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Mineral Royalty Mispayments: The Payor's Rights, Obligations, and Risks in Royalty Mispayment Scenarios, Including the Pitfalls and Prerogative of Self-Help Recoupment

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MINERAL ROYALTY MISPAYMENTS: THE PAYOR'S RIGHTS, OBLIGATIONS, AND RISKS IN ROYALTY MISPAYMENT SCENARIOS, INCLUDING THE PITFALLS AND PREROGATIVE OF SELF-HELP RECOUPMENT

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I. INTRODUCTION

Given an operator's large volume of oil and gas production, the numerous and disparate leases under which production is carried out, the varying royalty fractions, the minute decimal interests, and the cumbersome calculation models that often dictate royalty payments, as well as the thousands of diverse payees receiving the royalty payments, it is inevitable that either human or electronic error will occasionally cause incorrect royalty distributions. For these same reasons, such mistakes may go unnoticed for many months or even years.

Although any miscalculation can go unnoticed, an overpayment may go undetected for much longer than an underpayment. In this regard, a royalty underpayment is naturally more likely to be noticed by a scrupulous payee, who will then draw the error to the payor's attention.[2] From the payor's perspective, an underpayment, once discovered, can be fairly easily corrected and, as explained herein, may not be necessary if the payor correspondingly overpaid another royalty payee. An overpayment, on the other hand, is more troublesome in both respects. First, overpayments may go undetected for much longer because a recipient is more likely to accept the overpayment and not investigate any inclinations regarding a miscalculation. Once the payor discovers the overpayment, recovering the monies can be more difficult—and sometimes impossible—for both practical and legal reasons.

Practically, the payee may have spent or otherwise disposed of the money, and may have no means of repayment. Legally, certain defenses and other limitations may defeat or reduce a legal claim. Thus, a payor has important financial and legal incentives to ensure that overpayments are avoided, but also quickly discovered. Once overpayments are discovered, it is important to understand whether recovery of the monies is feasible and likely, and, if so, what steps to take in order to effectively and efficiently recover the monies.

To aid in these efforts, this Article provides a survey of the legal doctrines and defenses commonly encountered in mineral royalty mispayment cases, including whether the payor is entitled to self-help re-

2. In the context of mineral royalty payments, the "payor" is generally an operator or lessee and the "payee" is the lessor or mineral owner, but, for simplicity, this Article will refer simply to these entities or individuals as the "payor" and "payee" respectively.

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coupment of overpaid royalties. This Article is not a comprehensive study on all aspects of royalty mispayments, but instead provides a practical overview of the foundational legal theories underlying typical mispayment claims and defenses.

II. Resolving Royalty Underpayments

The majority of this Article discusses a payor's recoupment rights in royalty overpayment scenarios, but that discussion is incomplete without also highlighting a few key points related to royalty underpayments. An underpayment—once discovered—may be fairly easily corrected. If the payor has inadvertently retained the monies, it may simply tender the payment to the intended payee. The payor is not, however, responsible for the underpayment in every scenario. In this regard, an executed division order can affect the payor's response to a royalty underpayment (and, for that matter, a royalty overpayment) in certain instances—that is, in situations where the payor underpays a payee *and* correspondingly overpays another payee.

As a condition to payment of royalties, a payor is entitled to receive a signed division order from the payee containing certain provisions, among which is the fractional and/or decimal interest in production claimed by the payee.[3] The purpose of a division order is to provide a procedure for distributing the proceeds from the sale of oil and gas by authorizing and directing to whom and in what proportion to distribute the sale proceeds.[4]

Once executed, a division order binds an underpaid payee until revoked.[5] One principle underlying this rule is detrimental reliance.[6] In a typical case, a payor following a division order pays out the correct total of proceeds owed but errs in the distribution—overpaying some royalty owners and underpaying others.[7] If the underpaid payee's lawsuit against the payor was not estopped, a payor would be forced to pay the amount of the overpayment twice—once to the overpaid payee under the division order and again to the underpaid payee through his suit.[8] Thus, the payor would have double liability for the amount of the overpayment.[9] Exposing the payor to double liability is unfair because he has relied upon the division order's representations and has not personally benefitted from the errors.[10]

3. Neel v. Killam Oil Co., 88 S.W.3d 334, 342 (Tex. App.—San Antonio 2002, pet. denied) (citing Tex. Nat. Res. Code Ann. § 91.402(c)(1)(C) (West 2002)).

4. *Id.* (citing Gavenda v. Strata Energy, Inc., 705 S.W.2d 690, 691 (Tex. 1986)).

5. *Gavenda*, 705 S.W.2d at 691 (citing Exxon Corp. v. Middleton, 613 S.W.2d 240, 250 (Tex. 1981)).

6. *Id.*

7. *Id.* at 692.

8. *Id.*

9. *Id.*

10. *Id.*

In such situations, the underpaid royalty payee has a remedy—he can recover from the overpaid payee.[11] The basis for recovery is unjust enrichment, just as it is in the scenarios where the payor overpays a payee but does not correspondingly underpay another payee.[12] In both scenarios, the overpaid payee is not entitled to the royalties.[13] Thus, if one payee is overpaid by receiving another underpaid payee's royalties, and if the payments were made pursuant to executed division orders, the payor is not liable to the underpaid payee and does not have to seek recoupment on its behalf.[14]

As it relates to scenarios where the payor inadvertently overpays a payee but does not underpay another payee, an executed division order will probably not impact the payor's ability to recover the overpaid monies. As discussed further herein, the bottom line in recoupment cases is whether the money, in equity and good conscience, belongs to the payor. If the overpayment is the result of a mistake of fact (e.g., clerical error, unconscious ignorance of a fact, paid the money twice, etc.), it is generally recoverable.

III. Recouping Mineral Royalty Overpayments

A. *The Typical Cause of Action to Affirmatively Recover Overpaid Royalties: Money Had and Received*

In mineral royalty overpayment cases, the fundamental cause of action that might allow the payor to recoup the overpaid monies is generally referred to as "money had and received" (although some courts have also called it "restitution").[15] Each overpayment case should be carefully reviewed, as the facts and circumstances may give rise to other causes of action. That being said, simple royalty-recoupment actions usually sound in equity as money-had-and-received claims, which seek to avoid unjust enrichment, and require proving two elements: (1) the defendant holds money; and (2) the money, in equity and good conscience, belongs to the plaintiff.[16] Generally, for the payor to recover, it must show that the payee received a benefit that is unconscionable for the payee to retain.[17]

By way of additional preface, a more detailed explanation of a money-had-and-received claim is helpful, as each case is unique and the outcome is determined by a balancing of the equities. In addition, because courts sometimes use the terms "money had and received"

11. *Id.*
12. *Id.*
13. *Id.*
14. *Id.* at 692–93.
15. *See, e.g.*, Edwards v. Mid-Continent Office Distribs., L.P., 252 S.W.3d 833 (Tex. App.—Dallas 2008, pet. denied).
16. Staats v. Miller, 243 S.W.2d 686, 687–88 (Tex. 1951).
17. Cmty. Mut. Ins. Co. v. Owen, 804 S.W.2d 602, 606 (Tex. App.—Houston [1st Dist.] 1991, writ denied).

and "restitution" interchangeably, it merits further discussion.[18] As noted, a cause of action for money had and received is equitable in nature and belongs conceptually to the doctrine of unjust enrichment. To this end, courts generally focus on the facts alleged and recovery sought in order to categorize an action as one for money had and received or for restitution. Further, courts describe a money-had-and-received claim in general principles.[19] For example, courts have stated that a claim for money had and received seeks to restore money where equity and good conscience require restitution; it is not premised on wrongdoing, but seeks to determine to which party, in equity, justice, and law the money belongs; and seeks to prevent unconscionable loss to the payor and unjust enrichment to the payee.[20] As the foregoing broad descriptions demonstrate, a cause of action for money had and received is less restricted and fettered by technical rules and formalities than any other form of action.[21] It aims at the abstract justice of the case and looks solely to the inquiry: whether the defendant holds money that rightfully belongs to the plaintiff.[22]

Applying these principles, Texas courts have allowed recovery of overpaid monies in a variety of scenarios, including: (1) by a defrauded party against the party that committed the fraud;[23] (2) by a party that made an overpayment;[24] (3) by a party that paid money to the wrong person;[25] (4) by a party that credited money to the wrong account;[26] and (5) when earnest money was released to the wrong client.[27] The common thread in these decisions is that they are all dependent upon a balancing of the equities in each unique case.[28]

1. The Typical Defense to Recoupment Claims: The Voluntary-Payment Rule

A common affirmative defense to the equitable claim of money had and received is known as the voluntary-payment rule ("VPR"). In 2005, the Texas Supreme Court provided a detailed history and sum-

18. *Edwards*, 252 S.W.3d at 837 n.7.
19. *Id.* at 837.
20. *Id.* (citations omitted).
21. *Id.*
22. *Id.*
23. Staats v. Miller, 243 S.W.2d 686, 687–88 (Tex. 1951).
24. Benson v. Travelers Ins. Co., 464 S.W.2d 709, 713 (Tex. Civ. App.—Dallas 1971, no writ).
25. Amoco Prod. Co. v. Smith, 946 S.W.2d 162, 165 (Tex. App.—El Paso 1997, no writ).
26. Doss v. Homecomings Fin. Network, Inc., 210 S.W.3d 706, 710–11 (Tex. App.—Corpus Christi 2006, pet. denied).
27. Lyman D. Robinson Family Ltd. P'ship v. McWilliams & Thompson, PLLC, 143 S.W.3d 518, 520 (Tex. App.—Dallas 2004, pet. denied).
28. Edwards v. Mid-Continent Office Distribs., L.P., 252 S.W.3d 833, 838 (Tex. App.—Dallas 2008, pet. denied).

mary of the present status and application of the VPR in *BMG Direct Marketing, Inc. v. Peake*.[29] There, the Court explained that the VPR states: "Money voluntarily paid on a claim of right, with full knowledge of all the facts, in the absence of fraud, deception, duress, or compulsion, cannot be recovered back merely because the party at the time of payment was ignorant of or mistook the law as to his liability."[30] For the VPR to apply, the overpayment must have been truly voluntary, that is, done by design, intentionally, purposely, by choice, of one's own accord, or by the free exercise of will.[31] In other words, there must appear "an intention on the part of the payor to waive his rights."[32]

To better understand the VPR, it is helpful to review the public policy concerns that contributed to the rule's development, which generally have to do with ensuring the finality of settlements. In this regard, the policy underlying the VPR in the context of private parties has been described as follows:

> [A] party who pays a claim is deemed to have made his own decision that it is justly due. If he thinks otherwise, he should resist. He should not pay out his money, leading the other party to act as though the matter were closed, and then be in a position to change his mind and invoke the aid of the courts to get it back.
>
> . . .
>
> [Further,] public policy favors protecting the finality of payments when a person is aware of all the facts upon which the liability to make payment depends, and there is no fraud, deception, duress, or coercion involved.[33]

Consistent with these policies, Texas courts have long precluded recovery of payments made under mistake of law if the payment was made with full knowledge of all the facts.[34] This is true even if the party was ignorant of or mistook the law as to his liability.[35] Said another way, when one party makes a decision as to his legal liability or obligation to make a payment to another party, and he then makes that payment in satisfaction of the obligation, he cannot change his mind and seek to retract the payment if he later learns that he was not *actually* legally obligated to make the payment. As noted, if a party could retract his settlement payment upon discovering, for example, a previously unknown legal defense to the obligation, such post-settlement changes would undermine the finality that is necessary to promote the resolution of disputes between parties. Thus, a "voluntary"

29. BMG Direct Mktg., Inc. v. Peake, 178 S.W.3d 763, 768–71 (Tex. 2005).
30. *Id.* at 768 (citing Pennell v. United Ins. Co., 243 S.W.2d 572, 576 (Tex. 1951)).
31. Gulf Oil Corp. v. Lone Star Producing Co., 322 F.2d 28, 31 (5th Cir. 1963).
32. *Id.*
33. *BMG*, 178 S.W.3d at 768–69.
34. *Id.* (citing *Pennell*, 243 S.W.2d at 576; Gilliam v. Alford, 6 S.W. 757, 759 (Tex. 1887)).
35. *Id.* (citing *Pennell*, 243 S.W.2d at 576; *Gilliam*, 6 S.W. at 759).

payment made after concluding—even erroneously—that the payment is legally required cannot be retracted and recovered, unless the payment was procured by fraud, deception, duress, or compulsion.[36]

Based on this longstanding principle, the VPR surfaced as a defense to claims asserting unjust enrichment; that is to say, when a plaintiff sues for restitution claiming that a payment constitutes unjust enrichment, a defendant may raise the VPR as a defense.[37] Accordingly, this defense is often asserted in response to a money-had-and-received claim, which, as noted above, is an equitable cause that seeks to avoid unjust enrichment.[38]

The VPR is an effective defense even if the payor is mistaken as to his legal obligation to pay—an error commonly referred to as a "mistake of law." For example, a payment held to have been made under a mistake of law includes an insurer's mistaken payment of benefits under an insurance policy.[39] In *Pennell v. United Ins. Co, Inc.*, the insurer made a determination as to its payment liability under an accident and health policy and paid the insured accordingly.[40] Later, the insurer learned that the insured was riding in a jeep at the time of the accident, which was not a covered auto under the policy.[41] The court held that there was no evidence that the insurer made a mistake as to the type of auto when it paid—the insurer may not have thoroughly investigated the claim—and that the question of whether the insurance provision applied was one of law.[42] Accordingly, the court held the VPR precluded recoupment.[43]

As an additional example, reliance on an incorrect title opinion has been held to constitute a mistake of law.[44] In *Castle Texas Oil and Gas Ltd. v. Dominion Oklahoma Texas Exploration and Production*, the court denied Dominion's attempted recovery of $782,688.09 in overpaid royalties, finding that Dominion's overpayment was due to a mistake of law.[45] There, Dominion sought reimbursement of overpaid royalties after receiving a supplemental title opinion that indicated its

36. *Id.* (citing *Pennell*, 243 S.W.2d at 576; *Gilliam*, 6 S.W. at 759).

37. *BMG*, 178 S.W.3d at 768 (citing Randazzo v. Harris Bank Palatine, N.A., 262 F.3d 663, 670 (7th Cir. 2001)).

38. Doss v. Homecoming Fin. Network, Inc., 210 S.W.3d 706, 711 (Tex. App.—Corpus Christi 2006, pet. denied).

39. *Pennell*, 243 S.W.2d at 576 (mistake as to applicability of double indemnity provision).

40. *Id.* at 575.

41. *Id.* at 573.

42. *Id.* at 576.

43. *Id.*

44. Castle Tex. Oil & Gas Ltd. P'ship v. Dominion Okla. Tex. Exploration & Prod., No. 13-04-307-CV, 2005 WL 1797065, at *4 (Tex. App.—Corpus Christi July 28, 2005, no pet.) (mem. op.) (holding the interaction and interpretation of legal documents is a question of law, not of fact).

45. *Id.*

payment calculations were incorrect.[46] The court found that Dominion changed the calculation of royalties based upon legal documents, not because of a factual mistake.[47] In this regard, the court stated that Dominion came to its "present position by its own admission because of a supplemental title opinion, not because of new or previously undeterminable facts. In short, the interaction and interpretation of legal documents is a question of law, not of fact."[48]

That being said, overpayments may be recovered if they are made due to a "mistake of fact."[49] In this regard, recovery of payments based on a mistake of fact does not violate the policies underlying the VPR because such mistakes do not contribute to the party's determination of its liability to pay, and such factual mistakes generally vitiate the "voluntariness" of the payment.[50]

2. A Counter-Defense to the Voluntary Payment Rule: Mistake of Fact

As noted above, money paid voluntarily may be recoverable if the payment was made due to fraud, deception, duress, or compulsion.[51] In addition, to trigger the VPR, money must have been paid with "full knowledge of all the facts."[52] In the context of mineral royalty overpayments, an overpayment due to fraud, deception, duress, or compulsion is probably rare. In this regard, the payor is more likely to make an overpayment due to a mistake of fact, such as clerical or mathematical errors. Thus, the important question becomes: What constitutes a "mistake of fact"?

In short, mistakes of fact include overpayments due to mathematical or clerical mistakes, ignorance of the true amount of production, or other negligent errors.[53] The Fort Worth Court of Appeals explained mistake of fact in *Hull v. Freedman*, a case involving overpaid oil royalties, as follows:

> It is the general rule that money paid under a mistake of fact, that is, an unconscious ignorance or forgetfulness of a fact, may be recovered. This is true where, for example, by reason of such mistake a debt has been paid twice, or the amount paid was in excess of the amount due. The reason for the rule is that the payee ought not to

46. *Id.*
47. *Id.*
48. *Id.*
49. Atl. Ref. Co. v. Tidwell, 318 S.W.2d 905, 907 (Tex. Civ. App.—Houston 1958, writ ref'd n.r.e.) (holding overpayments caused by accident or mistake were not "voluntary" in the sense that a voluntary payment is a defense to an action to recover money).
50. *Id.*
51. BMG Direct Mktg., Inc. v. Peake, 178 S.W.3d 763, 768–71 (Tex. 2005).
52. *Id.*
53. *See* cases cited *infra* notes 54, 58–59.

> retain what in conscience does not belong to him as against the person to whom in conscience it does belong.
>
> The mere fact that the mistake was due to negligence on the part of the person who made the payment will not preclude a recovery. The payor may recover though he had the means of knowing the facts at the time, where he did not have actual knowledge of them, unless the payment was made intentionally and in circumstances showing a determination to pay without choosing to investigate the facts. Negligence in paying does not give the payee the right to retain what was not his due, unless he was misled or prejudiced by the mistake.[54]

In *Hull v. Freedman*, oil royalties were to be paid based on the number of barrels produced per day.[55] The payee was overpaid when production slipped below the stated threshold.[56] The court allowed recovery because the payor made the overpayment due to an unintentional mistake of fact—the payor was mistaken about the drop in production and, as a result, overpaid royalties.[57] Recently, another court noted that *Hull v. Freedman* illustrates a true mistake of fact.[58]

In another example, the court in *Atlantic Refining Company v. Tidwell* permitted recovery of overpaid royalties under the mistake of fact theory when an oil company employee made a clerical error.[59] There, the plaintiff overpaid royalties because an employee in the "oil accounting section" of the company inadvertently transposed certain numbers, thereby allotting to one owner an interest belonging to another.[60] In rejecting the VPR as a defense, the court held that, under such a mistake of fact (i.e., when overpayment is by accident), the payment was not "voluntary" as the VPR requires.[61] Instead, the court found the overpayments by the oil and gas company were made with "unconscious ignorance of the facts."[62] This holding is particularly relevant to corporate payors, as the court explained mistake of fact in the context of entities with many employees. Specifically, the court stated:

> There is a presumption of regularity in the course of business of the conduct of affairs. This Court will presume, therefore, in the absence of evidence to the contrary, that said employee was undertak-

54. Hull v. Freedman, 383 S.W.2d 236, 239 (Tex. Civ. App.—Fort Worth 1964, writ ref'd n.r.e.) (citing 44 TEX. JUR. 2D *Mistake of Fact* § 77 (1961)).
55. *Id.* at 237.
56. *Id.*
57. *Id.* at 239.
58. Castle Tex. Oil & Gas Ltd. P'ship v. Dominion Okla. Tex. Exploration & Prod., No. 13-04-307-CV, 2005 WL 1797065, at *3 (Tex. App.—Corpus Christi July 28, 2005, no pet.) (mem. op.).
59. Atl. Ref. Co. v. Tidwell, 318 S.W.2d 905, 907 (Tex. Civ. App.—Houston 1958, writ ref'd n.r.e.).
60. *Id.*
61. *Id.*
62. *Id.*

> ing to perform his duty honestly and regularly, and that he did not intentionally or consciously [make the error.]
>
> . . .
>
> Manifestly, in a large corporation such as [Atlantic Refining Company] it would be impossible for anyone or any group of employees to know all of the facts pertaining to production, the interests of the owners, the accounting, the payments of royalties and the other numerous details in connection with the operations of such a business.[63]
>
> . . .
>
> In the present case the employee who made the mistake did so without consciously knowing it and in ignorance thereof.[64]

Thus, in short, the VPR is not a defense to the recoupment of monies paid under a mistake of fact because payment in such cases is not "voluntary" as the rule requires.[65]

3. Other Defenses

In addition to the VPR, defenses commonly seen in recoupment cases include estoppel/prejudice/changed circumstances and unilateral mistake of fact.

a. Estoppel, Prejudice and Changed Circumstances

In overpayment situations, it is likely that the recipient of the overpayment has used or otherwise disposed of the money he received. As a result, defendants in overpayment cases often argue that they would be prejudiced by allowing the payor to recover the funds. Generally, courts may restore funds to a party who paid because of a mistake of fact if the payee has not *materially* changed its position in reliance upon the payee's mistake.[66] To this end, once the payor makes a prima facie case, the payee has the burden of proving a sufficient change of circumstances to make it inequitable to restore the funds to the payor.[67]

Whether a changed-circumstances argument provides a successful defense to a recoupment claim depends largely on the facts of the case—as noted, recoupment claims are equitable in nature. Accordingly, courts rely on equity to find both for and against recoupment claims. For example, in a case involving a $15,000 overpayment of earnest money, the defendants asserted that the plaintiff's two-year delay in seeking return of the money was prejudicial.[68] Specifically,

63. *Id.*
64. *Id.* at 908.
65. *Id.* at 907.
66. Bryan v. Citizens Nat'l Bank, 628 S.W.2d 761, 763 (Tex. 1982).
67. Lincoln Nat'l Life Ins. Co. v. Rittman, 790 S.W.2d 791, 793 (Tex. App.—Houston [14th Dist.] 1990, no writ).
68. Lyman D. Robinson Family Ltd. P'ship v. McWilliams & Thompson, PLLC, 143 S.W.3d 518, 520–21 (Tex. App.—Dallas 2004, pet. denied).

the defendants argued that returning the money would prejudice them because they had already paid taxes on the extra money and made extra expenditures in reliance on the payment.[69] The court disagreed, stating it could not conclude that receiving money to which they were not entitled, claiming it and paying taxes on it, and spending it caused any "prejudice" to the defendants.[70] From a policy perspective, allowing a payee's dissipation of proceeds as a defense to repayment creates an incentive for the recipient of mistakenly paid funds to spend the money—and that is not an incentive most courts want to create.

Conversely, courts have also used equity to justify denying recoupment claims. For example, in *Lincoln National Life Insurance Co. v. Rittman*, the court used equity as its "deeper reason for denying" restitution to an insurer that erroneously paid benefits for the daughter of its insured.[71] In that case, the insured used the extended benefit payments to keep his daughter in treatment, and he further testified that he would have withdrawn his daughter from the hospital had he been required to pay the medical costs personally.[72] Thus, given the disparity in decisions applying the foregoing rules, assessing the likelihood of successful recoupment necessarily requires a case-by-case analysis of the applicable "equitable facts."

Finally, the changed-circumstances defense does not apply when a payment is made under a reservation of rights. In this regard, the Texas Supreme Court recently rejected changed circumstances as a defense to a recoupment claim arising from the payment of a judgment that was later reversed on appeal.[73] In that case, the court held that the VPR does not preclude restitution when a payment on a judgment is coupled with an expressed intent to appeal when appellate relief is attainable.[74] The court also rejected the payee's contention that its tax payment, which was the result of accepting the payment, precluded a restitution claim.[75] While the law recognizes a defense based on a change of position, the defense generally applies only to the extent that restitution would cause loss to an innocent party.[76]

b. Unilateral Mistake

In addition to "changed circumstances," defendants in a few cases have successfully asserted "unilateral mistake of fact" as a defense to restitution claims. The cases discussing and applying "unilateral mis-

69. *Id.* at 520.
70. *Id.*
71. *Rittman*, 790 S.W.2d at 794.
72. *Id.* at 792.
73. Miga v. Jensen, 299 S.W.3d 98, 102–05 (Tex. 2009).
74. *Id.* at 105.
75. *Id.*
76. *Id.*

take of fact" do not clearly define unilateral mistake and, moreover, do not explicitly create a requirement that the mistake of fact be "mutual" in every restitution case. Indeed, many of the cases discussing unilateral mistake look more like "mistake of law" cases.

For example, in *Sellman v. American National Insurance Company*, one of the earlier unilateral mistake cases, the court denied recovery of erroneously paid monies in an insurance case.[77] There, the insurer's agent proactively sought to pay death benefits after it—and many of the family members—thought the insured had died in a railroad accident (the family even had a funeral after mistakenly identifying the body).[78] Later, it was discovered that the insured was actually living in another city, at which time the insurance company sought to recover the death benefits it had paid to the insured's former wife.[79]

The *Sellman* court rejected the insurer's recoupment claim, holding that if there was a mistake as to whether the insured was dead or alive, it was a mistake of the insurance company agent and was a unilateral mistake.[80] In its holding, the court relied on authority dealing with deed cancellations (i.e., if the grantor executed a mineral deed, but thought it was a mineral lease, that is considered a unilateral mistake, and cancellation of the deed is not permitted) to reject the insurer's claim to recover insurance proceeds.[81]

Like other cases discussing unilateral mistake, the *Sellman* case looks very much like a case involving a mistake of law. In this regard, the insurer in *Sellman* concluded that it was legally obligated to pay the insurance proceeds, and then did so. For purposes of the VPR, it had knowledge of all the relevant facts and decided to tender the payment.[82] In fact, most of the cases using the term "unilateral mistake" in the context of overpayment of monies are insurance cases, and the court, in at least one instance, explained that these cases involve "money paid voluntarily with full knowledge of all facts, not money paid by mistake."[83] Thus, the *Sellman* rationale may be limited to insurance cases.

Unilateral mistake also appears in tax recoupment cases. In one case involving a tax dispute, the court noted (without citing any authority) that the mistake of fact must be mutual and not merely the

77. Sellman v. Am. Nat'l Ins. Co., 281 S.W.2d 150, 151–52 (Tex. Civ. App.—Texarkana 1955, writ dism'd w.o.j.).

78. *Id.*

79. *Id.* at 152.

80. *Id.* at 154.

81. *Id.* (citing Tex. Osage Coop. Royalty Pool v. Guzman, 153 S.W.2d 239 (Tex. Civ. App.—San Antonio 1941, no writ)).

82. Lyman D. Robinson Family Ltd. P'ship v. McWilliams & Thompson, PLLC, 143 S.W.3d 518, 521 (Tex. App.—Dallas 2004, pet. denied).

83. *Id.*; *see also*, *e.g.*, Emp'rs Cas. Co. v. Universal Underwriters Ins. Co., 404 S.W.2d 954, 955 (Tex. Civ. App.—Amarillo 1966, no writ).

product of the complaining party's inattention.[84] This does not appear to be the rule, however, as it relates to general recoupment claims. In fact, most cases explaining a money-had-and-received claim note that recoupment is available even when the overpayment is due to the payor's negligence, such as a clerical error, so long as recoupment is equitable.[85] If the payor was negligent, or was carelessly ignorant of the facts as to which he was mistaken, while not necessarily barring recovery, those factors could be considered in determining the equities between the parties and may reduce the amount of recovery.[86]

Further, tax recoupment cases may be distinguished from typical recoupment claims because different public policies are at play. In addition, the VPR has been applied infrequently in tax cases and more harshly due to policy reasons.[87] To this end, in the taxation context, the VPR is intended to prevent the taxing entity from using funds paid by taxpayers in a given budget year and then subsequently being required to refund the amounts.[88] The VPR policy in tax cases is to discourage litigation and to secure the taxing authority's ability to orderly conduct its affairs.[89] Regardless, the VPR's applicability in tax matters has been altered by recent statutory remedies.[90] For example, the Texas Tax Code now provides that a person may recover a voluntary payment of certain illegal taxes, as long as the person paid under protest.[91] Thus, the VPR is no longer outcome determinative in many tax cases.[92] Given the foregoing, the tax overpayment cases appear to have little bearing on other routine overpayment cases.

Finally, the best example of a true unilateral mistake might be illustrated in *Pacific Molasses Co. v. Graves*.[93] In that case, two related corporations had a misunderstanding or made a mistake between them as to which of them would pay a bill owed to a molasses company.[94] The payor sought recoupment after the other entity would not reimburse him for the payment.[95] Both entities were arguably responsible for the debt.[96] The court held the mistake between them was

84. Tex. Nat'l Bank of Baytown v. Harris Cnty., 765 S.W.2d 823, 826 (Tex. App.—Houston [14th Dist.] 1988, writ denied).

85. *See* Hull v. Freedman, 383 S.W.2d 236, 239 (Tex. Civ. App.—Fort Worth 1964, writ ref'd n.r.e.) (citing 44 TEX. JUR. 2D *Mistake of Fact* § 77 (1961)).

86. Gulf Oil Corp. v. Lone Star Producing Co., 322 F.2d 28, 31 (5th Cir. 1963).

87. BMG Direct Mktg., Inc. v. Peake, 178 S.W.3d 763, 770 (Tex. 2005).

88. *Id.* (citing City of Laredo v. S. Tex. Nat'l Bank, 775 S.W.2d 729, 731 (Tex. App.—San Antonio 1989, writ denied)).

89. *Id.* (citing Salvaggio v. Hous. Indep. Sch. Dist., 752 S.W.2d 189, 193 (Tex. App.—Houston [14th Dist.] 1988, writ denied)).

90. *Id.*

91. *Id.* (citing TEX. TAX CODE § 112.052(a) (2005)).

92. *Id.*

93. Pac. Molasses Co. v. Graves, 451 S.W.2d 294 (Tex. Civ. App.—San Antonio 1970, writ ref'd n.r.e.).

94. *Id.* at 297.

95. *Id.*

96. *Id.*

unilateral and did not support a finding of the type of mistake that would entitle the payor to equitable relief.[97] This type of unilateral mistake is not the typical scenario encountered in royalty mispayment scenarios.[98]

B. *A Payor's Right to Exercise Self-Help Recoupment*

As a preface to the legal analysis necessary to explain a payor's self-help recoupment rights, it is worth noting that an informal poll has revealed that payors routinely recoup royalty overpayments through unilateral "adjustments," "off-sets," "revenue rebooking," or otherwise withholding or debiting a payee's future royalties until the overpaid amounts are collected. While business practices differ, most payors generally follow a procedure that includes notifying the payee of the overpayment and of their intent to correct it by withholding future royalties. If the amount to be recouped is minimal, however, sometimes no notice is provided. Conversely, if the amount to be recouped is significant, if the overpayments have occurred for a long time, or if the payee is of strategic importance, the operator may handle the matter with a more "white-gloved" approach. For simplicity, such recoupment activities are herein as "self-help."

As it relates to self-help recoupment, it is self-evident that the payor who mistakenly overpays royalties is particularly well-positioned to recoup the monies by simply withholding future royalties until the overpaid amounts are recovered (assuming there are future royalties to be paid). What is less clear, however, is whether such self-help recoupment is permissible. In this regard, recoupment claims are sometimes subject to certain defenses and equitable reductions, depending upon the facts and circumstances of the case.[99] Whether the payee is entitled to any such reductions is a question for the judge or jury. If, however, the payor unilaterally withholds royalties until it recoups all of the overpaid monies, the payor may be judging for itself whether the payee is entitled to any offsets or other defenses. The general rule appears to be that a payor has this right.

1. What gives a payor the right of self-help recoupment?

Commentators generally agree that a payor who mistakenly overpays mineral royalties is entitled to recover the overpaid amounts. Specifically, one commentator notes that "where as a result of good-faith mistake royalty has been paid to a person not entitled to receive same or where excessive payments have been made in good faith, it is generally held that the lessee (or purchaser) who has made such payments may recover from the payee the payments to which he is not

97. *Id.* at 298.
98. *Id.*
99. *See supra* Part III.A.

entitled."[100] Another commentator more broadly states that the right of the payor to withhold overpayment from royalty is an exercise of the right of recoupment.[101]

In addition, courts in Utah, Oklahoma, New Mexico, and Louisiana have held that payors are entitled to self-help recoupment, and some of those holdings will be discussed in further detail herein.[102] The most detailed analysis of this issue comes from the Kansas Supreme Court in its 1975 opinion issued in *Waechter v. Amoco Production Co.*[103] There, the court provides a step-by-step review of several issues permeating self-help recoupment (indeed, the court even uses the term "self-help"), including defensive recoupment, counterclaims, setoff, statutes of limitations issues, and even how the doctrine of "pure defense" allows an affirmative claim that is otherwise barred by limitations to be asserted defensively to defeat or reduce a payee's claim for nonpayment of royalties. Because the court's analysis is thorough and illustrative, this section of the Article uses the *Waechter* opinion as an analytical model and attempts to replicate its reasoning using Texas authority.

a. The Waechter Case

Waechter was a class action case involving about 3,000 lessees who Amoco overpaid a total of about $10,000,000 in royalties.[104] Amoco made the overpayments during a three-year period, and Amoco's self-help deductions from later royalty payments all occurred more than five years after its recoupment cause of action accrued.[105]

Amoco was supposed to pay royalties based on a 1950 gas purchase contract whereby the purchaser agreed to pay Amoco 8.4 cents per Mcf until 1961.[106] In 1953, however, the Kansas Corporation Commission ("KCC") issued an order requiring all gas from the subject field be sold for not less than 11 cents per Mcf.[107] Accordingly, the purchaser paid Amoco 11 cents per Mcf, and Amoco likewise paid its lessors a royalty on the 11 cents (rather than the contractual 8.4).[108] This went on for about three years, during which time the purchaser indicated that it considered the KCC order illegal and informed Amoco that it was going to seek reimbursement for the difference between 8.4 and 11 cents should it be successful in challenging the

100. PATRICK H. MARTIN AND BRUCE M. KRAMER, WILLIAMS & MEYERS, OIL AND GAS LAW, § 657 (Abridged 4th ed. 2010).
101. 3 EUGENE KUNTZ, A TREATISE ON OIL AND GAS, § 42.8 (1987).
102. Freston v. Gulf Oil Co., 565 P.2d 787, 789 (Utah 1977).
103. Waechter v. Amoco Prod. Co., 537 P.2d 228 (Kan. 1975).
104. *Id.* at 230.
105. *Id.* at 250.
106. *Id.* at 249–50.
107. *Id.* at 249.
108. *Id.* at 250.

KCC order.[109] In light of the purchaser's challenge, Amoco notified all its payees that all payments were being made on the basis of the KCC 11-cent order, but should that order be overturned, the payees would be required to refund the overpayments (the difference between 8.4 and 11 cents) and that acceptance of Amoco's royalty checks constituted their agreement to refund the excess amounts.[110]

The KCC order was ultimately invalidated, and Amoco reimbursed its purchaser for the overpayments (following a lawsuit).[111] Then, Amoco notified its payees of the overpayments and requested they reimburse Amoco in full or allow Amoco to withhold 25% of their future royalties until the overpayment was recouped.[112] Some payees refunded the money in total, some agreed to the 25% royalty withholding, but many others simply did nothing.[113] As to the latter group who did nothing, Amoco began withholding part of their royalties without notice, as if they had agreed to the deductions.[114] The royalty owners subsequently filed suit against Amoco, which led to the *Waechter* class action suit.[115]

b. Legal Analysis

In analyzing Amoco's right to withhold future royalties, the court first determined that the overpayments were not made voluntarily.[116] Specifically, Amoco's overpayments were not voluntary because the KCC order compelled it to make payments on the 11 cent regulated price rather than the 8.4 cent contracted price.[117] (In typical contexts, a payor's overpayments are not voluntary because they are made by mistake.) Next, while noting it was not dispositive in the case, the court acknowledged that if a royalty check is sent under protest and refers to a KCC minimum price order, and if the payee endorsed and cashed the check despite those references, that would create a "refund contract" between the payee and payor.[118]

Regardless, the court went on to say that the "real basis" underlying Amoco's right to be refunded is—as we have previously discussed—a right of recoupment implied at law to avoid unjust enrichment of the payee.[119] That implied right requires the payee to make restitution.[120] The payees argued that Amoco's recoupment was impermissible be-

109. *Id.* at 249–50.
110. *Id.* at 250.
111. *Id.*
112. *Id.*
113. *Id.*
114. *Id.*
115. *Id.*
116. *Id.* at 251.
117. *Id.*
118. *Id.*
119. *Id.* at 252.
120. *See id.*

cause it was barred by limitations (Amoco recouped five years after its cause of action accrued).[121] The court disagreed, explaining that a statute of limitations under Kansas law is remedial in nature—that is, it does not confer a right of action.[122] Although the expiration of limitations might bar an affirmative remedy, it does not discharge a debt, and it does not prevent Amoco from asserting its right of recoupment defensively.[123]

In this vein, the court cited a variety of authorities discussing limitations, including a Harvard Law Review article stating that even if an affirmative claim is barred by limitations, "[o]ther rights collateral to the barred claim may still be asserted, and it may be that the remedy of self-help is not affected. But if the time limit is considered 'substantive,' it bars the underlying claim as well, and all remedial rights are extinguished."[124] The court also cited 6 Williston on Contracts § 2002, wherein it is stated that "another consequence of the doctrine that the remedy is barred rather than the obligation discharged is that the creditor remains entitled after the statute has run to use any other means of collecting his debt than a direct right of action."[125] Thus, Amoco's defense of recoupment, although barred as an affirmative action, could be asserted defensively to defeat or reduce the payees' claims.[126] This is called the "pure defense" rule.[127]

Closely related to the pure defense rule is the common law doctrine of recoupment.[128] In this defensive context, "[r]ecoupment is the right of a defendant, in the same action, to cut down the plaintiff's demand . . . It means a deduction from a money claim whereby cross demands arising out of the same transaction are allowed to compensate one another . . . ."[129] Under Kansas common law, recoupment is available as a defense but is limited to matters arising out of or connected with the contract or transaction forming the basis of the plaintiff's claim.[130] In this manner, recoupment differs from setoff—that is, setoff applies in the context of different transactions and/or contracts.[131] Thus, in addition to its right under the "pure defense" theory, Amoco could also assert the common law recoupment defense.[132]

Applying the foregoing rules, doctrines, and defenses, the court held that Amoco's self-help recoupment was permissible under either

121. *Id.* at 252–53.
122. *Id.* at 254.
123. *Id.*
124. *Id.*
125. *Id.* at 255.
126. *Id.*
127. *Id.*
128. *See id.*
129. *Id.* at 254–55.
130. *Id.* at 255.
131. *Id.*
132. *Id.*

the "pure defense" theory or under the common law recoupment theory.[133] The court further concluded that Amoco's "extra-judicial" action of withholding the monies made no difference.[134] To this end, Amoco came into possession of the gas proceeds lawfully—they were not acquired by force, collusion, or unfair means, which might present a wholly different picture.[135] In short, the lessors' indebtedness was not extinguished by the lapse of time, and Amoco did not retain any money to which it was not morally entitled under all the circumstances.[136]

2. Applying Waechter in Texas

As explained, the court in *Waechter* determined that Amoco's self-help recoupment was permissible (or defensible) under either the "pure defense" theory or the common law recoupment doctrine. Further, the court also found that Amoco's extra-judicial action of withholding the monies from future royalties made no difference, as Amoco obtained the money lawfully (i.e., Amoco was entitled to receive the proceeds from the sale of gas). This section of the Article surveys Texas authority to determine whether these principals are legally tenable in Texas.

As further preface, one of the important principles underlying the defensive doctrines discussed in *Waechter* is that even though a party's affirmative right to recover a debt is barred, that does not mean the debtor ceases to owe the money.[137] Instead, it simply means the creditor cannot seek affirmative relief in the courts. In this regard, statutes of limitation are often considered remedial in nature, meaning they do not curtail substantive rights but simply provide a deadline by which those rights may be enforced affirmatively in court. Consistent with the *Waechter* analysis, statutes of limitation are remedial in Texas.[138] Thus, permitting the defensive doctrines used in *Waechter* would not run afoul of Texas reasoning relating to statutes of limitation.

a. The "Pure Defense" Theory

The "pure defense" theory, as outlined in *Waechter*, essentially states that a counterclaim growing out of the same contract and transaction on which the plaintiff's claim is based (basically the "same transaction or occurrence" standard) may be asserted defensively to

133. *Id.*
134. *Id.*
135. *Id.*
136. *Id.* at 256.
137. *See id.* at 254.
138. Cadle Co. v. Matheson, 870 S.W.2d 548, 550 (Tex. App.—Houston [1st Dist.] 1994, writ denied).

reduce any judgment received by the plaintiff, even though the defendant's claim would otherwise be barred if asserted affirmatively.[139]

Texas courts have applied and explained a similar principle, but sometimes more narrowly. Many Texas holdings lead back to the 1923 opinion in *Mason v. Peterson*, where the court allowed a defendant/purchaser's misrepresentation of a fact defense to defeat a seller/plaintiff's suit for payment on a promissory note.[140] Since the defendant sought no affirmative relief, its claim was not subject to limitations.[141] The court reasoned that if the plaintiff misrepresented a fact regarding the property, such fraud or mistake entered into and vitiated the contract, but only to the extent of the resultant injury.[142] Because the defendant in *Mason* only sought to reduce the plaintiff's claim by the amount of his injury resulting from a misrepresentation or fraud, the court held it was not a cross-action or counterclaim, thus it was not subject to statute of limitations.[143]

Just a few years after *Mason*, an appellate court held that payment may be pled in strict defense to recover upon a note and, in such cases, is a "pure defense" not subject to limitations.[144] Not long thereafter, the Texas Supreme Court held that "if the subject matter of the defense be of an intrinsically defensive nature, which, if given effect, will operate merely as a negation of the plaintiff's asserted right to recover, or in abatement, either wholly or partially, of the amount claimed, the statute of limitations does not apply."[145] The foregoing holdings—particularly *Mason*—have been construed as creating a narrow "pure defense" doctrine that requires the matter asserted defensively to go to the "foundation of the plaintiff's demand." What does "foundation of the plaintiff's demand" mean? At least one commentator states that this is a much more stringent requirement than the common-law rule under which a defendant's claim arising from the "same transaction or occurrence" as the plaintiff's claim could be asserted defensively in recoupment.[146]

Despite comments regarding Texas's apparently "narrow" version of the pure defense doctrine, later Texas courts seem to apply the doctrine more loosely.[147] In one case, the plaintiff filed suit to obtain

139. *Waechter*, 537 P.2d at 254.
140. Mason v. Peterson, 250 S.W. 142 (Tex. 1923).
141. *Id.* at 147.
142. *Id.* at 146–47.
143. *Id.* at 147.
144. Whitehead v. Wicker, 280 S.W. 604, 606–07 (Tex. Civ. App.—Amarillo 1926, no writ).
145. Morris-Buick Co. v. Davis, 91 S.W.2d 313, 314 (Tex. 1936).
146. 5 WILLIAM V. DORSANEO III ET AL., TEXAS LITIGATION GUIDE § 72.05 (2003) (citing Bull v. United States, 295 U.S. 247, 262 (1935)).
147. *See, e.g.*, Christian v. First Nat'l Bank of Weatherford, 531 S.W.2d 832, 838 (Tex. Civ. App.—Fort Worth 1975, writ ref'd n.r.e.) (It is well settled that the statute of limitations is not applicable to matters set up strictly by way of defense. This includes defenses of offsets, credits, and payments). *But see* S. Pac. Co. v. Porter, 331

possession and confirmation of title to a tract of land occupied by the defendant.[148] In response, the defendant alleged that the plaintiff had offered to sell the land and that the defendant had accepted the offer.[149] In addition, the defendant asserted a counterclaim for specific performance.[150] The plaintiff argued that the defendant's claim for specific performance was barred by limitations, but the court held it was asserted only as a "pure defense" in "negation of the plaintiff's asserted right to recover."[151]

Although the distinction between an independent cause of action and a claim going to the "foundation" of the plaintiff's cause of action is difficult to articulate in light of the various and disparate holdings on this issue, the Houston Court of Appeals provided one of the better explanations in *Flukinger v. Straughan*, where it stated:

> The question of whether an answer sets up a counterclaim or is merely defensive must be determined by the facts alleged, and not by the name given the plea or by the particular form of the prayer for relief. A test for making the determination is to inquire whether the defendant could have maintained a suit to enforce the claim before suit was bought by the plaintiff. If the defendant could have maintained such an independent suit, the claim will be regarded as a setoff or counterclaim. If the suit could not have been maintained, it is a defensive plea.[152]

Based on this explanation, it seems plausible that a payor would have grounds to argue its recoupment rights as a "pure defense." Presumably, at the time the payee files suit, the payor would have already either partially or fully recouped the subject monies. Thus, as it relates to the sued upon royalties (i.e., the royalties the payee contends it is owed), the payor would have no cause to sue—that is, the payor cannot sue for recoupment on the amounts already recouped. Thus, the payor could no longer maintain an action for recoupment. Consequently, the overpayment and attendant right to recoup is asserted only defensively to negate the payee's claim for payment.

b. The Common Law Doctrine of Recoupment

Texas law regarding the doctrine of recoupment has also been mixed. In 1936, the Texas Supreme Court in *Morris-Buick Co. v. Da-*

S.W.2d 42, 45 (Tex. 1960) (stating that recoupment is narrow in Texas and it must be predicated upon a factor which would vitiate a contract either in whole or in part as of the time the contract was made) (citing Mason v. Peterson, 250 S.W. 142 (Tex. 1923)).

148. Murphy v. Sills, 268 S.W.2d 296, 298–99 (Tex. Civ. App.—Beaumont 1953, writ dism'd).

149. *Id.* at 299.

150. *Id.*

151. *Id.* at 307–08.

152. Flukinger v. Straughan, 795 S.W.2d 779, 787 (Tex. App.—Houston [14th Dist.] 1990, writ denied) (citing 67 TEX. JUR. 3D *Setoffs, Counterclaims, and Cross Actions* § 52 (1989)).

vis acknowledged that other jurisdictions recognized the doctrine of recoupment but stated it had "no place in the jurisprudence of this State."[153] Around the same time, however, the Fifth Circuit—apparently ignoring the *Morris-Buick* holding—allowed a defendant to assert recoupment defensively.[154] In doing so, the court noted that Texas adopted the doctrine of recoupment when it adopted the "common law" by statute in 1840.[155] Later, the Texas Supreme Court again discussed recoupment in *Southern Pacific Co. v. Porter*.[156] There, the court went back to *Mason v. Peterson* (which it had relied on in *Morris-Buick*) to state that recoupment had a narrow scope in Texas.[157] Specifically, the court held that recoupment "must be predicated upon a factor which would vitiate a contract either in whole or in part as of the time the contract was made."[158]

Despite this narrow explanation of the recoupment doctrine, more recent appellate courts seem to apply a broader standard consistent with other common law jurisdictions. For instance, in the context of a counterclaim asserting a violation of the Truth in Lending Act, one court explained that:

> [R]ecoupment, one form of counterclaim, is a 'demand arising from the same transaction as the plaintiff's claim,' while an offset arises out of a transaction different than one forming the basis of plaintiff's claim. Regarding the applicability of statutes of limitations to a demand in the nature of a recoupment, both Texas and Federal courts follow the general rule that a recoupment, when pled only to defeat plaintiff's claim, is not barred by the statute of limitations so long as the plaintiff's main action itself is timely. The defense of recoupment may be asserted even though the same claim asserted as an independent cause of action would be barred by limitations.[159]

At the same time, opinions as recent as 1999 refer to the recoupment doctrine as "very narrow." For example, the San Antonio Court of Appeals recently stated the following about recoupment in an unpublished opinion:

> [T]he supreme court has confined recoupment to the very narrow situation in which the claim for recoupment is 'predicated on a factor which would vitiate a contract either in whole or in part as of the

153. Morris-Buick Co. v. Davis, 91 S.W.2d 313, 314 (Tex. 1936).
154. Pennsylvania R.R. Co. v. Miller, 124 F.2d 160, 161–62 (5th Cir. 1941).
155. *Id.* at 162.
156. S. Pac. Co. v. Porter, 331 S.W.2d 42 (Tex. 1960).
157. *Id.* at 45.
158. *Id.*
159. Garza v. Allied Fin. Co., 566 S.W.2d 57, 62–63 (Tex. Civ. App.—Corpus Christi 1978, no writ) *reformed and aff'd on rehearing*, 626 S.W.2d 120 (Tex. App.—Corpus Christi 1981, writ ref'd n.r.e.); *see also,* Spradling v. Corbett, No. 07-95-0158-CV, 1996 Tex. App. LEXIS 3181, at *16 (Tex. App.—Amarillo July 23, 1996, writ denied) (not designated for publication); FDIC v. Graham, 882 S.W.2d 890, 899 (Tex. App.—Houston [14th Dist.] 1994, no writ); Brown v. U.S. Life Credit Corp., 602 S.W.2d 94, 96 (Tex. Civ. App.—Fort Worth 1980, no writ).

> time the contract was made.' Recoupment has thus been interpreted as a defensive doctrine, dependent upon the assertion of a contract cause of action by a plaintiff, and 'available only to reduce or satisfy [a] plaintiffs' claim.'[160]

Even if modern Texas courts interpret the doctrine of recoupment narrowly, it would seem that if a payor asserted overpayment of royalties as a defense to a claim for unpaid royalties, such defense would fit even a narrow rule. In this regard, a defense that the royalties have already been paid would arguably go to the heart of the plaintiff's claim for payment. Regardless, in these situations, the Texas "revival statute" provides a safety net (of sorts), should a court find the recoupment doctrine inapplicable.

c. Setoff

Texas courts have also recognized the defensive plea of "setoff" but, unlike recoupment, hold that such pleas are subject to the statute of limitations because a setoff arises from a transaction extrinsic to the plaintiff's claims.[161] In *Morris-Buick Co. v. Davis*, where the court discussed the "pure defense" doctrine, the court also discussed setoff.[162] Specifically, the court noted that when a claim asserted defensively does not go to the foundation of the plaintiff's claim, it cannot effect a reduction of the amount of the plaintiff's claim except by way of setoff.[163] In such cases, however—and unlike recoupment—the setoff plea is subject to the applicable statute of limitations.[164]

The Texas Supreme Court reiterated this rule in 1977 in *Hobbs Trailers v. J.T. Arnett Grain Company, Inc.*[165] In *Hobbs*, the court again relied on *Mason v. Peterson* to explain the distinction between defenses that go to the "foundation of the plaintiff's claim" and those that do not.[166] On the one hand, a defense of failure of consideration by reason of fraud or mutual mistake would be a defense going to the foundation of a plaintiff's suit for contractual performance and would qualify as a pure defense.[167] On the other hand, a defendant's claim that the plaintiff also breached the contract would be an independent

160. Bray v. Bray, No. 04-98-00633-CV, 1999 Tex. App. LEXIS 4448, at *3–*5 (Tex. App.—San Antonio June 16, 1999, pet. denied) (not designated for publication) (citations omitted).

161. 5 WILLIAM V. DORSANEO III ET AL., TEXAS LITIGATION GUIDE § 72.05 (2003).

162. Morris-Buick Co. v. Davis, 91 S.W.2d 313, 314 (Tex. 1936); *see also* Finger v. Morris, 468 S.W.2d 572, 579 (Tex. Civ. App.—Houston [14th Dist.] 1971, writ ref'd n.r.e.) (citing *Morris-Buick Co.*, 91 S.W.2d at 314).

163. *Id.*

164. *Id.*

165. Hobbs Trailers v. J.T. Arnett Grain Co., 560 S.W.2d 85, 88 (Tex. 1977).

166. *Id.*

167. *Id.*

obligation of the plaintiff and could therefore only be raised by way of setoff or counterclaim, both of which are subject to limitations.[168]

In short, a setoff is a demand that the defendant has against the plaintiff that arises out of a transaction extrinsic to the plaintiff's cause of action.[169] In such cases, the statute of limitations is available to the opposing party to defeat the defense.[170] Setoff would be available and useful in royalty recoupment cases if the payor has recouped overpaid royalties from wells subject to different leases.

3. Similar Holdings from Other Jurisdictions

In addition to the *Waechter* holding, other states' courts have expressly held that the lessee may recoup mistakenly overpaid royalties from current and future royalties. This section of the Article discusses some of these holdings.

a. Utah

In *Freston v. Gulf Oil Co. U.S.*, the Utah Supreme Court held that the right of recoupment is inherent in all contractual matters, and, as such, a payor was justified in withholding future royalties to recoup mistakenly overpaid monies.[171] Notably, the Utah court cited a Texas case for the proposition that it would be highly inequitable to allow the royalty payee to retain something that was not his.[172] Thus, at least one case relying on Texas authority has expressly permitted a payor's self-help recoupment from future royalties on the same well.

In the *Freston* case, a payor's audit revealed a $48,880.53 overpayment to the royalty payee.[173] Upon discovering the overpayment, the payor sent a letter to the payee advising that future payments would be withheld until the overpayment was recovered.[174] The payor then withheld royalties to recoup the overpayment.[175] As a result, the payee sued the payor seeking to recover the withheld royalties and/or to terminate the lease.[176] In doing so, the payee alleged the payor was precluded from recouping the overpaid amounts based on the payee's alleged "changed circumstances." Specifically, the payee asserted it had increased tax liabilities, substantial investments, and purchases

168. *Id.*
169. FDIC v. Graham, 882 S.W.2d 890, 899 (Tex. App.—Houston [14th Dist.] 1994, no writ).
170. Spradling v. Corbett, No. 07-95-0158-CV, 1996 Tex. App. LEXIS 3181, at *17 (Tex. App.—Amarillo July 23, 1996, writ denied) (not designated for publication).
171. Freston v. Gulf Oil Co., 565 P.2d 787, 789 (Utah 1977).
172. *Id.* at 788 (citing Gulf Oil Corp. v. Lone Star Producing Co., 322 F.2d 28 (5th Cir. 1963)).
173. *Id.*
174. *Id.*
175. *Id.*
176. *Id.*

that apparently consumed all the excess royalties.[177] The court noted, however, that the payor did not ask the payee to "dig into their pocket and return the overpayment in toto."[178] Instead, the payor merely looked to the future proceeds for repayment.[179] Given these facts, the court concluded it would be inequitable to allow the payee to retain "something that was not theirs."[180]

b. Oklahoma

In a recent Oklahoma case, the court allowed a payor's self-help recoupment from future royalties on both the overpaid well *and* another well, which was drilled under a separate lease on which there were no overpayments.[181] There, after the payor withheld royalties to recoup the overpayment, the royalty owner sued for an accounting and damages for conversion of royalties.[182] The court granted summary judgment for the payor, finding the payor had a right to withhold royalties from the same well on a theory of "recoupment" and, similarly, had a right to withhold royalties on another well based on a theory of "setoff."[183]

Specifically, the court held that the payor's right of recoupment is its right to have a deduction from the amount of the payee's damages, for the reason that the plaintiff/payee has not complied with its cross-obligations arising under the same contract.[184] In addition, the defining characteristic of setoff is that the mutual debt and claim are generally those arising from different transactions.[185] The equitable doctrine of setoff permits the setoff of an obligation under one contract against the obligation of any other contract between the same parties, such that the payor could properly recover overpayments on one well against the amounts due the payee from another.[186] Consequently, "in an action against one upon a contract, he may offset or plead as a defense thereto any claim to him by virtue of any contract with one instituting the same."[187] The court went on to say, however, that regardless of the characterization as setoff or recoupment, it goes without saying that, in an appropriate circumstance, overpayments of royalty made by mistake may be recovered from the payee.[188]

177. *Id.*
178. *Id.*
179. *Id.*
180. *Id.* at 789.
181. Nelson v. Linn Midcontinent Exploration, L.L.C., 228 P.2d 533, 535 (Okla. Civ. App. 2009).
182. *Id.* at 534.
183. *Id.* at 534–35.
184. *Id.* at 534.
185. *Id.* at 535.
186. *Id.*
187. *Id.*
188. *Id.* (citing 3 HOWARD R. WILLIAMS & CHARLES J. MEYERS, OIL AND GAS LAW § 657 (1993); 3 EUGENE KUNTZ, A TREATISE ON OIL AND GAS § 42.8 (1987)).

In an earlier case, the Oklahoma Supreme Court held that a payor in a royalty overpayment case was not only entitled to recoup the overpaid monies, but it was also entitled to prejudgment interest on the amounts the payee refused to return and was further entitled to attorney's fees following its favorable verdict in the payee's lawsuit for an accounting on an oil and gas contract.[189] In that case, Phillips 66 notified its payee of the overpayment due to an inadvertent "mistake of fact" and began self-help recoupment when the payee failed to surrender the overpayments.[190] As a result, the payee sued Phillips 66 for an accounting.[191] The trial court entered a judgment in favor of Phillips 66, and the court of appeals affirmed.[192] The court granted certiorari to consider only two issues: whether Phillips 66 was entitled to recover interest on the overpaid amounts and attorney's fees resulting from the accounting suit.[193] The court answered both questions affirmatively.[194]

c. New Mexico

In 1998, a New Mexico court of appeals recognized a payor's right to recoup mistakenly overpaid royalties in *City of Carlsbad v. Grace*.[195] There, Grace overpaid the city during a sixteen-year period.[196] Upon discovering the overpayments, Grace demanded repayment and then withheld royalties for two and a half years, at which time the city filed a declaratory judgment action to determine whether Grace was entitled to withhold the royalties.[197] The court found that Grace's affirmative right to recoup was barred by the applicable statute of limitations, but the court also recognized (apparently for the first time in New Mexico jurisprudence) that "it appears to be universally recognized that equitable recoupment is allowed as a defense in oil and gas cases although the statute of limitations has expired."[198] Among other authorities, the court cited *Waechter*.[199]

Ultimately, the court remanded the case for a determination of whether Grace was entitled to "equitable recoupment," and the court suggested several factors that could be considered by the trial court in making this determination.[200] These factors include the parties' diligence in discovering the accounting error, Grace's accounting proce-

189. Shanbour v. Phillips 66 Natural Gas Co., 864 P.2d 815, 816 (Okla. 1993).
190. *Id.*
191. *Id.*
192. *Id.*
193. *Id.*
194. *Id.*
195. City of Carlsbad v. Grace, 966 P.2d 1178 (N.M. Ct. App. 1998).
196. *Id.* at 1180.
197. *Id.*
198. *Id.* at 1185.
199. *Id.*
200. *Id.* at 1186.

dures, the city's reliance on future royalty payments, the city's ability to withstand reductions in future royalty payments, and the strong policy disfavoring stale claims against cities.[201] In short, the court was to consider "the dollar amounts involved and their practical considerations to the parties."[202] Finally, the court left open the possibility that Grace could also be entitled to recover interest on the overpayments.[203]

d. Louisiana

In the context of a gas purchase agreement, a Louisiana court has also held that mistaken overpayments are recoverable.[204] In *Dynamic Exploration, Inc. v. Sugar Bowl Gas Corp.*, the gas purchaser discovered that an error in the calculation of the amount of gas purchased had caused it to overpay the gas producer.[205] The gas purchaser then applied its overpayments to current charges.[206] As a result, the gas producer filed suit for the amounts withheld.[207] Much of the opinion dealt with contractual provisions specific to that case, but ultimately the court recognized that overpayments made by negligent mistakes are recoverable and that the gas purchaser was entitled to recover its overpayments.[208]

4. Potential Pitfalls in Self-Help Recoupment

As many of the foregoing cases exemplify, a payor's self-help recoupment can precipitate a lawsuit by a disagreeable payee. If that happens, the payor may be subject to breach of contract, conversion, and interest claims, among others. In addition, once the payor is placed in the defensive position, it will want to be sure its counterclaims and defenses are properly and timely asserted. For an example of a potential pitfall, we can look to the Texas case of *Bright & Company v. Holbein Family Mineral Trust.* There, the payor mistakenly overpaid a non-participating royalty owner a one-eighth royalty rather than the correct one-sixteenth royalty.[209] After discovering the mistake, the payor ceased all royalty payments to the overpaid payee.[210] Several years later, the payee filed suit alleging breach of contract and

201. *Id.*
202. *Id.*
203. *Id.* at 1187–88.
204. Dynamic Exploration, Inc. v. Sugar Bowl Gas Corp., 367 So. 2d 18, 19 (La. Ct. App. 1978).
205. *Id.*
206. *See id.* at 19–20.
207. *Id.* at 19.
208. *Id.* at 24.
209. Bright & Co. v. Holbein Family Mineral Trust, 995 S.W.2d 742, 744 (Tex. App.—San Antonio 1999, pet. denied).
210. *Id.*

statutory nonpayment of royalties.[211] In an amended answer, the payor alleged setoff as an affirmative defense and counterclaim, arguing that it was entitled to recoup the amounts it had overpaid.[212] The court found, however, that the payor's defense of setoff was actually a counterclaim that was barred by the statute of limitations (this is consistent with our earlier discussion of setoff).[213] The court noted that the counterclaim may have been revived had the payor filed it within thirty days of its answer due-date, as provided in TEX. CIV. PRAC. & REM. CODE § 16.069, but the payor did not timely assert that claim.[214] The court held that the payor's overpayment did not negate the payee's claim for nonpayment of royalties.[215] Thus, the court affirmed the payee's judgment for the unpaid royalties plus interest.[216]

The key takeaways from this case include: (1) the potential right of recoupment does not provide carte blanche permission to recoup by withholding royalties; instead, the payor must analyze its right of recoupment and its ability to assert the claim so as to avoid and/or foresee potential contractual penalties and statutory interest on unpaid royalties; and (2) if the payee files suit, the payor must be sure to timely assert all applicable defenses (such as setoff, payment, or recoupment) and counterclaims (such as money had and received). Indeed, the outcome in *Bright* may have been completely different had the payor pled all its available defenses and counterclaims.

IV. CONCLUSION

Given the volume and complexity of mineral royalty calculations, mispayments are inevitable. In the context of underpayments, the payee should first determine whether there is a corresponding overpayment and then determine whether there are signed division orders. If yes to both questions, the underpaid payee must recover from the overpaid payee. In other scenarios, and depending on the circumstances, the payee may reconcile the underpayment by simply tendering the underpaid amounts to the appropriate payee. With regard to overpayments, the payor may seek affirmative relief in the courts or, in certain situations, commence self-help measures to recoup the overpaid amounts. Affirmatively, the payor may assert a money-had-and-received claim but must consider the prospect of equitable reductions in certain limited scenarios. If self-help is implemented and the payor is called upon to defend his actions, he should be sure to assert all available defenses, including payment, recoupment, and setoff. In addition, the payor may affirmatively assert a money-had-and-received

211. *Id.* at 743.
212. *Id.* at 746.
213. *Id.* at 747.
214. *Id.* at 746–47.
215. *Id.* at 747.
216. *Id.* at 748.

counterclaim to negate a payee's royalty suit. If the statute of limitations for the payor's counterclaim has expired, the claim would likely be revived by statute if filed within thirty days of his answer due-date.

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