Mineral Royalty Mispayments: A Discussion of Common Mispayment Scenarios and Applicable Law

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Outline

- Common Royalty Mispayment Scenarios
  - Causes
  - Underpayments
  - Overpayments
- Resolving Underpayments
  - Who has to pay?
- Resolving Overpayments
  - Can overpayments be recovered?
  - Judicial and self-help recoupment
  - The operator’s claims and defenses
- Examples from cases (discussed throughout)
Why?

- **Underpayments**
  - Lessee has a contractual obligation to pay royalties
  - Interest may accrue
  - Leases may expire (although uncommon in certain states)

- **Overpayments**
  - Operator may lose revenue

- Know how to respond when mispayments occur
- Avoid and catch some of the common mistakes
- Insight into how these cases are legally analyzed
What Causes Mispayments?

- Human error
  - Simple clerical mistakes
  - Transposed numbers
  - Typographical errors
- Miscalculations
  - Complicated decimal interests are common
  - Example: \( \frac{5}{6} \times \frac{4}{7} \times \frac{1}{8} \times \frac{37.55}{683.02} = 0.0033272406 \)
- System/computer glitches
- Uncommon contractual provisions
- Mistaken identity (paid the wrong person)
- Mistakes of judgment
What Type of Mispayments?

Two basic types:

1) **Underpayment**
   - Royalty payee is due royalties on past production
   - Usually caught by payee
   - Generally may be cured

2) **Overpayment**
   - Royalty payee was paid more than its share
   - May go undetected for many years
   - More challenging (practically and legally)
Royalty Mispayments

**Example #1: The David Family Case**

- **Facts (underpayment and overpayment)**
  - David Lease pooled with John Lease
  - Davids continued receiving royalties on lease-basis rather than unit-basis for over four years
  - Operator discovers that Davids were overpaid $164,000+
  - Johns have been underpaid (no royalties or division orders)

- **Once the mispayment is discovered:**
  - Operator pays the Johns their royalties
  - Operator notifies Davids of overpayment
  - Operator informs Davids that it will reduce future royalties to recoup the overpaid amounts

- **What happens next?**
Royalty Mispayments

Example #1: The David Family Case

• The operator gets sued.
  – Breach of Contract; Breach of Duty to Pool in Good Faith; Breach of Duty to Conduct Operations as a Reasonably Prudent Operator; Subterranean Trespass; TRO and Injunction

3.03 For purposes of Rule 47, Texas Rules of Civil Procedure, Plaintiff does allege the maximum amount of recovery in this suit will not exceed $15,000,000.00, past and future monetary damages, exclusive of interest, costs, attorney’s fees and statutory multiple and exemplary or punitive damages.

5.03 [The Corporation and its Affiliate Operator] are related oil and gas entities responsible for plundering lands throughout North Central Texas in search of Barnett Shale gas production.
Royalty Mispayments

Example #1: The David Family Case

• Underpayment to Johns – resolved by paying

• Overpayment to David Family
  – Operator counterclaims for recoupment
  – Davids’ response
    • “Voluntary Payment Rule” defense
    • Claims limited by statute of limitations

• Conclusion?
  – Parties settled shortly after mediation
  – Davids agreed to operator recouping by withholding 50% of royalties on additional wells drilled up to $121,000
Mispayment Overview: *Three-Part Analysis*

**Part A:**
Identify Mispayment Type(s) and Resolve Underpayments

**Part B:**
Analyze Overpayment Facts/Evaluate Recoverability

**Part C:**
Assess Recoupment Options
Mispayment Analysis Part A:

Underpayments
If there is a signed division order, and the underpaid payee’s money is with another overpaid payee, then the underpaid payee must recoup from the overpaid payee.

Part A – Underpayments (cont’d): Signed Division Orders

Payor

Division Order
Pay me 2 bags.
Signed, Payee #1

Payee #1

Payee #2

(5 bags to distribute)
Part A – Underpayments (cont’d): Signed Division Orders

- Payee #1 may pursue a claim against Payee #2 to recover its underpayment. Payee #2 has been overpaid.
- No underpayment claim against Payor.
- Payor did not retain any excess.
Part A – Underpayments (cont’d): Example #2: Gavenda Case

• Facts
  – Gavendas owned an undivided 1/2 NPRI (15-year reservation)
  – Strata’s title examination found that Gavendas owned 1/16 NPRI
  – Division and transfer orders completed and executed at 1/16
    • Royalties disbursed and accepted by the Gavendas at 1/16
  – Two days before their 15-year interest terminated, the Gavendas revoked the division and transfer orders
  – Gavendas sue to recoup $2.4 million in underpaid royalties

• Strata’s Position: The division and transfer orders are binding until revoked.

• Gavendas’ Position: No, not when the payor is enriched.
Part A – Underpayments (cont’d): Example #2: Gavenda Case

• Holding?
  – The general rule is that division orders and transfer orders bind the underpaid royalty owners until revoked.
  – Exception: When the operator retains the benefits.

• Reasoning:
  – Payor is entitled to receive a signed division order as a condition of payment.
  – Division order binds underpaid royalty owner until revoked.
  – Operator’s rely on the signed division orders, so payees are estopped from pursuing claims against payor due to payor’s detrimental reliance.
Part A – Underpayments (cont’d): Signed Division Orders

- If Payor retains the excess, the signed division order does not bar Payee’s underpayment claim against the Payor.
- Payee #1 has no claim against Payee #2.
Two general causes of action if underpaid:

1. Breach of Contract claim against Lessee
   - Obligation to pay royalties under the lease
   - Lease may include a termination provision

   - May sue “Payor” (lessee, operator, first purchaser)
   - Payor = first purchaser unless first purchaser and one with right to produce have agreed that operator is to distribute and has the proceeds
Part A – Underpayments (cont’d): Payee’s Breach of Contract Claim

– Obligation to pay royalties under the lease
– Lease may include a termination provision (example):
  • [I]f Lessee fails to timely pay royalty as herein required; then in addition to all other rights and remedies available to Lessor, Lessor shall, at its option, have the right to cancel and terminate this lease as to all of the lands covered hereby by filing an affidavit of record in Tarrant County, Texas reciting the non-payment of royalties; provided, however, Lessor shall give written notice to Lessee . . . of such intention. . .
Part A – Underpayments (cont’d): Example #3: XTO v. Pennebaker

• Facts and Trial Court Findings:
  – Lessor sued for nonpayment, conversion, trespass to try title, and for a declaration to terminate the lease
  – Lessors notified XTO of intent to terminate via two letters
  – Trial court held the lease terminated according to its terms (as to all acreage even though nonpayment claim was related to one of three producing wells)

• On Appeal (opinion from December 29, 2011)
  – Reversed the trial court because affidavit not filed in Tarrant County property records (even though notice of intent given)
  – Cancellation not favored; strict contract compliance required
Part A – Underpayments (cont’d):
Example #4: Shell Oil Co. v. Ross

• Facts
  – Ross family underpaid
  – In one month, price paid on certain wells was 93% higher than that paid on other wells
  – Shell admitted it simply made a mistake
  – Rosses alleged Shell had intentionally concealed the underpayment
  – Rosses filed suit 5-7 years after the underpayments occurred

• Holding
  – Rosses claims are barred by statute of limitations
Part A – Underpayments (cont’d):  
Example #4: Shell Oil Co. v. Ross

• Holding
  – Statute of limitations period was not extended by either Fraudulent Concealment or Discovery Rule
  – The Rosses could have discovered the underpayment through the exercise of due diligence
  – Readily available public information was available to reveal the discrepancy.
  – Payees must exercise reasonable diligence in examining their royalty statements; certain underpayments are discoverable
Part A – Underpayments (cont’d): **Claims Under TEX. NAT. RES. CODE**

- **TEX. NAT. RES. CODE** §§ 91.402-04
- § 91.402 provides deadlines for payment of proceeds
- § 91.404 creates a *cause of action* for payee
  - Protects royalty interest owners, working interest owners, and operators
  - Claimant must specifically plead this claim
Part A – Underpayments (cont’d):

- **Tex. Nat. Res. Code § 91.403(a) (paraphrased)**
  - If payment has not been made for any reason in the time limits specified in Section 91.402 . . . payor must pay interest at two percentage points above the percentage rate charged on loans to depository institutions by the New York Federal Reserve Bank, unless the parties agreed to different

- **Tex. Nat. Res. Code § 91.402 (may suspend royalties)**
  - Dispute regarding title that would affect distribution of payments
  - Reasonable doubt that payee has clear title to its interest

- **Tex. Nat. Res. Code § 91.404**
  - Payee must give written notice; Payor has 30 days to cure
Part A – Underpayments (cont’d): Summary

– Who has the underpaid Payee’s money?
  • Payor or another Payee?
– Are there signed division orders? Gavenda
– Are there termination provisions in the lease?
– Evaluate repayment obligations
– Assess recoupment options
Overpayments

Part B: Analyze Overpayment Facts
Part C: Assess Recoupment Options
Mispayment Analysis Parts B & C: Overpayments

• Inevitable
• May be caused by (simple clerical errors):
  – Transposed numbers
  – Miscalculations (decimal interests often derived from complicated fractional equations)
  – Typos in title opinions
  – System errors or other computer glitches
  – Title/ownership analysis errors
• Underpayments often detected and reported by payee
• Overpayments often go undetected for long periods
Mispayment Analysis Parts B & C: Overpayments = More Challenging

- Practical Challenges
  - No one is happy to hear they’ve been overpaid
  - Payee may have spent the money
  - Payee may be business partner

- Legal Challenges
  - Lawsuit may be required
  - Time limits on recovery
  - Defenses available
  - Risks and costs of litigation
Mispayment Analysis Part B: What Caused the Overpayment?

- Why is this assessment important?
  - Mistake of fact (generally recoverable)
    - Transposed numbers/typographical errors
    - Computer/system glitch
    - Calculation errors
    - Misnamed payee
    - Other “negligent” errors
    - Payments considered “involuntary”
  - Mistake of law (may not be recoverable)
Part B – Overpayments (cont’d): Affirmative Right to Recover

- Generally, the payor has a right to recoup mistakenly overpaid royalties.

- Lessee’s obligation to pay lessor royalties creates a debtor-creditor relationship, and the overpayment of royalties creates a debt in favor of the lessee.

- Money had and received claim (2 elements):
  1) The defendant holds money; and
  2) The money, in equity and good conscience, belongs to the plaintiff.
Part B – Overpayments (cont’d): Affirmative Right to Recover

• Money Had & Received Claim
  – To whom does the money belong?
  – Not based on wrongdoing by payee
  – Payee may passively receive the benefit

• May be subject to “equitable reductions”
  – Unfair to have payee return funds?
  – Factually-intensive questions
  – Time, amount, and cause will be factors
Part B – Overpayments (cont’d): 
*Equitable Decisions*

- Decisions for judge or jury
  - Subjective questions = unpredictable outcomes

- Negative image to overcome
  - O&G producers receiving negative publicity (e.g. “Gasland” and “fracing” protests)
  - Home-court advantage to overcome

- Important that payor has “clean hands”
  - Be as prudent as possible
  - Communicate mistakes to payee swiftly
  - Offer reasonable means of repayment
Mispayment Analysis Parts B & C:

What overpayments may not be recoverable?
Mistake of Law

 Example #5: The Castle Case

• Facts
  – Suit by Castle Texas Oil for unpaid overriding royalty
  – Letter agreement created an overriding royalty as follows:
    • “[E]qual to the difference between all existing royalties, overriding royalties, and other lease burdens, if any, of record as of date hereof, which are payable out of the interests in such leases conveyed hereby, and 25% of 8/8th…”
    • 19 assignments in the record
    • 10.65234% vs. 7.101562%
  – Payor’s position:
    • It had been overpaying until it received a new title opinion
    • Inherited the royalty payment calculations and never assessed legal implications at all, thus it was a mistake of fact
Mistake of Law

Example #5: The Castle Case

• Ruling:
  – The court agreed with payor’s interpretation of the title documents, thus Castle had been overpaid
  – BUT, the court held for Castle on the recoupment claim
  – Payor said it “inherited” the royalty calculations and later learned of mistake through title opinion
  – Thus, the court held it was a mistake of law
    • Payor is charged with knowledge of the relevant documents defining royalties and overrides
    • Interaction and interpretation of legal documents is question of law, not of fact
    • The overpayment was a result of a mistake of law

• Is this correct?
Part B – Overpayments (cont’d):
Example #6: Atlantic Refining Co.

• Facts (case from 1958)
  – Clerical error caused mix-up in owner numbers
    • Owner assigned “No. 921020” was given “No. 912020.”
  – Resulted in an overpayment
  – Trial court ruled against payor, finding payments were “voluntary”

• Court of Appeals
  – Payment was not voluntary within the meaning of VPR
  – “This Court will presume, in the absence of evidence to the contrary, that the employee was undertaking to perform his duty honestly and regularly, and that he did not intentionally or consciously [make the error.]”
Part B – Overpayments (cont’d):  

**Example #6: Atlantic Refining Co.**

- Court of Appeals (continued):
  
  - “Manifestly, in a large corporation it would be impossible for anyone or any group of employees to know all of the facts pertaining to production, the interests of the owners, the accounting, the payments of royalties and the other numerous details in connection with the operations of such a business.”
  
  - Thus, the employee who made the mistake did so without consciously knowing it and in ignorance thereof.
  
  - Mistake was the unconscious transposition of digits, which proximately caused the overpayments.
Mispayment Analysis Part C: Assess Recoupment Options

Recoupment
Does the operator/payor have the right to recoup overpaid royalties?

Commentators generally say “yes.”
- The right of the lessee of withhold overpayments from royalty is an exercise of the right of recoupment. Kuntz, Law of Oil and Gas
- Royalties overpaid due to a good-faith mistake may be recovered from the payee. Williams & Myers, Oil and Gas Law

Some courts say “yes.”
Part C – Recoupment (cont’d):

Example #7: The Waechter Case

- **Waechter v. Amoco Prod. Co., 537 P.2d 228 (Kan. 1975).**

- **Facts**
  - Class-action suit by 3,000 lessors overpaid about $10,000,000
  - Amoco overpaid due to an order by Kansas Corp. Commission that gas from certain field must be sold for not less than 11 cents per MCF rather than Amoco’s contractual 8.4 cents per MCF
  - Amoco challenged the KCC order, and told payees it was paying at 11 cents but maintaining 8.4 cents was the correct amount
  - Amoco wins challenge, and offers payees the following repayment options (without interest):
    - Repay overpayments in full; or
    - Authorize 25% withhold on future royalties until recouped in full.
Part C – Recoupment (cont’d):

Example #7: The Waechter Case

• Holding
  – Amoco’s overpayments were not “voluntary.”
  – Amoco had an implied right of recoupment to avoid unjust enrichment.
  – Recoupment not barred by limitations (5 years after payment) because statute of limitations is remedial not substantive, and Amoco asserted the right defensively.
  – The court justified Amoco’s right of recoupment via:
    • Defensive recoupment (limited to same contract or transaction that is the basis of the plaintiff’s claim); and
    • The doctrine of “pure defense.”
  – Amoco’s “extra-judicial” action (i.e. self-help) of withhold the monies made no difference.
Part C – Recoupment (cont’d):  
Example #8: The Bright & Co. Case

• Facts
  – Operator mistakenly overpaid 1/8th instead of 1/16th royalty
  – After discovering mistake, operator ceased paying royalties
  – Payee did not notice for several years, but then sued
  – Operator answered and alleged “setoff” as an affirmative defense

• Holding
  – “Setoff” defense was actually a counterclaim that was barred by statute of limitations
    • Court noted a counterclaim may have been revived by TEX. CIV. PRAC. & REM. CODE § 16.069, but it was not alleged
  – Operator liable for unpaid royalties plus interest
Part C – Recoupment (cont’d):


• **Facts (Oklahoma case)**
  – Payee filed suit for nonpayment of royalties on a well “A”
  – Operator responded that it had withheld the royalties due to overpayments made on well “B”

• **Holding**
  – The operator had a right to withhold the overpayments either under a recoupment OR setoff theory
  – “A ‘recoupment’ is the right of the defendant to have a deduction from the amount of the plaintiff’s damages, for the reason that the plaintiff has not complied with the cross-obligations or independent covenants arising under the same contract.”
  – Regardless of whether it is a recoupment or setoff, overpayments of royalty made by mistake may be recovered.
Mineral Royalty Mispayments

Conclusions

- Underpayments usually fairly easy to resolve
  - If executed division order, underpaid recovers from overpaid
  - Watch for lease-termination provisions

- Overpayments are more complicated
  - Requires factual and legal analysis
  - Mistakenly overpaid royalties generally recoverable
  - Subject to equitable reductions, depending on circumstances
  - Assess how to recover overpayment; recoupment may be available through self-help
Thank you!

• If you have questions or comments, please feel free to contact us:

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