THE SECOND GENERATION OF ROYALTY LITIGATION

by

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for

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I. INTRODUCTION

A. The First Generation
   1. Royalty Clause Obligations
      a. Determining gross value of production. Market Value litigation.
      b. Determining net value of production. Deductible Costs litigation.
   2. Granting Clause Obligations
      a. What are "other minerals?"
      b. Is helium included in the grant?
   3. Implied Covenant Obligations
      a. Protect against drainage.
      b. Further develop.

B. The Second Generation
   1. Royalty Management Issues - Early 80s
      a. Timely payment - interest.
      b. Information to identify how royalty payment was calculated.
   2. Return to the Royalty Clause
      a. I want 1/8th of the Gas Purchase Agreement.
      b. Has my lessee obtained the best deal for US?
   3. Implied Covenant Obligations
      a. Marketing obligation.
      b. Related to marketing - protect against drainage (access to market and split-stream sales).
      c. Related to marketing - obligation to operate efficiently (do the right things at the right time). Poor business person or poor soothsayer?
   4. Shut-In Royalty Obligations
      a. Covenant or condition?
      b. Split-stream sales.
   5. Federal Impact
      a. FERC Order 451
      b. FERC Orders 436, 500, 500-B, and 500-C
      c. Public Utility Law

II. TAKE-OR-PAY PAYMENTS AND SETTLEMENTS

A. Courts Divided
   1. No production, no sale, no royalty due. See Mesa Petroleum Co. v. U.S. Dept. of Interior, 647 F.Supp. 1350 (W.D. La. 1986), appeal pending in 5th Circuit.
   2. Focus less on express terms of royalty clause and more on the lessor/lessee relationship and industry practices. See Diamond Shamrock Exploration Co. v. Hodel, No. 86-537 (E.D. La. Jan. 23, 1987), appeal pending in 5th Circuit.

B. Hard-Core Pro-Royalty Owner States
   1. Conceptual difficulty in associating royalty clause with gas sales contract.
   2. For example, Kansas will not limit the potential market value of royalty by the terms of the gas sales contract or federal price regulations. Nor will they enforce division orders which attempt to limit the terms of the royalty clause.

C. Oklahoma
   1. Apache Gas Products Corp. v. Oklahoma Tax Com'n, 509 P.2d 109 (Okla. 1973). "Value" of production for purposes of the Oklahoma Gross Production Tax would be calculated using the price producer receives for gas under the gas sales contract.
      a. Court notes the "realities of the natural gas industry."
      b. Necessity of marketing under long-term contracts.
   2. Tara Petroleum Corp. v. Hughey, 630 P.2d 1269 (Okla. 1981). Gas sales contract, made by lessee in good faith, establishes the limits of lessee's royalty obligation under the oil and gas lease.
      a. Court recognizes the necessity of long-term contracts (at that time).
      b. Court acknowledges there is a nexus between the oil and gas lease and the gas sales contract created by the lessee's implied obligation to market production.
      c. Such a rule is "fair" to producers and not "unfair" to royalty owners - producer not receiving any collateral benefit because they are limited to price set by the gas sales contract.
   3. Proportionality Analysis - how will the benefits and burdens be distributed between lessor and lessee.
      a. Is the lessee receiving any benefits which the lessor will be unable to share in proportionately?
      b. If the lessor will not share proportionately in any benefits, has lessee traded any of lessor's rights to obtain the disproportionate benefit?

4. How is the price of gas determined in negotiating a gas sales contract? Price tied to quantity? Obligation to take? Do you give up some per MCF value to obtain broad processing rights?

D. Third Party Beneficiary Rights

1. Lessors, dissatisfied with their lessee's actions in renegotiating a gas contract, settling a take-or-pay claim, exercising FERC Order 451 GFN rights, or giving "offers of credit" under FERC Order 500, may try to bring everything back to square one asserting the contract cannot be amended without their consent.
2. Gas sales contracts seldom expressly exclude the lessor as having third party rights in the contract.
3. Factors to determine whether parties intended to confer a benefit upon the lessor:
   a. Foreseeable lessor may assert an interest in the contract?
   b. Will the promisor render any performance directly to the lessor?
   c. What was the <u>purpose</u> and <u>motive</u> of the lessee and gas purchaser in making the contract?
   d. Lessor reliance upon the contract?
4. Ability of purchaser and lessee to alter contract:
   a. Can amend any time before lessor has knowledge of the contract and relies upon it.
   b. Varying degrees of acknowledging and relying upon the contract.
   c. Remember that division order where the lessor was asked to accept payments under the gas sales contract in satisfaction of lessee's royalty obligation?

III. MARKETING COVENANT

A. (Macro) Proportionality Analysis

1. As one commentator has noted: There are ways pipelines can help producers.
2. All of lessee's business relations considered when lessee makes a business decision. How will this affect my <u>business</u>? What is the best option for my <u>business</u>?
   a. Prudent operator standard - What is the best option for my business which will not adversely affect my royalty <u>owner</u> (not owner<u>s</u>).
   b. Not a fiduciary - but courts will take a dim view when the benefits disproportionately favor the lessee to the demonstrable detriment of their lessor. "Ordinary" good faith in these cases tends to create some extraordinary obligations on the lessee.

3. The cases that will chart future litigation in this area:
   a. Amoco Production Co. v. Alexander, 622 S.W.2d 563 (Tex. 1981) (obligation to protect lessor against field-wide drainage--without regard for obligation to other lessors in the field).
   b. Amoco Production Co. v. First Baptist Church of Pyote, 579 S.W.2d 280 (Tex.Civ.App. 1979), writ refused, n.r.e., (lessee breached obligation to market gas in good faith when it marketed lessor's gas at less than prevailing prices in order to obtain collateral benefits which would not be shared with the lessor).

B. Diligent Marketing Requirement
   1. Diligence takes on new meaning when lessor isn't receiving a check but their neighbor, owning a fractional share of production in the same well, is getting banner royalties because their lessee is selling the full production stream.
      a. Not much of a problem in Oklahoma where the lessors share in all production from the well.
      b. Many states have never addressed the matter because they have never had split-stream connections. Everyone traditionally sold to one pipeline and the pipeline always was able to take gas.
   2. FERC "Options"
      a. Exercise rights under FERC Order 451 to enter into Good Faith Negotiations to obtain a release so you can find alternative markets?
      b. FERC Orders 500, 500-B, and 500-C. Sell to other markets--regardless of cross-crediting problems?

C. Prudence - Making The Best Deal
   1. Best deal considering the interests of lessor and lessee.
   2. Long-term contract? Release? Exercise GFN option or stay away from triggering a possible abandonment?

IV. SHUT-IN ROYALTY OBLIGATIONS

A. Is the well "shut-in" when a cotenant of your lessee is producing a million cubic feet of gas each day and you aren't getting a royalty check? (Assume non-Oklahoma situation).

B. Like the take-or-pay clause, the courts may be inclined to look at the lessor/lessee relationship and not the precise terms of the shut-in royalty clause to resolve these disputes.

C. Although the habendum clause may be satisfied by production, courts may look to what induced the lessor to enter into the transaction - the prospect of royalty. When production, from which a royalty is paid, is not obtained, the lease will terminate unless the lease provides for the situation in some other manner - such as paying shut-in royalty.

1. Could lose a lease where there is current production and marketing under a split-stream sales situation and lessee fails to timely pay shut-in royalty to lessors not participating in the current production.
2. New Mexico seems to be a state ripe for this sort of claim.
   a. See Darr v. Eldridge, 66 N.M. 260, 346 P.2d 1041 (1959) (royalty is lessor's "chief inducement for executing lease . . . .").
   b. See Greer v. Salmon, 82 N.M. 245, 479 P.2d 294 (1970) (common form of shut-in royalty clause created a condition on the grant as opposed to a covenant - failure to timely pay shut-in royalty caused the lease to terminate).
3. Note: In Greer the court equates production under the habendum clause with the generation of revenue from which a royalty can be paid. "'[P]roduction' must be equated with producing and paying a royalty." Greer, 479 P.2d at 297 and 298.

V. FERC AND THE ROYALTY OWNER

A. Marketing Covenant

1. Any time marketing options are provided to the lessee there is the chance they will select the wrong option.
2. Opportunity to breach the efficient operator covenant. A "bad" choice.
3. Opportunity to breach the marketing covenant.
   a. By doing nothing.
   b. By losing a market.
   c. By compromising lessor's position.

B. Good Faith Dilemmas

1. FERC Order 451
   a. What's best for Lessee may not be best for lessor X.
   b. What's best for lessor X may not be best for Lessee's lessor Y.
   c. Failure to act does not resolve the problem.
2. FERC Order 500
   a. If Lessee refuses to offer credits and transport gas, because of adverse impact on unrelated contracts, lessor X will not receive any royalty--or perhaps a reduced royalty.
   b. If Lessee ships to meet marketing demands of lessor X, can lessor Y (who is the beneficiary of a high-priced take-or-pay contract), complain about the cross-crediting Lessee has set into motion?

C. Options For Lessor <u>And</u> Lessee?

1. Try to get the lessor actively involved in the decision-making process? Not likely.
2. Let lessor take gas in kind? If you don't like the way I'm doing it, do it yourself?
    a. May be some unanticipated benefits to lessor <u>and</u> lessee under Order 500.
    b. Transportation of gas "owned" by lessor not subject to offer of credit requirements under Order 500. Perhaps a way to reduce credits by 12.5% (assuming 1/8th royalty) on all gas shipped.

No doubt the practice of oil and gas law will continue to be interesting.

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