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ROYALTY JURISPRUDENCE: A TALE OF TWO STATES

by

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> "It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity . . . ."

***A Tale of Two Cities,* by Charles Dickens**

I. INTRODUCTION

Beyond the rules, beyond the doctrine, are the motivating forces for decision that influence why courts make, or refuse to make, new law. The motivating forces are typically the product of an underlying judicial philosophy that the court may, or may not, care to articulate. Once the judicial philosophy is accurately identified, it can serve as a predictive tool for how the court may resolve the next case on the subject while allowing a more effective critique of the court's decision. It will also instruct counsel on how to plead, prosecute, and defend the next case. In this presentation, the relevant judicial philosophies of the Supreme Court of Colorado and the Supreme Court of Texas are identified and examined to illustrate how they impact the resolution of basic property and contract issues regarding the calculation of oil and gas royalties. The contrast in approach taken by these courts is fundamental; representing differing judicial philosophies concerning the oil and gas lease and the lessor/lessee relationship. Multi-billion-dollar royalty calculation issues are being decided by the judicial philosophies these courts pursue.

Litigants addressing royalty calculation issues under state law other than Colorado and Texas will seek to have courts follow the law of one of these states. Royalty owners will point to Colorado law as stating the proper rule while the lessee/producer will rely on Texas law. Another court's willingness to accept either the Colorado or Texas analysis will depend, in many cases, on their willingness to embrace the same motivating forces prompting the Colorado and Texas supreme courts to adopt their respective rules.

II. WHAT DOES "AT THE WELL" TELL US?

Recognizing that the oil and gas lease contains thousands of words that impact the rights and obligations of the parties, for our purposes we will focus on a royalty clause that requires payment of a royalty:

> "On gas . . . produced from said land and **sold or used off the premises or in the manufacture of gasoline or other products** therefrom, the ***market value at the***

mouth of the well of one-eighth of the gas so sold or used, provided that on gas **sold at the wells** the royalty shall be one-eighth of the ***amount realized from such sale*** . . . ."

III. NATURE OF THE DISPUTE

At what point in the production/marketing process must royalty be determined?

What role will the express terms of the oil and gas lease (such as "at the well") play in defining the critical calculation point? What role will implied terms play?

IV. PRINCIPLES ON WHICH THERE IS AGREEMENT

Royalty Value Theorem: "When compensation under a contract is based upon a set percentage of the value of something, there will be a tendency by each party to either minimize or maximize the value."

Linear Enhancement of Production Value: "As a general proposition, as oil or gas moves downstream from the wellhead it increases in value."

"This increase in value is comprised of two components: (1) investments made in the production either by the lessee providing a facility or service or purchasing the service from others; and (2) the increased value of the production in a particular form at a particular location."

Lessors will pursue theories that require their royalty to be determined as far downstream from the wellhead as possible; lessees will pursue theories that determine royalty at the point of extraction. The issue: what does the lease require? The reality: what will the court say the lease requires?

V. ZERO-SUM GAME OF CONTRACT INTERPRETATION

Litigation of these issues does not result in any "new pie." The result will be to either leave the parties with the pie they already have, or force a re-slicing of the existing pie to give one party a larger piece with the other party receiving a correspondingly smaller piece.

This could also result in behavior that makes the total pie smaller – such as when a producer avoids downstream marketing altogether in favor of a wellhead sale.

VI. TEXAS JURISPRUDENCE: THE *SCIENCE* OF CONTRACT INTERPRETATION

"**Science**" is defined by Webster's as "a branch of knowledge or study dealing with a body of facts or truths systematically arranged and showing the operation of general laws . . . ."

The Texas Supreme Court treats royalty issues as just another exercise in contract

interpretation by using a set of interpretive rules that will yield a "meaning" relying upon the language contained within the document.

Reluctance to find language "ambiguous" so the court does not stray from the contract terms.

Willingness to ascribe meaning to terms such as "market value." *Yzaguirre v. KCS Resources*, Inc., 53 S.W.3d 368 (Tex. 2001).

Willingness to give meaning to terms such as "at the well." *Heritage Resources, Inc. v. NationsBank*, 939 S.W.2d 118 (Tex. 1996).

Reluctance to resort to "implied" covenants unless it is necessary to give effect to the terms of the writing and then only to the extent the implied is consistent with the express terms of the writing. "It is not enough to say than an implied covenant is necessary in order to make the contract fair, or that without such a covenant it would be improvident or unwise, or that the contract would operate unjustly." *Danciger Oil & Refining Co. v. Powell*, 154 S.W.2d 632, 635 (Tex. 1941). See also, *HECI Exploration Co. v. Neel*, 982 S.W.2d 881 (Tex. 1988).

The Texas Supreme Court generally refuses to employ contract interpretation techniques to address alleged inequities asserted on behalf of a party to the contract. Compare *Texas Oil & Gas Corp. v. Vela*, 429 S.W.2d 866 (Tex. 1968) (no equity for the lessee), with *Yzaguirre* (no equity for the lessor). However, it does not mean it will ignore all inequities. E.g., *Amoco Production Co. v. First Baptist Church of Pyote*, 611 S.W.2d 610 (Tex. 1981) (breach of good faith for lessee to intentionally sell gas at less than market value where lessee would obtain collateral benefits from the sale not shared by the lessor). In essence *First Baptist Church* is a case requiring Amoco to perform, in good faith, its express covenant obligation to calculate royalty under a "proceeds" clause.

VII. COLORADO JURISPRUDENCE: THE *ART* OF CONTRACT INTERPRETATION

"**Art**" is defined by Webster's as "the quality, production, expression, or realm, according to aesthetic principles, of what is beautiful, appealing, or of more than ordinary significance." It may not be too structured, or predictable, but it is pretty – or at least "aesthetically pleasing" to the court's sense of equity and fairness. What are the "aesthetic principles" being pursued by the Colorado Supreme Court? How do they break away from "science" to create a more aesthetically pleasing picture of the law?

The architect of implied covenant law, Professor Maurice Merrill, acknowledged it was imperative to get away from the express terms of the oil and gas lease because those terms, more often than not, were selected by the lessee so, not surprisingly, enforcement of the lease as written generally will not improve the lessor's position under the lease. MAURICE H. MERRILL, THE LAW RELATING TO COVENANTS IMPLIED IN OIL AND GAS LEASES 466, 467-68 (2d ed. 1940).

Professor Merrill called for "radical departures" from traditional contract interpretation rules

to refashion the oil and gas lease bargain using implied covenants. *Id.* at 465. A modern Merrill disciple attempts to elevate Merrill's thesis into "rule" status stating: "One of the best-settled rules in oil and gas law is that courts give royalty owners extra contract protection in order to equalize the balance of power between the royalty owner and the lessee, which usually is an operating oil and gas company." John Burritt McArthur, *The Mutual Benefit Implied Covenant for Oil and Gas Royalty Owners*, 41 NAT. RESOURCES J. 795, 797 (2001). Contrast the views of a non-believer of Merrill: David E. Pierce, *The Renaissance of* Law *in the* Law of *Oil and Gas*, 42 WASHBURN L. J. 909 (2004); David E. Pierce, *Exploring the Jurisprudential Underpinnings of the Implied Covenant to Market*, 48 ROCKY MTN. MIN. L. INST. 10-1 (2002) (other than the obligation to perform and enforce contracts in good faith, the only time a court should provide "extra contract protection" to a party is when the agreement is held to be unconscionable, applying standard unconscionability analysis).

The Colorado Supreme Court has elected to avoid a direct attack on express lease terms by first holding the lease, the "at the well" language, is "silent" with regard "to the allocation of costs . . . ." *Rogers v. Westerman Farm Co.*, 29 P.3d 887, 896 (Colo. 2001). Query: Is "silent" the same as "ambiguous"? It is interesting that at no point in the court's opinion does it use the term "ambiguous" in discussing the lease language. Instead, it works through several royalty clauses which use the phrase "at the well" and indicates it has no idea what message the parties were trying to convey using that language.

"Silence" is the basis for inviting the creation of an implied covenant to address the issue and for use of the "construe against the lessee" rule of construction. *Id.* at 902 ("because the leases are silent, we must look to the implied covenant to market . . . to determine the proper allocation of costs.").

What prompts the Colorado Supreme Court to find so unclear that which the Texas Supreme Court found to be so clear?

Not only is the language "silent," it is "misleading." 29 P.3d at 897 ("Notwithstanding an initial misleading appearance that the lease language provides for allocation of costs . . . ."). Here it must have misled the lessee into thinking it could deduct costs.

Notes that one commentator "has suggested that lessees, in order to avoid alerting lessors to their motives, have intentionally used 'at the well' language to avoid directly stating their objectives in sharing costs." *Id.* at 899.

Equate the bargaining power between lessee and lessor to that of an insurance company and its customers. *Id.* at 902.

Lessors are not as sophisticated in oil and gas law as their lessee counterparts. *Id.* This was also noted in *Garman v. Conoco, Inc.*, 886 P.2d 652, 660 (Colo. 1994).

Previously, I have summarized the court's underlying view of the relationship as follows:

"From the court's perspective, the incompetency of the Colorado lessor is matched only by the deviousness of the Colorado lessee." 48 ROCKY MTN. MIN. L. INST. at 10-17.

The court is looking for a more "aesthetically pleasing" outcome for the lessors by requiring their lessees to be responsible for downstream costs unless they explicitly provide in the oil and gas lease what can be deducted – something more explicit than stating that production, for royalty purposes, will be valued "at the well" as opposed to "at the intake flange of an interstate pipeline."

However, the court goes further by imposing on lessees the obligation to produce a "marketable product" which means "both a physical condition such that the gas would be acceptable for sale in a commercial market, and a location-based assessment, such that it would be saleable in a commercial marketplace." 29 P.3d at 912. Generally, the key is determining "commercial marketplace" which will then dictate the "physical condition" of the gas to be sold in the market.

"Commercial marketplace," because of the linear nature of gas moving from wellhead to end use, requires the selection of the "proper" location for determining royalty. To perhaps mitigate the effect of the new rule, and ensure the employment of future oil and gas law students, the court states: "The determination as to when gas is marketable is a question of fact." *Id.*

Selling the gas in an arm's-length transaction, in good faith, at the well, does not protect the lessee from having to pay a royalty on values subsequently found, by a judge or jury, to have been available downstream of the wellhead at what is held to be the "commercial marketplace."

> While we agree that a single purchaser, in a good faith purchase of gas, is evidence that there is a market for the gas, we do not agree that such a purchase conclusively establishes a market. The determination of whether a market exists is an issue of fact to be decided by a jury, based on the facts and circumstances which may include factors other than a single purchase of gas. *Id.* at 910.

The court appears to be requiring that lessees be required to prove, to a jury, that the lessor has been treated fairly whenever the lessor questions: (1) the lessee's marketing program; or (2) the deduction of costs to work back to a valuation point upstream of the point of sale.

VIII. ART AND SCIENCE IN OTHER STATES

Kansas: *Smith v. Amoco Production Co.*, 31 P.3d 255 (Kan. 2001); *Sternberger v. Marathon Oil Co.*, 894 P.2d 788 (Kan. 1995); *Schupbach v. Continental Oil Co.*, 394 P.2d 1 (Kan. 1964); *Gilmore v. Superior Oil Co.*, 388 P.2d 602 (Kan. 1964). Some of both; *Smith* is science, *Schupbach* and *Gilmore* are art, *Sternberger* is science while professing art.

Oklahoma: *Mittelstaedt v. Santa Fe Minerals, Inc.*, 1998 OK 7, 954 P.2d 1203; *Howell v. Texaco Inc*., 2004 OK 92, 112 P.3d 1154. Art.

North Dakota: *Bice v. Petro-Hunt, L.L.C.*, 2009 ND 124, 768 N.W.2d 496. Science.

West Virginia: *Tawney v. Columbia Nat. Res., L.L.C.*, 633 S.E.2d 22 (W.Va. 2006). Art.