NO. 14-0302

IN THE SUPREME COURT OF TEXAS

CHESAPEAKE EXPLORATION, L.L.C
AND CHESAPEAKE OPERATING, INC., Petitioners

v.

MARTHA ROWAN HYDER, ET AL., Respondents

ON PETITION FOR REVIEW
FROM THE FOURTH COURT OF APPEALS, SAN ANTONIO, TEXAS
COURT OF APPEALS NO. 04-12-00769-CV

BRIEF OF AMICUS CURIAE

TEXAS LAND AND MINERAL OWNERS ASSOCIATION AND NATIONAL ASSOCIATION OF ROYALTY OWNERS-TEXAS, INC.

Hon. Raul A. Gonzalez
State Bar No. 32
rgonzalezlaw@aol.com
10511 River Plantation Dr.
Austin, Texas 78747
512-280-1002 Telephone
512-292-4513 Telecopier

John B. McFarland
State Bar No. 13598500
jmcfarland@gdhm.com
GRAVES, DOUGHERTY, HEARON & MOODY, P.C.
401 Congress Avenue, Suite 2200
Austin, Texas 78701-3744
(512) 480-5618 Telephone
(512) 480-5818 Telecopier

ATTORNEYS FOR TEXAS LAND AND MINERAL OWNERS ASSOCIATION AND NATIONAL ASSOCIATION OF ROYALTY OWNERS-TEXAS, INC.

TABLE OF CONTENTS

INDEX OF AUTHORITIES

Cases **Page(s)**

IDENTITY AND INTEREST OF AMICUS CURIAE TEXAS LAND AND MINERAL OWNERS ASSOCIATION

Texas Land and Mineral Owners Association ("TLMA") is a statewide advocacy association whose members are farmers, ranchers, and royalty owners. TLMA's charter is to support a business and legal environment that accommodates the continued exploration for and production of oil and natural gas and also protects the property rights of mineral owners.

The National Association of Royalty Owners-Texas, Inc. ("NARO-Texas") is a non-profit trade association organized under Texas law, representing a statewide membership of oil and gas royalty owners and landowners. NARO-Texas seeks to protect the economic interests and promote the legal rights of oil and gas royalty owners throughout Texas.

TLMA and NARO-Texas are paying the fees for preparation and submission of this brief.

INTRODUCTION

Texas Land & Mineral Owners' Association files this brief in support of the Hyders' arguments. The lease in question was negotiated by sophisticated parties represented by counsel; the parties exercised their freedom of contract and agreed to modify the general rules regarding cost sharing of post-production costs; the parties in clear and unambiguous language declared that the lessor's overriding royalty shall be "cost-free;" the court of appeals applied settled rules of construction to interpret the lease and correctly decided the case; and this Court does not have conflicts jurisdiction. In the alternative, if the Court should grant the Petition for Review, the judgment of the Fourth Court of Appeals should be affirmed.

This is one of a long line of cases in which Chesapeake has sought to profit at the expense of royalty owners by unjustified deduction of post-production costs from royalties. Chesapeake is the most aggressive exploration company in the industry in seeking to deduct post-production costs. Its practices have led most recently to a class action RICO suit in Pennsylvania[1] and an investigation by the U.S. Department of Justice of its royalty payment practices.[2] Investigative reports

[1] http://www.courthousenews.com/2014/06/25/69022.htm (last visited Dec. 3, 2014).

[2] http://powersource.post-gazette.com/powersource/latest-oil-and-gas/2014/11/13/Dept-Of-Justice-Has-Subpoenaed-Chesapeake-Energy-s-Royalty-Records/stories/201411130283 (last visited Dec. 3, 2014).

published by Pro Publica, the Wall Street Journal and Forbes[3] conclude that Chesapeake's methods have greatly reduced the royalties it pays to its royalty owners, by an average of 85 cents per mcf – much more than other similarly situated operators. Royalty owners' suits have been brought against Chesapeake by the Dallas-Fort Worth Airport, the City of Fort Worth, the Fort Worth Independent School District, the City of Arlington, the Arlington Independent School District, the Bass family, and Tarrant County College, among many others. These suits have caused the company to report in its latest annual report that "adverse results in pending cases would cause our obligations to royalty owners to increase and would negatively impact our future results of operations."[4]

In defending its practice of deducting post-production costs, Chesapeake repeatedly cites this Court's opinion in *Heritage v. NationsBank*, 939 S.W.2d 118 (Tex. 1996). Despite the very limited precedential value of that opinion, Chesapeake's attorneys refer to that case as the "seminal and controlling case" in all of its royalty litigation over post-production costs, regardless of the language in the lease.[5]

To avoid Chesapeake's reliance on *Heritage*, landowners have adopted the

---

[3] http://www.forbes.com/sites/christopherhelman/2014/03/17/screwing-royalty-owners-means-chesapeake-is-stealing-cash (last visited Dec. 3, 2014).

[4] Chesapeake Energy Corporation 2013 Form 10-K, page 30, found at http://www.chk.com/investors/annual-and-quarterly-reports#AR (last visited Dec. 3, 2014).

[5] Chesapeake Brief on the Merits, page 20.

practice of inserting provisions in their leases like the one in the Hyder lease, in which the lessor and lessee agree that "the holding in the case of *Heritage* … shall have no application to the terms and provisions of this Lease." This is the first case in which such a *Heritage* disclaimer has been an issue. Despite this disclaimer, and despite the clear and unambiguous language in the lease that the lessor's overriding royalty shall be "cost-free," Chesapeake continues to assert that *Heritage* entitles it to deduct post-production costs.

SUMMARY OF ARGUMENT

The Court should reject Chesapeake's argument that its decision in *Heritage* controls here. *Heritage* is of limited precedential value and, since it was decided, many lessors have drafted provisions in their leases to preclude *Heritage* from applying to them. The Court should give meaning to contract language that is designed to prohibit lessees from allocating post-production costs to royalty owners.

ARGUMENT

A. *Heritage* is of limited precedential authority and lessors like Hyder should be allowed to contract around it.

Four opinions were written by members of this Court in *Heritage*. Initially, the court issued three opinions: one by Justice Baker, joined by Chief Justice Phillips and Justices Cornyn, Enoch and Spector; a concurring opinion by Justice Owen in which Justice Hecht joined; and a dissenting opinion by Justice Gonzalez

joined by Justice Abbott. Justice Gonzalez issued a second opinion dissenting on rehearing. *See Heritage Resources v. NationsBank*, 960 S.W.2d 619 (Tex. 1997) (Gonzalez, J. dissenting on motion for rehearing). In his second opinion, Justice Gonzalez revealed that Justices Cornyn, Spector and Abbott joined him in voting to grant NationsBank's motion for rehearing; Justice Enoch recused himself; and Justice Phillips "has also switched his position and now agrees with Justice Owen's concurrence, in which Justice Hecht joined, … leaving Justice Baker as the lone remaining supporter of his original majority opinion." *Id.* at 620. This left the Court equally divided. Justice Gonzalez concluded:

> Because we are without majority agreement on the reasons supporting the judgment, … the judgment itself has very limited precedential value and controls only this case. *See University of Tex. Med. Brand at Galveston v. York*, 871 S.W.2d 175, 176-177 (Tex. 1994). Cases relying on the new rule of law pronounced in the Court's April 25, 1996 opinion are similarly restricted. *See, e.g., Judice v. Mewbourne Oil Co.,*, 939 S.W.2d 133, 135-136 (Tex. 1996) (citing *Heritage Resources* for proposition that lessee must share in post-production costs because "[t]he royalty is to be determined based on 'market value at the well'").

Id. After the Court's original opinions in *Heritage*, many educational institutions, charitable organizations, individual royalty owners and oil and gas practitioners filed amicus curiae briefs asking the court to reconsider its opinion, including the Commissioner of the Texas General Land Office, the University of Texas System, Southern Methodist University, the Baptist Foundation of Texas, the Boy Scouts of America, the Moody Foundation, the Texas Bankers Association, the Independent

Bankers Association of Texas, and the National Association of Royalty Owners. *Id.* at 619. As anticipated by those amici, the decision in *Heritage* has stirred conflict and controversy between exploration companies and royalty owners over the deductibility of post-production costs.

The leases in *Heritage* provided that royalties would be based on the market value at the well of gas produced and sold, "provided, however, that there shall be no deductions from the value of the Lessor's royalty by reason of any required processing, cost of dehydration, compression, transportation or other matter to market such gas." *Heritage*, 939 S.W.2d at 120-21. The holding in the (original) majority opinion is that, because the royalty was to be calculated based on the value of the gas "at the well," no deduction was being taken *from that value* in calculating the lessor's royalty – even though, in calculating the "market value" of the lessor's gas, Heritage deducted transportation costs from its sales price. The opinion concluded that "the post-production clauses merely restated existing law."

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

939 S.W.2d at 123.

In her concurring opinion, Justice Owen said: "it is important to note that we are construing specific language in specific oil and gas leases. Parties to a lease

may allocate costs, including post-production or marketing costs, as they choose." 939 S.W.2d at 124.

B. *Heritage* should not be applied to the Hyder Lease.

How, then, should the limited precedent of the *Heritage* case apply to construction of the royalty provisions of the Hyder lease? The answer, according to the parties' own agreement, is stated in the lease itself: **"the holding in the case of *Heritage* … shall have no application to the terms and provisions of this Lease." (Emphasis added)** In other words, Justice Baker's conclusion in *Heritage* that the no-deductions provisions of the NationsBank lease are "surplusage" does not apply to the Hyder lease. Regarding the overriding royalty to be paid to the Hyders, "cost-free" means what it says – *no costs* shall be deducted in calculating the amounts due for the overriding royalty.

Chesapeake argues that it should be able to deduct post-production costs because the Hyders' overriding royalty is measured based on the value of the gas at the well and, therefore, it can deduct those costs even though the lease provides that the overriding royalty shall be "cost-free." The Hyder lease, however, does not say that the royalty is measured based on the value of the gas at the well. In effect, Chesapeake is arguing that the "cost-free" language is "surplusage," just as it was held to be in *Heritage*. But the parties have agreed in this lease that *Heritage* shall have no application to the lease. So the words "cost-free" cannot be

surplusage.

The intent of the parties to a contract is to be derived from the language of the contract as a whole. *Forbau v. Aetna Life Ins. Co.*, 876 S.W.2d 132, 133 (Tex. 1994). All provisions of the contract must be read together to discern the parties' intent. *Id.* The intent of the parties in the Hyder lease is clear: royalties, including the overriding royalty, are to be calculated and paid without any deductions.

Because *Heritage* has very limited precedential value, it applies (if at all) only to cases with the same lease language. The Hyder lease does not provide that the overriding royalty is to be calculated based on the "market value at the well." It provides that the royalty is to be based on "gross production" from the well. Neither Chesapeake nor the Texas Oil & Gas Association (TxOGA) cites any precedent for their argument that a royalty on "gross production" must be based on market value at the well.

Chesapeake makes two additional arguments in an attempt to avoid the *Heritage* disclaimer that should give this Court pause. First, it argues that the clause is too vague and does not specify "what supposed legal rights the parties intentionally and knowingly relinquished …." Brief at 22. Chesapeake understood the intent of the parties in inserting the *Heritage* disclaimer. All oil and gas practitioners understand the holding in *Heritage*. That holding is that, when a lease provides for payment of royalty based on the market value "at the well," post-

production costs may be deducted even if the lease prohibits such deductions. The intent of the parties to the Hyder lease is clear: notwithstanding the holding in *Heritage*, post-production costs cannot be deducted from the royalty.[6]

Chesapeake also argues that recognition of the effect of the *Heritage* disclaimer in the Hyder lease should somehow be against public policy because it "would encourage parties to attempt to contract around controlling precedent when they disagree with this Court's decision …" Brief at 24. Again Chesapeake cites no authority for this proposition. Justice Owen made clear in her concurring opinion in *Heritage* that the parties to an oil and gas lease are free to agree to allocate post-production costs however they wish. Chesapeake is attempting to expand the holding in *Heritage* to say that a lessee can *always* deduct post-production costs from royalties, regardless of the provisions of the lease, and that it would be against public policy to provide otherwise.

C. "Cost-free" does not mean free of only production costs.

Both Chesapeake and TxOGA argue that "cost-free (except only its portion of production taxes)" means free of production costs, but not post-production costs. TxOGA argues that the phrase "cost free," when associated with an overriding royalty, is "understood in the industry" to make the overriding royalty free of

[6] As the Hyder's brief points out, Chesapeake's counsel certainly understood the meaning of the intent and result of the *Heritage* disclaimer when it argued Chesapeake's case in *Potts v. Chesapeake* before the 5th Circuit Court of Appeals. Chesapeake's counsel there cited the *Heritage* disclaimer in the Hyder lease as one of the "many ways parties can contract around *Heritage*."

production costs that must be paid by the working interest. TxOGA cites no authority or evidence for such an "industry understanding." Words in a contract should be given their plain, ordinary meaning. *Tawes v. Barnes*, 340 S.W.3d 419, 425-426 (Tex. 2011). "Cost-free" means what it says. No expert testimony is needed to understand the meaning of those words. No Texas case cited by either Chesapeake or TxOGA holds that post-production costs may be deducted from a "cost-free" overriding royalty. As pointed out in the Hyders' brief, a royalty is by definition free of production costs. "Cost-free" is redundant unless it also includes post-production costs.

D. There is no basis to treat the overriding royalty differently from the landowner's royalty.

Chesapeake and TxOGA also seek to distinguish a royalty from an overriding royalty, arguing that post-production costs are always deductible from overriding royalties, even if they are to be paid "cost-free". It is true that the royalty reserved in an oil and gas lease is different from a royalty carved out of a working interest. They are distinguishable by their origin. But for both royalties and overriding royalties, under Texas law, the holder of the royalty bears no production costs; but does, *absent agreement to the contrary*, bear post-production costs. As stated by Justice Owen, "parties to a lease may allocate costs, including post-production or marketing costs, as they choose." *Heritage*, 939 S.W.2d at 124. In the Hyder lease, the parties chose to allocate all post-production costs to the

lessee, for both the landowners' royalty and the overriding royalty.

Conclusion

The Court of Appeals correctly construed the Hyder lease to prohibit Chesapeake from deducting post-production costs either from the landowners' royalty or from the overriding royalty. The opinion applies well-established principles of contract construction to do so. This Court's opinion in *Heritage v. NationsBank* has no application to this case, both because of its limited precedential value and because of the express disclaimer of the *Heritage* holding in the Hyder lease. Chesapeake's petition for review should be denied. Alternatively, if this Court decides to accept this case, the opinion of the court below should be in all things affirmed.

Respectfully submitted,

/s/ Hon. Raul A. Gonzalez
Hon. Raul A. Gonzalez
10511 River Plantation Dr.
Austin, Texas 78747
512-280-1002 Telephone
512-292-4513 Telecopier

GRAVES, DOUGHERTY, HEARON & MOODY
A Professional Corporation
401 Congress Avenue, Suite 2200
Austin, Texas 78701
Telephone: (512) 480.5682
Facsimile: (512) 480.5882

By: /s/ John B. McFarland
John B. McFarland
State Bar No. 13598500
ATTORNEYS FOR TEXAS LAND AND MINERAL OWNERS ASSOCIATION AND NATIONAL ASSOCIATION OF ROYALTY OWNERS-TEXAS

CERTIFICATE OF COMPLIANCE

This brief complies with the type-volume limitation of Tex. R. App. P.9.4(i)(2)(B) because it contains 2,307 words, excluding the parts of the brief exempted by Tex. R. App. P. 9.4(i)(l). The undersigned relied on the word count of MS Word, the computer program used to prepare the brief.

/s/ John B. McFarland
John B. McFarland

CERTIFICATE OF SERVICE

By my signature below, I hereby certify that a true and correct copy of the above and foregoing document has been sent via electronic filing to the following counsel this the 5th day of December, 2014.

Bart A. Rue bart.rue@kellyhart.com Matthew D. Stayton matt.stayton@kellyhart.com KELLY HART & HALLMAN, LLP 201 Main Street, Suite 2500 Fort Worth, Texas 76102 *Attorneys for Petitioners*	David J. Drez III david.drez@wickphillips.com Jeffrey W. Hellberg, Jr. jeff.hellberg@wickphillips.com Jacob T. Fain Jacob.fain@wickphillips.com Wick Phillips Gould & Martin, LLP 100 Throckmorton, Suite 500 Fort Worth, Texas 76102 *Attorneys for Respondents*
Michael A. Heidler mheidler@velaw.com Vinson & Elkins LLP 2801 Via Fortuna, Suite 100 Austin, Texas 78746 *Attorneys for Amicus Curiae Texas Oil & Gas Association*	Marie R. Yeates myeates@velaw.com Vinson & Elkins LLP 1001 Fannin Street, Suite 2500 Houston, Texas 77002 *Attorneys for Amicus Curiae Texas Oil & Gas Association*

/s/ John B. McFarland
John B. McFarland