# Profitable Mineral Management Breakfast Series

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**Date:** **May 03, 2016**

**Topic:** **"The implications for the Texas Supreme Court's decision in Hyder v. Chesapeake."**

**Location:** **San Antonio Petroleum Club**
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**Time:** 7:30 AM Breakfast
8:00 AM Presenter
8:50 AM Questions & Answers

**Introduction:** **E.O. (Trey) Scott, III, Trinity Mineral Management, Ltd.**

**Presenter:** **Laura Burney, St. Mary's Law School**
"The implications for the Texas Supreme Court's decision in Hyder v. Chesapeake."

- Introduction and Background
- Post-production costs
- Background on "Market Value at the Well" Litigation
- The Effect of Express Clauses on Implied Covenants
- Rules of Deed Interpretation
- Express Lease Clauses: The Death of Implied Covenants?
- The "Implied Covenant to Market" Example
- Implied Covenant to Market: General Background
- What is "Market Value"? – States Adopted Different views:
- The "Market Value at the Well" Provision: Is "At the Well" a Plain Term?
- States Adopt Different Views of "At the Well"
- Drafting Around the Post-Production Cost Issue in Texas
- Heritage Resources
- Drafting around Heritage Resources?

- Hyder v. Chesapeake – The Fate of "No Deductions Clauses" in the Shale Era
- Texas Supreme Court's Hyder Opinion: A Narrow 5 to 4 Victory for Royalty Owners
- The Fate of "No Deductions" Clauses in the Shale Era?
- Drafting a "No Deductions" Clause
- The Oil and Gas Lease in the Shale Era: The Fate of Implied Covenants and Pro-Landowners Clauses
- The "Post Production Costs" Issue

**Upcoming:**

**Jun 07: Keith Franklin**
Using Adverse Possession to Clean Up Your Title Mess

**Jul 05: Trey Scott**
Lease Compliance Audits: Dinosaurs to Dollars and Dollars to Details

**Aug 02: To Be Announced**

# Laura H. Burney

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Professor Laura Burney has written extensively on oil and gas law issues, and is a frequent speaker at conferences and courses for attorneys and other professionals in the industry. She was the Albert and Helen Herrmann Professor of Natural Resources Law at St. Mary's University School of Law, where she began teaching in 1985. She returned to private practice from 2004 to 2010, working on lease and deed litigation, royalty underpayment class actions as an expert, and negotiations for the King Ranch/Exxon lease.

In addition to teaching, she has served as an advocate, arbitrator and as a mediator in oil and gas disputes, and as a consulting or testifying expert in cases in several states. Ms. Burney served as a trustee for the Rocky Mountain Mineral Law Foundation and teaches in RMMLF's Annual Oil and Gas Law Short Course. She also served on the Oil, Gas & Energy Resources Law Council of the State Bar of Texas for nine years, completing her tenure as chair in 2005. She now serves as vice-chair of the State Bar of Texas' Pattern Jury Charge Committee for Oil and Gas disputes and continues to teach oil and gas and property law, and to practice and work as a mediator and arbitrator.

Several of her papers and law review articles have analyzed deed interpretation issues, and that background led to her briefing and arguing cases in the Texas Supreme Court, most recently Hysaw v. Dawkins.

# THE "POST PRODUCTION COSTS" ISSUE:

# *CHESAPEAKE V. HYDER*

# AND THE

# IMPLICATIONS FOR PRO-LESSOR CLAUSES

# IN THE

# SHALE ERA OIL AND GAS LEASE


BY

LAURA H. BURNEY

# Introduction and Background

- **"Post Production Cost" (PPC) Issue** concerns on-going wave of oil and gas lease litigation over meaning of the gas royalty clause.

- Royalty Provisions in "Producer's 88" or Bath Lease is Bifurcated (Two different Royalty Bases):

1) If gas sold at the well royalties based on amount realized or proceeds

2) If gas sold off premises [processed] royalty basis = "market value at the well."

# Introduction and Background

- **"Market Value at the Well"** provision predominates due to deregulation and other factors.

- Does that phrase allow producers to charge their lessors with their share of post-production costs? *Two Views Discussed Below:*

- *1) Marketable Product and 2) Plain Meaning (Texas)*

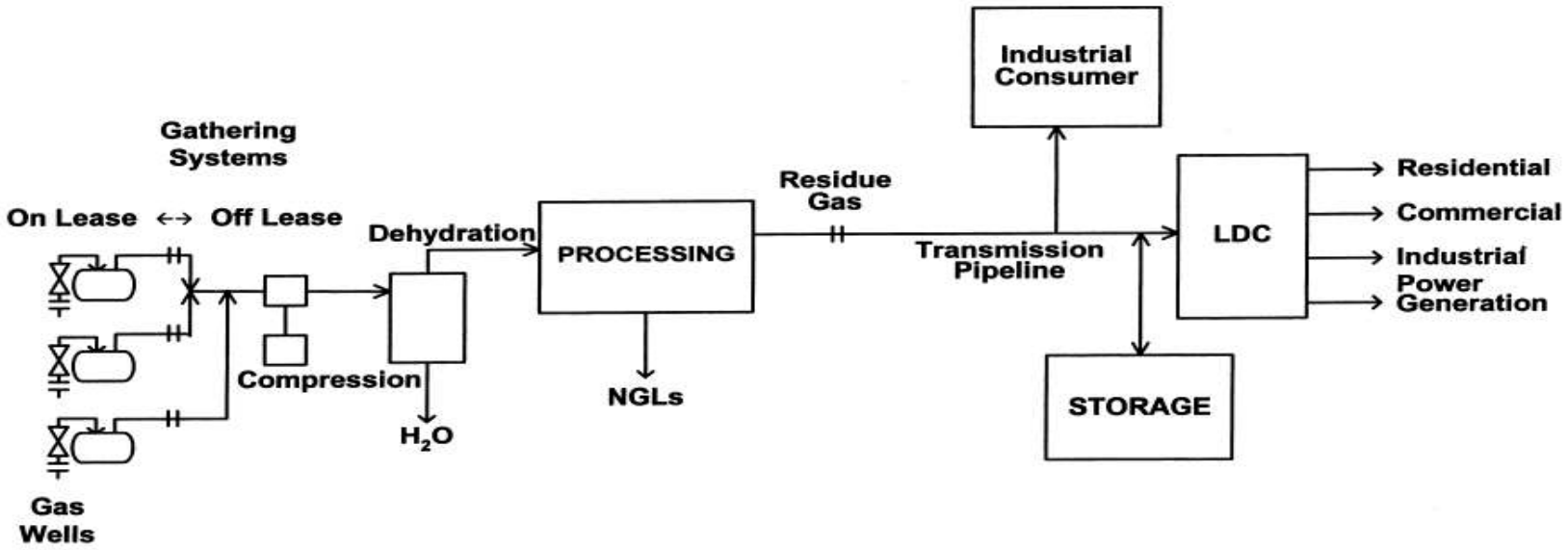
- Can parties draft a clause that requires the producer to bear all of those costs?

  The legacy of *Heritage Resources* in Texas

# Post-production costs:

**Producers sell gas "at tail gate of processing plant" and "work back" to value "at the well" by deducting costs of processing, dehydration, compression and transportation**

## NATURAL GAS INDUSTRY



# Background on "Market Value at the Well" Litigation

- Issues:

1) What does "market value" mean? What does "at the well" mean?

2) Do these terms have "plain meanings" that prohibit implying covenants –here the implied covenant to market – that will further policy goals and affect the producers' royalty obligations?

# The Effect of Express Clauses on Implied Covenants

- "At Law" Basis: Policy rather than lease terms may control regardless of express terms. Generally protects landowner/lessor.

- "In Fact" Basis: Express terms "can" bar courts from implying covenants (*see* delay rental clause example).

Question in "In Fact" Jurisdictions: When do express terms "clearly" prevent courts from implying covenants?

# The Effect of Express Clauses on Implied Covenants

- If meaning of terms control:

Document Interpretation Serves as (Unreliable) Gatekeeper

"When I use a word . . .it means just what I choose it to mean—neither more nor less."

Footnote 1 of Burney Paper citing Justice Alito's use of Humpty Dumpty's famous phrase in criticizing *King v. Burwell* (upholding Affordable Care Act)

# I. Rules of Deed Interpretation

**A. Generally presented as 3 step process:**

- 4 Corners Approach: Ascertain parties' intent from deed
- Canons of Construction
- Ambiguous or Unambiguous? Question of law for court

**B. Role of Extrinsic Evidence (not Parol Evidence Rule!):**

**Surrounding circumstances allowed even if unambiguous but subsequent conduct only if ambiguous.**

**Summary:**

- Deceptively simple rules that lead to unpredictable and inconsistent results; variations among courts and states

- Courts' Interpretations = guidance for **drafting** and **form** selection

# Express Lease Clauses: The Death of Implied Covenants?

- Before the Shale Boom scholars had contemplated this question. Writing in 1997, Professor Jacqueline Weaver invoked the famous anecdote about Mark Twain's untimely death and questioned if such reports regarding implied covenants were also exaggerated.

- Professor Weaver summarized Texas' approach as showing a "reluctance to allow express language to bar implied covenants. . . "

Texas has since switched course with Texas Supreme Court decisions that interpret the lease through a pro-producer lens.

*See* Heritage Resources v. NationsBank (1996); Heci v. Neel (1998); Wagner & Brown v. Sheppard (2008), Coastal Oil Co. v. Garza (2008) and others, including Hyder v. Chesapeake (2015)

# The "Implied Covenant to Market" Example

- The "Market Value at the Well" Gas royalty provision standard in a "Producer's 88" or Bath Lease Form
- Extensively Litigated throughout the U.S for decades in light of price fluctuations, regulatory changes and marketing practices.
- When have courts decided that express terms bar the implied covenant to market?

# Implied Covenant to Market: General Background

- Viewed as component of broad duty lessee owes to manage and administer the lease as RPO
- The duty arises upon discovery of oil and gas
- Most case law focuses on gas rather than oil
- The bifurcated gas royalty clause provisions:

Lessee owes lessor 1/8$^{th}$ royalty on **"amount realized" [proceeds]** if gas produced <u>at the well</u>

or on **"market value at the well"** if gas is produced and <u>sold off the leased premises</u>.

# What is "Market Value"? – States Adopted Different views:

- **"Cooperative Venture" View**: "Market Value" = the price lessees were receiving for gas as long as they had entered into long-term contracts in good faith as an RPO. (pro-producer effect at the time).

- **Louisiana Adopts this View**: *Henry v. Ballard & Cordell Corp.*(La. 1982)(views lease as cooperative venture; therefore implied covenant to market requires honoring producers' prudent marketing decisions- rejects Texas' *Vela* view).

# What is "Market Value"? – States Adopted Different views

- **"Plain Meaning" View (Texas)**: The plain meaning of "market value" = value of gas on day produced. Required producers to base lessors' royalty on higher values than they received for gas under long-term contracts (pro- lessor effect at the time since contract prices were lower than MV). *See* **Vela** (1968).

- Market Value = Objective term and requires objective proof such as comparable sales or "work back method"

# Implied Covenant to Market (con't)

- In Texas, applies only to "proceeds" or amount realized gas-royalty provision, not "market value at the well" standard.

- ***Yzaguirre v. KCS Resources, Inc.,*** 53 S.W. 3d 368 (Tex. 2001)(aka "the reverse *Vela* case"):

Lessors argued that lessee should base royalty payments on proceeds lessee received for gas under a dedicated gas-purchase contract price, which was higher than current spot prices for gas.

Lessors asserted implied covenant to market – court held the covenant did not apply to the objective "market value at the well" standard.

*Yzaguirre* + *HECI v. Neel* (and others) = restriction of doctrine of implied covenants in Texas

# Implied Covenant to Market (con't)

- ***Yzaguirre***: Texas Supreme Court viewed "market value at the well" royalty provision as an express objective basis for calculating royalties; therefore implied covenant to market did not apply:

"Essentially, the Royalty Owners wish to use an implied marketing covenant to negate the express royalty provisions in the leases and transform the 'market value' royalty into a 'higher of market value or proceeds' royalty."

*Express terms control and court declines to "rewrite the parties' bargain": Producer wins*

*Note the drafting lessons for lessors*

# The "Market Value at the Well" Provision: Is "At the Well" a Plain Term?

- On-going gas royalty litigation wave raises this question:

In calculating the lessor's royalty under a "market value at the well" lease provision, may the producer charge the lessor with a proportionate share of the post-production costs that the producer incurs once the gas has been produced at the well?

# States Adopt Different Views of "At the Well"

- "**First-Marketable Product" Rule**:

Requires producers to bear costs of placing gas in a marketable condition (Colorado, Oklahoma, Kansas, West Virginia by case law; Wyoming, Michigan, Nevada, federal lands by statutes)

- Colorado Example: Views "at the well" as silent regarding post-production costs; relies on policy and implied covenant to market to protect lessors. *Rogers v. Westerman* (Colo. 2001)

# States Adopt Different Views of "At the Well"

- **"Plain Meaning" Rule**:

"At the well" is a plain term allowing producer to base royalties on the value of the gas "at the well" – the "work back method" (deducting post-production costs from sales price at tail gate of plant) provides that value. (Texas, Louisiana, Mississippi, Pennsylvania by statute, New Mexico maybe and others unclear or undecided)

Texas Example: *Heritage Resources v. NationsBank* (Tex. 1996)(clarified in plurality opinion that Texas law allowed producers to charge lessors with their share of post-production costs under "market value at the well" standard; also *acknowledges parties may contract differently*).

But Can Parties Draft Around this Rule in Texas?

# Drafting Around the Post-production Cost Issue in Texas

- After *Heritage Resources (Tex. 1996)*, is it possible to draft a lease that requires lessee to bear post-production costs?

- The *Heritage* Clause: Lessee shall pay the Lessor ¼ of the *market value at the well* for all gas . .produced from the leased premises and sold by lessee. . .; *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.*"

# *Heritage Resources* continued

- Texas Supreme Court held that lessee had not violated lease clause by charging lessor with post-production transportation costs. Decision was 4 to 4 (one justice recused himself).

- No-deductions language was "surplusage" as there had been no deductions from the "value of the lessor's royalty," which was defined in the lease as "market value at the well."

- Dissenters: "*What could be more clear?*" Noted numerous amici supporting their position; predicted (incorrectly) that opinion would have "little precedential value."

- A recent Supreme Court of North Dakota Case agreed with dissent: K*ittleson v. Grynberg Petroleum Co*. 2016 WL 690632(N.D.) (interpreting *Heritage Resources* no-deductions clause to mean no deductions – but does not cite *Heritage Resources*).

# Drafting around *Heritage Resources*?

- ***Warren***: "The oil and gas lease construed here appears to fall squarely within the *Heritage* holding: it provides for royalty based on "the amount realized by Lessee, computed at the mouth of the well."

- Therefore, the "no deductions for post-production cost" provisions in the lease did not prohibit deductions.

*Warren v. Chesapeake Exploration*, 759 F.3d 413 (5th Cir. 2014)
(Opinion by Justice Priscilla Owen, author of plurality in *Heritage Resources*)

# Drafting around *Heritage Resources*?

- ***Potts***: The lease provides that royalty shall be based on the "**market value at the point of sale**," and that "all royalty paid to [Lessors] shall be **free of all costs and expenses** related to the exploration, production and marketing of oil and gas produced from the lease including, but not limited to, costs of compression, dehydration, treatment and transportation."

*Potts v. Chesapeake Exploration*, 760 F. 3d 470 (5th Cir. 2014)(Opinion by Justice Priscilla Owen, author of plurality in *Heritage Resources*).

- Post-production costs permitted because "point of sale" was at the well (not at tail gate of processing plant)." *Heritage* applied. *Lessor had questioned producer's use of affiliate sales to manipulate the "point of sale."*

*See "Fracking Kings Double-Cross"(article describing Chesapeake's use of affiliates and royalty-payment practices in Pennsylvania and other states, ProPublica March 2014)*

# *Hyder v. Chesapeake*– The Fate of "No Deductions Clauses" in the Shale Era

- ***Hyder* Clause**: Long and detailed royalty clauses including: "The royalty reserved herein by Lessors shall be **free and clear of all production and post-production costs and expenses."**

- Lease contains **"*Heritages Resources* Disclaimer"**: "Lessors and Lessee agree that the holding in *Heritage Resources, Inc. v. Nationsbank*, 939 S.W.2d 118 (Tex. 1996) shall have no application to the terms and provision of this Lease." Lease avoids "market value at the well."

- Court of Appeals Decision: Chesapeake (assignee of original lease) breached Hyder's lease and underpaid royalties under two separate royalty clauses by charging Hyders with post-production costs. Gives meaning to all clauses in the lease and refuses to rewrite the parties' bargain.

- Chesapeake appeals finding regarding only one of the royalty provisions, labeled an "overriding royalty" to Texas Supreme Court. Does not appeal appellate court's finding that a gas royalty clause based on proceeds prohibited deductions of post-production costs.

# Texas Supreme Court's *Hyder* Opinion: A Narrow 5 to 4 Victory for Royalty Owners

**Majority**:

- Analyzed the Hyder's proceeds gas royalty clause and agreed with decision but disputed the appellate court's approach, even though Chesapeake had not appealed that issue;
- Considered other "no deductions" phrases "surplusage" (*Heritage Resources* "surplusage" canon survives);
- "Cost free" label could refer only to fact that royalty interests are free of production costs, not post-production costs;
- Stated it accorded no weight to the "*Heritage Resources* Disclaimer."

# Texas Supreme Court's *Hyder* Opinion: A Narrow 5 to 4 Victory for Royalty Owners

**Dissent**: Interpreted clause as permitting the deductions and concluded that Chesapeake should not be burdened with post-production costs; viewed the majority opinion as giving the Hyders "more than the royalty for which they bargained." *Chesapeake Exploration, L.L.C. v. Hyder at *6.*

*Hyder* has not broadly rescued "no deductions" clauses from the *Heritage Resources* bin. Instead, while the court pledges allegiance to the "plain meaning" approach, the opinion navigates a circuitous and narrow interpretative path through the language in the Hyder's lease. Professor Burney conclusion

# The Fate of "No Deductions" Clauses in the Shale Era?

- Hyders won despite strong industry objection - multiple amicus briefs; TXOGA (Texas Oil and Gas Association) labeled opinion unprecedented and predicted devastating effects on industry (TXOGA Brief signed by Professors Smith and Martin).

- Impact of *Hyder* on other cases: *Bass* case settled; *In Re Fort Worth* settling (Multi-district litigation involving hundreds of leases and thousands of landowners); *GLO v. Sandridge Energy, Inc.* (interpreted State lease as permitting deductions for CO2 royalty; petition for review filed).

- Compare the North Dakota Supreme Court's approach in *Kittleson.* Doesn't cite *Heritage Resources* but takes dissenters' approach.

- Louisiana cases embrace "plain meaning" approach, seem to reject a "surplusage" canon, but represent "roll of the dice" inherent in document interpretation.

# Drafting a "No Deductions" Clause

- Avoid "market value at the well" or any iteration of that phrase, or any label that could suggest PPCs are appropriate (e.g. "net" or in *Hyder* "over-ride");
- Avoid words that create fact questions, such as "marketable product";
- Cite and recite "No post-production cost deductions" as opposed to production costs, and be specific regarding the costs (gathering, transportation, etc.—name them)

# The Oil and Gas Lease in the Shale Era: The Fate Of Implied Covenants and Pro-Landowner Clauses

- Implied Covenants – Relegated to a minor role in light of extensive express clauses in Shale Era Leases.
- Document interpretation controls resolution of oil and gas lease disputes.
- Texas – supreme court has evolved from broadly implying covenants to declining to do so even when express terms arguably do not create a bar. *See Heci v. Neel.* Therefore, landowners must rely on express clauses to protect their interests in a pro-producer state.

*The Texas Vela and Reverse-Vela cases adhered to plain meaning of "market value at the well" whether it benefitted the lessor or the lessee and refused to "rewrite the parties' bargain." Louisiana has evolved from relying on implied covenant and "cooperative venture" view to plain-meaning approach*

# The Oil and Gas Lease in the Shale Era: The Fate Of Implied Covenants and Pro-Landowner Clauses The PPC Example

- The "Plain Meaning" approach provides predictability for lessors and producers, which encourages negotiation rather than litigation. BUT document interpretation will continue as unreliable gatekeeper.

- Parties should negotiate rather than litigate in light of Shale Era realities that affect "Reasonably Prudent Operators'" decisions (such as economic changes, geological discoveries and technological advances).

**Dispute Resolution procedures provide more promising and efficient resolutions to oil and gas lease disputes in the Shale Era.**

# THE "POST PRODUCTION COSTS" ISSUE:

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