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Oil and Gas Royalty Disputes

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At the beginning of the fourth quarter of 2015, the price of crude oil fell below $50 per barrel, and natural gas prices were similarly low. At the same time, the price per share of Chesapeake Energy Corp., a natural gas and oil exploration and production company based in Oklahoma City, was approximately $8, a share price decline of more than 70 percent for the year.

Chesapeake Energy is currently embroiled in litigation brought by thousands of mineral estate owners/lessors regarding, among other issues, alleged underpayment of royalties. If the mineral estate owners/lessors prevail, Chesapeake Energy may be required to pay plaintiffs more than $1 billion.

The Chesapeake Energy royalty litigation is a prime example of how an extended period of low oil and gas prices may lead to increased litigation commenced by landowners/lessors. Distressed and bankrupt companies are the prime targets of such litigation. This article discusses the oil and gas royalty in general, the pending Chesapeake Energy litigation, and reported royalty disputes in bankruptcy.

The Oil and Gas Royalty

The royalty clause of an oil and gas lease sets forth the proper calculation of the lessor's royalty (*i.e.*, the lessor's share of oil and/or gas production, free of the expenses entailed in producing the oil and/or gas). State law governs the interpretation of the royalty clause. With respect to Texas oil and gas leases, "[w]hile a royalty is free of the costs of production, it is 'usually subject to post-production costs, including taxes, treatment costs to render it marketable, and transportation costs.'"[2] Further, the royalty on oil production may be paid "in-kind"; therefore, a lessor may be paid a share of the produced oil itself. In contrast, a royalty for gas, though it may be paid "in-kind," is typically paid in money, which reflects a share of the proceeds generated from the actual sale of the gas. In most instances, the oil and gas producer remits payment of the royalty to the lessor after the oil and gas is sold. The parties to a lease agreement may modify the general rules regarding royalty payments.

The determination of the proper oil royalty in most cases is straightforward. Oil is often sold at or near the well, and there is an established market price for the oil. As the following discussion of gas royalty dispute litigation highlights, the calculation of the gas royalty is complex. Consequently, most royalty disputes in and out of bankruptcy court concern how royalties are calculated on gas that has been produced and sold.

Unlike oil, for gas to be sold and/or used it must be transported from the well (via the pipeline), treated, compressed and prepared for market. Parties to oil and gas leases may grapple with what post-production costs associated with getting the gas to market are deductible from the amount of the royalty due to the lessor.

In addition, parties often include royalty clauses in oil and gas leases that require lessees to calculate gas royalty payments based on "the market value at the well."[3] Further, under Texas law, "market value at the well means the value of gas at the well, before it is transported, treated, compressed or otherwise prepared for market."[4]

When a Texas oil and gas lease provides that the lessor will calculate the gas royalty based on "market value at the well," the lessor must employ one of two generally accepted methods to calculate the gas royalty.[5] The lessor must first seek to use the "comparable sales" method of calculation,[6] whereby market value is determined by looking to the price of the gas in a sale transaction that is

1 This article represents the views of the author, and such views should not necessarily be imputed to Simmons Legal PLLC or its respective affiliates and clients.
2 *See, e.g., Potts v. Chesapeake Exploration LLC*, Civ. A. No. 3:12-CV-1596-O, 2013 WL 874711, at * 4 (N.D. Tex. March 11, 2013) (citations omitted).
3 *Id.* at * 5.
4 *Id.* (internal quotation marks and citation omitted).
5 *Id.*
6 *Id.*

comparable in "time, quality, quantity, and availability of marketing outlets."[7]

If there are no readily available comparable sales transactions, the second acceptable method for calculating a gas royalty is the "net-back" (or "work-back") approach.[8] Under this approach, the lessor "first finds a point in the downstream sale process where market value for the gas can be established. After identifying the market value downstream, the net-back approach then requires deductions of reasonable post-production costs from that point back to the well to determine the market value at the well."[9]

Chesapeake Energy Litigation

More than 400 lawsuits are pending against Chesapeake Energy. Mineral estate owners/lessors allege that Chesapeake Energy improperly calculated the price of gas sold "at the wellhead" and incorrectly deducted post-production expenses when calculating the royalty that was due to lessors. The first trial is scheduled for February 2016 in Texas state court in Tarrant County.[10]

Chesapeake Energy has an uphill battle in the pending litigation given that its subsidiaries lost a royalty dispute fight in the state court case of *Chesapeake Exploration LLC and Chesapeake Operating Inc. v. Hyder*.[11] In that case, Chesapeake Exploration LLC, a Chesapeake Energy subsidiary, was the lessee under an oil and gas lease covering 948 mineral acres in the Barnett Shale.[12] Further, only gas was produced on the lease.[13] During the course of their business relationship with Chesapeake Exploration, the mineral estate owners/lessors commenced state court litigation against Chesapeake Exploration alleging that they were underpaid in royalties.[14] The mineral estate owners' specific grievance was that Chesapeake Exploration erroneously deducted post-production costs from the royalty due on the owner lessor's overriding royalty interests.[15] After examining and interpreting, among other provisions, the following two gas-royalty provisions contained in the lease, the court sided with the mineral estate owners/lessors:

1. *Gas-produced royalty.* The first royalty provision pertaining to gas production provided that the lessee would pay the lessor 25 percent of the price that had actually been received by the lessee "for all gas produced from the leased premises and sold or used." The lease further provided that the royalty on all gas produced and sold or used was "free and clear of all production and post-production costs and expenses."[16]
2. *Disputed overriding royalty provision.* The second gas royalty provision, which was the provision subject to dispute in the litigation, provided for "a perpetual, cost-free (except only its portion of production taxes) overriding royalty of 5 percent ... of gross production obtained from direction wells drilled on the lease but bottomed on nearby land."[17]

The general rule is that an overriding royalty, like a regular royalty, "is free of production costs but must bear its share of post-production costs, unless the parties agree otherwise."[18] In the *Chesapeake Exploration* case, the court found that the parties modified the general rule in the lease and specifically provided for a "cost-free" overriding royalty free of post-production costs.[19] Accordingly, the court affirmed the lower court's judgment awarding the mineral estate owners/lessors $575,359.90 in post-production costs deducted from overriding royalties in error.[20]

Royalty Disputes in Bankruptcy Cases

In the bankruptcy case of *Aurora Oil & Gas Corp.*, the U.S. Bankruptcy Court for the District of Michigan decided a royalty dispute between Aurora Energy Ltd. (the lessee) and Frontier Energy LLC (the lessor).[21] The royalty dispute litigation was initially commenced in state court prior to the bankruptcy filing, but was removed to the bankruptcy court by Aurora.[22]

Frontier alleged that Aurora underpaid royalties on two oil and gas leases due to a miscalculation of "payout" and the improper deduction of certain costs.[23] One of the leases specifically stated that the "[l]essor's royalty shall be free of all costs excepting those costs incurred by lessee for CO_2 removal, third-party transportation, and necessary compression."[24] Despite this language, Frontier challenged Aurora's deduction of, among other expenses, transportation costs and first-stage compression costs.[25] Frontier also opposed the rate used by Aurora to calculate the CO_2 removal cost.[26] Siding with Aurora, the court found that Aurora's calculations and deduction of post-production costs were reasonable and proper.[27]

Initially, the royalty was 15 percent of the proceeds of a sale of produced gas.[28] However, the lease also contained an escalating royalty-payout clause.[29] Pursuant to the lease terms, the royalty paid to Frontier would increase once the project reached its break-even point and began to generate a profit.[30] The lease defined "payout" as

> the point in time that the *proceeds of production* attributable to the interest of lessee in all wells drilled upon the Antrim Unit, less royalties and other lease burdens and production or similar taxes, equals the costs incurred by lessee for drilling, testing, completing and equipping all wells, constructing and installing all necessary gathering lines, facilities and pipelines, including meters, plus the cost of operating the Antrim Unit prior to Payout.[31]

7 *Id.* (internal quotation marks and citation omitted).
8 *Id.* (internal citations omitted).
9 *Id.*
10 *See, e.g.*, Max B. Baker, "First Trials Set for Chesapeake Royalty Cases," *Star Telegram*, July 17, 2015, *available at* www.star-telegram.com/news/business/barnett-shale/article27543175.html. *See also* Dianna Hunt, "Landowners Challenge Gas Giant Chesapeake on Royalties," *Dallas Morning News*, Sept. 19, 2015, *available at* www.dallasnews.com/news/metro/20150919-landowners-challenge-gas-giant-chesapeake-on-royalties.ece (both links were last visited on Oct. 21, 2015).
11 No. 14-0302, 2015 WL 3653446, at * 1 (Tex. June 12, 2015) (pet. for rehearing filed Aug. 5, 2015).
12 *Id.*
13 *Id.*
14 *Id.*
15 *Id.*
16 *Id.* (internal quotation marks and citation omitted).
17 *Id.* (internal quotation marks and citation omitted).
18 *Id.*
19 *Id.* at *3-5.
20 *Id.* at *3.
21 *See Frontier Energy LLC v. Aurora Energy Ltd. (In re Aurora Oil & Gas Corp.)*, 460 B.R. 470 (Bankr. W.D. Mich. 2011).
22 *Id.* at 474-75.
23 *Id.* at 475.
24 *Id.* at 482.
25 *Id.* at 482-487.
26 *Id.*
27 *Id.*
28 *Id.* at 487.
29 *Id.*
30 *Id.* at 487-88.
31 *Id.* (emphasis added).

Once "payout," the break-event point, was reached, Aurora was required to pay a royalty based on the price for which produced gas was sold.[32] The lease provided for the following rate structure under the escalating royalty clause:

1. 15 percent of the proceeds of sale attributable to a price up to and including $2.50 per 1 million British Thermal Units (MMbtu);
2. 25 percent of the proceeds of sale attributable to a price greater than $2.50 per MMbtu and up to and including a price of $3.50 per MMbtu; and
3. 50 percent of the proceeds of sale attributable to a price in excess of $3.50 per MMbtu.[33]

Frontier argued, among other issues, that when calculating whether "payout" was achieved, which would trigger the escalating royalty, Aurora could not deduct post-production expenses from the "proceeds of production."[34] Disagreeing with Frontier, the court found "that the phrase 'proceeds of production' means proceeds of sale, minus [post-production costs], and therefore, Aurora's deductions of [post-production costs] in calculating [the] Payout was consistent with the" language of the lease.[35]

In the *KY USA Energy* case in the U.S. Bankruptcy Court for the Western District of Kentucky, royalty owners commenced litigation against the debtor for alleged underpayment of royalties on gas production.[36] The subject oil and gas leases provided for payment of a gas royalty that was "one-eighth, at the market price at the well for the gas so used, for the gas from each well where gas only is found."[37]

The gas produced at the well was not fit and marketable for sale,[38] so the debtor constructed a pipeline and gathering system to transport the unmarketable natural gas to a treatment facility owned by Seminole Energy.[39] At the well, a meter measured the volume of gas produced as the gas entered the pipeline and gathering system.[40] After Seminole Energy treated the gas to remove nitrogen and inerts, it purchased the gas from the debtor at a price calculated based on the volume of gas.[41]

The price paid by Seminole Energy was the basis for calculation of the one-eighth royalty payments to royalty owners.[42] Further, since the gas was not immediately saleable at the wellhead, the debtor passed along the treatment costs to the royalty owners on a *pro rata* basis.[43]

In the bankruptcy litigation, the royalty owners contended that under Kentucky law, their royalties should be free from post-production costs such as treatment and gathering.[44] Upon review and analysis of Kentucky law, the court disagreed with the royalty owners and concluded that the debtor's deduction of post-production expenses was warranted[45] because "Kentucky follows the 'at-the-well' rule, which allows for the deduction of post-production costs before the payment of royalties on an oil and gas lease."[46]

In the 1980s, Texaco likewise found itself a defendant in litigation regarding underpayment of gas royalties.[47] Even though Texaco's bankruptcy case was filed in the U.S. Bankruptcy Court for the Southern District of New York, the court transferred the dispute to the U.S. Bankruptcy Court for the Middle District of Louisiana for the ultimate determination of its underpaid royalties claim.[48]

Conclusion

A continued period of low oil and gas prices may lead to an increasing number of royalty disputes in and outside of bankruptcy. As both bankruptcy and nonbankruptcy case law reveals, the litigation will most likely involve the proper calculation of the gas royalty. Therefore, it would behoove bankruptcy and insolvency practitioners to familiarize themselves with these types of disputes in preparation for a possible uptick in this type of litigation. abi

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32 *Id.* at 487.
33 *Id.* As clarification, a 15 percent royalty is to be applied to the first $2.50 per MMbtu regardless of the total sales price.
34 *Id.* at 487-91.
35 *Id.* at 491.
36 *K&D Energy v. KY USA Energy Inc. (In re KY USA Energy Inc.)*, 448 B.R. 191 (Bankr. W.D. Ky. 2011).
37 *Id.* at 192-93.
38 *Id.* at 193.
39 *Id.*
40 *Id.*
41 *Id.*
42 *Id.*
43 *Id.*
44 *Id.*
45 *Id.* at 194-96.
46 *Id.* at 196.
47 *See In re Texaco Inc.*, 89 B.R. 382 (Bankr. S.D.N.Y. 1988).
48 *Id.*