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Royalty Litigation in the Appalachian Basin

Other Issues

Natural Gas Market – Last year, the natural gas market saw monthly average wellhead prices fall by over 50%, from a record high of $10.35 per Mcf in October 2005 to $5.03 per Mcf in October 2006. While still significantly above the average wellhead price for 2004, the annual average wellhead price for 2006 fell to $6.42 per Mcf from $7.33 per Mcf in 2005. The driving force behind this decline was mild weather and significant storage volumes, aided by a growth in onshore production. Analysts are sharply divided over what to expect for 2007, with many believing that prices will remain flat or decline slightly. A few analysts, however, look at first-year production decline rates and predict a robust market for 2007, particularly if weather returns to normal.

FERC Transparency Regulations – On April 19, 2007, the Federal Energy Regulatory Commission proposed regulations that would, among other things, require buyers and sellers of more than a de minimis volume of natural gas (defined as 2,200,000 MMBtus annually) to report numbers and volumes of relevant transactions to the FERC and others. Authorized by the Energy Policy Act of 2005, this expands significantly the FERC's oversight of certain U.S. natural gas producers and consumers. Comments are due July 11, 2007.

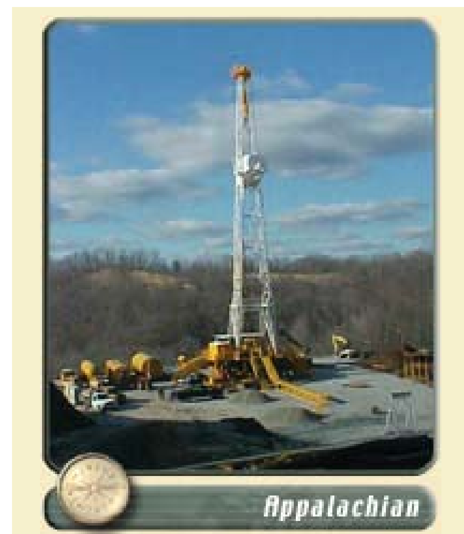
SPCC Regulations – U.S. EPA has extended by final rule the deadline for compliance with amendments to federal SPCC regulations to July 1, 2009. During the interim, it expects to propose and finalize additional amendments specifically related to oil and gas production facilities.

Vorys Energy Group. Vorys' Energy and Utility Practice Group is one of the premier energy practices in the Appalachian Basin, with experience representing energy producers, service companies, local distribution companies and end-users in a wide range of business, litigation and regulatory matters. You can reach the authors of this article W. Jonathan Airey at 614.464.6346 or via email at wjairey@vssp.com; John K. Keller at 614.464.6389 or via email at jkkeller@vssp.com; or Gregory D. Russell at 614.464.5468 or via email at gdrussell@vssp.com.

Class action royalty litigation has reached the Appalachian Basin, and it's likely to spread. A West Virginia jury recently awarded plaintiffs in *Estate of Tawney v. Columbia Natural Resources (CNR), et al.*, over $400 million, consisting of approximately $134.3 million in compensatory damages and $270 million in punitive damages. Plaintiffs claimed that CNR had underpaid royalties by failing to pay on the current market value of the gas and by improperly deducting post-production costs necessary to bring the gas to market. Several similar suits have been filed against other West Virginia and Kentucky producers.

The West Virginia Litigation

Much of the Tawney litigation to date has focused on the post-production cost issue. Following its previous decision in *Wellman v. Energy Resources, Inc.* (2000), the West Virginia Supreme Court of Appeals in Tawney held that the royalty provisions at issue did not allow the deduction of post-production costs even where payment was calculated "at the wellhead," "net all costs beyond the wellhead," and "less all taxes, assessments and adjustments." It based that decision on the belief that the producer has a "responsibility to get the oil or gas in marketable condition and actually transport it to market." Therefore, "unless the lease provides otherwise, the lessee must bear all costs incurred in exploring for, producing, marketing and transporting the product to the point of sale."



Examining the lease language at issue, the Court found it to be ambiguous. That is, the "at the wellhead"-type royalty language used in the leases (as quoted above) did not clearly express an intent by parties to allow the deduction of post-production costs. The Court reasoned that "while the language arguably indicates that the royalty is to be calculated at the well * * * the language does not indicate how or by what method the royalty is to be calculated." As a result, "the general language at issue simply is inadequate to indicate an intent by the parties to agree to a * * * 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." The Court thus construed the lease against CNR, allowing the trial to move forward.

At trial, the jury awarded plaintiffs over $40 million for making payments

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based on the price received from forward sales rather than the existing market price of the gas, and over $15 million for deductions related to gathering, processing and volume reductions made by CNR related to line loss. It also awarded over $30 million for royalties based on alleged volume misallocations where no meter was set at the well and CNR relied on an improper "correction factor" in determining royalty volumes. In addition, the jury found that CNR had committed fraud when making these deductions, based on royalty payment statements that indicated – according to plaintiffs – that no deductions were being taken at all.

payment, refer to the Check Number, Check Date and Client Number. Number and notify us if changes are required.

Type Interest	Rate (S)	Your Share MCF/BBLs	Your Share Prod. Charges	Your (S) Payment
Royalty Interest	3.38	5.03	0.00	16.98
Royalty Interest	3.37	4.79	0.00	16.14
Royalty Interest	3.37	[illegible]	0.00	14.16
Royalty Interest	2.89	0.54	0.00	1.56
Royalty Interest				

Recent post-trial filings have focused on the propriety of the punitive damages award, with defense counsel arguing that the bulk of that award is inappropriate because the case involved a contract dispute and not fraud (contract disputes typically do not allow for punitive awards). Plaintiffs' counsel has responded by claiming that punitive damages are indeed proper because the production statements were misleading, constituting fraudulent concealment. At the same time, plaintiffs' counsel has also asked for an award of attorneys fees and expenses, which could add another *$100 million* to the amount owed by CNR.

And this doesn't begin to address other major issues stemming from the award, involving, for example, royalties based on pre-payments received by CNR under 5 year forward sales contracts at prices that were good at the time but which became significantly lower than market over the contract periods; and the trial court's instruction to the jury that while CNR did not owe lessors a fiduciary duty to report deductions, once CNR undertook to do so, it owed lessors a duty to do so accurately or risk a claim of fraudulent concealment. All of this makes for the very real likelihood of protracted litigation (absent settlement) on issues vital to producers but to date left unaddressed in the Appalachian Basin.

Ohio's Statute of Limitations

Fortunately, Ohio producers are likely to benefit from a recent change in the law applicable to royalty claims. H.B. No. 443, which became effective on April 6, 2007, provides that claims involving the payment of lease royalties in Ohio shall be governed by a *4-year statute of limitations* (i.e., a claim must be brought within that 4-year period or dismissed as untimely), a far cry from the 15-year limitation period that used to apply. Not only does this drive down the amount of any royalty damages claim that a producer might face, it also reduces significantly the interest component of any potential award – by as much as 75% or more, possibly. This makes royalty litigation in Ohio significantly less attractive to the potential plaintiff and – just as importantly – plaintiff's counsel. It is not a guaranteed defense, however, to royalty claims.

So what can a producer do to protect itself going forward? A couple of things may help: First, the producer should review the royalty provisions in its current lease forms to ensure that post-production cost deductions are expressly allowed if those deductions are in fact being taken, and amend the provision if not. At the same time, the producer should consider whether the amounts collected from royalty owners justify the risk of a class action suit – they may not. Second, and this is not new, the producer should consider an express disclaimer of many of the covenants sometimes read into the lease relationship. Third, and perhaps most importantly for the *Tawney* defendants, the producer should review the statements it typically sends with its royalty payments for potentially misleading information to avoid the claim (spurious or not) that a royalty owner is being defrauded. *Tawney* may stand for the proposition that no good deed – *i.e.*, providing more information than required – goes unpunished. Given the lack of guidance from Appalachian Basin courts, there is no magic bullet here to protect even the vigilant producer. But it is a start.

If you have any questions on these or other energy issues, please feel free to get in touch with any of the authors at the contact information listed in the sidebar.

Additional References

- Energy Information Administration www.eia.doe.gov
- Federal Energy Regulatory Commission www.ferc.gov
- Ohio Oil and Gas Association www.ooga.org

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