LENAPE RESOURCES CORPORATION v. TENNESSEE GAS PIPELINE COMPANY: NATURAL GAS TAKE-OR-PAY CONTRACTS UNDER THE UNIFORM COMMERCIAL CODE

I. Introduction

In an effort to meet increasing demands for natural gas in the interstate market during the 1970s and early 1980s, interstate natural gas pipeline companies entered into long-term natural gas purchase and sales agreement contracts (gas purchase agreements) with natural gas producers at high prices.[1] Take-or-pay provisions were a standard feature of many of these gas purchase agreements. The essence of a take-or-pay contract is simple: the producer agrees to sell and deliver to the pipeline up to 100% of the gas production capacity of a particular reserve or well, and the pipeline agrees to purchase and receive from the producer the contractually designated quantity or, if the gas is available but not taken, to pay for all or some agreed portion of the available gas.[2] Unfortunately for pipeline companies, demand for natural gas dropped sharply during the 1980's resulting in low prices for new natural gas. The market would not accept the expensive take-or-pay gas. As a result, the pipelines did not purchase the gas, thus incurring huge payment obligations to producers for surplus unused gas in committed reserves.

In *Lenape Resources Corp. v. Tennessee Gas Pipeline Co.*,[3] the Tennessee Gas Pipeline Company (Tennessee) challenged its take-or-pay obligations to the Lenape Resources Corporation (Lenape)[4] under the theory that the Lenape gas purchase agreement constituted an output contract and was, therefore, subject to the good faith and proportionality requirements

1. *See generally* J. Michael Medina, Essay, *The Take-Or-Pay Wars: A Cautionary Analysis for the Future*, 27 Tulsa L.J. 283 (1991). *See also* John Burritt McArthur, *The Take-Or-Pay Crisis: Diagnosis, Treatment, and Cure for Immorality in the Marketplace*, 22 N.M. L. Rev. 353 (1992).

2. *See* Prenalta Corp. v. Colorado Interstate Gas Co., 994 F. 2d 677, 687 (10th Cir. 1991), which held that the remedy for breach of a take-or-pay contract is the "[Q]uantity of gas which is equal to the difference between the Contract Quantity and [what the] Buyer actual[ly] takes." *See also* McArthur, *supra* note 1 at 358.

3. Lenape Resources Corp. v. Tennesee Gas Pipeline Co., 925 S.W.2d 565 (Tex. 1996). The Texas Supreme Court had rendered a previous decision in the case, which was withdrawn upon a grant of rehearing and superseded by the present case. Lenape Resources Corp. v. Tennessee Gas Pipeline Co., No. 94-0278, 1995 WL 453226 (Tex. Aug. 1, 1995).

4. Also named as defendants were Tesoro Exploration and Production Company (Tesoro), Coastal Oil and Gas Corporation (Coastal), and Gulf Energy and Development Corporation (Gulf). Tesoro and Coastal entered into a farmout agreement with Lenape, and as a result became the "sellers" under the gas purchase agreement. Gulf gathered the natural gas from the committed reserves. *See Lenape*, 925 S.W.2d at 568. *See also* Tennessee Gas Pipeline Co. v. Lenape Resources Corp., 870 S.W.2d 286, 290 (Tex. Ct. App. 1993).

of Section 2.306 of the Uniform Commercial Code (UCC).[5] The Supreme Court of Texas, in a five to four decision, rejected Tennessee's challenge. However, in a strong dissent, four justices concluded that take-or-pay contracts are output contracts and, therefore, are subject to Section 2.306 good faith and proportionality requirements.[6] Thus, the minority would have remanded the matter back to the trial court for a determination as to whether Lenape's huge increase in production violated such UCC requirements.

This Note scrutinizes the majority decision in the *Lenape* case and concludes that the majority may have reached its decision based more on policy concerns than on sound legal reasoning. Section II of this Note provides some general background on take-or-pay contracts. Section III details the circumstances which led Tennessee to challenge its contractual obligations to Lenape. Section IV provides the procedural history of the case. Section V analyzes the majority opinion in light of the dissent. Section VI discusses the motivating policy considerations. Finally, Section VII concludes that the majority in *Lenape* decided the matter wrongly, and that allowing take-or-pay contracts to be subject to Section 2.306 good faith and proportionality requirements would not seriously diminish natural gas production nor re-allocate market risks.

II. Take-or-Pay Provisions of Gas Purchase Agreement Contracts

The energy crisis of the early 1970s increased demand for natural gas. This increase in demand combined with a disparate pricing structure between interstate and intrastate gas resulted in a shortage of interstate natural gas.[7] While the price of intrastate natural gas increased with rising demand, federal regulation held interstate gas prices artificially low. Producers naturally targeted intrastate markets for new gas production, exacerbating the shortage of gas available for interstate markets. [8] Thus, in an

5. Tex. Bus. & Com. Code Ann. § 2.306 (West 1994).

6. Two other courts have characterized gas purchase agreements with take-or-pay provisions as "output contracts". These characterizations do not appear to have been challenged, thus the decisions lack any in-depth analysis. In United States v. Great Plains Gasification Assoc., 819 F.2d 831, 834 (8th Cir. 1987), the circuit court upheld a district court ruling that "Gas purchase agreements [with take-or-pay clauses] unambiguously require the pipelines to purchase the . . . entire output, so long as the gas meets contract specifications." The court applied Illinois law to a contract for synthetic gas converted from lignite coal. In American Exploration Co. v. Columbia Gas Transmission Corp., 779 F.2d 310, 311 (6th Cir. 1985), the court noted that "The basic structure of the contract is thus that of a *fixed-price output contract* with . . . [the buyer] obligated to take or pay for later a fixed percentage of the . . . gas in any given year" (emphasis added) (applying Ohio law).

7. *See* Ryan E. Griffitts, Comment, *Roye Realty & Developing, Inc. v. Arkla, Inc.: Two Steps Forward Two Steps Back in the Take-Or-Pay Saga*, 20 Okla. City U. L. Rev. 219, 222 (1995). *See also* McArthur, *supra* note 1 at 361.

8. At the time, the Federal Energy Regulatory Commission's (FERC) jurisdiction over the price of natural gas sold interstate was construed broadly, allowing for regulation of natural gas prices at the wellhead, Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672 (1954), and for gas sold intrastate, if it was co-mingled in the same pipeline with gas sold interstate, California v. Lo-Vaca Gathering Co., 397 U.S. 366 (1965). FERC jurisdiction, however, has never been asserted over natural gas sold completely

effort to secure a steady supply of interstate gas for customers, interstate pipeline companies entered into risky long-term take-or-pay gas purchase agreement contracts with producers, often at high prices.[9]

The Natural Gas Policy Act of 1978 (NGPA)[10] attempted to remedy the market distortion created by two separate natural gas markets by regulating intrastate as well as interstate gas sales for an interim period (the deregulation of both beginning in 1985) and by encouraging new production.[11] Anticipating that the price of new natural gas production would climb even higher once NGPA deregulation was complete, pipeline companies rushed to lock in new natural gas production at a set price in the form of additional natural gas take-or-pay contracts.[12]

Long-term gas purchase agreement contracts provide a flexible and reliable source of gas for pipelines, which is especially important during seasonal demand peaks.[13] Take-or-pay clauses within these contracts allow a reliable source of income to producers who must risk capital on exploration and drilling.[14] However, the take-or-pay provision also allocates the risk of declining demand and subsequent declining market prices for gas to pipeline companies. Unfortunately for the interstate pipeline companies, an economic recession, lower oil prices, and increased conservation measures by consumers all contributed to a decreased commercial and residential demand for natural gas during the early 1980s.[15] Increased supply and decreased demand significantly lowered the price of new natural gas. The availability of low-priced gas posed a serious problem for interstate pipeline companies with high priced take-or-pay obligations. By 1986, outstanding take-or-pay liabilities were estimated at $5.7 billion dollars.[16] Rather than continue to pay for high priced unused gas, most pipeline companies decided to renegotiate or to simply breach their contractual obligations.[17]

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within intrastate markets. Without federal regulation to keep the price of gas sold in intrastate markets artificially below the market clearing price, the price of intrastate gas continued to rise as demand increased.

9. *See* McArthur, *supra* note 1, at 361. "[P]ipelines were primarily under pressure to secure stable supplies, not to find low-priced gas. Pipelines were insulated from the market because the FERC allowed them to "pass through" costs . . . so the costs of expensive gas would be spread among all their customers. This pricing . . . left the pipelines even more secure about buying additional gas at very high prices." *Id.*

10. 15 U.S.C. §§ 3301-3432 (1994).

11. *See generally* Rodney L. Brown, Jr., Note, *Legislative History of the Natural Gas Policy Act: Title I,* 59 TEX. L. REV. 101 (1980).

12. *See* McArthur, *supra* note 1, at 361.

13. *See* David L. Kearney, *The Take-Or-Pay Controversy from the Pipeline Perspective,* 13 OKLA. CITY U. L. REV. 479, 479 (1988).

14. *See* David L. Roland, *Take-Or-Pay Provisions: Major Problems for the Natural Gas Industry,* 18 ST. MARY'S L. J. 251, 261 (1986).

15. *See* McArthur, *supra* note 1, at 362-63.

16. J. Michael Medina, et al., *Take or Litigate: Enforcing the Plain Meaning of the Take-Or-Pay Clause in Natural Gas Contracts,* 40 ARK. L. REV. 185, 186 (1986).

17. *See* McArthur, *supra* note 1, at 363-64.

Pipelines raised a multitude of affirmative legal defenses in the inevitable breach of contract litigation which followed, generally with limited success.[18] Many producers chose to settle rather than face lengthy and costly court proceedings, and generally settled on terms favorable to pipeline companies.[19] Where producers have pursued litigation, however, courts have been willing to interpret the terms of gas purchase agreements strictly.[20] Thus, successful defenses by pipeline companies have often centered around specific contract language.[21]

III. Background of the Tennessee-Lenape Dispute

Tennessee entered into a gas purchase agreement with Lenape's predecessor in interest in 1979.[22] The gas purchase agreement included a take-or-pay provision obligating Tennessee to take, or pay for if not taken, 85% of the production capacity from the gas reserves committed in the gas purchase agreement under various oil and gas leases in Zapata County, Texas.[23] The gas purchase agreement allowed Lenape an unlimited increase in production on the field, including the drilling of new wells.[24]

When market conditions changed in the early 1980s, Tennessee attempted to reduce its take-or-pay obligations with producers, including Lenape. Tennessee instituted an "emergency gas purchase policy," essentially threatening a breach of take-or-pay obligations under the theory of force majeure if producers (including Lenape) did not agree to amend their gas purchase agreements under terms favorable to Tennessee.[25] Because of Tennessee's "emergency gas purchase policy," Lenape had no incentive to increase the already low production on the committed reserves. As a result, lessors of the committed reserves sued Lenape for breach of the implied covenant to develop the gas lease.[26]

The lessors' suit ultimately lead to the pooling of acreage committed under the gas purchase agreement with adjacent, non-committed acreage to form one unit over the same natural gas reserve.[27] Three new natural

18. *See generally* McArthur, *supra* note 1, *see also* Medina, *supra* note 1.

19. As McArthur rather bitterly states, "The judicial system has enforced most of the contracts that survived the delay and costs of litigation, but focusing on these cases only obscures the dismal fact that most contracts that were breached were settled for a fraction of their value long before they reached the courts." *supra* note 1, at 458.

20. Medina, *supra* note 1, at 285.

21. Kearney, *supra* note 13, at 481.

22. Tennessee Gas Pipeline Co. v. Lenape Resources Corp., 870 S.W.2d 286, 290 (Tex. Ct. App. 1993). The original sellers were National Exploration Company and Eton Partnership.

23. Section 3(a) of the gas purchase agreement states: "Seller agrees to sell and deliver to Buyer, and Buyer agrees to purchase and receive, or pay for if available and not taken, Seller's pro rata part of . . . [85% of the Seller's delivery capacity] from the committed reserves: . . ." Lenape Resources Corp. v. Tennessee Gas Pipeline Co., 925 S.W.2d 565, 569 (Tex. 1996).

24. *Id.* at 568.

25. *Id.*

26. *Id.*

27. As the court explains:

> Tesoro Exploration and Production Company obtained lease options from the lessors and backed the lessors in their lawsuit against Lenape. Lenape settled the lawsuit with its lessors

gas wells were drilled on this unit, one of which was located on acreage originally committed in the gas purchase agreement, and two of which were located on acreage not originally committed in the gas purchase agreement.[28]

The new wells dramatically increased the production capacity of the natural gas reserve and Tennessee's related take-or-pay obligations. Tennessee asserts that during the first twelve years of its gas purchase agreement with Lenape, it was never liable for greater than $300,000 in gas production in any given year. However, with the expanded acreage and increased production, Tennessee paid $89 million under the same gas purchase agreement in 1993 alone.[29]

IV. Statement of the Case

Tennessee sued Lenape in 1990 seeking a declaration under various theories that it was not liable for the huge increase in production attributable to the three new gas wells. The 57th District Court of Texas summarily ruled in favor of Lenape on all issues.[30] The San Antonio Court of Appeals reversed the trial court's summary judgment, ruling that the take-or-pay provision constituted an "output" contract, subject to UCC Section 2.306 good faith and proportionality requirements,[31] while affirming the remainder of the trial court's judgment. The Supreme Court of Texas reversed the Court of Appeals and affirmed the District Court's ruling that UCC Section 2.306 did not apply to the gas purchase agreement.[32]

V. Decision Analysis

The central issue decided in the *Lenape* case was whether the Lenape contract was subject to the good faith and proportionality requirements of UCC Section 2.306.

As a preliminary matter, the Texas Legislature has declared that natural gas is a good, if it is severed from the land, and is thus subject to the

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> and agreed to unitize part of the committed acreage with adjacent property. The unitization formed the Guerra A and B units, each comprised of one-half of the committed acreage and additional acreage outside the [gas purchase agreement's] committed acreage.

Id.

28. Lenape was allowed to unitize committed acreage with adjacent non-committed acreage under its gas purchase agreement with Tennessee. *See Lenape*, 925 S.W.2d at 568.

29. *See id.* at 568 n.1.

30. *Id.* at 569.

31. Tennessee Gas Pipeline Co. v. Lenape Resources Corp., 870 S.W.2d 286, 290 (Tex. Ct. App. 1993).

32. The Texas Supreme Court unanimously upheld the lower court rulings on other issues, finding for Lenape. These issues include: 1) the determination of price escalation factors for committed natural gas; 2) whether Tennessee was obligated to purchase a proportionate share of the gas produced from unitized acreage not originally committed under the gas purchase agreement; and 3) whether Tennessee may contest its obligations under the gas purchase agreement based upon a termination of the lease between Lenape and the lessors. *See* Lenape Resources Corp. v. Tennessee Gas Pipeline Co., 925 S.W.2d 565 (Tex. 1996).

UCC.[33] A majority of other states have codified similar provisions.[34] Therefore, the applicability of the UCC in general to the Lenape contract was not an issue.

The portion of Section 2.306(1) at issue states: "A term which measures *the quantity* by the *output of the seller* . . . means such *actual output* or requirements *as may occur in good faith*, except that *no quantity unreasonably disproportionate* to . . . any *normal* or otherwise comparable *prior output* or requirements may be tendered or demanded" (emphasis added).[35] For Section 2.306 to be applicable to a contract, the contract must be deemed an output contract. An output contract is simply a contract in which the quantity to be sold is indefinite (or, in the alternative, is not sufficiently definite), and the buyer's obligation is established as a percentage of the entire production capacity of the seller.[36] Prior to the UCC, courts declined to enforce many output contracts on grounds of indefiniteness and lack of mutuality.[37] Section 2.306 corrects such faults by operating as a "gap filler" – that is, by defining the quantity term as the entire output of the seller – but only if the output occurs in good faith and is reasonably proportionate to the potential output the contracting parties expected.[38] Courts generally have upheld output contracts under the UCC, provided the seller's output is in "good faith and according to commercial standards of fair dealing in the trade so that his output will proximate a reasonably foreseeable figure."[39]

The majority in *Lenape* postulated that the Lenape gas purchase agreement was not an output contract. The court reasoned that the take-or-pay contract could not be an output contract because the buyer was not *obligated* to purchase the gas, but could have instead chosen the *alternative* performance of paying for the exclusive dedication of the committed reserves for a specified period of time.[40] The majority was correct in noting that for the "pay" option of the take-or-pay contract the buyer was not actually paying for gas produced but, instead, was paying for the *right* to take the gas from dedicated reserves for a specified period of time.[41] How-

33. "A contract for the sale of minerals [including natural gas] . . . removed from realty is a contract for the sale of goods . . . ." TEX. BUS & COM. CODE ANN. § 2.107(a) (West 1994)

34. All but five states (Louisiana, Maryland, Ohio, Vermont, and Wyoming) have adopted provisions stating that a contract for the sale of minerals, including oil and gas to be severed from land, is a contract for the sale of goods under the UCC. For a complete listing of the applicable code sections, *see Lenape*, 925 S.W.2d at 577 n.1 (footnote 1 of dissenting opinion).

35. TEX. BUS. & COM. CODE ANN. § 2.306 (West 1994).

36. *See* Meyer v. Sandhills Beef, Inc., 318 N.W.2d 863, 866 (Neb. 1984) (a contract for an entire standing mature corn crop, which had been estimated as to quantity, was not an output contract because the quantity was sufficiently definite).

37. For a discussion of this, *see Lenape* at 577 (part I of dissenting opinion).

38. Section 2.306 of the UCC "[G]ives validity to the contract despite the uncertainty as to quantity, while at the same time making certain equitable exceptions." *Meyer*, 318 N.W.2d at 866.

39. *See* Francis M. Dougherty, Annotation, *Output Contracts Under § 2-306(1) of Uniform Commercial Code*, 30 A.L.R.4th 396 (1984).

40. *Lenape*, 925 S.W.2d at 569-70.

41. *Id.* at 570. *See also* Diamond Shamrock Exploration Co. v. Hodel, 853 F.2d 1159, 1167-68 (5th Cir.1988).

ever, as the dissent pointed out, the buyer still had no practical "alternative performance." The contractual obligations of the buyer remain based upon the physical production capacity of the reserves, regardless of which "alternative" the buyer chooses. The "alternative" is simply a function of the unique quality of natural gas in that it is not actually "produced" unless it is physically taken and used by the buyer.[42] The obligation of the buyer remains dependent upon the variables of production which the seller controls, as in any other output contract.

The majority also pointed out that many forces beyond the control of the seller work to limit natural gas production, including the physical size of the committed reserves and regulatory constraints on production. In such circumstances, the majority reasoned that a take-or-pay contract could not be an output contract because production was inherently limited and, therefore, quantity was sufficiently definite.[43] However, while the production of gas from any field is finite, the reality of finite production should not automatically render the quantity term of the contract as sufficiently definite. Factors limiting production are not unique to the natural gas industry. The laws of physics and the reality of finite resources operate to limit the production of *any* good or service.[44] The production capacity of the seller is always a function of the seller's industry, within a given set of constraints and variables. As the dissent noted, there is nothing in Section 2.306 which would require output contracts to have "infinite production or purchasing capacity."[45] To do so would, by definition, make an output contract an impossibility, and render Section 2.306 moot.

While, based upon the above suppositions, the *Lenape* majority clearly believes that a take-or-pay clause does not convert a gas purchase agreement into an output contract, the majority failed to actually decide this with respect to the Lenape contract.[46] Instead, the court held that Section 2.306 did not apply to the Lenape gas purchase agreement because the "parties agreed to quantity obligations that differ from those imposed by Section 2.306."[47] Section 2.306 operates as a "gap filler" which applies only when the quantity term of the contract is indefinite, therefore, the Section

42. *Lenape*, 925 S.W.2d at 578 (Phillips, C.J., dissenting).

> [G]as is not actually produced and does not become the seller's "output" if the buyer does not take delivery. This is not a valid basis for removing [gas purchase agreements] from the reach of Section 2.306 . . . the buyer's obligation . . . is dependent upon the seller's physical capacity to deliver gas at a given time.

If the producer were selling widgets instead of natural gas, the buyer would have the option of storing the unused widgets in the buyer's warehouse, rather than allowing them to remain with the producer. However, regardless of where the widgets were stored, the buyer's contractual obligations to pay for the widgets produced would remain.

43. *Lenape*, 925 S.W.2d at 570.

44. If a widget producer contracts to sell all widgets the producer is capable of making, the producer is still limited to making a finite number of widgets, even if the producer were able to devote the entire global quantity of labor and natural resources to widget making.

45. *Lenape*, 925 S.W.2d at 578 (Phillips, C.J., dissenting).

46. *Id.* at 579.

47. *Lenape*, 925 S.W.2d at 570.

does not apply when the quantity term is sufficiently definite.[48] The majority held that the quantity term of the Lenape gas purchase agreement was sufficiently definite and that Section 2.306 did not apply. The contract required Tennessee to purchase a quantity of gas defined as eighty-five percent of Lenape's delivery capacity. As the majority rather illogically pointed out, "The specific quantity of natural gas for which Tennessee must take or pay is a simple mathematical calculation: [equal to] .85 multiplied by Sellers' delivery capacity. Section 2.306 does not apply to fill in the quantity . . . because the quantity is specified as a determinable amount, Sellers' delivery capacity."[49] Thus, the majority simply concluded that the quantity term of the Lenape contract was a "set" amount of gas, as determined by a mathematical percent of Lenape's (uncertain) production capacity.

While Tennessee's obligations were dependent upon Lenape's production capacity, the level of such production capacity was anything but set. New wells drilled on the committed reserves increased production capacity by several hundred percent. The production capacity of any natural gas reserve, while ultimately limited, is largely dependent upon the actions of the producer.[50] Furthermore, the contracting parties in this case were aware of the potential for a large increase in production from committed reserves, and the gas purchase agreement placed no restrictions on that increase.[51] Given the circumstances and the sophistication of the contracting parties, the absence of such a restriction on total production would appear to indicate a deliberate intent of the parties to omit a definite quantity term.

The majority relied on two cases to support their contention that the quantity term of the gas purchase agreement was sufficiently definite. In *Riegle Fiber Corp. v Anderson Gin Co.*,[52] the court held that a contract for cotton grown on a set number of acres was sufficiently definite. Likewise, in *Fort Hill Lumber Co. v. Georgia-Pacific Corp.*,[53] the quantity term of a contract for all of the lumber in a specified area was definite. These cases do not support the majority decision. In both *Riegle* and *Fort Hill*, the contracts provided a *specific standard or formula* for determining the approximate *total* production of cotton or lumber. The gas purchase agreement in

48. *See* Dougherty, *supra* note 39.

49. *Lenape*, 925 S.W.2d at 571.

50. As Chief Justice Phillips explains, "They contracted for 85% of Sellers' delivery capacity for twenty years. That could be all of the gas, or only a fraction of it, depending not only on fortune and physics, but also to some extent on the Sellers' aggressiveness in exploring and developing the underlying leases." *Id.* at 579 (Phillips, C.J., dissenting).

51. The gas purchase agreement between Lenape and Tennessee permitted Lenape

> . . . to increase delivery capacity by drilling new wells and unitizing, provides that Sellers are not obligated to deliver any predetermined quantity or to maintain any predetermined level of deliverability, anticipates that the Sellers may increase delivery capacity, and demonstrates by virtue of all its provisions taken together that the parties expected that delivery capacity could increase significantly.

Id. at 579.

52. 512 F.2d 784, 790 (5th Cir. 1975).

53. 493 P.2d 1366, 1368 (Or. 1972).

the present case had no standard to estimate total production *a priori*. The formula used in the Lenape contract only determined production capacity after the fact.[54] The gas purchase agreement placed no restrictions whatsoever on the number or total production capacity of gas wells on the committed reserves.[55]

The majority in *Lenape* held that Section 2.306 of the UCC did not apply to take-or-pay provisions of gas purchase agreements. However, the gas purchase agreement in this case set no limits on Lenape's maximum production capacity from the committed reserves, and was therefore sufficiently indefinite for Section 2.306 to apply. Tennessee's obligations under the gas purchase agreement were dependent upon Lenape's uncertain production capacity, regardless of whether Tennessee choose to take the gas or not.

VI. Policy Considerations

The primary purpose of take-or-pay provisions specifically, and long-term gas purchase agreements generally, is to allocate the risk of fluctuating market demands for natural gas to the purchaser.[56] Long-term take-or-pay contracts provide a certain market for gas produced from committed reserves. This assurance encourages investment in the exploration and production of natural gas[57] and provides stability in the lessor/lessee relationship.[58] The majority in *Lenape* identified these policy considerations and asserted that application of Section 2.306 to Lenape's gas purchase agreement would undermine the primary purpose of Tennessee's take-or-pay obligations and would result in "a fundamental shift in the party bearing the market risk . . . inject[ing] uncertainty into the natural gas production industry."[59]

Although the majority was convinced otherwise, fear of a fundamental shift in market risk allocation and an associated impedance on production may be unwarranted.[60] Application of Section 2.306 to take-or-pay contracts does not automatically exempt the purchaser from payment obliga-

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54. *Lenape*, 925 S.W.2d at 569.

55. *Id.* at 567.

56. *See* Exxon Corp. v. West Texas Gathering Co., 868 S.W.2d. 299, 302 (Tex. 1993). *See generally*, Richard J. Pierce, *Reconsidering the Roles of Regulation and Competition in the Natural Gas Industry*, 97 HARV. L. REV. 345, 353-7 (1983). *See also* Roland, *supra* note 11.

57. As Pierce explains: "Long-term contracts allow parties to bargain for the socially optimum mix of price and supply security. Any attempt to prohibit the use of provisions like take-or-pay clauses . . . would discourage producers from entering into long-term contracts [and] would inevitably reduce the incentive to find and produce gas." See Pierce, *supra* note 56, at 356-57.

58. If a producer does not drill wells on a lease as would a reasonably prudent operator, the producer may be in breach of an implied covenant to develop the lease. The majority in Lenape asserts that the application of Section 2.306 to take-or-pay contracts would undermine the stability of gas purchase agreements to the point that producers would routinely breach this covenant. *See Lenape*, 925 S.W.2d at 572.

59. *Id.* at 573.

60. "The Sellers and numerous amici have urgently suggested that such a holding would ineluctably bring the oil and gas industry in Texas to a grinding halt. Their arguments, while no doubt sincere, are for several reasons not persuasive." *Id.* at 581 (Phillips, C.J., dissenting).

tions but simply puts before the trial court the question of good faith and proportionality. As the dissent explains: "The Seller still has a certain market for all the natural gas it pumps in good faith and in a reasonable proportion to estimated or prior output. This should be, in almost all cases, all the gas that a Seller produces."[61] Challenging a take-or-pay contract under Section 2.306 merely subjects the contract to a test of the contracting parties' reasonable expectations of quantity, which for the oil and gas industry must naturally "encompass very wide fluctuations in quantity."[62] Such scrutiny does not limit a producer's guarantee of a market for their product, regardless of market demand fluctuations, but only serves to limit the range of production to that which the parties reasonably expected in the bargained-for-exchange.

In *Lenape*, both parties to the gas purchase agreement were experienced in the natural gas industry. Both parties were aware of the uncertain nature of the oil and gas market and the potential for a large increase in production capacity. However, the questions of whether an increase in production of this magnitude was reasonably foreseeable and proportionate to the possible production expected by the parties, and whether Lenape acted in good faith considering the circumstances, are questions the trial court should have determined. Allowing Tennessee to raise these questions would not have fundamentally altered the allocation of market risk, but would have allowed Tennessee's take-or-pay contract the same protections of good faith and reasonable expectations afforded all other option contracts under the UCC. The *Lenape* court's fear that application of Section 2.306 would undermine take-or-pay contracts appears to be unfounded.[63]

VII. Conclusion

The *Lenape* court wrongly concluded that take-or-pay gas purchase agreements are not subject to Section 2.306 of the UCC. The decision appeared to be motivated, in substantial part, by the majority's fear that in protecting the purchaser of natural gas in a take-or-pay contract from unreasonably large increases in production, the fundamental allocation of risk associated with market demand fluctuations would be shifted to the point that a significant decrease in exploration and production would occur. Although purchasers of natural gas should not be excused from take-or-pay obligations simply because of an unforseen market shift or an unusually large increase in production capacity, neither should natural gas

61. *Id.*

62. *Id.*

63. The dissenting opinion in *Lenape* analyzed how the reasonable proportionality and good faith for quantity increases requirements of Section 2.306 should operate in the take-or-pay circumstances. They concluded that, because of the sophisticated knowledge of the parties and inherent uncertainty of the natural gas industry, "[P]roducers will not face a jury trial over the enforceability of a take-or-pay gas purchase contract every time a new well is drilled or a successful strike is celebrated. Only in extraordinary cases will a fact issue be raised as to whether a tendered quantity is unreasonably disproportionate to prior output under Section 2.306." *Id.* at 583 (Phillips, C.J., dissenting).

producers be insulated from the scrutiny of good faith and proportionality limits on production when the contract quantity is sufficiently indefinite. Genuine issues of good faith and reasonable proportionality with regard to a production capacity increase should, when raised by a purchaser of natural gas obligated to a take-or-pay contract, be decided by a trial court and not dismissed as a matter of law.

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