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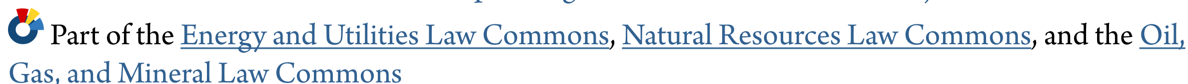
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ONE J

Oil and Gas, Natural Resources, and Energy Journal

VOLUME 4 NUMBER 3

OKLAHOMA

Matt Schlensker & Justin Fisher[*]

Two state cases touch on the deductibility of postproduction costs from royalty payments and Oklahoma's definition of paying in producing quantities. Also, a couple federal district courts rule on the proper way to rescind a contract and an exception to the Production Revenue Standards Act being the exclusive remedy for the incorrect payment of oil and gas proceeds. Finally, Oklahoma amends portions of the Production Revenue Standards Act.

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1. *Pummill v. Hancock Expl. LLC,* 2018 OK CIV APP 48, 419 P.3d 1268 (Okla. Civ. App. 2018).

The Civil Court of Appeals issued an opinion concerning what types of costs may be deducted from royalty payments due to a lessor, reasserting Oklahoma's approach to the implied covenant to market.

Plaintiffs are the successors of the lessors of two 1966 oil and gas leases covering 160 acres in Grady County.[1] The leases are now part of a 640 acre drilling and spacing unit, which has been producing natural gas since 1985.[2] One lease contained a "gross proceeds" royalty clause, and the other lease contained a "market price at the well" clause.[3]

Defendants are the successors to the original lessees of the two leases.[4] They are non-operating working interest owners in the producing well, which is operated by Cimarex Energy Co. of Colorado.[5] Since June of 2005, Cimarex has marketed production from the well and distributed royalty proceeds.[6]

Plaintiffs claim Defendants did not bear all of the costs necessary to market the gas and create a marketable product, while the Defendants argued the lease provisions negated the implied covenant to market.[7] Also, Defendants requested the court declare the gas is "marketable at the custody transfer meter."[8] The meter connected to a gathering system owned by a group referred to as "Enogex," which gathered and transported the gas to its off-lease processing plants.[9] There, Enogex extracted natural gas liquids and delivered the residue gas for sale into high pressure pipelines.[10] Defendants specifically requested the court declare they could proportionately charge Plaintiffs for processing costs incurred at the Enogex plants and a determination that they could charge "any costs incurred for gas production" from the well so long as those costs met the requisites specified in *Mittelstaedt v. Santa Fe Minerals, Inc.*[11]

1. *Pummill*, 2014 OK CIV APP at ¶ 4, 419 P.3d at 1270.
2. *Id*.
3. *Id*.
4. *Id*. at ¶ 5, 419 P.3d at 1271.
5. *Id*. at ¶ 6, 419 P.3d at 1271.
6. *Id*.
7. *Id*. at ¶¶ 7-8, 419 P.3d at 1271.
8. *Id*.
9. *Id*.
10. *Id*. at ¶ 8, 419 P.3d at 1271.
11. *Id*. at ¶ 9, 419 P.3d at 1271.

The trial court granted Plaintiff's motion for summary judgment, stating (1) the lease language did not abrogate the implied covenant to market, so gas royalty payments were "free of all costs to create a marketable product," (2) Defendants' use of a "percentage of proceeds" gas purchase contract with third parties instead of a "cash fee gathering agreement" did not affect the amount of royalty owed under the leases, and (3) Defendants owed Plaintiffs royalty on gas from the well "used off the lease or in the manufacture of products at the gas plant."[12]

Defendants appealed and in June of 2014, the Civil Court of Appeals unanimously affirmed the lower court's decision.[13] On appeal, the Oklahoma Supreme Court vacated the appellate court's decision and remanded the case back to the trial court.[14] The Court wanted the lower court to resolve disputed fact issues concerning the three points noted above.[15]

On remand, the trial court again found for the Plaintiffs, noting that neither lease describes any costs which may be charged against the lessor's royalty.[16] If a lessee wants to deduct costs for compression, gathering, or processing, the court noted the lessee should include that type of deduction language in the lease.[17]

Also, the trial court rejected Defendants' claim that the gas was a marketable product when it was produced from the well, finding the production was not complete until the gas was "delivered to the place of sale in marketable form."[18]

Also, even if the court agreed with Defendants' marketability argument, it found the Defendants did not meet the criteria stated in *Mittelstaedt*: that the processing fees were reasonable, enhanced the value of an already marketable product, and increased royalty proceeds in proportion to the fee charged.[19]

The Civil Court of Appeals affirmed the lower court's decision and noted Defendants' main contention is the trial court erred in finding the gas produced from the well was not a marketable product until the processing

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12. *Id*. at ¶¶ 9, 10, 419 P.3d at 1271-72.
13. *Id*.
14. *Id*.
15. *Id*.
16. *Id*. at ¶ 12, 419 P.3d at 1272.
17. *Id*. at ¶ 13, 419 P.3d at 1272.
18. *Id*.
19. *Id*. at ¶ 17, 419 P.3d at 1273.

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had occurred at the plant.[20] Defendants asked the court to adopt the Kansas definition of "marketable" to be "production is merchantable once the operator has put it into a condition acceptable to a purchaser in a good faith transaction."[21]

The court rejected the Kansas approach, noting it is undisputed that the gas from the well must be compressed and dehydrated to even be accepted into the Enogex pipeline.[22] The gas must also undergo additional processes to be acceptable for delivery.[23] Also, Defendants do not actually sell the gas until it reaches the pipeline.[24] While Defendants argued there was a market at the wellhead, it seems to be a "purely hypothetical" market since no sales at the wellhead were even attempted.[25]

The appellate court found the gas from the well was not an "already marketable product" as required by *Mittelstaedt*.[26] The court found *Fawcett* to be inapplicable here because *Mittelstaedt* is controlling precedent; the *Fawcett* court did not overturn the rule that a lessee has a duty to make a marketable product, and in *Fawcett*, the gas was actually sold at the wellhead, instead of at the pipeline.[27]

Also, the court found the Defendants did not even argue that they met all of the *Mittelstaedt* requirements, specifically that the postproduction costs increased the royalty revenues.[28]

2. *Hall v. Galmor,* 2018 OK 59, No. 115078, 2018 WL 3133124 (Okla. June 26, 2018).

The Oklahoma Supreme Court discussed how to determine if an oil and gas well is capable of producing in paying quantities and the effect of Oklahoma's statutory Pugh clause.

For more than 50 years, Galmor's predecessors entered into thirty oil and gas leases covering lands in Beckham County, Oklahoma.[29] Each lease included a primary term and a secondary term, making the leases effective

20. *Id*. at ¶ 20, 419 P.3d at 1274.
21. *Id*. at ¶ 29, 419 P.3d at 1276 (citing *Fawcett v. Oil Producers, Inc., of Kansas*, 302 Kan. 350, 352 P.3d 1032, 1034 (2015)).
22. *Id*. at ¶¶ 38-40, 419 P.3d at 1278.
23. *Id*.
24. *Id*.
25. *Id*.
26. *Id*. at ¶ 41, 419 P.3d at 1278-79.
27. *Id*. at ¶ 44, 419 P.3d at 1279.
28. *Id*. at ¶ 47, 419 P.3d at 1279.
29. *Hall*, 2018 OK at ¶ 1.

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for as long as oil or gas was produced from the leased premises.[30] Twenty-nine of those leases included "cessation of production" clauses, providing the lessee with a limited amount of time to re-establish production should a well cease production.[31]

These leases included several different classes of production.[32] Galmor's predecessors drilled seven wells located on lands covered by fourteen of the leases.[33] Two of those fourteen leases included lands that were also subject to voluntary pooling agreements with lands covered by six more leases but where no wells had been drilled.[34] The remaining ten leases did not have any completed wells drilled on their lands, and they were not held by any pooling agreements or spacing units.[35]

During the secondary terms of the fourteen leases with producing wells, six of the seven wells actually produced oil and gas.[36] Some of those wells ceased production for "a number of years" during the 1990's, but they later regained their previous production levels.[37]

Galmor's immediate predecessor, Marion Energy Inc. ("Marion"), stopped production from five of the producing wells in August of 2011, and a sixth well in January of 2012.[38] The seventh well produced for six months before it was shut down in May of 2008, all for unclear reasons.[39]

Soon after stopping production from the seven wells, Marion sought to sell all of its assets in Beckham and Greer Counties.[40] First, Marion contacted Galmor about buying these assets, but Galmor declined due to the asking price.[41] Marion also approached E.L. "Bo" Hall, d/b/a Hall Family Production ("Hall"), but Hall declined due to its concerns over "the marketability of title to the underlying leases and Marion Energy's failure to market the product and/or pay shut-in royalties for the last three years."[42]

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30. *Id.*
31. *Id.*
32. *Id.* at ¶¶ 2-4.
33. *Id.*
34. *Id.*
35. *Id.*
36. *Id.*
37. *Id.* at ¶ 3.
38. *Id.* at ¶ 4.
39. *Id.* at ¶ 5.
40. *Id.* at ¶ 6.
41. *Id.*
42. *Id.*

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Then in October of 2014, Marion sold all of its assets to Galmor for a reduced price.[43]

While negotiating with Marion, Hall acquired fifteen top leases covering many of the same lands as Marion's fourteen bottom leases.[44] In July of 2014, before Marion sold its assets to Galmor, Hall notified Marion that it intended to take over operations of the seven wells and asked Marion to release its bottom leases.[45] Marion refused and later completed its sale to Galmor.[46]

In February of 2015, Hall sued Galmor, looking to invalidate the fourteen bottom leases and quiet title in favor of Hall's fifteen top leases.[47] At the trial level, opposing engineering experts offered their opinions regarding the ability of the seven wells to produce in paying quantities.[48] Hall's title attorney could not say definitively whether or not the wells were capable of production.[49]

However, Hall himself, the owner of the top leases, took the stand and his attorney asked if Hall believed he could "produce seven wells in question here today in – in paying quantities?"[50] Hall's response: "It would pay to me."[51]

Based on that testimony, the trial court ruled in favor of Galmor that his bottom leases were still valid.[52] Citing *Pack v. Santa Fe Minerals*, the trial court stated a "lease will continue as long as the well is capable of production in paying quantities subject, of course, to any violation of any other express provisions such as the shut-in royalty clause or implied covenants such as the covenant to market."[53] The court also pointed out that a lessee must demand compliance with an implied covenant before a court will grant a forfeiture, and a stranger to the lease may not make such a demand.[54] The court ruled all seven wells were capable of production

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43. *Id*.
44. *Id*. at ¶ 8.
45. *Id*.
46. *Id*.
47. *Id*.
48. *Id*. at ¶ 9.
49. *Id*.
50. *Id*.
51. *Id*.
52. *Id*. at ¶ 9-10.
53. *Id*. (citing *Pack v. Santa Fe Minerals*, 1994 OK 23, 869 P.2d 323 (Okla. 1994)).
54. *Id*.

during the period they were shut in and no demand to comply with an implied covenant was made by any of the royalty owners.[55]

Hall argued the trial court should have quieted title in his favor for the ten leases which did not have any completed wells and were not subject to any pooling agreement (the "Non-Unit Leases"), as well as lands outside the 160 acre tracts where the seven wells are located ("Pugh Clause Lands").[56]

The Supreme Court defined production in paying quantities as an amount of production "sufficient to yield a profit to the lessee over operating expenses."[57] If a well is not actually producing, it only needs to be "capable of producing in paying quantities."[58] Hall argued the trial court should have defined "capable" as meaning "the well must be maintained in turn-key condition such that it will produce in paying quantities immediately upon being turned 'on.'"[59]

The Supreme Court rejected a rigid definition of the term "capable" and stated the only relevant time period for determining capability is the moment prior to the shutting-in of the well.[60] As long as the well was capable of producing in paying quantities at the moment it was shut-in, the well remains "capable" throughout the shut-in period.[61] The Court ruled operators do not need to "continually maintain their shut-in wells in turn-key condition."[62]

Also, the Court ruled the seven wells were capable of producing in paying quantities, citing, inter alia, the "inference to be drawn from Hall's purchase of top leases on these wells that these wells were perfectly good wells that were capable of producing in paying quantities," and "Hall's testimony that he could make the wells produce in paying quantities for him."[63]

Next, Hall argued that the trial court should have quieted title to the Pugh Clause Lands in his favor.[64] He argued Oklahoma's statutory Pugh clause requires all lands outside the 160 acre spacing units to be automatically

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55. *Id.*
56. *Id.* at ¶ 14.
57. *Id.* at ¶ 22.
58. *Id.*
59. *Id.* at ¶ 23.
60. *Id.* at ¶ 26.
61. *Id.*
62. *Id.*
63. *Id.* at ¶ 28.
64. *Id.* at ¶ 43.

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released from their leases ninety days after their primary terms expired, which would have been December of 2010.[65]

Galmor responded that Hall was misapplying the statutory Pugh clause's purpose of conservation and protection of correlative rights.[66] Also, Galmor argued canceling these leasehold interests lying outside the spacing units would amount to an unconstitutional taking for private use.[67]

The Court noted subpart (b) of the clause states: "In case of a spacing unit of one hundred sixty (160) acres or more, no oil and/or gas leasehold interest outside the spacing unit involved may be held by production from the spacing unit more than ninety (90) days beyond the expiration of the primary term of the lease."[68] The Court ruled this clause extinguishes all interests falling outside the spacing unit, even if those interests would usually be held by the habendum clause of the lease.[69]

After a discussion of policy concerns, the Court found the statutory Pugh clause is not an unconstitutional taking in violation of the Oklahoma Constitution.[70] The Court reversed the lower court and ruled Galmor's leasehold interests in the Pugh Clause Lands should be forfeited, and Hall's interest in same should be quieted.[71]

Finally, as to the Non-Unit Leases, the Court again reversed the lower court and ruled that since no wells were ever drilled on the lands covered by those leases, Galmor's leasehold interests in same should be forfeited, and Hall's interest in same should be quieted.[72]

In the end, the Oklahoma Supreme Court rejected a rigid definition of "capability" with regards to production in paying quantities and ruled if a well is capable of production in paying quantities on the day it is shut-in, then it is considered capable throughout its shut-in period.

3. *Petroflow Energy Corp. v. Sezar Energy, L.P.,* No. 16-CV-700-TCK-JFJ, 2017 WL 4399193 (N.D. Okla. Oct. 3, 2017).

The Northern District of Oklahoma held a Participation Agreement could not be rescinded because neither party had even attempted to have the agreement rescinded.

65. *Id*.
66. *Id*. at ¶ 44.
67. *Id*.
68. *Id*. at ¶ 46.
69. *Id*. at ¶ 51.
70. *Id*. at ¶¶ 52-66.
71. *Id*. at ¶¶ 67-69.
72. *Id*. at ¶ 70.

In June of 2014, Plaintiff entered into a "Central Prospect Participation Agreement" ("Agreement") with Defendants Sezar Energy, L.P. and Brittany Energy, LLC ("Defendants").[73] Prior to the Agreement, the parties had both been independently drilling wells throughout eastern central Oklahoma, an area the parties referred to as the "Area of Mutual Interest," or "AMI."[74] The Agreement was designed so the parties would jointly develop and exchange working interests within the AMI.[75]

The Agreement indicated Plaintiff was entering into an agreement with Equal Energy, Ltd. scheduled to close by July 31, 2014 (the "Equal Acquisition").[76] Once that deal closed, Plaintiff would own multiple oil and gas leases within the AMI.[77] The Agreement was effective June 15, 2014, but not "actionable" until the closing of the Equal Acquisition.[78] The parties also entered into a Joint Operating Agreement ("JOA") which was incorporated into the Agreement.[79]

The Agreement covered all Leasehold Interests within the AMI and provided that Plaintiff would sell a 30.00% working interest in the Properties to Defendants.[80] The Agreement would not terminate if Defendants decided not to participate in any one lease and/or well in the AMI.[81] Also, the JOA provided that if any Party acquired or contracted to acquire any oil and gas interest in the AMI, then the non-acquiring Party would have the opportunity to participate in that interest.[82]

Plaintiff argued the Agreement required Defendants to pay their proportionate share of leasehold costs on certain undeveloped leases (the "Disputed Leases").[83] Defendants responded that they had no obligation regarding the Disputed Leases because same were "after-acquired" leases, and Plaintiff failed to provide Defendants with notice and an opportunity to participate in these leases pursuant to the JOA.[84] Plaintiff argued the JOA is inapplicable to the Disputed Leases.[85]

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73. *Petroflow*, 2017 WL 4399193 at *1.
74. *Id*.
75. *Id*.
76. *Id*.
77. *Id*.
78. *Id*.
79. *Id*.
80. *Id*. at *2.
81. *Id*.
82. *Id*. at *3.
83. *Id*.
84. *Id*.
85. *Id*.

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Plaintiff sued alleging breach of contract concerning the Disputed Leases.[86] Defendants provided an affirmative defense of failure of consideration.[87] Regarding the breach of contract claim, the court noted that under Section 2.1 of the Agreement, Defendants agreed to buy undivided working interests in Properties relating to lands in the AMI.[88] Section 2.2 stated Defendants shall pay Plaintiff actual costs of the "leases, title and other costs associated with the Leasehold Interests" and "agree[] to further pay their proportionate share of all future Properties acquisition and force pooling costs necessary for the drilling of any subsequent well(s) in the AMI."[89] Plaintiff argued these provisions did not require a "participation notice with respect to future lease acquisitions . . . ."[90] Also, Plaintiff argued the JOA did not apply to undeveloped leases, but rather the drilling of wells.[91]

Defendants argued Plaintiff must provide notice with respect to any lease it acquires within the AMI because the Agreement does not state how "future Properties acquisition" occurs.[92] Also, in the event of a conflict, the JOA prevails over the Agreement.[93]

The court ruled the Defendants did not reference any language in the Agreement requiring Plaintiff to provide a participation notice to Defendants regarding undeveloped leases.[94] The court refused to infer that the JOA notice provision would govern any "future Properties acquisition."[95] Since Defendants could not show the JOA applied to undeveloped leases as a matter of law, the court denied Defendants' motion for summary judgment.[96]

Regarding Defendants' failure of consideration defense, the court denied that motion as well.[97] Defendants argued they could rescind the Agreement because Plaintiff "unreasonably delayed assigning leases to Defendants until they had expired or would soon expire, and as a result, the majority of

86. *Id.*
87. *Id.*
88. *Id.* at *4.
89. *Id.*
90. *Id.*
91. *Id.*
92. *Id.* at *5.
93. *Id.*
94. *Id.* at *6.
95. *Id.*
96. *Id.*
97. *Id.* at *5.

the Disputed Leases had little to no value by the time they were assigned to Defendants."[98]

The court noted that under Oklahoma law, a party seeking rescission of a contract must rescind same "promptly, upon discovering the facts which entitle him to rescind" and "must restore to [him] everything of value which he has received from him under the contract . . . ."[99] Defendants obtained working interests in leases under the Agreement and received their share of revenues from those leases; however, Defendants did not attempt to rescind the Agreement.[100] Therefore, the court granted Plaintiff's motion for summary judgment.[101]

4. *McClintock v. ExxonMobil Oil Corp.,* No. CIV-16-136-KEW, 2018 WL 1547373 (E.D. Okla. Mar. 29, 2018).

This district court ruled Oklahoma's Production Revenue Standards Act is the exclusive remedy for nonpayment or underpayment of royalties, with a specific exception.

Plaintiff alleged she owned some oil and gas wells in Oklahoma.[102] ExxonMobil operated some producing wells in Oklahoma where it was obligated to pay oil and gas proceeds to Plaintiff.[103] Enterprise Crude Oil, LLC was the first purchase of production from those wells, and it was also alleged to be obligated to pay oil and gas proceeds to Plaintiff.[104]

Plaintiff argued Defendants were legally obligated to pay interest on untimely payments to royalty owners, but Defendants "routinely delay payment of production proceeds and deny Owners the interest payments to which they are entitled as part of an overarching scheme to avoid its obligations under Oklahoma law."[105]

Plaintiff claimed the proper payments of royalty proceeds and interest, as well as asserting a claim for fraud. Plaintiff alleged Defendants "knowingly and intentionally suppressed the fact that interest was owed to Plaintiff" and "intended to avoid their obligation to pay the statutorily mandated interest and only pay when an Owner specifically requests payment of the statutory

98. *Id*.
99. *Id*.
100. *Id*.
101. *Id*.
102. *McClintock*, 2018 WL 1547373 at *1.
103. *Id*.
104. *Id*.
105. *Id*.

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interest."[106] Also, Plaintiff stated she "relied on and trusted Defendants to pay them the full O&G Proceeds to which they were entitled under Oklahoma law."[107]

Enterprise requested a dismissal of Plaintiff's common law fraud claim and argued (1) the Energy Litigation Reform Act (the "Reform Act") specifically precluded Plaintiff from pursuing the fraud claim because of its "exclusive remedy" language; and (2) even if the fraud claim is allowed to proceed, Plaintiff's allegations are not actionable fraud in Oklahoma.[108]

The Reform Act provides the Production Revenue Standards Act (the "PRSA") "shall provide the exclusive remedy to a person entitled to proceeds from production for failure of a holder to pay the proceeds within the time periods required for payment."[109] The PRSA specifies interest due for failure to properly pay proceeds, and the Reform Act indicates same is an adequate remedy and no other penalty or damages shall be recoverable, unless a finder of fact determines by clear and convincing evidence that the party which failed to pay proceeds did so with the "actual, knowing and willful intent: (a) to deceive the person to whom the proceeds were due, or (b) to deprive proceeds from the person the holder knows, or is aware, is legally entitled thereto."[110]

Enterprise argued Plaintiff may only seek the remedies provided in the PRSA.[111] Plaintiff argued she may pursue any claim under Oklahoma law if the showing of intent and deception is made as required by the Reform Act.[112] The court noted there is almost no case authority to interpret this part of Oklahoma law, but its duty is to give the statute its plain and unambiguous meaning.[113]

The court ruled the state legislature clearly intended the remedies in the PRSA to be the exclusive remedies a party may seek concerning incorrect payment of oil and gas proceeds.[114] However, the legislature created an exception for other types of remedies when it is determined that the operator failed to pay proceeds with "actual, knowing and willful intent."[115]

106. *Id*. at *2.
107. *Id*.
108. *See id*. at *3.
109. *Id*. at *2.
110. *Id*.
111. *Id*. at *3.
112. *Id*.
113. *Id*.
114. *Id*. at *4.
115. *Id*.

Therefore, the court allowed Plaintiff to maintain her fraud claim until a finder of fact has the opportunity to determine if Defendants acted with such intent.[116]

Also, Enterprise argued it had no duty to disclose to Plaintiff whether she was entitled to interest under the PRSA, and therefore Plaintiff's claim does not meet the criteria for a fraud claim in Oklahoma.[117] After citing those criteria, the court determined Plaintiff's complaint had enough detail to provide Defendants with notice of the allegations.[118]

H.B. 2775, 2018 Leg., Reg. Sess. (Okla. 2018).

The Oklahoma legislature amended the Production Revenue Standards Act (the "Act") regarding marketable title and interest payments for unpaid oil and gas proceeds. The Act sets forth when an operator must pay oil and gas proceeds to royalty owners and how much interest accrues when an operator fails to make such payments in a timely manner.[119]

Previously, if a person did not have marketable title, an operator was charged six percent interest for non-payment of proceeds. HB 2775 amended the Act to provide for the scenario where a portion of a person's interest may be marketable, while the remaining portion of their interest may not be marketable. Also, effective November 1, 2018, HB 2775 amended the six percent interest penalty for non-marketable title to the prime interest rate as reported in the Wall Street Journal.

Finally, where marketability remains uncured, or the operator has not been provided with an acceptable affidavit of heirship which conforms to Section 67 of Title 16 of the Oklahoma Statutes, for a period of 120 days from the date payment is due, HB 2775 allows the operator to elect to interplead the proceeds into a court to determine the persons legally entitled to the proceeds.

116. *Id.*
117. *Id.*
118. *Id.*
119. H.B. 2775.

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