Chapter 10
EXPLORING THE JURISPRUDENTIAL UNDERPINNINGS OF THE IMPLIED COVENANT TO MARKET

David E. Pierce
Professor of Law
Washburn University
Topeka, Kansas

Synopsis

§ 10.01 Introduction

Courts use implied covenants as interpretive tools to complete an otherwise incomplete contract. As with any interpretive tool, the goal is to give effect to the intent of the contracting parties. If the parties' intent can be ascertained from the express terms of the contract, courts need not look beyond the express terms to define the parties' rights and obligations.[1] Therefore, any analysis of implied covenant jurisprudence should begin with an analysis of the proper role for courts in contract interpretation.

Fundamental freedom of contract concepts require that courts enforce the parties' contract—not a contract of the court's making.[2] The essence of contract law is "private ordering," the ability of individuals in a free society to create the rules that govern their relationships. However, when the contract made by the parties is not clear, or is otherwise incomplete, courts are permitted to intervene to the extent necessary to ascertain, and give effect to, the parties' presumed intentions. Although this provides courts with an opportunity to im-

[1] Maurice H. Merrill, *The Law Relating to Covenants Implied in Oil and Gas Leases* § 2, at 19 (2d ed. 1940) ("If the parties have expressly stipulated concerning any of these contingencies, the task of the court, in the event that their clashing interests reach the stage of litigation, is simply to construe the meaning of the provisions of the lease and to enforce them as construed."). However, Professor Merrill's approach to implied covenants is not based upon interpreting the oil and gas lease. The foundation for his analysis is a policy of protecting the lessor to the extent the lease does not expressly, and precisely, address a matter. Therefore, he would recognize implied covenants to protect the lessor, even when the oil and gas lease expressly addresses the matter, so long as the implied obligations are not inconsistent with any express obligations. Merrill, § 6, at 27.

[2] "The objective of interpretation in the general law of contracts is to carry out the understanding of the parties rather than to impose obligations on them contrary to their understanding: 'the courts do not make a contract for the parties.' " *Restatement (Second) of Contracts* § 201 cmt. c (1981).

pact the resulting terms of the contract, the interpretive process should always be circumscribed by freedom of contract principles.

§ 10.02 The Public and Private Dimensions of Contract Interpretation

Freedom of contract is a recognized public policy.[3] Beyond preserving freedom of contract, and avoiding certain improper activities,[4] the public really doesn't have an interest in whether a lessor receives a 1/4th royalty or a 1/8th royalty. Nor does the public have an interest in whether the lessee is forced to calculate royalty on downstream values without allowing for the cost of moving gas to a downstream marketing location. Indeed, the public does not have a stake in the substantive content of most contracts.

When the subject matter of the contract does not trigger a matter of public concern, the public's interest will be limited to "procedural" issues: was the contract the product of a legitimate bargained-for exchange? This inquiry relates primarily to the formation of the contract. Was it the product of fraud, misrepresentation, duress, or undue influence? Absent a defect in the bargaining process—the "procedural" context of the bargain—courts recognize the parties are "free" to fashion the substance of their bargain.

This provides the basic dividing line between contract and tort. Tort law is the product of duties imposed on individuals by the "public." Contract law is the product of duties imposed on individuals by their own volition. For example, an oil and gas lease procured through fraud violates a public duty. The substantive content of the oil and gas lease obtained through fraud does not matter; it is the manner in which the assent of the other party was procured that offends the public, and is therefore the subject of public retribution through tort. In some in-

---

[3] "The principle of freedom of contract is itself rooted in the notion that it is in the public interest to recognize that individuals have broad powers to order their own affairs by making legally enforceable promises." *Restatement (Second) of Contracts* ch. 8, Intro. Note, at 2 (1981).

[4] "Improper activities" would include contracts that violate public policy, are procured through fraud, misrepresentation, duress, or undue influence, or suffer from unconscionability.

stances the same activity may be so odious to public interests as to also warrant retribution through statutory civil or criminal remedies.

When courts interpret contracts they must be careful that any duty imposed on the parties is truly a private duty emanating from the contract and not a public duty emanating from the court. To the extent the duty does not emanate from the contract, the court is essentially reordering the parties' contract by granting new rights to one party which, of necessity, takes away corresponding rights from the other party. The jurisprudential tool by which courts legitimately grant new rights, while taking away corresponding rights, is the unconscionability analysis. Prior to adopting an unconscionability analysis, courts used more clandestine techniques to accomplish the contractual reordering they deemed appropriate.[5] Often a court's efforts to define the "incomplete" contract were also designed to arrive at what the court felt was a more "fair" contract. In the course of converting the "incomplete" to the "fair," courts often departed from the terms of the parties' contract.

§ 10.03 The "Incomplete" Contract and the "Unfair" Contract

[1] The Omitted Term and the Incomplete Contract

The *Restatement (Second) of Contracts* refers to the "incomplete" contract as the "omitted term" problem.[6] Section 204 of the *Restatement (Second) of Contracts* provides: "When the par-

---

[5]The official comment to U.C.C. § 2-302 (1977), discussing the "purposes" for the Code's new unconscionability section, states:

> This section is intended to make it possible for the courts to police explicitly against the contracts or clauses which they find to be unconscionable. In the past such policing has been accomplished by adverse construction of language, by manipulation of the rules of offer and acceptance or by determinations that the clause is contrary to public policy or to the dominant purpose of the contract. This section is intended to allow the court to pass directly on the unconscionability of the contract or particular clause therein and to make a conclusion of law as to its unconscionability.

U.C.C. § 2-302 cmt. 1 (1977).

[6]*Restatement (Second) of Contracts* § 204 (1981). Professor Farnsworth states the problem as follows: "Sometimes . . . disputes arise because there is no contract language that is relevant to the situation that has arisen." E. Allan Farnsworth, *Contracts* 494 (3d ed. 1999).

ties to a bargain sufficiently defined to be a contract have not agreed with respect to a term which is essential to a determination of their rights and duties, a term which is reasonable in the circumstances is supplied by the court."[7] The *Restatement* recognizes that "interpretation" and supplying an "omitted term" can be two sequential analyses. The first analysis will be to interpret the express terms of the contract in an effort to define the omitted term required to complete the contract.[8] If this provides the answer by supplying the appropriate term, the process is complete. However, if it is not possible to effectively fashion the contours of the omitted term from the express contract language, the court will proceed to the second level of analysis to "supply a term which comports with community standards of fairness and policy"[9] or, as stated in the black letter rule: "a term which is reasonable in the circumstances . . . ."[10]

In contract law vernacular, the first level of analysis would be described as "implied in fact" while the second level of analysis would be termed "implied in law."[11] Apparently the distinction has not been accorded any significance in general contract law because both the "implied-in-fact" and "implied-in-law" analyses are contract-based obligations[12] as opposed to restitution-based obligations. The pursuit of the omitted term,

---

[7] Restatement (Second) of Contracts § 204.

[8] The *Restatement* describes this process as follows: "Where there is tacit agreement or a common tacit assumption or where a term can be supplied by logical deduction from agreed terms and the circumstances, interpretation may be enough." *Restatement (Second) of Contracts* § 204 cmt. c (1981). Professor Farnsworth describes the analysis as follows:

> Interpretation is necessarily the first step in the process, since a court will supply a term only after it has determined that the language of the agreement does not cover the case at hand. It follows that any term that a court would supply can be derogated from by agreement of the parties, either explicitly or by necessary inference. The resulting rule is therefore a default rule rather than a mandatory rule.

E. Allan Farnsworth, *Contracts* 498 (3d ed. 1999).

[9] *Restatement (Second) of Contracts* § 204 cmt. d (1981).

[10] *Restatement (Second) of Contracts* § 204 (1981).

[11] E. Allan Farnsworth, *Contracts* 499 (3d ed. 1999).

[12] Therefore they are both constrained, to varying degrees, by the terms of the contract and freedom of contract principles.

regardless of the level of analysis being employed, is undertaken to complete the contract created by the parties. The process is not pursued to improve the position of one party at the expense of the other; the process is pursued to define the bargain, not pass judgment on its fairness. Any fairness issues should be addressed under an unconscionability analysis.

[2] Unconscionability and the "Unfair" Contract

Although critics of unconscionability may view it as an affront to freedom of contract, when properly applied it actually promotes freedom of contract by imposing a principled analysis on courts desiring to rewrite contracts. The *Restatement (Second) of Contracts* and the Uniform Commercial Code each have similar statements of the basic unconscionability analysis: "If a contract or term thereof is unconscionable at the time the contract is made a court may refuse to enforce the contract, or may enforce the remainder of the contract without the unconscionable term, or may so limit the application of any unconscionable term as to avoid an unconscionable result."[13] The challenge for an unconscionability analysis is identifying situations that warrant intervention to prevent " 'oppression and unfair surprise' " while ensuring the court is not merely changing the " 'allocation of risks because of superior bargaining power.' "[14] As noted in the comments to the *Restatement (Second) of Contracts*:

> A bargain is not unconscionable merely because the parties to it are unequal in bargaining position, nor even because the inequality results in an allocation of risks to the weaker party. But gross inequality of bargaining power, together with terms unreasonably favorable to the stronger party, may confirm indications that the transaction involved elements of deception or compulsion, or may show that the weaker party had no meaningful choice, no real alternative, or did not in fact assent or appear to assent to the unfair terms.[15]

---

[13] *Restatement (Second) of Contracts* § 208 (1981). The Uniform Commercial Code uses similar language but instructs that the issue is a "matter of law" for the court and that when considering the unconscionability of a contract "the parties shall be afforded a reasonable opportunity to present evidence as to its commercial setting, purpose and effect to aid the court in making the determination." U.C.C. § 2-302(1) & (2) (1977).

[14] *Restatement (Second) of Contracts* § 208 cmt. b (1981), quoting from U.C.C. § 2-302 cmt. 1 (1977).

[15] *Restatement (Second) of Contracts* § 208 cmt. d (1981).

Courts seeking to distinguish the "fair" from the "unfair" bargain generally look for a mix of procedural devices that assist the dominant party in obtaining unfair substantive terms. The reasoning is that but for the "procedural" unconscionability the complaining party would not have agreed to the unfair "substantive" terms they seek to have nullified through the unconscionability analysis.[16] Professor Farnsworth has summarized the impact of the unconscionability analysis stating:

> On the whole, judges have been cautious in applying the doctrine of unconscionability, recognizing that the parties often must make their contract quickly, that their bargaining power will rarely be equal, and that courts are ill-equipped to deal with problems of unequal distribution of wealth in society. Most cases of unconscionability involve a combination of procedural and substantive unconscionability, and it is generally agreed that if more of one is present, then less of the other is required.[17]

[3] Unconscionability and the Oil and Gas Lease

In *Brewster v. Lanyon Zinc Co.*, the lessor asserted the terms of the oil and gas lease "were altogether unconscionable."[18] The court rejected the lessor's unconscionability claim and instead

---

[16] "Theoretically it is possible for a contract to be oppressive taken as a whole, even though there is no weakness in the bargaining process and no single term which is in itself unconscionable." *Restatement (Second) of Contracts* § 208 cmt. c (1981).

[17] E. Allan Farnsworth, *Contracts* 312 (3d ed. 1999).

[18] Brewster v. Lanyon Zinc Co., 140 F. 801, 806 (8th Cir. 1905). The court, quoting Justice Story's *Equity Jurisprudence*, observed:

> [T]he allegations of inadequacy of consideration and of inequality in terms may be dismissed with a reference to the rule which controls a court of equity in such cases. It is stated by Story as follows (1 *Equity Jurisprudence*, § 244): "Mere inadequacy of price or any other inequality in the bargain is not, however, to be understood as constituting, per se, a ground to avoid a bargain in equity. For courts of equity as well as courts of law act upon the general ground that every person who is not from his peculiar condition or circumstances under disability is entitled to dispose of his property in such manner and upon such terms as he chooses; and whether his bargains are wise and discreet, or profitable or unprofitable, or otherwise, are considerations, not for courts of justice, but for the party himself to deliberate upon."

Brewster, 140 F. at 806.

addressed the controversy as an interpretive problem involving an omitted term.[19] In a 1987 article I observed that:

> [C]ourts have not directly attacked the conscionability of the oil and gas lease. Most litigants, instead of attacking the fairness of the relationship, have sought relief through benevolent judicial construction of the lease. This approach has given rise to the familiar rules of construction that the lease will be interpreted against the lessee, and in favor of the lessor, and to promote development and prevent delay.[20]

Implied covenant jurisprudence has played an important role in mitigating what would otherwise be viewed as a rather harsh bargain under the oil and gas lease.[21] However, even absent implied covenants and other mitigating analyses, it is doubtful a court would find the oil and gas lease to be unconscionable. Although the bargaining process has some of the elements of an adhesion contract,[22] the landowner is actually the party in the position to demand a bargain on a take-it-or-leave-it basis. The landowner does not have to lease his or her land.[23] At some point in time there will likely be multiple developers seeking to lease the land. If properly informed, the landowner will be able to respond to any developer proposal. In these situations the key is knowledge that: (1) there is abso-

---

[19] The specific omission was a term concerning the lessee's obligation to further develop the leased land following discovery. The court found:

> The implication necessarily arising from these provisions [express lease terms]—the intention which they obviously reflect—is that if, at the end of the five-year period prescribed for original exploration and development, oil and gas, one or both, had been found to exist in the demised premises in paying quantities, the work of exploration, development, and production should proceed with reasonable diligence for the common benefit of the parties, or the premises be surrendered to the lessor.

Brewster, 140 F. at 810.

[20] David E. Pierce, "Rethinking the Oil and Gas Lease," 22 *Tulsa L.J.* 445, 454-55 (1987).

[21] For example, the right to hold the leased acreage, as to all areas and depths, with a single well without any obligation to further develop or protect against drainage.

[22] The oil and gas lease is presented to the landowner as a form document with small type and the developer typically does not invite negotiation of the terms.

[23] Although the rule of capture would prompt the landowner to consider development when there is adjacent production likely to cause drainage, this would also be the situation that would provide the landowner with maximum bargaining power.

lutely no obligation to lease,[24] (2) waiting to lease generally favors the landowner, and (3) as the speculative value of the land increases, the landowner's bargaining power increases.

Unconscionability does not protect a contracting party from making uninformed decisions. If a landowner wants the $100 in bonus money being offered to lease his or her land, the fact the landowner does not investigate the situation or fully comprehend the nature of the transaction does not relieve the landowner of his or her contractual obligations. So long as the transaction is not the product of fraud or misrepresentation, or structured in a manner to prevent the landowner from learning the terms of the deal, courts have not been willing to alter the terms of the contract to give the landowner a "better" or different deal.

This creates an opportunity for a circular unconscionability/interpretive analysis. As noted previously, unconscionability analysis was developed to provide a principled basis for avoiding contracts, and contract terms, found by the court to be unconscionable. However, if it is clear the contract, or contract terms, are not *un*conscionable, will courts nevertheless revert to the interpretive techniques the unconscionability analysis was designed to eliminate to avoid the otherwise "conscionable" terms? This is where courts must take stock of their proper role in the interpretive process acknowledging: first, the contract terms are not unconscionable;[25] and second, the goal is to interpret the contract that the parties made as opposed to the one they should have, or could have, made. With this in mind, how will courts deal with the "incomplete" but conscionable oil and gas lease?

[24] In some states, such as Oklahoma, this statement would have to be considered in light of compulsory pooling statutes that could force a landowner to make his or her minerals available for development.

[25] Unless of course there is something about the situation that would make the terms unconscionable under an unconscionability analysis.

§ 10.04 Fundamentals of Implied Covenant Analysis

[1] Why Do Courts Imply Covenants in Oil and Gas Leases?

The jurisprudence to date indicates courts imply covenants in oil and gas leases for two reasons: (1) to complete an incomplete contract; and (2) to make the "unfair" contract "fair," or "more fair." These are the functional descriptions of the role of implied covenants. Typically courts and commentators refer to these two categories by their legal descriptions: "implied in fact" and "implied in law."[26] The implied-in-fact approach to implied covenants acknowledges their interpretive role: to complete the incomplete contract. The implied-in-law approach acknowledges their protective role: to protect the lessor's interests under the lease.[27]

---

[26] As stated by Williams and Meyers: "A covenant is implied in fact when its existence is derived from the written agreement and the circumstances surrounding its execution. A covenant is implied in law when it is added to the contract by a court to promote fairness, justice, and equity." Patrick H. Martin & Bruce M. Kramer, *Williams & Meyers on Oil and Gas Law* § 803, at 18 (2001). Professor Weaver has employed a functional approach by identifying three models for resolving implied covenant disputes:

> 1. The equity model. This model holds that covenants are implied in law primarily to prevent unfairness to lessors. The actual language of the lease may be and often is considered evidence of the parties' intentions, but this does not necessarily control the outcome; whatever is fair is determinative. . . .
>
> 2. The contract or relational model. This model closely adheres to the "implied in fact" theory and limits the courts' inquiry to what the parties reasonably would have intended given the nature and purpose of the specific contract and the circumstances under which it was made. . . .
>
> 3. The policy model. This model allows public policy values—external to the parties' expectations or to judicial norms of equity—to influence the outcome of implied covenant litigation.

Jacqueline Lang Weaver, "Implied Covenants in Oil and Gas Law Under Federal Energy Price Regulation," 34 *Vanderbilt L. Rev.* 1473, 1489-90 (1981).

[27] Perhaps the clearest statement of the implied-in-law classification is by Professor Merrill where, under the heading "Implied Covenant a Fiction," he states:

> Of course, the implied covenant is a fiction, used like other fictions by the law in order to achieve a desirable result. The parties have not agreed consciously upon the terms which the law implies; it is even possible that they have never consciously directed their attention to the matter. The obligations are imposed, not by the agreement of the parties, but by operation of law.

The Kansas Supreme Court, in *Smith v. Amoco Production Co.*,[28] considering an oil and gas lessee's obligations under the implied covenant to market, notes the fundamental distinction between an implied-in-law and implied-in-fact analysis stating:

> A contract implied in fact is one "inferred from the facts and circumstances of the case" but which is "not formally or explicitly stated in words.". . . It is the product of agreement, although it is not expressed in words. . . . A contract implied in law does not rest on actual agreement. It is a legal fiction created by the courts to ensure justice or to prevent unjust enrichment.[29]

Commentators and courts have assumed these classifications operate in an all-or-nothing context: if implied in fact, then all opportunities for analysis under the covenant will employ implied-in-fact principles, but if implied in law the covenant analyses will be consistent with implied-in-law principles. However, courts have not always been consistent in their analysis. For example, the court may apply an implied-in-fact analysis when identifying the existence of the covenant but then depart from the implied-in-fact analysis when defining the prudent operator standard and allocating burden of proof.[30] Such hybrid approaches are most likely the product of failing to fully appreciate, in the first instance, the jurisprudential underpinning of the implied covenant the court is applying.

Maurice H. Merrill, *The Law Relating to Covenants Implied in Oil and Gas Leases* § 7, at 27 (2d ed. 1940).

[28] 31 P.3d 255 (Kan. 2001).

[29] Smith v. Amoco Production Co., 31 P.3d 255, 265 (Kan. 2001).

[30] This appears to be the case with many of the marketable product cases. For example, in *Mittelstaedt v. Santa Fe Minerals, Inc.*, 954 P.2d 1203 (Okla. 1998), the court addresses at length the content of the implied covenant to market and the obligations it imposes on the lessee. The court begins its analysis by examining the terms of the underlying lease. However, nowhere does the court address the role the prudent operator standard will play in determining a lessee's compliance with implied obligations and the court makes it clear that the burden of proof on all issues is on the lessee. The court concludes its opinion stating:

> In sum, a royalty interest may bear post-production costs of transporting, blending, compression, and dehydration, when the costs are reasonable, when actual royalty revenues increase in proportion to the costs assessed against the royalty interest, when the costs are associated with transforming an already marketable product into an enhanced product, *and when the lessee meets its burden of showing these facts*.

954 P.2d at 1210 (emphasis added).

[2] How Many Implied Covenants?

If the role of implied covenants is to protect the lessor's interests under the lease, then there is probably only one implied covenant: the implied covenant to protect and maximize the lessor's interest under the oil and gas lease.[31] If the role of implied covenants is to assist in interpreting the oil and gas lease, there are an unlimited number of implied covenants because they will be fashioned as the express terms of the lease require. Commentators have suggested a "unified analysis" for implied covenants which merely requires the lessee "to act as a reasonable prudent operator."[32] Such a unified analysis suggests there is one all-encompassing duty imposed on oil and gas lessees by blending the identification of the covenant with the standard that will be used to evaluate compliance with the covenant. Of course, if no duty is imposed, there is no need for a standard to determine whether it has been discharged.

The lessor-protection implied-in-law analysis, being implied in law, combines the duty with the standard of care: lessees must do whatever is necessary to protect and maximize the lessor's interest under the oil and gas lease. In contrast, the interpretive implied-in-fact analysis consists of two distinct steps: (1) what must be implied to interpret and complete the contract of the parties? and (2) once a duty in step (1) is defined, did the lessee act as a prudent operator to comply with the duty? Only to the extent a duty is defined in step (1) will the court inquire about complying with the duty in step (2). The lack of a two-step analysis may indicate the court was pursuing, perhaps inadver-

---

[31] In *Yzaguirre v. KCS Resources, Inc.*, 53 S.W.3d 368, 374 (Tex. 2001), the lessors asserted " 'the entire body of implied covenant law has been aimed at . . . making sure the royalty owner gets the best deal.' "

[32] Professor Lowe observes in his treatise:

> Some have suggested that there is in fact only one implied covenant—the implied covenant to act as a reasonable prudent operator. A unified analysis does not fit the case method by which the courts have developed the various implied covenants. A unified analysis is useful, however, because the reasonable prudent operator standard is the common denominator of all implied covenants.

John S. Lowe, *Oil and Gas Law in a Nutshell* 300 (3d ed. 1995). As noted in the next section, the prudent operator standard may not be such a "common denominator" when dealing with the implied covenant to market.

tently, an implied-in-law analysis. This may explain the "marketable product" analyses used by the courts in Colorado,[33] Kansas,[34] Oklahoma,[35] and West Virginia[36] which appear devoid of any "step two" prudent operator analysis.[37]

[3] What is a Prudent Operator?

When courts apply the prudent operator standard, they must evaluate whether the obligation will be driven by the lessee's particular "internal" facts in addition to the "external" facts any lessee would confront under the circumstances. For example, the *external* facts all lessees face could include: porosity, permeability, and productive capacity of the leased land; physical location of wells on the leased land; proximity of wells to pipelines and other marketing facilities; presence of impurities in production from wells on the leased land; general market conditions; and government regulation. The *internal* facts unique to the lessee, regardless of the external facts the lessee is facing, could include: number of leases owned in the area; total volume of production obtained or purchased from other leases; existence of an in-house marketing department; ownership of gathering, treating, processing, and other facilities; affiliation with other companies; technical competence; and financial condition. Under the objective prudent operator standard, only external facts should be considered; the lessee's personal internal facts should not matter.

This has been most clearly recognized under the "single lease" analysis used by courts in Texas[38] and Kansas.[39] Under

---

[33] Rogers v. Westerman Farm Co., 29 P.3d 887 (Colo. 2001); Garman v. Conoco, Inc., 886 P.2d 652 (Colo. 1994).

[34] Sternberger v. Marathon Oil Co., 894 P.2d 788 (Kan. 1995); Schupbach v. Continental Oil Co., 394 P.2d 1 (Kan. 1964); Gilmore v. Superior Oil Co., 388 P.2d 602 (Kan. 1964).

[35] Mittelstaedt v. Santa Fe Minerals, Inc., 954 P.2d 1203 (Okla. 1998); TXO Production Corp. v. Comm'rs of the Land Office, 903 P.2d 259 (Okla. 1994); Wood v. TXO Production Corp., 854 P.2d 880 (Okla. 1993).

[36] Wellman v. Energy Resources, Inc., 557 S.E.2d 254 (W. Va. 2001).

[37] See discussion at § 10.05[1] *infra*.

[38] Amoco Production Co. v. Alexander, 622 S.W.2d 563 (Tex. 1981).

[39] Smith v. Amoco Production Co., 31 P.3d 255, 272 (Kan. 2001) (Kansas refers to the single lease analysis as the "independent duty principle.").

the single lease analysis the prudent operator standard is applied as though the lessee owned only the lease at issue. The standard will be the same whether the lessee owns only the lease at issue, or the lease at issue and all the surrounding leases. Therefore, the prudent operator is a hypothetical operator as opposed to the particular operator that happens to own the lease.[40] The goal is to define a single standard of conduct based upon the external facts associated with the leased land as opposed to a varying standard of conduct depending upon the unique condition of the lessee. This benefits the lessor and the lessee. The lessor is benefited because compliance with its contract will be defined by the factual situations confronting any lessee owning the contract; contractual obligations will not be diminished because the lessee lacks technical competence or cash. The lessee is benefited because it will not be penalized for owning adjacent leases, a pipeline, or stock in an affiliated company.

Sometimes courts, seeking to protect the lessor, will consider the internal facts regarding the lessee. Typically this is done to support an implied-in-law analysis designed to insulate the lessor from a perceived injustice by its lessee. The common-lessee situation is an example of the court factoring into the drainage equation the lessee's control of the draining leases. For example, Mississippi courts apply an "equity rule" to require a common lessee to protect a lease against drainage even

[40] Such an approach is also consistent with the assignment clause of the oil and gas lease. As Professor Kuntz observes in his treatise: "It has been held that a lease which contains no provision against assignment is assignable and that the undertaking does not involve the placing of trust and confidence in the lessee nor the exercise of personal skill by the lessee which might otherwise preclude assignability." Eugene Kuntz, *A Treatise on the Law of Oil and Gas* § 51.2(a), at 306-07 (1990). Assignment principles can also be affected by the implied-in-law and implied-in-fact analysis. Professor Sullivan notes in his treatise:

> The continuing obligation of the lessee after assignment depends upon whether these covenants are implied in fact or in law. If implied in fact, they conform to the unexpressed intent of the parties and therefore are contractual in nature, and the obligations of the lessee continue. If implied in law, they stem from the mutual relationship of the parties and therefore privity of estate is a prerequisite, and the obligations of the lessee terminate upon assignment. The tendency of the cases is to regard them as implied in fact.

Robert E. Sullivan, *Handbook of Oil and Gas Law* § 128, at 235 (1955).

though it would not be profitable to drill a protection well.[41] Some courts have even created labels to give the situation a tort-like status by calling it "fraudulent drainage."[42] Other courts have not revised the underlying duty, but have adjusted procedural requirements to make it easier for the lessor to pursue his or her contract remedies.[43] If the prudent operator is truly an objective, hypothetical standard, the lessee's ownership of the draining leases should not matter.[44]

[4] Who Has the Burden of Proof?

When courts place the burden of proof on the lessee, they are assuming an implied-in-law, lessor-protection role. Contrast the approach taken by the Kansas Supreme Court in *Smith v. Amoco Production Co.*[45] with that taken by the Colorado Supreme Court in *Garman v. Conoco, Inc.*[46] In *Smith* the court evaluated Amoco's marketing decisions in light of changing regulatory environments to determine whether Amoco acted as a prudent operator. In remanding the case to the district court the following guidelines were provided to evaluate Amoco's marketing decisions:

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

---

[41] Monsanto Chemical Co. v. Sykes, 147 So. 2d 290 (Miss. 1962).

[42] Dillard v. United Fuel Gas Co., 173 S.E. 573, 575 (W. Va. 1934).

[43] *E.g.*, U.V. Industries, Inc. v. Danielson, 602 P.2d 571 (Mont. 1979) (prior notice and demand for protection not required when lessee owns the draining lease); Dixon v. Anadarko Production Co., 505 P.2d 1394 (Okla. 1973) (shift burden of proving profitability of protection well to lessee owning the draining lease).

[44] *See, e.g.*, Amoco Production Co. v. Alexander, 622 S.W.2d 563 (Tex. 1981).

[45] 31 P.3d 255 (Kan. 2001).

[46] 886 P.2d 652 (Colo. 1994).

> 5. The facts are not contested, and Amoco's actions are not patently imprudent; thus *expert testimony will be required to establish a breach of the covenants alleged.*[47]

This is a classic implied-in-fact approach.

In *Garman v. Cononco, Inc.*[48] the court held the implied covenant to market would define whether a post-extraction cost could be deducted before calculating royalty.[49] The court holds that only costs incurred after a marketable product is obtained can be deducted before calculating royalty. Regarding the burden of proof, the court states:

> Upon obtaining a marketable product, any additional costs incurred to enhance the value of the marketable gas, such as those costs conceded by the Garmans, may be charged against nonworking interest owners. To the extent that certain processing costs enhance the value of an already marketable product *the burden should be placed upon the lessee to show such costs are reasonable, and that actual royalty revenues increase in proportion with the costs assessed* against the nonworking interest.[50]

The allocation of the burden of proof to the defendant is often indicative of an implied-in-law effort to protect the complaining party.

§ 10.05 Marketing Covenant Jurisprudence

Analysis of cases addressing the implied covenant to market reveals much about the often unspoken jurisprudential path a court has taken. As previously noted, these paths can be characterized as either implied in law or implied in fact. The judicial agendas can be characterized as either interpreting the lease or adjusting the lease terms to promote the lessor's interests.

---

[47] Smith v. Amoco Production Co., 31 P.3d 255, 273-74 (Kan. 2001) (emphasis added).

[48] 886 P.2d 652 (Colo. 1994).

[49] The case also contains some classic implied-in-law language, such as: "In Colorado we have characterized the duty to market as a covenant contained in every oil and gas lease." *Garman*, 886 P.2d at 659, n.21. This suggests that a court-defined obligation will apply to all leases except to the extent it is expressly, and precisely, disclaimed. For example, in a later case the Colorado Supreme Court nullified express "at the well" and "market value" language in the leases to ensure its lessor-protection mission is not obstructed by having to give meaning to the contract language. *See* Rogers v. Westerman Farm Co., 29 P.3d 887, 895-902 (Colo. 2001).

[50] Garman v. Conoco, Inc., 886 P.2d 652, 661 (Colo. 1994) (emphasis added).

[1] An Implied-in-Law Analysis: *Rogers v. Westerman Farm Co.* and the Marketable Product Rule

Why would a court consciously set out to use an implied covenant to avoid giving effect to the terms of the oil and gas lease?[51] In *Rogers v. Westerman Farm Co.*[52] the observations made by the court suggest that commonly-encountered phrases, such as "at the well" and "market value," in every single lease where they appear, are the product of unfair lessee scheming to dupe money from unsuspecting lessors.[53] From the court's perspective, the incompetency of the Colorado lessor[54] is matched only by the deviousness of the Colorado lessee.[55] Therefore the court in *Rogers* pursues an implied-in-law lessor-

---

[51] The jurisprudential explanation is simple: the court believes unless the impact of certain lease terms ("at the well" and "market value") are blunted by implication, the result will be unfair.

[52] 29 P.3d 887 (Colo. 2001).

[53] In essence the court deems each lessor to be hopelessly ignorant and incapable of comprehending that the value of gas "at the well" may be less than its downstream value after it has been gathered, compressed, dehydrated, treated, processed, and otherwise aggregated, packaged, and marketed.

[54] In Colorado lessors have no "bargaining power" and are in the same "unequal" position as the insured with its insurance company. *Rogers*, 29 P.3d at 902. Lessors do not know as much about oil and gas law as their lessees. *Id.* ("lessors are not usually familiar with the law related to oil and gas leases, while lessees, through experience drafting and litigating leases, generally are.").

[55] Like a seasoned trial attorney painting a mental picture for the jury, the court begins to make its case by characterizing the lease language as not unclear or ambiguous, but "misleading." *Id.* at 897 ("Notwithstanding an initial misleading appearance that the lease language provides for allocation of costs, it is apparent that when scrutinized in depth, each lease clause provision inadequately addresses allocation of costs."). The court, citing an article by Professor Anderson, suggests the "misleading" language is part of a lessee scheme to fool the lessor: "Moreover, Anderson has suggested that lessees, in order to avoid alerting lessors of their motives, have intentionally used 'at the well' language to avoid directly stating their objectives in sharing costs." *Id.* at 899. The court also relies upon Professor Anderson's theory that " 'a royalty clause should be construed in its entirety and against the party who offered it, and in light of the fact that the royalty clause is the means by which the lessor receives the primary consideration for a productive lease.' " *Id.* at 898, quoting: Owen L. Anderson, "Royalty Valuation: Should Royalty Obligations be Determined Intrinsically, Theoretically, or Realistically, Part 2 (Should Courts Contemplate the Forest or Dissect Each Tree?)," 37 *Nat. Resources J.* 611, 636 (1997). Apparently this proposed rule of construction would apply even though the lease was not deemed ambiguous. The court also relies upon "the generally accepted rule that oil and gas leases are strictly construed against the lessee in favor of the lessor." *Rogers*, 29 P.3d at 901.

protection approach to determining when downstream marketing costs can be deducted to calculate royalty.[56]

Rogers is unique because the express terms of the oil and gas leases, and the facts external to the leases, support a finding that royalty is payable on the value of the gas at the place where it is extracted from the ground—at the well. The court found that all of the leases provided for payment of royalty "at the well" or "at the mouth of the well."[57] The gas was "sweet" and "dry" when produced at the well.[58] Gas had been routinely sold at the well and some of the gas was currently being sold at the well or being used in its as-produced condition.[59] Many of the leases provided for a royalty based upon the "market value" of the gas at the well.[60] The court then posed the question:

---

[56] After listing all the inequalities between lessors and lessees, the court refuses to give any effect to the "at the well" language and instead concludes: "because the leases are silent, we must look to the implied covenant to market, and our previous decision in *Garman v. Conoco*, to determine the proper allocation of costs." *Rogers*, 29 P.3d at 902. At this critical point the court frees itself of interpretive restraints contained in the oil and gas leases to pursue its mission of creating a "fairer" contract for the parties.

[57] *Rogers*, 29 P.3d at 891 ("The leases all provide, with some variation, for royalties to be paid based on the gas 'at the well' or 'at the mouth of the well.' ").

[58] *Id.* at 892.

[59] *Id.* at 893.

[60] *Id.* at 897. The court engages in a tortured analysis of the royalty clauses and concludes they offer no express guidance on how royalty should be calculated. "Market value" offers no help because "there is no indication as to how such value is to be determined." *Id.* The court continues, stating:

> Furthermore, this language does not indicate whether the calculation of market value at the well includes or excludes costs, and does not describe how those costs should be allocated, if at all, between the parties. Thus, because the lease language fails to even describe either the costs or the allowable deductions, it is silent with respect to all deductions.

Id. The court's "analysis" is a good reminder that when a court does not wish to "interpret" express terms there is simply no way to force the issue. Justice Fontron realized the futility in his concurring opinion in *Schupbach v. Continental Oil Co.*, 394 P.2d 1 (Kan. 1964), where he states:

> I find it extremely difficult to accept the rationale of *Gilmore v. Superior Oil Co.*, 192 Kan. 388, 388 P.2d 602. It offends my sense of logic to say that the market value of gas at the mouth of the well is the price for which the gas is ultimately sold after having been so processed that it has become marketable. I would consider that market value of gas at the well would be that amount for which it could be sold, after deducting such reasonable expense as was required to render it saleable.

"whether the leases at issue are silent with respect to how royalties are to be paid"[61] and then answered: "we conclude that all of the leases are, in fact, silent with respect to the allocation of costs."[62] This provides the court with the predicate for defining an *implied* duty to pay royalty.

Although the court's first level of analysis invites it to fashion an implied duty, if the court were pursing an implied-in-fact analysis it would again refer to the lease for guidance regarding the content of such duty. This is another revealing aspect of the *Rogers* opinion: instead of referring to the lease for guidance, it examines other marketing cases and adopts a rule that provides the vast majority of lessors in Colorado with royalty rights never before recognized by a court.[63] The court states: "[W]e believe that the more accurate[64] definition of marketabil-

---

> However, I recognize that the point has been decided otherwise by this court, and for such reason will concur in the result reached in this case.

Schupbach, 394 P.2d at 7. The *Gilmore/Schupbach* cases, like *Rogers*, were driven by a desire to provide the lessors with a better deal than what the terms of their leases provided. The royalty clauses in each case provided for "1/8 of the proceeds of the sale thereof at the mouth of the well." *Gilmore*, 388 P.2d at 605; *Schupbach*, 394 P.2d at 2. The deduction at issue was for compression costs. The courts first found the leases ambiguous and proceeded to interpret them "in favor of the lessor and against the lessee." *Gilmore*, 388 P.2d at 603; *Schupbach*, 394 P.2d at 4. The courts also observed that the lessee provides the lease form, "dictates the terms," and therefore if the lessee wants a better deal it can simply provide for it in its next form lease. *Gilmore*, 388 P.2d at 603; *Schupbach*, 394 P.2d at 4. The courts then turned to the implied covenant to market, in what is perhaps the first statement of the marketable product rule, to hold the compression costs should not have been deducted to calculate the lessors' royalties. *Gilmore*, 388 P.2d at 606 ("The only purpose for the compressing station was to put enough force behind the gas to enable it to enter the pipeline on the lease. *This made the gas marketable and was in satisfaction of the duties of the lessee so to do.*") (emphasis added); *Schupbach*, 394 P.2d at 4-5 (" 'Where a lessee, as here, in extracting oil from the ground also extracts gas *and in order to carry out its duty to find a market* for such gas and prevent the waste thereof, separates the oil from the *gas and compresses the gas to make it marketable*, when such gas is sold the lessee has title and possession thereof as its personal property and under the terms of the leases here being considered, it is required to pay one eighth of the gross proceeds to the lessors.' ") (emphasis added).

[61] *Rogers*, 29 P.3d at 896.

[62] *Id.* at 897.

[63] The court states its mission as follows: "[W]e must define marketability under Colorado law, and specifically under the implied duty to market found in every oil and gas lease." *Id.* at 903.

[64] Fair? More fair?

ity includes both a reference to the physical condition of the gas, as well as the ability for the gas to be sold in a commercial marketplace."[65] This is followed by a passing recitation of the prudent operator rule[66] but then the court states: "In determining whether a lessee has met the obligations imposed by the implied duty to market, we look to the nature of the lessee's duty to market, and, implicitly, how a determination of marketability is made."[67]

This means there will be no prudent operator analysis.[68] The only issue, which the court states is an issue of fact,[69] is whether the lessee's royalty calculations reflect values associated with the sale of gas in a marketable condition at the appropriate marketing location. At some future date, a jury will determine whether the gas "is in the physical condition such that it is acceptable to be bought and sold in a commercial marketplace, and in the location of a commercial marketplace, such that it is commercially saleable in the oil and gas marketplace."[70]

The court's analysis in *Rogers* is a pure implied-in-law approach designed to give perhaps the vast majority of Colorado lessors a cost-free royalty calculated on downstream values. The case should have state-wide impact and will affect any

---

[65] *Rogers*, 29 P.3d at 903.

[66] "The covenant requires that the lessee exercise reasonable diligence to market the products, defined as 'whatever, in the circumstances would be reasonably expected of all operators of ordinary prudence, having regard to the interests of both lessor and lessee.' " *Id.* at 903. However, the court's analysis suggests that the "reasonable diligence" must begin at the appropriate marketing location. If the marketing takes place upstream of the required location, it cannot, under the court's analysis, ever be prudent.

[67] *Id.* at 904.

[68] The court notes: "The commercial market and the condition of the gas dictates the marketability of the gas, not the independent actions of a particular lessee." *Id.* at 909. Nor would the actions of a hypothetical lessee seem to matter. Satisfying the obligation will depend solely upon external facts concerning the condition of the gas and the nature of the market at the location where it is being sold. In most cases the condition of the gas will not matter because the location of the required market will dictate the quality of the gas necessary to access the market. Nor may the lessee seek certainty by making actual sales to an unaffiliated purchaser for the best price available. The court notes that although such a sale may be "evidence" that there is a market for the gas, it will not conclusively establish the required market. *Id.* at 910.

[69] *Id.* at 905-06. This means each marketing decision will be open to challenge, after-the-fact, with the ultimate outcome turning on a jury's perception of the situation.

[70] *Id.* at 906.

lease that does not expressly, explicitly, and precisely state the location of the permissible market and the specific costs that can be deducted to calculate royalty. The court effectively shifts from lessees to lessors substantial value under the oil and gas lease. Why? Because it is, according to a unanimous Colorado Supreme Court, the fair thing to do under the circumstances.

[2] An Implied-in-Fact Analysis: *Yzaguirre v. KCS Resources, Inc.* and the Meaning of "Market Value"

In stark contrast to *Rogers*, the Texas Supreme Court, in *Yzaguirre v. KCS Resources, Inc.*,[71] takes an implied-in-fact approach to interpreting the lease royalty clause. The *Yzaguirre* case also demonstrates the two-step implied-in-fact analysis where the issue is resolved with the first step. It also features a lessor explicitly seeking to have the court employ an implied-in-law analysis to maximize and protect the lessor's interests.

The lessee in *Yzaguirre* had been selling gas off the leased premises which triggered the obligation to pay royalty on the "market value" of the gas.[72] The lessee was selling its gas under a long-term gas contract providing for prices in excess of the current market value.[73] Instead of calculating royalty using the gas contract proceeds, the lessee paid royalty using the lower current market values.[74] The Texas Supreme Court, in *Texas Oil & Gas Corp. v. Vela*[75] and *Exxon Corp. v. Middleton*,[76] held a market value royalty obligation could not be satisfied by paying a share of the contract proceeds. However, when *Vela* and *Middleton* were decided gas prices were rapidly escalating and the current market value for gas exceeded the lessees' gas contract prices. In each case the lessee was obligated to pay royalty on the higher market values even though the lessee had only received the lower contract prices for the gas.

---

[71] 53 S.W.3d 368 (Tex. 2001).

[72] Yzaguirre v. KCS Resources, Inc., 53 S.W.3d 368, 370 (Tex. 2001).

[73] *Id.*

[74] *Id.* at 372.

[75] 429 S.W.2d 866 (Tex. 1968).

[76] 613 S.W.2d 240 (Tex. 1981).

The *Vela/Middleton* cases prompted the lessors in *Yzaguirre* to pursue the following implied covenant argument:

> The Royalty Owners next argue that by not paying royalties based on the proceeds received under the GPA [gas purchase agreement], KCS has breached its implied covenant to reasonably market the oil and gas. . . .
>
> [T]he Royalty Owners claim that the implied covenant to reasonably market the oil and gas means that the producer must attempt to obtain the best price available for the benefit of the royalty owner.[77]

At oral argument the lessors' attorney argued: " '[T]he entire body of implied covenant law has been aimed at . . . making sure the royalty owner gets the best deal.' "[78] Rejecting this argument, the court first addressed the lessor-protection basis for implying a covenant by noting: "Because the lease provides an objective basis for calculating royalties that is independent of the price the lessee actually obtains, the lessor does not need the protection of an implied covenant."[79] So long as the lessee pays royalty based upon the market value of the gas when produced, "the parties have received the benefit of their bargain."[80]

However, the court nevertheless proceeds to step one of the implied-in-fact analysis, examines the lease language, and concludes the express terms of the royalty clause answer how the lessor's royalty should be calculated: use market value, not contract proceeds. The court notes the lessors "wish to use an implied marketing covenant to negate the express royalty provisions in the leases and transform the 'market value' royalty into a 'higher of market value or proceeds' royalty."[81] Refusing the lessors' invitation to use an implied-in-law analysis to improve their position, the court states: "We will not now rewrite this leases's plain terms to give the Royalty Owners the benefit of a bargain they never made."[82]

---

[77] *Yzaguirre*, 53 S.W.3d at 373.
[78] *Id.* at 374.
[79] *Id.*
[80] *Id.*
[81] *Id.*
[82] *Id.*

The court's analysis in *Yzaguirre* is consistent with the interpretive role of implied covenants: if the meaning of the lease can be determined without an implied covenant, no covenant will be implied. This is consistent with the court's decision in *HECI Exploration Co. v. Neel*[83] where the Texas implied-in-fact analysis is summarized as follows:

> This court has not lightly implied covenants in mineral leases . . . . Our decisions have repeatedly emphasized that courts "cannot make contracts [for] the parties.". . . A covenant will not be implied unless it appears from the express terms of the contract that "it was so clearly within the contemplation of the parties that they deemed it unnecessary to express it," and therefore they 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.". . . A court cannot imply a covenant to achieve what it believes to be a fair contract or to remedy an unwise or improvident contract . . . .[84]

The case that follows illustrates how an implied-in-fact analysis operates when a covenant is implied and the court proceeds to step two of the analysis.

[3] An Implied-in-Fact Analysis: *Smith v. Amoco Production Co.* and the Marketing Dilemma

The Kansas Supreme Court, in *Smith v. Amoco Production Co.*,[85] was placed in the unique position of having to specifically address the jurisprudential foundation of the implied covenant to market before applying the covenant to the facts. The initial issue was whether the 5-year statute of limitations for written agreements would apply when the lessor's lawsuit was based upon the implied covenant to market. The lessee argued the 3-year limitations period for "[a]ll actions upon contracts, obligations or liabilities expressed or implied but not in writing" should apply.[86] To support their respective positions, the parties focused on the jurisprudential basis for implied covenants

[83] 982 S.W.2d 881 (Tex. 1998).

[84] HECI Exploration Co. v. Neel, 982 S.W.2d 881, 888-89 (Tex. 1998).

[85] 31 P.3d 255 (Kan. 2001).

[86] Smith v. Amoco Production Co., 31 P.3d 255, 264 (Kan. 2001).

with the lessee arguing they are implied in law and the lessor arguing they are implied in fact.[87]

Following a thorough survey of court decisions and commentary on the issue, the court concludes that implied covenants under the oil and gas lease are implied in "fact" not "law." Therefore the statute of limitations for a written contract applies because the implied covenants are an interpretation of, and therefore a part of, the written contract.[88]

After determining the statute of limitations issue, the court turned to the task of interpreting the oil and gas leases in light of the lessors' claim that Amoco had an implied obligation to obtain the "best price" for gas in order to maximize the lessors' royalty.[89] Amoco's dilemma was that it owned thousands of leases comprising a 600,000-acre block of land dedicated under a single 1950 gas contract to Williams Natural Gas Company, Inc. After enduring over three decades of government regulation and associated upheavals in the gas industry, Amoco was left with a gas contract covering thousands of wells authorized to receive a range of prices, depending upon the unique regulatory status of each well. Therefore, gas sold from some wells could receive no more than $0.579/MMBtu while others could receive up to $5.762/MMBtu, with many regulated prices in between. Effective January 23, 1987, the Federal Energy Regulatory Commission's Order 451 made it possible for Amoco to trigger a mechanism that could result in raising the low-price gas wells to at least current market prices of $1.29 to $1.42. However, the same process that could trigger price increases for some could result in price decreases to others; for example, the $5.762 price could be reduced to the $1.29 to $1.42 current market prices.

Other important facts facing Amoco were the terms of the Williams gas contract—it did not provide for a minimum take obligation. Although it contained a ratable take requirement, if

---

[87] Typically it will be the lessee arguing implied covenants are implied in fact, not law, and the lessor arguing they are implied in law, not fact. However, litigants tend to fight the battle at hand.

[88] *Smith*, 31 P.3d at 265-68.

[89] *Id.* at 269-70.

Williams took no gas from the field, its ratable take from Amoco would be zero. Therefore, Williams could take just enough gas to keep the leases in effect and let the rest remain in the reservoir.[90] Amoco's response to this state of affairs was to try to renegotiate the gas contract so that it could currently market all the gas it could produce. When it was evident negotiations would not be successful, Amoco, on June 8, 1989, triggered the Order 451 process. The end result of this action was that the $0.579/MMBtu gas, and other low-priced gas, became eligible for the Order 451 price of $2.864/MMBtu;[91] the $5.762/MMBtu gas, and other high-priced gas, were subject to reduced prices.

Amoco's action resulted in two lawsuits, and its marketing covenant dilemma. The first suit was by the low-priced gas lessors asserting that Amoco breached its implied covenant to market by waiting to trigger Order 451 until June 8, 1989, when it could have done so as early as January 23, 1987.[92] The second suit was by the high-priced gas lessors asserting Amoco never should have triggered Order 451 and when it did it breached its implied covenant to market.[93] Amoco's dilemma was created by the Federal Energy Regulatory Commission when it gave all gas sellers the authority to trigger, or not trigger, the Order 451 process. With different vintages of gas under a single contract, any action, or inaction, by the gas seller would give rise to some sort of lessor complaint.

The court begins its implied covenant analysis noting: "Kansas has always recognized the duty of a lessee under an oil and gas lease to use reasonable diligence in finding a market for the product or run the risk of causing the lease to lapse."[94] Under Kansas law this would be the result under the express haben-

---

[90] The liberal, arguably non-existent, prorationing regulation by the Kansas Corporation Commission accommodated Williams' use of the Hugoton Gas Field for its de facto gas storage program. *See generally* Rachel C. Lipman, "Hugoton Gas Field: The Ongoing Battle Over Allowables, Underage, and Infill Wells," 33 *Washburn L.J.* 852 (1994).

[91] 31 P.3d at 261.

[92] This was *Youngren v. Amoco Production Co.*, Case No. 89 CV22, the class action which Amoco settled. *Smith*, 31 P.3d at 262-63.

[93] This is the *Smith* case.

[94] *Smith*, 31 P.3d at 271.

dum clause provisions.[95] The court does not engage in a clearly-defined step one implied-in-fact analysis. Amoco argued:

> [R]oyalty owners under a proceeds lease are merely entitled to a share of money received from the actual sales of gas; royalty owners under a market value lease are merely entitled to a share of the market value which is determined by what a willing buyer would pay to a willing seller in a free market.[96]

With regard to the market value leases, Amoco would appear to be correct since Kansas follows a *Vela/Middelton* approach to the market value royalty issue.[97] Therefore, regardless of what price the lessee is entitled to receive under the gas contract, the lessor must be paid a royalty based upon the market value of the gas when it is produced. Amoco's proceeds argument is not as convincing since the lessee's action, or inaction, can directly impact the proceeds that will serve as the basis for the lessor's royalty.

The proceeds issue raises an interesting problem. There is no omitted term in this case. The issue, instead, is determining what the term "'proceeds" means. There does not appear to be anything to imply, therefore an implied covenant analysis is not necessary. Instead we are concerned with the lessee's "performance" under a contract with a "proceeds" royalty measure. Arguably the issue is whether the lessee has acted in "good faith" in performing its contractual obligation to generate proceeds. "Good faith" is more of a subjective standard and therefore, depending upon the facts, can be either more or less demanding than an objective prudent operator standard.

The court does not directly respond to Amoco's arguments. Instead, it responds to the lessors' contention there is an implied covenant to obtain the "best price in gas contracting."[98]

---

[95] Elliott v. Crystal Springs Oil Co., 187 P. 692 (Kan. 1920). As I have noted previously: "Kansas interprets the production requirement literally in conjunction with the lessor's economic goal of receiving income from the lease through royalties. If the required substance is not being produced and marketed on the date the primary term ends, the lease terminates." David E. Pierce, *Kansas Oil & Gas Handbook* § 9.23, 9-22 to 9-23 (1986).

[96] *Smith*, 31 P.3d at 269.

[97] *E.g.*, Holmes v. Kewanee Oil Co., 664 P.2d 1335, 1341 (Kan. 1983). *See* David E. Pierce, *Kansas Oil & Gas Handbook* § 9.50, 9-70.

[98] *Smith*, 31 P.3d at 269-70.

The court rejects the lessors' best price theory and instead notes the standard in Kansas has been defined as "reasonable terms,"[99] including a "reasonable price,"[100] that is obtained "within a reasonable time following production."[101] It remains to be seen whether following remand the court will rely upon the express "market value" language to resolve the issues under the market value royalty leases. With regard to the proceeds leases, instead of a "good faith" express covenant analysis the court follows the lead of the lessors and uses an implied covenant analysis, which triggers step two of the implied-in-fact analysis.

In step two the court defines the standard that will be used to determine whether the duty defined in step one has been satisfied. The duty identified in step one of *Smith* appears to be whether Amoco, in pursuing its options under Order 451, fulfilled its implied obligation to market the lessors' gas on "reasonable terms" considering the regulatory environment, dedication under the Williams gas contract,[102] and all other circumstances existing at the time the marketing decision was made.[103] To evaluate Amoco's actions the court articulates an implied-in-fact prudent operator standard. First, Amoco has an independent duty under each lease.[104] External facts will govern Amoco's obligations, not Amoco's individualized internal factual situation. Second, Amoco's compliance with its implied duties will be "measured by the standard of a reasonably prudent operator and judged on the circumstances existing at the

---

[99] *Id.* at 271.

[100] *Id.* at 272.

[101] *Id.* at 271.

[102] A fact that could influence the outcome of the case is that regardless of the price Williams had to pay for gas it took, Williams had no take obligation under the contract. *Smith*, 31 P.3d at 260-61 (findings of fact regarding the Williams gas contract).

[103] The court notes at various points in its opinion: "When negotiating with Williams Natural Gas under good-faith negotiating provisions, Amoco had a marketing duty to each of its lessors." *Id.* at 272. "The ultimate question for the district court is fact specific . . . . Did Amoco's actions under Order 451 breach the implied covenant to market?" *Id.* at 273.

[104] *Id.* at 272. "The independent duty principle is applied to prevent Amoco from making the management of a given lease dependent upon the management of another lease." *Id.*

time of the alleged breach."[105] Third, as part of the prudent operator analysis the court should consider the "purpose of Order 451,"[106] "the regulatory background,"[107] and "national policy reflected under the NGPA [Natural Gas Policy Act] and the purpose of FERC's Order 451."[108] Fourth, compliance in any given case is an issue of fact.[109]

Unlike the marketable product cases, in *Smith* the implied covenant is not self-executing. Once the duty is defined, the surrounding circumstances are evaluated to determine what a prudent operator would do to discharge the duty. In contrast, under the marketable product analysis the issue is not whether a prudent operator would sell gas at the well, but whether the gas was a "marketable product" at the well. This removes lessee discretion from the inquiry and runs counter to two principles stressed by the court in *Smith*: First, that courts should not " 'examine in hindsight the business decisions of a gas producer' " and second, that " '[t]he greatest possible leeway should be indulged the lessee in his decisions about marketing gas . . . .' "[110] Although the step one analysis in *Smith* is not totally consistent with an implied-in-fact approach, once the court moves to its step two analysis the prudent operator standard is applied in a consistent implied-in-fact manner.

§ 10.06 Conclusions: Defining *Un*cooperative Relationships

Professors Williams and Meyers have advanced the theory that implied covenants find their foundation in the principle of "cooperation."[111] Like the concept of "good faith," it is difficult to

---

[105] *Id.* at 271.

[106] *Id.* at 273.

[107] *Id.*

[108] *Id.*

[109] *Id.*

[110] *Smith*, 31 P.3d at 271.

[111] Patrick H. Martin & Bruce M. Kramer, *Williams & Meyers on Oil and Gas Law* § 802.1, at 9 (2001) ("The broad ground on which implied covenants are properly rested is believed to be the contract principle of cooperation."). Professor Kuntz has also characterized the oil and gas lease relationship as a "cooperative" "venture or undertaking" stating:

argue against contracting parties cooperating with one another. These concepts are useful in determining how the parties should perform or enforce defined obligations but they offer no principled assistance when the basic obligation has yet to be defined. Although cooperation is rather useless as an interpretive tool, it can serve a significant role when a court seeks to depart from interpretation and remake the obligations of the parties.[112]

When defining basic lease obligations, the parties are not concerned with "cooperation"; they are concerned with domination.[113] The lessee wants to deduct the costs it incurs to move

---

> When the lessor and lessee enter into an oil and gas lease, it is for the fundamental purpose of providing for the exploration, development, and operation of the leased premises for the mutual profit and advantage of both the lessor and lessee. The venture or undertaking is in a very real sense a cooperative one. The lessor provides the raw material in the form of an unexploited mineral interest, and the lessee undertakes to exploit it for their common advantage. With the success of the venture dependent upon the contribution which each party makes, it is essential that both parties cooperate in the undertaking.

Eugene Kuntz, *A Treatise on the Law of Oil & Gas* § 55.1(a), 15 (1991). Professor Kuntz's cooperative venture observations must be considered in the context of his description of the parties' competing interests:

> To a limited extent, the interests of the lessor and lessee concur in the exploration, development, and operation of the premises covered by the oil and gas lease. Their interests concur in that they both derive economic benefit from the production of oil and gas. To a greater extent, however, their interests are in conflict.
>
> The cause of the conflict in the interests of the lessor and lessee is very simple. The lessee must bear the cost of any operation on the leased premises, whether such operation is exploration, development, or production; while the benefits derived by the lessor from production are free and clear of costs. It is true that any activity in exploration, development, and operation of the leased premises involves a risk of loss to both lessor and lessee, but the risk of loss to which the lessor is exposed is negligible in comparison to the risk undertaken by the lessee.

Eugene Kuntz, *A Treatise on the Law of Oil & Gas* § 54.2, 1-2 (1991).

[112] For a strong endorsement of the cooperative venture analysis see: John S. Lowe, "Defining the Royalty Obligation," 49 *SMU L.J.* 223, 251 (1996) ("Eventually, even courts that are not constrained by precedent probably will adopt the cooperative venture analysis.").

[113] Previously I have posited the "royalty value theorem" which states: "When compensation under a contract is based upon a set percentage of the value of something, there will be a tendency by each party to either minimize or maximize the value." I first articulated this principle in David E. Pierce, "What's Behind the Valuation Controversy Anyway?" *Federal & Indian Oil & Gas Royalty Valuation &*

gas to a downstream marketing point; the lessor wants royalty calculated on the downstream value without any deduction of costs. "Cooperation" in this context means deciding that money must be taken from one party and given to the other. Who will be the first to "cooperate" in this situation? Which party should be forced to "cooperate" by the court? In the marketing context, cooperation would seem to function more as a justification for a "fairness" analysis than a viable interpretive tool. The concept of cooperation fails to acknowledge the basic conflicting interests of the lessor and lessee and that in most cases they will be competing to ensure the lease is interpreted to selfishly promote their individual economic interests.

When mutually exclusive interpretive issues are involved, courts must "interpret" the contract and resolve the issues. This may involve determining the meaning of contract language; it may involve implying obligations. If the court desires to pursue an implied-in-fact analysis, the contract will be the court's primary guide. If the court desires to pursue an implied-in-law analysis, the court's view of what is fair under the circumstances will guide its interpretation. It is submitted the appropriate balance between freedom of contract and fairness has already been struck with the contract serving as the interpretive guide unless the result would be "unconscionable" under existing unconscionability analysis. Such an approach forces courts to address fairness issues using a principled analysis while preserving the conscionable terms of the parties' contract.

---

troversy Anyway?" *Federal & Indian Oil & Gas Royalty Valuation & Management III*, 1-1 (Rocky Mt. Min. L. Fdn. 2000). I expand on my analysis of the royalty value theorem, and its contribution to the *un*cooperative relationship, in: David E. Pierce, "The Royalty Value Theorem and the Legal Calculus of Post-Extraction Costs," 23 *Energy Min. L. Inst.* 10-1 (2002).