Take-or-Pay Payments and Settlements - Does the Landowner Share?

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TAKE-OR-PAY PAYMENTS AND SETTLEMENTS—DOES THE LANDOWNER SHARE?

Take-or-pay clauses in gas sales contracts have sparked a new flood of litigation recently involving huge sums of money. The take-or-pay provision requires the purchaser, typically a pipeline company, "to take, or failing to take, to pay for the minimum annual contract volume of gas which the producer-seller has available for delivery." Slow markets and decreased demand during the past several years have forced gas purchasers to make large payments on gas they are unable to take. Consequently, much litigation has arisen involving take-or-pay payments. This article explores a new phenomenon in this area—the lessor's interest in take-or-pay payments. Initially, a brief history of the gas market is presented for an understanding of the predicament the industry faces. The relationship between the lessor and the lessee is then discussed, followed by an evaluation of the lessor's claim for royalties under take-or-pay payments and take-or-pay settlements.

HISTORY

A brief review of the natural gas market is beneficial to understanding the widespread use of take-or-pay clauses in the gas industry. For many years there were relatively few buyers of natural gas, and gas contracts were negotiated on a long-term basis and at fixed prices. Since contracts did not require purchases in periods of low demand, producers were left short of cash when the markets dropped. In 1954, the United States Supreme Court subjected the wellhead price of gas, and hence producers of that gas, to regulation under the Natural Gas Act. The rates established by the federal government, however, failed to encourage the exploration and development of new reserves, resulting in severe gas shortages during the 1970s. In an effort to remedy this situation, Congress passed the Natural Gas Policy Act (NGPA) of 1978, which established maximum lawful prices for natural gas in the interstate market. The NGPA allowed for substantially higher prices, which caused increased exploration and production and led to the creation of large

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reserves of natural gas. An economic recession occurred shortly afterwards, however, and the increased reserves developed into an oversupply of natural gas that remains today.

Take-or-pay clauses gained widespread use in gas purchase contracts when gas shortages appeared in the 1970s, although the clauses were used occasionally before that time. Using the increased bargaining power the shortages gave them, producers sought such clauses to compensate for the regulated price of interstate gas, which was well below the unregulated price of intrastate gas. These measures also protected producers from drops in demand. Take-or-pay clauses, however, were not without benefit for the pipeline companies. They were given flexibility in the amount of gas that was taken. Since gas cannot be stored, the pipelines could now take only the amounts needed and, rather than face breaching the contracts when the market demand was low, simply pay for the remaining amounts not taken.

The pipeline also has the option of making up the gas it previously paid for but did not take. This make-up provision benefits the purchaser, for it does not require him to take gas that he has no market for and cannot store. If the purchaser later takes in excess of the minimum amount required at the time, it can receive the gas it previously paid for but did not take. Make-up clauses, however, cannot always be used. For example, economic conditions may keep the market demand low during the make-up period. Likewise, the make-up may be limited by maximum take provisions, and by “depletion of the reservoir or reduction of production capacity.”

LESSOR-LESSEE RELATIONSHIP

An understanding of the relationship between a lessor and lessee of an oil and gas lease and the duties, express and implied, that the lessee owes the lessor is necessary for a determination of when royalties are payable. There are many types of lease forms available, each subject to modification in a particular transaction. The relationship between the parties is, however, essentially the same under nearly all forms of lease.

6. Id.
7. Arbaugh, supra note 2, at 11-5.
8. Id. at 11-6.
9. Take-or-pay clauses require “the purchaser to take a specified quantity of gas or to pay for the same.” H. Williams & C. Meyers, supra note 1, at 750.
Implied Obligation to Market

Based upon the relationship created by the mineral lease, the lessee owes an implied obligation to market the minerals diligently once they have been produced and to obtain the best price possible. The duty to market produced gas is based on the lessee's superior ability to find a market and to commit to a sale of the gas. The duty to market is especially important for gas since gas ordinarily cannot be stored upon production. Production of gas, therefore, requires the existence of a pipeline from the well to the place of delivery. The high costs of constructing a pipeline and of transporting the gas to the market encourage long-term gas purchase contracts, which assure the purchaser of sufficient amounts of gas to justify the expense of the pipeline. The fact that the lessee has the exclusive operating rights and determines when production will occur also supports the implied duty to market.

Given the lessee's duty and authority to market the lessor's gas, his relationship to the lessor with respect to the gas sales contract must be analyzed to determine the lessor's interest in take-or-pay proceeds. At first, it might appear that the lease authorizes the lessee to act as the lessor's representative; from this, it might be concluded that the take-or-pay clause in the gas purchase contract either creates a stipulation

12. The implied covenant to market and the obligation to obtain the best price possible for the gas are among several duties the courts have conferred upon lessees arising from oil and gas leases. Additional implied covenants include:
   1. the implied covenant to drill an initial exploratory well;
   2. the implied covenant to protect against drainage;
   3. the implied covenant to use reasonable care in producing the minerals;
   4. the implied covenant of reasonable development; and
   5. the implied covenant of further exploration.


14. In instances in which the royalty clause provides for payments based on value or proceeds, which most gas leases do, the lessee clearly has a duty to market because the lessor lacks the power of disposition and is dependent on the lessee for any return in the venture. H. Williams & C. Meyers, Oil & Gas Law § 853 (1986). The obligation to market is a bit hazier, however, when the royalty provision allows the lessor to take the minerals in kind. This is sometimes done in oil leases. While the lessor is dependent upon production by the lessee, the lessor obtains control of the minerals upon production and should be free to dispose of them as he sees fit. Williams and Meyers argue that the duty to market also applies even though the product is taken in kind. "As a practical matter, . . . the typical lessor lacks both the experience and facilities to dispose of the oil (gas) produced, and for this reason we suggest that the lessee is under an implied duty to market oil (gas), even though the lease provides for royalty in kind." Id. This argument should be even stronger for gas given the great expense incurred in marketing gas and the small interest attributable to the lessor.
pour autrui in favor of the lessor, or benefits the lessor directly, having been negotiated by the lessee as agent.

Stipulation Pour Autrui

Some argue that the gas sales contract between the lessee-producer and the pipeline-purchaser creates a stipulation pour autrui in favor of the lessor. If this were the case, the lessor would have an interest in take-or-pay proceeds. A stipulation pour autrui in a contract creates a benefit for a third person. The benefit must form "the condition or consideration" of the contract rather than being merely incidental to the agreement. Professor J. Denson Smith developed a practical test that has been widely used by the courts to determine when the promise can be construed as consideration or as incidental. He stated that the relationship between the promisee (purchaser) and the alleged third-party beneficiary (lessee) must be examined to see if a legal or factual relationship exists between them that would justify the creation of a stipulation pour autrui. Professor Smith also formulated factors upon which to determine the existence of a factual or legal relationship:

1. The existence of a legal relationship between the promisee and the third person involving an obligation owed by the promisee to the beneficiary which performance of the promise will discharge; (or)
2. The existence of a factual relationship between the promisee and the third person, where, (a) there is a possibility of future liability either personal or real on the part of the promisee to the beneficiary against which performance of the promise (promise) will protect the former; (b) securing an advantage for the third person may beneficially affect the promisee in a material way; (c) there are ties of kinship or other circumstances indicating that benefit by way of gratuity was intended.

In addition to the legal or factual relationship, the stipulator and the promisee must have intended to confer a benefit on the third party through their agreement, either expressly or implicitly.

18. Broussard, 481 So. 2d at 127. Intention of the parties was the only factor considered by the Broussard court; thus it may now be the only determinative factor.
19. Hargroder, 290 So. 2d 874; Fontenot v. Marquette Casualty Co., 258 La. 671, 247 So. 2d 572 (La. 1971); Andrepond, 231 So. 2d 347.
Using these factors, the gas sales contract does not appear to create a stipulation pour autrui. It is true that a legal relationship, the gas sales contract, does exist between the gas purchaser and the lessee-producer. The purchaser discharges his obligation by paying for the gas under the terms of the contract, with the lessor receiving his share when his lessee pays the royalties due from the sale. The lessee, however, does not intend to benefit the lessor. The implied duty to market binds the lessee to market the lessor's fractional interest, and the lessee receives compensation for doing so. Likewise the purchaser, as stipulator, does not have the requisite intent. For this relationship to exist the stipulator must intend to discharge an obligation by paying the third-party beneficiary. However, the gas purchaser owes no obligation to the lessor. While the lessor has a right to the value of his gas sold through the gas sales contract, the purchaser is not liable on this debt. The practicalities of the gas industry show that the benefit the lessor derives from the gas contract is a mere incident of the contractual purpose. The great expense of marketing gas makes it unlikely that a purchaser would contract to buy only the lessor's share. That share, usually a one-eighth interest, is not large enough to earn the producer a reasonable return. The purchaser generally seeks the producer's interest, which accounts for the bulk of the amount produced. Therefore, the lessor's interest usually is not "the condition or consideration" for the purchaser entering into this contract. As a result, the take-or-pay clause cannot be a stipulation pour autrui in favor of the lessor.

The argument for declaring the lessor a third-party beneficiary is based on the holding by several jurisdictions that a lessor may be a third-party beneficiary to a sublease. The basis of these holdings, however, is contrary to Louisiana law, and thus cannot lend support. One California court based its decision on a California Civil Code article that is similar to Louisiana's article concerning stipulations pour autrui and on the intent of the parties to the contract. The court determined

20. This is evident by the purchaser's willingness to contract for gas even though the lessor sometimes has the option of taking his share in kind.

21. Louisiana courts have not ruled directly on the issue of the lessor as third party beneficiary. In Amoco Prod. Co. v. Columbia Gas Transmission Corp., 490 So. 2d 1135 (La. App. 4th Cir.), writ denied, 494 So. 2d 327 (1986), the court held that the lessors had standing to assert such a theory in a suit to enforce a gas purchase contract, but that the lessors had not as yet proved a basis to enforce the contract.

22. Hartman Ranch Co. v. Associated Oil Co., 10 Cal. 2d 232, 73 P.2d 1163, 1169 (1937). The court stated: "Section 1559, Civil Code, provides: 'A contract, made expressly for the benefit of a third person, may be enforced by him at any time before the parties thereto rescind it.'" See Cal. Civ. Code § 1559 (West 1982). The court also relied on common law contracts authorities, quoting 2 Williston on Contracts 1042 (rev. ed.): "A person is a creditor beneficiary (third party beneficiary) if no intention to make a gift appears from the terms of the promise, and performance of the promise will satisfy a duty of the promisee to the beneficiary."
that the sublessee clearly intended to benefit the lessor by an express promise in the sublease in which the sublessee "expressly assume[d] and agree[d] to perform all the obligations and covenants provided for in said parent lease." The argument theorizes that a sublease may be analogized to a gas sales contract in dealing with the lessor-lessee relationship. A lessee enters into the gas sales contract in order to discharge his duty to market the lessor's gas; thus he does intend to benefit the lessor through this agreement. The purchaser should be aware of the relationship based on his knowledge of the industry. Traditionally, however, Louisiana jurisprudence held that there was no privity of contract between the sublessee and the prime lessor and therefore the lessor could not sue the sublessee for breach of the obligations under the lease; consequently, the lessor should not be considered a third party beneficiary.

With the adoption of the Mineral Code in 1975, a prime lessor is now allowed to demand performance of the sublessee directly. This could lead one to argue that lessors are third-party beneficiaries to a sublease and, hence, to a gas sales contract as well. However, the sublease and the gas sales contract are not in fact analogous. Under the sublease, the sublessee expressly contracts to assume certain obligations under the lease, including the payment of royalties for gas produced. Therefore, the lessor has a right of action against him directly if royalties are not paid when due. This is not the case with the gas sales contract. The purchaser contracts to buy gas from the producer, thus obligating himself to pay the purchase price. The obligation he undertakes does not include the lessee's obligation to pay royalties to the lessor. Thus, the purchaser does not intend to benefit the lessor, negating the possibility that the gas sales contract is a stipulation pour autrui. The lessee markets the lessor's gas based on a contractual obligation, not as a gratuity.

If the lessor is considered a third-party beneficiary, he has a right of action on the gas contract. Once the lessor receives royalty payments stemming from sales under the gas sales contract, he manifests his intent to accept the benefits. After his acceptance the contract cannot be modified without his consent. Such a construction may lead to numerous problems between the parties to the contract with respect to take-or-

23. Hartman, 10 Cal. 2d at 243, 73 P.2d at 1168.
25. Louisiana Mineral Code article 128 provides: "To the extent of the interest acquired, an assignee or sublessee acquires the rights and powers of the lessee and becomes responsible directly to the original lessor for performance of the lessee's obligations." La. R.S. 31:128 (1975).
pay settlements, which will be discussed more fully later. As yet, though, the Louisiana courts do not consider the lessor to be a third-party beneficiary.

Agency

Another theory that lessors could advance to claim a portion of take-or-pay proceeds is that the lessee acts as the lessor’s agent, making the lessor a party to the contract. The Civil Code defines a mandate as “an act by which one person gives power to another to transact for him and in his name, one or several affairs.” Acceptance by the agent may be express or tacit, and tacit acceptance may be inferred from the agent’s acting under the power or from his silence when the power is transmitted to him. Therefore, it could be argued that the lessor designates the lessee as his agent in the royalty clause since the lessee is under an implied obligation to market the gas.

The Mineral Code, however, undercuts this theory by providing that [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.

This article declares that development is to be undertaken for the mutual advantage of the parties. By contrast, an agent must act solely for the advantage of his principal. Because the lessee is not a fiduciary, he does not have this obligation. The lessee, so long as he remains in good faith and avoids any detriment to his lessor, may obtain benefits solely for himself, something an agent cannot do. In short, the mineral lessee has greater powers and is held to less stringent duties than the agent. Hence, the agency model is inappropriate for the mineral lessor-lessee relationship.

26. This analysis is not intended to be an exhaustive list of the possible types of relationships between the lessor and the lessee, but only those that may arise as a result of the gas sales contract.
28. Id. art. 2989.
30. Some other jurisdictions have held that the implied obligation to market does create an agency relationship between the lessor and the lessee. See Wolfe v. Texas Co., 83 F.2d 425 (10th Cir.), cert. denied, 299 U.S. 553, 57 S. Ct. 15 (1936).
31. This is not to say that the lessee can never act as the lessor’s agent. If the lessor has the right to take his interest in kind, yet permits the lessee to market the gas on his behalf, the lessee would undoubtedly be the lessor’s agent. In this case, the lessor is entitled to the product, not just the proceeds, and has expressly granted the marketing
The relationship between the lessor and the lessee arises by operation of law based on the implied obligations of the lease. The lessee is held to the standards of a prudent operator, but he is not a fiduciary of the lessor. Because the lessee is not an agent, he is permitted to obtain benefits for himself without violating his duties to the lessor, provided he acts in good faith and in a reasonably prudent manner. As will be shown, one of these benefits should be the right to receive take-or-pay payments without the duty to share with the lessor.

**Royalties For Take-or-Pay Proceeds**

The mineral lessor cannot be characterized either as the beneficiary of a stipulation pour autrui or as the principal of an agency relationship. So, the lessor must base any claim to an interest in take-or-pay proceeds on the royalty clause in the lease. Mineral leases grant the lessor a fractional royalty based upon production. The primary purpose of the royalty clause is to determine the division of economic benefits between the parties. The lessee usually markets the entire amount produced from the well, although the lease may give the lessor the right to take the oil or gas in kind, and to use it or market it himself. When the lessee markets the product, the lessor receives a fractional portion of the price according to the terms of the royalty clause. Louisiana jurisprudence holds that the lessee and the landowner own the gas when it reaches the surface of the ground in the proportion provided for in the royalty clause for severance tax purposes. This should also be the case for property law.

Despite the great number of different forms of mineral leases available, there are three basic types of royalty clauses used: 1) the proceeds clause; 2) the market value clause; and 3) the market price clause. The power to the lessee. The lessee under such circumstances would have a fiduciary obligation to the lessor and could not negotiate benefits that the lessor did not share. Nevertheless, this arrangement is almost nonexistent in gas leases. Gas leases, except in extremely rare situations, provide only for royalties on the proceeds or the value of production, not for in kind royalties. Hence, as a practical matter the lessee would almost never act as the lessor's agent.

32. Typical royalty clauses are reproduced infra note 35.
33. Harrell, Developments in Nonregulatory Oil & Gas Law, 30 Inst. on Oil & Gas L. & Tax'n 3ll, 334-35 (1979).
35. Examples of the three types of clauses are as follows:
1) The proceeds clause: On gas, including casinghead gas and other gaseous hydrocarbons, saved and marketed by lessee, 1/8th of the proceeds received by
royalty provision, whatever the type, has been said to create "a co-operative venture with the lessor contributing the land and the lessee contributing the capital and expertise necessary to develop the minerals for the mutual benefit of both parties." Mineral leases typically do not provide for the payment of royalties when gas is paid for but not taken under a take-or-pay clause. Today, a lessor would be wise to negotiate for such payment to avoid future problems.

The general rules of contractual interpretation will apply in determining if the obligation to pay royalties on take-or-pay payments arises from the royalty clause. Technical terms, when used in contracts, carry their technical meanings. Thus, the definition of "royalty" in the Louisiana Mineral Code may assist resolution of the issue. The Code defines the term as

any interest in production, or its value, from or attributable to land subject to a mineral lease, that is deliverable or payable to the lessor or others entitled to share therein. . . . "Royalty" also includes sums payable to the lessor that are classified by the lease as constructive production.

Construing this definition with the typical royalty clauses leads to the conclusion that royalties should not be paid on take-or-pay payments. Under the royalty clauses, royalties are paid when gas is "produced," "sold," or "marketed." The technical meanings of these terms in the oil and gas industry supports this result. "Production" occurs only when


2) The market value clause: The royalties to be paid by Lessee are . . . on gas, one-eighth (1/8) of the market value at the well of the gas used by Lessee in operations not connected with the land leased or any pooled unit containing all or a part of said land; the royalty on gas sold by Lessee to be one-eighth (1/8) of the amount realized at the well from such sales. Bath's Form 42 CPM-New South Louisiana Revised Six (6)-Pooling.

3) The market price clause: To pay lessor for gas of whatsoever nature or kind (with all of its constituents) produced and sold or used off the leased premises, or used in the manufacture of products therefrom, 1/8th at the market price at the well for the gas sold, used off the premises, or in the manufacture of products therefrom. Fischl, supra, at 24.

36. Harrell, supra note 33, at 334. See also H. Williams & C. Meyers, supra note 14, § 802.1.

37. Words of art and technical terms must be given their technical meaning when the contract involves a technical matter. La. Civ. Code art. 2047.


the minerals are physically severed from the ground.\textsuperscript{40} This is reiterated in Williams and Meyers' definition of a "producing well" as one that "produces oil or gas. . . . The term does not include a well that has discovered oil or gas but does not produce either."\textsuperscript{41} A "sale" pursuant to a gas sales contract is viewed similarly as occurring "only upon production and delivery . . . . [N]o particular gas is sold until it is identified—i.e., brought to the surface."\textsuperscript{42} "Marketing" requires prior production so that a thing exists which is capable by being marketed.\textsuperscript{43}

In the few instances in which this issue has arisen, this construction of the royalty provisions has won favor. The Fifth Circuit, for example, determined that royalties from federal outer continental shelf leases were not due on take-or-pay payments in \textit{Diamond Shamrock Exploration Corp. v. Hodel}.\textsuperscript{44} The lease provisions at issue provided for royalty payments on the value of "production saved, removed or sold" from the leased premises.\textsuperscript{45} The court held that royalty payments are only due upon production, which, said the court, does not occur until the gas has been physically severed from the ground. Since take-or-pay payments are only made when there is no production, noted the court, royalties cannot be due on take-or-pay payments.

The government argued that the take-or-pay payments are part of the total consideration for the sale of gas, constituting part of the price of gas which is sold under the contract. The court rejected this position, and found that take-or-pay clauses are used to apportion the risks of natural gas production and sales between the buyer and seller. The seller bears the risk of production. To compensate seller for that risk, buyer agrees to take, or pay for if not taken, a minimum quantity of gas. The buyer bears the risk of market demand. The take-or-pay clause insures

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\item \textsuperscript{40} Diamond Shamrock Exploration Corp. v. Hodel, 853 F.2d 1159, 1168 (5th Cir. 1988). See also Wyoming v. Pennzoil Co., 752 P.2d 975, 979 (Wyo. 1988); Energy Oils, Inc. v. Montana Power Co., 626 F.2d 731, 738 (9th Cir. 1980); Union Oil Co. v. Touchet, 229 La. 316, 325, 86 So. 2d 50, 53 (1956); Continental Oil Co. v. Landry, 215 La. 518, 524, 41 So. 2d 73, 75 (1949).
\item \textsuperscript{41} H. William & C. Meyers, supra note 1, at 677.
\item \textsuperscript{42} Piney Woods Country Life School v. Shell Oil Co., 726 F.2d 225, 234, reh'g denied, 750 F.2d 69 (5th Cir. 1984), cert. denied, 471 U.S. 1005, 105 S. Ct. 1868 (1985).
\item \textsuperscript{43} Diamond Shamrock, 853 F.2d at 1166-67.
\item \textsuperscript{44} This action was consolidated before the Fifth Circuit with Mesa Petroleum Co. v. U.S. Dept. of Interior. \textit{Mesa} had been tried before the Western District, which held that no royalties were due. See Mesa Petroleum Co. v. U.S. Dept. of Interior, 647 F. Supp. 1350 (W.D. La. 1986). \textit{Diamond Shamrock}, however, was heard by the Eastern District, which instead ruled that royalties were due under the take-or-pay clause. See \textit{Diamond Shamrock Exploration Co. v. Hodel}, No. 86-537 (E.D. La. Jan. 23, 1987). See also \textit{Wyoming}, 752 P.2d 975.
\item \textsuperscript{45} Diamond Shamrock, 853 F.2d at 1161.
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that if the demand for gas goes down, seller will still receive
the price for the contract quantity delivered each year.\textsuperscript{46}

Therefore, such payments did not constitute payments for the sale of
gas, but rather, were for the purchaser's failure to buy the gas.

The Federal Energy Regulatory Commission (FERC) takes a similar
position. In the context of make-up gas, the Commission stated in \textit{ANR Pipeline Co. v. Wagner & Brown}\textsuperscript{47} that until take-or-pay payments have
been applied to a sale, the payments are not part of the price of gas.
A sale first occurs when the gas is made up, not at the time the take-
or-pay payment is made. Similarly, FERC treats the take-or-pay pay-
ments as pre-paid assets, which cannot be passed on to customers as a
purchased gas cost until the make-up gas is taken.\textsuperscript{48}

The royalty provisions concerning take-or-pay payments cannot be
ambiguous if the clause provides for royalties when gas is “produced,”
“sold,” or “marketed.”\textsuperscript{49} Clearly, these terms do not provide for payments
on gas that is still in the ground and thus not susceptible of
ownership. Similarly, royalties should not be due on the other common
types of royalty clauses. The proceeds clause\textsuperscript{50} provides for royalties on
gas “saved and marketed by lessee.” The \textit{Diamond Shamrock} court
found that without production, there is nothing for the producer to
market.\textsuperscript{51} This would also seem to be the case with the requirement of
“saving” the gas to determine when royalties are due.

The market value clause\textsuperscript{52} requires royalties on the “market value
at the well” and “on gas sold . . . at the well.” As stated, \textit{Diamond Shamrock}
found there was no market without production and thus there
can be no market value. Furthermore, the courts require that gas must
be identified, which requires production, for a sale to occur.\textsuperscript{53} Finally,
the market price clause\textsuperscript{54} provides for the payment of royalties on gas
“produced and sold or used.” This language has been construed by
\textit{Diamond Shamrock} as not requiring royalty payments.

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  \item \textsuperscript{46} Id. at 1167 (quoting Universal Resources Corp. v. Panhandle E. Pipeline Co.,
813 F.2d 77, 80 (5th Cir. 1987).
  \item \textsuperscript{47} 44 F.E.R.C. ¶ 61,057 (1988).
  \item \textsuperscript{48} \textit{Diamond Shamrock}, 853 F.2d at 1167 (citing FERC Stats. & Regs. [Regs. Pream-
  \item \textsuperscript{49} Wyoming v. Pennzoil, 752 P.2d 975, 979 (Wyo. 1988).
  \item \textsuperscript{50} See supra note 35.
  \item \textsuperscript{51} Diamond Shamrock Exploration Co. v. Hodel, 853 F.2d 1159, 1166-67 (5th Cir.
1988).
  \item \textsuperscript{52} See supra note 35.
  \item \textsuperscript{53} Piney Woods Country Life School v. Shell Oil Co., 726 F.2d 225, reh’g denied,
  \item \textsuperscript{54} See supra note 35.
\end{itemize}
The Louisiana Supreme Court's holding in *Henry v. Ballard & Cordell Corp.* may lead one to suspect that the court may uphold the lessee's position on take-or-pay. *Henry*, a "market value" case, involved the interpretation of mineral leases. In that case the court refused to construe the ambiguities of the lease provision against the lessee; instead, the court relied on "the practical realities of the oil and gas industry, and the obligations of the lessee to market the gas at the best possible price at the time the leases were made," for these factors have bearing on the intent of the parties regarding when royalties are due. Such an analysis is in accordance with the Civil Code, which provides that "interpretation of a contract is the determination of the common intent of the parties." Gas sales contracts are generally negotiated by the gas purchasers on a long-term basis out of necessity, because transporting the gas involves such great expense. Long-term contracts ensure that a sufficient amount of gas has been committed for a sufficient period of time to enable the purchasers to earn a reasonable return on their investments.

In light of the above arguments based on the technical meanings and court holdings concerning the construction of the royalty clause as it affects the take-or-pay payments, an analysis of the arguments in favor of the lessors follows. Lessors could turn the above stated royalty clause agreement around and argue that the payments are in lieu of production, and thereby included under the royalty provision. This argument falters on close analysis. Where the lease calls for royalties on production, there is no room for substituted production unless it is specifically provided. Lessors have the ability to negotiate for substituted production benefits if they want them. For instance, lease forms typically provide for shut-in royalty payments in lieu of production, in this way maintaining a lease that would otherwise expire in the absence of production. Lessors have also been able to negotiate "in lieu" royalty provisions that are paid to the royalty owners in place of the drilling of a well and the production of minerals. The amount payable is usually based on production from offset wells; thus royalty owners receive what they would have if a well had been drilled. Yet, without these provisions the lessor would not receive the benefits. Since the lessor could so easily have included a substituted production term, it is not unreasonable to require some indication that the parties intended take-or-pay payments.

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55. 418 So. 2d 1334 (La. 1982).
56. Id. at 1337-38.
58. *Henry*, 418 So. 2d at 1336.
59. Moses, "In Lieu" Royalty Agreements in the Oil Industry, 3 Hous. L. Rev. 84, 86 (1965).
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...to be included in the royalty clause. The standard royalty provisions do not expressly or impliedly provide for such payments.

Another argument in favor of the lessors is based simply on equity: it seems fair to require the lessee to share all monetary benefits gained under gas sales contracts with the lessor. If the lessor had not granted him the right to produce the gas, the lessee would have no right to the payments at all. It can be argued that anything received in consideration of the gas sales contract should likewise accrue to the lessor.

This argument may be convincing when the gas sales contract is based on one lease with an unlimited make-up period. It loses its bite, however, when analyzed in light of the usual situation, which provides for production of gas from numerous leases out of a particular field or area.

A hypothetical illustrates the practical difficulties in allocating take-or-pay proceeds in the ordinary case. Consider the consequences when a lessee enters into separate leases with A and B, under which he drills and obtains production from each and from which gas is to be sold under the same gas sales contract. Furthermore, assume that A and B's wells are contained in separate units. A's well produces to its capacity; however, B is not producing due to decreased demand. Can both A and B claim royalties on take-or-pay payments, and if so, in what proportion? A is receiving royalties on full production; therefore, it would appear B should receive royalties on the payments. However, if it is successfully argued that the payments increase the price of the gas, A is not receiving full value for his gas that is sold if he does not share in the take-or-pay payments. Moreover, if the purchaser later makes up the gas out of A's well, but royalties were earlier paid to B on the take-or-pay payments, what is A now entitled to? These examples illustrate that if the gas sales contract is based on field-wide leases, which is typically the case, the take-or-pay payments cannot be allocated to any particular lease. The situation becomes even more tenuous as more leases from more units are covered under the gas contract, which is customarily done in the industry. The lessee is under a duty to treat each lessor equally; therefore, he may not favor one over another.60

The "fairness" argument also neglects the fact that the take-or-pay provision is primarily used to protect the producer from the risk he undergoes in production, and to compensate the seller for standing ready to deliver gas pursuant to the gas sales contract, as well as allowing him to meet operating costs and taxes.61 Since the royalty owner does not share this risk, it seems he should not be compensated for it.

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60. Amoco Prod. Co. v. First Baptist Church, 579 S.W.2d 280 (Tex. Civ. App. 1979), writ ref. n.r.e., 611 S.W.2d 610 (1980).
61. Kramer, Royalty Obligations Under the Gun—The Effect of Take-or-Pay Clauses
The make-up clause further complicates the lessor's position. This clause generally provides that the producer will refund to the purchaser any payments made in excess of gas taken that the producer is now unable to deliver. Since, during the make-up period, the purchaser is willing to take more gas that the seller can no longer deliver, the purchaser has a right to the value that he is able to make up. If the lessor previously received royalties on these payments, he should likewise be required to refund his proportion to the purchaser. Practically speaking, this does not seem likely to occur; the money probably will already have been spent. Thus, the lessee, as the party to the gas sales contract, is stuck with the entire refund with little chance of obtaining reimbursement from the lessor.

In addition, if the purchaser takes make-up gas and the price has risen higher than was paid under the take-or-pay payment, the purchaser must pay this difference. If the lessor also shares in the take-or-pay payments, the producer must make a second payment to the lessor even though there has only been one purchase of gas.62

A further argument that royalties are owed rests on the “fundamental nature of the lessor-lessee relationship, as reflected by the terms of the lease,”63 and by the inherent cooperativeness and mutuality of the relationship. Thus, it is argued, any benefit the lessee receives from his negotiations pursuant to the gas sales contract should likewise accrue to the lessor in a proportionate amount. The position is premised on the lessee's implied obligation to market as a reasonably prudent operator. However, this interpretation of the relationship ignores the fact that in Louisiana a lessee is not a fiduciary of the lessor. The lessee's obligation to contract for the best possible price for the lessor's gas does not preclude him from negotiating other advantages for himself that do not include the sale of gas.

Proponents of allowing royalties on take-or-pay proceeds point to the rule of liberal interpretation in construing royalty interests. The cases under which the rule arose, however, concerned the payment of royalties on extracted products not contemplated by the parties to the leases, such as natural gasoline or sulphur extracted from gas.64 The proponents must, of course, concede that take-or-pay payments are not constituent

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63. Comment, supra note 11, at 596.
elements of gas, but argue instead that the payments increase the value of the gas.\textsuperscript{65}

This reasoning overlooks the intent of the parties concerning take-or-pay payments and the language of the lease and of the gas sales contract. The take-or-pay payments do not relate to the value of the gas as a value cannot be given until the gas is sold.\textsuperscript{66} Another weakness with this argument is evident from the royalty provision. The proponents insist that there is an ambiguity in the royalty provision that should be construed against the lessee because the parties could not have contemplated royalties on take-or-pay payments at the time the lease was entered into. As previously asserted, the precise meanings of technical terms in royalty clauses remove all ambiguity, and nothing in the lease evidences an intention that take-or-pay payments should be included under the lessee’s obligations to the lessor.

**Take-or-Pay Settlements**

Producers, faced with enforcing valid contracts that could drive the pipeline-purchasers into bankruptcy, increasingly are renegotiating the gas purchase contracts. These renegotiations are aimed primarily at the minimum take requirements, but also involve the gas pricing provisions. By decreasing the price of gas that is now sold, the lessor will receive a reduction on his return for his fractional interest. Assuming for the sake of argument that the lessor is a third-party beneficiary to the gas sales contract, he would have standing to object.\textsuperscript{67} If he has previously accepted the benefits of the contract, royalties for instance, his interest cannot be modified without his consent. The lessor has a valid existing contract and, if the purchaser does not have a defense to performance, will be able to enforce the terms as stated in the contract. As a practical matter, it would be in the lessor’s best interest to consent to the renegotiation for the same reason the lessee is willing to renegotiate: the alternative could be the insolvency of the purchaser, with little likelihood of finding new markets at better terms.

\textsuperscript{65} "The source of the value is the same (as the constituent elements). Without the gas, there would be no other products to be extracted therefrom. Royalty being due under the lease on the gas, any value derived therefrom is by definition subject to royalty. By the same token, without gas, no take-or-pay payments would be forthcoming." Comment, supra note 11, at 614.

\textsuperscript{66} *Diamond Shamrock*, 853 F.2d at 1167, held that the clauses were added to apportion the risk of production, which the seller normally bears, and the risk of market demand, borne by the buyer.

\textsuperscript{67} A contract containing a stipulation pour autrui cannot be dissolved without the beneficiary’s consent once the beneficiary manifests his intention to take advantage of the benefit. See La. Civ. Code art. 1978.
To avoid conflicts with the lessor, it may be wise for the lessee to seek the lessor's consent before finalizing the renegotiation. This also leads to a variety of practical problems in that the lessor may lack familiarity with the gas sales contract. The lessor may not realize it is in his best interest to renegotiate when the end result is a smaller royalty check. The problem is compounded when there are numerous leases subject to the contract with a corresponding number of lessors.

An alternative approach, which attempts to forestall and perhaps avoid confrontation with the lessor, is available. The lessee can send written notice of the renegotiated contract containing information concerning the price of the gas and other pertinent matters. If the lessor cashes his royalty check based on the renegotiated terms, he has acquiesced to the new agreement and can no longer object. This argument depends on the lessee's acting in a reasonably prudent manner and in good faith, and giving adequate notice to the lessor.

It should be recalled in this regard that the lessor is not guaranteed a certain price on his interest, but rather receives the price the lessee is able to negotiate for the entire amount of gas produced. The lessee must, of course, abide by the prudent operator standard and his duty to market the lessor's gas. It is probably imprudent for the lessee to refuse to renegotiate if that might drive the purchaser into bankruptcy, which would deprive both him and his lessor of a market for their gas. Given the state of the gas market, it should be deemed prudent for the lessee to enter into renegotiations if the pipeline would suffer financial hardship because of large payments without the ability to take or later make up.

Whether or not the lessor has standing to object to the renegotiation of the gas sales contract, some lessors argue they should receive their proportionate share of the settlement payments. The settlements usually provide for a reduction or total waiver of the unpaid take-or-pay payments that have already accrued, as well as a reduction in the contract price that is more in line with current gas prices. The pipeline generally pays a lump sum settlement amount in exchange for these concessions. By lowering the contract price for gas, the lessor's royalty payments will be lower for the same amount of gas sold before the renegotiation. Therefore, since his rights are altered by the settlement, he might argue that he should share in the settlement payment.

The lessor, however, is not a party to the gas sales contract, nor does he bargain with the lessee concerning the price for which the gas will be sold. He contracts to receive his proportionate share of the price for which it is eventually sold minus his share of the costs. He may

be unaware of the price prior to renegotiation, and even if he knows the price, it is doubtful that he can show he reasonably relied on the price for future sales given the uncertainty in the amount that may be produced. The take-or-pay settlement, like the payments, is not part of the price of the gas sold. The settlement is paid to relieve the pipeline of the deficiencies accrued for the large amounts of gas contracted for which were not taken. Here, again, there is no production, no sale, and no market value of the gas. Just as not taking gas is the basis of making the payments, the same is true with the settlement. Therefore, even though the lessor will receive a smaller amount when gas is later sold, he has no reason to rely on the price the lessee originally obtained. The lessor receives his royalty when the gas is actually sold at the price for which it is sold. The settlement is instead for gas which is not sold; therefore, the lessor has no interest in the settlement proceeds.

CONCLUSION

The prevalence of take-or-pay clauses in gas sales contracts and the current oversupply of natural gas have combined to produce a flood of litigation. The lessors’ rights to royalties on take-or-pay payments and settlements are but one of the many issues involved. A close analysis of the lessor-lessee relationship based on the lease as a whole and, in particular, the royalty provision leads to the conclusion that the royalty obligation does not arise. The mineral lessee is under an obligation to market his lessor’s gas based on a unique relationship arising by operation of law. Pursuant to this obligation, the lessee typically enters into long-term gas sales contracts to market the gas under terms of mutual benefit to the lessor and the lessee. The lessor is not a third party beneficiary to the gas sales contract and thus does not have a direct right to royalties from the take-or-pay payments. Likewise, the lessee is not a fiduciary of the lessor; he thus is allowed to negotiate with the purchaser to obtain certain benefits for himself that will not accrue to his lessor. Yet the lessee must follow the standards of a reasonably prudent operator and obtain a fair deal for his lessor in good faith.

Problems are also created if royalties have been paid, but the producer is unable to provide make-up gas or if make-up gas is taken at a lower price than that which was paid. In both cases, those who received payments must reimburse the purchaser, yet only the producer is directly liable. Nor are royalties owed lessors by the terms of royalty clauses. The technical terms in the royalty clause, such as production, sale, and marketing, stand in the way of the lessors’ arguments. All of these terms presuppose a removal of gas from the ground, an event which does not occur if take-or-pay payments are made. The very reason take-or-pay payments are made is because there is no production. There
are also practical reasons for not allowing royalties in this situation. Under a typical gas sales contract involving numerous lessors in various units, it is impossible to allocate the interest to any particular well. If it is shared ratably, those whose wells produced to capacity would receive a windfall.

Likewise, royalties should not be payable to the lessor on take-or-pay settlements. There is no sale of gas under these terms, but rather the settlements are paid because the gas was not produced or sold. The lessor is not a party to the gas sales contract, nor is he given a guaranteed price on his interest. The lessee should be given the freedom to renegotiate the contract when it is in the best interest of the parties. If the lessee renegotiates the contract prudently and in good faith, the lessor should not be entitled to settlements based on renegotiating its terms when the sale of gas is not involved. The lessor is only entitled to royalties when the gas has been produced and sold with the royalties to be fixed according to the price for which it is sold. The settlement does not involve the sale of gas; therefore the lessor is not entitled to a portion of the proceeds.

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