IN THE UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF PENNSLYVANIA

DEMCHAK PARTNERS LIMITED PARTNERSHIP, et al. v. CHESAPEAKE OPERATING, L.L.C., Defendants.	Case No. 3:13-cv-02289-MEM

REPLY OF EDWARD AND KATHLEEN OSTROSKI IN SUPPORT OF THEIR EMERGENCY MOTION TO INTERVENE

Edward and Kathleen Ostroski, by counsel, William R. Caroselli and Caroselli Beachler McTiernan and Coleman, L.L.C., respectfully reply to the oppositions of Plaintiffs and Defendant to their emergency motion to intervene.

INTRODUCTION

The Court has broad discretion under the permissive intervention rule to allow interested persons to intervene. The Court should exercise that discretion in favor of allowing Movants to intervene in this case.

As the Court is aware, Movants have filed a proposed class action in this Court against Defendant's parent company, Chesapeake Energy Corporation ("Chesapeake Energy"), and Defendant's sister company, Chesapeake Operating, L.L.C. ("Chesapeake Operating"), for the conversion of natural gas royalties. That action is *Ostroski v. Chesapeake Energy Corporation, et al.*, Case No. 15-0234 (JEJ) ("Ostroski Conversion Action").

The *Demchak* class members are potential putative class members in the Ostroski Conversion Action but would be precluded from participating in that action by the *Demchak* release, thereby forfeiting the potential recovery of exemplary damages.

The settlement notice is confusing and incomplete because it could be read to allow participation in the Ostroski Conversion Action. The notice states that the release covers "Chesapeake and its affiliates." "Affiliate company" is sometimes defined in the law as a company that is controlled by another company. *See, e.g., In re Motorola Securities Litigation*, 644 F.3d 511, 518 n.1 (7th Cir. 2011) (noting that Black's Law Dictionary (6th ed. 1990) defines "affiliate company" as a company that is "controlled" by another company). When used in this sense, "affiliate" does not include a parent company or a sister company. Members of the settlement class may well think that they are only releasing Defendant and companies it owns or controls. Defendant does not own or control Chesapeake Energy or Chesapeake Operating.

As the consequences of the *Demchak* release would forfeit the ability to recover tort damages, including punitive damages, from Defendant's parent and sister companies, Class Counsel should be ordered to provide the actual release to the members of the settlement class. At a minimum they should be required to furnish the operative language of the release. Further, Movants respectfully submit that members of the settlement class should be provided notice of that the Ostroski Conversion Action is pending in this Court and that their acceptance of the *Demchak* settlement would preclude them from recovering damages in the Ostroski Conversion Action.

ARGUMENT

A. The Settlement Notice Is Insufficient, Confusing, Incomplete, and Defective as to the Scope of the Release.

The settlement notice is fatally defective because it does not mention, let alone adequately explain, that in addition to releasing the Lessee/Defendant class members will forever release Chesapeake Appalachia's "parents," "affiliates," "subsidiaries" and other non-affiliated parties. The notice states:

> In exchange for the benefits received by the class, Chesapeake and its affiliates will be released from any and all claims the Settlement class members may have against Chesapeake or its affiliates based upon the calculation, payment and/or reporting of royalties pursuant to a Pennsylvania Lease, in accordance with the Amended Settlement Agreement. The Settlement affects only Chesapeake and/or its affiliates and does not affect how any other entity calculates and/or pays royalties."

The notice is confusing and incomplete because it states that the settlement "affects only Chesapeake and/or its affiliates and does not affect how any other entities calculate and/or pay royalties" without disclosing that class members would be releasing Defendant's "third party payment processors," "independent contractors" and "working interest owners" from any and all claims, as well.

Also, as explained above, "affiliate" can mean companies that are controlled by another company. Defendant does not control Chesapeake Energy or Chesapeake Operating. Thus, class members could quite correctly conclude from reading the notice that the release does not bar them from actions against these companies when in fact it does.

Finally, disclosure of the actual release language does not solve the underlying problem that the release language is simply too broad to be equitable. As detailed in the Ostroski Conversion Complaint and in the filings in this docket by the Pennsylvania Attorney General, the conduct of Chesapeake Energy and Chesapeake Operating was egregious in the extreme. These companies should not be permitted to evade tort liability via a release in a contract action in which they are not named.

B. <u>Movants Meet the Requirements for Permissive Intervention Under Rule 24 (b).</u>

Rule 24(b) allows anyone who has "a claim or defense that shares with the main action a common question of law or fact" the right to permissively intervene.

F.R.C.P. 24(b). When an intervener shares a "question of law or fact in common" with the original plaintiffs, permissive intervention is allowed. *McKay v. Hayison*, 614 F.2d 899, 906 (3d. Cir. 1980). The Ostroski Conversion Case shares common questions of law and fact with this action because the claims in both cases arise from the underpayment of natural gas royalties under leases with Chesapeake Appalachia. As such, this Court should permit Movants to intervene under Rule 24(b).

C. <u>The Settlement Is Woefully Inadequate</u>

The full extent of the underpayment of the royalties is detailed in the Ostroski Conversion Complaint. As set forth in that Complaint, Defendant had no right to deduct any costs from the royalties because all were incurred after Defendant had sold the gas and transferred title to the buyer.

In their responses in opposition to this motion to intervene, Class Counsel and Defendant contend that the "market enhancement clauses" permits them to deduct costs incurred by Defendant after it has sold the gas. This is patently incorrect. In interpreting the Guaranteed Minimum Royalty Act, the Pennsylvania Supreme Court held in Kilmer that only "post production costs" can be deducted from gas royalties, and carefully defined these as "those expenditures from when the gas exits the ground until it is sold." *Kilmer v. Elexco Land Services, Inc.*, 990

A.2d 1147, 1149, n.2 (Pa. 2010). Costs incurred thereafter are not "post production costs" and are not deductible.

This precise question arose in *Pollock v. Energy Corporation of America*, a gas royalty case successfully tried to a jury in federal court in Pittsburgh earlier this year. Before the case went to trial, the court entered partial summary judgment as to liability against the Defendant gas producer, ruling that it had breached the leases by deducting transportation costs that where incurred after the producer had transferred title its marketing affiliate. See *Pollock v. Energy Corporation of America*, No. 10-1553, 2013 WL 275327 at *1-2 (W. D. Pa. Jan. 24, 2013) (Conti, C.J.).

Although Defendant in this case was barred from taking any costs from the royalties as a matter of law, the proposed settlement fails to recoup all of the costs deducted. Stripped to its essentials, the proposed settlement is this:

- Defendant would make an initial payment of 55% of all the costs deducted prior to September 1, 2013. This reimbursement, however, would only be for costs incurred between the well and the point where the gathering system interconnects with the interstate pipeline system. There would be no reimbursement of costs deducted for interstate transportation, even though they exceeded the industry norm.

- Defendant would make a payment of 27.5% of all costs deducted from September 1, 2013 through the effective date of the settlement. Again, there would be no reimbursement of the deductions taken for interstate transportation.

- Following the settlement, Chesapeake would then use a "Future Royalty Calculation Method" that would remain in effect "so long thereafter as Chesapeake is paying Royalties to the Settlement Class Members and their successors and assigns on Gas produced pursuant to the Pennsylvania Leases." Under this method, the royalty owner would pay 100% of the interstate transportation costs transportation and 72.5% of the costs between the well and the interstate pipeline system (thereby making permanent the cost structure put in place for gas produced after September 1, 2013).

- Although the royalty owners never had an obligation to pay any costs (because the lessee incurs none), the settlement states that the new method of calculating the royalties is a "benefit" because 72.5% of the costs are deducted rather than 100%. The alleged "benefit" of paying 72.5% instead of 100% is illusory, however, because no deductions are permitted as a matter of law.

- Class Counsel seek as legal fees not only one-third of the costs reimbursed to the class, they seek one-third of the so-called "benefit" from the new method of calculating the royalties. These bonus payments would continue for up to five years. Thus, one-third of the 27.5% of the costs that Defendant would stop deducting would not inure to the royalty owners but to Class Counsel, all on the fiction that the settlement is creating a "benefit" when, in fact, it reforms the leases to allow deductions that are not presently deductible.

The obvious questions raised by this unconscionable settlement are these:

1. Why aren't all the costs reimbursed since none were incurred when the lessee held title?

2. Why, with no explanation, does the amount of the cost reimbursements drop from 55% and to 27.5%?

3. Why aren't interstate transportation deductions reimbursed since these costs likewise are incurred after the lessee has transferred title.

4. Why are the transportation deductions higher than the industry norm?

5. Why is the method of calculating the royalties permitted to continue even if present and future court rulings and statutes make the method unlawful?

6. Why do the lawyers receive one-third of the 27.5% "economic benefit" under the new method for up to five years when the new method, rather than benefiting the royalty owners, burdens them with costs they presently have no obligation to pay?

7. Why, with no explanation, is there no settlement payment on the claim in the *Demchak* complaint that the royalties were calculated on below-market prices?

Respectfully submitted,

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CERTIFICATE OF SERVICE

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