

THE IMPLIED COVENANT TO MARKET: A FEW YEARS LATER

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I. INTRODUCTION

In 2000 the author published an article, *The Implied Marketing Covenant in Oil and Gas Leases: The Producer’s Perspective*,¹ which discussed the implied obligation of a lessee under an oil and gas lease to act prudently with regards to marketing production. The thesis of that article may be stated rather simply: the *implied covenant to market* obligates an oil and gas lessee to act as a reasonably prudent operator in producing and marketing oil and gas.² The covenant includes an obligation to make reasonable efforts to produce oil and gas once they have been discovered.³ It also imposes an obligation to make reasonably prudent efforts to obtain the best price for production if, and only if, the royalty payable under the lease depends on the price received by the

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1. Scott Lansdown, *The Implied Marketing Covenant in Oil and Gas Leases: The Producer’s Perspective*, 31 ST. MARY’S L.J. 297 (2000) [hereinafter Lansdown, *Producer’s Perspective*].

2. *Id.* at 306.

3. *Id.* at 303.

lessee. The covenant may also impose an obligation of reasonable prudence with regard to other actions by the lessee to the extent, and only to the extent, that the actions of the lessee affect the interests of the royalty owner.⁴ The implied marketing covenant should not, however, be applied to change the express and unambiguous terms of an oil and gas lease simply because those changes may produce a desirable result for the royalty owner.⁵

Producer's Perspective focused on three specific misapplications of the implied marketing covenant: (1) precluding the deduction of post-production costs in the calculation of royalties;⁶ (2) requiring that the lessee pay royalty on the proceeds of the settlement of take-or-pay claims with gas purchasers;⁷ and (3) requiring that the lessee pay royalty based on the proceeds received for production in cases where the lease provides that royalty be based on the market value of production.⁸ The circumstance giving rise to the last issue is sometimes referred to as the "reverse *Vela/Middleton*" situation, from two Texas cases that held that where royalty is to be based on market value (rather than proceeds), market value is determined by the current market instead of the price paid under a long-term contract for the sale of gas entered into by the lessee.⁹ *Vela* and *Middleton* involved the payment of royalties on gas that was sold under long-term, low-priced contracts at a time when the market value of the gas had increased substantially.¹⁰ The reverse *Vela/Middleton* situation thus involves the payment of royalty on gas that was sold under a long term contract at a price that exceeded market value at the time of the sale.

It is worth noting that, in all three of the situations referenced above, even when there is a determination that the implied marketing covenant does not apply to achieve the result sought by the royalty owner, this does not necessarily resolve the question of whether the royalty owner might be entitled to relief. In each situation, other issues of contractual interpretation are involved that might or might not be resolved in the

4. Generally, herein, the term *royalty owner* will be used to refer to parties entitled to the payment of royalty under oil and gas leases. Sometimes the term *lessor* is used to refer to such parties. This term is somewhat inaccurate or, more specifically, incomplete since the royalty owners under a lease may include the original parties to the lease, as well as parties that owned severed royalty interests prior to the lease being granted and parties that were conveyed royalty interests after the lease was granted.

5. Lansdown, *Producer's Perspective*, *supra* note 1, at 305.

6. Post-production costs are costs incurred after oil or gas is produced and prior to its being marketed. *See id.* at 324-25.

7. For a general description of this issue, *see* Michael P. Pearson & Richard D. Watt, *To Share or Not to Share: Royalty Obligations Arising out of Take-or-Pay or Similar Gas Contract Litigation*, 42 INST. ON OIL & GAS L. & TAX'N 14-1 (Sw. Legal Found. 1991).

8. *See* Lansdown, *Producer's Perspective*, *supra* note 1, at 346-47.

9. *Tex. Oil & Gas Corp. v. Vela*, 429 S.W.2d 866 (Tex. 1968); *Exxon Corp. v. Middleton*, 613 S.W.2d 240 (Tex. 1981).

10. *Vela*, 429 S.W.2d at 868; *Middleton*, 613 S.W.2d at 241.

royalty owner's favor. This is exemplified by the first of the areas discussed—the deductibility of post-production costs—which was the subject of a second article by the author, *The Marketable Condition Rule*.¹¹ Under the *marketable condition rule*, which has been proposed by some commentators and adopted by some courts, post-production costs can only be deducted after production is put in a *marketable condition*. The original proponent of the marketable condition rule, Professor Maurice Merrill, based the application of the rule on the implied covenant to market.¹² On the other hand, some commentators, most notably the late Professor Eugene Kuntz and Professor Owen Anderson, have argued for its application as a matter of contractual interpretation.¹³ Similarly, in the case of the payment of royalty on take-or-pay settlements, there was a question as to whether such payment should be made as a matter of contractual interpretation.¹⁴ Once that question was answered in the negative, royalty owners then argued that the payment of royalty on such settlements was required by the implied covenant to market.

The contractual construction adopted in *Vela* and *Middleton* creates an additional twist because the application of the same rule of contractual interpretation can favor either the royalty owner or the lessee, depending on the facts. When the market value of gas exceeds the price received by the lessee (as was the case in *Vela* and *Middleton*), the royalty owner benefits from a contractual interpretation holding that the price received under a long-term contract does not constitute market value. By contrast, in those circumstances when the market value of the gas is less than the price received (i.e., the reverse *Vela/Middleton* situation), the royalty owner benefits from a contractual interpretation holding that the price received does constitute market value.

Since the publication of *Producer's Perspective*, there have been a number of developments with regard to the implied covenant to market. Probably the most significant of these developments is the firm rejection in Texas of the application of the implied covenant to market in the reverse *Vela/Middleton* situation, a development which has been addressed with a considerable sounding of alarm by one commentator.¹⁵

Part II of this article will discuss the policy considerations surrounding the application of the implied covenant to market. Part III will discuss

11. Scott Lansdown, *The Marketable Condition Rule*, 44 S. TEX. L. REV. 667 (2003) [hereinafter Lansdown, *The Marketable Condition Rule*].

12. *Id.* at 678-80.

13. *Id.* at 680-82 & 696-701.

14. See Pearson & Watt, *supra* note 7, at 14-1.

15. See John Burritt McArthur, *A Minority of One? The Reasons to Reject the Texas Supreme Court's Recent Abandonment of the Duty to Market in Market-Value Leases*, 37 TEX. TECH L. REV. 271 (2005) [hereinafter McArthur, *A Minority of One*].

developments in the application of the implied covenant in circumstances where royalty is based on market value (including the reverse *Vela/Middleton* situation). Finally, Part IV will discuss developments in the law in the other two areas that were covered by *Producer's Perspective*—the deduction of post-production costs and the payment of royalty on the proceeds of the settlement of take-or-pay claims with gas purchasers.

II. POLICY CONSIDERATIONS

In discussing the implied covenant to market, it is useful to refer to two articles by Professor David Pierce of the Washburn University School of Law, *Exploring the Jurisprudential Underpinnings of the Implied Covenant to Market*, published in 2002, and *The Renaissance of Law in the Law of Oil and Gas: The Contract Dimension*, published in 2004.¹⁶ In these articles, Professor Pierce does an excellent job of explaining the bases for the covenants, as well as the difference between implying the covenants to implement the intent of the parties and implying the covenants to reach a result that a court felt was “fair” or “just.” Professor Pierce begins his first article by noting the importance of freedom of contract as a public policy:

Fundamental freedom of contract concepts require that courts enforce the parties' contract—not a contract of the court's making. The essence of contract law is “private ordering,” the ability of individuals in a free society to create the rules that govern their relationships.¹⁷

As Professor Pierce indicates, in the context of interpreting the oil and gas lease, there is generally no public interest that outweighs the value of honoring this fundamental freedom of contract:

Beyond preserving freedom of contract, and avoiding certain improper activities, the public really doesn't have an interest in whether a lessor receives a 1/4 royalty or a 1/8 royalty. Nor does the public have an interest in whether the lessee is forced to calculate royalty on downstream values without allowing for the cost of moving gas to a downstream marketing location.¹⁸

16. David Pierce, *Exploring the Jurisprudential Underpinnings of the Implied Covenant to Market*, 48 ROCKY MTN. MIN. L. INST. 10-1 (2002) [hereinafter Pierce, *Jurisprudential Underpinnings*]; David Pierce, *The Renaissance of Law in the Law of Oil and Gas: The Contract Dimension*, 42 WASHBURN L. J. 909 (2004) [hereinafter Pierce, *The Renaissance of Law*].

17. Pierce, *Jurisprudential Underpinnings*, *supra* note 16, at 10-2. See also Bruce M. Kramer, *Interpreting the Royalty Obligation by Looking at the Express Language: What a Novel Idea?*, 35 TEX. TECH L. REV. 223, 224 (2004) (“[W]hen the parties have articulated their intent through express language, the court's principal role, in the absence of fraud, duress, or mutual mistake, is to enforce the agreement as written.”).

18. Pierce, *Jurisprudential Underpinnings*, *supra* note 16, at 10-3.

Indeed, if there is a public interest involved in deciding the way that royalties are determined, it tends to argue for the position of the lessee, since minimizing royalty payments minimizes the cost of producing oil and gas.¹⁹ This is not to suggest that the rights of royalty owners should be ignored or impaired; the point is simply that once those rights have been established under the clear and unambiguous terms of an oil and gas lease, there is no compelling policy reason to rewrite those terms simply to increase the amounts that royalty owners receive.

This is a central point to any understanding of the implied covenants and their proper application. Because the freedom of parties to contract is an important policy, and because there is really no substantial countervailing policy, courts should not, as a general rule, rewrite agreements simply to reach results that they deem more fair or desirable. Doubtless there are many cases where a court might, if it ignored the rules of contractual interpretation and the language of the contract before it, be moved to reach a result other than the one mandated by proper interpretation of the applicable agreement. If freedom of contract is to mean anything, however, the basic task of the courts must be to determine the bargain that the parties made, not to make the bargain that they believe the parties should have made.²⁰

As Professor Pierce observes:

The jurisprudence to date indicates courts imply covenants in oil and gas leases for two reasons: (1) to complete an incomplete contract; and (2) to make the "unfair" contract "fair," or "more fair." These are the functional descriptions of the role of implied covenants.

19. As the author has noted:

In fact, there are policy arguments in favor of minimizing royalty payments: Increased royalty payments increase the costs of operations, which will inevitably tend to both discourage exploration and production activities and increase the price of oil and gas. Since these costs fall upon the overall population, and the benefit of increasing the royalty burden flows to a limited (and generally at least reasonably well off) group of royalty owners, public policy would suggest that any doubt be resolved in minimizing royalty payments.

Lansdown, *The Marketable Condition Rule*, *supra* note 11, at 700 n.156.

20. This does not mean that courts will never intervene to reach a result that is not consistent with the bargain that the parties made. However, as Professor Pierce indicates, it simply means that such cases are restricted to cases of unconscionability. For example, "an oil and gas lease procured through fraud violates a public duty . . . and is therefore the subject of public retribution through tort." Pierce, *Jurisprudential Underpinnings*, *supra* note 16, at 10-3. Professor Pierce observes that a claim of unconscionability was made in what is regarded as the seminal case involving the complied covenants: *Brewster v. Lanyon Zinc Co.*, 140 F. 801, 806 (8th Cir. 1905). The court in that case, however, properly rejected the claim of unconscionability and instead addressed the issue before it as one of determining the parties' intent in a situation where they had not addressed an area with specific language. Pierce, *Jurisprudential Underpinnings*, *supra* note 16, at 10-7.

Typically courts and commentators refer to these two categories by their legal descriptions: *implied in fact* and *implied in law*.²¹

Professor Pierce thus phrases the basic question as follows:

[I]f it is clear the contract terms are not unconscionable, will courts nevertheless revert to the interpretative techniques the unconscionability analysis was designed to eliminate to avoid the otherwise “conscionable” terms?²²

As an example of a case utilizing the *implied in law* approach, Professor Pierce cites *Rogers v. Westerman Farm Co.*,²³ a case criticized at some length in *The Marketable Condition Rule*. As explained by both Professor Pierce and the author, it is clear that the court in *Westerman Farm* utilized the implied covenant to market to basically ignore the clear language of the lease.²⁴ The court justified this result by assuming that the terms of the leases involved were the result of unequal bargaining positions between the lessee and the lessor.²⁵

In *The Renaissance of Law*, Professor Pierce addresses the argument that the implied covenants are required because an oil and gas lease is the

21. *Id.* at 10-9. See also 5 HOWARD R. WILLIAMS & CHARLES J. MEYERS, OIL AND GAS LAW § 803, at 18.3 (1997) (“A covenant is implied in fact when its existence is derived from the written agreement and the circumstances surrounding its execution. A covenant is implied in law when it is added to the contract by a court to promote fairness, justice and equity.”). Some recent commentators advocating the *implied in law* position have argued that the covenants are based in equity and/or public policy. See Lansdown, *Producer’s Perspective*, *supra* note 1, at 302 n.15.

22. Pierce, *Jurisprudential Underpinnings*, *supra* note 16, at 10-9.

23. 29 P.3d 887 (Colo. 2001).

24. “[*Westerman Farm*] is unique because the express terms of the oil and gas leases, and the facts external to the leases, support a finding that royalty is payable on the value of the gas at the place where it is extracted from the ground—at the well.” Pierce, *Jurisprudential Underpinnings*, *supra* note 16, at 10-17. See also Lansdown, *The Marketable Condition Rule*, *supra* note 11, at 691-92. As Professor Pierce also points out, under the reasoning of the *Westerman Farm* court there is no prudent operator analysis, because the only issue is whether the royalty that is paid reflects the sale of gas in a marketable condition. Pierce, *Jurisprudential Underpinnings* at 10-20. Professor Pierce’s observation is basically the same as the observation of the author with regard to the post-production cost issue: “The fundamental problem with applying the implied marketing covenant to cases involving postproduction costs is that the allegations in such cases have nothing to do with the prudence exercised by the lessee in marketing production.” Lansdown, *Producer’s Perspective*, *supra* note 1, at 335. The opinion in *Westerman Farm* actually came very close to acknowledging this in its observation that “[w]hether the lessees acted in bad faith is a separate issue from the determination of marketability for the purposes of determining allocation of costs [and calculating royalty payments].” *Westerman Farm*, 29 P.3d at 908. Discussing this observation, the author noted in *The Marketable Condition Rule*: “This is precisely the point. The implied covenants impose a certain *standard of conduct* (specifically the prudent operator standard) upon a lessee with regard to the lessee’s actions under the terms of the lease; it is not related to the lessee’s compliance with a standard of conduct.” Lansdown, *The Marketable Condition Rule*, *supra* note 11, at 695.

25. See *Westerman Farm*, 29 P.3d at 902. As Professor Pierce notes: “[T]he observations made by the court [in *Westerman Farm*] suggest that commonly-encountered phrases such as ‘at the well’ and ‘market value’ in every single lease where they appear are the product of unfair lessee scheming to dupe unsuspecting lessors out of their royalty.” Pierce, *Jurisprudential Underpinnings*, *supra* note 16, at 10-16.

product of an unequal bargain between the lessor and the lessee. He begins his discussion with a contention that the primary reason for the misuses of the implied covenants is the special status afforded to oil and gas law.²⁶ As he notes: “The best example of the modern disconnect between contract law and oil and gas law is the so-called ‘law of’ implied covenants.”²⁷ Professor Pierce indicates that much of the credit or blame for this can be given to Professor Maurice Merrill, the author of *The Law Relating to Covenants Implied in Oil and Gas Leases*, much of whose work was “influenced by [Professor Merrill’s] underlying belief that the oil and gas lease, as written, was an unfair bargain that needed to be mitigated by courts implying contract terms as a matter of law.”²⁸

Professor Pierce summarizes “Professor Merrill’s perceived need for ‘oil and gas law’ to rescue lessors from their oil and gas lease bargains” as follows:

- (1) Lessors are generally less sophisticated than lessees concerning oil and gas development and legal issues;
- (2) lessees generally begin the negotiating process by tendering a printed form of oil and gas lease;
- (3) the form contains provisions generally favorable to the lessee;
- and (4) lessors often do not negotiate the lease terms.²⁹

However, as Professor Pierce notes: “These same observations could be made about many typical contracting situations; but courts have not abandoned basic contract law principles when there is inequality of sophistication or bargaining power.”³⁰

As Professor Pierce also observes, Professor Merrill’s contentions concerning the leasing process may be characterized as, at best, incomplete and, at worst, simply wrong.³¹ In addition, Professor Pierce contends that:

Professor Merrill’s premise that oil and gas leases are some sort of adhesion contract is also false. Although it is true that oil and gas leases create a standard relationship, have their own unique structure and terminology, and are frequently presented to lessors

26. “Jurisprudential flaws have developed as courts depart from basic contract, property, or tort law in pursuit of ‘oil and gas law’ concepts.” Pierce, *The Renaissance of Law, supra* note 16, at 909.

27. *Id.* at 911.

28. *Id.*

29. *Id.* at 914.

30. *Id.*

31. “For example, what if the landowner is represented by counsel knowledgeable in ‘oil and gas law’? What if the landowner entering into the oil and gas lease is in fact a sophisticated oil and gas developer who negotiated the lease terms, which are contained in a customized document with provisions uniquely beneficial to the landowner/lessor?” *Id.* at 915. As any attorney who has reviewed oil and gas leases in the “hot” Barnett Shale play in the Dallas/Fort Worth area can confirm, this situation is by no means uncommon.

using form documents, the relative circumstances of the contracting parties often defy classification as an adhesion contract.³²

Professor Pierce notes that his own independent analysis of leasing transactions leads to the conclusion that “the prototypical leasing transaction Professor Merrill uses to justify judicial intervention is not, in fact, the typical situation.”³³

Finally, Professor Pierce observes that: “Even if one accepts Professor Merrill’s premise that the oil and gas lease is an adhesion contract, this is simply the beginning of the analysis, not the end. Adhesion contracts are enforceable like any other contract. The ‘contract law’ test used to identify the unenforceable adhesion contract is unconscionability.”³⁴ Thus, Professor Pierce returns to the point, which he originally made in *Jurisprudential Underpinnings*, that the courts’ intervention to change the terms of the parties’ bargain should be limited to circumstances involving unconscionability. For advocates of judicial intervention like Professor Merrill, the problem with using unconscionability is that, in most cases, the application of the concept would not allow the courts to simply add obligations for the lessee that were not contained in the oil and gas lease. Of course, “if a court desires an outcome that cannot be achieved by applying an unconscionability analysis, it may simply choose to rely upon an interpretative rule that will get it where it believes the equities lead.”³⁵ That inappropriate reliance on an interpretive rule is precisely what the author criticized in *Producer’s Perspective*. There is no question that, in the three areas discussed in that article, royalty owners attempted (sometimes successfully) to use the implied covenant to market as an “interpretive rule” to rewrite the terms of the parties’ agreement.

32. *Id.* at 916. As Professor Pierce indicates:

For example, it is the prospective lessor, as the owner of the minerals, who has the “take-it-or-leave-it” power over the transaction. They cannot be compelled to lease their land on terms demanded by the lessee. In any event, lessees rarely present their offers to lease on a take-it-or-leave-it basis. Frequently there are other lessees in the area willing to negotiate. However, the same lessees are not going to negotiate against themselves if the landowner accepts the offered deal. This is not all that different from a sale of real estate. If the buyer doesn’t offer less money, the seller will get their price.

Id. (footnote omitted).

33. *Id.* Professor Pierce indicates that he has, on several opportunities, conducted empirical research involving the analysis of a sampling of leases, or all of the leases held by a lessee in a county, state, or field. *Id.* He describes one such study, involving the oil and gas leases used by Union Pacific Resources Company throughout Texas, that was used as evidence in a class certification in *Union Pacific Resources Group v. Neinast*, 67 S.W.3d 275 (Tex. App.—Houston [1st Dist.] 2001, pet. denied). Pierce, *The Renaissance of Law*, *supra* note 16, at 916. (*Neinast* is discussed, *infra*, at note 74.). Among other things, Professor Pierce found that there was “a considerable level of contractual diversity among the lease,” and that “the vast majority of the documents indicated [that] they were the product of active negotiation between the lessor (or the lessor’s legal counsel or other representative) and the lessee.” *Id.* at 917.

34. *Id.*

35. *Id.* at 918.

III. RECENT DEVELOPMENTS CONCERNING MARKET VALUE ROYALTY

A. *The Meaning of "Market Value"*

Before discussing recent developments in the area of market value royalty it will be useful to clarify the meaning of the term "market value." The fundamental rule established by *Vela/Middleton* was that royalty could be determined on one of two bases: "proceeds" and "market value." Market value, as the court in *Vela* noted, "clearly means the prevailing market price at the time of sale or use."³⁶ Market value is thus an objective concept in the sense that the value upon which royalty is to be based is entirely independent of the diligence exercised by the lessee in marketing production. By contrast, where royalty is to be based on proceeds, it is clear that the amount paid may be substantially affected by the diligence of the lessee.

The use of the term "objective" is not, however, intended to suggest that market value will always be easy to ascertain. Depending upon the production involved, it may require a detailed factual investigation by the court. Additionally, as the author has noted, market value may, in fact, be a range of values. In this case, a court may test whether royalty has been properly based upon market value by utilizing a two-part test: "(1) Does the evidence indicate that the mechanism that is used will yield a value that is likely to be within a range of current 'prevailing prices,' and (2) Is the mechanism free of any 'systemic' bias that would cause it to consistently understate market value?"³⁷

As this test demonstrates, market value is not something that can be affected by the actions of a lessee. Accordingly, it makes no sense to impose any obligation upon lessees with regard to the marketing of production in cases where royalty is to be based on market value.

Some confusion as to what constitutes market value may be created by the fact that lessees may, in cases where royalty is to be based on market value, pay royalty based on the amount that they receive for production.³⁸ Where a lessee is selling gas on a short-term basis in a competitive market, it may be entirely reasonable for the lessee to assume that the amount it receives reflects market value. This does not, however, change the fact that royalty is to be based on market value. If a lessee bases its royalty payments on the price it receives and a royalty owner argues that it has been underpaid, the question would be whether the price received

36. *Tex. Oil & Gas Corp. v. Vela*, 429 S.W.2d 866, 871 (Tex. 1968).

37. Lansdown, *Producer's Perspective*, *supra* note 1, at 354-55.

38. This concept has actually been codified in Texas. See TEX. NAT. RES. CODE ANN. § 91.401(i) (Vernon 2007) (defining "market value," "market price," "prevailing price in the field," and similar terms as "the amount realized at the mouth of the well by the seller of such production in an arm's-length transaction").

was, in fact, equal to market value. The lessee's diligence in marketing production would be irrelevant; it could introduce evidence of Herculean efforts on its part to obtain the best price available but, if the royalty owner were able to demonstrate that the price obtained was not within the current range of prevailing prices, the royalty owner would be able to recover the difference between the amount paid and the proper market value. It is also important to recognize that the fact that lessees who are obligated to pay royalty based on market value may properly utilize the price that they receive for production is clearly of no relevance in situations where the lessee has entered into a long-term contract for the sale of gas and the contract price is substantially different from the market price (i.e., the situation faced by the courts in *Vela, Middleton*, and the *Yzaguirre* case to be discussed).³⁹

Another possible argument for the proposition that the actions of the lessee can affect market value is that the lessee's sales of production actually affect the market value of production since market value is based on contemporaneous transactions, one of which is the sale by the lessee. The author is not aware of any royalty owner making this argument, and, given the highly competitive nature of the gas market in most areas, it is easy to understand why. If the royalty owner does not believe that the price received by a lessee is sufficiently high (despite the fact that the lessee has every incentive to seek the highest price possible), there will almost always be nearby sales of gas to which the royalty owner can refer in order to support the argument that the amount received by the lessee does not represent true market value.⁴⁰

39. In fact, in *Yzaguirre* the royalty owners argued that "producers have always based 'market value' royalty payments on actual sales proceeds, so the leases already require [the lessee] to pay royalty on [the long term contract price]." *Yzaguirre v. KCS Res., Inc.*, 53 S.W.3d 368, 372 (Tex. 2001). The court properly rejected this contention; while lessees may well have assumed that the prices that they received in a competitive gas market represented market value this did not mean that they were obligated to continue to pay on the price received once they had entered into a long term contract which provided for a price that no longer reflected market value. Mr. John Burritt McArthur, whose views are discussed in in Part III.C.1, states that, "In rare cases, parties in jurisdictions loyal to *Vela* may even be able to submit the lessee's contract price as the best factual proof of market value." McArthur, *A Minority of One*, *supra* note 15, at 283. Mr. McArthur does not provide any explanation of why such cases should be rare. Since most gas today is not sold under long term contracts that fix the price, such cases should be the rule, rather than the exception.

40. Indeed, this is acknowledged by John McArthur, the primary proponent of the application of the implied marketing covenant in market value royalty situations:

Like oil, natural gas has become a commodity traded at market centers with prices published by trade journals. While reported prices may have been subject to some manipulation—such that the Federal Energy Regulatory Commission (FERC) and the Commodity Futures Trading Commission have taken steps to improve price reporting—large, active groups of willing buyers and sellers are at market-center hubs, again just as with oil. Gas is commonly priced on a netback basis to the well, starting with the market-center price and then subtracting the costs of transportation to that market (to the extent the lease allows such deductions).

Mention should be made of one specific exception to the general rule that the lessee's actions cannot affect market value. The exception occurs where production can be sold in a price regulated environment and the actions of the lessee can affect the regulated price. As noted in *Producer's Perspective*, some jurisdictions that apply the *Vela/Middleton* rule hold that where royalty is to be based on market value, if the price of gas is subject to regulation, the regulated price will be deemed to be market value.⁴¹ Of course, if the lessee has some control over the regulated price applied to gas upon which it is paying royalty, it has an obligation to act as a reasonably prudent operator in exercising such control.

The implied covenant to market was used to impose obligations on a lessee in a situation involving price-controlled gas in *Shelton v. Exxon Corp.*,⁴² which was discussed in *Producer's Perspective*. As noted therein, in evaluating a lessee's conduct in marketing production when prices are subject to governmental control, it is important to recognize that: (1) the implied covenant to market only requires a lessee to take those actions that would mutually benefit the royalty owner and the lessee; (2) a lessee is entitled to take into consideration those matters that would be considered by a reasonably prudent operator, and such matters may not be dismissed from consideration simply because they are *outside costs*; and (3) the lessee's conduct must be evaluated in light of the circumstances that existed at the time the marketing occurred and not with the benefit of hindsight.⁴³

A recent case involving the application of price controls is *Smith v. Amoco Production Co.*, a class action suit based on allegations that the lessee had violated the implied covenant to market due to the manner in which it had marketed gas that was subject to the Natural Gas Policy Act.⁴⁴ The royalty owners in *Smith* argued that the lessee had violated the implied covenant to market by invoking Federal Energy Regulatory Commission Order 451 in order to require its gas purchaser to renegotiate its gas contracts. This, they argued, substantially increased the price of certain high-priced gas while substantially decreasing the price of certain low-priced gas. The lessee was sued by the royalty owners under the leases where the price was increased, who argued that the lessee should have invoked Order 451 sooner, and by the royalty owners

McArthur, *A Minority of One*, *supra* note 15, at 302-03. Clearly, under the market described above, the notion that an individual lessee has an obligation to achieve a particular price because of concerns that the price received by that lessee may affect the "market" are absurd.

41. See Lansdown, *Producer's Perspective*, *supra* note 1, at 315.

42. 719 F.Supp. 537 (S.D. Tex. 1989), *aff'd in part and rev'd in part*, 921 F.2d 595 (5th Cir. 1991).

43. Lansdown, *Producer's Perspective*, *supra* note 1, at 317-23. See also *Smith v. Amoco Prod. Co.*, 31 P.3d 255, 273 (Kan. 2001).

44. 31 P.3d at 257.

under the leases where the price was decreased, who argued that invoking Order 451 violated the implied covenant to market. The case involving the former group of royalty owners was settled.⁴⁵

In addressing the question of whether the lessee had violated the implied covenant to market, the court cited an earlier decision, *Robbins v. Chevron U.S.A., Inc.*, for the proposition that lessees should be given the greatest possible leeway in making marketing decisions and that courts generally should not second guess operators' marketing decisions unless there is a conflict of interest between the lessee and the royalty owner.⁴⁶ However, the court noted that:

The difficulty here lies in crafting an even-handed formula because of the lessors' claim of conflict in the interest between [the lessee] and the lessors. [The lessee] admits that its obligations as lessee apply independently to each lease. The independent duty principle is applied to prevent [the lessee] from making the management of a given lease dependent upon the management of another lease.⁴⁷

The court concluded that the lessee's invocation of Order 451 to renegotiate its gas contracts should not expose it to automatic liability and that "the implied covenant to market is to be enforced with a consideration given to the purpose of Order 451."⁴⁸ The court also noted, however, that the lessee "should not be allowed to manipulate the procedure to receive an undue benefit for itself."⁴⁹ Concluding that the question of compliance with the implied covenant to market was one of fact, the court set out the following considerations for the trial court to apply in determining whether the covenant had been complied with:

1. [The lessee's] conduct will be evaluated by considering "what an experienced operator of ordinary prudence would do under the same or similar circumstances, having due regard for the interests of both [lessor and lessee]."
2. Evaluation of [the lessee's] conduct under the prudent operator standard is a question of fact.
3. The district court must apply the prudent operator standard to the facts as they existed at the time [the lessee] took the action complained of.
4. The lessors have the burden of proof.

45. *Id.* at 262-63. This dilemma faced by the lessee in *Smith* is an illustration of the problem of the concept of "outside costs" discussed in Lansdown, *Producer's Perspective*, *supra* note 1, at 319-21.

46. 31 P.3d at 271 (citing 785 P.2d 1010 (Kan. 1990)).

47. *Id.* at 271-72.

48. *Id.* at 273.

49. *Id.*

5. The facts are not contested, and [the lessee's] actions are not patently imprudent; thus, expert testimony will be required to establish a breach of the covenants alleged.⁵⁰

Smith v. Amoco certainly underlines the point made in *Producer's Perspective* that, in cases involving gas subject to price regulation, the application of the implied marketing covenant raises complex issues that must be addressed carefully. Beyond that, it should be noted that because little, if any, natural gas produced and sold today is subject to price regulation, the significance of this exception is minimal and decreasing.⁵¹ Thus, this exception should not be a major consideration in addressing the general application of the implied covenant in cases where royalty is based on market value. Apart from that, it is extremely important to recognize that the existence of this exception does nothing to impair the basic rule that the implied marketing covenant should not afford royalty owners relief when the actions of the lessee cannot affect the interest of such royalty owners.

At this point, before turning to the case law and commentary on the application of the implied marketing covenant in cases where royalty is to be based on market value, it is worth returning to a central thesis of *Producer's Perspective* and of this article: in any given situation involving the payment of royalty based on the market value of production, market value either is or is not something that can be affected by the actions of a lessee. If it can be affected by the actions of the lessee, then the implied covenant to market will be applicable.⁵² If it cannot be so affected, then the implied covenant to market will not be applicable. If those that argue against the positions taken in this article believe that market value can be affected by the actions of a lessee, they should describe how this occurs. If they cannot do so, they should describe how it makes sense to impose an implied obligation with regard to a lessee's decision making if that decision making cannot have any impact on the party for whom the obligation is being imposed.

50. *Id.* at 273-74 (citations omitted).

51. McArthur, *A Minority of One*, *supra* note 15, at 283 ("Such holdings [that the market price of gas is limited by the regulated price] are increasingly irrelevant because of natural gas deregulation.")

52. This is, in fact, the case in those jurisdictions that have rejected *Vela/Middleton* and held that market value may be the price received under a long term sales contract entered into in good faith.

*B. Case Law*1. *Yzaguirre* and the Reverse *Vela/Middleton* Issue

The Texas Supreme Court clearly rejected the application of the implied marketing covenant in the reverse *Vela/Middleton* context in *Yzaguirre v. KCS Resources, Inc.*⁵³ The oil and gas leases involved in that case contained what are sometimes referred to as bifurcated royalty clauses, under which the royalties on gas sold at the well are based on the amount realized,⁵⁴ while the royalties on gas sold off the premises are based on market value.⁵⁵ The lessees in that case entered into a long-term gas sales contract that provided for the sale of gas away from the well. Thus, under the bifurcated royalty clause, royalties were to be based on market value. The price escalation clause of the gas sales contract entered into by the lessees resulted in the price paid for the gas greatly exceeding the market value of the gas, and the lessees filed an action for a declaratory judgment that they were required to pay royalty based only on market value, rather than at the higher amount received under the gas sales contract price.

The royalty owners contended that the difference between the two methods for calculating royalty under the bifurcated royalty clause lay “in what costs are deducted before calculating royalties, not in the rate on which royalty is based . . . [thus,] both amount-realized and market-value royalties start with the price the producer actually receives for the gas, with the difference being that the lessee subtracts transportation costs from the proceeds before paying a market-value royalty.”⁵⁶ The court rejected this contention, stating that the parties to the leases had, in unambiguous terms, based the royalty on the amount realized where gas was sold at the well and on market value where gas was sold off the premises.⁵⁷

53. 53 S.W.3d 368, 370 (Tex. 2001). In an earlier case that was not designated for publication, the Dallas Court of Appeals, like the court in *Yzaguirre*, rejected the application of the implied covenant to market in the reverse *Vela/Middleton* situation. See *de los Santos v. Coastal Oil & Gas Corp.*, No. 05-97-00029-CV, 1999 WL 619639 (Tex. App.—Dallas Aug. 17, 1999, pet. denied) (not designated for publication); Lansdown, *Producer's Perspective*, *supra* note 1, at 351 n. 238.

54. This method for determining royalty is sometimes referred to, and will be referred to herein, as the “proceeds” method.

55. Lansdown, *Producer's Perspective*, *supra* note 1, at 372.

56. *Yzaguirre*, 53 S.W.3d at 372. Professor Owen Anderson supports this interpretation of the royalty clause. See Owen Anderson, *A Royalty Odyssey*, 53 INST. ON OIL & GAS L. 4-1, 4-2 at 10-4-5, n.14. (The Center for Am. and Int'l Law 2002) [hereinafter *A Royalty Odyssey*]. However, he also acknowledges that the contrary view was clearly adopted in the *Middleton* case. *Id.*

57. *Yzaguirre*, 53 S.W.3d at 372. The court noted that the royalty provisions were quite similar to the royalty clauses involved in the *Vela* case.

The initial question faced in *Yzaguirre* was one of contractual interpretation. The problem faced by the royalty owners was that the clear precedent of *Vela* and *Middleton* mandated a contractual interpretation that was not in their favor. Faced with this obstacle, the royalty owners sought to rewrite the contract using the implied marketing covenant. The court, however, rejected this argument, stating:

Because the lease provides an objective basis for calculating royalties that is independent of the price the lessee actually obtains, the lessor does not need the protection of an implied covenant. Depending on future market behavior, this may be financially beneficial to the lessor, as it was in *Vela*, or it may be less advantageous, as here. In either event, the parties have received the benefit of their bargain.⁵⁸

The royalty owners also argued that the position of the lessees was contrary to the Supreme Court's earlier decision in *Cabot Corp. v. Brown*, in which the court held that "under a gas royalty clause providing for royalties based on market value, the lessee has an obligation to obtain the best current price reasonably available."⁵⁹ The court in *Yzaguirre* noted that the decision in *Cabot Corp.* was based on division orders and not on whether the implied covenant required the lessee to pay royalty based on best available price; thus, the language from that case was dicta.⁶⁰ In addition, the court noted that the court in *Cabot Corp.* cited a treatise stating that "a market-value royalty is based on 'the best current market price reasonably available.'"⁶¹ The court thus concluded that it was not bound by the dicta of *Cabot Corp.*⁶²

As the court in *Yzaguirre* correctly noted, the royalty owners in the case before it were attempting to use the implied marketing covenant "to negate the express royalty provisions in the leases and transform the

58. *Id.* at 374.

59. 754 S.W.2d 104, 106 (Tex. 1987).

60. For a description of division orders and some of the issues that they present, see Laura H. Burney, *The Interaction of the Division Order and the Lease Royalty Clause*, 28 ST. MARY'S L. J. 353 (1997). Professor Burney describes division orders as follows:

In its simplest form, the division order is a relatively short document that the lessees or the purchasers of the production (payors) send to royalty owners and other interested parties (payees) in order to affirm the size of each payee's interest. Generally, the division order asks the payee to warrant or to certify his or her interest, and to indemnify the payor in the event the payee is overpaid. Because the basis for calculating the royalty is not defined specifically in the lease royalty clause, payors also use division orders to specify the terms of the oil or gas sales contract. In turn, these terms are intended to provide the basis for calculating the payee's royalty payment.

Id. at 358.

61. *Yzaguirre v. KCS Res., Inc.*, 53 S.W.3d 368, 374 (Tex. 2001) (citing RICHARD W. HEMINGWAY, *LAW OF OIL AND GAS* § 8.9(C), 443 (2d ed. 1983)) (emphasis added). This treatise's handling of the issue of market value is discussed *infra* at Part III.B.

62. 53 S.W.3d at 374. For a further discussion of *Cabot Corp.*, see *infra* Part III.C.1.

'market value' royalty into a 'higher of market value or proceeds' royalty."⁶³ The court went on to state that:

The implied covenant to reasonably market oil and gas serves to protect a lessor from a lessee's self-dealing or negligence. It does not override the express terms of the oil and gas lease whenever a lessee negotiates a sales contract that turns out to be especially lucrative. We will not now rewrite this lease's plain terms to give the royalty owners the benefit of a bargain they never made.⁶⁴

The foregoing is precisely the argument that was made in *Producer's Perspective*: the implied covenant to market imposes a standard of conduct on lessees in areas where the lessees' actions may affect the interest of royalty owners.⁶⁵ The covenant is not intended to rewrite the terms of the oil and gas lease simply because the new terms would benefit the royalty owner.

2. *Hankins* and Affiliate Transactions

In *Union Pacific Resources Group v. Hankins*, the Texas Supreme Court rejected the application of the implied covenant to market in cases involving transactions between the affiliates of a lessee.⁶⁶ *Hankins* involved a class action certification. The allegations of royalty underpayment in the case were based on inter-affiliate sales by the lessee. Allegations concerning allegedly artificially low prices for gas sold to affiliates are common in royalty cases; such allegations include contentions that prices paid by affiliates are artificially low as well as contentions that the proceeds are reduced by improperly charged marketing fees.⁶⁷ Both of these allegations were made in *Hankins*. There have been suggestions that, in evaluating a lessee's conduct in making inter-affiliate sales, courts should impose a higher standard than the reasonably prudent operator standard that is generally imposed in cases involving implied covenants.⁶⁸ As the court found in *Hankins*, however, where royalty is to be based on market value, no scrutiny whatsoever of

63. *Id.*

64. *Id.* (citation omitted).

65. Lansdown, *Producer's Perspective*, *supra* note 1, at 348-49.

66. 111 S.W.3d 69 (Tex. 2003).

67. *See, e.g.*, *Stirman v. Exxon Corp.*, 280 F.3d 554 (5th Cir. 2002); *Craig v. Champlin Petrol. Co.*, 435 F.2d 933 (10th Cir. 1971); *Parker v. TXO Prod. Corp.*, 716 S.W.2d 644 (Tex. App.—Corpus Christi 1986, no writ).

68. The author has also noted that the question of whether a higher standard should be imposed may not be as significant as it initially appears, since, as a practical matter courts are likely to scrutinize transactions between affiliates carefully, regardless of what standard they purport to impose. Lansdown, *Producer's Perspective*, *supra* note 1, at 309-10. It is extremely important to recognize, however, that the entire question of the standard of conduct that is to be applied in evaluating a lessee's conduct in marketing production is only relevant when the conduct of the lessee has an impact on the interest of the royalty owner, i.e., when royalty is to be based on the price received by the lessee.

the lessee's conduct is required because the lessee's conduct has no impact on the value upon which royalty is to be paid. Addressing the issue of inter-affiliate transactions, the court noted:

[T]hese inter-affiliate transactions do not determine the amounts owed under market value leases—under a market value lease the producer need not attempt to obtain the best price available. *Yzaguirre*, 53 S.W. 3d at 373. A producer could provide its affiliate with gas at any price it chose, but the royalty owners would be protected because their payment would be “based on the prevailing market price at the time of sale.” *Id.* at 372.⁶⁹

Similarly, with regard to marketing fees charged by affiliates, the court noted that “the producer could choose to pay its affiliates a marketing fee, and this payment would not reduce the gas price that it was obligated to pay lessors—the inter-affiliate transaction might reduce the proceeds it purported to receive, but it could not reduce the objective market value of the gas.”⁷⁰

Attempting to get around the argument that the inter-affiliate transactions were irrelevant where royalty was based on market value, the royalty owners in *Hankins* also sought to pursue the contractual interpretation route by contending that market value was equal to the best price obtainable and that was the amount that the Union Pacific marketing affiliates had received.⁷¹ It should be noted that if this argument is accepted, it renders moot the question of the applicability of the implied covenant to market. If, as a matter of contractual interpretation, market value is the price received by the marketing affiliates, there is no need to resort to the implied marketing covenant to achieve that result. The court in *Hankins*, however, properly rejected the contractual interpretation proposed by the royalty owners. It noted that, even if the royalty owners could establish that the affiliate transactions were a sham, this did not demonstrate that the price received by the marketing affiliates represented both market value and the best price obtainable “because the marketing affiliates may have been able to receive a price higher than market value, either through a long-term contract as in *Yzaguirre* or simply through extraordinary negotiations in sales efforts that exceeded the results reasonably obtainable by an ordinary lessee.”⁷² As the court noted, “Under this scenario the proceeds [royalty] owners would be entitled to share in the lessee's good fortune, while the market value owners would not be.”⁷³

69. *Hankins*, 111 S.W.3d at 74.

70. *Id.*

71. *Id.*

72. *Id.* at 75.

73. *Id.*

Hankins provides a good illustration, with regard to affiliate sales, of the basic rule laid down in *Yzaguirre* and argued for in *Producer's Perspective*: the implied marketing covenant should be applied only in those cases where the lessee's conduct can affect the royalty owner. The lessee may engage in sham transactions involving affiliates or may charge marketing fees that bear no relation to the actual costs of marketing gas, but such actions are simply irrelevant in cases where the royalty owner is protected by a royalty clause that requires the royalty to be based on market value, because neither the sham transactions nor the marketing fees have any impact on the amount that is to be paid to the royalty owners.

3. *Hankins* and the Issue of Class Action Certification

Hankins involved an effort to certify a class of royalty owners based on allegations that the lessee had breached the implied covenant to market.⁷⁴ Addressing the question of whether the royalty owners had met the commonality requirement for certifying a class, the court concluded:

Thus, the question under a market-value lease would be whether the lessees paid royalties based on market value, while the question under a proceeds lease would be whether the proceeds actually received by the lessee were a fraud or a sham. These are different inquiries. Under some circumstances, a reasonable marketer may sell gas for more or less than market value, as when a lease is subject to a long-term purchase contract.⁷⁵

Like *Hankins*, *Stirman v. Exxon Corp.* involved an effort to certify a class action, in this case against Exxon Corp., consisting of all private royalty owners in the continental United States.⁷⁶ The allegation was that Exxon

74. *Union Pac. Res. Group, Inc. v. Neinast*, 67 S.W.3d 275 (Tex. App.—Houston [1st Dist.] 2001, pet. denied) was also a class certification case involving the implied covenant to market that preceded *Hankins*. In *Neinast* the court noted that in *Yzaguirre* it had reaffirmed the concept that “there is no implied covenant in an oil and gas lease when the lease expressly covers the subject matter of the covenant sought to be implied” and concluded that by certifying the class based on the existence of an implied covenant to market in all leases, the trial court had not complied with its duty to identify substantive issues that are dispositive of the litigation. *Id.* at 282. The court also noted that certifying the class defeated the standard of conduct that the royalty owners had sought to impose—that of the reasonably prudent operator. As the court indicated: “Determining the best reasonably attainable price under same or similar circumstances necessarily contemplates a fact specific, location-by-location inquiry for each lease. For these reasons, individual, rather than common, issues predominate.” *Id.* (citation omitted).

75. *Hankins*, 111 S.W.3d at 74.

76. 280 F.3d 554, 557 (5th Cir. 2002). The purported class was also restricted to leases that “provide[d] for payment of royalties on natural gas production on an amount realized/net proceeds basis or a market value/market price basis.” *Id.* This would cover the royalty clauses in virtually all oil and gas leases. The court noted that “[t]he putative class included royalty interest owners in Alabama, Arkansas, California, Colorado, Florida, Kansas, Louisiana, Mississippi, Montana, New Mexico, North Dakota, Oklahoma, Texas, Utah, and Wyoming.” *Id.* at 558.

had violated the implied covenant to market by engaging in transfers within its own divisions at a lower price than the price for which it eventually sold the gas.⁷⁷ The royalty owners also alleged that Exxon had charged unreasonable post-production costs.⁷⁸

Stirman is worth mentioning, if for no other reason than that it involved a clash between two preeminent experts in oil and gas law—Professors Bruce Kramer and Jacqueline Weaver, both of whom provided testimony.⁷⁹ Professor Weaver testified that “all oil and gas lessors are subject to the reasonably prudent operator standard and that in very few cases do lessees attempt to lessen the burden of this standard by express lease provisions.”⁸⁰ Professor Weaver also claimed “that case law indicated that an implied covenant to market exists in both market value and proceeds leases.”⁸¹ In response, Professor Kramer testified that different jurisdictions use different standards in applying the reasonably prudent operator standard and that “the highest court of each state has not made clear that an implied covenant to market even exists in each state.”⁸²

The court noted that the Texas Supreme Court held in *Yzaguirre* “that there is no implied covenant to market in market value leases, as these have their own express covenant”⁸³ and that “other states take different views of the implied covenant to market, and some have not addressed whether such a covenant exists.”⁸⁴ Thus the court concluded:

77. *Id.* at 557.

78. *Id.* at 558.

79. The use of legal experts in oil and gas cases in recent years is an intriguing development that is beyond the scope of this article. Interestingly, the court’s opinion noted that “Professor Weaver was originally retained by the plaintiffs as an expert in this case, but by the time of the evidentiary hearing had become one of the plaintiffs’ lawyers instead.” *Id.* at 560, n. 5. It should be noted that, although the author is employed by Exxon Mobil Corporation, the successor to Exxon Corporation, he had no involvement in the case.

80. *Stirman*, 280 F.3d at 560. This appears to be an error; presumably the court intended to say that all *lessees* are subject to the reasonably prudent operator standard.

81. Insofar as the author is aware, Professor Weaver was the first authority to argue that royalty owners in the reverse *Vela/Middleton* situation should prevail due to the implied covenant to market. See Jacqueline Lang Weaver, *When Express Clauses Bar Implied Covenants, Especially in Natural Gas Marketing Scenarios*, 37 Nat. Resources J. 491 (1997). This is a position that the author vigorously (in his humble opinion) disputed. Lansdown, *Producer’s Perspective*, *supra* note 1, at 351-56.

82. *Stirman*, 280 F.3d at 560-61. It appears that there was also an issue as to the application of division orders. Professor Weaver cited statutes from eight states precluding division orders from overriding oil and gas lease terms, while Professor Kramer testified that these statutes were not uniform in their application. *Id.* at 560-61.

83. *Id.* at 562. The court did not explain what it meant when it referred to royalty owners under market value leases having their own express covenant, but presumably this was a reference to the fact that such royalty owners are protected from the lessee paying royalty based on anything less than the market value.

84. *Id.* The court observed:

An implied covenant to market has been found generally in Arkansas, Colorado, Kansas, Louisiana, Montana, and New Mexico. Oklahoma generally recognizes an implied covenant to market, but does not always recognize such a covenant on behalf of overriding royalty owners. In contrast, Colorado has allowed overriding royalty

These differences in the law of the jurisdiction at issue demonstrate that the law is not uniform as to any implied covenant to market, or at least that the plaintiffs have not demonstrated uniformity. The plaintiffs have not met their burden of showing that there are common issues of law or fact, or that these predominate over individual issues.⁸⁵

The issues that arise in attempts at class certification are, it is fair to say, many and complex. It is not possible to address them in detail in the context of this article beyond noting that, in determining whether to certify a class, courts must—as did the court in *Hankins* and the other cases cited—recognize that proceeds and market value leases present fundamentally different issues that must be addressed separately.

C. Commentary

1. The Position of Mr. McArthur

Yzaguirre and *Hankins* have stirred considerable concern for one commentator, John Burritt McArthur. As Professor David Pierce has noted, Mr. McArthur may fairly be characterized (and he might well accept such a characterization) as the modern day incarnation of Professor Maurice Merrill, “[m]uch of [whose] work was influenced by his underlying belief that the oil and gas lease, as written, was an unfair

owners to sue based on an implied covenant to market. Texas recognizes an implied covenant to market in proceeds leases, but not in market value leases. In a case involving Utah oil and gas leases, the Tenth Circuit stated that there is an implied covenant to market in oil and gas leases. However, the Tenth Circuit did not cite any Utah authorities for this proposition, and the Utah courts do not seem to have addressed this issue. Finally, the Wyoming courts seem to have recognized an implied covenant to market.

Id. at 564-65. The court noted that cases cited by the plaintiffs for Alabama, California, Florida, Mississippi, and North Dakota did not recognize the existence of an implied covenant to market in those states. *Id.* at 565.

85. *Id.* at 566. The court also noted: “Additionally, the district court never considered whether a class action is a superior method for adjudicating this controversy. The district court must conduct a ‘rigorous analysis’ of the Rule 23 requirements [citation]. This was not done in this case.” Following the opinion in *Stirman*, the plaintiffs attempted to certify two classes, one consisting of royalty owners in Texas and the other consisting of royalty owners in the remaining states covered by the initial effort. However, the district court eventually granted the lessees motion for summary judgment and for class decertification, on the grounds that: (1) evaluation of the royalty owners’ claims would require a review of each lease; (2) there would be difficulty in determining damages since state law differs as to whether royalty owners bear post-production costs; (3) the proposed class representative of the Texas class was not representative, since all of that party’s lease provided for payment based on market value, and, under Texas law the implied covenant to market was thus inapplicable; (4) individual issues prevailed over common issues, since each lease would need to be examined to determine whether the implied covenant to market was applicable; and (5) the scope of the class was inappropriate because only royalties in Texas and Louisiana were subject to the internal *field price* process for determining royalty. *Hunter v. Exxon Corp.*, No. Civ.A. SA99CA0763XR, 2005 WL 357682 (W.D. Tex 2005). See also *Enron Oil & Gas Co. v. Joffrion*, 116 S.W.3d 215 (Tex. App.—Tyler 2003, no pet.).

bargain that needed to be mitigated by courts implying contract terms as a matter of law.”⁸⁶

Mr. McArthur’s original foray into this subject, *The Precedent Trap and the Irrational Persistence of the Vela Rule*, was published shortly after the decision in *Yzaguirre*.⁸⁷ Initially, it should be noted that *The Precedent Trap* did not address *Yzaguirre*’s holding that the implied covenant to market did not apply where royalty was to be based on market value; rather, it was an attack on the *Vela/Middleton* rule and the upholding of that rule in *Yzaguirre*. The author does not take any position with regard to the *Vela/Middleton* rule and acknowledges that (1) many commentators criticized the rule;⁸⁸ and (2) courts in some states rejected the *Vela/Middleton* rule.⁸⁹ The key point for the purpose of this article is that *Vela/Middleton* firmly established a rule of contractual interpretation. It is not the purpose of this article to reargue that rule’s validity. Thus, the article does not address Mr. McArthur’s arguments with regard to that rule, other than to make a couple of observations.

First, in his vigorous argument that the court in *Yzaguirre* should have overturned *Vela/Middleton*, Mr. McArthur fails to mention the point that the *Vela/Middleton* rule, when it was adopted, was clearly a rule that favored the royalty owners, and, if *Yzaguirre* had overturned *Vela/Middleton*, it would have reached a result that also clearly favored the royalty owners. In other words, Mr. McArthur is not simply arguing that courts should not be bound by what he contends is a bad precedent,

86. Pierce, *The Renaissance of Law*, *supra* note 16, at 911. Discussing Mr. McArthur’s advocacy of the “mutual benefit implied covenant,” Professor Pierce notes that his opening statement and foundational premise are “pure Merrill.” *Id.* at 913.

87. John Burritt McArthur, 39 HOUS. L. REV. 979, 980-82 (2002).

88. See, e.g., *A Royalty Odyssey*, *supra*, note 56; but see Bruce M. Kramer, *Interpreting the Royalty Obligation by Looking at the Express Language: What a Novel Idea?*, 35 TEX. TECH L. REV. 223, 249 (2004). Discussing *Tara Petroleum Corp. v. Hughey*, 630 P.2d 1269 (Okla. 1981), in which the Oklahoma Supreme Court rejected the *Vela/Middleton* rule on the grounds that it would be unfair to producers and that rejection of the rule would not be unfair to royalty owners, Professor Kramer observes:

How the court can determine that it is consonant with the intent and understanding of the parties and is not unfair to the lessors is unknown to me. Royalty clauses use different terms to describe different royalty calculation methodologies. If the parties want to pay on the basis of the amount received by the lessee, language in leases can lead to that result. However, in these cases, the parties voluntarily chose to include multiple payment methodologies, including some based on market value or market price. The Oklahoma Supreme Court was essentially, using the language of *Foster*, [*Foster v. Atl. Refining Co.*, 329 F.2d 485 (5th Cir. 1964), a predecessor to *Vela* and *Middleton* that reached a similar result] and *Vela*, rewriting the oil and gas lease royalty clause to achieve what it perceived to be a fair result, partially by adding the implied covenant to market to the express royalty clause language. In this case, a decision fair to the lessee and, notwithstanding the court’s protestations to the contrary, unfair to the lessor is the result.

Kramer, *supra* note 88, at 249. Professor Kramer later notes that “Louisiana, Arkansas, and Oklahoma are willing to bail out unfortunate lessees from making bad economic and contractual choices in their oil and gas leases.” *Id.* at 251.

89. See Lansdown, *Producer’s Perspective*, *supra* note 1, at 313-14.

or at least that does not fully describe his position. In fact, he is arguing that the court should cast off an incorrect contractual interpretation that nevertheless resulted in a substantial financial benefit for royalty owners at the expense of lessees and adopt different contractual interpretation that will, once again, deliver financially rewarding results for royalty owners at the expense of lessees.⁹⁰

Second, if one accepts Mr. McArthur's view that *Vela/Middleton* should be overturned, there is no necessity to resort to the implied marketing covenant at all. If the court had elected to overturn *Vela/Middleton* and to hold that market value could include the amount specified in long-term gas contracts, there would have been no need for the royalty owners to assert that the implied covenant to market should be applied to change a market value royalty obligation into a proceeds obligation.

The central point of *Producer's Perspective*, and of the holding in *Yzaguirre* and *Hankins*, was that the implied covenant to market should not be utilized as a mechanism to reshuffle the parties' clear and unambiguous rights.⁹¹ It is precisely that reshuffling through the implied covenant to market that Mr. McArthur (sort of) argued for in his second article, *A Minority of One? The Reasons to Reject the Texas Supreme Court's Recent Abandonment of the Duty to Market in Market-Value Leases*.⁹² This article begins with a restatement of Mr. McArthur's argument against *Vela/Middleton*,⁹³ and he then proceeds to discuss *Yzaguirre* as the case that began "Texas' abandonment of the duty to market in market-value cases."⁹⁴

90. Mr. McArthur's description of the Texas Supreme Court's actions in this area are deeply inconsistent. He scolds the court in *Middleton* for not having "sufficient candor to list the proportionate increase in the royalty owners' actual share of production when the royalty share was computed at the higher price that they ordered Exxon to pay" and notes that the fact that royalty owners were getting substantially more than one-eighth of the amounts received by the lessee "did not trouble judges so wedded to the soothing but misleading certainty of *Vela's* plain meaning analysis." McArthur, *A Minority of One*, *supra* note 15, at 282. Shortly thereafter, he pivots and accuses the court of rendering "Lessees in Texas . . . free to engage in self-dealing in market-value leases under the extraordinarily relaxed standard of business ethics enunciated by the Texas court." *Id.* at 284.

91. See Kramer, *supra* note 88, at 240 ("The extrinsic approach shows a lack of respect for the language of the parties and allows the royalty clause to be reformed to cover an unanticipated circumstance in order to achieve the Merrill goals of fairness and justice.").

92. McArthur, *A Minority of One*, *supra* note 15.

93. *Id.* at 272-285.

94. *Id.* at 285. Mr. McArthur contends that "Yzaguirre seemed a good case for the royalty owners because, in the past, [the lessee] had specifically affirmed that it would indeed share the benefits of its sales contract." *Id.* Certainly, if there had been binding representations by the lessee that might lead to a result contrary to the *Vela/Middleton* rule this might have been a basis for the court reaching such a result. Why such representations would form the basis for overturning, with regard to all cases, whether they involved such representations or not, a rule that was clearly and unambiguously adopted by the Texas Supreme Court, Mr. McArthur does not choose to explain.

Before discussing some of the individual points made in *A Minority of One*, it is important to note the reason for the “sort of” qualification in the preceding paragraph. As discussed above, the only way that the implied marketing covenant can be made to apply in a market value lease is if it is applied not to evaluate the actions of the lessee in marketing production, but to simply change the terms of the parties’ lease. It is thus extremely significant that Mr. McArthur stops short of arguing, in *A Minority of One*, that the implied marketing covenant should be applied to change the contractual terms argued to by the parties as such terms were interpreted in *Vela*, *Middleton*, *Yzaguirre*, and *Hankins*. Rather, he spends a great deal of time discussing how *Yzaguirre* and *Hankins* deprived royalty owners of protection without explaining how applying the implied marketing covenant would provide such protection. It is fair to infer that he believes that the implied marketing covenant should be applied to throw out the terms of the oil and gas lease, but it is quite relevant that he does not actually come out and say so.

At the beginning of his discussion of *Yzaguirre*, Mr. McArthur states:

In what should be an intensely factual matter, the court’s announcement that the lease’s market value price terms provides an objective measure of value was not coupled with any evidence. With a few strokes of the computer key, the court wiped away protection that Texas royalty owners had enjoyed for decades, a protection still enjoyed by royalty owners in all other major producing states.⁹⁵

Initially, it should be noted that, although Mr. McArthur states that the court was faced with “an intensely factual matter,” he does not explain what the factual inquiry was supposed to be.⁹⁶ Similarly, he does not explain what sort of evidence the court was supposed to review. Of course the actual determination of market value may be an intensely factual matter, but the determination of whether royalty is to be based on market value or the amount received is a legal question having no factual element whatsoever. It is also worth noting that Mr. McArthur’s reference to the wiping away of protections enjoyed by Texas royalty owners is not accompanied by citation to any cases in which the implied marketing covenant was utilized in Texas to afford royalty owners relief in a situation where royalty was based on market value. He later cites the opinion in a single case, *Cabot Corp. v. Brown*, which, as discussed below, is a confusing opinion that can probably be explained (to the extent that such explanation is necessary) by the limited, and probably disappearing, *price controlled gas exception*. This hardly provides a reason to shed copious tears for Texas royalty owners.

^{95.} *Id.* at 286.

^{96.} *Id.*

The author does acknowledge that the court in *Yzaguirre* may have overstated its case a bit when it stated that the implied marketing covenant is *never* applicable in cases where royalty is to be based on market value. One specific exception to this general rule described in Part III.A is the situation where gas is subject to price controls in jurisdictions where market value is dependent upon the controlled price. Additionally, it is very likely that where a lessee simply fails to make reasonably prudent efforts to market gas (that is, the lessee simply fails to produce and market gas in a situation where a market is available) a court would find that the implied marketing covenant was applicable.⁹⁷ This author suggests that the proper formulation of the applicable law is as he has already stated: the implied covenant to market does not provide relief to royalty owners, and indeed none of the implied covenants provide such relief in cases where the properly defined contractual interests of the royalty owner are not adversely affected by the actions of a lessee. It should be noted that the foregoing does not indicate that the covenants do not apply. The author would suggest that whether they apply or not is not really relevant, so long as courts properly address the question of whether that application affords royalty owners any relief.

A very useful analogy in this situation is provided by the application of the implied obligation to protect the lease against drainage. There is no question that this covenant is implied in every lease, in the absence of express language to the contrary.⁹⁸ However, in cases where (1) the drainage is occurring to a lease in which the royalty is owned by the same party that owns the royalty in the drained lease; and (2) the royalty fraction provided for in the draining lease is equal to or greater than the royalty fraction in the lease that is being drained, it is clear that the royalty owner has no relief under the implied covenant to protect against drainage, since the royalty owner has suffered no damage.⁹⁹ In other words, the covenant is implied, but since the actions of the lessee in that case do not have any adverse impact on the properly defined interests of the royalty owner, the royalty owner will not be allowed to recover. Similarly, in a situation where royalty is based on market value, the actions of the lessee in marketing production will generally not have any impact on the interest of the royalty owner. It is not particularly important whether one characterizes this situation as one in which the covenant is inapplicable or as one in which the covenant applies but does

97. Clearly in such a case, unlike in *Yzaguirre* and *Hankins*, the royalty owner's properly defined contractual interest is being damaged by the actions (or failure to act) of the lessee.

98. 5 WILLIAMS & MEYERS, *supra* note 21, at § 821 ("The implied covenant to protect the leasehold from drainage serves to protect the lessor from permanent loss of oil or gas due to migration of substances from the leasehold to neighboring land.").

99. *Id.* at § 822.5.

not afford the royalty owner a basis for recovery. If Mr. McArthur wishes to argue for the latter interpretation, this author will not dispute him.¹⁰⁰

In *A Minority of One*, Mr. McArthur argues that even after *Yzaguirre* there was some hope that the Texas judiciary might still use the implied covenant to market to protect against lessee abuses in the cases of self dealing.¹⁰¹ Interestingly, Mr. McArthur acknowledges that, “[i]f an objective market is truly to be the only guide, then the subjective evidence of what the lessee does with the particular output (and whether the lessee does it with an affiliate or not) should be irrelevant.”¹⁰² This is, of course, the result that the court reached in *Hankins*, with the result, according to Mr. McArthur, that “Texas lessors with market-value leases have lost their traditional protection against self-dealing.”¹⁰³ Despite Mr. McArthur’s shock at the failure of Texas courts to protect royalty owners against the “abuses” of self-dealing, he fails to explain why royalty owners need such protection in cases where their royalty is to be based on market value. Indeed, Mr. McArthur’s horror at the holding in *Hankins* is even more difficult to understand than his consternation at *Yzaguirre*: while it is certainly the case that *Yzaguirre* clearly foreclosed recovery by royalty owners under some circumstances (albeit as a result of the proper application of existing rules of contractual interpretation), the same cannot be said of *Hankins*. In *Hankins* the royalty owners argued that the prices received by the lessee from its marketing affiliates were artificially low and were also reduced by improperly charged marketing fees. In other words, the *Hankins* royalty owners were arguing that the price received by the lessee from its affiliate did not represent market value. What precludes them from making this argument and contending that the amount received by the marketing affiliate constituted market value, or that market value was even higher than that? If Mr. McArthur is aware of what factors precluded the royalty owners from advancing this case, he does not share them with his readers.

It is Mr. McArthur’s contention that both *Yzaguirre* and *Hankins* are examples of “conservative judicial activism” that “limit social control of corporate activity by reducing business disputes to purely contractual

100. Another way of illustrating this view of the issue is to hypothetically grant Mr. McArthur his wish and assume that the covenant to act prudently in marketing production is implied even where a lease provides for royalty based on market value. What is the result? The lessee may be obligated to attempt to obtain a particular price, but its failure to do so does not give the royalty owner any cause of action, since royalty will be paid based on market value. The only way that the covenant can be applied to benefit the royalty owner is if it is applied not to evaluate the conduct of the lessee, but rather to simply rewrite the terms of the lease to give the royalty owner a better bargain than is yielded by contractual interpretation.

101. McArthur, *A Minority of One*, *supra* note 15, at 287.

102. *Id.*

103. *Id.* at 288.

terms, with the contract given only a narrow, liability-limiting reading.”¹⁰⁴ It is worth setting out Mr. McArthur’s explanation of the importance (in his view) of these extra-contractual rules:

Extra-contract[ual] rules, most of which lie in the body of tort law, generally stand for society’s imposition of broad regulatory standards that set boundaries upon the private exchanges negotiated by the parties. From fiduciary obligations needed to protect dependent parties to negligence tests that penalize careless behavior, from the implied covenants that add extra duties to effectuate leases to statutory tort responsibility in such areas as employment, environment, and corporate disclosure, such rules enforce the limits that the larger society has deemed necessary to restrain the excesses of unregulated competition.¹⁰⁵

It is unclear what Mr. McArthur means by his reference to the implied covenants adding extra duties to “effectuate leases.” If he is suggesting that the implied covenants are imposed to effectuate the intent of the parties to leases, the author would not quarrel with him. On the other hand, as discussed in Part II, it is not the proper role of the implied covenants to act as a sort of lessor’s version of consumer protection legislation and rewrite an agreement entered into freely by the parties. Probably nothing illustrates this more clearly than the fact that it is universally recognized that any implied covenant will be overridden by the express terms of the lease.¹⁰⁶ If the implied covenants were intended, as Mr. McArthur contends, to impose “boundaries upon the private exchanges negotiated by the parties,”¹⁰⁷ it would make no sense to have these boundaries ignored so long as the express language of the lease was sufficiently specific.

Further, Mr. McArthur’s high-minded language with regard to “[pro-] conservative judicial activism [seeking] to strip away these societal rules [that protect royalty owners]”¹⁰⁸ has nothing to do with the application of *Vela/Middleton*. In fact, as Mr. McArthur not only admits, but actively asserts, *Vela/Middleton* gave royalty owners a windfall by holding that the price derived under a long-term contract for the sale of gas did not represent market value.¹⁰⁹ It is interesting to note Mr. McArthur’s opposition to this type of narrow contractual reading, since *Vela/Middleton* represented a windfall for the royalty owners at the

104. McArthur, *A Minority of One*, *supra* note 15, at 289.

105. *Id.*

106. See 5 WILLIAMS & MEYERS, *supra* note 21, at § 812.

107. McArthur, *A Minority of One*, *supra* note 15, at 289.

108. *Id.*

109. *Id.*

expense of the oil and gas companies—precisely the opposite result from what he claims is yielded by “conservative judicial activism.”

It is probably fair to say that *Vela/Middleton* and *Yzaguirre/Hankins* reflect a general approach to contractual interpretation that tends to favor a literal reading of contracts.¹¹⁰ Whatever may be the advantages and disadvantages of this approach, the absurdity of the notion that it is a mechanism for depriving individuals of protections against corporate power cannot be better illustrated than by the results in *Vela/Middleton*, which represented a blow to corporate interests if ever there was one.

Mr. McArthur goes on to claim that *Yzaguirre* and *Hankins* ignore substantial precedent with regard to the implied marketing covenant. The fundamental problem with his argument is that he does not cite a single case in which a court held that the implied marketing covenant should be applied to change a market value royalty obligation to a proceeds obligation. The fact that courts may, at times, indicate that the covenant to market should be implied in all oil and gas leases is hardly strong support for the proposition that it should be implied to overturn the clear and unambiguous terms of the lease. Indeed, as noted previously, the author has no quarrel with the concept that the implied marketing covenant should be implied in all leases. The point is that its proper application has no effect in most cases where royalty is to be based on market value and specifically has no effect in the situations presented in *Yzaguirre* and *Hankins*.

The case that Mr. McArthur relies most heavily upon is the Texas Supreme Court case of *Cabot Corp. v. Brown*.¹¹¹ As Mr. McArthur notes, the royalty clause involved in *Cabot Corp.* provided for the payment of royalty based on market value and, in that case, the court upheld the application of the implied covenant to market.

The facts in *Cabot Corp.* were complex. The case involved a contract under which gas produced from the royalty owner’s premises was transported to an interstate gas transmission system where it was exchanged for gas that was used by the lessee at its gas plants. (The reason for the exchange does not appear to be clear.) The court relied on division orders, executed by the royalty owner, which provided that royalty be paid on the price determined by the Federal Power Commission (“FPC”) if the royalty owner’s gas was subject to the FPC’s jurisdiction.¹¹² Frankly, the court’s opinion is confusing (and the author might go so far as to say incoherent). For instance, in answer to the

110. Mr. McArthur characterizes this approach as “narrow” and “literalist.” *Id.* at 278. See also Kramer, *supra* note 88, at 251 (“The Texas Supreme Court has been, over the years, a primary adherent to the parsing approach to contract and deed interpretation issues.”).

111. 754 S.W.2d 104 (Tex. 1987).

112. *Id.* at 105.

royalty owner's argument that its gas was not subject to the FPC's jurisdiction, the court held that it was "unnecessary for us to confront the legal question involving dedication to interstate commerce."¹¹³ Since the plain language of the division order certainly appeared to make the applicability of the division order dependent upon such dedication, it is difficult to understand the court's reasoning.¹¹⁴ In any event, since the court held that royalties were to be governed by the terms of the division order, its statement with regard to the implied marketing covenant is, as the *Yzaguirre* court held, clearly dicta.¹¹⁵

The more significant problem with the reference to the implied marketing covenant in *Cabot Corp.* is that the court does not explain why a lessee would have an obligation to obtain the best price possible where royalty is to be based on market value. One possible explanation is that the court was referring to the royalty owner's argument that the lessee had an implied obligation to obtain an abandonment of the gas in question from FPC jurisdiction—i.e., that it was obligated to take actions that would have increased the price that the lessee could have received for the gas.¹¹⁶ This is the specific exception that is addressed in Part III.B. Again, this does not affect the basic rule that where royalty is to be based on market value and the lessee's actions cannot affect the market value of production, the implied covenant to market does not apply.

Another possible explanation for the dicta regarding the implied marketing covenant in *Cabot Corp.* is the court's citation of the late

113. *Id.* at 106.

114. The royalty owner also argued that, even if the gas was subject to regulation by the FPC, the lessee had a duty as a reasonably prudent operator to seek abandonment of the gas's dedication to interstate commerce and thus to such regulation. *Id.* The court held that: "Although we recognize in certain circumstances the lessee has a duty to seek favorable administrative action, we do not reach that issue here." *Id.* at 107 (citations omitted). Again, it is difficult to see why the court did not need to reach that issue. While, as the author has noted, there are many issues involved in the application of the implied marketing covenant in that circumstance (*see supra* Part III.A), it is the author's opinion that the mere fact that a lessee's obligations are governed by a division order does not eliminate the application of the covenant.

115. *See* discussion of *Yzaguirre*, *supra* notes 61-63 and accompanying text. Professor Owen Anderson contends that the statement regarding royalty in *Cabot Corp.* should not be considered dicta because:

In *Cabot*, the court held that the lessee had breached the implied covenant to market gas at the best price under a market-value lease; however, an action on the breach was barred until the lessor revoked their division order, which provided that the lessors would accept royalties based upon the proceeds that the lessee had received.

A Royalty Odyssey, *supra* note 58, at 4-8. With the greatest respect to Professor Anderson, the author does not believe that the court made such a finding; in fact, as noted, the court expressly held that it did not need to reach the question.

116. 754 S.W.2d at 106-7 ("[The royalty owner] introduced expert testimony that a reasonably prudent operator would have sought an abandonment and that abandonment would have been granted by the FPC. She claimed abandonment of jurisdiction by the FPC would have freed the gas from the exchange agreement and made it available for marketing at intrastate prices.").

Professor Richard Hemingway's well known treatise on oil and gas law.¹¹⁷ The court presumably relied on the following statement of the treatise: "The lessee . . . has an obligation to obtain the best price reasonably possible. Under a gas royalty clause providing for payment of part of the "market price or market value" this would be the best current market price reasonably available."¹¹⁸ The problem with this statement is that it confuses the payment of royalty based on proceeds with payment based on market value. It is clear that Professor Hemingway believed that the obligation of the lessee is to obtain "the best current market price reasonably available" and pay royalty based on that price.¹¹⁹ Of course, the lessee's obligation under a market value royalty clause is to pay royalty based on market value regardless of the price that the lessee receives.¹²⁰

Another case cited by Mr. McArthur that clearly addressed the application of the implied marketing covenant in a situation where royalty is based on market value is *Smith v. Amoco Production Co.*¹²¹ However, as discussed in Part III.A, *Smith* clearly involved gas that was subject to regulation, and allegations that the lessee should have sought a classification of the gas for pricing purposes that was favorable to the royalty owners, which again falls under an exception, the significance of which is limited, and likely disappearing.¹²²

117. *Id.* at 106 (citing RICHARD W. HEMINGWAY, THE LAW OF OIL AND GAS, § 8.9(C) (2d ed. 1983)).

118. HEMINGWAY, THE LAW OF OIL AND GAS § 8.9(C).

119. *Id.*

120. In an earlier section of the treatise Professor Hemingway engages in a discussion of the concepts of both market price and market value:

Generally, value is established by opinion evidence concerned with comparable sales and intrinsic uses of the product or like products. However, it appears that where actual sales of gas or petroleum products exist in the field, the cases treat market value the same as market price, and generally indicate that an actual market in the field will be practically conclusive evidence of value.

Id. at § 7.4(C). It is possible that Professor Hemingway believed that, since market value could be determined based on sales in the field, the lessee's actions in marketing production could affect that market value, and therefore the implied marketing covenant should be applied to require the lessee to maximize that value. As indicated in Part III.A., this concept is without merit in today's gas market.

121. 31 P.3d 255 (Kan 2001), cited in McArthur, *A Minority of One*, *supra* note 15, at 292.

122. See discussion of *Smith*, *supra* note 51 and accompanying text. Mr. McArthur also cites *Rogers v. Westerman Farm Co.*, 29 P.3d 887 (Colo. 2001), discussed *supra* in note 140 and accompanying text and cited in *A Minority of One*, *supra* note 15, at 293. The severe problems with that opinion were discussed in Lansdown, *The Marketable Condition Rule*, *supra* note 11, at 691-96. The author would only add that perhaps the best demonstration of the disastrous nature of that opinion is provided by the fact that Professor Owen Anderson, one of the primary sources cited in the opinion itself, has been extremely critical of the decision. See *A Royalty Oddesey*, *supra* note 56, at 4-1, 4-12, 4-15 ("The *Rogers* opinion is an unnecessarily long stream-of-consciousness discussion of royalty and the implied covenant to market In the end, the court in *Rogers* takes the implied covenant to market on an odyssey to a new and distant galaxy.")

Mr. McArthur also cites various oil and gas treatises, claiming that they support his view that the implied covenant to market should be applied in situations where royalty is based on market value.¹²³ However, with one exception, the sources he cites simply contain general statements about the applicability of the implied marketing covenant, the irrelevance of which has already been addressed. The exception is his discussion of what is probably the most respected oil and gas law treatise—OIL AND GAS LAW by Williams & Meyers (currently edited by Bruce Kramer and Pat Martin). After indicating that the treatise contains general statements as to the applicability of the marketing covenant, Mr. McArthur states: “The treatise now has a short section that post-*Yzaguirre* Texas varies the duty based upon the pricing clause, but the conspicuous lack of other case authority itself highlights *Yzaguirre*’s aberrant nature.”¹²⁴ In fact the treatise states:

In a situation in which the parties have an express royalty clause providing for a market value calculation, can the implied covenant to market, including the duty to obtain the highest price obtainable, effectively convert the market value royalty clause into an amount realized clause? In *Yzaguirre v. KCS Resources, Inc.*, the Texas Supreme Court rejected the application of the implied covenant to market as urged by royalty owners in a situation in which the lessee was receiving a contract price for natural gas that was much higher than the market value. The court concluded that to apply the implied marketing covenant would change the express terms of the royalty clause calling for a market value based royalty.¹²⁵

The treatise then concludes its discussion with a quotation from *Yzaguirre*. There is nothing to suggest that *Yzaguirre* is in any way an aberration (and of course it is not an aberration on the question of whether a royalty owner under a market value royalty clause may recover where the contract price exceeds market value, since no other case has addressed the issue). Nothing in the treatise even vaguely suggests that the decision is incorrect.

Since Mr. McArthur relies on the Williams & Meyers treatise, mention should also be made of its discussion of the duty to market gas where the royalty clause provides for the payment of a fixed amount, rather than a fraction of the market value or proceeds of production. The treatise states:

In the case of leases reserving a fixed, annual sum as royalty on producing gas wells, damages for breach of the marketing covenant

123. McArthur, *A Minority of One*, *supra* note 15, at 297-99.

124. *Id.* at 298.

125. 5 WILLIAMS & MEYERS, *supra* note 21, § 853, at 394.4-5.

will be limited to the amount of money specified by the royalty clause. If the specified sum is tendered by the lessee and accepted by the lessor, an action for breach of the marketing covenant cannot be maintained even though the lessee has made no effort to market the gas, *since the failure to market has caused the lessor no damage*.¹²⁶

This is precisely analogous to the situation where royalty is to be based on market value. As long as the actions of the lessee cannot affect the amount of money that the royalty owner is paid, there is no action for a breach of the implied covenant to market. It is, the author believes, entirely safe to infer that the authors of the treatise would reach exactly the same conclusion if the lessee in the above situation had engaged in the inter-affiliate transactions that Mr. McArthur so vehemently opposes. Again, regardless of whether the implied marketing covenant applies, since the actions of the lessee do not affect the amount paid to the royalty owner under a proper contractual interpretation of the lessee's obligations, there is no action for violation of the covenant because the royalty owner has not been damaged.

As already noted, in *A Minority of One* Mr. McArthur never actually comes out and states that the implied marketing covenant should be utilized to require a lessee under a market value royalty clause to pay royalty based on proceeds when those proceeds exceed market value. He does, however, engage in a discussion about the nature of market value and proceeds that presumably is intended to suggest that result or something like it. He does this primarily by attempting to re-argue *Vela/Middleton* and begins by stating:

Yzaguirre and *Hankins* were driven, as was *Vela*, by the factual belief that market value and proceeds are two entirely unrelated quantities The price categories are actually much more linked. The history of the lease provisions indicates that the difference between them did not originate to connote differences in price, but to tell whether deductions could be taken if any difference was intended at all.¹²⁷

This is not, however, an argument for the application of the implied marketing covenant. Rather it is an attempt to reargue *Vela/Middleton*; Mr. McArthur's argument is precisely the argument with regard to contractual interpretation that was made by the royalty owners in *Yzaguirre* and properly rejected by the court as inconsistent with the clear rule of contractual interpretation that *Vela/Middleton* established.¹²⁸ Mr. McArthur goes on to state:

126. *Id.*, at 394.2 (emphasis added).
127. McArthur, *A Minority of One*, *supra* note 15, at 300. See also *A Royalty Odyssey*, *supra* note 56, at 4-5, n.14.
128. See discussion of *Yzaguirre*, *supra* notes 56-58 and accompanying text.

Market-value and proceeds leases are intimately related in a manner that ensures that the primary evidence in either kind of case should be the same. In a market-value case, the first and often best evidence of the available market is the amount that the lessee, using diligence, actually secured for the production. Included in the value determination should be the decision of whether to sell in the spot market or for the long term.¹²⁹

This article does not argue with the concept that the amount received by the lessee in a *current* arms-length sale of production is evidence of market value. The entire point of the holdings in *Vela*, *Middleton*, *Yzaguirre*, and *Hankins*, however, is that where a lessee binds production to a long term contract at a fixed price (or, in any event, a price that does not reflect the current market), the amount received by the lessee does not represent market value. Again, Mr. McArthur is simply attempting to reargue *Vela/Middleton*.¹³⁰

A *Minority of One* concludes with an extended argument that *Yzaguirre* and *Hankins* are “wreaking havoc” in the area of class action litigation in Texas.¹³¹ The issue of class certification was discussed in Part III.B.3. The author, being but a humble oil and gas attorney, does not purport to any degree of expertise in issues related to class action, but would refer to Professor David Pierce’s statement that one of the reasons counsel for royalty owners seek to invoke the implied covenant to market “is that it provides them with a theory that directs the courts attention away from individual contract rights towards generic concepts of what might be ‘more fair’ if the parties were starting anew—unburdened by

129. McArthur, *A Minority of One*, *supra* note 15, at 301.

130. A couple of points regarding Mr. McArthur’s analysis are also worth noting. First, he states:

Some of the factors cited by *Hankins*—for instance quantity and available outlets—can vary with the lessee. Lessors contract with lessees precisely to gain their expertise and resources One unprecedented change wrought by *Yzaguirre* and *Hankins*, a change implicit in *Vela*, is that Texas lessors may no longer benefit from the skill of their lessees.

Id. at 302. In the author’s experience of more than 25 years working with oil and gas issues in Texas, most oil and gas leases allow for free assignability, and it is the rare exception rather than the rule to find a lease that has been held by a single party for its lifetime. It is thus clear that most lessors do not, in fact, enter into oil and gas leases in order to receive the benefits of the expertise of a particular lessee. Second, Mr. McArthur refers to the “implied covenant’s ban on self dealing.” *Id.* However, he cites no support for the existence of such a ban; in fact, as noted in *Producer’s Perspective*, even in cases where royalty is based on proceeds, while it is likely that a court will subject the lessees’ actions to particularly careful scrutiny, such scrutiny does not constitute a ban on self dealing. Indeed, in the two cases where courts appeared to adopt a “stricter standard” for cases involving self-dealing, the courts, after subjecting the transactions before them to heightened scrutiny, found that the actions of the lessees did not violate the implied marketing covenant. Lansdown, *Producer’s Perspective*, *supra* note 1, at 310.

131. McArthur, *A Minority of One*, *supra* note 15, at 306-24.

things like existing contract language.”¹³² The author’s consistent position throughout *Producer’s Perspective*, *The Marketable Condition Rule*, and this article has been that courts should continue to be burdened by “things like existing contract language” and should tread very carefully before rewriting contracts in the interest of what they perceive as fair. It appears safe to say that this is not a proposition with which Mr. McArthur would agree.

2. The Observations of Professor Anderson

Professor Owen Anderson does not demonstrate the same alarm as Mr. McArthur over *Yzaguirre*, which he refers to as *Alev* (i.e. “reverse *Vela*”) on the grounds that it is shorter and “easier to pronounce than *Yzaguirre*.”¹³³ In fact, he describes it as a case that, “although unconvincing, seems to reach the right Texas result.”¹³⁴ However, he contends:

One problem with *Alev* is that the court simply assumes that market value is truly “objective.” In reality, market value may be determined on a number of bases, including expert testimony. Moreover, *Vela* determined market value on the basis of prevailing *contract* prices at the time of production for the period in dispute, as there was no spot market for gas in 1968. Query whether market value should be determined on the basis of how gas is typically sold by reasonable and prudent operators for the time period in question, which would seem to be consistent with *Vela*? This “back-door” route to some type of implied market-value covenant, however, seems to have been closed by *Alev*.¹³⁵

132. Pierce, *The Renaissance of Law*, *supra* note 16, at 913, n.12. Professor Pierce goes on to observe that:

This is critical for the new breed of entrepreneurial counsel seeking their next class action investment opportunity. Because there are often significant substantive differences among oil and gas contracts, the implied covenant theory is often employed to try to homogenize the contracts into one obligation and to try and satisfy the requirements for class action treatment. This process of contract homogenization typically results in the taking away of contract rights from some and conferring new rights on others. This appears to be one area where the procedural expediency of the class action is achieved only by altering the substantive rights of the parties subject to the class action.

Id.

133. *A Royalty Odyssey*, *supra* note 56, at 4-5.

134. *Id.* at 4-5.

135. *Id.* at 4-7. Professor Anderson notes that “the argument that lessees may owe some duty to pay royalty on the highest ‘market value’ has received some support in *Union Pacific Resource Group v. Hankins*.” *Id.* at 4-7 to 4-8. However, he was citing to the Court of Appeals decision, which, as discussed in Part III.B.3, was overruled by the Texas Supreme Court. Professor Pierce also suggests that Kansas rejected *Yzaguirre* in *Smith v. Amoco Production Co.*, but notes that “[d]ue to the class action nature of *Smith*, it is possible that the court overstated Kansas law on the scope of the implied covenant to market and may choose to follow *Yzaguirre* in future cases.” Pierce, *The Renaissance of Law*, *supra* note 16, at 914. The author does not

Initially, it should be noted that some of the disagreement between Professor Anderson and the author may result from their respective use of the term *objective*. As noted in Part III.A, the author does not suggest that because market value is objective, it is necessarily easy to determine, or even that it is necessarily a single number. Rather, the term refers to the fact that market value must be ascertained independently of an evaluation of the efforts of the lessee. As the court stated in *Middleton*, “Market value is defined as the price property would bring when it is offered for sale by one who desires, but is not obligated to sell, and is bought by one who is under no necessity of buying it.”¹³⁶ This is a determination that is made by examining the relevant market data, not by considering whether the efforts of the lessee were consistent with the reasonably prudent operator standard.

Professor Anderson’s suggested back-door route to the application of the implied covenant to market appears to be founded on the concept that market value should be based on gas that is sold by reasonable and prudent operators, which should, in turn, result in each lessee having an obligation to seek the best price so as to maximize that market value. There are a couple of problems with this approach. First, the implied covenant is imposed on the lessee, not on whatever group of marketers of production is utilized in determining market value. Second, as a practical matter, the author is not aware of experts on market value suggesting that the diligence of producers is a factor in evaluating transactions to come up with a market value.

In a later section of the article, Professor Anderson explains that:

. . . under the Texas construction of market-value/market price royalty clauses . . . the lessee should have an implied duty to use the best objective market value when calculating the royalty payable. If this duty exists, however, and that is questionable after *Yzaguirre*, it seems to be a different duty from the duty a lessee owes under “proceeds/amount-realized” royalty clauses, which is to sell the gas for the best price obtainable.¹³⁷

The author fully agrees with this statement with the exception of the suggestion that the duty is “questionable after *Yzaguirre*.” In fact the author absolutely acknowledges that, where royalty is to be based on market value, the lessee is obligated to adopt a mechanism that accurately reflects market value, and rejects any suggestion that this obligation was changed by *Yzaguirre*. The point is that the obligation of

necessarily agree, however, that *Smith* rejected *Yzaguirre*; as noted in Part III.A, *Smith* involved gas that was subject to price regulation and was thus probably subject to the exception discussed therein.

136. *Exxon Corp. v. Middleton*, 613 S.W.2d 240, 246 (Tex. 1981).

137. *A Royalty Odyssey*, *supra* note 56, at 4-34.

the lessee is to comply with the terms of its oil and gas lease, which require the accurate determination of market value, in the same sense that, under a lease that provides for the payment of a 3/16 royalty, the lessee is obligated to use that fraction and not pay the royalty owner based on a 1/8 royalty. This is not a duty that is imposed by the implied covenant to market, and it is not a duty where performance is measured by the diligence exercised by the lessee. Rather, the question is whether the lessee has adopted a mechanism that accurately reflects market value (preferably using the two part test proposed by the author).¹³⁸

IV. OTHER ISSUES

Of the three issues related to the application of the implied covenant to market that were discussed in *Producer's Perspective*, the application of the reverse *Vela/Middleton* rule has received the most attention from both courts and commentators. Some mention should be made, however, of the two other issues discussed, the deduction of post-production costs and the obligation to pay royalty on settlements under take-or-pay clauses in gas sales contracts.

A. *The Deduction of Post-Production Costs*

The issue of the deductibility of post-production costs is addressed in *The Marketable Condition Rule*.¹³⁹ That article detailed developments in the law regarding the deductibility of post-production costs subsequent to *Producer's Perspective*, in particular, the unfortunate decision in *Rogers v. Westerman Farm Co.*¹⁴⁰ It is worth noting that at least one court found the decision in *Westerman Farm* wanting. *Bailey v. Shell Western E & P, Inc.* involved a claim by the owners of an overriding royalty interest in leases in Colorado that produced carbon dioxide that was transported to Texas and used in enhanced oil recovery.¹⁴¹ The royalty owners alleged that the lessees had improperly deducted post-production costs in determining royalty. The court rejected the claim on various grounds. The plaintiffs cited *Westerman Farm* for the proposition that “Colorado law prohibits charges from the value of the royalty-interest oil before its being in a commercial marketplace and in marketable condition.”¹⁴² Citing *The Marketable Condition Rule*, the court noted, “In one confusing and probably wrong case, the court determined that the leases before it

138. See *supra* Part III.A.

139. Lansdown, *The Marketable Condition Rule*, *supra* note 11.

140. 29 P.3d 887 (Colo. 2001).

141. 555 F.Supp.2d 767 (S.D. Tex. 2008).

142. *Id.* at 773.

required that the operator not deduct the costs of post-production treatment—because the leases did not expressly allocate them.”¹⁴³

In *Wellman v. Energy Resources, Inc.*, the Supreme Court of West Virginia rejected the deductibility of post-production costs in the case before it.¹⁴⁴ The court noted that:

The rationale for holding that a lessee may not charge a lessor for “post production” expenses appears to be most often predicated on the idea that the lessee not only has a right under an oil and gas lease to produce oil or gas, but he also has a duty, either express, or under an implied covenant, to market the oil or gas produced. The rationale proceeds to hold the duty to market embraces the responsibility to get the oil or gas in marketable condition and actually transport it to market.¹⁴⁵

This is the mistake that underlies the application of the marketable condition rule. The issue is not whether a lessee has an implied obligation to market the oil and gas that it produces; clearly such an obligation will generally be imposed in the absence of language to the contrary in the applicable lease. The existence of such a duty does not, however, have anything to do with the allocation of the costs that are incurred in such marketing.¹⁴⁶ Interestingly, the court in *Wellman* did acknowledge that the costs of marketing could be charged to the lessor if the lease specifically provided for this.¹⁴⁷ The court also stated that the language indicating that royalty was to be based on proceeds from the sale of gas at the mouth of the well might indicate that the parties intended that the lessor might be required to bear some of the costs of transporting gas from the well to the point of sale.¹⁴⁸ The court concluded, however, that the issue was moot because the lessee had not introduced any evidence to show that the costs were actually incurred or that they were reasonable.¹⁴⁹ Thus, the court left open the possibility that marketing costs might be deductible if properly proved by the lessee. However, in *Tawney v. Columbia Natural Resources, L.L.C.*, the court rejected the argument that an at the wellhead type provision allowed for the deduction of post-production costs.¹⁵⁰ Basically, the court held that the language was ambiguous, noting that it did not “indicate *how* or *by what method* the royalty is to be

143. *Id.*

144. 557 S.E.2d 254 (W. Va. 2001).

145. *Id.* at 264.

146. See Lansdown, *The Marketable Condition Rule*, *supra* note 11, at 694-95. See also Lansdown, *Producer's Perspective*, *supra* note 1, at 335-38.

147. 557 S.E.2d at 264.

148. *Id.* at 265.

149. *Id.* at 265. A provision that royalty is to be determined *at the well* clearly indicates that post-production costs should be deductible. *Id.*

150. 633 S.E.2d 22 (W. Va. 2006).

calculated or the gas is to be valued.”¹⁵¹ Like the court in *Westerman Farm*, the court in *Tawney* simply ignored a long line of precedent clearly holding what *at the well* means.¹⁵²

B. Sharing in Take-or-Pay Settlements

The remaining issue that was addressed in *Producer's Perspective* was the question of whether the implied covenant to market obligated a lessee to pay royalty on gas contract settlements.¹⁵³ Since *Producer's Perspective*, one case has addressed this question, *SEECO, Inc. v. Hales*.¹⁵⁴ In *SEECO* the court held that the lessee was obligated to pay royalty on such settlements, but did so on the grounds of an Arkansas statute, rather than on the implied covenant to market.¹⁵⁵ It should be noted that, since clauses imposing take-or-pay obligations are generally not included in today's gas sales contracts, it is unlikely that this issue will arise in the future unless there is a major change in the gas market.

V. CONCLUSION

As illustrated by the foregoing discussion, a number of things have happened since the publication of *Producer's Perspective*. The author's position with regard to the *Vela/Middleton* issue has been vindicated by courts in Texas, which has resulted in a strong reaction from at least one commentator. On the other hand, courts outside of Texas have continued to reach results contrary to the position taken in *Producer's Perspective* with regard to the application of the implied marketing covenant to the deduction of post-production costs, the most prominent example being the *Westerman Farm* case. The author hopes his views on that case were

151. *Id.* at 28.

152. See Lansdown, *The Marketable Condition Rule*, *supra* note 11, at 691-92. The *Tawney* court dismissed its prior suggestion in *Wellman* that the term *at the well* might allow for the deduction of post-production costs as dicta, noting that the court "simply did not decide in *Wellman* whether 'at the wellhead'-type language is or is not ambiguous." 633 S.E.2d at 29.

153. Lansdown, *Producer's Perspective*, *supra* note 1, at 338-46.

154. 22 S.W.3d 157 (Ark. 2000).

155. 22 S.W.3d at 181. The statute in question provides that:

It shall be the duty of both the lessee, or his assignee, and any pipeline company, corporation, or individual contracting for the purchase of oil or gas under any oil, gas, or mineral lease to protect the royalty of the lessor's interest by paying to the lessor or his assignees the same price, *including premiums, steaming charges, and bonuses of whatsoever name* for royalty oil or gas that is paid the operator or lessee under the lease for the working interest thereunder.

ARK. CODE ANN. § 15-74-705 (1994). The *SEECO* court referred to *Klein v. Arkoma Production Co.*, 73 F.3d 779 (8th Cir. 1996), and *Klein v. Jones*, 980 F.2d 521 (8th Cir. 1992), which upheld the obligation to pay royalties on such settlements, noting that the Eighth Circuit in those cases adopted the "Harrell Rule" under which "oil and gas leases are construed in a manner so that the lessee and lessor split all economic benefits arising from those leases." 22 S.W.3d at 181. Acknowledging that the lessees in the case before it might be correct that most jurisdictions reject the Harrell rule, the court noted that the lessees had not addressed the above quoted statute which "appears to decide this issue." *Id.* at 181.

adequately stated in *The Marketable Condition Rule*. Future developments with regard to the implied marketing covenant are hard to predict. However, the author's position is, and will continue to be, as stated in *Producer's Perspective*:

Because the "anything goes" application of the implied covenants is not based on any particular legal criteria or reasoning, adopting such an approach is likely to lead to extended litigation, as well as uncertainty concerning the lessee's obligations. Such uncertainty can only discourage oil and gas operations to the detriment of the general public.¹⁵⁶

156. Lansdown, *Producer's Perspective*, *supra* note 1, at 358.