**IN THE UNITED STATES DISTRICT COURT**
**FOR THE SOUTHERN DISTRICT OF TEXAS**
**HOUSTON DIVISION**

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|---|---|---|
| GERTRUDE PETROLEUM CORPORATION, | § | |
| | § | |
| Plaintiff and Counterdefendant, | § | Civil Action No. 98-0001 |
| vs. | § | |
| | § | |
| ROGER J. ROYALTY, et. al. | § | |
| | § | |
| Defendants and Counterplaintiffs | § | |

**THE ROYALTY OWNERS'TRIAL BRIEF**

**To the Honorable E.M. Jurist,**
**United States District Judge:**

Roger J. Royalty, *et. al.* (collectively the "Royalty Owners") file this Trial Brief in the above-captioned civil action.

## Overview

1. Gertrude Petroleum Corporation ("GPC") pays gas royalty to the Royalty Owners under two oil and gas leases. The plain language of the leases prohibits GPC from diluting that royalty by deducting post-production expenses such as marketing and transportation costs that GPC incurs in transporting and selling the gas.

2. Despite this indisputable lease language, GPC has been deducting marketing and transportation costs from the Royalty Owners' royalty since GPC assumed responsibility for paying the royalty in 1996. GPC rationalizes this conduct by relying on the Texas Supreme Court's decision in *Heritage Resources, Inc. v. Nationsbank*, 939 S.W.2d 118 (Tex. 1996), *rehearing overruled*, 960 S.W.2d 619 (Tex. 1997) (the *"Heritage* decision"). GPC contends that the *Heritage* decision is dispositive legal authority that authorizes GPC to deduct post-production expenses despite lease language that prohibits such deductions. Stated simply, GPC contends that *Heritage* trumps the plain language of the lease.

3. GPC misinterprets the precedential value of the *Heritage* decision. GPC's deduction of post-production expenses from the Royalty Owner's royalty—in the face of clear lease language prohibiting such deductions—is neither condoned under Texas law nor customary oil and gas industry standards. Accordingly, the Court should approve a judgment against GPC and in favor of the Royalty Owners and against for the amount of GPC's illegal deductions from the Royalty Owners' royalty.

**Facts**

4. GPC pays royalty to the Royalty Owners under two leases ("the Leases") that contain the following provision:

> 3. The royalties to be paid or delivered by Lessee to Lessors, . . ., are as follows:
>
> * * *
>
> (b) Gas: On all gas, one sixth (1/6th) of the greater of (1) the market value at the wellhead at the time of sale, *free of all costs and expenses* (emphasis supplied), or (2) gas sold at the well . . . . However, if the gas sales contract makes any deductions for the expense fo compression, gathering, processing, treating, dehydrating, transporting, marketing or other services necessary to make the gas available or merchantable to a purchaser, then such deductions shall be added to the price received by Lessee for such gas for the purposes of payment of royalties called for herein so that Lessors' royalty shall not bear, directly or indirectly, any of such expenses.
>
> * * *
>
> (g) Costs of Producing; Use of Oil, Gas and Water: It is further agreed that Lessors' royalty *shall never bear, either directly or indirectly, any part of the cost or expense of production, gathering, dehydration, compression, transportation, manufacturing, processing, treating or marketing* (emphasis supplied) of the oil or gas (as herein defined) from the Lease premises; . .

5. GPC and the Royalty Owners agree that the foregoing royalty clause is unambiguous.

6. Since GPC assumed responsibility for paying royalty to the Royalty Owners under the Leases in 1996, GPC has deducted post-production costs—namely transportation and marketing

fees—from the Royalty Owners' royalty. The post-production costs that GPC deducted from the Royalty Owners' royalties were not listed on the check stub or attachment to the payment form that GPC used in paying royalties to the Royalty Owners. These deductions resulted in the Royalty Owners receiving substantially less royalty from GPC than they would have received had the expenses not been deducted. The difference between the royalty amount that the Royalty Owners have received and the amount that they would have received had GPC not deducted these expenses is referred to as the "Disputed Royalty" in this memorandum.

7. During a routine review of GPC's royalty payments in March 2000, the Royalty Owners discovered that GPC was deducting post-production costs from their royalty and promptly notified GPC of their intent to exercise their right to terminate the Leases as a result of GPC's underpayment of royalty. In response, GPC commenced this case requesting a declaratory judgment that the *Heritage* decision authorizes such deductions. Subsequently, the Royalty Owners' asserted a counterclaim to recover the Disputed Royalty from GPC, and the case is now ready for trial.

**Argument and Authorities**

8. Two generally accepted methods in the oil and gas industry determine the "market value at the well" under a lease royalty clause—the comparable-sales method and the net-back method. In determining market value at the well under the Leases involved in this proceeding, GPC uses the net-back method. The net-back method means that GPC subtracts post-production costs from its sales price to arrive at the value on which GPC calculated royalties.

9. Sales of gas seldom take place at the wellhead. Accordingly, the lessee-producer incurs post-production costs such as transportation and marketing fees prior to sale of the gas. Once the market value in the field has been determined, the lessee-producer generally deducts from that value the costs of taking its gas to that market and making it marketable.

10. Under a typical "market value" royalty clause, the "market value at the well" is derived by deducting post-production costs, regardless of whether the lessee-producer uses its own sales price as the market value (as GPC did in this case) or uses the comparable-sales method. Accordingly, in negotiating a lease with a prospective lessee-producer, a lessor has a strong economic incentive to seek to modify the royalty clause of the lease to prohibit deduction of post-production costs in deriving this market value. Stated another way, this issue is simply an economic trading point in negotiations between a lessor and lessee-producer. Royalty owners routinely seek to negotiate such a lease modification to enhance the value of their royalty. That is precisely what the Royalty Owners did in lease negotiations regarding the Leases involved in this case.

11. The purpose and effect of the above-described "no deduction of post-petition costs" proviso in the Leases' royalty clause is to relieve the Royalty Owners of all costs of transporting or marketing the gas. Such language is considered a straightforward way of shifting to the lessee-producer the costs attributable to performance of the lessee's implied duty of marketing the gas. It also serves to avoid the disputes that often arise between the lessor and lessee relating to post-production costs. If the lessor must bear a part of post-production costs and the lessee-producer is the provider of those post-production services, then the lessee-producer has an incentive to inflate the value of those services in its royalty calculation. Lawsuits abound in Texas and elsewhere in which a wily lessee-producer has sought to pad such costs to the detriment of royalty owners. This incentive is eliminated if the lessee-producer must bear all of those costs under the lease.

12. This Court has a duty to construe the royalty clause, if possible, to give equal dignity to all of its provisions, and to avoid a construction which would render any part of the clause meaningless. As the Texas Supreme Court stated in *McMahon v. Christmann*, 303 S.W.2d 341, 344 (Tex. 1957):

> In interpreting the lease it is the duty of the court to seek the intention of the parties. The intention of the parties, as that intention is expressed in the lease, is to be ascertained by a consideration of all of the provisions of the lease, and by harmonizing, if possible, those provisions which appear to be in conflict. (citations omitted).

13. GPC's interpretation of the royalty clause in the Leases violates these basic canons of construction. GPC's construction fails to give equal weight to the "no deduction of post-production costs" proviso, and fails to construe the clause as a whole so as to give all parts of the clause a meaning. "Surplus" language in common parlance is language that has no meaning in the context of the document and does not alter preceding provisions. This cannot be said about the "no deduction of post-production costs" proviso in the Leases involved in this proceeding.

14. Under GPC's construction, once the draftsman uses the phrase "market value at the well," anything further intended to modify or limit this phrase to the lessor's advantage is impossible because this phrase is invulnerable to change or modification as a matter of law. Stated another way, GPC concludes that, under a "market value at the well" royalty clause, it is proper for the lessee-producer to calculate market value by deducting from its sales proceeds any post-production costs incurred. The "no deduction from post-petition costs" proviso that the Royalty Owners added to the Leases involved in this case states that there shall be no deductions for post-production costs. Does GPC really mean to say that such a proviso merely restates existing law?

15. Having so construed the clause, GPC concludes that the "no deduction from post-petition costs" proviso has no practical effect—GPC need not deduct post-production costs from the market value *at the well*, because the market value at the well is *by definition* the value after deduction of post-production costs. Based on this narrow and technical interpretation, GPC concludes that the proviso is surplusage.

16. GPC's construction is simply contrary to well-defined canons of contract construction. Absent compelling reason, the United States Supreme Court has long held that

contracts "made in an arm's-length negotiation by experienced and sophisticated businessmen . . . should be honored by the parties and enforced by the courts." *M/S Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1, 12 (1972).

17. Similarly, fundamental principles of Texas law provide that parties enjoy the utmost freedom of contract. Texas courts will enforce a contract freely made for a lawful purpose and will give effect to the written expression of the parties' intent. *Crutchfield v. Associates Inv. Co.*, 376 S.W.2d 957, 959 (Tex. Civ. App—Dallas 1964, writ ref'd); *Forbau v. Aetna Life Ins. Co.*, 876 S.W.2d 132, 133 (Tex. 1994).

18. In rationalizing its deduction of post-production expenses before calculating the Royalty Owners' royalty when the Leases provide specifically that it cannot do so, GPC contends that the *Heritage* decision entitles it to do so. However, GPC misinterprets the limited precedential effect of the *Heritage* decision. In *Heritage*, the Texas Supreme Court was confronted with similar facts and circumstances as here—an operator had deducted post-production expenses before calculating royalty in the face of express lease language that prohibited deduction of such post-production expenses. In one of the more controversial decisions (at least in oil and gas circles) of recent Texas Supreme Court history, the Court, by a 7-2 majority, held in its original decision that the "no deduction" language of the lease was mere "surplusage" and, thus, the operator could deduct the post-production expenses despite the lease language prohibiting such deductions. *Heritage* 939 S.W.2d at 123. The 7-2 Supreme Court majority in the original *Heritage* decision lined up as follows:

| **Majority (5)** | **Concur (2)** | **Dissent (2)** |
|---|---|---|
| Justice Baker | Justice Owen | Justice Gonzalez |
| Chief Justice Phillips | Justice Hecht | Justice Abbott |
| Justice Cornyn | | |
| Justice Enoch | | |
| Justice Spector | | |

19. Publication of the *Heritage* decision set off a widespread firestorm in the oil and gas industry. Among the disparate parties-in-interest that filed an amicus brief supporting the motion for rehearing to overturn the *Heritage* decision were the following: The Texas Land Commissioner, the Boy Scouts of America, the University of Texas System, Southern Methodist University, the Baptist Foundation of America, the National Association of Royalty Owners, the Texas Bankers Association, Texas Commerce Bank, Moody National Bank, and Frost National Bank.

20. Contrary to GPC's suggestion in its briefs, the Texas Supreme Court's decision on rehearing in *Heritage* was far from an endorsement of the original *Heritage* decision (the cite for the *Heritage* rehearing decision is 960 S.W.2d 619 (Tex. 1997)). On rehearing, the original 7-2 majority of the Court splintered into the following, with Justice Enoch recusing himself on rehearing:

| **Majority (1)** | **Concur (3)** | **Dissent (4)** |
|---|---|---|
| Justice Baker | Justice Owen | Justice Gonzalez |
| | Justice Hecht | Justice Abbott |
| | Chief Justice Phillips | Justice Cornyn |
| | | Justice Spector |

21. Consequently, on rehearing, the Texas Supreme Court undermined any precedential impact of its original *Heritage* decision. On rehearing, more Justices actually supported the dissenting opinion in *Heritage* than either the majority opinion or the concurring opinion. Indeed, on rehearing, only one Justice (J. Baker) still supported the original majority opinion, and two justices (J. Cornyn and J. Spector) actually switched their votes entirely from the majority opinion to the dissent.

22. Accordingly, due to Justice Enoch's recusal on rehearing, the Supreme Court deadlocked 4-4 on the motion for rehearing of the *Heritage* decision. This result left the original *Heritage* decision standing technically, but eviscerated its precedential value because the Court was

without majority agreement on the reasons supporting the original *Heritage* decision. Under Texas law, where the Supreme Court is without a majority agreement on the reasons supporting a judgment, the judgment has very limited precedential value and controls only that case. *Univ. of Tex. Med. Branch at Galv. v. York*, 871 S.W.2d 175, 176-77 (Tex. 1994).

23. The Texas Supreme Court utilized this principle when it considered the scope of governmental immunity arising from alleged negligent use of a patient's medical records in *Texas Dept. of Mental Health and Mental Ret. v. Petty*, 848 S.W.2d 680, 686 (Tex. 1992). In that case, the plaintiff sued TDMHMR for negligence in misusing her institutional medical records. In a plurality decision, a divided Court concurred in the judgment affirming the judgment of the appeals court and the trial court awarding the plaintiff recovery under the Tort Claims Act. *Id.* at 685. However, no majority for the Court expressed a single rationale supporting the judgment. Rather, four justices concluded that the plaintiff's treatment records were tangible personal property and four justices dissented, concluding that medical records were not tangible personal property. In affirming the lower court's judgment in *Petty* without a majority agreement on the reasons supporting the judgment, the judgment itself has very limited precedential value and would control the result only in identical cases. *See*: Linda Novak, Note, *The Precedential Value of Supreme Court Plurality Decisions*, 80 COLUM.L.REV. 756, 756-758 and 779 (1987).

24. As the Supreme Court stated in the *York*:

> Because the principles of law involved have not been agreed upon by a majority of the sitting court, the plurality opinion is not authority for determination of other cases, either in this Court or lower courts.
>
> Furthermore, because Petty was affirmed without a coherent majority rationale, it is our duty to endeavor to resolve issues as important as waiver of governmental immunity so as to provide a reasoning that may offer guidance not only for the parties, but for future litigants, the bench, the bar, and the general public in shaping their conduct and decisions. *See*: Novak, *supra*, at 757-8 (footnotes omitted). While we may look to Petty for guidance, we are not bound by the result in that case and

> must consider anew the issue of governmental immunity for negligent use of information contained in a patient's medical records.

*Univ. of Tex. Med. Branch at Galv. v. York*, 871 S.W.2d at 177 (Tex. 1994).

25. Consequently, rather than being the trump card that GPC suggests, the *Heritage* decision is nothing more than a bluff. It certainly is not justification for GPC's improper deduction of post-production expenses in the face of express lease provisions prohibiting such deductions. Indeed, under the *York* decision, it is this Court's duty to resolve this proceeding on its merits. *York*, 871 S.W.2d at 177.

26. Finally, as somewhat of a throw-in, GPC argues that the Royalty Owners should be estopped from claiming that the post-production deductions were improper. The only evidence to support this contention is a February 4, 1997 letter from GPC to counsel for some of the Royalty Owners concerning negotiations over a lease separate and apart from the Leases involved in this proceeding. Nothing in that letter notifies the Royalty Owner's counsel (who only represented only some of the royalty owners, anyway) that GPC was deducting post-production costs under the Leases involved in this proceeding. Counsel for the Royalty Owners is aware of no legal authority for the proposition that the heavy burden of an estoppel defense can be sustained through proof of delivery of a letter that has nothing to do with the subject matter of the proceeding in which the estoppel defense is asserted.

27. Moreover, GPC cannot assert the equitable defense of estoppel because it has "unclean hands." The post-production costs that GPC deducted before calculating the Royalty Group's royalties were not listed on the check stub or attachment to the payment form that GPC used in paying royalties to the Royalty Group. Sections 91.502(7)(10) and (11) of the Texas Natural Resources Code specifically require GPC to disclose such deductions or adjustments on the royalty check stub or attachment to the royalty payment form accompanying the royalty payments to the

Royalty Owners. Inasmuch as GPC did not comply with that statute, GPC withheld information from which the Royalty Owners could have ascertained such improper deductions. GPC cannot, on one hand, assert that the Royalty Owners should be estopped from recovering the Disputed Royalty because they should have known about the improper deductions when, on the other hand, GPC illegally withheld the information from which the Royalty Owners could have discovered the improper deductions.

## Conclusion

GPC is in denial. Confronted with the fact that it is deducting post-production expenses from royalty even though the plain terms of the applicable leases forbid such deductions, GPC proffers the *Heritage* decision as justification for its wrongful conduct. Unfortunately for GPC, the *Heritage* decision is of extremely limited precedential value under Texas law.

Accordingly, GPC's misconduct—deduction of post-production expenses despite clear lease language prohibiting such deductions—must stand on its own before this Court. Applying fundamental principles of contract construction under either state or federal law, GPC's deduction of post-production costs is a violation of the Leases' royalty clause. As a result, the Royalty Owners should be awarded the Disputed Royalty in this proceeding, and GPC's request for a declaratory judgment should be denied.

**Houston, Texas**
**December 1, 2000**

Respectfully submitted,

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