Ohio Federal Court Rules in Landowner Royalty Case

David J. Wigham • *Attorney*

An Ohio federal district court recently issued a decision in Lutz v. Chesapeake Appalachia, L.L.C, 4:09-cv2256), holding that, under Ohio law, producers may deduct post-production costs from landowner royalties where the lease contains language stating that the royalty to be paid to the landowner is the "market value at the well".

The U.S. District Court for the Northern District of Ohio had previously asked the Supreme Court of Ohio to decide whether, under Ohio law, a producer could deduct post-production costs, but the Supreme Court of Ohio did not specifically address the issue. Instead, the Supreme Court of Ohio ruled that a determination of what post-production 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. See Lutz v. Chesapeake Appalachia, L.L.C., 148 Ohio St.3d 524, 2016-Ohio-7549. 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).

With the Ohio Supreme Court's decision, the case turned back to the federal court for it to rule on whether the language in the applicable leases would require application of the "at the well" rule or the "marketable product" rule. Because the Ohio Supreme Court did not specifically decide the issue, the federal court was left to decide the issue based on how it thought the Ohio Supreme

Court would rule if the Ohio Supreme Court were examining the specific leases at issue in Lutz. The federal court looked at four of the several leases at issue in the case, and all four contained the same language:

The royalties to be paid by Lessee: . . .(b) on gas, . . .produced from said land and sold or used off the premises . . .the market value at the well of one-eighth of the gas so sold or used, provided that on gas sold at the wells the royalty shall be one-eighth of the amount realized from such sale.

The federal court ultimately determined that based upon Ohio's rules regarding contract interpretation and the language of the applicable lease, the "at the well" rule would apply to these particular leases. For the landowners in Lutz that had this particular lease language, this means that those producers can deduct post-production costs, including gathering, compression, treatment, processing, transportation, and dehydration costs, meaning that ultimately, the landowners would receive less in royalties.

Though this ruling by the federal court is only considered as "persuasive authority" as to Ohio state courts, it could still impact how other federal judges within Ohio, and other Ohio state courts interpret similar lease language in other oil and gas leases.

Because the issue of post-production costs is going to be decided on a lease-by-lease basis, landowners should review their specific lease language or have counsel review their leases to determine whether the producer is allowed to deduct post-production costs. Time may be of the essence, as the United States Sixth Circuit Court of Appeals has held that claims could be barred if not brought within four years of the time that the royalty is paid.

Another area of potential dispute involves how oil and gas are priced for purposes of landowner royalty payments. For example, a producer could be paying oil royalties based on a lower spot market price for oil when it is actually selling its oil at a much higher futures price based on a commodity contract. Also, a producer could be paying gas royalties based on a much lower price used to sell gas to a related subsidiary company, who will then mark up the price to sell to an unrelated third party. In either of these instances, landowners could potentially recover additional royalties based on such price differential.

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 and commodity pricing (while being exclusively in control of this information), has created a climate of uncertainty.

Ohio landowners who have leased their minerals and who are now receiving royalties from Utica Shale wells are urged to seek assistance in evaluating all of their royalty audit and possible litigation options. These landowners are also encouraged to retain experienced legal counsel for assistance. There may be situations involving drilling units in Monroe and the surrounding counties where producers could possibly be underpaying royalties based on incorrect commodity pricing or are improperly deducting postproduction costs from royalties. Landowners will need assistance from an experienced counsel to work with a royalty auditor to ensure royalty payments are properly being paid and any underpayments are recovered. Landowners who are approached to sign new leases or to ratify old ones will also want to seek out counsel regarding the precise language to use regarding post-production costs. A royalty that is free of post-production costs can result in substantially greater royalties for the landowner.

David J. Wigham is a second-generation oil and gas attorney at the law firm of Roetzel & Andress, with more than 25 years of experience in the industry. He maintains offices in Akron and Wooster, Ohio, and can be reached at 330-762-7969.