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When Express Clauses Bar Implied Covenants, Especially in Natural Gas Marketing Scenarios

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I. INTRODUCTION

"We are told that [implied] Contract [law], like God, is dead," to paraphrase Grant Gilmore.[1] At least, so it might appear in Texas oil and gas law. Lessors face such difficult burdens of proof under the implied covenant to reasonably develop that their only recourse is to protect themselves with express provisions governing this duty.[2] The implied covenant to protect against drainage may often be gutted by the lessee's routine insertion of an express offset clause that weakens the lessor's protection while slyly suggesting that the lessee has promised the lessor a benefit.[3] Many eulogies to the implied covenant to market have been sung in leases where royalties are based on market value rather than proceeds.[4] And lessors, we are told, must use self-help or other bodies of law, such as agency/principal rules, to rescue their in-kind oil royalties from lessees who generally owe them no implied marketing duties whatsoever.[5]

Are these reports of the death of implied covenant law as exaggerated as Mark Twain's death once was? More importantly, is implied covenant law dying an honorable death, having served the industry well for many decades, but no longer needed in the new century, especially in gas marketing? Its death or terminal illness is then cause for celebration rather than mourning.

This Article seeks to answer both questions about implied covenant law in Texas, particularly as related to a lessee's gas marketing duties. Part

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1. GRANT GILMORE, THE DEATH OF CONTRACT 1 (1995).

2. ERNEST E. SMITH & JACQUELINE LANG WEAVER, 1 TEXAS LAW OF OIL AND GAS § 5.2(B), at 255-0 (1996).

The recent invention of 3-D seismic technology may allow lessors to better arm themselves with proof of lessees' failure to drill profitable wells, thus reinvigorating the implied covenant to develop.

3. *See infra* text accompanying notes 54 and 55.

4. *See infra* sources cited in note 128.

5. SMITH & WEAVER, *supra* note 2, § 5.4(B)(2), at 281 (discussing Cook v. Tompkins, 713 S.W.2d 417 (Tex. App. 1986, no writ)). Agency/principal rules may provide even stronger protection to lessors than implied covenant law, so lessors are not left powerless.

II examines the general framework adopted in Texas for determining whether a covenant should be implied in a particular conveyance and the specific lease provisions that lessees wield as swords to vanquish implied covenants in non-marketing contexts. Part III focuses on the implied covenant to market and those lease clauses and division orders which seemingly doom this covenant to extinction in Texas. The analysis in Part IV argues that the implied covenant to market should and will continue to play a strong role in balancing the interests of lessees and lessors in the marketing of natural gas. Part V concludes with a look to the future at the types of research and knowledge that oil and gas lawyers, both in practice and in academe, will need to evaluate implied covenant claims in the future.

II. WHEN EXPRESS CLAUSES BAR IMPLIED COVENANTS IN THE NON-MARKETING CONTEXT

A. The Nature of Implied Covenants-Three Models and a Synthesis

From the earliest days of the oil industry, implied covenants have played an integral role in defining the duties of a lessee under an oil and gas lease.[6] Yet the doctrinal origins of implied covenant law and its continuing vitality and validity in light of changing public policy are still a matter of some controversy.[7] In a previous article, I canvassed this debate and suggested that the following three models are used to resolve implied covenant disputes:[8]

> 1. The equity model. Covenants are implied in law, primarily to prevent unfairness to lessors. This model often presumes the superior bargaining power of lessees: that lessors are handed a standard printed lease form drafted by the lessee and are simply not able to protect their interests through negotiation. The actual language of the lease is often

6. *See* Brewster v. Lanyon Zinc Co., 140 F. 801 (8th Cir. 1905). At an early date, the Texas Supreme Court cited *Brewster* approvingly as the lodestar for implied covenant litigation in Texas. *See* Freeport Sulphur Co. v. American Sulphur Royalty Co., 6 S.W.2d 1039 (Tex. 1928).

7. *See* Jacqueline Lang Weaver, *Implied Covenants in Oil and Gas Law Under Federal Energy Price Regulation*, 34 VAND. L. REV. 1473, 1485–89 (1981).

8. *Id.* at 1485–94. Professor A.W. Walker, Jr. contended that implied covenants in oil and gas leases were implied in fact in Texas. *See* A.W. Walker, Jr., *The Nature of The Property Interests Created by an Oil and Gas Lease in Texas*, 11 TEX. L. REV. 399, 404 (1933). Professor Maurice Merrill argued that such covenants are implied in law. MAURICE H. MERRILL, COVENANTS IMPLIED IN OIL AND GAS LEASES § 220 (2d ed. 1940).

> considered as evidence of the parties' intentions, but this does not necessarily control the outcome.
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> 2. The contract model. Covenants are implied in fact based on the parties' reasonable expectations, given the nature and purpose of the specific contract and the circumstances under which it was made.
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> 3. The policy model. Public policy values (such as promoting a competitive, deregulated gas market) external to the parties' expectations or to judicial norms of equity are used to influence the outcome of the litigation. These policy values are most often found in legislated expressions of national or state priorities.

Each model can rightfully claim to be fair: the first because it explicitly considers equity; the second because fairness in private contract law is defined as that which most closely represents the parties' intentions; and the third because it measures fairness through norms expressed in the political process.

Professors Williams and Meyers have synthesized the debate between "in fact" and "in law" covenants by arguing that implied covenants reflect the broad principle of cooperation applicable to all contracts.[9] This principle requires that the parties to an agreement cooperate to carry out the purposes of the contract and is based upon both the reasonable expectations of the parties and ethical norms of conduct.[10] The cooperation principle derives from a long history of Anglo-American common law embodying the implication of duties of good faith and culminating in the adoption of the Uniform Commercial Code's obligation of good faith in every contract.

Adopting the principle of cooperation as the jurisprudential basis of implied covenant law avoids what Williams and Meyers consider the false dichotomy of "in fact" versus "in law" covenants. These authors write:

> If the principle of cooperation is accepted as the correct basis for implying covenants, then there is an element of both fact and law in the implication. The duty of cooperation requires the parties to conduct themselves in such a manner as to

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9. HOWARD R. WILLIAMS & CHARLES J. MEYERS, 5 OIL & GAS LAW § 802.1 (1996).

10. Williams and Meyers cite the well-known case of *Wood v. Lucy, Lady Duff-Gordon*, 118 N.E. 214 (N.Y. 1917), a fixture of most first-year contract casebooks, as illustrative of the principle of cooperation. In this case, the grantee of an exclusive selling agency was held to an implied promise to use best efforts to promote the sales of grantor's fashions because grantor's compensation depended on these sales. The analogy is clear to implied covenants in an oil and gas lease wherein lessor's royalty is dependent on lessee's diligence.

> promote the basic purposes of the contract. To this extent it is rooted in fact, because undoubtedly parties do enter into a contract with the expectation that conduct will be directed towards the end of accomplishing its purposes. Undoubtedly the principle of cooperation also represents an ethical norm; but an ethical norm can be a fact, and can be the predicate for reasonable expectations.
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> ....
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> It is our conclusion that implied covenants rest on the duty of cooperation, which is ultimately derived from the intention of the parties but that the application of an implied covenant to any particular dispute may properly be influenced by concepts of proper ethical conduct.[11]

Whichever model is adopted by the courts and commentators, there seems to be general agreement that implied covenants are necessary in oil and gas law to protect lessors from negligent and incompetent lessees, from lessees who speculate, and from lessees who self-deal. Often, the difference between the equity model and the contract model seems subsumed in the courts' use of a standard rule that contracts are to be construed against their drafters (that is, against lessees in an oil and gas lease transaction) when doubt exists about the parties' intentions.[12] Nonetheless, a court's choice of the contract model versus the equity model may have real consequences. The contract model may inhibit a court from finding an implied covenant outside of the printed words of the contract while the equity model may facilitate a search for such a covenant in order to promote fairness.[13]

In recent years, the classification debate has assumed a more serious dimension as the courts in oil and gas producing states have split in their approaches to interpreting the express royalty clause in an oil and gas lease. Professor Lowe has handily classified the competing approaches as the "plain terms" versus the "cooperative venture" jurisdictions.[14] The dichotomy between jurisdictions arose over the meaning of "market value" in the gas royalty clause of the typical lease. A majority of jurisdictions, including Texas, have held that "market value" is a "plain term" with a well-defined meaning: the price a willing buyer and seller would pay at the

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11. WILLIAMS & MEYERS, *supra* note 9, § 803, at 24.

12. *See* Bruce M. Kramer, *The Sisyphean Task of Interpreting Mineral Deeds and Leases: An Encyclopedia of Canons of Construction*, 24 TEX. TECH. L. REV. 1, 103–08 (1993).

13. WILLIAMS & MEYERS, *supra* note 9, § 803, at 20.

14. John S. Lowe, *Defining the Royalty Obligation*, 49 SMU L. REV. 223, 232–36 (1996).

time gas is produced.[15] Under the "plain term" rule, lessors with market value royalty clauses were able to reap royalties amounting to far more than the proceeds received by lessees from their long-term sales contracts with gas purchasers. For example, in *Texas Oil & Gas Corp. v. Vela*,[16] the lessee had negotiated a gas sales contract in 1933 which dedicated the gas to the pipeline purchaser at a sales price of 2.3 cents per MCF for the life of the lease. At that time, these contract terms were the best that a reasonably prudent operator could have obtained. By the 1960s, the price of similar gas in the same market area had risen to about 16 cents per MCF. Under the "plain terms" meaning of market value, the lessee owed one-eighth of the 16 cents, or almost the entire two cents received as proceeds, to the lessor as royalty.

In contrast, the "cooperative venture" jurisdictions treated market value as an ambiguous term and interpreted it in light of the practical realities and customs of the industry. In these states, market value was defined as the contract price received by the lessee, as long as this price reflected the best terms that a reasonably prudent operator could have obtained at the time of contracting with the gas purchaser. Thus, market value royalties were equated to proceeds royalties. The cooperative venture jurisdictions expressly used fairness to producers as a rationale for interpreting the lease in this manner.[17] In addition, these courts recognized the "necessity of the market" which required that gas producers negotiate sales contracts to meet their implied marketing duty to lessors at a time when long-term sales contracts were virtually the only method of marketing.[18] These jurisdictions often outwardly acknowledged the cooperative nature of the oil and gas lease as a relational contract in which

15. The leading Texas case is *Texas Oil & Gas Corp. v. Vela*, 429 S.W.2d 866 (Tex. 1968):

> [The parties to the lease] might have agreed that the royalty on gas produced from a gas well would be a fractional part of the amount realized by the lessee from its sale. Instead of doing so, however, they stipulated in plain terms that the lessee would pay one-eighth of the market price at the well of all gas sold or used off the premises. This clearly means the prevailing market price at the time of the sale or use.

Id. at 871.

16. *Id.* at 866.

17. *See, e.g.*, Tara Petroleum Corp. v. Hughey, 630 P.2d 1269, 1273 (Okla. 1981) (lessors not entitled to have royalty calculated on the highest current price in the field because "[t]his would not be fair to the producers").

18. *Id.* The court also noted that the Federal Power Commission had outlawed the use of "most favored nations" clauses which producers had inserted into their contracts with pipeline purchasers so that their gas sales prices would rise as the purchaser offered higher prices in newer contracts to other producers.

implied covenants play a pivotal role in contract interpretation, as espoused by Williams and Meyers in the context of implied covenants.[19]

The market value cases involve the interpretation of the express clause of an oil and gas lease and arguably have no effect on a court's approach to implied covenant jurisprudence.[20] However, the consonance

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19. Those cases are collected in Lowe, *supra* note 14 at 234-36. Some of the "cooperative venture" courts also used equitable principles of fundamental fairness as an aid to interpreting these leases in a manner that would not bankrupt lessees. *See, e.g.*, Henry v. Ballard, 418 So. 2d 1334 (La. 1982):

> Where the mineral lease provides for payment to the lessor of a fractional royalty interest, the lease arrangement is in the nature of a cooperative venture: the lessor contributes the land and the lessee the capital and expertise necessary to develop the minerals for the mutual benefit of both parties.... The ultimate objective of the royalty provisions of a lease is to fix the division between the lessor and lessee of the economic benefits anticipated from the development of the minerals.

Id. at 1338.

The cooperative principle espoused by Williams and Meyers as the foundation of implied covenant law and the cooperative venture analysis used to define market value in some jurisdictions are similar, but not identical. The cooperative principle explains why courts insert implied covenants into oil and gas leases: to require both parties to promote the basic purposes of the contract. The cooperative principle is rooted in fact and derived from the intentions of the parties, although ethical norms may influence the application of an implied covenant. The cooperative venture analysis reasons in the reverse: because implied covenants exist in an oil and gas lease, the express terms of a lease should be interpreted to promote fairness between lessee and lessor and consistency with the lessee's implied duties.

20. For example, the Texas Supreme Court in *Vela* could have concluded that market value meant contract price without any reference to fairness or implied covenant jurisprudence. Indeed, four justices dissented in *Vela* on the basis that "market price" was not a plain term because it failed to state at what time the market price was to be determined. The lease did not expressly state that this price was the current or prevailing market price of gas when produced rather than the price fixed in 1933 at the time the gas sales contract was negotiated. The dissenting justices looked at the common practices in the industry at the time the gas sales contract was made in 1933. At that time, all parties to the lease knew that gas could only be marketed under long-term sales contracts. Consequently all of the parties knew "that the term 'market price' necessarily meant the price prevailing for gas on long-term contract as of the time the sale contract should be made." 429 S.W.2d. at 879. The dissenting justices did not base their opinion on notions of fairness or the cooperative nature of the oil and gas lease. They simply interpreted the contract according to industry custom.

Section 220 of the Restatement (Second) of Contracts states that an agreement is to be interpreted in accordance with relevant usage if both parties know of this usage. Furthermore, comment d to section 220 explains that usage relevant to interpretation is part of the context of an agreement in determining whether there is ambiguity as well as in resolving ambiguity. Usage can be shown without a finding that ambiguity exists. Thus, the normal effect of usage on a written contract is to vary its meaning from the meaning it would otherwise have. These Restatement rules are independent of norms of fairness or cooperation and could have been used to find that "market value" meant the long-term contract price. RESTATEMENT (SECOND) OF CONTRACTS § 220 (1981).

between the "plain terms" rule of contract interpretation and the "implied in fact" classification of implied covenants is obvious. Those jurisdictions which have not acknowledged the equitable nature of implied covenants as being implied in law due to the relationship between the parties may be less likely to find that an implied covenant exists outside of the express language in a lease, and thus will be less likely to resolve disputes over a lessee's implied duties in favor of the lessor. The dichotomy between implying covenants "in fact" or "in law" then becomes more than mere "academic shadowboxing."[21] For this reason, it is important to examine a jurisdiction's choice of model in implied covenant jurisprudence.

B. The Texas Model

The Texas courts seem to have adopted the contract model that implied covenants are implied in fact in oil and gas leases. This conclusion is supported by the following language from *Danciger Oil & Refining Co. of Texas v. Powell*,[22] often cited as the leading case on this point:

> An implied covenant must rest entirely on the presumed intention of the parties as gathered from the terms as actually expressed in the written instrument itself, and it must appear that it was so clearly within the contemplation of the parties that they deemed it unnecessary to express it, and therefore omitted to do so, or it must appear that it is necessary to infer such a covenant in order to effectuate the full purpose of the contract as a whole as gathered from the written instrument. It is not enough to say that an implied covenant is necessary in order to make the contract fair, or that without such a covenant it would be improvident or unwise, or that the contract would operate unjustly.[23]

The *Tara* majority opinion, which used fairness and industry custom as guides to interpreting market price as the contract price, believed that its interpretation "is consonant with the intent and understanding of parties to oil and gas leases." 630 P.2d at 1274. Viewed in this manner, the split between jurisdictions over the meaning of market value is little more than a difference in opinion as to the use of industry custom in interpreting contracts.

21. WILLIAMS & MEYERS, *supra* note 9, § 803, at 20. Indeed, the authors of this treatise use the case of *Danciger Oil & Refining Co. of Texas v. Powell*, 154 S.W.2d 632 (Tex. 1941) to illustrate how adoption of the contract model may inhibit courts from finding implied covenants exist. In their opinion, the result in *Danciger* would have been harder to support, and might even have been different, if the Texas courts believed that covenants are implied in law. WILLIAMS & MEYERS, *supra* note 9, § 803 at 20–22. In my opinion, the *Danciger* result is well-reasoned and would not be differently decided under the equity model, as discussed in the next part of this Article.

22. 154 S.W.2d 632.

23. *Id.* at 635.

Applying this analysis to the specific contract at hand, which was a deed rather than a lease, the court held that no implied covenant to develop existed between the grantor/owner of a reserved royalty interest who had deeded his mineral interest to the grantee/lessee, an oil operator. The court carefully explained the result it reached, based on its analysis of the contract language as a whole in light of the circumstances under which the contract was made and the purposes sought to be accomplished by it.[24]

The court's analysis focused on four factors. First, the conveyance was a deed, not a lease. This alone was not conclusive; the court clearly recognized that implied covenants might arise from deeds.[25] Second, the grantors had received a very large cash payment up front, as is usual in a mineral conveyance when a large cash consideration is the "moving cause" for the grantor's conveyance of property to a grantee motivated by an investment purpose rather than a development purpose.[26] Third, nothing indicated a dominant purpose to obtain development of the tract rather than its use for investment purposes. The contract specifically provided for drilling offset wells to prevent drainage, but no provision was made for drilling any other wells.[27] Fourth, and perhaps most importantly, the contract stated that the grantee should have "the right at any time . . . to develop such oil and gas . . . subject only to the limitations and covenants hereinafter set forth."[28] The court gave great weight to the quoted language that evidenced an intention to exclude every covenant except those expressly bargained for.

The only circumstance in *Danciger* arguing in favor of implication of a covenant to develop was the fact that the grantor had retained a royalty interest in the minerals. This provision alone was not sufficient to justify reading an implied covenant into the contract in light of the other language and circumstances involved in the grant.

While *Danciger* can fairly be characterized as the leading case on the nature of implied covenants in Texas, it is itself premised on an earlier Texas Supreme Court case, *Freeport Sulphur Co. v. American Sulphur Royalty Co. of Texas*.[29] In *Freeport*, the court also performed a careful analysis of the

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24. *Id.*

25. *Id.* (citing Freeport Sulphur Company v. American Sulphur Royalty Company Co., 6 S.W.2d 1039 (Tex. 1928), discussed *infra* at text accompanying notes 29–35).

26. *Id.* at 635–36. As a general rule, exploration and development are not considered to be the moving factors in conveying mineral deeds. 1 WILLIAMS & MEYERS, *supra* note 9, § 205.1 (1996).

27. *Danciger*, 154 S.W.2d at 636.

28. *Id.*

29. 6 S.W.2d 1039. Other early Texas cases recognizing implied covenants include *Grubb v. McAfee*, 212 S.W. 464 (Tex. 1919) (oil and gas lease); *Benavides v. Hunt*, 15 S.W. 396 (Tex.

language of the conveyance to determine whether an implied covenant should exist and, if so, whether it was negated by express language. In this case, the grantors conveyed sulfur-rich land by deed, in exchange for $450,000 in cash, royalties based on $1.75 per ton for the first 200,000 tons and 75 cents a ton thereafter, and an express covenant that the grantees would erect and operate a complete plant using the Frasch process on the land within 18 months. The grantee built the plant as promised (indeed, it built four plants) and operated the property continuously until it shut down operations for fourteen months in 1921 and 1922 and for several years from 1924 to the date of trial. The grantor sued to recover lost royalties for breach of the implied covenant to reasonably develop.

The court began its analysis by proclaiming the *Danciger* principle that covenants may be implied only when necessary to give effect to the intent of the parties and the purpose of the contract when viewed as a whole, not to make the contract fair.[30] The court refused to surmise whether the principal consideration for the conveyance was the $450,000 or the royalty. Clearly, the royalty was part of the consideration, and evidently a substantial part.[31] If this consideration was to be realized, a covenant for development and operation must exist to give effect to that part of the contract. This implied covenant would exist in a deed for solid minerals just as in a lease of fugacious oil and gas.

The court then negated the existence of the implied covenant to develop by finding that the express clause requiring one Frasch plant barred this implied covenant.[32] The grantor/royalty owners argued that this provision applied only to the construction of a test plant (that is, to exploratory operations) and was not intended to bar a separate duty to develop. However, the court found nothing to indicate that the duty was to operate a test plant. Indeed, the language indicated that the plant had already been tested in Louisiana under the Frasch patent which had now expired.

However, this same language requiring construction of one plant carried the necessary implication of an implied covenant for continuous operation of the plant in order to realize the bargained-for royalties: "The parties having contracted for development, an implied covenant exists for diligent operation for the best advantage and benefit of both."[33]

1891) (coal lease); and *J.M. Guffey Petroleum Co. v. Jeff Chaison Townsite Co.*, 107 S.W. 609 (Tex. Civ. App. 1907).

30. *Freeport Sulphur*, 6 S.W.2d at 1041. The court recognized that the customs and practices of the business to which the contract relates may be considered in this analysis.

31. *Id.* at 1043.

32. *Id.*

33. *Id.*

The grantee/operator then argued that its decision to operate or to shut down the plant was wholly within its judgment and sound discretion, as long as it acted in good faith without fraud.[34] The operator contended that the $450,000 cash payment and the large cost of constructing a plant were sufficient assurance to the royalty owners that sulfur would be produced, because the sulfur company had such large amounts of capital invested in the property that its self-interest would protect the royalty owners. The court disagreed. The correct rule was that enunciated in *Brewster v. Lanyon Zinc Co.*, the reasonably prudent operator standard requiring reasonable diligence rather than mere good faith.[35] The supreme court remanded the case to the district court to determine whether the sulfur company had acted as a reasonably prudent operator in suspending production.

A third key case forms the triad of early Texas Supreme Court cases on the nature of implied covenants in oil and gas law. In *Cowden v. Broderick & Calvert, Inc.*,[36] the court specifically addressed the issue of how to interpret lease clauses that appear to negate implied covenants. The lease in question contained a clause reading: "In the event of production on adjoining land, the lessee agrees to drill proper and necessary offsets along property lines; lessor agrees that all other development shall be at the discretion of the lessee."[37]

The court reasoned that this express development clause barred the implied covenant to develop with reasonable diligence that ordinarily would have arisen after the discovery of oil.[38] However, the express clause did not bar application of a good faith standard to protect the lessor's interest in development. The court analyzed the quoted lease provision as follows:

> The lessor, in agreeing that all other development should be at the discretion of the lessee, did not leave the development to the complete option of the lessee and his assigns, to develop or not to develop at their pleasure. 'At the discretion of' may, under some circumstances, mean 'at the option of,'

34. *Id.*

35. *Id.* at 1044. The Texas court quoted the correct rule from *Brewster*: "Whatever, in the circumstances, would be reasonably expected of operators of ordinary prudence, having regard to the interests of both lessor and lessee, is what is required." An earlier Texas case had also rejected the good faith standard in implied covenant law, explaining that "[t]he 'man on the spot' may be an expert and use his best judgment; yet he may be negligent or otherwise fall short of what the circumstances require." Texas Co. v. Ramsower, 7 S.W.2d 872, 874, *on mot. for reh'g*, 10 S.W.2d 537 (Tex. Comm'n App. 1928).

36. 114 S.W.2d 1166 (Tex. 1938).

37. *Id.* at 1168.

38. *Id.* at 1170–71.

> but usually it does not. Discretion differs from uncontrolled will . . . . 'Discretion means the equitable decision of what is just and proper under the circumstances.' . . . [or the] 'freedom to act according to honest judgment' and that discretion as used in the law was not 'a word for arbitrary will or inconsiderate action.'[citations omitted] A construction of the lease that would leave further development to the option or uncontrolled will of the lessee and his assigns should be avoided, because it would tend to prevent the accomplishment of the purpose for which the lease was made, that is the production of oil and gas with payment of royalty to the lessor.[39]

The supreme court remanded the case to the district court for trial under the good faith standard. The court's reasoning in this case seems to blur the line between the contract model based on "necessity," which asks what covenants would necessarily be implied in fact, and the equity model. The court was clearly reluctant to free the lessee from any judicial controls over its decisionmaking despite language strongly suggesting that this was the parties' intent.

The equity and the contract models will often result in the same analysis, as recognized by the Texas Supreme Court in another leading opinion in implied covenant jurisprudence:

> Contractual implications are justified only on the ground of necessity . . . . Mr. Merrill suggests that the true basis of the whole doctrine of implied covenants in oil and gas leases may be found in the determination of courts to enforce fair dealing between lessor and lessee which could not otherwise be assured . . . . While necessity and fair dealing alike require the implication of the obligation by the lessee in leases such as the one now before the court for reasonable diligence in oil and gas exploration, development, and production, yet neither necessity nor fair dealing requires the further implication that such obligation shall operate as a limitation on the estate acquired by the lessee.[40]

In sum, implied covenants in Texas seem to be implied in fact under the contract model. However, the leading cases still often discuss fair dealing and good faith in language reminiscent of the equity model. In addition, even under the contract model, express language that might bar implied covenants is read narrowly. In *Freeport Sulphur*, the express language was interpreted to bar only the covenant to develop, not the

39. *Id.* at 1171.

40. W.T. Waggoner Estate v. Sigler Oil Co., 19 S.W.2d 27, 31-32 (Tex. 1929).

covenant to operate; and in *Cowden*, the express language of "discretion" did not bar a trial to determine whether the lessee had acted in good faith. These two cases demonstrate the guiding principles established at an early date in the interpretation of express clauses which purport to bar implied covenants: First, that the express clause must be very clear, and second, that the language of the lease should be construed against its drafter, the lessee, whenever its meaning is doubtful. As Professor A. W. Walker writes, after acknowledging that covenants are implied in fact in Texas:

> In order to prevent the implication of these covenants . . .the intention of the parties to that effect must be indicated very clearly in the lease. This follows as a matter of course from the very theory upon which the implication of these covenants is justified. If the reservation of royalties contingent upon production indicates that the parties intended these implied duties to exist, and their implication is deemed necessary to effectuate the purpose for which the lease was executed, it is apparent that they will be implied in all leases wherein a royalty of this type is reserved unless the intention of the parties otherwise clearly appears.[41]

Because covenants are implied in fact, it also follows that the implied duties are as strong as any express duties in the lease; the implied duties are necessary to fulfill the purposes of the lease. In *Texas Co. v. Ramsower*, the court wrote: "The implied obligation . . . is as much a part of the contract as if expressly stated. The fact that the obligation rests in implication and not in words may have an important bearing on remedies and their enforcement, but not in respect to rights otherwise."[42]

In all of these early cases, the court performed a careful analysis of the language of the contract as a whole considered in light of the circumstances in which it was made. The cases set a strong foundation of rational analysis to apply to future disputes between operators and royalty owners. The next sections of this part of the Article survey the Texas cases which discuss when express language in a contract is strong enough to bar specific implied covenants.

C. The Implied Covenant to Drill an Initial Well

The well-settled rule regarding application of implied covenants is that when a contract contains an express covenant on a subject, no implied

41. Walker, *supra* note 8, at 407–08.
42. *Ramsower*, 7 S.W.2d 872, 874 (Tex. Comm'n App. 1928).

covenant can exist as to the same subject.[43] Under this rule, the delay rental clause in the modern lease expressly bars the implied covenant to drill an initial well on a leasehold.[44] The delay rental clause was created to avoid the dissatisfaction experienced by both lessees and lessors with the earliest lease forms. These forms had long fixed terms that ended even if the lessee had secured production. Moreover, the lessee was not assured that the lease would last the fixed term because courts implied a covenant to drill an exploratory well within a reasonable time.[45]

Despite its seemingly plain language, the delay rental clause does not bar the implied covenant to drill offset wells to protect against drainage even when the offset well would be the first well drilled on the tract.[46] The Texas courts have held that the delay rental clause is not inconsistent with the drainage covenant; each acts independently for a different purpose. The delay rental clause was adopted to displace the duty to drill an initial exploratory well, not the duty to protect against drainage.[47]

Furthermore, in Texas, the lessor's acceptance of delay rentals with knowledge of drainage, does not bar the lessor from bringing suit for breach of the offset covenant.[48] In this regard, Texas differs from the majority of jurisdictions which hold that such lessors who accept delay rentals with knowledge of drainage are barred from bringing suit during the period

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43. 5 WILLIAMS & MEYERS, *supra* note 9, § 826; MERRILL, *supra* note 8, § 6; 5 EUGENE KUNTZ, A TREATISE ON THE LAW OF OIL & GAS § 55.2 (1994). *See, e.g.*, Simms Oil Co. v. Flewellen, 156 S.W.2d 521 (Tex. Comm'n App. 1941) (opinion adopted by Texas Supreme Court, 1941).

44. The modern "unless" lease form basically reads "upon payment of delay rentals, commencement of drilling operations may be deferred." Under an "or" form of lease, the lessee promises to either drill or pay delay rentals. *See generally*, 5 WILLIAMS & MEYERS, *supra* note 9, §§ 811–13; McCallister v. Texas Co., 223 S.W. 859 (Tex. App. 1920, writ ref'd).

45. 3 WILLIAMS & MEYERS, *supra* note 9, §§ 601.1–.4. The early "no term" lease which allowed the lessee to extend the lease indefinitely with the payment of delay rentals was so successfully attacked by lessors in court that it also fell from use. Under both the long fixed-term lease and the no-term lease, courts held that the lessee had an implied duty to drill an exploratory well within a reasonable time. Both leases failed to provide certainty as to the rights of the parties to the lease. The modern delay rental clause, coupled with the fixed, relatively short, primary term in the habendum clause of the lease, unequivocally gives the lessee the right to delay drilling an initial well if he so chooses.

46. *Ramsower*, 7 S.W.2d 872 (delay rental clause refers to an initial exploratory or development well to be drilled at the will of the lessee and does not relate to the subject matter of the drainage covenant; the two covenants include different subjects).

47. See generally, 5 WILLIAMS & MEYERS, *supra* note 9, § 826.2; Will Mann Richardson, *Doctrine of Development Covenants Re-examined in Light of Express Covenants and Conservation Orders*, 9 INST. ON OIL & GAS L. & TAX'N 321, 325 (1958).

48. *Ramsower*, 7 S.W.2d 872.

covered by the rental payment, based on theories of waiver, estoppel or election of remedies.[49] The Texas position is the better reasoned one.

The delay rental cases, which differentiate initial wells from offset wells, illustrate the principle that an express clause may supersede an implied covenant, but only to the extent that the express provision is in actual conflict with the implied duty.

D. The Implied Covenant to Protect Against Drainage

At an early date, the courts imposed on lessees the implied covenant to protect the leasehold against the ultimate loss of hydrocarbons resulting from drainage to another leasehold.[50] Unlike solid minerals, oil and gas migrate underground in response to pressure differentials caused by well drilling. Reasonable prudent operators must protect their lease lines against this migration.

Following the general rule, an express lease provision dealing explicitly with the obligation to drill offset wells will normally displace the implied covenant to the extent the express clause is inconsistent with the implied covenant.[51] The inconsistency must be clear. Broad clauses stating that the lessee has no obligation to drill or has no obligation to develop either before or after the discovery of oil or gas do not bar the implied covenant to protect against drainage.[52] As one court stated:

> It is true that drilling an offset well is in a sense developing the property. But the implied covenant to drill offset wells . . . is a distinct obligation from the obligation imposed by the implied covenant to develop the property . . . . The express stipulation against, or the full performance of, the obligation of the lessee to develop the property will not relieve the obligation to prevent drainage.[53]

Most leases contain a provision similar to the following (although the offset distance may vary): "In the event a well producing in paying quantities is brought in an adjacent land and within 330 feet of and draining the leased premises, Lessee agrees to drill such offset wells as a reasonably

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49. 5 WILLIAMS & MEYERS *supra* note 9, § 826.2.

50. *See, e.g.*, Texas Pacific Coal & Oil Co. v. Barker, 6 S.W.2d 1031 (Tex. 1928).

51. 5 WILLIAMS & MEYERS, *supra* note 9, § 826.3.

52. J.M. Guffey v. Jeff Chaison Townsite Co., 107 S.W. 609 (Tex. Civ. App. 1908, no writ); Stanolind Oil & Gas Co. v. Christian, 83 S.W.2d 408 (Tex. App. 1935, writ ref'd); Brown v. Smith, 174 S.W.2d 43 (Tex. 1943); Foster v. Atlantic Ref. Co., 329 F.2d 485 (5th Cir. 1964). *See generally*, 5 KUNTZ, *supra* note 43, § 61.2 (1994).

53. *Stanolind Oil & Gas*, 83 S.W.2d at 409. The lease at issue contained a clause reading: "There shall be no express or IMPLIED obligation on the part of lessee to develop said premises for oil, gas or other minerals, either before or after discovery thereof . . . ."

prudent operator would drill." This express provision mimics the implied covenant to protect against drainage which requires a lessee to drill an offset well when the lessor has proved substantial drainage and that a reasonably prudent operator would drill such a well (that is, when the well would be profitable to drill).

It can be argued, then, that this express provision should have no effect on the implied covenant that it mimics. The lessee has committed to act as a reasonably prudent operator when offset wells are drilled within the specified distance from the lease line; and since the typical lease is silent as to the lessee's duty to offset a well beyond the express distance stated in the lease, the implied duty would continue to exist here as well. The typical express offset clause does not state that the lessee will protect against drainage *only* if wells are drilled within 330 feet of the lease line.[54] Yet, the general rule appears to be that the typical express provision will bar the implied offset covenant to protect against an adjoining well brought in more than 330 feet away, even if the well is draining the lease premises.[55] Thus, the express covenant to protect against wells drilled within 330 feet of the lease line is interpreted as displacing the implied covenant to protect against wells both within and outside the 330-foot distance.

While often stated as a general rule, few cases exist on point. This may reflect the self-interest of lessees in protecting their lease lines from drainage by rival operators no matter what distance the offset well. However, it probably also reflects recognition by Texas lessees that the express provision is strongly disfavored by the Texas courts which have narrowed the ambit of protection it accords lessees against the implied covenant duty in two major ways.

First, the Texas courts have reached the rather curious result that the typical express offset covenant bars the implied, but only during the primary term. After the primary term expires, the implied covenant duty reappears.[56] This result was premised on the then-existing case law which

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54. Charles Meyers has argued that "from the standpoint of grammar and logic," the clear meaning of the typical express clause is that it bars any implied duty to protect against drainage from wells outside the offset distance. Charles Meyers, *The Effect of Express Provisions in an Oil and Gas Lease on Implied Obligations*, 14 L.S.U. MIN. L. INST. 90, 108 (1967). In restating his position in the treatise, Meyers writes: "The logical inference that must be drawn from a clause that obliges the operator to drill offsets only as to wells within (say) 150 feet from lease boundaries is that he is not obliged to drill offsets to wells more than 150 feet away." 5 WILLIAMS & MEYERS, *supra* note 9, § 826.3, at 206. I would agree with his logic if the typical express clause contained the word "only," but it does not.

55. R. HEMINGWAY, LAW OF OIL AND GAS § 8.6 (3d ed. 1991); 5 KUNTZ, *supra* note 43, § 61.2 (1994).

56. See, for example, *Coats v. Brown*, 301 S.W.2d 932 (Tex. App. 1957); *Chapman v. Sohio Petroleum Co.*, 297 S.W.2d 885 (Tex. App. 1956, writ ref'd n.r.e.); and *Magnolia Petroleum Co. v. Page*, 141 S.W.2d 691 (Tex. App. 1956, writ ref'd), all of which rely on *Humble Oil & Refining*

held that acceptance of delay rentals barred the implied covenant to protect against drainage. In 1929, the Texas courts reversed this premise in *Texas Co. v. Ramsower*, as discussed above. After *Ramsower*, if the express clause is effective at any time during the life of the lease, it should be effective at all times. Yet the Texas courts, even after 1929, continue to hew to the old rule that limits the effectiveness of the express clause to the primary term of the lease.

Moreover, it is difficult to find a Texas case that directly states that the typical express offset clause bars the implied protection covenant. Hemingway's treatise cites four Texas appellate cases as support for the general rule, but none of the four interprets the typical clause.[57] Williams and Meyers' treatise states that only one reported Texas case was found where the typical express clause was used to deny recovery to a lessor, and in this case, an alternate ground was also relied on.[58]

Secondly, the Texas courts have held that the express offset clause is not effective to bar the implied covenant to protect against drainage at all in a "common lessee" situation.[59] In a per curiam decision refusing a writ of error in *Shell Oil Co. v. Stansbury*, the Texas Supreme Court wrote:

> The Court of Civil Appeals correctly held that the express provision in the Stansbury lease which obligated Shell to drill an offset well if a draining well was within a specified distance from the Stansbury property line did not limit Shell's

Co. v. Strauss, 243 S.W. 528 (Tex. App. 1922). The historical analysis of these cases is treated in detail in 5 WILLIAMS & MEYERS, *supra* note 9, § 826.3.

57. HEMINGWAY, *supra* note 55, § 8.6, at 565 n.80 (citing Burt v. Deorsam, 227 S.W. 354 (Tex. App. 1921, writ denied) (offset clause required lessee to drill regardless of expected profitability if well producing at least 50 barrels of oil a day for 30 consecutive days was brought in on adjacent land); Wolter v. Houston Oil Co., 74 S.W.2d 706 (Tex. App. 1934, no writ) (offset clause did not contain an express distance; issue involved whether offset well had been drilled on "adjoining lands"); *Page*, 141 S.W.2d 691 (typical express offset clause accompanied by clause that "the judgment of the lessee, when not fraudulently exercised ... shall be conclusive"); *Coats*, 301 S.W.2d 932 (same)).

58. 5 WILLIAMS & MEYERS, *supra* note 9, § 826.3, at 207 n.24 (citing Hutchins v. Humble Oil & Ref. Co., 161 S.W.2d 571 (Tex. App. 1942, writ ref'd w.o.m.)). The court in *Hutchins* denied recovery to the lessor primarily because the lessor had not proved the profitability of drilling an additional well on one lease. However, the court also cited two other grounds for denial: first, that the lessor had accepted delay rentals on the second tract at issue; and second, that the express offset clause barred the protection covenant. *Hutchins* actually involved a "common lessee" situation. In a subsequent case, the Texas Supreme Court wrote that "[w]e specifically disapprove any language in the opinion of *Hutchins* ... which conflicts with the principle that a lessee is under a duty to protect his lessor against depletion of the lessor's minerals by the affirmative act of the lessee upon adjacent land." Shell Oil Co. v. Stansbury, 410 S.W.2d 187, 188 (Tex. 1966)(per curiam).

59. A "common lessee" situation occurs where an operator has leased two adjoining tracts and has drilled a well on one tract which is draining its own lessor on the other tract.

obligation to drill when Shell was the one causing the drainage to the Stansbury land.[60]

This brief per curiam opinion does not explain why the "common lessee" situation should be treated differently from the "rival operator" scenario for purposes of allowing an express clause to bar an implied covenant. However, one reason is obvious: the lessee who is being drained by a rival operator's well is self-motivated to drill an offset well to prevent the drainage of the lessee's own working interest in the oil or gas. The lessor may be losing her ⅛ royalty oil due to drainage from the rival well, but the lessee is losing the other ⅞. This incentive is lacking when the lessee is draining itself from operations on adjoining land. Indeed, the lessee would prefer to drill only one well and drain two tracts at once rather than drill two wells.

Under the equity model of implied covenant law, a court may feel free to interpret, indeed ignore the express language of an offset clause in order to achieve a fair result. Similarly, it is difficult to view the lease as a cooperative venture and yet allow the lessee to drain its own lessor, shielded by an express offset clause drafted by the lessee. Arguably, even under the contract model, the lessor would not expect that its own lessee would be the one draining the tract and robbing the lessor of the royalty that is the primary consideration for the lease. Also arguably, the conflict of interest or self-dealing which arises in a common lessee situation is not within the contemplation of the parties to the lease. In *Amoco Production Co. v. Alexander*, the Texas Supreme Court frankly acknowledged that "[t]he conflicts of interest of Amoco, as a common lessee, cause us concern,"[61] in a case involving the implied covenant to protect against drainage. Certainly it is difficult to view the lease as a cooperative venture and yet allow the lessee to drain its own lessor, shielded by an express offset clause drafted by the lessee.

The appellate court in *Stansbury* had interpreted an express offset clause that differed slightly from the typical one. The clause required that the lessee drill offset wells as a reasonably prudent operator would drill if wells were brought in an adjacent land "within offset distance as fixed by

60. 410 S.W.2d at 188 (denying the writ of error brought in Shell Oil Co. v. Stansbury, 401 S.W.2d 623 (Tex. App. 1966)). *See also* Amoco Prod. Co. v. Alexander, 622 S.W.2d 563 (Tex. 1981) (affirming that an express offset provision does not limit the lessee's offset covenant when the lessee is causing the drainage).

61. Amoco Prod. Co. v. Alexander,622 S.W.2d at 569. *See also* Amoco Prod. Co. v. First Baptist Church of Pyote, 611 S.W.2d 610 (Tex. 1980) (common lessee breached the implied covenant to market by receiving collateral benefits for itself which were not shared with one set of lessors).

the spacing rules of any governmental regulatory body" and if drainage was occurring. In interpreting this clause, the appellate court wrote:

> A lessor and lessee may contract so that lessee is never under obligation to drill an offset well. To so contract, however, the language must be very clear. In this lease there is no contract that lessee shall not be under obligation to drill an offset well. The offset clause under consideration recognized that under the Statewide Field Rules no maximum offset distance had been fixed but that in the future governmental authority could have a rule fixing a maximum offset distance. There being no offset distance fixed by any governmental authority, Shell was obligated to drill such offset wells as a reasonably prudent operator would drill under the same or similar circumstances on the Stansbury land to protect it from drainage whether it owned leases on adjoining land or not.[62]

The appellate court held that a spacing rule prohibiting the drilling of a well within 330 feet of a property line did not establish an "offset distance;" therefore the express clause was not effective to bar the implied covenant duty.

The appellate court's analysis is indicative of the judicial reluctance to find that the express offset clause bars an implied covenant. The clause smacks of unfairness. Most landowners who read the clause would think that it acts to their benefit by imposing an additional duty on the lessee, when in reality the provision decreases the lessor's protection if interpreted as a bar to any duty to protect from draining wells beyond the specified distance. For this reason, Professor Meyers has argued persuasively that the courts should not allow the express offset clause to negate the implied covenant.[63] The courts have often adopted his view in the common lessee situation.[64]

If courts were to adopt the equity model of implied covenants, they could easily hold that the typical express offset clause should not bar the implied covenant in non-common lessee cases as well. Even under the contract model, which is so firmly rooted in the intent of the parties as reflected by their writings, it can be argued that the typical express offset provision should not be given effect because it does not clearly negate the implied offset covenant. It does not say that the lessee will protect against

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62. 401 S.W.2d at 630–31.

63. Meyers, *supra* note 54, at 107–10 ("The courts should be unmasking the wolf, not helping him keep his sheep's clothing neatly in place"), *also appearing in* 5 WILLIAMS & MEYERS, *supra* note 9, § 826.3.

64. *Alexander*, 622 S.W.2d at 569; Williams v. Humble Oil & Ref. Co., 432 F.2d 165 (5th Cir. 1970) (involving Louisiana lease), *reh'g denied*, 435 F.2d 772 (5th Cir. 1970).

drainage *only* from wells drilled closer than a specified distance.[65] In Professor Merrill's view, the express provision simply sets a minimum standard as to the distance within which drainage is presumed to occur. A lessor would have to prove that drainage is taking place if the rival well is beyond the offset distance,[66] but the express clause would not be an absolute bar to such a cause of action.

Moreover, the differences between the "common lessee" scenario and the "rival operator" scenario may not be so large as to justify different treatment. In the common lessee situation, if the operator does not drill an offset well and has no other wells on a tract, the operator risks losing the lease on this tract under the habendum clause of the lease.[67] Thus, the common lessee may often be self-motivated to drill the offset well. The inherent unfairness of the express clause in either situation remains the same.

Furthermore, the "common lessee" situation is fairly common. Lessees often seek to aggregate numerous tracts into large leased blocks.[68] Since this is a common practice, lessors presumably know of the risks of signing a lease with an express offset clause in it. Arguably then, jurisdictions like Texas which do not allow the express clause to bar the implied covenant in common lessee drainage cases are, in reality, adopting the equity model of implied covenant jurisprudence rather than the contract model. Put simply, why should lessors be protected against self-dealing lessees in a common lessee situation but not against negligent or incompetent lessees in a rival operator scenario, when the express offset clause is so poorly worded to alert lessors to its consequences and its inherent unfairness?[69]

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65. Some courts have held that the express offset clause bars the implied covenant to offset in a common lessee situation, but then have created a separate and distinct implied covenant described as a lessee's duty to protect the interests of the lessor against depletion of the lessor's lands by the affirmative act of the lessee upon adjacent property. See, for example, *Millette v. Phillips Petroleum Co.*, 48 So. 2d 344 (1950), and other cases cited in HEMINGWAY, *supra* note 55, § 8.7.

66. Maurice H. Merrill, *Lease Clauses Affecting Implied Covenants*, 2 INST. ON OIL & GAS L. & TAX'N 141, 173 (1951).

67. Of course, if the two commonly held leases contain pooling clauses, the lessee may combine the two tracts under this clause and hold both leases with one well. In this case, both lessors will receive a fair share of production from the one well; neither will suffer drainage. Some courts have suggested that reasonably prudent operators may have a duty to pool as part of the implied covenant to protect against drainage. *Alexander*, 622 S.W.2d 563; *Williams*, 432 F.2d 165.

68. 8 WILLIAMS & MEYERS, *supra* note 9, at 98–99 (explaining "block" and "block leases").

69. As a final note, the per curiam opinion by the Texas Supreme Court in *Stansbury*, quoted *supra* text accompanying note 60, is carefully worded to apply only to the common lessee situation whereas the appellate court stated that it would not allow the express offset

E. The Implied Covenant to Develop

All jurisdictions impose the reasonably prudent operator standard on lessees to develop the leased tract diligently.[70] The delay rental clause bars the implied duty to drill a first well (absent drainage), during the primary term of the lease, whether the well is an exploratory or a development well.[71] In other words, the development covenant arises only after initial production is obtained.[72]

Many leases contain a shut-in royalty clause that allows the lessee to hold a lease in effect even though the wells on the lease are not producing. A typical clause reads that "where gas from a gas well is not being sold, lessee may pay as royalty ___ dollars per year and upon such payment, it will be considered that gas is being produced under the habendum clause of this lease."[73]

Does a shut-in gas royalty clause displace the implied development covenant? No cases appear to exist, but it should not. Shut-in royalties are paid as a substitute for production to preserve the lease under its habendum clause, not as a substitute for drilling operations.[74]

An express clause can bar the implied development covenant if it is interpreted as reflecting the parties' intent to embody the entire development obligation. Thus, in *Gulf Production Co. v. Kishi*,[75] an express provision for drilling 12 wells on a 150-acre tract and six more wells on a 20-acre tract was held to define the entire development obligation, leaving no room for the implied covenant. However, in *Sinclair Oil & Gas Co. v.*

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clause to bar the implied covenant whether or not the lessee was causing the drainage, quoted *supra* text accompanying note 62. By negative inference, then, the Texas Supreme Court arguably did not approve of the appellate court's broader statement. However, the appellate court's rationale that express language barring any obligation to drill offsets must be "very clear" is well-supported in the case law discussed throughout this Article. Given the paucity of cases that purport to support the general rule that the typical express offset clause bars the implied protection covenant, *see supra* text accompanying notes 56–57, any negative inference is quite weak.

70. The Texas Supreme Court recognized the implied covenant to develop as early as 1891 in a coal lease in *Benavides v. Hunt*, 15 S.W. 396 (Tex. 1891) and applied this law to an oil and gas lease as early as 1919 in *Grubb v. McAfee*, 212 S.W. 464 (Tex. 1919).

71. Link v. State's Oil Corp., 229 S.W. 693 (Tex. App. 1921).

72. Coats v. Brown, 301 S.W.2d 932 (Tex. App. 1957).

73. 3 WILLIAMS & MEYERS, *supra* note 9, § 631.

74. 5 *Williams & Meyers*, *supra* note 9, § 835.2.

75. 103 S.W.2d 965 (Tex. Comm'n App. 1937). *See also* J.M. Guffey Petroleum Co. v. Jeff Chaison Townsite Co., 107 S.W. 609 (Tex. Civ. App. 1908) (express clause requiring lessee to pay minimum royalties of $400 per month, calculated at an above-market price on a 5.27-acre lease, held to bar obligation to drill other wells at a time of excess capacity in the oil field).

Masterson,[76] an express provision to drill six wells on 40,000 acres in a short time period after the lease was executed was interpreted as a provision to speed up the implied covenant to reasonably develop, not to displace it.[77] Any other interpretation would "give ear to the absurd."[78]

In a third case, *Hull v. Magnolia Petroleum Co.*,[79] the lease stated that the grantee was "not under obligation to nor compelled to commence or drill any well or wells or conduct any character of operations on the land herein described during the term of this grant," except to protect the land from drainage. The lease contained about 6,000 acres and the lessee had drilled two producing wells. The court narrowly construed this express development clause to apply only to the primary term of the lease, and not to the lease's extension by production in paying quantities.

The court's reasoning focused on the "principal apparent purpose" of the parties to a lease; this purpose being the development of the lease for oil and gas.[80] To construe the word "term" to apply to lease extensions beyond the ten-year primary term would render the lease self-contradictory and nullify another provision in the lease that operations extending the grant beyond ten years "must be prosecuted with reasonable diligence." The court's analysis again demonstrates the judicial disfavor for express clauses purporting to bar covenants implied to accomplish the very purpose of the lease.

The most interesting oil and gas case under the development covenant is *W.T. Waggoner Estate v. Sigler Oil Co.*[81] The lease in this case required that the lessee pay annual rentals of $100,000 a year for the life of the lease, provided that "each producing well shall hold 2,000 acres in a square, said well to be the center, and said 2,000 acres shall be released as to further annual rental."[82] The lease was to remain in force for five years and as long thereafter as oil or gas was produced from the land. Clearly, this lease did not contain the typical "unless" delay rental clause which normally bars any implied covenant to drill an initial well on a leasehold. The annual rental payment of $100,000 was an absolute obligation of the lessee, which could be reduced by the 2,000-acre proviso, but which co-existed with any royalties paid from production for the life of the lease.

The issue in *Waggoner* was whether this express clause barred the implied development covenant as to a particular 3,000-acre tract of the 85,000-acre lease. The lessee had drilled two wells on this 3,000 acres. The

76. 271 F.2d 310 (5th Cir. 1959).
77. *Id.* at 323.
78. *Id.*
79. 119 F.2d 123 (5th Cir. 1941), *rev'd on other grounds*, 314 U.S. 575 (1941).
80. *Id.* at 125.
81. 19 S.W.2d 27 (Tex. 1929).
82. *Id.* at 28.

court of civil appeals had construed this clause as discharging the lessee from any further obligation to develop each 2,000-acre block containing a producing well at its center, at least for the five years of the primary term of the lease.[83]

The Texas Supreme Court did not agree with this construction. It would "do violence to what all parties plainly intended should we interpret this lease in such manner as to absolve the lessee or his assigns from the duty of reasonable development after proving that the 3,000 acres contained oil in paying quantities."[84] After the two wells were brought in, no revenue whatever was to be derived from the land thereby released from rental payments save through royalties. The principal consideration for a lease is royalties, and to accomplish the "manifest intention of the parties," the law implies a duty to reasonably develop.[85] The supreme court ignored the fact that this particular lease provided for annual delay rentals of $100,000 in addition to royalties.

The supreme court did not analyze the 2,000-acre provision beyond the reasoning described above. It seemed to be "plainly" obvious to the court that such a provision was not intended to bar the implied covenant to develop as to each 2,000-acre block.[86] The expense of drilling merely earned the lessee the right to reduce rentals on certain acreage, but did not affect the implied covenant to drill additional wells on this acreage if profitable to do so.

Yet it is not so plainly obvious why this proviso should not have barred the development covenant during the primary term. The appellate court interpreted the clause as follows:

> We think this stipulation means that [lessee] might have held the entire 85,000 acres for the full term of five years by drilling to production one well on each 2,000 acres within the term, because as a whole, the agreement binds the lessee to pay rental at the rate of $1.18 per acre until a producing well is found, and after that that particular 2,000 acres is released from the further payment of rent. The reasonable inference from this provision is that the parties contemplated that the royalties from one producing well upon every 2,000 acres would, at least during the term of the lease, equal or exceed the annual rent, and it was inserted to induce appellant to

83. *Id.*
84. *Id.* at 29.
85. *Id.*
86. One oil well can usually drain oil from about 40 acres, and a gas well can drain about 640 acres. Thus, two oil wells on 3,000 acres would not fully develop the acreage.

> drill at least one well on each 2,000 acres, thereby testing within the five years the whole area covered by the lease.[87]

The court of civil appeals declined to pass on the issue of whether the 2,000-acre proviso barred any further implied duty to develop after the first five years. In contrast, the supreme court unequivocally stated that this provision did not bar the implied duty to develop either during or after the primary term.[88] The appellate court construction of the provision seems correct. A strong argument can be made, then, that such a rental provision does bar the implied duty during the primary term of the lease when considered in light of all the circumstances and the language of this particular lease taken as a whole. The Waggoner lease was dated 1919 and covered wildcat, unexplored territory. The annual cash rentals were a substantial consideration. Indeed, for a lease of wildcat territory, the cash rentals were arguably the principal consideration, not royalties from risky exploratory drilling which commonly result in dry holes.[89]

The Texas Supreme Court's willingness to interpret express development clauses as "starter" provisions, or minimums, seems at odds with the approach of some appellate courts in offset cases where the typical express offset clause (in a non-common lessee situation) is said to bar the implied covenant rather than to establish a minimum obligation, at least during the primary term.

One final case involving a coal lease contrasts strangely with the oil and gas precedents discussed here. In *Dallas Power & Light Co. v. Cleghorn*,[90] the Texas Supreme Court held that the following provision in a no-term coal lease barred implication of any duty to develop within a reasonable time:

> It is understood between the parties hereto that this lease shall not be forfeited for any failure to prosecute mining operations . . . nor shall any forfeiture be claimed or enforced for the breach of any implied covenant, but the title to the minerals in said land hereby leased shall not revert to First

87. Sigler Oil Co. v. W.T. Waggoner Estate, 276 S.W. 936, 940 (Tex. App. 1925).

88. 19 S.W.2d at 29.

89. The lessee had expended $150,000 in exploration before the suit was brought. It had drilled four wells on the 3,000 acres, two of which were producing oil in paying quantities, but not yet enough to cover all of lessee's costs. Eight dry wells had been drilled within a radius of 1½ miles of the initial well. 276 S.W.2d at 940.

One obvious interpretation of this provision would hold that the express rental provision barred any implied covenant to drill exploratory wells in new areas of the 85,000-acre lease, but did not bar the implied covenant to drill development wells near wells found to be productive. However, Texas does not recognize an implied covenant to explore separate from the implied covenant to develop. Clifton v. Koontz, 325 S.W.2d 684 (Tex. 1959); Sun Oil Exploration & Prod. Co. v. Jackson, 783 S.W.2d 202 (Tex. 1989).

90. 623 S.W.2d 310 (Tex. 1981).

> Party [lessor] or his assigns so long as the annual rentals as herein provided for are being paid . . . .
>
> . . . .
>
> As long as Second Party [lessee] pays to First Party the lease rentals herein specified . . . Second Party shall have, and he is hereby granted, the exclusive right to . . . such premises . . . ."[91]

The court cited both *Danciger* and *Freeport Sulphur Co.* as support for its summary judgment in favor of lessee. The court stated that the provision had a "plain meaning" and that the words used were clear.[92]

Yet the words had hardly seemed clear to the appellate court which had reversed the trial court's grant of summary judgment to the lessee. The coal leases lacked a primary term and allowed the lessees to hold the leases indefinitely with no exploration or development, merely by payment of nominal annual rentals.[93] The appellate court traced the historical reluctance of Texas courts to accept these "no term" leases.[94] Such leases had either been invalidated for want of mutuality or, in more recent times, interpreted them to require that the lessee comply with an implied duty to develop within a reasonable time.[95] Given this precedent, the appellate court in *Cleghorn* found that the express clause did not bar an implied covenant to develop within a reasonable time.

The usual remedy for breach of the implied covenant is damages or a conditional decree to perform rather than outright forfeiture. Thus, the court reasoned that the functional purpose of the express clause in the "no term" lease was to prohibit forfeiture without precluding the other, more common, remedies for breach. The clause did not specifically define the lessee's duty to develop as had the leases in *Kishi* or *Freeport Sulphur*. Indeed, the appellate court found that the cited cases supported the lessor's position rather than the lessee's.

The supreme court opinion in *Cleghorn* does not explain why the language in this express clause is so clear as to bar the implied covenant. Also, there is no evidence in the court opinion regarding the amount of bonus or rentals paid to the lessors as consideration for the right to delay development indefinitely under a "no term" lease. Three supreme court justices concurred in the majority opinion on the basis that coal production

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91. *Id.* at 311.

92. *Id.* at 312.

93. Cleghorn v. Dallas Power & Light Co., 611 S.W.2d 893, 894, *rev'd*, 623 S.W.2d 310 (Tex. 1981). Two of the thirteen coal leases at issue did have primary terms, and as to these, the appellate court affirmed a summary judgment in favor of lessee.

94. *Id.* at 896–97.

95. *Id.* at 896. See also *Weed v. Brazos Electric Power Cooperative*, 574 S.W.2d 570 (Tex. App. 1978) for additional history and precedents.

and use are so different from oil and gas drilling and production that implied covenants in oil and gas leases may not even be applicable to coal leases.[96] Because of the nature of the coal industry, long delays in coal production may well be within the contemplation of the parties to a coal lease.[97]

If oil and gas jurisprudence is to be applied to coal leases, the appellate opinion in *Cleghorn* is better grounded in such precedent than the supreme court opinion.[98] As we have seen, express clauses that purport to bar implied covenants are to be construed narrowly. Most authorities agree that a covenant to develop should be implied in no-term leases that contain delay rental clauses.[99] Without such an implication, the lease becomes a mineral deed, contrary to the fundamental purpose of a lease that is developing the mineral reserves. Professor Walker's careful analysis of the seminal Texas cases on the nature of the property interest in oil and gas leases concluded that Texas had adopted the view that the lessee under a no-term lease could pay delay rentals, but only for a reasonable time; after such time, the lessor could demand development.[100] The supreme court opinion in *Cleghorn* is contrary to this established body of oil and gas law.

F. Other Controls over Lessee Discretion

In numerous other instances, the courts have construed leases to constrain the lessee's discretion. Two examples make the point. First, the typical pooling clause is replete with the lessee's discretionary power to pool "at its option;" or, when "in Lessee's judgment it is advisable to do so;" or, when it is "in the judgment of Lessee to promote conservation;" and, further, Lessee "may at its election exercise its pooling option after

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96. 623 S.W.2d at 312.

97. In *Cleghorn*, two of the 13 leases had primary terms of 20 years and would have expired for lack of production within a few months of the appellate court's opinion.

Primary terms of thirty years are common in coal industry leases. Note, *Texas No-Term Leases*-Dallas Power and Light Co. v. Cleghorn, 34 BAYLOR L. REV. 717, 731 (1982). For this reason, the lessee's delay in *Cleghorn* could be considered reasonable, notwithstanding that the coal leases had been entered into during the 1950s and early 1960s.

98. Implied covenant law has been applied in the uranium industry. In *United States Steel Corp. v. Whitley*, 636 S.W.2d 465 (Tex. App. 1982, writ ref'd n.r.e.), the court held that a uranium lessee had breached its implied covenant duty to act with due diligence in producing the uranium, using oil and gas cases as precedents. The lessee argued unsuccessfully that the amount of due diligence required to mine hard minerals was not nearly as great as that required to mine oil and gas. *Id.* at 471.

99. WILLIAMS & MEYERS, *supra* note 9, § 812; Walker, *supra* note 8, at 418; 5 KUNTZ, *supra* note 43, § 52.5.

100. Walker, *supra* note 8, at 418–19; *see also* Note, *Texas No-Term Leases*, *supra* note 97, at 723–24.

commencing a well." The courts nonetheless require that the lessee exercise its pooling power in good faith.[101] In Texas, this duty has sometimes been described as a "fiduciary obligation on the part of the lessee to exercise the utmost good faith toward the lessor in exercising the power granted under a pooling provision."[102] At other times, the lessee's exercise of the pooling power has been judged by the standard of a reasonably prudent operator.[103] Whatever the standard, the Texas courts have policed the lessee's pooling power to protect the lessor against gerrymandered units hastily formed by lessees who have failed to secure production on the lessor's tract.

Second, many leases grant the lessee the right "at any time" to remove all property and fixtures placed by lessee on said land. The courts have held "at any time" to mean "within a reasonable time."[104] Further, when removing the casing would be inequitable to the lessor because the well is still producing, the court has denied the lessee's right to remove casing in order to preserve the lessor's royalty.[105]

As shown in the earlier discussion of *Cowden v. Broderick & Clavert, Inc.*, even when a lease expressly grants the lessee "discretion" over development decisions, the Texas Supreme Court will continue to police the bargain to determine whether the lessee acted in good faith.[106]

G. Summary

In general, Texas courts have been very reluctant to allow lessees to exercise unrestrained discretion over leasehold activity, even when express language might be interpreted to allow such freedom. The courts are also reluctant to allow express lease language to bar implied covenants, unless the intent is clear. Thus, despite the seemingly "plain" lease language that payment of delay rentals allows the lessee to defer drilling, the delay rental clause does not bar the implied covenant to drill offset wells. Nor do express development stipulations bar the implied offset covenant.

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101. Elliot v. Davis, 553 S.W.2d 223 (Tex. App. 1977, writ ref'd n.r.e.). *See generally* HEMINGWAY, *supra* note 55, § 7.13; 4 WILLIAMS & MEYERS, *supra* note 9, § 670.2 (describing the "duty of fair dealing" used by the courts to circumscribe lessee's discretionary power to pool); 1 SMITH & WEAVER, *supra* note 2, § 4.8(B).

102. Expando Prod. Co. v. Marshall, 407 S.W.2d 254 (Tex. App 1966, writ ref'd n.r.e.); 6 WILLIAMS & MEYERS, *supra* note 9, § 955.

103. Circle Dot Ranch, Inc. v. Sidwell Oil & Gas, Inc., 891 S.W.2d 342 (Tex. App. 1995, writ denied).

104. HEMINGWAY, *supra* note 55, § 7.10.

105. Woodson Oil Co. v. Pruett, 298 S.W.2d 856 (Tex. App. 1957, writ ref'd n.r.e.); Patton v. Rogers, 417 S.W.2d 470 (Tex. App. 1967, writ ref'd n.r.e.).

106. *See supra* text accompanying notes 36–39.

Moreover, the typical express offset clause will not be allowed to bar the implied duty to offset in a common lessee situation or after the primary term of a lease has expired. The express offset clause may bar the implied covenant in a non-common lessee situation, although the case support for this rule is sparse. If the express offset clause can act as such a bar, this result is contrary to the equity model and arguably even to the contract model which generally requires clear language to negate implied covenants. The typical express offset clause should not bar the implied covenant because it is not written clearly enough.

The results of most of the cases reviewed in this section would probably be the same whether the courts adopted the equity model or the contract model of implied covenants. In some instances, notably the offset cases and the development case of *W.T. Waggoner Estate v. Sigler Oil Co.*, the courts' reluctance to find that express clauses bar implied covenants sounds more in equity than in contract. Despite the seemingly narrow jurisprudential foundation proclaimed in *Danciger Oil & Refining Co. of Texas v. Powell* that implied covenants are to "rest entirely" on the presumed intention of the parties as actually expressed in the written instrument or as "necessary" to effectuate the full purpose of the contract,[107] the Texas courts have generally been liberal in imposing implied duties on lessees to the benefit of lessors. Time and time again, the courts have found that the plain terms of an express clause are not plain or clear enough to bar the underlying implied covenants that exist to further the principal purpose of the lease: to secure oil and gas production and return royalties to the lessor and profits to the lessee. This judicial posture renders inconsequential the difference between the equity model and the contract model. This conclusion supports the Williams' and Meyers' position that implied covenants derive from the principle of cooperation inherent in the nature of an oil and gas lease and sounding both in fact and in law. Even without adopting this position, the Texas cases show that a jurisdiction's formal adherence to the implied in fact model does not necessarily weaken the actual protections offered to the lessor by implied covenant law.[108]

107. *See* quote *supra* text accompanying note 23.

108. It is somewhat ironic that the jurisdictions which adopted the cooperative venture model in the market value cases did so to ensure fairness to the lessee, not to the lessor. *See supra* text accompanying note 17.

III. The Implied Covenant to Market

A. Introduction

The implied marketing covenant has been recognized in Texas from the oil industry's earliest days.[109] This covenant requires that the lessee use due diligence to market the oil and gas produced from the lease. Due diligence includes an obligation to obtain the best price that a reasonably prudent operator could obtain.[110]

Most of the marketing covenant cases involve the lessee's efforts to sell gas rather than oil. The typical lease has a two-pronged gas royalty clause which requires the lessee to pay royalties based on "market value at the well" if the gas is sold or used off the premises and to pay the "amount realized" from the sale if the gas is sold at the wells.

Under an "amount realized" or "proceeds" lease clause, the lessor's royalty is clearly tied to the lessee's diligence in securing a good sales price and other terms in its negotiations with the gas purchaser. Lessors have won some implied covenant cases based on the lessee's failure to market the gas at the highest possible price under a proceeds lease clause,[111] and have lost some of these cases because the lessee was found to have acted as a reasonably prudent operator.[112] The issue of whether the "market value" royalty clause negates the implied covenant to market is discussed below. Because this Article focuses on when express clauses bar implied covenant duties, the reader is referred to other sources for detailed discussion of the implied marketing covenant in general.[113]

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109. *See* Cole Petroleum Co. v. United States Gas & Oil Co., 41 S.W.2d 414 (Tex. 1931); Rhoads Drilling Co. v. Allred, 70 S.W.2d 576 (Tex. Comm'n App. 1934); Poe v. Humble Oil & Ref. Co., 288 S.W. 264 (Tex. App. 1926), *rev'd on other grounds*, 29 S.W.2d 1019 (Tex. Comm'n App. 1930); Masterson v. Amarillo Oil Co., 253 S.W. 908 (Tex. App. 1923, writ dism'd w.o.j.); Morgan v. Houston Oil Co. of Texas, 84 S.W.2d 312 (Tex. App. 1935); Guleke v. Humble Oil & Ref. Co., 126 S.W.2d 38 (Tex. App. 1939).

110. HEMINGWAY, *supra* note 55, § 8.9C; 5 WILLIAMS & MEYERS, *supra* note 9, § 853; 1 SMITH & WEAVER, *supra* note 2, § 5.4(B); 5 KUNTZ, *supra* note 43, § 60.3; MERRILL, *supra* note 8, § 84.

111. *See, e.g.*, Amoco Prod. Co. v. First Baptist Church of Pyote, 579 S.W.2d 280 (Tex. App. 1979, writ ref'd n.r.e.); Le Cuno Oil Co. v. Smith, 306 S.W.2d 190 (Tex. App. 1957, writ ref'd n.r.e.).

112. *See, e.g.*, Parker v. TXO Production Corp., 716 S.W.2d 644 (Tex. App. 1986, no writ); Davis v. CIG Exploration, Inc., 789 F.2d 328 (5th Cir. 1986).

113. *See, e.g.*, Michael P. Irvin, *The Implied Covenant to Market in the Deregulated Natural Gas Industry*, 42 ROCKY MTN. MIN. L. INST. 18-1 (1996); sources cited *supra* note 110.

B. Effect of a Shut-in Royalty Clause

A shut-in royalty clause does not bar the implied covenant to market. The shut-in clause provides a legal substitute for production in paying quantities under the habendum clause of a lease; it does not absolve the lessee from searching diligently for a market.[114]

In interpreting the express language of the shut-in royalty clause, the courts generally require that the shut-in well be capable of producing in paying quantities, even though the express lease provision itself does not say this.[115] This approach reflects the same underpinning as implied covenant law: that a lease is for the mutual benefit of both lessee and lessor. A lessee attempting to hold a lease by paying a shut-in royalty on a well which is not capable of producing in paying quantities is either speculating or has delayed too long in commencing a well under the express terms of the lease's habendum clause.

C. Express Clauses Barring the Implied Duty to Market

Few lease clauses other than the shut-in royalty clause affect the lessee's duty to market gas.[116] One Texas case exists, however, in which an

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114. HEMINGWAY, *supra* note 55, § 8.9c; 5 WILLIAMS & MEYERS, *supra* note 9, § 858.2; 1 SMITH & WEAVER, *supra* note 2, § 5.4(B)(1); 5 KUNTZ, *supra* note 43, § 60.3; MERRILL, *supra* note 8, § 84. If the shut-in clause contains a specific time limit on how long shut-ins can be paid, the lessee has a strong argument that such an express provision establishes a reasonable time for finding a market without risking an action of breach of the marketing covenant. *See also* Bruce M. Kramer & Chris Pearson, *The Implied Marketing Covenant in Oil and Gas Leases: Some Needed Changes in the 80s*, 46 LA. L. REV. 787, 801–08 (1986); Robert E. Beck, *Shutting-in: For What Reasons and for How Long*, 33 WASHBURN L.J. 749, 779–85 (1994).

115. Kidd v. Hoggett, 331 S.W.2d 515 (Tex. App. 1960, writ ref'd n.r.e.).

116. The oil royalty clause of a lease often permits the lessor to take the oil royalty in kind. Arguably, this oil is then under the control of the lessor and the lessee has no duty to market it. However, as a practical matter, the typical lessor has neither the expertise nor the facilities to dispose of his own oil. Most commentators state that the better rule is to imply a duty to market oil, even when the lease provides for royalty in kind. 5 WILLIAMS & MEYERS, *supra* note 9, § 853, at 393-94; 1 SMITH & WEAVER, *supra* note 2, § 5.4(B)(2). In *Cook v. Tompkins*, 713 S.W.2d 417 (Tex. App. 1986, no writ), the court held that the implied marketing duty did not require a lessee to make sure that the oil purchaser actually paid the lessor the royalties owed. The oil purchaser did not have the lessor's address and the accrued royalties owed were later greatly reduced when the purchaser went into bankruptcy. The lessor sued the lessee for the lost royalties under the implied duty to market. The court rejected the lessor's argument because of the "in kind" royalty clause and because the lessor was knowledgeable in oil and gas matters. Despite *Cook*, lessees who sell royalty oil may have assumed an agency relationship which will impose even greater duties on the lessee than those imposed under implied covenant law. 1 SMITH & WEAVER, *supra* note 2, § 5.4(B)(2), at 281-0. Moreover, *Cook* clearly recognizes that the implied covenant to market exists under an "in kind" royalty clause; the court merely held that the covenant was not breached under the facts of the case.

express clause was held to negate the implied duty to market. In *Gex v. Texas Co.*,[117] the court construed the following provision in a mineral deed executed by the Gexes as grantors to the Texas Company:

> It is agreed that the Texas Company, its successors or assigns, shall never be under obligation to drill or mine for oil or gas or other minerals, but that such mining or drilling, both before and after production, shall be wholly at the option of said grantee . . . . However, should oil or gas be produced from said premises in paying quantities by the Texas Company, . . . then there shall be paid to grantors . . . a royalty of one-eighth (1/8) of the interest hereby conveyed . . . .[118]

The Texas Company drilled one well on the 640-acre tract in which the Gexes had retained the 1/8 royalty interest and then committed the gas from the well to a minimum 25-year sales contract (from 1951 to 1976 and for an indefinite period thereafter) without the Gexes' consent. The gas was committed at prices that eventually fell below its market value. The Gexes filed suit alleging that the Texas Company had not acted as a reasonably prudent operator in marketing their gas.

The court held that the express clauses quoted above in the mineral deed barred the implication of any covenants requiring the delivery of gas in kind or any implied covenant to market. The deed eliminated all duties to ever drill or mine and the expression "wholly at the option of Grantee" also eliminated any implied covenant to market. The court distinguished the "option" language in this case from the "discretion" language in *Cowden*[119] that had been held to substitute a good faith standard for the reasonably prudent operator standard usually applied in implied covenant cases.

Furthermore, the Gexes were held to have no right to take royalty gas in kind because their royalty was phrased in terms of being "paid" to grantor, and payment means a payment of money. The Texas Company had paid 1/8 of the proceeds received from the gas to the Gexes. The Gexes had not provided facilities to receive or take any gas in kind, and the Texas Company therefore had the implied authority by virtue of business usage and custom to sell and market all the gas for the mutual profit of the parties.[120] The court then went one step further and held that the Gexes had no cause of action against the Texas Company for using its agency authority to market the gas at below market value.

117. 337 S.W.2d 820 (Tex. App. 1960, writ ref'd n.r.e.).
118. *Id.* at 822.
119. *See* quoted *Cowden* language *supra* text accompanying note 37.
120. 337 S.W.2d. at 828.

This case actually foreshadowed (but with quite a different result) the assertion that lessors would successfully make in *Texas Oil & Gas Corp. v. Vela*[121] a few years later: that their market value royalty clauses required lessees to pay them royalties based on a price higher than the price actually received by the lessee for the sale of the gas. The court in *Gex* seemed utterly unwilling to allow nonparticipating royalty interest owners holding under a mineral deed to bring such a cause of action. Indeed the court in *Gex* took judicial notice of the fact that long-term sales contracts for gas are a common practice. Summary judgment in favor of the Texas Company was affirmed.[122]

While the court's reluctance to impose the "market value" royalty problem on lessees in 1960 may be understandable (and the court's subsequent turnabout in *Vela* as incomprehensible), much of the *Gex* court's reasoning is open to serious criticism.[123] First, the deed expressly committed only drilling and mining operations to grantee's option. It was silent as to marketing. The language in the deed can be reasonably interpreted to allow the grantee complete discretion over the decision to enter into the costly act of drilling; yet if it drilled, the lessee would then be under an implied obligation to use reasonable diligence in marketing the production. An express provision negating certain implied covenants should not be interpreted as negating other covenants not mentioned.[124]

Second, grantee's exercise of its option to market does not mean it should be allowed to proceed to market negligently, without regard to the reasonably prudent operator standard or the interests of the royalty owner. Again, the court held that the provision that drilling was "wholly at the option of the Grantee" precluded the implied covenant to market. The court reasoned that proper development of a lease necessarily involved marketing, so conversely, an express covenant negating a duty to develop

121. 429 S.W.2d 866 (Tex. 1968). In *Vela*, the lessee had entered into a sales contract in 1935 for the life of the lease under which gas was committed to be sold at 2.3 cents per MCF. By the 1960s, similar gas in the field was selling for about 13 cents per MCF. The lessors were owed royalties based on the market price of the gas. The court held that "market price" clearly meant the prevailing market price at the time of the sale or use of the gas. The gas was "being sold" at the time it was delivered to the purchaser, not at the time of the gas sales contract entered into in 1935. *Id.* at 871. Therefore, under the express terms of the lease, the lessor was due a 1/8 royalty based on the market price of 13 cents rather than the proceeds price of 2.3 cents.

122. 337 S.W.2d at 828.

123. 5 WILLIAMS & MEYERS, *supra* note 9, § 858.3.

124. For example, the delay rental clause negates the implied covenant to drill an initial well, but it does not negate the implied covenant to protect against drainage, *see supra* text accompanying notes 43–49. Similarly, an express development clause does not negate the implied covenant to protect against drainage.

would negate the marketing covenant as well.[125] This reasoning is simply incorrect.

Third, the express duty in the deed to "pay" a royalty of ⅛ would ordinarily be construed to require the payment of ⅛ of the market value of the gas produced and sold from the well. In sustaining the Texas Company's motion for summary judgment, the court held that the complaint of sale below market value was irrelevant because the company had no duty to obtain the market price. A better reasoned decision would have held that absent an express provision requiring payment based on market value, the duty to "pay" requires a duty to pay based on proceeds received, as long as such proceeds reflected the best price that a reasonably prudent operator could have obtained at the time of contracting with the gas purchaser.[126] Because the Gexes did not have an express market value royalty clause to claim under,[127] the court could easily have entered judgment for lessee without wreaking havoc on well-established principles of interpreting implied covenants in leases. In sum, the *Gex* case is aberrant and should not be used as a guide to implied covenant analysis in Texas.

D. The Implied Covenant to Market under Market Value Royalty Clauses

Many commentators have stated that the implied covenant to market does not exist if royalties are based on market value.[128] The existence

125. 337 S.W.2d at 826. The court noted that the Texas Supreme Court in *Cowden v. Broderick & Calvert, Inc.*, 114 S.W.2d 1166 (Tex. 1938) had distinguished "discretion" from "at the option of." The first phrase simply lowers the lessee's implied duty to a "good faith" standard whereas the second negates any implied duty completely. Even assuming a good faith standard might apply, the court found no evidence of bad faith or improper motive in *Cowden*.

126. Alternatively, the court could have adopted the viewpoint of the dissenting justices in *Vela* that even under a "market value" royalty clause, the lessee is obligated to pay royalties based on "proceeds" because of the custom in the industry of selling gas under long-term contracts. *Vela*, 429 S.W.2d at 878–81.

127. The royalty owners in *Gex* had argued, unsuccessfully, that they were owed royalties expressly based on market value because their royalty clause had been modified by a communitization (pooling) provision requiring royalties to be paid on the amount realized or the market value, "whichever is greater." 337 S.W.2d at 824. The court held the modification to be inapplicable because the lessee had never exercised the right to communitize.

128. *See* 5 WILLIAMS & MEYERS, *supra* note 9, § 856.3; Bruce M. Kramer & Chris Pearson, *The Implied Marketing Covenant in Oil and Gas Leases: Some Needed Changes for the 80s*, 46 LA. L. REV. 787, 815 n.166 (1986); Thomas A. Harrell, *Recent Developments in Nonregulatory Oil and Gas Law*, 31 INST. ON OIL & GAS L. & TAX'N 327 (1980); Hardwick & Hayes, *Gas Marketing Royalty Issues in the 1990s*, SPECIAL INST. ON OIL & GAS ROYALTIES ON NON-FEDERAL LANDS, 2-1, 2-30 to 2-31 (ROCKY MTN. MIN. L. FOUND. (1993)); Patrick H. Martin, *Implied*

of an express market value clause bars the implied covenant because lessor's royalties are tied to an external standard rather than to the efforts of the lessee to market diligently. This prevailing view seems odd in light of two cases involving Texas leases that do indeed hold that such a covenant exists under a market value lease (absent an amendatory division order).[129]

In *Shelton v. Exxon Corp.*,[130] the lessor won a large judgment against the lessee for failure to market gas prudently under a market value lease. Exxon had developed a marketing strategy that sold substantial quantities of gas from the King Ranch to large customers under corporate warranty contracts. Unlike leases dedicated to interstate pipeline purchasers under federal regulation, warranty contracts do not designate the origin of the gas to be supplied. Exxon simply warranted that it would supply X quantity of gas at a certain price to its customers.

While Exxon argued that it, its customers, and the King Ranch all expected the gas contracts to be supplied by the King Ranch gas and that Exxon needed this gas to fulfill its contracts, these needs and expectations did not rise to the level of a commitment of the King Ranch gas to the contracts in question. Thus, the court held that Exxon was legally free to commit this gas to newer, higher priced contracts. Shelton argued that Exxon, as a reasonably prudent operator, should have dedicated the King Ranch gas to new contracts at prices that would have allowed the gas to be classified under Section 105(b)(2) of the Natural Gas Policy Act (NGPA) rather than Section 109, its ultimate classification. Section 105 gas could be legally sold at a higher price than Section 109 gas, i.e., the gas had a higher market value potential as Section 109 gas than as Section 105 gas.

The court found that Exxon, as a reasonably prudent operator, should have been aware of the imminent passage of the Natural Gas Policy Act that would classify gas into different categories with different price ceilings and escalators for each category. Thus, it was imprudent for Exxon to continue marketing the gas in a manner that limited its market value to a lower federally controlled price than could have been received. In short,

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Covenants in Oil and Gas Leases-Past, Present and Future, 33 WASHBURN L.J. 639, 653–54 (1994).

129. In addition to the two cases discussed in detail in this Article, see *Texas Oil & Gas Corp. v. Hagen*, 683 S.W.2d 24 (Tex. App. 1984) *opinion set aside and case settled*, 760 S.W.2d 960 (Tex. 1988). Before setting the appellate opinion aside, the Texas Supreme Court had issued an opinion in this case, see 31 TEX. S. CT. J. 140 (Dec. 15, 1987), affirming in part the judgment for lessors finding breach of the implied covenant to market under a market value lease. Upon settlement, the supreme court also withdrew this judgment and opinion.

130. 719 F. Supp. 537 (S.D. Tex. 1989), *rev'd on other grounds*, 921 F.2d 595 (5th Cir. 1991).

Exxon failed to market its gas at its highest possible market value. Relying on established Texas cases,[131] the federal court wrote:

> Exxon was required to market the King Ranch gas in the manner reasonably most profitable for the mineral interest owners and Exxon's operations on the King Ranch leases. Shelton and the other mineral interest owners cannot be penalized for Exxon's inability to back its corporate warranty contracts so long as they did not take part in formulating the marketing scheme of which those contracts are a part. Nor should they suffer for Exxon's failure to take the regulatory environment into account in marketing the gas, if it could have done so. Since the marketing scheme was Exxon's own, Exxon is at risk when the prudence of the scheme is judged.
>
> ....
>
> Exxon's failure to [prudently market] can only be attributed to its interest in fulfilling its corporate warranties without having to purchase gas on the open market. Exxon's method of marketing the King Ranch gas completely subordinated the rights of the mineral interest owners to Exxon's financial gain. Exxon's acts and omissions in so doing were not those of a reasonable, prudent operator having its own and the plaintiff's interests in mind.[132]

Shelton's victory under implied covenant law was short-lived. On appeal, the court held that Shelton was barred from bringing suit because he had signed a Settlement Agreement that encompassed this cause of action.[133] This ending does not affect the trial court's reasoning about the implied covenant to market under a market value royalty clause.

Similarly, in *Cabot Corp. v. Brown*,[134] the Texas Supreme Court recognized the existence of the implied covenant to market in a market value lease, but then held that the implied covenant was barred by express language in the division order. The supreme court in *Cabot* described the implied covenant to market as follows:

> Included within the covenant to manage and administer the lease is the duty to reasonably market the oil and gas produced from the premises. [citations omitted] This duty is

131. The court primarily relied on: *Amoco Production Co. v. Alexander*, 622 S.W.2d 563 (Tex. 1981), *Freeport Sulphur Co. v. American Sulphur Royalty Co. of Texas*, 6 S.W.2d 1039 (Tex. 1928), and *Amoco Production Co. v. First Baptist Church of Pyote*, 579 S.W.2d 280 (Tex. App. 1979, writ ref'd n.r.e.).

132. 719 F. Supp. at 549.

133. Shelton v. Exxon Corp., 843 F.2d 212, 218 (5th Cir. 1988).

134. 754 S.W.2d 104 (Tex. 1987).

> also two-pronged: the lessee must market the production with due diligence and obtain the best price reasonably possible. 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.[135]

The factual setting of *Cabot* is similar to that of *Shelton*: the lessee failed to maximize the market value of gas obtainable under federal pricing regulations. However, the facts in *Cabot* are somewhat more complex. In 1967, the Browns entered into a market value lease with Cabot. In 1967, Cabot and Transwestern Pipeline Company entered into a contract called an "exchange of gas." At that time, interstate prices were higher than intrastate prices.[136] A well on the lease began production in 1968 and the Browns signed division orders in January 1968 to receive their share of the well's production. Under the exchange contract, the Browns' gas was transported by Cabot through its pipeline to Transwestern's interstate pipeline system where the gas was commingled with gas to be sold in the interstate market. At that point, title to the Brown gas passed to Transwestern.

In exchange, Transwestern delivered an equivalent volume of gas to Cabot in another Texas county. Cabot used the exchange gas in its own Texas plant where it was commingled with gas produced or purchased by Cabot from the intrastate market. Thus, the Browns' gas never really left Texas.

The majority of the commingled gas which remained after Cabot processed it in its own plants was sold on the intrastate market at prices higher than the federal price ceilings. Because this sale of commingled gases provided a basis for the assertion of Federal Power Commission (FPC) pricing jurisdiction, in 1975 Cabot sought and obtained a Henshaw exemption for gas received and consumed within the state. Cabot sold the Browns' gas for $1.35 per MCF. However, Cabot paid royalties to the Browns on the basis of the federally regulated price of 38 to 80 cents, the price apparently received by Cabot from Transwestern at the delivery point to Transwestern's interstate pipeline.

The Browns brought suit under two causes of action, both alleging breach of the implied covenant to market. First, they argued that their gas was not dedicated to interstate commerce and thus was not subject to FPC pricing jurisdiction. Consequently, the Brown's argued that Cabot was paying royalties based on a price less than market value, in breach of its implied marketing duties. Second, the Browns pled in the alternative that, if the sale was subject to FPC jurisdiction, Cabot had an implied marketing

135. *Id.* at 106.
136. *Id.* at 107.

duty to seek abandonment of the exchange agreement to free the gas for sale into the higher-priced intrastate market. Brown presented expert testimony that a reasonably prudent operator would have sought and obtained an abandonment from the FPC.[137]

Based on a jury finding that Cabot had failed to reasonably market the gas, the trial court rendered judgment for the Browns. The court of appeals affirmed, holding that the gas had not been dedicated to interstate commerce.[138] Brown was awarded $424,000 in damages, based on expert testimony and evidence of comparable sales by Cabot to purchasers in the intrastate market. The expert also testified that a reasonably prudent operator would have sought abandonment on Cabot's behalf, had the gas been found to be dedicated.

The Browns' victory in the lower courts was as short-lived as Shelton's was on appeal. The Texas Supreme Court reversed the judgment for the Browns based on the language of the signed division orders.

E. Express Language in a Division Order Can Bar the Implied Marketing Covenant: *Cabot v. Brown*

The Texas Supreme Court in *Cabot* found it unnecessary to confront the legal question of whether the Browns' gas was dedicated to interstate commerce. Similarly, the justices found it unnecessary to reach the issue of whether a reasonably prudent operator would have sought and obtained an abandonment of FPC jurisdiction over this gas. Instead, the court held that the following language in the division order barred the implied marketing covenant until the lessors revoked the division order:

> Payments for gas shall be made to the above-named owners, . . . in proportion to their respective interests as shown above at the then effective price provided in that certain Gas Contract dated August 15, 1967, covering said land, entered into by and between Cabot Corporation, as seller, and Transwestern Pipeline Company as buyer, . . . or, if such gas sale be subject to the jurisdiction of the Federal Power Commission, at the price (rate) finally determined by the Federal power [sic] Commission to be applicable to the gas delivered.[139]

The supreme court concluded that the Browns were bound by the interstate prices under its prior holding in *Exxon Corp. v. Middleton*.[140] The

137. Cabot Corp. v. Brown, 716 S.W.2d 656, 661 (Tex. App. 1986, writ granted).
138. *Id.* at 659.
139. *Id.*
140. 613 S.W.2d 240 (Tex. 1981).

Middleton holding was paraphrased in *Cabot* as concluding that "division orders executed by royalty owners, which obligated the lessees to pay royalties at lower rates than those required under the gas royalty clauses, were nevertheless binding on the royalty owners until revoked."[141] Under *Middleton*, although division orders do not supplant the lease contract, they are binding between the parties for the time and to the extent that they have been or are being acted on and made the basis of settlements and payments.[142]

In so holding, the supreme court allowed the language in a division order to bar an implied covenant in a lease, using as precedent a case involving settlement of royalty payments by division orders under the express terms of a lease. The *Middleton* case did not involve the implied covenant to market. Rather, it reaffirmed the holding in *Vela* that a lessee must pay royalties based on market value when the lease so requires, even though market value, as measured by the price of similar gas, is much higher than the proceeds received by the lessee under a long-term gas sales contract.[143] The *Middleton* lessors could seek royalties based on the higher market value of gas only after they revoked the signed division orders which provided for royalties based on the lower amount realized from the gas sales. The majority opinion in *Cabot* failed to distinguish between the two very different scenarios. Never before had language in a division order been held to negate an implied covenant duty.

The dissenting opinion in *Cabot* better reflects the precedent that existed at the time *Cabot* was decided. The dissent concluded that the exchange of gas between Cabot and Transwestern was indeed subject to FPC jurisdiction (contrary to the holding of the appellate court), but nonetheless concluded that the lessors should have won under their alternative theory: that the lessee, as a reasonably prudent operator, could have secured an abandonment order from the FPC.[144] The dissenting opinion noted that the supreme court had long recognized that a lessee's implied covenant duties included the duty to seek favorable administrative

141. *Cabot*, 754 S.W.2d at 107.

142. 613 S.W.2d at 250.

143. *Id.* at 244–49.

144. 754 S.W.2d at 111. It is important to note that the majority opinion did not rely on a finding that the exchange gas was subject to FPC jurisdiction. The majority specifically held that "[i]t is unnecessary for us to confront the legal question involving dedication to interstate commerce." *Id.* at 106. Thus the majority would have held that the division orders barred the implied marketing covenant cause of action even if the gas was not subject to the FPC pricing regulations. The court's holding gives the lessee virtually unfettered discretion to decide whether or not a sale is subject to FPC jurisdiction under a division order which by its express terms, only allows royalty payments based on the FPC price "if" the gas sale is subject to the FPC.

action.[145] Division orders had never been allowed to shield lessees from underpayments to lessors, especially when the lessee was inequitably reaping the benefits of FPC jurisdiction at one end of a sales transaction by paying royalties based on the low interstate price, while selling the gas at the other end at a much higher intrastate price, not shared with the royalty owners.

These Texas cases, both under the marketing covenant and other implied covenants, define the framework within which future disputes over a lessee's marketing decisions should be analyzed. The next part of this Article looks at four scenarios likely to arise in the natural gas marketing context of today.

IV. ANALYSIS OF THE IMPLIED COVENANT TO MARKET: FOUR SCENARIOS IN NATURAL GAS MARKETING

A. The Reverse-*Vela* Scenario

> Lessor's lease requires a royalty based on market value of the gas sold at the well. Lessee enters into a long-term contract in the 1970s to sell gas to a pipeline purchaser at $7.00/MCF. During the 1990s, the price of similar gas drops to $2.00/MCF. Lessee continues to collect $7.00/MCF from the purchaser, but pays the lessor a royalty of⅛ of $2.00/MCF. Has the lessee violated the implied covenant to market?

This scenario is, of course, the reverse-*Vela*[146] situation. Under *Vela,* reaffirmed in *Middleton,* the Texas Supreme Court held that a lessee who entered into a long-term contract to sell gas at $2.00/MCF, followed by an increase in the price of similar gas to $7.00/MCF, was required to pay royalties based on the $7.00 price under the express terms of a market value lease clause.[147]

Commentators have uniformly agreed that both logic and fairness dictate that lessees in the reverse-*Vela* scenario are free to collect a high price from the purchaser and account to the royalty owner based on the lower market value.[148] While not usually phrased in this manner, the reasoning is that the express market value clause in the lease bars any implied covenant to share the lessee's premium price with the lessor.

145. The leading case is *Amoco Production Co. v. Alexander,* 622 S.W.2d 563 (Tex. 1981).
146. Texas Oil & Gas Co. v. Vela, 429 S.W.2d 866 (Tex. 1968).
147. *Id.* The holding in *Vela* was reaffirmed in *Middleton,* 613 S.W.2d 240.
148. *See, e.g.,* Irvin, *supra* note 113.

As yet, there appears to be no reported case in Texas or elsewhere addressing this scenario. Anecdotal evidence suggests that lessees playing out this scenario in the real world are paying lessors based on proceeds rather than market value, despite the compelling logic of *Vela*. Why might this be?[149] Perhaps it is not so clear that the express market value clause bars the implied covenant in this situation.

A lessor's own logical reading of the case law on implied covenants in Texas would advance in a three-step process as follows: First, the lessors in *Vela* sued the lessees under two different causes of action: one for breach of the express market value clause, and the other for breach of the implied marketing covenant. The trial court found only a breach of the express clause. The lessees had entered into the long-term gas sales contract in good faith and had not violated their implied duty to market.[150] In neither *Vela* nor *Middleton* did the court ever state that a market value clause barred the implied covenant. Indeed, the Texas courts would have held that the implied covenant to market does exist under market value leases.

Second, there is no direct conflict between a market value clause and the implied marketing covenant. Leases are to be construed against lessees and express clauses are not to bar implied covenants unless the two are in direct conflict.[151] There is no illogic in holding that the market value clause puts an express floor, or minimum price, on the amount due the lessor, while the implied covenant requires that the lessee pay more than this minimum if he does better than the market. In essence, the market value clause is a "starter" clause specifying the minimum duty owed, but not the maximum due under the implied covenant.[152]

Third, the Texas courts have clearly stated that market value can be determined in several ways. Recently the supreme court decided that, although evidence of comparable sales may be the most desirable method of determining market value, it is not the only method. The "netback" or "workback" formula of using sales proceeds minus the reasonable costs of transporting to the point of sales is a second method for determining market

149. The Texas division order statute, *infra* note 154, may partly explain this situation, at least as to division orders enacted after August 26, 1991, the effective date of the statute.

150. Texas Oil & Gas Co. v. Vela, 405 S.W.2d 68, 74 (Tex. App. 1966, writ granted).

151. *See, e.g.*, Freeport Sulphur Co. v. American Sulphur Royalty Co. of Texas, 6 S.W.2d 1039 (Tex. 1928); cases cited *supra* note 52; 5 KUNTZ, *supra* note 43, § 61.2; 5 WILLIAMS & MEYERS, *supra* note 9, § 826.

152. *W.T. Waggoner Estate v. Sigler Oil Co.*, discussed *supra* text accompanying notes 40, 81–89 and *Shell Oil Co. v. Stansbury*, discussed *supra* text accompanying notes 60–64 are precedents for this approach.

value.[153] Following this line of argument, lessors would advance proof that lessees themselves typically view market value as the price they receive for the gas sold when making severance tax payments. Further proof may well show that trade custom and usage in the industry is such that lessees in a reverse-*Vela* scenario are in fact paying lessors based on proceeds.

Despite the apparent logic of this three-step analysis, unless the Texas courts switch from the "plain terms" model to the "cooperative venture" model of interpreting express clauses in oil and gas leases, royalty owners in the reverse-*Vela* situation are not likely to win this case.[154] The express market value clause seems likely to bar the implied covenant duty in the reverse-*Vela* context.

B. The "If" Scenario: A Variation on *Cabot*

> Lessee owes royalties to lessor under a proceeds lease. The lessor has signed a division order with the following language:
>
> Royalty payments for gas sold shall be based on the net proceeds realized at the well by lessee. If the gas is processed in or near the field where produced, royalty

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153. Heritage Resources Inc. v. Nationsbank, 939 S.W.2d 118 (Tex. 1996). *See also* Owen L. Anderson, *Calculating Royalty: 'Costs' Subsequent to Production-Figures Don't Lie, but....*, 33 WASHBURN L.J. 591, 598–606 (1994).

154. A Texas division order statute, enacted in 1991, appears to equate "market value" with "amount realized." The statutory provision reads as follows:

> A division order may be used to clarify royalty settlement terms in the oil and gas lease.... [T]he terms "market value", "market price," "prevailing price in the field," or other such language, when used as a basis of valuation in the oil and gas lease, shall be defined as the amount realized at the mouth of the well by the seller of such production in an arm's length transaction.

2 TEX. NAT. RES. CODE ANN. § 91.402(i) (Vernon 1993).

This statutory provision seems to codify the holding in *Middleton* that division orders basing payments on amount realized are binding until revoked; the lessor who is owed market value royalties under the terms of the lease must first revoke the proceeds division order. Exxon Corp. v. Middleton, 613 S.W.2d 240 (Tex. 1981). The *Middleton* opinion, when issued in 1981, assisted lessees coping with the "plain terms" jurisprudence of *Vela's* definition of market value. In 1991, the price of natural gas at the wellhead was $1.59 per MCF, having fallen substantially since 1984. *Annual Energy Review 1991*, Table 81, p. 181 (Energy Information Administration). By 1991, many lessees had signed long-term gas sales contracts with contract prices substantially above this level. Thus, in 1991, it was advantageous to royalty owners to receive royalties based on proceeds from contracts at above-market prices rather than the market value reflected in the spot market price for gas. The 1991 pricing situation was the reverse of that which existed when *Vela* and *Middleton* were decided in 1968 and 1981 respectively. In 1991, lessees, not lessors, would want to revoke division orders based on proceeds and pay lessors the lower market price for gas.

> payments shall be based on the net proceeds received at the well, as determined by the agreement between the producer and the processor.
>
> The lessor brings a cause of action for breach of the implied marketing covenant alleging that the lessee has imprudently processed the gas rather than sold it in unprocessed form. The lessee's decision to process is driven by the lessee's ownership interest in the processing plant and its desire to maximize processing profits.

This scenario is designed to focus attention on the *Cabot* opinion that held that the express language in a division order barred the implied marketing covenant until the division order was revoked.[155] As we have seen, the Texas courts generally will not lightly displace implied lease covenants unless such covenants are inconsistent with an express clause clearly intended to embrace the lessee's entire duty under the implied covenant.

In light of this framework analysis, *Cabot* majority opinion is wrongly decided. Nothing in either the *Cabot* division order or in the analogous one above suggests that the lessee's decision to trigger the "if" provision is immune from review under implied covenant law. The "if" provision clearly places discretionary power in the lessee, a power that brings with it an implied duty to use the power wisely, absent clear language to the contrary.

Unless *Cabot* is overruled, royalty owners must seek ways to minimize its effect on implied covenant litigation. The *Cabot* majority opinion distinguished its own holding from prior rulings that division orders do not, as a general rule, relieve the lessee of a duty to market gas as a reasonably prudent operator.[156] These precedents strongly suggest that the *Cabot* opinion does not apply to division orders or leases which expressly require royalty payments based on proceeds, as in the scenario described above.

Thus, the *Cabot* opinion should be limited to hold that the express language of division orders can bar the implied marketing covenant only in the case of a "market value" royalty clause. The *Middleton/Cabot* sequence of cases arose from the litigious and complicated issues of determining market value under federal pricing regulations in jurisdictions

155. Cabot v. Brown, 754 S.W.2d 104 (Tex. 1987).

156. The court distinguished *Amoco Production Co. v. First Baptist Church of Pyote*, 579 S.W.2d 280 (Tex. App. 1979, writ ref'd n.r.e) and *Le Cuno Oil Co. v. Smith*, 306 S.W.2d 190 (Tex. App. 1957, writ ref'd n.r.e.). In *Amoco*, the particular division order at issue referred to proceeds at the well and did not change the lease royalty clause also based on proceeds. In *Le Cuno*, the division order based on proceeds was held to require the lessee to exercise good faith in any contract it entered disposing of the royalty owners' gas.

hewing to the *Vela* rule that market value may differ radically from the proceeds actually received by lessees. The *Cabot* court held that *Middleton* was controlling in its language that division orders are binding "for the time and to the extent that they have been or are being acted on and made the basis of settlements and payments."[157] This language in *Middleton* is actually taken from the language in *Phillips Petroleum Co. v. Williams*.[158] The *Phillips* language is directly tied to the need for clarity about what is "market value:"

> The very existence of this and the other numerous other litigations which have arisen over the meaning and effect of market price or rate provisions and over what was the market price or value of the gas, and the fact that these agreements [the division orders] fix, as due, sums which may from time to time be more or less than the prevailing market price, give full support to and make binding payments and settlements thereunder.[159]

Under this reasoning, the *Middleton/Cabot* sequence of holdings is simply not applicable to proceeds leases at all. I would argue further that the sequence is not applicable in any scenario other than the determination of market value in a price-regulated industry.[160] In today's deregulated environment, *Cabot* should be treated as a dead letter.

C. The Index Pricing Scenario

> Lessee owes lessor royalties based on a market value lease clause. Lessee accounts to lessor for royalties based on the nearest market hub price of $2.00 per MCF minus

157. 754 S.W.2d at 107.
158. 158 F.2d 723, 727 (5th Cir. 1946).
159. *Id.*
160. The *Cabot* holding may also be limited to the fact situation in which the lessee's initial marketing decision was prudent when first made. Arguably, the lessee in *Cabot* had acted prudently in entering into the 1967 contract with the pipeline purchaser because at that time interstate prices were higher than intrastate prices, a fact specifically noted by the court. *Cabot*, 754 S.W.2d at 107. Had the price differential been reversed, the court might have found breach of the implied marketing duty. Still, this fact makes the *Cabot* opinion even more difficult to explain: Why should a lessee not be held to act as a reasonably prudent operator throughout the term of the lease? Such an operator should continue to monitor the price differential and seek FPC abandonment if intrastate prices became higher than interstate prices, unless the cost of doing so would exceed the benefits. It is quite clear why Cabot did not seek FPC action; it was reaping the benefits of the price differential without having to share the differential with the lessors. Such self-dealing has always been condemned in implied covenant law. *See, e.g.*, Amoco Prod. Co. v. Alexander, 622 S.W.2d 563 (Tex. 1981); *First Baptist Church of Pyote*, 579 S.W.2d 280.

> transportation expenses from the wellhead to the hub of 30 cents per MCF. The royalty payments are independent of the proceeds actually received by lessee from the sale of this gas. Lessor brings suit arguing that this market hub price is not the best price that the lessee could have received; indeed the lessor has proof that the lessee's proceeds, netted back to the well, are higher than the netback hub price.

The lessor's cause of action in this law suit can be characterized in two ways: first, as an action under the express clause of the lease; and second, as a cause of action under implied covenant law. The first battle will be fought through expert testimony about which market hub, if any, sells gas comparable in time, quantity, quality and end use to the lessor's gas.[161]

The implied covenant battle will be fought on a different playing field. The lessee will first argue that no implied covenant exists under a market value royalty clause. This oft-cited principle is too broadly stated. While it may apply in a reverse-*Vela* situation, the principle does not apply when the lessee has discretion to choose the classification category (as the lessees in *Shelton* and *Cabot* could do under federal price controls) or to choose the market index price that will define market value. The lessee's exercise of this discretion is subject to the reasonably prudent operator standard.

Thus, if the lessee elects to value the royalty gas at one market hub, yet the lessee is actually selling the gas at another market hub where it is both valued and sold at a higher price, this lessee may have violated the reasonably prudent operator standard.

The implied marketing covenant will also arise in this scenario if the lessee is a vertically integrated major or one of the new mega-marketers and is manipulating the index used to value royalty gas. The published price indices used as a marker of market value are deficient in many respects.[162] Participation by producers in reporting prices to the survey collectors is voluntary. Producers may not want to reveal competitive price information either for antitrust or strategic business reasons. It is most often the large vertically integrated major producers and marketers who decline to participate in the price surveys. These majors buy and sell enormous quantities of gas at prices which may not enter into the published surveys. This scenario presents an obvious opportunity for producer/marketers to sell at an unreported price above the market hub price, while basing their royalties on the hub's reported price. Even a difference of a penny between

161. See *Exxon Corp. v. Middleton*, 613 S.W.2d 240, 246–49 (Tex. 1981) for a discussion of the methodology of determining market value.

162. Craig R. Carver, *Natural Gas Price Indices: Do They Provide a Sound Basis for Sales and Royalty Payments?*, 42 ROCKY MTN. MIN. L. INST. 10-15, 10-16 (1996).

the hub's reported price and the mega-marketer's actual price can result in millions of dollars of underpaid royalties.

In one of the class action suits currently undergoing the class certification process in the Texas courts, the producer and its marketing affiliates used an "index formula" as the basis for paying royalty owners. The producer first calculated a wellhead index price by taking an average of three published price surveys for gas sold at transportation delivery points and netted this price back to the wellhead. It then compared this wellhead index price with the "market realization" price that it actually received in sales to third parties. The producer then compared the two figures and applied this rule: If "market realization" was greater than the index price, settle at index. If "market realization" equaled the index price, settle at index. If "market realization" was less than index price, settle at "market realization" minus two cents.[163] This formula is a "heads lessee wins, tails lessor loses" game.

Conduct such as this will provide ample opportunity for implied covenant law in the new world of index pricing. Whether the lease royalty clause is based on market value or proceeds, the lessee has an implied duty to market gas on the best possible terms. Constructing an index formula or manipulating market indices in a manner which sets the lessor's royalty at a lower price than the lessee is actually receiving violates this principle.

D. The Take-or-Pay Scenarios

> Scenario One: A lessee bargains with its pipeline-purchaser for a buy-down of the purchaser's take-or-pay contract with the producer. The lessee is offered a cash payment of $2 million in exchange for reducing the price of gas from $7.00/MCF to $3.00/MCF. The lessee counters with an offer, which is accepted by the purchaser, to reduce the price of gas to $2.50/MCF in exchange for receiving a cash payment of $4 million. The lessee owes the lessor royalty under a "proceeds" or "amount realized" royalty clause.
>
> Scenario Two: A pipeline-purchaser breaches its contract to buy gas from a producer at $7.00/MCF under a take-or-pay contract. The producer sues and during the litigation sells the gas subject to the contract on the spot market for $2.00/MCF to mitigate damages. Ultimately, the parties settle the take-or-pay dispute in a buy-out that terminates the contract in exchange for a cash settlement. Part of the $6 million cash settlement represents the projected

163. Altheide v. Meridian Oil Inc., Cause #92-026182, 113th Judicial District Court of Harris County, Tex., Motion for Class Certification filed Sept. 23, 1996.

difference between the \$7.00/MCF contract price and the market price of gas over the remaining term of the contract, including the two years of litigation during which the gas was actually sold on the spot market.

The lessee's conduct in the first scenario strongly suggests that the lessee has breached its implied marketing duty to its royalty interest owners. The lessee has not sought to market the gas at its highest possible price considering the interests of both the lessee and lessor. The lessee has traded a lower price of gas for a cash benefit that will not be shared with royalty owners, in a self-dealing manner.[164] No express clause would appear to bar subjecting this lessee's judgment to the reasonably prudent operator standard.

The second scenario is a simplified version of *TransAmerican Natural Gas Corp. v. Finkelstein.*[165] In *Finkelstein,* an overriding royalty interest owner sought a share of the settlement proceeds on natural gas actually produced before the buy-out of the take-or-pay contract. Finkelstein essentially argued that the lessee had received two prices for the produced gas: first, the spot market price; and second, the difference between the contract price and the spot market price as settlement proceeds. Finkelstein argued that under implied covenant law and a proceeds lease, a lessee must share with its lessor the combined high price for gas which the lessee has in fact received on gas actually produced.

While the opinion in *Finkelstein* often uses the words "lease" and "lessee" to describe the relationship between Finkelstein and the producer, TransAmerican, the relationship was not one of lessee to lessor. Rather, Finkelstein was an overriding royalty interest owner who had earned the right to certain percentages of gas produced and sold from the La Perla Ranch through his successful efforts to secure for TransAmerican the mineral rights under this ranch. The original $^{1}/_{16}$ overriding royalty interest was defined as "equivalent to $^{1}/_{16}$ of the net revenue interest" from all such mineral rights.[166] Finkelstein later acquired an additional overriding royalty interest through a settlement of his claims against TransAmerican in TransAmerican's bankruptcy proceedings. This additional override was phrased in the following terms:

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164. *See, e.g., First Baptist Church of Pyote,* 579 S.W.2d 280. See also *Manges v. Guerra,* 673 S.W.2d 180 (Tex. 1984) for an analogous breach of the duty owed by the executive right owner to a nonexecutive mineral interest owner.

165. 933 S.W.2d 591 (Tex. App. 1996) (en banc opinion dated August 14, 1996, overturning the original three-judge panel opinion issued in April 1996 which had affirmed the trial court's judgment in favor of the royalty interest owner under implied covenant law).

166. *Id.* at 593–94.

> [A]n overriding royalty interest of one and one-half percent (1½%) of all oil, gas, [and] other hydrocarbons . . . produced and saved from or attributed to the interests owned by [TransAmerican] . . . in and to all (i) . . . oil and gas lease . . . , (ii) development agreements, joint development agreements, farm-out agreements, . . . net revenue interest agreements, and, without exception, all other agreements which have as their purpose or will involve or be concerned with the exploration, drilling and/or production of oil [or] gas, . . . and (iii) all other interests in land, including, but not limited to fee mineral interests, royalty interests, overriding royalty interests, net profits interests, production payments and other similar interests in production of oil [or] gas.[167]

The original panel opinion in *Finkelstein* carefully threaded its way around previous cases in which royalty owners had been defeated in their efforts to secure a share of take-or-pay proceeds. None of these cases had presented the issue of whether the implied marketing covenant required a lessee to pay its lessor a share of take-or-pay settlement proceeds on gas actually produced after a purchaser had repudiated the take-or-pay contract and then was made to pay "repudiation" damages for the breach. Finkelstein argued, quite successfully at first, that when a purchaser breached a take-or-pay contract and the producer first sold the "repudiated" gas on the spot market (for, say $2.00/MCF) and then received substantial damages equal to the difference between the spot price and the contract price (say, $7.00/MCF) on that produced gas, the producer/lessee owed its lessor a share of the repudiation damages under implied covenant law. Every lessee owes its lessors the duty to market at the highest possible price and this duty requires sharing the highest price received for the produced gas, including any repudiation damages.

Following the lead of several commentators, the original panel opinion distinguished nonrecoupable buyouts from other types of take-or-pay proceeds:

> When a buyer breaches its take-or-pay obligation and compensates for its breach with take-or-pay damages, the gas remains committed to the contract and stays in the ground . . . . A royalty interest dependent upon production is therefore not owed at the time the take-or-pay payment is made. Rather royalty is owed when the buyer actually takes the gas pursuant to its contractual make up right, and its account is credited with the corresponding amount of the take-or-pay damages. But if the buyer repudiates the contract,

167. *Id.* at 597–98.

> and the seller mitigates its damages by producing and selling gas to third parties at the spot market price, the gas is gone. If royalty is not owed on the seller's repudiation damages, the royalty owner will never recover royalty on the price effectively received for the gas produced and sold on the spot market during the period of repudiation. Repudiation damages are thus in the nature of a nonrecoupable "buyout."[168]

A few months after the panel opinion was issued, Finkelstein's victory was overturned in an en banc opinion on motion for rehearing. A majority of four justices held that Finkelstein was not entitled to any part of the take-or-pay proceeds. The three judges who had decided the original panel opinion in Finkelstein's favor filed their panel opinion as a dissent.

The majority opinion in the en banc *Finkelstein* begins the analysis part of its ruling by citing *Danciger Oil & Refining Co. of Texas v. Powell*[169] for the principle that courts are not to read additional provisions into a lease.[170] Because Finkelstein, an experienced independent producer, could have, but did not, specifically included a provision that allowed for royalty to be paid on proceeds from take-or-pay settlements, Finkelstein could not recover on this basis. The court appears to hold that the lack of express language in Finkelstein's grant bars any implied covenant from securing to him the highest price received by his lessee.

Unlike *Danciger*, however, the court did not explain why the language of Finkelstein's specific contracts failed to show a dominant purpose to obtain royalties on gas produced at the highest price received by the lessee. Furthermore, *Danciger* does not stand for the proposition that courts should not read additional provisions into a lease. Rather its holding is that "covenants will be implied in fact when necessary to give effect to the actual intention of the parties as reflected by the contract or conveyance as construed in its entirety in the light of the circumstances under which it was made and the purposes sought to be accomplished thereby."[171]

The court in *Danciger* refused to read an implied covenant to develop into the specific terms of Danciger's royalty grant. It found that Danciger had received a large cash payment as consideration for conveying a mineral deed. The court stated that mineral deeds usually do not have development as their dominant purpose; they are investment vehicles. Moreover, in *Danciger*, the deed expressly stated that the grantee/operator was only subject to a duty to protect against drainage and to no other duty.

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168. *Id.* at 608 (citing 1 SMITH & WEAVER, *supra* note 2, § 4.6(E)(6)(b), at 215-1 to 215-4).
169. 154 S.W.2d 632 (Tex. 1941).
170. 933 S.W.2d at 597.
171. 154 S.W.2d at 635.

By way of contrast, Finkelstein's only compensation for his efforts in securing mineral interests for TransAmerican were the overriding royalties.[172] No language in Finkelstein's grants showed any hint of reducing or negating the implied covenant to market. Indeed royalties based on "net revenues" or "proceeds" suggest just the opposite, a dominant purpose of obtaining the highest price possible. Far from being exclusionary and was not limited to the list of typical industry agreements (such as farmouts). Instead, it included, "without exception, all other agreements which have as their purpose or will involve or be concerned with" the exploration or production of oil or gas. It is difficult to argue that take-or-pay payments are not "concerned" with the production of gas.[173]

Instead of analyzing the express language of the Finkelstein royalty provision and the circumstances surrounding its creation (other than Finkelstein's expertise in oil and gas matters), the majority opinion stated the following propositions as "one-liners" from past cases:

> a. "The lessee's royalty obligations are determined from lease agreements executed prior to and wholly independent of gas purchase contracts. The royalties are fixed and unaffected by the gas contracts," citing *Middleton*.[174]
> b. "Take or pay is not a benefit which flows from the marketing covenant of a lease," citing *Mandell v. Hamman Oil & Refining Co.*[175]
> c. "[T]he pay option under a take-or-pay contract is not a payment for the sale of gas. Rather it is a payment for the exclusive dedication of reserves for a fixed period of time," citing *Lenape Resources Corp. v. Tennessee Gas Pipeline Co.*[176]

Yet each of these one-liners seems an inaccurate snapshot of the holdings in the cited cases. Surely royalties are crucially affected by the gas

172. In *United States Steel Corp. v. Whitley*, 636 S.W.2d 465 (Tex. App. 1982, writ ref'd n.r.e.), the court held that a uranium lessee owed implied covenant duties to an overriding royalty interest owner; the court found *Danciger* inapplicable because it involved a mineral deed, not a lease. *Id.* at 474. The court upheld the judgment for the overriding royalty interest owner even though the conveyance creating the override stated that uranium operations "shall be at the will of the assignor."

173. Curiously, neither the majority nor the dissenting opinions in the en banc opinion differentiate between Finkelstein's first grant of a royalty based on a "net revenue interest" and the second grant which added an additional 1.5 per cent royalty applied to a much broader base of revenues.

174. 613 S.W.2d 240, 245 (Tex. 1981), *cited in Finkelstein*, 933 S.W.2d at 598.

175. 822 S.W.2d 153, 165 (Tex. App. 1991, writ denied), *cited in Finkelstein*, 933 S.W.2d at 600.

176. 925 S.W.2d 565, 570 (Tex. 1996), *cited in Finkelstein*, 933 S.W.2d at 598.

contract entered into by a lessee.[177] The *Middleton* opinion simply holds that the royalties payable to a lessor under an express market value clause may differ from the royalties due based on proceeds. *Middleton* says nothing about implied covenant law.

The quotation from *Mandell* also seems inappropriate in that the next line in the *Mandell* opinion reads that "Hamman was required to obtain for appellants [royalty owners] only benefits received that were related to the sale of gas that had been produced."[178] The holding of *Mandell* is that production is the key to royalty, a proposition that neither side disputed in *Finkelstein*. Moreover, the statement that take-or-pay is "not a benefit which flows from the marketing covenant" is much too broad. A lessee who failed to negotiate a take-or-pay provision in a gas purchase contract at a time when all other producers in a field were doing so would surely have violated the reasonably prudent operator standard. This lessee's gas would probably be the first to be cut back by a purchaser when demand fell because the purchaser would suffer no liability for not taking this gas vis-a-vis gas from the other producers in the field with take-or-pay contracts.

In addition, the en banc *Finkelstein* opinion fails to acknowledge that the lessors in *Hamman* received damages for their pricing claims against their lessee. The lessee, Hamman Oil, had sued its pipeline-purchaser, Tennessee Gas Pipeline Company, for breach of its sales contract. In 1983, Tennessee refused to take more than half of the gas that Hamman could produce and, in addition, reduced the contract price to the minimum lawful rate for interstate gas. Hamman asserted claims for Tennessee's unauthorized price reductions on the gas that was taken and for drainage caused by Tennessee's violation of the ratable take provision in the contract.[179] Tennessee ultimately paid eight million dollars to settle all of Hamman's claims. Hamman itself determined that the royalty owners were due a portion of this settlement that reflected recovery for the price reduction on the gas produced and for the drainage claims.[180] The *Finkelstein* court does not explain why lessors may receive royalties on pricing settlements due to price reductions by the original pipeline purchaser, but are not due royalties on pricing settlements when the original purchaser has repudiated the contract and the gas is then sold on the spot market to other

177. For example, a lessee who signs a gas contract to sell gas for 50 cents when a reasonably prudent operator would sell for $1.00 is crucially affected by the lessee's failure to act competently.

178. 822 S.W.2d at 165.

179. *Id.* at 157.

180. *Id.*

purchasers. Certainly, it is not clear what "plain language" sustains this result.[181]

The court's reading of *Lenape* on the nature of take-or-pay seems to be the key to the court's decision. The *Finkelstein* court viewed the repudiation damages as an award for nonproduction, for gas not taken or paid for under the gas purchase agreement.[182] The award represented the compromise of a dedication claim that existed independently of the lease. Thus, even though the gas was in fact produced, no royalties were due on it.

The *Finkelstein* court also failed to examine the facts and circumstances surrounding the growth of take-or-pay contracts in the 1970s. During this decade of severe gas shortages, the federal government extensively regulated gas prices so that pipeline purchasers were not free to compete for sales from producers on the basis of price. Increasingly, purchasers competed on the basis of other terms in the purchase contracts, notably the take-or-pay provision.[183] Viewed in this manner, the settlement of a take-or-pay provision for repudiation damages is difficult to divorce from a lessee's implied obligation to pay the highest price received on production from a lease. Take-or-pay clauses were a substitute for higher prices, so a share of repudiation damages for breach of this clause would compensate the lessor for this trade-off.[184]

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181. In *Hamman*, neither party contested the payment of royalties to lessors based on the pricing and drainage claims. It appears from anecdotal evidence that many lessees, like Hamman, have read implied covenant law to require these payments. If these payments amount to trade custom and practice, it is indeed odd to find a court stating so broadly that "take or pay is not a benefit which flows from the marketing covenant of a lease."

182. TransAmerican Natural Gas Corp. v. Finkelstein, 933 S.W.2d 591, 597–99 (Tex. App. 1996).

183. JOHN S. LOWE, OIL & GAS LAW IN A NUTSHELL 288–90 (3d ed. 1995).

184. Even the *Lenape* court recognized that take-or-pay contracts are integrally related to a lessee's production. This court viewed the "central purpose" of take-or-pay clauses as allocating the risk of market demand fluctuations to the buyer; invalidating such contracts would shift the market risk back to the producer and "inevitably chill exploration and production." Lenape Resources Corp. v. Tennessee Gas Pipeline Co., 925 S.W.2d 565, 572 (Tex. 1996). The *Lenape* court could hardly fail to recognize the relationship between implied covenant law and the take-or-pay clause, given the facts of the case. The dispute between Lenape and the pipeline originated because Lenape's lessors had become unhappy with the low production and revenues received from two wells on their lease. When the price and demand for gas plummeted in the early 1980s, Tennessee Gas sent notice to all its producers that it would reduce its purchases and prices and not honor its take-or-pay obligations with producers who refused to amend their contracts with the pipeline. Lenape had little reason to drill or develop new wells under these conditions. Lenape's lessors sued for breach of the implied covenant to develop their tract and for failure to produce in paying quantities. Lenape settled the lawsuit by agreeing to pool part of the committed acreage with adjacent property. After pooling, Lenape entered into a farm-out with Tesoro and Coastal. Tesoro then drilled new wells which boosted the productive capacity of the leased acreage, greatly

Ironically, a federal district court in Mississippi, relying on the original panel opinion in *Finkelstein*, held that royalty owners could share in nonrecoupable take-or-pay settlements.[185] This court thought that the Texas panel opinion had followed the dictates of *Danciger* and had awarded royalties to Finkelstein based on "the Texas courts' literal interpretations of lease language" under the plain terms model of jurisprudence.[186]

Clearly, "plain terms," are not so plain.

The Texas Supreme Court will likely review *Finkelstein*. In that event, the court will have to engage in a more careful analysis of the language and circumstances surrounding the creation of the *Finkelstein* royalties, if the court is to remain true to the spirit of *Danciger Oil & Refining Co. of Texas v. Powell* and many of the other cases discussed in this Article. What is there in the language and circumstances of Finkelstein's net revenue interests which negates the existence of an implied covenant to share that part of the take-or-pay judgment based on the highest price received by the lessee for gas actually produced? Is the circumstance of Finkelstein's status as an experienced oil and gas operator determinative? Is a "net revenue interest" so well defined in the oil and gas industry that no one would expect it to include any part of a take-or-pay settlement? Are overriding royalty interest owners to be treated differently from lessors under a lease, because the inherent nature of an override is somehow riskier?

If the judgment against Finkelstein is ultimately upheld, premised on Finkelstein's status and the peculiar language of his grant, then ordinary lessors owning royalties based on the "amount realized" from gas production under a typical lease might succeed in a similar lawsuit, despite Finkelstein's loss.[187]

No lessor is likely to succeed, however, if the *Finkelstein* opinion is ultimately premised on the inherent nature of a take-or-pay provision in a gas sales contract as being completely divorced from a lessee's duty to act as a reasonably prudent operator in marketing gas under an oil and gas

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exacerbating the take-or-pay dispute between Lenape and its pipeline purchaser. *Id.* at 568, 572.

185. Williamson v. Elf Aquitaine, Inc., 925 F. Supp. 1163 (N.D. Miss. 1996).

186. *Id.* at 1169–70. See also dissenting Justice Rickhoff's parting shot in *Finkelstein* on denial of Finkelstein's motion for rehearing. 933 S.W.2d at 611 (characterizing the majority opinion as a "tortured climb" over the express language of the lease).

Finkelstein had successfully pleaded an alternative cause of action based on unjust enrichment in the trial court. The en banc appellate opinion reversed recovery on this equitable claim because no implied or quasi-contract can arise if the subject is covered by an express contract, especially one entered into by sophisticated parties. *Id.* at 600.

187. As noted, the court in *Finkelstein* seemed to go out of its way to frame the dispute between Finkelstein and TransAmerican as one between lessee and lessor, as if to discourage any further lawsuits by lessors.

lease. The appellate court's string of one liners from *Middleton, Mandell,* and *Lenape* then earns the *Finkelstein* result a one-liner of its own: "the revenge of *Vela.*" Once the supreme court majority in *Vela* interpreted the express royalty clause in a lease such that lessors' royalties were no longer tied to the lessee's prudently negotiated gas sales contract, a crack appeared in the cooperative model of an oil and gas lease. Not surprisingly, this development posted danger signs to implied covenant law that is closely tied to the cooperative nature of the lease.

If Texas precedent is carefully honored in the supreme court's review of *Finkelstein,* this crack should not become a hole. Whether Finkelstein wins or loses at the highest level, the supreme court should engage in reasoned analysis, based on the express language and all the facts and circumstances surrounding the contract as required under *Danciger.* Such an analysis should avoid stringing "one-liners" together in a misleading manner that will undoubtedly cause mischief and instability in the law for years to come.

Texas has a long jurisprudential history of oil and gas law that has consistently honored the cooperative nature of the oil and gas lease, albeit while adopting the "implied in fact" contract model of implied covenants. In many instances, lessors have won implied covenant cases despite what appear to be "plain terms" in favor of the lessee. The Texas courts have shown a noted reluctance to allow express language to bar implied covenants, except when the two are in direct conflict and the express clause is clear. Put simply, the "plain terms" model of interpretation of express clauses in leases does not ordain that express clauses be read broadly to bar implied covenants in oil and gas leases.

In the end, the ultimate lesson of *Finkelstein* is that the "plain terms" model of the oil and gas lease is difficult to apply and conceptually inferior to the cooperative model in describing the relationship between lessors and lessees. Terms in dispute are hardly ever "plain," nor do contract terms arise in a vacuum devoid of context. Yet, under either model, arguments can be advanced both for and against the sharing by royalty interest owners in take-or-pay settlements.[188] The task for the Texas Supreme Court is to advance its arguments coherently while remaining true to the jurisprudence of implied covenant law discussed in this Article.

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188. The arguments on both sides are presented in Lowe, *supra* note 14; at 244–64, 266–67. Professor Lowe's article analyzes whether take-or-pay payments should be shared by royalty owners under the express terms of their leases and does not purport to examine the related issue of the scope of implied covenants. *Id.* at 229. Despite the thoroughness of his analysis, the article does not discuss the *Finkelstein* scenario wherein royalties are sought on take-or-pay settlements for gas actually produced, either under the express terms of a lease or under implied covenant law.

V. A LOOK TO THE FUTURE

Implied contract law is not dead in Texas. Its principles will be applied to new marketing scenarios, such as those illustrated in this Article in the natural gas marketing context. Implied covenant law is intensely fact specific in its application. A lessee must act as a reasonably prudent operator would under similar facts and circumstances considering the interests of both the lessor and the lessee. The facts and circumstances that will bear most strongly on the evaluation of the lessee's conduct in the new, deregulated environment set a research agenda for the upcoming millennium. I predict that lawyers interested in implied covenant issues will become students of many other bodies of knowledge, including:

1. Corporate law. When does the marketing affiliate of a producer fall into the alter ego doctrine such that the transactions between marketer and producer are treated as sham sales or as sales that do not reflect market value?

2. Antitrust law. Will the gains of moving from a regulated to a deregulated industry be thwarted by the mega-mergers that are now occurring between large marketers and producers? Will the problem of pipeline monopoly power shift from the interstate market of open access to unregulated local gathering lines? Empirical studies of hub markets, of the degree of competition in regional natural gas markets, and of the statistical validity of the price indices used to determine market value will become part of the oil and gas lawyer's required reading. State oil and gas commissions and attorneys general are also likely to take an active interest in these matters.

3. Class certification procedures. Increasingly, royalty interest owners are pursuing claims against their lessees through class action suits involving hundreds, if not thousands, of royalty interest owners. Will these owners be able to meet the procedural requirements for class certification?

4. Commercial law. The Uniform Commercial Code's emphasis on good faith in contract performance seems to embrace the doctrine of implied covenants. Yet good faith has "atrophied" as a contract doctrine in Texas.[189] What impact will the doctrine of good faith in non-oil and gas cases have on oil and gas jurisprudence?

5. Law and Economics. "Law and economics" scholars have urged the courts to impose a higher standard of scrutiny on long-term relational contracts or contracts using open terms when the interests of the parties under such contracts diverge. The oil and gas lease is often used as the

189. *See* Mark P. Gergen, *A Cautionary Tale about Contractual Good Faith in Texas*, 72 TEX. L. REV. 1235 (1994).

paradigm of such long-term contracts[190] Will the courts adopt the "rule of joint maximization" and other reforms suggested by these scholars as guidelines for enforcing and interpreting implied covenants in oil and gas leases?

This research agenda will keep implied covenant law alive and well into the twenty-first century.

190. *See, e.g.*, Mark P. Gergen, *The Use of Open Terms in Contract*, 92 COLUMBIA L. REV. 997 (1992); Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089 (1981); Charles J. Meyers & Steven M. Crafton, *The Covenant of Further Exploration-Thirty Years Later*, 32 ROCKY MTN. MIN. L. INST. 1-1 (1986).