IN THE SUPREME COURT OF OHIO

REGIS F. LUTZ, et al.,

Plaintiffs - Respondents

v.

CHESAPEAKE APPALACHIA, LLC,

Defendant-Petitioner.

Supreme Court Case No. 2015-0545

On Review of Certified Question from the United States District Court, Northern District of Ohio, Eastern Division

Case No. 4:09-cv-02256

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INTRODUCTION

The certified question on review is:

> Does Ohio follow the "at the well" rule (which permits the deduction of post-production costs) or does it follow some version of the "marketable product" rule (which limits the deduction of post-production costs under certain circumstances)?

There are three gas royalty clauses at issue in this case. All three are quoted in the district court's certification order and all three are subject to pending summary judgment proceedings in that court. The Petitioner, Chesapeake Appalachia, LLC ("Chesapeake"), presents argument only as to one of the royalty clauses, the one in the lease attached to its brief providing for a royalty of one-eighth of the "market value at the well."

Chesapeake argues that the "at the well" language in that royalty clause allows it to charge its gas royalty owners a pro rata share of the post production costs incurred when it sells gas downstream of the well. Chesapeake is incorrect. There has been no market for gas "at the well" since the federal government deregulated the natural gas industry under FERC Order 636 in 1992. When there is no "market at the well," the lessee's "implied covenant to market" – long recognized in Ohio – requires the lessee to sell the gas where there *is* a market. Further, a party with a contractual duty in Ohio must pay the costs of performing the duty, absent express language to the contrary. Thus, an oil and gas lessee in Ohio must (1) market the gas and (2) pay the costs of doing so unless the lease expressly provides otherwise.

A different approach, crafted by gas producers and adopted by some courts, is the "at the well" rule. This rule assumes that a market "at the well" still exists. It then attempts to determine a theoretical "market value at the well" using the "netback" method. Under this method, the gas producer subtracts all costs incurred between the well and the point of sale from the sale price and pays a royalty on the net price.

The "netback" method resorts to fiction to allow the gas producer to avoid paying costs. As one legal scholar explains:

> For there to be a real market price or market value, there must be a market, a marketable product, a ready and willing seller, and a ready and willing buyer. Courts ignore these realities in gas royalty cases when they permit a lessee to work back to the wellhead by deducting post-wellhead costs. In so doing, they allow the lessee to work back to a point where only an unmarketable raw material may exist, and they essentially create a fictional seller, a fictional buyer, a fictional market, a fictional marketable product, and a fictional market price.

Owen L. Anderson, *Royalty Valuation*, Part II, 37 Nat. Res. J. 611, 638-639 (1997).

A growing number of courts refuse to allow gas producers to use these multiple fictions. The trend across the country is now in favor of the "marketable product" rule. More candid members of the gas royalty defense bar acknowledge this trend. Lawyers at Steptoe & Johnson LLP wrote in 2012:

> It seems courts are trending toward the marketable product rule when assessing the validity of royalty calculations, so the prudent lessee in a shale region should assume it will be held responsible for post production costs. Contractual language to the contrary may help share the burden with lessors in some states. However the fact that covenants to market are being more readily implied demonstrates that royalty calculation decisions are trending in favor of lessors.

Karen E. Kahle & Denielle M. Stritch, *Grouping the Marcellus Payout: Use of Class Actions in Royalty Litigation Concerning Post Production Costs*, 88 N.D. Law Review 699, 710-711 (2012). On the same theme, a now-retired partner at the Columbus office of Vorys, Seymour and Pease LLP wrote in 2004 that "the implied covenant to market has found increasing favor with courts called upon to determine how natural gas is to be valued for purposes of calculating royalties." David W. Hardymon, *Adrift on the Implied Covenant to Market*, 24 Energy & Min. L. Inst., Ch. 8 (2004) at 234.

Commentators agree. *See, e.g.*, Byron C. Keeling & Karolyn King Gillespie, *The First Marketable Product Doctrine*, 37 St. Mary's L.J. 1, 5 (2005) (the tide is turning against the "at the well rule"); Rachel M. Kirk, *Variations in the Marketable Product Rule from State to State*, 60 Okla. L. Rev. 769, 773 (2007) (while some jurisdictions have adopted the at-the-well rule, "more states have recently adopted some variation of the marketable product rule").

The "at the well" rule still holds a slight 9-7 majority over the "marketable product" rule. If one counts the three states that have codified the "marketable product" rule, however, the "marketable product" rule is applied in *more states* and to *the majority of all gas produced. See* John Burritt McArthur, OIL AND GAS IMPLIED COVENANTS FOR THE TWENTY-FIRST CENTURY, Juris Publishing, Inc. (2014) at 265 ("a marketable-condition rule applies in a majority of producing states and to a considerable majority of production in the United States").

The close split across the country is reflected in the Appalachian Basin. Courts in **West Virginia** (in 2006) and **Virginia** (in 2011) have ruled that "at the well" language does *not* allow for the deduction of post production costs. In **Michigan**, the legislature, displeased with court rulings adopting the "at the well" rule, enacted legislation in 1999 providing that the lessee "shall not deduct from the lessor's royalty any portion of post production costs" absent express language. In **Pennsylvania**, the state supreme court construed a minimum royalty statute in 2010 as allowing the "netback" method where the lease expressly provided for cost deductions on the ground that the minimum royalty was one-eighth of the net proceeds, not one-eighth of the gross. The court, however, did not address whether "at the well" royalty language is sufficient to allow the deduction of costs. In **Kentucky**, the state supreme court adopted the "at the well" rule this year based on case precedent not found in Ohio. **New York** is yet to address the issue.

The marketable product rule reflects sound economic principles, as well as the bargain struck by the lessor and lessee. The gas producer receives *seven-eighths* of the proceeds even though the royalty owner contributes *all the gas.* The reason for this lopsided division of the proceeds is that, under the covenant to market, the gas producer pays the costs of making the gas marketable and taking it to market. Gas producers now try to force royalty owners to pay marketing costs not because the producers have a proper legal basis, but because those costs have increased. Whether a party has the obligation to pay costs does not turn on whether the costs are large or small, however, but on which party has the duty of performance.

The "at the well" rule would not apply in this case even if it were recognized in Ohio. "Parties may implicitly modify an agreement by their actions." *City of St. Mary's v. Auglaize Co. Bd. of Commrs.*, 115 Ohio St.3d 387, ¶ 39, 2006-Ohio-1033, 875 N.E.2d 561, 567. In this case, no costs were deducted from 1970/1971 (when the leases were executed) until 1993. A case precisely on point is *Schmidt v. Texas Meridian Resources, Ltd.*, 4th Dist. Washington No. 94CA12, 1994 WL 728059 (Dec. 30, 1994). In *Schmidt*, as here, the original lessee on an oil and gas lease deducted no costs from the gas royalties. The court held that "[a] continued, different course of performance between parties manifests a modification of the original agreement," and that, as a result, no costs could be deducted from the royalties *regardless* of whether Ohio is a "marketable product" rule or the "at the well" rule jurisdiction. *Id.* at *5-6.

For the reasons set forth herein, this Court should hold that under Ohio law the implied covenant to market includes the cost of performance and that, as a result, an oil and gas lessee must pay all post production costs, absent express lease language to the contrary.

COUNTERSTATEMENT OF FACTS

The Natural Gas Industry[1]

When a natural gas producer wishes to produce gas from property it does not own, it enters into an oil and gas lease with the owner of the gas rights. The owner of the gas rights (the lessor or "royalty owner") conveys the gas rights to the lessee (the gas producer) in exchange for a monthly gas royalty. Traditionally, the gas royalty is one-eighth (12.5%) of either the proceeds of the sale of the gas (under a "proceeds lease") or the market value of the gas (under a "market value lease").

Prior to 1992, interstate pipeline companies had monopoly control over their interstate pipeline systems. They would buy gas at the wellhead, transport it through their midstream and interstate pipeline systems and sell it to local distribution companies. In 1992, the Federal Energy Regulatory Commission ("FERC") issued FERC Order 636 to create greater competition in the marketing of natural gas. Interstate pipeline companies were no longer permitted to own gas. They were restricted to providing gas transportation and storage services at federally approved rates. The interstate pipeline system, previously used exclusively by the interstate pipeline companies to transport their own gas, was opened to independent gas marketers.

These changes in the market structure virtually eliminated gas sales "at the well." Independent gas marketers have no practical way to buy gas "at the well," as this would require well-by-well negotiations with various gas producers and separate contracts with various operators of midstream systems. Chesapeake admits that there is now no feasible way for gas purchasers to buy gas "at the well." It states that "if gas is sold at sold at the well, the buyer itself

[1] This section summarizes the basics of the oil and gas industry as presented in numerous books, treatises and articles. *See, e.g.,* Eugene O. Kuntz, A Treatise on the Law of Oil and Gas (Lexis 2007); John S. Lowe, Oil & Gas in a Nutshell (West 5th ed. 2009).

must then incur the post production costs to gather and transport the gas to where it will be used (*assuming that the buyer can even arrange such services on its own*)." Petitioner's Br. at 4-5 (emphasis added). The parenthetical is key. In today's market structure, it is not feasible for independent gas marketers to arrange for the gas from individual wells to be gathered, aggregated, processed and transported to the interstate pipeline system.[2]

To sell their gas in this new market structure, gas producers began to transport their gas to the interstate system. Gas producers today sell their gas either at the entrance to the interstate system or at points on the interstate system. As a result, gas producers now incur costs between the well and the point of sale. These costs, known as "post production costs," include costs such as the costs of gathering, processing, dehydration, compression and, in some cases, interstate transportation.

With the change in the market structure resulting from Order 636, oil and gas lessors and lessees began to use new lease forms that state how post production costs are to be paid. These leases invariably provide either (1) that the gas producer will pay all post production costs (in which case the royalty interest usually remains at the traditional one-eighth (12.5%), or (2) that the post production costs shall be shared by the gas producer and royalty owner on a pro rata basis (in which case the royalty is usually increased 16%, 18% or even 20% as a set off).

Unfortunately, less responsible gas producers made no attempt to renegotiate their pre-1992 leases, knowing this would likely result in an increased royalty percentage. Wishing to

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[2] The only sales that now occur "at the well" are sales to a gas marketing affiliate. These infamous sales are notorious for their self-dealing. The price paid by the affiliate is invariably an artificially low price used to reduce the amount of the royalties. The affiliate then turns around and resells the gas at the true market price. Courts routinely disregard such "sham sales" and require that the gas royalties be calculated using the price paid in the first arm's length sale to a disinterested third party. *See, e.g., Frankhouser v. XTO Energy,* 2012 U.S. Dist. LEXIS 31404 at *15 (W.D. Okla. March 8, 2012); *Howell v. Texaco,* 112 P.3d 1154, 1160 (Okl. 2004); *Texas Oil and Gas Corp. v. Hagen,* 683 S.W.2d 24, 28 (Tex.App. 1984).

have it both ways (low royalty percentage *and* cost deductions), these producers simply started deducting post production costs without a lease addendum. Often (as in this case), they did so without notice to the royalty owner and without disclosure of the deductions on the royalty check stubs. This resulted in litigation across the country over whether post production costs are properly deductible under pre-1992 lease forms. Some jurisdictions have adopted the "marketable product" rule (disallowing cost deductions) while others have adopted the "at the well" rule (allowing deductions).

The "Marketable Product Rule" and the "At the Well" Rule

Under the "marketable product" rule, the obligation to pay post production costs rests solely with the gas producer. Jurisdictions recognizing the "marketable product" rule hold that the gas producer's "implied covenant to market" includes the cost of performance, meaning that the gas producer pays the costs of putting the gas in marketable condition and delivering it to market.

Under the "at the well" rule, the obligation to pay post production costs is shared by the gas producer and royalty owner on a pro-rata basis. If a lease provides for a one-eighth royalty, the gas producer pays seven-eighths of the post production costs and the royalty owner pays one-eighth. This is accomplished by use of the "netback" method, under which the gas producer subtracts all post production costs from the sales price and pays a royalty on the net price.

The Fictional Basis of the "At the Well" Rule

The "at the well" rule appears, at first blush, to make perfect sense. Both the gas producer and the royalty owner benefit from the higher price downstream. Gas producers argue that it is therefore only fitting that the royalty owner pay a pro rata share of the costs necessary to obtain the higher price. Otherwise, gas producers argue, the royalty owner would "get a free ride." This argument's superficial appeal fades under examination because it is based on the fiction that there *is* a market value at the well. There has been no market at the well since 1992. As such, "market value at the well" has no proper function in the calculation of gas royalties because a royalty cannot be calculated using a variable that does not exist. If a lease provides for a royalty on the "market value at the well," the implied covenant to market requires the gas producer to sell the gas where there *is* a market and to pay the attendant costs.

<u>The Law of Other Jurisdictions</u>

No jurisdiction has codified the "at the well" rule. Four jurisdictions have codified the "marketable product" rule. These are Michigan, Nevada, Wyoming and the federal government.[3]

Chesapeake states at page 14 of its brief that "[t]he federal government has accepted the 'at the well' rule and netback method for calculating royalties." It cites 30 C.F.R. 1206.151), a definitional section that includes a definition for the "netback method." The substantive regulation on royalties, however, is 30 C.F.R. 1206.152(i) ("The lessee must place gas in marketable condition and market the gas for the mutual benefit of the lessee and lessor at no cost to the Federal Government."). *See also* Bruce M. Kramer, *Royalty Interest in the United States: Not Cut from the Same Cloth,* 29 Tulsa L.J. 3 4 at 473, n.113 (1994) ("Most federal oil and gas leases place the burden of most post production costs on the lessee under the so-called 'marketable condition rule.'"); McArthur, *supra,* at 232 (stating that the federal government

[3] *See* Mich. Comp. Laws Ann. §324.61503b(1) (1999) (lessee "shall not deduct from the lessor's royalty any portion of post production costs unless the lease explicitly allows for the deduction of post production costs."); Nev.Rev.Stat. 522.115(1)(a);(3) (1991) (lessee shall pay all costs of production, including costs of associated with the "gathering, compressing, pressurizing, heater treating, dehydrating, separating and storing of oil and gas"); Wyo.Stat.Ann. §30-5-304(a)(i); (a)(v) (1977) (lessee shall pay all costs of "gathering, compressing, pressurizing, heater treating, dehydrating, separating, storing or transporting the oil to the storage tanks or the gas into the market pipeline"); 30 C.F.R. 1206.152(i) ("The lessee must place gas in marketable condition and market the gas for the mutual benefit of the lessee and lessor at no cost to the Federal Government.").

applies a marketable condition rule to its property); Kirk, *supra*, at 773 (federal government follows marketable product rule).[4]

Under common law, the "at the well" rules stills holds a slight 9-7 majority. This lead is tenuous, however, due to the trend toward the "marketable product" rule. The nine states following the "at the well rule" under common law are Pennsylvania, Kentucky, Mississippi, Louisiana, Texas, California, North Dakota, Montana and Michigan (Michigan by common law before it codified the "marketable product" rule). The seven states following the "marketable product" rule under common law are West Virginia, Virginia, Colorado, Kansas, Arkansas, Oklahoma and New Mexico.

Further explanation is necessary as to three states in the 9-7 tally – Pennsylvania, New Mexico and Texas. Although Pennsylvania is included as an "at the well" rule state, it is an open question whether Pennsylvania would allow the deduction of post production costs under "at the well" language. In *Kilmer v. Elexco Land Services, Inc.*, 990 A.2d 1147 (Pa. 2010), the state supreme court ruled that the minimum one-eighth royalty under the state's Guaranteed Minimum Royalty Act is one-eighth of the net proceeds, not one-eighth of the gross. *Id.* at 1157. The court held, therefore, that post production costs could be deducted from the royalties under the lease in that case – which *expressly permitted* the deduction of a list of post production costs – without violating the statute. *Id. Kilmer* did not address whether "at the well" royalty language allows for the deduction of post production costs, leading the defense bar to caution clients that such language might *not* suffice. *See* Gladden and Maxwell, K&L Gates -- Oil and Gas Alert,

[4] There is one very narrow set of circumstances in which the gas producer may use the netback method when paying royalties to the federal government. This is when "the lessee's contract includes a reservation of the right to process gas and the lessee exercises that right" (30 C.F.R. 1206.153(a)) *and* "the gas is not sold pursuant to an arm's length contract." (30 C.F.R. 1206.153(c)). Even then, the netback method is allowed only if two other more accurate methods of valuation cannot be used. 30 C.F.R. 1206.153(c).

Drafting Lease Royalty Clauses in the Appalachian Basin after Kilmer, April 27, 2010 (www.klgates.com) at 2 (stating that *Kilmer* leaves unanswered whether "at the well" language allows for expense deductions and advising gas producers to use express language).

New Mexico is counted as a "marketable product" jurisdiction in the tally above despite *Elliott Industries, Ltd. v. BP America Prod. Co.*, 407 F.3d 1091, 1113-14 (10th Cir. 2005), in which the Tenth Circuit held that New Mexico would follow the "at the well" rule. In a careful analysis of the two post-*Elliott* decisions of the Supreme Court of New Mexico, the federal district court in New Mexico has predicted that the state supreme court will "find that the [marketable product] rule is included in oil and gas contracts as part of the implied duty to market." *The Anderson Living Trust v. WPX Energy Production, LLC*, 2015 WL 1321479 (D. N.M. March 19, 2015) at *105, ¶ 60.

Texas, while generally following "at the well" rule, handed Chesapeake two major defeats this summer. In *Chesapeake Exploration, LLC v. Hyder*, No. 14-0302, 2015 WL 3653446 (Texas, June 12, 2015), the Texas Supreme Court held that Chesapeake breached various leases by deducting post production costs, including a lease providing for "a perpetual, cost-free (except only its portion of production taxes) overriding royalty of five percent (5.0%) of gross production obtained." *Id.* at *2-5. In *Trinity Valley School v. Chesapeake Operating, Inc.*, No. 3:13-cv-01082-K, 2015 WL 4945911 (N.D. Tex., Aug. 19, 2015), a federal district court ruled that post production costs could not be deducted under various leases, including a lease providing for a royalty equal to the higher of the market value or price received by the lessee's affiliate. *Id.* at 2-8.

What follows is a summary of the approach taken in the seven jurisdictions adopting the "marketable product" doctrine by common law.

West Virginia

In *Tawney v. Columbia Natural Resources, LLC*, 633 S.E.2d 22 (2006), The West Virginia Supreme Court held, in answering a certified question, that "at the wellhead" type language is insufficient to alter the generally recognized rule that the lessee must bear all costs of marketing and transporting the product to the point of sale. The court stated:

> [I]n light of our traditional rule that lessors are to receive a royalty of the sale price of gas, the general lease language at issue simply is inadequate to indicate an intent of the parties to agree to a contrary rule – that the lessors are not to receive 1/8 of the sale price but rather 1/8 of the sale price less a proportionate share of deductions for transporting and processing the gas.

Tawney, 633 S.E.2d at 28 (court's emphasis).

Virginia

In *Legard v. EQT Prod. Co.*, 2011 WL 86598 at *10 (W.D. Va. Jan. 11, 2011) (Rep. and Rec., adopted in 2011 WL4527784 at *1), the U.S. District Court for the Western District of Virginia rejected the defendant's argument "at the well" royalty language allows for the deduction of post production costs:

> I reject EQT's argument that "at the well" language, as a matter of law, allows it to share all post production costs with the royalty owners. Instead I hold that Virginia courts would follow the "first marketable product" rule, and hold the lessee solely responsible for all costs incurred in making the gas produced from the well marketable, unless, as is the case in the November 27, 1990 lease, the parties specifically agree otherwise."

Id. at *11.

Colorado

In *Rogers v. Westerman Farm Co.*, 29 P.3d 887 (Colo. 2001) (*en banc*), the Colorado Supreme Court, sitting *en banc*, held that leases with "at the well" language – including one providing for a royalty on gas not sold at the well of "one-eighth *(1/8th) of the market value* *thereof at the mouth of the well* – were silent as to the allocation of costs and that "the implied covenant to market obligates the lessee to incur those post-production costs necessary to place the gas in a condition acceptable for market." *Id.* at 902. The court held further that gas does not reach marketable product status until it arrives at the location of a commercial marketplace where it is saleable. *Id.* at 906.

Kansas

In *Gilmore v. Superior Oil Co.*, 388 P.2d 602 (Kan. 1964), the Kansas Supreme Court held that the lessee could not deduct compression costs from the royalties because without compression the gas was not marketable. *Id.* at 606-607. In the subsequent case of *Sternberger v. Marathon Oil Co.*, 849 P.2d 788 (Kan. 1995), the same court held that a lease providing for a royalty of one-eighth of the "market price at the well" was silent as to post production costs, that the "lessee has a duty to produce a marketable product and the lessee alone bears the expense in making the product marketable." *Id.* at 794.[5]

Arkansas

In *Hanna Oil & Gas & Co. v. Taylor*, 759 S.W.2d 563 (Ark. 1988), the Supreme Court of Arkansas held that a lease that provided for a royalty on "one-eighth of the proceeds received by Lessee at the well for all gas ... produced from the leased premises and sold by Lessee" did not allow the lessee to deduct the costs of compression from the royalties because the lease was silent as to compression costs. *Id.* at 564-565.

[5] On the facts before it, however, the *Sternberger* court determined that there was no evidence before it that the gas was not in marketable condition at the well and therefore held that the lessee could deduct a proportionate share of the reasonable costs of transporting the gas to market. *Id.* at 799-800.

Oklahoma

In *Wood v. TXO Production Corp.*, 854 P.2d 880 (Okla. 1992), the Oklahoma Supreme Court held that a lease providing for a royalty of "*3/16 at the market price at the well for the gas sold*" did not allow the lessee to deduct the costs of preparing the gas for market, including the costs of compression. *Id.* at 882. In the subsequent case of *TXO Production Corp. v. State of Oklahoma*, 903 P.2d 259 (Ok. 1994), the same court expanded on *Wood* in holding that "the costs for compression, dehydration, and gathering are not chargeable to the lessors because such processes are necessary to make the product marketable under the implied covenant to market." *Id.* at 263.

New Mexico

As discussed above on page 10, New Mexico, sometimes included as a state following the "at the well" rule, is more likely a marketable product jurisdiction. *See The Anderson Living Trust v. WPX Energy Production, LLC*, 2015 WL 1321479 (D. N.M. March 19, 2015) at *105, ¶ 60 (predicting that the state supreme court will "find that the [marketable product] rule is included in oil and gas contracts as part of the implied duty to market."

<u>Procedural History of This and Related Cases</u>

This is the last of five class actions in the Appalachian region bringing the *same royalty claims* against the *same gas producer* for the *same conduct*. All five cases concern gas leases that were previously held by Columbia Natural Resources, Inc. ("CNR") and later acquired by Chesapeake. In all five cases the plaintiffs alleged that CNR underpaid their gas royalties by deducting post production costs beginning in 1993.

The first of the cases was *Tawney*, filed in state court in West Virginia. In *Tawney*, the Supreme Court of West Virginia held, in answering a certified question, that post production costs are not deductible under "at the well" language or any other language that does not expressly grant the right to deduct costs. *Tawney v. Columbia Natural Resources, LLC*, 633 S.E.2d at 22, 27-28 (W.Va. 2006). The case proceeded to trial and the jury returned a verdict of $134M in compensatory damages.

The next two cases, both filed by Kentucky royalty owners, were *Thacker v. Chesapeake Appalachia, LLC*, No. 7:07-cv-00026 (E.D. Ky.) and *Poplar Creek v. Chesapeake Appalachia, LLC*, No. 7:07-cv-00026 (E.D. Ky.) Chesapeake settled *Thacker* for $28.7M. In *Poplar Creek*, the district court dismissed the case on the ground that Kentucky recognizes the "at the well rule" and the Sixth Circuit affirmed. *Poplar Creek*, 636 F.3d 235, 244 (6th Cir. 2011).

The last case, filed by Virginia royalty owners, was *Healy v. Chesapeake Appalachia, LLC*, Case No. 1:10-cv-23 (W.D.Va.). The court in that case held, in denying a motion to dismiss, that "Virginia courts would recognize an implied duty on the part of oil and gas lessees to operate diligently and prudently, including a duty to market the gas produced." *Healy*, 2011 WL 24261 at *16 (W.D. Va. Jan. 5, 2011). Chesapeake subsequently settled for $3.4M.

The complaint in the instant case, like the others, includ *Daubert* Motion to Exclude Testimony of Michael Nranian Regarding Consumer Expectations, Cost of Curtain Shield Airbags and Warnings and Motion to Strike Undisclosed Warnings Opinions and Supporting Memorandum of Law is wholly without merit and should be denied.

ed a breach of contract count and various non-contract counts. The district court dismissed the non-contract counts on the ground that parties to a contract are limited to contract remedies and dismissed the breach of contract count as time barred. The plaintiffs appealed the dismissal of the contract count and the Sixth Circuit reversed. *See Lutz v. Chesapeake*

Appalachia, LLC, 717 F.3d 459 (6th Cir. 2013). Following remand to the district court, the parties filed cross motions for summary judgment. The district court then certified the instant question.

The Three Royalty Clauses in This Case

The leases in this case, all executed in 1970 or 1971, name Murphy Oil Company as the lessee. The leases have been assigned by one lessee to another over the years. These include Chesapeake, which held the leases from 2005 until it assigned them a few years later.

The leases have three variant gas royalty clauses, as follows:

> The royalties to be paid by Lessee are.... (b) on gas, including casinghead gas or other gaseous substance, produced and sold or used off the premises or for the extraction of gasoline or other product therefrom, <u>the market value at the well of one-eighth of the gas so sold or used</u>, provided that on gas sold at the wells the royalty shall be one-eighth of the amount realized from such sale.
>
> Lessee to receive the <u>field market price per thousand cubic feet for one-eighth (1/8) of all gas marketed</u> from the premises.
>
> Lessee covenants and agrees to deliver to the credit of the Lessor, as royalty, free of cost, in the pipeline to which the wells drilled by the Lessee may be connected the equal <u>one-eighth part of all Oil and/or Gas produced and saved</u> from said leased premises.

The district court's certification order correctly quotes all three gas royalty clauses. Copies of the leases of the named Plaintiffs containing these various royalty clauses are attached hereto as Respondents' Exhibit A.

The Cross Motions for Summary Judgment

Chesapeake has moved for summary judgment, but only as to the first of the three royalty clauses quoted above. Respondents have moved for summary judgment on all three royalty clauses.

ARGUMENT

I. RESPONSES TO CHESAPEAKE'S PROPOSITIONS OF LAW

A. Response To Chesapeake's First Proposition of Law

Oil And Gas Leases Are Construed As Written And According To Their Plain Meaning.

Chesapeake's first proposition of law is correct, but does not support Chesapeake's contention that the "market value at the well" language in one of the royalty clauses allows it to deduct post production costs. The proposition actually supports Respondents' position that post production costs *cannot* be deducted. In its discussion on this proposition, Chesapeake correctly quotes this Court as holding that a court must "look to the plain and ordinary meaning of the language used" and "is not permitted to alter a lawful contract by imputing an intent contrary to that expressed by the parties." Petitioner's Br. at 8 (quoting *Westfield Ins. Co. v. Galatis*, 100 Ohio St. 3d216, 2003-Ohio-5849, ¶ 11). Chesapeake would have this Court transgress these rules of construction by rewriting the phrase "market value at the well" to read "theoretical market value at the well, if one existed, using a net-back method in which lessee can determine the dollar amount of post production costs in its sole discretion." Chesapeake, in short, wants this Court to impute a meaning to "market value at the well" that is contrary to the plain meaning of those words.

In Ohio, a party with a contractual duty must pay the costs of performance, even when, as here, subsequent events cause those costs to increase. As the Ohio Court of Appeals has explained, quoting this Court:

> "It is well established that the increased cost of performance of a contractual term does not excuse non-performance." See *Mason Tire & Rubber Co. v. Cummins-Blair Co.* (1927), 116 Ohio St. 554. The rule as stated in the Restatement of Contracts § 467 is that "'facts existing when a bargain is made or occurring thereafter making performance of a promise more difficult or expensive than

> the parties anticipate, do not prevent a duty from arising or discharge a duty that has arisen.'" *Richards v. Hidden Valley* (Dec. 17, 1981) 8th Dist. No. 43486.

Fine v. U.S. Erie Islands Co., 6th District Ottawa No. OT-07-048, 2009 Ohio 1531, ¶ 28, 2009 WL 82656 at *5 (March 31, 2009).

This approach reflects hornbook contract law. *See, e.g.,* E. Allan Farnsworth, Contracts § 9.6 (2d ed. 1990); 18 Walter H.E. Jaeger, Williston on Contracts §1963 (3d ed. 1978); Arthur Linton Corbin, Corbin on Contracts §1333 (1962). *See also* Owen L. Anderson, *Royalty Valuation*, Part 1, 37 Nat. Resources J. 547, 604 (1997) ("If a party to a contract owes a duty of performance, such as the lessee's duty to market the gas product, then that party unquestionably has the obligation to absorb the costs of performance in absence of an expressed agreement to the contrary.); Merrill, THE LAW RELATING TO COVENANTS IMPLIED IN OIL AND GAS LEASES at 214-215 ("If it is the lessee's obligation to market the product, it seems to necessarily follow that his task is also to prepare it for market" and "no part of the costs of marketing of or preparation for the sale is chargeable to the lessor"); Kahle & Stritch, *supra*, at 724 ("as long as the implied covenant to market is applicable, lessees will be required to pay royalties without deductions").

The most up-to-date and comprehensive discussion of the "marketable product" rule and the "at the well" rule is on pages 231-288 of OIL AND GAS IMPLIED COVENANTS FOR THE TWENTY-FIRST CENTURY, Juris Publishing, Inc. (2014) by John Burritt McArthur. Respondents commend that portion of the book to the Court's attention and attach it as Respondents' Exhibit B.

B. Response to Chesapeake's Second Proposition of Law

Oil and Gas Leases Are Construed So As To Avoid Rendering Terms Meaningless.

Chesapeake's second proposition is also a correct statement of law. It too, however, does not support Chesapeake's contention that "at the well" language allows it to charge post production costs to its royalty owners. Chesapeake is correct that, when possible, contracts should be construed in a way that gives meaning to all of its provisions. This does not mean, however, that provisions *that have been rendered meaningless by changed circumstances should be given a meaning that does not exist.* There is no longer a market for gas at the well. Gas royalties cannot be calculated using a variable that does not exist. If a lease provides for a royalty on the "market value at the well" and none exists, the gas producer's implied covenant to market requires it to sell the gas where a market actually exists and to pay the attendant costs. *See* above at pages 16-17.

C. Response To Chesapeake's Third Proposition of Law

Under Ohio Law, Leases Providing That Royalties Are To Be Paid Based On The "Market Value" Of Gas "At The Well" Should Be Applied As Written.

Chesapeake's third proposition is also a correct statement of law, but it likewise does not support Chesapeake's contention that "at the well" language allows it to charge post production costs to its royalty owners. Chesapeake is correct that, when possible, an oil and gas lease providing for royalties on the market value at the well should be applied as written. The lease, however, does not provide that the royalty shall be "*based on* the market value at the well." It provides that the royalty shall *be* "the market value at the well of one-eighth of the gas so sold or used." There no longer is such a market. Even if Chesapeake were correct that the lease provided for a royalty "based on" the market value at the well, this would not support Chesapeake's position that it can deduct post production costs. A royalty cannot be "based on" something that no longer exists.

D. <u>Response To Chesapeake's Fourth Proposition of Law</u>

Most States Have Adopted The "At The Well" Rule Because It Gives Meaning To Lease Language Providing That Royalties Are To Be Paid Based On The Market Value Of Gas At The Well.

Chesapeake's fourth proposition is incorrect. Ten states and the federal government have adopted the marketable product rule, three by statute (Michigan, Nevada, Wyoming) and seven by common law (West Virginia, Virginia, Colorado, Kansas, Arkansas, Oklahoma and New Mexico). In contrast, nine states have adopted the "at the well" rule (Pennsylvania, Kentucky, Mississippi, Louisiana, Texas, California, North Dakota, Montana and Michigan, the last of these before Michigan codified the "marketable product" rule). *See* above at pages 8-13. Thus, the actual tally, when states with statutes are included, is 10-9 in favor of the "marketable product" rule. As explained by McArthur, "a marketable-condition rule applies in a majority of producing states and to a considerable majority of production in the United States." McArthur, *supra*, at 265.

E. <u>Response To Chesapeake's Fifth Proposition of Law</u>

Neither the "Marketable Product" Rule Nor the "*Tawney*" Rule Gives Meaning To Contractual "Market Value at the Well" Language.

Chesapeake's fifth proposition is incorrect. First, the "marketable product" rule *does* give meaning to the term "market value at the well." The term means precisely what it says – the market value of gas at the well. As explained above, however, there is no longer a market at the well. Gas royalties cannot be calculated using a variable that does not exist. If a lease provides for a royalty on the "market value at the well" and none exists, the gas producer's implied covenant to market requires it to sell the gas where a market actually exists and to pay the attendant costs. *See* above at pages 16-17.

It is Chesapeake's reading of "market value at the well" that fails to give meaning to those words. Chesapeake would have this Court rewrite the phrase "market value at the well" to read "the theoretical market value at the well, if one existed, using a net-back method in which lessee determines the dollar amount of post production costs in its sole discretion." This rewrite would be contrary to the plain meaning of "market value at the well."

Second, there is no "*Tawney*" rule. In *Tawney*, the West Virginia Supreme Court simply applied West Virginia's equivalent of the marketable product rule, which it described as "our traditional rule that lessors are to receive a royalty of the sale price of gas," and declined to follow what it described as the "contrary rule – that the lessors are not to receive 1/8 of the sale price but rather 1/8 of the sale price less a proportionate share of deductions for transporting and processing the gas." *Tawney*, 633 S.E.2d at 28. *Tawney* is a straightforward application of the marketable product rule, albeit without that nomenclature.

Chesapeake has argued that *Tawney* stands alone as an outlier jurisdiction in holding that "at the well" language is insufficient to allow the deduction of post production costs. That simply is not the case. Three of the other marketable product jurisdictions reach the same conclusion and the others can be expected to do so when presented with a lease with "at the well" royalty language.

In *Rogers,* the Colorado Supreme Court considered four variants of "at the well" royalty clauses. It held all were silent as to the costs necessary "to place the gas in a condition acceptable for market" and that the lessee was therefore obligated to pay these costs under the marketable product rule. *Rogers, Id.* 29 P.3d at 902.

In *Gilmore*, the Kansas Supreme Court held that a lease providing for a royalty on "proceeds at the mouth of the well" did not allow the lessee to deduct compression costs because compression is necessary to make the gas marketable. *Gilmore*, 388 P.2d at 605-607. In *Sternberger*, the same court held that a lease providing for a royalty of 1/8 of the "market price at the well" was silent as to post production costs and that, as a result, "the lessee alone bears the expense in making the product marketable." *Sternberger*, 894 P.2d at 796-800.

In *Legard,* the U.S. District Court for the Western District of Virginia rejected the defendant's argument that "at the well" royalty language allows for the deduction of post production costs:

> I reject EQT's argument that "at the well" language, as a matter of law, allows it to share all post production costs with the royalty owners. Instead I hold that Virginia courts would follow the "first marketable product" rule, and hold the lessee solely responsible for all costs incurred in making the gas produced from the well marketable, unless, as is the case in the November 27, 1990 lease, the parties specifically agree otherwise."

Legard, 2011 WL 86598 at *10.

II. RESPONDENTS' PROPOSITIONS OF LAW

Respondents adopt Chesapeake's propositions of law 1-3 as correct statements of law, although each should be begin with "Generally, ..." Rules of contract interpretation are aids to interpretation, not inflexible edicts. As explained above, however, Chesapeake's propositions 1-3 do not support Chesapeake's argument that "market value at the well" lease language allows it to deduct post production costs from gas royalties. They support Respondents' position that such costs may not be deducted.

Respondents' First Proposition of Law

Ohio Recognizes the "Implied Covenant to Market" in All Oil and Gas Leases.

Ohio recognizes that oil and gas leases included an implied covenant to market. *See, e.g., Yoder v. Artex Oil Co.*, 2014 WL 6467477 at *7 (Ohio App. Nov. 13, 2014); *Mauger v. Positron*

Resources, Inc., 5th Dist. Morgan No. 14AP0001, 2014-Ohio-4613 ¶ 60, 2014 WL 5306930 at *11 (Ohio App. Oct. 6, 2014).

<u>Respondents' Second Proposition of Law</u>

Contractual Duties Include Both the Performance of the Duty and Payment of All Costs Necessary for Performance of the Duty.

The "implied covenant to market" includes (1) the duty to market and (2) the costs of performance. *See* above at pages 16-17.

<u>Respondents' Third Proposition of Law</u>

More Jurisdictions Recognize the "Marketable Product" Rule Than the "At the Well" Rule.

Ten states have adopted the "marketable product" rule and nine have adopted the "at the well" rule. *See* above at pages 8-13.

<u>Respondents' Fourth Proposition of Law</u>

A Party May Waive The Terms Of A Written Contract By Words Or Conduct.

"A party may waive the terms of a written contract by words or conduct." *White Co. v. Canton Transportation Co.* (1936), 131 Ohio St. 190 at paragraph two of syllabus.

<u>Respondents' Fifth Proposition of Law</u>

Parties May Implicitly Modify An Agreement By Their Actions and a Continued, Different Course of Performance Between Parties Manifests A Modification of the Original Agreement.

"Parties may implicitly modify an agreement by their actions." *City of St. Mary's v. Auglaize Co. Bd. of Commrs.*, 115 Ohio St.3d 387, ¶ 39, 2006-Ohio-1033, 875 N.E.2d 561, 567. Further, "[a] continued, different course of performance between parties manifests a modification of the original agreement." *Schmidt v. Texas Meridian Resources, Ltd.*, 4th Dist. Washington No. 94CA12, 1994 WL 728059 at *5-6 (Dec. 30, 1994).

In *Schmidt*, the plaintiffs alleged that the defendant breached oil and gas leases by deducting the costs of transporting the gas to a downstream market. Two of the lease forms had "at the well" royalty language ("proceeds of the sale of the gas at the mouth of the well" and "market price at the well"). *Id.* at *2-3. The trial court entered judgment against the gas producer and the gas producer appealed. The Ohio Court of Appeals affirmed, holding that it made *no difference* which rule Ohio followed because, regardless, the course of performance of the original lessee in taking no deductions controlled. The court explained:

> Even assuming *arguendo* that the royalty provisions, as written herein, allowed for the deduction of transportation costs, it is evident that subsequent events altered that arrangement. Oil and gas leases, as discussed previously, are contracts and are subject to certain fundamental contract principals. It is well settled that a party may waive the terms of a written contract by words or conduct. *White Co. v. Canton Transportation Co.* (1936), 131 Ohio St. 190 at paragraph two of syllabus. Such conduct would amount to an estoppel on the parties so acting. *Id.* at paragraph two of syllabus; *also see Angola Dev. Co. v. Lion Dry Goods Co.* (Jul. 21, 1989), Lucas App. No. 1-88-380, unreported. The subsequent acts of parties may also modify the terms of a contract between them. *Software Clearing House, Inc. v. Intrack, Inc.* (1990), 66 OhioApp.3d 163, 172; *Huntington National Bank v. Am. National Bank* (June 17, 1993), Cuyahoga App. Nos. 62680 & 62893, unreported. A continued, different, "course of performance" between parties manifests a modification of the original agreement. Calamari & Perillo, Contracts (2d ed. 1970) 130, Section 3-15. It make no difference what name is applied to that theory whether it be waiver, estoppel, novation or what have you; the theory is simply that the parties showed that they did not intend a particular provision of the contract to be strictly observed. *Id.* at fn 89 citing Willey v. Terry & Wright, Inc. (Ky. 1967), 421 S.W.2d 362, 363.
>
> ************
>
> [T]he court below found a course of performance between the parties which modified the lease agreement *even if the royalty provisions therein were construed to allow for deduction of transportation costs*. There is ample evidence in the record to support such a finding. The trial court found that Republic Mineral [the original lessee] had never charged any natural gas transportation costs against lessors the entire time it held the

> leasehold estates. **** The lower court could reasonably find from this evidence that the parties behaved in such a manner as *to modify whatever provision of the royalty clause which would have permitted deduction of these costs*. Indeed, the court could conclude from the action of the parties that such deduction of costs *was not even contemplated* in their agreement.

Id. at *5-6 (emphasis added).

The result in *Schmidt* has been reached in every gas royalty case with a *Schmidt* fact pattern. *See, e.g., Tawney,* 633 S.E.2d at 28 (post production costs not deductible because lessee did not deduct them until 1993, long after leases were executed); *Hanna Oil & Gas Co. v. Taylor*, 759 S.W.2d 563, 564-565 (Ark. 1988) (disallowing deduction of compression costs because the lessee did not deduct them during the first two years they were incurred); *Skaggs v. Heard*, 172 F. Supp. 813, 817 (S.D. Tex. 1959) (compression costs not deductible because none were deducted until two years after compressor was installed).

No post production costs can be deducted under the leases in this case because the original lessee, Murphy Oil Company, deducted none. Nor did its assignee, Columbia Natural Resources, Inc. ("CNR"). CNR did not begin to deduct post production costs until 1993.

CNR issued the same form of check stub to its royalty owners in all Appalachian states. *See* Ohio Check Stubs (ECF 114-18 through 114-22); West Virginia Check Stubs (ECF 118-3); and Kentucky Check Stubs (ECF 118-4). The expenses were reported on the check stubs under the column "Your Share Prod. Charges." *Tawney*, Findings of Fact and Conclusions of Law, 2007 WL 5539870 (W.Va.Cir.Ct. Jun. 27, 2007) (ECF 118-2) at 26-27. Prior to 1993, CNR did not deduct any post production costs and correctly reported "$0.00" under "Your Share Prod. Charges" on the check stubs. *Id.* Beginning in 1993, CNR began to covertly deduct post production costs without notice to its lessors, all the while continuing to report "$0.00" on the check stubs under "Your Share Prod. Charges." *Id.* CNR's method of miscalculating and underpaying the royalties was uniform among all of its Appalachian royalty owners. *Id.* at 59 ("CNR treated each and every royalty owner (except on flat rate leases) exactly the same, regardless of the type of lease involved, including the same rate for the sale of gas, the same deductions, including volume deductions, and the same expenses for gathering, processing and marketing.").

<u>Respondents' Sixth Proposition of Law</u>

The Arguments of the *Amici* are Incorrect on the Law

The *amici* in this case, all with financial self interest in this case, echo the arguments made by Chesapeake. This is to be expected from industry *amici*, gas producers and their associations. Bruce M. Kramer requires additional discussion.

Mr. Kramer is one of the current editors of the Williams and Meyers treatise on oil and gas law, generally included among the top three oil and gas treatises. In recent years, he has regularly appeared in court as an expert for the defense in gas royalty cases. This has not gone unnoticed. In *Oil and Gas Implied Covenants for the Twenty-First Century*, John Burritt McArthur dryly observes, in a sentence that references only Williams and Meyers, that "a number of commentators, often authors who represent producers or testify as experts for producers, have argued for the deductibility of all costs incurred off the well." McArthur goes on to state:

> Indicative of their sympathies, the authors of the current version of Williams and Meyers do not discuss the marketable condition rule under the implied covenant to market, but instead cross-reference it to a contract section on "Royalty Clauses." There they list a series of expenses on which they claim the royalty interest is "usually subject to a proportionate share where the royalty or non-operating interests is payable 'at the well.'" But this no-longer-accurate assertion sidesteps today's division among the courts and the majority barring deductions. Only at the end of this section does the treatise mention that "[b]eginning around 1960" a number of

> courts began to hold otherwise – in a section in which the authors include separate "critique[s] of" two of the leading marketable condition cases.

McArthur, *supra*, at 235 (citations omitted).

Prior to the deaths of Howard Williams and Charles Meyers, the Williams & Meyers treatise was recognized for its objective portrayal of the state of the law. As just demonstrated, the treatise has transitioned toward advocacy under its current editors. This advocacy tracks the pro-industry positions Mr. Kramer presents in his active career as a defense expert.

Mr. Kramer's concept of the role of an expert witness is revealing. He states, in explaining why different courts reach different results on the same issues:

> Disparate results in disparate trials may be inevitable given the nature of the jury system and the *ability of the parties to hire sufficient experts to persuade each jury as to the correctness of their interpretation.*

Bruce M. Kramer, *Royalty Interest in the United States: Not Cut from the Same Cloth*, 29 Tulsa Law Journal 3/4 (Spring/Summer 1994) (emphasis added). The role of an expert, in Mr. Kramer's view, is not to impartially present specialized knowledge, but to "persuade" judge and jury to the "correctness" of the position of the party that hires the expert.

Mr. Kramer's own powers of persuasion are not without limit. The jury in the gas royalty case of *Pollock v. Energy Corporation of America*, tried in federal court in Pittsburgh this spring, listened politely to Mr. Kramer's testimony that the defendant had properly paid the gas royalties and then returned a verdict for the plaintiff class after only an hour's deliberation.

<u>Respondents' Seventh Proposition of Law</u>

Chesapeake Presents No Argument As To The Other Royalty Clauses.

Chesapeake incorrectly states (at page 3 of its brief) that this case concerns only leases with "market value at the well" language. The district court quoted all three royalty clauses in its certification order and all three lease are subject to the summary judgment proceedings in district court. By not addressing the leases without "at the well" language in its opening merit brief, Chesapeake has conceded by waiver that no costs can be charged the royalty owner under the other leases. *See State v. Boswell*, 121 Ohio St.3d (2009), 2009-Ohio-1577 at ¶ 11 (declining to consider argument not in brief); *Estate of Ridley v. Hamilton Co. Bd. of Mental Health*, 102 Ohio St.3d 230, 2004-Ohio-2629 (2004) (same).

There is not even a colorable argument that Chesapeake can deduct post production costs under these other royalty clauses. At *best*, those royalty clauses are ambiguous as to the payment of post production costs and, under Ohio law, ambiguities in an oil and gas lease are construed against the gas producer. *Kenny v. Chesapeake Appalachia, LLC*, 7th District Columbiana No. 14-CO24, 2015-Ohio-1278, ¶ 15 (March 30, 2015). Chesapeake has wisely and appropriately waived argument as to those leases.

CONCLUSION

This Court should hold that in Ohio the implied covenant to market includes the cost of performing the covenant and that, as a result, an oil and gas lessee must pay all costs necessary to place the gas in marketable condition and take it to market, absent express lease language to the contrary.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that on September 22, 2015, a copy of the foregoing was filed electronically on the Court's E-Filng Portal, causing notice of this filing to be sent to all parties who have appeared in this action, and that copies of the foregoing were served by regular U.S. Mail, postage pre-paid, on the counsel listed below:

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