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Henry v. Ballard & Cordell, Corp.: Louisiana Chooses a Point in Time in the Market Value Gas Royalty Controversy

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HENRY v. BALLARD & CORDELL, CORP.
LOUISIANA CHOOSES A POINT IN TIME IN THE MARKET
VALUE GAS ROYALTY CONTROVERSY

Defendant, an oil and gas drilling company, executed mineral leases with four different parties between 1953 and 1961. Two of the leases based gas royalties on the "market value" of the gas at the well when the gas was "sold or used off the premises" and on the "amount realized" from the sale of the gas when the gas was "sold at the well." The other leases simply based gas royalties on the market value of the gas "sold or used by the lessee in operations not connected with the land." In 1961, defendant sold the gas to an interstate gas purchaser (American Louisiana Pipeline Company). It then paid the lessors royalties based on the price in this 1961 gas sales contract. In 1978, the lessors sued the lessee for outstanding royalties, claiming that they were owed the difference between the royalties they actually had been paid and the royalties based on the *current* market value of the gas. The trial court ruled in favor of the lessors, holding that the term "market value" in the gas royalty clauses meant current market value. The Louisiana Third Circuit Court of Appeal reversed.¹ The Louisiana Supreme Court affirmed and *held* that "market value" meant the price for which gas could be sold when it was first committed for sale to the purchaser. *Henry v. Ballard & Cordell Corp.*, 418 So. 2d 1334 (1982).

When parties base gas royalty payments on the "market value" of the gas, problems arise concerning *where* market value is to be determined,² *what* market is to determine the market value,³ *if there is* a market for the gas at all,⁴ and, if so, whether market value is

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1. 401 So. 2d 600 (La. App. 3d Cir. 1981).

2. See *Wall v. United Gas Pub. Serv. Co.*, 178 La. 908, 152 So. 561 (1934).

3. This includes the question of whether the federal ceiling price for natural gas should influence the determination of market value in a gas royalty clause. Before the Natural Gas Policy Act of 1978, 15 U.S.C. §§ 3301-3432 (Supp. II 1978), only interstate gas purchases were regulated. Some lessees sold gas to interstate gas purchasers and based royalty payments on the price received in such sales. Lessors claimed market value should be determined by the intrastate price. For decisions holding the federal ceiling price to be irrelevant, see *Mobil Oil Corp. v. Federal Power Comm'n*, 463 F.2d 256 (D.C. Cir. 1972); *Lightcap v. Mobil Oil Corp.*, 221 Kan. 448, 562 P.2d 1, *cert. denied*, 434 U.S. 876 (1977), *reh'g denied*, 440 U.S. 931 (1979). But see *Brent v. Natural Gas Pipeline Co.*, 457 F. Supp. 155 (N.D. Tex. 1978).

4. Harrell, *Recent Development in Nonregulatory Oil and Gas Law*, 31 INST. ON OIL & GAS L. & TAXN 327, 343 (1980). Professor Harrell argues that there is no

to be determined *before* or *after* the lessee has processed the gas and made it marketable.⁵

An additional problem concerns *when* market value is to be determined. This problem arises when a lessee commits the gas to a long-term gas sales contract and pays royalties to the lessor based upon the price received under such contract. Years later, the lessor files suit for overdue royalties claiming that the royalties paid to him have not been based on the *current* value of the gas. Succinctly stated the problem is whether the parties intended for royalty payments to be determined by the market value of the gas when the lessee committed it to the gas sales contract or the current market value computed on a daily basis as the gas is produced and delivered to the purchaser.

The meaning of the term "market value" has been the source of frequent litigation in numerous jurisdictions.⁶ The Texas position is best represented by the Texas Supreme Court's decision in *Texas Oil & Gas v. Vela*.⁷ In *Vela*, the lessee, in 1937, committed gas for purchase under a long-term gas sales contract. In the early 1960s, he was sued for outstanding royalties when the current market price began to far exceed the contract price. The Texas Supreme Court held that despite any good faith efforts of the lessee to prudently market the gas⁸ and any circumstances or conditions affecting the oil and gas industry at the time the lease was confected,⁹ there was no

market for gas in the traditional sense. Gas can be sold only if there is a purchaser near the well with enough money to spend to connect his lines to the well.

5. Compare *Coyle v. Louisiana Gas & Fuel Co.*, 175 La. 990, 144 So. 737 (1932) (lessee required to pay royalty on value of gasoline extracted from the gas produced, but lessor had to share extraction costs) with *McCoy v. United Gas Pub. Serv. Co.*, 57 F. Supp. 444 (W.D. La. 1932) (lessee required to pay royalty on value of raw gas, even though gasoline was later extracted).

6. See generally *Foster v. Atlantic Ref. Co.*, 329 F.2d 485 (5th Cir. 1964); *Lightcap v. Mobil Oil Corp.*, 221 Kan. 448, 562 P.2d 1, cert. denied, 434 U.S. 876 (1977), reh'g denied, 440 U.S. 931 (1979); *Tara Petroleum Corp. v. Hughey*, 630 P.2d 1269 (Okla. 1981); *Texas Oil & Gas Corp. v. Vela*, 429 S.W.2d 866 (Tex. 1968).

7. 429 S.W.2d 866 (Tex. 1968); see also *Lightcap v. Mobil Oil Corp.*, 221 Kan. 448, 562 P.2d 1, cert. denied, 434 U.S. 876 (1977), reh'g denied, 440 U.S. 931 (1979).

8. 429 S.W.2d at 870. The Texas court noted the uncontested nature of the trial court's determination that the lessee had marketed the gas in good faith. It is well established that the lessee has the duty to market any gas produced in paying quantities as a reasonably prudent operator. This includes the duty to market the gas promptly at arm's length for the best possible price once gas in paying quantities is discovered. See LA. MIN. CODE: LA. R.S. 31:122 (1974), comment; 5 H. WILLIAMS & C. MEYERS, OIL & GAS LAW § 853 (1982); Martin, *A Modern Look at Implied Covenants to Explore, Develop, and Market Under Mineral Leases*, 27 INST. ON OIL & GAS L. & TAX'N 177 (1976).

9. 429 S.W.2d at 870. The Texas court noted several circumstances and condi-

indication of any intent of the parties to tie the lessor's royalties to the gas sales contract price. The court found that the gas sales contract was completely separate from the lease and the intended meaning of the term "market value" was unaffected by such contract.¹⁰ The court noted that the parties knew how to base royalty payments on the gas sales contract price since the royalty for "casinghead gas"¹¹ was tied to the "proceeds received" from its sale and concluded that as this same method was not used to determine the royalty for gas well gas,¹² the parties must have intended for market value to mean something else. The court then held that the parties intended market value to mean the *current* price for which gas comparable in "time, quality and availability to marketing outlets" could be sold.¹³

The Oklahoma position is best set forth in the Oklahoma Supreme Court decision in *Tara Petroleum Corp. v. Hughey*.¹⁴ The lessee in *Tara* committed gas for purchase in the interstate market under a two-year gas sales contract. Shortly thereafter, the federal price ceiling for interstate gas sales was raised substantially. The lessor sued for outstanding royalties, claiming that he was owed royalties based on the difference between the federally determined ceiling price and the gas sales contract price.

The Oklahoma Supreme Court was unwilling to ignore both the lessee's implied obligation to prudently market the gas¹⁵ and the prac-

tions affecting the lessee's decision to market the gas. First, the bargain was struck with the only nearby gas purchaser. Second, the lessee had no choice but to sell the gas at the price the gas purchaser stipulated and on a "life of the lease" basis. Third, gas is not sold on a day-to-day basis; it can be marketed only under a long-term contract that fixes the price to be paid throughout its term.

10. The court stated:

[N]one of the royalty owners has ever agreed to accept royalties on the basis of the price stipulated in the contracts. The royalties to which they are entitled must be determined from the provisions of the oil and gas lease, which was executed prior to and is wholly independent of the gas sales contract.

429 S.W.2d at 870.

11. 429 S.W.2d at 871. Casinghead gas is "[g]as produced with oil in oil wells, the gas being taken from the well through the casinghead at the top of the well, as distinguished from gas produced from a gas well." 8 H. WILLIAMS & C. MEYERS, *supra* note 8, at 88.

12. "Gas well gas" is a term used to denote "gas produced other than in association with the production of oil from an oil well." 8 H. WILLIAMS & C. MEYERS, *supra* note 8, at 312. Gas well gas is gas extracted from a well that is mostly producing natural gas. It is handled and processed differently than casinghead gas.

13. 429 S.W.2d at 872.

14. 630 P.2d 1269 (Okla. 1981).

15. See note 8, *supra*.

ticalities of the oil and gas industry.¹⁶ It held that when the parties base gas royalties on market value and the lessee markets in good faith, market value is the price that the lessee receives in the gas purchase agreement. The court noted that a different result would be reached if the lessee did not prudently market the gas. Although the Oklahoma court sought an equitable result, the decision was based upon the court's opinion that parties to gas production contracts intend market value to be determined at the time the lessee fulfills his implied obligation to prudently market by committing the gas for purchase.

In the instant case, the Louisiana Supreme Court sided with the Oklahoma position. In a 4-3 decision, the court held that the parties intended for market value to be determined at the time the lessee fulfilled his implied obligation to prudently market the gas by committing it for purchase. To support this decision, Justice Blanche, writing for the majority, first discussed the practicalities of the oil and gas industry. He noted that the lessee's duty to market gas as a reasonably prudent operator is well-founded in Louisiana law.¹⁷ He observed that American Louisiana Pipeline Company was the only available purchaser of gas in the field where the lessor's property was located; therefore, the lessee had the choice of either selling the gas to American Louisiana or not selling it at all. He further found that the gas purchase agreement was negotiated in good faith and at arm's length, resulting in an agreement favorable to both the lessor and the lessee.¹⁸ Finally, he recognized the universal industry prac-

16. See note 9, *supra*.

17. 418 So. 2d at 1335. LA. MIN. CODE: LA. R.S. 31:122 (1974) provides:

A mineral lessee is not under a fiduciary obligation to his lessor, but he is bound to perform the contract in good faith and to develop and operate the property leased as a reasonably prudent operator for the mutual benefit of himself and his lessor. Parties may stipulate what shall constitute reasonably prudent conduct on the part of the lessee.

The comments to article 122 of the Mineral Code suggest that the basis of the article is Civil Code article 2710, which requires the lessee to "enjoy the thing leased as a good administrator."

The comments to article 122 recognize the lessee's obligation to act as a reasonably prudent operator in four ways, one of which includes the obligation to prudently market. For Louisiana cases discussing the obligation to prudently market, see *Risinger v. Arkansas-Louisiana Gas Co.*, 198 La. 101, 3 So. 2d 289 (1941); *Hutchinson v. Atlas Oil Co.*, 148 La. 540, 87 So. 265 (1921); *Waseco Chem. & Supply Co. v. Bayou State Oil Corp.*, 371 So. 2d 305 (La. App. 2d Cir.), *writ refused*, 374 So. 2d 656 (La. 1979); *Lelong v. Richardson*, 126 So. 2d 819 (La. App. 2d Cir. 1961).

18. 418 So. 2d at 1336. When the gas in question was marketed in 1961, a buyers' market existed because of the abundant supply of gas and its relatively stable price. *Ballard & Cordell* was given a "take it or leave it" offer by American Louisiana which

tice whereby gas purchasers demand long-term gas sales contracts and noted the substantial capital outlay needed for gas purchasers to build the necessary pipeline facilities to transport gas from wells to the main lines.¹⁹

After noting that the issue was *res nova* in Louisiana,²⁰ the *Henry* court examined the approach taken in other jurisdictions. The majority found the *Vela* decision unsatisfactory because the Texas Supreme Court refused to interpret market value in light of the economic necessities of the oil and gas industry.²¹ The court recognized three factors that should be considered in the interpretation of gas royalty provisions. First, a mineral lease that requires the lessee to pay the lessor a fractional royalty interest is an undertaking in the nature of a cooperative venture.²² The lessor supplies the land, and the lessee supplies the capital, machinery, skill, and manpower necessary to develop the property. The lessee therefore has an implied obligation to develop the property as a reasonably prudent operator for the benefit of both parties. Second, the objective of the royalty provision

required the lessee to construct a pipeline one mile to the north (off the premises) in order to connect to American Louisiana's lines. Still, Ballard & Cordell was able to negotiate an escalation clause. The contract was to last 20 years. American Louisiana was to pay 18.25 cents mcf for the first five years, 20.75 cents mcf for the second five years, 23.25 cents mcf for the third five years, and 25.75 cents mcf for the remaining five years. The evidence established that this contract was excellent at the time. See *Henry v. Ballard & Cordell Corp.*, 401 So. 2d 600 (La. App. 3d Cir. 1981).

19. 418 So. 2d at 1336. See Harrell, *supra* note 4, at 341; Holliman, *Exxon Corp. v. Middleton: Some Answers but Additional Confusion in the Volatile Area of Market Value Gas Royalty Litigation*, 13 ST. MARY'S L.J. 1, 72 (1981).

20. 418 So. 2d at 1335. In *Wall v. United Gas Pub. Serv. Co.*, 178 La. 908, 152 So. 561 (1934), the Louisiana Supreme Court defined market value as "the price actually given in current market dealings." However, this part of the *Wall* decision was dicta. The controversy in *Wall* concerned *where* market value was to be determined (off the premises or at the well), not *when*. All parties agreed that the current value should be paid. No Louisiana decision other than *Henry* has directly faced the issue of when market value is to be determined where long-term gas sales contracts are involved.

21. 418 So. 2d at 1337. See note 9, *supra*.

22. 418 So. 2d at 1338. See 5 H. WILLIAMS & C. MEYERS, *supra* note 8, § 802.1; Harrell, *Development in Nonregulatory Oil & Gas Law*, 30 INST. ON OIL & GAS L. & TAXN 311, 334 (1979). The mineral exploration undertaking is compared to the joint venture in a nontechnical sense. It is, however, an association of two or more parties for the single purpose of profiting from a single activity—mineral exploration. The above authors argue that the obligation of the lessee to prudently develop the leasehold arises from the implied expectations of the parties to this cooperative venture. *Contra* Martin, *supra* note 8, at 198, where the author argues that the reasonably prudent operator standard "grows out of an attempt on the part of the courts to promote . . . justice and fair dealing by requiring lessees to adhere to a particular norm of conduct."

is to fix a division of the minerals produced.²³ Oil usually is divided in kind,²⁴ and the lessor usually has the authority to dispose of the product as he wishes. However, the physical nature of gas dictates that it cannot be handled like oil; hence, the parties to a mineral lease usually contemplate that the lessee will dispose of the gas for the lessor.²⁵ The lessor is compensated by receiving a portion of the value of the gas produced. Third, at the time of confection of the *Henry* leases, gas could not be marketed prudently on a short-term basis. Such markets did not exist,²⁶ or the price obtained in them was lower than that obtained in the long-term market.²⁷

The majority noted with approval that the Oklahoma Supreme Court had interpreted the *Tara* gas royalty provision in light of industry circumstances and conditions.²⁸ The majority found "strong support" for this position in the Civil Code articles on contract interpretation.²⁹

23. 418 So. 2d at 1338. See 3 H. WILLIAMS & C. MEYERS, *supra* note 8, § 642; Harrell, *supra* note 22, at 334.

24. 418 So. 2d at 1338. See Harrell, *supra* note 22, at 335. In-kind royalty involves a division of the physical substance in proportion to each party's fractional interest.

25. 418 So. 2d at 1338. Gas is difficult to handle and transport, and few lessors have the expertise or resources necessary to market it. See 5 H. WILLIAMS & C. MEYERS, *supra* note 8, § 853; Harrell, *supra* note 22, at 335; see generally Holliman, *supra* note 19.

26. See note 9, *supra*. See also Harrell, *supra* note 22, at 335; Holliman, *supra* note 19, at 72.

27. 418 So. 2d at 1339. Understandably, if a gas purchaser is to suffer the expenses of constructing the pipeline facilities necessary to connect his main lines to the well, he should be willing to pay more for a long-term commitment at a stable price than for a short-term commitment.

28. *Id.* at 1339.

29. *Id.* at 1339 (citing LA. CIV. CODE arts. 1945-1962). Article 1945, which contains the basic rules for contract interpretation, provides:

Legal agreements having the effects of law upon the parties, none but the parties can abrogate or modify them. Upon this principle are established the following rules:

First—That no general or special legislative act can be so construed as to avoid or modify a legal contract previously made;

Second—That courts are bound to give legal effect to all such contracts according to the intent of all the parties;

Third—That the intent is to be determined by the words of the contract, when these are clear and explicit and lead to no absurd consequences;

Fourth—That it is the common intent of the parties—that is, the intention of all—that is to be sought for; if there was a difference in this intent, there was no common consent and, consequently, no contract.

The following rule is well established in Louisiana: Where a written agreement is unclear, ambiguous, or will lead to absurd or impossible consequences, the court should look beyond it to gather the true intent of the parties. See *Boisseu v. Vallon & Jordano*, 174 La. 492, 141 So. 38 (1932); *Bohm v. CIT Financial Servs.*, 348 So. 2d 132 (La. App. 1st Cir.), writ denied, 350 So. 2d 673 (1977).

According to article 1950,³⁰ a court should ascertain the common intent of the parties when anything is doubtful. The *Henry* majority considered the circumstances surrounding the parties at the time the contract was confected and concluded that in light of the lessee's well-known obligation to prudently market the gas, the need to market gas on a long-term basis, and the custom of the industry to calculate gas royalty payments on the amount received in the gas sales contract,³¹ the parties intended market value to be determined by the 1961 gas sales contract price.

As the courts search for the parties' intent, they should consider the circumstances and conditions affecting the parties at the time the contract was agreed to. See *Louisiana Power & Light Co. v. Town of Arcadia*, 119 F. Supp. 818 (W.D. La. 1954); *Cooley v. Meridian Lumber Co.*, 195 La. 631, 197 So. 255 (1940); *Andrews Coal Co. v. Board of Directors of Pub. Schools, Parish of Orleans*, 151 La. 695, 92 So. 303 (1922). The courts should construe ambiguous terms as the parties must have understood them. See *Salles v. Stafford; Derbes & Roy*, 173 La. 361, 137 So. 62 (1931).

30. LA. CIV. CODE art. 1950 provides: "When there is anything doubtful in agreements, we must endeavor to ascertain what was the common intention of the parties, rather than to adhere to the literal sense of the terms." See *Jacka v. Ouachita Parish School Bd.*, 249 La. 223, 186 So. 2d 571 (1966); *Herbert v. Valenti*, 235 So. 2d 193 (La. App. 4th Cir. 1970).

31. The Louisiana Supreme Court and the court of appeal both found that there is an industry practice whereby lessees base royalty payments on the price they receive in the gas sales contract. This is understandable because the best indication of market value is the gas sales contract price and the lessee would not want to pay the lessor's royalty based on a higher price than the lessee receives under the gas sales contract. 418 So. 2d at 1340. See *Harrell*, *supra* note 4; *Holliman*, *supra* note 19.

As authority for interpreting market value in light of industry "custom," the court cited Civil Code article 1964: "Equity, usage and law supply such incidents only as the parties may reasonably be supposed to have been silent upon from a knowledge that they would be supplied from one of these sources."

The court probably meant to refer to an industry "usage" instead of a "custom." A usage lacks an essential element of a custom—the *opinio juris*, or the psychological conviction in the community that the practice has legal sanction and binds the parties. Customs do not have to be proven or alleged by the parties to be binding; usages must be proven. Customs bind the parties unless the parties specifically derogate from them; usages bind the parties only if it is proven that both parties were aware or can at least be presumed to have been aware of them. See generally F. GENY, *METHOD OF INTERPRETATION AND SOURCES OF PRIVATE POSITIVE LAW* nos. 119 & 132 (2d ed. La. St. L. Inst. trans. 1963); *New Roads Oilmill & Mfg. Co. v. Kline, Wilson & Co.*, 154 F. 296 (5th Cir. 1907).

The court apparently used the term "custom" loosely to refer to the industry "usage" of basing gas royalty payments on the gas sales contract price. It is doubtful that this practice is so well established and widely recognized that it has achieved the status of a custom.

LA. CIV. CODE art. 1953 provides: "Whatever is ambiguous is determined according to the usage of the country where the contract is made." Article 1964 supplies incidents to a contract where the parties are silent. Article 1953 is a rule of contract interpretation which is to be used to construe ambiguous terms that the parties have

As noted by the Louisiana Supreme Court, *Vela* and its progeny have been criticized for their failure to recognize the nature of the mineral exploration undertaking; therefore, a closer look at that undertaking is necessary.³² The lessee's duty to prudently market the gas produced arises out of the cooperative nature of the parties' relationship. This obligation is well recognized by Louisiana law,³³ and as with the other implied obligations,³⁴ the lessee may be subject to cancellation of the lease or damages if he fails to fulfill it.³⁵

Two important aspects of the lessee's duty to prudently market the gas should be noted. First, when the parties base gas royalties on market value, they must have some market in mind. That market must be either fluctuous, as in a current market, or stable and determinable, as in a market existing at some definite point in time. The profits of the mineral exploration undertaking cannot be divided until the gas is sold; therefore, the parties probably intend for market value to be determined in the market in which the lessee fulfills the parties' expectations by selling the gas to their profit. This market is fixed in time when the lessee enters the gas purchase agreement pursuant to his obligation to prudently market the gas. Since this is the market most likely contemplated by the parties, the courts should base gas royalties on it unless a clear intent to do otherwise is expressed.³⁶

Second, part of the obligation to prudently market is the obligation to market *at the best possible price*.³⁷ Both parties intend for the

used. Although the court was not wrong in applying usage according to article 1964, article 1953 is additional codal authority for construing the term "market value" in light of industry usage. *See generally* Nordan-Lawton Oil & Gas Corp. of Tex. v. Miller, 272 F. Supp. 125 (W.D. La. 1967); Szush Mach. Works v. Shell Oil Co., 344 So. 2d 699 (La. App. 4th Cir. 1977); Fee v. Vancouver Plywood Co., 331 So. 2d 151 (La. App. 3d Cir. 1976); Terrell v. Alexandria Auto Co., 12 La. App. 625, 125 So. 757 (2d Cir. 1930).

32. See note 22, *supra*.

33. See note 17, *supra*.

34. See LA. MIN. CODE: LA. R.S. 31:122 (1974), comment.

35. *See generally id.*; see, e.g., Risinger v. Arkansas-Louisiana Gas Co., 198 La. 101, 3 So. 2d 289 (1941) (lack of available technology to separate salt water from gas at an economical price excused lessee from marketing gas); Hutchison v. Atlas Oil Co., 148 La. 540, 87 So. 265 (1921) (lease was cancelled because of lessee's failure to develop and market); Lelong v. Richardson, 126 So. 2d 819 (La. App. 2d Cir. 1961) (lack of available market excused lessee's failure to further develop and market, thereby defeating lessor's suit to cancel lease).

36. Fischl argues that as the gas sales contract is being "within the contemplation of the parties at the making of the lease [it] should be binding upon lessor when entered into by lessee in good faith." Fischl, *Ascertaining the Value or Price of Gas for Purposes of the Royalty Clause*, 21 OKLA. L. REV. 22, 31 (1968); see also Harrell, *supra* note 22, at 336.

37. M. MERRILL, COVENANTS IMPLIED IN OIL & GAS LEASES § 84 (2d ed. 1940 & Supp. 1964); see Roy v. Arkansas-Louisiana Gas Co., 200 La. 233, 7 So. 2d 895 (1942).

lessee to obtain the best possible price, and it is a breach of the implied obligation to market for the lessee to sell the gas at anything less. If the lessor did not intend to base his royalty on the market value represented by the gas sales contract price, he would not care about the price at which the gas was sold.³⁸ The lessor must have intended to base his royalty on the gas sales contract price if he also intended to impose upon the lessee the obligation to market at the best possible price. The reason for imposing this duty is to protect the lessor's interest in his royalty. Hence, unless a clear contrary intent is expressed, the lessor's royalty is entitled to no more protection than the lessee's good faith, arm's length bargaining for the best possible price.³⁹

As the court recognized, when most leases currently in production were signed, the best market for gas, if there was a market at all, was the long-term market.⁴⁰ Few gas purchasers were willing to spend the large amounts of time and resources necessary to build transportation lines from their main lines to gas wells unless they could be assured of the right to buy the gas at a set price for a long period of time. The closer a gas well was to a gas purchaser's pipeline, the easier it was for the lessee to bargain with the purchaser over such matters as price and contract duration. However, a gas well could be so remote that no gas purchasers were willing to spend the necessary time and money to transport the gas.⁴¹ In this predicament, the lessee had little choice but to transport the gas himself. Louisiana has long recognized the lessee's right to deduct transportation costs proportionately from the lessor's royalty payments.⁴² Unfortunately, the lessee's decision to build the requisite transportation facilities did not necessarily mean he could escape the demands for a long-term commitment. When most leases currently in production were signed, a buyers' market existed and lessees had very poor bargaining power.⁴³

It seems unlikely that the parties in *Henry* intended to base gas royalty payments on a current value basis—they knew that the lessee had the obligation to market the gas and that he would be forced to market it under a long-term contract. If market value was inter-

38. Harrell, *supra* note 4, at 329.

39. For an excellent discussion, see Fischl, *supra* note 36, at 22.

40. 418 So. 2d at 1338. See Harrell, *supra* note 22, at 335.

41. Because of a variety of factors (poor quality gas, remote location of wells, quantity of the reserve), there may not be a willing buyer for gas from a particular well. See note 4, *supra*.

42. See *Wall v. United Gas Pub. Serv. Co.*, 178 La. 908, 152 So. 561 (1934); *Coyle v. Louisiana Gas & Fuel Co.*, 175 La. 990, 144 So. 737 (1932).

43. See note 18, *supra*.

puted as current value, the lessee would have assumed all the risks of future gas price escalation. This would be inconsistent with the nature of the mineral exploration undertaking, where both parties share the risks.⁴⁴ Furthermore, it is unlikely that the parties intended to base gas royalties on a current, short-term market when, at the time the *Henry* leases were completed, gas simply was not sold in this manner.⁴⁵

Another problem concerns when the sale of gas is final. In Louisiana, gas is not owned by anyone until it is extracted and reduced to possession;⁴⁶ hence, the gas purchaser does not own the gas until it is pumped out of the ground and into his lines. This makes the gas purchase contract executory.⁴⁷ The *Vela* court reasoned that since the parties based the gas royalty on the market value of gas sold or used off the premises and since the gas was not "sold" until it was delivered to the gas purchaser, the parties intended the market value to be determined as the gas was delivered to the purchaser.⁴⁸ Under this approach, the lessee's profit remains constant while the lessor's profit escalates on a daily basis for as long as the gas is delivered and its price rises.⁴⁹ However, the parties may not have intended for "sold" to refer to *when* gas was delivered. Concerns over when gas is sold (or reduced to possession and ownership) are normally considered by the lessee and the gas purchaser.⁵⁰ The purpose of a gas royalty clause is not to determine when gas is sold, but to divide the value of the gas between the lessee and the lessor. Since the lessee has the obligation to prudently market the gas, it is logical to assume that the parties intended for "sold" to mean that point in time when the lessee fulfilled his obligation to market by committing

44. See *supra* note 22 and accompanying text.

45. See text at note 40, *supra*.

46. LA. MIN. CODE: LA. R.S. 31:7 (1974) provides: "Minerals are reduced to possession when they are under physical control that permits delivery to another." The leading Louisiana decision on when the ownership of minerals vests is *Frost-Johnson Lumber Co. v. Salling's Heirs*, 150 La. 756, 91 So. 207 (1922), wherein the court held that a landowner does not own the minerals beneath his property; instead, he owns the exclusive right to search for them and reduce them to possession. A landowner does not own minerals until they have been reduced to possession.

47. An executory contract is "a contract that has not as yet been fully completed or performed." BLACK'S LAW DICTIONARY 512 (5th ed. 1979).

48. 429 S.W.2d at 871.

49. Clearly, different economic conditions would cause the opposite result. The lessor's royalty would decrease if the price for gas decreased, while the lessee would continue to receive the amount stipulated in the gas sales contract. It is unlikely that a lessor would intend such a result.

50. Holliman, *supra* note 19, at 68.

the gas for sale.⁵¹ When the parties base gas royalties on the market value when "sold off the premises," they more likely are concerned with confection of the gas sales contract than with delivery to the gas purchaser. In this context, "sold" should have a broader meaning than "when title vests."⁵² If market value is to be determined at the time the lessee markets the gas, the best evidence of that value is the price for which the gas is prudently marketed.⁵³

The *Henry* court correctly considered the industry usage of basing gas royalty payments on the gas sales contract price.⁵⁴ No lack of skill or experience was proven by any of the lessors, and the complexity of the leases indicated that experienced parties confectioned them. In dissent, Justice Watson said the leases were not "negotiated,"⁵⁵ thereby implying that the lessors knew nothing of the oil and gas industry or the terms of the leases and implying that the lessors were presented with stock industry lease forms and given the choice of either accepting or rejecting the terms therein. However, the court of appeal had found that "[t]here was no evidence presented from which the [district] court could reasonably have concluded that the lessee in these cases had prepared the leases."⁵⁶ If both parties participated in the preparation of the leases, it is reasonable to conclude that the lessors were knowledgeable, experienced, and aware of industry usages.

Although the supreme court did not discuss it, the purpose of calculating gas royalties differently when gas is "sold or used off the premises," rather than sold "at the well," should be considered. Gas is considered "sold off the premises" when the lessee transports the gas off the property where it is produced in order to market it. Gas is "sold at the well" when the gas purchaser bears the expense of connecting his lines to the well.⁵⁷ When the lessee bears transportation expenses, he is entitled to compensation from the lessor as a result⁵⁸ and he usually gets a higher price from the gas purchaser. If the lessor's royalties are based on the total proceeds that the lessee

51. Harrell, *supra* note 4, at 332; Holliman, *supra* note 19, at 69.

52. Holliman, *supra* note 19, at 69.

53. Harrell, *supra* note 4, at 343-46. Professor Harrell argues quite persuasively that the market value of gas is best determined by the price the lessee obtains in an arm's length gas sales contract, taking into consideration all of the circumstances and conditions affecting the particular time and place of the sale.

54. See note 31, *supra*.

55. 418 So. 2d at 1344.

56. 401 So. 2d at 606.

57. See Holliman, *supra* note 19, at 68.

58. See text at note 42, *supra*.

receives from sales off the premises, the lessor takes advantage of the higher price the lessee receives without compensating the lessee for his expenses. Therefore, by basing the royalty for gas sold off the premises on its market value at the well, the parties properly compensate the lessee for his transportation expenses, *i.e.*, they calculate the royalty on the lower price that would have been received at the well had the gas in fact been sold there.⁵⁹ However, this explanation of why the parties compute royalties differently when gas is "sold off the premises" or "at the well" has nothing to do with whether market value is interpreted as current and fluctuating or stable and determinable.

It is difficult to think of any reason why the parties would want to distinguish between gas sold at the well and gas sold off the premises other than for purposes of compensation to the lessee for transportation and processing expenses. If the lessor intends the term "market value" to be interpreted as current value, thereby protecting his royalty from future price increases, there is no reason for him to desire this protection only for gas sold off the premises (and not for gas sold at the well); nevertheless, the leases in *Henry* based royalties on market value only when the gas was sold off the premises.⁶⁰

59. Of course, it is not suggested that basing gas royalties on the market value at the well when gas is sold off the premises is the *only* way to compensate the lessee for his transportation and processing expenses.

60. One interpretation of the royalty clause provides an explanation for why lessors would want their royalties based on future price increases only for gas sold "off the premises." Lessors could argue that since gas is reduced to possession and ownership when it is first brought out of the ground, that is when the parties intend to divide the value of the gas between themselves. The lessee has the obligation to prudently market the gas at that point, and if he does so, the lessor will be satisfied with the price he receives in the sale. However, if the lessee takes the gas off the premises, he does so at his own risk. He no longer has the obligation to prudently market the gas, and he can dispose of it as he pleases. Therefore, the lessor needs protection from the possible folly of the lessee when he sells the gas off the premises. The lessor thus demands the current market value of the gas since he cannot be sure when the lessee will market the gas off the premises or whether the lessee's *personal* venture will prove profitable.

The obvious problem with the above interpretation of the gas royalty clause is that it assumes the parties are primarily concerned with where the gas is delivered, instead of how the gas is sold. See text at notes 51-52, *supra*. In addition, it penalizes the lessee when he sells gas off the premises out of necessity instead of by choice. See text at notes 40-41, *supra*. It also assumes that lessors *need* protection from lessees, ignoring the fact that the lessee invariably has more time, money, and resources invested in the venture than does the lessor. The lessee will seldom if ever sell the gas imprudently or in bad faith since his financial outcome is always determined by

The *Henry* dissenters felt that the proper approach was to construe the lease's ambiguity against the lessee, since they felt that he was the party who had drafted the lease.⁶¹ Their authority was articles 1957 and 1958.⁶² In addition, a rule peculiar to the oil and gas industry provides that any ambiguity in a mineral lease should be construed against the lessee.⁶³ Louisiana has given this rule lip service in the past;⁶⁴ however, it is not well-founded in Louisiana law⁶⁵ and the intent of the parties should be ascertained if at all possible. The courts should construe ambiguity against the lessee only if the common intent of the parties cannot be ascertained.⁶⁶ The majority's effort to find the parties' intent is more in accord with proper contract interpretation.

Although the *Henry* decision favors the lessee,⁶⁷ a careful reading of the majority opinion indicates that Louisiana has not embraced the broad rule espoused by the *Tara* court.⁶⁸ According to *Tara*, any time

the gas sale. See Martin, *supra* note 8, at 202. Finally, the above interpretation assumes that the parties intend to relieve the lessee of the obligation to prudently market when gas is sold off the premises, despite the uniform judicial imposition of this obligation in the past. See note 8, *supra*.

61. 418 So. 2d at 1342, 1344 (Dennis, Watson, & Lemmon, JJ., dissenting). Justice Dennis believed the intent of the parties was to base market value on the current market value. However, he believed that if this was not the clear intent, Civil Code articles 1957 and 1958 applied. Justice Watson believed that articles 1957 and 1958 applied since the lease was not "negotiated."

62. LA. CIV. CODE art. 1957 provides: "In a doubtful case the agreement is interpreted against him who has contracted the obligation." LA. CIV. CODE art. 1958 provides: "But if the doubt or obscurity arise for the want of necessary explanation which one of the parties ought to have given, or from any other negligence or fault of his, the construction most favorable to the other party shall be adopted, whether he be obligor or obligee." See Miller v. Kellerman, 228 F. Supp. 446 (W.D. La. 1964); Edwards v. Terminix 57, Inc., 292 So. 2d 851 (La. App. 2d Cir. 1974); Cyr v. Louisiana Intra-state Gas Corp., 273 So. 2d 694 (La. App. 1st Cir. 1973); Leithman v. Dolphin Swimming Pool Co., 252 So. 2d 557 (La. App. 4th Cir. 1971).

63. I. KUNTZ, A TREATISE ON THE LAW OF OIL AND GAS: A REVISION OF THORNTON ON OIL & GAS § 16.1 (1962).

64. Rives v. Gulf Ref. Co. of La., 133 La. 178, 62 So. 623 (1913).

65. See Hunt Trust v. Crowell Land & Mineral Corp., 210 La. 945, 28 So. 2d 669 (1946); Fee v. Vancouver Plywood Lumber Co., 331 So. 2d 151 (La. App. 3d Cir. 1976); see also 2 W. SUMMERS, OIL & GAS 485 (1959).

66. Fee v. Vancouver Plywood Lumber Co., 331 So. 2d 151, 155 (La. App. 3d Cir. 1976).

67. The decision favored the *Henry* lessee because the price of gas rose after the gas sales contract was confected; however, the decision would have favored the lessor had the price of gas gone down after the gas sales contract was confected. See *supra* note 49 and accompanying text.

68. Tara Petroleum Co. v. Hughey, 630 P.2d 1269 (Okla. 1981).

the parties base gas royalty payments on the market value of the gas and the lessee markets the gas as a reasonably prudent operator, the court automatically will afford the lessee protection by defining market value as the value represented in the gas sales contract. The *Henry* majority, however, emphasized that its holding was strictly limited to those findings of fact before the court concerning the intent of the parties to the specific leases.⁶⁹ The court did not want to penalize the lessee's good faith efforts to market the gas by making him pay royalties based on a fluctuous, current market value several times higher than the price he was receiving under the gas sales contract. However, the court indicated that if it had been faced with different circumstances, the result would have been different: "Had plaintiffs shown that the purpose of the market value royalty clause was to provide them with protection as to price . . . then we would arrive at a different conclusion."⁷⁰ Justice Calogero concurred only because he believed that the holding was limited to the specific leases before the court and because he believed the defendants proved the parties' intent better than the plaintiffs.⁷¹

The results of future litigation in this area will be determined by which side best proves the parties' intent. Lessors should present evidence that they intended, through the use of the term "market value," to protect themselves from royalty payments which did not reflect the current value of the gas. Lessees should urge the fairness of the result reached in *Henry* and look for evidence to prove that their lessors were experienced and fully aware of the nature of the mineral exploration undertaking and the circumstances of the oil and gas industry.

Frederick Scott Kaiser

69. Applying the pertinent rules of contract interpretation to *the evidence presented in these cases*, we find the parties to the mineral leases at issue intended that royalties based on the "market value" of the gas be computed on the basis of the price received for the gas under the 1961 sales contract.

418 So. 2d at 1340 (emphasis added).

70. *Id.*

71. *Id.* at 1341.