CASE NO. 13-10601
IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

GORDON POTTS; BRANDY WEST,

Plaintiffs – Appellants

v.

CHESAPEAKE EXPLORATION, L.L.C.,

Defendant – Appellee

Appeal from Civil Action No. 3:12-CV-1596-O
In the United States District Court for the
Northern District of Texas, Dallas Division
Honorable Reed C. O'Connor, Presiding

BRIEF OF AMICI CURIAE TEXAS LAND OWNERS ASSOCIATION AND NATIONAL ASSOCIATION OF ROYALTY OWNERS-TEXAS IN SUPPORT OF APPELLANTS' PETITION FOR REHEARING EN BANC

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IDENTITY AND INTEREST OF AMICI CURIAE

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

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

TLMA and NARO are interested in the outcome of this case because members of both organizations have entered into oil and gas leases with language similar to the language in the lease at issue here. The legal rights of those members will therefore be potentially affected by the Court's ruling.

No counsel for either party to this appeal authored this brief in whole or in part. No party to this appeal, nor counsel for any party has contributed money that was intended to fund preparing or submitting this brief. No person other than TLMA and NARO or their counsel have contributed money that was intended to

fund preparing or submitting the brief. Neither Appellant is a member of TLMA or NARO.

ARGUMENT

A. When Read as a Whole the Language of the Potts Lease Does Not Allow the Deduction of Production Costs.

The deductibility of post-production costs is an issue often hotly negotiated in an oil and gas lease. Since the decision in *Heritage Res., Inc. v. NationsBank*, 939 S.W.2d 118 (Tex. 1996), mineral owners have attempted with varying degrees of success to prohibit deduction of such costs by inserting language requiring royalties to be based on the price received at the point of sale. Those attempts have been premised on the suggestions made in Justice Owen's concurring opinion in *Heritage*.

In the lease at issue (the "Potts Lease"), the parties negotiated language providing that gas royalties would be calculated based on "the market value at the point of sale" of that gas. Potts Lease, ¶ 11, ROA 213. The lease further provides that:

> Notwithstanding anything to the contrary herein contained, all royalty paid [Lessor] shall be free of all costs and expenses related to the exploration, production and marketing of oil and gas production from the lease including, but not limited to, costs of compression, dehydration, treatment and transportation.

Id.

In order to circumvent the "point of sale" and other language intended by mineral owners in leases to prohibit deduction of post-production costs, Chesapeake Exploration, L.L.C., ("Chesapeake") has adopted the tactic of marketing its gas through its own subsidiary marketing company. By selling its gas to its own affiliate at the wellhead, Chesapeake can claim that its royalties are based on prices received at the "point of sale," even though in fact those royalties are based on prices received by its affiliate company, after deduction of post-production costs.

To avoid Chesapeake's scheme for circumventing lease clauses that prohibit deduction of post-production costs, the Potts Lease includes language requiring royalties to be based on sales to unrelated third parties at prices arrived at through arms-length negotiations. Such a provision is in paragraph 37 of the Potts lease:

> After initial production is established, payment of royalty to Lessor shall be made within 120 days. All payments of royalty thereafter are to be paid 60 days after the end of the production month for oil, and 90 days after the end of the production month for gas. *Payments of royalties to Lessor shall be made monthly and shall be based on sales of leased substances to unrelated third parties at prices arrived at through arms length negotiations.* Royalties to Lessor on leased substances not sold in an arms length transaction shall be determined based on prevailing values at the time in the area. [Chesapeake] shall have the obligation to disclose to Lessor any information pertinent to this determination.

ROA 217 (emphasis added).

The Panel opinion fails to give full effect to all relevant language contained in paragraph 37. The Panel's opinion states that paragraph 37:

> specifically contemplates that if the lessee sells the gas to an affiliate, the royalty shall "be determined based on prevailing values at the time in the area." *Paragraph 37 does not require the point of sale to be the point at which the gas is ultimately sold to a non-affiliated entity.*

Slip Op. p. 10 (emphasis added). The Panel misreads paragraph 37. Paragraph 37 expressly does require that the point of sale be the point at which the gas is ultimately sold to a non-affiliated entity. The fourth sentence of paragraph 37, on which the Panel relies, provides that royalty shall "be determined based on prevailing values at the time in the area" only if leased substances are "not sold in an arms length transaction." But the third sentence of the paragraph says that "payments of royalties … shall be based on sales of leased substances to unrelated third parties at prices arrived at through arms length negotiations." Logically, the fourth sentence applies only if there is *no arms-length sale* of the gas, either by the lessee or an affiliate of the lessee. If gas is sold in an arms-length transaction by an affiliate of lessee, then the third sentence applies. In such a case, the royalty must be based on the price received by the affiliate in the arms-length transaction. In this case that price is the weighted average price received by Chesapeake's affiliate.

Having established that the price on which royalties should be based is the affiliate's weighted average price, the question then is whether under the Potts

Lease post-production costs can be deducted from that price. Paragraph 11 provides that "all royalty paid to Lessor shall be free of all costs and expenses related to the exploration, production and marketing of oil and gas production from the lease including, but not limited to, costs of compression, dehydration, treatment and transportation." Therefore, under the express language of the Potts Lease, royalty on gas must be based on the weighted average price received in the first arms-length sale, without deduction of post-production costs.

B. Heritage, Even if Still Good Law, Does Not Address the Facts Presented Here.

The Panel's reliance on *Heritage* is misplaced for two reasons. First, *Heritage* did not involve a sale by the lessee to its affiliate at the mouth of the well. The gas in *Heritage* was transported by the lessee to a point of sale off of the lease. There was no language in the Heritage lease concerning sale to an affiliate.

Second, *Heritage* has very limited precedential value, because of the evenly divided court on motion for rehearing. As pointed out in the Appellants' motion for rehearing, the Texas Supreme Court split 4-4 on rehearing. As a result, there was no majority opinion. Three justices, including Justice Owen, agreed with her original concurring opinion. Four justices (Justice Gonzalez, Justice John Cornyn, Justice Greg Abbott, and Justice Rose Spector) voted to grant rehearing, indicating their agreement with Justice Gonzalez's original dissenting opinion. The substantial changes in the court's alignment in *Heritage* occurred after an amicus

brief supporting rehearing was filed by The Moody Foundation, the Texas Banker's Association, Independent Bankers' Association of Texas, the National Association of Royalty Owners, River Oaks Trust Company, Texas Commerce Bank, First Victoria National Bank, The Moody National Bank, American National Insurance Company, Harry M. Whittington, C.C. Small, Jr., Howard P. Newton, Jeffery L. Hart, Clayton Hoover, Cullen R. Looney, W.F. Countiss, Dan Moody, Jr., Ben F. Vaughan, III, John McFarland, and Richard Watt, joined by the Commissioner of the Texas General Land Office, the University of Texas System, Southern Methodist University, the Baptist Foundation of Texas, and the Boy Scouts of America.

Since its opinion in *Heritage*, the Texas Supreme Court has not again examined or discussed its opinions in that case.[1] As pointed out in the Potts' motion for rehearing, the Panel's statement that *Heritage* is now "binding law," based on "numerous cases from both the Supreme Court of Texas and this court citing" *Heritage,* is not correct based on the limited treatment of *Heritage* in subsequent cases. As stated by Justice Gonzalez in his opinion on motion for rehearing, "[b]ecause we are without majority agreement on the reasons supporting the judgment, … the judgment itself has very limited precedential value and

[1] The Texas Supreme Court has cited *Heritage* several times for the general propositions set forth in the opinion concerning construction of contracts. The Court recently referred to *Heritage* in a footnote in its decision in *French v. Occidental Permian, Ltd.*, __ S.W.3d__, 2014 WL 2895999, *1 n. 5 (Tex. 2014), now pending on motion for rehearing. There was no dispute in that case that the lease being construed authorized deduction of post-production costs. No Texas Supreme Court opinion has examined or discussed the precedential value of *Heritage.*

controls only this case." 960 S.W.2d at 620. No subsequent opinion by the Texas Supreme Court has discussed or expanded the precedential value of *Heritage*.

The Panel's opinion also suffers from the same fault as Justice Owen's concurring opinion in *Heritage*. Both opinions examine the particular language used in the leases, parsing the language grammatically, without looking at the four corners of the lease and attempting to understand and apply the overall intent of the parties. As Justice Gonzalez wrote in his dissenting opinion in *Heritage*:

> Under basic rules of contract interpretation, this Court must give effect to the written expression of the parties' intent. *See Forbau v. Aetna Life Ins. Co.,* 876 S.W.2d 132, 133 (Tex. 1994). To do so involves reading all parts of the contract together, giving effect to each individual part. *Id*. In this case, however, the Court unnecessarily looks to the trade meaning of the words used to conclude that the post-production clause is surplusage as a matter of law. 939 S.W.2d 118. … Neither the majority nor the concurrence give proper legal effect to specific language in these contracts which clearly denotes the parties' intent that "there shall be no deductions from the value of Lessor's royalty by reason of any … cost of … transportation." *See Forbau*, 876 S.W.2d at 133-34.

939 S.W.2d at 132. The language in the Potts Lease, reading all parts of the contract together, makes clear that Chesapeake agreed to pay royalties based on the price received in the first arms-length sale of the gas, without deduction of post-production costs.

C. This Appeal Presents An Important Issue of Texas Oil & Gas Law That Should Be Certified to the Texas Supreme Court.

There are presently dozens of cases pending against Chesapeake for underpayment of royalties, many of which involve Chesapeake's practice of selling gas to its wholly owned subsidiary. The Panel's opinion in this case has already been cited by Chesapeake in many of those cases. This Court's opinion will have an important effect on those and other cases in Texas.

The Panel's resolution of this important issue of Texas law was based entirely on *Heritage v. NationsBank*, an 18-year-old Texas case in which the Court split 4-4 on rehearing. That decision was described by Justice Gonzalez, writing for four of those justices, as having "very little precedential value." 960 S.W.2d at 620. No subsequent Texas Supreme Court decision has spoken to or modified that assessment. As a matter of law, therefore, the Panel did not have "sufficient sources" of Texas Law to issue such a far-reaching decision on such an important issue of Texas oil and gas law. As a result, this Court should grant Appellants' motion for rehearing and certify the issue to the Texas Supreme Court for definitive resolution. See *Williamson v. Elf Aquitaine, Inc*., 138 F.3d 546, 549 (5th Cir. 1998) (certification decision rests in part on whether there are "sufficient sources" of state law to guide the Court's ruling on a matter of state law.)

CONCLUSION

This case presents an important issue of Texas oil and gas law that potentially involves billions of dollars across the state. Because the Panel's resolution of that issue is contrary to the plain language negotiated by the parties and is based on an 18-year-old Texas case of questionable precedential authority, Amici Curiae respectfully request that this Court grant rehearing *en banc* and certify the issue presented to the Texas Supreme Court.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing was served on the 2nd day of September, 2014, to the following counsel of record via electronic service using the CM/ECF:

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CERTIFICATE OF COMPLIANCE WITH Rule 32(a)

Undersigned counsel certifies that this brief complies with the type-volume limitations of Fed. R. App. 32(a)(7)(B) because it contains 2,075 words, and, excluding the parts of the brief exempted by Rule 32(a)(7)(B)(iii), less than the words permitted.

Undersigned counsel further certifies that this brief complies with the typeface requirements of Fed. R. App. 32(a)(5) and the type style requirements of Fed. R. App. 32(a)(6) because this brief has been prepared in a proportionally spaced 14-point Time New Roman typeface (with 12-point font for footnotes) using Microsoft Word 2010.

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