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CURRENT ISSUES IN OIL & GAS ROYALTY LITIGATION

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Current Issues in Oil and Gas Royalty Litigation

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Courts in the oil and gas-producing states have always experienced at least some level of litigation over the scope and nature of payments owing to royalty owners in connection with oil and gas production and operations. However, in recent years, the number of lawsuits over royalty payment issues has reached an unprecedented level. Most of the more-recent royalty owner actions (1) seek to claim a share of gas contract litigation settlements between lessees and gas purchasers, (2) object to the action of lessees in taking into account certain "post-production" and marketing-related expenses in determining the value, price or proceeds upon which gas royalty payments are determined, (3) object to the use of "posted prices" in calculating the payments to royalty owners for crude oil production, or (4) challenge certain marketing transactions between producer-lessees and their affiliated entities. In asserting these types of claims, royalty owner counsel have increasingly attempted to use class action procedure, as opposed to limiting the lawsuit to the claims of their own individual clients.

A. POST-PRODUCTION COST LITIGATION.

Over the years, the courts in the oil and gas-producing states have in a number of cases addressed the extent to which a lessee may deduct from royalty payments a proportionate share of "post-production" and marketing-related expenses (e.g., gas gathering, transportation, compression, dehydration and blending costs). The lessee typically does not seek to have the royalty owner pre-pay these expenses out of pocket; rather, lessees usually ask only that they be permitted to take those expenses into account in calculating the value, price or proceeds upon which the royalty payments are to be based. During the latter 1980's and throughout the 1990's, dramatic changes in the gas industry and gas marketing business have changed the way in which many lessees market gas production. Lessees have increasingly incurred major expenses (expenses traditionally borne by the gas purchaser) in attempting to obtain better, higher-priced

markets for gas production than the markets available in the vicinity of the well. Lessees argue that such activities go above and beyond their duties under the oil and gas lease, and that it is appropriate to take the expenses incurred in connection with those activities into account in calculating gas royalty payments. On the other hand, a number of royalty owners have argued that their royalty payments should not take into account any portion of those expenses. These conflicting positions have led to a number of recent lawsuits addressing the extent to which lessees may pass on to royalty owners a proportionate share of expenses incurred in connection with the marketing of gas production in the new industry environment. Some of the recent cases which have addressed this issue are described below:

1. Garman v. Conoco Inc., 886 P.2d 652 (Colo. 1994).

In this case, the Supreme Court of Colorado addressed the following question certified from a Federal Court in Colorado: "Under Colorado law, is the owner of an overriding royalty interest in gas production required to bear a proportionate share of post-production costs, such as processing, transportation, and compression, when the assignment creating the overriding royalty interest is silent as to how post-production costs are to be borne?" Under the facts presented, the court found that the implied covenant to market obligated the lessee to incur those post-production costs which were found to be necessary to place the gas produced from the subject property in a condition acceptable for market. The court further found that the overriding royalty interest owners were not obligated to bear a share of those costs.

The court in *Garman* stated that its ruling was limited to those post-production costs which were required to transform raw gas into a marketable product. "Upon obtaining a marketable product, any additional costs incurred to enhance the value of the *marketable* gas. . . may be charged against nonworking interest owners. To the extent that certain processing costs enhance the value of an already marketable product the burden should be placed upon the lessee to show such costs are reasonable, and that actual royalty revenues increase in proportion with the costs assessed against the nonworking interest." (Emphasis supplied by the court) 886 P.2d at 661.

2. TXO Production Corp. v. Commissioners of the Land Office, 903 P.2d 259 (Okla. 1994).

In this case, the lessee under an oil and gas lease covering State lands brought an action for declaratory judgment to determine whether it could deduct from royalty payments to the State a proportionate share of certain post-production costs. The royalty clause in the State oil and gas lease provided that TXO would deliver or cause to be delivered to the Commissioners "without cost into pipelines," an agreed fraction "of the oil or gas produced from the leased premises and [the agreed fraction] of all casinghead or drip gas or gasoline or other hydrocarbon substances produced from any well or wells

on said premises, or in lieu thereof, pay to [the Commissioners] the market value thereof, as the Commissioners may elect." The Commissioners elected to receive their royalty under the "market value" alternative. When TXO made royalty payments to the Commissioners, it deducted a portion of the proceeds to cover the Commissioners' share of gas compression, dehydration and gathering expenses. The Commissioners asserted that such expenses should not have been deducted from their royalty payments. In interpreting the above-quoted royalty clause, the court found that the language "without cost into pipelines" modified both the "in kind" and "market value" royalty alternatives provided for in the lease.

The Oklahoma Supreme Court stated that, in Oklahoma, the lessee's duty to market involves obtaining a marketable product. The court found that, under the particular facts presented in this case, the costs for compression, dehydration and gathering could not be charged to the Commissioners because those processes were necessary to make the product marketable. 903 P.2d at 262-263. However, the court made a specific point of stating that it was not disturbing its prior ruling in *Johnson v. Jernigan*, 475 P.2d 396 (Okla. 1970), which held, among other things, that the royalty owner is required to bear its proportionate share of transportation costs when the sale occurs off the leased premises.

3. Sternberger v. Marathon Oil Company. 894 P.2d 788 (Kan.1995).

This was a multistate class action lawsuit, involving oil and gas leases covering lands in Kansas, Oklahoma and Texas. TXO (predecessor in interest to Marathon) had deducted from its gas royalty payments certain "marketing costs" or "gathering line amortization expenses" in order to recover a portion of the expenses it incurred in constructing and maintaining gas gathering pipeline systems to transport the gas from the leases to markets off the lease. The gas royalty provision which governed the claims of all class members provided that TXO would pay as gas royalty a specified fraction "at the market price at the well (but, as to gas sold by lessee, in no event more than [the agreed fraction] of the proceeds received by lessee from such sales), for the gas sold used off the premises, or in the manufacture of products therefrom..." There was no market for gas at the wellhead, and TXO had been unable to induce a gas purchaser to construct a pipeline to the wells. Consequently, TXO laid its own gas gathering pipeline system to transport gas from the wells to the market. TXO then deducted from royalty payments a "line amortization charge" to recover a proportionate share of the cost of the pipeline. The court noted that, as to some properties, the line amortization charges were designed to recoup a proportionate share of the costs in one year (at which point the deductions would cease). As to other properties, the charges were to continue throughout the life of the well.

The Kansas Supreme Court held that the lessee has the duty to produce a marketable product, and that the lessee alone bears the expense of making the gas

marketable. However, in *Sternberger*, the court found that there was no evidence that the gas produced by Marathon was not marketable at the mouth of the well (other than the lack of a purchaser at that location). The court noted that there was no evidence that Marathon had engaged in any activity designed to enhance the product, such as compression, processing or dehydration. Moreover, there was no evidence that Marathon attempted to deduct any expenses in making the gas marketable other than those of constructing a pipeline to transport the gas to the purchaser or to a transmission pipeline. (The court found that the deductions made by Marathon were properly characterized as "transportation" rather than as "gathering" or production costs.) Consequently, the Kansas Supreme Court held that, under Kansas law, the royalty owners were responsible for their proportionate shares of the reasonable expenses of transporting the gas from the wellhead to market, and that Marathon could properly deduct a proportionate share of those expenses from the royalties. 894 P.2d at 799-800. The court found that Oklahoma and Texas law similarly allowed the same deductions.

4. Judice v. Mewbourne Oil Company. 939 S.W.2d 133 (Tex. 1996).

The question in this case was whether post-production compression costs could be allocated to royalty owners under the terms of certain oil and gas leases and division orders. The court made a number of findings too numerous to recite in this paper. As to those oil and gas leases which provided that royalty was to be based on the "market value [of the gas] at the well," the court held that the lease meant that royalty was to be paid based on the "value at the well, net of any value added by compressing the gas after it leaves the wellhead." 939 S.W.2d at 135.

The court also reviewed two forms of division orders. The first form provided that settlement "for gas sold shall be based on the gross proceeds realized at the well by you. For gas used off the leases, settlement shall be based on market value at the well." The second form of division order provided that payments for gas was to be made "based on the net proceeds realized at the well by you," following this language, the following bracketed words in the division order form were deleted: [after deducting any costs incurred in compressing, treating, transporting and/or dehydrating the gas for delivery. If the gas is processed in or near the field where produced, settlement shall be based on the net proceeds realized at the well, as determined by the agreement between the producer and processor, or, in the absence of such an agreement, the same basis as settlement with other producers of gas of like kind and quality processed at the same plant. For gas used off the lease, settlement shall be based on market value at the well.] Most of the gas produced under each of the leases was sold off the leased premises to a third party purchaser.

As to the first form of division order, the court found that the term "gross proceeds" means that the royalty is to be based on the gross price received by the lessee, and that the use of the term "at the well" indicates just the opposite---that royalty was to be

based on the value of the gas at the well. Thus, the court concluded that there was an inherent conflict in the use of the two terms in the division order language which rendered the clause in the first form ambiguous, and that the trial court did not err in entering judgment in favor of the royalty owners on the first form of division order. As to the second form of division order, the court held that the trial court erred in holding for the royalty owners. The appellate court noted that the division order unambiguously provided that royalty was to be based on "net proceeds at the well." The term "net proceeds" was found to expressly contemplate deductions, and that the phrase "at the well" meant before value was added by preparing the gas for market. The court held that the handwritten deletions in the division order did not alter the effect of the remaining language.

5. Heritage Resources, Inc. v. Nationsbank, 939 S.W.2d 118 (Tex. 1996).

Nationsbank sued Heritage contending that Heritage deducted transportation costs from the value of its royalty in violation of the oil and gas leases. The court made a number of rulings and observations in this case, including the following: (1) It found that the lower court had erroneously construed a royalty clause which provided for payment based on market value at the well to mean that royalty was to be based on the market value at the point of sale with no deductions for post-production costs. The court rejected the notion that the lessee was required to pay royalties based on the market value at the point of sale. (2) The oil and gas leases in this case provided that royalty was to be based on the market value at the well, and contained additional language stating as follows: "provided, however, that **there shall be no deductions from the value of Lessor's royalty** by reason of any required processing, cost of dehydration, compression, transportation, or other matter to market such gas." With regard to this special language, the court held that the "value of the lessor's royalty" was the market value at the well, multiplied by the applicable royalty fraction. The court found that the clause dealing with post-production costs simply specified that there could be no deduction from the value of the lessor's royalty by reason of any post-production costs. The court reversed the trial court's ruling in favor of the royalty owner.

6. XAE Corporation v. SMR Property Management Co., No. 87,466, Oklahoma Court of Appeals (Division No. I) (Opinion dated January 14, 1997, Appeal Pending).

In XAE Corporation v. SMR Property Management Company, the plaintiffs were owners of overriding royalty interests under instruments which provided that the overriding royalty was "to be delivered . . . free and clear of all costs and expenses whatsoever, save and except gross production taxes or other governmental taxes properly chargeable thereto." Gas produced from the subject wells was delivered to a plant where carbon dioxide, hydrogen sulfide and water were extracted, and the gas was compressed to meet the specifications for delivery into a major pipeline. The overriding royalty interest owners sued to recover the amount of deductions for gathering, delivery and treatment

charges. The Oklahoma Court of Appeals concluded that the overriding royalty owners in this case should be treated essentially the same as royalty owners with respect to the litigated issue. The court found that the lessee was obligated to incur the expenses in question in order to make the gas a "marketable product," and that the lessee should alone bear all of those expenses, and therefore held for the override owners.

The Oklahoma Supreme Court has granted discretionary review of this case, which frequently indicates that the court is going to reverse or significantly modify the decision under review. The parties are currently awaiting a decision from the higher court.

7. Schroeder v. Terra Energy, Ltd., 565 N.W.2d 887 (Mich. App. 1997).

The plaintiffs, royalty owners of Terra, alleged that Terra had paid them royalties without based on the "gross proceeds" of gas sales, without deducting postproduction costs, for about two years. Terra then advised that it would deduct postproduction costs in the future and would also reduce future revenues in recoup past overpayments. The royalty clause of the applicable lease provided that gas royalties would be paid based upon "gross proceeds at the wellhead." Terra argued that the valuation of the gas should occur at the wellhead and that, in the absence of any market at the wellhead, such valuation must take into consideration the postproduction costs necessary to prepare the gas for its ultimate market. The royalty owners argued that the gas should be valued for royalty purposes where the market for the gas exists and that there was no need to reduce the sales price by postproduction costs.

The court held that, in determining "gross proceeds at the wellhead," in the absence of an actual sale of gas at the wellhead resulting in ascertainable gross proceeds, the gross proceeds from the sale of gas elsewhere must be extrapolated, backwards or forwards, to reflect appropriate adjustments due to differences in the location, quality, or characteristics of what is being sold. Here, gas was sold 30 miles from the wellhead. At that point the gas sold had been altered, both by being transported to a point at which a large buyer was willing to accept the production from a relatively small leasehold, and by being processed to eliminate impurities so the purchaser could put the commodity directly to its intended end uses. The court found that these enhancements were the result of effort and monetary expenditures by the lessee, which expenses were properly deducted from the price received at the point of sale to determine the gross proceeds at the wellhead. The court rejected the royalty owner's argument that the lack of explicit language in the oil and gas lease allocating post-production costs meant that such costs were not deductible, noting that the lease provision in question was a standard provision reflecting customary practices in the industry. The court found that, while the royalty provision could have been clearer, it was nevertheless sufficiently unambiguous. The court also rejected the argument that the lessee was estopped from beginning such deductions by virtue of its conduct in non making such deductions for some two years.

Mittelstaedt v. Santa Fe Minerals, 1998 Ok. 7

- request for clarification by fed ct. to Okla. Ct.
- where oil co can show that costs enhanced value received, then costs can be deducted

B. ROYALTY OWNER CLAIMS TO A SHARE OF GAS CONTRACT LITIGATION SETTLEMENTS.

During the 1980's, many producers filed, or threatened to file, suits against gas purchasers alleging that the purchasers had failed to comply with the terms and provisions of applicable gas purchase contracts. Many of these suits alleged that the purchaser breached the "take-or-pay" provisions of the gas purchase contracts. Many producers settled these claims by entering into settlement agreements, the terms of which would vary on a case-to-case basis. Some of those settlements involved an agreement on the part of the gas purchaser to make a stipulated cash payment in consideration for the release of the claims for prior breaches of the gas contract. Some of those settlements also involved an agreement under which the producer would stipulate to the termination of the disputed gas purchase contract.

For a number of years, royalty owners have been attempting to claim a share of the sums received by producers under such gas contract settlements. Many of the cases on this issue have favored the producer and have held that the payments received under those settlements were not royalty-bearing. See, e.g., *Mandell v. Hamman Oil and Refining Co.*, 822 S.W.2d 153, 165 (Tex. App. Houston 1991) ("Production is the key to royalty. . . Royalty does not accrue until gas is produced, that is, physically severed from the soil. . ."); *Gerard J.W. Bos. & Co. Inc. v. Harkins & Co.*, 883 F.2d 379, 382 (5th Cir. 1989) (holding that, under Mississippi law, the royalty owner was a mere incidental beneficiary and had no rights under the gas purchase contract); *Wyoming v. Pennzoil Co.*, 752 P.2d 975, 980 (Wyo. 1988) ("The language of the lease, considered in its entirety, demonstrates that the intention of the parties was that royalty payments would be due only after the gas was sold or used, and no sale could be identified unless the gas was severed from the leased land."); *Diamond Shamrock Exploration Corp. v. Hodel*, 853 F.2d 1159, 1168 (5th Cir. 1988) (royalty is not due on take-or-pay payment unless and until there is "actual physical severance of minerals from the formation"); *Killam Oil Co. v. Bruni*, 806 S.W.2d 264, 268 (Tex. App. San Antonio 1991, writ denied) (under a standard lease, take-or-pay payments do not constitute any part of the price paid for produced gas. . . These payments are made when gas is not produced, and as such, bear no royalty."); *Hurd Enterprises, Ltd. v. Bruni*, 828 S.W.2d 101, 110 (Tex. App. San Antonio 1992) (Footnote 12: "Because take-or-pay provisions are intended to apportion the risks of natural gas production, it follows that the benefits from those provisions should not be shared by royalty owners.").

More recently, while most of the court decisions have favored producers, some courts have held in favor of the royalty owners. The decisions in certain states which have favored the position of royalty owners resulted in a significant increase in the number of lawsuits filed with respect to this issue during the 1994-1995 time frame. Some of the more recent and/or currently-pending decisions in this area include the following:

1. Roye Realty & Developing, Inc. v. Watson, No. 76,848, 1996 WL 515794, ___ P.2d ___, Oklahoma Supreme Court (Opinion issued September 10, 1996).

In this case, the lessee had entered into the settlement of a gas contract lawsuit. The royalty owners contended that, by virtue of the failure to pay to the royalty owners a share of the sums received by the lessee in connection with that settlement, the lessee had breached the oil and gas leases, had violated 52 O.S. 1991, §540(a), and had breached a fiduciary duty which was alleged to be owing by the lessee to the royalty owners. The royalty owners also alleged that they were third party beneficiaries under the gas purchase contract and/or under the settlement agreement. In the course of discovery, the lessee refused to produce for the royalty owners a copy of the settlement agreement. The royalty owners filed a motion asking the court to compel the lessee to produce a copy of the settlement agreement. The lessee and gas purchaser argued that the settlement agreement was not relevant to any claim by the royalty owners, and moved for summary judgment in their favor. The trial court denied the motion to compel and entered summary judgment in favor of the producer and gas purchaser, finding that the sums received under the settlement were not subject to royalty claims.

The Oklahoma Court of Appeals reversed the trial court and ruled in favor of the royalty owners. While the decision of the court cites no prior cases or legal authority, the court stated that the "take-or-pay" arrangement was simply a "marketing substitute or alternative to severance and sale." The court further stated that "by receiving payment either for the severance and taking of oil and gas by a purchaser or for granting a right to refuse to take oil and gas that the purchaser was obliged to take, the lessee markets the oil and gas. The lessee also incurs liability to pay the lessor a royalty on the revenue generated from such marketing." The court held that the royalty owners were entitled to a royalty share of "any payments received in connection with the marketing of gas that was subject to the production capability of [the lessee]. This includes take or pay payments or a settlement of take or pay liability. . . ." Since the applicable settlement agreement was not part of the record before the trial court, the Court of Appeals made this ruling without reviewing the terms of the settlement agreement.

The Oklahoma Supreme Court then granted discretionary review, reversed the ruling of the Oklahoma Court of Appeals, reinstated the trial court ruling and held for the lessee. The court held that the terms of the oil and gas lease decided the issue. Under the language of the lease the Watsons were only entitled to royalties on gas produced, saved and sold from the premises. Take-or-pay payments were not made for gas produced and sold, so no royalty was owing on such payments. The court further held that the royalty owners were not third party beneficiaries of the gas purchase contract, and were not entitled to share in the take-or-pay settlement under that alternative theory.

2. Harvey E. Yates Co. v. Powell, 98 F.3d 1222 (10th Cir. 1996).

HEYCO, the lessee under oil and gas leases covering lands owned by the State of New Mexico, entered into settlements with El Paso and Transwestern resolving alleged breaches of gas purchase contracts. Certain of the settlement payments were made in exchange for price and take reduction amendments to the gas contracts. Based on the contract amendments, HEYCO was paid the generally prevailing market price of its gas, which was a price substantially lower than the prior contract rate. The Commissioner of state lands asserted that the state should pay royalties on the proceeds of the settlement and alleged claims for (1) breach of the duty to market and breach of the duty of good faith and fair dealing; (2) constructive sale of gas; (3) breach of the duty to pay royalties; (4) unjust enrichment; and (5) third party beneficiary.

The Tenth Circuit held that, under the oil and gas leases at issue in the case, the lessee need only pay the lessor as royalty one-eighth of the cash value of the gas produced and saved from the leased premises. That is, the lessee is not obligated to pay a royalty on the cash value of the gas in the abstract, but only on the cash value of gas which is actually produced and saved from the leased property. The Tenth Circuit recognized three "guiding principles" that were applicable to the issue in this case: First, royalty payments are not due under a "production" type lease unless and until gas is physically extracted from the leased premises. Second, nonrecoupable proceeds received by a lessee in settlement of the take-or-pay provision of a gas supply contract are specifically for "non-production" and, thus, are not royalty-bearing. Third, any portion of a settlement payment that is a buy-down of the contract price for gas that is actually produced and taken by the settling purchaser is subject to the lessor's royalty interest at the time of such production, but only in an amount reflecting a fair apportionment of the price adjustment payment over the purchases affected by such price adjustment. The court also declined to adopt the "cooperative venture" or "Harrell" rule, finding that the cases which have applied that rule are states which have unique statutes which expand the definition of royalty, and that the rule has received little support from other states. The court concluded that the lessee's duty to pay royalty on that portion of a settlement which is attributable to future price reductions is not triggered until that future production is actually taken by the gas purchaser who made the settlement payment.

3. Klein v. Arkoma Production Company, 73 F.3d 779 (8th Cir. 1996).

This case was an appeal of the remanded proceedings which occurred after the Eighth Circuit's earlier ruling in *Klein v. Jones*, 980 F.2d 521 (8th Cir. 1992). The issue before the court was whether royalty owners were entitled to share in any portion of the \$173 million that two individuals received from various transactions. The court found that the royalty owners were entitled to a fractional royalty share of the portion of the cash sum which was found to represent a "premium" paid by the gas purchaser in order to obtain a favorable modification to a gas purchase contract. The court stated that the implied

covenant to market under Arkansas law included a duty to share the proceeds of gas marketing decisions with the lessors. The court further found that since the evidence showed that the defendants had settled a take-or-pay claim, and had failed to share it with the royalty owners as they were required to do under Arkansas law, the royalty owners were entitled to judgment on their claim for unjust enrichment.

The district court had found that the actions of Arkoma in reforming the gas contract were prudent and reasonable. *Klein v. Arkoma Production Co.*, No. 90-2060, Mem. Opn. at 46 (W.D. Ark. Jan. 5, 1994). The Eighth Circuit held that, while the district court's finding may be correct, the court has misperceived the issue. It held that the implied covenant to market under a lease necessarily encompasses not only the duty to make prudent and reasonable business decisions, but the duty to share the proceeds of those decisions with the lessors. The court found that the breach in this case was neither the decision to settle the claims against the gas purchaser nor the decision to reform the gas contract; rather, the breach of the implied covenant to market was the failure to share the benefits of the settlement with the beneficial owners of those proceeds.

4. Watts v. Atlantic Richfield Co., 115 F.3d 785 (10th Cir. 1997).

In *Watts v. Atlantic Richfield Company*, the mineral owner-lessors under some 40 oil and gas leases sued ARCO seeking recovery for alleged unpaid gas royalties under six separate legal theories: (1) Breach of contractual duty to pay royalties, (2) breach of the implied covenant to market, breach of fiduciary duty, (4) constructive fraud, (5) breach of duty of good faith, and (6) civil conspiracy. The claims were related to the fact that ARCO had entered into a settlement of certain gas contract claims with its gas purchaser, but did not pay any share of the sums it received under that settlement to the mineral owners. The district court granted summary judgment in favor of ARCO, finding, among other things, (1) that the oil and gas leases at issue in the case did not provide for royalties to be paid on sums received in connection with gas contract settlements, and (2) that none of the sums received by ARCO in connection with the settlement constituted payment for the production and sale of gas, and were thus not royalty bearing.

The Tenth Circuit Court of Appeals reversed the ruling of the district court, and remanded the case for further proceedings, stating: (1) that each of the subject oil and gas leases required royalties to be paid only on the proceeds from the sale of gas actually produced from the wells; (2) that, in determining whether royalties were owed on the sums received by ARCO under the gas contract settlement, the relevant question is whether or not the funds making up the payment actually pay for any gas severed from the ground; (3) that nonrecoupable sums received by the lessee in settlement of take-or-pay gas contract claims are specifically not for production and are, therefore, not royalty bearing; and (4) that sums paid to buy-down (reduce) the contract price paid for gas that is actually produced and taken by the settling gas purchaser is subject to the lessor's royalty interest at the time of production, but only in an amount reflecting a fair apportionment of the price

adjustment payment over the purchases affected by such price adjustment. At the time this paper was submitted for reproduction, the Tenth Circuit had not yet ruled on ARCO's Petition for Rehearing.

5. Johns Hopkins Hospital v. Peabody Coal Company, No. 92-64, United States District Court for the Western District of Kentucky (March 21, 1996).

This case involved the rights of the lessor under a coal lease. The lessee and a coal purchaser reached an agreement for the purchaser to buy-out the existing coal supply agreement. The lessee released the purchaser from the remaining two years of the coal supply agreement in exchange for the payment of \$17.5 million. The lessee then entered into two new coal supply agreements with reduced volume requirements and, on one of the two agreements, a substantially reduced selling price for the coal. The lessee did not pay any royalties to the lessor with respect to the payment received under the settlement agreement.

The court noted that there was nothing in the coal lease obligating the lessee to pay royalties when it received consideration for anything other than the severance of coal from the lessor's property. Rather, royalties were owed only in the event that actual production -- the severance of coal -- occurred. Thus, the court held that the settlement payment did not trigger any royalty obligations.

6. Transamerican Natural Gas Corporation v. Finkelstein, 933 S.W.2d 591 (Tex. App. - San Antonio, 1996).

This case involved a claim by an overriding royalty interest owner to a share of the sums received by his lessee in connection with a gas contract settlement. The statement of facts set forth with respect to this case reveals a series of unusual facts and events which appear to have contributed to the initial panel decision of the Texas Court of Appeals. The two largest elements of the gas contract settlement at issue in this case included take-or-pay damages and repudiation damages for the remainder of the contract term.

In the initial decision which, the court stated, addressed an issue not previously decided by the Texas Court of Appeals, the court found that the overriding royalty interest owner was entitled to recover a share of the settlement sums paid in connection with the gas contract settlement. The court noted that if the owner was to be paid on the full price effectively received for the gas produced and sold during the repudiation period, the royalty should be calculated not only on the basis of the spot market price received by the lessee after the termination of the contract, but also, to some extent, on the basis of the repudiation damages. Under the particular circumstances presented in this case, the court found that, once the purchaser's make-up right was terminated by the cancellation

of the gas contract, the settlement proceeds relating to the repudiation damages had the practical effect of increasing the price paid for the gas which was actually produced.

On August 14, 1996, the Texas Court of Appeals granted TransAmerican's Motion for Rehearing *en banc*, it withdrew the earlier opinion and it substituted a new opinion in its place. In the new opinion, the court held, among other things: (1) That the overriding royalty owner was not entitled to a share of the take-or-pay and contract repudiation settlement sums; (2) that the language of the governing conveyance documents which described the payments which the overriding royalty owner was entitled to receive were limited to payments for gas actually extracted from the land; (3) that both settlement components involved payments for non-production; (4) that take-or-pay payments are not a benefit flowing from the implied marketing covenant under an oil and gas lease; (5) that the monies received under the settlement did not have the effect of increasing the price paid for gas that was taken from the property; (6) that, even if the gas purchaser was allowed a "credit" for gas the lessee sold on the spot market in mitigation of its alleged repudiation damages, this did not change the nature of the settlement as the compromise of a dedication claim that existed independently of the lease; (7) that the lessee did not receive an unfair windfall by refusing to pay royalty; and (8) that, with respect to the plaintiff's proposed distinction between "take-or-pay" damages and "contract repudiation" damages, the court considered that "a breach is a breach," and that both forms of payments are for gas not taken or paid for under the gas purchase agreement. Consequently, the court held that TransAmerican was not required to share the proceeds of its settlement with the overriding royalty owner.

7. Independent Petroleum Association of America v. Babbitt, 92 F.3d 1248 (D.C. Cir. 1996).

This case involved a dispute over whether lump-sum payments made by gas pipelines to lessees to settle large take-or-pay liabilities accrued under long-term gas purchase contracts are properly subject to royalties under federal oil and gas leases. The settlement agreement in question agreed to a complete buy out of the gas contract, terminating the contract in exchange for a nonrecoupable and nonrefundable cash payment. The Department of the Interior (DOI) argued (1) that the payment was royalty-bearing, contending that the parties to a buy out arrangement know that subsequent production will be sold at lower prices and that the lessee-producer will not obtain the same price as under the original contract; (2) that a lump-sum payment to buy out the obligation to take required volumes at higher prices compensates the lessee in some degree for the reduced price the lessee would receive when the gas is later produced and delivered; (3) that the fact that a substitute purchaser, instead of the original purchaser, was involved in the buy out situation should not change the result--the benefit to the lessee was the same regardless of the identity of the party taking delivery of the gas. The DOI contended that the payment was therefore attributable to the volumes of gas later taken and became part of the total amount paid to the lessee for that production.

The court described the issue as being one of whether it was arbitrary and capricious for the DOI to conclude that take-or-pay settlement payments are royalty bearing in light of its determination [following the case of *Diamond Shamrock Exploration Co. v. Hodel*, 853 F.2d 1159 (5th Cir. 1988)] that take-or-pay payments themselves are not royalty bearing until those payments are specifically allocated to gas that is physically severed from the ground. The court concluded that the DOI had failed to give a sufficient non-arbitrary reason for treating the two types of payments differently. "Under *Diamond Shamrock's* construction of the royalties statute as requiring a link between payments subject to royalty and the physical severance of gas, there is no meaningful distinction between a settlement payment and a recoupable take-or-pay payment in that no gas is actually produced in either case. But unlike the recoupable take-or-pay payment, a nonrecoupable settlement payment is never credited as payment for any gas actually severed from the ground. When gas is actually severed and sold to a substitute purchaser, the settlement payment does not serve as payment for the gas. The link between the funds on which royalties are claimed and the actual production of gas is missing." 92 F.3d at 1259-60. The court concluded that neither take-or-pay payments nor take-or-pay settlement payments are royalty bearing unless and until they are credited toward the purchase of make-up gas.

8. Alameda Corporation v. Transamerican Natural Gas Corporation, 950 S.W.2d 93 (Tex. App. - Houston, 1997).

Alameda, a royalty owner, brought suit against its lessee seeking a share of the proceeds received by the lessee under a gas contract litigation settlement. Alameda asserted the theories of unjust enrichment and breach of the duty to reasonably market the gas. At the conclusion of the trial, judgment was entered in favor of the lessee and against Alameda. Alameda appealed, arguing that the bulk of the settlement payments was not for take-or-pay damages but for the gas purchaser's repudiation of the gas purchase agreement. Because the gas purchaser relinquished its make-up rights as part of the settlement, Alameda argued that it was as though the gas had been produced, delivered, taken and paid for, thereby making the payment subject to royalty. The court further considered the contention that a settlement which provides for the gas purchaser's relinquishment of its right to recoup gas paid for but not taken (1) has the practical effect of increasing the price paid for gas actually produced, (2) creates a windfall for the producer, and (3) deprives the royalty owner of a subsequent opportunity to share in the lump sum payment when the paid for, but not produced, gas is later produced and sold at less than the contract price.

The appellate court affirmed the ruling against the royalty owner, holding as follows: (1) The court agreed with the court's analysis in *TransAmerican Natural Gas Corp. v. Finkelstein*, 933 S.W.2d 591 (Tex. App. – San Antonio, 1996). Alameda's royalty interest was tied to production, and the settlement payment in this case was not made for production. (2) The court specifically declined to follow the so-called "Harrell Rule," or cooperative venture theory, described in *Klein v. Arkoma Production Co.*, 73 F.3d 779 (8th

Cir. 1996), stating that such theory is derived from unique state statutes that expand the definition of "royalty," and that the theory has not received much additional support from other courts. (3) The court observed that the lessee's duty to market pertains to the "production" of gas. Because no gas was produced to El Paso, the settlement proceeds could not constitute damages for breach of the marketing covenant. The court found that, absent "production" under the El Paso gas contract, the lessee's duty to market was not triggered as a matter of law.

9. In re Century Offshore Management Corp., 111 F.3d 443 (6th Cir. 1997).

Century was the lessee under federal oil and gas leases. The MMS sought to recover royalties on a lump sum payment which the gas purchaser made to the lessee to terminate gas contracts and replace them with new contracts based on current, floating market prices. The court concluded that "the transaction, viewed as a whole, was clearly linked to gas 'production saved, removed or sold,' and that royalties were therefore owing on the lump sum payment. The court stated that an up-front payment made in exchange for a substituted gas contract that changes the price of the old contract, followed by new gas purchases, was sufficient to trigger royalty obligations under the Outer Continental Shelf Lands Act, 43 U.S.C. §§ 1331-1356.

10. Condra v. Quinoco Petroleum, Inc., 954 S.W.2d 68 (Tex. App. -- San Antonio, 1997).

The lessees under the subject oil and gas leases entered into a settlement of claims against the gas purchaser for breach of a gas purchase contract. The purchaser was required to pay the lessees a recoupable payment and a nonrecoupable payment. The recoupable payment was a prepayment for gas to be delivered in the future. The nonrecoupable payment was consideration for certain amendments to the gas purchase contract and settlement of other claims, one of which was the purchaser's alleged failure to take rateably from the lessees' wells. The gas contract was amended to delete the favorable price provisions and insert market or spot pricing, eliminate the take-or-pay obligation, and extend the term of the agreement for an additional three years. Overriding royalty interest owners under the leases brought suit claiming a share of the settlement payments.

The court held that in favor of the lessees, finding in part as follows: (1) The nonrecoupable payment was not paid for production, so the overriding royalty interest owners were not entitled to be paid a share of that sum. (2) With respect to the issue of whether the implied covenant to market can be breached by the settlement of a claim for breach of the take-or-pay provisions in a gas purchase contract, the court held that the duty to reasonably market is not triggered in the absence of production. Thus, since the settlement payments were paid in the absence of production, the duty to market was not breached.

11. Helmerich & Payne, Inc. v. State of Oklahoma, ex rel. Commissioners of the Land Office. 935 P.2d 1179 (Okla. 1997).

While the captioned case did not involve a gas contract litigation settlement, the issues in the case are of related interest. In this case, the plaintiffs were lessees under oil and gas leases covering state lands. The lessees had sold gas under gas contracts which provided that the purchaser would reimburse the lessees for gross production and petroleum excise taxes paid to the state in connection with the gas sold under those contracts. The Commissioners of the Land Office (CLO) demanded that the lessees pay additional royalties to the state based on the reimbursement amounts paid by the gas purchaser for those state severance taxes. The lessees denied that any royalties were owing on those payments, and the lessees brought an action against the CLO seeking a declaratory judgment to that effect. In the course of the litigation, the CLO contended that the tax reimbursement payments represented additional value paid by the purchaser for the gas production. The CLO further argued that the regulations governing state oil and gas leases defined the price for purposes of computing gas royalties as the "value received under the sale contract" or "gross proceeds" received under the sale contract (the royalty clause of the state's form of oil and gas lease referred to payment on the basis of "market value").

The court concluded that the CLO was not entitled to additional royalty based upon the gas purchaser's tax payments because the royalty clauses in the leases, even as augmented by the aforementioned regulations, did not require it. The court held that the term "market value," as used in the royalty clauses of the state oil and gas leases, meant the gas purchase contract price. The contracts established a price in the form of a cash payment per mcf of gas. That was the price upon which the CLO's royalty was to be calculated. The court found that the regulations relied upon by the CLO were general and tried to be all encompassing, but could not be stretched to include royalty on the gas purchaser's tax payments.

C. ROYALTY OWNER LAWSUITS OVER TRANSACTIONS BETWEEN LESSEES AND AFFILIATED ENTITIES.

As indicated earlier, significant changes have occurred throughout the late 1980s and 1990s in the way in which lessee-producers market natural gas. Some of the larger gas producers now have affiliated companies which engage in the purchase and sale of natural gas production from both the affiliated producer and third party gas producers. Where a lessee has sold gas from a well to an affiliated gas purchaser, some royalty owners have alleged that the price paid by the affiliated entity is not a fair price upon which to base royalty payments. While few lawsuits have been filed in this area (when compared with the other types of issues discussed above), the issue of affiliate marketing transactions has received some attention in the courthouse.

One of the cases in this area which has received significant attention in the industry is the case of *Caroline Altheide, et al., v. Meridian Oil, Inc., et al.*, No. 14-95-00619-CV, in the Fourteenth Court of Appeals, Houston, Texas. In this case, the plaintiffs allege that Meridian improperly calculated settlement prices paid to royalty owners, overriding royalty owners and working interest owners when gas or gas liquids were sold or gathered by affiliated companies. The plaintiffs have asserted causes of action for breach of implied contractual duties, breach of express contract (leases, operating agreements and division orders), breach of fiduciary duty, fraudulent misrepresentation, tortious interference, and breach of alleged duty of good faith and fair dealing. The defendants deny the allegations and assert, among other things, that the plaintiffs' claims are barred by (1) the express terms of written oil and gas leases, operating agreements, unit agreements, contracts and division orders applicable to each plaintiff; (2) the applicable statutes of limitations; and (3) ratification, waiver and estoppel.

The district court certified this case as a "class action" lawsuit. According to the briefs that have been filed, the certification order certified a nationwide class of approximately 35,000 diverse royalty, overriding royalty and working interest owners with respect to virtually all gas production of the defendants in 22 states over a nine-year time period. The defendants have appealed that certification order, and that appeal is currently pending before the Texas Court of Appeals. The defendants contend, among other things, that the trial court approved an unprecedented "class" in a case involving breach of contract and fraud claims for underpayment of royalties, which will require individualized proof and separate trials or jury findings regarding contractual rights, reliance and limitations with respect to each of the 35,000 class members. The defendants assert that the class certification order will render the case unmanageable, and that it should be reversed. A settlement of this case is the subject of a pending appeal.

For a discussion of the judicial treatment of certain aspects of transactions between oil and gas producers and affiliated entities, see, e.g., *Texas Oil & Gas Corp. v. Hagen*, 683 S.W.2d 24 (Tex. App. - Texarkana 1984), *affirmed in part and reversed in part*, 31 Tex. Sup. Ct. J. 140 (Tex. 1987), *judgment and opinion of the Supreme Court withdrawn, judgment of the Court of Appeals set aside, motion for rehearing and cause dismissed as moot*, 760 S.W.2d 960 (Tex. 1988); *Parker v. TXO Production Corp.*, 716 S.W.2d 644 (Tex. App. - Corpus Christi 1986); *Exxon Corp. v. Middleton*, 571 S.W.2d 349 (Tex. App. - Houston 1978); *Amoco Production Company v. First Baptist Church of Pyote*, 579 S.W.2d 280 (Tex. App. - El Paso 1979); *Tara Petroleum Corporation v. Hughey*, 630 P.2d 1269 (Okla. 1981); *Young v. West Edmond Hunton Lime Unit*, 275 P.2d 304 (Okla. 1954); *True Oil Company v. Sinclair Oil Corporation*, 771 P.2d 781 (Wyo. 1989); and *Coosewoon v. Meridian Oil Co.*, 25 F.3d 920 (10th Cir. 1994).

D. "POSTED PRICE" CRUDE OIL LITIGATION.

Beginning in the summer of 1995, a series of lawsuits have been filed in various states which are generally based upon the allegations that crude oil has been sold from producing oil wells based upon "posted prices," that royalty owners have been paid (in whole or in part) based upon those "posted prices," and that "posted prices" allegedly do not represent fair value for the crude oil production. The claims and theories of relief, as well as the supporting factual allegations, vary between certain of these cases. While not an exhaustive list, some of the cases filed on this general subject are as follows:

1. Texas General Land Office, et al. v. Amoco Production Company, et al., No. 95-08680, In the District Court of Travis County, Texas, 345th Judicial District (Filed July 14, 1995).

The Plaintiffs state in their Petition that they propose to bring a class action lawsuit on behalf of "those persons to whom the defendants have made royalty or overriding royalty payments, calculated by the defendants on the basis of 'posted prices' for crude oil." The Plaintiffs contend that the Defendants' prior payment practices with respect to oil production (1) breached contractual obligations alleged to be owing to the Plaintiffs under oil and gas leases and division orders, (2) breached an alleged implied duty on the part of the Defendants to market crude oil with due diligence and to obtain the best price reasonably possible, (3) breached the Defendants' alleged statutory duties as lessees of the Texas General Land Office, (4) breached the Defendants' alleged duty to act reasonably and in good faith under the Uniform Commercial Code, and (5) obligated the Defendants to render an accounting to the proposed class members with respect to the amounts allegedly owed to them.

2. Texas General Land Office, et al. v. Union Pacific Resources Company, No. 954-241, In the District Court of Fayette County, Texas, 155th Judicial District.

The Plaintiffs state in their Petition that they propose to bring this action on behalf of the persons "to whom UPRC has made royalty or overriding royalty payments for producing properties in Texas on the basis of prices below those prices that UPRC and [Union Pacific Fuels, Inc.] achieve in arms-length transactions." The Plaintiffs contend that the prior payment practices of the Defendant with respect to oil production (1) breached contractual obligations alleged to be owing to the Plaintiffs under oil and gas leases and division orders, (2) breached an alleged implied duty on the part of the Defendant to market crude oil with due diligence and to obtain the highest attainable price, (3) violated the Defendant's alleged statutory duty as a lessee of the Texas General Land Office, (4) violated an alleged duty on the part of the Defendant under the Uniform Commercial Code to act reasonably and in good faith, and (5) obligated the Defendant to render an accounting to the proposed class members with respect to the amounts allegedly owed to them.

3. State of Texas, Lee County, et al. v. Amerada Hess Corporation, et al., No. 10,652, In the District Court of Lee County, Texas, 21st Judicial District (Filed August 31, 1995).

The Plaintiffs state in their Petition that they propose to bring this action on behalf of "all those owners of royalty interests, overriding royalty interests, working interests or other interests to whom any of the defendants have made payments for oil or gas." The Plaintiffs allege that the Defendants are common carriers and/or common purchasers of crude oil and condensate and/or natural gas and the natural gas liquids contained therein, and that the Defendants are under statutory duties not to discriminate in the purchasing, taking, gathering, transportation or sale of oil or gas. The Plaintiffs further allege that the Defendants have violated their statutory duties not to discriminate by buying and/or selling oil attributable to the members of the proposed Plaintiff class at prices alleged to be lower than actual market prices (based on so-called "posted prices"), while at the same time allegedly realizing higher prices and values for their own production of oil produced in the same fields. The Plaintiffs contend that the prior payment practices of the Defendants with respect to oil production (1) violated statutory duties allegedly owing under Section 111.261 of the Texas Natural Resources Code, (2) violated statutory duties allegedly owing under Section 111.262 of the Texas Natural Resources Code, (3) violated statutory duties allegedly owing under Section 111.263 of the Texas Natural Resources Code, and (4) obligated the Defendants to render an accounting to the proposed class members.

4. Carl Engwall, et al. v. Amerada Hess Corporation, Case No. CV-95-322, In the Fifth Judicial District Court of Chaves County, New Mexico (Filed September 1, 1995).

The Plaintiffs state in their Complaint that they propose to bring this action on behalf of a class of "all other persons to whom Defendants have underpaid royalty or overriding royalty payments on crude oil during the period January 1, 1986, to date." The Plaintiffs contend that the prior payment practices of the Defendants with respect to oil production (1) violated contractual duties alleged to be owing to the Plaintiffs under oil and gas leases and other agreements, in an intentional, reckless and wanton manner, (2) breached an alleged implied duty of good faith and fair dealing in the marketing of crude oil for fair market value and in the payment of royalties and overriding royalties to the proposed class, and violated an alleged duty to obtain the best price reasonably available for production, (3) obligated the Defendants to render an accounting to the proposed class members of the amounts allegedly owed to them, (4) constituted unfair or unconscionable trade practices under the New Mexico Unfair Trade Practices Act, and (5) violated the duties allegedly owing by the Defendants under the New Mexico Oil and Gas Proceeds Payment Act.

5. Laura J. Kershaw, et al. v. Amoco Production Company, et al., No. CJ-95-184, In the District Court of Seminole County, Oklahoma (Filed September 13, 1995).

The Plaintiffs state in their Petition that they propose to bring this case as a class action lawsuit on behalf of "those persons to whom the defendants have made royalty or overriding royalty payments, calculated by the defendants on the basis of 'posted' prices for crude oil." The Plaintiffs contend that the Defendants' prior payment practices with respect to oil production (1) breached the contractual obligations alleged to be owing to the Plaintiffs under oil and gas leases and division orders, (2) breached an alleged implied duty on the part of the Defendants to market crude oil with due diligence and to obtain the best price reasonably possible, (3) breached a duty allegedly owing by the Defendants under the Uniform Commercial Code to act reasonably and in good faith, and (4) obligated the Defendants to render an accounting to the proposed class members with respect to the amounts allegedly owed to them.

6. The McMahon Foundation, et al. v. Amerada Hess Corporation, et al., No. H-96-1155, United States District Court for the Southern District of Texas, Houston Division (Filed April 10, 1996).

The Plaintiffs state in their Complaint that they propose to bring this action on behalf of a class of "all owners of Direct Payee Royalty Interests and Working Interests who were paid or credited by virtue of Lease Production Oil produced and first sold to one or more Defendants or Affiliate Traders from a mineral lease at or by reference to posted price at any time since September 30, 1986." The Plaintiffs allege a combination and conspiracy among the Defendants to fix, depress, stabilize and maintain at artificially low levels the prices paid for the first purchase of Lease Production Oil sold from leases in which the proposed class members own interests. The Plaintiffs allege violations of the Sherman Act §1. (The capitalized terms are defined in the Complaint.)

7. Cameron Parish School Board, et al. v. Texaco, Inc., et al., No. 10-14264, Before the 38th Judicial District Court, Parish of Cameron, Louisiana.

The Plaintiffs state in their Petition that they propose to bring this action on behalf of a class of "all other persons, entities, and public bodies to whom defendants have underpaid royalties on crude oil and condensate during the period from January 1, 1986 to date." The Plaintiffs contend that the prior payment practices of the Defendants with respect to oil production (1) breached contractual obligations alleged to be owing to the Plaintiffs under oil and gas leases, (2) breached an alleged implied duty to act in good faith, to act as a prudent operator and to use due diligence in marketing crude oil for the best and highest price reasonably obtainable, (3) allegedly constituted unfair methods of competition and unfair and deceptive trade practices under the Louisiana Unfair Trade Practices and Consumer Protection Law, (4) violated duties allegedly owing under the Louisiana Mineral

Code (R.S. 31:1, et seq.), (5) allegedly constituted fraud under the Louisiana Civil Code Article 1953, (6) allegedly constituted a wrongful conversion of royalties belonging to the Plaintiffs, and (7) obligated the Defendants to render an accounting to the proposed class members.

8. Jerry Kelly, et al., v. Exxon Corporation, No. CV-96- , In the Circuit Court of Santa Rosa County, Florida.

The Plaintiffs state in their Complaint that they propose to bring a class action lawsuit on behalf of "all individuals and entities who have in the past or are now receiving royalties and/or overriding royalty payments from crude oil production in those parts of the Jay Oil Field located in Santa Rosa County, Florida." The Plaintiffs contend that the Defendants' prior payment practices with respect to oil production (1) breached contractual obligations alleged to be owing to the Plaintiffs under leases and other agreements, (2) breached alleged implied duties on the part of the Defendants to act in good faith and with fair dealings, to market crude oil with due diligence for the best and highest price reasonably obtainable, to act as prudent operators, and to pay the full amount of royalties and overriding royalties due to the Plaintiffs from the sale of oil, (3) breached the Defendants' alleged fiduciary obligations under leases and other obligations, (4) violated alleged contractual, statutory and common law duties to the Plaintiffs to disclose on each check the actual value received by the Defendants for the crude oil, thereby leading to claims for fraud, misrepresentations and deceit, (5) wrongfully and intentionally converted royalties and overriding royalties alleged to be the property of the Plaintiffs, and (6) obligated the Defendants to render an accounting to the proposed class members with respect to the amounts allegedly owed to them.

Professor Conine of the University of Houston Law Center has written a recent article analyzing many of the issues raised in the crude oil royalty litigation. See Gary B. Conine, "Crude Oil Royalty Valuation: The Growing Controversy Over Posted Prices and Market Value," 43 Rocky Mtn. Min. L. Instit. 18-1 (1997).