Energy, Utilities, Oil, and Gas ALERT

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Ohio Supreme Court Rules in Landowner Royalty Case

By David Wigham, Partner

In a closely watched and long-awaited case with potentially sweeping industry-wide consequences, the Supreme Court of Ohio refused to adopt a default rule regarding deduction of postproduction costs from landowner royalties in Ohio.

In the case of *Lutz v. Chesapeake Appalachia, L.L.C.*, issued on November 2, 2016, the Supreme Court of Ohio ruled that a determination of what postproduction costs, if any, may be deducted from landowner royalties must be decided based on the language used in each individual oil and gas lease, or, if the lease language is ambiguous, based on extrinsic evidence. As a result, the Court declined to answer the certified question of law regarding which default rule Ohio should follow — the "at the well" rule (which permits the deduction of postproduction costs) or the "marketable product" rule (which limits the deduction of postproduction costs under certain circumstances).

Despite the fact that the Court declined to establish a default rule, the decision nevertheless could have far-reaching consequences for both landowners and producers. In particular, older leases containing gas royalty provisions drafted when natural gas prices were regulated could generate significant litigation going forward. Based on the *Lutz* decision, courts will likely determine future royalty-dispute cases on a lease-by-lease basis by examining the lease language and extrinsic evidence such as old landowner royalty statements. Not only will this likely prove an onerous burden on producers and landowners, it may also prove to be a potential bar to landowner class action lawsuits based on underpayment of gas royalties.

The potential scope of the *Lutz* ruling could be limited primarily to older leases that were signed prior to the deregulation of natural gas in 1992. Many modern leases intended for Utica shale development contain more detailed provisions that attempt to more clearly spell out what postproduction costs may be deducted from landowner royalties. Shale producers have used these more modern leases to lease thousands of acres and have attempted to keep them as uniform as possible.

Furthermore, most older leases signed prior to deregulation were intended for use with conventional wells and do not contain provisions that allow for the development of unconventional Shale wells. Thus, most Shale producers will often seek to amend these older leases prior to proceeding with Shale development, thereby providing landowners with an opportunity to renegotiate royalty and postproduction cost provisions, in addition to other important lease provisions.

These more modern leases may still be subject to considerable dispute regarding what types of postproduction costs are deducted from landowner royalties and whether these costs are reasonable. As Justice Pfeiffer observed in his dissent in *Lutz*, producers completely control postproduction costs, and these costs can be easily manipulated. Producers should be wary of challenges to both the type and amount of postproduction costs being deducted from landowner royalties; And since many Shale producers have used standard lease forms, or slight variants of standard forms, landowners could potentially be in a better position to successfully pursue class action cases based on underpayment of landowner royalties.

Many Shale producers have carefully drafted the lease language they are using for Shale development and have included provisions intended to allow for deduction of postproduction costs from landowner royalties. With Utica development proceeding in Ohio, producers are relying on such provisions to pass on postproduction costs to landowners; but producers commonly provide royalty statements that are difficult, if not impossible, to read or interpret. This, combined with some producers being reluctant to provide postproduction cost information (while

being exclusively in control of this information), has created a climate of uncertainty, which will undoubtedly lead to litigation.

Please contact any of the following Roetzel attorneys for further information.

Author
David Wigham
dwigham@ralaw.com

Additional Contacts
Brian Moore
bmoore@ralaw.com

Shane Farolino
sfarolino@ralaw.com

Timothy B. Pettorini
tpettorini@ralaw.com

J. Benjamin Fraifogl
bfraifogl@ralaw.com

Sara E. Fanning
sfanning@ralaw.com

J. Breton McNab
bmcnab@ralaw.com

Lucas K. Palmer
lpalmer@ralaw.com

Media Contact
Ashley McCool
amccool@ralaw.com

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For more information, please contact Roetzel's **Marketing Department** at 330.849.6636.