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Phillip E. Norvell

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THE IMPLIED DUTY TO MARKET

Presented by: Phillip E. Norvell

Phillip E. Norvell is a Professor of Law at the University of Arkansas School of Law. (Property, Oil and Gas, Water Law). He received his B.A., J.D. from University of Oklahoma in 1973. He was a trial attorney for the Federal Trade Commission from 1973 to 1975, and has been a speaker at previous Arkansas Natural Resources Law Institutes, Institute on Oil and Gas Law Taxation, Southwestern Legal Foundation and Mississippi Law Institute on Oil and Gas Law. He is editor of Oil and Gas Reporter, and is a member of the Arkansas Oil and Gas Commission.

The Implied Duty to Market: "Damned If You Do and Damned If You Don't"

by

Professor Phillip E. Norvell

University of Arkansas School of Law (Fayetteville)

I. Problems Encountered in Marketing Gas

A. Failure to Market Due to Depressed Market Conditions

1. Producers without contracts have experienced low price offers or lack of market
2. Producers with contracts have encountered refusals to take or pay, or demands to market out or renegotiate contracts

B. Changing Structure of Gas Market

1. Rise of the "spot market" and casual sales of gas
2. Producer's access to pipelines to transport gas directly to distributors and end users

II. The Effect of Marketing on the Habendum Clause: Maintaining the Oil and Gas Lease during the Secondary Term

A. Marketing is required to satisfy the secondary term requirement of production in paying quantities, *Standolind Oil & Gas Co. v. Barnhill*, 107 S.W.2d 746 (Tex. Civ. App. 1937, error ref'd). See, generally, H. Williams & C. Meyers, *Oil & Gas Law* § 604.1 for a citation to the cases.

1. Constructive Production; Shut-in Gas Royalty

Shut-in gas royalty evolved in the 1930's to permit lessee to satisfy the secondary term requirement when no actual market existed for gas. Shut-in gas royalty is paid in lieu of royalty as "constructive production". Lowe, *Shut-In Royalty Payments*, 5 *Eastern Min. L. Inst.* § 18-02 (1984).

2. Maintaining the lease during the secondary term by shut-in gas royalty clause

- a. Shut-in well must be capable of producing gas in paying quantities, *Pray v. Premier Petroleum, Inc.*, 233 Kan. 351, 662 P.2d 255 (1983).

b. Failure to properly pay shut-in gas royalties

Traditional theory provided that if the shut-in gas royalty clause was drafted as a "special limitation", the failure to properly pay shut-in gas royalties during the secondary term results in lease termination. Also, if the shut-in gas royalty clause was drafted as an obligation, i.e., a covenant, failure to properly pay such payments only incurs liability for damages. See, E. Kuntz, *The Law of Oil and Gas*, 46.3 (1972). Contra, Lowe, *supra*, 18.03, 18.04.

B. Marketing is not required to satisfy the secondary term requirement of production in paying quantities: The implied covenant to market within a reasonable time. *McVicker v. Horn, Robinson & Nathan*, 322 P.2d 410 (Ok. 1958); See, also H. Williams & C. Meyers, *supra* § 604.1.

1. Lease does not terminate ipso facto, or by express terms, at the end of the primary term by the lessee's failure to market; and, the obligation to market is implied with the lessee having a reasonable time after discovery to comply with such covenant. *McVicker v. Horn, Robinson & Nathan*, Id.

- a. failure to exercise due diligence to market will result in lease termination, *Townsend v. Creekmore-Rooney Co.*, 358 P.2d 1103 (Ok. 1960).
- b. failure to market within a reasonable time, despite exercise of due diligence, results in lease termination, *McVicker v. Horn, Robinson & Nathan*, 322 P.2d 410 (Ok. 1958).
- c. exercising due diligence and marketing within reasonable time depends upon facts and circumstances of each case, Id. See also, *Gazin v. Pan American Petroleum Corporation*, 367 P.2d 1010 (Ok. 1961).

2. The effect of shut-in gas royalty on the implied covenant to market within a reasonable time

- a. The inclusion of a shut-in gas royalty clause does not displace the implied obligation to market within a reasonable time but constitutes an additional fact, i.e., the payment of consideration while gas is not being marketed, to be considered along with the other facts and circumstances to determine if the lessee has exercised due diligence in attempting to market or has marketed within a reasonable time. Thus, the payment of shut-in gas royalties decreases the likelihood of lease termination resulting from a breach of the implied obligation to market. E. Kuntz, *supra*, § 46.1.
- b. Failure to timely pay shut-in gas royalties pursuant to clause requiring such payment to maintain lease during secondary term in absence of production does not result in lease termination, *Gard v. Kaiser*, 582 P.2d 1311 (Ok. 1978).

C. Recent marketing problems raised by the shut-in-gas royalty clause

1. Failure to sale due to poor price

Shut-in gas royalty clause applicable only to absence of market;

- a. Literal interpretation of shut-in gas royalty clauses, *Freeman v. Magnolia Petroleum Co.*, 171 S.W.2d 339 (Tex. 1943).
- b. Absence of market shut-in gas royalty clause should be construed to confer discretion on lessee to determine whether given offer constitutes adequate "market", *Pierce, Lessor/Lessee Relations in a Turbulent Gas Market*, 38 Oil & Gas Inst. § 8.02 (Matthew Bender 1987).
- c. Risk of losing lease in a jurisdiction which requires actual marketing to satisfy the secondary term, *Pierce, supra*.

2. Maintaining a lease by shut-in gas royalty payments when price offered precludes production in paying quantities

Reasonable basis for future profitable operations based on expected changes in market conditions should be sufficient to satisfy shut-in gas royalty clause. See, e.g., *Barby v. Singer*, 648 P.2d 14 (Ok. 1982). Also, see *Pierce, supra*, 8.02.

III. The Implied Covenant to Market

A. The Prima Facie Case

1. Discovery of gas on the leased premises
2. Failure to market the discovered gas
3. Ability to market the hydrocarbons if the lessee had complied with the relevant standard of conduct
4. Damages proximately caused by the lessee's breach of the relevant standard of conduct

For citations to the cases enunciating the requirements for the prima facie case, see generally, *H. Williams & C. Meyers, Oil & Gas Law* § 855 et seq.

B. The identity of interest between lessor and lessee as to marketing

Typically the sale of gas encompasses the entire leasehold interest including the lessee's working interest and the royalty share. Thus, ordinarily the interests of the lessor and lessee will coincide; both desire the best sale available. See generally, *H. Williams & C. Meyers, supra* § 856.3 et seq.

C. The effect of Payment of Shut-In Gas Royalties on the Marketing Covenant.

Payment of shut-in gas royalties does not avoid lessee's obligation to market within a reasonable time, *Pray v. Premier Petroleum, Inc.*, 233 Kan. 351, 662 P.2d 255 (1983).

D. The Implied Covenant to Market in Action.

1. Failure to market at best price obtainable: *Piney Woods Country Life School v. Shell Oil Co.*, 539 F. Supp. 957 (S.D. Miss. 1982) aff'd in part, rev'd in part, and remanded, 726 F.2d 225 (5th Cir. 1984), reh. denied, 750 F.2d 69 (5th Cir. 1984), cert. denied, 471 U.S. 1005, 105 S.Ct.1868 (1985). But see, *Amoco Prod. Co. v. First Baptist Church*, 570 S.W.2d 280 (Tex. Civ. App. 1979) error ref'd n.r.e. 611 S.W.2d 610 (Tex. 1980).
2. Failure to diligently market gas: *Baby v. Cabot Corp.*, 550 F. Supp. 188 (W.D. Ok. 1981) (dilatoriness in renegotiating expired gas purchase contract).
3. Dedication of gas to pre-existing gas purchase contract providing for less than market value sale price and lacking annual redetermination clause, with lessee receiving collateral benefit for such dedication: *Amoco Prod. Co. v. First Baptist Church*, 570 S.W.2d 280 (Tex. Civ. App. 1979) error ref'd n.r.e. 611 S.W.2d 610 (Tex. 1980).
4. Sale to Wholly Owned Subsidiary at Below Market Price: *Parker v. TXO Production Corp.*, 716 S.W.2d 644 (Tex. App. - Corpus Christi 1986); *Texas Oil & Gas Corp. v. Hagen*, 683 S.W.2d 24 (Tex. App. -Texarkana 1984, writ granted).
5. Failure to Include a Price Redetermination Clause in Gas Sale Contract: *Davis v. CIG Exploration Inc.*, 789 F.2d 328 (5th Cir. Tex. 1986); *Piney Woods Country Life School v. Shell Oil Co.*, 539 F. Supp. 957 (S.D. Miss. 1982) aff'd in part, rev'd in part, and remanded, 726 F.2d 225 (5th Cir 1984), reh. denied, 750 F.2d 69 (5th Cir. 1984), cert. denied, 471 U.S. 1005, 105 S.Ct. 1868 (1985).
6. Failure to Market at Intrastate Rates: *Cabot Corp v. Brown*, 716 S.W.2d 656 (Tex. App. - Corpus Chriti 1986).
7. Failure to notify lessor prior to execution of oil and gas lease that gas will be sold at a set price pursuant to a previously negotiated gas purchase contract: *Diamond Shamrock Corp. v. Harris*, 284 Ark. 270, 681 S.W.2d 317 (1984).
8. Lessee's Duty to Assure Payment to Lessor: *Cook v. Tompkins*, 713 S.W.2d 417 (Tex. App. Eastland 1986)

D. The Search for the Proper Standard of Conduct: "Second Guessing the Lessee's Business Judgment"

1. The Prudent Operator Standard
2. Good Faith
3. The Fluctuating Standard

For a discussion of the cases and the commentator's views on the proper standard of conduct, see, Kramer & Pearson, The Implied Marketing Covenant in Oil and Gas Leases: Some Needed Changes for the 80's, 46 La. L. Rev. 787, 809 (1986).

Bibliography:

Kramer & Pearson, The Implied Marketing Covenant in Oil and Gas Leases: Some Needed Changes for the 80's, 46 La. L. Rev. 787 (1986); Martin, A Modern Look at Implied Covenants to Explore, Develop, and Market Under Mineral Leases, 37th Oil and Gas Inst. 177 (Matthew Bender 1986); Pierce, Lessee/Lessor Relation in a Turbulent Gas Market; 38th Oil & Gas Inst. § 8 (Matthew Bender 1987); Weaver, Implied Covenants in Oil and Gas Law Under Federal Energy Price Regulation, 34 Vand. L. Rev. 1473 (1981).