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THE IMPLIED DUTY TO MARKET

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

by

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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


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

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 § 604.1.

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;


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


The Implied Covenant to Market in Action.


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).


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).

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).