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Are Modern "Compensatory" Royalty Clauses Enforceable?

Existing precedent and recent technological developments make it likely that courts will analyze compensatory royalty provisions, often contained in a modern offset clause, to determine whether the amount of compensatory royalties due constitutes an unenforceable penalty or enforceable liquidated damages.

Courts have long held that oil and gas lessees have an implied obligation to drill an offset well to prevent a neighboring well from draining the hydrocarbons underneath the leased land.[1] As is often the case with implied covenants, lessors and lessees responded by including explicit, negotiated duties in their leases to address potential drainage, which modify or displace the implied "offset" covenant.[2] In recent years, including the development of major shale plays across the U.S., sophisticated lessors have modified or disclaimed the implied covenant to prevent drainage by including complicated express offset clauses in their leases. These clauses take a variety of forms, but many include provisions that "deem" a well located within a certain distance of their property line to be draining from the lease, regardless of whether drainage is actually occurring.[3]

In the face of such "deemed" drainage, the lessee has a choice: drill an offset well, provide geological or technical evidence that no drainage is occurring, release acreage, or pay "compensatory" royalties.[4] Often, the option to drill an offset well, provide information, and/or release acreage expires after a stated period of time, such as 180 days, after which the lessee is obligated to pay compensatory royalties based on a percentage of the production from the well deemed to be draining the leased tract. Recently, practitioners have suggested that, if such clauses become the subject of litigation, courts may analyze them to determine whether they are an enforceable liquidated damages provision or an unenforceable penalty clause.[5] Such an analysis is not only possible, but likely.

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[1] 3-5 Williams & Meyers, Oil and Gas Law § 821. To prove a breach of the implied covenant to drill an offset well, the lessor must prove: (1) that substantial drainage has taken place on the leasehold; and (2) that an offset well would produce oil or gas in paying quantities. *Id.* at § 822.

[2] *Id.* at § 826.3.

[3] Jason Newman and Louis E. Layrisson III, *Offset Clauses in a World Without Drainage*, 9 Tex. J. Oil Gas & Energy L. 1, 17-25 (2014).

[4] *Id.* at 25-31; *see also Hooks v. Samson Lone Star, Ltd. P'ship*, 457 S.W.3d 52, 56 (Tex. 2015).

[5] Newman and Layrisson III, *supra* n.3 at 34. The authors provide a comprehensive treatment of many potential legal ramifications of modern offset clauses, only some of which are addressed here.

The legal distinction between a valid liquidated damages provision and unenforceable "penalty" clause is well-recognized. For a liquidated damages clause to be enforceable, the agreed damages must be reasonable both "in light of the difficulties of proof of loss" and "in light of the anticipated or actual loss caused by the breach."[6]

The evidence strongly suggests that courts will apply this analysis to modern offset clauses with compensatory royalty provisions. In fact, in administrative law cases involving the Department of the Interior, the liquidated damages/penalty clause analysis has essentially already been applied to the assessment of compensatory royalties for a lessee's failure to drill an offset well.[7] Moreover, courts have not been hesitant to analyze analogous provisions of oil and gas leases under the liquidated damages/ penalty clause inquiry. Indeed, with regard to agreed damages (sometimes also referred to as a "compensatory royalty") for breach of an express agreement to drill an ordinary well within a specified time, a leading treatise states:

> When an action is brought to recover the amount named in the contract or the bond for breach of the agreement to drill, the *principal question* is whether the amount agreed upon is to be regarded as a penalty or as liquidated damages.[8]

Numerous other cases apply the liquidated damages/penalty clause analysis to other lease provisions,[9] and most jurisdictions adhere to the principle that oil and gas leases are properly analyzed as a matter of contract law.[10] In short, there is a substantial body of law courts can draw from to decide whether to analyze a modern compensatory royalty clause according to the liquidated damages/penalty clause analysis, and it weighs in favor of courts electing to do so.

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[6] Restatement (Second) of Contracts § 356 (1981); *Phillips v. Phillips*, 820 S.W.2d 785, 788 (Tex. 1991) (applying nearly identical test).

[7] *Nola Grace Ptasynski*, 63 IBLA 240, 256-57 (April 19, 1982) (holding that a compensatory royalty assessed by the federal government penalized the lessee of a federal lease and thus was unjustified under the administrative regulation in question); *cf. Pan Am. Petroleum Corp. v. Udall*, 192 F. Supp. 626, 629 (D.D.C 1961) (holding, in a review of compensatory royalties assessed by the Secretary of the Interior, that "[w]hile it may be true that [the lessor] could absolutely require the drilling of offset wells, still, according to the [the lease in question], if he permits compensatory royalties in lieu thereof, these must be arrived at on the basis of estimates of actual drainage.").

[8] 3 Summers Oil and Gas § 23:2 (3d ed.) (emphasis added); *see also Presnal v. TLL Energy Corp.*, 788 S.W.2d 123, 127 (Tex. App.—Houston [14th Dist] 1990, writ denied) (extensively analyzing agreed damages for failure to drill a regular, non-offset well under liquidated damages/penalty clause analysis).

[9] *See, e.g.*, *Trafalgar House Oil & Gas Inc. v. De Hinojosa*, 773 S.W.2d 797, 798 (Tex. App.—San Antonio 1989, no pet.) (liquidated damages/penalty analysis applied to agreed damages for failure to comply with a lease's notice of assignment provision).

[10] *See, e.g.*, *Tittizer v. Union Gas Corp.*, 171 S.W.3d 857, 860 (Tex. 2005) ("An oil and gas lease is a contract and is therefore interpreted as such.").

The question then becomes: what factors will be most relevant to a court's analysis? The starting place is the factors relevant to whether agreed damages are reasonable or not—namely, the difficulty of estimating damages ahead of time and the extent to which the agreed damages differ from anticipated or actual damages. However, based on existing precedent, these two basic touchstones can be expanded into the following set of factors:

1. The difficulty of estimating drainage ahead of time

Courts have stated over the years that oil and gas development is a business fraught with uncertainty and that liquidated damages are an effective solution for grappling with the inability to predict what exists or occurs in the subsurface.[11] While that may be true as a general statement, in contexts such as whether there is drainage from a well on an adjacent tract, times have changed. Specifically, it is increasingly clear that modern drilling and completion techniques either cause little to no drainage beyond short distances or that any actual drainage can be more easily monitored.[12] Lessees will thus be able to argue that estimates of potential drainage are quite possible (there is none) and that liquidated damages are unnecessary. Lessors, on the other hand, will argue that the standard is not possibility of estimation, but rather the *difficulty* of such estimation at the time the lease is executed. They will point out that understanding the precise subsurface geology and other factors that determine drainage are still difficult (*i.e.*, technologically complicated or expensive given the need for real-time monitoring) to estimate at such an early stage.

2. The extent to which agreed damages differ from anticipated or actual drainage

   a. The extent of actual drainage

Practitioners should keep industry and technological advances in mind when making arguments about the extent of actual drainage. Modern production techniques drain from only a short distance, and in horizontal wells utilizing hydraulic fracturing, only intentionally perforated sections of the borehole produce hydrocarbons.[13] For wells with many such points, lessees can argue that production points located outside the stated drainage zone or portions of the borehole within the stated drainage zone that lack productive capacity should not be considered sources of prohibited actual drainage. The amount of actual drainage in a given case will likely remain a fight between expert witnesses, but there is new information and new modes of analyses for experts to contend with.

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[11] *See, e.g.*, *Presnal*, 788 S.W.2d at 127 (noting that "[t]he inherent difficulty of estimating damages resulting from a failure to drill is one reason why landowners would want stipulated damage provisions in their leases and why courts sometimes view them favorably.")

[12] Christopher S. Kulander, *Common Law Aspects of Shale Oil and Gas Development*, 49 Idaho L. Rev. 367, 388 (2013) (overview of improvements in monitoring technology); Newman and Layrisson III, *supra* n.3 at *2 (compiling sources related to drainage from hydraulically fractured wells).

[13] L. Poe Legette, et al., *Federal Regulation of Hydraulic Fracturing: A Conversational Introduction*, 33 E. Min. L. Found. § 22.08 (2012).

b. The amount of production upon which the compensatory royalty is to be paid

Compensatory royalties are often assessed based on the production from the well deemed to be draining the lease. Some leases base the compensatory royalty on a percentage of the adjacent wells' production, while others are silent. Under a liquidated damages/penalty clause analysis, the arguments here will center on what percentage of production approximates the subsurface reality. Some percentages, namely 100%, may be held per se unreasonable, as that would assume that all of the hydrocarbons produced by a well on the adjacent tract flowed from under the leased land, which is highly unlikely.[14]

Lessees will push to expand the universe of unreasonable percentages, especially when the draining well is a horizontal one utilizing hydraulic fracturing. Such wells, as discussed, are generally only productive at the locations of intentional perforations. The more such productive points fall outside the drainage zone, the more unreasonable certain percentages become. For example, if only one of the ten production points of a potentially draining well are located in the drainage zone, how reasonable is it for the lessee to pay compensatory royalties based on 75% of the draining well's production? 50%? And so forth.

c. The time period for which the compensatory royalty is to be paid

Courts are also likely to consider the time period for which a lessee owes compensatory royalties for failure to drill an offset well. Some offset clauses are silent on this point, while others fix the starting point for such royalties at the moment a draining well is first completed or produces oil or gas in paying quantities.[15] Lessors understandably prefer, from a financial standpoint, that the compensatory royalties date back to the moment of first production, especially if the well is a horizontal, hydraulically fractured one where its productive capacity is likely to diminish greatly after the first few weeks or months.[16] However, because many offset clauses allow a lessee up to 180 days to complete an offset well before the compensatory royalty obligation kicks in, requiring a lessee to pay compensatory royalties dating back to the date of initial production from the draining well may have the effect of requiring a lessee to pay royalties for a time period during which the lessee had no obligation to drill. At least one court has construed such a royalty as punitive in nature.[17]

[14] *Udall*, 192 F. Supp. at 629 (construing a compensatory royalty based on 100% of the production from a draining well as punitive and unenforceable on the grounds that such a royalty "disregards the obvious fact that part, at least, of the oil produced from the [draining] well must reasonably be determined to come from below the surface of the land included in the lease on which the [draining] well is located.")

[15] Newman and Layrisson III, *supra* n.3 at *30.

[16] *Id.*

[17] *Ptasynski*, 63 IBLA at 256-57 ("If [a] compensatory royalty is designed to compensate the lessor for drainage occurring because of a failure to complete a protective well, it is difficult to understand why the lessor should be compensated for the period of time during which the lessee was under no obligation to drill . . . . The only way we could justify such an assessment was if, indeed, the Government was penalizing the lessee for failure to drill an offset well.")

d. Evidence indicating a specific bargained-for exchange for the terms of the compensatory royalty

A lessor is likely to argue that the compensatory royalty in an express offset clause is a specifically bargained-for provision meant to incentivize protection of the lease or meant to avoid the uncertainty and expense of having to prove a breach of an express or implied covenant to drill an offset well in litigation. These arguments would likely be bolstered by any lease language explaining the basis for the parties' estimates of drainage or a stated recognition of the uncertainties faced at the time of lease execution, but would likely be undercut by provisions allowing the lessee to disprove actual drainage. In the latter situation, lessees would be able to point out that the lease itself recognizes that proof of the actual extent of drainage is possible and apparently not prohibitively expensive, but then ignores that evidence for purposes of the amount of the compensatory royalty.

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