

## **Recent Developments in Royalty Litigation in the Shale Plays**

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### **Recent Developments in Royalty Litigation in the Shale Plays**

Now that shale formations in Texas, Appalachia and elsewhere are in active production and royalties on that production are being paid, questions regarding those royalties and how they should be calculated and paid are receiving increased attention. This is particularly true in light of lower natural gas prices and the resulting reduction in profits on gas sold. This paper will discuss some of the recent cases addressing these issues.

#### **§XX.01 Post-Production Costs.**

The most significant question that has been addressed by courts is which post-production costs, including the costs to gather, market, treat, separate and transport the gas to market, can be considered in calculating a lessor's royalty payment. There are two general approaches to the treatment of post-production costs in making royalty payments and the jurisdictions that have considered the issue are split. The majority of jurisdictions that have addressed the issue, including Texas and Pennsylvania,<sup>1</sup> apply the "at the well" rule. The "at the well" rule allows for deduction of post-production costs prior to payment of royalties. "At the well" refers to the gas in its natural state at the point of extraction, before any treatment or transportation. When

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<sup>1</sup> Kentucky, North Dakota, California, New Mexico, Michigan, and Mississippi also follow some version of this rule.

gas is processed or transported before the point of sale, the “at the well” price is determined by the net-back method. Under the net-back method, “value at the point of valuation is determined by taking the downstream sales price and deducting from it the costs incurred by the working interest owner ... to move the gas from the point of valuation to the actual point of sale.”<sup>2</sup> In “at the well” jurisdictions, both lessors and lessees share proportionately in both the costs and benefits of post-production activities. Post-production cost deductions are generally permitted in these jurisdictions where the oil and gas lease at issue contains language referencing post-production costs or language referencing “at the well” or “at the wellhead.”

A minority of jurisdictions<sup>3</sup> that have ruled on post-production cost deductions have applied the marketable product doctrine. These jurisdictions still consider a lessor’s royalty under a lease to be their cost-free share of production, but production “is understood not simply as the initial capture of the raw material, but in light of the lessee’s implied duty to market the captured materials, is instead thought of as extending to the production of a ‘marketable product.’”<sup>4</sup> Therefore, in jurisdictions applying the marketable product doctrine, if a lease is silent as to allocation of costs, the implied covenant to market obligates the lessee to incur costs necessary to render the gas marketable.<sup>5</sup> After the gas is considered marketable, however, post-

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<sup>2</sup> Bruce M. Kramer, *Royalty Interests in the United States: Not Cut from the Same Cloth*, 29 Tulsa L. Rev. 449, 461 (1994). See also 30 C.F.R. § 206.101 (“‘Netback method’ (or workback method) means a method for calculating market value of oil at the lease. Under this method, costs of transportation, processing, or manufacturing are deducted from the proceeds received for the oil and any extracted, processed, or manufactured products, or from the value of the oil or any extracted, processed, or manufactured products at the first point at which reasonable values for any such products may be determined by a sale pursuant to an arm's-length contract or comparison to other sales of such products, to ascertain value at the lease.”).

<sup>3</sup> Colorado, Oklahoma, Kansas, and Arkansas all follow some version of this rule.

<sup>4</sup> *Baker et al. v. Magnum Hunter Production, Inc.*, Case No. 2013-SC-000497, (Ky. August 20, 2015) (citing Rachel M. Kirk, *Variations in the Marketable Product Rule from State to State*, 60 Okla. L. R. 769 (2007)).

<sup>5</sup> See Williams & Meyers, *Manual of Oil and Gas Terms*.

production costs may be deducted. In jurisdictions applying the marketable product doctrine, courts will generally only allow deductions after the gas is in a marketable condition where leases contain language such as “gross proceeds received at the well,” “market price at the well,” “proceeds at the well,” and “market value at the well.”<sup>6</sup> West Virginia applies the “point of sale” approach, an extreme version of the marketable product doctrine, under which no post-production costs between the wellhead and the point of sale may be deducted from the royalty.<sup>7</sup> In West Virginia, deductions are permitted only if the oil and gas lease at issue specifically identifies the deductions and the method for calculating those deductions.

Recent cases suggest the continued dominance of the “at the well” rule, and a rejection of attempts to extend the current reach of the marketable product doctrine. The Supreme Court of Kentucky affirmed that state’s status as an “at the well” jurisdiction. The Kansas Supreme Court limited the application of the marketable product doctrine, traditionally applied in that state, by holding that the duty to make gas marketable is satisfied when the operator delivers the gas to the purchaser in a condition acceptable to the purchaser in a good faith transaction. The Supreme Court of Ohio is currently considering the issue. Meanwhile, the Supreme Court of Texas issued a decision which emphasizes that both the “at the well” and the marketable product rules can be modified by lease language which expressly governs apportionment of certain post-production costs.

**A. State High Court Confirms Kentucky is an “At The Well” Jurisdiction.**

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<sup>6</sup> See e.g. *Rogers v. Westerman Farm Co.*, 29 P.2d 887 (Colo. 2001); *Wood v. TXO Prod. Corp.*, 854 P.2d 880 (Okla. 1992).

<sup>7</sup> *Estate of Tawney v. Columbia Natural Resources, LLC*, 633 S.E.2d 22 (W. Va. 2006).

In *Baker v. Magnum Hunter Production*,<sup>8</sup> the Supreme Court of Kentucky confirmed that absent language to the contrary, a royalty in an oil and gas lease is based on the value of the raw gas captured at the well. The Plaintiff-lessors in the case had argued that Lessees had improperly deducted costs for gathering, compression, and treatment of gas. Plaintiffs' leases provided that they were entitled to receive royalties of "one-eighth of the market price at the well for gas sold or for the gas so used from each well off the premises." They argued that under Kentucky law, the provision required their royalty to be calculated based on the sale of gas made "marketable," after accumulating, compressing, and treating the gas. Plaintiffs did acknowledge that bona fide transportation costs were proper deductions. As part of their case, Plaintiffs challenged the Sixth Circuit's recent characterization of Kentucky as an "at the well" jurisdiction.<sup>9</sup> The Kentucky Supreme Court disagreed, and held that under established Kentucky law, an oil and gas royalty is the lessor's cost-free share of production, with "production" understood as the raw gas captured at the well.

The court rejected plaintiffs' assertion that because prior Kentucky cases involving post-production costs had only specifically considered transportation costs, some variation of the marketable product doctrine was consistent with Kentucky law. The court held that the implied duty to market the gas did not extend beyond "selling the gas at a reasonable price at the well side," and a reasonable well-side price could be determined by an actual well-side sale, by comparable sales in the vicinity, or by applying the net-back method to deduct downstream costs. Finally, the court rejected the plaintiffs' argument that the word "market" in "market price at the well" required the gas to be marketable before royalties were calculated. The court found that

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<sup>8</sup> *Baker et al. v. Magnum Hunter Production, Inc.*, Case No. 2013-SC-000497, (Ky. August 20, 2015).

<sup>9</sup> *Poplar Creek Dev. Co. v. Chesapeake Appalachia, L.L.C.*, 636 F.3d 235 (6th Cir.).

“without more specificity,” those words could not overcome the presumption that the royalty be based on the value of proceeds of the raw gas produced at the well. The court characterized the “at the well” approach as “not only long-standing but also fair in every sense,” and pointed out that under the marketable product approach, the landowner actually receives more than one-eighth of the value of the raw gas produced from their property.

**B. Kansas Supreme Court Weakens Marketable Product Doctrine.**

In *Fawcett v. Oil Producers, Inc. of Kansas*,<sup>10</sup> plaintiff royalty owners brought a class action against Oil Producers, Inc., of Kansas (“OPIK”), on behalf of all royalty owners who were paid royalties, claiming underpayment. The District Court granted class certification and granted plaintiffs partial summary judgment on the ground that OPIK impermissibly reduced plaintiffs’ royalty payments by charging certain processing and transportation fees. Oil Producers filed an interlocutory appeal. The Court of Appeals affirmed.

The crux of the issue was whether the operator could take into account the deductions and adjustments identified in third-party purchase agreements when calculating royalties. The leases at issue provided that royalties were based on the “proceeds” of the sale of gas and were silent as to deductions. The third-party purchasers paid OPIK for the raw gas received at the wellhead based on a percentage of specified index prices or the third-party purchasers’ actual revenue when that gas is sold to others, reduced by certain costs. For example, under OPIK’s contract with third-party purchaser ONEOK Midstream Gas Supply, L.L.C., in exchange for natural gas delivered by OPIK, ONEOK agreed to pay a percentage of its income from the sale of the natural gas and the natural gas liquids recovered from the raw gas—less deductions from the natural gas income for: a “base gathering and compression fee” of 55 cents per MMBtu;

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<sup>10</sup> *Fawcett v. Oil Producers, Inc. of Kansas*, 2015 WL 4033549 (Kan. July 2, 2015).

approximately 6 percent for plant, gathering, and compression fuel; 1.14 percent for fuel lost and unaccounted for; and, if applicable, fees paid to others to deliver the gas to ONEOK's processing facility. OPIK and ONEOK further agreed the amount due under this formula constituted full consideration for the gas and all of its constituents received at the wellhead by ONEOK. Title to the gas passed to ONEOK at or near the wellhead.

Lessors argued that the wellhead sale to an unaffiliated gatherer should be ignored in calculating royalties and that the gatherer's resale price at the plant without deduction of the gatherer's processing and transportation fees should be the basis for the royalty. Lessors invoked the "marketable condition rule" or "marketable product rule," for the principle that the operators were responsible to make the gas marketable at their own expense. The lessors argued that the gas was not marketable until it entered an interstate pipeline, so the royalties in treating and transporting the gas up to that point could not be deducted. OPIK countered that it fulfilled its duty to market by entering into the third party purchase agreements for sale of the gas at the wellhead and argued that the third party agreements benefitted royalty owners because they were able to share in higher prices received for the gas sold closer to the consumer.

The Supreme Court of Kansas reviewed its applicable caselaw on the subject and determined that when gas is sold at the well it has been marketed and when the operator is required to pay a royalty on its proceeds from such sales, the operator may not deduct any pre-sale expenses required to make the gas acceptable to the third-party purchaser. The Court distinguished post-production costs, however, stating that "post-sale, post-production expenses to fractionate raw natural gas into its various valuable components or transform it into interstate pipeline quality gas are different than expenses of drilling and equipping the well or delivering the gas to the purchaser." In so finding, the court expressly rejected the Colorado Supreme

Court's holding in *Rogers v. Westerman Farm Co.*,<sup>11</sup> that, based on the operator's duty to market, an operator can be solely responsible for post-production, post-sale processing expenses when the lease requires royalties to be calculated on the operator's proceeds from the sale of gas at the well.

The Supreme Court of Kansas held that "when a lease provides for royalties based on a share of proceeds from the sale of gas at the well, and the gas is sold at the well, the operator's duty to bear the expense of making the gas marketable does not, as a matter of law, extend beyond that geographical point to post-sale expenses. In other words, the duty to make gas marketable is satisfied when the operator delivers the gas to the purchaser in a condition acceptable to the purchaser in a good faith transaction." Finally, the court acknowledged that there could be potential "claims for mischief" given that their finding leaves operators with nearly unilateral control over production and marketing, but qualified that the interest of royalty owners are protected by the covenant of good faith and fair dealing and the implied duty to market.

### **C. Ohio Supreme Court Accepts Key Certified Question Regarding Post-Production Costs.**

In a putative class action pending in the Northern District of Ohio, *Lutz v. Chesapeake Appalachia L.L.C.*,<sup>12</sup> the plaintiffs claim they were underpaid royalties beginning in 1993. In 2010, the District Court dismissed the plaintiffs' complaint as barred by the applicable four year statute of limitations because certain claims accrued in 1993 and the remaining claims accrued in 2000. In May of 2013, the Sixth Circuit Court of Appeals reversed and remanded, holding that because the leases at issue are divisible contracts, the four year statute of limitations is triggered

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<sup>11</sup> *Rogers v. Westerman Farm Co.*, 29 P.3d 887, 891 n. 1, 912–13 (Colo.2001).

<sup>12</sup> *Lutz v. Chesapeake Appalachia L.L.C.*, Case No. 4:09-cv-02256 (N.D. Ohio).



by each monthly royalty payment. The Sixth Circuit also remanded the issue of whether plaintiffs were permitted to go back further than the four years under the doctrine of fraudulent concealment because plaintiffs claim the original lessee fraudulently concealed allegedly improper deductions and royalty calculations.

The plaintiffs claim they were not paid royalties on gas lost between the wellhead and point of sale and that royalties were calculated based on long term sales contracts instead of current market values. On April 1, 2015, the U.S. District Court for the Northern District of Ohio certified a question of law concerning the deduction of post-production costs to the Supreme Court of Ohio. The question certified is as follows: “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)?” The Supreme Court of Ohio accepted review of the issue in June of 2015.

**D. Supreme Court of Kentucky Holds Severance Tax Not Deductible as a Post-Production Cost.**

In *Appalachian Land Company v. EQT Production Company*,<sup>13</sup> the Supreme Court of Kentucky considered whether the cost of a state severance tax could be deducted as a post-production cost from a lessor’s royalties. The issue arose out of a class action originally filed in the U.S. District Court for the Eastern District of Kentucky, wherein the plaintiffs had deducted post-production costs including processing, transportation, and all severance taxes. The district court certified the following question to the Supreme Court of Kentucky:

“Does Kentucky’s ‘at-the-well’ rule allow a natural-gas processor to deduct all severance taxes paid at market prior to calculating a contractual royalty payment

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<sup>13</sup> *Appalachian Land Co. v. EQT Production Co.*, Case No. 2013-SC-000598, (Ky. August 20, 2015).

based on ‘the market price of gas at the well,’ or does the resource’s at-the-well price include a proportionate share of the severance taxes owed such that a processor may deduct only that portion of the severance taxes attributable to the gathering, compression and treatment of the resource prior to calculating the appropriate royalty payment?”

The majority declined to accept either proposition, and instead held that absent a specific lease provision apportioning severance taxes, a lessee may not deduct any portion of severance taxes prior to calculating royalties.

The majority reviewed prior cases, and held that the tax was intended to burden the business of extracting minerals, and not the land containing the minerals. The majority also distinguished Kentucky’s severance tax statute from those of other states which specifically provide for the payment of severance taxes by the royalty owner. The majority pointed out that “while the sale of the gas is contingent upon payment of the severance tax, the tax does not enhance the value of the gas.” The court found “it would run contrary to the parties’ intent – and the purpose of the ‘at the well’ rule – for the royalty owner to share in an expense that does nothing to improve the quality of the product beyond the well-head.” The court acknowledged that tax policy is a legislative concern, and the legislature has the ability to modify the statute if necessary. Two dissenting justices would have found that the portion of severance taxes attributable to processing of gas after extraction could be properly deducted from royalties.

**E. Texas High Court Applies “Cost Free” Language to Post-Production Costs.**

In *Chesapeake Exploration, L.L.C. v. Hyder*,<sup>14</sup> the Texas Supreme Court narrowly ruled in favor of lessors in the interpretation of a specific provision governing deductions from an overriding royalty in a lease. The court considered the meaning of language providing that the lessor received a “perpetual, cost-free (except only its portion of production taxes) overriding royalty of 5 percent of gross production obtained” from drilling sites on the Hyders’ property. Chesapeake argued that because of the “gross production” language in the provision, the royalty is only “cost free” to the point where the gas is extracted. Chesapeake argued the provision should not apply to activities beyond the wellhead, like treatment and transportation, which add value to the gas. Chesapeake argued that “cost-free overriding royalty” was merely a synonym for overriding royalty and cited a number of lease provisions discussed in other cases supporting that view.

The Hyders countered that the cost-free language was meant to indicate that there would be no deduction of post-production costs. They argued the requirement that the overriding royalty be “cost free” could only refer to postproduction costs, because the royalty is free of production costs without saying so. The Hyders also argued they should not bear post-production costs under the Lease because of a provision in the lease disclaiming the application of the *Heritage Resources* case, in which the Supreme Court of Texas held that a royalty is free of production expenses but “usually subject to post-production costs, including taxes ... and transportation costs.”<sup>15</sup> The court in that case did qualify that “the parties may modify this general rule by agreement.”

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<sup>14</sup>*Chesapeake Exploration, L.L.C. v. Hyder*, Case No. 14-0302, 2015 WL 3653446 (Tex. June 12, 2015).

<sup>15</sup>*Heritage Resources, Inc. v. Nationsbank*, 939 S.W.2d 118, 121–122 (Tex. 1996).

After a bench trial, the trial court rendered judgment for the Hyders, awarding them \$575,359.90 in postproduction costs. The court of appeals affirmed and the Texas Supreme Court granted Chesapeake's petition for review. The Texas Supreme Court ruled in a 5-4 decision that post-production costs could not be deducted from the overriding royalty under the lease. A majority of the Justices found that the language "cost-free," in the overriding royalty provision, though not as clear as language in a separate royalty provision in the Lease, was "reasonably interpreted" to exempt the overriding royalty from postproduction costs. The majority also pointed out that the disputed clause excepts production taxes, which are often considered postproduction expenses, from the "cost-free" designation.

Justice Brown, writing for the dissent, stated that he would have held the "cost-free" designation should not operate to add value to the Hyders' overriding royalty, and disagreed with the majority that such language "expresses an intent to abrogate the default rule that the lessee bears post-production costs." Justice Brown stated that "it may be true that we have, on occasion, generally categorized taxes as a post-production cost. But, as the Court recognizes, parties often allocate tax liability on the royalty owner while at the same time specifically emphasizing that the royalty is free from production costs." Furthermore, while the language in the provision governing the overriding royalty interest was merely "cost-free," a separate royalty provision was specified as being: "free and clear of all production and post-production costs and expenses, including but not limited to, production, gathering, separating, storing, dehydrating, compressing, transporting, processing, treating, marketing, delivering or any other costs and expenses incurred between the wellhead and Lessee's point of delivery or sale of such share to a third party." The dissent found the difference in the provisions highlighted the fact that the "cost-free" language was not intended to apply to post-production costs. The dissent ultimately

read the overriding-royalty clause as granting the Hyders a percentage of production before post-production value was added.

While the application of the *Hyder* case to other royalty disputes may be limited as a result of the specific lease language interpreted in the case, the Texas Supreme Court's discussion of *Heritage Resources* may be of interest to producers. The majority noted that the disclaimer of the *Heritage Resources* case in the Lease did not influence their decision, but they did state that "*Heritage Resources* does not suggest, much less hold, that a royalty cannot be made free of postproduction costs. *Heritage Resources* holds only that the effect of a lease is governed by a fair reading of its text. A disclaimer of that holding, like the one in this case, cannot free a royalty of postproduction costs when the text of the lease itself does not do so."

**F. Update on Post-Production Cost Cases in Pennsylvania State and Federal Courts.**

On March 5, 2015 a jury found in favor of a class of plaintiff lessors against Defendant Energy Corporation of America, on claims that ECA had improperly deducted interstate pipeline costs and marketing expenses from their royalties. The court denied ECA's post-trial motions, concluding extended litigation of the matter in the Western District of Pennsylvania.<sup>16</sup> *Pollock* was one of the first significant post-*Kilmer* class action royalty challenges in Pennsylvania. Plaintiffs raised multiple issues regarding underpayment of royalties, and argued that: ECA did not pay royalties on gas that was lost between the well and point of sale, ECA did not pay royalties on gas used before the point of sale, ECA deducted post-production costs not expressly permitted by the leases and allocated post-production costs on a pro rata basis, and ECA calculated royalties on sales price instead of the price paid.

In January of 2013, District Judge Conti granted summary judgment in favor of

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<sup>16</sup> *Pollock v. Energy Corp. of Am.*, 2015 WL 3795659 (W.D. Pa. June 18, 2015).

ECA on plaintiffs' claims that ECA's allocation method was improper, that deductions for marketing and dehydration and compression of gas were improper, and that plaintiffs were entitled to royalties on proceeds from hedging transactions by ECA.<sup>17</sup> In rejecting plaintiffs' claim regarding ECA's allocation method, the court endorsed the allocation of post-production costs on a pro rata basis. This settled an issue of first impression in Pennsylvania, and followed industry custom and practice. In September of 2013, the court adopted the Magistrate's recommendation that two classes be certified in the case – one of lessors who alleged that post-production cost deductions were improperly taken related to transportation and one of lessors who alleged improper marketing costs involving an affiliate.<sup>18</sup> In July of 2015, ECA appealed the verdict to the Third Circuit Court of Appeals.

In *Hall v. CNX Gas Company*,<sup>19</sup> the plaintiffs brought an action in the Court of Common Pleas of Allegheny County, and argued that the court should reverse its holding on allocation of post-production costs in a similar case – *Lawrence, et al., vs. Atlas Resources, Inc., et al.*<sup>20</sup> In *Lawrence*, the court had held that where leases were silent on the issue of allocation, the lessor was permitted to allocate post-production costs on a pro-rata basis rather than calculate the costs per well. The courts' reasoning differed from *Pollock* in that instead of relying on industry custom, the court held that the pro-rata allocation of post-production costs met the expectations of the parties under “community standards of fairness and policy.”

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<sup>17</sup> *Pollock v. Energy Corp. of Am.*, 2013 WL 275327 (W.D. Pa. Jan. 24, 2013).

<sup>18</sup> *Pollock v. Energy Corp. of Am.*, 2013 WL 5338009 (W.D. Pa. Sept. 16, 2013) *report and recommendation adopted*, CIV.A. 10-1553, 2013 WL 5491736 (W.D. Pa. Sept. 30, 2013).

<sup>19</sup> *Earl D. Hall, Sr.; Betty Jane Hall; Earl D. Hall, Jr.; on behalf of themselves and all others similarly situated, v. CNX Gas Company, LLC*, No. GD 10-21633 (Ct. Com. Pl. Allegheny Cnty.).

<sup>20</sup> *Lawrence, et al., vs. Atlas Resources, Inc., et al.*, No. GD-10-011904 (Ct. Com. Pl. Allegheny Cnty.).

The plaintiffs in *Hall* brought similar claims to those raised by the plaintiffs in *Pollock* and *Lawrence*, and argued that deductions of lost and used gas based on allocation of post-production costs breached the leases. The court granted the defendants' motion for summary judgment on the grounds that there were no material factual differences of fact between *Lawrence* and *Hall*. The Plaintiffs in *Hall* subsequently appealed the case to the Pennsylvania Superior Court. Oral argument in the case is scheduled for September 17, 2015.

**G. Texas Court Considers Treatment of Casinghead Gas a Post-Production Cost.**

In *French v. Occidental Permian, Ltd.*,<sup>21</sup> the Texas Supreme Court overturned a \$10 million judgement and held that the costs of processing casinghead gas resulting in part from CO<sub>2</sub> injection were properly deducted from Plaintiffs' royalties. Because production at the wells at issue had substantially declined, operator Occidental Permian injected large amounts of CO<sub>2</sub> into the field in an effort to enhance recovery. The injection of CO<sub>2</sub> significantly improved production but resulted in the production of CO<sub>2</sub>-laden casinghead gas. Occidental processed the gas to (1) remove the CO<sub>2</sub> and other contaminants for reinjection into the reservoir and (2) extract the natural gas liquids for sale. After describing that a royalty is generally "free of the expenses of production [but] subject to postproduction costs, including . . . treatment costs to render [production] marketable . . .," the court noted that the dispute hinged on whether the removal of CO<sub>2</sub> from the casinghead gas was a production or post-production cost. The court found that Occidental could have reinjected all of the casinghead gas produced, but performed further processing for the benefit of both parties. "French, having given Oxy the right and discretion to decide whether to reinject or process the casinghead gas and having benefitted from

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<sup>21</sup> *French v. Occidental Permian, Ltd.*, 440 S.W.3d 1, 3 (Tex. 2014), *reh'g denied* (Oct. 3, 2014).

that decision, must share in the cost of CO2 removal.” This case is noteworthy in that the court emphasized the benefits of the enhanced recovery method at issue to both the lessors and lessees.

**§XX.02. Other Recent Cases Involving Royalty Disputes.**

**A. Failure to Join Lessors Impacted by Suit Results in Dismissal.**

In *Crawford v. XTO Energy Inc.*,<sup>22</sup> plaintiff Richard Crawford brought an action for conversion, breach of the lease, declaratory judgment, and to quiet title to a strip of land which was placed in a unit operated by XTO. XTO had ceased paying royalties to Crawford, and instead paid adjacent landowners, as a result of a title opinion stating that Crawford lacked an interest in the subject tract under Texas’ strip and gore doctrine. The trial court judge ordered the joinder of the adjacent landowners in the unit, and dismissed the case when Crawford failed to join those parties. On appeal, the majority held that the trial judge did not abuse his discretion in dismissing the suit against XTO. The majority held that “the inescapable conclusion is that either the nonjoined adjacent landowners will not be bound by the trial court’s ultimate decision on the declaratory judgment portion of Crawford’s suit, or the nonjoined adjacent landowners could lose some of their royalty payments. ... In either scenario, a fact pattern is presented that would support the joinder of the adjacent landowners.”

**B. RICO Suit in Pennsylvania Survives Motion to Dismiss.**

In June of 2014, Plaintiffs brought a putative class action against Chesapeake Energy and Access Midstream Partners in *The Suessenbach Family Limited Partnership et. al v. Access Midstream Partners*,<sup>23</sup> alleging RICO violations and mail fraud, along with claims for honest services fraud, unjust enrichment, conversion, and civil conspiracy. The claims are based on

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<sup>22</sup> *Crawford v. XTO Energy Inc.*, 455 S.W.3d 245 (Tex Ct. App. 2015).

<sup>23</sup> *The Suessenbach Family Limited Partnershi et. al v. Access Midstream Partners, L.P. et. al*, Case No. 3:14-cv-01197 (M.D. Pa. Jun 20, 2014).



Plaintiffs' allegation that Chesapeake Energy formed the affiliate entity Access Midstream Partners, and subsequently sold its midstream assets to Access Midstream in order to fund Chesapeake's ongoing operations. Plaintiffs' complaint alleges close and continuing ties between Chesapeake Energy and Access Midstream, and alleges that the two companies were not operating at an arm's length. Plaintiffs allege that Chesapeake Energy and Access Midstream entered into agreements in which Chesapeake Energy's subsidiaries agreed to pay Access Midstream inflated rates for natural gas gathering and transportation services, including intrastate transport, in part to pay back Access Midstream for what they characterize as "off-balance sheet loans."

Plaintiffs allege that, as a result, between October 2012 and January 2014, deductions of greater than the statutory minimum 12% were deducted from their royalty payments. On August 26, 2014, Chesapeake Energy and Access Midstream filed separate motions to dismiss. In its motion, Chesapeake argued that plaintiffs failed to allege injury because the gathering rate deducted from royalties did not increase after the defendants entered into the subject agreements in 2012. Chesapeake further argued that the source of plaintiffs' claimed injury – the 2012 agreements between Chesapeake Energy and Access Midstream - was not related to the mailing of royalty stubs, which Plaintiffs relied upon for their mail fraud and RICO claims.

In evaluating the motions to dismiss, the court found that Plaintiffs' allegations that their deductions had jumped from 24% in October of 2013 to 39% in January of 2014, as well as statements from analysts unable to explain the increase, were sufficient for the majority of Plaintiffs' claims to survive dismissal. The court found that plaintiffs' allegation that the royalty stubs were designed to lull them into a belief that there was no fraud was sufficient support for the RICO claim to avoid dismissal. The court found that the mailings themselves were

fraudulent in that they contained inflated fees. The court also rejected Chesapeake's gist of the action defense, on the grounds that it was too early to determine whether the gist of the action lay in contract or in tort. The court dismissed Plaintiffs "honest services" fraud claim, finding that plaintiffs did not sufficiently allege a fiduciary duty existed between them and defendants.

In two similar cases, *A & B Campbell Family et al v. Chesapeake Energy Corporation et. al*,<sup>24</sup> and *Brown v. Access Midstream Partners, L.P. et. al*,<sup>25</sup> the plaintiffs have also brought claims, including RICO actions, against Chesapeake Energy and Access Midstream arising out of the 2012 agreements between the two entities. Chesapeake had filed a motion to dismiss in *A&B Campbell*, but the Plaintiffs amended their complaint on July 18, 2015. The defendants in *Brown* have filed motions to dismiss, which are pending.

### **C. Flaring Class Actions Not Proper Before Exhaustion of North Dakota State Administrative Remedies.**

Three putative class actions were brought in state court and removed to the U.S. District Court for the district of North Dakota in November of 2013: *Sorenson et al. v. Burlington Resources Oil & Gas Co. LP*,<sup>26</sup> *Wisdahl v. XTO Energy Inc*,<sup>27</sup> and *Border Farm Trust v. Samson Resources Co.*<sup>28</sup> Plaintiffs brought claims seeking royalties due for gas flared, alleging violations of state statutes as well as common law claims of waste and conversion. North Dakota law permits flaring for a one-year period from the date that a well commences production, but prohibits the practice thereafter. Defendants moved to dismiss on the grounds that Plaintiffs had

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<sup>24</sup> *A & B Campbell Family et al v. Chesapeake Energy Corporation et. al*, Case No. 3:15-cv-00340 (M.D. Pa. Feb 17, 2015).

<sup>25</sup> *Brown v. Access Midstream Partners, L.P. et. al*, Case No. 3:14-cv-00591 (M.D. Pa. Mar 28, 2014).

<sup>26</sup> *Sorenson et al. v. Burlington Resources Oil & Gas Co. LP*, Case No. 4:13-cv-00132, (D. ND. May 14, 2014).

<sup>27</sup> *Wisdahl v. XTO Energy Inc.*, Case No. 4:13-cv-00136, (D. ND. May 14, 2014).

<sup>28</sup> *Border Farm Trust v. Samson Resources Co.*, Case No. 4:13-cv-00141, (D. ND. May 14, 2014).

failed to exhaust their administrative remedies. The court agreed, and dismissed the actions on the grounds that the production of oil and gas in North Dakota are governed by the Act for the Control of Gas and Oil Resources, which granted the North Dakota Industrial Commission “very broad authority to regulate and administer oil and gas related activities in the state of North Dakota.” The court held that Plaintiffs’ proper remedy was to file a petition with the North Dakota Industrial Commission. The court also dismissed the waste and conversion claims on the grounds that they were preempted by the North Dakota statute governing flared gas.

**D. U.S. Supreme Court Clarifies Standard for Pleading Amount in Controversy.**

In *Dart Cherokee Basin Operating Co. v. Owens*,<sup>29</sup> plaintiff Brandon Owens filed a putative class action in Kansas state court alleging that defendants Dart Cherokee Basin Operating Company, and Cherokee Basin Pipeline, underpaid royalties owed to the putative class members. The complaint sought a “fair and reasonable amount” to compensate the putative class members for damages allegedly sustained. Dart Cherokee invoked federal jurisdiction under the Class Action Fairness Act of 2005 (CAFA) and removed the case to the U.S. District Court for the District of Kansas. One requirement for removal under CAFA is that the amount in controversy must exceed \$5 million. In its notice of removal, Dart Cherokee stated that Plaintiffs’ alleged damages totaled more than \$8.2 million. Plaintiffs moved to remand the case on the grounds that Dart Cherokee provided “no evidence” in their notice of removal for the \$8.2 million figure, and thus did not adequately support their burden to prove that the amount in controversy exceeded the jurisdictional minimum. The district court agreed and remanded the case. The US Supreme Court granted Dart Cherokee’s petition for certiorari to decide the degree

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<sup>29</sup> *Dart Cherokee Basin Operating Co. v. Owens*, 135 S. Ct. 547, 551 (2014).

of support required for a party pleading amount in controversy in a notice of removal under CAFA.

The Court held that the district court had improperly relied on a “presumption against removal” that should not have applied to a party removing under CAFA. The Court also held that when a defendant seeks federal court jurisdiction, their amount in controversy allegation should be accepted in good faith. It is only after a plaintiff has contested the amount in controversy that the court should weigh the evidence submitted. In that case, removal will be considered proper if the district court finds by a preponderance of the evidence that the amount in controversy exceeds the jurisdictional threshold.

**§XX.03. Conclusion.**

Cases involving the calculation and payments of royalties will undoubtedly continue so long as royalties are being paid, but cases such as the recent ones described above help to better define what can be included in royalty calculations and when claims can be made. Hopefully, this guidance will help producers and royalty owners better handle disputes going forward.