MAXIMIXING CONTRACTUAL DAMAGES:

LESSONS FROM OIL AND GAS TRIAL WORK

University of Texas School of Law
Page Keeton Civil Litigation Conference
October 2009

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I. OVERVIEW OF THIS PAPER

Working on contract cases presents many challenges for plaintiff's counsel. The range of recoverable damages – although broadly defined under Texas law – must be proved under demanding evidentiary standards in order to satisfy ultimate "factual" or "legal" sufficiency review. Expert challenges readily come to any expert witness sponsoring a contract plaintiff's damages model. Appellate scrutiny is demanding.

To succeed in this litigation climate, the contract plaintiff's attorney must be both highly efficient and exceedingly thorough. Typically, such skills come only from devoting attention to one type of contract practice, such as oil and gas law or insurance law. Focusing on one practice area builds expertise in the attorney so that he/she can work quickly yet carefully with legal standards, evidence and expert witnesses.

This Paper's author has spent the majority of his time on oil and gas cases for the past seven years, after having enjoyed a generic contract practice in the preceding years. Oil and gas cases involve almost exclusively contract-law issues and contractual damages, though in a specialized real-estate context involving fairly esoteric industry terminology and subject matter. Satisfying Texas's demanding standards for defining and proving contractual damages is a constant hurdle for the plaintiff's attorney in oil and gas cases.

This Paper seeks to extrapolate certain "lessons learned" from an oil and gas practice for the generic contract plaintiff's attorney. Such lessons teach that maximizing contractual damages – in a very careful, credible manner – is a necessity. Because Texas law lacks ready means for recovering punitive damages in contract cases, maximizing contractual damages becomes extremely important in order to (a) keep the amount in controversy sufficiently large to justify the time and expenditure for the case, and (b) avoid uneconomical litigation, a threat specially significant for contingency-fee attorneys. The introductory sections and the final section provide primers on contractual damages, oil and gas law and attorney's fees. The key section is the fourth section, which applies the lessons learned from oil and gas cases to a generic contract practice.

II. GENERAL PRINCIPLES OF CONTRACTUAL DAMAGES

"The essential elements of a breach of contract claim are the existence of a valid contract, performance or tendered performance by the plaintiff, breach of the contract by the defendant, and damages sustained as a result of the breach. The normal measure of damages in a breach of contract case is the benefit of the bargain, the purpose of which is to restore the injured party to the economic position it would have been in had the contract been performed." *City of The Colony v. N. Tex. Mun. Water Dist.*, 272 S.W.3d 699, 739 (Tex. App. – Fort Worth 2008, pet. filed) (citations omitted).

The "benefit of the bargain" measure potentially entitles the contract plaintiff to a wide variety of actual damages: recovery of expenditures made in performance of the contract, the lost value caused by the breaching party's non-performance or partial

performance, and even "lost profits" or lost "future" value. *See, e.g.*, *Mistletoe Express Service v. Locke*, 762 S.W.2d 637, 638 (Tex. App. – Texarkana 1988, no writ) ("It is a general rule that the victim of a breach of contract should be restored to the position he would have been in had the contract been performed. Determining that position involves finding *what additions to the injured party's wealth have been prevented by the breach* and *what subtractions from his wealth have been caused by it*."); *Dixon v. Modelist*, 157 S.W.3d 454, 456 (Tex. App. – Houston [14th Dist.] 2004, no pet.) ("While Texas law does require damages as an element of proof in breach of contract actions, it defines contract damages to include 'future damages' . . . [–] [t]his principle recognizes that a party to a contract who properly claims future damages has been harmed in a current, real sense, in that his or her expectations regarding the contract have been diminished." (citation omitted)).

Proving any kind of contractual damages requires proof meeting the "reasonable certainty" standard. *See Dixon*, 157 S.W.3d at 456 (holding that "future damages" – as with other kinds of contractual damages – must be "proven by a reasonable certainty").

The devil is in the details for the contract plaintiff's counsel seeking either to define contractual damages or to prove contractual damages with "reasonable certainty." An active oil and gas practice – which involves a constant grappling with contract law and contractual damages – yields significant insights for how a generic contract plaintiff can meet the challenging burden of recovering contractual damages.

III. GENERAL PRINCIPLES OF OIL AND GAS LAW

A. The Contract: An Oil and Gas "Lease."

An "oil and gas lease" is a great misnomer. It is not a "lease" in a landlord-tenant sense of the word. Rather, it is a unique real estate conveyance – one that typically grants an interest in the oil and gas beneath the surface to a "lessee" (the grantee, the producer), allowing the "lessor" (the grantor, the landowner) to retain surface rights and to receive a royalty share of oil and gas production, so long as the lessee timely finds and produces the oil and gas. The lessor's surface rights typically yield to the lessee's mineral rights, whenever the two sets of rights conflict with each other.

"Each owner of land owns separately, distinctly and exclusively all the oil and gas under his land . . . ." *Elliff v. Texon Drilling Co.*, 210 S.W.2d 558, 561 (Tex. 1948). Put in a more "legal" way, the landowner has "absolute title in severalty to the oil and gas in place beneath his land." *Id.* If the landowner leases his minerals, as many Texan ranchers have done in favor of legacy producers, the landowner's lessee owns a "determinable fee" – a right to drill and produce the landowner's oil and gas subject to all lease provisions, including the ever-important royalty clause. When oil and gas production ceases, typically the lessee loses the mineral estate. *See Sun Oil Co. v. Madeley*, 626 S.W.2d 726, 732 (Tex. 1981) ("The lease conveys a determinable fee estate in the oil, gas and minerals to the lessee . . . ." (citation omitted)); *Rogers v. Ricane Enters.*, 884 S.W.2d 763, 766 n.2 (Tex. 1994) (construing an oil and gas lease as "[a]

determinable fee . . . a property interest which is burdened by a provision in the conveyance providing for automatic expiration of the estate upon occurrence of an operative event [usually, the cessation of oil and gas production by the lessee], an event which may or may not occur").

B. The Dispute: a Transitory Breach-of-Contract Claim with General Subject-Matter Jurisdiction and Venue.

Although the lease is a unique real estate conveyance, disputes over royalty payments due under a lease typically constitute pure breach-of-contract claims. They are not "title" or "real property" claims; they are contract claims in a real-estate context. Therefore, lease claims are transitory contract claims that are (i) subject to a court's general subject-matter jurisdiction (that is, various state courts potentially could entertain these claims) and (ii) governed by the general venue statute (that is, the claims need not be filed in the county containing the oil and gas property/lease). The subject-matter jurisdiction point is discussed in subsection IV below. As to the general venue statute: In *Yzaguirre v. KCS Resources, Inc.*, 53 S.W.3d 368, 371 (Tex. 2001), Texas appellate courts *rejected* arguments that royalty-underpayment claims implicate real-property concepts like "boundaries of the leases or the percentage of the Royalty Owners' royalties," which could have triggered "mandatory venue" in the County containing the royalties. *Yzaguirre* holds that "[a]lthough oil and gas leases are an interest in real property, the applicable version of section 15.001 applied only when ownership of the property was in dispute," and "[t]he substance of the dispute . . . is about the obligations [defendant] owes to the Royalty Owners under the terms of the leases, not the boundaries of the leases or the percentage of the Royalty Owners' royalties." *Id. See also id.* ("Because the suit does not involve recovering real property or quieting title, the court of appeals correctly concluded that the mandatory venue provisions of the former version of section 15.001 do not apply."); *Beard v. Endeavor Natural Gas, L.P.*, 2008 Tex. App. LEXIS 9629, at * 7 & n.1 (Tex. App. – Houston [1st Dist.] Dec. 19, 2008, pet. denied) (holding that mandatory venue per § 15.001 did not apply because a lawsuit "about the proper calculation of royalties" was subject to Texas's general venue statute).

Stated differently, royalty-underpayment claims under an oil and gas lease are not "local" real-estate claims. Rather, they are "transitory" contract claims involving personal property (extracted oil and gas) and payments due on such personalty. *See also* David E. Pierce, *From Extraction to Enduse: The Legal Background*, PRIVATE OIL & GAS ROYALTIES, RMMLF VOL. 2003, NO. 1 ("Perhaps the most important aspect of these two valuation approaches [*i.e.*, 'market value' and 'amount realized'] is that *in neither case will the lessor [i.e., royalty owner] have any ownership interest in extracted gas*. Instead all the gas will be the *personal property of the lessee [i.e., gas producer]* which the lessee can dispose of without the consent of the lessor. *The lessor's royalty rights in the gas are contractual rights* the lessee must discharge in accordance with the terms of the oil and gas lease." (emphasis added)).

C. Finding the Sales Point for the Oil and Gas Produced.

Where is the oil and gas *sold*? The answer to this question – the sales point of extracted (produced, severed) oil or gas – often determines the payment obligation due on the oil or gas sold. Leases and sometimes "unit agreements" (consolidations of many prior leases under one operator) will define the payment obligation due a royalty owner or non-operating working interest owner differently for sales "on lease/unit" and sales "off lease/unit." A common distinction is that "off lease/unit" sales will implicate a "market value" valuation standard, whereas "on lease/unit" sales will implicate an "amount realized" or "proceeds" valuation standard.

Often "on the [leased] premises" means a sales point or custody-transfer point somewhere on the lease's acreage description. Determining this point becomes quite complicated when the lease is unitized with other leases: courts typically review the unit agreements to determine whether such agreements have amended the acreage descriptions in the underlying leases – thereby making *any* sales point or custody-transfer point "on the unit" to mean "on the [leased] premises." Royalty owners – who typically are not parties to the sales arrangements that designate sales points or custody-transfer points – can protest the "on premises" or "off premises" distinction, as necessary, in order to fall under either a "market value" royalty clause (which typically is "off premises") or "proceeds" royalty clause (which typically is "on premises"). *Middleton* and *Piney Woods* are two leading cases in Texas and nationally for settling disputes over the "on premises" or "off premises" distinction. *See generally Exxon Corp. v. Middleton*, 613 S.W.2d 240, 244 (Tex. 1981) (construing "off the premises" in the Producers 88 Lease form (and like forms): "We conclude 'off the premises' modifies both 'sold' and 'used.' The 'premises' is the land described in the lease agreement. Therefore, sold 'off the premises' means gas which is sold outside the leased premises."); *Piney Woods Country Life Sch. v. Shell Oil Co.*, 726 F.2d 225, 232-33 (5th Cir. 1984) (Widsom, J.) (holding that the mere transfer of title to gas (per the producer's third-party sales contract) does not determine true sales point for determination of which royalty clause applies, particularly when lessee can benefit (that is, avoid a "market value at the well" obligation) by arbitrarily picking the transfer of title point).

D. The "Market Value" Valuation Standard.

"Market value" is an express contractual term. It has what courts call an "objective" meaning. Put differently, it has a pricing standard determined by a competitive marketplace, independent of what a lessee actually obtains under the sales arrangement at issue, and unimpeded by the particular buyer's or seller's marketing conduct at issue. "Market value" is "an objective basis for calculating royalties that is independent of the price the lessee actually obtains." *Yzaguirre v. KCS Resources, Inc.*, 53 S.W.3d 368, 374 (Tex. 2001).

"Market value at the well has a commonly accepted meaning in the oil and gas industry. Market value is the price a willing seller obtains from a willing buyer. There

are two methods to determine market value at the well." *Heritage Resources, Inc. v. Nationsbank*, 939 S.W.2d 118, 122 (Tex. 1996) (citations omitted). "The most desirable method is to use comparable sales. A comparable sale is one that is comparable in time, quality, quantity, and availability of marketing outlets." *Id.* at 122 (citing *Exxon Corp. v. Middleton*, 613 S.W.2d 240, 246 (Tex. 1981); *Texas Oil & Gas Corp. v. Vela*, 429 S.W.2d 866, 872 (Tex. 1968)). "Courts use the second method when information about comparable sales is not readily available. This method involves subtracting reasonable post-production marketing costs from the market value at the point of sale." *Id.* at 122 (citations omitted).

The trailing phrases "at the well," "in the field" or the like play an important role in defining the term "market value." Such phrases appear commonly in royalty clauses and in unit agreements. These phrases adjust either oil's or gas's market value downward to a wellhead price or a field delivery-point price (*e.g.*, a field-meter price). The downward adjustments subtract certain post-production costs from "market value" in order to reduce market value down to a specific upstream sales/transfer point's price. *See, e.g.*, *Judice v. Mewbourne Oil Co.*, 939 S.W.2d 133, 135 (Tex. 1996) ("This phrase ['at the well'] means value at the well, net of any value added by compressing the gas after it leaves the wellhead." (citations omitted)).[3]

E. The "Duty to Market" Valuation Standard.

The "duty to market" – which is present in all Texas "proceeds" or "amount realized" leases – is a type of "implied covenant." It has all of the traditional characteristics of implied covenants. Arguably the duty is present also in unit agreements and division orders that define a payment obligation as "proceeds" or "amount realized," but give the party owing the payment obligation unbridled discretion to define that amount due. The party owed the payment obligation, in such instances, would benefit from a duty to market to instill honesty and competence by the party owing the obligation.

Texas courts imply covenants in oil and gas leases in order to protect lessors' interests[4]: "[s]ince the early history of oil and gas litigation, the courts have held that

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[3] *See also Heritage Resources*, 939 S.W.2d at 129 (Owen, J., concurring) (explaining that the phrase "at the well" enables a lessee to pay on a market-value price that is *adjusted downward* for post-production costs: "Market Value 'at the well' means the value of gas at the well, before it is transported, treated, compressed or otherwise prepared for market"); *id.* (Owen, J., concurring) (citing "*Wall v. United Gas Pub. Serv. Co.*, 152 So. 561, 564 (La. 1934) (market price means *market value in the field* and the lessee is not required to bear all the expense of carrying gas to a market *beyond the field*)" (emphasis added)); TEX. NAT. RES. CODE § 91.402(i) ("With respect to oil and/or gas sold in the field where produced or at a gathering point in the immediate vicinity, the terms 'market value,' 'market price,' *'prevailing price in the field,' or other such language*, when used as a basis of valuation in the oil and gas lease, shall be defined as the amount realized *at the mouth of the well* by the seller of such production in an arm's-length transaction." (emphasis added)).

[4] *See Amoco Prod. Co. v. Alexander*, 622 S.W.2d 563, 567-68, 570 (Tex. 1981).