

Oil & Gas Law

Class 14: OGL (6 / 7) –

Implied Covenants 1: The Implied Covenant to Market

Implied Covenants - Intro

- ***What are they (conceptually)?***
- ***Where do they come from?***
- ***Why do we need them...isn't OGL complete?***
 - TX Form – 11 clauses
 - 1: Granting clause
 - 2: Primary Term
 - 3: Royalty
 - 4: Pooling
 - 5: Delay Rental
 - 6: Secondary Term – “Savings Clauses”
 - 7: Other Misc. Rts
 - 8-11: “Contract clauses” – breach/FM/title/assignment

Implied Covenants - Intro

- Arise b/c the parties have omitted a term that's essential to a determination of their rights and obligations under that contact
- 2 types of analysis:
 - Use the terms that are there (i.e., the express terms of the K) to define what was left out
 - “implied in fact”
 - Supply a term that is consistent w/ sense of fairness or w/ industry policies
 - “implied in law”

Implied Covenants - Intro

- Purposes of I/C's
 - Make an unfair contract fair
 - Balance parties' position where 1 party (Lessee) has clear and exclusive control
 - ex: Rogers v. Westerman Farm (pp. 342-3): L'ees scheming to dupe unsuspected L'ors out of their royalty ... L'or's incompetency matched only by L'ee's deviousness

Implied Covenants - Intro

- “Implied” how?
 - ... in fact or in law? (in other words, ***is the Court finding the I/Cs, or is it making them?***)
 - Most commentators admit that the I/Cs are judicial creations, “used to achieve a desired result”
- Bottom Line ... Implied Covenants are:
 - Troublesome
 - Almost impossible to predict or prepare for
 - From the Lessee’s perspective, they increase the risks and costs associated with OGLs

I/C #1: Market

■ ***Why do we need this?***

- See p. 325 (middle, quoting from Wms. & Meyers): interests of L'or and L'ee usually aligned, but where they are not, closer inspection / analysis of L'ee's bus. judgment is needed

■ 3 issues

- Time
- Price
- Post-production costs
- =====
- Overarching Issue: the “reasonably prudent operator”

I/C to Market: Issue 1 – Time

- Interconnected with the shut-in royalty clause
- Note p. 318 – bottom paragraph
 - Parties obviously anticipated “some” delay in marketing
 - S-IR is for Lessee’s protection, while the I/C to Market is for Lessor’s benefit; so the I/C acts as a limit to how long the SIR can and will operate
- **Problem, p. 320**

I/C to Market: Issue 1 – Time

- **What if the product is stored and not sold right away? Would royalty be paid ...**
 - ... on mkt. price in effect when it was produced?
 - ... on mkt. price in effect when it is sold?
 - ... on actual sales price?

I/C to Market: Issue 2 – Price

- ***With respect to the “price” component, is the I/C to Market an obligation to:***
 - ❑ Get a reasonable price
 - ❑ Get the best price possible
 - ❑ Get the best price that is reasonably possible
 - ❑ Get a price that is consistent with other Lessees in the area

Amoco v. 1st Bapt. Ch. Pyote

- *Was Amoco's breach (a) its failure to get the best available K terms, or (b) that it got extra benefits for itself in properties that the Church had no interest in?*
- *Would Amoco have been liable if it had NOT renegotiated the Pioneer K?*
- **NOTE: pp. 329 – 330 N4**
 - Very important / practical litigation tip!!!

Amoco v. Bapt. Ch. – Gas Mktg.

- **1. Problem: p. 329 → “royalty pooling”**
- **2. Lessee has 20,000 MMBtu to sell, and 2 possible markets; which should it select?**
 - **1. sale for 5,000 MMBtu (rest sold at spot = \$4.50)**
 - **\$9 / MMBtu, pt. of sale is delivery at plant;**
 - **Transport and processing costs of \$3.50;**
 - **Term is 1 year;**
 - **2. sale for 12,000 MMBtu (rest sold at spot = \$4.50)**
 - **\$7.25 / MMBtu, pt. of sale is delivery to the interstate pipeline**
 - **Transport and processing costs of \$1.50**
 - **Term is 2 years**

I/C to Market: Problem

■ Situation ...

- L'ee has 1 L/T premium contract to sell 10,000 MMBtu/d at \$6.00 / MMBtu, w/ rest of gas being sold on the spot market at \$4.00 / MMBtu
- L'ee has 2 groups of wells that produce a combined volume of 18,000 MMBtu/d
 - 1 group produces 12,000
 - 1 group produces 6,000
- ***Can L'ee market the 18,000 in a way that doesn't violate the I/C to Market?***
- ***Does it make a difference if 1 group has a "market value" royalty, and the other group has a "sale proceeds" royalty?***

I/C to Market: Issue 3 – Post-Production Costs

- Garman: *the “marketable product rule”*
- *What are the different schools of thought on post-production costs?*
- Different approaches
 - TX / LA: royalty holder pays after gas severed at wellhead
 - OK / KS / ARK / ND: Lessee pays up to point of sale, consistent w/ a covenant to market
 - pp. 345-6 N7: roughly equal no. of states have adopted / rejected the marketable product rule

I/C to Market: Issue 3 – Post-Production Costs

- Points to Remember
 - The differing state approaches only apply when the Lease is silent about post-production costs
 - The parties can agree to allocate however they want
 - The OK /KS approach applies only to costs that make the gas marketable
 - t/f, costs incurred after that, to enhance value, are properly deducted
 - “Post-production costs” must still be reasonable [p. 346-7, N8]
- ***What is a “marketable product”? [p. 342-3 N4]***

NEXT CLASS ...

- Finish the rest of the Implied Covenants
- **Ch. 3 Secs. E3 (b), (c) and (d)**
 - → pp. 347 – 382

Quiz Results ... by the numbers

- 9 As (20%)
- 18 Bs (40%)
- 18 “others” (40%)
- **Class Avg. = 80.4**
- =====
- Highest grade: 98
 - Also 1– 96 & 1– 95
- =====
- I graded pretty leniently
- See my comments / questions / suggestions on your paper
- ***Come see me or contact me ...***

Quiz Results – Selected Answers (1/2)

■ Section I – definitions

- ❑ Gave benefit of doubt if it appeared you knew what you were talking about
- ❑ Vague generalizations ... NO
- ❑ Missing a key element ... NO

■ Section II – lost pts

- ❑ Q2 (RRC Jd): **80%** (36 / 45) → a & d [CL4/sl4]
- ❑ Q3 (S/T/R/ac): **73%** (33 / 45)
- ❑ Q4 (city ord): **67%** (30 / 45) → a & c [CL7/sl10]
- ❑ Q5 (pool. cal.): **51%** (23 / 45) → 60 / 100 / 85

Quiz Results – Selected Answers (2/2)

■ Section III Q1 (VSR):

- ❑ A) 40 ac. – t/f VSR doesn't apply
- ❑ B) VSR attached to shallow in 1970, before 1982 sale
- ❑ C) merger of 2 deeper res., t/f later date for deepest reverts back to 1980, before 1985 sale to Jones

■ Section III Q2 (RoC):

- ❑ C) can FBN use RoC as defense vs Thompson?
 - violate spacing rule (or other reg ... allowable?)
 - “bad pipe? = neg?”
 - waste / neg / trespass
- ❑ D) can WC use RoC as defense vs Thompson?
 - abandonment
 - was gas produced? Real vs personal property