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Authors:

Walter A. Bunt, Jr.
412.355.8906
walter.bunt@klgates.com

Theodore A. McConnell
412.355.6566
ted.mcconnell@klgates.com

Paul K. Stockman
412.355.8313
paul.stockman@klgates.com

Heather L. Lamparter
412.355.8253
heather.lamparter@klgates.com

West Virginia Court Enters $405 Million Judgment Against Natural Gas Company in Royalty Owner Class Action

A recent West Virginia ruling may limit the ability of oil and gas lessees to deduct post-production costs from royalty payments

A $405 million dollar judgment in a Roane County, West Virginia class action could significantly impact the oil and gas industry and alter how royalties are calculated under mineral leases. This enormous verdict, in *Estate of Garrison Tawney, et al. v. Columbia Natural Resources, et al.*, was the result of a suit alleging that Columbia Natural Resources ("CNR")[1] had wrongfully calculated royalty payments owed to mineral owners. The verdict, which included $134.3 million in compensatory damages and $270 million in punitive damages, was recently upheld when Judge Thomas C. Evan, III denied the defendant's post-trial motion (which had asked the Court to set aside the punitive damages).[2]

The Tawney Case

In *Tawney*, the Plaintiffs, on behalf of a class of 10,440 West Virginia oil and natural gas royalty owners, filed suit against CNR alleging that it had fraudulently, intentionally and knowingly underpaid royalties to the Plaintiffs, by deducting post-production costs and by entering into futures contracts that resulted in below-market-value sale prices.

The Plaintiffs argued that CNR routinely subtracted fees for gathering and transporting the gas to interstate pipelines, and also assessed volume deductions.[3] All deductions were charged equally to royalty owners regardless of distance between well and transmission line. The Plaintiffs believed that such fees and deductions were improper under the numerous leases, which contained varying language on calculation of royalties.[4] CNR contended that all of the leases clearly and unambiguously allowed the lessee to deduct post-production costs. The trial court certified this issue to the West Virginia Supreme Court of Appeals, asking the Court to rule, in advance of trial, whether producers could deduct for production and marketing costs under leases providing that royalties were calculated:

- "at the well" or "at the wellhead,"
- "net of all costs beyond the wellhead," or
- "less all taxes, assessments, and adjustments."

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[1] Oklahoma-based Chesapeake Energy purchased CNR for $2.2 billion in November 2005.

[2] Judge Evans also denied the Plaintiffs' motion for post-trial relief, which requested that the Defendants pay Plaintiffs' attorneys' fees in excess of $1 million.

[3] Specifically, CNR allegedly (i) assessed fees for CNR's delivery of gas from the well to the transmission line, (ii) assessed fees for the processing of gas to make it suitable for delivery, (iii) adjusted production volumes to account for losses due to leaks in gathering system and (iv) adjusted production volumes for other volume losses incurred in transmission.

[4] At issue in *Tawney* were 1,382 separate leases.

The West Virginia Supreme Court held that the above clauses were ambiguous, construed them in favor of the royalty owner, and held that, without additional express language, the clauses did not permit the lessee to deduct production costs. In particular, the Court stated that if a lease is to allocate production costs between the lessor and the lessee, the lease "must expressly provide that the lessor shall bear some part of the costs incurred between the wellhead and the point of sale, identify with particularity the specific deduction the lessee intends to take from the lessor's royalty, and indicate the method of calculating the amount to be deducted." *Estate of Tawney v. Columbia Natural Resources, L.L.C.*, 633 S.E.2d 22, 24 (W. Va. 2006) (syllabus ¶ 10).[5]

The Plaintiffs also argued that CNR wrongfully sold gas at less than market value. At the crux of this argument was the so-called "Mahonia deal." Under this transaction, CNR entered into two forward or futures contracts, which provided for the sale of gas in advance to Mahonia for a fixed price over a five-year period. CNR received $400 million in advance payments because of the Mahonia contracts. CNR blended the Mahonia contracts with other gas sales, and royalty owners received royalties based on an average sales price.

Ultimately, Judge Evans ruled as a matter of law, based on the Supreme Court's ruling, (i) that CNR was not entitled to deduct production and marketing costs, (ii) that the Plaintiffs were entitled to recover for royalties lost as a result of CNR's volume deductions, and (iii) that CNR was required to pay a 1/8 royalty[6] on all wells, metered and non-metered. As a result, the principal questions left for the jury to determine were: (i) whether CNR could properly consider the lower Mahonia sales numbers when calculating royalties and (ii) whether CNR was liable for punitive damages. The jury answered these questions in favor of the Plaintiff class.

Justification for Punitive Damages

Perhaps the most remarkable factor in *Tawney* is the trial court's allowance of punitive damages. In *Tawney*, the Plaintiffs successfully argued that punitive damages were warranted because CNR had acted fraudulently in two ways:

- First, the Plaintiffs cited CNR's royalty statements that listed $0 as the landowner's shared production cost, while CNR in practice was deducting post-production expenses from gas sales. The Plaintiffs contended that these omissions on the statements amounted to fraudulent concealment.

- Second, the Plaintiffs alleged that Mahonia did not prudently market the gas in order to find the highest price and argued that CNR had only entered into the futures contract in order to have immediate cash-in-hand to pay down CNR's debt from a recent merger.

CNR countered that the Mahonia contracts were negotiated for record-high prices and allowed CNR to have immediate cash to expand drilling and conduct further exploration. CNR further contended that it should not be penalized because the price of natural gas rose even further during the contract period and that it had no duty to disclose the contracts to the royalty owners. The jury evidently was not convinced by CNR's arguments, however, because it assessed the punitive damage award.

Conclusion

Undoubtedly hoping to benefit from the favorable certified question opinion, at least four more class action royalty owner suits have been filed in West Virginia, and other royalty class actions continue to be filed in other states. This increase in royalty litigation serves to remind oil and gas companies that class action litigation remains a significant concern. Because of the variety of often-aged lease forms that govern royalty

[5] For a discussion of other jurisdictions' approach to the deductibility of production and marketing costs from royalties, *see, e.g.*, Annotation, *Sufficiency of "At the Well" Language in Oil and Gas Leases to Allocate Costs*, 99 A.L.R. 5th 415 (2002).

[6] By statute in West Virginia, a lessee is entitled to a 1/8 royalty.

payments and the multi-state nature of many oil and gas companies' operations, this is an intricate area of the law. Companies, therefore, may be well advised to consult with experienced counsel who can assist them in assessing the risk posed by royalty-owner class actions and in defending against any claims that may be asserted.