DEFINING THE ROLE OF INDUSTRY
CUSTOM AND USAGE IN OIL &
GAS LITIGATION

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I. INTRODUCTION

Industry "custom and usage" evidence can be powerful; sometimes it will be the determinative factor in litigation.¹ Courts sometimes ask for custom and usage evidence.² Litigants frequently seek

1. For example, in Energen Res. MAQ, Inc. v. Dalbosco, 23 S.W.3d 551 (Tex. App.—Houston [1st Dist.] 2000, pet. denied), Dalbosco assigned oil and gas leases to Energen under an agreement, known as a "farmout," whereby Energen acquired the right to drill wells on the leases for the parties’ mutual benefit. After producing from a well for several years, Energen decided to plug the well because of its marginal production. Dalbosco asserted that Energen had a duty to give advance notice of Energen’s intention to plug any well drilled under their farmout agreement. The farmout agreement did not address the issue, but Dalbosco sought to introduce evidence of a custom and usage in the oil and gas industry to give notice of an intent to plug a well. The trial court granted Energen’s motion for summary judgment. The court of appeals reversed the trial court holding that a material issue of fact existed regarding the asserted industry custom and usage. Dalbosco v. Total Minatome Corp., No. 01-92-00898-CV, 1994 WL 109475, (Tex. App.—Houston [1st Dist.] March 31, 1994) (not designated for publication). Following remand to the trial court, the custom and usage evidence was presented to the jury which found such an industry custom and usage existed and that Energen’s failure to give the required notice was a breach of the farmout agreement justifying an award of $216,000 in damages and $140,000 in attorney’s fees. Energen Resources, 23 S.W.3d at 552-53. In the second appeal the jury award was affirmed with the court noting: "Evidence of custom and usage is admissible to add to a contract that is silent on a particular matter." Id. at 557. See also Oxley v. Gen. Atl. Res., Inc., 936 P.2d 943 (Okla. 1997) (reversing summary judgment; issue of material fact existed regarding custom and usage associated with interest owner voting practices under joint operating agreement); Esplanade Oil & Gas, Inc. v. Templeton Energy Income Corp., No. Civ.A. No. 86-1362 1988 WL 86856 (E.D. La. Aug. 16, 1988) (evaluating conflicting custom and usage testimony to conclude a drop in oil prices was an “adverse material change” that would permit buyer to avoid closing on purchase of producing properties).

2. E.g., Shell Offshore, Inc. v. Kirby Exploration Co. of Tex., 909 F.2d 811, 816 (5th Cir. 1990) ("It is in the interests of justice for the district court to explore the customs and practices in the offshore oil and gas industry dealing with the type of problem presented in
to use custom and usage evidence to resolve interpretive and substantive issues arising in property, contract, tort, agency, and other legal disciplines, including the discipline we call "oil and gas law." This article analyzes the role custom and usage evidence plays in litigation concerning the oil and gas industry.  

Analysis of existing case law reveals that custom and usage evidence has been employed for many different purposes—with courts employing differing threshold procedural and substantive requirements depending upon the context in which the evidence is offered. The goal of this article is to identify, categorize, and analyze the various ways custom and usage are used by litigants and managed by judges. By clearly identifying the various contexts in which custom and usage evidence is sought to be used by litigants, and in which it is admitted, excluded, or limited by the courts, it should be possible to develop a principled analysis of when such evidence is necessary, appropriate, and inappropriate. This will assist counsel in evaluating when custom and usage evidence is essential, or desirable. In addition to addressing the substantive law of custom and usage, this article examines the procedural hurdles to admission of custom and usage evidence. It will also serve as a useful tool for explaining to prospective custom and usage witnesses their role in a case. However, before addressing the law of custom and usage, it is first necessary to define what is meant by "custom and usage."

II. DEFINING "CUSTOM AND USAGE": THE WAY THINGS ARE DONE

The modern definition of industry "custom and usage" is simply: the way things are done within an industry. For example, in Energen Resources MAQ, Inc. v. Dalbosco, the custom and usage evidence was offered to prove "the way things are done" when a party to a farmout agreement decides to plug a well.

In the modern context, the relevant term is "usage" as opposed to "custom."

3. The same analytical observations can be made of other industries. Each industry will have its own unique ways of doing business—their own "customs" and "usages." In the first American treatise devoted to the topic, the author addresses custom and usage issues by examining various businesses, such as banking, common carriers, and insurance, as well as various relationships, such as landlord and tenant, master and servant, partnership, principal and agent, and vendor and purchaser. John D. Lawson, The Law of Usages and Customs IX (Bancroft-Whitney 1887) [hereinafter Lawson].


5. Id.
Traditionally "custom" was limited to practices uniformly followed by an industry, the origin of which cannot be identified because it has been such a long-standing practice. Today the focus is on "usage" which is a much broader, less-demanding concept than custom. "Usages" can be created by the parties to a transaction and they can change. Today use of the term "custom," in tandem with the word "usage," is surplusage. Industry "usage" therefore has the same meaning as industry "custom and usage."

The Restatement (Second) of Contracts defines "usage" as "habitual or customary practice." Usage as a dynamic concept, to be proven in any particular situation, is addressed by a comment to Restatement section 219 as follows:

"Usage is not in itself a legal rule but merely habit or practice in fact. A particular usage may be more or less widespread. It may prevail throughout an area, and the area may be small or large—a city, a state or larger region. A usage may prevail among all people in the area, or only in a special trade or other group. Usages change over time, and persons in close association often develop temporary usages peculiar to themselves."

The Restatement also uses the term "usage of trade" which it defines as "a usage having such regularity of observance in a place, vocation, or trade as to justify an expectation that it will be observed with respect to a particular agreement."

As with the term "usage," the comment to the Restatement notes: "A usage of trade need not be 'ancient or immemorial,'

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6. Frequently the term "practice" is used instead of "usage;" often the phrase "custom and practice" is used instead of "custom and usage." There does not appear to be any intended distinction between the terms. The term "practice" is frequently encountered when the term "usage" would sound awkward in the sentence. For example: "It was her normal practice to give notice." vs. "It was her normal usage to give notice."

7. An early commentator described the rule as follows:
A common-law custom must have existed so long that the memory of man runneth not to the contrary. If a usage could be shown to have commenced, it was void as a custom. Every custom, of course, must have had a commencement, but if its inception could be discovered, then the individual by whose particular will the custom had its birth would be discovered; and it was a maxim that no one man could be allowed to make a law, but that a custom could only have its origin in the will of the whole. The time 'whereof the memory of man runneth not to the contrary' received a technical limitation and was understood to refer to the commencement of the reign of King Richard I.

LAWSON, supra note 3, at 26. King Richard I was "Richard the Lion-Hearted" who reigned as King of England from 1189-1199. WEBSTER'S NEW UNIVERSAL UNABRIDGED DICTIONARY 1231 (1992) [hereinafter WEBSTER'S]. Therefore, technically a common law "custom" must have been in existence since 1189.


9. Id. at cmt. a.

10. RESTATEMENT (SECOND) OF CONTRACTS § 222(1) (1981). An interesting derivation of this rule has been developed by the Oklahoma Supreme Court concerning the use of standardized forms by the oil and gas industry. In Oxley, 936 P.2d at 946, the affidavit of expert witness R. Dobie Langenkamp (lawyer, oil operator, law professor) stated it was the "custom and usage in the oil industry" that when a successor operator receives a majority of working interest votes, that party immediately becomes the operator and parties who voted for them cannot change their vote during the 60-day election period. Noting the
Instead of requiring an "ancient or immemorial" and "universal" standard similar to that used to prove a common law custom, the Restatement requires the party to establish its existence, and relevance, as a matter of fact.\textsuperscript{12}

The distinction between a "usage" and a "usage of trade" is explained by the Restatement by characterizing "usage of trade" as a "particular application" of the rules governing "usage."\textsuperscript{13} The major practical distinction between a "usage" and "usage of trade" under the Restatement is that a party can be bound to a "usage" if they "knew or had reason to know of the usage,"\textsuperscript{14} while a party can be bound to a "usage of trade" if they "know or have reason to know" of the trade usage or if the "usage of trade" is part of the "vocation or trade in which the parties are engaged ...."\textsuperscript{15} When the parties to a contract are "engaged" in a "vocation or trade" they are presumed to contract with regard for the usages of the "vocation or trade."\textsuperscript{16} The Uniform Commercial Code ("U.C.C.") applies a similar analysis.\textsuperscript{17}

unique utility of custom and usage when interpreting operating agreements, the court stated:

Custom and usage should be considered when interpreting a contract. . . . This would especially be true when construing the JOA in the present case, which is based upon a standard form in use in the oil and gas industry since 1956. . . . Thus, if on remand, the evidence shows that it is the custom and usage that vote changes are not permitted, then the JOA should be so interpreted.

\textit{Id.} The court held that the existence of such a usage created a material issue of fact which must be resolved at trial and reversed the trial court's order granting summary judgment. \textit{Id.} at 947.

11. \textit{Id.} at cmt. b.

12. The existence and scope of a usage of trade are to be determined as questions of fact." \textsc{Restatement (Second) of Contracts} § 222(2) (1981).

13. \textit{Id.} at cmt. a. ("This section . . . states a particular application of the rules stated in §§ 220 and 221.").

14. \textsc{Restatement (Second) of Contracts} § 220(1) (1982) ("Usage Relevant to Interpretation"). See also \textsc{Restatement (Second) of Contracts} § 221 ("Usage Supplementing an Agreement") ("each party knows or has reason to know of the usage").

15. \textsc{Restatement (Second) of Contracts} § 222(3) (1981) ("Unless otherwise agreed, a usage of trade in the vocation or trade in which the parties are engaged or a usage of trade of which they know or have reason to know gives meaning to or supplements or qualifies their agreement.") (emphasis added).

16. Subsection VII.E. of this article addresses when a party without actual knowledge of a usage will nevertheless be bound by the usage. \textit{See infra} text accompanying notes 396-441.

17. The U.C.C. definition of "usage of trade" includes "any practice or method of dealing having such regularity of observance in a place, vocation or trade as to justify an expectation that it will be observed with respect to the transaction in question." U.C.C. § 1-205(2) (1977). Under the 2001 revisions to Article 1 of the U.C.C., § 1-205(2) is found at new § 1-303(c). Commenting on the significance of the "trade" aspect of this definition, Professors White and Summers observe:

Note particularly that it is not necessary for both parties to be consciously aware of the trade usage. It is enough if the trade usage is such as to "justify an expectation" of its observance. Subsection 1-205(3) adds that a usage of trade is binding if it is a usage of the vocation or trade in which the parties are engaged or is a usage which the parties are or should be aware.
The U.C.C. has played a major role in defining the modern concept of "custom and usage." The Restatement definition of "usage of trade" is patterned off of U.C.C. § 1-205(2) which states, in part:

A usage of trade is any practice or method of dealing having such regularity of observance in a place, vocation or trade as to justify an expectation that it will be observed with respect to the transaction in question. The existence and scope of such a usage are to be proved as facts . . . .

Under the U.C.C., usage is recognized as an integral part of the parties' bargain. Therefore, usage evidence can be offered to "explain" or "supplement" the terms of a fully integrated agreement. With a working definition of "custom and usage" evidence, the next step is to consider why courts even consider usage evidence.

JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE 111 (5th ed. 2000) (emphasis added) [hereinafter WHITE & SUMMERS].

In the 2001 revisions to Article 1 of the U.C.C., § 1-102(2)(b) is found at new § 1-103(a)(2). Under the 2001 revisions to article 1 of the U.C.C., § 1-102(b) is found at new § 1-103(a)(2).


20. U.C.C. § 1-205(2) (1977) (emphasis added). Under the 2001 revisions to Article 1 of the U.C.C., § 1-205(2) is found at new § 1-303(c).

21. U.C.C. § 1-201(3) defines "Agreement" to mean "the bargain of the parties in fact as found in their language or by implication from other circumstances including course of dealing or usage of trade or course of performance . . . ." U.C.C. § 1-201(3) (1977) (emphasis added). The comment explains: "[T]he word ["Agreement"] is intended to include the full recognition of usage of trade, course of dealing, course of performance and the surrounding circumstances as effective parts thereof . . . ." Id. at cmt. 3. As noted by Professors White and Summers: "These sources [course of dealing, usage of trade, and course of performance] are relevant not only to the interpretation of express contract terms, but may themselves constitute contract terms." WHITE & SUMMERS, supra note 17, at 111. Under the 2001 revisions to Article 1 of the U.C.C., § 1-201(3) is found at new § 1-201(b)(3).

22. The Article 2 version of the parol evidence rule, U.C.C. section 2-202, expressly provides that "a writing intended by the parties as a final expression of their agreement," even "a complete and exclusive statement of the terms of the agreement," can be "explained or supplemented by . . . usage of trade . . . ." U.C.C. § 2-202 (1977). The comment to section 2-202 explains that the role of usage evidence is to ascertain the "true understanding of the parties" with "the assumption that the . . . usages of trade were taken for granted when the document was phrased." Id. at cmt. 2. Professors White and Summers observe:

Even if the writing is a "complete and exclusive" statement of the terms of the agreement, parties may still introduce course of dealing, usage of trade, or course of performance to explain, supplement, or add to the agreement (but not contradict it). This is so even where the language of the agreement is unambiguous on its face.

WHITE & SUMMERS, supra note 17, at 98-99. Under the 2003 revisions to Article 2 of the U.C.C., section 2-202 has been modified by providing that a "final expression of their agreement . . . may be supplemented by evidence of course of performance, course of dealing or usage of trade (Section 1-303) . . . ." U.C.C. § 2-202(1)(a) (2003). Although the word "explained" has been dropped from the phrase "explained or supplemented," the concept is picked up in new subsection (2) which makes it clear that usage evidence can be used for interpretation, in any event, by providing that: "Terms in a record may be explained by evidence of course of performance, course of dealing, or usage of trade without a preliminary determination by the court that the language used is ambiguous." U.C.C. § 2-202(2) (2003).
III. APPLICABLE USAGES PROVIDE MEANING TO THE CONTRACT TERMS

Ideally, the goal in any dispute over the meaning of contract terms is to ascertain the intent of the parties. The inquiry is, under the facts, what “meaning” should be given to a particular term, phrase, clause, or agreement structure? Often what may at first appear to be odd wording and agreement structure will become readily apparent once usages associated with the transaction are understood. Usage evidence provides information that is often necessary for the accurate interpretation of the contract. Problems arise, however, when the “four-corners” of the contract document do not reveal the applicable usages and it becomes necessary to consider evidence outside of the document: “extrinsic evidence.” Whenever a party seeks to offer extrinsic evidence to interpret an unambiguous, integrated writing the other party to the contract will seek to exclude the evidence under the parol evidence rule.

A. PAROL EVIDENCE RULE LIMITATIONS ON USAGE EVIDENCE

Technically, the parol evidence rule has nothing to do with the “interpretation” of contract terms. Instead, the rule simply defines what

23. However, Professor Farnsworth warns that what courts purport to do under the rubric of “the intentions of the parties” may not, in fact, account for their intentions: The court does indeed carry out their intentions in those relatively rare cases in which the parties attached the same meaning to the language in question. But if the parties attached different meanings to that language, the court’s task is the more complex one of applying a standard of reasonableness to determine which party’s intention is to be carried out at the expense of the other’s. And if the parties attached no meaning to that language, its task is to find by a standard of reasonableness a meaning that does not accord with any intention at all.


24. The Restatement provides: “Interpretation of contracts deals with the meaning given to language and other conduct by the parties rather than with meanings established by law. But the relevant intention of a party is that manifested by him rather than any different undisclosed intention.” RESTATEMENT (SECOND) OF CONTRACTS § 212 cmt. a (1981). See generally E. Allan Farnsworth, “Meaning” in the Law of Contracts, 76 YALE L. J. 939 (1967).

25. The most logical rationale for the parol evidence rule is the “merger” concept that a subsequent integrated writing of the parties will discharge all prior oral or written agreements. This is the rationale adopted by the Restatement which provides, in part: (1) A binding integrated agreement discharges prior agreements to the extent that it is inconsistent with them. (2) A binding completely integrated agreement discharges prior agreements to the extent they are within its scope. RESTATEMENT (SECOND) OF CONTRACTS § 213 (1981) (emphasis added). In comment a, it is noted: “This Section states what is commonly known as the parol evidence rule. It is not a rule of evidence but a rule of substantive law. Nor is it a rule of interpretation; it defines the subject matter of interpretation.” Id. at cmt. a.

The merger/discharge function of the parol evidence rule recognizes the distinct roles of identifying the writing to be interpreted and the independent act of interpretation. Profes-
agreements constitute the “contract” that will be interpreted.\textsuperscript{26} The rule defines the evidence that can be considered in ascertaining the terms of the contract. After identifying the universe of terms, the rule has done its job. Determining what that universe of terms “mean” is not a task for the parol evidence rule, but rather for the law governing contract interpretation.\textsuperscript{27} For example, in \textit{Jeanes v. Henderson},\textsuperscript{28} Jeanes asserted that when Henderson sold certain interests to Stallworth, Henderson breached their contract granting Jeanes an “option to purchase all of his [Henderson’s] interest should he ever decide to sell his Interest.” The dispute focused on the meaning of the term “Interest” as used in the Jeanes/Henderson contract.\textsuperscript{29} At trial, Henderson testified that since another company, Kewanee Oil, already had a right of first refusal on the “Lokey-Cartwright leases,” the parties never intended Jeanes’ option to attach to those interests but was limited to future acquisitions outside the Lokey-Cartwright leases. Jeanes objected to Henderson’s testimony as “improper parol evidence’ that varied and contradicted the 1971 contract.”\textsuperscript{30} On appeal, the court determined the testimony was properly admitted because it “did not vary or contradict any terms of the 1971 contract but...
explained and interpreted them.”

Unfortunately, the parol evidence rule is sometimes improperly pressed into service at the term *interpretation* stage of analysis in addition to its legitimate term *identification* stage of analysis. The *Restatement* makes it clear that: “Agreements and negotiations prior to or contemporaneous with the adoption of a writing are admissible in evidence to establish . . . the meaning of the writing, whether or not integrated . . . .”

However, some courts have employed the parol evidence rule to limit extrinsic “meaning” evidence unless the court first finds the agreement is ambiguous. Other courts have carefully distinguished the interpretive role from the identification of terms to be interpreted, and have recognized that usage evidence is properly classified as interpretive.

31. *Id.* The court states the analysis as follows: “The term ‘interest’ in the third option was not self-defining and was in this sense ambiguous. Henderson’s testimony was thus admissible to determine the meaning of the term.” *Id.*

32. *Restatement (Second) of Contracts* § 214(c) (1981) (emphasis added). The existence of Kewanee Oil’s right of first refusal, at the time the Jeans/Henderson contract was made, would also be a relevant “surrounding circumstance” the court should be able to consider. See infra text accompanying notes 45–50.

33. 12 *Samuel Williston & Richard A. Lord, A Treatise on the Law of Contracts* § 34:7 (4th ed. 1999). The “common law” rule is stated as follows:

As a general rule at common law, parol or extrinsic evidence is admissible to explain or supplement terms of a contract which are ambiguous or uncertain as used in the contract and cannot be satisfactorily explained by reference to other portions of the contract. Under this common-law principle, usage is admissible to explain or interpret ambiguous terms or provisions of a contract.

The common-law parol evidence rule requires a finding that the contract is ambiguous prior to the admission of evidence of usage.

*Id.* at 45–46.

34. Professor Corbin states in his treatise:

No parol evidence that is offered can be said to vary or contradict a writing until by process of interpretation it is determined what the writing means. The “parol evidence rule” is not, and does not purport to be, a rule of interpretation or a rule as to the admission of evidence for the purpose of interpretation. Even if a written document has been assented to as the complete and accurate integration of the terms of a contract, it must still be interpreted; and all those factors that are of assistance in this process may be proved by oral testimony.

Custom and usage of a particular place or trade can be proved to give to the words of a written contract a meaning different from that which would be given to the words by their more general usage. This is true even though the words are ordinarily words in common use such as words of number or words expressing a period of time.

6 *Arthur Linton Corbin, Corbin on Contracts* § 579 at 120, 131 (interim ed. 1979).

35. Professor Kniffin observes in the Revised Edition of *Corbin on Contracts*:

Trade and local usage are among the varieties of extrinsic evidence most frequently and most readily admitted by courts in order to discern the meaning of contract terms, as well as the meaning of terms of offer and acceptance.

Commentary in both the Uniform Commercial Code and the Restatement (Second) of Contracts clearly indicates that the “plain meaning rule” is inapplicable to evidence of trade usage. Disputed terms are therefore not required to be ambiguous before evidence of trade usage can be utilized to interpret them. . . . The Restatement (Second) of Contracts explains that the plain meaning rule is inapplicable when evidence of trade usage is proffered: “There is no requirement that an agreement be ambiguous before evidence
The U.C.C. best articulates the interpretive role of usage evidence by expressly stating that even a “complete and exclusive [written] statement of the terms of the agreement” can be “explained or supplemented” by “usage of trade.”36 Although the express written terms of the agreement cannot be “contradicted” by usage evidence, another Code provision directs that the “express terms of the agreement and any . . . usage of trade, shall be construed whenever reasonable as consistent with each other . . . .”37 The “express terms shall control . . . usage of trade” only when a consistent construction would be “unreasonable.”38 The comments to U.C.C. section 2-202 describe the interpretive role of usage evidence as follows:

Paragraph (a) makes admissible evidence of course of dealing, usage of trade and course of performance to explain or supplement the terms of any writing stating the agreement of the parties in order that the true understanding of the parties as to the agreement may be reached. Such writings are to be read on the assumption that the course of prior dealings between the parties and the usages of trade were taken for granted when the document was phrased. Unless carefully negated they have become an element of the meaning of the words used.39

The “carefully negated” requirement associated with section 2-202, in conjunction with the “unreasonable construction” test of section 2-208(2), make it likely that most usage evidence will be admissible under the parol evidence rule.40 Most exclusions will occur when counsel tries to add or subtract terms to the contract under the guise of usage evidence. These

of usage of trade can be shown . . . .” Not infrequently, however, cases are found in which rules are laid down, as if well established, that evidence of usage or custom is not admissible to vary or contradict the plain terms of a written contract or to make a contract where the parties have made none. Such statements are very misleading in form and are very likely to lead to unjust decisions. Because trade usage supplies a particular meaning that is used by members of a trade, this meaning will often differ from the meaning assigned by the general public. If a court were to apply the “plain meaning rule,” the court might be obliged to refuse to admit evidence of the trade usage. For example, the court could hold that the meaning of “dozen” is clearly twelve, so that proffered evidence of the chefs’ trade usage that a dozen doughnuts is thirteen, “a baker’s dozen,” would be excluded from consideration.

38. Id.  
40. The line between “explained or supplemented” and not reasonably “consistent” is easier to draw when it is acknowledged that the “agreement” being defined is “the bargain of the parties in fact as found in their language or by implication from other circumstances including . . . usage of trade . . . .” U.C.C. § 1-201(3) (1977). The comment to this section states: “As used in this Act the word [Agreement] is intended to include full recognition of usage of trade . . . as effective parts thereof . . . .” Id. at cmt. 3. This concept is also noted in the comment to section 1-102 which states: “‘Agreement’ here includes the effect given to . . . usage of trade . . . by Sections 1-201, 1-205 and 2-208 . . . .” U.C.C. § 1-102 (1977) cmt. 2.
tactics can often be revealed by identifying the purpose for which the evidence is being offered: is it to identify the universe of terms that comprise the contract or is it to interpret the contract terms already found to comprise the contract? Even this test, however, is difficult to apply in many cases.

In 2003, the National Conference of Commissioners on Uniform State Laws and the American Law Institute approved a revised text for Article 2 of the U.C.C. With regard to usage, the primary changes were organizational with the elimination of U.C.C. sections 1-205 and 2-208, and replacing them with new section 1-303 to make the course of performance, course of dealing, and usage of trade provisions apply to all commercial transactions, not merely those covered by Article 2. Regarding the role of usage in contract interpretation, a new subsection to the Code’s parol evidence rule, section 2-202, makes it clear that such evidence can be considered even when the language is unambiguous.

B. Parol Evidence Rule Not a Limitation on “Context” and “Surrounding Circumstances” Evidence

Every contract has a context. Context is often described in terms of

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41. Applying parol evidence principles.
42. “Interpretation” would also include omitted terms that are provided by implication from the express terms contained in the written agreement. For example, in *Cheek v. Metzer*, 291 S.W. 860 (Tex. 1927), the court interpreted the contracts to require performance within a “reasonable time.” To determine what is a reasonable time the court must consider “the circumstances in evidence surrounding the situation of the parties and the subject-matter under which the contract was executed.” *Id.* at 863. Once an omitted term is supplied, its meaning is determined in the same manner as though it were an express term. “[W]hen an implied obligation is established, the contract is to be construed as a whole, and the implied provisions are to be read into and become part of the contract as though expressly set forth therein.” *Id.*

43. For example, in *U.S. Tex Oil Corp. v. Kynerd*, 296 F. 836 (5th Cir. 1924), an assignment conveyed “seven-eighths of all oil and gas produced from the leased land . . . .” Usage testimony was offered to establish that “seven-eighths of the oil produced under the terms of such a lease means seven-eighths of the oil less the fuel oil . . . .” *Id.* at 841. The court ruled this evidence was improper noting:

> The intention of the parties evidenced by their use of the words “seven-eighths (7/8) of the oil and gas produced,” was not subject to be varied or contradicted by evidence to the effect that that language had a meaning not expressed by it. An express written contract, embodying in clear and positive terms the intention of the parties, cannot be varied by evidence of usage or custom.

*Id.* The court essentially held 7/8ths = 7/8ths and usage evidence will not change this result. However, the real term for interpretation is “produced” oil and gas. Does “produced” include oil and gas that is used for fuel and not marketed? Usages in the trade would seem relevant when the focus is on the meaning of the term “produced.”

44. U.C.C. § 2-202(2) (2003) states that: “Terms in a record may be explained by evidence of course of performance, course of dealing, or usage of trade without a preliminary determination by the court that the language used is ambiguous.”

45. As defined by *Webster’s*, “context” means: “the parts of a written or spoken statement that precede or follow a specific word or passage, usually influencing the meaning or effect” and “the set of circumstances or facts that surround a particular event, situation, etc. . . . .” *Webster’s*, supra note 7, at 439. “Context” could also mean “the fleshy, fibrous body of the pileus in mushrooms . . . .” *Id.* It all depends on the “context” of the
the "surrounding circumstances." Professor Farnsworth identifies, as one of his "Fundamental Principles of Interpretation," the importance of courts considering "all the relevant circumstances surrounding the transaction." The U.C.C. also alludes to the importance of surrounding circumstance evidence by providing:

[The meaning of the agreement of the parties is to be determined by the language used by them and by their action, read and interpreted in the light of commercial practices and other surrounding circumstances. The measure and background for interpretation are set by the commercial context, which may explain and supplement even the language of a formal or final writing.]

The Restatement (Second) of Property provides that a conveyance should be interpreted "in light of the circumstances of its formulation." Although Professor Farnsworth advocates consideration of "prior negotiations" as part of the relevant surrounding circumstances, many courts would exclude prior negotiation evidence under the "plain meaning rule." Under the plain meaning rule, the court will evaluate the writing, and the relevant surrounding circumstances to determine whether the contract is sufficiently clear regarding the matter at issue. If it is, it will be interpreted without regard for the prior negotiation evi-

situation which meaning is intended. Are we talking about contracts, mushrooms, or mushroom contracts?

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46. Interestingly, "context of situation" is defined as "the totality of extralinguistic features having relevance to a communicative act." WEBSTER'S, supra note 7, at 439.

47. FARNSWORTH, supra note 23, at § 7.10.

48. Professor Farnsworth observes, and contends:

The overarching principle of contract interpretation is that the court is free to look to all the relevant circumstances surrounding the transaction. This includes the state of the world, including the state of the law, at the time. It also includes all writings, oral statements, and other conduct by which the parties manifested their assent, together with any prior negotiations between them and any applicable course of dealing, course of performance, or usage. The entire agreement, including all writings, should be read together in light of all the circumstances. Since the purpose of this inquiry is to ascertain the meaning to be given to the language, there should be no requirement that the language be ambiguous, vague, or otherwise uncertain before the inquiry is undertaken.

Id. at 467.


51. FARNSWORTH, supra note 23, at § 7.10.

52. Texas Gas Exploration Corp. v. Broughton Offshore Ltd. II, 790 S.W.2d 781, 785 (Tex. App.—Houston [14th Dist.] 1990, no writ) ("The record reveals that the requested instruction was properly denied. Custom and usage of trade are not relevant where the contract language is, like the language before this court, clear and unambiguous.").

53. Usually this level of clarity is expressed in terms of being "ambiguous" or "unambiguous."

54. Courts differ as to whether prior negotiation evidence can be considered at this initial stage of determining whether the agreement is ambiguous. FARNSWORTH, supra note 23, at 478-79.
dence. If the writing is not clear on the point, the prior negotiation evidence is admissible for the purpose of interpretation.

However, some courts have extended the plain meaning rule to exclude any extrinsic evidence. Professor Farnsworth labels this a "four corners rule" where courts purport to limit their inquiry to the four corners of the final, completely integrated writing. Although many cases can be found which reference the four corners of the contract being interpreted, they are actually applying a plain meaning rule because they frequently consider some form of surrounding circumstance evidence to interpret the contract. The lack of consistency in the cases can be explained by a basic failure to: (1) distinguish the role of the parol evidence rule from the role of interpretation; (2) recognize the substantive merger/discharge rationale for the parol evidence rule instead of an evidentiary rationale; and (3) recognize the necessity of considering context when interpreting a contract.

The Texas Supreme Court describes the relationship between the parol evidence rule and the surrounding circumstances interpretive rule in discussing whether a court could consider that the parties had struck a clause from an oil and gas lease:

55. There are actually two "contexts" with regard to a four-corners rule. First is a permissive context in which a court is required to examine all language within the "four-corners" of the document to ascertain the intent of the parties. This is an interpretive rule designed to seek a harmonization of the total contract language instead of giving any particular type or location of a clause decisive effect. E.g., Heyen v. Hartnett, 679 P.2d 1152, 1156 (Kan. 1984) ("The fundamental rule in construing the effect of written instruments is that the intent and purpose of the parties be determined from an examination of the entire instrument or from its four-corners. Thus the language used anywhere in the instrument should be taken into consideration and construed in harmony with other provisions."). Second is the restrictive context in which it is stated as a sort of adjunct to the parol evidence rule by suggesting all interpretation must focus on language within the four corners of the document to the exclusion of anything "extrinsic" to the document. E.g., Coastal Oil & Gas Corp. v. Roberts, 28 S.W.3d 759, 764 (Tex. App.-Corpus Christi 2000), reh'g granted (Aug. 23, 2001), motion to dismiss granted in part (Mar. 21, 2002), judgment set aside (Mar. 21, 2002) ("Courts apply lease clauses as written and refuse to imply terms not found within the four corners of the document.").

56. Professor Farnsworth explains the "four corners rule" approach as follows: At times it is misleadingly suggested that a plain meaning rule excludes more than evidence of prior negotiations during the first stage. Such a rule, under which the court cannot look to any circumstances outside the writing to determine whether the language lacks the required degree of clarity, is often called a "four corners rule." It is sometimes associated with a distinction, attributed to Sir Francis Bacon, between latent and patent ambiguities. But even under a plain meaning rule, evidence of surrounding circumstances, as distinguished from evidence of prior negotiations, should be admitted during the first stage.

FARNSWORTH, supra note 23, at 477-78.

57. See supra text accompanying notes 25-27.

58. See supra note 25.

59. See supra text accompanying notes 45-50.

60. Gibson v. Turner, 294 S.W.2d 781, 785 (Tex. 1956). Arguably there should be no problem in this case regarding the deleted clause because the deletion is clearly evidenced on the face of the document (the "four corners") without any reference to extrinsic evidence. As the court noted: "The original lease was introduced in evidence and following the above quoted provision of the paragraph was printed a proportionate reduction of
The Court may read a written document in the light of surrounding circumstances, which can be proved, in order to arrive at the true meaning and intention of the parties as expressed in the words used, but will not hear parol evidence of language or words other than those used by the parties themselves in the writing. No other words are to be added to or subtracted from the written instrument.

[In construing a contract a court may look to the circumstances surrounding the parties at the time the contract was entered into, the situation of the parties, and the subject matter of the instrument, regardless of whether the language used in the contract be ambiguous.]

However, the role of surrounding circumstances evidence in Texas is still unclear.

For example, in *Sun Oil Company v. Madeley,* the court had to determine whether an oil and gas lease granted the lessor a net profits interest in gas production as well as oil production. There was no dispute that the lessor was entitled to a 1/8th royalty on oil and gas plus a 7/16ths net profits interest in oil production. The court recites the familiar Texas interpretive inquiry: “In construing this lease, it is our task to seek the intention of the parties as that intention is expressed in the lease.” This statement appears to incorporate the parol evidence rule by, in effect, concluding the lease is a fully integrated agreement. Therefore, the “terms” to be interpreted are those found in the lease. However, this statement also has a “four-corners” connotation that suggests the “meaning” of the terms must be found on the face of the instrument. The surrounding circumstances rule belies a “four-corners” limitation on the meaning of the terms. In *Madeley,* Sun argued: “the courts may only consider extrinsic evidence after the instrument itself is found to be ambiguous.” The lessor responded by arguing: “[W]hen the construction of a contract is at issue, the court must first consult surrounding circumstances to determine whether or not the contract is ambiguous.” The court responded stating:

Lessors state the proper rule. Evidence of surrounding circumstances may be consulted. If, in the light of surrounding circumstances, the language of the contract appears to be capable of only a

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61. *Id.* at 785 (quoting Self v. King, 28 Tex. 552, 554 (1866) and Ryan v. Kent, 36 S.W.2d 1007, 1010 (Tex. Comm'n App. 1931)).
63. 626 S.W.2d 726 (Tex. 1981).
64. *Id.* at 727 (“The principal issue is whether lessors are entitled to one-half the proceeds from the 7/8ths working interest gas, casinghead gas and condensate . . . .”).
65. *Id.* at 727-28 (emphasis added).
66. *Id.* at 731.
67. *Id.*
single meaning, the court can confine itself to the writing . . . .

The surrounding circumstances evidence revealed that in 1932, when the lease was executed: (1) the lessors' land was next to a proven oil field; (2) the lessors were in a strong bargaining position because they had waited to lease their land; (3) the lessors were represented by an attorney experienced in oil and gas matters; (4) there was very little gas production; (5) gas was viewed as being of limited value; and (6) a memorandum in Sun's files focused on oil. The court held that this evidence was properly considered but the court of appeals also considered evidence regarding Sun's subsequent conduct "of accounting to lessors for one-half the proceeds from working interest gas over an extended period of time." The supreme court concluded that the court of appeals relied: "More upon Sun's subsequent conduct than it does upon the unambiguous language of the lease." This was not surrounding circumstances evidence, but rather evidence of Sun's interpretation of the contract which can be considered only when the contract is first found to be ambiguous. Limiting its analysis to the express terms of the lease and surrounding circumstances evidence, the court held the lease was unambiguous and only conveyed a right to a net profits in oil and not gas.

Usage constitutes one of the potential surrounding circumstances that must be considered to understand the context of the contract. Although usage evidence is often treated as a special type of extrinsic evidence, it is merely evidence of the context in which the parties were operating when they made their contract. The role of usage, and other surrounding circumstance evidence, become more focused when the interpretive process is fully defined. Although the ultimate goal is to ascer-

68. Id.
69. Id. at 732.
70. Id.
71. Id.
72. Id. The court stated: "Only where a contract is first found to be ambiguous may the courts consider the parties' interpretation. . . . Where the meaning of the contract is plain and unambiguous, a party's construction is immaterial." Id. Although this evidence lacks the temporal proximity to be "surrounding circumstances" evidence, it would appear to be "course of performance" evidence that would be useful in determining the intent of the parties.
73. Id. ("Although the lessors urge that we examine the facts and circumstances surrounding execution of the lease, this evidence does not aid their construction.").
74. The comment to Restatement section 220 notes: "Usage relevant to interpretation is treated as part of the context of an agreement in determining whether there is ambiguity or contradiction as well as in resolving ambiguity or contradiction. There is no requirement that an ambiguity be shown before usage can be shown, and no prohibition against showing that language or conduct have a different meaning in the light of usage from the meaning they might have apart from the usage. The normal effect of a usage on a written contract is to vary its meaning from the meaning it would otherwise have.

75. The "Introductory Note" to the Restatement chapter on "The Scope of Contractual Obligations" states: "Whether or not there is a writing, the parties' intention is read in its context, and usages common to the parties are often an important part of the context." RESTATEMENT (SECOND) OF CONTRACTS, Chapter 9, Introductory Note.
tain the meaning of a contract, the problem is often trying to determine "whose meaning prevails." When the parties to a contract do not attach the same meaning to its terms, courts look for the meaning attached by one party (A) when the other party (B) either knew, or had reason to know, of the other party's (A's) meaning. Often times the context of the contract, and the surrounding circumstances, including usage, will provide a factual basis for concluding a party either "knew" or "had reason to know" of the meaning attached by the other party. When courts find it necessary to consider rules of interpretation, a primary goal will be to consider the surrounding circumstances and attempt to identify the primary purpose the parties seek to accomplish through their contract.

Surrounding circumstances, particularly usage, can play a major interpretive role when the parties employ technical terms. In this regard, the Restatement provides a special rule of interpretation that "[u]nless a different intention is manifested, . . . technical terms and words of art are given their technical meaning when used in a transaction within their technical field." The relationship between the "technical terms" rule and the parol evidence rule is addressed in Mescalero Energy, Inc. v. Underwriters Indemnity General Agency, Inc., where the court considered the meaning of the term "formation" in an insurance contract covering oil and gas operations. The policy covered a blowout whenever there is an uncontrolled flow of oil, gas, or water "between two or more separate formations . . . ." The issue was whether a blowout in the Austin Chalk involved "two or more separate formations." The insurer offered a definition found in the Williams & Meyers Manual of Oil and Gas Terms

76. "Interpretation of a promise or agreement or a term thereof is the ascertainment of its meaning." Restatement (Second) of Contracts § 200 (1981).
77. Id. at § 201.
78. Id. at § 201(2).
79. The comments to Restatement section 201 express the importance of usages and context: "Uncertainties in the meaning of words are ordinarily greatly reduced by the context in which they are used." Restatement (Second) of Contracts § 201 cmt. b (1981).
80. Restatement (Second) of Contracts section 202(1) (1981) provides: "Words and other conduct are interpreted in the light of all the circumstances, and if the principal purpose of the parties is ascertainable it is given great weight." Restatement (Second) of Contracts § 202(1) (1981). Comment a indicates: The rules [of interpretation] are general in character, and serve merely as guides in the process of interpretation. They do not depend upon any determination that there is an ambiguity, but are used in determining what meanings are reasonably possible as well as in choosing among possible meanings." Id. at cmt. a. Comment b again stresses the importance of context, stating:
   The meaning of words and other symbols commonly depends on their context; the meaning of other conduct is even more dependent on the circumstances. In interpreting the words and conduct of the parties to a contract, a court seeks to put itself in the position they occupied at the time the contract was made.
83. Id. at 316.
84. Id. at 316-17.
supporting its position that the Austin Chalk is a single formation. The insured offered expert testimony that the term "formation" is defined in such a way that the Austin Chalk consists of multiple formations.

The insurer sought to exclude the insured's definition of formation arguing it violated the parol evidence rule. However, the court noted that the insurer relied upon extrinsic evidence to support its definition of formation. The only difference was the insurer looked to a dictionary while the insured relied upon expert testimony for its definition. The court stated the issue as whether the extrinsic evidence of a technical definition must take any particular form, such as a dictionary as opposed to expert testimony. The court approved the use of any form of extrinsic evidence when it is offered to establish "the commonly understood meaning of the term within a particular industry." Even though the competing technical definitions resulted in a finding that the contract was ambiguous, the court found: "Nevertheless, extrinsic evidence may be admissible to give the words of a contract a meaning consistent with that to which they are reasonably susceptible, i.e., to "interpret" contractual terms."

IV. SOURCES OF USAGE INFORMATION: ARGUMENT, ANECDOTE, AND FACT

There are three ways usage information becomes available to a court: (1) the parties can present evidence on the matter at trial and establish the existence, or non-existence of the usage as a fact; (2) The parties can argue for recognition, or non-recognition of the usage based upon case law, law journals, treatises, and other non-evidentiary information; or (3)

85. The definition was as follows:
A succession of sedimentary beds that were deposited continuously and under the same general conditions. It may consist of one type of rock or of alternations of types. An individual bed or group of beds distinct in character from the rest of the formation and persisting over a large area is called a "member" of the formation. Formations are usually named for the town or area in which they were first recognized and described, often at a place where the formation outcrops. For example, the Austin chalk formation outcrops at Austin, Texas.

86. The insured's definition of formation was: "[a]ny mappable, separate, self containing pressure unit within a geologic interval." Mescalero Energy, 56 S.W.3d at 318.

87. Id. at 322.
88. Id. at 323.
89. Id. The court observed:
Appellees concede (indeed urge) that we refer to one form of extrinsic evidence—the Williams & Meyers dictionary. The question for us is: "Can a reasonable definition of an industry term be established through expert testimony?" We hold that it can.

90. Mescalero Energy, 56 S.W.3d at 320.
91. Id. (quoting Nat'l Union Fire Ins. Co. v. CBI Indus., Inc., 907 S.W.2d 517, 521 (Tex. 1995)).
92. The term "information" is used instead of "evidence" because often what the court relies upon to accept or reject a usage is not evidence.
the judge can unilaterally accept or reject the usage based upon his or her own anecdotal conclusions about the industry or the world in general. To the extent counsel fails to address the matter as one of fact at trial, they run the risk of having the usage issue decided by argument or anecdote. Therefore, counsel litigating any oil and gas matter\textsuperscript{93} must carefully evaluate their case to identify situations where establishing the relevant usage, as fact, would be important. Otherwise they run the risk of an adverse conclusion through the unrestrained processes of argument and anecdote.

A. Usage Via Argument

When usage and other surrounding circumstance evidence is not established as a matter of fact, the court is effectively unrestrained in how it arrives at conclusions on such matters. Often the critical conclusions are made based upon the court's acceptance or rejection of arguments made by counsel. For example, the complexity of defining when usage evidence can be used, and for what purpose, is illustrated by the court's interpretation of "gross proceeds at the wellhead" in \textit{Schroeder v. Terra Energy, Ltd.}\textsuperscript{94} The lessee produced natural gas which it transported thirty miles to a treatment facility where it was sold with other gas to a pipeline company.\textsuperscript{95} The lessee deducted from the downstream gas sales proceeds the cost associated with moving the gas from the wellhead to the point of sale. The lessor asserted it was entitled to the "best available market price" which was the market price at the point of sale, not the wellhead.\textsuperscript{96} The court identifies the "principal issue" as: "whether the language 'gross proceeds at the wellhead' used in the agreement fairly contemplates the deduction of postproduction costs from the sales price of the gas."\textsuperscript{97} The lessee \textit{argued on appeal}\textsuperscript{98} that "industry usage of the language and

\begin{itemize}
\item \textsuperscript{93} The same concerns exist with every other contract interpretation situation, regardless of the subject matter or legal discipline.
\item \textsuperscript{94} 565 N.W.2d 887 (Mich. Ct. App. 1997). This case also demonstrates the importance of carefully identifying the usage evidence offered and the precise basis for the court's usage analysis. Although this case at first appears to be addressing usage evidence issues, no usage evidence was offered and the court merely responded to the lessee's appellate argument regarding usages.
\item \textsuperscript{95} \textit{Id.} at 982. The court noted:
  
  Here, the only place gas is sold is at Kalkaska, approximately thirty miles from the wellhead. And at that point the gas sold has been altered, both by being transported to a point at which a large buyer like Michcon is willing to accept the production from a relatively small leasehold and by being processed to eliminate impurities so the purchaser can put the commodity directly to its intended end use.

\textit{Id.} at 892.
\item \textsuperscript{96} \textit{Id.}
\item \textsuperscript{97} \textit{Id.} at 891. The court also offered an alternative statement of the issue: "The issue can also be put in terms of where the gas is to be valued for purposes of determining plaintiffs' royalty payments." \textit{Id.} at 891 n.3. I submit that this alternative statement of the issue is the most accurate. David E. Pierce, \textit{The Royalty Value Theorem and the Legal Calculus of Post-Extraction Costs}, 23 \textit{Energy & Min. L. Inst.} 151, 155-62 (2002) ("§ 6.02. Are Courts Addressing the Right Question?") [hereinafter \textit{Royalty Value Theorem}].
\item \textsuperscript{98} There is no indication in the opinion that any usage evidence was offered at trial.
\end{itemize}
custom” requires that royalty values be determined at the wellhead.\textsuperscript{99} The court rejects this argument by assuming such a usage would not be binding upon a lessor who was unaware of the usage.\textsuperscript{100} The correct basis for rejecting the lessee’s usage argument would appear to be a lack of evidence to support the existence, scope, and applicability of the usage. The court's usage analysis suffers from the same weakness as the lessee’s usage argument: it is not based upon the facts, and the lessee fails to address the facts regarding the usage.\textsuperscript{101} For example, how does the court know this lessor\textsuperscript{102} was not aware of the usage? How does the court know this lessor, although not aware of the usage, nevertheless should have known of its existence? How does the court know this lessor was not a member of the trade to such an extent that knowledge of the usage will be imputed to the lessor? Obviously these are factual issues and without addressing the underlying facts, any generic statements by the court, or counsel, will be just that—statements. The court noted that the lessee’s argument was as follows: since a form contract is involved, the lessor is on notice of the industry practice.\textsuperscript{103} Although the court is quick to recognize the lessor's contract may vary from the norm, the court again fails to

\textsuperscript{99.} Schroeder, 565 N.W.2d at 891.

\textsuperscript{100.} Id. at 892. The court stated:

\textit{A general principle of contract law is that, even where such usage or custom is well established, it is not controlling if only one party meant the usage or custom to be operative and the other party had no reason to know of this interpretation. . . . Before a usage or custom of trade, otherwise affirmatively proved to exist, can be invoked to construe a contract, it first must be shown that the party against whom it is asserted knew of the usage and had reason to know that the other party assented to the words or the contract in accordance with it, or that, if the party against whom it is asserted did not know of the usage, an ordinary person in that party's position would have known of it.}

\textit{Id.} However, under the Restatement and U.C.C. it is possible to be bound to a trade usage by merely participating in the trade. \textit{Restatement (Second) of Contracts} § 222(3) (1981) (“Unless otherwise agreed, a usage of trade in the vocation or trade in which the parties are engaged or a usage of trade of which they know or have reason to know gives meaning to or supplements or qualifies their agreement.”) (emphasis added); U.C.C. § 1-205(3) (1977) (“A . . . usage of trade in the vocation or trade in which they are engaged or of which they are or should be aware . . . .”) (emphasis added); U.C.C. § 1-303(d) (2003).

\textsuperscript{101.} This is a factual issue. \textit{Restatement (Second) of Contracts} § 222(2) (1981) (“The existence and scope of a usage of trade are to be determined as questions of fact.”); U.C.C. § 1-205(2) (“The existence and scope of such usage are to be proved as facts.”); U.C.C. § 1-303(c) (2003) (“The existence and scope of such a usage must be proved as facts.”) (emphasis added). Also note that if the lessor was represented by counsel when the lease was negotiated “it may be reasonable to hold a nonmerchant to mercantile standards if he is represented by a mercantile agent.” \textit{Restatement (Second) of Contracts} § 221 cmt. b (1981); U.C.C. § 2-104(1) (1977) (defining “merchant” to include “a person who deals in goods of the kind or otherwise by his occupation holds himself out as having knowledge or skill peculiar to the practices or goods involved in the transaction or to whom such knowledge or skill may be attributed by his employment of an agent or broker or other intermediary who by his occupation holds himself out as having such knowledge or skill.”) (emphasis added).

\textsuperscript{102.} Or their attorney or other third party that may have assisted them in negotiating the lease. \textit{Id.}

\textsuperscript{103.} The court stated: “The law imposes no requirement that the terms and provisions of a contact shall be the same as, or similar to, those that neighbors and trade associations of the contracting parties are accustomed to agree upon.” Schroeder, 565 N.W.2d at 892.
address the issue in the factual context of this lessor, and this lessor's contract. The correct response by the court should have been to simply rule that no evidence in the record established the usage the lessee was seeking to rely upon.

Although the court rejects the lessee's usage argument, the court seems to acknowledge later in its opinion that the use of "standard clauses reflects customary practices in the industry," quoting as authority the following passage from the Williams & Meyers treatise:

Inasmuch as gas royalty is ordinarily payable in money rather than in kind and is measured by value or proceeds at the wellhead, it is not customary, as in the case of the oil royalty payable in kind, to specify that the royalty is free of cost of production.

The court also observed that another case, "also relying on trade usage," interpreted "gross proceeds ... at the mouth of the well" to mean "proceeds less the expenses to make the gas marketable because the gas was not marketable at the wellhead ...." The court apparently views these statements regarding usage as persuasive information it could consider in evaluating the parties' arguments.

The court in Old Kent Bank & Trust Co. v. Amoco Production Co., also considers the following information:

In this case, the use of the language "gross proceeds at the wellhead" by the parties appears meaningless in isolation because the gas is not sold at the wellhead and, thus, there are no proceeds at the wellhead. However, if the term is understood to identify the location at which gas is valued for purposes of calculating a lessor's royalties, then the language "at the wellhead" becomes clearer and has a logical purpose in the contract. In construing "wellhead" thusly—in a manner that seeks to accord reasonable meaning to the plain language of the contract—we believe that it necessarily follows that to determine the royalty valuation, postproduction costs must be subtracted from the sales price of the gas where it is subsequently marketed.109

104. The facts recited in the opinion indicate the oil and gas lease at issue had been negotiated. The royalty clause of the lease had been changed to increase the royalty from 12.5% to 19.375% and the lease agreement included an additional "letter agreement." Id. at 890.

105. See supra text accompanying notes 10-12.

106. Schroeder, 565 N.W.2d at 894 (quoting 3 WILLIAMS & MEYERS, OIL AND GAS LAW, § 643.2, p. 529 (emphasis by the court)).


108. Schroeder, 565 N.W.2d at 894.

109. This is also what the court does in the Old Kent case where it unilaterally concluded: "accepted trade usage of similar, if not identical phrases, leads me to conclude that the parties could only have intended it to refer to the proceeds less expenses method of calculating royalties." Old Kent Bank & Trust, 679 F. Supp. at 1445. Instead of referring to any evidence offered as part of the parties' summary judgment submissions, the court quotes from a Fifth Circuit case and the Williams & Meyers treatise on oil and gas law. Id.

110. Id.
This suggests another form of evidence may have been useful in this case: evidence concerning the "surrounding circumstances" at the time the parties entered into the contract. The relevant surrounding circumstance evidence would focus on the different ways gas is marketed and how the "at the wellhead" and other royalty clause language developed. Since it is not a type of usage evidence, the limitations associated with usage would not apply. Unless counsel is willing to leave usage and other surrounding circumstances issues to chance, they must focus on these potential issues and determine whether it is possible, or desirable, to address them factually at trial. An even more disturbing phenomenon is when courts arrive at usage conclusions, critical to the outcome of a case, relying upon their own anecdotally-based beliefs.

B. Usage Via Anecdote

The greatest risk of losing a case on inaccurate usage information is when the court, often an appellate court, unilaterally decides an issue based upon anecdotal statements derived from the legal literature, assertions of counsel, or the judge's general knowledge. For example, the Colorado Supreme Court, in Garman v. Conoco, Inc., was asked to respond to a certified question from the United States District Court for the District of Colorado regarding post-production costs that can be deducted to calculate an overriding royalty "when the assignment creating the overriding royalty interest is silent" on the matter. The lessee/assignee argued, in its appellate brief, that "industry practice allows proportionate allocation of post-production costs . . . ." The court rejected this argument stating:

Before one can be bound by industry custom "he must know of it or it must be so universal and well-established that he is presumed to have knowledge of its existence," . . . Further, the parties must have contracted with reference to the custom. . . . Custom and industry practice may be an appropriate consideration when Conoco deals with other oil exploration companies. Cf. Pletchas v. Von Poppenheim, 148 Colo. 127, 130, 365 P.2d 261, 263 (Colo. 1961) (Parties engaged in same occupation are presumed to have knowledge of

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111. See supra text accompanying notes 45-50.
112. 886 P.2d 652 (Colo. 1994).
113. The certified question was:
Under Colorado law, is the owner of an overriding royalty interest in gas production required to bear a proportionate share of post-production costs, such as processing, transportation, and compression, when the assignment creating the overriding royalty interest is silent as to how post-production costs are to be borne?

Id. at 653. It is submitted that such a question regarding the interpretation of a written document is meaningless without considering the question in the context of the actual document involved and the parties to the document.
114. Id. at 660.
115. The issue is not addressed in the context of excluding offered usage evidence at trial. As was the situation in Schroeder, 565 N.W.2d 887, the court is merely addressing the usage issue as an argument put forth at the appellate level.
Sometimes, however, executing an oil and gas lease, or assigning a lease won under the previously existing federal lottery system is the extent of a party’s contact with the oil industry. Conoco cannot invoke industry custom to limit the rights of royalty and overriding royalty owners unsophisticated in the intricacies of mineral development.\(^{116}\)

Contrary to the court’s general statements regarding the lack of sophistication of overriding royalty owners, the very interest involved in this case was created by Monarch Oil & Uranium Co. when it reserved a 4.00% overriding royalty in leases covering 10,742 acres.\(^{117}\) The facts recited by the court indicate the overriding royalty owner was one of those “other oil exploration companies” at the time the interest at issue was created.\(^{118}\) It was the oil company that created the overriding royalty when it assigned the working interest in the leases to Lee A. Adams, who subsequently sold his interest to Conoco.\(^{119}\) Therefore, a usage at the time the assignment creating the overriding royalty was made would come within the court’s rule that: “Parties engaged in the same occupation are presumed to have knowledge of business usage.”\(^{120}\) This is an example of where specific usage evidence may have been helpful, particularly since the original creator of the overriding royalty, Monarch Oil & Uranium Co., had entered into division orders providing for deductions consistent with Conoco’s usage theory.\(^{121}\)

The Garman case also illustrates the importance of focusing on the temporal nature of usage evidence. For example, it is totally irrelevant what the plaintiff Garman knew about the oil and gas industry, or what his intent was concerning Conoco’s obligations. The only relevant inquiry should be what Garman’s predecessor in interest, Monarch Oil & Uranium Co., knew about the oil and gas industry and its usages at the time it created the overriding royalty interest at issue.\(^ {122}\)

The Colorado Supreme Court’s analysis in Garman is an excellent example of how a court’s anecdotal conclusions on an issue can be totally wrong and, totally devastating to a party’s case. The court’s pre-disposition to arrive at a conclusion that would benefit the overriding royalty owner\(^ {123}\) was aided by the unreal context—total lack of context—of the

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\(^{116}\) Garman, 886 P.2d at 660 (citations omitted) (emphasis added). The italicized language represents the Colorado Supreme Court’s anecdotal conclusion on a determinative issue regarding usage. However, as will be seen, the court’s very opinion reveals its anecdotal conclusion, regarding this overriding royalty interest, was inaccurate.

\(^{117}\) Id. at 654-55 n.5.

\(^{118}\) Id. at 660.

\(^{119}\) Id. at 654-55 n.5.

\(^{120}\) Id. at 660.

\(^{121}\) Id. at 655 n.7 (“In 1982, Monarch . . . executed an Oil and Gas Transfer Order prepared by Conoco which provided that settlement for gas sold shall be based on the net proceeds realized at the well by you [Conoco] after deducting any costs incurred in compressing, treating, transporting and/or dehydrating the gas for delivery.”).

\(^{122}\) See infra text accompanying notes 382-395.

\(^{123}\) Viewing them, in this case erroneously, as the underdog of the transaction requiring judicial protection.
certified question procedure. The goal of opposing counsel in this situation is to fight anecdote with fact. This can only be done effectively during trial.

.C. USAGE VIA FACT

Although there appears to be no dispute that an asserted usage must be established as a matter of fact, as the discussions in the preceding sections demonstrate, this rule may be overlooked if counsel is unable to control usage by argument or anecdote through the presentation of fact. Counsel may be hoping his or her client’s version of argument or anecdote usage will be adopted by the court; or perhaps the facts do not support a usage beneficial to the client. When, however, the facts would support a usage beneficial to the client, counsel should seek to establish the usage as fact. Counsel must also be prepared to respond to any contrary usage evidence offered by the opposing side.

An appropriate approach to usage analysis is demonstrated by the court's holding in Exxon Corp. v. Pluff where landowner Pluff sued asserting Exxon had an implied obligation to restore the surface once operations on the leased land ceased. The 1930 oil and gas lease contained an express clause stating: “[Exxon] shall have the right at any time 

124. See supra text accompanying notes 11-12.
125. However, even when the usage is established as a matter of fact, the fact must be relevant to resolving the disputed issue. See infra text accompanying notes 282-299. For example, in Davis v. Cities Serv. Oil Co., 338 F.2d 70 (10th Cir. 1964), the parties stipulated that: Where it is necessary or appropriate to file an affidavit of production, it is the established custom and practice of the industry in the State of Kansas, that the operator of the lease or the owner of the working interest, prepare and file the affidavit, and the owner of an overriding royalty interest does not do so.

Id. at 73. In 1923, Davis had assigned 160 acres of a 1,280-acre lease to Cities with Davis retaining a 1/32nd overriding royalty on production from the assigned interest. Although in 1924 other portions of the 1,280-acre lease were developed, as of 1955, the 160 acres assigned to Cities had not been developed. The developed portion had been assigned by Davis to Sinclair, who prepared and filed an affidavit of production covering only the acreage described in the Davis-to-Sinclair assignment. In 1955, the heirs of the original lessor granted a lease to Adair covering the 160-acre Cities lease. Ultimately, it was held that since there was no affidavit of production covering this 160-acre portion of the original 1,280-acre lease, Adair did not have constructive notice that it had been perpetuated by production and Adair took as a bona fide purchaser as against Cities, and Davis. Id. at 72-73. Davis asserted Cities had a duty, arising out of the stipulated industry usage, to file an affidavit of production that would have protected Davis' overriding royalty interest. In rejecting Davis' usage argument, the court held:

[We] do not think that the custom and practice relied upon by appellant has any application in this case. Such custom and practice applies only where production is obtained by the assignee of a lease under the lease assigned to him. No production was ever obtained by the assignee, Cities Service, under the lease in question and therefore any obligations that might be imposed by custom and practice never arose.

Id. at 74.
126. This would be a two-pronged attack focusing on the "reliability" of the offered evidence and the substance of the evidence. See infra text accompanying notes 300-318.
during or after the expiration of this lease to remove all property and fixtures placed by [Exxon] on said land including the right to draw and remove all casing.\textsuperscript{128} The landowner asserted this express clause also created an implied duty on Exxon to “remove oilfield materials on the expiration of the lease . . . .\textsuperscript{129} As support for the alleged implied duty, the landowner contended such a duty “was imposed as ‘a custom and usage of the industry.’”\textsuperscript{130}

The court rejected the landowner’s custom and usage argument because “concerning the custom and usage at the time the lease was executed” was offered.\textsuperscript{131} Noting that the existence of a custom and usage is “a question of fact,” the court held the landowner cannot, on appeal, rely upon custom and usage to support its proposition.\textsuperscript{132} However, with regard to Exxon’s assertion of the industry practice at the time the original well derricks were erected on the property, the court found: “At trial, all witnesses agreed that given the technology at the time, it was reasonable, customary, and necessary for an oil operator to use concrete derrick corners for standard derricks.”\textsuperscript{133} This case illustrates the importance of offering evidence at trial to support usages essential to a party’s claim or defense.

The admission of evidence to establish a usage as fact does not mean the court must treat the fact as determinative. It is merely evidence the court must weigh with other evidence. In some instances, however, the usage will be clearly established as a fact at trial but denied effect on appeal. For example, in \textit{Bellport v. Harrison},\textsuperscript{134} the parties entered into a contract for Harrison to sell Bellport “one-half of his royalty”\textsuperscript{135} using a written memorandum stating: “Received of A. J. Bellport, $2,400.00, payment for 1/16 royalty on west 1/2 of southwest 1/4 section 33, township 26, range 2 east, Sedgwick county, Kansas, title to be delivered as soon as papers are completed.”\textsuperscript{136} Harrison’s mineral interest was leased at the time of the agreement; the lease provided for payment of a 1/8th royalty.\textsuperscript{137} Harrison contended Bellport was entitled to one-half of Harri-

\textsuperscript{128} \textit{Id.} at 29.
\textsuperscript{129} \textit{Id.} The fixtures at issue were foundations for derricks used to drill wells on the leased land before portable drilling equipment was available. Prior to 1984, when the wells on the property ceased producing, Exxon removed all of the derricks, drilling equipment, and tanks from the property, but left some of the concrete foundations, pipes, and other materials. No further operations were conducted on the property by Exxon after 1984. On June 1, 1984 Exxon assigned certain deep rights in the lease and in December 1991 assigned the balance of its rights to another operator. Pluff purchased the property for $10,000 on June 12, 1992. \textit{Id.} at 25.
\textsuperscript{130} \textit{Id.} at 30.
\textsuperscript{131} \textit{Id.}
\textsuperscript{132} \textit{Id.}
\textsuperscript{133} \textit{Id.} at 25 n.2.
\textsuperscript{134} 255 P. 52 (Kan. 1927).
\textsuperscript{135} \textit{Id.}
\textsuperscript{136} \textit{Id.} The written agreement in this situation revealed that the parties did not intend it to be a fully integrated agreement: “to be delivered as soon as papers are completed.” \textit{Id.} (emphasis added).
\textsuperscript{137} \textit{Id.}
son’s 1/8th royalty, which would expire in the event the oil and gas lease on the property expired. Bellport contended he was entitled to a one-half mineral interest and the reference to “1/16th royalty” was intended to convey Bellport a one-half mineral interest that would entitle him to one-half of the 1/8th royalty.138

At trial, Bellport offered evidence “that a custom existed in the oil fields of southern Kansas, including Wichita, by which the ordinary meaning of the word ‘royalty’ was enlarged so as to include one-half of the oil and gas or other mineral lying in the land in place . . . .”139 The jury found that such a custom existed and found in favor of Bellport.140 After reciting many restrictive historic “custom” concepts, the Kansas Supreme Court reversed holding:

To enlarge the ordinary meaning of the word “royalty” by proof of a usage or custom so as to require these additional conveyances and obligations of the assignor is so unreasonable as not to be entertained. Generally speaking, the law is not like a costume, to be put on or taken off in conformity to the dictates of custom and usage . . . . The usage and custom relied upon must not be in opposition to well-settled principles of law, nor unreasonable.141

The court applies a plain meaning analysis to conclude that “royalty” has a clear meaning which cannot be altered by usage evidence.142

The Kansas Supreme Court, in Bellport, rejected the notion that the term “royalty” can have a usage meaning different from its “well-known meaning.” The difficulty with such an approach is revealed by the Kansas Supreme Court’s observations in later cases. For example, in Heyen v. Hartnett,143 the court relies, in part, on its anecdotal observation of “widespread confusion as to the fractional interest in the minerals required to produce a certain share of royalties under an oil and gas lease . . . .”144 In Heyen, the granting clause conveyed “an undivided 1/16 interest” but a present lease clause provided for “an undivided 1/2 interest in the Royalties, Rentals and Proceeds therefrom . . . .”145 The court reviews prior cases in which either the fraction at issue, or the nature of the interest created, were at issue because the parties apparently believed that when a landowner leases their land they no longer own the “miner-

138. Id. at 52-53.
139. Id. at 53.
140. The Supreme Court noted: “Well-informed, reliable witnesses testified to the existence of such custom; other witnesses, evidently just as well informed and as reliable, stated that no such custom existed.” Id. at 54. This would seem to be the sort of dispute uniquely suited to resolution by the finder-of-fact, in this case the jury that heard the evidence and observed the witnesses.
141. Id. at 54.
142. The court posed the question as one of law: “The first legal question presented is whether in view of the fact that the word ‘royalty’ used in the written memorandum has a well-known meaning, such meaning can be enlarged, as contended for by plaintiff, by showing a custom. The answer must be in the negative.” Id. at 53.
144. Id. at 1158.
145. Id. at 1154.
als,” but rather own a 1/8th “royalty.” Therefore, it would be plausible for someone wanting to convey 1/2 of their “minerals” to mistakenly convey a 1/16th “royalty.” Whether they did or not, is an issue of fact; one that appeared to have been established at trial in the Bellport case but undone by the Supreme Court as being “so unreasonable as not to be entertained.” The usage must not have been too unreasonable since the Supreme Court recognized similar concepts in Lathrop and Heyen.

V. USAGE EVIDENCE IN THE OIL & GAS CONTEXT

This section examines various oil and gas cases where courts considered usage in deciding the case. In each situation, as with the Schroeder and Garman cases discussed in the previous section, the source of the usage evidence will be identified as either argument, anecdote, or fact. The discussion illustrates how the information was used in the case, the source of the information, and the influence the information had on the court’s subsequent findings.

A. Royalty Calculation Issues

One of the most intense and enduring subjects of oil and gas litigation is the calculation of royalty under the oil and gas lease. As I have noted in previous writings, the customary approach to royalty compensation is a recipe for conflict. Three facts contribute to the conflict: First, the “physical fact” that the value of extracted oil or gas generally increases as it moves closer to its point of consumption. Second, the “contractual fact” that most oil and gas leases provide for payment of a royalty to the lessor based upon the “value” of the oil or gas measured either in terms of the “market value” of a share of production or the “proceeds” associated with a sale of production. Third, the “human nature fact,” upon

146. Id. at 1158.
147. Commenting on use of the word “royalty,” the Kansas Supreme Court noted: As we have frequently stated the term “royalty” is often rather loosely and inaccurately used by men in the petroleum industry, those dealing in oil and gas holdings and at times by attorneys. Some persons refer to oil and gas in place as royalty. Others refer to royalty as the landowner’s share in production. We have, therefore, repeatedly held the true nature and character of the instrument is not to be determined by the name or label attached thereto but by its intent as reflected by the terms, the contents thereof.


149. See supra text accompanying notes 94-123.

150. I have attempted to describe the essence of all royalty calculation disputes employing what I have termed “the royalty value theorem” which provides: “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.” David E. Pierce, What’s Behind the Valuation Controversy Anyway? Federal & Indian Oil & Gas Royalty Valuation & Management III, 1-1 (Rocky Mtn. Min. L. Fdn. 2000) (original statement of the theorem); Royalty Value Theorem, supra note 97 (expanded discussion of the royalty value theorem).

151. This is because additional capital is often invested to gather, compress, dehydrate, treat, aggregate, package, market, and otherwise get the gas where it is to be consumed.
which the royalty value theorem is based, that lessors will seek to maximize values for royalty purposes while lessees will seek to minimize values for royalty purposes.

Assume, for illustration purposes: (1) Lessee extracts gas and then spends $1.00/Mcf to gather, compress, dehydrate, aggregate, package, and market the gas at a point downstream from the point of extraction; (2) the gas, at the point of extraction, has a market value of $2.00; (3) the downstream sales point value, after the Lessee’s $1.00 of post-extraction investment, is $3.50; and (4) the royalty clause states:

The royalties to be paid by Lessee are as follows: . . . On gas, including casinghead gas, condensate or other gaseous substances, produced from said land and sold or used off the leased premises or for the extraction of gasoline or other products therefrom, the market value at the well of one-eighth of the gas sold or used, provided that on gas sold at the wells the royalty shall be one-eighth of the amount realized from such sale.153

Under the royalty value theorem the Lessee will seek to pay the Lessor 1/8th of $2.00 as a royalty, based upon the value of the gas at the point of extraction. The royalty value theorem indicates the Lessor will seek a royalty of 1/8th of $3.50. The dispute will be resolved, in most states,154 relying upon the parties’ contract; typically the oil and gas lease.155 However, as noted previously in the Schroeder and Garman cases,156 courts have been inclined to consider usage information that may influence the court’s interpretation of the royalty obligation.

1. Courts Seeking the Aid of Usage Evidence

Sometimes a court notes the potential value of absent usage evi-

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152. The volumetric unit of measure for natural gas is “thousand cubic feet” or “Mcf;” the heating value unit of measure is “million British thermal units” or “MMBtus.” One Mcf of gas equals one MMBtu when the Btu content of the gas is 1,000 Btu per cubic foot. THOMAS G. JOHNSON, HANDBOOK ON GAS CONTRACTS 36 (1982).

153. EUGENE O. KUNTZ ET AL., FORMS MANUAL TO ACCOMPANY CASES AND MATERIALS ON OIL AND GAS LAW 12 (3d ed. 1998) (AAPL Form 675 Oil and Gas Lease, ¶ 3.) [hereinafter FORMS MANUAL].

154. In Colorado the terms of the parties’ contract may not determine the outcome. See Rogers v. Westerman Farm Co., 29 P.3d 887 (Colo. 2001); David E. Pierce, Exploring the Jurisprudential Underpinnings of the Implied Covenant to Market, 48 ROCKY MTN. MIN. L. INST. 10-1, 10-16 to 10-17 (2002) [hereinafter Jurisprudential Underpinnings].

155. Additional royalty calculation language may also be found in other documents, such as a pooling agreement or division order. See David E. Pierce, From Extraction to Enduse: The Legal Background, PRIVATE OIL & GAS ROYALTIES 3-18 to 3-19, 3-27 to 3-29 (Rocky Mt. Min. L. Fdn. 2003).

156. See supra text accompanying notes 94-123.
This was the case in *Mittelstaedt v. Santa Fe Minerals, Inc.* where a majority of the Oklahoma Supreme Court observed:

The lessee has a duty to provide a marketable product available to market at the wellhead or leased premises. Generally, custom and usage in the industry are used in determining the scope of duties created by the lease. Neither the facts given us nor the legal arguments on the certified question identify custom and usage with respect to the individual costs at issue when the leases were executed.

However, the dissenting justices, remarkably, consider custom and practices purported to be followed by ancient Roman marble miners, Greek silver miners, and 13th century English lead miners.

The court in *Mittelstaedt* was responding to a certified question posed by the Tenth Circuit Court of Appeals seeking guidance on the rule Oklahoma would apply to calculate royalty when gas is marketed downstream of the wellhead. The court had to determine whether reasonable costs associated with “transporting, blending, compression, and dehydration” can be deducted from downstream sales values to determine an upstream value that the lessee is authorized to use to calculate royalty.

In discussing the lessee’s “duty to provide a marketable product availa-
ble to market at the wellhead or leased premises,"163 and the value of industry custom and usage to define the duty, the court cites the Kansas Supreme Court case of Matzen v. Hugoton Production Co.164 In Matzen the lease required the following: "The lessee shall pay lessor, as royalty, one-eighth of the proceeds from the sale of the gas, as such, from wells where gas only is found."165 Discussing the lessee's royalty obligation, the court in Matzen states:

It was as much Hugoton's duty to find a market on the leased premises without cost to the plaintiffs as it was to find and produce the gas . . . , but that duty did not extend to providing a gathering system to transport and process the gas off the leases at a large capital outlay with attending financial hazards in order to obtain a market at which the gas might be sold. When plaintiffs' leases were executed it was the established custom and practice in the field to measure, determine the price, and pay royalty at the wellhead for gas produced . . . . The language 'proceeds from the sale of the gas, as such,' must be construed from the context of the leases and the custom and practice in the field at the time they were executed . . . .166

Although the Kansas Supreme Court in Matzen did not describe the evidence relied upon to establish the usage of calculating royalty on a wellhead basis,167 the court noted that the finding was made at the trial court level by stating:

The trial court found, among other things, that at the time the leases covering plaintiffs' land were executed it was the established practice and custom in the gas production industry to measure, determine the price, and pay gas royalty at the wellhead on all gas produced in the field upon a pressure basis of 16.4 pounds, which was later changed by the State Corporation Commission to a pressure basis of 14.65 pounds, and concluded that to determine proceeds at the wellhead per M.c.f. it was necessary to subtract from gross proceeds derived from Hugoton's total sales proper chargeable operating expenses incurred in procuring such proceeds, including gathering, processing and dehydrating, and divide the net proceeds by total volume of gas produced (M.c.f.)-the quotient being the wellhead price per M.c.f. of gas produced.168

In addition to usage, the Matzen court indicated that the lease must be

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163. Id. at 1208.
164. 321 P.2d 576, 582 (Kan. 1958) (cited by the Oklahoma Supreme Court at 954 P.2d at 1208).
165. Id. at 578-79.
166. Id. at 581-82 (emphasis added). The parties to this case did not dispute that "Hugoton's royalty obligation is to be determined at the wellhead rather than at the point of sale and delivery of the lease . . . ." Id. at 580.
167. If the parties had disputed this issue, the usage evidence would have assumed a critical role because the royalty clause at issue did not tie "proceeds from the sale of the gas" to an express location, such as "at the well" or "at the mouth of the well."
168. Id. at 580 (emphasis added). There is no indication in the opinion as to what the trial judge considered in arriving at its finding.
"construed from the context of the lease . . . ." The word "context," as used by the court, would seem to mean: "the set of circumstances or facts that surround a particular event, situation, etc. . . ." It is significant that the Oklahoma Supreme Court in Mittelstaedt expressed the desire to receive and consider usage evidence. Although the court expressly notes "[n]either the facts given us nor the legal arguments on the certified question identify custom and usage" evidence, the court went on to note: "it is common knowledge that raw or unprocessed gas usually undergoes certain field processes necessary to create a marketable product." The court seems to pull this finding from its reading of a Court of Claims case, Exxon Corp. v. United States. If a party desires to try and control this sort of unilateral recognition of a usage by argument or anecdote they have two options: (1) offer evidence at trial on the matter; or (2) rely upon written and oral arguments to distinguish, explain, or supplement the court's extraction of usage from other sources of information, such as cases, treatises, and other legal, and non-legal, literature. The best approach would be to do both, recognizing that evidence establishing the matter as a fact at trial will make it more difficult for the court to ignore.

Justice Opala, dissenting in Mittelstaedt, demonstrated just how far a court may be willing to go to use its own brand of "custom and usage" information to resolve a contract dispute in spite of the contract. Justice Opala, aided by the carefully researched, interesting, but inapplicable, 169.

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169. Id. at 582 (emphasis added).
170. The "context" of the word "context" used by the court.
171. WEBSTER'S, supra note 7, at 439. This "surrounding circumstances" definition fits the court's use of the term as opposed to the other meaning, which is "the parts of a written or spoken statement that precede or follow a specific word or passage, usually influencing its meaning or effect. . . ." Id.
172. Mittelstaedt, 954 P.2d at 1208 (emphasis added). Is this "common knowledge" a usage or is it more in the nature of a universal, indisputable, fact or circumstance the court can adopt by judicial notice? Is this surreptitious "usage" evidence or "judicial notice" without an opportunity to be heard? Federal Rules of Evidence, Rule 201 (b) states:

A judicially noticed fact must be one not subject to reasonable dispute in that it is either (1) generally known within the territorial jurisdiction of the trial court or (2) capable of accurate and ready determination by resort to sources whose accuracy cannot reasonably be questioned.

FED. R. EVID. 201(b). More likely the court's "common knowledge" is the product of argument or anecdote.

173. 954 P.2d at 1208 (discussing Exxon Corp. v. United States, 33 Fed. Cl. 250, 271 (1995)). The Exxon case dealt with the classification of "production" costs for purposes of calculating entitlement to an income tax deduction and had nothing to do with the calculation of royalty or interpretation of the oil and gas lease.

174. Apparently counsel for the lessee pointed out, in argument, the limitations to using a tax case such as Exxon Corp. v. United States, because the court felt constrained to caution: "However, the Exxon court was well aware that its conclusion was not necessarily the same for calculating royalties." Mittelstaedt, 954 P.2d at 1208.

175. The findings are inapplicable because they have nothing to do with the modern context of oil and gas development in the United States. This quintessential "American" industry was not developed until after the Civil War and evolved to meet the special needs of the oil and gas resource and the oil and gas industry in a modern democratic society. Other than use of the term "royalty" to describe the landowner's compensation in the event of production, the oil and gas industry has little connection to the Greeks, Romans,
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...scholarly findings of Professor Anderson, uses 13th and 19th century English lead mining practices, ancient Greek silver royalty practices, and Roman marble royalty practices to reject "a property-based royalty calculation." Remarkably, Justice Opala concluded: "We should follow this historically true model and refuse to apply property-law notions to determine royalty payments at the wellhead." In rejecting the existing law, and proposing an approach suggested by Professor Anderson, Justice Opala stated: "The model I recognize conforms to the historical interpretation of royalty clauses . . . ." The context of the term "historical" in Justice Opala's statement is what miners were doing for the King of England in the 13th and 19th centuries, not what oil and gas lessees have been doing in the fields of Oklahoma. Perhaps the most glaring omission from his historical interpretation is that it fails to consider the express language of the documents used by the industry to develop oil and gas, and how such language relates to the usage at issue. Instead, Justice Opala indicated that the express terms of oil and gas leases: "[N]eedlessly complicate royalty-clause interpretation by focusing solely on specific terms, such as 'market value,' 'market price,' 'proceeds,' or 'amount realized.' . . . All of these terms should be viewed as synonyms . . . ." or even the English. Instead, the usages have been those of the Pennsylvanians, Kansans, Oklahomans, Texans, and others within the United States where oil and gas have been found.

176. Owen L. Anderson, Royalty Valuation: Should Royalty Obligations Be Determined Intrinsically, Theoretically, or Realistically? Part I, Why All the Fuss? What Does History Reveal? 37 NAT. RESOURCES J. 547, 571-83 (1997) [hereinafter Anderson]. Professor Anderson, and Justice Opala, give more significance to the historical use of the term "royalty" than they do to express terms contained in the oil and gas lease, which, for example, direct that "royalty" shall mean 1/8th of "the market value at the well" of the gas when produced and saved by the lessee. Rather than giving effect to these particular terms of the modern oil and gas lease, Professor Anderson's analysis states:

Based upon my study of available secondary sources, there is no evidence that the established point for the remittance of royalty was ever at the mouth of a mine or that royalty was actually remitted the instant raw ore was converted from real to personal property.

Id. at 573. The problem is that Professor Anderson is seeking an answer to a 20th Century usage question regarding oil and gas law by looking at "mining customs of ancient Greece at the silver mines of Laurium, circa 480 B.C. following the defeat of the Persians." Id.

177. Mittelstaedt, 954 P.2d at 1214 n.41 (Opala, J., dissenting). Professor Anderson's thesis, which was fully adopted by Justice Opala, is that the general historical notion of "royalty" should override a "property" analysis of the royalty obligation. Anderson, supra note 176, at 583. The basic problem with this approach is that the "property" analysis they seek to eschew is actually a "contract" analysis. The terms of the oil and gas lease contract, like most any contract, define the rights of the parties which give rise to their "property" interests in oil and gas as produced.

178. Id. at 1215
179. Id. at 1216
180. After making his "historical interpretation" statement, Justice Opala cites the reader back to footnote 41 where he walks the reader from centuries of Derbyshire lead mining back to the beginning of civilization. Id. at 1216 n.57 (referring the reader to 954 P.2d at 1214 n.41).
181. Id. at 1216-17. Justice Opala relies upon two premises to justify ignoring the specific language of the oil and gas lease: (1) "[O]il and gas lease contracts are printed by the lessee on standard forms and are rarely negotiated." Id. at 1216. (2) "Given the large number of small interest-owning lessors, any suggestion that negotiation commonly occurs is
Mittelstaedt highlights the importance of usage evidence. The majority of the court clearly thought usage evidence would be useful in resolving the issues before the court. Equally important is providing relevant usage evidence in an effort to prevent the court from considering usage by anecdote or argument, such as Justice Opala’s use of ancient mining practices as an interpretive tool that would take precedence over contract language which would otherwise “needlessly complicate royalty-clause interpretation . . .”

2. Courts Declining to Follow Usage Evidence

The admission of usage evidence does not mean the court must adopt the interpretive conclusions suggested by the evidence. Instead, the court may find that other evidence, most notably the express terms of the contract, may outweigh the usage interpretation. For example, various forms of usage testimony have been accepted, and rejected, in the process of defining the meaning of the terms “market value” and “market price” in the royalty clause. In Texas Oil & Gas Corp. v. Vela, the court held that the term “market price” referred to the current price of gas when actually produced as opposed to the price when the lessee entered into a good faith, long-term sales contract. In his dissent, Justice Hamilton came to a contrary conclusion by stating:

absurd.” Id. at 1216 n.59. Both of these issues could, in many cases, be refuted by direct evidence to the contrary, or opinion evidence on local usages that reflect differing practices. Without conducting any sort of unconscionability analysis, Justice Opala would nevertheless effectively nullify express language in the lease to achieve an outcome more in line with his view of an equitable result that also happens to coincide with practices of the ancient Greeks.

182. Id. at 1216. Even this observation by Justice Opala is based, in part, on an assumed usage applicable to the case: “It is important to remember that oil and gas lease contracts are printed by the lessee on standard forms and are rarely negotiated.” Id. In many instances this observation will simply be untrue; many oil and gas leases are in fact negotiated and significant concessions made by the lessee to obtain the lessor’s assent. Frequently the lease will include an extensive “addendum” tendered by the lessor that makes it more of a “lesser’s” document instead of a “lessee’s standard form.” See, e.g., FORMS MANUAL, supra note 153, at 17 (form lease prepared by the Oklahoma Mineral Owners Association), 21-25 (28-paragraph “Exhibit A” attachment used by an Oklahoma attorney representing oil and gas lessors), 29-32 (37-paragraph “Addendum” used by a Kansas attorney representing oil and gas lessors).

183. In many instances the issue will be determining which party’s usage evidence should be followed. For example, in Explanade Oil & Gas, Inc. v. Templeton Energy Income Corp., No. Civ. A. No. 86-1362, 1988 WL 86856 (E.D. La. Aug. 16, 1988), the court considered the meaning of the phrase “adverse material change” that can trigger a buyer’s refusal to close on the purchase of producing oil and gas properties. One expert, Mr. Gibson, testified that the phrase “does not refer to a change in the value of the properties, according to his understanding of the customs and usages of the oil industry” and “it is the custom within the industry that the risk of a decrease in the price of oil is usually on the buyer, while the risk of any changes to the properties is on the seller.” Another expert, Mr. Sumerwell, testified “that a drop in the price of oil is clearly covered in the letter agreement as an adverse material change” and “it is the custom for the seller to bear the risk of a drop in the price of oil, not the buyer.” The court concluded: “the testimony of Mr. Sumerwell was more convincing than that of Mr. Gibson” and therefore “the seller should bear the risk of a drop in the price of oil, not the buyer.” Id. at *9.

184. 429 S.W.2d 866 (Tex. 1968).
Since it appears that the royalty provision fails to state as of what time the "market price" is to be determined, I think, we must look to *common practices in the industry at the time the lease contract was made in 1933* to ascertain what was the intention of the parties with reference to this matter. All parties agree and this Court so holds that at such time the only sales for gas from wells producing gas only were made on long-term contracts or for the life of the lease. The parties, when they entered into the lease contract, knew how such gas had to be marketed; it had to be marketed under a contract similar to the one before us. Consequently, when the parties entered into the lease contract, they all 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.\(^{185}\)

The court of appeals in *Exxon Corp. v. Middleton*\(^ {186}\) commented on industry usage noting:

Throughout the history of the industry a "custom and usage" had developed under which the royalty owners were compensated by payment of a designated percentage of the "proceeds" of the sale of gas. From these proceeds were deducted severance taxes and, where applicable, the cost of compression or other processing of the gas needed to bring it up to pipeline specifications and to obtain the liquid content by-product. This so-called "custom and usage" largely ignored the exact language of the oil and gas leases and their gas royalty provisions. The attitude was exemplified by the unequivocal testimony of one of the original lessors, who was a plaintiff in this suit. The lessor testified that he knew that the gas produced under his leases was being sold by Sun and that he understood that Sun was to pay royalties based upon what it got for that gas. Specifically, the following exchange took place during trial:

Q. They were supposed to base your royalty on what they got for the gas?

A. Always.\(^ {187}\)

However, this usage would not override what the Texas Supreme Court holds is the plain meaning of the term "market price."\(^ {188}\)

This was not the case in *Butler v. Exxon Corp.*\(^ {189}\) where the court relies upon usage evidence to expand the phrase "at the well" to include a sales point off the leased premises.\(^ {190}\) Essentially the court held that the "amount realized" clause, which contemplates a sale "at the well," did not require the sale to be "on the premises."\(^ {191}\) The court of appeals relied upon the trial court's finding of fact #12 which stated:

\(^{185}\) Id. at 879 (Hamilton, J., dissenting) (emphasis added).


\(^{187}\) Id. at 353.

\(^{188}\) As the court of appeals noted: "The complacency of the lease operators was shattered, however, by the holding of the Supreme Court of Texas in the case of Texas Oil & Gas Corp. v. Vela ...." Id.

\(^{189}\) 559 S.W.2d 410 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.).

\(^{190}\) Two of the leases provided for "market value at the well" for gas "sold or used off the premises" and "amount realized" "on gas sold at the wells ...." Id. at 412.

\(^{191}\) Id. at 416.
The court further finds that the sale of gas from these leases was a sale 'at the wells' within the meaning of those terms in the leases. It is so understood in the industry. Specifically, this Court finds that the term 'at the well' means gas delivery which occurs in the vicinity of the field of production where the wells are located, rather than at some remote location such as the other end of a transmission line.\textsuperscript{192}

Finding #12 was the product of opinion evidence offered by the consulting petroleum engineers of each party who were tendered as expert witnesses.\textsuperscript{193}

However, when this analysis was presented to the Texas Supreme Court in the \textit{Middleton} case, it noted:

The court [in \textit{Butler}] relied primarily on expert testimony about what constituted a "sale at the well" as understood in the oil and gas industry. To the extent the Court of Civil Appeals' interpretation of the royalty clause in \textit{Butler, supra}, conflicts with our interpretation of this clause, it is disapproved.\textsuperscript{194}

The court in \textit{Middleton} held the phrase sold "off the premises" was defined by the boundaries of the leased land.\textsuperscript{195} In \textit{Middleton}, as in \textit{Vela}, the Texas Supreme Court was unwilling to depart from the express terms of the oil and gas lease specifying a market value royalty when gas was not sold on the leased premises.\textsuperscript{196} Although the usage evidence may have been accurate and reliable, the court found it did not dictate a departure from what it considered to be the plain terms of the contract. This is an important observation, particularly when considering the difficulties courts have in admitting extrinsic evidence to interpret contracts. Although courts may freely consider extrinsic evidence to interpret a contract, the ultimate goal is for the court to consider all available evidence and then conclude what the contract means. This often requires the marshaling of evidence—evidence that suggests many conclusions—to arrive at a single conclusion.

\textsuperscript{192} Id. at 414 (emphasis added).
\textsuperscript{193} Id. at 413 ("Each side used a consulting petroleum engineer to develop their theory of the case."). Id. at 416 ("Certainly, both Mr. Powell and Mr. Gruy recognized this ["at the well" interpretation] in their testimony.").
\textsuperscript{194} \textit{Middleton}, at 244.
\textsuperscript{195} The court held:
We conclude "off the premises" modifies both "sold" and "used." The "premises" is the land described in the lease agreement. Therefore, sold "off the premises" means gas which is sold outside the leased premises. Thus, "sold at the wells" means sold at the wells within the lease, and not sold at the wells within the field.

\textit{Id.} at 243.
\textsuperscript{196} The Texas Supreme Court again focused on the "plain terms of the lease" in \textit{Yzaguirre v. KCS Res., Inc.}, 53 S.W.3d 368 (Tex. 2001):
[In \textit{Vela}] ... we held that the plain terms of the lease required the lessee to pay a market-value royalty even though the lessee received less than market value under its long-term sales contract. ... The same plain terms that fix the lessee's duty to pay royalty also defines the benefit the lessor is entitled to receive. Thus, under the leases, Yzaguirre and the other \textit{Royalty Owners} are entitled to a market value royalty, not an amount-realized royalty.
3. Courts Guided by Usage Evidence

In Creson v. Amoco Production Co., the court interpreted the meaning of a royalty clause in a unit agreement providing for a share of the “net proceeds derived from the sale of Carbon Dioxide Gas at the well . . .” In the first step of its analysis, the trial court concluded that the unit agreement was unambiguous. The court of appeals commented on the evidence the trial court considered stating: “In determining whether the Unit Agreement is ambiguous, the trial court could properly consider the context of the agreement, including the circumstances surrounding it, and any relevant usage of trade or course of dealing.” Once the trial court determined the agreement was unambiguous, it turned to the task of ascertaining the meaning of the agreement. Commenting on the evidence used for this second step in the interpretive process, the court of appeals observed: “Relying in part on expert testimony, the trial court determined that the phrase “net proceeds . . . at the well” had a long standing and unambiguous meaning in the oil and gas industry in computing royalty settlement or payment.” This illustrates how usage evidence can be employed to interpret a contract. Without opining on what the agreement at issue means, the expert can offer testimony on how the agreement compares to common forms of agreements used by the industry containing similar or identical language. The judge or jury can then use the evidence to arrive at its own conclusions regarding the meaning of the contract at issue.

The court of appeals also relied upon treatise discussions and precedents from other jurisdictions to support the proposition that to determine a value “free of the cost of production” calculated “at the well” would require the deduction of value-enhancing costs incurred by the lessee beyond the wellhead. The court also rejected the plaintiffs’ argument that a standard unit agreement clause providing that royalty would be “free of cost,” limits the deduction of costs to calculate “net proceeds . . . at the well.” Again referring to treatise commentators as a source of what is, and is not, “customary,” the court quoted the following:

Inasmuch as gas royalty is ordinarily payable in money rather than in kind and is measured by value or proceeds at the wellhead, it is not

198. Id. at 855. The plaintiffs were overriding royalty owners who were subject to the terms of the unit agreement. Id.
199. Id. at 856 (emphasis added).
200. Id. at 857.
201. “Commentators have noted that royalty clauses in instruments creating overriding royalty interests generally provide that proceeds will be delivered free of cost of production . . . The commentators and case law, however, generally distinguish between production costs and costs incurred post-production.” Id. at 857.
202. Article 14.3 of the Unit Agreement provided:
Royalty Owners Free of Cost. This Agreement is not intended to impose, and shall not be construed to impose, upon any Royalty Owner any obligation to pay Unit Expense unless such Royalty Owner is otherwise so obligated.
Id. at 856.
customary, as in the case of oil royalty payable in kind, to specify that the royalty is free of cost of production. Freedom from such costs of production is implicit in the provision for payment of a share of the proceeds or value at the wellhead. However an occasional lease makes this specific even in the case of the gas royalty.203

The court relied upon this observation to conclude:

We interpret Section 14.3 as an explicit statement of what is implicit in most leases providing for the payment of royalties based on "net proceeds at the well." In other words, Section 14.3 specifies that the royalties will be free from the costs of production. This section does not permit royalty owners to reap the benefits of an enhanced value of the gas sold downstream. . . . Free of cost provisions are not inconsistent with allowing post-production, value-enhancing costs to be used to calculate the value of the gas at the wellhead.204

Therefore, the court used a mix of expert testimony, treatise commentary, and judicial opinions to conclude that its interpretation of "net proceeds at the well" was consistent with industry usage and the correct interpretation under the facts.

The interpretation of a nonparticipating royalty was at issue in Scott Paper Co. v. Taslog, Inc.205 where the court relied on usage evidence to define the substances subject to royalty206 and how such substances should be valued to calculate the amount due.207 It appears that the usage regarding royalty calculation was supported by "evidence, undisputed by appellants"208 while the usage regarding the scope of the rights granted was an unchallenged “assertion” of the “common industry practice.”209 In either event, the case illustrates the importance of addressing any usage “assertion” or “evidence” with any available counter-assertion, or evidence, if such exists.

203. Id. at 860 (quoting 3 Patrick H. Martin & Bruce M. Kramer, Williams and Meyers Oil and Gas Law § 643.2, at 530.1 (1999)) (emphasis added).
204. Id. at 860-61.
205. 638 F.2d 790 (5th Cir. 1981).
206. “[A]ppellants . . . have not challenged Taslog’s assertion that the common industry practice is to pay gas royalties and not sulphur royalties on hydrogen sulfide gas.” Id. at 795.
207. The court noted:
   The absence of an available market does not mean that the gas lacks value, however. In such situations the fair value of the gas is extrapolated by deducting from the sales revenue of the sulphur extracted from the gas the cost of transmission, processing, and a reasonable return on investment. Taslog introduced evidence, undisputed by appellants, that this method of valuation is universally used in the oil and gas industry to determine the value of hydrogen sulfide gas “at all [sic] well.” The district court did not err in adopting a method of valuation that was agreed to by the parties and that is consistent with both applicable legal principles and industry practice.
   Id. at 799 (emphasis added).
208. Id. at 799.
209. Id. at 795.
B. DISPROPORTIONATE TAKES AND GAS BALANCING ISSUES

The simple act of accounting for gas as it is produced from a well can be a complex undertaking. Initially it would appear that all you need to do is determine each party's proportionate ownership in the produced gas. Each owner would then receive their share of the produced gas and use that quantity for calculating any royalty and production taxes they may owe. This is the typical process when the substance being produced is a hydrocarbon in its liquid phase, such as oil and condensate. Substances produced in a liquid phase at or near the lease can be readily sold without having to rely upon pipeline transportation. However, production of substances in the gas phase are dependent upon three pipeline-driven realities: (1) most gas requires access to some sort of pipeline to be marketed—a "physical" reality; (2) the space available on a pipeline is allocated by contract between the producer, or the producer's gas purchaser, and the transporter—a "legal" reality; and (3) the ability to produce and transport gas is limited by the gas purchaser's willingness or ability to take the gas—a "legal" and "physical" reality.

If an owner of gas from a well is unable, or unwilling, to market their share of the gas production, what happens? If all owners fail to market their share of the gas, disproportionate gas take problems are avoided. However, if as is often the case, one or more owners market gas while other owners fail to market, disproportionate takes occur. The rights and obligations of the parties regarding these disproportionate takes are frequently addressed as an issue of industry custom and usage. The issue is typically addressed in two distinct parts: First, can one owner take more than its proportionate share of the gas stream? Second, assuming the disproportionate take is permissible, how must the parties be brought back into "balance?"

210. The subject has even warranted its own "Law of" article: see David E. Pierce, The Law of Disproportionate Gas Sales, 26 TULSA L. J. 135 (1990) [hereinafter Disproportionate Gas Sales].

211. However, depending upon the terms of each party's underlying oil and gas lease, there may be habendum clause problems and implied marketing covenant problems. For example, in Kansas, the habendum clause problems are particularly vexing for the lessee because the common form of shut-in royalty clause may not provide the marketing flexibility lessees enjoy in other states. Tucker v. Hugoton Energy Corp., 855 P.2d 929, 936 (Kan. 1993) ("Because, in this case, at the time of shut-in there was a limited market available to defendant-lessees for the gas producible from the six wells at issue, the shut-in royalty clauses could not be invoked to perpetuate the leases."). In Howerton v. Kansas Nat. Gas Co., 81 Kan. 553, 106 P. 47 (1910), rev'd in part, 82 Kan. 367, 108 P. 813 (1910) (reversed as to remedy for breach; damages were an adequate remedy), the court held the oil and gas lease gave rise to an implied obligation to prudently produce and market oil and gas from a well for the mutual benefit of the lessor and lessee.

212. E.g., Harrell v. Samson Res. Co., 980 P.2d 99, 105 (Okla. 1998) ("We have said that gas balancing is incorporated into the JOA through industry custom and usage.").

213. This is usually phrased as the "conversion" issue. See, e.g., Anderson v. Dyco Petroleum Corp., 782 P.2d 1367, 1371 (Okla. 1989) (rejecting conversion claims and applying a cotenancy analysis).

214. This is usually phrased as the "balancing" issue. See, e.g., Doheny v. Wexpro Co., 974 F.3d 130, 133 (10th Cir. 1992) ("In these appeals we are asked to determine, in the
I. Express Contract Terms

Each issue requires a review of the express contract terms. For example, both issues may be fully addressed in a "gas balancing agreement" which expressly authorizes disproportionate takes and specifies how the parties will be brought into balance. Absent a gas balancing agreement, the relevant contract is typically the "operating agreement" which most often consists of a version of the "A.A.P.L. Form 610 Model Form Operating Agreement." The relevant operating agreement terms concerning disproportionate take issues include the "ownership" clause and absence of a formal gas balancing agreement, the proper remedy to correct a gas production imbalance.

215. A drafting committee of the Rocky Mountain Mineral Law Foundation prepared the "Form 6," April, 1990 entitled "Gas Balancing Agreement" which has met with limited use in the industry to address disproportionate take and gas balancing issues. Copies of the Form 6 can be obtained from the Rocky Mountain Mineral Law Foundation, 7039 East 18th Avenue, Denver, Colorado 80220, (303) 321-8100, http://www.rmmflf.org. The form is reproduced in FORMS MANUAL, supra note 153, at 157-159. The Form 6 authorizes disproportionate takes as follows:

(a) Any time a party, or such party's purchaser, is not taking or marketing its full share of gas produced from a particular formation in a well ("non-marketing" party), the remaining parties ("marketing" parties) shall have the right, but not the obligation, to produce, take, sell and deliver for such marketing parties' accounts, in addition to the full share of gas to which the marketing parties are otherwise entitled, all or any portion of the gas attributable to a non-marketing party. (Gas attributable to a non-marketing party, taken by a marketing party, is referred to in this Agreement as "overproduction"). If there is more than one marketing party taking gas attributable to a non-marketing party, each marketing party shall be entitled to take a non-marketing party's gas in the ratio that such marketing party's interest in production bears to the total interest in production of all marketing parties.

Form 6 § 2.(a), lines 25-33. The balancing issue is addressed in part by the Form 6 as follows:

(b) A party that has not taken its proportionate share of gas produced from any formation in a well ("Underproduced Party") shall be credited with gas in storage equal to its share of gas produced but not taken, less its share of gas used in lease operations, vented or lost ("underproduction"). Such Underproduced Party, upon giving timely written notice to Operator, shall be entitled, on a monthly basis beginning the month following receipt of notice, to produce, take, sell and deliver, in addition to the full share of gas to which such party is otherwise entitled, a quantity of gas ("make-up gas") equal to fifty percent (50%) of the total share of gas attributable to all parties having cumulative overproduction (individually called "Overproduced Party"). Such make-up gas shall be credited against such Underproduced Party's accrued underproduction in order of accrual. Notwithstanding the foregoing and subject to subsection (c) below: (i) an Overproduced Party shall never be obligated to reduce its takes to less than fifty percent (50%) of the quantity to which such party is otherwise entitled and (ii) an Underproduced Party shall never be allowed to make up underproduction during the months of December, January, February and March.

Form 6 § 2.(b), lines 34-45.

216. Since 1956, the American Association of Professional Landmen ("A.A.P.L.") has made available four versions of the Model Form Operating Agreement (1956, 1977, 1982, and 1989), which have been widely used in the oil and gas industry to coordinate development when a leased area is owned by more than one developer. Copies of the forms may be obtained from Kraftbilt Products, Box 800, Tulsa, Oklahoma 74101, 1-800-331-7290, http://www.kraftbilt.com. The 1989 version of the form is reproduced in FORMS MANUAL, supra note 1533, at 121-42.
the “take-in-kind” clause. For example, the “ownership” clause of the 1989 version of the Model Form Operating Agreement provides:

Unless changed by other provisions, all costs and liabilities incurred in operations under this agreement shall be borne and paid, and all equipment and materials acquired in operations on the Contract Area shall be owned, by the parties as their interests are set forth in Exhibit “A.” In the same manner, the parties shall also own all production of Oil and Gas from the Contract Area . . . .

The Model Form’s “take-in-kind” clause provides:

Each party shall take in kind or separately dispose of its proportionate share of all Oil and Gas produced from the Contract Area, exclusive of production which may be used in development and producing operations and in preparing and treating Oil and Gas for marketing purposes and production unavoidably lost.

The express terms of the operating agreement do not address whether one owner in the well can take more than their proportionate share of the production when another owner fails to take their share of the gas. All it states is that “each party shall take in kind or separately dispose of its proportionate share of all Oil and Gas produced from the Contract Area . . . .” What if they do not? What can the taking parties do? The operating agreement indicates that “the parties shall also own all production of Oil and Gas from the Contract Area . . . .” Must the taking and non-taking parties’ rights be determined under the law of cotenancy? Are there conversion problems if X takes the full gas stream when Y and Z fail to take their shares of the gas? Once we get past the take issues, what does the operating agreement say about getting the parties back into balance? The operating agreements in use simply fail to address these issues and, although they are expressly addressed in gas balancing agreements, most multi-party development activities are governed by an

217. The “Exhibit A” will list each leasehold owner and their percentage ownership in the “Contract Area.” The “Contract Area” typically coincides with the acreage area necessary to complete the contemplated well. For example, if X has an oil and gas lease covering the North Half of section 30, Y has a lease covering the Southeast Quarter of section 30, and Z has a lease covering the Southwest Quarter of section 30, if the Contract Area consists of section 30 the Exhibit A would indicate the following Contract Area “ownership”: X 50%; Y 25%; Z 25%.


220. Id. In Questar Pipeline Co. v. Grynberg, 201 F.3d 1277 (10th Cir. 2000), the court indicated in dicta that a party’s failure to take was a breach of contract under a Unit Operating Agreement provision directing that: “Each Party shall currently as produced take in kind or separately dispose of its share of Production . . . .” Id. at 1285 (“By providing a remedy for underproduction [operator right to sell gas in the event a party fails to take] the Unit Operating Agreement is not authorizing it, but merely supplying a contractual response in case of a breach.”).


222. See generally Disproportionate Gas Sales, supra note 210.
operating agreement without a gas balancing agreement. This means courts must often consider evidence that goes beyond the "four-corners" of the operating agreement to ascertain the parties' rights and obligations regarding disproportionate takes; evidence that is "extrinsic" to the operating agreement.

2. Potential Sources of Extrinsic Evidence

Sometimes parties to an operating agreement may have addressed disproportionate take issues while negotiating over whether to include, as an exhibit to the operating agreement, some form of gas balancing agreement. Although they failed to agree on a gas balancing agreement, they may have discussed the disproportionate take issue. This situation implicates the parol evidence rule, which regulates when and how such prior negotiations can be used to define the content of the parties' contractual relationship.

However, if the parties did not focus on the issue prior to signing an operating agreement, there will be no prior negotiation evidence to consider. This means that in many cases the only extrinsic evidence at issue relates to: (1) the "surrounding circumstances" that provide the context for understanding the transaction; and (2) industry usage, which may also be viewed as a special category of surrounding circumstances.

a. Surrounding Circumstances Evidence

Surrounding circumstances encompass a broader base of information than merely industry usage. For example, a common item of surrounding circumstances evidence in oil and gas litigation is the "regulatory context" of the gas market. The premise is that a court or jury cannot properly consider the contract issues without being aware of the regulatory climate in which the parties to the contract had to operate. For example, when addressing the disproportionate take issues, counsel may want to educate the judge and jury on the Federal Energy Regulatory

\[\text{223. \(\text{id. at 165-68.}\)}\]
\[\text{224. \text{See supra text accompanying notes 25-31.}\)}\]
\[\text{225. \text{It is also possible that the prior negotiation evidence merely indicates the parties decided not to define their rights using a gas balancing agreement.}\)}\]
\[\text{226. \text{See supra text accompanying notes 74-77.}\)}\]
\[\text{227. \text{In Columbia Gas Transmission Corp. v. New Ulm Gas, LTD, 940 S.W.2d 587 (Tex. 1996), the court considered the regulatory context as part of "the circumstances surrounding the formation of the contract;" a gas purchase agreement. The evidence at trial revealed:}\)}\]
\[\text{When this contract was signed in 1980, it is undisputed that the parties knew that a huge volume of gas would be deregulated on January 1, 1985. The effect this deregulation would have on the price of gas was not known, however. It is therefore not surprising that the parties incorporated a market-out provision (section 3.1.3) that established a complex procedure to adjust the section 3.1.1 price to the market price of gas. The interpretation of 3.1.3 proffered by New Ulm would frustrate the intent of this provision.}\]
\[\text{id. at 591. In this case the surrounding circumstances evidence was used to support a finding that the contract was not ambiguous. \text{id. at 591-92.}\]
Commission's ("FERC") administrative initiatives to deregulate the middle-man merchant role of the interstate pipeline. The process resulted in pipeline companies, as traditional gas purchasers, often refusing to buy gas from producers that had dedicated gas supplies to the pipeline companies. This resulted in disproportionate takes as some producers marketed gas while others were gripped in litigation with their gas purchasers and were unable to market. As the gas contract litigation subsided, and the new regulatory regime took hold, producers found that marketing under the new regime would be much more complex. No longer would they negotiate long-term package deals for sale to a pipeline purchaser at or near the field where the gas was produced. Instead, negotiation would become an on-going process, often on a 30-day cycle as producers scramble to find a purchaser for their gas—and a way to move the gas from the wellhead to the designated sales point. Today disproportionate takes can occur anytime there is a failure to make a sale, failure of a purchaser to take the gas they have contracted to take, or failure of a link in the transportation network from wellhead to the sales point. Disproportionate takes can also occur by design when a producer voluntarily decides not to produce—typically planning to overproduce at some later date to take advantage of what they hope will be higher prices or lower transportation rates.

These surrounding circumstances become particularly important as courts evaluate the "equities" of the situation to fashion remedies. The other source of extrinsic evidence, which all parties will attempt to use to press their case, is usage evidence.

b. Usage Evidence

The disproportionate take cases offer an opportunity to study usage jurisprudence. At one level, what some courts define as "industry usage" may be better described as an acknowledgment of past "judicial usage" in dealing with a particular problem. For example, in *Harrell v. Samson Re*.

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228. This regulatory context can often play a major role in resolving royalty and other oil and gas disputes. For example, in *Smith v. Amoco Prod. Co.*, 31 P.3d 255 (Kan. 2001), the regulatory developments leading up to and including the promulgation of FERC Order 451 played a major role in determining whether Amoco breached an implied covenant to market gas. The court described the trial court's task on remand as follows: "The task for the finder of fact is balancing any conflict of interest that may follow invoking Order 451 and embarking on good-faith negotiating provisions, tempered by the regulatory background and national policy reflected under the NGPA and the purpose of FERC's order 451." Id. at 273 (emphasis added).

229. See generally Peter W. Goodwin, *Gas Sales Transactions after FERC Order No. 436, 44 Inst. on Oil & Gas Law and Tax'n 9-1 (1993).*


231. E.g., *Teel v. Pub. Serv. Co. of Oklahoma*, 767 P.2d 391, 394 (Okla. 1985) (operator and other working interest owners entered into twenty-year gas sales contract which Teel believed was "unfair and discriminatory") .

232. E.g., *Doheny v. Wexpro Co.*, 974 F.2d 130, 132 (10th Cir. 1992) ("Plaintiffs consistently have maintained that it is not economically feasible to sell their gas to a third party because of the costs involved in transporting gas in Questar's pipeline.").
sources Co., the Oklahoma Supreme Court observed: “Oklahoma case law makes clear, however, that three methods of balancing are incorporated into the common law by industry custom and usage.” This statement is followed by a string of citations where the courts addressed disproportionate take issues by considering the various ways industry responded to the situation. The court’s reference to usage as “the common law” appears to be a throwback to the demanding traditional definition of “custom” and usage as being a practice so long-standing that it has become common law. For example, in Heiman v. Atlantic Richfield Co., the court discussed various approaches to gas balancing that can be incorporated into the joint operating agreement through “industry custom and usage.” The citations the court relied upon were used to describe this “industry custom and usage” as “part of the common law,” “part of the applicable law,” and “custom and usage incorporated into the common law.” The court then relied upon the custom-as-law analysis to support the proposition that: “Silence on an issue of applicable law [here supplied by “industry custom and usage”] in an agreement will not negate that law; rather a contractual adjustment of rights contrary to law must be clearly expressed in the agreement before applicable law will not apply.” It is not possible to reconcile these statements with modern usage analysis.

If these same references were “usage” as defined in this article, once established as a matter of fact they would become an integral part of the contract. It therefore appears what the Oklahoma Supreme Court referred to in Harrell and Heiman is more a matter of evaluating and applying past judicial analysis instead of an industry usage. An examination of the cases relied upon by the Harrell and Heiman opinions illustrates how easily usage can be misdefined, and thereby misused, by the courts.

In the first of the cases, Beren v. Harper Oil Co., Beren owned a partnership interest in 25% of the working interest in a well subject to an operating agreement. Harper and other working interest owners, comprising 50% of the working interest, marketed their gas to Arkla while marketed their gas to Arkla while

234. Id. at 105. See also Heiman v. Atl. Richfield Co., 891 P.2d 1252, 1257 (Okla. 1995) (“In Anderson, we described the three methods of balancing as industry practices recognized by the courts, including periodic cash-balancing.”).
236. See supra text accompanying notes 6-12.
238. Id. at 1257.
239. Id. at n.4.
240. Id. at 1258 n.5.
241. See supra text accompanying notes 18-22. However, they would have no force of “law” and would be applicable only to the contract at issue and only to the extent established as a matter of fact during the trial in which the contract is being interpreted.
244. Id. at 1356-57.
Beren marketed its gas to ONG.\textsuperscript{245} High line pressures on ONG's pipeline prevented it from receiving gas from Beren during the term of their contract, resulting in the gas being taken by the other working interest owners who were selling to Arkla. This caused the disproportionate gas takes and the resulting imbalance between Beren and the Harper working interests.\textsuperscript{246} In 1971 Beren began selling to Arkla and the disproportionate takes ceased.\textsuperscript{247} The issue before the court was how to bring Beren and Harper into balance because of the pre-1971 disproportionate takes.

The court first examined the operating agreement and acknowledged each parties' ownership in production and the right to take their share of production in kind.\textsuperscript{248} However, with regard to the balancing issue, the court noted:

The parties entered into no arrangement to 'balance' among themselves any inequalities which might result from gas deliveries to the respective purchasers that were not proportionate to the ownership of the sellers in the well and the gas produced therefrom. The question of 'balancing' was left open.\textsuperscript{249}

The court follows this statement with a quotation from \textit{Wolfe v. Texas Co.} which states:

(1) Parties to a contract are presumed to know a well-defined trade usage generally adopted by those engaged in the business to which the contract relates.

(2) Persons, who enter into a contract in the ordinary course of business, unless the terms of the contract indicate a contrary intention, are presumed to have incorporated therein any applicable, existing general trade usage relating to such business.\textsuperscript{250}

During trial the following testimony was provided by Harper's expert witness:

It is the custom to permit, if at all possible, the underproduced party to take his increased share of gas production in kind and dispose of it as he sees fit. Now then, once a well depletes and production can no longer be obtained, then again it is the custom in the industry for there to be a cash balancing between the parties.\textsuperscript{251}

Harper offered this evidence to try to establish that Beren's sole remedy under the operating agreement was to balance in kind unless the well was depleted, in which case cash balancing could take place. Beren was seeking a present cash balancing while the well was still producing.\textsuperscript{252}

\textsuperscript{245} \textit{Id.} at 1357.
\textsuperscript{246} \textit{Id.} at 1358.
\textsuperscript{247} \textit{Id.}
\textsuperscript{248} \textit{Id.} at 1357.
\textsuperscript{249} \textit{Id.} at 1358.
\textsuperscript{250} \textit{Id.} (quoting Wolfe v. Texas Co., 83 F.2d 425, 429 (10th Cir. 1936)).
\textsuperscript{251} \textit{Id.} at 1359.
\textsuperscript{252} The underlying dispute in almost all balancing cases is which party will get the time value of the money represented by the disproportionate takes. For example, Beren was
If the usage is established as a matter of fact, it can become part of the parties' contract as though it were expressly stated in the contract. This would limit the court's ability to order a remedy that is inconsistent with the contract. In addition to the expert testimony offered by Harper, the court also noted articles in which commentators identify three approaches to balancing disproportionate takes: balancing in kind, periodic cash balancing, and cash balancing upon reservoir depletion. The court also observed: "Throughout the history of the oil and gas industry there have been situations of balance and imbalance in the taking of gas. These inequities are customarily settled 'in kind' between the co-owners, or by the Corporation Commission of Oklahoma." In spite of these observations, the court held:

While balancing in kind, based on custom and usage, may be apropos in many instances where imbalance exists, under the particular facts of this case which establish that the well is depleting; that this cause of imbalance, i.e., the split connection, has been eliminated and there is no immediately foreseeable continued imbalancing in production because there is but one purchaser of gas from the well; the equities dictate an immediate accounting and cash balancing between the owners of interest in the well.

If the court concluded that balancing in kind, as opposed to current cash balancing, is an industry usage incorporated into the parties' contract, the court could not disregard the provision any more than it could disregard an express term of the contract.

It is submitted that the court's opinion is consistent with the usage evidence it considered. The problem, for Harper, was that the usage evidence did not dictate a rejection of current cash balancing as an acceptable option under the contract. Harper's expert accurately described how gas imbalances are resolved—*when the parties are able to agree.* Typically they will agree upon a balancing program where the underproduced by 163,702 MCF. If Beren was required to make up the imbalance by in-kind balancing, it might take years to accomplish, depending upon the current productivity of the well, Beren's gas contract, and the willingness of the other working interest owners to reduce their current takes to allow for a timely make-up. If Beren were required to wait until depletion to complete a make-up, this could be decades. The rate of make-up is critical because of the time value of money. Whenever an over-produced party is able to delay the ultimate day of reckoning, they have the free use of the underproduced party's money. The value of the right to receive a dollar in the future is less than the value of the same dollar received today. For example, assuming 10% could be earned on a dollar in-hand today, the same dollar received in 20 years would be worth less than 15¢. *Grant S. Nelson et al., Contemporary Property* 292 (1996) (Table of Present and Future Values).

254. *Id.*
255. *Id.* at 1360.
256. Unless it was found to be unconscionable or otherwise against public policy; there is no hint in the court's opinion that the parties were not free to agree to in-kind balancing as the underproduced party's sole remedy.
257. Stating that the parties will balance in-kind does not solve the problem. Even if the parties agreed that balancing in-kind was their sole remedy, what does that mean? Will the under produced party be able to take all of the overproduced parties' gas until brought
underproduced party can take more than its percentage share of the production until it is brought into balance. Often this post-imbalance agreement looks a lot like a gas balancing agreement the parties could have entered into prior to the imbalance. However, the disputes that reach the courts concern instances where the parties have not entered into a gas balancing agreement and are unable to arrive at a voluntary post-imbalance agreement. Often the parties actually negotiated the gas balancing issue when entering their operating agreement contract and consciously refused to accept gas balancing terms that are frequently similar to those put forth as "industry custom and usage." It would be improper for a court to impose a balancing obligation relying upon usage when the parties expressly refused to adopt an approach required by the usage. The court took note of the usage but apparently concluded it did not define the parties' rights when a dispute over balancing equities required judicial intervention—i.e., the parties could not agree.

The second case to address these issues is United Petroleum Exploration, Inc. v. Premier Resources, Ltd. where United, the underproduced party, was seeking balancing in kind and the overproduced party, Premier, was offering current cash balancing to eliminate the imbalance. Although the court acknowledged "the general custom of the industry to balance in kind, if possible," it noted the basic teaching of Beren as requiring "an examination of the particular circumstances of each case" and that "the method of balancing chosen should reflect an intention by the court to restore the underproduced party to the position into balance? Or, will the underproduced party be limited to a certain percentage of the overproduced parties' gas until brought into balance? If so, who determines the percentage? Can the underproduced party seek makeup gas during the high-demand heating season months? These are the sort of issues addressed in a gas balancing agreement. Absent a gas balancing agreement, the only way to resolve these issues, and thereby facilitate balancing in-kind, is if the parties are able to agree. If they cannot agree, they will often seek an equitable remedy from the court.

258. Often the operating agreement itself will reflect that rejection of a gas balancing agreement was a conscious election by the parties. For example, see the 1989 Model Form Operating Agreement, under Article VI, section G. "Taking Production in Kind" provides two mutually exclusive options for the parties: "Option No. 1: Gas Balancing Agreement Attached" and "Option No. 2: No Gas Balancing Agreement." FORMS MANUAL, supra note 153, at 133-34.


260. Apparently it was not the time value of money driving the dispute but the benefit of 20/20 hindsight as to the value of the overproduced gas. Gas prices were apparently escalating such that making up the imbalance by taking the overproduced party's share of the gas was a better deal for the underproduced party. Id. at 132 ("While there is evidence that the fair market value of the gas was greater than the contractual value being paid, there is nothing in the record to indicate a factual dispute that the price received by Premier for the gas produced was less than the fair market value of the gas at the time Premier entered into its contract with Northern.") (emphasis added).

261. Id. at 131. Which I would interpret to mean: if the parties can agree on balancing in kind as the remedy plus the details of how balancing in kind will be accomplished.

262. Id. at 130 ("Thus, it is apparent from the language of the Beren court that an examination of the particular circumstances of each case must be considered in determining the method of balancing to be used.").
which he would have occupied if the imbalance had not occurred."

Analysis of the Beren and United cases reveals that the so-called industry preference for balancing in kind plays no role when the parties are unable to agree upon balancing in kind as a remedy. Instead, the court should examine the equities of each case and arrive at a solution that is fair under the circumstances. In Beren, cash balancing was ordered to prevent the overproduced party from capitalizing on the time value of the overproduced gas; in United, cash balancing was ordered to prevent the underproduced party from capitalizing on a rising gas market and perfect knowledge of how it compared with the overproduced party's actual sales. These precise holdings in Beren and United nevertheless begin to mutate into something different as courts and commentators focus on usage and in-kind balancing.

The Oklahoma Supreme Court, in Anderson v. Dyco Petroleum Corp., noted that "certain practices of the industry have been acknowledged by the courts but observes it was not being asked to resolve the balancing issue. When the Court of Appeals for the Tenth Circuit examined the balancing issue in Doheny v. Wexpro Co., it characterized the Beren and United cases as follows:

The district court held balancing in kind is the preferred method for balancing in the industry . . . . The few cases to address the issue are in accord, as are the authors who have addressed the subject . . . .

These authorities do not espouse requiring in kind balancing in every instance. Rather, they reflect prevailing sentiment to use in kind balancing unless the equities dictate otherwise.

The court in Doheny elevates in-kind balancing to a preferred status. The court appears to be making a ruling as a matter of law as opposed to any sort of usage analysis: at least in Wyoming when a balancing dispute arises the presumption will be that it should be resolved by allowing the underproduced party to make up the imbalance by using in-kind balancing. In Pogo Production Co. v. Shell Offshore, Inc. the trial court held “that in the absence of an agreement the custom and usage of the

263. Id. at 131.
265. Id. at 1373 ("These practices involve balancing in kind the production from the well by allowing cotenants, like Appellants, the opportunity to market gas from the well (i.e. taking a certain percentage of an overproduced party's gas until any imbalance in the cotenant's takes from the well are made up), by periodic cash balancing whereby underproduced cotenants receive cash from producing cotenants in proportion to their respective interests and cash balancing upon any particular gas reservoir's depletion.").
266. Id. at n.18 ("On the instant record we have no reason to and do not express any view as to which method of balancing might be appropriate in this case.").
267. Doheny, 974 F.2d 130 (applying Wyoming law).
268. Id. at 133.
269. The details of how this in-kind balancing is to be accomplished are not addressed. Presumably, the trial court will order the "designated percentage" of the overproduced parties' gas that can be taken by the underproduced party until they are in balance.
270. 898 F.2d 1064 (5th Cir. 1990) (applying Louisiana law).
industry required balancing in kind." 271 The Court of Appeals for the Fifth Circuit mitigated this statement somewhat noting: "In short, balancing in kind is the preferred method of remedying underproduction." 272

The Oklahoma Supreme Court, in Heiman, relied upon Beren, United, and Anderson to equate the preference for "pre-depletion cash-balancing" with balancing in kind concluding: "Pre-depletion cash-balancing as industry custom and usage is incorporated into the joint operating agreement." 273 Chief Justice Alma Wilson observed in his dissenting opinion 274 in Heiman:

Although ARCO presented no evidence of industry custom and usage before the trial court, on rehearing ARCO explains that industry custom declared that ARCO, the operator, was the owner of 100 percent of the gas which it produced and sold and that Heiman, working interest owners who failed to take in kind or separately dispose of their share of the gas, were not entitled to receive any production proceeds until depletion of the well. 275

Apparently ARCO was seeking to establish usage through "argument." The court adopted a contrary usage either by accepting the counter-arguments of Heiman, by anecdote from the court's own experience, or as a matter of law emanating from prior precedent. It appears, however, no balancing "usage" was established as a matter of fact in the case.

When the Oklahoma Supreme Court addressed the issue in Harrell, it described the Beren, United, Anderson rule as follows: "Oklahoma case law makes clear, however, that three methods of balancing are incorporated into the common law by industry custom and usage . . . . We have said that gas balancing is incorporated into the JOA through industry custom and usage." 276 This is not "usage" under a particular operating agreement, but rather a judicial observation made throughout the cases that when parties get out of balance, there are common techniques that can be used to correct the imbalance. The "common law" analyzed in this section reveals that no single method of balancing actually takes precedence over the other. Instead, courts will consider the circumstances of

271. Id. at 1066 (emphasis added). The operating agreement expressly acknowledged that the parties were not addressing the balancing issue at that time stating:

Any party's failure to timely take or sell its share of gas production shall not prohibit the other party or parties from producing their share of production, provided that non-producing party or parties may recoup or recover their share from future production and/or in cash by suitable agreement.

Id. at 1065. Depending upon whether "suitable agreement" modifies both "future production" and "cash," it appears the parties intentionally left the issue of balancing open. The trial court, in effect, creates a default rule that if the parties cannot agree otherwise, balancing in kind will be the underproduced party's sole remedy.

272. Id. at 1067.

273. Heiman, 891 P.2d at 1257 (emphasis added).

274. Justice Wilson's dissent focused on the rate of interest that should be awarded Heiman and the application of subsequently enacted payment statutes. He believed the interest issue was governed by Okla. Stat. tit. 52, section 540. Heiman, 891 P.2d at 1259 (Wilson, J., dissenting).

275. Id. at 1260 (emphasis added).

276. Harrell, 980 P.2d at 105 (emphasis added).
each situation and fashion a remedy that is equitable to all parties; in some situations this will result in balancing in-kind, pre-depletion cash balancing, cash balancing upon depletion, or any other appropriate remedy that fairly addresses the situation.\footnote{277} As noted previously, the so-called “usage” regarding a preference for balancing in-kind would not be applicable to situations where the parties are unable to agree.

The balancing cases illustrate several interesting points regarding usage jurisprudence. First, what courts and commentators label as “usage” may not be a usage that relates to a particular contract established as fact at trial. Instead, it may be a judicial recognition of a practice that has, through citation and lore, assumed the status of a rule of law.\footnote{278} Second, usages must be defined with precision. For example, it is true that on an industry-wide basis—when parties come to an agreement regarding balancing—the preferred method for maintaining balance is through in-kind balancing. However, this preference has nothing to do with the situation where the parties are unable to agree on balancing. If the preferred agreed-upon form of balancing is in-kind, and the parties have not been able to agree, the implication is that at least one party affirmatively rejected in-kind balancing. Third, usage is properly used to interpret a particular contract. A usage identified in one case, concerning a particular contract, may not apply in a different case, with a different contract or different parties. Therefore, counsel must be prepared to counter usages that are the product of prior cases or different contracts, by exposing their weaknesses, or inapplicability, through the presentation of fact. Fourth, the existence and content of a usage must be established as a fact at trial.\footnote{279} This means that commentary and prior judicial opinions regarding usage will be of little value—unless the usage is being established by argument or anecdote.\footnote{280} The requirement that usage be established

\footnote{277. The party proposing a remedy not previously recognized would have the burden of demonstrating why it is superior to one of the three “practices of the industry . . . acknowledged by the courts to remedy situations . . . where only certain working interest owners have sold production.” Id. However, since these issues typically arise in an “accounting” proceeding, the burden should not be too demanding.  
\footnote{278. However, this is one of those areas where counsel can fight “law” with “fact.” The legal effect of such judicial usages can be overcome because they operate as default rules that apply when the facts do not dictate otherwise.  
\footnote{279. For example, in Questar Pipeline Co. v. Grynberg, 201 F.3d 1277 (10th Cir. 2000), the plaintiff established that it is industry custom and usage for all parties to currently take their gas if possible instead of allowing parties to deliberately withhold their gas from market. The plaintiff established this usage through cross-examination of the defendant’s expert: “Questar’s senior attorney, an expert on industry practice, admitted that industry custom dictates that as long as an owner has a market for its gas it should not be allowed to make the strategic decision not to sell its gas and to make someone else take more than their share.” Id. at 1285. With regard to a marketing working interest owner’s obligation to take a share of an underproduced party’s gas, the court noted: “Even Questar’s own expert witness admitted that if Terra did not take its share of production, industry standard and practice dictated that Grynberg had the right, but not the obligation, to take that additional share.” Id. at 1286.  
\footnote{280. There is always a risk that a court may refuse to consider usage arguments not preserved at the trial court level. In Kincaid v. W. Operating Co., 890 P.2d 249 (Colo. Ct.}
as a fact recognizes why the inquiry is being made in the first place: to determine the meaning of a particular contract before the court. As the focus drifts away from this task, courts become more inclined to accept usages established through argument and anecdote. The following section addresses the process by which usage by argument and anecdote are fought with usage evidence as fact.

VI. PRESENTING USAGE EVIDENCE AS FACT

The evidentiary considerations addressed in this section are "relevancy" and "reliability." The parol evidence rule, and other non-evidentiary exclusionary rules, have been examined in previous sections. The focus of this section is to identify the analysis courts use to determine when offered usage evidence will be admitted. Generally, evidence will be admitted when it is "relevant" to the matters at issue and is found to be "reliable."

A. MUST BE RELEVANT: WILL IT HELP THE FACT-FINDER?

The general rule is that all "relevant" evidence is admissible. "Relevant evidence" is defined as evidence having "any tendency" to make the existence of a fact "that is of consequence to the determination of the action" either "more probable or less probable than it would be without the evidence." For usage evidence the "of consequence to the determination of the action" requirement will often be the determinative issue and creates a bridge between procedural evidentiary rules and substantive exclusionary rules such as the parol evidence rule. For example, if the usage evidence is excluded because it would violate the parol evidence rule, then it would not be "relevant" because the offered evidence would not impact—be "of consequence"—to the "determination of the

App. 1994), the defendant, on appeal, sought to rely upon two law review articles as supporting its contention that a joint operating agreement did not give rise to an area of mutual interest. Refusing to consider the articles, the court held:

Here, while the articles cited by defendant may indeed represent the industry custom, because they were not cited to the trial court, defendant cannot now assert that they definitively identify the custom of the oil and gas industry. It is improper for us to consider the articles on appeal, as we are without authority to make factual findings.

Id. at 252. The Kincaid case highlights a technique for trying to battle the other party's attempts at establishing usage by anecdote or argument at the appellate level. By demanding that usage be established as a matter of fact, this will shift the focus away from appellate arguments to the evidence offered at trial.

281. See supra text accompanying notes 25-44.


283. FED. R. EVID. 401; TEX. R. EVID. 401. The "fact," to be relevant, need not be determinative of the matter at issue, it just needs to be "of consequence" to the issues. It must add something to the mix of information that will assist in resolving an issue but it need not resolve the issue, nor must it make it more-likely-than-not that the issue should be resolved in a particular way.
action.” As a practical matter this means all potential exclusionary rules should be applied to the facts before considering relevancy issues.

Other substantive rules of law can also make evidence irrelevant. For example, in Exxon Pipeline Co. v. Zwahr, expert testimony was admitted concerning the value of the land taken by Exxon in condemning a pipeline easement. The Texas Supreme Court held the testimony was improperly admitted because it sought to establish the value of the condemned land by considering the value of the easement to Exxon. The testimony was improper because it was “irrelevant to determining the value of the land taken from the Zwahrs and therefore inadmissible under Texas Rule of Evidence 702.” The Zwahr case demonstrates the importance of carefully defining the substantive parameters of an expert’s testimony to ensure their methodology is consistent with existing law.

If the usage evidence being offered passes the substantive rule gauntlet, the next test will be to determine whether the evidence will help to establish a proposition that is of legal significance to the lawsuit. This requires an examination of the pleadings and pretrial orders to ascertain the matters at issue in the litigation. For example, if the cause of action is for breach of a gas purchase contract, and the defense is that a contract was never formed, usage evidence concerning the procedure for entering into and formalizing gas purchase contracts would be “of consequence to the determination of the action” to the extent it makes it “more probable or less probable” that a contract was formed. In addition to considering the pleadings and pretrial orders, the legally-significant proposition may arise out of examination of statutes and case law concerning the potential role of usage evidence. For example, in Oklahoma a statute provides: “A contract is to be interpreted according to the law and usage of the place where it is to be performed, or, if it does not indicate a place of performance, according to the law and usage of the place where it is made.” Case law can also establish the relevancy of the offered evidence. For example, in Mittelstaedt v. Santa Fe Minerals, Inc., the Oklahoma Supreme Court suggested that industry custom and usage evi-

284. 88 S.W.3d 623 (Tex. 2002).
285. Id. at 629 (“Kangieser’s testimony as a whole reveals that he premised his valuation on the fact of Exxon’s condemnation, thus improperly including project enhancement in that valuation.”).
286. Id. at 631.
287. However, if counsel is planning to challenge the existing rule, they will want to ensure evidence is offered applying the existing rule, while proffering evidence supporting their challenge to the rule. In Zwahr, the plaintiff was attempting to avoid the rule by focusing on the assignment value of an existing easement on the land owned by another company.
289. Id.
290. Manchester Pipeline Corp. v. Peoples Nat. Gas Co., 862 F.2d 1349 (10th Cir. 1988) (noting that to determine whether parties had entered into a contract, the court could consider custom and usage regarding the procedure for formalizing a gas purchase contract.).
Evidence on deducting costs to calculate royalty would have been relevant to interpret the oil and gas leases at issue.\(^2\text{93}\)

Although the evidence may be relevant, the trial judge can nevertheless exclude the evidence when it could cause unfair prejudice, confuse the issue, mislead the jury, or cause undue delay or be needlessly cumulative.\(^2\text{94}\) The "probative value" must be "substantially outweighed" by the "danger" of "unfair prejudice, confusion of the issues, or misleading the jury, or by considerations of undue delay, waste of time, or needless presentation of cumulative evidence."\(^2\text{95}\) Some earlier cases impose special pleading requirements to alert the other party that usage evidence will be offered.\(^2\text{96}\) The U.C.C. addresses the issue as one of "unfair surprise" by providing: "Evidence of a relevant usage of trade offered by one party is not admissible unless and until he has given the other party such notice as the court finds sufficient to prevent unfair surprise to the latter."\(^2\text{97}\)

Today, with requirements for the exchange of expert reports and disclosures, it would be difficult to claim "unfair surprise" unless the issue is not disclosed in the report, deposition, or other discovery or pleading documents.\(^2\text{98}\) Presumably this rule would prevent raising usage assertions for the first time at the appellate level by brief or argument.\(^2\text{99}\) If the evidence survives these objections, and is found to be relevant, the next evidentiary hurdle, when being offered through an "expert," is whether the usage evidence is "reliable."

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\(^{293}\) The court in *Mittelstaedt* observed:

Generally, custom and usage in the industry are used in determining the scope of duties created by the lease. . . . Neither the facts given us nor the legal argument on the certified question identify custom and usage with respect to the individual costs at issue when the leases were executed.

. . . .

The parties have not shown that the actual costs at issue are, or are not, treated by the industry as production costs or post-production costs for our purpose.

. . . .

Generally, costs have been construed as either production costs which are never allocated, or post-production costs, which may or may not be allocated, based upon the nature of the cost as it relates to the duties of the lessee created by the express language of the lease, the implied covenants, and custom and usage in the industry. . . .

*Id.* at 1208, 1209. *See supra* note 2.

\(^{294}\) FED. R. EVID. 403; TEX. R. EVID. 403.

\(^{295}\) *Id.*

\(^{296}\) *E.g.*, Grube v. Donnell Exploration Co., 286 S.W.2d 179, 180-81 (Tex. Civ. App.—El Paso 1955, writ ref'd n.r.e.) ("such custom was not pleaded by appellant and it seems to be well settled that if a custom is relied on to establish liability or defeat liability, such custom must be pleaded.").

\(^{297}\) U.C.C. § 1-205(6) (1977); U.C.C. § 1-303(g) (2003).

\(^{298}\) FED. R. CIV. P. 26; TEX. R. CIV. P. 195.

\(^{299}\) However, it would seem to offer no protection against usage by judicial anecdote.
B. MUST BE RELIABLE: USAGE EVIDENCE THROUGH THE EXPERT WITNESS

Usage evidence is frequently offered through an expert witness. Often if you are able to exclude the expert’s testimony you will be able to eliminate the lawsuit, or a defense to the lawsuit. This can result in the critical trial-before-the-trial to determine whether expert testimony essential to the case will be admissible. The focus of the inquiry is

300. For example, in Texas E. Transmission Corp. v. Marathon Oil Co., No. CIV. A. 96-4079, 1997 WL 539675, (E.D. La., Aug. 28, 1997) (not reported in F. Supp.), the court considers competing interpretations of the following clause in a gas purchase agreement: 5. Seller shall have the right at its election during the term of this contract to substitute other gas for all or a portion of the gas hereunder and the right to deliver such substitute gas to Buyer at mutually agreeable points in the area of or downstream of the delivery points set forth in this Agreement, provided the substituted gas contains reserves and deliverability equal to or in excess of the reserves under the leases originally committed to this contract. Id. at *3. Marathon sought to substitute additional acreage that would replace the depleting acreage dedicated to the contract. Texas Eastern objected because the effect of the change would be to increase the volume of gas it would be obligated to purchase under what had become an unfavorable gas contract. In reaching its decision to deny Marathon’s motion for summary judgment, and grant Texas Eastern’s cross-motion for summary judgment, the court relied heavily upon the affidavit testimony of three professors tendered by Texas Eastern. The court described the testimony of one of the professors as follows: Texas Eastern has submitted the affidavits of Dr. Saul Litvinoff, Professor Shael Herman, and Professor L. Linton Morgan in support of its cross-motion for summary judgment. . . . Professor Morgan stated that “[f]or a long term gas sales contract to provide either the buyer or seller with the sole and unlimited option to change the leases and reserves affected by the contract would be completely inconsistent with the custom and usage of the oil and gas industry.” . . . Id. at *9 (emphasis added). The impact of the professors’ testimony is reflected in the court’s final statement in the opinion: “[T]he Court agrees with Dr. Saul Litvinoff, Professor Shael Herman, and Professor L. Linton Morgan that the contract restricts the quantity of gas to the amount of gas produced from the lands and leaseholds covered by the SP 89 Contract, namely, the SP 89 Lease.” Id. at *17. Similar expert testimony, regarding a similar issue under a Texas Eastern contract with Amerada Hess Corporation, resulted in a similar ruling in Texas E. Transmission Corp. v. Amerada Hess Corp., Nos. CIV. A. 97-0518 & CIV. A. 97-1742, 1997 WL 613125, (E. D. La. Sept. 25, 1997).

301. In Texas, these matters may be determined before trial in a Texas Rules of Evidence, Rule 104(a) hearing or a Texas Rules of Civil Procedure, Rule 166a(i) no evidence motion. Texas Rules of Evidence, Rule 104(a) provides: Preliminary questions concerning the qualification of a person to be a witness, the existence of a privilege, or the admissibility of evidence shall be determined by the court, subject to the provisions of subdivision (b). In making its determination the court is not bound by the rules of evidence except those with respect to privileges. Texas Rules of Civil Procedure, Rule 166a(i) provides: After adequate time for discovery, a party without presenting summary judgment evidence may move for summary judgment on the ground that there is no evidence of one or more essential elements of a claim or defense on which an adverse party would have the burden of proof at trial. The motion must state the elements as to which there is no evidence. The court must grant the motion unless the respondent produces summary judgment evidence raising a genuine issue of material fact.

See generally E. R. Norwood, Expert Witnesses in Oil and Gas Litigation: Robinson/ Daubert Challenges, 28th ANNUAL ERNEST E. SMITH OIL, GAS & MINERAL LAW INSTITUTE, Paper 8, The University of Texas School of Law (March 22, 2002) [hereinafter Norwood]. If efforts to exclude the testimony at these pre-trial stages fail, the objection must
whether the testimony being offered by the expert is "reliable" as defined by the applicable rules of evidence.302 For example, Texas Rules of Evidence, Rule 702 states:

If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education may testify thereto in the form of an opinion or otherwise.303

The federal counterpart is Federal Rules of Evidence, Rule 702, which states:

If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education may testify thereto in the form of an opinion or otherwise, if

(1) the testimony is based upon sufficient facts or data, (2) the testimony is the product of reliable principles and methods, and (3) the witness has applied the principles and methods reliably to the facts of the case.304

The italicized language reflects the amendment to Rule 702 incorporating the United States Supreme Court's analyses in Daubert v. Merrell Dow Pharmaceuticals, Inc.305 and Kumho Tire Co. v. Carmichael.306 Although the Texas rule does not contain the italicized language, the same requirements have been imposed by Texas courts interpreting the Texas Rule of Evidence 702.307

The Texas Supreme Court has refined the reliability analysis by focusing on: (1) the expert; and (2) the expert's methodology. Although the expert witness must possess expertise from their "knowledge, skill, experience, training, or education,"308 they must also have expertise relating to the specific matter on which they will testify. This is step one of the

be renewed at trial to preserve the issue on appeal. Id. at 30 ("If the trial court rules pre-trial to deny a party's Robinson/Daubert challenge to an expert's testimony, the opposing party should, at trial, object to the challenged expert's testimony, adopting as the grounds for such objection those grounds set out in the Rule 104(a) hearing. Further, the objecting party should seek an agreement, on the record, from the offering party that the objection to the challenged expert's testimony will be considered a running objection as to each of the challenged opinions so as to avoid any risk of waiving the objection.").

303. TEX. R. EVID. 702.
304. FED. R. EVID. 702 (emphasis added).
305. Daubert, 509 U.S. 579 (experts relying upon scientific principles, knowledge, and technique must connect their conclusions, with supporting analysis, applying supporting data that is collected through a supporting methodology).
306. 526 U.S.137 (1999) (Daubert analysis applies to "technical" knowledge and "specialized" knowledge, based upon observation and experience, as opposed to scientific principles).
308. TEX. R. EVID. 702.
reliability inquiry: is this person the proper expert for the issues in this case? The Texas Supreme Court, in Borders v. Heise,\(^{309}\) focused on the suitable expert stating: "What is required is that the offering party establish that the expert has ‘knowledge, skill, expertise, training, or education,’ regarding the specific issue before the court which would qualify the expert to give an opinion on that particular subject."\(^{310}\) For example, in Gammill v. Jack Williams Chevrolet,\(^{311}\) a mechanical engineer familiar with aircraft design did not qualify as an expert concerning automobile design.\(^{312}\) This means when counsel evaluates the need for expert testimony they must: (1) carefully define the issues that necessitate expert testimony; (2) identify the general and specific areas of knowledge associated with the issues; (3) identify specific areas of expertise required to effectively address the issues; and (4) seek out persons with the specific expertise.\(^{313}\)

Step two of the process focuses on the expert’s methodology used to arrive at an opinion. The expert’s opinion must be based upon some sort of information obtained or possessed by the expert. The major component of a court’s reliability analysis will be considering how this information was collected, why it was collected, how it was used by the expert, and how the expert’s conclusions relate to the expert’s analysis of the information. These are the "good grounds" for the expert’s testimony the United States Supreme Court refers to in its Daubert opinion.\(^{314}\) Testimony by even the most highly credentialed and qualified expert must be excluded if the methodology they employ to arrive at their opinions is unreliable. For example, in Kumho Tire,\(^{315}\) the admittedly qualified expert’s testimony was properly excluded because of: "the methodology employed by the expert in analyzing the data obtained in the visual inspection, and the scientific basis, if any, for such an analysis."\(^{316}\)

The burden again falls on counsel seeking expert assistance to ensure the expert has the opportunity to properly: (1) identify the information they need to address their assigned issues; (2) collect the information in a

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\(^{309}\) 924 S.W.2d 148 (Tex. 1996).

\(^{310}\) Id. at 153 (emphasis added).

\(^{311}\) Gammill, 972 S.W.2d 713.

\(^{312}\) Id. at 726.

\(^{313}\) E. R. Norwood offers the following advice:

The practitioner should thoroughly examine a perspective expert’s experience with the matter in dispute. Specifically, the attorney should request that the expert provide the dates, times, places, specific jobs, or assignments, involving the same, or similar, fact issues as the ones in litigation. . . . Conversely, the opponent to such expert testimony should devote sufficient time and energy, in discovery, to determine the specific experience the putative expert has in the subject matter at issue.

Norwood, supra note 301, at 5-6.

\(^{314}\) Daubert, 509 U.S. at 590 ("Proposed testimony must be supported by appropriate validation—i.e., 'good grounds,' based on what is known.").

\(^{315}\) Kumho Tire, 526 U.S. 137.

\(^{316}\) Id. at 153. The Supreme Court noted: "The relevant issue was whether the expert [or any expert employing the visual inspection methodology] could reliably determine the cause of this tire's separation. Id. at 154."
Defining the Role

Defensible manner; (3) analyze the collected information in a defensible manner; and (4) arrive at conclusions—opinions—that are supported by their expert analysis of the collected information. The key to a sound methodology begins with good lawyering. In each case counsel must consider the legal context of the litigation and identify those issues that present an opportunity for the effective use of expert testimony. Counsel must consider what facts would be necessary to allow an expert witness to opine on an issue and then determine how the necessary facts can be identified. The expert’s analysis of the collected facts provides the final element of the methodology. These tasks will normally be evaluated once the appropriate person having the specific expertise to address the issues has been identified. The expert will provide the input necessary to identify what they will need to obtain reliable information to determine whether favorable facts exist. The expert will then proceed to collect the information and develop the methodology required to effectively evaluate the information and distill the facts. At this stage, if the facts are not favorable to the party’s position commissioning their collection, they can be used by counsel for settlement purposes. The goal is to ensure that any opinion, “good or bad,” is based upon reliable information and that the expert’s conclusions from the information are based upon a reliable analysis of the information.

C. FIGHTING ANECDOTE AND ARGUMENT WITH FACT:
HYPOTHETICAL ILLUSTRATION

In this section the anecdote/argument/fact problem, discussed in prior sections, will be examined in the context of assembling relevant and reliable facts for presentation at trial through expert testimony regarding when natural gas becomes a “marketable product” in Oklahoma. Assume that in 1990 an oil and gas lease was entered into between Acme

317. If the expert is unable to agree with the essential elements of a litigant’s theory, they run the risk of becoming an expert for the other side through the process of cross-examination. In Goodwin v. Standard Oil Co. of La., 290 F. 92 (8th Cir. 1923), the expert was tendered by the plaintiff to establish that a custom existed in the oil and gas industry for a lessee “to drill protection wells as soon as wells were drilled near the boundary line on adjoining land . . . .” Id. at 96. However, further probing into the expert’s opinion revealed that “the time of drilling protection wells in territory such as here disclosed, was almost entirely a matter of judgment.” Id. This was the precise point the defendant wanted to make: drilling a protection well is not automatic, but depends upon many circumstances the operator must weigh.

318. See Helena Chem. Co. v. Wilkins, 47 S.W.3d 486, 499 (Tex. 2001) (“If an expert relies upon unreliable foundational data, any opinion drawn from that data is likewise unreliable . . . . Further, an expert’s testimony is unreliable even when the underlying data is sound if the expert’s methodology is flawed.”). Norwood offers the following advice:

The challenged expert must systematically, step-by-step, demonstrate how each opinion is supported by the data, or facts, and how the expert’s methodology applied to the data, or facts, yields the expert’s opinion. The expert should also show that he has considered other possible explanations of the data, or facts, and how and why he has ruled out such other explanations.

Norwood, supra note 301, at 20.

319. The governing law in Oklahoma is found in Mittelstaedt. Mittelstaedt, 954 P.2d 1203.
Oil Company, lessee, and John Landowner, lessor, providing for payment of a royalty as follows:

The lessee shall pay as royalty free of cost on the lease for gas of whatsoever nature or kind (with all of its constituents) produced and sold, 3/16 of the gross proceeds received for the gas sold, or, if such gas is used by lessee off the leased premises or used by lessee for the manufacture of casinghead gasoline or other products, lessee shall pay lessor 3/16 of the prevailing market price at the wellhead for the gas so used; payments to be made monthly.320

Acme drilled a well on the lease and began producing natural gas in 1991. The gas was "used" by Acme to "manufacture" products through processing, which Acme sold as natural gas liquids and residue gas as they emerged from a gas processing plant located several miles from the leased land.

Acme currently sells the natural gas liquids and residue gas and nets the equivalent of $4.00/MMBtu. However, Acme is paying John royalty based upon a wellhead value of $2.00/MMBtu.321 John believes his royalty should be 3/16ths of $4.00, not $2.00. Although John does not dispute that the "prevailing market price at the wellhead for the gas so used" portion of the royalty clause applies, he contends a "marketable product" does not arise until the gas is processed.

The major issue in this dispute concerns the "location" where John's royalty should be calculated. Should it be the value of the gas as produced "at the wellhead" or the value of gas in general at a downstream location, in this case the outlet of a processing plant? In Texas the court would focus on the express terms of the oil and gas lease and find that the proper location is "at the wellhead."322 The analysis in Oklahoma apparently323 requires the court to find that the gas, at the point of valuation,

320. This language is taken from a lease form "Prepared by Oklahoma Mineral Owners Association" for use "primarily from the perspective of the landowner." FORMS MANUAL, supra note 153, at 17, ¶ 2, and at 19, Note 1 (emphasis added).

321. The difference between the $2.00 wellhead value and the $4.00 downstream, processed value, can be attributed to a number of factors. First, the gas has been subjected to a substantial capital investment in processing equipment to provide the facilities necessary to separate and then fractionate the natural gas liquids. Second, the gas has been combined with larger volumes of gas for marketing (aggregated value) and the party selling the gas has most likely provided new "obligation value" to the gas in the form of a promise to have, for example, a certain volume of gas available for sale at certain times (packaged value). Third, the gas has been moved to a downstream marketing point that reflects the value of the commodity at a more centralized location following the additional capital investment to gather, compress, and treat the gas to get it to the point of sale at the processing plant. Fourth, new risk has been incurred by the producer to engage in the gathering, processing, and contracting to try and create new value for the gas beyond the point where it is produced at the wellhead. See Royalty Value Theorem, supra note 97, at 154, nn. 5-7.

322. E.g., Judice v. Mewbourne Oil Co., 939 S.W.2d 133, 135 (Tex. 1996) (lease requiring royalty based on "the market value at the well" is not ambiguous and "means value at the well ....").

323. I qualify this statement with the word "apparently" because in the relevant cases, the issues were presented to the court as whether certain costs can be deducted to calculate royalty. E.g., Mitelstaedt, 954 P.2d at 1204-05 (Okl. 1998) (certified question inquired
was a "marketable product."324 Therefore, the first critical issue will be whether gas produced from John's land was a "marketable product" when produced "at the well." If it was, the next issue will be determining the value of this "marketable product" at the location where produced, and presumably in the condition and volumes produced. Often resolving the first issue eliminates the need to consider the second issue.325

Each party will therefore focus on evidence as to whether the gas at issue is a "marketable product" as produced "at the well." Although it appears the "marketable product" analysis has been grafted onto the oil and gas lease as a matter of law,326 the "marketable product" analysis is being conducted, ostensibly, to determine the meaning of the lease contract.327 As noted previously, usage evidence can play an important role in this area.328

The sort of usage evidence a lessor may want to offer concerns the practice of lessees dictating the terms of oil and gas leases. To the extent the oil and gas lease can be portrayed as an adhesion contract, the lessor may be able to convince a court to apply favorable rules of construction, such as interpreting the lease strictly against the lessee and in favor of the lessor.329 However, if the jurisdiction has already made such a finding in

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324. The precise ruling in Mittelstaedt states: [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. Mittelstaedt, 954 P.2d at 1210 (emphasis added).

325. The parties may be able to stipulate to the value of gas at the wellhead, with the only issue being whether it is a "marketable product" at the wellhead.

326. It appears the "marketable product" analysis is the result of asking the wrong question. Instead of ascertaining the "market value" at the well, courts, counsel, and commentators have posed the issue as whether costs can be deducted from downstream values to calculate royalty. This prompted courts to consider the issue as "what must the lessee do to prepare the gas for market" as opposed to ascertaining the value of the gas stream at a particular location. Royalty Value Theorem, supra note 97, at 151, 155-62 (§ 6.02. Are Courts Addressing the Right Question?).

327. At least this is the case in states that treat the implied covenant to market as a covenant implied "in fact" as opposed to implied "in law." Jurisprudential Underpinnings, supra note 154, at 10-16 to 10-20 and 10-23 to 10-28 (comparing implied in law approach of the Colorado Supreme Court in Rogers v. Westerman Farm Co., 29 P.3d 887 (Colo. 2001) with the implied in fact approach of the Kansas Supreme Court in Smith v. Amoco Prod. Co., 31 P.3d 255 (Kan. 2001) and the Oklahoma Supreme Court in Mittelstaedt, 954 P.2d 1203).

328. See supra text accompanying notes 150-82; 197-209.

329. In a case applying an early version of the marketable product analysis the Kansas Supreme Court stated:
prior cases by anecdote or argument, the lessor may not want to address the issue as a matter of fact, because the facts may not be in accordance with the anecdotal presumption.

For the lessee, in every case they will want to determine whether the facts support such an anecdotal presumption. This can be done by fashioning a study that examines the actual oil and gas leases, and related documents and circumstances, to answer the question: are they the product of an adhesion contract in which the terms were dictated by the lessee? Although these facts will not answer what the market value of the gas is at the wellhead, it will be “relevant” in combating anecdotal rules of construction that can impact the inquiry. Because the study will be performed by a person qualified to testify as an expert, the primary concern will be “reliability.”

The underlying reliability issue is the “so what” analysis. If the study is conducted, will an analysis of the results yield information that logically supports the expert’s opinion? For example, if the expert examines the oil and gas leases at issue and finds that the lease forms had been altered by changing the primary term from 10 years to 2 years, and the royalty fraction from 1/8th to 3/16ths, does this provide reliable information from which the expert can conclude the leases were the product of negotiation? If a study of all leases in the county reveals that multiple oil

Gilmore v. Superior Oil Co., 388 P.2d 602, 605 (Kan. 1964). More recently, the Colorado Supreme Court uses the same justification to apply a particularly harsh version of the marketable product rule stating:

Finally, in interpreting leases like those in this case, we are mindful of the generally accepted rule that oil and gas leases are strictly construed against the lessee in favor of the lessor. . . . This rule is generally based on the recognition that the bargaining power between a lessor and lessee is similar to that historically found between an insurance company and its customers. . . .

Thus, the parties are in similar unequal positions. For example, lessors are not usually familiar with the law related to oil and gas leases, while lessees, through experience drafting and litigating leases, generally are.

Rogers, 29 P.3d ay 901-02.

330. See supra text accompanying notes 112-123.

331. This would particularly be a concern when the lessor is a class representative because it is highly unlikely that the level of knowledge and experience among class members, and the details of how each lease was negotiated, will be the same. If the class representative is a sophisticated lessor that actually negotiated the lease, their position may harm other members of the class lacking sophistication. If the class representative is not sophisticated, applying their situation to all class members will be unfair to the defendant in those situations where there are lessors with a high level of sophistication, or who relied upon counsel or other knowledgeable people to negotiate the lease.

332. Or any other anecdotal information that may be adverse to the lessee’s position.

333. See supra text accompanying notes 112-123.

334. See supra text accompanying notes 300-318.

335. This is perhaps some of the best objective evidence that negotiation of some sort took place. Often there will be a mix of leases where some lessors gave a lease providing for a 1/8th royalty and 10-year primary term while other lessors obtained considerably
companies were competing for leases at the same time, does this tend to
dispel the notion of an adhesion contract?336 What if certain mineral
owners in the area refused to lease their land?337 Sometimes lease altera­
tions in an area may reveal a pattern of changes that can be attributed to
a particular attorney representing landowners in the area. In the hands of
a qualified expert this information can be used to arrive at real, as op­
posed to assumed or anecdotal, conclusions regarding how the leases
were assembled.

Once the parties have explored the collateral issues, the governing is­

tue remains: is the gas a "marketable product" as produced at the well?
As with the adhesion contract issue, the goal is to identify relevant facts
that address whether the gas is a "marketable product" at the well, and if
not, at what point in the downstream marketing chain does it become a
"marketable product." One obvious approach to this issue is to fashion a
study that examines the actual gas marketing patterns in the area. The
relevant information would be evidence of gas sales from the lease at
issue and the surrounding area. This would also be supplemented with
evidence of the regulatory environment that may have caused marketing
patterns to shift from time-to-time. Changes in ownership of gathering
systems and processing plants could also affect marketing patterns. The
facts would be collected from various contracts supplemented with expert
knowledge of the relevant regulatory regimes.

To the extent the study reflects past or present marketing of gas at the
wellhead, the lessor will be forced to pursue a "legal" as opposed to a
"factual" definition of "marketable product." This was done successfully
in Rogers v. Western Farm Co.,338 where the Colorado Supreme Court,
following several anecdotal conclusions regarding lease relationships,339

better terms. This would tend to indicate that those lessors who sought a better deal re­
ceived it, and that those who didn't seek a better deal, received the offered deal.

336. The "adhesion" nature of the contract suggests there is no competition for a lease
on their land. However, just because a contract is labeled an "adhesion contract" does not
mean it is any less enforceable as written. Absent a finding of unconscionability, the con­
tract should be fully enforceable. See Jurisprudential Underpinnings, supra note 154, at 10­
6 to 10-9.

337. This goes to the heart of the adhesion contract assertion. It is actually the mineral
owner that has the take-it-or-leave-it power over lessees. As a general rule, a lessee must
obtain a lease from the mineral owner to develop their land. Therefore, it is the mineral
owner who, in the first instance, has the power to determine whether development will
take place—and who will conduct that development. I have observed previously:

Although the bargaining process has some of the elements of an adhesion
contract, 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. At some point in time there will likely be multiple develop­
ers 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 absolutely no obligation to lease, (2) waiting to
lease generally favors the lessor, and (3) as the speculative value of the land
increases, the landowner's bargaining power increases.

Jurisprudential Underpinnings, supra note 154, at 10-8.

338. Rogers, 29 P.3d 887.

339. Id. at 901-02. See supra text accompanying notes 112-123.
held: “Gas is marketable when it is in the physical condition such that it is acceptable to be bought and sold in a commercial marketplace,340 and in the location of a commercial marketplace, such that it is commercially saleable in the oil and gas marketplace.”341 Because the Acme Oil/John Landowner dispute is governed by Oklahoma law, a detailed factual inquiry into the first location where gas can be sold following extraction would be relevant to determining its marketability.

The lessor’s goal in these cases will be to steer the court away from the language of the lease and focus on general concepts of “marketable product”—a term not to be found in any oil and gas lease. The lessee’s goal will be to keep the court focused on the underlying task: what does the oil and gas lease mean? The lessee will pose the question as whether the lease suggests that gas is a marketable product when extracted. This is where usage evidence can play a major role. For example, the lessee may be able to present usage evidence that oil and gas leases used in the area, at the time the lease at issue was granted, routinely provided for a determination of royalty at the time and place where the gas is extracted from the ground. The usage is represented by express language used in hundreds of oil and gas leases that provide for a royalty based upon the value of gas “at the well” when it is produced. The final step is to connect the usage to the lease at issue. This is typically done with the expert witness comparing the usage lease language with the lease at issue.

This comparative technique for presenting usage evidence in contract cases allows the expert witness to compare the contract at issue with what is commonly encountered in the industry. The technique is illustrated by the court in Nordell International Resources, LTD v. Triton Indonesia, Inc.,342 where the witness noted: “Under the typical Joint Operating Agreement in the oil and gas industry, the operator has the right to receive payment in advance of each non-operator’s share of the costs upon demand, but the operator itself does not have to make the payments until the bills come due.”343 This establishes the expert’s understanding of how advance payment requests are administered under common forms of operating agreements that employ language similar to the contract at issue. The expert’s knowledge and study of existing operating agreements provides the baseline for concluding they take a consistent approach to a problem and represent an industry “usage;” the way things are done in

340. If you stop with this requirement, you have a basic factual inquiry regarding marketable product. This first step comprises the basic marketable product analysis used by the Supreme Courts of Kansas and Oklahoma. Sternberger v. Marathon Oil Co., 894 P.2d 788, 799 (Kan. 1995) (“Contrary to SKROA’s argument, however, there is no evidence in this case that the gas produced by Marathon was not marketable at the mouth of the well other than the lack of a purchaser at that location.”); Mittelstaedt, 954 P.2d at 1206 (“Making the gas available to market at the leased premises means that the lessee must produce the gas in a marketable form at the leased premises.”).
341. Rogers, 29 P.3d at 906.
343. Id. at *3. The non-operator argued the operator violated their agreement by failing to “issue cash calls to itself.”
the industry concerning advance payments by non-operators to operators. The expert then makes the connection with the contract at issue by indicating the interpretation offered by the party sponsoring the expert, in this case Triton, is consistent with industry usage.344 In Nordell, the court concluded: “The custom and practice in the oil and gas industry was consistent with Triton’s understanding of the contract.”345

When the case is tried to a jury, the process is completed with a jury instruction regarding the usage. For example, in E.P. Operating Co. v. Sonora Exploration Corp.,346 the court reviews the following instruction:

If you find that a custom or usage existed in the oil and gas industry that where a party places its gas in the transmission pipeline owned by another, that the party placing the gas in the pipeline agrees to pay for its transmission, then that custom and usage may be considered in determining the contractual intent of the parties.347

The jury will then determine, as a matter of fact, whether such a usage exists and if so, its impact on the issues it must decide.

VII. A PRINCIPLED ANALYSIS FOR EVALUATING USAGE EVIDENCE

Custom and usage jurisprudence is difficult to apply because there are many steps in analyzing usage evidence that can be manipulated to support a desired outcome. Courts often treat the subject similar to a group of canons of construction where they select canons that support its interpretation while ignoring those that do not fit the desired interpretation.348 The goal of this section is to provide a principled analysis, based upon the “law of usage,” that courts can employ to evaluate usage evidence. The first task is to address substantive exclusionary principles, such as the parol evidence rule.

A. KEEP THE PAROL EVIDENCE RULE IN ITS PROPER CONTEXT

When presented with usage evidence, courts should first consider the purpose for which the evidence is being offered. If offered to identify terms of the contract not referenced in the parties’ written agreement, limitations imposed by the parol evidence rule will need to be considered.349 However, the parol evidence rule should impose no limitation if the usage evidence is being offered to define the meaning of the written

344. Depending on the position of the party, evidence may be offered to show that a proffered interpretation is inconsistent with industry usage.
345. Id.
346. 862 S.W.2d 149 (Tex. App.—Houston [1st Dist.] 1993, writ denied).
347. Id. at 153.
349. This does not necessarily mean the evidence will be excluded; it means the court must consider whether the writing is integrated, and if so whether it is a full or partial integration. Next, the court must determine whether the evidence is, nevertheless, admissible in light of the full or partial integration. See supra text accompanying notes 25-44.
agreement. When usage is properly viewed as part of the written agreement itself, the parol evidence rule is not implicated. This means the usage, being a component of the writing, can be established through extrinsic evidence without running afoul of the parol evidence rule.

For example, assume a contract provides that party A will sell all its "equipment" on a lease to party B, and the issue is whether the term "equipment" includes a pipeline on the lease owned by party A. Party A seeks to offer testimony that in the oil and gas industry the use of the term "equipment" would not include the pipeline. Party B asserts that the offered evidence violates the parol evidence rule because it seeks to add the following new terms to the fully integrated written agreement: "not including pipelines." Party A will respond that nothing is being added because the term "equipment," when properly defined, means "not including pipelines." The "writing" contains the word "equipment" and the evidence is being offered to determine what the writing means. The party did not go outside of the written agreement to find the term "equipment" so the parol evidence rule is not triggered.

Surrounding circumstances evidence would be subject to a similar analysis. Relevant evidence of the situation of the parties and the state of the world at the time the written agreement was entered into provides a context for interpreting the writing. For example, building on the "equipment" example, party A may be able to show that when A acquired its leasehold interest, the pipeline had been installed and owned by a third party, and treated as an investment separate from the "equipment" on the lease. Party B may be able to show that the pipeline was installed by the original lessee, and transferred to successive lessees as part of the leasehold rights. In addition to this context evidence, Party B may be able to prove that all lessees in this area routinely install and operate a "pipeline" as part of their individual leasehold development. This evi-

351. In Jeanes v. Henderson, 703 F.2d 855 (5th Cir. 1983), the court, applying Texas law, considers a similar issue:

Jeanes argued that the phrase "equipment costs on each well sufficient to attach the same into existing lines" found in the 1971 contract supplied him with this interest in the pipelines. Henderson disagreed and offered an expert's testimony on the meaning of the term "equipment" in the oil and gas industry. The expert testified that equipment means casing, tubing, wellhead equipment, and gathering lines, but not the major transporting lines. The court admitted this testimony over Jeanes' objection and the jury found that the 1971 contract did not provide Jeanes with an ownership interest in the new pipeline.

Id. at 861. Noting the district court has "wide discretion to admit or exclude expert testimony" the Court of Appeals affirms finding no abuse of discretion. Id. at 861-62.
352. For example, in Intratex Gas Co. v. Puckett, 886 S.W.2d 274 (Tex. App.—El Paso 1994, no writ), the lessee offered the expert testimony of Dr. Diana Olien, "an oil and gas industry historian," focusing on the situation immediately before enactment of the Natural Gas Policy Act of 1978. She testified: "that during the years surrounding this contract's execution, the energy industry anticipated federal regulation of the intrastate gas market." Id. at 278. This and other expert testimony focused on the meaning of an area rate clause in the parties' gas purchase contract.
dence could also establish a usage in the area that a sale of lease "equipment" includes this sort of pipeline.  

Recognized exceptions to the parol evidence rule will allow usage evidence to establish even the terms of the contract. For example, if the issue concerns whether a contract was formed, the parol evidence rule does not apply. One of the basic requirements of contract formation is an agreement that is definite enough for a court to enforce. In *Lynx Exploration and Production Co. v. 4-Sight Operating Co.*, the parties entered into a letter agreement conditioned upon Lynx's acceptance of a purchase agreement that would contain a list of items typically addressed in a purchase and sale of oil and gas properties. The parties never came to an agreement on many of the listed items but Lynx contended an enforceable agreement nevertheless existed between the parties. Lynx presented usage evidence that the "supplemental terms were consistent with the standards of the oil and gas industry at the time and place in question . . . " Although this was accurate, it did not solve the basic problem of determining the specific content of the terms necessary to make the contract definite enough to enforce.

353. Some courts carve out types of parol evidence when describing admissible surrounding circumstances evidence. For example, in *KMI Cont'l Offshore Prod. Co. v. ACF Petroleum Co.*, 746 S.W.2d 238 (Tex. App.—Houston [1st Dist.] 1987, writ denied), the court states the rule as follows:

Evidence of the circumstances surrounding the execution of the contract should be considered, but the circumstances are merely an aid in the construction of the contract's language. Moreover, the circumstances to be considered are not the parties' statements of what they intended the contract to mean, but circumstances known to the parties at the time they entered into the contract, such as what the industry considered to be the norm or reasonable and prudent.

*Id.* at 241 (emphasis added).

354. *Restatement (Second) of Contracts* § 214(d) (1981) ("Agreements and negotiations prior to or contemporaneous with the adoption of a writing are admissible in evidence to establish . . . (d) illegality, fraud, duress, mistake, lack of consideration, or other invalidating cause . . . .")


356. 891 S.W.2d 785 (Tex. App.—Texarkana 1995, writ denied).

357. Among the listed items to agree upon were:

1. Performance deposit ($150,000.00) to be delivered to mutually agreeable escrow agent upon complete execution of Purchase and Sale Agreement),
2. Title, including acceptance of form and terms of existing contractual agreements relating to the properties,
3. Liabilities and responsibilities associated with or arising from ownership and/or operations prior to closing date,
4. Environmental conditions,
5. Designation of successor operator,
6. Over/under produced gas wells,
7. Inspection of the properties and verification of price, quality and quantity of production; and
8. Accounting matters.

*Id.* at 788.

358. *Id.* at 789.

359. *Id.* ("[Lynx] never offered any summary judgment proof showing a usage of the terms in the oil and gas industry that would make the terms specific enough for the court to enforce.").
In *Peoples Ice & Fuel Co. v. Dickey Oil Co.*, the usage evidence provided the certainty necessary to support a binding agreement. The oil and gas lessee argued that its gas sales agreement with the gas purchaser was too indefinite to enforce because the purchaser did not commit to take a specified quantity of gas. The lessee's main complaint was that the purchaser acquired the exclusive right to purchase the lessee's gas without committing to buy a specified quantity. The purchaser submitted usage evidence which established its practice of purchasing from several lessees in the area and then prorating the gas it took from each based upon the production capacity of each lease and the status of the gas as casinghead or dry. The court expressly found that the parties contracted with knowledge of this usage, which adequately defined the volumes the purchaser was obligated to take. Whether a letter of intent can constitute an offer creating a power of acceptance was answered with usage evidence in *Drilling Well Control, Inc. v. Smith Industries, Inc.*, where the court relies upon "custom and usage in the oil field fabricating business" that "a 'letter of intent' such as the June 7, 1965 letter, is construed as a firm order and contract if accepted."364

In most cases the parol evidence rule should not be an impediment to considering usage evidence. This means that usage evidence will be filtered applying relevancy and reliability standards, instead of substantive parol evidence limitations. However, courts sometimes employ usage-specific rules to limit the impact of usage evidence, often reaching back into the history of "custom" to thwart modern-day usages.

B. AVOID HISTORICAL "CUSTOM" ANALYSES WHEN EVALUATING "USAGE" EVIDENCE

When a court is not inclined to recognize a usage, it may attempt to bolster its position by applying a more rigorous historical "custom" analysis instead of a modern usage analysis. For example, in *Grube v. Donnell Exploration Co.*, the court upheld the trial court's exclusion of offered usage evidence regarding whether a driller must give notice when

361. *Id.* at 320.
362. *Id.* at 328. This provided the required certainty regarding the purchaser's obligations and also avoided the lessee's mutuality argument. The trial court found that the purchaser engaged in the following usages:

- In this case . . . the petition alleged and the proof showed that certain customs and usages prevailed in the McPherson field. Starting with the proposition that plaintiff or its predecessors had furnished the only market for gas in the field, it was shown . . . that what may be called a standard form of contract was used; that the price for gas was the same in all instances; that when gas was purchased the leasehold was the unit and not the individual wells thereon; that negotiations were orally concluded and subsequently confirmed by written agreement.

*Id.* at 326.
363. 459 S.W.2d 462 (Tex. Civ. App.—Houston [1st Dist.] 1970, writ ref'd n.r.e.).
364. *Id.* at 464.
365. *Grube*, 286 S.W.2d 179.
it shifts from a footage charge to day work compensation. The court rejected the usage evidence listing several requirements associated with “custom” evidence, to include that the custom was not: (1) “established for a sufficient length of time to have become generally known;” (2) “certain and uniform;” (3) “notorious;” and (4) “known to the parties to the contract, or that the parties contracted with reference to it.” Under a modern usage analysis, there is no minimum length of time the usage must exist, nor must it be “certain and uniform” or “notorious,” and a party can be subject to a usage which they should have known about under the facts.

Usage evidence should be tested applying the same requirements imposed on other types of evidence, without resorting to maxims that create additional hurdles to admissibility. This forces the parties, judges, and juries to consider, weigh, and evaluate the evidence and accept or reject the usage based upon the evidence presented. When historical “custom” concepts creep into the analysis, they corrupt the analysis by preventing the trier of fact from considering relevant facts.

C. Usage is a Factual Inquiry Undertaken on a Case-by-Case Basis

There is no “precedent” that establishes a usage in one case that will necessarily be applicable to another case. As noted previously, “usage” is an issue of fact, to be established as a fact, in each case. Similarly, the function of usage evidence is to provide context to interpret a particular agreement, between specific parties. From the evidence presented, the court will determine whether a usage exists and its content. For example, in Phillips Petroleum Co. v. Buster, the lessor

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366. Id. at 180.
367. Id. at 181.
368. See supra text accompanying notes 6-18.
369. The evidence must be “relevant” and “reliable.” See supra text accompanying notes 282-318.
370. Courts should not impose any sort of heightened evidentiary standard to establish a usage. Among the special requirements imposed on a party trying to establish a traditional “custom” was that the “requisites of a good custom must all be established by evidence which is clear and convincing.” Jarecki Mfg. Co. v. Merriam, 180 P. 224, 225 (Kan. 1919). As the court explains, a mere preponderance of the evidence will not be enough: The very nature of the subject is such it is not enough that the evidence on the side of the existence of the custom merely preponderate—merely overbalance in some degree the weight of evidence on the other side. It must be of such cogency as to satisfy the mind and generate full belief.

Id. This special evidentiary requirement, along with the other custom maxims, perhaps played a legitimate role when “custom” was equated with “law.” See supra text accompanying note 7. Today, usage is a matter of “fact” not “law.”
371. See supra text accompanying notes 19-20.
372. Restatement (Second) of Contracts § 222(2) (1981) (“The existence and scope of a usage of trade are to be determined as questions of fact.”); U.C.C. § 1-205(2) (1977) (“The existence and scope of such a usage [of trade] are to be proved as facts.”); U.C.C. § 1-303(c) (2003) (“The existence and scope of such a usage [of trade] must be proved as facts.”).
373. 241 F.2d 178 (10th Cir. 1957).
sought to establish a usage obligating lessee's to sell gas to farmers for so long as the farmer operates an irrigation well. Evaluating the evidence, the court concluded that there was no usage to furnish gas and that the practice was to enter into negotiated agreements when the lessee elected to sell irrigation gas.\textsuperscript{374}

Frequently the evidence offered to establish the usage will, when put in proper context, negate the usage it purports to recognize. In \textit{Texas Gas Exploration Corp. v. Broughton Offshore Ltd. II},\textsuperscript{375} the trial court refused to instruct the jury on a trade usage Texas Gas sought to establish regarding drilling contracts. Upholding the trial judge's ruling, the court focused on evidence offered through Texas Gas' expert that belied the existence of the usage.\textsuperscript{376} Although the court in \textit{Texas Gas} was poised to rely upon an overly-broad application of the parol evidence rule\textsuperscript{377} and custom-era maxims\textsuperscript{378} to affirm the trial court, it instead evaluated the evidence offered and found it lacking.

Establishing a usage as a matter of fact in each case is not only an obligation, but also a sort of "right" to not be subjected to usages that have not been so established. Counsel must be prepared to identify situations where a court has, perhaps inadvertently, elevated a usage to "law" status.\textsuperscript{379} The proper response to such situations is to focus on the "law of usage" which requires that a usage be established as a matter of fact in any case where it is offered to interpret an agreement.\textsuperscript{380} This will also be the major deterrent to usage by argument or anecdote.\textsuperscript{381}

D. Usage Has a Temporal Context

The temporal context of usage evidence highlights its interpretive function. The interpretive goal is to ascertain the intent of the parties—at the time they entered into their agreement. Therefore, the relevant usages

\textsuperscript{374} \textit{Id.} at 184-85.
\textsuperscript{375} \textit{Id.} at 790 S.W.2d 781 (Tex. App.—Houston [14th Dist.] 1990, no writ).
\textsuperscript{376} \textit{Id.} at 786 ("Its own expert testified on direct examination that it was not customary for an operator to change rigs during the drilling of a well, and that it had not occurred in his experience.").
\textsuperscript{377} \textit{Id.} at 785 ("Custom and usage of trade are not relevant where the contract language is, like the language before this court, clear and unambiguous.").
\textsuperscript{378} \textit{Id.} ("[T]here must be evidence that the custom was generally known, or had been established for a sufficient length of time to become generally known, and that it was known to all parties to the contract or that the parties had contracted with reference to it.").
\textsuperscript{379} \textit{See supra} text accompanying notes 267-280.
\textsuperscript{380} This also means that most usage issues will not be resolved through summary judgment. For example, in \textit{Carter Baron Drilling v. Badger Oil Corp.}, 581 F. Supp. 592 (D. Colo. 1984), the court found that usage evidence can be considered to interpret a drilling contract. However, each side presented affidavits which asserted a usage that supported their conflicting interpretations of the drilling contract. After finding a plausible basis for each assertion, the court denied summary judgment stating: "Summary judgment should not be awarded when an issue turns on credibility." \textit{Id.} at 600. \textit{See also} First Nat'l Bank of Jackson v. Pursue Energy Corp., 784 F.2d 659, 664 (5th Cir. 1986) (denying summary judgment to consider the "practice of the industry regarding the proper payment of royalties" on sulphur recovered after processing natural gas).
\textsuperscript{381} \textit{See supra} text accompanying notes 94-123.
will be those at the time the contract was entered into, not when the dispute arises. The temporal context also identifies the relevant parties to the contract as being those parties at the time the contract was made. Because leasehold interests are frequently assigned, and mineral interest ownership will change by conveyance and succession, the parties at the time of the dispute will frequently be different from those at the time the contract was made.

For example, in Garman v. Conoco, Inc., the ownership of the overriding royalty at the time of the dispute was Conoco, James Garman, Robert Garman, and Mark Garman. However, at the time the assignment creating the overriding royalty was entered into, the parties were Monarch Oil & Uranium Co., the lessee/assignor that created the overriding royalty, and Lee A. Adams, the assignee of the lease burdened by the overriding royalty. Conoco obtained Adams' interest in a subsequent assignment. Therefore, the appropriate temporal surrounding circumstances would be those that existed at the time the contract was entered into; in this case when Monarch assigned its interest to Adams.

In addition to defining the appropriate time-frame, the rights of the Garmans and Conoco are defined by the rights their assignors had in the property: Monarch, as the predecessor in interest to the Garmans, and Adams as Conoco's predecessor in interest. In addition to focusing on usages and circumstances as of the date of the original assignment, the "parties," for purposes of applying usage rules, are the assignor oil company, Monarch, and an individual assignee, Lee Adams. This is absolutely critical to evaluating usage issues because the court evaluated Conoco's usage argument by considering the industry knowledge of Conoco and the Garmans. Instead of inquiring about the industry knowledge of the Garmans, the court should have focused on the industry

383. Id. at 655, n.5.
384. Monarch had obtained its leasehold interest from M.B. and B.K. Garman who obtained eight oil and gas leases from the federal government covering 10,742 acres. Id. at 654-55 n.5.
385. Id. at 655.
386. The court really does not "evaluate" anything, but instead, relies upon anecdotal statements to resolve usage arguments against Conoco. See supra text accompanying notes 112-123.
387. The court stated:
We find Conoco's argument that industry practice allows proportionate allocation of post-production costs unpersuasive. Before one can be bound by industry custom "he must know of it or it must be so universal and well-established that he is presumed to have knowledge of its existence."... Further, the parties must have contracted with reference to the custom.... Custom and industry practice may be an appropriate consideration when Conoco deals with other oil exploration companies.... Often, however, executing an oil and gas lease, or assigning a federal lease won under the previously existing federal lottery system is the extent of a party's contact with the oil industry.... Conoco cannot invoke industry custom to limit the rights of royalty and overriding royalty owners unsophisticated in the intricacies of mineral development.

Garman, 886 P.2d at 660.
knowledge of the Garmans' predecessor in interest: Monarch Oil and Uranium Co. It was the Monarch "oil" company that created the over­ riding royalty.388 Therefore, Monarch apparently was a member of the industry and would have been subject to its usages at the time the over­ riding royalty was created.389

The importance of the temporal context of usage evidence is the focus of the court’s review in Energen Resources MAQ, Inc. v. Dalbosco,390 where the court identified the issue by stating:

Energen contends that the trial court should not have submitted a jury question on custom and usage in the industry requiring notice before plugging and abandoning the McDuffie well because there was no evidence presented at trial of such a custom and usage in the industry in 1981. Jury question number one asked the following:

Did the custom and usage in the oil and gas industry in 1981 impose a contractual duty on Defendant to provide notice to Don Dalbosco of its intent to abandon and plug the McDuffie No. 1 well before the expiration of the McDuffie lease?

The jury answered, “Yes.” Energen objected to the submission of this question on the ground that there was no evidence to support the issue.391

Energen was not challenging the sufficiency of the evidence regarding the usage, instead it argued that Dalbosco failed to establish the usage existed in 1981.392 In response, the court carefully combed the usage evidence offered at trial and held there was evidence from which the jury could reasonably infer the usage was in existence in 1981.393 Any party offering usage evidence should avoid this problem by clearly establishing the temporal context of their usage at trial.

Surrounding circumstances evidence also has a temporal reference.

388. The facts indicate the Garmans obtained their overriding royalty interest before Conoco even had an interest in the property. Id. at 662 (Erickson, J., specially concurring) (“An assignment of an overriding royalty interest was made to the Garmans prior to the time Conoco obtained its working interest.”).

389. It is doubtful the court really wanted to know about the parties or their usages. The phrasing of the certified question assumes a generic legal answer is possible: “Under Colorado law, is the owner of an overriding royalty interest in gas production required to bear a proportionate share of post-production costs, such as processing, transportation, and compression, when the assignment creating the overriding royalty interest is silent as to how post-production costs are to be borne?” Id. at 653. The court provides a generic answer without interpreting the contract that would otherwise define each party’s rights. None of the justices consider the issue presented by the express terms of the overriding royalty assignment: does the amount paid equal, or exceed, the “market price for . . . gas prevailing in the field where produced . . . .” Id. at 664 (Erickson, J., specially concurring) (quoting language of the assignment). Therefore, the issue is not the deduction of costs, but rather ascertaining the “market price” for gas in the “field where produced.” Once this number is known, it can be compared to what was paid to ascertain if the contract has been breached. See Royalty Value Theorem, supra note 97, at 155-62.


391. Id. at 554 (emphasis added).

392. Id.

393. Id. at 554-56.
For example, in *Piney Woods Country Life School v. Shell Oil Co.*, the court considered the state of the law at the time Shell entered into oil and gas leases providing for a "market value" royalty. The historical context of the transaction should always be established. For example, the existence, or non-existence, of commentary, problems, cases, statutes, regulations, other agreements, and theories can all have an impact on why the parties pursued a particular course of action. To accurately portray the situation of the parties, counsel must set the stage as it was when the agreement at issue was created.

When considering usage evidence, or evidence of surrounding circumstances, judges, counsel, and witnesses must be careful to place themselves in the proper time-frame to ensure the evidence is relevant to the matters at issue. Equally important, the proper parties must be identified to ensure issues regarding industry knowledge are evaluated focusing on the correct parties.

E. THE KNOWLEDGE REQUIREMENT—FACT NOT FICTION

Courts frequently comment on whether a party to an agreement had knowledge of a usage sought to be employed to interpret or supplement their agreement. This appears to be a sort of "swing" issue which courts either scrutinize or ignore depending upon whether the usage evidence supports the court's resolution of the dispute. Regardless of the court's approach, the issue is often resolved by anecdotal judicial conclusions instead of fact.

The substantive knowledge requirement is stated by the *Restatement (Second) of Contracts* as whether the parties "knew or had reason to know of the usage . . . ." The party seeking to rely upon a usage has

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394. 726 F.2d 225 (5th Cir. 1984).
395. The court noted:
   Moreover, Shell and those from whom it received leases by assignment were
   or should have been aware that "market value" had been held to mean value
   at the time of production both in old cases like *Wall* and in new cases like
   *Foster* and *Vela*. *Foster* was decided in 1964. *Vela* was decided by the Texas
   Court of Civil Appeals in 1966 and affirmed by the Texas Supreme Court in
   1968. From the record it appears that no lease at issue here predates *Foster*
   and only a few predate *Vela*. Though not binding on Mississippi lessees,
   these decisions were widely discussed in the industry and *should have*
   alerted the lessees to the potential legal effect of the royalty clause. Shell certainly
   had ample opportunity to change the language if in fact it intended a "pro-
   ceeds" lease.

Id. at 235 (emphasis added). Apparently no evidence was offered at trial regarding what "Shell" knew about the law at the time it entered into the leases. However, this is certainly something that could be pursued at trial—by both parties—without leaving it to argument, anecdote, and resulting judicial whim.

396. *E.g., Garman*, 886 P.2d at 660 ("Conoco cannot invoke industry custom to limit the rights of royalty and overriding royalty owners unsophisticated in the intricacies of mineral development.").

397. Frequently the anecdotal conclusion may be inconsistent with the facts. *See, e.g., supra* text accompanying notes 381-388.

the burden of proving the other party's knowledge. The Restatement divides usage into two categories: usage “Relevant to Interpretation” and usage “Supplementing an Agreement.” Comment a to section 221 explains the separate section on “Supplementing an Agreement” as follows:

This Section extends the same principle [stated in section 220] to cases where the parties did not advert to the problem with which the usage deals, or where one or each separately foresaw the problem but failed to manifest any intention with respect to it. In such cases, in the absence of usage, the court would supply a reasonable term . . . . But, if there is a reasonable usage which supplies an omitted term and the parties know or have reason to know of the usage, it is a surer guide than the court's own judgment of what is reasonable.

The Restatement, and the U.C.C., each provide a special rule for “usage of trade” by imputing knowledge to all parties who are engaged in the relevant trade. Therefore, a party to an agreement will have “knowledge” of a usage of trade if they have actual knowledge of the usage, under the circumstances they should of had knowledge of the usage, or they are engaged in the trade. When evaluating a party's knowledge, their use of a knowledgeable agent, such as an oil and gas attorney, can also be considered.

The knowledge requirement is addressed by the court in Jeanes v. Henderson where one of the parties, Jeanes, objected to the admission of expert testimony offered by Henderson concerning “the meaning of the term ‘equipment’ in the oil and gas industry.” Jeanes argued the testimony was inadmissible “because both parties to the contract were not members of the oil and gas industry.” In distinguishing a case put forth by Jeanes, the court stated:

399. “Hence a party who asserts a meaning based on usage must show either that the other party knew of the usage or that the other party had reason to know of it.” Id. at cmt. b.
402. RESTATEMENT (SECOND) OF CONTRACTS § 221 cmt. a (1981). The Restatement also provides:

The more general and well-established a usage is, the stronger is the inference that a party knew or had reason to know of it. Similarly, the fact that a usage is reasonable may tend to show that the parties contracted with reference to it or that a particular party knew or had reason to know of it.

Id. at cmt. b.
403. RESTATEMENT (SECOND) OF CONTRACTS § 222(3) (1981); U.C.C. §1-205(3) (1977); U.C.C. § 1-303(d) (2003).
404. Id.
406. Jeanes, 703 F.2d 855.
407. Id. at 861.
408. Id.
It held only that evidence of trade usage is inadmissible when neither party to the contract was a member of the trade. At the same time, the court recognized cases allowing evidence of trade usage in which the party claiming the benefit of the usage was a member of the trade. Here, Henderson was actively involved in the oil and gas industry. Although the court does not discuss how the usage became binding on Jeanes, it must be on the basis that Jeanes, by participating in the oil and gas trade, became subject to its usages.

The knowledge issue is another area frequently dominated by anecdote instead of fact. The court in Piney Woods Country Life School v. Shell Oil Co. used the lessee's industry status to impose a heightened level of knowledge regarding the meaning of "market value," while refusing to impute any knowledge of the industry on the royalty owner. In each situation the conclusion is based upon argument or anecdote, not fact. If the lessee desires to attack the court's assumptions, or the lessor desires to ensure they are not revised, it should be done through the presentation of fact at trial.

410. Jeanes, 703 F.2d at 861.
411. Jeanes invested money with Henderson to finance Henderson's development of oil and gas leases. In return, Jeanes was assigned a working interest in several wells. Id. at 856-57.
412. RESTATEMENT (SECOND) OF CONTRACTS § 222(3) (1981) ("Unless otherwise agreed, a usage of trade in the vocation or trade in which the parties are engaged or a usage of trade of which they know or have reason to know gives meaning to or supplements or qualifies their agreement.") (emphasis added). See supra text accompanying notes 13-20.
413. Piney Woods, 726 F.2d 225.
414. Id. at 236.
415. For example, the court noted: "Shell asserts that 'royalty payments based upon good faith contract prices have always been the custom in Mississippi.'" Id. at 236 (emphasis added). Shell's argument apparently was not supported by usage evidence entered at trial. The court also states: "This allegation of 'custom' is of course self-serving." Id. (emphasis added). The court replies to Shell's custom-by-argument with its own custom-by-anecdote: "The payment of royalties is controlled by lessees, and lessors have no ready means of ascertaining current market value other than to take the lessees' word for it." Id.
416. Regarding the lessee's knowledge, the court stated:

   But our decision that market value means value rather than proceeds is not simply an instance of interpretation against the lessee. It is rather a holding that, although the royalty clauses might have been less than lucid to laymen, they were quite readily understandable to those in the industry. Shell knew what a "market value" lease was and what a "proceeds" lease was.

Id. Regarding the lessor's lack of knowledge the court states:

   For a practice to be legally relevant custom, both parties to the contract must have actual or presumed knowledge of the practice. Those not engaged in an industry will not be presumed to know that words which have common meanings outside the industry have a different meaning inside it. Market value in these leases is most easily understood to mean current value; the lessors cannot be presumed to know that Shell and other producers made a practice of basing their royalty payments on a different criterion. We will not find "custom" binding on lessors from a practice within the control and understanding only of the lessees.

Id. This apparently creates the baseline rule the lessee must overcome, by offering, if available, facts to the contrary.
If the court finds that the usage should apply, they typically give the knowledge issue little attention in their opinion. Contrast, for example, the Piney Woods analysis with the court's approach in Wolfe v. Texas Co.,\(^{417}\) where a usage between lessees and oil purchasers is held to be binding on a lessor. The court first described the usage by stating:

The proof established and the trial court found there was a well-defined usage generally adopted by those engaged in the business of producing, marketing or purchasing crude petroleum oil in Oklahoma, giving the producer of oil under a lease, where the lessor fails either to provide storage for the royalty oil or to sell the same, authority as agent of the lessor, to sell the royalty oil along with the working interest oil, at the posted price and on the customary terms, and giving the purchaser, where the title of the lessor is not merchantable, the right to withhold payment without liability for interest until an abstract has been furnished showing merchantable title in the lessor and a division order has been executed and delivered by the lessor.\(^{418}\)

The issue was whether the oil purchaser was obligated to pay interest on money held in suspense for five years pending the outcome of litigation over the lessor's title. After describing the usage, the court noted the following rule: "Parties to a contract are presumed to know a well-defined trade usage generally adopted by those engaged in the business to which the contract relates."\(^{419}\) However, at no place in the opinion did the court attempt to ascertain whether the lessor had any knowledge, actual or presumed, of the usages practiced by its lessee in dealing with oil purchasers. The court instead relied upon two alternative theories to support its holding: first, the lessee was acting as the lessor's agent with authority to dispose of the lessor's oil on terms consistent with the usage; or second, the lessee had implied contractual authority to dispose of the lessor's oil "on the customary terms . . . ."\(^{420}\) Although the agency theory may avoid having to evaluate the lessor's knowledge regarding the usage,\(^{421}\) the implied contract theory would require the court to evaluate whether the lessor fell within the rule that: "Persons, who enter into a contract in the ordinary course of business, unless the terms of the contract indicate a contrary intention, are presumed to have incorporated therein any applicable, existing general trade usage relating to such business."\(^{422}\) The court did not engage in this analysis; instead the usage was applied without inquiry into whether the lessor "knew or had reason to know of the usage . . . ."\(^{423}\)

\(^{417}\) 83 F.2d 425 (10th Cir. 1936).
\(^{418}\) Id. at 429.
\(^{419}\) Id.
\(^{420}\) Id. at 430.
\(^{421}\) The issue being whether the lessee's agreement to such terms was within the scope of its authority.
\(^{422}\) Wolfe, 83 F.2d at 429.
\(^{423}\) Restatement (Second) of Contracts § 220(1) (1981).
Although the jurisprudence on this issue may at times reflect more of an exercise in judicial equity instead of principled analysis, litigants must always be prepared to address whether the relevant party “knew or had reason to know of the usage.” In the oil and gas lease setting the issue will typically be whether the “lessor” was aware of the usage. Actual knowledge will often be difficult to establish since oil and gas leases may have been entered into decades past with the original parties long since dead or defunct. Therefore, in most cases the focus will not be on what the lessor actually knew, a subjective inquiry, but rather on what they “had reason to know,” an objective inquiry; or whether the facts indicate they were “engaged” in the oil and gas industry.

When determining whether both parties must be aware of a usage, the function of the usage must be identified. For example, if the usage is being offered to interpret the basic rights and obligations of the parties to a contract, courts will evaluate the situation to determine if knowledge of the usage should be imputed to all parties. However, once the basic contours of the contract are defined, if the usage is offered to define a party’s performance under the contract, the usage is being offered to establish the baseline for conduct regardless of either party’s knowledge of the usage. Although it may be difficult to conceptually distinguish interpretation, which establishes the obligation from performance that discharges the obligation, in practice courts have been able to make the distinction.

For example, if the usage evidence is offered to show compliance with a specific requirement or standard, the focus will not be on any particular party’s knowledge of the usage. This was the case in Nygaard v. Continental Resources, Inc., where the lessee sought to exercise an option to extend an oil and gas lease using a sight draft. The critical option date was January 4, 1998; the lessee sent the lessor a “five-day sight draft” on December 12, 1997. The lessor delayed responding until January 8 when the lessor’s attorney asserted the option had lapsed stating: “The sight draft is unacceptable as it does not represent payment.” The requirement or standard at issue in Nygaard was established by the court’s adoption of Restatement (Second) of Contracts section 249 that states:

Where the payment or offer of payment of money is made a condition of an obligor’s duty, payment or offer of payment in any manner current in the ordinary course of business satisfies the requirement unless the obligee demands payment in legal tender and gives any extension of time reasonably necessary to procure it.

424. “Awareness” here means that the usage will be imputed to both parties because: (1) they are a member of the trade, and it is a trade usage; (2) they have actual knowledge of the usage; or (3) under the facts, they should have been aware of the usage. See supra text accompanying notes 397-403.
425. 598 N.W.2d 851 (N.D. 1999).
426. Id. at 852.
427. Id.
428. Id. at 853 (emphasis added).
Since the lease did not expressly require payment in legal tender, the court focused on whether sight drafts are used "in the ordinary course of business . . ." The court did not have to address the knowledge of the parties because the lessor, in its court briefs, acknowledged that "sight drafts are commonly used in the oil and gas leasing business in North Dakota."\footnote{Id. at 854.} In this situation, it should not matter whether either party is a member of the "trade" or has notice of the "usage." Instead, the court is looking for facts that trigger the application of an established principle. If they exist, the principle will apply; if they do not exist, it will not apply.

In \textit{United States v. Stanolind Crude Oil Purchasing Co.},\footnote{113 F.2d 194 (10th Cir. 1940).} the crude oil purchaser's use of division orders requiring a 3\% deduction of oil volumes for dirt, sediment, and transportation losses, was established as a usage of trade.\footnote{The division orders provided:

Third: The Stanolind Crude Oil Purchasing Company shall deduct three percent from all oil received from wells into the pipe lines for its account on account of dirt and sediment, and, in addition, shall deduct one-twentieth of one percent, for each degree of heat above normal temperature, and oil shall be steamed when necessary to render it merchantable.

\textit{Id.} at 197.} The court relied upon this usage evidence to refute the government's fraud claim that the division orders misrepresented the facts because the oil in fact did not contain 3\% dirt and sediment.\footnote{Id.} The court recognized that a trade usage existed in the area for purchasers to use a flat 3\% deduction to cover impurities and shrinkage or loss that might occur during transportation.\footnote{The court relied upon several treatises and agency findings to conclude:

In the marketing of crude oil, it is the practice to run the production from the well into settling tanks and permit the heavier ingredients, constituting impurities, to settle to the bottom. The part that is not thus settled off is run into the pipe line. This practice removes a part, but not all, of the impurities and pipe line losses, provision is made in the division orders for deduction of a stipulated percentage. This practice or usage of deducting three percent on account of dirt and sediment and transportation losses had its inception in Pennsylvania. During the time that oil has been produced in Oklahoma and in its neighboring state of Kansas, it has been the uniform practice and usage to incorporate in division orders a provision for the deduction of three per cent of the oil received into the pipe lines on account of dirt and sediment. This deduction is to cover not only impurities in the oil, but also shrinkage or loss during transportation. Like deductions are made in other areas.

\textit{Id.} at 199 (footnotes omitted).} The division order did not make any sort of representations, it merely reflected the formula purchasers use to account for impurities and transportation losses.\footnote{\textit{Id.} at 200-01.}

Usage evidence has also been admitted to establish that a party was familiar with the terms commonly used for a particular transaction. For example, in \textit{Kinkead v. Western Atlas Int'l, Inc.},\footnote{Kinkead, 894 P.2d 1123.} the issue was whether a "service order" signed by Kinkead at the drillsite created a contract
which included a "hold harmless" clause on the back of the form.436 Upholding the hold harmless provision, the court relied upon evidence that "it was customary and common usage in the industry that the risk of loss or damage to certain property for services performed by a wireline service company is typically borne by the customer . . . ." 437 In this situation, the evidence is not being used to establish the terms,438 or to interpret them, but rather that such terms are commonly encountered and would not be unexpected by someone in Kinkead's position.

When usage evidence is offered to establish the general industry backdrop under which the parties dealt,439 or the manner in which an industry participant typically responds to a situation, there appears to be no knowledge requirement. With regard to the meaning of a technical term, the knowledge requirement appears to be quite limited. For example, the Restatement (Second) of Contracts instructs that "technical terms and word of art" are to be "given their technical meaning" if they are being used "in a transaction within their technical field." 440 Once it is established that the term was used in an industry transaction, then technical meaning will be ascribed to a technical term. This appears to coincide with the Restatement's "Usage of Trade" provisions which imputes the requisite knowledge when "the parties are engaged" in the trade.441 This is just one example of the special treatment accorded usage evidence regarding technical terms.

F. Usage Has a Special Role Regarding Technical Terms

Technical terms and terms of art are treated as a special form of usage, apparently with a less demanding knowledge requirement by parties to contracts employing such terms.442 Section 202 of Restatement (Second) of Contracts, under the heading "Rules in Aid of Interpretation," provides:

(3) Unless a different intention is manifested,
   (a) where language has a generally prevailing meaning, it is inter-
       preted in accordance with that meaning;

436. The drill string became stuck while Kinkead was drilling a well. Kinkead hired Western to address the problem and in the process the drill string parted and fell within the casing. Although Western was hired orally, Kinkead subsequently signed Western's service order that contained a hold harmless clause absolving Western from any liability for its own negligence. Kinkead argued the exculpatory provisions were not explicit enough and Kinkead had not read the back of the form where the clause was located. Id.

437. Id. at 1127.
438. However, the court stated "that such custom is implied in the oral contract" but the express language was also contained in the "service order" the court describes as "a formalization of the prior [oral] agreement." Id.
439. This would include evidence to establish the "surrounding circumstances."

442. The primary requirement seems to be that the technical meaning will apply "when used in a transaction within their technical field." See infra text accompanying notes 439-440.
(b) technical terms and words of art are given their technical meaning when used in a transaction within their technical field.443 Many states have general statutory provisions that adopt a similar rule of interpretation.444 The oil and gas industry is replete with its own unique terminology with meanings foreign to "generally prevailing meaning."445 For example, the clause in an operating agreement authorizing recovery of multiples of a non-consenting party's share of development costs446 is typically described as a non-consent "penalty." This common usage of the term has been seized upon to try and characterize the clause as an unenforceable "penalty" instead of an enforceable liquidated damages provision.447 The court in Nearburg v. Yates Petroleum Corp.448 observed:

We note preliminarily that, although we follow custom by referring to the operating agreement provisions at issue as a "penalty," they do not meet the definition of a penalty as set forth in the Restatement and Corbin on Contracts. . . . The parties to the operating agreement are not obligated to participate in all proposed operations, and a non-consent election cannot convincingly be characterized as a breach. . . . Therefore, we do not regard the non-consent penalty provision as involving liquidated damages or an unenforceable penalty.449

The context of the term "penalty," regarding operating agreements in the oil and gas industry, describes a contractual obligation that is unrelated to the legal context of an unenforceable penalty associated with the enforcement of a liquidated damages clause.

The interpretation of technical terms is viewed as an independent basis for considering usage evidence. In Musser Davis Land Co. v. Union Pacific Res.,450 the court interpreted the granting clause of an oil and gas lease to determine if seismic operations are encompassed by the term "exploration."451 The court noted that "the usages, words of art, and

444. E.g., La. Civ. Code Ann. art. 2047 (West 1987) ("Words of art and technical terms must be given their technical meaning when the contract involves a technical matter."); Okla. Stat. Ann. tit. 15, § 160 (West 1993) ("The words of a contract are to be understood in their ordinary and popular sense, rather than according to their strict legal meaning, unless used by the parties in a technical sense, or unless a special meaning is given to them by usage, in which case the latter must be followed.").
445. The industry's unique terminology is part of the "surrounding circumstances" courts should consider when interpreting agreements. See supra text accompanying notes 81-91.
446. E.g., A.A.P.L. Form 610-1989 Model Form Operating Agreement, Article VI, § B.2.(b), p. 7, lines 7-26. This form is reproduced in Forms Manual, supra note 153, at 121-42.
447. See Hamilton v. Texas Oil & Gas Corp., 648 S.W.2d 316, 321 (Tex. App.—El Paso 1982, writ ref'd n.r.e.) (rejecting the penalty argument, but evaluating the clause as an enforceable liquidated damages clause).
449. Id. at 565-66.
450. 201 F.3d 561 (5th Cir. 2000).
451. Id. at 565.
technical terms of the oil and gas industry should be taken into consideration in interpreting the lease exploration clause." The court then proceeded to examine several oil and gas law treatises to support its holding that seismic operations are included in the grant to engage in "exploration" of the leased land.

Even technical terms used by an industry may be used in different technical contexts. For example, in *McAffee v. City of Garnett*, the technical term was contained in a gas contract where the seller agreed to deliver to the buyer "gas of merchantable quality." The buyer contended the seller had to add an odorant to the gas before delivery for the gas to be "gas of merchantable quality." The seller contended "gas of merchantable quality" referred only to the quality and heating value of the gas. The court found: "that the test of 'gas of merchantable quality' in this case must be determined within the context of its meaning, use and acceptance in the natural gas trade or business." It then proceeded to examine evidence from "Mr. Hofsess, a graduate engineer with long experience and now an executive of the defendant company," who testified as follows:

[I]t is and has always been the practice in the industry that odorization is the responsibility of the retail distributor; that interstate pipeline companies operating in Kansas have never odorized natural gas supplied to retail distributors for resale to consumers; that the provisions as to quality found in the City's contract are those contained in their Federal Power Commission Gas Tariff and are incorporated in every contract under which they company sells gas for resale.

The opposing expert did not refute Mr. Hofsess' testimony, but merely noted that introducing gas into a retail distribution system, without odorant, is unsafe and therefore would not be "merchantable." However, only Mr. Hofsess' testimony addressed "who" had the obligation to add the odorant so the gas could be distributed to consumers. The court accepted Mr. Hofsess' usage testimony and concluded the gas, as tendered by the seller, was "of a merchantable quality" as the term was used in the contract.

The *McAffee* case highlights the use of expert witnesses to define tech-

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452. *Id.*
453. The court also relied upon a Texas case noting: "the opinion is instructive in the instant matter because it sheds light upon industry practice and custom." *Id.* at 567.
454. *Id.* at 565-66 ("Thus the industry usages and practices indicate that in Louisiana and elsewhere an exclusive right of exploration lease clause generally is understood to include the right to conduct seismic operations.").
456. *Id.* at 297.
457. *Id.* at 300.
458. *Id.*
459. *Id.* at 299.
460. *Id.* at 298.
461. *Id.* at 299.
462. *Id.* at 300.
technical terms. In *Phillips Oil Co. v. OKC Corp.*, the court noted: "What better way is there to discover the technical meaning than through the use of Federal Rule of Evidence 702." In *Phillips*, the court considered expert petroleum accounting testimony to interpret "net profits accounting provisions" in a farmout agreement. The court in *Sidwell Oil & Gas Co., Inc. v. Loyd*, considered the expert testimony of E. R. Sidwell regarding payment of delay rental on oil and gas leases in the Ness County area. The court found his "[t]wenty-five years in the oil business should be sufficient to qualify him to testify as to custom and usage of that business with regard to terminology and meaning of words used in written leases."

Regardless of how "expert" the expert is, their testimony must still be relevant and reliable, and the usage of the term at issue must be established, as fact, in each case. This becomes particularly important with regard to one of the most frequently cited oil and gas industry dictionaries: *Williams & Meyers Manual of Oil and Gas Terms*. The Manual is published as a separate paper-bound volume with the most current version maintained as Volume 8 to *Williams & Meyers on Oil and Gas Law*. It is, without a doubt, an excellent work and one that has been relied upon by lawyers and judges for years. For example, in *Sandefer Oil & Gas, Inc. v. Duohon*, the court, interpreting a "horizontal Pugh clause," uses the Manual to support its view of the applicable usage regarding the term "horizon." However, before relying upon the Manual as a source for defining industry terms, its limitations should be considered. As the authors of the Manual note in their Foreword: "a considerable number of oil and gas terms lack a standardized meaning: usage varies from place to place, or the same word conveys several meanings, not always consistent."

More important is an understanding about how many of the terms end up in the Manual. The process is best illustrated by the court’s opinion in

464. *Id.* at 281.
466. *Id.* at 1115.
467. *See supra* text accompanying notes 282-318.
468. *See supra* text accompanying notes 371-381.
470. 8 Patrick H. Martin & Bruce M. Kramer, *Williams & Meyers on Oil & Gas Law* (2002) [hereinafter *MARTIN & KRAMER*].
471. 961 F.2d 1207 (5th Cir. 1992).
472. *Id.* at 1211. The court concluded:

We agree with this definition [of the term horizon] which we find consistent with the usage of the term in the oil and gas industry. See *Williams & Meyers, Manual of Oil & Gas Terms*, 566 (1991) (defining horizon as "a zone of a particular formation ... of sufficient porosity and permeability to form a petroleum reservoir"). Thus, the horizontal lease boundary under the Lounsherry tract is 100 feet below the bottom of the Middle Missipp, at whatever depth it is found throughout the leased tract.

*Id.*

473. *MANUAL OF TERMS*, *supra* note 469, at v.
Defining the Role

Mescalero Energy, Inc. v. Underwriters Gen. Agency, Inc. In Mescalero, one expert relied upon a definition of the term "formation" found in the Manual. The insurance company sponsoring the Manual definition of "formation" objected to evidence being offered by the insured's expert. Ultimately, the court held that these are both forms of extrinsic evidence designed to define an industry term; one happens to come from a book, the other comes from the expert's understanding of the industry.

The expert for the insurance company sponsored the Manual definition of formation as "the one most generally accepted in the industry." However, cross-examination of the expert revealed the following:

Counsel: You gave a definition of formation in your affidavit, correct?
Riseden: Yes.
Counsel: Have you ever used that definition in defining formation before?
Riseden: No.

As the court noted: "Although Riseden [the insurer's expert] testified that Davenport's [the insured's expert] definition of a formation was not generally accepted and that Williams & Meyers' definition was the term's generally understood meaning, he conceded that he had never used the Williams & Meyers definition before his expert affidavit .... Riseden was a petroleum engineer. His first encounter with the Williams & Mey-

474. Mescalero, 56 S.W.3d 313.
475. Id. at 320.
476. The objection was the insured's expert's affidavit, containing an alternative definition of the term "formation," "should be excluded as impermissible parol evidence." Id. at 322.
477. The court noted: "The question for us is: 'Can a reasonable definition of an industry term be established through expert testimony?' We hold that it can." Id. at 323. The court also answered the more basic question of whether any extrinsic evidence, from a dictionary, expert, or otherwise, can be considered in this case. First, the court stated the maxim: "Courts may not look to extrinsic evidence to prove the existence of an ambiguity." Id. at 320. Second, it states:

Nevertheless, extrinsic evidence may "be admissible to give words of a contract a meaning consistent with that to which they are reasonably susceptible, i.e., to 'interpret' contractual terms." ... Texas courts often resort to the use of external reference such as dictionaries to determine an insurance policy term's plain, ordinary, and generally accepted meaning. ...

In particular, a specialized industry or trade term may require extrinsic evidence of the commonly understood meaning of the term within a particular industry ....

Id. This takes on even more importance when an insurance policy is involved; once an ambiguity is found to exist the interpretive maxim applies that requires a court to "construe the policy against the insurer when ambiguous policy terms permit more than one interpretation, especially when the policy terms exclude or limit coverage." Id. at 319. In this case the dispute is over a policy exclusion of blowout coverage that involves only a single formation as opposed to blowouts "between two or more separate formations ...."

Id. at 316. The insured argued the Austin Chalk constituted "two or more separate formations;" the insurer contended it was a single formation. Therefore, the dispute centered on what is a "formation." Id. at 316-17.
478. Id. at 318.
479. Id. at 321.
480. Id.
ers’ definition was likely when it was brought to his attention by counsel for the insurer.

What about the inherent authority of the definition itself? What weight does its presence in the Manual command? In Mescalero, the dispute focused on whether the “Austin Chalk” consisted of a single formation or multiple formations. The superficial appeal of the Manual’s definition of “formation” is obvious:

A succession of sedimentary beds that were deposited continuously and under the same general conditions. It may consist of one type of rock or of alternations of types. An individual bed or group of beds distinct in character from the rest of the formation and persisting over a large area is called a “member” of the formation. Formations are usually named for the town or area in which they were first recognized and described, often at a place where the formation outcrops. For example, the Austin Chalk formation outcrops at Austin, Texas.

The insurers tendered this as “the” definition for “formation” and noted the Texas Supreme Court, in another case, had quoted the definition in discussing the term “stratum.” The court found that the evidence presented by the insured established that the Manual’s definition was not the only reasonable definition and that the Texas Supreme Court had not “adopted” the definition “as the only and unambiguous meaning of the term [‘formation’].” At a more basic level, the court could have simply noted that establishing a usage is a matter of fact to be proven in each case. Therefore, the unique circumstances of this case will determine the appropriate usage by identifying and evaluating the pertinent facts. The use of a definition in another case, or the existence of a definition in the Manual, standing alone are of little substantive value. Their significance should be evaluated, as the Court of Appeals did in Mescalero, to ascertain their relevance to the matter currently at issue.

Whenever a party is faced with an unfavorable Manual definition, they should inquire about the inner workings of how something becomes

481. It is revealing that in another portion of the court’s opinion the court uses the Manual to define the word “kick” to distinguish it from a “blowout.” Id. at 316, n.4.
482. Mescalero, 56 S.W.3d at 315-16. The insurance policy being interpreted provided coverage for a blowout “between two or more separate formations” but not for a blowout within a single formation. The insured was drilling in the “Austin Chalk” at the time of the blowout. Id. at 316.
484. Mescalero, 56 S.W.3d at 318 (citing Amarillo Oil Co. v. Energy-Agri Prods., Inc., 794 S.W.2d 20, 23 n.3 (Tex. 1990)).
485. Mescalero, 56 S.W.3d at 322.
486. Id. at 323.
487. To include the usage of technical terms and terms of art.
488. See supra text accompanying notes 371-381.
489. Or you want to ascertain the relative strength of a favorable definition.
a definition in the Manual.\textsuperscript{490} Often the source of the definition is supplied by a court case. For example, the \textit{Mescalero} case itself is now the source of another definition of "formation" which reads: "a mappable, separate, self contained pressure unit within a geological interval."\textsuperscript{491} The 9th edition of the \textit{Manual} added the following definition of "formation:" "A mappable unit composed of the same kind of rock or a distinctive combination of rock types."\textsuperscript{492} Therefore, the presence of a definition in the \textit{Manual} may mean nothing more than it was mentioned in a court opinion, or a government document or other commentary, and selected by the editors for inclusion in the \textit{Manual}. This offers little insight into ascertaining the intent of the parties to a particular agreement under a particular set of circumstances. In most situations the parties to the agreement at issue will be unaware of the \textit{Manual}; it will usually be the counsel involved, after a dispute has arisen, who first discover the \textit{Manual} definitions. Although the \textit{Manual} may provide some evidence of a term's usage, it will merely be a preliminary step in establishing the usage as a matter of fact.

G. JURISPRUDENTIAL CHOICES EXCLUDING USAGE EVIDENCE SHOULD BE CAREFULLY IDENTIFIED

Often it is difficult to distinguish an anecdotal conclusion from a decision. Perhaps the best test is to simply ask: did the court arrive at a conclusion relying upon some assumed state of affairs or did it simply make a decision on how the world ought to be? Appellate courts are in the business of deciding how the world ought to be, but more often they are trying to ascertain, under a given set of facts, how a situation fits within the world as previously defined. The amorphous jurisprudential line between property law and contract law\textsuperscript{493} offers an analytical reference for when courts may be inclined to favor generic decisions over individualized conclusions. Although property law, like contract law, seeks to give effect to the intent of the parties, property law often has competing public inter-

\textsuperscript{490} One approach would be to obtain the testimony of the persons who compile and maintain the \textit{Manual}; currently they are Professors Bruce M. Kramer and Patrick H. Martin.

\textsuperscript{491} \textit{Mescalero}, 56 S.W.3d at 318. \textit{Martin \& Kramer, supra note 470, at 412.1 to 412.2 adding discussion of the \textit{Mescalero} analysis to commentary under the term "formation".}

\textsuperscript{492} \textit{Howard R. Williams \& Charles J. Meyers, Manual of Oil and Gas Terms} 425 (9th ed. 1994). The indicated source of this definition is from an appendix to an offshore resource management program administered by a government agency.

\textsuperscript{493} For example, depending upon the state in which an oil and gas lease is taken it may be viewed as a conveyance or a contract. However, regardless of whether the oil and gas leasehold interest is a corporeal or incorporeal hereditament, courts purport to apply contract interpretation rules even though they all create interests affecting real property. \textit{E.g., McNally v. Guevara}, 989 S.W.2d 380, 387 (Tex. App.—Austin 1999, no pet.) ("These rules of deed interpretation are virtually identical to those for construing contracts. In fact, when reciting rules of construction relating to deed interpretation, courts often cite to contract cases.").
ests that sometimes elevate certainty and administration above individu­
ated intentions.

This property vs. contract policy is illustrated in the Colorado Supreme Court's decision in McCormick v. Union Pacific Res. Co.,494 where the court held that a deed reservation of "other minerals" reserves oil and gas.495 The decision drew a concurring opinion from Justice Rice chastising the court for its conclusion that:

Although the term "minerals" is not inherently unambiguous and extrinsic evidence may be required to ascertain the parties' intent in certain circumstances, our study of Colorado legal precedent, custom, and usage convinces us that Colorado adheres to the majority rule that deed reservation language reserving "other minerals" reserves oil and gas.496

In considering the effect of reservations in land grants to railroads, the court discussed commentary and factual evidence which tended to define conveyancing custom and usage.497 Justice Rice objected to consideration of such evidence stating:

Without regard to whether the language in the deed reservation in this case completely addresses whether oil and gas are included as minerals, the majority determines that the term minerals has a well-settled meaning that includes oil and gas. . . . In doing so, the majority relies on historical information concerning custom and usage to determine both the ambiguity of the term minerals and its meaning. Furthermore, by relying on such information to ascertain the meaning of the term minerals, the majority determines an issue of fact properly determined by a trial court. . . . Indeed, the custom and usage information relied upon by the majority is precisely the type of evidence the trial court barred by its grant of summary judgment. Thus, the majority opinion has the effect of denying the landowners the opportunity to present their evidence concerning custom and usage, while at the same time relying on its own descriptions of custom and usage.498

Justice Rice is essentially telling the court to make a decision, as a matter of law, that will apply regardless of the circumstances extrinsic to the deed language. It appears that is what the court in fact did,499 and the reference to commentators and usage were merely information used to bolster the court's decision.500

495. Id. at 348 ("We hold that Colorado adheres to the majority rule that the deed reservation language 'other minerals' reserves oil and gas.").
496. Id. at 349 (emphasis added).
497. Id. at 349-54. The court concluded: "Based on our study of Colorado precedent, custom, usage, and learned commentary thereon, we hold that a deed reservation for 'other minerals' reserves oil and gas." Id. at 354.
498. Id. at 355 (Rice, J., concurring) (emphasis added).
499. The court made it clear that "[i]n this case presents a legal question" which the court resolves as a matter of "property law." Id. at 354.
500. It also appears that the court's statement that "the term 'minerals' is not inherently unambiguous" is referencing minerals other than oil and gas. This is reflected in the court's
In defending against the offering of usage evidence, counsel should be attuned to whether the area has been, or should be, preempted by the court's property-based decisions. Usage evidence in such situations is not relevant because it would not establish a fact "that is of consequence to the determination of the action." If the matter has already been determined as a matter of property law, there will be no room for interpretation because the meaning has already been established by the court. The problem, however, is that such "property law" decisions are rarely clearly articulated; the McCormick decision is one of those rare exceptions. If courts are not willing to entertain the interpretation of documents, they should clearly state the policy basis for their decision and refuse to engage in construction games and evidentiary maneuvers to arrive at desired outcomes.

VIII. CONCLUSIONS

Usage evidence is often essential to the proper interpretation of agreements. Unfortunately, the interpretive process has been dominated more by maxims to support outcomes instead of principled analysis to ascertain meaning. This has resulted in case law that sometimes treats usage evidence restrictively as simply another form of "extrinsic" evidence. However, the modern trend, no doubt driven by the Restatement (Second) of Contracts and the U.C.C., is to recognize usages as an inherent part of agreements associated with an industry. Once this is done, the focus can be upon the quality of the evidence offered to establish and define a usage. Instead of the parol evidence rule, courts should be focusing on relevance and reliability to decide what the trier of fact can, and cannot, consider. Courts, and counsel, should be careful to ensure that usages are established as fact and not left to argument or anecdote. Trial counsel will need to identify the areas where usage evidence may be of assistance, and set about structuring a plan by which the facts can be ascertained, and if necessary, presented at trial. Failure to present relevant usage evidence can mean the difference between winning and losing a case.