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Post-Production Royalty Disputes

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I. SCOPE OF ARTICLE

The underlying purpose of the oil and gas lease is to grant one's minerals to another for the purpose of risking time and capital to explore for and produce hydrocarbons. Created without a predetermined lifespan, the oil and gas lease commences a relationship between lessor and lessee that may last for decades often surviving the succession of interests on both sides. The one monthly constant contact between the lessor and lessee is the payment of royalty on production. Of the various types of disputes that can arise between lessor and lessee, arguably the most common includes whether royalty payments have been properly paid. With the proliferation of custom royalty clauses applied to multi-phase and multi-product hydrocarbon production, transported and processed via complex multiple delivery systems and marketing arrangements, answering the question of proper payment can be challenging. Texas courts have recently provided litigants with new guidance in navigating custom royalty clauses and their application to royalty disputes. This paper will address the common issues arising out of post-production royalty disputes and how Texas courts have addressed them.

II. THE ROYALTY CLAUSE AND TEXAS DECISIONS

A. THE PRODUCERS 88 ROYALTY CLAUSE

The primary contractual obligation in an oil and gas lease is the duty to pay royalty once production is established. Lessees' calculation and payment of royalty over the years has generated many disputes leading to the creation of well-developed case law in Texas. Historically, royalty provisions under the leases were based on the "Producers 88" form royalty clause requirement to pay on the "posted price" for oil or either the "market value" at the well for gas sold off the lease or "proceeds" received by the lessee, if sold at the well. Although royalty provisions in modern custom leases have become much more complex, the question of how courts determine market value commonly arises in litigating older leases.

B. FAILURE TO PAY MARKET VALUE

In *Exxon Corp. v. Middleton*, 613 S.W.2d 240, 249 (Tex. 1981), the Texas supreme court examined whether Exxon had sold gas from the Middleton lease at market value. The *Middleton* lease covered acreage in Chambers County and contained the following typical producers 88 royalty clause:

> . . . on gas, including casinghead gas or other gaseous substances, produced from said land or sold or used off the premises or in the manufacture of gasoline or other product therefrom, shall be the ***market value*** at the well of one-eighth of the gas so sold or used, provided that on gas so sold at the wells the royalties shall be one-eighth of the amount realized from such sale.

Middleton treated all of Exxon's gas sales as occurring "off the premises" and the court agreed. *Id.* at 243. Thus, Exxon was charged with paying royalty based on the "market value" of the gas sold at the well. Middleton sued Exxon for failing to pay royalty on the market value of the gas and proffered expert testimony to establish Exxon's breach. The court noted that market value "may be calculated by using comparable sales" which are those sales "comparable in time, quality, quantity, and availability of marketing outlets." *Id.* at 246. Middleton's expert opined that Exxon had failed to pay royalty at market value and arrived at his conclusion by taking the average of the three highest prices paid for gas in the area. *Id.* In formulating his opinions, Middleton's expert reviewed nearly 30,000 Form 60-150 Gas Purchaser Reports ("GPR's") filed with the Texas Comptroller's office. The GPR's provided the following details:

a) the name of the purchaser and seller of gas;

b) the month and year of the transaction;

c) the lease and county from which the gas was produced;

d) the quality of the gas or whether it originated from an oil or gas well;

e) the volume purchased; and

f) the price.

Id. at 245.

In determining a relevant marketing area, the expert took sales from Texas Railroad Commission Districts 2, 3 and 4 which comprise a large part of the Texas Gulf Coast. The Court approved using sales from this area because:

1) sales comparable in time, quality, quantity and availability of marketing outlets occurred from these districts;

2) gas production, gathering, transmission and ultimate consumption occurred in these districts; and

3) one of the other Defendants' experts testified that many gas purchase contracts use TRRC Districts 2, 3 and 4 in their price redetermination clauses.

Id. at 247.

With regard to the quality of the gas sold, the court noted that:

1) the *Middleton* expert testified that most of the comparable sales were for sweet gas;

2) he adjusted the sales used according to the btu content of the gas;

3) the Defendants' experts testified that the quality of the gas was comparable;

4) the GPR's confirmed that most of the gas sold was for sweet gas;

5) the sales were all intrastate sales and thus sold in the same type of market, *e.g.* regulated market or unregulated market.

Id.

The court also found that the quantities of the sales, although different, were comparable because:

1) the *Middleton* expert testified that in these districts from the period between 1973 and 1975, quantity did not affect prices;

2) one of the Defendants' experts also testified that volume did not affect prices; and

3) the *Middleton* expert testified that by taking the btu value and making the necessary adjustments, differing volumes of sales could be made comparable.

Id.

In discussing comparability of marketing outlets, the court noted that the *Middleton* expert testified that TRRC Districts 2, 3 and 4 contained a substantial network of pipelines.

The court also found that the sales were comparable in time. The *Middleton* expert took the three highest prices from the first month of every quarter to establish market value. In validating this methodology, the court noted that the parties had stipulated that the market value of the gas would be determined quarterly.

In approving the use of the average of the three highest prices, the court noted that:

1) because prices were rising, the highest prices represented the most current transactions;

2) the *Middleton* expert testified that most gas contracts set initial and redetermined prices based on the highest prices in the area;

3) Exxon paid royalty on other gas based on the average of the three highest prices for sales over one million cubic feet per day and adjusted for btu content;

4) another Defendant had also agreed to using a similar formula in a separate arbitration proceeding and a negotiated gas contract.

C. HERITAGE AND THE NET BACK

In situations where comparable sales are either not available or cannot be established, Texas courts turn to a different method to determine market value. In *Heritage Resources v. Nationsbank*, the lessee was taking transportation costs from the wellhead to the point of sale and deducting them from royalty payments. 939 S.W.2d 118, 120 (Tex. 1997). The lessor objected on the grounds that the lease provided that royalties were to be paid on "market value at the well" and yet still free of any "deductions…by reason of any required processing, cost of dehydration, compression, transportation, or other matter to market such gas." *Id.* at 120–21. The court stated that the "general rule" is that royalty payments are typically subject to post-production costs, but also mentioned that parties may modify that rule by agreement. *Id.* at 122. The court concluded that the term "market value at the well" entitled lessee to make reasonable postproduction deductions in order to arrive at a price reflecting value "at the well' as opposed to its value at the point of sale. *Id.* The court did not apply the 'no deductions' clause concluding that it was a merely a restatement of "existing law" and "surplusage". *Id.* at 122–23.

As for determining "market value at the well," the supreme court cited *Middleton*, noting that "[t]he most desirable method is to use comparable sales." *Id*. But what if such information is not available, as was the case in *Heritage*? The *Heritage* court identified a second method to determine market value, whereby "reasonable post-production marketing costs" were to be deducted from the "market value at the point of sale." *Id*. While the court does not define what exactly "market value at the point of sale" is, at least one case suggests that it is "the amount received by [the lessee] for the gas." *Le Cuno Oil v. Smith*, 306 S.W. 2d 190, 193 (Tex. Civ. App—Texarkana 1957, writ denied). Thus, when comparable sales data is not available, *Le Cuno* suggests that "market value at the well" may be calculated by subtracting reasonable post-production costs from the gross proceeds that the lessee received from their purchaser.

D. ROYALTY CLAUSES AFTER HERITAGE

Following Heritage, landowner oil and gas lease drafters began to add clauses to address its effects so as to attempt to prevent post-production deductions from royalty. The last several years has seen courts consider the effect of so called "*anti-Heritage*" royalty clauses. These clauses are often designed to secure maximum value for the royalty owner and maintain a true "cost-free" royalty as far along the post-production process as possible.

1. Warren v. Chesapeake

The Fifth Circuit, applying Texas law, recently considered the effect of an "anti-*Heritage*" addendum on three separate oil and gas leases. *Warren v. Chesapeake Expl., L.L.C.*, 759 F.3d 413, 414 (5th Cir. 2014). Two of the leases were identical and provided for payment of royalty on the amount realized at the mouth of the well. *See id*. at 415. However, the Warrens' leases contained an addendum:

> 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…

Id. at 416.

The leases also contained language in the addendums that provided they were to supersede any inconsistent language in the leases. The Court held that the language in the addendums had no effect on Heritage's application to the leases because the language was not inconsistent with the royalty provisions—it did not change the point at which royalty is computed—*at the well*. *See Id.* at 418. The court noted that the Warrens could have included language in the addendum that would calculate their royalty based on the *actual proceeds of sale*, but they did not. *See Id*. The court treated the third lease differently because though the pre-printed lease form was also an "at the well" lease, the addendum provided for valuation at the *point of sale*. With little discussion, the court concluded that the claims based on the third lease should not have been dismissed. *Id*. at 419–20.

2. Potts v. Chesapeake

While *Warren* recognized the importance of point-of-sale valuation, the court in *Potts v. Chesapeake Expl.*, *L.L.C.*, 760 F.3d 470 (5th Cir. 2014) noted that it does not prohibit post-production deductions in every case. The lease at issue in *Potts* provided a royalty on the market value at the time of sale of ¼ of the gas sold or used…paid to lessor 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." *Id*. at 471–72. Chesapeake would sell gas to an affiliate at the wellhead and the affiliate would refine the gas and sell it upstream. *Id*. at 473. Chesapeake calculated the royalty based on the sale price at the wellhead. *Id*. The court concluded that the anti-*Heritage* provision was ineffective because Chesapeake correctly calculated the royalty based on the sales price at the wellhead. *Id*. at 474.

3. Chesapeake v. Hyder

Recently, the Supreme Court of Texas considered whether the language in a lease expressed an intent to work around the default rule that "an overriding royalty on oil and gas production is free of production costs but must bear its share of postproduction costs." *Chesapeake Expl., L.L.C. v. Hyder*, 483 S.W.3d 870, 871 (Tex. 2016). The provision in dispute provided for:

> "a perpetual, ***cost-free*** (except only its portion of production taxes) overriding royalty of five percent (5.0%) of gross production obtained" . . . .

The Hyders' lease also included an intended "work around" Heritage that stated: "Lessors and Lessee agree that the holding in the case of *Heritage Resources, Inc. v. NationsBank*, 939 S.W.2d 118 (Tex.1996) shall have no application to the terms and provisions of this Lease." *Id*. at 872. Chesapeake argued that "cost free" merely emphasized that a royalty interest was free of production costs. *Id*. at 875. The court disagreed and noted that the price-received basis for payment in the lease was enough to excuse the lessors from post-production costs. *See id*. The very nature of a "proceeds lease" means the royalty is free of post-production costs, and the additional "free and clear of all production . . . costs" language in the Hyder lease might be considered surplusage. *Id*. at 873.

4. Burlington v. Texas Crude

This most recent Texas Supreme Court decision dealing with post-production royalty disputes is *Burlington Resources v. Texas Crude Energy*, 573 S.W. 198 (Tex. 2019). In *Texas Crude*, the Court held that a provision for delivery of an overriding royalty interest "into the pipeline" contemplated valuation at the well and therefore authorized deduction of post-production costs.

The granting clause of the assignment at issue provided for delivery of the overriding royalty interest "into the pipelines, tanks or other receptacles with which the wells may be connected." *Id.* at 201. The valuation clause of the assignment contained nearly identical language providing for delivery "into the pipeline," or at assignee's election, for assignor to pay assignee the applicable percentage of the value of the hydrocarbons. *Id.* The valuation clause defined value for arm's length sales, like the sales at issue in the case, as "the amount realized from such sale of such production and any products thereof." *Id.* at 202.
Burlington – the assignor – argued that the parties' agreements when read together entitled it to deduct Texas Crude's share of post-production costs from the royalty payments. *Id.* Burlington emphasized the general rule that royalty interests usually bear post-production costs. *Id.* at 204. On the other hand, Texas Crude contended that the parties had contracted otherwise by specifying that the royalty would be paid after sale of the product based on the "amount realized from such sale," not based on the product's value at the well. *Id.*

However, the Court agreed with Burlington and explained that it was necessary to examine the entire valuation clause "in its context and in conjunction with other clauses to which the parties agreed, including the immediately preceding Granting Clause." *Id.* at 205. The Court was "persuaded that Burlington's position is more faithful to all of the contractual language chosen by the parties and more aligned with the parties' intent as expressed in writing." *Id.* at 206.

The Court further clarified that it has never held that an "amount realized" valuation method frees a royalty holder from its usual obligation to share post-production costs even when the parties have agreed to value the royalty interest at the well. *Id.* at 205. When the court of appeals suggested otherwise, the Court noted, it misunderstood the Court's decision in *Hyder*. *Id.* In addition, the Court pointed to the prior decisions in *Heritage* and *Warren* suggesting that when the parties specify an "at the well" valuation point, the royalty holder must share in post-production costs regardless of how the royalty is calculated. *Id.*

Thus, the Court held that in the context of the agreements between the parties, the parties intended the "into the pipeline" language to fix the royalty's valuation point at the physical spot where the interest must be delivered – at the wellhead or nearby. *Id.* at 211. Therefore, Burlington had the right to subtract post-production costs from the "amount realized" in downstream sales prices in order to calculate the product's value as it flowed "into the pipelines, tanks or other receptables with which the wells may be connected." *Id.*

The *Texas Crude* Court treated the point when hydrocarbons enter "into the pipeline" similarly to "at the well" for royalty valuation purposes, even if lessee has to pay a percentage of the proceeds as royalty. However, as the Court noted before its analysis, "the decisive factor in each case is the language chosen by the parties to express their agreement/" *Id.*, citing *Heritage Res.*, 939 S.W.2d at 124 (Owen, J., concurring) ("Our task is to determine how those costs were allocated under *these* particular leases.").

E. CABOT V. BROWN & THE DUTY TO MARKET

Royalty disputes may involve complaints about the prices obtained by the lessee. The implied duty to manage and administer an oil and gas lease includes the duty to reasonably market the oil and gas produced from the premises. *Cabot v. Brown*, 754 S.W.2d 104 (Tex. 1987); *Amoco Prod. Co. v. First Baptist Church of Pyote*, 579 S.W.2d 280 (Tex. Civ. App.—El Paso 1979), *writ ref'd n.r.e.*, 611 S.W.2d 610 (Tex. 1980) (per curiam). A lessee satisfies the duty to market by 1) marketing the production with due diligence and 2) obtaining the best price reasonably possible. *Cabot*, 754 S.W.2d at 106. The applicable standard of care for the marketing covenant is that of a reasonably prudent operator under the same or similar circumstances. *Id.*

Cabot involved a lessee that had begun exchanging gas with Transwestern Pipeline Company for sale in California. Because the exchanged gas was sold on the interstate market, it was subject to federal price ceilings. Cabot would take the gas received from Transwestern Pipeline as part of the exchange and obtain a higher price in the intrastate market. Instead of paying at the higher price received on the exchanged gas sold intrastate, Cabot paid royalty based on the federal price ceilings, as if the gas had been sold in the interstate market. The lessors sued Cabot for 1) failing to pay royalty on the higher intrastate price and for 2) failing to withdraw from the exchange agreement with Transwestern and sell the gas on the intrastate market at a higher price. The lessors used expert testimony to establish that a reasonably prudent operator would have:

1) sought an abandonment of the exchange agreement with Transwestern and

2) that federal regulators would have granted the withdrawal.

Id. at 107.

Once withdrawn from the exchange agreement, the gas would no longer be subject to federal price ceilings and could have been marketed at higher intrastate prices. *Id.* The court upheld the jury's finding that lessees breached the marketing covenant and remanded for a determination of lessors' damages. *Id.* at 108.

In *Yzaguirre v. KCS Resources, Inc.*, 53 S.W.3d 368, 374 (Tex. 2001), lessees refused to pay lessors a favorable price that was being obtained under a long-term gas purchase agreement. Instead, lessees paid lessors a lower 'market' price than what was being received. The court refused to apply the implied marketing covenant to the *Yzaguirre* market value royalty clause and supported its decisions on the following grounds:

> In this case, the parties entered into a lease requiring a market-value royalty. Because the lease provides an objective basis for calculating royalties that is independent of the price the lessee actually obtains, the lessor does not need the protection of an implied covenant. Depending on future

> market behavior, this may be financially beneficial to the lessor, as it was in *Vela*, or it may be less advantageous, as here. In either event, the parties have received the benefit of their bargain.

Id. at 374.

The *Yzaguirre* Court commented that the royalty owners' argument was an attempt to transform the market value royalty clause into a "higher of market value or proceeds" royalty clause. Although the Yzaguirre lease did not, custom oil and gas royalty clauses will often contain such a "higher of" multi-prong royalty clause and may also contain a third prong tied to an established index price such as the Houston Ship Channel Price as reported in a particular publication such as Inside FERC.

F. NATURAL GAS PROCESSING

Rich or 'wet" natural gas is often processed so that hydrocarbon liquids are extracted to form a hydrocarbon liquid known as y-grade. The y-grade is then separated into constituent hydrocarbons including ethane, propane, butane, isobutane, pentane and pentanes plus.[1] The extracted liquids are then sold separately as well as the residual, now 'dry' gas. The sales of the resulting liquids and residual gas usually results in a substantially higher value than the equivalent volume of gas would have received had it not been processed. When is a royalty owner entitled to its share of the premium value received from such processing? In *Bowden v. Phillips*, the Texas Supreme Court considered a royalty owners' royalty claims for the increased value of processed gas. The Court noted that, subject to the terms in the applicable royalty clause, "royalty owners generally are entitled to a royalty on the total amount of minerals they sell from their mineral estate, including all components of those minerals—no less and no more." *Bowden*, 247 S.W.3d 690, 706 (Tex. 2008). However, the Court recognized that, unless otherwise specified in the mineral lease, the lessee will generally "bear both the cost and benefits from processing and treatment" of hydrocarbons after initial production. *Id.* The Court held that nothing in the applicable royalty clauses changed "these common principles". See also discussion below of *Yturria v. Kerr-McGee*, 291 Fed. Appx. 626, 2008 WL 4155830 (5th Cir. 2008) (recognizing that a royalty provision may require calculation based on something more than the amount received by the lessee after processing an sale). Thus, the answer to the question of whether royalties are to be paid on the higher prices received after processing depends on the specific language of the royalty clause. Although the *Bowden* royalty clauses did not, modern custom oil and gas royalty clauses now commonly address the payment of royalties on processed gas including the higher premiums obtained by processing.

G. MODERN CUSTOM ROYALTY CLAUSES

While the traditional producers 88 royalty clauses fixed royalty value at the wellhead, with proceeds/market value as the price component, modern royalty clauses have become more complex. Modern leases will separate the royalty obligation by hydrocarbon product to include oil, condensate (or other field liquids), gas and liquids extracted from gas via processing. Catchall royalty clauses designed to apply to any other hydrocarbon product not contemplated by the specific royalty clause is also become more common. These leases also avoid the "at the well" trap by not fixing royalty value at the well, but further downstream, either at the point of sale, or even beyond. The leases will also contain free royalty clauses designed to prevent any postproduction deductions including for transportation, processing, treatment, or other expenses required to prepare are ultimately deliver the hydrocarbons to market.[2] To further deal with lessees who outsource their gas processing and to further avoid the risk of the free royalty clause being considered "surplusage", lease drafters have also added "add-back" provisions in the royalty clauses to require lessees to add any transportation, processing, treatment or other fees and expenses deducted from the prices received by lessees. Lease drafters will also have "no-commingling" clauses, clauses designed provide lessors' royalty when lessee has 'hedged'

[1] http://www.gasprocessingnews.com/features/201402/make-purity-profits-from-y-grade.aspx

[2] One example of such a lease form is the Texas General Land Office form: https://www.glo.texas.gov/energy-business/oil-gas/mineral-leasing/leasing/forms/Form_Relinquishment_Act_Lease.pdf

lessors' production at a higher price than what is being received. Measurement requirements in the lease can also be very specific so at to ensure proper measurement before production leaves the leasehold.

H. Devon v. Sheppard

The 13th court of appeals in Corpus is currently considering a post-production royalty dispute out of DeWitt County involving free royalty and add-back provisions styled *Devon Energy Prod. Co. v. Michael A. Sheppard*, No. 13-19-00036-CV (Tex. App.—Corpus Christi, 2019). All briefing was completed in November, 2019, and the court denied a request for oral argument and will be submitted on the briefs.

1. Procedural History

Lessors in Dewitt County sued Devon for failure to properly pay royalties. The parties filed cross-motions of summary judgment asking the court to resolve twenty-three disputed issues regarding whether additional royalties were owed to Plaintiffs. Among other issues, the trial court determined that the leases required Defendants to "add to" their "gross proceeds" prior to calculating Plaintiffs' royalties. The Honorable Robert E. Bell of the 24th Judicial District Court granted summary judgment in favor of the Plaintiffs on all twenty-three disputed issues. Defendants appealed to the Thirteenth Court of Appeals.

2. Applicable Lease Provisions:

Oil Royalty – Paragraph 3a:

3. The royalties to be paid by Lessee are: (a) on oil, One-Fifth (1/5th) of that produced and saved from said land, the same to be delivered, free of all costs and expenses to the Lessor into the pipeline, or other receptacle to which the Lessee may connect its wells or the market value thereof, at the option of the Lessor, such value to be determined by (1) the highest posted price, pus premium, if any, offered or paid for oil, condensate, distillate, or other liquid hydrocarbons, respectively of a like type and gravity for the field where produced and when run, or (2) the gross proceeds of the sale thereof, whichever is greater.

Gas Royalty – Paragraph 3b:

(b) on gas, including casinghead gas or other gaseous substance, produced from said land. One-Fifth (1/5th) of the greater of (1) the market value at the wellhead of such gas, paid to Lessor free of all costs and expenses, or (2) the gross proceeds realized from the sale of such gas, free of all costs and expenses, to the first non-affiliated third party purchaser under a bona fide arms-length sale or contract. "Gross proceeds" (for royalty payment purposes) shall mean the total monies and other consideration accruing to or paid the Lessee or received by Lessee for disposition or sale of all unprocessed gas proceeds, residue gas, gas plant products or other products. Gross proceeds shall include, but is not limited to advance payments, take-or-pay payments (whether paid pursuant to contract, in settlement or received by judgment) reimbursement for production or severance taxes and any and all other reimbursements or payments.

Add-to/back Clause – Paragraph 3(c):

(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 or marketing of the oil or gas, then such deduction, expense or cost shall be added to the market value or 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.

Royalty Free of Costs Clause – Addendum L:

Payments of royalty under the terms of this lease shall never bear or be charged with, either directly or indirectly, any part of the costs or expenses of production, gathering, dehydration, compression, transportation, manufacturing, processing, treating, post-production expenses, marketing or otherwise making the oil or gas ready for sale or use, nor any costs of construction, operation or depreciation of any plant or other facilities for processing or treating said oil or gas. Anything to the contrary herein notwithstanding, it is expressly provided that the terms of this paragraph shall be controlling over the provisions of Paragraph 3 of this lease to the contrary and this paragraph shall not be treated as surplusage despite the holding in the cases styled *Heritage Resources, Inc. v. NationsBank*, 939 S.W.2d 118 (Tex.

1999) and *Judice v. Mewbourne Oil Co.,* S.W.2d 135-36 (Tex. 1996).

3. Appellant Lessee's Argument

Lessee/appellant contends that the Plaintiffs' royalties were properly paid based on the proceeds actually received for the sale of production from the leases without any deductions incurred by Lessees before they sell the production. Lessees claim that the "add-back" clause in the leases was tailored to prevent Defendants from reducing the royalty they pay to Plaintiffs by offsetting the gross proceeds of sales with lessees' own post-production costs, not the anticipated post-sale downstream costs that may be incurred by the third-party purchaser.

Lessees' briefing argues the significance of the "point of valuation" of royalty: (a) that the add-back clause alters "at the well" point of valuation and ensures the point of valuation under the leases is at the point of sale to a third-party purchaser; (b) that the clause assures that no costs incurred by the lessee prior to the point of sale are deducted for Plaintiffs' royalty and (c) that the clause does not shift the point of valuation further downstream beyond the point of sale.

Lessees further argue that "proceeds" is the amount the producer actually receives in the sale; that the royalty clause prevents Lessees from reducing the amount received by any contract charges; that the Lessees do not share in any added value to the production after the sale; and that Lessees should not be obligated to pay royalty on a portion of value that was never actually received by lessee. Lessee further argue that sales prices based on adjusted downstream index prices do not impose Contractual Charges under the terms of the lease and that any anticipated costs that may be incurred by the purchaser after lessee sells the production are not costs incurred by lessee, directly or indirectly, and thus not contractual charges subject to royalty.

Lessees further argue that royalty is not owed on lease and unit fuel, third-party fuel, lost gas or retained drip condensate, as there were no proceeds from such production. Furthermore, additional royalties are not owed based on the lessees' decision to set contractually fixed recovery factors as the lessors are still receiving a royalty on 100% of lessee's proceeds. Lessee's argue that the processor takes title to separated components and pays the producer accordingly and pays Plaintiffs a royalty on that amount. When Defendants sell the residue gas stream, Defendants pay royalty on the proceeds of that sale as well.

4. Plaintiff Royalty Owner's Argument

The plaintiff/appellee royalty owners' briefing argues that determining the "gross proceeds" for royalty payment is not the end of the exercise, and under the "Add to" clause, lessee should have "added to…gross proceeds" when calculating lessors' royalties. Defendants have never added anything to their proceeds.

Lessor's argue that the lease language does not contain any point of sale language and does away with any implied impenetrable point-of-sale royalty cap. Instead, the Lessees treated the "Add-to" provision as a 'no deductions' from royalty provision, Therefore, where operations were performed and whether reductions benefited Lessees have no bearing on the negotiated contract language. Instead of a "proceeds" lease, lessors claim royalty must be paid on a "proceeds plus" basis. Because the lessee has great flexibility to make marketing decisions for lessor's royalty share of hydrocarbons, as a tradeoff, lessors contend that the royalty provisions entitle lessors to receive royalties that are insulated from the costs of lessees' decisions to allow a third-party to provide processing services to hydrocarbons. Instead, lessee renders the 'Add-to-Proceeds' provision meaningless and mischaracterize it as a "no deducts from royalty" provision.

The lessors further stress that the Royalty Free of Costs provision states that royalty shall not be "directly" or "indirectly" charged with "any part" of costs or expenses and expressly indicates that the provision should not be treated as "surplusage". Lessors argue that the provision contains unique attributes that have never been reviewed by any Texas court and expresses the parties' understanding of prior Texas cases and the intention that the provision not be treated as "surplusage'. The Lessees' cite to the *Yturria v. Kerr-McGee,* 291 Fed. Appx. 626, 2008 WL 4155830 (5th Cir. 2008), which recognized that a royalty provision can account for factors downstream of the point of sale and can be calculated based on something more than the amount received by the lessee.

The royalty clauses being litigated in the Sheppard case reflect language in more modern custom royalty clauses and the claims being litigated are indicative of the current post-production royalty disputes that arise from these clauses.

I. Royalty Disputes and the Confusion of Goods

The commingling doctrine has a long history of application in the oil patch. The entire process of hydrocarbon extraction, gathering and marketing lends itself to the risk of a confusion of goods claim. Once oil or gas from two wells is mixed, it cannot readily be separated. Without accurate measurement, preceded by constituent separation, at the wellhead, it becomes difficult, if not impossible, to accurately allocate back to each well once the product is commingled and delivered to market so as to accurately calculate royalty. Section 88.052 of the Texas Natural Resources Code requires operators to "accurately measure[e] the amount of the oil or gas and mak[e] and preserv[e] an accurate record of the amount." TEX. NAT. RES. CODE ANN. § 88.052 (West 2018). In enacting Section 88.052's predecessor, the Texas Legislature recognized the risk to landowners of being defrauded without accurate measurement of hydrocarbons. Act of May 12, 1933, 43d Leg., R.S., ch. 165, S 13, 1933 Tex. Gen Laws 422, 427 (stating "a great many landowners of this State are being defrauded of their proper royalty interest in oil and gas"). Additional Texas Railroad Commission rules related to accurate measurement include TEX. NAT. RES. CODE. ANN. §§ 88.0.053, 91.052 AND TEXAS RAILROAD COMMISSION RULE 27. As early as 1940, royalty owners were arguing to Texas courts that if their commingled hydrocarbons could not be determined with reasonable certainty, they would be entitled "to recover for the whole mass." *E.g.*, *Ortiz Oil Co. v. Luttes*, 142 S.W.2d 1050, 1055 (Tex. Civ. App.— Texarkana 1940, writ dis'd by agr.) (finding that application of the commingling doctrine was unnecessary because "the jury could form a reasonably certain estimate of the amount of the property converted").

1. *Mooers*, the Burden of Proof, and Fraud *Sine Qua Non*?

The Texas Supreme Court first applied the confusion of good doctrine to oil and gas production in *Mooers v. Richardson Petroleum Co.*, 204 S.W.2d 606 (Tex. 1947). In *Mooers*, Richardson Petroleum operated wells on various tracts in Nueces County. *Id.* at 607. Mooers owned royalty interests in the Erigan Tract. *Id.* When production on Richardson's wells on other leases began to drop below their daily allowables, Richardson secretly installed pipelines from the Erigan No. 1 well to the other off- lease wells in order to make it appear as though the off- lease wells were producing sufficient hydrocarbons. *Id.* Richardson, for a span of five years, impermissibly flowed oil from the Erigan No. 1 well without paying Mooers royalty from such production. *Id.* No accurate accounts were kept of the amount of oil illegally taken from the wells on the plaintiff's tract. *Id.* The intermediate court found that "'[i]t is now impossible to unscramble the commingled mass caused entirely by the willful misconduct of the defendant and its predecessors,' and . . . was a case calling for the application of the equitable rule of commingled assets." *Id.* at 608. The court of appeals further stated:

[t]he trial court was instructed that, since Richardson fraudulently commingled and confused the oil from [Mooers' acreage] with oil from other leases and was unable to establish clearly and distinctly the amount of oil which was run from [Mooers' acreage], Mooers was entitled to recover his 1/16 royalty from all oil produced from wells connected by secret pipes to [Mooers' acreage] during the entire period of commingling. *Id.*

The Texas Supreme Court agreed and held that "this case is a proper one for the application of the commingling rule and the instructions of the Court of Civil Appeals correctly embody its elements." *Id.* The court explained, however, that the rule of damages has no application unless there is proof of the commingling, and since the Court of Civil Appeals based its amended judgment on the assumption that there had been actual commingling of oil in certain wells on the adjacent leases in the face of conflicting evidence as to the fact, it reversed the judgment and remanded the case to the trial court where these facts could be determined. *Id.* Thus, *Mooers* established the first part of the commingling analysis, being the determination by the fact finder (if there is contrary evidence) as to whether the hydrocarbons were in fact commingled. If commingling were established, the burden would then shift to the commingler to establish "clearly and distinctly" the amount of hydrocarbons from the plaintiff's lease. *Id.* At least one later intermediate court decision, discussed *infra*, would suggest that some willful misconduct, as in *Mooers*, would be a requirement prior to application of the commingling doctrine. *Id.*

2. Commingling of Oil and Gas Prices

In *Natural Gas Distributing Corp. v. Williams*, Williams, an overriding royalty interest owner, sued the working interest owner for additional royalty payments because lease gas was commingled downstream with off-lease gas and was sold at varying prices, ranging from $0.08 per mcf to $0.25 per mcf. 355 S.W.2d 194, 196 (Tex. Civ. App—Waco 1962, writ ref'd n.r.e.). Natural Gas Distributing paid Williams a 1/8th overriding royalty based only on a price of $0.08 to $0.09 per mcf. *Id.* at 195–96. Williams sued to recover royalty payments under the commingling theory since it would be impossible to determine at what price Williams' gas was sold after it was put into the commingled stream. *Id.* at 196–97. The jury found that the highest price paid was $0.25, and the trial court awarded damages as the difference between the royalties due at a price of $0.25 and the amount actually paid. *Id.* at 197. The Waco court reversed the award because the instrument creating the override only required payment on 1/8 "of the *net proceeds at the well*" while the $0.25 prices were paid "some 50 miles down the line." *Id.* Moreover, the Court noted that the commingling doctrine as described in *Mooers* was inapplicable because the Defendant was not guilty of willful misconduct as was the *Mooers* defendant. *Id.* Thus, while the *Williams* court recognized commingling of hydrocarbon prices in its analysis, it did not afford a commingling remedy to the plaintiff for other reasons.

Humble, as discussed below, would apply the commingling doctrine under a set of facts that did not include the "wrongful misconduct," *i.e.*, fraud claims brought in *Mooers* because of the Defendants' secret pipelines. Had the Williams' override not fixed valuation as 'net proceeds at the well,' but rather proceeds or market value at the point of sale, and had this case taken place after *Humble*'s application of commingling without fraud, the result in *Williams* would likely have been different.

3. Commingling Absent Fraud and the Modern Standard

In *Humble Oil & Refining Co. v. West*, West reserved a 1/6 royalty on all gas produced from the Clear Lake Field. 508 S.W.2d 812, 813 (Tex. 1974). Humble, the operator of the wells in the field, determined that the gas reservoir was being depleted by production and should be used for storage of extraneous gas to prevent water from encroaching into the field and destroying it. *Id.* The Wests sued Humble and pled two remedies. *Id.* at 813–14. First, West argued that the injection should cease until all of the native gas was produced. *Id.* at 813. Alternatively, West argued that it should receive a royalty on all of the gas produced from the field whether or not such gas is native or injected. *Id.* at 813–14. The trial court denied injunctive relief but ordered Humble to account to West for royalties on all gas produced irrespective of whether the gas was native or injected. *Id.* at 814.

Before the Texas Supreme Court, West made two arguments in support of the claim that it was entitled to royalties on all of the gas. First, West argued that Humble had effectively lost title to its gas once injected, and because the royalty reservation entitled West to all oil, gas and minerals produced and saved from the properties, Humble owed a royalty on all gas produced and saved, whether native or extraneous. *Id.* In its analysis, the court looked to *Lone Star Gas Co. v. Murchison*, 353 S.W.2d 870 (Tex. Civ. App.—Dallas 1962, writ ref'd n.r.e.). *Id.* at 817. Murchison argued Lone Star lost title to extraneous gas it injected into a storage reservoir as the gas became like a "wild animal," subject to capture. *Id.* Rejecting the notion that the gas returned to its natural and wild state and was thus subject to the rule of capture, the *Murchison* court found the correct rule was "'once severed from the realty, gas and oil, like other minerals, become personal property . . . title to natural gas once having been reduced to possession is not lost by the injection of such gas into a natural reservoir for storage purposes.'" *Id.* (quoting *White v. N. Y. State Natural Gas Corp.*, 190 F.Supp. 342, 347, 349 (W.D. Pa. 1960). Thus, the Court held, "Humble's ownership of the gas as personal property is not altered either upon injection of the gas in the reservoir or upon later production of the gas. The language of the conveyance does no more than reserve the royalty interest in the native gas in the reservoir, and Humble's ownership of the extraneous gas is unaffected thereby." *Id.*

However, the Court then turned to the alternative confusion of goods argument and the question "of determining whether Humble's intentional 'confusion' of the two bodies of gas should result in a forfeiture of its exclusive rights to the extraneous gas." *Id.* at 818. The Court then stated:

As a general rule, the confusion of goods theory attaches only when the commingled goods of different parties are so confused that the property of each cannot be distinguished. Where the mixture is homogeneous, the goods being similar in nature and value, and if the portion of each may be properly shown, each party may claim his aliquot share of the mass. Additionally, the burden is on the one commingling the goods to properly identify the aliquot share of each owner; thus, if goods are so confused as to render the mixture incapable of proper division according to the pre-existing rights of the parties, the loss must

> fall on the one who occasioned the mixture. Stated differently, since Humble is responsible for, and is possessed with peculiar knowledge of the gas injection, it is under the burden of establishing the aliquot shares with reasonable certainty.

Id. (citations omitted).
"Aliquot" is defined as "[c]ontained in a larger whole an exact number of times; fractional ”
Aliquot, BLACK'S LAW DICTIONARY (10th ed. 2014).
The Court would further discuss the burden shifting analysis as follows:

> [T]he act of commingling native and extraneous gas did not impose upon Humble the obligation of paying royalties on all gas thereafter produced from the reservoir, if the evidence establishes with reasonable certainty the volume of gas reserves upon which the Wests would have been entitled to royalties, absent injection of extraneous gas. The burden of this showing devolves upon Humble after proof by the Wests of their royalty interests, together with proof of Humble's commingling of extraneous and native gas. The threshold question for determination is whether the requisite computation of reserves is capable of establishment with reasonable certainty . . . .

Id. at 819.
West had not accused Humble of fraud but rather sued for Humble's failure to pay royalty under its contractual obligations as set forth in the royalty reservation. Thus, *Humble* extended the confusion of goods remedy to non-fraudulent comminglers and established that the defendant would have to pay royalty on all of the gas unless it established the plaintiff's share with "reasonable certainty."
With the standard in place, the Supreme Court remanded the case to the trial court so it could determine whether the native gas in the reservoir could be determined with reasonable certainty, and if so, whether Humble had met that burden. *Id*. at 819.
Following remand to the trial court, the Houston Court of Appeals provided insight as to the kind of evidence that would constitute a "reasonably certain" estimate. *Exxon Corp. v. West*, 543 S.W.2d 667 (Tex. Civ. App.—Houston [1st Dist.] 1976, writ ref'd n.r.e.). At trial, Exxon (formerly Humble) presented expert testimony from a geologist and a petroleum engineer (both employees) about the maximum amount of gas that could have been in the reservoir prior to the beginning of re-injection operations. *Id*. at 670. The court made special mention of how the measurement of every parameter was extended to the "bounds of reason." *Id*. Among the data presented in favor of Exxon's estimate were electric well logs, core samples, and well test information. *Id*. at 670–71.

The court of appeals found that the expert testimony met Exxon's burden to establish an estimate of the native gas volume. *Id.* at 673. Exxon had the burden to demonstrate by a preponderance of the evidence that their estimate was "reasonably certain," as such, the court entered judgment upon the basis of that amount. *Id.* The Wests did not provide any contradicting rebuttal expert testimony. *Id.* at 671. Without any controverting evidence, the court held that the Wests were only entitled to royalty payments for the volume estimated by Exxon's expert testimony. *Id.* at 674.

In *Lindemann Operating Co., Inc. v. Strange,* Plaintiff royalty and working interest owner sued Defendant operator for commingling production with off-lease production. 256 S.W.3d 766, 772 (Tex. App.—Fort Worth 2008, no pet.). The court found insufficient evidence to support a jury finding of willful commingling and reversed the trial court's judgment as to commingling. *Id.* at 787. In its holding, the court recognized that, when applying the commingling rule, "one who willfully commingles" will be held to a strict burden; however, "the application of such a burden is not appropriate until 'the facts establish that there has been a commingling.'" *Id.* at 782 (citing *Mooers v. Richardson Petroleum Co.*, 204 S.W.2d 606, 608 (Tex. 1947)).

In *Repsol Oil and Gas USA v. Matrix Petroleum, LLC*, No. 04-18-00411-CV, Plaintiff Matrix and others owned working interests in wells operated by Repsol (formerly Talisman Energy USA Inc.) and others in LaSalle County. The Matrix plaintiffs brought suit for breach of a 1954 Joint Operating Agreement, fraud, breach of fiduciary duty, conversion, confusion of goods, negligence and violations of the Texas Natural Resource Code. After a jury trial, the trial court entered judgment on May 25, 2018, awarding the Matrix plaintiffs over $103 million dollars in actual damages, disgorgement and attorneys' fees. The trial court also awarded the defendants over $5.3 million on their counterclaims. Although the Matrix judgment lists various damage items, including improper accounting, deductions and fees, the court awarded $11,265,228 in disgorgement damages to one of the Plaintiffs, being Defendants' net revenue interest share "of the net revenues from commingled production." A notice of appeal was filed on June 20, 2018. The case is still pending in the Fourth Court of Appeals of Texas as of the date of this article.

III. ISSUES IN AUDITING MODERN HYDROCARBON PRODUCTION

A. Downstream Commingling

With the advent of marketing hubs, gas producers now commonly aggregate gas from various leases into central delivery points. Once delivered to the marketing hubs, producers sell the commingled gas to various purchasers at varying prices in the form of, *inter alia*, spot sales and sales tied to an index price. The resulting mixture of gas volumes and varying prices makes tracing the price received for volumes of gas from a particular lease difficult, if not impossible. How does a lessee satisfy its obligation to pay on the proceeds received for its lessors' production, when such proceeds cannot be accurately determined? Producers have responded to this problem by creating a weighted average sales price and paying all leases contributing gas to the pool the same average price. The result of paying on an average price is that the lessor can no longer accurately determine what price her gas was sold for. This downstream commingling at the sales point has triggered claims by lessors that, under *Humble*, would entitle them to the highest prices paid for lease volumes produced from the lease and eventually sold into the market pool. *See* Michael P. Pearson, *Gas Royalty Calculation 2005—An Update*, 30 ST. B.

TEX. OIL GAS & ENERGY RESOURCES L. SEC. REP., Num. 3, Mar. 2006 at 76–78.

B. Condensate Shrinkage

Condensate production with high wellhead Reed Vapor Pressure (RVP)[3] presents several problems in attempting to trace and account from wellhead to sales point. High RVP condensate is highly volatile and will shrink substantially as the pressure and temperature are reduced through the post-production process. Therefore, a volume measurement at the wellhead can 'shrink' substantially, sometimes in excess 30% once the condensate has reached standard pressure and temperature and gas and NGLs are released from the condensate. Lessees must take sophisticated measures, including the use of process software, in an attempt to account for this shrinkage, making sure that the hydrocarbons released from the depressurized condensate are themselves captured, processed and marketed. Once condensate that is destined to shrink at a certain rate is commingled with condensate with differing RVP, and thus different shrinkage rates, and then further stabilized (shrunk) downstream, how reliable is the allocation method used by the lessee to determine lessor's share of the resulting condensate production? Have the unique characteristics of each production stream been considered in the lessee's allocation methodology? These are the questions that arise during the royalty audit process.

C. Lease/Plant Fuel Usage

Another common audit issue is lessee's use of lease fuel. While earlier leases allowed for the lessee have free use of produced gas to power its wellsite equipment, modern leases often require payment of royalty for such used fuel. Moreover, royalty may also be due on plant fuel usage if the royalty clause provides for such payment. Common issues include determining whether the lessee/processor are accurately measuring the lease fuel, whether the lease/plant fuel used could have produced NGL volumes, whether royalty is being paid on such usage and whether lease/plant fuel is being paid at the correct price.

D. FLARING/VENTING

During the production process, the lessee will often flare and/or vent produced hydrocarbons. When called for in the lease, lessee must pay royalties on such flared/vented gas. Similar to lease fuel issues, the audit may include an attempt to determine whether the lessee is accurately measuring the flared/vented gas, whether such gas could have produced NGL volumes along with the lost value of same, whether royalty is being paid on such gas and whether payments on such gas are being paid at the correct price.

E. Lost & Unaccounted for Hydrocarbons

All lessees must deal with lost and unaccounted for gas (LUF) during the transportation process. LUF is the difference of the physical input of gas and the physical output of gas out of the pipeline system.[4] Causes of such LUF can include meter accuracies as well as how a company "handles line pack, unmeasured fuel, unmeasured company use gas, retrograde condensate, timing of reported gas loss

[3]See https://en.wikipedia.org/wiki/Reid_vapor_pressure

[4] http://flowcal.com/wp-content/uploads/2012/02/Determining-Lost-and-Unaccounted-For-Gas-Loss.pdf

events, and missing gas loss events."[5] When a lease (or other implied duties) requires royalty to paid on all hydrocarbon's produced, as opposed to just what is sold, or otherwise burdens the lessee with payment of royalty of LUF (or unreasonable LUF), the audit will include a determination of such LUF. This process will include an attempt to determine whether the LUF was accurately measured, whether such LUF gas/condensate could have produced NGL volumes or other products, including the value thereof, whether royalty is being paid on such LUF and whether payments on such LUF hydrocarbons are being paid at the correct price.

F. Transportation & Fractionation Fees (T&F)

When gas is delivered to a processing plant, a mixed NGL product called Y-grade or raw mix is extracted, leaving dry residue gas. Y-grade, in its natural state has no dedicated market or known use.[6] For a fee, gas processors will deliver the Y-grade to a fractionation plant, where the mixed NGL's are separated into discrete NGL products including ethane, ethane-propane mix, propane, normal butane, isobutane and natural gasoline. These resulting products are then supplied to downstream markets including petrochemical facilities, refineries, end-use markets and exported to international LPG markets.[7] These fees, known as transportation and fractionation fees (T&F) are usually deducted from the proceeds received by the delivering lessee. If the lease prohibits these deductions from royalty calculations, the audit will include a determination of such T&F fees. This process will include an attempt to determine the amount of T&F Fees charged to the lessors' share of production (which can be difficult if not impossible if commingled and delivered to different processors, see discussion, *infra*, on confusion of goods), whether royalty is being paid on such T&F fees and whether royalty payments on such T&F fees are being paid at the correct price.

In *Yturria v. Kerr-McGree*, 291 Fed.Appx. 626, 2008 WL 4155830 (5th Cir. 2008), the Fifth Circuit considered whether T&F fees charged against the lessee's proceeds were deductible from Lessors' royalty. The court found that the amended royalty clause required royalty payments based on the "total revenue derived" as opposed to the "revenue received by Lessee". *Id.* at *633. The court found the royalty clause was amended to prevent lessees from reducing lessors' royalty through "alleged 'gamesmanship'". *Id.* at *634. Thus, the Court affirmed the trial court's ruling that lessors' royalty had to be calculated based on the index price per gallon for all plant products before deductions are made for T&F fees. *Id.*

G. Skim Oil

When a lessee separates raw wellhead production on the lease, the separated water can contain significant amounts of oil. This oil will be separated from the produced water once delivered to a saltwater disposal facility. The amount of oil that can be extracted has been reported to be between .25% to 1% per barrel of produced water.[8][9] When a lease requires royalty to paid on all hydrocarbon's produced, as opposed to just what is sold, or otherwise burdens the lessee with payment of

[5] *Id.*
[6] http://www.gasprocessingnews.com/features/201402/make-purity-profits-from-y-grade.aspx
[7] https://www.targaresources.com/operations/logistics-marketing/overview/ngl-transportation-services
[8] http://www.saltwaterdisposalinstitute.com/oil-skimming-operation/
[9] https://www.tswrdev.com/ufaqs/what-is-skim-oil/

royalty on recovered skim oil, the audit will include an attempt to determine the amount, value and appropriate royalty for such recovered skim oil.

H. Oil Contract Pricing Deductions

Oil purchase contracts will often be tied to a certain index price and contain certain built in deductions, including for transportation, pipeline loss and gathering fees.[1011] When a lease requires royalty to paid on oil gross proceeds without deductions made in such sales contracts (or requires such deductions to be added back into the price), these deductions become relevant in the audit process.

IV. THE STATUES OF LIMITATION ON ROYALTY CLAIMS

For the vast majority of mineral owners, contact with their lessee is limited to receiving a check in the mail. The information needed to discover a claim has been historically difficult to obtain and more importantly difficult to interpret. Without the aid of a petroleum engineer and a landman, resources usually available only to lessees and wealthy lessors, how is the typical mineral owner to know whether he has been underpaid or left unprotected? Not surprisingly, many years can pass before a mineral owner discovers, if she discovers at all, that the lessee has breached one or several of these obligations. Thus, it is inherent in the lessor/lessee relationship that the discovery of one breach often leads to the discovery of others occurring several years prior. Claims brought for violations of the royalty clause are governed by contract law.

A. The Applicable Statutes

Because there is no general statute applicable to breach of contract claims other than actions for a "debt" under TEX. CIV. PRAC. & REM. CODE ANN. §16.004 (Vernon 1997), the residual statute at TEX. CIV. PRAC. & REM. CODE ANN. § 16.051 (Vernon 1997) is commonly cited as support for the applicability of the four-year statute of limitations on breach of contract claims. *See Stine v. Stewart*, 80 S.W.3d 586, 592 (Tex. 2002). The residual statute states that except for actions to recover real property, "[e]very action for which there is no express limitations period . . . must be brought not later than four years after the day the cause of action accrues." TEX. CIV. PRAC. & REM. CODE ANN. § 16.051 (Vernon 1997). Not surprisingly, courts have applied the four-year limitations period for claims involving breach of the express provisions of oil and gas leases including claims for underpayment or improper payment of royalty. *Bright & Co. v. Holbein Family Mineral Trust*, 995 S.W.2d 742, 745 (Tex. App.—San Antonio 1999, pet. denied); *Hay v. Shell Oil Co.*, 986 S.W.2d 772, 776 (Tex. App.—Corpus Christi 1999, pet. denied). Moreover, violations of a lessee's implied duties are also subject to the four-year statute of limitation. *HECI Exploration Co. v. Neel*, 982 S.W.2d 881, 885 (Tex. 1998). The accrual date signals the commencement of the limitations period and when the plaintiff may first bring suit. *See XCO Prod. Co. v. Jamison*, 194 S.W.3d 622, 634 (Tex. App.—Houston [14th Dist.] 2006, pet. denied). For a breach of contract action, accrual is typically at the time of the breach. *Jones v. Blume*, 196 S.W.3d 440, 446 (Tex. App.—Dallas 2006, pet denied). When an obligation accrues monthly, as in the duty to pay royalty, any claims for improper payment accrue monthly as well. *Harrison v. Bass*

[1010]https://www.sec.gov/Archives/edgar/data/891456/000119312511209286/dex101.htm

[11]https://www.sec.gov/Archives/edgar/data/1539838/000119312512360997/d295327dex1026.htm

Enters. Prod. Co., 888 S.W.2d 532, 537 (Tex. App.—Corpus Christi 1994, no pet.).

B. The Discovery Rule

One exception to the application of limitations is the discovery rule which will defer the accrual date of a cause of action where the injury is 1) inherently undiscoverable and 2) objectively verifiable. *S.V. v. R.V.*, 933 S.W.2d 1, 6 (Tex. 1996); *Wagner & Brown v. Horwood*, 58 S.W.3d 732, 734 (Tex. 2001), *Computer Assocs. v. Altai, Inc.*, 918 S.W.2d 453, 456 (Tex. 1996). If applicable, the discovery rule tolls the accrual date of the cause of action to a later date when plaintiff discovered or, in the exercise of reasonable diligence, should have discovered both "the wrongful act and the resulting injury." *S.V.*, 933 S.W.2d at 4 (citing *Trinity River Auth. v. URS Consultants, Inc.*, 889 S.W. 259, 262 (Tex. 1994)). Texas courts have been instructed to apply the discovery rule categorically, that is, determine whether the particular category of injury that is being claimed satisfies the requirements for applicability of the discovery rule. *HECI Exploration Co. v. Neel*, 982 S.W.2d 881, 886 (Tex. 1998); *Wagner & Brown v. Horwood*, 58 S.W.3d 732, 734–35 (Tex. 2001). However, because some injuries are too specific to be placed in a particular category, it can be argued that the discovery rule has been applied, at times, on a case by case basis. *See* O'CONNOR'S TEXAS CAUSES OF ACTION, Ch. 56, P.1404 (2007) (citing *Nugent v. Pilgrim's Pride Corp.*, 30 S.W.3d 562, 574 (Tex. App.—Texarkana 2000, pet. denied) (injuries caused by exposure to toxic pollutants blowing from defendant's feed mill and overflowing from adjoining property during heavy rains inherently undiscoverable); *Matthiessen v. Schaefer*, 27 S.W.3d 25, 31 (Tex. App.—San Antonio 2000, pet. denied) (injury caused by purchase of property based on seller's negligent misrepresentation that only a few acres of land were located in 100-year flood plain was inherently undiscoverable)).

The Texas Supreme Court's most thorough discussion of the elements making up the discovery rule came in its 1996 decision in *S.V. v. R.V.*, 933 S.W.2d 1 (Tex. 1996). *S.V.* involved a child who sued her father for negligence in sexually abusing her after the limitations period had run. With regard to the first requirement that an injury be inherently undiscoverable, the court stated:

> To be "inherently undiscoverable", an injury need not be absolutely impossible to discover, else suit would never be filed and the question whether to apply the discovery rule would never arise. Nor does "inherently undiscoverable" mean merely that a particular plaintiff did not discover his injury within the prescribed period of limitations; discovery of a particular injury is dependent not solely on the nature of the injury but on the circumstances in which it occurred and plaintiff's diligence as well. **An injury is inherently undiscoverable if it is by nature unlikely to be discovered within the prescribed limitations period despite due diligence**.

S.V., 933 S.W.2d at 7 (citing *Computer Assocs. v. Altai, Inc.*, 918 S.W.2d 453, 456 (Tex. 1994)) (emphasis added).

With regard to the second element that the injury be objectively verifiable, the court was faced with inconclusive expert testimony regarding the accuracy of 'recovered' memories and behavioral symptoms. After discussing the admitted shortcomings by the experts in whether to rely on such memories and symptoms to establish abuse, the court agreed that the "scientific community has not reached consensus on how to gauge the truth or falsity of 'recovered' memories." *S.V.*, 933 S.W.2d at 17–18. Because there was no other objective evidence such as a confession by the abuser, contemporaneous recorded statements in the form of diaries or letters, medical records showing physical injury, an eyewitness account, or photographs or recordings of the abuse, the plaintiff's injury could not be objectively verified. Thus, an injury is objectively verifiable for purpose of the discovery rule when the facts are supported by "direct, physical evidence" or when "the alleged injury [is] indisputable." *Id.* at 7. Bringing the objectively verifiable requirement closer to a breach of covenant claim, the Houston Court of Appeals has held that an injury resulting from a breach of contract was objectively verifiable by looking at the defendants' contract with a third party. *Oliver v. Rogers*, 976 S.W.2d 792, 802 (Tex. App.—Houston [1st Dist.] 1998, pet. denied). More recently, the Texas Supreme Court admitted that "[s]ome contract breaches may be inherently undiscoverable and objectively verifiable." *Via Net v. TIG Ins. Co.*, 211 S.W.3d 310, 315 (Tex. 2006).

1. The Burden to Negate the Discovery Rule

Although a plaintiff may have the burden to establish its discovery rule defense at trial, a defendant moving for summary judgment on the affirmative defense of limitations must negate applicability of the discovery rule as a matter of law. *Rhone-Poulenc, Inc. v. Steel*, 997 S.W.2d 217, 223 (Tex. 1999); *Lewis v. Nolan*, 105 S.W.3d 185, 187 (Tex. App.—Houston [14th Dist.] 2003, review denied). The Texas Supreme Court recently recognized a movant's burden to negate the discovery rule in order to obtain a summary judgment on limitations, however the plaintiff has to have pled it. Not surprisingly, the court stated that "Defendants are not required to guess what unpleaded claims might apply and negate them." *Via Net v. TIG Ins. Co.*, 211 S.W.3d 310, 313 (Tex. 2006, no pet.).

2. Application of the Discovery Rule in Royalty Disputes

***Wagner & Brown, Ltd. v. Horwood*, 58 S.W.3d 732 (Tex. 2001)**

Three years after its holding in *Neel*, the Texas Supreme Court again considered applicability of the discovery rule in the oil and gas context in *Wagner & Brown, Ltd. v. Horwood*, 58 S.W.3d 732 (Tex. 2001). In *Horwood*, two royalty owners sued Wagner & Brown, Ltd. for deducting excessive compression and gathering charges from their royalty payments. Plaintiffs alleged improper deductions as far back as 1982 although suit was not brought until 1996. The trial court refused to apply the discovery rule and granted summary judgment based on limitations for payments made prior to 1992. The Texas Supreme Court granted review after the court of appeals applied the discovery rule to the claims accruing prior to 1992. In its ruling, the court addressed a claim commonly made by lessees at the time that the category of injury found to be inherently undiscoverable applied to <u>all</u> breaches of express or implied covenants in oil and gas leases. The court identified the category of injuries in *Neel* to apply to damages to the common reservoir. *Id.* at 736. The court then analyzed whether claims of excessive compression and gathering charges are inherently undiscoverable. The court noted that although no information regarding the charges was publicly available, plaintiffs could have turned to Wagner & Brown, its affiliated gathering company Canyon or the gas purchasers for information. Thus, the claims were not inherently undiscoverable and those which accrued more than four years prior to date of suit were barred by limitations. As in *HECI*, the *Horwood* court recognized that the discovery rule would not preclude the deferral of limitations in the event of fraudulent concealment and admitted that "[i]f Wagner & Brown fraudulently misrepresented or concealed facts forming the basis of [plaintiffs'] injury. . . limitations may, indeed, have been tolled." *Id*.

C. Fraudulent Concealment

Separate and apart from the discovery rule as a defense to the statute of limitations is fraudulent concealment. The Texas Supreme Court has discussed the durability of limitations defenses in the face of fraud:

> Texas courts have long adhered to the view that fraud vitiates whatever it touches, and have consistently held that a party will not be permitted to avail himself of the protection of a limitations statute when by his own fraud he has prevented the other party from seeking redress within the limitations period. To reward a wrongdoer for his own fraudulent contrivance would make the statute a means of encouraging rather than preventing fraud.

Borderlon v. Peck, 661 S.W.2d 907, 908–09 (Tex. 1983).

1. The Elements

When a party fraudulently conceals facts which disclose a cause of action, the statute of limitations is tolled "until the fraud is discovered or could have been discovered with reasonable diligence." *Velsicol Chemical Corp. v. Winograd*, 956 S.W.2d 529, 531 (Tex. 1997). The elements of fraudulent concealment require 1) the defendants' knowledge of the wrongful conduct, 2) that the defendant purposefully concealed the wrongful conduct, and 3) that the plaintiff reasonably relied on the defendants' deception. *See Mitchell Energy Corp. v. Bartlett*, 958 S.W.2d 430, 439 (Tex. App.—Fort Worth 1997, pet. denied); *Advent Trust v. Hyder*, 12 S.W.3d 534, 541 (Tex. App.—San Antonio 1999, pet. denied); *but see Shah v. Moss*, 67 S.W.3d 836, 841 (Tex. 2001) (identifying only elements 1) and 2) as necessary to establish fraudulent concealment). The concealment element can be satisfied by either a misrepresentation or silence when under a duty to speak. *See Am. Tobacco Co. v Grinnell*, 951 S.W.2d 420, 436 (Tex. 1997). Unlike the discovery rule, in responding to a defendants' summary judgment on limitations, a plaintiff has the burden to raise a fact issue on each element of its fraudulent concealment defense. *See KPMG Peat Marwick v. Harrison County Hous. Fin. Corp.*, 988 S.W.2d 746, 748 (Tex. 1999).

2. What makes a misrepresentation?

Courts have recognized various scenarios which satisfy the misrepresentation/silence element, including:

a) when a defendant makes a representation that is literally true but used to create an impression substantially false. *See State Nat. Bank of El Paso v. Farah Mfg. Co.*, 678 S.W.2d 661, 681 (Tex. App.—El Paso 1984, writ dism'd); *Blanton v. Sherman Compress Co.*, 256 S.W.2d 884, 887 (Tex. Civ. App.—Dallas 1953, no writ).

b) when a defendant makes a deceptive answer or uses any other indirect but misleading language. *N. Am.*

Life Ins. Co. v. Wilburn, 392 S.W.2d 364, 368 (Tex. Civ. App.—Dallas 1965, no writ).

c) when a defendant makes a partial representation, a duty to disclose the whole truth is triggered. *See Spoljaric v. Percival Tours, Inc.*, 708 S.W.2d 432, 435 (Tex. 1986).

d) when a defendant makes a representation, new information that makes an earlier representation misleading or untrue must also be disclosed. *Hogett v. Brown*, 971 S.W.2d 472, 487 (Tex. App.—Houston [14th Dist.] 1997, pet. denied).

e) when a defendant, intending to defraud another, makes the representation to a third party with the intent that it should be repeated to the intended party for the purpose of deceiving him or her. *See Custom Leasing, Inc. v. Texas Bank & Trust Co. of Dallas*, 516 S.W.2d 138, 142 (Tex. 1974) (a misrepresentation "may be made directly to the other or by a manifestation to third persons intended to reach the other").

f) when a defendant makes a fraudulent misrepresentation, even when the maker of the misrepresentation does not know the identity of the person whom the misrepresentation will reach. *Pacific Mutual Life Ins. Co. v. Ernest & Young & Co.*, 10 S.W.3d 798, 805 (Tex. App.—Dallas 2000, no pet.) (citing the RESTATEMENT (SECOND) OF TORTS § 531 comment e. (1977)).

These obligations apply even in an arm's length transaction. *See Ralston Purina Co. v. McKendrick*, 850 S.W.2d 629, 636 (Tex. App.—San Antonio 1993, writ denied). In *Neel*, the court observed "if an operator fraudulently concealed information from the lessee, decisions of this and other courts indicate that limitations may be tolled." *HECI Exploration Co v. Neel*, 982 S.W.2d 881, 886 (Tex. 1998); *see also Wagner & Brown, Ltd. v. Horwood*, 58 S.W.3d 732, 736 (Tex. 2001) (noting that if lessee fraudulently misrepresented or concealed facts forming the basis of lessors' injury, limitations may have been tolled).

3. Fraudulent Concealment in Oil & Gas accounting and royalty cases

Cass v. Stephens, 156 S.W.3d 38 (Tex. App.—El Paso 2004, pet. denied)

As previously discussed, *Cass v. Stephens*, 156 S.W.3d 38 (Tex. App.—El Paso 2004, pet. denied) involved the successful application of fraudulent concealment (and the discovery rule) in the oil and gas context. After finding in favor of the plaintiff working interest owners for breach of contract and other claims, the jury also found that defendants had fraudulently concealed the breach of contract claim. Focusing on the joint interest billing statements (JIBs), the court noted that although defendants kept detailed accounting records, only a "condensed and abbreviated accounting" was disclosed to the joint interest owners. *Id.* at 65. Also noted was opinion testimony claiming that this accounting "procedure was implemented to keep Stephens from discovering the types of costs that were being billed to the joint interest accounts." *Id.* Defendants also destroyed relevant documents and concealed relationships with numerous affiliate entities. *Id.* Because the court found sufficient evidence that defendants had fraudulently concealed the breaches of the joint operating agreement, the jury's finding was upheld.

Shell Oil Co. v. Ross, 356 S.W.3d 924 (Tex. 2011)

"[T]he discovery rule does not apply to defer the accrual of royalty owners' claims for underpayments when the injury could have been discovered through the exercise of due diligence." *Shell Oil Co. v. Ross*, 356 S.W.3d 924, 925 (Tex. 2011). In *Shell Oil Co. v. Ross*, the Texas Supreme Court extended this rule holding that fraudulent concealment of underpayments still does not defer the accrual of the royalty owner's claims where "pertinent information was readily accessible and publicly available. *Id.*

The Rosses sued Shell Oil Co. ("Shell") for underpayment of royalty beyond the four-year statute of limitations relying on Shell's fraudulent concealment to toll limitations. *Id.* at 926. "Shell 'set up an elaborate scheme to allow it to [underpay] royalties, and then made multiple misrepresentations to cover up this scheme, [including] making false representations in the monthly [royalty] statements,' which the Rosses reasonably relied on." *Id.* A jury found in favor of the Rosses on fraudulent concealment and awarded damages for underpayment, which was affirmed by the court of appeals. *Id.* at 927.

The Texas Supreme Court, however, disagreed, citing its decision in *BP v. Marshall* that "fraudulent concealment only tolls the statute of limitations until 'the fraud is discovered or could have been discovered with reasonable diligence.'" *Id.* (quoting *BP Am. Prod. Co. v. Marshall*, 342 S.W.3d 59, 67 (Tex. 2011)). Here, the Court claimed the Rosses failed to exercise reasonable diligence because they did not consult the "public record." *Id.* at 928. While the Rosses argue that the only way to obtain relevant information would have been to secure "Shell's internal records or a confidential contract with a third-party," Shell argued the Rosses should have "conducted additional investigation, including asking Shell about the prices, asking the companies Shell sold the gas to the price they paid, consulting publicly available records at the Texas General Land Office (GLO), and researching the prices listed in the publicly-available El Paso Permian Basin Index." *Id.*

"Diligence is required when claimants have been 'put on notice of the alleged harm of injury-causing actions.'" *Id.* (quoting *Exxon Corp. v. Emerald Oil & Gas Co.*, 348 S.W.3d 194, 207 (Tex. 2011)). The Court held that the large discrepancy in prices the Rosses were receiving for different wells should have alerted them to Shell's wrongdoing, which "triggered the Rosses' duty to investigate the royalty payments." *Id.* For the same reason, the discovery rule also did not apply to toll limitations on the Rosses' claims. *Id.* at 930.Therefore, the Court reversed and rendered judgment for Shell. *Id.*

D. Equitable Estoppel as a Defense to a Limitations Defense

The use of equitable estoppel has been applied to a broad range of scenarios in various contexts. In defending a claim of limitations, equitable estoppel may be invoked to prevent the pleading of limitations if an opponent makes representations which induce a plaintiff to delay filing suit within the applicable limitations period. *Cook v. Smith*, 673 S.W.2d 232, 235 (Tex. App.—Dallas 1984, writ ref'd n.r.e.). By their words or conduct, parties can estop themselves from pleading limitations. *Gibson v. Campbell*, 624 S.W.2d 728, 733 (Tex. App.—Fort Worth 1981, no writ). Similar to fraudulent concealment, false representations or concealment of material facts can be the basis for equitable estoppel. *See id.* However, while fraud centers around the misrepresentation itself, estoppel is said to center around the changed position that results from the misrepresentation. See *Maguire Oil Co. v. City of Houston*, 69 S.W.3d 350, 367 (Tex. App.—Texarkana 2002, pet. denied)).

One court stated the distinction as follows:

> The one [fraudulent concealment] presupposes the plaintiff is ignorant of the facts necessary to constitute the accrual of a cause of action; the other [equitable estoppel] presupposes that the plaintiff knows those facts but does not sue on the cause of action because the defendant has induced him not to sue. The one operates on a theory of "tolling" the limitations period for the period of the plaintiff's ignorance; the other directly forbids the defendant to interpose the limitations bar so long as the plaintiff is reasonable in relying upon the defendant's inducement not to sue.

Leonard v. Eskew, 731 S.W.2d 124, 129 (Tex. App.—Austin 1987, writ ref'd n.r.e.).

The elements of equitable estoppel have been defined as: 1) a false representation or concealment of material facts; 2) made with knowledge, actual or constructive, of those facts; 3) with the intention that the representation or concealment be acted on; 4) to another without knowledge or the means of obtaining knowledge of the facts; 5) who reasonably relies on the representations to its detriment. *Advent Trust v. Hyder*, 12 S.W.3d 534, 541 (Tex. App.—San Antonio 1999, pet. denied); *Johnson & Higgins v. Kenneco Energy, Inc.*, 962 S.W.2d 507, 515–16 (Tex. 1998). However, in order for equity to deprive a defendant of its limitations defense, the plaintiff "must have not ignored the requirements of due care and blindly relied upon a situation as being what it seemed rather than as being what it in reality was." *Neal v. Pickett*, 280 S.W. 748, 753 (Tex. Comm'n App. 1926, judgm't adopted).

E. Equitable Defenses When a Royalty Owner Accepts Royalties

One common attempt to apply these equitable defenses is in the context of an underpayment of royalty claim. Should a royalty owner be prevented from asserting an underpayment claim simply because he has historically accepted an underpayment in the past? One federal district court recently dealt with whether the acceptance of royalty underpayments waives a royalty underpayment claim or estops the plaintiff from complaining of the underpayment. In *Yturria v. Kerr-McGee Oil & Gas Onshore, LP*, No. 7:05-cv-181, 2006 WL 3227326, *12 (S.D. Tex. Nov. 6, 2006) *aff'd Yturria v. Kerr-McGee Oil & Gas Onshore, LLC*, 291 Fed.Appx. 626, 2008 WL 4155830 (5th Cir. 2008), lessees argued that by accepting royalty payments as well as settling and releasing the defendants in prior litigation, plaintiffs had waived their underpayment claims. Defendants also argued that the doctrine of quasi-estoppel barred plaintiffs' claims because of the benefit received by plaintiffs in accepting the underpaid royalties. The court first found that plaintiffs' conduct was not evidence of a *waiver* and denied defendants' summary judgment on the defense. In granting plaintiffs' summary judgment on defendants' *quasi-estoppel* claim, the court focused on whether the underpayment could satisfy quasi-estoppel's requirement of the acceptance of a benefit. The court stated that it "defies the Court how Defendants managed to conclude that plaintiffs have benefited in accepting, for the past ten years, an underpayment of royalties. To be blunt, the Court sees no benefit." *Id.* at *14. The Fifth Circuit affirmed the district court's ruling, recognizing that Plaintiffs accepted royalties without knowledge of Kerr-McGee's improper payment of such royalties. *Yturria v. Kerr-McGee Oil & Gas Onshore, LLC*, No. 07- 40636, 2008 WL 4155830, *10 (5th Cir. Sept. 8, 2008),

Outside of the oil and gas context, the Texas Supreme Court has similarly articulated the argument that the acceptance of a lesser amount that what is owed does not give rise to estoppel. *Lopez v. Munoz*, 22 S.W.3d 857, 864 (Tex. 2000) (holding that the plaintiffs' initial acceptance of a lesser portion of a settlement is not inconsistent with their later assertion that they were entitled to more).

V. CONCLUSION

Although there exists a substantial body of law regarding post-production royalty disputes, Texas courts have made clear that the parties are free to contract as they so choose and the critical component in each dispute is the actual language of the applicable agreement between the parties and the effect of each lease will have to be determined on its own terms.