Permian & Mid-Con Energy Series

Litigating Oil and Gas Cases in Texas

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Post-Production Costs

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Background

- General Texas rule on post-production costs.
- Production costs.
- Post-production costs.
- Gross proceeds leases.
- Has become a frequently litigated issue.

Devon v. Sheppard, No. 20-0904 (Tex. 2022)

- Court determined that the lease was a "**proceeds-plus**" lease.
- **Background**: Parties agreed that the lease was "gross proceeds" lease. Lessee was selling oil under a contract that set the price based on an index and then subtracted $18 per barrel for "gathering and handling, inclusive of rail car transportation."
- Conflict centered on an unconventional provision:

> 3(c) If any disposition, contract or sale of oil or gas shall include *any reduction or charge for the expenses or costs* of production, treatment, transportation, manufacturing, process[ing] or marketing of the oil or gas, *then such deduction, expense or cost shall be added to ... gross proceeds* so that Lessor's royalty shall *never be chargeable directly or indirectly with any costs or expenses* other than its pro rata share of severance or production taxes.

- **Proceeds Plus** leases that employ a two-prong calculation of the royalty base.

1. The producers must properly determine their gross proceeds from selling the production, which by definition must be free of post-production costs.

2. When the producers' contracts, sales, or dispositions state that enumerated post-production costs or expenses have been deducted in setting the sales prices, those costs and expenses "shall be added to the ... gross proceeds."

Nettye Engler Energy v. BlueStone Natural Resources, No. 20-0639 (Tex. 2022)

- Deed conveying the mineral estate reserved a nonparticipating royalty interest and required delivery of the grantors' fractional share "**free of cost in the pipe line, if any, otherwise free of cost at the mouth of the well or mine**."

- Both parties agreed that the royalty is free of production costs and post-production costs that are incurred prior to delivery into the pipeline. However, the parties could not agree on the location of delivery.
- Bluestone argued that it is the gathering system and deducted the post-production costs associated with the gathering system.
- Engler argued the Energy Transfer pipeline.
- Ultimately came down to the meaning of a single word: What is a "pipeline?"
- The Court relied on the dictionary and industry manuals to affirm that a gathering system is a pipeline.
- Takeaway: The Court stressed that all contracts, including mineral conveyances, are construed as a whole to ascertain the parties' intent from the language they used to express their agreement.

EnerVest v. Mayfield, No. 04-21-00337-CV (Tex. App.–San Antonio 2022, pet. filed)

- Lease royalty provision specifies a market value at the mouth of the well.
- EnerVest uses some of the gas sent downstream as fuel gas to power compressors and dehydrators and does not pay royalty on that gas.
- Questions:

  1. Do royalty provisions that specify a "market value at the mouth of the well" calculation require the royalty holder to share in post-production costs?

     Holding: Yes.

  2. Is fuel gas a post-production cost as a matter of law?

     Holding: Yes.

- **Royalty provision:** gas royalties were to be paid "on gas … produced … and sold or used off the premises, … the market value at the mouth of the well of one-eighth of the gas … ."
- Free use provision: allowed the lessee to have "free use of … gas … from said land … for all drilling operations hereunder, and the royalty shall be computed after deducting any so used."

EP Energy E&P Company v. Storey Minerals

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EP Energy E&P Company v. Storey Minerals, LTD, No. 04-19-00534-CV (Tex. App.–San Antonio 2022, pet. denied)

- Most Favored Nations ("MFN") clause case.
- Lessee EP and three Lessors "MSB" entered into three identical leases with MFN clauses.
- 2 years later signed Leases amendments for deferred bonus payments.
- Thereafter, EP acquired two leases that triggered the MFN clause.
- EP argued the MFN clause is prospective.
- MSB argued MFN clause is retroactive.

EP Energy E&P Company v. Storey Minerals, LTD, cont…

"If at any time during the existence of this lease, the lessee ... acquires an Oil and Gas Lease on a portion of the leased premises with any ... entity that owns a mineral interest in the leased premises on such terms that the *royalty, bonus, and rentals or any of them* are greater than those provided to be paid to lessor hereunder, lessee expressly stipulates, warrants, and agrees that it *will execute an amendment to this lease, effective as of the date of the third party lease on the leased premises*, to provide that the lessor hereunder *shall receive thereafter* the same percentage (per net mineral acre) *royalty, bonus, and/or rentals* as any subsequent lessor of the leased premises to the extent that such royalty, bonus, and/or rentals are greater than those provided to be paid herein." [Emphasis added.]

- The court held in favor of MSB and that the plain language of the MFN clause required no prospective or retroactive construction. It provides straightforward instructions: if the bonus amount is higher in a triggering lease, (1) execute an amendment to the A leases to provide the same bonus per net mineral acre as the triggering lease and (2) pay the same bonus per net mineral acre as the triggering lease.

- Take away: The court held that although it may look to surrounding circumstances even when a lease is unambiguous as a matter of law, it may not make the language of the agreement say what it does not say.

Navigating Double Fractions

What's the Problem with Double Fractions?

- Double fractions in the granting clause and conflicting fractions elsewhere in mineral deeds have vexed parties, title examiners, and courts for decades
- The shale boom spawned a new wave of fixed versus floating disputes, often in the context of NPRI's
- The Texas Supreme Court's opinions in 2016 and 2018 embraced an emerging interpretive rule—the estate misconception theory

Fixed Versus Floating – Recent History

- *Hysaw v. Dawkins*, 483 S.W.3d 1 (Tex. 2016)
  - Will providing that each child of the testatrix would receive "one-third (1/3) of an undivided one-eighth (1/8) of all oil … that may be produced from any of said lands, the same being a non-participating royalty interest"; and (2) if any of the testatrix's royalty is sold during her lifetime, then each child will receive "one-third of the remainder of the unsold royalty."
  - Fixed 1/24th royalty interest or floating interest equal to 1/3rd of royalty.
  - Because the second clause indicated that the testatrix intended her children to share royalty equally, "[t]he only plausible construction supported by a holistic reading of the will is that [the testatrix] used 'one-eighth royalty' as shorthand for the entire royalty interest a lessor could retain under a mineral lease."
  - Therefore, floating not fixed

Fixed Versus Floating – Recent History

- *U.S. Shale Energy II, LLC v. Laborde Properties, L.P.*, 551 S.W.3d 148 (Tex. 2018)
  - Grantor reserved "an undivided one-half (1/2) interest in and to the Oil Royalty, … the same being equal to one-sixteenth (1/16) of the production."
  - Floating 1/2 of the royalty or fixed 1/16th of production?
  - The Court found that the first part of the clause created a "floating royalty interest equal to one-half of the royalty" and analyzed whether the second half of the clause "indicates an interest fixed at 1/16 of production despite the language in the first [half] tying it to the royalty."
  - No. Only reasonable way to read the deed, according to the Supreme Court, is to construe it as reserving a floating 1/2 royalty interest that, at the time the deed was executed, conferred a 1/16th royalty interest because of the existing lease's 1/8 royalty.

Van Dyke v. Navigator Group

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Van Dyke v. Navigator Group, No. 21-0146 (Tex. 2023)

- Significant Texas Supreme Court case
- Adopts a rebuttable presumption of floating interest in double fraction cases
- Rebuttable by language of contrary intent within the instrument
- Further buttressed perhaps by Presumed Grant Doctrine
- Court revisits the Estate Misconception Theory

Van Dyke Facts

- In 1924, grantor conveyed ranch with the following reservation:
  - "It is understood and agreed that one-half of one-eighth of all minerals and mineral rights in said land are reserved in grantors … and are not conveyed herein."
- Successors of grantees argued that this reservation was of a 1/16 mineral interest. The successors of grantors argued that the reservation reserved 1/2 mineral interest.
- The trial court and court of appeals agreed with grantees; the Supreme Court reversed, holding that each side owns 1/2 of the minerals.

Estate Misconception Theory

- Presumes the grantor in oil & gas deed mistook what she owned when property was subject to existing O&G lease
  - 1/8th royalty leases were once ubiquitous
  - To convey a fraction of the mineral estate subject to an existing lease, grantors created confusion by using two fractions in the granting clause
  - “1/2 of 1/8 royalty” “1/2 of usual 1/8 . . .”
  - 1/16th royalty into perpetuity or 1/2 of whatever royalty may be under future leases or 1/2 of mineral interest (current royalty and possibility of reverter)?

Estate Misconception cont . . .

- Courts developed doctrine to rationalize cases where they were convinced that grantor intended to convey fraction of all the mineral interest, consisting of the existing royalty and 8/8 of the possibility of reverter.
- Theory was that grantor under existing lease misconceived their current estate by assuming the lease converted ownership to 1/8 in the ***mineral estate***. Intending to convey an undivided 1/2 of what they owned grantor multiplied 1/2 by 1/8 and therefore used the fraction 1/16 in the deed's granting clause.

Estate Misconception cont . . .

- Vast variety of granting clauses and multi-clause lease forms presented countless different presentations of the double and conflicting fraction problems
- Conflicts between clauses, such as the granting and “subject to” clause caused courts to spawn the much maligned “two grant” theory
- Apparently inconsistent court opinions led to confusion and uncertainty for parties seeking to convey property and for title examiners

Van Dyke Presumption

- Supreme Court adopted a “brighter” line approach (not a “bright-line approach”) and got there using the estate misconception theory

- “When courts confront a double fraction involving 1/8 in an instrument, the logic of our analysis in *Hysaw* [*v. Dawkins*, 483 S.W.3d 1 (Tex. 2016)] requires that ***we begin with a presumption that the mere use of such a double fraction was purposeful*** and that 1/8 reflects the *entire* mineral estate, not just 1/8 of it. … Our analysis in *Hysaw* thus warrants the use of a rebuttable presumption that the term 1/8 a double fraction in mineral instruments of this era refers to the entire mineral estate. Because there is “little explanation” for using a double fraction for any other purpose, this presumption reflects historical usage and common sense.”

Van Dyke Presumption . . .

- "The use of the double fraction [presumption] in this deed, combined with the *lack* of anything that could rebut the presumption, is precisely why we can conclude as a matter of law that this deed did not use 1/8 in its arithmetical sense but instead reserved to the Mulkey grantors a ½ interest in the mineral estate."

Presumed Grant Doctrine

- Court's analysis of the presumed grant doctrine buttressed its holding
- Presumed grant doctrine
  - Title by circumstantial evidence
  - Common law form of adverse possession

Presumed Grant Doctrine cont . . .

- To establish title by presumed grant, proponent must show
  - (1) a long-asserted and open claim, adverse to that of the apparent owner;
  - (2) nonclaim by the apparent owner; and
  - (3) acquiescence by the apparent owner in the adverse claim.

- Court of appeals determined that a gap in title was a necessary fourth element, but the Supreme Court rejected it
- Supreme Court detailed 100-year history between the parties establishing the three elements above

Presumed Grant Doctrine cont . . .

- Can the presumed grant evidence affect the rebuttable presumption estate misconception analysis?
- No.
- Court makes clear that "the extrinsic evidence of transactions and history between the parties is *not* probative" in the analysis involving application of estate misconception presumption and search for rebuttal evidence elsewhere within the granting instrument.

Post Van Dyke . . . What next?

- When interpreting a double fraction problem using 1/8 in the granting clause, start by applying the Van Dyke presumption
- Look for textual evidence elsewhere in the instrument that could rebut the presumption that 1/8 means the grantor's entire estate
- And/or is there evidence in the history of how the parties treated the conveyance or reservation to support application of the presumed grant doctrine.

- Will Van Dyke solve the double fraction dilemma once and for all?
- Not a chance . . . We will surely find plenty to argue about.

Fixed vs. Floating NPRI Pre- and Post-Van Dyke

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Davis v. COG Operating, No. 08-20-00205-CV (Tex. App.–El Paso 2022, pet. filed)

- Construed both a 1926 Deed and 1939 Deed
- 1939 Warranty Deed reserved "one-fourth (1/4) of the 1/8 royalty usually reserved . . ."
- Deed referenced an earlier 1926 Deed stating "1/32 of the oil, gas and other minerals has heretofore been conveyed . . ."
- The 1926 Deed granting clause stated "1/32 interest in and to all of the oil, gas, and other minerals ***in and under*** *. . ."* and also referenced a 1/4 interest in (1) royalty; (2) rentals; (3) oil, gas, and other minerals; and (4) all future rents.
- Court first construed 1926 Deed as conveying a mineral not royalty interest then applied *Concord Oil* to reconcile competing fractions and find a conveyance of 1/4 mineral interest

Davis v. COG Operating cont . . .

- El Paso court finds the 1939 Deed unambiguous
- Court finds that the clause describing the previously conveyed interest as "1/32 of the oil, gas and other minerals" sufficiently put the subsequent grantee on notice of a previous reservation of 1/4 of the mineral estate
- Applying the estate misconception doctrine, Court concludes that the parties intended to reserve a floating 1/4 nonparticipating royalty interest.
  - "one-fourth (1/4) of the 1/8 royalty usually reserved . . ."

Davis v. COG Operating cont . . .

- El Paso Court rejected evidence of 80+ years of history to support grantee's "presumed grant" argument stating that it only applied in cases involving a gap in the chain of title
- This "fourth element" for the presumed grant doctrine was rejected by the Texas Supreme Court three months later in *Van Dyke v. Navigator Group*
- COG filed motion for rehearing, which was denied on February 14, 2023, just three days before *Van Dyke* was issued

Hahn v. ConocoPhillips, No. 13-21-00310-CV (Tex. App.–Corpus Christi 2022, pet. filed)

- 2002 Warranty Deed: reserving
  - "an undivided one-half (1/2) non-participating interest in and to all of the royalty . . . (same being an undivided one-half (1/2) of [Hahn's] one-fourth (1/4) or an undivided one-eighth (1/8) royalty"
  - Reverted to grantor after 15 years (term NPRI)
  - Conoco pooled and had Hahn sign a ratification of the lease and stipulation of interests stating "it was the intent of the parties in the deed from [Hahn] to [the Gipses] . . . that the interest reserved was a one-eighth (1/8) 'of royalty' for a term of [fifteen] years].
  - In 2018, Corpus Christi Court held that Hahn had a fixed 1/8 royalty

Hahn v. ConocoPhillips cont . . .

- On remand, Conoco argued that by his ratification of the lease, Hahn reduced his interest from fixed to floating - a 1/8th royalty to 1/8 "of royalty" (1/32).
  - COP relied on *Montgomery v. Rittersbacher*
- Court rejected Conoco's argument and construction of *Montgomery*
- *Practice Tip – Hire lawyers who know your business and speak the language. Oil & Gas law is full of dusty arcane rules, implied terms, and situations in which 1/8 isn't really 1/8.*

Royalty Asset Holdings II v. Bayswater, No. 08-22-00108-CV (Tex. App.–El Paso 2023, pet. filed)

- First Opinion following ***Van Dyke***
- 1945 Deed reserving:
  - an "undivided 1/4th of the landowner's usual 1/8th royalty interest (being a full 1/32nd royalty interest). . ."
  - No executive rights, bonus or delay rentals – NPRI – but is it a fixed 1/32 or a floating 1/4?
- Subsequent 2008 1/4 royalty lease is executed

Royalty Asset Holdings II v. Bayswater cont. . .

- El Paso Court first cites *Hysaw* for the principle that courts reject mechanical rules of construction, then goes on to employ the fairly mechanical *Van Dyke* presumption
- Following discussion of the estate misconception theory, Court applies the *Van Dyke* rebuttable resumption
- Court then examines remainder of the instrument for potential evidence to rebut the presumption—finds none
  - "Usual 1/8 royalty" – proxy for landowner's royalty (and POR)
  - "Single-Fraction Parenthetical" – in isolation implies a fixed 1/32, but construed as "non-essential explanation" of the double fraction clause
  - "Future Leases" – evidence of intent for royalty to take place in the future

Royalty Asset Holdings II v. Bayswater cont . . .

- First application of *Van Dyke* presumption
- Analysis more streamlined than many fixed versus floating cases
- Is this the shape of things to come?

Foote v. Texcel Exploration

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Foote v. Texcel Exploration, Inc., No. 11-20-00028-CV (Tex. App.–Eastland 2022, pet. filed)

- Injury to livestock case
- Well Settled Texas Law v. Lessor's argument to expand premises liability
- Holding: Court refused the Lessor's argument and ruled that premises liability applies to persons, and no authority exists in Texas equating person and livestock for the purpose
- Take away: The lease or SUA must contain appropriate language obligating the lessee or operator to construct a fence capable of turning cattle around its operations

Thistle Creek Ranch v. Ironroc Energy Partners

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Thistle Creek Ranch v. Ironroc Energy Partners, No. 14-20-00347-CV (Tex. App.–Houston [14th Dist.] 2022, no pet.)

- PPQ case
- Historically, court's have construed habendum clauses tying term of lease to production beyond the primary term to include an implied "in paying quantities."
- Frustrates purpose of the lease if operator can hold lease in effect into perpetuity with non-economic (unprofitable) production
- This lease had peculiar language in the habendum - "and as long thereafter as operations, as hereinafter described, are conducted . . ."
- Lease defined operations as endeavoring to obtain production "whether or not in paying quantities."
- Dangerous lease form for landowners

Effective Collaboration in Oil & Gas Litigation

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Effective Collaboration

1. Know your team – Land/in-house legal; in-house/outside counsel; land department/outside counsel
2. Recognize potential legal issues – when does a disgruntled landowner become a litigant?
3. Assess material v. immaterial risk and have the courage to discuss
4. Involve in-house counsel early to head off problems
5. Give an opinion / communicate succinctly
6. Recognize when a landowner's lawyer may expedite resolution
7. Understand the business
8. The value of counsel with industry/upstream expertise
9. Emails are forever
10. Billing issues

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