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Eighth Circuit Affirms Producer's Royalty Calculations Under North Dakota Law

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The United States Court of Appeals for the Eighth Circuit has affirmed a district court's ruling that overriding royalty owners generally must bear their share of post-production costs under North Dakota law. The Eighth Circuit's Opinion is available through this link and reported at *Highline Exploration, Inc. v. QEP Energy Co.*, --- F.3d ---, 2022 U.S. App. LEXIS 21402 (8th Cir. Aug. 3, 2022).

The Court's Opinion, along with a recent decision by the North Dakota Supreme Court, indicate the willingness to apply plain meaning to common language used in royalty instruments. These decisions offer much-needed certainty to North Dakota producers considering how to calculate payments to royalty and overriding royalty owners.

BACKGROUND

A group of overriding royalty owners sued an oil and gas producer in federal court, arguing that the producer improperly deducted post-production costs from their payments. The overriding royalty owners claimed that their interests outlined in the lease assignments provided that payment would be “free and clear of all costs and expenses” for development and operation, exempted them from bearing any costs for gathering, processing, or transporting oil and natural gas downstream.

The producer denied that its deductions were improper, arguing that the terms “development” and “operation” commonly were understood to reference on-lease production costs, and did not extend to services performed downstream. The producer relied on the generally accepted rule that, absent express language to the contrary, overriding royalty interests must bear their proportionate share of post-production costs.

While the federal district court case was pending, the North Dakota Supreme Court issued its opinion in *Blasi v. Bruin E&P Partners, LLC*, 2021 ND 86, 959 N.W.2d 872. *Blasi* held that, as a matter of law, lessees may deduct transportation costs from royalties on the production of oil to be paid “free of cost” into a pipeline. The Court in *Blasi* interpreted the parties' lease based on its plain language; interpretations of that language by other jurisdictions and treatises; and, most importantly, in the context of commercial realities that seek to avoid uncertainty over where royalties traditionally are valued.

Citing *Blasi* and other cases, the federal district court in *Highline Exploration* granted summary judgment in favor of the producer based on

the plain language of the overriding royalty instruments, holding the producer properly deducted post-production costs.

EIGHTH CIRCUIT OPINION

Affirming summary judgment in favor of the producer, the Eighth Circuit held that overriding royalty interests that are “free and clear” of development and operation costs do not exempt the interests from costs incurred to gather, process, or transport oil and natural gas. Rather, the Court explained that the “free and clear” clause in the lease assignments clarified *which* costs were deductible from the overriding royalty interests. Accordingly, the Court recognized that, under North Dakota law, overriding royalty interests are subject to post-production costs unless the parties expressly agree otherwise.

The Court also considered the scope of “operation” costs, concluding that an overriding royalty interest's exemption from such costs does not extend to post-production costs. The Eighth Circuit underscored that its interpretation of royalty instruments under North Dakota law is aligned with the laws and common industry understanding of other oil and gas producing jurisdictions.

TAKEAWAY

The Court's Opinion, confirming the federal district court's order and in combination with the North Dakota Supreme Court's decision in *Blasi*, reaffirm that North Dakota courts will apply general rules of contract interpretation to royalty and overriding royalty language; and rely on the common industry understanding from other oil and gas jurisdictions. These decisions provide clarity and certainty to producers calculating royalties and overriding royalties based on standard industry language.

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