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Royalty Clause Construction in Texas: Is *Hyder* part of the *Heritage* or More Surplusage?

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I. Introduction.

In the intervening years between when the Texas Supreme Court decided *Heritage* in 1996 and *Hyder* arrived at the Texas Supreme Court in 2015 oil production in Texas increased by 80% and natural gas production increased by 32%.[1]

During that same time in highly populated areas such as the Barnett Shale, countless leases were entered into and many strayed from typical form leases. Some parties engaged counsel to develop tailored leases. Others negotiated as an entire neighborhood or subdivision. All vied for the best terms. In the middle of 2008, some lease bonuses in the Barnett Shale approached $30,000 per acre before natural gas prices rapidly declined later that year.

With more leases, lessors, and money came more disputes. *Hyder* was filed in 2010, and what started out as a simple disagreement about lease language evolved into much more in the midst of widespread disputes between lessors and lessees. The Fourth Court of Appeals rendered its decision in March 2014. When the Texas Supreme Court considered *Hyder* in 2015, it marked one of the few times the legacy of *Heritage* found its way back to the Court.

II. A brief history of oil and gas royalty clause construction cases under Texas law.

According to Westlaw™, *Heritage* has been cited 343 times by Texas appellate courts. And while criticism of the *Heritage* decision is often the battle cry of the royalty owner, few Texas cases engage in an in-depth discussion of the case. Most of the cases that cite *Heritage* have nothing to do with oil and gas and instead reference some of the Court's pronouncements on contract construction. Before *Heritage*, the two most significant decisions affecting royalty owners were *Texas Oil & Gas Corporation v. Vela* (1968) and *Exxon v. Middleton* (1981).[2] Neither case, however, specifically focused on whether post-production costs could be deducted. Instead they examined "market value" and, in the case of *Middleton*, whether the sale in question occurred on or off the leased premises to determine whether the royalty obligation was based on proceeds or market value.[3]

In *Heritage*, the Texas Supreme Court construed royalty clauses under three different leases, examining the question of whether transportation costs were properly deducted from the lessor's royalty share.[4] Each of the leases based the lessor's royalty on "market value at the well," and in substantively identical language provided that "there shall be no deductions from the value of the Lessor's royalty" for various post-production activities, including the cost of transportation.[5]

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[1] *Heritage Res., Inc. v. NationsBank*, 939 S.W.2d 118 (Tex. 1996); *Chesapeake Exploration, L.L.C. v. Hyder*, No. 14-0302, 2016 WL 352231 (Tex. Jan. 29, 2016); *Crude Oil Production and Well Counts (since 1935)*, R.R. COMM'N OF TEX., http://www.rrc.state.tx.us/oil-gas/research-and-statistics/production-data/historical-production-data/crude-oil-production-and-well-counts-since-1935/ (last visited Mar. 7, 2016); *Natural Gas Production and Wells Counts (since 1935)*, R.R. COMM'N OF TEX., http://www.rrc.state.tx.us/oil-gas/research-and-statistics/production-data/historical-production-data/natural-gas-production-and-well-counts-since-1935/ (last visited Mar. 7, 2016).

[2] *Texas Oil & Gas Corp. v. Vela*, 429 S.W.2d 866 (Tex. 1968); *Exxon Corp. v. Middleton*, 613 S.W.2d 240 (Tex. 1981).

[3] *See generally Vela*, 429 S.W.2d at 866; *Middleton*, 613 S.W.2d at 242.

[4] *Heritage Res.*, 939 S.W.2d at 121.

[5] *Id*. at 120-21.

The lessors did not contest the reasonableness of the transportation costs, and thus the only issue was whether the operative leases permitted the deductions.[6] The lessee argued that the leases only prohibited deductions from the sales price that would make the royalty less than the market value at the well. While the Court of Appeals found that the lessee's construction would render the prohibition on post-production costs meaningless, the Supreme Court disagreed, finding "that applying the trade meaning of royalty and market value at the well renders the post-production clauses surplusage as a matter of law."[7]

After reciting the general rules of contract construction and accepted meaning of royalty as the landowner's share of production, free of the expenses of production, the Court examined the language at issue. The Court observed that "[m]arket value at the well has a commonly accepted meaning in the oil and gas industry" and is determined most desirably by comparable sales, or alternatively by the "net-back" method.[8] While comparable sales involve sales that are comparable in time, quality, quantity, and the availability of marketing outlets, the "net-back" method involves subtracting reasonable post-production marketing costs from the price at the point of sale to arrive at the market value at the well.[9]

In finding that the clauses limiting post-production costs in *Heritage* were surplusage, the Court noted that the leases all prohibited deductions *from the value* of the lessor's royalty.[10] The value was established by the lease: market value at the well. From this value, the lease prohibited the deduction of post-production costs. The Court said "the only conclusion we can draw is that the post-production clauses merely restate existing law."[11] The Court continued:

> We recognize that our construction of the royalty clauses in two of the three leases[12] arguably renders the post-productions clause unnecessary where gas sales occur off the lease. However, the commonly accepted meaning of the "royalty" and "market value at the well" terms renders the post-production clause in each lease surplusage as a matter of law.[13]

Justice Owen's concurring opinion in *Heritage* is lengthier than the majority opinion and includes an in-depth discussion of historical precedent from Texas and other states regarding "market value at the well" and post-production costs. Justice Owen determined that "it can fairly

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[6] *Id*. at 121.
[7] *Id*. The first use of "surplusage" by a Texas court appears to have been in 1844 in the case of *Saddler v. Republic of Texas*. *Saddler v. Republic of Texas*, Dallam 610 (Tex. 1844). There, four gentlemen were indicted for an "affray," and one, Hiram Saddler, was found guilty. The indictment alleged that Saddler and his cohorts "did quarrel and fight and make an affray." The Court observed that quarrelling and fighting were not offenses at common law or by statute, and thus were treated as surplusage. Saddler's conviction, and fine of ten dollars and court costs, was affirmed.
[8] *Heritage Res.*, 939 S.W.2d at 122.
[9] *Id*.
[10] *Id*.
[11] *Id*.
[12] Two of the three leases make a distinction about gas sold off premises (market value at the well) versus gas sold at the well (amount realized).
[13] *Heritage Res.*, 939 S.W.2d at 123.

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