ARTICLE

THE "POST-PRODUCTION COSTS" ISSUE IN TEXAS AND LOUISIANA: IMPLICATIONS FOR THE FATE OF IMPLIED COVENANTS AND PRO-LESSOR CLAUSES IN THE SHALE ERA OIL AND GAS LEASE

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"When I use a word . . . it means just what I choose it to mean—neither more nor less."[1]

I. INTRODUCTION

The "post-production cost" issue concerns an ongoing wave of oil and gas lease litigation focused on the gas royalty clause.[2] Historically, standard lease forms—whether labeled a "Producer's 88"[3] or a "Bath lease"[4]—contained a gas royalty clause that described a lessee's royalty obligation as follows: Lessee owes lessor royalty based on proceeds or the "amount realized" for the sale of the gas, if sold at the well, or on "market value at the well" if the gas was produced and sold off the leased premises. Note the two possible royalty payment bases applied depending on where the gas was sold: "at the well" or "off the leased premises." As commentators have noted, in light of deregulation of gas markets, the development of marketing

1. During a speech at the Federalist Society's Texas Chapters Conference on September 21, 2015, Justice Samuel Alito criticized the Supreme Court's interpretation of the Affordable Care Act in *King v. Burwell*, remarking: "Last term was a term in which the court followed what Humpty Dumpty famously said: 'When I use a word . . . it means just what I choose it to mean—neither more nor less.'" Tony Mauro, *Justice Alito Critiques Supreme Court Colleagues*, NAT'L L.J.: LEGAL TIMES (Sept. 21, 2015, 12:48 PM), www.nationallawjournal.com/legaltimes/id=1202737732899; *see also* King v. Burwell, 135 S. Ct. 2480, 2497 (2015) (Scalia, J., dissenting) ("Words no longer have meaning if an [e]xchange that is *not* established by the [s]tate is 'established by the [s]tate.'").

2. Many impressive articles have addressed this issue. Professor Owen Anderson's two-part articles are frequently cited by commentators and courts. *See* Scott Lansdown, *The Marketable Condition Rule*, 44 S. TEX. L. REV. 667, 669 (2003) (describing the post-production cost issue as the most recent wave of gas royalty clause litigation). *See generally* Owen L. Anderson, *Royalty Valuation: Should Royalty Obligations Be Determined Intrinsically, Theoretically, or Realistically? Part I*, 37 NAT. RESOURCES J. 547 (1997) [hereinafter Anderson, *Part I*] (addressing the reasons for the rise of royalty litigation); Owen L. Anderson, *Royalty Valuation: Should Royalty Obligations Be Determined Intrinsically, Theoretically, or Realistically? Part II*, 37 Nat. RESOURCES J. 611 (1997) [hereinafter Anderson, *Part II*] (providing recommendations on how to interpret royalty clauses). For a thorough discussion of all aspects of implied covenant law, see generally JOHN BURRITT MCARTHUR, OIL AND GAS IMPLIED COVENANTS FOR THE 21ST CENTURY (2014).

3. *See infra* note 18 for discussion of a "Producer's 88."

4. *See, e.g.*, Culpepper v. EOG Res., Inc., 47,154 (La. App. 2 Cir. 5/16/12), 92 So. 3d 1141, 1142 (using the term "Bath lease" to describe the "standard" gas lease at issue in the case); *see also* Dickson v. Sklarco L.L.C., No. 5:11-CV-00352, 2013 WL 1828051, at *6 (W.D. La. Apr. 29, 2013) (calling the lease in question a "Bath form").

hubs, and other factors, gas has not been sold "at the well" for decades; therefore, when the lease contains the traditional bifurcated clause, the market value at the well provision likely governs the lessee's gas royalty obligation.[5]

In disputes between lessors and their lessees over the meaning of the "market value at the well" phrase, courts have reached different interpretations. In general, states fall into one of two camps.[6] Some jurisdictions, known as "marketable product rule" states, rely on the implied covenant to market.[7] In those states, the producer—not the lessor—bears the burden of paying "post-production costs."[8] These costs include those incurred to enhance the gas after it has been produced at the well, such as transportation, compression, dehydration, and processing costs.[9] In other jurisdictions, including the two this Article focuses on, Texas and Louisiana, courts have held that lessors bear their proportionate share of these costs.[10] These states sanction a "work-back" or "reconstruction approach" that allows producers to deduct post-production costs in determining the market value at the well of the gas.[11]

To avoid the Texas/Louisiana view of the "market value at the well" phrase, some lessors, particularly those with bargaining power during the shale-play booms, included express no-deductions clauses.[12] Drafting an

5. Patricia Proctor et al., *Moving Through the Rocky Legal Terrain to Find a 'Safe' Royalty Clause or a 'New' Market at the Well*, 19 TEX. WESLEYAN L. REV. 145, 147 (2012); *see* John S. Lowe, *Defining the Royalty Obligation*, 49 SMU L. REV. 223, 223–24 (1996) (describing how restructuring of the natural gas markets in the 1980s and 1990s "has fundamentally changed the way the natural gas industry conducts business"). Professor Anderson explains in detail that the depletion allowance played a significant role in downstream sales and ultimately the post-production cost issue. Anderson, *Part I*, *supra* note 2, at 561–66.

6. *See infra* note 84 and accompanying text.

7. Rachel M. Kirk, Comment, *Variations in the Marketable-Product Rule from State to State*, 60 OKLA. L. REV. 769, 774 (2007).

8. *Id.*

9. *See* Rogers v. Westerman Farm Co., 29 P.3d 887, 900 (Colo. 2001) (discussing the costs required to make gasoline marketable).

10. *See infra* note 89 and accompanying text.

11. *See* Heritage Res., Inc. v. NationsBank, 939 S.W.2d 118, 129 (Tex. 1996) (discussing the work-back method in Texas, and noting Louisiana uses the same "reconstruction" approach); Piney Woods Country Life Sch. v. Shell Oil Co., 726 F.2d 225, 238–39 (5th Cir. 1984) (describing the work-back method as appropriate to determine market value at well); Dickson v. Sklarco L.L.C., No. 5:11-CV-00352, 2013 WL 1828051, at *5 (W.D. La. Apr. 29, 2013) (noting "Louisiana law applies a 'reconstruction approach' to determine market value of gas, beginning with the gross proceeds of the sale of gas and then deducting any additional costs of taking the gas from the wellhead (the point of production) to point of sale").

12. For example, the *Hyder* lease discussed in this Article "involved a specifically negotiated, heavily tailored lease." Max B. Baker, *Texas High Court Rules for Hyders in Chesapeake Royalty Case*, STAR-TELEGRAM (June 12, 2015, 1:04 PM), http://www.star-telegram.com/news/business/barnett-

effective "no deductions" clause in Texas, however, has proved difficult in light of a 1996 Texas Supreme Court case, *Heritage Resources, Inc. v. NationsBank*.[13] But in a more recent opinion from that state's high court, *Chesapeake Exploration LLC v. Hyder*,[14] the court held the lessor had successfully drafted a no deductions clause.[15]

This Article discusses *Heritage Resources*, *Hyder*, and Louisiana cases addressing the "post-production costs" issue. To better understand that issue, this Article first provides a background on the interaction of express lease clauses and the doctrine of implied covenants. This discussion reveals that courts frequently view express or "plain" terms as barring implied covenants. The problem then, as commentators have noted—particularly regarding interpretations of the gas royalty clause—is that "plain terms" are not always so plain. Instead, different judges in the same state reach different interpretations of the same clause when applying accepted rules of document interpretation. Because of that fact, document interpretation determines the fate of implied covenants and express clauses. Because of the unpredictability inherent in the document interpretation process, and the recent dramatic drop in oil and gas prices,[16] this Article urges landowners and producers to avoid the courthouse and opt for the bargaining table, where negotiating and mediating procedures provide more efficient resolutions to disputes over the meaning of express lease clauses in the shale era.

II. BACKGROUND: THE INTERACTION OF IMPLIED COVENANTS AND EXPRESS LEASE CLAUSES

The law of implied covenants has played a distinctive role in oil and gas jurisprudence and practice. Writing in 1933, the respected oil and gas law scholar A.W. Walker observed that "[t]he law is well settled today that the

shale/article23859922.html; Austin Brister & Jonathan Baughman, *Lessor-Lessee Relations After Shale's Honeymoon Period*, LAW360 (Sept. 25, 2015, 10:44 AM EDT), https://www.law360.com/texas/articles/704637/lessor-lessee-relations-after-shale-s-honeymoon-period (describing shale era "land grab" when "lessors negotiated from a position of strength, demanding the inclusion of complicated clauses"); *see also* Keith B. Hall, *The Continuing Role of Implied Covenants in Developing Leased Lands*, 49 WASHBURN L.J. 313, 342 (2010) (noting that, while in Louisiana many leases are still based on standard forms, "it is not uncommon for prospective lessors, including persons unsophisticated in oil and gas matters, to retain counsel and bargain for lessor-favorable provisions").

13. Heritage Res., Inc. v. NationsBank, 939 S.W.2d 118 (Tex. 1996).

14. Chesapeake Expl., L.L.C. v. Hyder, 483 S.W.3d 870 (Tex. 2016).

15. *See id.* at 876 ("Here, the lease text clearly frees the gas royalty of postproduction costs, and reasonably interpreted, we conclude, does the same for the overriding royalty.").

16. Brister & Baughman, *supra* note 12 (describing effect of "oil Bust of 2015" on oil and gas lease litigation).

lessee in any oil and gas lease assumes a number of implied obligations to the lessor with reference to the operation and development of the leasehold premises, in the absence of express provisions relieving the lessee of these obligations."[17] At that time, as Walker noted, lease forms—often labeled a "Producer's 88"[18]—were prepared by lessees and lacked express clauses to protect a lessor's retained royalty interest.[19] For that reason, courts were "quick to conclude that the lessee has the obligation to perform certain unstated obligations."[20] Courts adopted these "unstated obligations," or implied covenants, in opinions resolving common disputes between lessors and their lessees, including claims that lessees had failed "to properly develop, protect from drainage, or market production from their leases.[21] Although differing lists exist of these separate implied covenants, all share one standard in common: the lessee must act as a "reasonably prudent operator under the same or similar facts and circumstances."[22] Texas and

17. A.W. Walker, Jr., *The Nature of the Property Interests Created by an Oil and Gas Lease in Texas (Pt. VIII)*, 11 TEX. L. REV. 399, 401 (1933). Although Texas has produced most of the case law, courts from other states and even the United States Supreme Court have contributed to the common law development of the doctrine of implied covenants in oil and gas leases. *See, e.g.*, Sauder v. Mid-Continent Petroleum Corp., 292 U.S. 272, 281 (1934) (regarding implied covenant to develop, the Court held "[t]he production of oil on a small portion of the leased tract cannot justify the lessee's holding the balance indefinitely and depriving the lessor, not only of the expected royalty from production pursuant to the lease, but of the privilege of making some other arrangement for availing himself of the mineral content of the land").

18. While these forms contain many typical clauses, one version can vary substantially from another; therefore, the Producer's 88 label does not suggest a "standard" lease form. These variations caused an early Texas court to determine that the caption Producers 88 was "incapable of definite applications." Fagg v. Texas Co., 57 S.W.2d 87, 89 (Tex. Comm'n App. 1933, judgm't affirmed). For a description of the history behind the Producers 88 form, see generally Leslie Moses, *The Evolution and Development of the Oil and Gas Lease*, 2 INST. ON OIL & GAS TAX'N 1, 27 (1951) or A.W. Walker, Jr., *Defects and Ambiguities in Oil and Gas Leases*, 28 TEX. L. REV. 895 (1950). For purposes of analysis, this Article uses the Producer's 88 label when a traditional pro-lessee form applies.

19. Walker, *supra* note 17, at 401.

20. JOHN S. LOWE, OWEN L. ANDERSON, ERNEST E. SMITH, DAVID E. PIERCE & CHRISTOPHER S. KULANDER, CASES AND MATERIALS ON OIL AND GAS LAW 315 (6th ed. 2013).

21. Amoco Prod. Co. v. Alexander, 622 S.W.2d 563, 566–68 (Tex. 1981).

22. *Id.* at 567–68. The following reflects a practical categorization of implied covenants recognized in Texas: (1) the duty to develop the leased acreage; (2) the duty to protect the leasehold from drainage; (3) the duty to market the production; and (4) the duty to diligently and properly operate the leasehold. *Id.* at 567. Although generally treated separately, courts have also imposed a duty of good faith pooling on lessees to reign in the broad discretion accorded them by lease pooling clauses, which is also governed by the reasonably prudent operator standard. *See* Amoco Prod. Co. v. Underwood, 558 S.W.2d 509, 512–13 (Tex. App.—Eastland 1977, writ ref'd) ("The jury could have properly concluded from the evidence and inferences . . . that the configuration of the unit was not established in good faith . . . ."). While the reasonably prudent operator standard in Texas is considered an objective standard, Pennsylvania applies a more subjective approach and has focused on a particular lessee's good faith judgment. *See* T.W. Phillips Gas & Oil Co. v. Jedlicka, 42 A.3d 261, 276–78 (Pa. 2012) (employing a subjective standard to review paying quantities under a lease and considering the

Louisiana have adopted this view of the lessee's duty, eschewing a fiduciary standard; although, as a civil law state with a mineral code, Louisiana has codified the duty.[23]

A. *The Basis for Implying Covenants in the Oil and Gas Lease: A Debate Without a Difference?*

Walker's summary incorporates the "in fact" basis for implying covenants.[24] As he noted, under that basis, the parties' intent expressed in the lease itself controls; therefore, courts should imply covenants only in the "absence of express covenants."[25] If express covenants appear, a court's next step is to determine whether their "plain meaning" preempts implied covenants.[26] For that reason, document interpretation becomes the gatekeeper for implying covenants. On the contrary, an "at law" or policy approach may free a court from the express terms that historically may have benefited the producer.[27] However, as scholars have noted, courts' allegiance to one basis or another is frequently difficult to discern or might

lessee's good faith in continuing to operate the well based on those paying quantities); *see also* George A. Bibikos, *A Review of the Implied Covenant of Development in the Shale Gas Era*, 115 W. VA. L. REV. 949, 958 (2013) (revisiting general principles with respect to implied duties of the lessor and calling attention to the differences between reasonably prudent operator states and subjective, good faith states).

23. LA. REV. STAT. § 31:122 (2006); Frey v. Amoco Prod. Co., 603 So.2d 166, 174 (La. 1992) ("In Louisiana, the implied covenants originate . . . [from the Civil Code's] mandate that the lessee enjoy the thing leased as 'a good administrator.' . . . The duty to act as a 'reasonably prudent operator,' imposed on the mineral lessee by Article 122 of the [m]ineral [c]ode, is thus an adaptation of the obligation of other lessees to act as 'good administrators.'"). Despite being a civil law jurisdiction, as scholars have noted in an article comparing the laws of Texas and Louisiana in the oil patch, there are many areas where the two states "are not terribly different." Patrick H. Martin & J. Lanier Yeates, *Louisiana and Texas Oil & Gas Law: An Overview of the Differences*, 52 LA. L. REV. 769, 769 (1992).

As discussed in this Article, the two states have joined the same camp regarding the allocation of post- production costs. Other issues in which Louisiana's implied covenant law may vary from that of Texas, such as its recognition of an implied covenant to restore the surface and an implied covenant to further explore, are beyond the scope of this Article. For a discussion of those issues, see Hall, *supra* note 11, at 314–15 (shedding light on the evolution, variety, and state-to-state differences in oil and gas lease implied covenants).

24. Walker, *supra* note 17, at 404.

25. *Id.* at 401. For a discussion of general debate among scholars about the basis for implying covenants, see MAURICE H. MERRILL, THE LAW RELATING TO COVENANTS IMPLIED IN OIL AND GAS LEASES 15–19 (2d ed. 1940) (providing a careful exposition of the arguments surrounding the validity of implied covenants in oil and gas leases).

26. Lowe, *supra* note 5, at 236.

27. *See* Rogers v. Westerman Farm Co., 29 P.3d 887, 902 (Colo. 2001) (highlighting the disparity in the relationship between lessors and lessees); *see also* ConocoPhillips Co. v. Lyons, 299 P.3d 844, 860 (N.M. 2012) (noting an implied covenant at law "has its origins not in the parties' agreement, but rather in law"); Davis v. Devon Energy Corp., 218 P.3d 75, 86 (N.M. 2009) (enforcing the policy that covenants implied in law or equity apply regardless of terms of document).

even be fiction.[28]

B. *The Influence of Implied Covenants on Lease Drafting*

Regardless of the exact bases for implying covenants, in addition to affecting lawsuits between lessors and lessees, courts' early recognition of implied covenants influenced lease drafting. Historically, because lessors typically lacked bargaining power, lessees easily inserted clauses intended to avoid implied duties. For example, the purpose of the delay rental clause, which became a standard feature of Producer's 88 and other lease forms, was to preempt an implied covenant to drill an initial well.[29] Regarding the implied covenant to develop, a lease in a 1938 case, *Cowden v. Broderick & Calvert, Inc.*,[30] provided that the "'lessor agrees that all other development shall be at the *discretion* of the lessee.'"[31] Other common clauses in older leases designed to pre-empt implied covenants expressly stated that the lessee's duty to drill an offset well to protect from drainage arose only when a well was drilled within a specified distance from the lease premises.[32]

1. The "Shale Era" Lease: Modern Technologies and Updated Forms

Although older forms may still control when they have been maintained by production,[33] modern-day leases bear little resemblance to a Producer's 88. One example is the fractional share of the landowner's royalty. Because the fraction 1/8th was standard for decades, courts have taken judicial notice

28. *See* Patrick H. Martin, *Implied Covenants in Oil and Gas Leases—Past, Present & Future*, 33 WASHBURN L.J. 639, 640 (1994) ("While some have contended that implied covenants are implied in fact, candor requires us to acknowledge that implied covenants are judicial creations, just as we are all now legal realists who will admit that courts often make law rather than merely find it."); *see also* Hall, *supra* note 12, at 15 (describing varying bases for implying covenants, including Louisiana's reliance on "particularized expressions of Louisiana Civil Code article 2710's requirement that a lessee use the 'thing leased as a good administrator'").

29. Jacqueline Lang Weaver, *When Express Clauses Bar Implied Covenants, Especially in Natural Gas Marketing Scenarios*, 37 NAT. RESOURCES J. 491, 503 (1997) (explaining that a delay rental clause expressly bars the implied covenant to drill an initial well).

30. Cowden v. Broderick & Calvert, Inc., 114 S.W.2d 1166 (Tex. 1938).

31. *Id.* at 1168 (emphasis added).

32. *See* Gulf Prod. Co. v. Kishi, 103 S.W.2d 965, 968 (Tex. 1937) (holding that because the lease contained an express provision requiring the lessee to drill twelve wells on a 150-acre tract, the implied covenant to develop did not apply). *But see* Sinclair Oil & Gas Co. v. Masterson, 271 F.2d 310, 322–24 (5th Cir. 1959) (allowing the implied covenant to develop claim despite an express provision requiring the lessee to drill six wells).

33. Jeffrey C. King, *Selected Re-Emerging and Emerging Trends in Oil and Gas Law as A Result of Production From Shale Formations*, 18 TEX. WESLEYAN L. REV. 1, 8 (2011). In Texas, "held by production" means the lease will be held "so long as that lease has a well that is producing in paying quantities." *Id.* at 9. For a discussion of "paying quantities" in Texas, see Clifton v. Koontz, 325 S.W.2d 684, 689 (Tex. 1959).

of that fact.[34] Eventually, 1/8th disappeared and landmen now routinely insert higher fractions—often 1/4th—in forms they initially slide across landowners' kitchen tables.[35] Regarding older 1/8th leases, lessors often ask for a higher royalty when negotiating with their lessees about other issues, such as potential lease termination or, particularly in Texas, pooling.[36] While the increased size of the landowner's royalty has led to disputes over the lessee's express royalty obligation,[37] other express pro-landowner clauses raise questions about the continued livelihood of implied covenants. Modern leases, drafted in response to court decisions interpreting older forms, include extensive and detailed provisions covering every aspect of the producer's drilling, producing, protection, marketing, pooling and royalty-payment duties, including extensive no "post-

34. *See* KCM Financial LLC v. Bradshaw, 457 S.W.3d 70, 76 (Tex. 2015) (recognizing 1/8th royalty was the standard); *see also* Laura H. Burney, *Oil, Gas, and Mineral Titles: Resolving Perennial Problems in the Shale Era,* 62 U. KAN. L. REV. 97, 114 (2013) (describing the effect of once-common 1/8th royalty on deed drafting and noting courts have taken judicial notice of the fact).

35. *Id.* at 115–16 (noting 1/8th is no longer the standard and describing the effect of higher lease royalties on deed litigation). "Landmen" work independently or for producers and are responsible for determining title to ensure leases are secured from an owner of some fraction of the minerals under a prospect. *See* Laura H. Burney, *Oil, Gas & Mineral Conveyances*, Paper Delivered at Rocky Mountain Mineral Law Foundations Annual Short Course (providing background on the role of landmen in the title perfection process); Terry E. Hogwood, *The Myth of the Cured Title Opinion*, 49 ROCKY MTN. MIN. L. FND. J. 345, 345 (2012) (describing the steps landmen and title attorneys take regarding mineral titles).

36. *See* Michael McElroy, *Production Allocation: Looking for a Basis for Discrimination*, OIL, GAS & ENERGY RES. L. SEC. B. TEX., Spring 2014, at 47 (arguing "[l]essors and their lawyers see horizontal drilling and production allocation as opportunities" to amend old leases by obtaining higher lease royalty). Mr. McElroy's paper addresses a current and controversial practice the railroad commission of Texas has adopted for granting lessees permission to form units for horizontal wells even when leases on certain tracts lack pooling power. For a discussion of this topic, which is beyond the scope of this Article, see Clifton Squibb, *The Age of Allocation: The End of Pooling as We Know It?*, 45 TEX. TECH. L. REV. 929, 931–34 (2013) (discussing "allocation wells" in general and the *Klotzman* case, where lessors asked for higher lease royalty in exchange for agreeing to the lessee's drilling of the horizontal well). This issue permeates in Texas, and not in other jurisdictions, because Texas lacks a comprehensive compulsory pooling act. *See generally* PATRICK H. MARTIN & BRUCE M. KRAMER, WILLIAMS & MEYERS OIL AND GAS LAW § 900 (2015) (describing pooling and unitization and the effects of those rules on different states).

37. The rise in the once-customary landowner's royalty from 1/8th to higher shares has led to extensive deed interpretations suits, particularly over whether a deed creates a fixed or a floating non-participating royalty. *See* Burney, *supra* note 34*,* at 115–16 (describing how recent litigation involving double and restated fractions hinges on if a "created a 'fixed' or an 'of' royalty interest."). For an early lease with an unusually large landowner's royalty, see Exxon Corp. v. Emerald Oil & Gas Co., 348 S.W.3d 194, 199 (Tex. 2009) (resolving a dispute over a 1950s lease that "included an atypical fifty percent royalty obligation and a stringent disclosure clause").

production deductions" provisions.[38]

C. *The Effect of Express Lease Clauses: The Death of Implied Covenants?*

Long before the Shale Boom and its recent decline[39] scholars contemplated this question. Writing in 1997, Professor Jacqueline Weaver invoked the famous anecdote about Mark Twain's untimely death and questioned if such reports regarding implied covenants were also exaggerated.[40] In particular, Professor Weaver focused on the role of express lease clauses in barring implied covenants. As noted above, theoretically, a jurisdiction's view about the basis for implying covenants determines whether they survive when express provisions also appear. If covenants are implied to promote equity or policy, often labeled the "at law" view, those considerations co-exist with or even trump express pro-producer clauses.[41] If covenants are "implied in fact," however, express terms may restrict or negate covenants. For example, in her 1997 article Professor Weaver noted that the implied covenant to protect against drainage may be "gutted by the lessee's routine insertion of an express offset clause that weakens the lessor's protection while slyly suggesting that the

38. *See* discussion of *Hyder* Part VI. Most state leases, including those in Texas and Louisiana, contain extensive pro-lessor provisions. *See* McArthur, *supra* note 2, at 276–78 (describing state leases and noting that "[s]tate leases bar deductions even in the most core no-deductions jurisdictions of Texas and Louisiana"). For an older pro-lessor lease, see *Emerald Oil & Gas Co.,* 348 S.W.3d at 199 (describing a 1950s lease which "included an atypical fifty percent royalty obligation and a stringent disclosure clause"). For an article urging courts to find approaches to avoid pro-lessor provisions in the shale era, see Jason Newman & Louis E. Layrisson, III, *Offset Clauses in a World Without Drainage*, 9 TEX. J. OIL GAS & ENERGY L. 1, 31–32 (2013–2014) (arguing courts should use the reasonably prudent operator standard to avoid "deemed drainage" provisions with horizontal wells). For a recent case interpreting a deemed drainage clause see Adams v. Murphy Expl. & Prod. Co., 497 S.W. 3d 510, 517 (Tex. App.—San Antonio 2016, pet. filed) (holding horizontal well was not offset well, meaning producer owed lessor compensatory royalty).

39. *See* Christian Berthelsen, *U.S. Oil Prices Fall to Six-Year Low*, WALL ST. J. (Aug. 13, 2015, 3:25 PM), http://www.wsj.com/articles/crude-oil-futures-mixed-in-asian-trade-1439430615 (describing the drop in American oil prices); Bradley Olson & Dan Murtaugh, *The Shale Boom Has Already Gone Bust—At Least for Now*, BLOOMBERG BUS. (May 3, 2015, 6:01 PM), https://www.bloomberg.com/news/articles/2015-05-03/the-shale-boom-has-already-gone-bust-at-least-for-now (reporting a fall in U.S. crude oil production); Asjylyn Loder, Donal Griffin & Jodi Xu Klein, *Biggest Wave Yet of U.S. Oil Defaults Looms as Bust Intensifies,* BLOOMBERG BUS. (Feb. 24, 2016, 8:15 PM), https://www.bloomberg.com/news/articles/2016-02-25/biggest-wave-yet-of-u-s-oil-defaults-looms-as-bust-intensifies (detailing "the U.S. oil bust").

40. Weaver, *supra* note 29, at 491.

41. "Implied covenants are of two types: those implied in fact and those implied in law. Covenants will be implied in fact where necessary to give effect the actual intentions of the parties as reflected by the contract . . . . Covenants are implied in law to promote fair dealing . . . ." Walker, *supra* note 17, at 402.

lessee has promised the lessor a benefit."[42] Yet courts' interpretations of that and other pro-lessee clauses often fared well for lessors. For example, in *Cowden*, where the lease gave the lessee "discretion" regarding development, the court reigned in that broad term by defining it as not permitting "uncontrolled will" or "inconsiderate action."[43] In fact, in her 1997 article Professor Weaver summarized Texas's approach as showing a "reluctance to allow express language to bar implied covenants."[44]

III. DOCUMENT INTERPRETATION AS THE GATEKEEPER FOR ENFORCING EXPRESS COVENANTS AND NEGATING IMPLIED COVENANTS

A. *The Texas Retreat from Implying Covenants*

Unfortunately for Texas landowners, Professor Weaver's conclusion that Texas courts are "reluctant" to allow express terms to bar implied covenants benefitting lessors is no longer accurate. Instead, recent cases have interpreted the oil and gas lease through a pro-producer lens.[45] For example, the Texas court has retreated from a pro-lessor approach to implying covenants on display in the seminal case of *Amoco Production Co. v. Alexander*,[46] which involved the implied covenant to protect from drainage. In that case the Texas Supreme Court determined that the covenant was not limited to local drainage as the producer had claimed, and held producers should take affirmative steps to satisfy the "reasonably prudent operator" standard.[47] However, in the 1997 case *HECI Exploration Co. v. Neel*,[48] the

42. Weaver, *supra* note 29, at 491.

43. *See id.* at 501 (describing other cases in which courts determined that express pro-lessee clauses did not bar implied covenants protecting lessors). Professor Weaver provides another example in which the court determined it "would do violence to what all parties plainly intended should we interpret this lease in such a manner as to absolve the lessee from the duty of reasonable development." *Id.* at 512 (discussing *W.T. Waggoner Estate v. Sigler Oil Co.*, 19 S.W.2d 27 (Tex. 1929)). For a recent case adopting this approach, see Hupp v. Beck Energy Corp., 2014-Ohio-4255, 20 N.E.3d 732, 752 (holding the phrase "are produced or are capable of being produced" in the judgment of the lessee does not permit the lease to continue in perpetuity at the lessee's sole discretion).

44. Weaver, *supra* note 29, at 542.

45. *See, e.g.*, HECI Expl. Co. v. Neel, 982 S.W.2d 881 (Tex. 1998) (finding no implied duty for a producer to notify a lessor of its intent to sue a neighboring operator and declining to apply discovery rule to another possible implied covenant cause of action based on a duty to notify of royalty owner's need to sue). For a criticism of the *HECI* decision, see Burney, *supra* note 34, at 158–61 (comparing *HECI v. Neel* with *Lesley v. Veteran's Land Board,* where court applied the discovery rule to a deed reformation cause of action).

46. Amoco Prod. Co. v. Alexander, 622 S.W.2d 563 (Tex. 1981).

47. *Id.* at 568–69 (describing affirmative steps a producer could take to satisfy duty, including seeking a spacing exception).

48. HECI Expl. Co. v. Neel, 982 S.W.2d 881 (Tex. 1998).

court contradicted *Alexander* and opined that it "has not lightly implied covenants" in the oil and gas lease.[49]

In *HECI*, the court determined that express terms prohibited it from implying a covenant requiring the producer to provide its lessor with notice about its intent to sue a neighboring operator for damaging the reservoir.[50] The court also declined to address another implied covenant, whether the lessee owed a duty to notify the lessor about the need to sue.[51] The court found no need to address that covenant, holding it would be barred by the statute of limitations. In reaching that conclusion, the court held the discovery rule did not apply because royalty owners must take affirmative steps to protect their interests and acquire knowledge about possible causes of action.[52] Commentators and judges have criticized *HECI* for unfairly burdening lessors with duties to protect their interests while absolving producers of simple duties to share information and protect their lessors.[53] *HECI* and other cases discussed in this Article demonstrate that, while the rules of document interpretation are designed to ascertain the intent of the parties, policy preferences often color that search.[54]

49. *Id.* at 888.

50. *Id.* at 891. The court determined that an implied duty to give notice of *intent to sue* was not "the type of agreement that was so clearly in the parties' contemplation that they thought it unnecessary to express." *Id.* Nor was it "necessary to infer such a covenant in order to effectuate the full purpose of the contract as a whole as gathered from the written instrument." *Id.* at 888.

51. *Id.* at 890–91.

52. *Id.* at 886.

53. Burney, *supra* note 34, at 160–61 (criticizing *HECI* and quoting a Texas appellate court justice's view that *HECI* unfairly and severely burdens lessors (citation omitted)). A recent Texas Supreme Court decision provides some relief to HECI's strict view of the discovery rule. Hooks v. Samson Lone Star Ltd., 457 S.W. 3d 52, 70 (Tex. 2015) (holding royalty owners are entitled to the discovery rule when a producer filed false a document with the railroad commission).

Louisiana has not adopted the burdensome approach to the statute of limitations as applied to suits for royalty underpayments. For a discussion of that issue, see McArthur, *supra* note 2, at 352 (commenting on the Louisiana Supreme Court's adoption of a "reasonable approach to disclosure and a discovery rule in a failure-to-pay royalties case" (citing Wells v. Zadeck, 2011-1232, p. 3 (La. 3/30/12)); 89 So.3d 1145, 1155. Mr. McArthur discusses *HECI* and other recent Texas Supreme Court cases that have restricted lessors' ability to prevail in royalty underpayment cases, and opines:

> The Texas Standard encourages lessees to lie about their performance and then hope that the Texas two-year tort statute and four-year contract statute of limitations will run before the lessor finds out. This exploitive relationship is not the one upon which the oil industry has been built in the United States.

Id. at 360.

54. *See* Laura H. Burney, *The Regrettable Rebirth of the Two-Grant Doctrine in Texas Deed Construction*, 34 S. TEX. L. REV. 73, 76, 80 n.35 (1993) (describing courts' approach to interpreting documents to ascertain the parties' intent, but noting courts enforce policy preferences through the "guise" of interpretation); *see generally* Bruce Kramer, *The Sisyphean Task of Interpreting Mineral Deeds and Leases: An*

B. *Louisiana and Texas: The Implied Covenant to Market and Market Value at the Well*

In Louisiana, the mineral code and court decisions continue to embrace the general *Amoco v. Alexander* view toward implying covenants, rather than the restrictive *HECI* approach.[55] However, as discussed below, Louisiana, like Texas, has limited the application of the implied covenant to market when the market value at the well gas royalty provision controls the producer's royalty obligation. Although the Louisiana Supreme Court has yet to expressly align the state with Texas's view on that phrase, as discussed below, lower court decisions suggest that result is inevitable and courts and commentators consistently place Louisiana in the Texas camp.[56] To better understand those decisions, the next section reviews the key market value at the well cases. These cases demonstrate, once again, that a court's interpretation of an express clause determines the fate of an implied covenant, particularly the implied covenant to market. In fact, as Professor John Lowe has concluded, "[l]itigation over the oil and gas lease royalty obligation shows the judicial construction process at its worst."[57]

Encyclopedia of Canons of Construction, 24 TEX. TECH. L. REV. 1 (1993) (providing an encyclopedia of mineral lease canons of construction). In *Heritage Resources, Inc.*, discussed *infra* Section VI, the Texas Supreme Court set forth the document interpretation process as follows:

> The question of whether a contract is ambiguous is one of law for the court. A contract is ambiguous when its meaning is uncertain and doubtful or is reasonably susceptible to more than one interpretation. In construing an unambiguous oil and gas lease our task is to ascertain the parties' intentions as expressed in the lease. To achieve this goal, we examine the entire document and consider each part with every other part so that the effect and meaning of one part on any other part may be determined. We presume that the parties to a contract intend every clause to have some effect. We give terms their plain, ordinary, and generally accepted meaning unless the instrument shows that the parties used them in a technical or different sense. This Court will enforce the unambiguous document as written.

Heritage Res., Inc. v. NationsBank, 939 S.W.2d 118, 121 (Tex. 1996) (citations omitted).

55. McArthur, *supra* note 2, at 192 n.101 (discussing the fact that *Amoco v. Alexander* reached the same conclusion as Louisiana decisions, including *Williams v. Humble Oil & Ref. Co.*, and that the comments to the Louisiana Mineral Code cite *Williams* with approval). However, Louisiana has retreated from implying a covenant that Texas never recognized: the implied covenant to restore the surface. *See* Hall, *supra* note 12, at 341–42 (discussing the Louisiana Supreme Court's 2005 opinion in *Terrebonne Parish Sch. Board v. Castex Energy* and observing it held "that there is no implied duty to restore the surface" and that "a contrary holding would impose duties on the lessee which the parties had not contemplated and for which they had not bargained" (citation omitted)). Texas expressly rejected an implied covenant to restore the surface in *Warren Petroleum Corp. v. Monzingo*. 304 S.W.2d 362, 362–63 (Tex. 1957).

56. *See, e.g.,* Kirk, *supra* note 7, at 788 ("One line of cases, stemming from Texas and Louisiana, follow the rule that nonoperating interests (royalty and overriding royalty owners) must bear their proportionate share of costs that are incurred after gas is severed at the wellhead.").

57. Lowe, *supra* note 5, at 232.

IV. GAS ROYALTY CLAUSE INTERPRETATIONS AND THE FATE OF THE IMPLIED COVENANT TO MARKET

A. *Market Value Litigation Results in Plain Meaning and Cooperative Venture Approaches: Texas and Louisiana Part Ways*

Litigation over the meaning of "market value" ultimately produced two views of that phrase. A majority of jurisdictions adopted a "plain meaning" approach to the meaning of "market value."[58] For example, in the 1968 *Texas Oil & Gas Corp. v. Vela*[59] decision, lessees urged courts to consider marketing realities and their good faith efforts as reasonably prudent operators in signing long-term gas contracts with lower prices than those "market values" prevailing when lessors sued claiming their royalties had been underpaid.[60] A minority of jurisdictions, including Louisiana, adopted the pro-producer view, one rejected in *Vela,* which became known as the "cooperative venture" view.[61]

In *Henry v. Ballard & Cordell Corp.*,[62] the Louisiana court viewed "market value" as ambiguous, rejecting *Vela's* "plain meaning" view of the phrase.[63] Quoting extensively from Professor Thomas Harrell, the Louisiana Supreme Court viewed the lease as a cooperative venture in which the lessor and lessee each contribute to the development of the oil and gas for the parties' mutual benefit.[64] While the implied covenant to market failed to influence the Texas court in *Vela*, the Louisiana Supreme Court viewed that covenant as the basis for the cooperative venture status of the lease:

> [A]ny determination of the market value of gas which admits the lessee's arrangements to market were prudently arrived at consistent with the lessee's obligation, but which at the same time permits either the lessor or lessee to receive a part of the gross revenues from the property greater than the

58. *See, e.g.*, Tex. Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 871 (Tex. 1968) ("[I]n plain terms [] the lessee would pay one-eighth of the market price at the well of all gas sold or used off the premises. This clearly means the prevailing market price at the time of the sale or use.").

59. Tex. Oil & Gas Corp. v. Vela, 429 S.W.2d 866 (Tex. 1968)

60. *Id.* at 871.

61. Lowe, *supra* note 5, at 264–65 (defining jurisdictions either as plain terms jurisdictions or cooperative venture jurisdictions depending on their interpretations of standard gas royalty clauses). States in the majority rule include Texas, Kansas, Montana, North Dakota, Mississippi, and West Virginia. *Id.* at 223. Louisiana, Oklahoma, and Arkansas are the only states that treat oil and gas leases as a cooperative venture. *Id.* at 254 n.208.

62. Henry v. Ballard & Cordell Corp., 418 So.2d 1334 (La. 1982).

63. *Id.* at 1340 ("The custom of the industry may also be considered in determining the true intent of the parties as to ambiguous provisions.").

64. *Id.* at 1338.

> fractional division contemplated by the lease, should be considered inherently contrary to the basic nature of the lease and be sustained only in the *clearest of cases*.[65]

In *Henry*, the Louisiana Supreme Court held the phrase "market value" was not sufficiently clear or plain to require the producers to base gas royalty payments on amounts greater than those they were receiving under the terms of their long-term gas contracts.[66]

Unlike Louisiana, in *Vela*, the Texas Supreme Court viewed the plain meaning of market value as the value of the gas on the day it was produced, regardless of the price producers were receiving under their long-term contracts; that interpretation required lessees to base royalties on amounts higher than they were receiving for sale of the gas.[67] Because Texas courts remained true to *Vela's* plain meaning view of the market value provision, when market realities later reversed to favor producers, lessors suffered the consequences. Specifically, in *Yzaguirre v. KCS Resources, Inc.*,[68] the court ruled that the lessee could base royalties on lower "market values" even though it was receiving higher prices for the gas under its contract.[69] In reaching that conclusion, the court rejected the lessor's claims that the implied covenant to market co-existed with the market value at the well standard.[70] Recognizing that the implied covenant to market applies to the amount realized or proceeds gas royalty provision, the court viewed market value at the well as an objective standard that renders the implied duty irrelevant.[71]

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65. *Id.* at 1334 n.10 (emphasis added) (quoting Thomas Harrell, *Developments in Non Regulatory Oil & Gas Law*, 30 INST. ON OIL & GAS L. & TAX'N 311, 335 (1979)).

66. For the argument that *Henry* departed from Louisiana precedent regarding the meaning of "market value," see J. Michael Veron, *In Search of Precedent in the Oil Path: Louisiana's Market Value Cases*, 44 LA. L. REV. 949, 962 (1984) (arguing *Henry* departed from *Wall v. United Gas Public Service Co.* and *Sartor v. United Carbon Co.*).

67. Texas Oil & Gas Corp. v. Vela, 429 S.W. 2d 866, 871 (Tex. 1968) ("It is clear then that the parties knew how to and did provide for royalties . . . based upon market price or market value, and based upon the proceeds derived by the lessee from the sale of gas. They might have agreed that the royalty on gas produced from a gas well would be a fractional part of the amount realized by the lessee from its sale. Instead of doing so, however, they stipulated in plain terms that the lessee would pay one-eighth of the market price at the well of all gas sold or used off the premises. This clearly means the prevailing market price at the time of the sale or use.").

68. Yzaguirre v. KCS Res., Inc., 53 S.W.3d 368 (Tex. 2001).

69. *Id.* at 373–74.

70. *Id.* at 372–74.

71. *Id.* The Texas Supreme Court recently reaffirmed that view in *French v. Occidental Permian, Ltd. See* French v. Occidental Permian Ltd., 440 S.W.3d 1, 8 n.22 (Tex. 2014) (declining to imply a covenant to market from essentially a "market value at the well" provision). Royalty owners had been heartened by an earlier Texas Supreme Court case, *Phillips Petroleum Co. v. Yarbrough*, which involved class-

B. *"Take or Pay" Litigation: Texas and Louisiana Remain in Different Camps*

Texas and Louisiana also followed their respective views regarding another wave of gas royalty clause litigation, the "take or pay" issue which arose as a result of regulatory changes and demand declines. As Professor Lowe explained, "the gas boom became a litigation boom as gas pipelines defaulted on their take-or-pay obligations."[72] When producers and purchasers settled for billions of dollars, royalty owners claimed their royalty clauses covered those sums.[73] In *Frey v. Amoco Production Co.*,[74] the Louisiana Supreme Court invoked the implied covenant to market, the cooperative venture view, and other factors, in holding that the lessor was entitled to share in take-or-pay payments.[75]

1. Louisiana Law and *Cimarex Energy Co. v. Chastant*:[76] Channeling a Texas Approach to a "Take or Pay" Issue

A recent Fifth Circuit case applying Louisiana law, however, found *Frey* "inapplicable" regarding hedging profits. In reaching its conclusion, the court in *Cimarex Energy Co. v. Chastant* rejected the lessor's claim that a different result was required under the "mutual benefit" covenant enshrined in the Louisiana statute requiring the lessee "to develop and operate the property leases . . . for the mutual benefit of himself and his lessor."[77] Instead, the *Chastant* opinion channels a Texas view by concluding that the lease's plain language governed:

> The mineral lease is clear as to how royalties are to be paid. Royalties on oil are to be paid on the "best market price obtainable" for the price received "f.o.b. the leased property," while royalties on gas are to be paid on "the market price at the mouth of the well." That clarity stops a court from

certification of royalty owners' underpayment claims, suggesting it approved of a broad application of the implied covenant to market. Brief for Dick Watts as Amicus Curiae Supporting Petitioner's Motion for Rehearing at 8–9, French v. Occidental Permian LTD, 440 S.W.3d 1 (Tex. 2014) (No. 12-1002). However, the court's opinion in *French*, discussed *infra* at Section VII, appears to have ended those hopes.

72. Lowe, *supra* note 5, at 227 (citations omitted).

73. BRUCE M. KRAMER MADDOX, LIABILITY TO ROYALTY OWNERS FOR PROCEEDS FROM TAKE-OR-PAY AND SETTLEMENT PAYMENTS § 14.01 (1994).

74. Frey v. Amoco Prod. Co., 603 So.2d 166 (La. 1992).

75. *Id.* at 174–76. The court also relied on Louisiana sales law and the fact that "the mineral law of Louisiana evolved not from the common law, but from the Civil Code, richly steeped in our civilian heritage." *Id.* at 182 (citing LA. STAT. ANN. § 31:2 cmt. (1975)).

76. Cimarex Energy Co. v. Chastant, 537 Fed. Appx. 561 (5th Cir. 2013).

77. *Id.* at 564–66 (quoting LA. STAT. ANN. § 31:122 (2016)).

interpreting the agreement beyond its plain language.[78]

The court distinguished *Frey* by noting that unlike take-or-pay settlements, the hedging profits were "supplements to production, not substitutes"; therefore, while take-or-pay payments were covered by the royalty clause lease terms, hedging profits were not.[79]

Chastant's plain meaning approach reflects the approach Texas courts had taken to the take-or-pay issue. For example, in *Killam Oil Co v. Bruni*,[80] a Texas court of appeals held the lessors had no right to share in take-or-pay settlements because "the term 'production'. . . means the actual physical extraction of the mineral from the soil."[81] To share in such take-or-pay benefits, the court of appeals noted that the lessors could have drafted a clause that specifically covered those payments.[82] Indeed, modern leases, particularly state lease forms, contain express clauses entitling the lessor to share in take-or-pay and other benefits generated under the lease.[83] As described below, however, the plain meaning of such pro-lessor lease terms often proves elusive.

V. "MARKET VALUE AT THE WELL": THE "POST-PRODUCTION COST" ISSUE AND THE FATE OF THE IMPLIED COVENANT TO MARKET

A. *The Two Camps: "Plain Meaning" and "Marketable Product Rule" States*

Court opinions addressing disputes over that once-standard market value at the well gas royalty payment provision eventually placed jurisdictions in one of two camps.[84] Some states favor the lessors' view that in addition to

78. *Id.* at 566.

79. *Id.* at 565–66.

80. Killam Oil Co. v. Bruni, 806 S.W.2d 264 (Tex. App.—San Antonio 1991, writ denied).

81. *Id.* at 267 (first citing Gulf Oil Corp. v. Reid, 337 S.W.3d 267 (Tex. 1960); and then citing Rogers v. Osborn, 261 S.W.2d 311 (Tex. 1953)); *see* Lowe, *supra* note 5, at 243 (providing a complete discussion of other cases addressing the take-or-pay issue in Texas and other states).

82. *See Killam Oil Co.*, 806 S.W.2d at 267–68 ("The [t]rust, as drafters of the lease, could have specifically included a provision allowing for royalties to be paid upon proceeds received by Killam and Hurd from settlements of disputes arising from a breach of take-or-pay provisions in gas contracts.").

83. *See* Lowe, *supra* note 5, at 238 n.98 (describing private and state leases broadly covering take-or-pay and other benefits).

84. McArthur, *supra* note 2, at 237 ("A large group of jurisdictions—a group that accounts for far more than half of the nation's oil and gas production—follows a marketable-condition rule that requires the lessee to bear the cost of putting oil and natural gas into a marketable condition."). In a footnote, Mr. McArthur disagrees with commentators who have claimed that the other camp, the Texas view (which requires royalty owners to bear their proportionate share or proportionate costs), is the majority rule. *Id.* at 237 n.72. Mr. McArthur asserts that "[a]t least five major producing states and

bearing the costs of producing the gas, the lessee bears the burden of costs incurred after the gas has been produced—post-production costs—such as gathering, compression, transportation and processing. Colorado exemplifies that camp, which scholars label "the first marketable product" view.[85] Although courts in that camp address the lease language, which is consistent with the plain meaning interpretative approach and an "in-fact" basis for implying covenants, their conclusions reflect an "at-law" or policy basis. Specifically, in *Rogers v. Westerman Farm Co.*,[86] the Colorado Supreme Court viewed the phrase "at the well" as silent regarding the allocation of post-production costs.[87] In light of that silence, the implied covenant to market controlled as well as a pro-lessor policy approach to lease interpretation.[88]

two lesser ones recognize, one way or another, a marketable-condition doctrine: Colorado, Kansas, Oklahoma, and West Virginia by caselaw, and Wyoming, Michigan, and Nevada by statute. . . . On the other side, Texas and Louisiana among major producers have firmly rejected the marketable-condition rule, North Dakota has shifted to the Texas camp, federal courts have assumed that Mississippi and Kentucky will allow deductions" along with Pennsylvania and likely Montana and Utah. *Id.*; *see also* George A. Bibikos & Jeffrey C. King, *A Primer on Oil and Gas Law in the Marcellus Shale States*, 4 TEX. J. OIL, GAS & ENERGY L. 155, 168–69 (2009) (proclaiming the Texas camp as the majority rule). New Mexico courts have found that under terms of state leases the burden of paying post-production costs had not been shifted to producers, but noted the issue remains to be determined for private leases. ConocoPhillips Co. v. Lyons, 299 P.3d 844, 850–54 (N.M. 2012). In a recent case, a federal judge reached the conclusion that New Mexico most likely will adopt the marketable-condition rule. *See* Anderson Living Trust v. WPX, 27 F. Supp. 3d 1188, 1243 (D.N.M. 2014) (holding there are "serious doubts [as to] whether the Tenth Circuit was correct in proclaiming that New Mexico law does not recognize a marketable condition rule"). The Ohio Supreme Court recently declined to adopt one camp or the other, holding instead that the specific language of each lease controls. Lutz v. Chesapeake Appalachia LLC, No. 2015–0545, 2016 WL 6519011, at *2 (Ohio Nov. 2, 2016). However, a recent Kansas Supreme Court decision has heightened the debate about whether Kansas remains a "marketable product" jurisdiction, and whether that view is the majority or minority view. *See* Fawcett v. Opik, 352 P.3d 1032, 1034 (Kan. 2015) (holding gas was marketable at the well when midstream companies took control of gas at that point under a sales agreement with producer). For contradicting views about the effect of this decision on Kansas law, compare John Burritt McArthur, *Mineral Royalties, Deductions, and* Fawcett v. Opik*: Continuity and Change in the Revised-But-Still-Standing Kansas Marketable-Product Rule*, 64 U. KAN. L. REV. 63 (2015), *with* Daniel M. McClure & Lauren Brogdon*, Kansas Curbs Marketable Product Rule in O&G Royalty Cases,* LAW360 (July 13, 2015 8:45 AM), https://www.law360.com/articles/677727/kansas-curbs-marketable-product-rule-in-o-g-royalty-cases.

85. *See* Rogers v. Westerman Farm Co., 29 P.3d 887, 906 (Colo. 2001) ("[I]n defining marketability under the implied covenant to market, we look to the first-marketable product rule for guidance."); *see also* Garman v. Conoco, Inc., 886 P.2d 652, 659 (Colo. 1994) (holding lessee responsible for costs "necessary to place gas in a condition acceptable for market").

86. Rogers v. Westerman Farm Co., 29 P.3d 887 (Colo. 2001).

87. *Id.* at 896.

88. *See id.* at 896, 906 (recognizing the unequal bargaining power between a lessor and lessee and the need to construe uncertain or ambiguous terms against the lessee); *see generally* Kirk, *supra* note 7, (discussing variations among the "marketable product rule" states).

According to scholars and courts, Louisiana and Texas fall firmly into the second camp.[89] For example, relying on *Vela's* approach to the "market value" portion of the phrase, Texas has interpreted "at the well" as plainly describing the point at which "market value" should be valued. The Texas view was confirmed in the controversial opinion, *Heritage Resources, Inc. v. NationsBank*.[90]

VI. TEXAS: THE ROAD FROM *HERITAGE RESOURCES* TO *HYDER*

Prior to the Texas Supreme Court's recent opinion in *Chesapeake Exploration, L.L.C. v. Hyder*,[91] royalty owners wondered whether it was possible to draft a no deductions clause that Texas courts would enforce.[92] That concern emerged with the 1996 *Heritage Resources* decision, and intensified with recent decisions interpreting no deductions clauses that were arguably designed to avoid *Heritage Resources'* holding.

A. Heritage Resources, Inc. v. NationsBank: *Plain Meaning of "No Deductions" Permits Deductions*

In addition to interpreting a no deductions clause, *Heritage Resources* confirmed Texas's view of market value at the well: that the phrase requires royalty owners to bear their proportionate share of post-production costs.[93]

The drafters of the *Heritage Resources* leases, however, appeared aware of this default rule. In an apparent attempt to draft around it, the royalty clause contained the following no deductions language:

> Lessee shall pay the Lessor 1/4 of the **market value at the well** for all gas (including all substances contained in such gas) produced from the leased premises and sold by Lessee or used off the leased premises, including sulphur produced in conjunction therewith; **provided, however, that there shall be no deductions from the value of Lessor's royalty by reason of any**

89. *See* McArthur, *supra* note 2, at 237 ("Texas and Louisiana . . . . firmly rejected the marketable-condition rule."); *see also* Lansdown, *supra* note 2, at 682 ("A number of major oil producing jurisdictions, including Texas, Louisiana, and California continue to adhere to the rule that royalty is to be calculated at the well."(citations omitted)).

90. *See* Laura H. Burney, *Determining the Legal Ramifications of Express Oil and Gas Lease Provisions: Do the Rules of Document Interpretation Provide Predictability?*, 19 E. MIN. L. INST. 86, 99 (1999) (describing contradictory opinions in *Heritage Resources* appellate and supreme court opinions and noting the supreme court received dozens of amicus curiae briefs asking court to change its decision).

91. Chesapeake Expl., L.L.C. v. Hyder, 483 S.W.3d 870 (Tex. 2016).

92. *See id.* at 876 (validating the enforcement of a no deductions clause when "the lease text clearly frees the gas royalty of post-production costs").

93. *See* Heritage Res., Inc. v. NationsBank, 939 S.W.2d 118, 121–22 (Tex. 1996) (discussing earlier cases that adopted the general rule that royalty is usually subject to post-production costs).

> **required processing, cost of dehydration, compression, transportation, or other matter to market such gas**.[94]

The court of appeals agreed with the lessors and held the default rule had been modified with the "provided, however, . . . no deductions" phrase.[95] In an opinion written by Justice Priscilla Owen, which became the court's plurality, the Texas Supreme Court disagreed.[96] In reaching that conclusion, the court followed the precise terms in the lease with this syllogism: First, the no-deductions provision applies to "the value of the Lessor's royalty."[97] That value is expressed as the market value at the well.[98] And because the market value at the well standard permits the deduction of post-production costs, it follows there have been no deductions from that value.[99] Having parsed the plain meaning of the clause with this syllogism, the court also proclaimed that the no deductions language "was surplusage as a matter of law."[100]

Demonstrating again that plain terms are never plain, a dissenting opinion in *Heritage Resources* proclaimed that the no deductions clause could not have been more clear, concluding that the clause unambiguously prohibited the deduction of post-production costs in plain English.[101] The dissent also

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94. *Id.* at 121 (emphasis added). The case addressed more than one lease, but the court determined that all could be interpreted the same based on the market value at the well provisions and the same no deductions clause. *Id.*

95. *See* Heritage Res., Inc. v. NationsBank, 895 S.W.2d 833, 836–37 (Tex. App.—El Paso 1995), *rev'd*, 939 S.W.2d 118, 120 (Tex. 1996) (noting the general rule applicable to post-production costs is subject to modification by the parties).

96. "Justice Cornyn and Justice Spector have joined Justice Abbott and me in voting to grant NationsBank's motion for rehearing. Chief Justice Phillips has also switched his position and now agrees with Justice Owen's concurrence, in which Justice Hecht joined. Justice Enoch has recused himself on rehearing, leaving Justice Baker as the lone remaining supporter of his original majority opinion. Thus, the Court is now deadlocked four-to-four on the proper disposition of the case." Heritage Res., Inc. v. Nations Bank, 960 S.W. 2d 619, 620 (Tex. 1997) (Gonzalez, J. dissenting opinion in motion for rehearing). In his opinion in overruling the motion for rehearing, Justice Gonzalez continued his criticisms of the court's original opinion:

> The contract at issue clearly denotes the parties' intent [regarding post-production costs]. The Court's unprecedented refusal to enforce the contract as written has generated quite a controversy. . . . On the whole, these amici support my view that the majority and the concurrence err by discarding the meaning the parties attributed to the 'no deductions' language at issue here.

Id. at 619. Lessors should not lose the benefit of their bargain because the Court now read language . . . as 'surplusage.'" *Id.*

97. *Heritage Res.,* 939 S.W.2d at 122.

98. *Id.*

99. *Id.*

100. *Id.* at 123.

101. *Id.* at 131 (Gonzalez, J., dissenting).

predicted that the opinion would have limited precedential value.[102] As described below, however, subsequent cases have disproved that prediction.

B. *Post*-Heritage Resources *Cases:* Warren *and* Potts

After *Heritage Resources*, one drafting lesson appeared "clear": in order to avoid the court's syllogism, remove the phrase market value at the well from the royalty clause. Absent that phrase, drafters presumed, courts should give meaning to a "no deductions for post-productions costs" phrase, rather than dispensing with it as "surplusage." Cases resolving disputes between one producer, Chesapeake, and its royalty owners reveal the difficulty of drafting around Texas's default rule.

In *Warren v. Chesapeake Exploration, L.L.C.*,[103] Justice Owen, the author of the *Heritage Resources* plurality but now on the Fifth Circuit Court of Appeals, interpreted leases with no-deduction clauses. These clauses provided for royalties based on "the amount realized . . . computed at the *mouth of the well*."[104] The lease contained an addendum, however, that stated all royalties would "be free of all costs, and expenses . . . including . . . costs of compression, dehydration, treatment and transportation."[105] In rejecting the lessors' claims that this language prevented Chesapeake from charging the lessors with post-production costs, Justice Owen turned to her previous opinion: because the lease here required valuation "at the mouth of the well," it falls squarely within the *Heritage Resources* reasoning.[106] Stated differently, because the parties failed to change the valuation point, the no-deductions language remained surplusage.

A no deductions clause in another dispute with Chesapeake met the same

102. *Id.* at 132. A recent case from the Supreme Court of North Dakota appears to agree with the dissent's view of the no deductions clause. *Kittleson v. Grynberg Petroleum Co.* addressed a royalty clause that basically tracked the language in the *Heritage Resources* lease; that is, the clause contained both the market value at the well basis plus the "no deductions from value of the lessor's royalty" phrase. Kittleson v. Grynberg Petroleum Co., 2016 ND 44, ¶ 15, 876 N.W.2d 443, 447. The court held this language clearly prevented deductions. *Id.* Although the North Dakota Supreme Court opinion does not cite *Heritage Resources*, the lessors' brief discussed the opinion at length, described it as having limited precedential value, and cited articles, including one I wrote, which have criticized the *Heritage Resources* opinion. Brief of Appellee at ¶¶ 19–24, Kittleson v. Grynberg Petroleum Co., 876 N.W.2d 443 (N.D. 2016) (No. 15-0075), 2015 WL 6776734 at *8 (citing Laura H. Burney, *Determining the Legal Ramifications of Express Oil and Gas Lease Provisions: Do the Rules of Document Interpretation Provide Predictability?,* 19 E. MIN. L. INST. 86, § 3.03 (1999)).

103. Warren v. Chesapeake Expl., L.L.C., 759 F.3d 413 (5th Cir. 2014).

104. *Id.* at 418 (emphasis added).

105. *Id.*

106. *Id.* Justice Owen viewed the "no deductions" clause in *Warren* as the functional equivalent to the clause in *Heritage Resources*. *Id.* at 413.

fate. The language at issue in *Potts v. Chesapeake Exploration, L.L.C.*[107] appeared to avoid the "market value" and "value at the mouth of the well" valuation points that doomed the royalty owners' cases in *Heritage Resources* and *Warren*. The lease in *Potts* provided that royalties would be based on the "market value at the *point of sale*," and included a no deductions clause.[108] Ultimately, the Fifth Circuit agreed with Chesapeake's argument that "point of sale" and "at the well" were the same because Chesapeake transferred title to its affiliate "at the well."[109] The lessors argued that the court's logic ignored Chesapeake's use and potential abuse of affiliate sales[110] and Justice Owen's own message in her *Heritage Resources* opinion to use "point of sale" as a valuation point.[111] Nonetheless, the Fifth Circuit assigned *Potts* to the *Heritage Resources* camp.[112]

107. Potts v. Chesapeake Expl., L.L.C., 760 F.3d 470 (5th Cir. 2014).

108. *Id.* at 471–72 (emphasis added).

109. *Id.* at 474. The court described Chesapeake's use of affiliate sales:

> An affiliate of Chesapeake, Chesapeake Operating, Inc. (COI), operates the lease on Chesapeake's behalf. COI, as agent for Chesapeake, sells gas produced from the lease to Chesapeake Energy Marketing, Inc. (CEMI), another affiliate of Chesapeake, at the wellhead located on the lessors' property. CEMI then transports the gas through a gathering system and resells it to unaffiliated purchasers at gas pipeline hubs that are considerable distances from the wellhead. The sales to unaffiliated purchasers occur at delivery points that include the Houston Ship Channel and locations in Louisiana and Alabama. CEMI pays Chesapeake the weighted average sales price that CEMI receives when it sells the gas downstream, after deducting post-production costs that CEMI incurs between the wellhead and the points at which deliveries to unaffiliated purchasers occur. The royalty that Chesapeake pays to the lessors is 1/4 of the price it receives from CEMI.

Id. at 472. Landowners in several states have sued Chesapeake challenging its use of affiliates and marketing practices. Abraham Lustgarten, *How the Kings of Fracking Double-Crossed Their Way to Riches,* DAILY BEAST (Mar. 3, 2014 4:45 AM), http://www.thedailybeast.com/articles/2014/03/13/how-chesapeake-energy-the-kings-of-fracking-double-crossed-their-way-to-riches.html.

110. *Potts*, 760 F.3d at 474–75. Confirming the precedential value of *Heritage Resources*, the opinion also rejects the Potts' argument that because *Heritage Resources* was only a plurality that had been highly criticized by practitioners and industry groups, it should be discounted. *Id.* at 476.

111. *Id.* at 474. Additional support exists for the Potts' assertions that Chesapeake used affiliate sales to render the "point of sale" as equivalent to "at the well." *See* Laura H. Burney, *The Interaction of the Division Order and the Lease Royalty Clause*, 28 ST. MARY'S L.J. 353, 398 (1997) ("[P]ractitioners could consider heeding the words of the concurring opinion [in *Heritage Resources*], which suggests using clauses stating that royalty would be based on the market value at the 'point of delivery or sale.' In today's new gas market, however, marked by deregulation, unbundled prices, and evolving roles for producers, processors, and transporters, even that phrase may be difficult to interpret and easy to manipulate."); *see also* Robert Theriot & Josh Downer, *Our Texas Heritage: The Summer of the No Deductions Clause,* HOUS. LAW., Nov./Dec. 2014, at 26, 28 (noting the plaintiff's attempts to contract around the *Heritage* Rule was based on Justice Owen's own recommendation that if the parties "had intended that the royalty owners would receive royalty based on the market value at the point of *delivery or sale*, they could have said so" (quoting Potts v. Chesapeake Expl., L.L.C., 760 F.3d 470, 476 (5th Cir. 2014))).

112. *Potts*, 760 F.3d at 475–76.

C. *The Texas Carbon Dioxide Cases:* French *and* SandRidge

The influence of *Heritage Resources* and the malleable nature of document interpretation surfaced in two recent Texas disputes involving carbon dioxide. In *French v. Occidental Permian, Ltd.*,[113] the Texas Supreme Court held that royalty owners, under market value at the well leases, were required to bear their share of the cost of removing carbon dioxide from casinghead gas re-injected for secondary recovery operations.[114] After reviewing the producer's contracts and circumstances for removing the carbon dioxide, the court viewed the removal as a post-production cost, rather than as a production cost, as the royalty owner had argued.[115] *French* perpetuates *Heritage Resources'* far-reaching view that market value at the well royalty provisions permit producers to deduct a broad range of post-production costs.[116]

Whereas the issue in *French* was whether the removal of carbon dioxide was a post-production cost under a market value at the well lease,[117] in *SandRidge* the parties disputed whether royalties were due separately on sales of carbon dioxide.[118] *Commissioner of the General Land Office of State v. SandRidge Energy, Inc.*[119] involves a dispute over private and State lease

113. French v. Occidental Permian, Ltd., 440 S.W.3d 1 (Tex. 2014).

114. *Id.* at 8. At issue were two leases, the Fuller Lease and the Cogdell Lease:

> The Fuller Lease call[ed] for a royalty 'on gas, including casinghead gas or other gaseous substance produced from said land and sold or used off the premises or in the manufacture of gasoline or other product therefrom' equal to 'the market value at the well of one-eighth (1/8th) of the gas so sold or used'. The Cogdell Lease call[ed] for a royalty of '1/4 of the net proceeds from the sale' of 'gasoline or other products manufactured and sold' from casinghead gas 'after deducting [the] cost of manufacturing the same.'

Id. at 2–3.

115. *See id.* at 9–10 ("French does not contend that the 30% of NGLs Oxy gives Kinder Morgan in kind overpays for her share of the postproduction expense of CO_2 removal; she argues only that no part of the CO_2 removal is a postproduction expense. Since we disagree, her claim fails."). "Occidental contracted with Kinder Morgan for processing CO_2–laden gas" and after processing, Kinder Morgan sent the gas, for further processing, to Torch Energy Marketing with whom Kinder Morgan contracted. *Id.* at 6, 7. Occidental paid Kinder Morgan a fee of 33¢/mcf of gas delivered to Kinder Morgan's plant, "plus 30% of the total NGLs in kind as well as all residual gas at the tailgate of the Snyder plant." *Id.* at 7. Kinder Morgan, in turn, paid Torch an escalating fee "beginning at 25¢/mcf of gas delivered to Snyder." *Id.* Occidental paid "French a royalty on 70% of the NGLs, but not on the 30% given to Kinder Morgan as in-kind compensation." *Id.* (footnote omitted).

116. *Accord* Christopher Kulander, The Royalty Clause, *Oil and Gas Law Short Course*, 30 (2015) (citing French v. Occidental Permian, Ltd., 440 S.W.3d 1 (Tex. 2014)).

117. *French*, 440 S.W.3d at 3.

118. Comm'r of Gen. Land Office of State v. SandRidge Energy, Inc., 454 S.W.3d 603, 618–19 (Tex. App.—El Paso 2014, pet. filed).

119. Comm'r of Gen. Land Office of State v. SandRidge Energy, Inc., 454 S.W.3d 603 (Tex. App.—El Paso 2014, pet. filed).

clauses with detailed provisions that "track[ed] the stages and contingencies of the production and improvement of natural gas."[120] The leases also contained a no deductions clause.[121] Although the producer in *SandRidge* had previously paid royalties on those sales, after building a plant to extract the carbon dioxide, the producer stopped paying the royalties.[122] In a lengthy opinion, the court of appeals ruled in favor of the producer, except regarding certain private leases that expressly provided for a royalty on carbon dioxide.[123] The case is currently pending before the Texas Supreme Court, which has asked for full briefing.[124] The appellate decision, however, represents a strict interpretative approach to an otherwise pro-lessor State lease form, an approach consistent with other Texas Supreme Court opinions, including the *Hyder* decision.

D. Hyder*: A Winning "No Deductions" Clause in a Narrow Ruling*

In another dispute involving Chesapeake, the Texas Supreme Court recently held that language in a lease "expresses a different agreement" than the default rule that royalty owners bear their share of post-production costs.[125] However, the opinion addresses only one interest: a unique royalty provision the lessors had negotiated for off-lease wells, labeled an "overriding royalty."[126] As explained below, this victory provides guidance for future drafting but no guarantees that other pro-lessor no deductions clauses can avoid the *Heritage Resources* result.

The *Hyder* lease was highly negotiated between the lessor and a previous lessee, Chesapeake's assignor.[127] Regarding royalty payments, the lease contained several provisions. An oil royalty provision, based on "the market value at the well" was not contested because no oil was produced from the

120. *Id.* at 618.

121. *Id.* at 609.

122. *Id.* at 607.

123. *See id.* at 622–24 (discussing the South Piñon Fee Lease).

124. The appeal to the Texas Supreme Court was abated while SandRidge underwent bankruptcy proceedings, then reinstated in 2017. Michelle Casady, *Texas Justices Reinstate Appeal Over SandRidge Royalties,* LAW360 (Jan. 6, 2017 3:22 PM EST), https://www.law360.com/articles/878242/texas-justices-reinstate-appeal-over-sandridge-royalties.

125. Chesapeake Expl., L.L.C. v. Hyder, 483 S.W.3d 870, 871 (Tex. 2016).

126. *Id.* at 871–72.

127. *Id.* at 871. The Hyder lease was originally entered into on September 1, 2004, between the Hyders and Four Sevens Oil Company who assigned the lease to Chesapeake. Christopher Kulander, *2014 Oil & Gas Case Law Update*, 47 TEX. TECH. L. REV. 661, 670 (2015). Reflecting the modern trend, the lease provided that the lessors would receive 1/4th as their landowner's royalty on oil and gas. *Id.*

lease.[128] Chesapeake, however, charged the lessors with post-production costs when calculating royalties under two other provisions.[129]

The first provision, a gas royalty provision, provided that for gas "sold or used on or off the [l]eased [p]remises" Chesapeake was to base the lessor's 1/4th royalty on "the price actually received" by Chesapeake.[130] That clause also stated that the royalty:

> [S]hall be free and clear of all production and post-production costs and expenses, including but not limited to, production, gathering, separating, storing dehydrating, compressing, transporting, processing, treating, marketing, delivering, or any other costs and expenses incurred between the wellhead and [Chesapeake's] point of delivery or sale of such share to a third party.[131]

The second royalty provision, one not commonly encountered, required the lessee to pay an "overriding royalty" for off-lease wells.[132] That clause provided that Chesapeake shall pay "a perpetual, cost-free (except only its portion of production taxes) overriding royalty of five percent (5%) of gross production . . . ."[133]

1. *Hyder* Court of Appeals Opinion

The court of appeals upheld the trial court's ruling that Chesapeake violated the express lease terms by charging the Hyders post-production costs under both the gas royalty and the overriding royalty clauses. Regarding the gas royalty clause, the appellate court distinguished *Heritage Resources*, which focused on "the value of the [l]essor's royalty."[134] The *Hyder* lease, on the other hand, stated the valuation for royalty purposes as

128. *Chesapeake*, 483 S.W.3d at 871.

129. *Id.* at 872.

130. Chesapeake Expl., L.L.C. v. Hyder, 427 S.W.3d 472, 476 (Tex. App.—San Antonio 2014).

131. *Id.* at 476 (emphasis added).

132. *Id.* at 478. The term "overriding royalty" generally applies to the royalty interest granted or reserved from the lessee's working interest. *Chesapeake*, 483 S.W.3d at 872–72. For example, lessees often reserve an overriding royalty interest in a document assigning the lease to another operator. *See, e.g.*, Paradigm Oil, Inc. v. Retamco Operating Inc., 372 S.W.3d 177, 180 (Tex. 2012) (exemplifying industry standards where Retamco chose to retain overriding royalty interests when assigning its lease). *See generally* M. C. Cottingham Miles & Paul Benavides, *Contracting for Clarity: Practical Solutions for Drafting Around the Current State of the Law Affecting Overriding Royalty Interests*, 46 TEX. TECH. L. REV. 1043, 1044 (2014) (emphasizing the frequency of reserving overriding royalty interests).

133. Chesapeake Expl., L.L.C. v. Hyder, 427 S.W.3d 472, 478 (Tex. App.—San Antonio 2014).

134. *Id.* at 477 (citing Heritage Resources, Inc. v. NationsBank, 939 S.W.2d 118, 120–23 (Tex. 1996)).

"the price actually received" by Chesapeake at its "point of sale."[135] That court also disagreed with Chesapeake's interpretation because it "ignore[ed] the 'free and clear' provision," and contradicted the plain reading of the royalty clause.[136]

While the plurality in *Heritage Resources* labeled the no deductions clause there "surplusage,"[137] the appellate court in *Hyder* viewed rules of document interpretation as requiring courts to ensure "that no provision will be rendered meaningless."[138] In giving meaning to all provisions, the appellate court also noted that this gas royalty clause contained a *Heritage Resources* disclaimer: "[The lessor and lessee] agree that the holding in the case of *Heritage Resources, Inc. v. NationsBank* . . . shall have no application to the terms and provisions of this [l]ease."[139] Finally, adhering to a plain meaning approach, the court of appeals rejected Chesapeake's plea that industry customs and traditional notions should guide their interpretation.[140] Instead, the court concluded that "these industry customs and traditional notions may be modified by the parties."[141]

Turning to the overriding royalty clause, the appellate court noted that the parties disagreed about the term "cost free" contained in that clause.[142] To begin, the court noted that "an over-riding royalty is free of production costs, but not free of post-production costs."[143] After acknowledging this default rule, the court concluded the *Hyder* lease was written to avoid that rule and prohibited deduction of post-production costs.[144] In rejecting Chesapeake's arguments, the court declined to rewrite the lease by ignoring the term "cost free."[145] Additionally, the court again turned to the lease provision expressly disclaiming the *Heritage Resources* decision.[146]

135. *Id.* at 481. Chesapeake had pointed to the "or" in the gas royalty clause and argued it could charge the Hyders their share of costs incurred between the "point of delivery" and the "point of "sale." *Id.* at 476.

136. *Id.* at 477.

137. Heritage Res., Inc. v. NationsBank, 939 S.W.2d 118, 131 (Tex. 1996).

138. *Chesapeake*, 427 S.W.3d at 477.

139. *Id.*

140. *Id.* at 477 n.1.

141. *Id.* (citing Heritage Res., Inc. v. NationsBank, 939 S.W.2d 118, 122 (Tex. 1996)).

142. *Id.* at 478.

143. *Id.* at 479.

144. *Id.* at 480.

145. *Id.*

146. *Id.* at 479.

2. The Texas Supreme Court's *Hyder* Opinion: A Five to Four Victory for the Lessor[147]

Chesapeake did not challenge the appellate court's ruling on the gas royalty clause.[148] In a five to four decision, the Texas Supreme Court ruled in the Hyders' favor on the remaining issue of whether the overriding royalty clause had rewritten the default rule regarding post-production costs.[149] As part of their reasoning, however, the majority still analyzed the Hyders' gas royalty clause and disputed the appellate court's approach.[150] That analysis and the court's view of the over-riding royalty clause demonstrate that *Hyder* has not broadly rescued no deductions clauses from the *Heritage Resources* bin. Instead, while the court invokes the plain meaning approach,[151] it navigates a circuitous and narrow interpretative path through the language in the Hyders' lease.

In reviewing the gas royalty clause, the Texas supreme court's majority opinion agreed that the *Hyder* lease was "clear" and avoided the default rule, but provided this reasoning:

> The gas royalty in the lease does not bear postproduction costs because it is based on the price Chesapeake actually receives for the gas through its affiliate . . . after postproduction costs have been paid. Often referred to as a

147. Chesapeake Expl., L.L.C. v. Hyder, 483 S.W.3d 870 (Tex. 2016). Chief Justice Hecht delivered the opinion of the Court, in which Justice Green, Justice Johnson, Justice Boyd, and Justice Devine joined. *Id.* Justice Brown filed a dissenting opinion, in which Justice Willett, Justice Guzman, and Justice Lehrmann joined. *Id.* at 876 (Brown, J., dissenting). After languishing on motion for rehearing, the original opinion was withdrawn on January 29, 2016, and replaced with an opinion that made only minor edits and did not change the result. *See* Chesapeake Expl., L.L.C. v. Hyder, No. 14-0302, 2015 WL 3653446 (Tex. Jan. 29, 2016) (withdrawing the original opinion of the court); *Chesapeake*, 483 S.W.3d at 870 (replacing initial opinion but preserving holding that overriding royalty would not bear the post-production costs). The delay stemmed from the dozens of amicus curiae briefs filed, most by industry groups urging the court to reconsider its opinion. *See* Michelle Casady, *Texas High Court Upholds Royalty Ruling Against Gas Co.*, LAW360 (Jan. 29, 2016, 8:17 PM EST), https://www.law360.com/articles/752602/texas-high-court-upholds-royalty-ruling-against-gas-co ("In its bid for rehearing, Chesapeake was backed by several other energy companies . . . that filed a joint amicus brief arguing the majority's opinion could be interpreted to mean royalties would have to be paid on money the energy producer never actually received.").

148. *See Chesapeake*, 483 S.W.3d at 873 n.17 ("Chesapeake does not dispute in this Court that 'the price actually received by the Lessee' for purposes of the gas royalty is the gas sales price its affiliate, Marketing, received, nor do the Hyders argue that the gas sales price was unfair." (citing Phillips Petrol. Co. v. Yarbrough, 405 S.W.3d 70, 78 (Tex. 2013))).

149. *Id.* at 871.

150. *See id.* at 873 n.18 (holding the royalty clause did not impact the meaning of noting "the court of appeals reasoned otherwise").

151. *Id.* at 876 ("*Heritage Resources* holds only that the effect of a lease is governed by a fair reading of its text. . . . Here, the lease text clearly frees the gas royalty of postproduction costs, and reasonably interpreted, we conclude, does the same for the overriding royalty.").

> "proceeds lease[,"] the price-received basis for payment in the lease is sufficient in itself to excuse the lessors from bearing postproduction costs.[152]

However, the Texas Supreme Court, unlike the appellate court, was not enamored with the additional phrase, "free and clear of all production and post-production costs and expenses" and the lease's "examples of various expenses."[153] On the contrary, the court viewed this language as having "no effect on the meaning of the provision. It might be regarded as emphasizing the cost-free nature of the gas royalty, or as surplusage."[154]

Applying this view to the term "cost free" as it appeared in the overriding royalty provision, the court agreed with Chesapeake that it could refer to production rather than post-production costs, since "lease drafters are not always driven by logic."[155] However, the court noted that the cost-free clause here had an exception for production taxes, a cost typically associated with post-production.[156] That exception, according to the majority, "cuts against Chesapeake's argument."[157] Yet, having recognized that weakness in the producer's argument, the court reaffirmed that "cost free" could refer to production costs.[158] Therefore, the court reasoned that Chesapeake had to show that "cost free" could not "nevertheless refer to postproduction costs here."[159]

To make this showing, Chesapeake stressed the differences between the gas royalty clause and the overriding clause.[160] Although admitting that the overriding clause was "not as clear" as the gas royalty clause, the court concluded that the "lease text clearly frees the gas royalty of post-production costs, and reasonably interpreted,[] . . . does the same for the overriding royalty."[161] To support that conclusion, the court surprisingly focused on a common provision in lease royalty clauses, the option for lessors to take

152. *Id.* at 873 (footnote omitted).

153. *Id.* at 871.

154. *Id.* at 873.

155. *Id.* at 874.

156. *See id.* at 874 n.20 (noting the Texas Tax Code's requirement "that all interested parties, including royalty owners, bear production taxes ratably" (citing TEX. TAX CODE § 201.205 (West 2015)).

157. *Id.* at 874. To drive home the point, the opinion continues: "It would make no sense to state that the royalty is free of production costs, except for postproduction taxes (no dogs allowed, except for cats)." *Id.*

158. *Id.*

159. *Id.*

160. *Id.* at 875. The dissenting justices, too, focused on the extensive differences in the gas royalty and overriding royalty provisions. *Id.* at 880 (Brown, J., dissenting).

161. *Id.* at 876.

their royalty share in-kind:[162]

> The fact that the Hyders might or might not be subject to postproduction costs by taking the gas in kind does not suggest that they must be subject to those costs when the royalty is paid in cash. The choice of how to take their royalty, and the consequences, are left to the Hyders. Accordingly, we conclude that "cost-free" in the overriding royalty provision includes postproduction costs.[163]

a. *Heritage Resources'* Surplusage Canon of Construction Survives

In a final missive, the majority opinion ends with a reminder of *Heritage Resources'* continued influence: "The disclaimer of *Heritage Resources'* holding does not influence our conclusion."[164] Recall also the view expressed earlier in the opinion about the "cost free" and "no deductions for postproduction costs" language in the gas royalty clause.[165] The court labeled those phrases as having no meaning, or as surplusage.[166] That surplusage canon, however, remains limited to the court's post-production cost cases. In fact, that canon contradicts not only the court of appeals's interpretations of those phrases in the Hyders' lease, but also the Texas Supreme Court's consistent admonishment in other document interpretation cases that courts should "harmonize" and give weight to all terms to ascertain the parties' intent.[167] Moreover, other jurisdictions,

162. Historically, lease forms typically provide an option for the lessor to take his share of the oil royalty "in kind"; however, that option is rarely exercised. *See* Bruce M. Kramer, *Interpreting the Royalty Obligation By Looking at the Express Language: What a Novel Idea?*, 35 TEX. TECH L. REV. 223, 227–229 (2004) (explaining the "classic" in-kind royalty clauses and their alternatives). Instead, the producer sells the oil and pays the lessor the fractional share of the proceeds from the sale as required in the lease. 1 ERNEST E. SMITH & JACQUELINE LANG WEAVER, TEXAS LAW OF OIL AND GAS § 4.6 (LexisNexis Matthew Bender 2015).

163. Chesapeake Expl., L.L.C. v. Hyder, 483 S.W.3d 870, 875 (Tex. 2016).

164. *Id.* at 876.

165. *Id.* at 875.

166. *Id.* at 873.

167. *See* Concord Oil Co. v. Pennzoil Expl. & Prod. Co., 966 S.W. 2d 451, 457–58 (Tex. 1998) (demonstrating the conveyance as a whole should be examined to understand the parties' intent and harmonize portions that appear to conflict); Coker v. Coker, 650 S.W. 2d 391, 393 (Tex. 1983) (highlighting the fact that courts should look at the entire contract to ensure they are correctly interpreting the parties' intent and trying to blend contradicting sections together); McMahon v. Christmann, 303 S.W. 2d 341, 344 (Tex. 1957) (furthering the principal that all the provisions of the contract should be harmonized whenever possible even when they seem to contradict). *See* Burney, *supra* note 54, at 76–77 (describing the steps in the deed interpretation process and that the goal is to ascertain the parties' intent from all of the language); Kramer, *supra* note 54, at 60–62 (describing canons of interpretation as tools the court can use when construing a contract and determining the parties' intent, but recognizing that judicial construction will never take precedent over express terms of the agreement).

including Louisiana, have not adopted the suplusage canon in lease interpretation cases.[168]

VII. LOUISIANA: CONFIRMATION OF THE TEXAS APPROACH TO "MARKET VALUE AT THE WELL" AND POST-PRODUCTION COSTS

A. Culpepper v. EOG Resources, Inc.:[169] *A Recent Case Reiterates a "Long-Held" View*

As noted above, commentators and courts have placed Louisiana firmly in the Texas camp regarding the allocation of post-production costs under a market value at the well gas royalty clause.[170] Recent cases confirm that placement. In a Louisiana appellate court opinion, *Culpepper v. EOG Resources, Inc.*, the sole issue was whether transportation costs were proper post-production costs under a Bath lease form.[171] As in the Texas cases discussed above, the gas royalty provision expressly provided it should be calculated at the mouth of the well.[172]

The court found "the [l]ease to be clear and unambiguous[,]" reasoning that "[t]he computation of a royalty 'at the well' has been long-held by our courts to include deductions for post-production costs."[173] The cases the court relied upon for this "long-held" view included decisions rendered between the 1930s and 1986:[174] *Merritt v. Southwestern Electric Power Co.*[175], *Freeland v. Sun Oil, Co. of Louisiana, Sartor v. United Gas Public Service Co.*[176], and *Wall v. United Gas Public Service Co.*[177]

Before reviewing case law, the *Culpepper* court first relied upon the familiar rules for interpreting all contracts; yet, reflecting the unpredictable nature of

168. A recent Supreme Court of North Dakota opinion contradicts *Heritage Resources'* approach to the identical clause. Kittleson v. Grynberg Petroleum Co, 876 N. W. 2d 443, 447 (2016). For a discussion of the *Kittleson* decision, see *supra* note 102.

169. Culpepper v. EOG Res., Inc., 47-154 (La. App. 2 Cir. 5/16/12); 92 So. 3d 1141.

170. *See supra* note 89.

171. *Culpepper*, 92 So.3d at 1143.

172. *Id.* at 1142.

173. *Id.* at 1144.

174. *Id.* at 1143–44 ("This court, in *Merritt v. Southwestern Electric Power Co.*, 499 So. 2d 210 (La. App. 2d Cir. 1986) [(per curiam)], recognized that Louisiana law allows the deduction of post-production costs when the royalty payment is determined 'at the mouth of the well.'"). For cases the court goes on to cite, see Freeland v. Sun Oil Co., 277 F.2d 154 (5th Cir. 1960); Sartor v. United Gas Pub. Serv. Co., 84 F.2d 436 (5th Cir. 1936); Wall v. United Gas Pub. Serv. Co., 152 So. 561 (La. 1934). For the view that the Louisiana Supreme Court departed from *Wall*, *Sartor*, and *Freeland* in its *Henry* decision, see Veron, *supra* note 66, at 960–61.

175. Merritt v. Sw. Elec. Power, 499 So.2d 210 (La. App. 2 Cir 1986) (per curiam).

176. Freeland v. Sun Oil Co., 277 F.2d 154 (5th Cir. 1960).

177. Wall v. United Gas Pub. Serv., Co., 152 So. 561 (La. 1934).

those rules, the circuit court reversed the finding of the trial court.[178] Specifically, the court disagreed with the trial judge's conclusion that the lease was ambiguous in light of references to an attached rider, which the appellate court viewed as having no relevance to the royalty obligation in the lease.[179]

B. Dickson v. Sklarco L.L.C.:[180] *An Express Deductions Clause Creates Ambiguity About Deductions*

In another recent case, a federal district court confirmed Louisiana's placement in the Texas "post-production cost" camp, but ultimately held a provision in an attached exhibit rendered the lease ambiguous.[181] In *Dickson v. Sklarco L.L.C.*, both the royalty owner and the producer filed cross-motions for summary judgment arguing their Bath form lease was unambiguous.[182] The producer claimed it could properly deduct gathering and transportation costs, and the royalty owner claimed the lease prohibited those deductions.[183] Following classic rules of document interpretation, the court began by analyzing the four-corners of the lease.[184] Because paragraph four contained a typical market value at the well clause, the court concluded that Louisiana law permits the producer to deduct the disputed costs.[185] However, in light of language in paragraph eight of an attached exhibit, the court determined its analysis could not end there.[186] Paragraph eight provided:

> The parties agree that **post production costs may be deducted** from . . . the proceeds from the sale of . . . natural gas . . . **insofar and only insofar** as such costs either enhance the value of the product being sold and the price obtained

178. Culpepper v. EOG Res., Inc., 47-154 (La. App. 2 Cir. 5/16/12); 92 So.3d 1141, 1143–1144 (explaining one document interpretation rule includes determining "whether a contract is clear or ambiguous" and stating "[a]mbiguity exists as to the parties' intent when the contract lacks a provision on the issue or when the language of the contract is uncertain or fairly susceptible to more than one interpretation") (citation omitted).

179. *Culpepper*, 92 So.3d at 1144.

180. Dickson v. Sklarco L.L.C., No. 5:11-CV-00352, 2013 WL 1828051 (W.D. La. Apr. 29, 2013).

181. *Id.* at *6.

182. *Id.* at *1.

183. *Id.* at *2.

184. *Id.* at *3.

185. *Id.* at *5 ("Louisiana law applies a reconstruction approach to determine the market value of gas, beginning with the gross proceeds of the sale of gas and then deducting any additional costs of taking the gas from the wellhead (the point of production) to the point of sale." (citing Merritt v. Sw. Elec. Power Co., 499 So. 2d 210, 213 (La. Ct. App. 1986) (per curiam))).

186. Dickson v. Sklarco L.L.C., No. 5:11-CV-00352, 2013 WL 1828051 at *6 (W.D. La. Apr. 29, 2013).

> for such product or are required to make the product marketable. **Without limitation upon the foregoing,** the treating, processing[,] or dehydrating of natural gas to meet pipeline quality specifications shall be deemed to enhance the value of the product being sold.[187]

Had this clause been a Texas dispute, one could safely bet that, in light of *Heritage Resources*, the court would view this language as reaffirming the default rule that producers may deduct post-production costs, including costs of transportation and gathering.[188] The final sentence listing costs "deemed" to enhance value begins with the broad qualifier that the list shall be "without limitation."[189] Additionally, rather than prohibit deductions, the clause permits deductions at least insofar as they "enhance the value of the product."[190] That last clause, and a previous reference about "mak[ing] the product marketable," however, invokes "marketable product" rule terms, which could be viewed as creating a fact question.[191] Nevertheless, the court concluded otherwise: "It is difficult to imagine what costs expended post production would not enhance the value of the product or make the product more marketable."[192]

Despite such statements suggesting the court viewed the lease as unambiguously permitting gathering and transportation deductions, the *Dickson* court reached its ambiguity determination by focusing on the parties' potential reason for adding the exhibit: "Why, then, was this language added to the contract? At the very least, the placement of the provision Exhibit 'B', as well as the language contained within it, raises issues of fact as to the parties' intent."[193] Under rules of document interpretation,

187. *Id.*

188. *See* Heritage Res., Inc. v. NationsBank, 939 S.W.2d 118, 122–23 (Tex. 1996) (approving deduction of post-production costs).

189. The court did address this clause in rejecting the royalty owner's argument that the canon of construction, *ejusdem generis*, applied. *Dickson*, 2013 WL 1828051, at *7. Under that canon, general words or phrases that follow a list of a specific class or classes are read to only apply to that specific class or classes. *Id.* According to the court, that canon did not apply here due to the phrase "[w]ithout limitation." *Id.*

190. *Id.* at *6.

191. *Id.*

192. *Id.* at 7. For criticism of the opinion from a Louisiana law professor and practitioner, see Keith B. Hall, *Survey: Louisiana*, 1 TEX. A&M L. REV. 103, 108–10 n.68 (2013) ("The court's reasoning can be questioned. . . . Under Louisiana law, the court should apply the language of the contract as written and should not resort to the consideration of extrinsic evidence to interpret the contract in the absence of ambiguity or absurd result. It does not appear that ambiguity was present or that an absurd result would occur if the lease was interpreted as written.") (internal citations omitted).

193. Dickson v. Sklarco L.L.C., No. 5:11-CV-00352, 2013 WL 1828051, at *7 (W.D. La. Apr. 29, 2013).

that ambiguity determination freed the court from the four-corners of the lease and allowed it to review evidence of the parties' course of conduct.[194] After that review, the court denied the parties' motions for summary judgment and remanded the case, having concluded "the record is unclear as to the parties' intent regarding" the costs at issue.[195]

C. Magnolia Point Minerals, LLC v. Chesapeake Louisiana:[196] *Rejection of the "Surplusage" Canon*

As in *Dickson*, the analysis of the lease at issue in *Magnolia Point Minerals, LLC v. Chesapeake Louisiana* ultimately turned on language in an exhibit.[197] And like *Dickson*, the case again demonstrates this reality: document interpretation cases can be unpredictable, drawn-out, and costly proceedings. The original lease in *Magnolia Point*, which was intensely negotiated, provided that gas royalties should be based on the "market value at the well." However, an exhibit to the lease provided that "no cost shall be charged or allocated to Lessor's interest except severance and other applicable taxes."[198] The dispute arose when the producer began deducting transportation costs from the lessor's royalty payments.[199]

In its first decision, the district court viewed the lease as unambiguous and ruled in favor of the producer, Chesapeake.[200] However, a year later, the court vacated that opinion and determined the lease was ambiguous. In reaching that conclusion, the court began by reciting rules of document

194. This "course of dealing" evidence included the following: the producer did not begin deducting for gathering and transportation until two years after it began paying royalties and the assignee/lessee reviewed the lease language. *Id.* at *9; *see also* Potts v. Chesapeake Expl., L.L.C., 760 F.3d 470, 472 (5th Cir. 2014) (explaining the facts of the case where the producer had originally not charged post-production costs to the lessor but changed course after reviewing the lease and in response to a dispute with the royalty owner over a most-favored nations clause).

195. *Dickson*, 2013 WL 1828051, at *9; *see also* Magnolia Point Minerals, LLC v. Chesapeake La., No. 11-00854, 2013 WL 3989579, at *5–*6 (W.D. La. Aug. 2, 2013) (finding lease ambiguous where form provided for "market value at the well" royalty basis but exhibit provided that "no cost shall be charged or allocated to Lessor's interest except severance taxes and other applicable taxes"). *But see* Columbine II Ltd. P'ship v. Energen Res. Corp., 129 Fed. App'x 119, 121–23 (5th Cir. 2005) (per curiam) (holding lease unambiguously prohibited deductions because express "no deductions for transportation costs" clause demonstrated intent to override "market value at the well").

196. Magnolia Point Minerals, LLC v. Chesapeake La., No. 11-00854, 2013 WL 3989579 (W.D. La. Aug. 2, 2013).

197. *Magnolia*, 2013 WL 3989579 at *5 (finding lease ambiguous where form provided for "market value at the well" royalty basis but exhibit provided that "no cost shall be charged or allocated to Lessor's interest except severance and other applicable taxes.").

198. *Id.*

199. *Id.* at *3.

200. Magnolia Point Minerals, LLC v. Chesapeake La., 2012 WL 3096043 (W.D. La. 2012), *withdrawn and vacated* 2012 WL 4406150, at *1 (W.D. La. 2012).

interpretation that require focusing on all terms in the document—contradicting Texas's surplusage canon—to "avoid neutralizing or ignoring any of them or treating them as 'surplusage.'"[201] In the court's view, the exhibit's "no cost" provision, particularly the reference to the "Lessor's interest," and the fact that the "no cost" provision failed to expressly refer to transportation costs, required the ambiguity determination.[202] Because that determination permits "examination of extrinsic evidence, including possible expert testimony," the litigation continued, meaning increased costs for all parties.[203]

VIII. DRAFTING "NO DEDUCTIONS" CLAUSES IN THE SHALE ERA

Opinions such as *Magnolia*, *Hyder*, and *Dickson* leave a drafter wondering what to do. Theoretically, careful and thorough drafting will protect the bargains producers and landowners strike, and help them avoid costly and protracted litigation. One obvious lesson from *Dickson* is to avoid language "permitting" certain deductions if in fact the parties intended to broadly prohibit them. Conversely, if the parties intend for the producer's royalty obligation to be governed by Louisiana's view of "market value at the well," they should avoid attempts to reinforce it, such as paragraph eight in the *Dickson* lease.[204] *Hyder* teaches that careful lease drafting can lead to an effective no deductions provision. Yet with the Texas Supreme Court's dismissive view of the *Heritage Resources* disclaimer and other express no deductions language,[205] *Hyder* must be mined for other drafting lessons, especially for Texas landowners and practitioners. Because both the majority and dissent approved of the gas royalty clause, that language should provide a reliable template.[206] That clause included a "proceeds" provision

201. *Magnolia*, 2013 WL 3989579, at *3.

202. *Id.* at *5. *Distinguishing* Columbine II Ltd. P'ship v. Energen Resources Corp., 129 Fed. Appx. 119 (5th Cir. 2005) (holding lease unambiguously prohibited deductions because express "no deductions for transportation costs" clause demonstrated intent to override "market value at the well"). The *Magnolia* opinion also noted that a recent Louisiana Supreme Court decision affected its decision. *Id.* at *3 (discussing *Clovelly Oil Co., LLC v. Midstates Petroleum Co.,* which held that "when the printed contract provisions irreconcilably conflict with the provisions added by the parties, the added provisions will control . . . ").

203. *Magnolia*, 2012 WL 3096043, at *5.

204. *See* Dickson v. Sklarco L.L.C., No. 5:11–CV–00352, 2013 WL 1828051, at *2 (W.D. La. Apr. 29, 2013) (providing Paragraph 8 of the Dickson lease).

205. Chesapeake Expl., L.L.C. v. Hyder, 483 S.W.3d 870, 876 (Tex. 2016) (rejecting the notion that disclaimers can preempt post-production costs).

206. The majority and dissent also agreed that the term "gross production obtained from each such well" in the overriding royalty clause referred to "the entire amount of gas produced, including gas used by Chesapeake or lost in postproduction operations." *Id.* at 873, 874; *id.* at 877(Brown, J., dissenting). But that phrase did not contribute to the conclusion that the overriding royalty did not

based on the price the lessee actually received, the lengthy "free and clear of all costs" provision, plus the specific list of prohibited post-production costs. To avoid the *Potts* and *Warren* traps, drafters should avoid the phrase market value at the well or any iteration that could suggest or allow that point of valuation.[207] Another drafting trick would be to avoid the "overriding" royalty label since the courts' opinions—and the lawyers and judges at oral arguments—struggled with the principle that "over-riding" royalties generally bear their share of post-production costs.[208] In addition to these provisions, drafters could continue to include the *Heritage Resources* disclaimer. As the justices in the court of appeals—and even dissenting justices in the supreme court's opinion—concluded, that language provides evidence of the plain meaning of the royalty clause, which should prove significant as other courts continue to determine the fate of other no deductions clauses in the shale era.[209]

IX. CONCLUSION

In addition to informing the fate of no deductions clauses, the cases discussed above reveal the fate of implied covenants in the shale era. Because modern forms include extensive express terms, the significance of

bear post-production costs. *Id.* at 873, 874; *id.* at 877 (Tex. 2016) (Brown, J., dissenting). *But see* Exxon Mobil Corp. v. Ala. Dep't of Conservation and Nat. Res., 986 So. 2d 1093, 1109 (Ala. 2007) (holding a "gross proceeds" term and other language prohibited charging state/lessor with post-production costs); Judice v. Mewbourne Oil Co., 939 S.W.2d 133, 136 (Tex. 1996) (determining the phrase "gross proceeds at the well" created ambiguity).

207. In addition to the *Potts* and *Warren* cases, a case decided the same day as *Heritage Resources* teaches that parties should avoid combining the terms "gross proceeds" and "at the well" to avoid an ambiguity determination. *Judice*, 939 S.W.2d at 136. However, at oral argument in *Hyder*, Chief Justice Hecht questioned Chesapeake's assertion that the royalty clause in *Hyder* was essentially a "market value at the well" clause, because it referred to "gross proceeds." *See* Transcript of Oral Argument, Chesapeake Expl., L.L.C. v. Hyder, 483 S.W.3d 870 (Tex. 2016) (No. 14-0302), 2015 WL 1648045, (expressing, in the words of Chief Justice Hecht, that "[i]t just seems an odd way to write a simple market value at the well" provision).

208. *Chesapeake*, 483 S.W.3d at 873 nn.13–14 (Brown, J., dissenting). During oral argument, the justices and Chesapeake's counsel struggled with whether over-riding royalties bear their share of post-production costs as a matter of law. Transcript of Oral Argument, Chesapeake Expl., L.L.C. v. Hyder, 483 S.W.3d 870 (Tex. 2016) (No. 14-0302), 2015 WL 1648045 (containing the question, posed by Justice Guzman, "if overriding royalties normally won't have production cost, then what does cost-free mean unless it refers to postproduction cost because generally they wouldn't incur those").

209. Chesapeake Expl. L.L.C. v. Hyder, 427 S.W.3d 472, 480 (Tex. App.—San Antonio 2014, pet. granted), *aff'd* 283 S.W.3d 870 (Tex. 2016), *reh'g denied*. The dissenters in the supreme court's decision disagreed "with the Hyders that the *Heritage* disclaimer requires a broad construction of 'cost free.'" *Chesapeake*, 483 S.W.3d at 880 (Brown, J., dissenting). However, they noted that the phrase was absent from the overriding royalty clause but was located in the gas royalty clause; therefore, they concluded the disclaimer "highlights that it is intended to support the 'free and clear' language" in the gas royalty clause. *Id.*

implied covenants will fade. Instead, as courts continue to address no deductions and other pro-lessor clauses, scrutiny of express terms will dominate lease litigation in "plain meaning" states. Texas and Louisiana remain firmly in that camp. Although Louisiana opinions detoured with the cooperative venture approach for resolving the "market value" and take-or-pay controversies, recent cases, including *Chastant*, and *Culpepper* embrace the "plain meaning" approach.[210] The *Dickson* opinion also pledged allegiance to that approach, but contradictory opinions in that case and others demonstrate again that plain terms are never plain.[211] Similarly, in Texas, that familiar pattern appeared in *Heritage Resources* and *Hyder*: the appellate and supreme court opinions reached different conclusions but agreed the lease terms controlled.[212] Moreover, ignoring the obvious contradiction, *Hyder* endorsed *Heritage Resources'* surplusage canon, which sanctions ignoring express terms, as part of its plain meaning approach. Fortunately, Louisiana and other jurisdictions have ignored that canon and Texas courts invoke it only in post-production cost disputes. For that reason, while the surplusage canon may impact the on-going battles over post-production costs in Texas, *Hyder* proves it should not doom other pro-lessor clauses.[213] Yet although landowners scored a victory in *Hyder,* the

210. Professor John Lowe, however, has concluded that the Texas/Louisiana view of the "market value at the well" phrase is in fact consistent with a cooperative venture view of the oil and gas lease. Lowe, *supra* note 5, at 261 ("The cooperative venture theory ought not extend to downstream entrepreneurial functions of the lessee."). Discussing the different opinions rendered in Louisiana and Texas in the "market value" and "take or pay" cases, Professor Lowe opined as follows: "It is ludicrous to conclude that lessors and lessees in adjoining states intended such sharply different meanings for the same lease terms or such varied financial impacts as the market value and royalty on take-or-pay decisions have brought." *Id.* at 244. The same can be said for the different camps regarding the effect of the "market value at the well" gas royalty obligation.

211. Dickson v. Sklarco L.L.C., No. 5:11-CV-00352, 2013 WL 1828051, at *3 (W.D. La. Apr. 29, 2013). *See supra* section VII.

212. The majority opinion lacks concern about burdening producers by enforcing "no deductions" clauses, despite having received strong amicus briefs from oil and gas organizations and producers urging the court to interpret the clause in their favor and predicting far-reaching negative consequences if the majority opinion stands. Brief of Amici Curiae BP America Production Company, Devon Energy Production Company, L.P., EOG Resources, Inc., et al., Chesapeake Expl. L.L.C. v. Hyder, 483 S.W.3d 870 (Tex. 2016) (No. 14-0302). In a previously-filed amicus curiae brief, "[t]he powerful Texas Oil and Gas Association had argued that if the decision goes 'uncorrected,' it will 'generate confusion and inefficiencies for the oil and gas industry.'" Max B. Baker, *supra* note 12. The dissenting opinion also focused primarily on the text of the lease. Chesapeake Expl., L.L.C. v. Hyder, 483 S.W.3d 870, 877 (Tex. 2016) (Brown, J., dissenting). However, while objecting to the majority's emphasis on the in-kind royalty provision, the dissenters expressed sympathy for the producer: "That Chesapeake undertook to market the gas should not saddle Chesapeake with post-production costs or entitle the Hyders to more than the royalty for which they bargained." *Id.*

213. Demonstrating the significance of *Hyder* for future "no deductions" disputes, a recent appellate court opinion rejected a producer's attempts to distinguish the terms in the Hyder lease in

majority and dissenting opinions also reflect the Texas Supreme Court's historically pro-producer view of oil and gas lease terms.[214] While that fact may concern landowners, producers too should consider the "roll of the dice" feature inherent in oil and gas lease litigation.[215] Indeed, the unpredictable nature of the document interpretation process should motivate landowners and producers to avoid the courtroom and head to the bargaining table, where negotiating and mediating procedures likely provide more promising and efficient resolutions to disputes over the meaning of express lease clauses in the shale era.[216]

interpreting an over-riding royalty created in lease assignments. Burlington Res. Oil & Gas Co. v. Texas Crude Energy, LLC and Amber Harvest, LLC, No. 13-16-00248-CV (Tex. App.—Corpus Christi Mar. 2, 2017). That case is one of hundreds of post-production cost disputes raging in Texas courts. *See* Jennifer Hiller, *Eagle Ford Mineral owners claim Chesapeake Energy underpays them*, HOU. CHRON. (Mar. 14, 2016, 9:31 PM), http://www.houstonchronicle.com/business/energy/article/Eagle-Ford-mineral-owners-claim-Chesapeake-Energy-6888685.php (describing "wave of royalty lawsuits" in the Eagle Ford Shale); Jess Krochtengel, *Chesapeake's Eagle Ford Royalty Cases Transferred To MDL*, LAW360 (Dec. 1, 2016, 2:13 PM EST), https://www.law360.com/articles/867751/chesapeake-s-eagle-ford-royalty-cases-transferred-to-mdl (reporting the Texas Multidistrict Litigation Panel has ordered consolidation of claims by 110 royalty owners).

214. *See* Laura H. Burney, *The Texas Supreme Court and Oil and Gas Jurisprudence: What Hath Wagner & Brown v. Sheppard Wrought?*, 5 TEX. J. OIL GAS & ENERGY L., 219, 222 (2010) (describing the trend that Texas Supreme Court opinions have favored producers for nearly twenty years); *see also* McArthur, *supra* note 2, at 356–60 (discussing other recent Texas Supreme Court cases that restricted lessors' chances of prevailing in royalty underpayment cases).

215. In addition to *Hyder* and *Hooks v. Samson* (*supra* note 53), another recent Texas Supreme Court opinion also favored the landowners. N. Shore Energy v. Harkins, 2016 WL 6311285 at *5 (Tex. Oct. 28, 2016) (reversing the appellate court and holding "the plain and express language" of an option agreement supported the landowner's interpretation of the land covered in the contract).

216. For a recent example of litigants opting to settle rather than risk the Texas Supreme Court's view of an express lease term, see ConocoPhillips Co. et al v. Vaquillas Unproven Minerals, Ltd., 2015 WL 4638272 (Tex. App.—San Antonio 2015, no filed.), *review granted, judgment set aside and remanded by agreement*; Michelle Casady, *Texas Justices Avoid ConocoPhillips Well Fight with Deal* (Oct. 14, 2016, 5:01 PM EDT), https://www.law360.com/articles/851583/texas-justices-avoid-conocophillips-well-fight-with-deal. Other writers have touted the value of alternative dispute procedures for oil and gas disputes. *See* Glen M. Ashworth, et. al., *Arbitration: The Underused Alternative for Oil and Gas Disputes*, TEX. LAW. (June 18, 2015) (urging use of arbitration and other dispute-resolution approaches for resolving oil and gas disputes). *See generally* ROGER FISHER & WILLIAM L. URY, GETTING TO YES: NEGOTIATING AGREEMENT WITHOUT GIVING IN (2011) (discussing negotiation strategies). In Texas, another shale-era reality lessors should consider is the fact obvious from the "no deductions" cases: The petroleum industry remains a powerful force in Texas. For another example, note the industry's influence in passing a bill that overturned local bans on hydraulic fracturing. Jim Malewitz, *With HB 40 Signed, Fracking to Resume in Denton*, TEX. TRIB. (May 22, 2015), https://www.texastribune.org/2015/05/22/despite-ban-fracking-resume-denton/ (reporting HB 40 "cruised through the Legislature" with industry backing).