Oil and Gas, Natural Resources, and Energy Journal

Volume 3 | Number 5

January 2018

Update on Oklahoma Oil and Gas Royalty Litigation

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Oil and Gas, Natural Resources, and Energy Journal

VOLUME 3 NUMBER 5

UPDATE ON OKLAHOMA OIL AND GAS ROYALTY LITIGATION*

PAMELA S. ANDERSON**

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I. Introduction

Gas royalties have been the subject of litigation between lessors/royalty owners and lessees/producers for at least twenty years. All these disputes relate, fundamentally, to the question of when and where gas becomes a "marketable product" in Oklahoma for purposes of making post-production cost deductions, which generally involve deductions for gathering, compression, transportation, dehydration, and processing.

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* This article was originally presented in November 2017 at the Eugene Kuntz Conference on Natural Resources Law and Policy in Oklahoma City. The Journal would like to thank Ms. Anderson for her permission to publish the article. For more information about the Kuntz Conference, visit http://www.law.ou.edu/onecenter/kuntz-conference.

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The question of when gas is a "marketable product" arises as a result of Oklahoma's implied duty to market. The producer's duty under this implied covenant includes the duty to produce a "marketable product" without cost to the lessor.[1] The duty to market is one of three or four generally recognized covenants implied in oil and gas leases.[2] Subsequent to obtaining a "marketable product," the royalty owner may be charged his or her proportionate share of post-production costs.[3] Thus the issue between royalty owners and producers relates to whether the producer has obtained a "marketable product."

II. Mechanics of Production, Transportation, and Sale of Natural Gas, and Royalty Payment Thereon

Natural gas, as produced at the surface, *i.e.*, the wellhead, has different and various chemical compositions, BTU (heat) contents, natural gas liquids contents, and wellhead pressures, depending upon the geographic production area and geologic production strata.

Once produced at the wellhead, natural gas is gathered in small diameter pipes, either from individual wellheads, or from a central delivery point ("CDP") in the field. This activity is generally referred to as "gathering." The gas is gathered from the wellhead and CDPs, and depending upon the location and chemical composition, is delivered either (1) to a processing plant, where natural gas liquids ("NGLs") are separated from the residue gas, or (2) to a treatment plant, w*here gas containing little or no NGLs is treated to remove non-combustible constituents in order to lessen the costs of mainline transmission, or (3) directly into mainline transmission pipelines, without processing or treatment, for further transportation downstream to ultimate users and consumers. In instances where gas is delivered to processing plants, the extracted NGLs are transported further downstream, separately, to fractionation plants, where they are fractionated into constituent components—namely, ethane, propane, butane, and iso-butane. As natural gas is transported from the wellhead through the processing or treatment plants and into the mainline transmission pipelines,

1. Wood v. TXO Production Corp., 854 P.2d 880, 883 (Okla. 1992) [hereinafter *Wood*].

2. *See, e.g.*, Sinclair Oil & Gas Co. v. Bishop, 441 P.2d 436 (Okla. 1967) (discussing implied covenants to market, to further develop the leased premises, and to protect against drainage).

3. Johnson v. Jernigan, 475 P.2d 396, 399 (Okla. 1970) [hereinafter *Johnson*].

it is usually compressed to allow the movement of greater volumes of gas, at lesser cost.

The activities of gathering, compression, processing, treatment, transportation and fractionation of NGLs, as well as mainline transmission, are generally referred to as "post-production" activity, as distinguished from "production" activity, which is limited to drilling, completing, equipping, producing, and operating the well itself. Post-production activity costs money, and such services may be provided by independent "midstream" companies, or in some instances, by midstream companies affiliated with a producer.

The typical royalty owner lawsuit involves one of two gas sales arrangements.[4] Under the first arrangement, the producer sells gas at the well or a nearby CDP to a company which provides midstream services.[5] Such sales are often made on a "percentage of proceeds" ("POP") basis, where the purchaser pays the producer a stated percentage of the proceeds received by the purchaser upon resale of the gas, after the purchaser has moved the gas to a downstream processing plant and processed the gas for the extraction of natural gas liquids.[6] The POP contracts may also provide that a portion of the gas sold to the midstream company may be used for fuel in transportation, compression, or processing of gas, and may also provide for a reduction in proceeds otherwise payable to offset the costs of off-lease transportation, compression, or treatment of gas.[7] Under this arrangement, the producer will typically pay royalties on the basis of the proceeds it receives from the midstream purchaser for the wellhead sale pursuant to the POP contract.

Under the second arrangement, the producer itself or its affiliate pays the midstream company to move gas from the wellhead to a downstream processing plant, pays the costs of compressing and processing the gas to extract natural gas liquids, and bears the loss of any gas used as fuel for transporting, compressing and processing the gas.[8] The producer then sells the residue gas and NGLs at the tailgate of the plant, or moves them further down the distribution chain for sale.[9] With this arrangement, the producer will typically pay royalties on the basis of the "netback" value at the

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4. *See generally* Richard B. Noulles, *What is Required for Gas to be a Marketable Product in Oklahoma?*, 85 OKLA. B.J. 139 (2014).

5. *Id.*

6. *Id.*

7. *Id.*

8. *Id.*

9. *Id.*

wellhead, after deductions for downstream costs for off-lease transportation, compression, and processing.

Under both arrangements, the residue gas is typically delivered into a mainline intrastate or interstate transmission line at the plant tailgate, where it is transmitted to the ultimate user or consumer. Under both arrangements, the producer may incur costs for treating, dehydrating, separating, compressing, and other operations on the leasehold before selling the gas, and those on-lease costs are not allocated to the royalty owners. The producer's position is that, under either arrangement, the gas is a "marketable product" when it is either sold or delivered into the midstream company's pipeline at the wellhead or CDP in the field.

Royalty owners, however, have argued that gas is not a "marketable product" until it is acceptable for delivery into a mainline intrastate or interstate transmission line at the tailgate of the processing plant, and that gas is not acceptable into such line until it has been processed for extraction of NGLs, dehydrated, and then compressed to the pressure necessary for entry into the mainline transmission line.[10] Thus, the royalty owners argue that all costs incurred prior to delivery into the mainline transmission line are being incurred to produce a "marketable product," and under Oklahoma's implied covenant to market, cannot be deducted from the royalty owner's share of royalties.[11]

III. The Duty to Obtain a "Marketable Product" in Oklahoma

Early on, the Oklahoma Supreme Court held in *Johnson* that a lessee's implied duty to market did *not* include bearing the full burden of delivery to an off-site purchaser:

> The lessee is obligated to develop the commodity he has found. . . . But in performing this [implied covenant] function, he is not required to provide pipe line facilities beyond the lease premises. It is apparent from the lease provisions that the parties assumed if and when gas was found and produced from the lease property that a prevailing market rate would exist at the wellhead or in the field upon which a royalty payment could be determined. They did not contemplate the lack of a market rate which would require the lessee to transport the gas to a purchaser at a location some distance away from the lease property.

10. *Id.*
11. *Id.*

> Under the lease the lessor is only entitled to a certain percentage of the gross proceeds at the prevailing market rate. As the prevailing market rate is determined at the wellhead or in the field so must the term "gross proceeds" be interpreted. "Gross proceeds" has reference to the value of gas on the lease property without deducting any of the expenses involved in developing and marketing the dry gas to this point of delivery. When the lessee has made the gas available for market then his sole financial burden ceases, and any further expenses beyond the lease property must be borne proportionally by the lessor and lessee.[12]

In *Wood* the Court rejected the claim that on-lease compression costs must be shared by the royalty owner.[13] The Court reaffirmed its holding that "expenses beyond the lease must be borne proportionately by the lessor and the lessee."[14]

In *TXO Prod. Corp. v. State ex rel. Comm'rs of the Land Office*, the Court held that dehydration and gathering costs on the leased premises could not be deducted from the royalties paid.[15] The lease gave the royalty owner the right to either take the gas in kind or be paid market value. Since the take-in-kind right was qualified by the phrase, "without cost into pipelines," the Court concluded the same qualification applied if the royalty owner elected to be paid, and held that TXO could not deduct any costs necessary to get the product into the receiving pipeline.[16] It seems clear, however, that "the pipeline" the Court referred to in *CLO* is "the purchaser's pipeline"—not some distant downstream interstate pipeline—because the Court expressly stated that "the gas is 'sold' when it enters the purchaser's line."[17]

Four years later, in *Mittelstaedt*, the Court answered the certified question of whether "an oil and gas lessee who is obligated to pay '3/16 of the gross proceeds received for the gas sold'" is "entitled to deduct a proportional share of transportation, compression, dehydration, and

12. *Johnson*, *supra* note 3, at 399.

13. *Wood*, *supra* note 1.

14. *Id.* at 881 (citing *Johnson*, *supra* note 3, at 399).

15. 903 P.2d 259 (Okla. 1994) [hereinafter *CLO*]; *see also* Mittelstaedt v. Santa Fe Minerals, Inc., 954 P.2d 1203, 1205 (Okla. 1998) (emphasizing that the activities in both *Wood* and *CLO* took place on the leased premises).

16. *CLO*, 903 P.2d at 261.

17. *Id.*

blending costs from the royalty interest paid to the lessor?"[18] The Court noted that in prior cases, the Court "had to fix the rights and duties of the parties according to the language of the leases and the implied covenants that go with them."[19]

The Court held that a gross proceeds royalty clause, when considered by itself, prohibits a lessee from deducting a proportionate share of transportation, compression, dehydration, and blending costs when such costs are associated with creating a marketable product.[20] However, the royalty owner must bear a proportionate share of such costs if those costs are reasonable, enhance the value of an already marketable product, and proportionally increase the royalty revenues.[21]

The Court also held that an individual analysis is required to determine whether the costs are deductible from royalty payments, because in some cases a royalty interest may be burdened with post-production costs, and in other cases it may not:

> In both *Wood* and *CLO* we were concerned with operations on the leased premises to make the product marketable. However, this does not mean that costs incurred after severance at the wellhead are necessarily shared by the lessors. We expressly rejected this approach in *Wood.* Post-production costs must be examined on an individual basis to determine if they are within the class of costs shared by a royalty interest.
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> . . .
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> Generally, costs have been construed as either production costs which are never allocated, or post-production costs, which may or may not be allocated, based upon the nature of the cost as it relates to the duties of the lessee created by the express language of the lease, the implied covenants, and custom and usage in the industry. We conclude that dehydration costs necessary to make a product marketable, or dehydration within the custom and usage of the lessee's duty to create a marketable product, without provision for cost to lessors in the lease, are expenses not paid from the royalty interest. However, excess

18. *Mittelstaedt*, *supra* note 15, at 1204-05.
19. *Id.* at 1205.
20. *Id.* at 1210.
21. *Id.* at 1205.

> dehydration to an already marketable product is to be allocated proportionally to the royalty interest.[22]

The Court also noted that downstream compression can be chargeable to a royalty owner if incurred to transport to a distant market.[23]

In *Howell v. Texaco Inc.,* the Court, after discussing the preferred methods for establishing market value at the wellhead, reaffirmed its rule in *Mittelstaedt*:

> When the gas is marketable at the wellhead, the reasonable post-production costs may be charged against the royalty payments. This is so because the referenced starting point in the calculations is the value of the gas after processing and the royalty owners are entitled only to the value of the gas that is marketable at the wellhead.[24]

In spite of these cases indicating that gas in Oklahoma may be a "marketable product" at the wellhead, numerous lawsuits have been filed by royalty owners challenging the propriety of post-production cost deductions.

IV. Royalty Class Actions

Because most gas royalty litigation in Oklahoma thus far has taken place in the context of class action royalty lawsuits, a discussion of Oklahoma's class action statute is appropriate. The Oklahoma Supreme Court has found Federal Rule 23 to be illustrative in addition to Oklahoma's own statutory regime.[25] Both statutes have two parts.

A class can be certified in an Oklahoma state or federal court only if it meets all four requirements of the first part of § 2023(A) or F.R.C.P. 23(a), and at least one of the separate requirements of § 2023(B) or F.R.C.P. 23(b). To certify a class, a plaintiff is first required to affirmatively demonstrate that (1) the class is so numerous that joinder of all members is impracticable, (2) there exist common issues of law or fact among the proposed class members, (3) plaintiff's claims are typical of the remaining

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22. *Id.* at 1208-09 (citation omitted).
23. *Id.*
24. 112 P.3d 1154, 1159-60 (Okla. 2004) (citation omitted).
25. Harvell v. Goodyear Tire & Rubber Co., 164 P.3d 1028, 1037 (Okla. 2006); OKLA. STAT. tit. 12, § 2023(A); FED. R. CIV. P. 23.

proposed class members, and (4) plaintiff is an adequate class representative.[26]

A plaintiff must also establish one of three requirements under § 2023(B) or Rule 23(b). In gas royalty litigation, plaintiffs most often rely upon § 2023(B)(3), which requires a plaintiff to additionally show "that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members," and "that a class action is superior to other available methods for the fair and efficient adjudication of the controversy."[27] The party seeking certification of a class action has the burden of satisfying all requirements for certification by a preponderance of the evidence.[28]

Prior to the United States Supreme Court's 2011 opinion in *Wal-Mart*, most Oklahoma state courts routinely certified royalty owner classes, and most of those cases were settled, with plaintiffs' attorneys being awarded fees of more than $500 million, with a few exceptions.[29] An exception to this rule occurred in the District Court of Pittsburg County, State of Oklahoma. In that case, Judge Taylor denied certification of a royalty class,[30] finding that "the various royalty provisions included in the proposed class are materially different, and because Amoco did not treat all royalty owners in a like fashion."[31] The Oklahoma Court of Civil Appeals affirmed that denial by unpublished opinion, stating:

> We think it sufficient to note that (1) gas produced by the wells in question was marketable at the wellhead, (2) the costs incurred between the wellhead and the pipeline tailgate to prepare the gas for introduction into the pipeline are post-production costs, and (3) the propriety of deducting these costs involves an individualized inquiry of the factors discussed in *Mittelstaedt v. Santa Fe Minerals*, making this issue unsuitable for class action disposition.[32]

The Oklahoma Supreme Court denied *certiorari.*[33]

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26. OKLA. STAT. tit. 12, § 2023(A); FED. R. CIV. P. 23(a).
27. OKLA. STAT. tit. 12, § 2023(B).
28. Wal-Mart Stores, Inc. v. Dukes, 564 U.S. 338, 344 (2011) [hereinafter *Wal-Mart*].
29. Watts v. Amoco Prod. Co., Case No. C-2001-73 (Okla. Dist. 2001).
30. Gillespie v. Amoco Prod. Co., Case No. CIV-96-063-M (E.D. Okla. Jan. 11, 1999); *Mittelstaedt*, *supra* note 15.
31. *Id*. at 3.
32. Watts v. Amoco Prod. Co., Case No. 90,404 (Okla. Civ. App. Sept. 14, 2004).
33. Rees v. BP Am. Prod. Co., 211 P.3d 910, 911 (Okla. Civ. App. 2008).

In arguing for class certification, royalty owners typically argue, *inter alia*, that "commonality" is met because the question of whether the above-described costs can properly be deducted from their royalties is a question which is applicable or "common" to all members of the putative class. Producers, on the other hand, argue that common questions do not exist, and cannot predominate, because of (1) the number of different royalty provisions which typically exist among putative class members, and which provide different bases for royalty calculation,[34] (2) the number of different sales or marketing arrangements which may be present as to the class wells, and (3) the differing qualities of gas produced from each well, which will affect the "marketability" of the gas.[35] Royalty owners have countered these arguments by contending that a producer's uniform payment methodology obviates the need for a lease-by-lease review, and that the differing marketing arrangements or qualities of gas do not prevent certification, because gas is never marketable until it is in a condition to be received by a mainline transmission line.

Until passage of the Class Action Fairness Act ("CAFA"),[36] few class action royalty cases were heard by federal courts in Oklahoma.[37] After the passage of CAFA in 2005, defendant producers and operators began removing putative royalty owner class actions to the federal courts. Most were removed to the Western District of Oklahoma, where the federal judges appeared to follow suit with the state court judges based on the fact that the defendant producers paid all the royalty owners using the same payment methodology, regardless of lease language.[38]

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34. Some of those provisions include royalty based upon "proceeds at the mouth of the well," "market price for the gas sold, used off the premises or in the manufacture of products therefrom," "gross proceeds at the prevailing market rate," "net proceeds realized . . . less the cost incurred by Lessee," take-in-kind, "gross proceeds" with no deductions, and "market price at the well," *i.e.*, gas will not be sold to any purchaser at less than standard market price.

35. *See Watts*, *supra* note 32.

36. 28 U.S.C. § 1332(d)(1), *et seq.*

37. An exception is *Gillespie v. Amoco Prod. Co.*, *supra* note 30, in which Judge Miles-LaGrange refused to certify a royalty class, finding that "Amoco's liability as to a particular plaintiff or proposed class member depends upon facts and circumstances unique to that plaintiff or proposed class member." Slip op. at 7. Judge Miles-LaGrange specifically "disagree[d] with the plaintiffs' contention that variances in the language of the leases involved do not matter and their contention that the costs at issue in connection with the proposed class members' claims are without exception neither deductible nor permitted as a matter of law." *Id.* at n.7.

38. *See* Naylor Farms, Inc. v. Anadarko OGC Co., 2009 WL 8572026 (W.D. Okla. 2009); Beer v. XTO Energy, Inc., 2009 WL 764500 (W.D. Okla. 2009); Hill v. Kaiser-

However, the *Wal-Mart* decision in 2011 changed the landscape with respect to the certification of class actions. Prior to *Wal-Mart*, class actions were routinely certified in Oklahoma on the basis of the existence of "common" questions of law or fact which plaintiffs contended could be posed with respect to all putative class members.[39] It was not until the Supreme Court's *Wal-Mart* decision that a detailed framework was set forth to determine whether a plaintiff could meet Rule 23's "commonality" requirement. The Court held that establishing common questions of law and fact under Rule 23(a)(2) requires more than merely posing questions that are "common" to a proposed class.[40] Rather, the claims "must depend upon a common contention" and the common contention "must be of such a nature that it is capable of classwide resolution—which means that determination of its truth or falsity will resolve an issue that is central to the validity of each one of the claims in one stroke."[41] "What matters to class certification is not the raising of common 'questions'—even in droves—but rather the capacity of a classwide proceeding to generate common *answers* to drive the resolution of the litigation."[42] "Dissimilarities within the proposed class are what have the potential to impede the generation of common answers."[43] *Wal-Mart* encouraged trial courts to conduct a "rigorous analysis" when determining if the prerequisites of Rule 23(a) have been satisfied.

In light of the 2011 *Wal-Mart* decision, two decisions by the Oklahoma Court of Civil Appeals ("COCA") reversed class certification orders issued by state court judges. In one such case, the plaintiffs sought class certification against an operator for "underpayment of royalties based on deduction of post-production costs."[44] In reversing the trial court's certification order, the COCA recognized the myriad of interests which must be addressed in oil and gas royalty actions, and concluded those interests precluded class certification, because while the class

Francis Oil Co., 2010 WL 2474051 (W.D. Okla. 2010); Hill v. Marathon Oil Co., 2010 WL 2365447 (W.D. Okla. 2010); Fankhouser v. XTO Energy, Inc., 2010 WL 5256807 (W.D. Okla. 2010).

39. *Wal-Mart*, *supra* note 28.

40. *Id*. at 2551 (noting that the language of Rule 23(a)(2) "is easy to misread, since any competently crafted class complaint literally raises common 'questions'") (internal citation and quotations omitted).

41. *Id*.

42. *Id*. (emphasis in original).

43. *Id*.

44. Panola Indep. Sch. Dist. No. 4 v. Unit Petroleum Co., 287 P.3d 1033 (Okla. Civ. App. 2012).

representative's claims were based upon the lessee's implied duty to market, "this duty is not owed to all royalty owners," because the class defined in *Panola* included force-pooled royalty owners whose claims would necessarily differ from the claims of the remainder of the class.[45] The court also found that because there were a number of different oil and gas leases with different royalty calculation provisions,

> [e]ach of these lease types requires a different inquiry in determining the royalty owner's claim for underpayment of royalties based on deduction of post-production costs. Therefore, each lease type would require the definition of a separate sub-class. We are unable to find a class action combining claimants from all these lease types is a superior method to adjudicate these claims.[46]

Similarly, the COCA reversed a district court order certifying a statewide class of royalty owners in an action for underpayment of royalties.[47] The COCA found that the requirements of commonality and superiority had not been met because (1) whether the costs for the services at issue could be deducted from royalties depended upon lease language and the marketability of the gas before the costs were incurred, (2) the leases at issue had varying royalty clauses, and some royalty owners had only pooling orders with the defendant, (3) the gas at issue was produced from over 1,000 fields in Oklahoma and would require individual determinations regarding the marketability of gas from each field, (4) the question of when and where particular gas is marketable is not settled in Oklahoma, and (5) even though the defendant used a "common method" to calculate all royalties, common issues did not predominate over individual issues and a class was not the superior method for resolving claims, because of the variety of leases involved and the varying marketability of gas throughout the class wells.[48]

After *Wal-Mart*, three judges in the Western District of Oklahoma also denied class certification motions. Judge Miles-LaGrange found that the plaintiff had not demonstrated "typicality" under Rule 23 because "the

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45. *Id.* at 1036.

46. *Id.* at 1036-37.

47. Fitzgerald v. Chesapeake Operating, Inc., Case No. 111,566 (Okla. Civ. App. 2014). *Fitzgerald* was originally released for publication by the COCA. However, on June 2, 2014, the opinion was withdrawn from publication without explanation.

48. *Id.* at 11, 15.

claims of the proposed class plaintiff Stanley Tucker are not typical of the proposed class member's claims involving hundreds of lease provisions."[49]

Similarly, Judge Miles-LaGrange refused to certify a class of royalty owners in 114 wells for the same reasons, namely, that (1) varying royalty terms in the Plaintiffs' and class members' leases "impedes generation of common answers," (2) the "central issue" of whether the defendant underpaid royalties could not be resolved "in one stroke," and (3) the varying lease terms would result in different answers to the allegedly common question.[50]

In the second such case, Judge Friot found that the plaintiff had not satisfied the "commonality" requirement because of lease specific issues.[51] Because of this, the plaintiff had also failed to establish the requirements for "predominance" and "superiority."[52] And Judge Heaton found the plaintiff had failed to establish "predominance," pointing out that "merely raising a common legal theory is not enough because commonality requires a common contention 'of such nature that it is capable of class-wide resolution—which means that determination of its truth or falsity will resolve an issue that is central to the validity of each one of the claims in one stroke.'"[53]

However, even after *Wal-Mart*, two Oklahoma federal courts certified classes of royalty owners.[54] In *QEP*, Judge Russell certified a class of royalty owners partially based upon the defendant's common payment methodology which did not take into account individual lease variances.[55] And in *XTO*, Judge Seay certified a class of royalty owners on that same basis.[56]

As a result of these conflicting federal decisions involving certification of royalty owner classes, the Tenth Circuit Court of Appeals, on June 26, 2012, granted permission to appeal the class certification orders.[57] By

49. Tucker v. BP Am. Prod. Co., 2011 WL 6018406, at *8 (W.D. Okla. 2011).

50. Morrison v. Anadarko Petroleum Corp., 280 F.R.D. 621, 625 (W.D. Okla. 2012).

51. Foster v. Merit Energy Co., 282 F.R.D. 541, 560 (W.D. Okla. 2012).

52. *Id.* at 562-63.

53. Foster v. Apache Corp., 285 F.R.D. 632, 641 (W.D. Okla. 2012).

54. Chieftain Royalty Co. v. QEP Energy, 281 F.R.D. 499 (W.D. Okla. 2012) [hereinafter *QEP*]; Chieftain Royalty Co. v. XTO Energy, Inc., 2012 WL 1231837 (E.D. Okla. 2012) [hereinafter *XTO*].

55. *Id*. at 503.

56. *XTO*, *supra* note 54, at *4.

57. Wallace B. Roderick Revocable Living Trust v. XTO Energy, Inc., 281 F.R.D. 477 (D. Kan. 2012), *appeal docketed*, No. 12-3176 (10th Cir. June 26, 2012); Chieftain Royalty

opinions issued on July 9, 2013, the Tenth Circuit, relying upon *Wal-Mart*, reversed the district courts' certification orders in both cases finding that (1) stating common questions in a class action lawsuit is not enough; the class-wide proceeding must generate common answers; (2) the defendant's uniform payment methodology did not establish Rule 23(a) commonality because the issue was not capable of class-wide resolution; (3) the district courts had not examined whether lease language variations would destroy the possibility of resolving common questions on a class-wide basis; (4) the district courts must address individual lease language differences to determine whether the lease language negates the implied duty to market; and (5) the district courts must examine the factual context of the individual wells to determine at which point gas is "marketable."[58]

Since issuance of the Tenth Circuit opinions in the *XTO* cases, Judge Russell has denied certification of a royalty class in a subsequent case.[59] In that case, Judge Russell found that common questions could not be resolved on a class-wide basis because determination of how much each royalty owner had been paid and how much each should have been paid required "owner by owner and month by month" calculations.[60] He also found that the claims of the class representative were not typical of the claims of the majority of the putative class members for this same reason.[61]

After *Wal-Mart*, the trend of Oklahoma courts to deny royalty class certifications has continued, though there are anomalies. In 2015, the COCA reversed the state district court's class certification order, stating that because of the variances in lease language and overriding royalty interests, and the differing gas qualities and marketing arrangements, the plaintiffs had "not met their burden to show that common merits questions could be resolved in a single stroke."[62] However, earlier in 2015, a different panel of the COCA affirmed the district court's certification of a New Mexico sub-class in a case in which Oklahoma and Texas sub-classes had previously been certified, even though the New Mexico sub-class, as well

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Co. v. XTO Energy, Inc., 2012 WL 1231837 (E.D. Okla. Apr. 12, 2012), *appeal docketed*, No. 12-7047 (10th Cir. July 5, 2012).

58. Wallace B. Roderick Living Trust v. XTO Energy, Inc., 725 F.3d 1213, 1218-19 (10th Cir. 2013); Chieftain Royalty Co. v. XTO Energy, Inc., 528 F. App'x 938, 942-43 (10th Cir. 2013) [hereinafter *XTO* cases].

59. *See* McKnight v. Linn Operating, Inc., 2016 WL 756541 (W.D. Okla. Feb. 2, 2016).

60. *Id.* at *8.

61. *Id.* at *6.

62. Tipton Home, Trustee v. Burlington Resources Oil & Gas Co., Case No. 111,735, at 26 (Okla. Civ. App. Aug. 13, 2015).

as the Texas and New Mexico sub-classes, involved thousands of leases with varying royalty provisions, and thousands of wells with varying gas quality and marketing arrangements.[63] The Supreme Court of Oklahoma ultimately, without opinion, denied certiorari of the order certifying the sub-class, as it had denied certiorari with respect to the Oklahoma and Texas sub-classes.

More recently, on February 8, 2017, the COCA reversed the district court's class certification order, stating in part:

> The question of where and when particular gas is marketable is not settled in Oklahoma. In addition, there is no categorical rule with respect to when post-production costs may be considered for royalty valuation. *Mittelstaedt*, 1998 OK 7, at 2, 954 P. 2d at 1205 ("in some cases a royalty interest may be burdened with post-production costs, and in other cases it may not"). Notably, "post-production costs must be examined on an *individual basis* to determine if they are within the class of costs shared by a royalty interest."[64]

In contrast to the most recent Western District of Oklahoma orders which have refused class certification under similar circumstances, Judge Heaton found that the plaintiffs in *Naylor Farms* had met their burden under Rule 23(b)(3) to prove:

- commonality, because 90% of the leases involved in the case were leases containing royalty provisions of the type possessed by the plaintiffs, which Oklahoma courts had already found contained the implied duty to market, and the court limited the class members to royalty owners with those leases only;
- typicality, because the court was limiting the class to leases of the type possessed by the plaintiffs, and because the defendant had admitted that the vast majority of its gas was sold at the wellhead, under a single type of marketing arrangement, and required processing;

63. Bank of Am. v. El Paso Nat. Gas Co., Case No. 112,648, at 8 (Okla. Civ. App. 2015).

64. Strack v. Continental Resources, Inc., 405 P.3d 131, 140 (Okla. Civ. App. 2017) (emphasis added).

- adequacy, because the defendant's defenses to the plaintiffs' individual claims did not demonstrate any conflicts of interest with other class members;
- predominance, because the court was limiting the class leases to those described above, and was excluding the plaintiffs' fraud claims (which would require individual proof of reliance) from the class certified;
- superiority, because the amount any individual royalty owner would recover would be dwarfed by the costs of trial, and it was unlikely any individual owner would be interested in controlling the litigation through an individual action; and
- manageability, because the court was limiting the class leases, and the defendant admitted the majority of gas was sold at the wellhead under a single type of contract and required processing.[65]

Chaparral subsequently petitioned the Tenth Circuit Court of Appeals for permission to appeal Judge Heaton's class certification order, and the Tenth Circuit granted permission on June 7, 2017. The appeal was expected to be fully briefed by December 2017.[66]

Thus, while it appears that the broadly-sweeping royalty class certifications of the past twenty years may have come to an end or are on the decline, some courts, at least, are willing to certify classes where (1) the number of lease royalty provisions are limited, and it clearly appears to the court that an implied covenant to market exists in this leases, (2) all gas is sold at a single location and is subject to a single marketing arrangement, and (3) there is no dispute as to whether the gas requires processing.

The decline in class certification, however, does not mean that royalty litigation itself is on the decline; it is simply changing form. The author is aware of a number of cases filed as putative class actions where the only issue is whether royalty owners have received "untimely" payments of oil and gas proceeds under the deadlines set forth in the Oklahoma Production Revenue Standards Act ("PRSA"), and if so, whether they received interest

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65. Naylor Farms, Inc. v. Chaparral Energy, LLC, 2017 WL 187542, at *4-9 (W.D. Okla. Jan. 17, 2017).

66. *Id.*, *appeal docketed*, No. 17-6146 (10th Cir. June 20, 2017) (briefing completed Dec. 14, 2017).

calculated in accordance with the PRSA.[67] The author is also aware of at least one royalty class action which was dismissed by the plaintiffs' counsel and refiled as an individual action with sixty-eight individual royalty owners as plaintiffs, but which raises the same issues with respect to "marketable product."[68]

V. "Marketable Product" in Oklahoma

Royalty owners in Oklahoma have taken the position that natural gas is not a "marketable product" until it meets the minimum quality specifications as required by pipeline or distribution companies that transport it in a fungible state to market. The author has found absolutely no Oklahoma law supporting this position, and indeed, the case law cited above shows that the Oklahoma recognizes that gas can be "marketable at the wellhead."[69] In addition, the Supreme Court of Kansas, to whom the Oklahoma Supreme Court looked in *Mittelstaedt*, recently rejected this same argument, finding that gas is "merchantable once the operator has put it in a condition acceptable to a purchaser in a good faith transaction."[70]

In fact, prior to the deregulation of gas in the late 1980s and early 1990s, almost all gas produced in the United States was sold at the lease by the producer to an intrastate or interstate pipeline company. The pipeline company bore all the costs of transporting, compressing, and processing the gas it purchased, while the producer bore none of those costs. Concomitantly, the pipeline company received all the increased value attributable to the transportation, compressing, and processing of the gas purchased. During this time period, the producer incurred almost no "off-lease" post-production costs, and gas was generally considered to be

67. OKLA. STAT. tit. 52, § 570.1, *et seq.*; *see, e.g.*, Speed v. JMA Energy Co., LLC, 2017 WL 2547240 (E.D. Okla. June 13, 2017); Ashcroft Grp. LLC v. Silver Creek Oil & Gas, LLC, Case No. 16-CV-388-RAW (E.D. Okla.).

68. Wattenbarger v. Newfield Expl. Mid-Continent, Inc., 2015 WL 12743740 (N.D. Okla. July 29, 2015); Doenges Ranch, Inc. v. Sanchez Prod. Partners, LP, Case No. CJ-2016-31 (June 21, 2016).

69. *Howell*, *supra* note 24, at 1159-60.

70. Fawcett v. Oil Producers, Inc. of Kan., 352 P.3d 1032, 1042 (Kan. 2015). In *Mittelstaedt*, the Oklahoma Supreme Court looked to the Kansas Supreme Court, quoting extensively from the Kansas decision in *Sternberger v. Marathon Oil Co.*, 894 P.2d 788 (Kan. 1955), stating that Kansas law is consistent with *Johnson v. Jernigan*, and that "[w]hen the gas is shown by the lessee to be in a *marketable form at the well* the royalty owner may be charged a proportionate expense of transporting that gas to the point of purchase." 954 P.2d at 1207, 1208 (emphasis added).

"marketable" when it was in a form acceptable to the pipeline company when delivered at the lease.[71]

However, beginning in the late 1980s and continuing into the early 1990s, the Federal Energy Regulatory Commission ("FERC") embarked on a gradual modification of the rules applicable to interstate pipelines and the services they may offer. The result was a series of orders which caused the interstate pipeline companies to "unbundle" their transportation services from their roles as buyers of wellhead gas and sellers of large volumes of gas to local distribution companies.

After this "unbundling," interstate pipelines no longer needed the field pipeline facilities they had built to purchase gas at the wellhead. If an interstate pipeline asked permission, however, FERC allowed these companies to sell portions of their pipeline systems to affiliated companies. These new "midstream" companies then operated the same pipeline systems to receive gas from the same wells formerly committed to pipeline company purchase contracts. The midstream companies would then either purchase gas at the lease and resell it, or transport it for a fee to a processing plant, where it was processed and compressed for delivery into the pipeline company's mainline transmission line for ultimate sale and delivery to a local distribution company or end user.

As far as the producer is concerned, the gas produced today is no different than it was prior to FERC's restructuring of the pipeline industry in the 1980s and 1990s. The changes to the regulatory framework for natural gas sales do not alter the fact that gas produced from the wells committed to these former interstate pipeline gas sales contracts was "pipeline quality" gas delivered directly to the interstate pipeline. The same gas from the same wells continues to be delivered into these pipeline systems. Arguably, the gas is as much a "marketable product" today as it was before "unbundling."

The royalty owners, however, take a different position, and contend that after restructuring and "unbundling," the gas is no longer "marketable" at the wellhead, and cannot be marketable until it has been transported to and processed at a downstream processing plant, where natural gas liquids are extracted and the residue gas is delivered into a pipeline company's mainline transmission line.

As noted above, the royalty class actions certified so far in Oklahoma have been settled. This is due, most often, to the magnitude of damages

71. *See Wood*, *supra* note 1; *CLO*, *supra* note 15; *Johnson*, *supra* note 3.

claimed by royalty owners, which often stretch back some thirty years,[72] and are potentially subject to extremely high rates of interest. Thus, final judgments addressing the issue of when gas is a "marketable product" have yet to reach the Oklahoma Supreme Court. While questions regarding this issue were certified to the Court by the Western District of Oklahoma in 2010, the Court declined to accept the questions, stating in a journal entry that there was already controlling Oklahoma precedent on the questions certified sufficient to allow the federal court to instruct the fact finders.[73]

However, numerous Oklahoma courts since that time have recognized that the law in Oklahoma is far from settled when it comes to what constitutes a "marketable product." Most recently, on February 8, 2017, the COCA in *Strack*, *supra*, stated in part:

> *The question of where and when particular gas is marketable is not settled in Oklahoma*. In addition, there is no categorical rule with respect to when post-production costs may be considered for royalty valuation. *Mittelstaedt*, 1998 OK 7, at 2, 954 P. 2d at 1205 ("in some cases a royalty interest may be burdened with post-production costs, and in other cases it may not"). Notably, "post-production costs must be examined on an *individual basis* to determine if they are within the class of costs shared by a royalty interest."[74]

In the November 24, 2015, decision of the COCA in *Tipton Home*, *supra*, the COCA made the same findings as those quoted immediately above in the 2017 *Strack* decision.[75] And the COCA stated in part: "The question of where and when particular gas is marketable is not settled in Oklahoma."[76]

Likewise, federal courts have recognized the unsettled nature of Oklahoma's law. For instance, the district court, in discussing *Mittelstaedt*, noted that "[h]aving left marketability to be determined as a question of

72. Royalty owners typically attempt to avoid the five-year statute of limitations for breach of contract by including claims for fraud which they contend toll that statute by reason of the discovery rule.

73. Hill v. Marathon Oil Co., CIV-08-37-R, 2010 WL 2365447 (W.D. Okla. June 9, 2010).

74. *Strack*, *supra* note 64, at 140 (emphasis added).

75. *See Tipton*, *supra* note 62, at 20.

76. *Fitzgerald*, *supra* note 47, at 8.

fact, the court did not attempt to define either the term 'marketable' or the term 'product.'"[77]

Relief, or at least partial relief, may be on the horizon. A non-class action royalty owner lawsuit currently pends before the Supreme Court of Oklahoma.[78] The appeal pending in *Pummill* arises from a February 9, 2016, corrected judgment resulting from a three-day bench trial before the District Court of Grady County, Oklahoma. The district court in *Pummill* found, *inter alia*, that the gas from the single well at issue, which was sold to an unrelated midstream company at the custody transfer meter near the well, was not marketable at the well because (1) it did not then meet the requirements of the downstream mainline transmission lines used to transmit residue gas to distant end user markets, and (2) even though the gas was acceptable for sale in an arm's-length transaction at the well, that did not establish the gas was marketable because wellhead gas is typically sold for a price that is derivative of the downstream values for processed natural gas liquids.[79] The key issues raised by the appellants in *Pummill* include:

1. "Did the district court err by concluding that gas produced from the [subject] well is not a marketable product until after it is gathered, compressed, dehydrated and processed into downstream mainline transmission pipeline quality residue gas?"
2. "Did the district court err by concluding that gas produced from the [subject] well is not a marketable product until it is processed at a downstream processing plant for the extraction of valuable natural gas liquids ('NGLs') and residue gas . . . ?"
3. "Did the district court err by concluding that the sale of gas under a percentage of proceeds contract . . . could not establish that gas was marketable at the well?"[80]

The *Pummill* appeal was filed on February 12, 2016, with briefing completed on August 23, 2016. That appeal has been treated within the oil and gas industry as an appeal that will likely be of significance to the development and clarification of Oklahoma royalty law. Notably, *amici*

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77. *Foster, supra* note 51, at 548-49 (citation and internal quotations omitted).
78. Pummill v. Hancock Expl., LLC, No. 114,703, 2016 WL 6277319 (Okla. Aug. 23, 2016).
79. Exhibit B to *Pummill* Amended Petition in Error.
80. Brief for Appellants, at 1-2, Pummill v. Hancock Expl., LLC, CV-2011-82, No. 114,703 (Okla Civ. App. 2016).

briefs have been filed in the *Pummill* appeal by the Oklahoma Oil and Gas Association, the Oklahoma Independent Petroleum Association, the GPA Midstream Association, The Coalition of Oklahoma Surface and Mineral Owners, and Tony Whisenant, a plaintiff royalty owner and proposed Class Representative in a class action lawsuit.

If the COCA chooses to rule on the "marketable product" issues in *Pummill*, that opinion, while not necessarily precedent, could certainly provide guidance to Oklahoma state and federal district courts.[81] Indeed, two federal district court cases involving royalty owner claims for underpayment have already been stayed by Judge Russell pending the outcome of the *Pummill* appeal.[82] Motions to stay have been filed in other federal and state cases as well.[83]

Finally, and most recently, the defendant moved Judge Payne to certify to the Oklahoma Supreme Court the question of what "marketable product" means for purposes of the rules of law announced in *Mittelstaedt*.[84] While it is the understanding of this author that Judge Payne originally seemed inclined to certify the question, he denied the motion on October 25, 2017.

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81. Since the initial presentation of this paper, the Oklahoma Court of Civil Appeals has issued its opinion affirming the district court's order in *Pummill*. Pummill v. Hancock Expl., LLC, Case No. 114,703 (Okla. Civ. App. Jan. 5, 2018). Unfortunately, it is not likely to provide much guidance to the courts or the oil and gas industry going forward, inasmuch as the court found that (1) under the facts of that case, the gas at issue was not marketable at the wellhead because Cimarex made no actual sales of any gas at the wellhead to any purchaser, and (2) Cimarex did not sustain its evidentiary burden of proving, under *Mittelstaedt*, that the actual royalty revenues would increase in proportion with the costs assessed against the non-working interests. Slip op. at 21, 23, 24. The court expressly rejected the definition of "marketable production" adopted by the Kansas Supreme Court in *Fawcett*, finding (1) it was bound to follow Oklahoma precedent, (2) it did not find language in *Fawcett* suggesting that the Kansas Supreme Court intended to overturn the existing rule that a lessee-operator has the duty to make gas marketable free of cost for field services to royalty owners, and (3) *Fawcett* is factually distinguishable because in that case, actual sales of gas occurred at the wellhead. Slip op. at 27-28. Appellants filed their Petition for Writ of Certiorari on January 25, 2018.

82. Harris v. Chevron U.S.A., Inc., CIV-15-94-C, 2015 WL 3746989 (W.D. Okla. June 15, 2015); Frank v. Crawley Petroleum Corp., Case No. CIV-14-1193-4-R (W.D. Okla. Oct. 10, 2013).

83. Chieftain Royalty Co. v. SM Energy Co., CIV-11-177-D, 2015 WL 9451069 (W.D. Okla. Dec. 23, 2015), *rev'd and remanded sub nom.*, Chieftain Royalty Co. v. Enervest Energy Institutional Fund XIII-A, L.P., 861 F.3d 1182 (10th Cir. 2017); *Doenges Ranch*, *supra* note 68.

84. Hoog v. Petroquest Energy, L.L.C., Case No. 16-CV-463-JHP (E.D. Okla. Oct. 25, 2016).

Clearly, many district and appellate courts in Oklahoma realize that the law regarding when and where gas becomes a "marketable product" is far from settled. The author submits that until there is a final, definitive opinion by the Oklahoma Supreme Court as to when gas becomes a "marketable product," royalty underpayment actions will continue to proliferate.

VI. Other Recent Decisions of Note

While not addressing royalty issues *per se*, the following opinion was rendered in the context of a class action royalty lawsuit and could have significant effects on class action litigation before the federal courts.

The case involved an appeal by two objectors after the settlement of a class action for royalty underpayments.[85] In the underlying action, the parties reached a settlement for a cash payment of $52 million, with class counsel requesting attorney fees in the amount of 40% of the settlement fund.[86] After hearing, the court awarded class counsel 33 1/3% of the settlement fund, or $17,333,333.33, as attorney fees.[87] Two class members objected to this fee (as well as the incentive award of $260,000 awarded to the named plaintiff) on the basis that the attorney fee should have been awarded on the basis of Oklahoma's "lodestar" approach, rather than on a strict "percentage-of-the-fund" analysis.[88]

The Tenth Circuit agreed, finding that because federal jurisdiction in the common-fund case before it was based on diversity of the parties, the doctrine established in *Erie R.R. Co. v. Tompkins*,[89] required the court to apply Oklahoma law governing the award of attorney fees in common-fund cases.[90] After distinguishing between "substantive fees," which are "those that 'are tied to the outcome of the litigation,'" and "procedural fees," which are "those that are 'generally based on a litigant's bad faith conduct in litigation,'" the court found that the fees at issue in *Chieftain* were "substantive fees," and as such, in a diversity case, are "therefore controlled by state law."[91] However, the court recognized there was no binding precedent in the Tenth Circuit regarding whether the federal court must follow state law in governing *how to calculate* a proper attorney fee.[92] The

85. *Enervest Energy*, *supra* note 83.
86. *Id.* at 1185.
87. *Id.*
88. *Id.*
89. 304 U.S. 64 (1938).
90. *Enervest Energy*, *supra* note 83, at 1187.
91. *Id*. at 1188.
92. *Id.* at 1189.

Tenth Circuit cited cases from five other circuits stating that when state law governs whether to award attorney fees, that state's law also governs how to calculate the amount.[93] The court held that since state law "governs the propriety of granting a fee award," "we must also apply the State's rules on how the amount of the fee is to be calculated because they are 'rules of decision by which the court will adjudicate the right to the fee.'"[94]

The court then turned to Oklahoma law to determine how to compute the attorney fee in *Chieftain*, noting that the controlling precedent for a common-fund case is *Burk v. Oklahoma City*,[95] which is still good law. That decision directed that, to enable a court to determine attorney fees, attorneys must present "detailed time records showing the work performed and offer evidence as to the reasonable value for the services performed."[96] This would allow the court to determine the "lodestar," and then consider other factors to provide an "incentive fee or bonus."[97]

The district court in *Chieftain* did not use the lodestar method to calculate class counsel's fee, and class counsel failed to provide the district court with the information necessary to apply that method.[98] In fact, class counsel acknowledged that they did not keep detailed time records on "every hour we do in these cases," and any time figures were just estimates.[99]

As a result, the Tenth Circuit set aside the fee award, stating "[t]he district court will have to decide in the first instance whether any award can be made in light of the absence of contemporaneous time records. It is unfortunate that class counsel did not do the necessary homework on Oklahoma law."[100]

Class counsel filed a petition for rehearing *en banc* on August 16, 2017, arguing that the Tenth Circuit panel's choice-of-law ruling conflicts with other United States Supreme Court cases that require courts to base choice-of-law rulings on whether applying federal law to an issue would disserve the interests that *Erie* protects, and that the panel's state law ruling ignored contrary Oklahoma Supreme Court and district court cases.[101] Numerous

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93. *Id.*
94. *Id.* at 1190 (citation omitted).
95. 598 P.2d 659 (Okla. 1979).
96. *Enervest Energy*, *supra* note 83, at 1190 (citation omitted).
97. *Id*.
98. *Id*. at 1191.
99. *Id.*
100. *Id.*
101. Chieftain Royalty Company's Petition for Rehearing and Rehearing En Banc at 1.

motions for leave to file *amici* briefs have also been filed with the Tenth Circuit, including motions by Arthur R. Miller, the Oklahoma Law Enforcement Retirement System, The Honorable Richard G. Van Dyck, Drew Edmondson, Provident Energy, Ltd., Charles M. Silver, and several representatives of royalty owners or royalty owner groups. The Tenth Circuit has not, as of the completion of this paper, issued rulings on either the Petition for Rehearing or the motions for leave to *amici* briefs.

In light of the Tenth Circuit's ruling in *Chieftain*, it appears that the wisest course for the foreseeable future, whether in Oklahoma state or federal courts, is for class counsel in common-fund cases to keep contemporaneous time records, even if they ultimately intend to request attorney fees on a "percentage-of-the-fund" basis.