipelines. The Supreme Court made it clear that an enterprise can also be an informal, illegal association-in-fact in United States v. Turkette, 452 U.S. 576, 580-93 (1980).

Every interstate pipeline easily fits the legal enterprise definition and the existence of the enterprise should be stipulated or subject to summary judgment well before trial.

327. *E.g.*, Bishop v. Corbitt Marine Ways, Inc., 802 F.2d 122, 123 (5th Cir. 1987) (citing numerous authorities). These courts have split over whether the same rule applies under 1962(a), which prohibits using income derived from a pattern of racketeering to operate an enterprise. Most courts do not apply the defendant/enterprise bar to this section. *See* J. RAKOFF & H. GOLDSTEIN, RICO CIVIL AND CRIMINAL LAW AND STRATEGY, 1-28 to -29 (1990). As pipelines invest the proceeds from their pattern of fraud to buy new reserves or spot market gas, all to keep their business running, they may also be subject to suit under section 1962(a), although some courts are now beginning to require a narrow and direct injury from the use of racketeering funds.

Section 1962(c) makes it illegal for a defendant to conduct or participate in the affairs of an enterprise through a pattern of racketeering. The Fourth Circuit held a number of years ago that a 1962(c) defendant could not be the enterprise because this would make the statute read as if a person can act through itself: "We would not take seriously, in the absence, at least, of very explicit statutory language, an assertion that a defendant could conspire with his right arm, which held, aimed and fired the fatal weapon." United States v. Computer Sciences Corp., 689 F.2d 1181, 1190 (4th Cir. 1982), *cert. denied*, 459 U.S. 1105 (1983). Only the Eleventh Circuit has disagreed. *See* United States v. Hartley, 678 F.2d 961, 989 (11th Cir. 1982), *cert. denied*, 459 U.S. 1170 (1983).

gas on the spot market and to offer to buy the producer's gas at a lower price. A third corporation may acquire reserves. These other corporations or any parent corporation can qualify as an enterprise, while the purchasing entity is left as the defendant. Or all entities could be named as defendants, but an illegal association-in-fact of these companies and the officers involved could be alleged as the enterprise. This alternative, however, requires the producer to prove that such an informal association exists independently of the corporate structure, a burden that may not be that easy to satisfy at trial.[328]

2. The Pattern of Racketeering

The second element likely to be controverted is the "pattern of racketeering." A plaintiff can sue under RICO only if injured by defendants who have some involvement with an enterprise using a "pattern" of racketeering. A pattern of racketeering is formed by "at least two or more" predicate acts, at least one of which occurred in the last ten years.[329] The predicate acts include mail fraud, wire fraud, securities fraud, and violations of the Hobbs Act.[330] Mail or wire fraud just requires a scheme to defraud and, respectively, the use of the interstate mails or wires.[331] The mailing need not contain a fraudulent statement. It just needs to be "incident to an essential part" of the unlawful scheme.[332] Proof of the elements of common-law fraud is not required.[333] Form letters refusing to buy gas or falsely claiming inability to buy, when in fact pipelines are desperately acquiring new gas to replace the gas they don't want to buy, can satisfy the requirement of a separate act of mail or wire fraud. Each mailing is a separate act.

The Supreme Court resolved a long-running dispute over what a "pattern" means with sufficient definiteness to establish that a pattern of racketeering will exist in most take-or-pay cases in a 1989 opinion, *H.J., Inc. v. Northwestern Bell Telephone Co.*.[334] Holding that in some instances

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328. *See* J. RAKOFF & H. GOLDSTEIN, *supra* note 327, at 1-23 to -25.

329. 18 U.S.C. § 1961(5) (1970).

330. *Id.* § 1961(A)-(D).

331. *E.g.*, United States v. Cury, 681 F.2d 406, 410-12 (5th Cir. 1982) (citing numerous cases). The scheme to defraud is an extraordinarily wide standard, encompassing "*any* scheme to deprive another of money or property by means of false or fraudulent pretenses, representations, or promises." Carpenter v. United States, 484 U.S. 19, 27 (1987). The statute reaches the "deprivation of something of value by trick, deceit, chicane or overreaching." *Id.* (quoting Hammerschmidt v. United States, 265 U.S. 182, 188 (1924)).

332. Pereira v. United States, 347 U.S. 1, 8 (1954).

333. McNally v. United States, 483 U.S. 350, 356-58 (1987), (citing with approval Durland v. United States, 161 U.S. 306, 312-13 (1896)).

334. 492 U.S. 229 (1989). The lower courts have been hostile to RICO from the moment plaintiffs began using it in civil cases. The courts fabricated numerous conditions that were never written into the statute, and indeed, were expressly rejected by Congress, in an effort to defeat RICO claims. Until 1985 many courts threw out cases in which a plaintiff could not prove a link with organized crime, a prior criminal conviction, or some kind of distinct "racketeering" injury. Not one word about any of these limits appears in RICO. These three popular restrictions were all rejected by the United States Supreme Court in Sedima S.P.R.L. v. Imrex Co., 473 U.S. 479 (1985). The majority in *Sedima* admonished lower courts that even though RICO was being used in "everyday

just two acts would be enough to prove a pattern, the Court noted that two acts were not necessarily enough to prove the relatedness envisioned by a pattern of racketeering.[335] After reviewing the legislative history, the Court held that a RICO plaintiff "must show that the racketeering predicates are related, *and* that they amount to or pose a threat of continued criminal activity."[336] The relatedness requirement is broad. It can be proved by acts that "have the same or similar purposes, results, participants, victims, or methods of commission, or otherwise are interrelated by distinguishing characteristics and are not isolated events."[337] The expansive pattern of fraud propagated by the pipelines satisfies every one of these separate tests. For continuity, the Court held that a plaintiff must prove "continuity of racketeering activity, or its threat . . . ."[338] Virtually all pipeline schemes of contract abrogation have continued for years, so this element should be easy to satisfy.

3. The Conduct Requirement

Perhaps the most novel part of RICO is its effort to define certain kinds of illegal conduct which, if carried out using a pattern of racketeering, gives rise to what the Supreme Court has correctly called a new, federal fraud violation with treble damages. There are four separate prohibited activities, ranging from acquiring or maintaining control, or exercising dominance over an enterprise through a pattern of racketeering[339] to conducting or participating in the affairs of an enterprise through a pattern of racketeering[340] and conspiring to commit one of these three

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fraud cases," not just against mobsters and criminals, and even if the courts found this to be an "extraordinary, if not outrageous" use, this defect was inherent in the broad wording of the statue and "its correction must lie with Congress." *Id.* at 501-02. In other words, not through judicially redrafting the statute.

The Supreme Court had given RICO a broad reading in each of its encounters with the statute by the time it decided *Sedima.* In United States v. Turkette, 452 U.S. 576 (1981), the Court held that a RICO enterprise did not have to be an illegal enterprise. In Russello v. United States, 464 U.S. 16 (1983), the Court gave a broad reading to the "interest" subject to forfeiture under RICO. The lower courts nonetheless set out again after *Sedima* to manufacture another judicial restriction. This time they pointed to footnote 14 of *Sedima,* which suggested that a "pattern of racketeering activity" might require more than two acts of racketeering and should be interpreted restrictively. The lower courts adopted a wide variety of pattern interpretations, ranging up to a requirement of two separate, independent illegal schemes, in efforts to defeat RICO actions.

The various renditions of the "pattern of racketeering" tests are listed in H.J., Inc. v. Northwestern Bell Tel. Co., 492 U.S. at 239 & n.2. The most liberal test was that of the Fifth Circuit, which seems to have held that two related predicate acts were sufficient in R.A.G.S. Couture, Inc. v. Hyatt, 774 F.2d 1350, 1355 (5th Cir. 1985). The Fifth Circuit promptly made its test more restrictive, however, by requiring relatedness and continuity in proving the enterprise element. *E.g.*, Manax v. McNamara, 842 F.2d 808, 811-12 (5th Cir. 1988); Montesano v. Seafirst Commercial Corp., 818 F.2d 423, 426-27 (5th Cir. 1987); Atkinson v. Anadarko Bank & Trust Co., 808 F.2d 438, 441 (5th Cir.), *cert. denied*, 483 U.S. 1032 (1987).

335. *H.J. Inc.*, 492 U.S. at 241-42.

336. *Id.* (emphasis in original).

337. *Id.* at 43 (citing 18 U.S.C. § 3575(e) (1970)).

338. *Id.*

339. 18 U.S.C. § 1962(a), (b) (1970).

340. *Id.* § 1962(c).

prohibited activities.[341] The broadest prohibited activity, and the one that is most applicable to take-or-pay cases, is conducting or participating in an enterprise through a pattern of racketeering. Pipelines which operate their business through a continuous stream of mail and wire fraud are conducting their business through a pattern of racketeering. The same conduct will give rise to a conspiracy claim.

RICO has become even more accessible now that the Supreme Court has held that state courts have concurrent jurisdiction over RICO claims.[342] Nonetheless, judicial hostility remains. Many federal courts use a standard form order which requires RICO plaintiffs to immediately provide an intricately detailed description of their RICO claims, as if it was proper to require a plaintiff to respond to a summary judgment motion before any discovery had occurred. Defendants prey on judicial hostility to the statute by complaining that they have been sued for the in terrorem effect of branding them a racketeer. To minimize adverse reactions, plaintiffs may want to avoid calling defendants "racketeers" or using other colorful language in their Complaint. The goal, after all, is to get treble damages, not to help or hurt the reputation of the defendants.

If history is any guide, judicial hostility to RICO will continue. In each of the past few years, amendments that would restrict or eliminate treble damages have appeared to have enough support to win passage in Congress. RICO has survived, however, and many of the prospective bills would not be retroactive. Thus producers should look closely at the facts of their case and add RICO claims if they are victims of a pipeline that has committed long-term, system-wide contract abrogation. And if the federal statute is amended to delete treble damages for private plaintiffs, producers should look closely at state law to determine if they are in a state that has a more liberal version of the racketeering statute.

E. Price Fixing, Monopolization and Attempted Monopolization, or Tying

The concentration of power in the pipeline industry has long been a concern of federal law. The pipelines' continuing monopoly power is the reason Congress has refused to deregulate the pipeline industry, even while returning producer pricing to the free market.[343] The industry is ripe for antitrust violations.

The primary antitrust violations are price fixing, often accompanied by a refusal to deal, monopolization and attempted monopolization, and tying. Although the Supreme Court has sharply cut back antitrust law in recent years, the antitrust laws and their treble damages remain a potent body of law. The two largest verdicts in 1989 were both in antitrust

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341. *Id.* § 1962(d).

342. Tafflin v. Levitt, 493 U.S. 455 (1990).

343. See, for example, the price fixing cases filed in the Central United States against Conoco and some other producers. *See* Public Serv. Co. of N.M. v. Southern Union Co., No. 81-0479-HB (D.N.M. Jan. 19, 1981).

cases, including one judgment of over $1 billion.[344] The major problems for producers will be overcoming the tangled web of standing and damage barriers that the Supreme Court has erected to bar antitrust plaintiffs.

A traditional violation with surface appeal, but one that seems unlikely to be proven in take-or-pay cases, is price fixing. Price fixing is the paradigmatic antitrust violation. It has been "per se" illegal to fix prices for almost the full century of the Sherman Act and a per se violation supposedly entitles the plaintiff to treble damages without any need to prove anticompetitive effect.[345]

"Horizontal" price fixing, price fixing among companies at the same "level" of the industry, such as competing pipelines, requires an agreement among competitors to stabilize, maintain, or change price levels and injury to the plaintiffs' business.[346] Pipelines share a wide variety of information through various trade associations, and the files of virtually each major pipeline contain evidence of monitoring the pricing and defenses of the other pipelines. Courts generally are reluctant, however, to let a plaintiff take a price fixing case to the jury without direct evidence of agreement. For instance, in *Cayman Exploration Corp. v. United Gas Pipe Line Co.*,[347] the Tenth Circuit affirmed dismissal of a horizontal price fixing case in which all the plaintiff could show was parallelism of prices. In the absence of some evidence of actual agreement, the claim failed.[348]

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344. In the lawsuit of ETSI v. Burlington N., No. B-84-979-CA (E.D. Tex. Nov. 10, 1989), a jury awarded ETSI actual damages of $345 million, trebled to well over a billion dollars, in a lawsuit based on allegations that a group of railroads that dominated the delivery of coal through railroads had combined to block ETSI's development of a coal slurry pipeline.

345. *See, e.g.*, Dr. Miles Medical Co. v. John Park, 220 U.S. 373 (1911). The Supreme Court has cut back on the per se violation by redefining some kinds of price fixing as subject to scrutiny under the rule of reason, and in essence making vertical price fixing subject to a rule of reason. *See, e.g.*, Broadcast Music Co., Inc. v. CBS, 441 U.S. 1 (1979); *cf.* Business Electronics v. Sharp, 485 U.S. 717 (1988) (agreement to terminate distributor "because of" its price cutting not per se violation). The traditional purchasing practices in which one or two pipelines would be the only purchasers of gas for interstate transmission in large sections offered easy opportunity for price fixing. In the late '70s and early '80s, for instance, consumers of gas in New Mexico and the Public Service Company of New Mexico filed a price fixing lawsuit against several affiliated transportation companies, plus the producers Supron, Consolidated, and Conoco. *See* Public Serv. Co. of N.M. v. Southern Union Co., No. 81-0479-HB (D.N.M. Jan. 19, 1981). The lawsuit grew in part out of the unusual pricing terms in gas purchase agreements, which often have "price redetermination" clauses in which the price under a contract is reset each year at the average of the highest prices in the area. The conspirators allegedly agreed to file a sham lawsuit in which the court would declare that certain price changes activated the price redetermination clauses. When the court did not do so, the defendants then allegedly settled to guarantee themselves the high prices. The plaintiffs won a jury verdict, a mistrial was granted when it turned out that one of the jurors had a relative who worked for the power company, and the case then settled.

346. *See, e.g.*, United States v. Socony-Vaccum Oil Co., 310 U.S. 150, 217-28 (1940). The Supreme Court has held that affiliated corporations cannot conspire for purposes of antitrust liability, so a conspiracy of various companies within a corporate chain, for instance the transportation and production affiliates, will not be actionable under the antitrust laws. Cooperweld Corp. v. Independence Tube Corp., 467 U.S. 752 (1985).

347. 873 F.2d 1357 (10th Cir. 1989).

348. As the court noted, conscious parallelism alone is not sufficient to show price fixing unless there is no independent reason for the conduct. *See, e.g.*, Pan-Islamic Trade Corp. v. Exxon Corp., 632 F.2d 539, 559 (5th Cir. 1980), *cert. denied*, 454 U.S. 927 (1981); *see also* Theodore Enters., Inc. v. Paramount Film Distrib. Corp., 346 U.S. 537, 541 (1954). Because conspiracies by their nature tend to be concealed, they are hard to prove.

Most producers will not have direct evidence of a horizontal conspiracy among pipelines. Some have tried to allege a vertical conspiracy between a pipeline and their victims, the producers who knuckled under and did agree to sell their gas for lower prices. These producer "conspirators" allegedly sold their gas at the expense of the producers who stuck to their contract rights.

Vertical price fixing traditionally was a per se violation, but in 1988 the Supreme Court effectively converted the test to a rule of reason test.[349] The first case applying a vertical price fixing theory in a take-or-pay case used the rule of reason standard. Ordinarily these cases involve an allegation that the pipeline and certain producers conspired to let the pipeline pay them *lower* prices, with the necessary result that the pipeline refuses to buy the plaintiff's higher-cost contract gas.[350] In *Cayman Exploration Corp. v. United Gas Pipe Line Co.*, the court summarily dismissed arguments that conspiring to purchase gas at lower prices could be anticompetitive. "Breach of contract is not inherently anticompetitive, and may, in fact, be economically efficient in certain circumstances. In those cases, contract law provides adequate remedies for the disruption of the nonbreaching party's reasonable expectations."[351] These allegations seemed to fail on two grounds. First, there is no rule of reason liability, and, second, any injury suffered by the producer is not antitrust injury.[352] A federal New Jersey trial court reached the same result, holding that actions taken by one pipeline to induce producers to accept a lower price did not create a price fixing conspiracy.[353]

Two claims that at first seem a better fit to the facts of take-or-pay cases are monopolization and attempted monopolization. Monopolization has two elements: (1) possession of monopoly power in a relevant market, and (2) willful "acquisition or maintenance" of that power.[354] The concentration of power in the pipelines' markets and the economics of the industry should often make a showing of adequate power in the relevant

349. In Business Electronics v. Sharp, 485 U.S. 717 (1988), the Court ostensibly left vertical price fixing subject to a per se test, but it held that a jury finding that the plaintiff was terminated because of its price cutting did not establish a per se violation. *Id.* at 723-24. The Court cited a "presumption" in favor of the per se rule. *Id.* at 723. The *Sharp* Court hostility to the per se rule, at least for vertical price fixing, added to the encouragement given to lower courts in Monsanto Co. v. Spray-Rite Service Corp., 465 U.S. 752, 764 (1984), to dismiss cases if the lower court itself decides that the evidence "tends to exclude the possibility" of independent action. I have discussed the effects of this precedent in McArthur, *The Terminated Distributor and Vertical Price-Fixing: What's Left After Sharp?*, 3 ANTITRUST 10 (Fall 1988).

350. In Garshman v. Universal Resources Holding, Inc., 625 F. Supp. 737, 742-43 (D.N.J. 1986), *aff'd*, 824 F.2d 223 (3d Cir. 1987), the court suggested that such allegations would be treated under the rule of reason. The Tenth Circuit accepted this approach in Cayman Exploration Corp. v. United Gas Pipe Line Co., 873 F.2d 1357 (10th Cir. 1989), following what has become the paradoxical lesson from the Supreme Court that it must apply a rule of reason analysis before deciding whether the per se rule applies. *Id.* at 1360-61.

351. *Cayman Exploration*, 873 F.2d at 1361.

352. *Id.*

353. *Garshman*, 625 F. Supp. at 743.

354. United States v. Grinell Corp., 384 U.S. 563, 570-71 (1966).

market possible.[355] In *Garshman v. Universal Resources Holding, Inc.*,[356] for instance, the court accepted, in ruling on a motion to dismiss, a relevant market of the natural gas field in which plaintiff's gas was produced. The product was the production of natural gas. The court found a quite general claim for monopolization adequately pled based on the pipeline's alleged refusal to deal unless producers submitted to renegotiation.

The *Garshman* plaintiffs fell afoul in both standing and injury requirements, but their unusual problem should not bar producer claims.[357] The court decided that the fact that the operator of the well succumbed to demands for lower prices was not enough to make the investors victims of antitrust injury "in any sense of the term."[358] The court did note, in language that actually should help producers, that producers indeed might have claims on other facts: "The probable victims of the allegedly predatory practice are the producers of natural gas who depend on Columbia's pipeline for transportation out of the gas field and on Columbia as a primary purchaser of natural gas, not the investors."[359] Unfortunately, courts hostile to the antitrust laws still may argue that refusing to sell except for lower prices is not an antitrust injury. This was the reasoning of the Tenth Circuit in *Cayman Exploration* on the section 1 price fixing claims.[360] Particularly if the pipeline is substituting a low-priced producer's gas for higher-priced contract gas, and not increasing its market share, courts will be reluctant to find competitive injury.

The situation is different, of course, if the pipeline itself is also a producer, even if through an affiliated company. This happened with El Paso Natural Gas Company and its machinations in New Mexico and Western Texas. One producer sued El Paso and related companies for breaching El Paso's take-or-pay contracts in order to divert purchases to its affiliate, and buying higher-priced gas by so doing. El Paso allegedly committed a variety of unlawful acts of monopolization, including monopoly leveraging using its power over transportation, using its control

355. The relevant market must be defined both by product and geographic area, and is supposedly a market set off by elasticity of demand from other markets so that the sellers in the market have the power to control prices or exclude competition. *See* Brown Shoe Co. v. United States, 370 U.S. 294, 336 (1962); *Grinell Corp.*, 384 U.S. at 571. In terms of wonderful imprecision, the market can also be a submarket if it has distinguishing indicia of demand. *See Brown Shoe*, 370 U.S. at 336. Market power generally is shown by market share, with the exact amounts required being somewhat at variance but likely to exceed 50%. *See, e.g.*, Cliff Food Stores, Inc. v. Kroger, Inc., 417 F.2d 203, 207 n.2 (5th Cir. 1969) (more than 50% market prerequisite for monopolization).

356. 625 F. Supp. 737 (D.N.J. 1980), *aff'd*, 824 F.2d 223 (3d Cir. 1987).

357. *Id.* The plaintiffs failed to have standing because of their unusual facts. The plaintiffs were investors whose well was operated by others and the court held that the operator, not they, was the immediate target of the antitrust conspiracy, so only it could sue (even though the investors had a direct assignment of the take-or-pay contract) because no privity existed between the investors and Columbia. *Id.* at 745.

358. *Id.* at 746.

359. *Id.*

360. *See Cayman Exploration Corp.*, 873 F.2d at 1361.

over the "essential facility" of the pipeline to advance market power in New Mexico gas purchases, and manipulating purchases to reduce the producers' wellhead "allowables."[361] El Paso's request for summary judgment was denied and the case settled just before trial.[362]

As the pipeline industry has evolved into two markets, one a gas commodities market and the other a transportation market, there is an increasing opportunity for pipelines to "leverage" their power by charging extortionate transportation prices as the fee for their willingness to buy gas. A pipeline might offer a favorably high price for gas, for instance, but then charge an extortionate transportation charge. FERC's continuing regulation of transportation rates may prevent such abuses of economic power, but producers should be vigilant and investigate the possibility of such claims.

Orders 380, 436, and 500 have opened pipeline markets to competition, and end-purchasers compete with pipelines to buy gas at the wellhead. The pipelines' share of the gas purchase market has dropped sharply. Monopolization and attempted monopolization should become less common as pipeline power declines. Furthermore, when a defendant can demonstrate that its market is open to new entrants, and pipelines will

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361. *See* Hartman v. Burlington N., No. 87-CA-313, slip op. at 42-49 (W.D. Tex. Mar. 22, 1988).

362. Another monopolization case may be the oddest take-or-pay cases on record, albeit one of little general application. Colorado Interstate Gas ("CIG"), which had breached many of its own take-or-pay contracts, sued another pipeline, Natural Gas Pipeline, for failing to take-or-pay for CIG's gas. Colorado Interstate Gas v. Natural Gas Pipeline, 885 F.2d 683 (10th Cir. 1989), *cert. denied*, 111 S. Ct. 441 (1991). CIG asserted that Natural stopped buying gas in order to pressure CIG to drop its own supply contracts, which Natural then picked up (increasing Natural's share of the market of supplying gas), and claimed this was tortious interference. *Id.* at 690-91. Finally, CIG claimed that Natural's pattern of takes was an attempt to bestow monopoly power on another party, the Trailblazer System, parts of which were owned by both CIG and Natural. *Id.* at 691-92. All three claims were tried to a jury and CIG ended up with a judgment of $724,023,361, an amount the trial court reduced to $412,237,972 because of overlapping claims. *Id.* at 685.

While the Tenth Circuit upheld the tortious interference claim, it rejected the antitrust claim because the plaintiff was a part owner of the beneficiary to the alleged antitrust conduct. *See generally id.* at 691-97. This unusual factor lead the Tenth Circuit to discount the high 53% market share of the Trailblazer system. Because Natural had used its contracts rather than economic coercion to increase market share, the court looked to the contract between Natural and CIG to determine how much power it gave Natural. It found such power very limited. First, even though Natural had used its contract with CIG to tie up all of CIG's capacity, it had only been able to increase the TrailBlazer Systems market share from 41% to 54%. *Id.* at 695. Second, Natural's power would only last as long as the CIG contract, and would then end. *Id.* at 696-97. That contract would expire in 1989, the year the Tenth Circuit issued its opinion. Given these limitations on Natural's power, the court found that there was no dangerous probability of success. *Id.* at 697.

CIG's loss, an appropriate if improperly rendered stroke of justice against a party that has made millions of dollars by breaching its own take-or-pay contracts, does not augur poorly for producers. Most producers do not have their own competing pipeline, and even when their take-or-pay contracts expire they will be at the mercy of the one or two dominant pipelines near their wells. Furthermore, in many areas pipeline market share is far above the level needed to prove monopolization, as well as attempted monopolization. And there can be little doubt that the unlawful schemes of the major interstate pipelines to extract price concessions from the producers are naked attempts by high-priced monopolists, unused to free market competition, to maintain their position against the new entrants who are knocking at the doors. Producers in such circumstances should not fear the difficulties of proving monopolization.

argue that many competing buyers have access to their markets, the courts may pretend that the relevant market is far larger than it really is.[363]

An antitrust violation can be proven based on an even lower market share if there is a dangerous probability that the pipeline will succeed in monopolizing the market. "Attempts" to monopolize just require a relevant market, a dangerous probability of success that ordinarily can be inferred by market shares as low as twenty or thirty percent, a specific intent to monopolize, and conduct furthering that intent that results in antitrust injury.[364] These claims will, however, have the same anticompetitive injury problem discussed above for monopolization claims.

A producer could sue for a tying violation if the pipeline uses its power over the market for one product, such as transportation, to force it to buy a second product, such as gas purchases. Traditionally, transportation and gas purchasing have been integrated services subject to FERC regulation and so probably would not be likely to be construed as separate products. That has all changed with FERC's injection of competition into the industry and its "unbundling" of the pipeline's roles as merchant and transporter, but FERC's continuing regulation of transportation rates reduces the likelihood that pipelines will be able to use their power in transportation to extort better gas prices from producers.

F. Courts Should Extend a Tort Duty of Good Faith to This Conduct

A major question confronting American courts is whether a tort duty of good faith should extend to systematic, intentional breaches of contract. American law has changed greatly in this area in the past two decades. California led the way, and many states have followed its lead, in recognizing a tort duty between an insurance company and its insureds, based on a perceived imbalance of bargaining power.[365] The primary area for this tort in California law has remained the insurance context. California courts have turned back what seemed to be efforts to create a more general tort duty of good faith in all contracts.[366]

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363. For instance, in the tying case of *Jefferson Parrish*, the Supreme Court "found" that a relevant market around Jefferson Parrish Hospital was not really the relevant market, in spite of competent expert evidence showing that this was indeed the market configuration, because patients could go to other hospitals. Jefferson Parish Hosp. Dist. No. 2 v. Hyde, 446 U.S. 2, 29-32 (1984).

364. Colorado Interstate Gas v. Natural Gas Pipeline, 885 F.2d at 693.

365. Of the four major gas producing states, both Oklahoma and Texas have followed California's lead in creating such a tort duty in insurance cases. *See, e.g.*, Arnold v. National County Mut. Fire Ins. Co., 725 S.W.2d 165, 167 (Tex. 1987); Aranda v. Insurance Co. of N. A., 748 S.W.2d 210, 212 (Tex. 1988); McCorkle v. Great Atlantic Ins. Co., 637 P.2d 583, 588 (Okla. 1981); Christian v. American Home Assurance Co., 577 P.2d 899, 904 (Okla. 1977). New Mexico has adopted a tort duty that potentially extends to all contracts that are intentionally breached. Romero v. Mervyn's, 109 N.M. 249, 784 P.2d 992 (1989).

366. Seaman's Direct Volume Serv., Inc. v. Standard Oil Co., 36 Cal. 3d 752, 686 P.2d 1158, 206 Cal. Rptr. 354 (1984). *See* Foley v. Interactive Data Corp., 47 Cal. 3d 654, 765 P.2d 373, 254 Cal. Rptr. 211 (1988) (no tort duty of good faith and fair dealing in employment contract); Moradi-Shala v. Fireman's Fund Ins. Co., 46 Cal. 3d 287, 758 P.2d 58, 250 Cal. Rptr. 116 (1988) (third parties cannot sue insurers for unfair insurance practices).

The reasons for not extending such a duty have been stated by the Ninth Circuit's very conservative Judge Kozinski. Kozinski has written derisively that finding a tort duty in contract cases could occur "[n]owhere but in the Cloud Cuckooland of modern tort theory . . . ."[367] In his view, the harm of such tort expansion is that it "generates serious costs and uncertainties, trivializes the law, and denies individuals and businesses the autonomy of adjusting mutual rights and responsibilities through voluntary contractual agreement."[368] The basis for Kozinski's charge seems to be his feeling that letting juries award punitive damages makes the impact of contract performance or nonperformance totally unpredictable, and, in Kozinski's words, even results in a new form of "entrepreneurship: investment in tort causes of actions."[369] This is the same concern that the Oklahoma Supreme Court raised when it refused to recognize a general tort duty of good faith and said that "parties should be free to contract for any lawful purpose and upon such terms as they believe to be in their mutual interest. To impose tort liability on a bank for every breach of contract would only serve to chill commercial transactions."[370]

These views are a product of the "Amoral School of Law," of "A-Contract-Is-Not-Really-A-Promise" theorists. In the view of its proponents, a contract is simply a business tool like any other, a breach is an option to be weighed like all forms of business activity, the contract can be abandoned if it becomes onerous, and efficiency will be served as long as contract damages are paid for the breach and the breachers' benefit still exceeds the damages paid.[371]

The New Mexico Supreme Court has well put the alternative view when endorsing a general tort duty for "wanton" or "fraudulent" breaches of contract. The court was faced with a trial court's award of punitive damages for a department store's intentional failure to perform a settlement contract. The court found punitive damages appropriate "in situations in which exposure merely to compensatory damages is an inadequate deterrent to prevent such oppressive conduct."[372] The court noted that it would not extend punitive damages to every intentional breach of contract, but dismissed the concern that recognizing a tort duty in *some* settings would cause uncertainty and confusion in business.[373] Instead, "logic suggests punitive damages be available when a party has breached a contract believing the wronged party cannot afford to contest the matter in court."[374] Indeed, not only was "[o]verreaching, malicious, or wanton conduct . . . inconsistent with legitimate business interests,"

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367. Oki Am., Inc. v. Microtech Int'l, Inc., 872 F.2d 312, 314 (9th Cir. 1989).
368. *Id.* at 315.
369. *Id.*
370. Rodgers v. Tucumseh Bank, 756 P.2d 1223, 1226-27 (Okla. 1988).
371. Delhi Gas Pipeline Corp. v. Hassell, 730 S.W.2d 159 (Tex. Civ. App. 1987).
372. Romero v. Mervyn's, 109 N.M. 249, 258 n.6, 784 P.2d 992, 1001 n.6 (1989).
373. *Id.* at 256, 784 P.2d at 999.
374. *Id.* at 258, 784 P.2d at 1001 n.6. The court made it very clear that its logical observation was merely dicta, and that it was not deciding whether to adopt this principle "in the present case." *Id.*

but such conduct *itself* "tends to undermine the stability of expectations essential to contractual relationships."[375]

Take-or-pay cases offer a perfect example of why tort damages are needed as remedies for contract breaches in some circumstances. A party with superior economic power is free to breach a group of contracts fully expecting that a majority of the victims will not have the means to pursue suits for contract damages. The argument that damages should be limited to contract damages rests on the assumption that there are no transactions costs, that courts and juries will always reach the right result, and that full compensation ultimately will be awarded for every contract breach. This myopic view has little relation to reality, as shown by the take-or-pay experience. Pipelines have systematically breached dozens of contracts, whole classes of contracts. They have claimed defenses that are wrong as a matter of law. Most pipelines' files contain direct evidence that the purpose of the breach was to use their economic power to avoid full contract liability. Take-or-pay settlement ratios themselves show how defenseless the system of contract law has been against this campaign of intentional breaches. Some tort duty should exist here because punitive damages are needed to deter the pipelines' contract breaches.[376]

While one can debate exactly how the legal principle should be defined, permitting tort liability in these cases of widespread, systematic breach will not turn every contract case into a tort case. Indeed, it is the supposed strength of the common law system that the law can change in increments. American courts are trained to make small, narrow, technical distinctions between cases. Opening the door to tort liability in these cases would not open the flood gates to permitting tort damages in every contract case.

A tort duty of good faith would apply to many pipeline cases even under existing law. Obviously in New Mexico the producer will have a tort claim. In Oklahoma, the supreme court has left open the possibility that "[g]ross recklessness or wanton negligence on behalf of a party to a contract may call for an application of the theory of tortious breach of contract."[377] And in Texas, the supreme court has said in dictum that "special relationships" other than just the insurance relationship may give rise to tort liability.[378]

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375. *Id.*

376. *See* Note, *infra* note 380, at 814.

377. Rodgers v. Tucumseh Bank, 756 P.2d 1223, 1227 (Okla. 1988). *But see* RJB Gas v. Colorado Interstate Gas Co., 813 P.2d 1, 11-12 (Okla. Ct. App. 1989) (refusing to permit punitive damage award in take-or-pay case).

378. *See* Arnold v. National County Mut. Fire Ins. Co., 725 S.W.2d 165 (Tex. 1987). The Commercial Code's statutory duty for good faith does not itself give rise to tort liability, or else every state adopting the Code would permit tortious breach of contract claims, but it can have other uses. For instance, producers should attack pipelines' often arbitrary reductions in prices under market-out clauses if the prices are discriminatory or unrelated to any rational market factors as violations of the duty of good faith.

The Texas Supreme Court granted a writ of error in a take-or-pay case in which the court of appeals found that punitive damages could not be recovered in a take-or-pay case, but decided the case without reaching the good faith issue in spite of the need for further guidance in Texas on

G. Other Tort Claims Against Pipelines

A producer will have a claim for negligence, with the right to seek punitive damages if the negligence rises to the level of gross negligence, if the pipeline's failure to take gas causes damage to the productive capacity of the well. For instance, in the *Texas Crude v. Delhi Gas Pipeline Corp.*[379] lawsuit, the jury found that Delhi's failure to take was negligent, proximately caused damage to Texas Crude, and awarded $5.6 million in damages.[380]

Producers may be able to sue for conversion if the pipeline is purchasing the gas of other interest owners in the same well or field who gave up their contract rights but punishes the plaintiff who resists such pressure, and if the producer can show that its reservoir will be depleted before its gas is produced. A conversion cause of action may be available if the pipeline takes gas but pays for it at a below contract price. If the amount of gas delivered was measured against the proper, higher contract price, it becomes clear that the pipeline has taken more gas than it paid for. In one case in which the producer sued for conversion, the jury awarded $5.5 million in damages for conversion.[381]

Every producer should consider a cause of action for fraudulent inducement. Many pipelines argue that they did not ever intend to take-or-pay for the producer's gas if they could not resell the gas at a profit, or at least without a severe loss.[382] In truth, the pipelines may not have

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what if any "special relationships" in Texas create a tort duty beyond the insurer/insured relationship. American Nat'l Petroleum Co. v. TransContinental Gas Pipeline Corp., 798 S.W.2d 274 (Tex. 1990).

In *American National*, the take-or-pay contract provided that the seller's sole contract remedy for any dissatisfaction with a market-out price was to ask to have the contract terminated. *Id.* at 276. The Texas Court of Appeals deleted all price damages based on the market-out because the seller's sole remedy for "dissatisfaction" with market-out prices was to seek termination. *Id.* at 280. This holding obliterates the duty of good faith and the protection it should provide to protect the seller from any bad faith market out. The supreme court did not address the duty of good faith issue. *Id.*

For the last ambiguous hints from the court, see Arnold v. National City Mutual Fire Ins. Co., 725 S.W.2d 165 (Tex. 1987); Aranda v. Insurance Co. of N. Am., 748 S.W.2d 210 (Tex. 1988). The availability of this tort still has not been answered conclusively in the country's largest gas producing state.

379. No. 85-7-540 (Tex. Civ. App. Aug. 14, 1986).

380. *See* Note, *Remedial Theories Supporting Tort and Antitrust Recovery in Take-or-Pay Litigation*, 39 BAYLOR L. REV. 809, 811-13 (1987).

381. Kimball v. Tenneco, Charge of The Court Question No. 4B, No. 27,880-S (Tex. Dist. Ct. Dec. 1, 1988); *see* Legg, *infra* note 395, at 71-72.

Kimball struck home with this claim in the case against Tenneco, in which the jury was instructed that a false promise could include a promise "to do an act in the future, with the present intention not to perform as promised . . . ." The jury found that Tenneco made at least four separate fraudulent inducements: falsely promising that added wells would be included under the contract, falsely stating that this was Tenneco's contract construction, falsely promising that Tenneco would provide compression as required by the contract, and falsely promising that Tenneco would buy at least eighty-five percent of the gas through the life of the contract, a promise that "fraudulently led Red Hill to believe that Tenneco would assume the recent changes in the gas market." The jury awarded approximately $250 million in actual damages, including projected future damages for this fraudulent inducement and $350 million in punitive damages. *Kimball*, Charge of the Court Questions 5B, 12A, No. 27, 880-3 (Tex. Dist. Ct. Dec. 1, 1988).

382. *See, e.g.*, Golsen v. ONG Western Inc., 756 P.2d 1209 (Okl. 1988).

expected to lose money, but it strains credulity for them to argue that they did not understand they *might* suffer losses if their market fell. Fraud can be proven, of course, not simply by a misrepresented objective fact, but also by a false statement of intent to perform at a time when the party does not intend to perform.[383]

The tort of duress has been defined as broadly as a use of power for illegitimate ends, which "may be evidenced by forcing the victim to choose between distasteful and costly situations, i.e., bow to duress or face bankruptcy, loss of credit rating, or loss of profits from a venture."[384] The pipeline will invariably argue that any party who has not succumbed to the pressure and given up its contract rights has no claim for duress. This is correct under the traditional rule that duress is not actionable just because a party is punished by another party with power,[385] but

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383. *E.g.*, RESTATEMENT (SECOND) OF TORT § 530 (1976).

In contrast to the successful claim against Tenneco discussed in *supra* note 381, in a case against El Paso Natural Gas Company, the trial court struck a claim of fraudulent inducement even though an El Paso Vice-President, the contract signatory, filed a summary judgment affidavit stating that El Paso's contract intended a "different allocation of risk" than standard take-or-pay contracts, that the "intent" of the take-or-pay clause "is to protect El Paso from having to pay large amounts of money for gas it was unable to take as a result of events outside of El Paso's control, that the take-or-pay contract was designed to "insulate" El Paso from such changes as increased gas availability, increased conservation, and increased hydroelectric power, and that El Paso's "purpose" was to buy gas that it would resell for a reasonable rate of return. Answer of El Paso Natural Gas Co. to Defendant's motion for Summary Judgment, Holland Affidavit, El Paso Natural Gas Co. v. GHR Energy Corp., No. 85-09329, ¶¶ 3, 5, 7, 12. Even though a jury surely was entitled to decide whether this affidavit alone indicated that El Paso did not intend to perform, to either take-or-pay, if prices fell, the court struck the claims. This in spite of the fact of the clear law in Texas that a promise of future performance with a present intent not to perform is actionable fraud. *See* Dodson v. Sizenbach, 663 S.W.2d 13, 15 (Tex. Civ. App. 1983) (following Stanfield v. O'Boyle, 462 S.W.2d 270 (Tex. 1971)); *accord* State Nat'l Bank v. Farah Mfg. Co., 678 S.W.2d 661, 681-82 (Tex. Civ. App. 1984).

Fraudulent inducement can be a good trap for an unwary pipeline in take-or-pay litigation. If pipeline executives testify that they understood and intended to have to take-or-pay for gas even if prices fell so that they would take a loss, they will face a much more skeptical jury when they valiantly try to explain how it is that there was some point at which prices had fallen so far that they should now be relieved of their obligation. If, on the other hand, they lie and state, as El Paso's Mr. Holland in essence stated, that they had *no* intent to perform if they could not resell the gas at a profit, they have admitted that their promises of future performance, embedded in the contract language itself, were false at the moment the contract was entered.

El Paso's primary defense was to argue that the fraudulent inducement claim "is nothing more than a breach of contract claim." El Paso cited a bunch of cases arguing that ordinarily no independent tort duty arises out of a contract claim. This position totally disregarded the fact, as shown in cases like *Dodson*, that a promise to perform a contract, made with no present intention of performing, does give rise to a tort claim for fraud. A party induced by fraud to enter a contract can affirm the contract and sue for damages of fraud. Dallas Farm Mach. Co. v. Reaves, 307 S.W.2d 233, 238-39 (Tex. 1957).

384. State Nat'l Bank of El Paso v. Farah Mfg. Co., 678 S.W.2d 661, 685-86 (Tex. App. 1984) (citing *inter alia* RESTATEMENT (SECOND) OF CONTRACTS § 176 (1981)).

385. Duress does provide a cause of action for a party who was coerced into giving concessions to overturn the contract produced by oppression and recover damages including punitive damages. Many pipelines persuade producers to drop contract prices, reduce take requirements, or insert market out clauses, and then breach the new, more favorable contracts anyway. In such cases duress can be an attractive claim, although the hotly contested issue will be whether the producers represented by counsel really were forced to enter these contracts against their will. The jury's answer is likely to turn on the financial condition of the producer at the time the concessions were given. Producers victimized by pipelines who will not perform even a reformed contract may also sue for fraudulent inducement, arguing with great plausibility that the pipeline never intended to honor the new contract.

instead requires success in "induc[ing] a compliance with his demand, against the will of such party through fear of injury to his business or property interests."[386] Limiting the availability of this tort to those who actually give up some contract right makes little sense. The parties who succumb to pressure at least were able to sell some gas, while the producer who refuses to renegotiate and stands on its contract is unable to sell any gas if the pipeline won't perform, gets no revenues, and is much more badly injured. The requirement that the plaintiff must have given up some right stems from the days when duress was merely a defense to avoid an onerous contract. Now that duress is generally recognized as an affirmative tort, those who are most injured by the tortious conduct, producers who stand fast against economic pressure and receive no income at all, certainly should have standing to sue.

These contract cases can sometimes be converted into tort cases by alleging a civil conspiracy to induce the breach of contract. Civil conspiracy provides a tort recovery whenever two or more people combine in agreement to perform an unlawful act.[387]

A producer can sue for tortious interference if it can show that some other entity induced the pipeline to breach its contract with the producer.[388] A party cannot tortiously interfere with its own contract, so the producer cannot sue the pipeline for tortious interference just because of the pipeline's own nonperformance.[389] One producer won a significant victory on a tortious interference claim by suing Transco for tortiously interfering with the producer's gas balancing agreement with a separate operator. The producer's gas imbalance agreement with the operator provided that

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386. *E.g.*, State Nat'l Bank v. Farah Mfg. Co., 678 S.W.2d 661, 684 (Tex. Civ. App. 1984); Housing Auth. of Dallas v. Hubbell, 325 S.W.2d 880, 902 (Tex. Civ. App. 1959); Dale v. Simon, 267 S.W. 467, 470 (Tex. Comm. App. 1924). Duress requires "subjecting a person to a pressure which overcomes his will and coerces him to comply with demands to which he would not yield if acting as a free agent." First Texas Savings Ass'n v. Dicker Center, Inc., 631 S.W.2d 179, 184 (Tex. Civ. App. 1982) (citations omitted).

387. *See, e.g.*, Schoellkopf v. Pledger, 778 S.W.2d 897, 900 (Tex. Civ. App. 1989); Durant Software v. Herman, 255 Cal. Rptr. 250 (Cal. App. 1989); Jet Courier Serv., Inc. v. Mulei, 771 P.2d 486 (Colo. 1989). Some jurisdictions do not require an independent wrongful act to prove this tort. *E.g.*, Lamotte v. Punchline of Columbia, Inc., 278 S.E.2d 711 (S.C. 1988); Martin v. Marlin, 529 So. 2d 1174 (Fla. 3d Dist. App. 1988).

One limitation upon this tort is that intracorporate conspiracies may not give rise to civil conspiracies, the pipelines' affiliates themselves cannot actually conspire among themselves. Garrido v. Burger King Corp., 558 So. 2d 79 (Fla. 3d Dist. App. 1990). The likeliest source for these claims exist when the producer can show conspiracy among several pipelines in an area, a conspiracy that could also give rise to antitrust liability, or a concerted action between a pipeline and large customers to breach these contracts and lower prices. If the stakes are high enough, a small amount of discovery into documents between the pipeline and its biggest customers may quickly determine whether there is a basis for this tort.

388. *E.g.*, *Schoellkopf*, 778 S.W.2d 897, 903; Barker v. Brown, 772 S.W.2d 507, 510 (Tex. Civ. App. 1989).

389. Claims that some pipeline affiliates, say its producing or marketing affiliate, tortiously interfered with the pipeline/producer contract may be difficult to raise. In Texas, for instance, such claims of affiliate tortious interference may well be barred. *See* Deauville Corp. v. Federated Dep't Stores, Inc., 756 F.2d 1183, 1196 (5th Cir. 1985) (applying Texas law); *Schoellkopf*, 778 S.W.2d at 903; Baker v. Welch, 735 S.W.2d 548, 549-50 (Tex. Civ. App. 1987). Other jurisdictions would permit such claims if the parent acts on an improper motive.

the operator would reallocate gas sales to maintain an appropriate balance among working interest owners.[390] Transco, which was not the operator, refused to buy gas from working interest owners who would not sign an amendment that waived Transco's take-or-pay liability and lowered prices and take-or-pay quantities.[391] The evidence suggested that Transco would refuse to buy anyone's gas from the wells unless all working interest owners acquiesced in the new Transco amendment.[392] A Transco officer admitted that the purpose of its conduct was "to put financial pressure on the non-signers" of the amendment.[393] The jury found tortious interference and the Texas Supreme Court confirmed, holding "[t]rying to coerce a party into a favorable settlement by threats under existing or potential future contracts with third parties is *not* privileged".[394]

One quick way to take the profit out of the strategy of delay is to get an order compelling specific performance of the take-or-pay contract. Unfortunately, the requirement of irreparable injury precludes injunctive relief in the great majority of the cases because the producer usually can be made whole by money damages.[395] Injunctive relief could be available if the pipeline's failure to perform causes drainage, otherwise damages the productive ability of the well, or if the producer can show that its financial existence is jeopardized by the failure to perform.[396]

VI. NEITHER JUDICIAL NOR LEGISLATIVE TAKE-OR-PAY RELIEF IS NECESSARY

Just because a contract is enforceable does not mean that it is good public policy to let the contract continue. If the sanctity of contract were the only governing principle, a contract for assassinating the President would be enforceable in order to protect principles of contract law. Thus the previous discussion of why take-or-pay contracts should be enforceable

390. American Nat'l Petroleum Co. v. TransContinental Gas Pipeline Corp., 798 S.W.2d 274, 275 & n.1 (Tex. 1990).

391. *Id.* at 276.

392. *Id.*

393. *Id.*

394. *Id.* at 279 (emphasis in original).

395. *See generally* Legg, *Natural Gas Contract Litigation in Oklahoma*, 11 OKLA. CITY U.L. Rev. 63, 67-68 (1988). An injunction or specific performance will not be awarded if damages alone are an "adequate" remedy, but a creative lawyer may be ale to show the necessary irreparable injury by jeopardy to the producer's business or damage to the reservoir or well producing change. *See generally* Note, *Gas Purchase Contracts: Equitable Remedies for Breach*, 24 HOUS. L. REV. 991, 1002-04 (1987). While the author found the courts liberalizing their approach to equitable relief, *id.* at 1003, it remains the case that producers will not get injunctive relief without a careful presentation of some injury like loss of business or drainage that cannot readily be replaced in dollars. *Id.*

396. There may be contractual defenses to tort claims. Many take-or-pay contracts give the buyer sole discretion to decide how to vary the level of takes on any given day, and the take-"or"-pay promise envisions that the pipeline may not want to take any gas at all. All take-or-pay contracts are subject to an obligation of good faith, but *if* a producer can show that the failure to take was intended to coerce the producer into renegotiating, and if the producer can show damage to the reservoir or productive capability of the well, the pipeline should not be able to hide behind its discretion to determine takes when faced with a negligence claim.

as a matter of existing law does not itself prove that this result is good social policy. In fact, however, both fairness and economic efficiency dictate that these contracts should be enforced.

A. *Fairness Dictates That the Courts Enforce Take-or-Pay Contracts*

The primary theme among pipelines is that take-or-pay contracts are unfair in today's economy. Many courts reviewing FERC's orders have adopted this theme without reason, analysis, and in defiance of the factual record developed by FERC. An example of this judicial hostility came in *Associated Gas Distributors v. FERC*,[397] the District of Columbia Court of Appeals decision remanding Order 436. Although the court had no authority to make an administrative fact finding, it did everything but tell FERC that it had to abrogate take-or-pay contracts. The court likened the effect of open access transportation to the choice given a condemned man "between the noose and the firing squad," attacked FERC's "seeming blindness to the possible impact of Order No. 436 on take-or-pay liability, and its tendency to elevate into affirmative benefits what are its best palliatives," found FERC's "factual assessments," which included a finding that pipelines did not need take-or-pay relief, "utterly Panglossian," and ordered FERC on remand to "more convincingly address the magnitude of the problem and the adverse consequences likely to result."[398] Dissenting Judge Mikva put it more bluntly, arguing that FERC's "decision to close its eyes and hope the problem will go away is no solution and should not be tolerated on remand."[399] Two years later in *American Gas Association v. FERC*, the court ordered FERC to take action and stop its data collection.[400]

An equally extreme attack on FERC came in *Mobil Oil v. FERC*,[401] the Fifth Circuit's reversal of Order 451. Ignoring the pipelines' monopoly power, the court indulged with apparent spontaneity in independent fact-finding and announced *sua sponte* that the shortages of the seventies "allowed producers to virtually dictate the terms and conditions of contracts for sale of natural gas to pipelines."[402] In the court's jaundiced view, producer efforts to make pipelines honor the terms of their take-or-pay contracts were little short of a crime. The court complained that "producers nevertheless continued seeking higher than market prices for gas covered by earlier executed take-or-pay contracts."[403] Without citing any evidence, and citation presumably would be impossible because the pipelines invariably refuse to produce full financial information about their take-or-pay exposure, the court somehow divined that "conditions now are such that numerous pipelines simply are unable, in many cir-

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397. 824 F.2d 981 (D.C. Cir.), *cert. denied*, 485 U.S. 1007 (1987).
398. *Id.* at 1024, 1025, 1030.
399. *Id.* at 1045 (Mikva, J., concurring in part and dissenting in part).
400. *See* American Gas Ass'n v. FERC, 888 F.2d 136 (D.C. Cir. 1989).
401. 885 F.2d 209 (5th Cir. 1989).
402. *Id.* at 223.
403. *Id.* at 215.

cumstances, to take the quantity of gas required by existing take-or-pay contracts."[404] Indeed, the court found "[t]he end result" of the take-or-pay situation to be "that both interstate and intrastate pipelines are currently burdened with take-or-pay contracts which potentially threaten their very existence as public utilities."[405] The court unburdened itself of these pronouncements even though Congress chose FERC rather than the court to engage in such factfinding, even though FERC's findings that would soon be issued under Order 500-H were totally contrary, and even though the pipelines had not submitted financial data from which anyone could determine whether any contracts threatened their existence and, in fact, were telling FERC the opposite. When the *Mobil Oil* opinion reached the Supreme Court, the case was quickly reversed on the grounds that the fifth circuit had improperly intervened in an area of FERC's expertise.[406]

All of these attacks rest on the factual assumption that producers dominate the gas sale market and have been able to oppress, respectively, pipelines and consumers. The body Congress delegated the authority to decide what is really happening in the gas market, of course, is FERC, not the courts. And when FERC looked at this issue, the evidence simply did not support such charges. As explained in detail in Orders 500-H and 500-I, FERC found to the contrary that *pipelines* continue to exercise monopoly power in gas purchasing and have successfully used that power to coerce settlements from producers. The great majority of take-or-pay liabilities have now been settled for less than twenty cents on the dollar. This is a sign of pipeline power, not exploitation by producers.[407]

The criticism of producers also overlooks the fact that producers went out and drilled for gas in reliance on the NGPA's price structure and pipeline promises. The NGPA was designed to raise interstate prices and

404. *Id.* at 223.

405. *Id.*

406. Mobil Oil Exploration & Producing Southeast Inc. v United Distribution Cos., 111 S. Ct. 615, 627-28 (1991). Perhaps the most vehement attack on take-or-pay contracts was made by Senator Metzenbaum in his comments on the Natural Gas Wellhead Decontrol Act of 1989. S. REP. No. 39, 101st Cong., 1st Sess. (1989). Metzenbaum views consumers as captives of both pipelines and producers. He thinks that many take-or-pay contracts have terms mysterious to a layman, "but they all serve one master: they lock in high prices and prevent the marketplace from forcing down expensively-priced supplies." *Id.* at 37. Metzenbaum expressed concern about the increase in concentration among gas *producers*, with the 20 top producers controlling fifty-three percent of the United States' gas reserves, and attacked FERC's pass-through of take-or-pay liabilities that, Metzenbaum argues, "were the result of producer price gouging and imprudent purchases by pipelines in the late seventies and early eighties." *Id.* at 38.

407. Indeed, even FERC has understated the extent to which producers have paid for the declining market. FERC argued that its findings showed that the burden of the falling gas market was being shared "equitably" between pipelines and producers. Order 500-I, 55 Fed. Reg. at 6611. In fact, producers who have given up *eighty percent* of their contract rights have borne by far the greater share of the market decline. The real burden will vary with each case. If a producer had a contractual right to five dollars per mcf for its gas, and gets only one dollar of its discounted revenues, and if the market price is $1.50, the producer has given up $2.50 per mcf while the pipeline only paid one dollar, instead of five dollars, for the injury. The actual burden will vary with the pricing under the contract, the available market price, and how long the contract runs, but this example is far closer to the real injury than FERC's fiction of an equitable distribution.

end the gas shortage. It succeeded. The way it succeeded was by giving producers the incentive to spend their own money, often borrowed money, to expand their drilling for natural gas. The highest prices, the incentive prices in section 107, were designed to compensate the costs of producing gas from certain inaccessible formations. While there can be wide variations in the kind of profits available for different categories of gas (for instance, some NGPA section 102 wells may have been quite expensive and cost as much to produce as they return, while others might have been earned high profits), there is no indication that producers as a group earned windfall profits from the NGPA's pricing structure.

Nor is there any evidence to support arguments of producer price gouging. Neither pipelines nor the courts have provided any reason to discount FERC's finding that the pipeline industry remains a monopolistic industry. Pipelines offered high prices, and consumer groups egged them on, because they wanted producers to explore for more gas, not because producers held a gun to their neck or had the power to extort these contracts. The pipelines and the consuming groups they represented got exactly what they wanted, more gas at the prices they promised to pay. That is not price gouging, and that is not a reason to abandon these fairly negotiated contracts.

The ease with which appellate courts have made their factual pronouncements is striking and discouraging. These courts are not evidentiary bodies and they have not held hearings on the conditions in the natural gas industry.[408] These courts are not authorized, empowered, or equipped to make such administrative determinations.

The profound judicial hostility to FERC's changing regulations should not hide what FERC has accomplished. In a series of orders, it has created a competitive structure in a formerly monopolistic industry. FERC has taken the quite general mandate of the NGPA that the gas markets shall be deregulated and translated it into one of the major restructurings in American industrial history. It has created a competitive wellhead market, in which consumers and other users can compete directly with pipelines to buy gas, and a competitive transportation market, in which interstate pipelines must truly operate as public utilities and offer non-discriminatory service to all takers. And it has done all this while providing the pipelines with specific, detailed relief from their take-or-pay problems in order to let them ride out the storm in today's market and emerge as strong competitors in the new world of natural gas.

These accomplishments, as well as FERC's factual determination that more take-or-pay relief is not required, are improperly criticized. The imposition of a largely competitive market onto an industry controlled by monopolists is a striking achievement, and it should not be overturned without a strong showing of necessity. Neither the pipelines nor the

408. Thus, for instance, how could the *Associated Gas Distributors* court know whether or not pipelines' existence as public utilities is threatened, without a hearing on the effect of specific take-or-pay contracts on each pipeline and effective cross-examination by producer groups?

appellate courts have shown *any* reason to reverse these beneficial changes. They have shown no reason why producers, who signed contracts that contained take-or-pay promises with every expectation that the pipelines would live up to their word, should have to give up the rights in their freely negotiated contracts. Contract law is part of a system of justice, not just a system of economics.[409] A contract is not a hope or prediction. Pipelines made these promises knowing full well that producers would base their business around these promises. Pipelines and other critics have shown no reason why these promises should not continue to be enforced.

B. *Take-or-Pay Contracts Do Not Offend Notions of Efficiency*

A second common attack on producers is the argument that it is somehow inefficient to enforce long-term contracts in the face of dramatic market changes. Even if the changes were "foreseeable," in the sense that the contract expressly allocates the risk of market decline to the buyers, pipelines point to the huge disparity between today's market price and the contract price in many of these contracts and argue that economic efficiency will suffer if they are burdened with these gas costs.[410]

The desire to let courts second-guess the sometimes harsh effects of long-term contracts itself puts those contracts in jeopardy. As the cost and sophistication of technology increases, so does the need to protect long-term bargains involving substantial financial stakes. Few producers would commit to a program of drilling deep exploratory wells, for instance, if they could not rely on a buyer's promise to pay for large volumes of gas at very high prices if gas is discovered. The increasingly intensive nature of drilling, with both the depth of the wells and the sophistication of techniques like horizontal drilling and well stimulation, makes the reliability of long-term contracts more important, not less

409. As Charles Fried argues, much more is at stake in a contract than just the efficient distribution of resources. A contract is an affirmation of freedom. "In order that I be as free as possible, that my will have the greatest possible range consistent with the similar will of others, it is necessary that there be a way in which I may commit myself." C. FRIED, CONTRACT AS PROMISE 13 (1981). Respecting another's promise is a way of honoring their fullness as people. *Id.* at 20-21. The moral basis for contracts goes way beyond the utilitarian advantages of enforcing them. *See id.* at 17.

410. One phrasing of this view on long-term contracts lies in the dictum in Aluminum Co. of America (ALCOA) v. Essex Group, Inc, 499 F. Supp. 53 (W.D. Pa. 1980). The judge in *ALCOA* reformed the contract, albeit for changes that he found were not foreseen by either side, on the authority of his belief that a "new spirit" of commercial law gave the courts the power to modify contracts "when a prudently drafted long-term contract goes badly awry." *Id.* at 89. The court seemed particularly loath to enforce the now-onerous contract when the corporate officers who endorsed it were fiduciaries and so "should not gamble with corporate funds." *Id.* at 90. Others have argued that a modern "relational" theory of contract, which considers even the third-party effects of a contract, requires the court to consider the parties' ongoing relationship as well as the specific contract terms. Note, *Deregulation and Natural Gas Purchase Contracts: Examination Through Neoclassical and Relational Contract Theories*, 25 WASHBURN L.J. 43, 64-65 (1985). This "relational" theory is so hopelessly vague and open-ended that it would let any judge reach any conclusion he or she desired, thus defeating the goal of predictable future performance that is at the core of contract. Consider the way the authors described the relational view of contract: "[t]he relational transaction, by contrast, intensifies role integrity, preservation of the relation, harmonization of relational conflict, harmonization with the social matrix, and supra contract norms." *Id.* at 64 (footnote omitted).

important, to the gas industry. Richard Pierce has put the point eloquently:

> Long-term contracts allow parties to bargain for the socially optimal mix of price and supply security. Any attempt to prohibit the use of provisions like take-or-pay clauses or indefinite price escalation clauses would discourage producers from entering into long-term contracts. And any attempt to compel producers to enter into long-term contracts lacking mechanisms for allocating volume and price risks would inevitably reduce the incentive to find and produce gas.[411]

The fact that some producers are making larger profits than some pipelines may have expected does not prove that enforcing these contracts is inefficient. High profit is the signal to encourage others to enter the industry, increase the supply of drillers, and ultimately produce lower gas costs.[412]

The other "efficiency" argument is that parties should be free to breach their contracts if the added profit they can make from the breach exceeds the damages they have to pay. In this "efficient" theory of breach, a contract is a utilitarian tool that can be abandoned if abandonment leads to increased profits. The contract has no ethical component at all, nor do its obligations. This position harkens back to Justice Holmes' comment that a contract is only "a prediction that you must pay damages if you do not keep it—and nothing else."[413] In this view, both parties are better off and efficiency is served if the contract victim gets it damages and the breaching party winds up better off after paying the damages.

The efficient theory of breach may look pretty to an economist, but it does not fit the real world. A first reason is of course the monopoly power of pipelines. If the judicial system worked perfectly, an efficient breacher who did not voluntarily disgorge the full measure of contract damages would be ordered to do so. Yet in the natural gas industry, pipelines who breach their contracts are paying less than twenty cents on the dollar. The fact that monopoly power distorts the core of economic relationships is presumably what led Congress to authorize treble damages for antitrust violations. Some added sanction was needed to counterbalance the power of the violators. For the same reason, punitive damages should be awarded to sanction these deliberate contract breachers.

The efficient theory of breach ignores many other risks. One is the risk and imperfection of courts and juries. If a pipeline breaches 100 contracts, and ends up being stuck with liability and damages on 90 contracts but gets off on the other 10 contracts, it has an incentive to breach all 100 contracts. There is always a chance that a jury will find

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411. Pierce, *supra* note 18, at 356-57.

412. To the extent that the high prices are based on a regulated price floor that is absent, the high profits will not induce new entrants because the condition for the profits is gone. Even then, however, those high prices were put in contracts because of market conditions, not regulatory conditions, and their existence suggests that high profits may be available again in the next upturn in the industry.

413. Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 462 (1897) (of course, Holmes also thought that the common law was merely the ability to predict how judges would decide cases).

for the pipeline, even if for extraneous reasons. Other imperfections include attorneys' fees, which in some states are not recoverable on contract actions; the possibility for sharp disputes over the measure of damages; and the failure of pre-judgment interest to compensate a producer for the lost time value of money.

Efficient breaches rarely exist in the real world. They certainly do not exist when one party to a contract has monopoly power, or when one party is able to adopt breach of contract as a weapon with the assurance that it will wind up better off than it would through contract performance. Whatever may be the case when parties simply have varying interpretations of contract obligations, breaches are not efficient when a party denies an obligation it clearly has, or refuses to perform because of the very market conditions from which it promised to protect the other party. In these circumstances, when the only purpose of the breach is to do better than the contract, ordinary contract damages are not enough. The efficient theory of breach does not require limits to contract damages in such circumstances. As Professor Posner has pointed out, more may be required for an "opportunistic" breach, when a breach is designed to better the position that the party would be in had it performed the contract.[414]

C. *FERC Should Not Be Reluctant to Pass Through a Substantial Part of These Costs to Consumers*

The fact that pipelines have followed bad legal advice or made bad decisions about their take-or-pay contracts does not mean that pipelines should not recover the costs they have incurred. Most pipelines entered these contracts because they were under severe pressure from regulators and their consuming public to assure an adequate supply of gas. The contracts did just that.

Memories are too short. Just as a pipeline somehow cannot recall that it knowingly agreed to make minimum take-or-pay payments even if prices fell, so too regulators and consumers somehow cannot recall that they encouraged the pipelines to enter these contracts to secure large gas supplies. Pipelines did so even though their rate of return is governed by regulation, so that they have only a limited opportunity to profit from any "upside."

There is no reason that the great majority of these costs should not be passed on. Pipelines have already forced down the cost of gas supplies by coercing producer settlements, and under Order 500 many are absorbing fifty percent of the gas settlement and buyout costs. This means that

414. R. Posner, Economic Analysis of Law 105 (1986). The efficient breach theory may be out of touch with reality in more ways than one. In an exhaustive review of 1400 irreparabhle injury cases, Doug Layçock found that specific remedies are not an exception and that it is unusual for plaintiffs to be limited to money damages. D. Laycock, The Death of the Irreparable Injury Rule 237-38, 245 (1991). The rare case when the rule could apply, when money damages do provide adequate compenstation because replacement goods or services are available, is "trivial", *id.* at 251, and in fact these are cases where there is likely to be little or no incentive to breach.

consuming groups will absorb a small part of the market decline, at the most.

Fortunately, the standards for passing on costs should permit recovery of most gas costs, unless FERC succumbs to political pressure from consuming groups. Congress had decreed that FERC can deny pass-through only in instances of "fraud and abuse." Miscalculation of future prices or even negligence in entering contracts presumably does not meet this test.[415]

Although most of this Article attacks pipelines for failing to perform their take-or-pay contracts, the pipelines' bad acts toward producers do not mean that pipelines should have to absorb the full burden of falling prices. Pipelines entered their contracts in good faith after severe regulatory and customer criticism for the gas shortages of the early Seventies.[416] It is unfair to test the prudence of those purchases today, when the unexpected has happened and the market has declined. A good deal of the burden of these prices should be borne by the people for whose benefit the drilling occurred and the take-or-pay contracts were signed. Producers already have borne the brunt of the falling market by writing off most of the contract obligation. Pipelines are now absorbing up to half of what is left under the Order 500 process FERC has created for passing through costs to customers. There is no reason for the courts of appeals or anyone else to make either producers or pipelines pay more of the bill.

The pipeline industry will remain a vital industry in the future, as will the gas producing industry. Natural gas is a relatively clean fuel that should see increasing use in transportation, heating, and industrial uses. Wide-scale experimental applications of natural gas for business trans-

415. The only problem with the fraud and abuse test is that FERC has decided that it will test the pipelines' purchasing practices now, rather than by looking at their appropriateness when the contracts were entered. Contracts that look ridiculous today may have made perfect sense when entered in 1980 or 1981. There is no reason to so penalize the pipelines for the dramatic changes in the market, any more than there is reason to penalize producers. Fortunately, the stringency of the fraud and abuse requirement will at least help make it difficult for consuming groups to prevent the pass through of legitimate costs. *See supra* note 237.

416. Whether trying to negotiate a settlement or planning trial strategy, a good lawyer is well advised to know as much as possible about his opponent's motives and thinking. One thoughtful and insightful commentator has explained the way that pipeline executives tend to view their mission as regulatory, with contracts "mere adjuncts to regulation," while to producers the contract is of course an end in itself, just as contract law treats it. Watson, *Conflicts Between Natural Gas Producers and Pipeline Purchasers*, 33 ROCKY MTN. MIN. LAW INST. § 3.02[2]-[3] (1988). The pipeline views the producer relationship as a process of continuous modification driven by the pipeline's public service role; the producer looks at each contract separately. *Id.* at § 3.02[4].

Anyone who has seen the greed with which many pipelines step all over their "long-term" relationships with producers to save a dollar or two, and the alacrity with which they leap to pass on all unavoidable costs to the public, has good cause to doubt whether public spiritedness is really the pipeline's driving motive. Nonetheless, Watson is absolutely correct that pipelines cannot be understood unless one realizes that their business practices have been fashioned in a regulated environment. They entered high priced take-or-pay contracts from regulatory pressure and correctly feel cheated when the same regulatory bodies develop amnesia as the time comes to pass those costs on to customers. The pipeline's problem is that this does not justify venting their frustration on innocent producers.

portation is just beginning, and almost certainly will follow for private automobile use.

Whatever wrong the pipelines did to producers, their actions were often the case of good people receiving and following very bad legal advice. When pipelines pretended take-or-pay contracts were not enforceable and intentionally injured their gas producing partners, they should pay and pay handsomely. They should not, however, be saddled with all of the remaining take-or-pay costs, the ones that will not go away through settlement. These costs were incurred for consumers, the gas inures to their benefit, and they should pay for it.

VII. CONCLUSION

The take-or-pay crisis has left few relationships unchanged in the natural gas industry. It will be years before the trust needed for normal, efficient business operation will be restored. The judicial system has enforced most of the contracts that survived the delay and costs of litigation, but focusing on these cases only obscures the dismal fact that most contracts that were breached were settled for a fraction of their value long before they reached the courts.

This article should help producers who still have take-or-pay claims receive full relief for their injuries. It should encourage courts to enforce these contracts on summary judgment. Finally, it offers proof that while the economic analysis embodied in the theory of "efficient" breach may sound logical, it does not hold up in the everyday world of the marketplace. The number of producers who did not get what they bargained for stands as sharp proof that there is rarely an adequate substitute to enforcing a contract just as it was written by the parties.