Royalty Litigation and Class Actions in Texas and the Fifth Circuit

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A full survey of royalty litigation in Texas could fill volumes. This article aims to provide a brief primer on two areas of recurring importance: when royalty interests bear post-production expenses and under what circumstances a royalty lawsuit can proceed as a class action.

Post-productions costs and "at the well" language

In Texas, the general rule is that royalty interests are typically not burdened by the costs of production (*i.e.* drilling and completion) but do bear their share of "post-production" costs (those necessary to move the hydrocarbons to market, such as gathering costs) unless the parties to an oil and gas lease agree otherwise. Complexity arises when parties attempt to change this default rule. Disputes arising from this complexity have been reinvigorated with the recent growth of oil and gas production in Texas. To understand the present-day controversy, it's necessary to understand the following line of cases.

<u>Heritage</u>

In *Heritage Resources, Inc. v. NationsBank*, 939 S.W.2d 118 (Tex. 1996), the leases at issue stated that the royalty would be calculated based on "the market value at the well . . . provided, however, that there shall be no deductions from the value of the Lessor's royalty by reason of any required . . . transportation" Despite this "no deductions" clause, Heritage paid royalty on a price that had been reduced by the value of transportation costs.

The five-justice majority (written by Justice Baker) and the two-justice concurrence (written by Justice Owen) both agreed with Heritage that the price paid was proper under the lease. Both concluded that the terms "royalty" and "market value at the well" were commonly understood terms in the industry; that royalty is "commonly defined as the landowner's share of production, free of expenses of production" but subject to post-production costs; and that one arrives at "market value at the well" in the absence of directly comparable sales by "subtracting reasonable post-production marketing costs from the market value at the point of sale." Based on these definitions, the majority and the concurrence concluded that a "market value at the well" royalty meant that the price upon which royalties would be paid should be reduced by the cost of post-production services necessary to get the gas from the well to the point of sale.

The majority decided that the "no deductions" clause was "surplusage," "merely restate[d] existing law," and served only to "illustrate that the lessee cannot pay the lessor less than his fractional value of . . . market value." Justice Owen's concurrence noted that while the result was probably contrary to the subjective intent of the lessors, Texas courts must construe a royalty clause (like any other provision of an oil and gas lease) based on the words used by the parties. And here, there can be no "deductions" of costs from the "market value at the well" because that value is "already net of reasonable marketing costs." She likewise concluded that the "no deduct" language was "meaningless", "ineffective" and "surplusage."

Notably, NationsBank filed a motion for rehearing that was overruled by a 4-4 vote. The voting breakdown changed substantially from the original opinion: one justice supported the reasoning of the majority opinion, three now supported Justice Owens' concurrence, four dissented, and the final justice recused himself. Though the result in *Heritage* was unchanged and the original opinion was not withdrawn, there was subsequent controversy over its precedential value.

Warren & Potts

In 2014, the Fifth Circuit decided two post-production deduction cases in two weeks—*Warren v. Chesapeake Exploration, LLC*, 759 F.3d 413 (5th Cir. 2014) and *Potts v. Chesapeake Expl., L.L.C.*, 760 F.3d 470 (5th Cir. 2014). Both concerned the application of *Heritage* to more recent lease forms and both opinions were authored by Justice Owen, the author of the *Heritage* concurrence.

In *Warren*, the gas royalty clause provided that the lessor's royalty would be 22.5% "of the amount realized by the Lessee, computed at the mouth of the well." An addendum attached to the lease provided:

Notwithstanding anything to the contrary herein contained, all royalty paid to Lessor shall be free of costs and expenses related to the exploration, production, and marketing of oil and gas production from the lease, including but not limited to costs of compression, dehydration, treatment and transportation.

The addendum also said it "shall supersede any portion of the printed form of this Lease which is inconsistent herewith." Despite the "cost free" language, Chesapeake calculated royalty based on a price that was reduced by the cost of post-production expenses. The Fifth Circuit affirmed the trial court's ruling that the phrase "computed at the mouth of the well" meant that Chesapeake correctly calculated royalty based on net proceeds after reductions for post-production costs. The addendum did not change the analysis, per *Heritage*.

In *Potts*, the gas royalty clause at issue stated that royalties would be based on "the market value at the point of sale" with this sentence immediately following:

Notwithstanding anything to the contrary herein contained, all royalty paid to Lessor shall be free of all costs and expenses related to the exploration, production and marketing of oil and gas production from the lease including, but not limited to, costs of compression, dehydration, treatment and transportation.

Here Chesapeake sold its gas to its marketing affiliate at the well (the "point of sale") and paid royalty based on a gas price that was "net" of post-production costs. Again, the Fifth Circuit affirmed the trial court's blessing of this practice. This "cost free" clause was as ineffective as the similar attempts to avoid post-production costs in *Warren* and *Heritage*, given that the gas was sold at the well.

Hyder

In 2016, the Texas Supreme Court decided *Chesapeake Exploration, LLC v. Hyder*, 483 S.W.3d 870 (Tex. 2016). The lease at issue contained three royalty provisions, but only one was in dispute. Nevertheless, the Supreme Court commented on the other two in dicta. The first, an oil royalty based on "market value at the well," bears post-production costs for the reasons stated in *Heritage*. The second, a gas royalty, "does not bear post-production costs because it is based on the price Chesapeake's marketing affiliate actually receives."

The third royalty, the one in dispute, was a "perpetual, cost-free (except only its portion of production taxes) overriding royalty of 5% of gross production obtained." The court agreed with the Hyders that this royalty did not bear post-production costs, because "the general term 'cost-free' does not distinguish between production and postproduction costs and thus literally refers to all costs." Or at least, Chesapeake failed to prove a different meaning of "cost-free."

The lease also contained two other provisions of interest: (a) a disclaimer saying that the holding in *Heritage* shall have no application to the construction of the lease, and (b) a clause stating that the gas royalty is "free and clear of all production and post-production costs and expenses." The Court indicated that neither provision had any influence on the construction of the royalty provisions – the *Heritage* disclaimer does not change "the lease text" and the "free and clear" language is mere "surplusage."

Post-Hyder

In *L.B. Bailey LP v. Encana Oil & Gas (USA) Inc.*, 2018 WL 3150691, the Western District of Texas summed up its view of the law post-*Hyder*:

> It is clear from both Texas Supreme Court and Fifth Circuit holdings that, under Texas law, royalties bear post-production costs unless the parties agree otherwise through an effective "no-deductions" clause. If the royalty is based on the market value of the product at the well (or similarly computed at the wellhead), post-production marketing costs are already deducted from that amount. Thus, any no-deductions clause is unambiguous surplusage as it does not alter the point of valuation . . . While parties are free to contract such that a royalty would not bear post-production costs, *the text of the royalty clause itself is key to determining if a no-deductions clause is effective*.

The Supreme Court of Texas also recently granted review in *Burlington v. Texas Crude*, 516 S.W.3d 638 (Tex. App.—Corpus Christi 2017, pet. granted). The overriding royalty assignments at issue state that Texas Crude's overriding royalty interest should be paid based on the "amount realized" from the sale of production. Each assignment also contains a granting clause providing for delivery of the hydrocarbons to the overriding royalty owner "into the pipelines, tanks or other receptacles with which the wells may be connected, free and clear of all development, operating, production, and other costs."

In the court of appeals, Texas Crude argued that "the amount realized" language, without any "at the well" provision attached to it, meant that its overriding royalty should not bear post-production costs. Burlington argued that the granting clause's "delivered into the pipelines" language effectively makes this an "amount realized at the well" royalty because the pipeline or tanks are adjacent to well.

The Corpus Christi court of appeals sided with Texas Crude and held that the overriding royalty interests bear of post-production expenses. The court, citing language from *Hyder* that the specification of a location for where the actual volume of production is measured "says nothing about whether the overriding royalty must bear post-production costs" and further concluded the "delivery" language in the granting clause would apply only if the royalty was taken in-kind, but not when paid in cash, as these royalties were. The Texas Supreme Court subsequently granted Burlington's petition for review, and the case was argued in October 2018.

Class Actions

Royalty class actions face an uphill battle in Texas state court. After the Texas Supreme Court's ruling in *Bowden v. Phillips Petroleum Co.*, 247 S.W.3d 690, 697 (Tex. 2008), one practitioner noted in the Texas Tech Law Review that "[i]t has become about as difficult to get a certified royalty class through the Texas Supreme Court as the Book of Mark says it is for a rich man to squeeze through the pearly gates into heaven." In decertifying classes of royalty owners, the *Bowden* court emphasized that individual determinations of the correct royalty calculation would have to be made on lease-by-lease or well-by-well basis. Due to these individualized determinations, common questions did not "predominate" as required for class certification. On the federal side, CAFA and *Walmart* have added additional hurdles to class certification.

Given the headwinds, royalty class actions have been infrequent in Texas and the Fifth Circuit in recent years. But they have not disappeared entirely, and a few recent developments are worth noting.

In October 2018, the Fifth Circuit decided *Seeligson v. Devon Energy Prod. Co., L.P.*, No. 17-10320, 2018 WL 5045671, at *1 (5th Cir. Oct. 16, 2018). District Judge Kinkeade had granted the plaintiffs' motion to reconsider his earlier denial of their motion to certify a class. The plaintiffs sought certification of a class of all Devon royalty owners with particular royalty clauses that receive revenue from wells where the gas is processed at the Bridgeport Gas Processing Plant, which is run by a Devon affiliate. The Plaintiffs' core claim is that Devon violated its duty to market the production for all these leases by failing to obtain a higher gas price from its affiliate. The Fifth Circuit offered both sides a mixed result. On the one hand, the Court affirmed that whether Devon had violated its marketing duties under the leases was a common question capable of class-wide resolution. On this point, the Court distinguished *Bowden* because *Bowden* left open whether violation of marketing duties could be resolved on a class-wide basis given Devon's "uniform pricing structure for every well." On the other hand, the Court ultimately reversed and remanded the class certification order because the District Court insufficiently addressed whether the common questions predominate over individual issues, such as the tolling of limitations.

Devon subsequently filed a petition for rehearing en banc, arguing that the panel's decision misapplies the Texas duty to market. The Texas Oil & Gas Association filed an amicus brief in support raising similar concerns and positing that the panel decision creates a forum-shopping incentive to bring royalty class actions in federal court.

In the Southern District, another group of royalty owners seeks class certification of their claims against Talisman Energy (now owned by Repsol). Their claim is that Talisman failed to "allocate" the correct value of commingled production to different wells, resulting in widespread underpayment of royalty owners with an interest in those wells. This case follows on the heels of a large state court verdict against Talisman in a case brought by some of its non-operating working interest owners for similar alleged wrongdoing. Talisman/Repsol opposes certification of a "novel" liability theory (common-law commingling) and argues that all the plaintiffs' theories require a highly individualized analysis improper for class resolution. District Judge Keith Ellison held a class certification hearing on August 29, 2018, but then stayed resolution of class certification pending the Fifth Circuit's decision in *Seeligson*. After *Seeligson* was decided, Judge Ellison ordered briefing on its impact.

Finally, because of the hurdles to class certification in royalty cases, especially in Texas state court, some plaintiffs have turned to alternative procedures for litigation at scale.

For example, the Texas judicial panel on multidistrict litigation has created three separate MDLs to handle royalty litigation. Two involve Chesapeake Energy and non-operating working interest owners in the Barnett Shale and the other involves Chesapeake and non-ops in the Eagle Ford Shale. The parties to the first Barnett Shale MDL settled over 13,000 claims for $53 million. The second Barnett MDL and the Eagle Ford MDL remain pending. These MDL cases are consolidated for pretrial proceedings only, to resolve common legal or factual issues. While these MDLs lack the prospect of a single, multi-plaintiff trial that a class action provides, pretrial consolidation has still resulted in several significant interlocutory summary judgment rulings that apply to numerous plaintiffs: dismissal of claims for breach of lease offset clauses, dismissal of claims for royalties based on producers' revenue from the use of financial derivatives, and denial of a summary judgment motion seeking to dismiss a "sham transaction" theory that seems to disregard inter-affiliate gas sales.

Other royalty owners have simply decided to pursue their class in multi-plaintiff actions under regular joinder rules, basing their royalty claims on identical lease forms. These actions include litigation over lease provisions that require lessees to "add back" various post-production expenses to the price used to calculate royalties. One the major controversies is over whether this duty to "add back" costs extends to costs incurred by third parties past the lessee's point of sale, because they affect the price the lessee receives from such third parties, and by extension, the price upon which the lessee bases its royalty payments.

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This article first appeared in *The Advocate,* Winter 2018, published by the State Bar of Texas Litigation Section.