Fairness Is in the Eye of the Beholder: The Conflicting Interpretations of the Correct Measure of Damages for Breaches of Natural Gas Contracts Containing Take-or-Pay Provisions

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I. INTRODUCTION

Contracts between the producers of natural gas and the pipeline buyers that transport the gas to consumers often contain "take-or-pay" provisions.1 Typically, these provisions require the buyer of the gas to either purchase at least a contractually specified minimum volume of gas at a price that is fixed by the contract, or to pay for that same minimum volume without taking physical possession of it.2 However, if the buyer pays for the gas without taking it, the buyer retains the right to take the prepaid quantity of gas in the future.3 The seller is contractually bound to deliver at least the specified minimum quantity of gas and is entitled to receive the contractually fixed rate for all of the gas that is taken by the pipeline.4

When buyers breach a contract that includes a take-or-pay provision, courts have a difficult time determining the correct measure of damages. This difficulty is illustrated by the different interpretations of the correct method for calculating damages that have been given by various courts. The difficulty in calculating the damages arises because some courts construe the take-or-pay clause as a strict contractual performance requirement that entitles the non-breaching party to the total amount of the payments due under the contract.5 Other courts6 assert

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3. Contracts generally limit the amount of time that the buyer has to take the prepaid gas. See id. at 662.
4. See id. at 659. Take-or-pay provisions usually consist of the following language: "Seller agrees to sell and deliver to [Buyer] and [Buyer] agrees to purchase and receive from Seller, or if available and not taken, pay for that quantity of pipeline gas..." Id. at 661.
that the take-or-pay clause is merely a statement of alternative contractual duties which, if breached, entitle the seller to the "difference between the market price at the time and place for tender and the unpaid contract price together with any incidental damages." The latter is the remedy prescribed by Section 2-708 of the Uniform Commercial Code (UCC). 7 An alternative interpretation of the take-or-pay clause that is rejected by both the majority and minority 8 would be that the take-or-pay clause is the equivalent of a liquidated damages provision. 9

The Colorado Supreme Court held in Colorado Interstate Gas Company, Inc. v. Chemco, Inc., that the breach of a contract containing a take-or-pay provision entitles the non-breaching party to the full amount of the take-or-pay payments due. 10 This rule is not supported by other state and federal courts. 11 However, the Colorado rule seems to be the most reasonable interpretation of the take-or-pay provisions in contracts and accordingly provides the correct measure of damages to the seller when the buyer breaches. The Colorado rule is supported by the clear and unambiguous language of most take-or-pay provisions; it maintains the contracting parties' allocation of risk, and it deters future breaches by buyers.

Part of the reason that courts have struggled with the issue of determining the proper measure of damages when buyers breach take-or-pay contracts is that it is a relatively new issue with little case law for courts to base their holdings upon. The lack of precedent has caused some disagreement between courts, all of which rely heavily on treatises rather than primary sources of the law to aid them in their decisions. 12 Because this is a relatively new issue that deals with the UCC,
it is important that courts develop a uniform rule that is based on careful consideration of all of the ramifications surrounding the various interpretations thereof. All states should establish a uniform rule so that there is predictability and uniform application of contract law and remedies throughout the United States.

This Note will examine the issue of determining the correct calculation of damages that should be awarded to sellers when buyers breach a contract that contains a take-or-pay clause. Part II of this Note discusses the background of this issue, including the applicable provisions of the UCC, and how other state and federal courts have ruled in similar cases that conflict with Chemco. Part III examines the facts and the Colorado Supreme Court’s reasoning in Chemco. Part IV analyzes Chemco, compares it to the holdings of other courts in similar cases, and concludes that the Colorado interpretation of take-or-pay provisions is the best rule and, as such, prescribes the correct amount of damages that the seller should be awarded if the buyer breaches.13

II. BACKGROUND

A. Reasons for Including Take-or-Pay Provisions in Contracts

Parties to a contract whereby a producer sells natural gas to a pipeline buyer often include take-or-pay provisions in the contract.14 One of the primary reasons that parties include take-or-pay provisions in such contracts is to allocate the risk of market price fluctuations.15 When the price for gas is set by the contract, the seller bears all of the risk because if the market price increases before the contract expires, the seller is bound to sell the gas to the buyer at the contractually agreed upon rate regardless of the higher market price. Thus, the buyer is guaranteed a fixed rate for the duration of the contract while the seller may be forced to sell the gas at a rate that is far below the market price.

In the absence of a take-or-pay provision, a buyer can refuse to purchase any gas if its resale becomes unprofitable due to a decline in the market price that puts the market price below the contract price. This places all of the risk on the seller. As a result, sellers can never get more than the market price, at the time that the contract is signed.


15. See id. at 359.
for their gas, while the buyers who resell the gas may gain significant profits therefrom if the market price rises significantly higher than the contract price. The take-or-pay provision insures that even if the market price of gas drops below the contract price, the buyer will still have to pay the seller for a minimum quantity of gas at the contract price regardless of whether the buyer takes the gas and resells it. This provision has the effect of allocating the risk of fluctuations in the market price between the buyer and seller, rather than forcing the seller to bear all of the risk. Thus, in a sense, contracts for the sale of gas that include take-or-pay provisions are analogous to futures markets, in that both parties bear some risk of loss due to fluctuations in the market price.

Take-or-pay provisions became prominent in the late 1970s when Congress enacted the Natural Gas Policy Act (NGPA) of 1978, which was intended to stabilize the price of natural gas. Because the price of natural gas was fixed by government regulation, the pipeline buyers lost a lot of their previously superior bargaining power and were forced to submit to take-or-pay provisions in order to contract with the gas selling producers. These take-or-pay provisions as well as the statutorily fixed prices for natural gas provided a great deal of certainty and stability for the natural gas market. However, in the mid-1980's, the natural gas industry was deregulated, and gas prices fell substantially, frequently far below the take-or-pay contract prices. Because of the decline in the market price for gas, many pipelines found it unprofitable to resell the gas that they were contractually obligated to pay for (regardless of whether they took it). This induced many pipeline buyers to breach their contracts with the producer sellers by not paying the sellers. Many of those breaches were litigated and the courts were called

16. Under most contracts with take-or-pay provisions, if the buyer does not take the gas at the time of the payment, it may treat the payment as a prepayment for gas that it will take in the future in excess of the contractually fixed minimum. Thus, if it pays for the minimum gas in month 1, but does not take the gas, it may pay for the minimum quantity in month 2 and take twice the minimum monthly quantity of gas because it has prepaid for one month. Contracts generally limit the duration of time that the buyer has to take the prepaid gas. See id. at 358-59.
17. See id.
19. See Griffitts, supra note 13, at 222.
20. Some commentators have referred to pipelines in the pre-NGPA times as monopolies with substantial bargaining power which was weakened by the passage of the NGPA. See McArthur, supra note 1, at 355.
21. See Griffitts, supra note 13, at 223.
22. See id.
23. See id.
upon to establish a remedy. Although not as frequent as in the mid-1980’s, pipeline buyers of natural gas continue to breach their contracts containing take-or-pay provisions with producer sellers.

Courts examining these types of contracts have generally upheld the validity of take-or-pay provisions. Defendant buyers, who have breached their contracts, normally raise several affirmative defenses but are typically unsuccessful. The court’s attention is therefore focused on a determination of the correct measure of damages for buyer’s breach of the take-or-pay provision.

B. UCC Provisions Covering the Remedy for Breach of a Contract Containing a Take-or-Pay Provision

Article 2 of the UCC, which has been adopted in every state but Louisiana, governs the sale of natural gas. While one might assume

25. This Note contends that similar breaches continue to occur because the courts have established a remedy that is favorable to the breaching pipelines, i.e. the remedy allows them to breach their contracts without paying the amount that they are contractually obligated to pay. This type of remedy has essentially eliminated the risk allocation to the pipelines.


27. See Prenalta Corp. v. Colorado Interstate Gas Co., 944 F.2d 677 (10th Cir. 1991); Universal Resources Corp. v. Panhandle E. Pipeline Co., 813 F.2d 77 (5th Cir. 1987); Colorado Interstate Gas Co., Inc. v. Chenco, Inc. 854 P.2d 1232, 1237 (Colo. 1993); Roye Realty & Dev., Inc. v. Arkla, Inc., 863 P.2d 1150 (Okla. 1993). See also 4 WILLIAMS & MEYERS, supra note 2, at § 724.5 (citing Northern Natural Gas Co. v. Republic Natural Gas Co., 241 P.2d 708 (Kan. 1952)).


that the universal adoption of the UCC would seem to eliminate confusion among courts as to the proper remedy for the breach of a contract containing a take-or-pay provision, there are different provisions within the UCC that lend support to conflicting interpretations of the correct measure of damages for the breach of such a contract. 32 Section 2-708 of the UCC states that a seller's damages for non-acceptance of goods (gas) or repudiation of contractual obligations by the buyer "is the difference between the market price at the time and place of tender and the unpaid contract price together with any incidental damages . . . but less expenses in consequence of the buyer's breach." 33 Thus, if the buyer breaches, the seller retains ownership of the gas that the buyer failed to pay for, and the buyer pays the difference between the contract price and the market price to the seller. 34 The majority of courts deciding this issue have stated that Section 2-708 of the UCC governs, and calculate damages according to the formula supplied thereby. 35

Other sections of the UCC allow contracting parties to vary the provisions of the UCC by contract 36 and to provide remedies for breaches of contracts that are either supplementary to or in lieu of those


31. See Universal Resources Corp. v. Panhandle E. Pipeline Co., 813 F.2d 77, 78 (5th Cir. 1987); Chemco, 854 P.2d at 1236; Roye Realty & Dev., Inc. v. Arkla, Inc., 863 P.2d 1150, 1153 (Okla. 1993).


34. Typically when the buyer breaches, the contract price will exceed the market price. Otherwise, the buyer would simply purchase the gas and then resell it at a profit, or assign the rights thereto.

35. See Prenalta Corp. v. Colorado Interstate Gas Co., 944 F.2d 677 (10th Cir. 1991); Universal Resources Corp. v. Panhandle E. Pipeline Co., 813 F.2d 77 (5th Cir. 1987); Roye Realty & Dev., Inc. v. Arkla, Inc., 863 P.2d 1150 (Okla. 1993).

prescribed by any specific section of the UCC. Thus, the very terms of a contract can supply the remedy for a breach thereof. Take-or-pay provisions have been interpreted as providing a remedy for breach of contract in lieu of Section 2-708 of the UCC. Under that interpretation, if the buyer breaches a contract that includes a take-or-pay provision, the seller retains ownership of the gas and the buyer pays the full amount of the remaining take-or-pay payments at the contract price. This is the remedy established by the Colorado Supreme Court in Chemco under the rationale that the take-or-pay clause established a contractual duty and that the damages for a breach thereof were the total amount of payments due under the contract. However, other courts have interpreted the take-or-pay clause as an alternative method of performance option that is breached if the buyer does not make the take-or-pay payments. Under this rationale the proper remedy is the difference between the contract and market prices. Section 2-718 of the UCC provides that “[d]amages for breach by either party may be liquidated in the agreement but only at an amount which is reasonable in the light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss, and the inconvenience or non-feasibility of otherwise obtaining an adequate remedy.” However, thus far, courts have refused to interpret take-or-pay provisions as the equivalent of liquidated damages.

One of the reasons why every state adopted the UCC was to provide uniformity in the legal treatment of contracts. Uniformity allows entities to conduct business with informed confidence about the legal ramifications of their actions. This lack of uniformity in the interpretation of the proper remedy for breach of contracts containing take-or-pay clauses should be rectified by the establishment of a clear rule. While either the majority rule or the Chemco rule will provide that uniformity,
the Chemco rule preserves the true meaning of the take-or-pay provision, maintains the contracting parties' allocation of risk, and acts as a deterrent against the breaching of contracts.

III. COLORADO INTERSTATE GAS COMPANY, INC. v. CHEMCO, INC.

A. Facts

In 1978, Chemco entered into a lease on oil and gas acreage in Colorado whereby it was permitted to drill for natural gas.45 The following year, Chemco entered into a fifteen-year contract containing a take-or-pay provision with Colorado Interstate Gas Company (CIG), which installed and operated gas collecting facilities on the Chemco well.46 Furthermore, the contract provided that "[d]uring the 5 years next succeeding the Contract Year in which Buyer has failed to take the gas so paid for, all gas well gas taken by Buyer from Seller which is in excess of the gas well Contract Quantity of gas for the current Contract Year . . . shall be delivered without charge to Buyer until such excess equals the amount of gas previously paid for but not taken."47

In 1985, CIG attempted to renegotiate the terms of the agreement when the market price of natural gas began to fall.48 As a result of Chemco's refusal to renegotiate the contract price, CIG stopped making its periodic payments to Chemco and unsuccessfully sought declaratory relief, claiming that it had a right under the contract to discontinue taking the gas.49 Chemco countersued for damages, claiming inter alia that CIG had breached its obligations under the take-or-pay clause.50

The trial court determined that there was a take-or-pay provision in the contract and that if the jury found that CIG had breached the contract, the damages should be all of the take-or-pay payments that were due under the contract.51 The jury found that CIG had breached the contract and awarded damages to Chemco pursuant to the court's directions.52 CIG then appealed the trial court's holding to the Colorado

46. Id. at 790-91.
47. Id. at 791.
48. CIG specifically wanted to alter the contract price for the natural gas. See id at 788.
49. The provision of the contract upon which CIG based its claim provided that the buyer could elect to discontinue taking gas if the quantity delivered by the well became so low that it was no longer economically feasible for the buyer to take the gas. However, this claim was rejected by the court. See id.
50. See id.
51. See id at 791.
52. See id at 788.
Court of Appeals, claiming that the trial court erred by not instructing the jury on the proper measure of damages.\textsuperscript{53} The Colorado Court of Appeals upheld the trial court's verdict and supported the trial court's instructions to the jury on the calculation of damages.\textsuperscript{54} On a subsequent appeal by CIG, the Colorado Supreme Court affirmed the holding of the trial court.\textsuperscript{55}

\textbf{B. The Court's Reasoning}

In its appeal, CIG asserted that because a contract containing a take-or-pay clause is one of alternative performances, the correct measure of damages for the breach thereof was given by section 2-708 of the UCC.\textsuperscript{56} The Colorado Supreme Court disagreed with this assertion and held that, "the remedy for breach of the alternative performance obligation is the payment of damages equivalent to the value of the remaining performance obligation."\textsuperscript{57} Thus, CIG was required to pay the full amount of the payments that it was contractually obligated to pay Chemco under the contract.

The court stated that, while the UCC governed the sale of natural gas, section 2-708 was not the only relevant section of the UCC with respect to the contract between Chemco and CIG.\textsuperscript{58} Specifically, section 1-102 of the UCC allows parties to vary provisions of the UCC by agreement,\textsuperscript{59} and section 2-719 provides that parties "'may provide for remedies in addition to or in substitution for those provided' by the UCC.'"\textsuperscript{60} Furthermore, section 2-718 of the UCC provides that parties may establish liquidated damages for breach of the contract as long as the damages are reasonable.\textsuperscript{61} Because the other provisions of the UCC were also relevant to the contract, the court asserted that "the agreement creates a performance obligation with a concomitant remedy for its breach."\textsuperscript{62} Thus, the court determined that the parties had agreed to provide for a remedy in substitution of the governing UCC remedies by including a take-or-pay provision in their contract.\textsuperscript{63} The court determined that the remedy for a breach by the buyer was that which was

\begin{enumerate}
\item See id at 790.
\item See id. at 792.
\item See Chemco, 854 P.2d at 1240.
\item See id. at 1236.
\item Id.
\item See id.\textsuperscript{58} See U.C.C. § 1-102(3) (1997).
\item Chemco, 854 P.2d at 1236 (quoting U.C.C. §2-719(1)(a) (1997)).
\item See U.C.C. § 2-718 (1997).
\item Chemco, 854 P.2d at 1236.
\item See id.
\end{enumerate}
provided by the contract: the full amount of payments due under the take-or-pay provision. 64

The court supported its holding by arguing that a take-or-pay provision is a means by which some risk can be allocated to the buyer, and that allowing the buyer to avoid its obligations under the contract undermines the allocation of risk made by the parties. 65 The risk to the buyer is that if the market price of natural gas falls, the buyer is nevertheless obligated to pay the seller the contract price regardless of whether the buyer takes the gas. Thus, when the buyer enters into the contract, it takes the risk that the market price may fall with the knowledge that, in that event, it will still have to pay for the minimum quantity of gas. The allocation of risk is one of the factors typically considered by contracting parties when they negotiate the terms of their contract. 66 The Colorado Supreme Court stated that if a court allows a buyer to breach a contract containing a take-or-pay provision without requiring the buyer to pay the contractually required amount, the court has in effect rewritten the contract by “reallocating the risk in a way not intended by the parties.” 67

Furthermore, the court argued that because the seller is a lost volume seller, “the payments made pursuant to a take-or-pay provision are not payments for the sale of gas,” but rather payments for an option to take the gas for a limited period of time in the future, and therefore, the buyer is not entitled to a reduction of the total amount of payments due under the contract based on the difference between the market price for the gas and the contract price. 68 However, the court rejected the notion that take-or-pay clauses are the equivalent of liquidated damage provisions. 69 The court reasoned that “[b]ecause the alternative is a performance obligation, it is distinguishable from the payment provisions of a liquidated damages remedy.” 70

64. See id.
65. See id at 1236-37.
66. See 6 LINDON CORBIN, CORBIN ON CONTRACTS § 1354, at 458 (1962).
67. Chemco, 854 P.2d at 1237.
68. See id.
69. See id.
70. Id.
IV. ANALYSIS

A. Plain Words of Contract Establish Buyer's Duties

The plain words of the contract between Chemco and CIG clearly establish each party's duties and obligations under the contract. The take-or-pay provision of the contract states that CIG must pay Chemco for a minimum quantity of gas regardless of whether it actually takes the gas. See Colorado Interstate Gas Co., Inc. v. Chemco, Inc., 833 P.2d 786, 790-91 (Colo. Ct. App. 1992). While CIG could subsequently take the prepaid gas any time within five years after having paid for it, CIG forfeited its rights by failing to do so. See id. at 791. Thus, as with any take-or-pay contract, CIG as the buyer was bound by the express terms of the contract to pay for the minimum quantity of gas regardless of whether it took the gas. See 4 WILLIAMS & MEYERS, supra note 2, at § 724.5. Failure to make such payments constituted a breach of contract.

Typically under the UCC, when a buyer breaches a contract for the sale of goods, the seller's damages are the difference between the market price and the unpaid contract price in addition to incidental damages. See U.C.C. § 2-708 (1997). However, as the court in Chemco correctly asserted, "the payments made pursuant to a take-or-pay provision are not payments for the sale of gas." See Chemco, 854 P.2d at 1237. Instead, those payments should be properly categorized as simply one of two alternative contract performance options. Because it is possible under the contract that CIG could pay for the gas and never actually receive it, the contract was not necessarily a contract for the sale of goods. Therefore, Section 2-708 of the UCC does not provide the appropriate remedy. CIG had two alternative methods by which it could fulfill its obligation under the contract: it could take the minimum quantity of gas and pay for it, or it could simply pay without taking the gas. See Chemco, 854 P.2d at 1237. As the Colorado Supreme Court stated, "[o]nce the "take-or-pay" alternative expired with the passage of time—the contract year—the damages are no longer measured by the value of that method of performance [taking and paying for the gas] even if that alternative performance is possible."

72. See id. at 791.
73. See 4 WILLIAMS & MEYERS, supra note 2, at § 724.5.
76. See Chemco, 854 P.2d at 1237. See also 5 LINDON CORBIN, CORBIN ON CONTRACTS § 1079, at 453-54 (1964).
77. See Chemco, 854 P.2d at 1237.
would yield a smaller recovery."78 Instead, the court stated, "performance becomes the monetary payment of a sum unambiguously defined by the contract."79

The court asserted that because the inclusion of a take-or-pay provision satisfied the requirements of Sections 1-102 and 2-719 of the UCC, it provided a remedy in substitution for those provided by other sections of the UCC.80 Therefore, the only proper remedy for a breach by the buyer was that prescribed by the contract: full payment of all outstanding take-or-pay payments.81 Other courts have refused to define take-or-pay provisions as "alternative remedies" that are enforceable pursuant to UCC Sections 1-102 and 2-719.82 In Roye Realty & Developing, Inc. v. Arkla, Inc., a case that has very similar facts to Chemco,83 the Oklahoma Supreme Court stated, "there is no indication in the take-or-pay provision of the contract that its terms are intended to vary the effect of provisions of the UCC."84 Pursuant to UCC Section 2-708, the Oklahoma court awarded as damages the difference between the market price and the contract price.85 Thus, while Colorado is willing to construe a take-or-pay clause as providing for a remedy that is supplementary to, or in lieu of, those provided by the UCC, Oklahoma is reluctant to make such a determination absent an express statement in the contract indicating the parties' intent to vary the remedies provided by the UCC, despite the clear and unambiguous wording of the take-or-pay provision. Other courts that have confronted the issue of calculating damages for the breach of contracts containing take-or-pay provisions have agreed with the Oklahoma Supreme Court.86

Although Oklahoma has adopted Sections 1-102 and 2-719 of the UCC,87 the court refused to interpret the take-or-pay provision as a supplementary provision for remedies other than those supplied by the

78. Id.
79. Id.
80. See id. at 1236. See also U.C.C. §§ 1-102, 2-719 (1997).
81. See Chemco, 854 P.2d at 1236.
82. See Prenalta Corp. v. Colorado Interstate Gas Co., 944 F.2d 677 (10th Cir. 1991); Universal Resources Corp. v. Panhandle E. Pipeline Co., 813 F.2d 77 (5th Cir. 1987); Roye Realty & Dev., Inc. v. Arkla, Inc., 863 P.2d 1150, 1157 (Okla. 1993).
83. The contract obligations were virtually identical: Arkla, the buyer was required to either take and pay Roye Realty the seller for at least a minimum quantity of gas or, alternatively, pay for the same quantity whether the gas was taken or not. When the market prices fell below the contractually fixed price, Arkla breached. See Roye Realty, 863 P.2d at 1150.
85. See id.
86. See Prenalta Corp. v. Colorado Interstate Gas Co., 944 F.2d 677 (10th Cir. 1991); Universal Resources Corp. v. Panhandle E. Pipeline Co., 813 F.2d 77 (5th Cir. 1987).
UCC. Additionally, the language of the court's opinion indicates that even if such a provision was expressly stated as being supplementary to, or in lieu of, those remedies supplied by other sections of the UCC, the court would still ignore those provisions and use the remedy supplied by Section 2-708 of the UCC. The court asserted that the purpose of Section 2-719 of the UCC was satisfied by awarding damages to the seller in the amount of the difference between the contract and market prices because the seller would receive the full contract price for the gas. However, this assertion is erroneous because the parties did not contract for the full market price. The Oklahoma rule has the effect of taking away some of the freedom that parties have to contract because it rewrites the contract. It also eliminates the predictability and enforceability of remedies that contracting parties choose to provide in lieu of those given by the UCC.

Because the payments made pursuant to take-or-pay provisions are not necessarily for the sale of gas, the Oklahoma rule distorts the purpose and the plain meaning of the take-or-pay provision and circumvents the intentions of both the contracting parties and Section 2-719 of the UCC. By so doing, the court essentially rewrites the contract. Thus, although Sections 1-102 and 2-719 of the UCC have been adopted in Oklahoma, the state supreme court has taken it upon itself to ignore a provision in a contract that, pursuant to Sections 1-102 and 2-719 of the UCC, provided for remedies other than those prescribed by the UCC. In addition, the Oklahoma/majority rule ignores Section 2-719 of the UCC and substitutes another remedy supplied by Section 2-708 of the UCC. If the payments made pursuant to take-or-pay provisions were always for the purchase of gas, then the Oklahoma rule would be correct. However, because the sellers can sometimes receive take-or-pay payments and never actually be required to deliver the minimum quantity of gas, the Oklahoma/majority rule does not put the seller in as good of a position as it would have been in if the buyer had not breached. For this reason, the Colorado rule is correct and preserves the intentions of the contracting parties as well as the plain language of their contract.

Buyers may argue that requiring full payment of the contract amount is inappropriate because that is not the remedy used in other common oil and gas industry contracts that contain alternative perform-

88. See Roye Realty, 863 P.2d at 1156.
89. See id. at 1157.
90. See Chemco, 854 F.2d at 1237; Roye Realty, 863 P.2d at 1155.
92. See Roye Realty, 863 P.2d at 1157-58.
ance obligations similar in form to take-or-pay obligations. For example, the buyer’s obligation is analogous to that of a lessee who pays delay rentals in lieu of drilling for oil or gas. 93 However, such contracts are distinguishable. The lessee can escape liability for failure to perform his obligations because the lease automatically terminates when the lessee fails to drill or pay its delay rentals. However, the buyer in a take-or-pay contract cannot escape such liability because the terms of the contract do not provide the same option of automatic termination as a result of failure to fulfill the contract. 94 Furthermore, there is nothing in a take-or-pay provision that allows the buyer to terminate the contract by failing to fulfill his contractual obligations and then taking an affirmative step to terminate the contract, as there is in contracts with “or” leases. 95

Thus, while those two types of leases, which are very common in the oil and gas industry, 96 provide alternative contract obligations, they are clearly distinguishable from take-or-pay provisions for several reasons. First, they are leases of the rights to drill for oil and/or gas while take-or-pay clauses are for the right to purchase gas that has already been produced. 97 Second, the two types of leases provide for termination of the contract as the remedy for a breach thereof, 98 whereas take-or-pay provisions do not give the buyers that option. 99 Third, under a lease it is in the non-breaching party’s best interest to have the contract terminate when the lessee fails to drill or pay rentals because the lessor is then free to find another lessee who will actually drill for oil and/or gas, which typically is more profitable to the lessor than the delay rental payments. 100 In contrast, it is not in the best interest of the seller of natural gas to allow the buyer to simply walk away from the contract because generally the reason why the buyer breaches is that the market price is below the contract price. In that situation, it will be difficult, if

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93. Generally, delay rentals are consideration paid by a lessee to a lessor in exchange for the right to postpone drilling operations. Typically, delay rental clauses allow the lessor to cancel a lease when the lessee fails to pay-or-drill. See Richard C. Maxwell et al., The Law of Oil and Gas 605 (6th ed. 1992). For a more in depth description of delay rentals, see 3 Williams & Meyers, supra note 2, at § 605.

94. With “unless leases,” the lease automatically terminates unless the lessee either drills-or-pays the delay rentals by a date specified in the lease. See 3 Williams & Meyers, supra note 2, at § 606.

95. With “or leases,” the lessee must pay the delay rentals, drill a well, or take an affirmative step to surrender the lease back to the lessor. See id. at § 607.

96. See id. at §§ 606-607.

97. See id. at §§ 605, 724.5.

98. See id. at §§ 606-607.

99. See id. at § 724.5.

100. See id. at § 605.
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not impossible, for the seller to find a new buyer that is willing to pay the same price as the original buyer who has breached the contract. Because of these significant differences between take-or-pay contracts and leases that also contain alternative performance provisions, the different treatment of the two is clearly appropriate.

B. Chemco Preserves the Purpose of the Take-or-Pay Provision

It is generally accepted that the primary purpose of take-or-pay provisions is to allocate risk between the buyer and seller of natural gas. The take-or-pay provision removes some of the risk from the seller and places some of the risk on the buyer. The seller risks that the market price will exceed the contract price at some point during the duration of the contract, and that it will be obligated to sell the gas at the lower contract price. The buyer risks that the market price will fall below the contract price at some point during the duration of the contract, and it will be obligated to either buy gas at a higher price than it is able to resell it or to pay for a minimum quantity of gas even if it never takes that minimum quantity.

When courts allow buyers to breach a contract containing a take-or-pay provision and only require them to pay the difference between the market price and the contract price, the buyer’s risk has been virtually eliminated. The Colorado Supreme Court recognized this flaw in the holdings of other courts. Accordingly, the court ruled that the correct amount of damages for breach was the full amount of take-or-pay payments that were due under the contract because “[a]ny other interpretation of the contract is tantamount to rewriting the contract, re-allocating the risk in a way not intended by the parties.” Some courts and commentators have made similar suggestions with re-


102. See McArthur, supra note 1, at 359.

103. This is the remedy that the majority of the courts who have been confronted with this issue have given to the sellers when buyers have breached. See Universal Resources Corp. v. Panhandle E. Pipeline Co., 813 F.2d 77 (5th Cir. 1987); Roye Realty & Dev., Inc. v. Arkla, Inc., 863 P.2d 1150 (Okla. 1993).

104. See Chemco, 854 P.2d at 1237.

105. Id.

106. See Kham & Nate’s Shoes No. 2, Inc. v. First Bank of Whiting, 908 F.2d 1351 (7th Cir. 1990) (“Firms that have negotiated contracts are entitled to enforce them to the letter, even to the great discomfort of their trading partners . . . . Parties to a contract are not each others’ fiduciaries”). Id. at 1357.

107. See generally Subha Narasimhan, Of Expectations, Incomplete Contracting and the Bargain Principle, 74 CAL. L. REV. 1123 (1986); Robert E. Scott, The Case For Market Dam-
spect to the proper role of the judiciary in terms of allowing parties to allocate risk in contracts themselves. They have generally suggested that courts should respect the risk allocation of contracting parties, and not seek to reallocate risk under the guise of fairness, because the allocation of risk is one of the elements of the contract that is bargained for by the contracting parties and should be enforced as written in the absence of coercion, fraud or unconscionability.108 On this same subject, the Seventh Circuit has stated, "[u]nless pacts are enforced according to their terms, the institution of contract, with all the advantages private negotiation and agreement brings, is jeopardized."109

However, in Roye Realty, the Oklahoma Supreme Court stated, "[a]lthough we agree that take-or-pay contracts were designed to allocate the risks involved in gas production and marketing, we cannot accede to the view that such allocation of risk is determinative of the measure of damages."110 Thus, even though the Roye Realty court recognized the purpose of the take-or-pay provisions, it took it upon itself to ignore that purpose and reallocate the risk so that the buyer was given substantially less risk than it was allocated by the contract. This alteration makes the contract a substantially better bargain for the buyer, such that it is highly probable that the buyer would have been required to pay a higher price for the gas if it had not accepted the allocation of the contractually provided risk during the pre-contract negotiations. As previously stated, courts should not be in the business of rewriting contracts or reallocating risk provided for therein. Thus, the Colorado rule is better at preserving the intentions of the contracting parties, and at preserving their bargained-for allocation of risk.

C. Take-or-Pay Clause is Distinguishable from Liquidated Damages Provisions

Alternatively a take-or-pay clause could be interpreted as equivalent to a liquidated damages provision, which is governed by Section 2-718 of the UCC.111 However, the Colorado Supreme Court and the majority of the courts have rejected that interpretation.112 In

109. Kham & Nate's Shoes, 908 F.2d at 1357.
112. See Prenalta Corp. v. Colorado Interstate Gas Co., 944 F.2d 677, 689 (10th Cir. 1991); Universal Resources Corp. v. Panhandle E. Pipeline Co., 813 F.2d 77 (5th Cir. 1987); Colorado Interstate Gas Co., Inc. v. Chemco, Inc., 854 P.2d 1232, 1237 (Colo. 1993); Roye Re-
Chemco, the court stated, "[b]ecause the alternative [paying for the gas without taking it] is a performance obligation, it is distinguishable from a liquidated damages remedy." This interpretation is valid because while liquidated damages provisions require the breaching party to pay a sum that is fixed by the contract upon breach, the alternative contract requires the payment of a fixed sum regardless of whether there is a breach of contract by the buyer. Thus, the take-or-pay provision is not a penalty for breach, but a performance obligation.

Because of this significant difference, courts should not analyze take-or-pay clauses as liquidated damages provisions. Thus, the reasonableness of the take-or-pay requirement is not an issue for the courts to examine, whereas reasonableness in light of the anticipated and actual harm is the core of the analysis with which courts scrutinize liquidated damages provisions. Furthermore, Official Comment 10 of Section 2-718 of the UCC asserts that take-or-pay provisions are not the equivalent of liquidated damages, and it cites the Fifth Circuit's holding in Universal Resources Corp. v. Panhandle Eastern Pipe Line Co. in support of this contention.

This universal acceptance of the difference between take-or-pay provisions and liquidated damages remedies is important because it allows sellers of natural gas to allocate some of the risk of fluctuations in the market price to the buyers. If take-or-pay provisions were treated as liquidated damages, then it is likely that the provisions would often be held unenforceable because they were unreasonably large in the case of a substantial decline in the market price for gas and, as such, considered to be a penalty. Furthermore, the take-or-pay requirement could easily be considered unreasonable in light of the anticipated harm if the buyer breached when there was only a slight decline in the market price. In that case the only real harm to the seller would be the costs of finding a new buyer and the slight difference between the market and contract prices. If the take-or-pay provisions were frequently declared unenforceable as unreasonable liquidated damages, then the whole risk...
allocation purpose of the take-or-pay clause would be defeated and the
take-or-pay clauses would essentially become meaningless.

D. Chemco Rule Does Not Give Seller Unjust Enrichment Nor Is It Unconscionable

1. Unjust Enrichment

One potential criticism of Chemco is that it creates an unjust enrichment because the seller is permitted to keep the gas that the buyer has not taken, and still receive the payments due under the take-or-pay provision. The elements of unjust enrichment are generally defined as a benefit conferred by one party that is known to and accepted by the other party and that such acceptance is inequitable without compensation given to the conferring party. A counter claim of unjust enrichment by a breaching buyer should fail because the buyer has not conferred any benefit on the seller. The only thing that the buyer has done is breach the contract between it and the seller, which is typically not considered to be a benefit to the non-breaching party. Additionally, because both parties, having equal bargaining power, negotiated and contracted for the take-or-pay provision, it is not inequitable for the seller to receive the full amount of the take-or-pay payments due under the contract and keep the gas that the buyer does not take. Furthermore, because the Sections 1-102 and 2-719 of the UCC permit parties to craft remedies beyond those supplied by other sections of the UCC, such a remedy is appropriate and permitted by the statutory law of nearly every state.

While it is true that the seller in essence gets the best of both worlds when it receives money for the gas that the buyer does not take, this only occurs when the buyer breaches the contract. The buyer should know its contractual obligations when it signs a contract, and if it is unwilling to fulfill its obligations thereunder, it should seek to bargain for a more favorable contract. Given that an individual seller is not likely to control the market price for natural gas, the seller is not forcing the buyer to breach. Furthermore, the buyer is in a position to prevent this gain for the seller by simply performing its obligations under

119. See infra Part II.A.
121. See McArthur, supra note 1, at 360.
122. See supra note 30 and Part II.B.
the contract and paying for the minimum quantity of gas required by the contract. For these reasons, an unjust enrichment counterclaim by a breaching buyer should be denied.

2. Unconscionability

The same argument that can be used to support a breaching buyer's unjust enrichment defense claim can also be used to support a defense of unconscionability. This claim is stronger than the unjust enrichment claim, but in practice it has been rejected by courts. Typically, buyers have claimed that the take-or-pay provision was not bargained for because there was disparate bargaining power between them and the sellers, making enforcement of the take-or-pay provision unconscionable. Section 2-302 of the UCC allows courts to refuse to enforce parts of contracts that the court determines are unconscionable. However, courts have generally rejected these claims because pipeline buyers usually draft gas purchase contracts and the buyers have substantial market and negotiating power which negates the disparate bargaining power assertion. The lack of success of the unconscionability defense in courts indicates that it is not likely to be a successful claim for breaching buyers to use in an effort to reduce the amount of damages they must pay.

E. Chemco Rule Provides a Deterrence against Future Breaches

Policy considerations also favor the Colorado rule over the majority rule. One policy basis of contract law is that society is better off when there is predictability in the performance and enforcement of contracts. Although there are economic arguments that support the concept of an efficient breach of contracts, if one ignores those relatively rare circumstances, and accepts that society as a whole is better off


124. See Medina, supra note 28, at 228.


126. One commentator has even stated that "(i)t should make a lawyer blush to stand before a court and argue that a contract negotiated by gas pipeline executives (with the assistance of counsel) contained a clause that was unconscionable at the time it was written." Medina, supra note 28, at n.42, quoting 1 JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE, PRACTITIONER'S EDITION § 7-18, at 33 (Supp. 1991).

127. See id.

128. See Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting, 908 F.2d 1351 (7th Cir. 1990); RICHARD A. POSNER, ECONOMIC ANALYSIS OF THE LAW, 89-91 (4th ed. 1988).

129. See id. at 94-95.
when contracts are fully performed, any policy that deters contract breaches is clearly in the public's best interest.

The Colorado rule imposes harsher penalties than the majority rule on buyers that breach contracts containing take-or-pay provisions. Under the Colorado rule, breaching buyers must pay the full amount of take-or-pay payments due under the contract, while the sellers retain the gas. In contrast, the majority rule allows the buyers to breach and only pay the difference between the market and contract prices. Clearly, the breaching buyer will always pay less in damages for breach under the majority rule than under the Colorado rule. As such, the Colorado rule will create a greater financial deterrent against contract breaches than the majority rule. For this public policy reason, the Colorado rule is a better rule for society.

V. CONCLUSION

Given the discrepancy between courts' interpretations of the correct measure of damages for a breach of a take-or-pay provision, a uniform interpretation needs to be established. While either the majority rule or the Colorado rule would establish the needed uniformity, the Colorado rule is superior for several important reasons. First, the Colorado rule preserves the plain wording of the contracts containing take-or-pay provisions. Second, the Colorado rule preserves the intentions of the contracting parties, by maintaining their bargained-for risk allocation. Finally, the Colorado rule establishes a deterrent against future contract breaches by buyers of natural gas by awarding a higher amount of damages to the non-breaching sellers than they would receive under the majority rule. Thus, the Colorado rule will provide stability and predictability in the natural gas market.

While the Colorado rule awards a greater amount of damages to the non-breaching sellers than the majority rule, the breaching buyers are getting what they bargained for. Fairness is truly in the eye of the beholder, and while the uniform adoption of the Colorado rule may have a negative impact on pipeline buyers of natural gas, they can always bargain to pay a higher price to the sellers in exchange for the omission of a take-or-pay provision, or a reduction in the minimum quantity of gas that they are required pay for. Courts should not take it upon themselves to rewrite contracts or reallocate the risk that is allocated therein.

130. See Chemco, 854 P.2d at 1236-37.
131. See Roye Realty, 863 P.2d at 1155.
132. This will benefit society. See infra Part IV.E. It will also satisfy one of the primary purposes set forth by the U.C.C. See U.C.C. §1-101 (1997).
Such allocations should be left to the contracting parties when they negotiate and draft the terms of their contracts. The drafting room is the forum where fairness should be determined, not the courtroom. For the foregoing reasons, the Colorado rule should be adopted by all of the jurisdictions that encounter cases that have similar facts to those in Chemco.

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