STATE OF MICHIGAN

IN THE CIRCUIT COURT FOR THE COUNTY OF GRAND TRAVERSE

JAMES W. BOYD, Trustee,

Plaintiff,

v

File No. 12-29182-CK
HON. PHILIP E. RODGERS, JR.

JORDAN DEVELOPMENT COMPANY, L.L.C.,
a Michigan Limited Liability Company,

Defendant.
_____/

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DECISION AND ORDER DENYING DEFENDANT'S MOTION FOR SUMMARY DISPOSITION

PROCEDURAL HISTORY

On May 11, 2012, Plaintiff in the above captioned case filed a Complaint alleging, in part, that Defendant failed to abide by the terms of the instruments controlling the calculation of royalties payable to the Debtors, improperly deducted post-production costs from overriding royalties due to Debtors and failed to pay Debtors royalties as required per the terms of said instruments.[1]

On June 7, 2012, Defendant filed a Motion for Summary Disposition, claiming that overriding royalty interests (hereinafter "ORRI") are subject to a pro rata share of post production costs and that the Assignments do not prohibit the deduction of a pro rata share of post production costs. The Plaintiff filed a Response on June 28, 2012, asserting that the Assignments are unambiguous and Defendant has improperly deducted costs for transportation, CO2 removal and compression. Subsequently, on July 2, 2012, the Court heard oral arguments

[1] "Debtors" refers to G. Woodward Stover II and Betsy Upton Stover. Plaintiff in this action is the duly appointed bankruptcy Trustee. However, the relevant overriding royalty interest in this case will be referred to as "Debtors' ORRI."

presented by both parties. At the conclusion of the oral arguments, the Plaintiff sought summary disposition pursuant to MCR 2.116(I)(2). The Court has reviewed all the documents submitted by the parties' and evaluated their respective arguments and, for the reasons stated herein, now issues this written decision and order denying the Defendant's Motion for Summary Disposition and granting that of the Plaintiff.

STANDARD OF REVIEW

A motion for summary disposition pursuant to MCR 2.116(C)(8), failure to state a claim upon which relief can be granted, tests the legal sufficiency of a claim.[2] Only the legal basis of the complaint is examined.[3] The factual allegations of the complaint are accepted as true, along with any inferences which may fairly be drawn therefrom. Unless the claim is so clearly unenforceable as a matter of law that no factual development could possibly justify recovery, the motion should be denied.[4] However, the mere statement of the pleader's conclusions, unsupported by allegations of fact upon which they may be based, will not suffice to state a cause of action.[5]

A motion filed under MCR 2.116(C)(10) tests the factual support for a claim and should be granted when there is no genuine issue of material fact and the moving party is entitled to judgment as a matter of law.[6] Under MCR 2.116(C)(10), a party may move for dismissal of a claim on the ground that "there is no genuine issue as to any material fact, and the moving party is entitled to judgment or partial judgment as a matter of law." A genuine issue of material fact exists when the record, giving the benefit of reasonable doubt to the opposing party, leaves open an issue upon which reasonable minds might differ.[7] The moving party must specifically identify the undisputed factual issues and support its position with documentary evidence.[8] The nonmovant then has the burden of showing that a genuine issue of disputed fact exists and

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[2] *Spiek v Dep't of Transportation*, 456 Mich 331; 572 NW2d 201 (1998).
[3] *Feyz v Mercy Mem Hosp*, 475 Mich 663; 719 NW2d 1 (2006).
[4] *Mills v White Castle Sys Inc*, 167 Mich App 202, 205; 421 NW2d 631 (1988).
[5] *NuVision v Dunscombe*, 163 Mich App 674, 681; 415 NW2d 234 (1988), lv den 430 Mich 875 (1988). See also, *Roberts v Pinkins*, 171 Mich App 648, 651; 430 NW2d 808 (1988).
[6] *Dressel v Ameribank*, 468 Mich 557, 561; 664 NW2d 151 (2003); *Miller v Purcell*, 246 Mich App 244, 246; 631 NW2d 760 (2001).
[7] *West v Gen Motors Corp*, 469 Mich 177; 665 NW2d 468 (2003).
[8] MCR 2.116(G)(3)(b); *Maiden v Rozwood*, 461 Mich 109, 120; 597 NW2d 817 (1999).

producing admissible evidence to establish those disputed facts.[9] Conjecture, speculation, conclusions, mere allegations or denials, and inadmissible hearsay are not sufficient to create a question of fact for the jury.[10] The trial court must consider all the documentary evidence in the light most favorable to the nonmoving party.[11] If the opposing party fails to present documentary evidence establishing the existence of a material factual dispute, the motion is properly granted.[12] Trial courts are not permitted to assess credibility or to determine facts on a motion for summary disposition.

ANALYSIS

Under oil and gas leases, lessees acquire the right to presently use and occupy a portion of the surface of the land needed to explore the premises for oil and gas.[13] Oil and gas leases generally provide for three types of payments to the lessors: a bonus payment, a delay rental, and a royalty.[14] The bonus payment is a cash consideration paid by the lessee for the execution of an oil and gas lease by the landowner, with payment being made when the lease is executed.[15] A delay rental is a sum paid by the lessee for the privilege of deferring drilling or production until some future date.[16] A royalty is paid to the lessor if and when oil or gas is actually produced.[17] It is defined as a share of the production or profits, free of the expenses of production.[18]

Conversely, an ORRI is an interest carved out of the lessee's share of the oil and gas.[19] The term ORRI has been defined as a fractional interest in the gross production of oil and gas under a lease, in addition to the usual royalties paid to the lessor, free of any exploration, drilling,

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[9] *Meagher v Wayne State Univ*, 222 Mich App 700, 719; 565 NW2d 401 (1997); *Neubacher v Globe Furniture Rentals*, 205 Mich App 418, 420; 522 NW2d 335 (1994).
[10] *LaMothe v Auto Club Ins Ass'n*, 214 Mich App 577, 586; 543 NW2d 42 (1995); *Cloverleaf Car Co v Phillips Petroleum Co*, 213 Mich App 186, 192-193; 540 NW2d 297 (1995); *Neubacher, supra* at 420; *SSC Assoc Ltd Partnership v Detroit Gen Retirement Sys*, 192 Mich App 360, 364; 480 NW2d 275 (1991).
[11] MCR 2.116(G)(4); *Maiden, supra* at 120.
[12] *McCormic v Auto Club Ins Ass'n*, 202 Mich App 233, 237; 507 NW2d 741 (1993).
[13] *VanValstine v Swanson*, 164 Mich App 396; 417 NW2d 516 (1987).
[14] *Id*. at 402.
[15] *Id*.
[16] *Id*.
[17] *Id*.
[18] *Id*. 402-403.
[19] *Phillips Petroleum Co v Oldland*, 187 F2d 780, 781 (CA 10, 1951).

development, operating, marketing or other costs incident to the production and sale of oil and gas produced from the lease.[20]

In the late 1980's, Terra Energy Ltd. (hereinafter "Assignor/Lessee") entered into various oil and gas leases, as Lessee, with property owners in Antrim County, Michigan. On December 5, 1989, Terra Energy Ltd. assigned and conveyed an ORRI in certain of its North Starmira Block oil and gas leases to G. Woodward Stover II.[21] On December 18, 1989, Terra Energy Ltd. executed a second Assignment of Overriding Royalty Interest (hereinafter "Assignment II") conveying an ORRI to G. Woodward Stover II in specified North Starmira Block leases.[22] Assignment I and Assignment II use the same formula to determine the ORRI.[23]

The ORRI, created by the Assignments, was based on the gross production from the North Starmira Block leases. However, the Starmira Block leases themselves did not create the ORRI and the leases do not govern the Debtors obligations. Therefore, the details of the Starmira Block leases are immaterial because the Assignments govern which costs, expenses and taxes are permissible charges.

Defendant acknowledges that, like most royalty interests, the Debtors' ORRI is free of the costs of exploration and production, but claims the ORRI is subject to a pro rata share of post production costs. In support of its position as to what deductions are permissible for the ORRI, Defendant cites the case of *Schroeder v Terra Energy, Ltd*, wherein the court held that an oil and gas lease providing for payment of gas royalties to lessors based on percentage of gross proceeds at the wellhead contemplated deduction of post-production costs from sales price of gas where it was subsequently marketed in determining royalty valuation.[24] The court further held that, absent actual sale of gas at the wellhead resulting in ascertainable gross proceeds, gross proceeds

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[20] *Dietrich v Sun Exploration & Production Co*, 784 F Supp 383 (ED Mich, 1992) citing *Meeker v Ambassador Oil Co*, 308 F2d 875, 822 (CA 10, 1963) rev'd on other grounds, 375 US 160; 84 S Ct 273; 11 L Ed 2d 261 (1964). See also, 58 ALR3d 1052, § 2[a], p1055.

[21] Assignment of Overriding Royalty Interest, (hereinafter "Assignment I") recorded March 28, 1990 with the Antrim County Register of at Liber 349, Pages 1035-1041. Pursuant to this Assignment, the ORRI assigned: (1) .125% x 8/8 on each of the North Starmira Block leases more than an 80% net revenue interest and (2) on each lease having more than 81% net revenue interest either (i) 1% x 8/8 or (ii) .5 x (19% less royalty and other burdens on such lease at the time of acquisition by assignor. Assignment indicates it was executed December 5, 1989, but became effective October 1, 1989.

[22] Assignment of Overriding Royalty Interest, recorded May 23, 1990 with the Antrim County Register of Deeds at Liber 351, Pages 830-832. Assignment indicates it was executed December 18, 1989, but became effective date March 6, 1989.

[23] See FN 21. Assignment I and Assignment II shall be jointly referred to as "the Assignments."

[24] *Schroeder v Terra Energy Ltd*, 223 Mich App 176; 565 NW2d 887 (1997).

from sale elsewhere must be extrapolated, backwards or forwards, to reflect appropriate adjustments due to differences in location, quality, or characteristics of what is being sold.[25]

However, *Schroeder* is distinguishable because it involved an action by a lessor against a mineral lessee over the deduction of post-production costs in calculating the lessor's royalty payments under an oil and gas lease and did not involve an ORRI created by assignment. The royalty interests in *Schroeder* were granted to the lessor as consideration for the leasing of his mineral interests and were not ORRI.

In this case, the Assignments creating the ORRI and did not include any language pertaining to gross proceeds at the wellhead. Therefore, the Defendant's reliance on *Schroeder* is misplaced, as the holdings of *Schroeder* are not applicable or relevant to this case.

The goal of contract interpretation is to ascertain and effectuate the intent of the contracting parties and the law presumes that the contracting parties' intent is embodied in the actual words used in the contract itself.[26] When interpreting contracts, courts give contractual language its plain and ordinary meaning unless otherwise defined.[27] Where a contract can be construed by its terms alone, it is the duty of the court to interpret it.[28] When the contractual language is plain and unambiguous, the contract must be enforced according to its terms.[29] A contractual provision is ambiguous if the words may reasonably be understood in different ways.[30] Furthermore, when a contract relating to mines or minerals possesses the elements necessary to a valid, enforceable contract generally, the established rules for interpreting contracts must be applied.[31]

In the interpretation of an assignment, the court will look to the language of the assignment and the surrounding circumstances.[32] It is not within the judiciary's function to look outside the instrument to get at the parties' intention and then carry out such intention, regardless

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[25] *Id*.
[26] *City of Grosse Pointe Park v Mich Muni Liability & Prop Pool*, 473 Mich 188, 218-219; 702 NW2d 106 (2005).
[27] *English v Blue Cross Blue Shield of Mich*, 263 Mich App 449, 471; 688 NW2d 523 (2004).
[28] *Klapp v United Ins Group Agency, Inc*, 468 Mich 459; 663 NW2d 447 (2003).
[29] *Burkhardt v Bailey*, 260 Mich App 636, 656; 680 NW2d 453 (2003).
[30] *Universal Underwriters Ins Co v Kneeland*, 464 Mich 491, 496; 628 NW2d 491 (2001).
[31] 53_A Am Jur 2d, Mines and Minerals, § 310, p 546.
[32] *Keyes v Scharer*, 14 Mich App 68; 165 NW2d 498 (1968).

of whether the instrument contains language sufficient to express it, but the court's sole duty is to find out what was meant by the language of the instrument.[33]

Here, both Assignments contained language stating:

> Said overriding royalty interest shall be free of all cost and expense of **development, operating and marketing**, except that it shall be subject to and bear its proportionate share of all **severance, production and other taxes** now or hereafter applicable thereto.[34] (Emphasis added.)

Severance tax is defined as a tax on mineral or forest products at the time they are removed from the soil.[35] By statute, the State of Michigan requires that each producer engaged in the business of severing oil and gas from the soil pay a severance tax.[36] Further, MCL § 205.315 states:

> The severance tax…shall be in lieu of all other taxes, state or local, upon the oil or gas…however, nothing herein contained shall in anywise exempt the machinery, appliances, pipe lines, tanks and other equipment used in the development or operation of said leases, or used to transmit or transport the said oil: And provided further, That nothing herein shall in anywise relieve any corporation or association from the payment of any franchise or privilege taxes required by the provisions of the state corporation laws.

Therefore, pursuant to the Assignments, the Debtors are responsible for a proportionate share of the severance tax assessed when the gas was removed from the soil.

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[33] *Michigan Chandelier Co v Morse*, 297 Mich 41; 297 NW 64 (1941).

[34] Development, operating and marketing costs/expenses are often used interchangeably in oil and gas law and include activities such as locating and furnishing equipment and supplies, drilling, labor, and costs for repairs, environmental testing and overhead charges. *Essley v Mershon*, 1953 OK 248; 262 P2d 417, 419 (1953) [development expenses included furnishing equipment and supplies]; *Trimble v Hope Natural Gas Co*, 117 W Va 650; 187 SE 331 (1936) [cost of drilling is development expense]; *Gaither Petroleum Corp v Hilcorp Energy I, LP*, unpublished opinion of the Court of Appeals of Texas, issued August 22, 2002 (Docket No. 13-01-705-CV); 2002 WL 1965457 [seismic testing is development expense]; *State ex rel Pierce v Carruth*, 19 La App 112; 139 So 514 (1932) [erecting equipment and drilling for oil or gas constitutes labor or service in operating any oil or gas well]; *Transcontinental Oil Co v Mid-Kansas Oil & Gas Co*, 29 F2d 323 (CA 5, 1928) [operating expenses include sale by operating of oil and gas produced]; *Altom v Mt Vernon Oil & Gas Co*, 174 La 775; 141 So 457 (1932) [cost to clean well is an operating expense]; *Fleming Oil & Gas Co v South Penn Oil Co*, 37 W Va 645; 17 SE 203 (1893) [operating expenses include costs incurred in procuring materials and ordering machinery, construction costs]; *Pshigoda v Texaco, Inc*, 703 SW2d 416 (1986) [operating and marketing expenses include taxes, overhead charges, labor, repairs, depreciation on salvable equipment]. See also, *infra* at FN 40.

[35] Black's Law Dictionary, 1374 (6 Ed, 1990).

[36] MCL § 205.301 *et seq*.

With regard to "production," the term may be subject to various meanings depending on the context in which it is used.[37] Here, it is clearly used in the context of a tax. So interpreted, the Debtors are responsible for a proportionate share of any production tax.

If "production" is not read in the context of a tax, the Debtors are not responsible for said costs. The processes necessary for "production" of gas are those necessary to sever or remove the gas from the well.[38] Therefore, costs associated with making the natural gas marketable after it has been severed or removed from the ground and any processes which are not necessary to remove the gas from the well are post-production, not "production" expenses.[39] Here, the Plaintiff argues that post-production costs such as transportation, CO_2 removal and compression are impermissible post-production cost deductions because said costs are incurred as part of and in marketing the gas.[40] The Court agrees.

The language of the Assignments is plain and unambiguous, therefore, they must be must be enforced according to their terms. The Debtors are responsible for their share of severance taxes, production taxes and other applicable taxes, however, they are not liable for expenses associated with development, operating and marketing.

In order to make the gas marketable, the CO_2 must first be removed. After the CO_2 is removed, the gas must be transported to the market for sale, either by a carrier or via compression in the pipeline. These activities are not necessary to remove the gas from the well, but they must occur before the gas can be sold. As such, the costs associated with CO_2 removal, compression and transportation are post-production expenses. Pursuant to the Assignments, Debtors are free of all cost and expense of development, operating and marketing and are not subject to a pro rata share of post-production costs.

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[37] *Chevron USA, Inc v State*, 134 Oil & Gas Rep 209; 918 P2d 980 (1996).
[38] *Shamrock Oil & Gas Corp v Comm'r of Internal Revenue*, 346 F2d 377, 379-380 (CA 5, 1965).
[39] *Chevron, supra* at 984; *Schroeder, supra* at 180.
[40] *Heritage Resources, Inc v NationsBank*, 39 Tex Sup Ct J 537; 939 SW2d 118 (1996) [postproduction marketing costs include transporting gas to market and processing gas to make it marketable]; *Cartwright v Cologne Production Co*, 182 SW3d 438, 442-445 (Tex App, 2006); [postproduction marketing expenses include compression and treatment costs, including the removal of hydrogen sulfide]; *Occidental Permian Ltd v French*, opinion of Texas Court of Appeals, issued October 31, 2012 (Docket No. 11-10-00282-CV); __ SW3d __ (2012) [removal of hydrogen sulfide from gas is postproduction activity done to render stream marketable]; *SHR Ltd Partnership v Mercury Exploration Co*, unpublished opinion per curiam of the Court of Appeals, issued April 11, 2006 (Docket No. 258058) [post-production costs necessary to render the raw product marketable and saleable as gas include costs incurred in saltwater disposal and gathering, separating, dehydrating, and compressing gas].

CONCLUSION

For the reasons stated herein, the Court finds that Defendant has improperly deducted post-productions costs from the Debtors' ORRI. Therefore, the Defendant's Motion for Summary Disposition is denied and that of the Plaintiff is granted. The Court will not assess sanctions against either party, but taxable costs may be assessed.

This is a final Order which resolves the last pending claim and closes the case.

IT IS SO ORDERED.

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HONORABLE PHILIP E. RODGERS, JR.
Circuit Court Judge