UT LAW CLE THE UNIVERSITY OF TEXAS SCHOOL OF LAW

PRESENTED AT

2017 Fundamentals of Oil, Gas and Mineral Law

April 13, 2017
Houston, Texas

Interpreting the Royalty Obligation by Looking at the Express Language: What a Novel Idea?

Presented By:
Monika U. Ehrman

Written By:
Bruce M. Kramer

LEXSEE 35 TEX TECH L REV 223

Texas Tech Law Review

2004

35 Tex. Tech L. Rev. 223

LENGTH: 21502 words

INTERPRETING THE ROYALTY OBLIGATION BY LOOKING AT THE EXPRESS LANGUAGE: WHAT A NOVEL IDEA?*

*This paper is a revised version of a paper presented at the Rocky Mountain Mineral Law Foundation's Special Institute on Private Oil and Gas Royalties held in Denver, Colorado in September 2003. The author wishes to thank the Foundation for permission to revise the article for publication in the Texas Tech Law Review.

NAME: by Bruce M. Kramer **

BIO:

** Maddox Professor of Law, Texas Tech University School of Law, 1974. B.A., University of California at Los Angeles, 1968; J.D., 1972; L.L.M., University of Illinois, 1975.

SUMMARY:
... But the role of this article is somewhat more limited than attempting to develop a grand, unifying theme for dealing with royalty interests. ... Under the facts before us, a search for the parties' specific intent relative to the obligation to pay royalty on the take-or-payproceeds would prove fruitless . . . Accordingly, we look not at the parties' intent to provide expressly for take-or-pay payments, but rather at the parties general intent in entering an oil and gas lease, viz.,the lessor supplies the land and the lessee the capital and expertise necessary to develop the land for the mutual benefit of both parties . . . Consequently, we endeavor to ascertain the meaning of the royalty clause in a manner consistent with the nature and purpose of an oil and gas lease, . . . having due regard for: 1) the function of a royalty clause; and 2) the lessee's implied obligation . . . to market diligently the gas produced. ... The change in the natural gas market that began in the 1970s triggered a series of cases that had to ask the reasonably straightforward question: If a lessee paid the lessor a fraction of a long-term contract price executed years prior to the date of delivery of the gas, has the lessor met its contractual obligation to pay the market value or market price of the gas? ...

TEXT:
[*223]

I. Introduction

It is indeed a daunting task to wax eloquent about a subject matter for which one's peers and mentors have felled many a tree beforehand. n1 But the role of this article is somewhat more limited than attempting to develop a grand, unifying theme for dealing with royalty interests. Instead, this article provides a brief historical perspective on the express language that has been used in the royalty clauses. n2 Royalty clauses are not uniform. n3 I have spent a good deal of time in the past five to ten years reviewing the language in **[*224]** literally thousands of oil and gas leases and assignments of oil and gas leases. While the overall structure of the basic royalty clause has remained unchanged over the past fifty years, the language used to describe either the delivery or payment obligation substantially varies. n4 This article discusses and analyzes some of the important terms found in many royalty clauses. n5 As Professor Anderson and I have noted, this parsing-of-language approach may lead to substantial differences in interpretation between states and sometimes within a single state. n6 In contrast to this parsing approach, several courts apply the extrinsic approach whereby courts use factors not gleaned from the language of the instrument to determine the parties' intent. n7 Professor Merrill and, to a certain extent, Professor Anderson are exponents of this approach. n8 Nonetheless, this article argues that when the parties have articulated their intent through express language, the court's principal role, in the absence of fraud, duress, or mutual mistake, is to enforce the agreement as written. One of the root causes of the disparate treatment of royalty clauses in the past two decades has been the change of external circumstances regarding the production and marketing of both oil and natural gas that does not mesh with the language used by the parties in instruments which may be decades old. n9 But without an understanding of why and how certain royalty clause language became widespread, our attempts to resolve our current problems often prove haphazard at best. Perhaps everyone would have been better off and the national forests saved from an onslaught of articles, tomes, and treatises if lease drafters had followed the simple advice given by Professor A.W. Walker, Jr., in 1932: "Too much care cannot be devoted to the preparation of a royalty clause in an oil and gas lease." n10

II. The Historical Antecedents

Some of the earliest oil and gas leases did not reserve to the mineral owner what is now called a royalty interest. Instead, a type of shared profits agreement using a fifty percent sharing arrangement was utilized. Nonetheless, within a few years it became commonplace for the owner of the **[*225]** mineral estate to reserve a smaller fraction, typically one-eighth, of all of the oil collected. n11 But the origin of the one-eighth fraction as the norm is clouded in history. n12 The earliest leases reported show a royalty share of as much as one-third of the oil produced. n13 Yet many of the earliest cases provide for a one-eighth in kind royalty for oil wells and a cash payment for gas wells. n14 One of the earliest printed oil and gas lease forms, first distributed around 1870, provided for the "usual royalty of one-eighth of the oil produced, but no payments for gas." n15 But by 1880, the flat rate royalty clause for gas began to appear in printed form leases. n16 By the turn of the twentieth century, few reported cases described the shared profits arrangement, preferring the typical royalty arrangement. n17 No explanation has ever been proffered for the demise of the shared profits agreement, but as with the no-term lease, it disappeared from the oil and gas scene in a reasonably short period of time.

By the decade of the 1910s, the leading oil and gas treatise identified the following seven methods that were currently in vogue for the fixing of the rents or royalties in a mining or oil and gas lease:

(1) a fixed sum; or an (2) annual or other periodical sum; or (3) a royalty on the amount of the minerals or oil mined or produced, payable at fixed intervals or times; or (4) a royalty, not, however, less in the aggregate than a specified sum each year; or (5) a royalty accompanied by a covenant to mine a certain minimum amount or pay a certain sum thereon; or (6) in case of a gas lease, to bore so many wells and pay so much a well, or forfeit a certain sum per well for a failure to bore the required number; or (7) in case of an oil lease, to pay a certain percentage of the oil taken out of the premises. n18

[*226]

Thus, early on scholars established that gas production was to be treated separately from oil production and that the traditional reservation of a fractional share of production was not the only remuneration received by the lessor. n19

But by the mid 1920s, standard oil and gas leases, whose basic structure and organization still prevails today, were in wide distribution. In Richard Leroy Benoit's Cyclopedia of Oil and Gas Forms published in 1926, the author lists twenty different types of oil royalty clauses and an even larger number of gas and casinghead gas royalty clauses. n20 The oil royalty clauses seen in 1926 mirror the type of oil royalty clauses seen in oil and gas leases fifty years later. n21 Several examples of the classic in-kind-only royalty clause are provided that contain differences concerning the point of delivery. Some of the clauses provide:

To deliver to the credit of the lessor, free of cost, in the pipe line to which lessee may connect its wells, the equal one-eighth part of all oil produced and saved from said leased premises . . .

If oil should be found in paying quantities on said premises, the lessee shall deliver as royalty to said lessor, free of expense, one-eighth part of all the oil saved from that produced, such delivery to be made either into tanks supplied by lessor, with connections by lessor provided, or into any pipe line that may be connected with the wells;