IN THE SUPREME COURT OF APPEALS OF WEST VIRGINIA

No. 21-0179

SWN PRODUCTION COMPANY, LLC and
EQUINOR USA ONSHORE PROPERTIES INC.
Petitioners,
v.
CHARLES KELLAM, PHYLLIS KELLAM,
and other persons and entities similarly situated,
Respondents,

***Upon Certified Questions from the United States District Court for the Northern District of West Virginia*, Case No. 5:20-cv-85**

OPENING BRIEF OF PETITIONERS SWN PRODUCTION COMPANY, LLC AND EQUINOR USA ONSHORE PROPERTIES INC.

Marc S. Tabolsky
(pro hac vice pending)
SCHIFFER HICKS JOHNSON PLLC
700 Louisiana, Suite 2650
Houston, TX 77002
713-357-5150
mtabolsky@shjlawfirm.com

Elbert Lin
(WVSB ID No. 12171)
HUNTON ANDREWS KURTH LLP
Riverfront Plaza, East Tower
951 East Byrd St., 18th Fl.
Richmond, VA 23219
804-788-7202
elin@huntonak.com

Timothy M. Miller
(WVSB ID No. 2564)
Jennifer J. Hicks
(WVSB ID No. 11423)
Katrina N. Bowers
(WVSB ID No. 12337)
BABST, CALLAND, CLEMENTS & ZOMNIR, P.C.
BB&T Square Suite 1000
300 Summers Street
Charleston, WV 25301
681-205-8888
681-205-8814 (fax)
tmiller@babstcalland.com
jhicks@babstcalland.com
kbowers@babstcalland.com

Counsel for Petitioners

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Page(s)

Cases

Statutes

Rules

Other Authorities

I. Assignments of error/certified questions.

The district court certified the following four questions to this Court:

1. Is *Estate of Tawney v. Columbia Natural Resources, L.L.C.*, 219 W.Va. 274, 633 S.E.2d 22 (2006) still good law in West Virginia? The district court's suggestion that *Tawney* should remain good law is incorrect, as this Court has correctly concluded that both *Tawney* and the case on which *Tawney* is premised (*Wellman v. Energy Res., Inc.*, 210 W. Va. 200, 557 S.E.2d 254 (2001)) are "inadequately reasoned" and stand on "faulty legs." *Leggett v. EQT Prod. Co.*, 239 W. Va. 264, 276–77, 800 S.E.2d 850, 862–63 (2017).

2. What is meant by the "method of calculating" the amount of post-production costs to be deducted? If *Tawney* does remain good law, then the district court's suggestion that it requires "a procedure, technique, or process for mathematically determining something" is incorrect. Rather, *Tawney* merely requires that a lease explain "*how much* of those costs will be deducted from the lessor's royalties"—by, for example, specifying that "all" or "reasonable" costs will be deducted. *Young v. Equinor USA Onshore Properties, Inc.*, 982 F.3d 201, 208 (4th Cir. 2020).

3. Is a simple listing of the types of costs which may be deducted sufficient to satisfy *Tawney*? If *Estate of Tawney* does remain good law, then listing the types of deductible costs satisfies its first requirement (that the lease "expressly provide that the lessor shall bear some part of the [post-production] costs"), and second requirement (that the lease "identify with particularity the specific deductions the lessee intends to take from the lessor's royalty"). 219 W.Va. at 274, 633 S.E.2d at 30. The lease would still have to satisfy *Tawney*'s third requirement (that the lease "indicate the method of calculating the amount to be deducted," *id.*), as discussed in Question 2, above.

4. If post-production costs are to be deducted, are they limited to direct costs or may indirect costs be deducted as well? West Virginia law does not distinguish between "direct" and "indirect" postproduction costs—as with "direct" costs, "indirect" costs may be deducted if the lease so provides, and the costs are "actually incurred" and "reasonable." *Leggett*, 239 W.Va. at 282, 800 S.E.2d at 868.

II. Statement of the Case.

A. Introduction.

This case presents a fundamental question of oil-and-gas law: Does the law of this State prohibit a lessee from deducting post-production costs when a lease (like the one at issue in this case) expressly states that the lessee may do exactly that? Under ordinary and longstanding principles of contract law, the answer to such a question is plainly no.

Some courts, like the district court in this case, have held that express provisions allocating post-production costs are ineffective unless the lease also satisfies other rigorous requirements. Citing *Wellman* and *Tawney*, they have held that even when the lease expressly says that the lessee can deduct post-production costs, the lessee cannot do so unless the lease provides a mathematical formula for how such costs will be calculated.

But in *Leggett*, this Court correctly recognized that both *Wellman* and *Tawney* are "inadequately reasoned" and rest on "faulty legs." 239 W. Va. at 276–77, 800 S.E.2d at 862–63. Though *Leggett* did not have occasion to overrule *Wellman* and *Tawney*, it explained that their "use of [the implied covenant to market] to reach the issue of cost allocation is highly questionable," *id.* at 275 n.15, 800 S.E.2d at 862 n.15 and has been described as "nothing more than a re-writing of the parties' contract to take money from the lessee and give it to the lessor," *id.* at 277, 800 S.E.2d at 863. And *Leggett* also "disagree[d] fully" with *Tawney*'s suggestion that "at the wellhead" is somehow ambiguous with respect to the allocation of post-production costs.

Id. at 278, 800 S.E.2d at 864. The result of *Wellman* and *Tawney* has been "chaos," *id.* at 277, 800 S.E.2d at 863, and numerous needless disputes regarding when post-production costs can be deducted when a lease unambiguously permits such deductions.

The district court in this case has now squarely presented to this Court whether *Wellman* and *Tawney* are good law, and the answer is "no." As *Leggett* explained, the requirement of extra clarity imposed by *Wellman* (and further explicated by *Tawney*) is flawed and based on an outdated view of the oil-and-gas industry that existed before deregulation in the early 1990s. This Court should take this opportunity to overrule these cases and hold instead that (1) the implied covenant to market does not impose a default rule that the lessee pays all post-production costs; and (2) whether a lessee may deduct post-production costs in calculating royalties should be based on the terms of the lease as interpreted by standard rules of contract law. Such a holding will do nothing more than to recognize—as with all other contracts—that oil-and-gas leases should be enforced as written and that courts cannot rewrite them based on purported implied covenants that are contrary to a lease's express terms: When a lease says a lessee may deduct post-production costs when calculating royalty, the lease means what is says.

Alternatively, if this Court reaffirms *Wellman* and *Tawney*, it should—at a minimum—interpret those cases as the Fourth Circuit recently did in *Young*. Like *Young*, this Court should reject any suggestion that *Tawney* "demand[s] that an oil-and-gas lease set out an Einsteinian proof for calculating post-production costs." 982 F.3d at 208. It should instead hold that *Tawney* "merely requires an oil and gas lease that expressly allocates some post-production costs to the lessor identify *which* costs and *how much* of those costs will be deducted from the lessor's royalties." *Id.* Those requirements were easily satisfied here, where the lease expressly states that post-production costs will be deducted, identifies which costs will be deducted, and provides that the lessee will bear its proportionate share of "any" costs.

Lastly, this Court should reject the district court's invitation to create even more confusion by distinguishing between "direct" and "indirect" post-production costs. There is no basis in law or logic for that distinction—rather, whether a particular "indirect" post-production cost is deductible depends simply on the terms of the applicable lease and whether the cost was "actually incurred" and "reasonable." *Leggett*, 239 W.Va. at 282, 800 S.E.2d at 868.

B. Legal background.

In the oil and gas industry, leases govern the relationship between the mineral owner (the lessor) and the producer (the lessee). The lessee—usually an oil-and-gas production company—will explore and develop the lessor's land for minerals to sell, in exchange for a royalty to the landowner that allows the landowner to share in the profits. *See, e.g.*, Eugene Kuntz, A TREATISE ON THE LAW OF OIL AND GAS, § 38.1(a) (1989). By law, the lessee bears all costs of "production"—*i.e.*, the costs of drilling and operating a well on the lessor's land. *Wellman*, 210 W. Va. at 209, 557 S.E.2d at 265. Royalty owners do not bear any share of these production costs nor are they deducted from the royalty.

The question in this case concerns *post*-production costs. These are costs associated with activities such as dehydrating and compressing the gas as well as transporting the gas downstream of the well to where the gas is sold. Moving the gas downstream and processing the gas to meet the pressure and quality standards of interstate pipelines (along with the costs incurred to obtain or provide these services) "enhance[s] the value of the gas," resulting in a higher sale price. *Appalachian Land Co. v. EQT Prod. Co.*, 468 S.W.3d 841, 847 (Ky. 2015).

Prior to "deregulation" of the oil-and-gas industry in 1993, post-production costs were not a contested issue in oil-and-gas leases. Back then, most gas was sold at the wellhead, where federally regulated interstate pipelines would then carry it to the point of consumption. David E. Pierce, *Royalty Jurisprudence: A Tale of Two States*, 49 WASHBURN L.J. 347, 368 (2010). Following "deregulation," however, producers began to sell gas themselves, downstream from the well, and incurred "post-production" costs along the way. *See id.* This sea change generated new disputes as to whether royalty owners would have to pay a proportionate share of these post-production costs, or whether they would be borne entirely by producers.

Shortly after "deregulation," this Court addressed the allocation of post-production costs in *Wellman v. Energy Resources, Inc.*, 210 W.Va. 200, 211, 557 S.E.2d 254 (2001). Although *Wellman* recognized that producers had only begun taking such deductions in "recent years," *id.* at 210, 557 S.E.2d at 264, *Wellman* did not attribute this change to the recent "deregulation" of the industry (a fact acknowledged nowhere in the opinion). Instead, *Wellman* reasoned that producers were attempting to "escape" the rule against deducting production costs by labeling them "*post*-production expenses." *Id.* (emphasis added).

Wellman then held that lessees bear all post-production costs "unless the lease provides otherwise." *Id.* at 211, 557 S.E.2d at 265. *Wellman* based this requirement of extra clarity on the "implied covenant[] to market the oil and gas produced." *Id.* at 210, 557 S.E.2d at 264; *accord id.* at 265 (citing Robert Tucker Donley, *The Law of Coal, Oil and Gas in West Virginia and Virginia* §§ 70 & 104 (1951)). Because that duty "embraces the responsibility to get the oil or gas in marketable condition and actually transport it to market," *Wellman* reasoned, the producer presumptively bears the associated costs. *Id.* at 211, 557 S.E.2d at 264. But "if an oil and gas lease provides that the lessor shall bear some part" of these costs, the lessee could deduct them "to the extent they were actually incurred and they were reasonable." *Id.*, 557 S.E.2d at 265. The novel rule created by *Wellman* is sometimes referred to as the "marketable product rule." *Leggett*, 239 W.Va. at 272, 800 S.E.2d at 858.

Five years later, this Court imposed additional requirements for when a lease "provides otherwise" and allows a lessee to share post-production costs with lessors. *Est. of Tawney v. Columbia Nat. Res., L.L.C.*, 219 W. Va. 266, 633 S.E.2d 22 (2006). *Tawney* held that the leases at issue there—which specified that royalties would be calculated "at the wellhead" (or similar language)—was insufficient to displace *Wellman*'s default rule that the lessee bear post-production costs because (in its view) the "wellhead" language was not clear enough as to whether post-production costs would be deducted. *Id.* at 272, 633 S.E.2d at 28. *Tawney* also found it "of significance" that "although some of the leases . . . were executed several decades ago, apparently [the producer] did not begin deducting post-production costs from the lessors' royalty payments until about 1993." *Id.* Like *Wellman*, *Tawney* failed entirely to recognize the deregulation that occurred in 1993, which had led to many producers incurring post-production costs that they had not faced in the past.

After holding that "at the wellhead" language failed to displace *Wellman*'s marketable-product rule, *Tawney* then held, more generally, that three requirements must be met to do so:

> [T]his Court now holds that language in an oil and gas lease that is intended to allocate between the lessor and lessee the costs of marketing the product and transporting it to the point of sale must expressly [1] provide that the lessor shall bear some part of the costs incurred between the wellhead and the point of sale, [2] identify with particularity the specific deductions the lessee intends to take from the lessor's royalty (usually 1/8), and [3] indicate the method of calculating the amount to be deducted from the royalty for such post-production costs.

Id. at 274, 633 S.E.2d at 30. *Tawney* did not explain these new requirements any further or identify their provenance. Nor did it provide guidance for how to determine whether a lease "indicate[d] the method of calculating" deductions for post-production costs.

This Court returned to post-production costs in 2017 in *Leggett*, a decision that severely criticized *Wellman* and *Tawney*. 239 W.Va. at 276–77, 800 S.E.2d at 861–63. Although *Leggett* addressed a different issue—whether post-production costs could be deducted under W. Va. Code § 22-6-8, rather than under a specific contract provision—it felt "compelled" to criticize both the marketable-condition rule established by *Wellman* and the application of that rule under *Tawney*. *Id.* at 276, 800 S.E.2d at 862.

First, *Leggett* explained that *Wellman* and *Tawney* were "inadequately reasoned" and rested upon "faulty legs." *Id.* at 276–77, 800 S.E.2d at 862–63. While the implied covenant to market was well-established, "the use of [that covenant] to reach the issue of cost allocation is highly questionable," *id.* at 275 n.15, and "'seems to arise more from an unwillingness to accept the realities of deregulation in the natural gas market than from implied covenant law,'" *id.* at 277 (quoting John W. Broomes, *Waste Not, Want Not: The Marketable Product Rule Violates Public Policy Against Waste of Natural Gas Resources*, 63 U. KAN. L. REV. 149, 170–71 (2014)). The rule embraced by *Wellman* and *Tawney* also resulted in a "windfall for lessors," *id.* at 276 (quoting Brian S. Wheeler, *Deducting Post-Production Costs When Calculating Royalty: What Does The Lease Provide?*, 8 APPALACHIAN J.L. 1, 8–9 (2008)), and amounted to "'nothing more than a re-writing of the parties' contract to take money from the lessee and give it to the lessor,'" *id.* (quoting David E. Pierce, *Royalty Jurisprudence: A Tale of Two States*, 49 WASHBURN L.J. 347, 374 (2010)).

Further, *Leggett* explained that *Wellman* and *Tawney* had "created chaos" and "fostered the belief—perhaps the reality—that the marketable product doctrine lacks any cornerstone principles." *Id.* at 277, 800 S.E.2d at 863 (quoting Byron C. Keeling & Karolyn King Gillespie, *The First Marketable Product Doctrine: Just What Is the "Product"?*, 37 ST. MARY'S L.J. 1, 77, 79–80 (2005)). In extending the implied covenant to market to post-production costs, *Wellman* had "failed to recognize the variations in the first marketable product doctrine from state to state, and whether intentionally (as a result of its apparent antagonism against oil and gas producers) or unintentionally (as a result of its cursory review of the case law) adopted yet another version of the first marketable product doctrine.'" *Id.* at 276, 800 S.E.2d at 862 (quoting Keeling & Gillespie, 37 ST. MARY'S L.J. at 77, 79) (cleaned up).

Second, *Leggett* "disagree[d] fully" with *Tawney*'s "rationale that 'at the wellhead' is ambiguous simply because it fails to fully outline allocation of postproduction costs." *Id.* at 278, 800 S.E.2d at 864. Citing numerous cases, *Leggett* held that value at the wellhead "has a very precise and definite meaning"—the "unprocessed wellhead price" prior to post-production efforts. *Id.* at 278–79, 800 S.E.2d at 864–65. And "the most logical way to ascertain the wellhead price is, in fact, to deduct the post-production costs from the 'value-added' downstream price." *Id.* at 280, 800 S.E.2d at 866. *Tawney*'s holding to the contrary reflected a "complete misunderstanding of the industry." *Id.* at 277, 800 S.E.2d at 863.

Last year, the Fourth Circuit heeded *Leggett*'s "stinging" criticisms by rejecting an overly broad reading of *Wellman* and *Tawney*. *Young v. Equinor USA Onshore Properties, Inc.*, 982 F.3d 201, 207 (4th Cir. 2020). In *Young*, the Fourth Circuit confronted whether a particular proceeds lease satisfied *Tawney*'s third prong—i.e., whether the lease adequately "indicate[d] the method of calculating the amount to be deducted from the royalty for such post-production costs." 982 F.3d at 207 (citation omitted). Before answering that question, the Fourth Circuit emphasized that "although *Leggett* didn't overrule *Wellman* and *Tawney*, its criticism of those cases and its endorsement of the work-back method inform our analysis here." *Id.* The Fourth Circuit then rejected the district court's over-rigorous application of *Tawney*'s three-prong test, explaining that

Tawney does not require a "'mathematical formula'" or "demand that an oil and gas lease set out an Einsteinian proof for calculating post-production costs." *Id.* at 208. The lease needed only to set forth "a simple formula" identifying "which costs and how much of those costs will be deducted from the [mineral owner's] royalties." *Id.* "Especially in light of *Leggett*," the Fourth Circuit reiterated in closing, "West Virginia law demands nothing more." *Id.* at 209.

C. Statement of facts.

Plaintiffs Charles and Phyllis Kellam entered into an oil and gas lease agreement in which Defendants Equinor USA Onshore Properties Inc. ("Equinor") and SWN Production Company ("SPC") ultimately acquired working interests.[1] SPC now operates oil and gas wells and production units within which the lands leased by the Kellams have been included. App. 3 at ¶¶ 8–9].

The Kellams' lease expressly allows lessee to deduct post-production costs, identifies the specific costs to be deducted, and describes how to calculate the amount to be deducted. There are three paragraphs that address these issues: Paragraphs 4(B), 10, and 11. *See* App. 57–58.

Paragraph 4(B) states that for oil and gas marketed and used off the leased premises, the lessee will pay to the lessor 1/8 "of the price paid to Lessee per thousand cubic feet of such oil, gas, and/or coalbed methane gas so marketed and used . . . less any charges for transportation, dehydration and compression paid by Lessee to deliver the oil, gas, and/or coalbed methane gas for sale." App. 57. In full, paragraph 4(B) states:

> In consideration of the premises the Lessee covenants and agrees: (B) To pay to the Lessor, as royalty for the oil, gas, and/or coalbed methane gas marketed and used off the premises and produced from each well drilled thereon, the sum of one-eighth

[1] The Kellams originally entered this agreement with Great Lakes Energy Partners, LLC in August 2007. App. 2 at ¶ 5. Great Lakes assigned the lease to Chesapeake Appalachia, LLC, App. 3 at ¶ 7, and Equinor and SPC then acquired working interests from Chesapeake's working interest in the Kellam Lease, App. 3 at ¶¶ 8–9.

> (1/8) of the price paid to Lessee per thousand cubic feet of such oil, gas, and/or coalbed methane gas so marketed and used, measured in accordance with Boyle's Law for the measurement of gas at varying pressures, on the basis of 10 ounces above 14.73 pounds atmospheric pressure, at a standard base temperature of 60 degrees Fahrenheit and stipulated flowing temperature of 60 degrees Fahrenheit, without allowance for temperature and barometric variations *less any charges for transportation, dehydration and compression paid by Lessee to deliver the oil, gas, and/or coalbed methane gas for sale.*

App. 57 (emphasis added).

Paragraphs 10 and 11 describe how those costs are apportioned among lessors. Paragraph 10 provides that if the leased premises are consolidated with other lands to form a development unit, "the Lessor agrees to accept, in lieu of the one-eighth (1/8) oil, gas, and/or coalbed methane gas royalty hereinbefore provided, that proportion of such one-eighth (1/8) royalty which the acreage consolidated bears to the total number of acres comprising said development unit." App. 58. And Paragraph 11 provides that "In case the Lessor owns a less interest in the above described premises than the entire and undivided fee simple therein, then the royalties and rentals herein provided for shall be paid to the Lessor only in the proportion which such interest bears to the whole and undivided fee." *Id.*

According to the Kellams, SPC and Equinor have all engaged in oil and gas production efforts under the authority of the Kellam lease "and each have deducted post-production costs from royalty checks due and payable to Charles Kellam and Phyllis Kellam and other similarly situated persons and/or entities." App. 3 at ¶ 10.[2]

---

[2] Because the proceedings before the federal district court were limited to SPC and Equinor's motion for judgment on the pleadings under Federal Rule of Civil Procedure 12(c), which assumed *arguendo* that the allegations of the Kellams' complaint were true, SPC and Equinor make the same assumption here. But neither SPC nor Equinor admit the truth of any allegation that they have denied in their respective answers.

D. Procedural history.

The Kellams filed this putative class action on April 28, 2020, in the United States District Court for the Northern District of West Virginia. App. 1–13. The Kellams alleged that (1) their lease did not permit the deduction of post-production costs and (2) Equinor and SPC improperly deducted post-production costs when calculating royalties to be paid to the Kellams. *Id.* at ¶¶ 21, 23, 26, 29, 35, 36. All of their claims are premised on the Kellams' assertion that it is improper for SPC and Equinor to deduct post-production costs. *Id.* at ¶¶ 22–23, 26–36. The Kellams also requested a declaratory judgment that the Defendants were not permitted to deduct post-production costs in the past and that they are not entitled to do so in the future either. *Id.* at ¶¶ 37–41.

On June 28, 2020, before SPC's or Equinor's deadline to respond to the complaint, Defendant Chesapeake Appalachia, LLC filed a voluntary Chapter 11 petition for relief in the United States Bankruptcy Court for the Southern District of Texas. App. 130. Upon receiving the notice that Chesapeake had filed a bankruptcy petition, the district court entered an order staying this case on July 7, 2020. *Id.*

While this case was stayed, the United States Court of Appeals for the Fourth Circuit issued its decision in *Young*, *see* Section II.B, *supra*, which reversed an opinion by the same district judge who certified the questions in the present case (Judge John Preston Bailey). In the decision reversed by *Young*, Judge Bailey had held that the lease in question failed to satisfy *Tawney* because it did not provide a "mathematical formula" for calculating post-production costs. *Young*, 982 F.3d at 207–08.[3] The Fourth Circuit disagreed, concluding that the lease did "indicate the

[3] The lease in *Young* expressly deducted from the royalty "post-production costs incurred by Lessee between the wellhead and the point of sale," and defined "post-production costs" as "all costs and expenses of (a) treating and processing oil and/or gas, and (b) separating liquid hydrocarbons from gas, other than condensate separated at the well, and (c) transporting oil and/or gas, including but not limited to transportation between the wellhead and any production or treating

method" for calculating deductions based on post-production costs: "to add up all of the identified, reasonable, and actually incurred post-production costs, and deduct them from SWN and Equinor's gross proceeds. The amount is then adjusted for the Youngs' fractional share of the total pooled acreage and their royalty rate." *Id.* at 209.

Following the Fourth Circuit's decision in *Young*, Judge Bailey lifted the stay in the present case on July 28, 2021. App. 130. SPC and Equinor then filed answers to the complaint, App. 15–25; 26–36, and simultaneously moved for judgment on the pleadings, seeking dismissal of all of the Kellams' claims with prejudice, App. 37–38.

In particular, SPC and Equinor argued that based on *Young*, the Kellams' lease satisfied *Tawney*'s requirements for when a lessee could deduct post-production costs when calculating royalties. App. 46–49. SPC and Equinor explained that the Kellams' lease expressly allowed the lessee to deduct transportation, dehydration, and compression charges paid to deliver the oil or gas produced from the leased premises to the point of sale and that the lease further provided how to determine what share of the identified post-production costs would be shared with the lessor. App. 46–47.

After briefing on SPC and Equinor's motion for judgment on the pleadings was complete, the district court issued an order that sua sponte certified four questions to this Court. App. 100–127. Foremost among these questions was whether *Tawney* remains the law of West Virginia. App. 104. The district court indicated that it believed that this Court should continue to uphold

---

facilities, and transportation to the point of sale, and (d) compressing gas for transportation and delivery purposes, and (e) metering oil and/or gas to determine the amount sold and/or the amount used by Lessee, and (f) sales charges, commissions and fees paid to third parties (whether or not affiliated) in connection with the sale of the gas, and (g) any and all other costs and expenses of any kind or nature incurred in regard to the gas, or the handling thereof, between the wellhead and the point of sale." 982 F.3d at 204.

Tawney. App. 124. The district court further asked this Court to decide, if *Tawney* remains the law of this State, what is required to indicate a method of calculating the amount of post-production costs to be deducted. App. 104. In its order, the district court made clear that it disagreed with the Fourth Circuit's decision in *Young*, and believed instead that *Tawney* required the lease to provide a mathematical formula for calculating all post-production costs. App. 120–121.

On October 27, 2021, this Court entered an order hold that his matter be scheduled for oral argument under Rule 20 during the January 2022 Term of Court. App. 128–129.

III. Summary of argument.

A. Assignment of Error No. 1 (Should Tawney remain the law of West Virginia).

This Court should overrule the marketable-product rule set forth in *Tawney* and *Wellman* that assumes the lessee in an oil-and-gas lease bears 100% of post-production costs. In *Leggett*, this Court explained at length how *Tawney* and *Wellman* were built on "faulty legs" that failed to appreciate the differences between how oil and gas were marketed before and after deregulation occurred in the early 1990s. Today, oil and gas are often sold far downstream of the wellhead, after the lessee has often paid substantial costs to deliver a product to its customer that is more valuable than what originally came out of the ground at the wellhead.

The fundamental legal flaw underlying *Wellman* and *Tawney* is that they invert the roles of express contractual terms and implied covenants. *Wellman* and *Tawney* work from the premise that there is an implied covenant to market that includes a marketable-condition rule that must be displaced by express language that satisfies the *Tawney* factors. But this is backwards and contrary to the law governing the respective roles of contract language and implied duties. Under the law of this State, the parties' obligations begin and end with the express, unambiguous terms of a contract. It is only when that contract is ambiguous or when there is a gap to be filled that an implied covenant may come into play in interpreting or construing a contract.

Instead of relying on the flawed requirements from *Tawney* and *Wellman* (which stem from a misunderstanding of the deregulated oil and gas industry), the Court should do what it did last year in the *Huffman* case: give effect to the plain, unambiguous language of a lease and reaffirm that an implied covenant cannot impose a duty or obligation that is contrary to a lease's plain terms. Whether a lease permits the deduction of post-production costs or allows the use of the netback method to calculate royalties owed "at the wellhead" should be based on a lease's plain terms.

In this case, the language in the Kellams' lease is crystal clear. In calculating the royalties owed to the lessor, the lessee must take the price received for oil and gas produced from the leased premises and may then deduct any charges it paid for transportation, dehydration, and compression to deliver the product to the point of sale. As such, the Court should hold that the implied covenant to market cannot override the plain text of the Kellams' lease that provides for such deductions in this case.

B. Assignments of Error Nos. 2 and 3 (What does "indicate a method of calculating" mean and does a simple listing of costs satisfy *Tawney*).

If the Court overrules the marketable-product rule established by *Wellman* and *Tawney*, then issues 2 and 3 become moot. Without that default rule, *Tawney*'s requirements for what a lease must provide to displace it become moot.

But if this Court reaffirms the marketable-product doctrine set forth in *Wellman* and *Tawney*, it should, at a minimum, adopt the common-sense interpretation of this doctrine explained in *Young*. As did *Young*, this Court should hold that *Tawney* is satisfied as long as a lease "expressly allocates some post-production costs to the lessor" and "identif[ies] *which* costs and *how much* of those costs will be deducted from the lessor's royalty." *Young*, 982 F.3d at 208.

Accordingly, this Court should hold that *Tawney* is satisfied where, as here, the lease identifies what post-production costs will be deducted when calculating royalty and dictates what proportion of the costs will be borne by the lessor.

Thus, when a lease says that the lessee can deduct certain costs incurred in delivering product to a point of sale downstream of the wellhead (like the Kellams' lease), the lease's terms are sufficient to rebut the *Wellman* requirements. Neither law nor policy justifies overriding plain, unambiguous lease terms providing that specific post-production costs will be deducted, and identifying the proportion of those costs that will be borne by the lessor. To suggest, as the district court did here, that leases must provide detailed a mathematical formula about how costs will be calculated is nothing more than judicial rewriting of a contract, which this Court criticized in *Leggett*.

C. Assignment of Error No. 4 (What post-production costs can be deducted).

Like issues 2 and 3, if the Court holds that the marketable-condition rule does not apply, the Court need not address this issue. In any event, the district court's order incorrectly suggests that when deduction of post-production costs is allowed, only purported "direct costs" may be deducted while purported "indirect costs" cannot. But there is no legal basis for that distinction. All post-production costs—whether "direct" or "indirect"—can be deducted if the language of the applicable lease allows it and the disputed costs were "actually incurred" and "reasonable." *Leggett*, 239 W.Va. at 282, 800 S.E.2d at 868.

IV. Statement regarding oral argument.

The Court has already stated that this matter should be scheduled for oral argument under Rule 20 of the Rules of Appellate Procedure. Given the importance of the issues presented in this case and its potential impact on the oil-and-gas industry in this State, Petitioners respectfully request that each side be given thirty minutes for oral argument.

V. Argument.

A. Standard of review.

Section 51-1A-3 of the West Virginia Code provides that "[t]he supreme court of appeals of West Virginia may answer a question of law certified to it by any court of the United States . . . if the answer may be determinative of an issue in a pending cause in the certifying court and if there is no controlling appellate decision, constitutional provision or statute of this state." W. Va. Code § 51-1A-3. While the Court may reformulate a certified question, Syl. Pt. 3, *Kincaid v. Magnum*, 189 W. Va. 404, 432 S.E.2d 74 (1993), W. Va. Code § 51-1A-4, it may not answer a question that is not dispositive of a claim or necessary to the decision of the case. *State ex rel. Advance Stores Co. v. Recht*, 230 W. Va. 464, 740 S.E.2d 59, 63–64 (2013).

This Court applies a de novo standard in addressing legal issues presented by certified question from a federal court. Syl. Pt. 1, *Leggett v. EQT Co.*, 239 W.Va. 264, 266, 800 S.E.2d 850, 851 (2017).

B. Assignment of Error No. 1: This Court should overrule *Tawney* and *Wellman*, and eliminate the default rule that the lessee bears all post-production costs.

1. <u>Leases should be enforced based on the plain meaning of their express terms.</u>

This Court recently reaffirmed three fundamental principles of law governing oil-and-gas leases that make clear that a lessee can deduct post-production costs when a lease says the lessee can do exactly that.

In *Ascent Resources – Marcellus, LLC v. Huffman*, 851 S.E.2d 782 (W. Va. 2020), this Court held that:

> An oil and gas lease which is clear in its provisions and free from ambiguity, either latent or patent, should be considered on the basis of its express provisions and is not subject to a practical construction by the parties.
>
> A valid written instrument which expresses the intent of the parties in plain and unambiguous language is not subject to judicial construction or interpretation but will be applied and enforced according to such intent.
>
> It is not the right or province of a court to alter, pervert or destroy the clear meaning and intent of the parties as expressed in unambiguous language in their written contract or to make a new or different contract for them.

Syl. Pts. 5, 6, 7 *Huffman*, 851 S.E.2d at 783 (internal quotation marks and citations omitted).

Huffman's guidance regarding oil-and-gas leases is consistent with well-settled law governing the interpretation of contracts. This Court has explained "courts cannot rewrite a contract . . . that plainly expresses the parties' intent . . . [and] [i]t is not the right or province of a court to alter, pervert or destroy the clear meaning and intent of the parties as expressed in unambiguous language in their written contract or to make a new or different contract for them." *Faith United Methodist Church & Cemetery of Terra Alta v. Morgan*, 231 W. Va. 423, 444, 745 S.E.2d 461, 482 (2013). *See also Bruce McDonald Holding Co. v. Addington, Inc.*, 241 W. Va. 451, 463–64, 825 S.E.2d 779, 791–92 (2019) (holding West Virginia courts must enforce, not "alter, pervert or destroy[,] the clear meaning and intent of the parties as expressed in unambiguous language in their written contract").

Additionally, when a contract's terms are unambiguous, they cannot be overridden or altered by an implied duty. *Thompson Dev., Inc. v. Kroger Co.*, 186 W. Va. 482, 485, 413 S.E.2d 137, 140 (1991) ("Consequently, to imply a covenant of continuous operation into the lease, the implied covenant must not be inconsistent with the express terms of the contract."); George Bibikos, *A Review of the Implied Covenant of Development in the Shale Gas Era*, 115 W. VA. L. REV. 949, 957 (2013) ("Over time, absent express language in the agreement, courts have, under certain circumstances, implied certain covenants into the lease."); *see also* Scott Lansdown, *The Implied Marketing Covenant in Oil and Gas Leases: The Producer's Perspective*, 31 ST. MARY'S L.J. 297, 304–35 (2000) ("Because the implied covenants are derived from the presumed intentions of the parties to the lease, they will not be imposed if doing so would be inconsistent with the express provisions of the lease."). This Court has expressly stated that the implied covenant to market (whatever it means) "is a tool utilized to resolve contractual ambiguities" and is only a "gap-filler[]" that can be used "to implement the parties' intentions where not otherwise stated." *Leggett*, 239 W. Va. at 275, 800 S.E.2d at 861.

Under these basic principles of contract law, it is plain that the Kellams' lease unambiguously allows lessees to deduct transportation, dehydration, and compression costs they incur between the wellhead and where they sell their oil and gas off the leased premises. The lease unequivocally states that the lessee agrees to pay the lessor "as royalty for the oil, gas, and/or coalbed methane gas marketed and used off the premises and produced from each well drilled thereon, the sum of one-eighth (1/8) of the price paid to Lessee per thousand cubic feet of such oil, gas, and/or coalbed methane gas so marketed and used . . . less any charges for transportation, dehydration and compression paid by Lessee to deliver the oil, gas, and/or coalbed methane gas for sale." App. 57. The only reason for this case—and similar other cases—is because this Court's decisions in *Tawney* and *Wellman* have been read to require something more than unambiguous language addressing deductions.

2. *Tawney* and *Wellman* should be overruled because they rest on faulty premises and improperly rewrite oil-and-gas leases.

As this Court correctly recognized in *Leggett*, both *Tawney* and *Wellman* were "inadequately reasoned" and rest on "faulty legs." 239 W. Va. at 276–77, 800 S.E.2d at 862–63. Because *Leggett* had no occasion to overrule those decisions, it "le[ft] for another day the continued vitality and scope of *Wellman* and *Tawney*." *Id.* at 277. That day is here—this Court should now overrule these flawed decisions and restore fairness and order to West Virginia law.

The core problem with *Wellman* and *Tawney* is their "use of the implied covenant to market to reach the issue of cost allocation," which *Leggett* rightly considered "highly questionable." 239 W. Va. at 276 n.15, 800 S.E.2d at 862 n.15. This implied covenant is limited to a duty to sell gas at a reasonable price, and bears no relationship to whether a lease permits deducting post-production costs from royalty. *See* Byron C. Keeling & Karolyn King Gillespie, *The First Marketable Product Doctrine: Just What is the "Product"?* 37 ST. MARY'S L.J. 1, 25 (2005) ("[T]he implied covenant to market is not a sweeping rule of law that allows courts to rewrite the terms of lease agreements."); Owen L. Anderson, *Royalty Valuation: Should Royalty Obligations Be Determined Intrinsically, Theoretically, or Realistically? Part 2*, 37 NAT. RESOURCES J. 611, 693 n.89 (1997) ("[T]he implied covenant to market has grown like Topsy. Arguably, it should be confined to its original purpose: to require the lessee to diligently seek a market for gas reserves that are shut-in.").

As explained in *Leggett*, *Wellman* and *Tawney*'s extension of this implied covenant to post-production costs arose "more from an unwillingness to accept the realities of [the 1993] deregulation in the natural gas market than from implied covenant law." *Leggett*, 239 W. Va. at 277, 800 S.E.2d at 863 (internal quotation marks and citation omitted). *See, supra,* Section II.B (discussing the impact of deregulation on the development of post-production costs). Because most gas is now purchased away from the wellhead, post-production costs are far greater than during the regulated era when most gas was sold at or near the wellhead. *Young*, 982 F.3d at 207 (citing *Leggett*, 239 W. Va. at 271 n.10, 800 S.E.2d at 857 n.10). The requirements embraced by *Wellman* and *Tawney* foist all of these costs on the lessee, amounting to "nothing more than a re-writing of the parties' contract to take money from the lessee and give it to the lessor." *Leggett*, 239 W. Va. at 277, 800 S.E.2d at 863 (internal quotation marks and citation omitted).

Wellman and *Tawney*'s requirements for extra clarity regarding post-production costs are also based on "a complete misunderstanding of the industry." *Leggett*, 239 W.Va. at 77, 800 S.E.2d at 863. Both *Wellman* and *Tawney* relied, in part, on the fact that the producers in those cases had suddenly begun deducting post-production costs in the early 1990s.[4] But neither *Wellman* nor *Tawney* acknowledged the obvious cause of this change—"deregulation" of the industry in 1993 had caused producers to begin incurring post-production costs. *See* John W. Broomes, *Waste Not, Want Not: The Marketable Product Rule Violates Public Policy Against Waste of Natural Gas Resources*, 63 KAN. L REV. 149, 170–74 (2014) ("[I]t seems that [*Tawney*] failed to consider the effects of regulation and deregulation on the sales and marketing practices of leases . . . ."); David E. Pierce, *Royalty Jurisprudence: A Tale of Two States*, 49 WASHBURN L.J. 347, 367–68 (2010) ("The problem with [*Tawney*'s] observation is that the lessee would not have incurred post-production costs prior to 1993 . . . ."). Sharing the burden of these new post-production costs with the lessor was entirely appropriate, as the lessor was also benefitting from these costs in the form of a higher sale price from which to calculate their royalty.

Further, the rule established by *Wellman* and *Tawney* bore "little resemblance to the fully-formed marketable product rules adopted by other . . . states." *Leggett*, 239 W.Va. at 273 n.13,

---

[4] *See Wellman*, 210 W.Va. at 210, 557 S.E.2d at 264 ("[T]here has been an attempt on the part of oil and gas producers in recent years to charge the landowner with a pro rata share of various expenses connected with the operation of an oil and gas lease . . . . To escape the rule that the lessee must pay the costs of discovery and production, these expenses have been referred to as 'post-production expenses.'"); *Tawney*, 219 W.Va. at 272, 633 S.E.2d at 28 ("Also of significance is the fact that although some of the leases below were executed several decades ago, apparently [the producer] did not begin deducting post-production costs from the lessors' royalty payments until about 1993.").

800 S.E.2d at 859 n.13. Most notably, *Wellman* and *Tawney* at times suggested that the implied covenant to market extended to the "point of sale." *See, e.g., Wellman*, 210 W.Va. at 211, 557 S.E.2d at 265 ("[U]nless the lease provides otherwise, the lessee must bear all costs incurred . . . to the point of sale."); *Tawney*, 219 W.Va. at 274, 633 S.E.2d at 30 (requiring leases to "expressly provide that the lessor shall bear some part of the costs incurred between the wellhead and the point of sale"). That rule would make West Virginia a minority of one, since in other states the implied covenant to market runs only until the first point of marketability. Brian S. Wheeler, *Deducting Post-Production Costs When Calculating Royalty: What Does The Lease Provide?*, 8 APPALACHIAN J.L. 1, 8–9 (2008). As explained in *Leggett*, this point-of-sale approach would "result[] in an even bigger windfall for lessors than the 'marketable product approach'" because the lessor would be paid a royalty based on processed gas sold downstream from the wellhead for which the lessee has added value at its sole expense. *Leggett*, 239 W.Va. at 276–77, 800 S.E.2d at 862–63.

Fortunately, *Wellman* and *Tawney* ultimately did *not* adopt a "point of sale" rule. As discussed below, their references to "point of sale" must be understood in the context of the opinions as a whole, which make clear that the implied covenant to market extends only to the point of marketability. *See* Section V.C, *infra*. Nevertheless, *Wellman* and *Tawney*'s repeated reference to "point of sale" reflected a lack of understanding of the implied covenant to market and has engendered considerable confusion. Of course, if the Court holds that the implied covenant to market does not address post-production costs at all (as it should), this issue becomes moot.

After *Wellman* adopted its flawed default rule that the lessee bear all post-production costs, *Tawney* then compounded this error in several ways. *First*, *Tawney* erroneously held that lease terms providing for calculation of the royalty "at the wellhead" were not clear enough to allow the lessee to deduct post-production costs. Syl. Pt. 11, *Tawney*, 219 W.Va. at 268, 633 S.E.2d at 24. *Leggett* "disagree[d] fully" with that conclusion, explaining that "the phrase 'at the wellhead' has a very precise and definite meaning." 239 W.Va. at 278, 800 S.E.2d at 864. Contrary to *Tawney*, a majority of states have held that "at the wellhead" language allows lessees to deduct post-production costs, holding that the "implied duty to market production does not require a lessee to bear the costs of marketing production alone." *See* Lindsey Scheel, *Oil and Gas Law-Rent or Royalties: North Dakota Joins the Majority of States in Adopting the "At the Well" Rule for Calculating Royalties on Oil and Gas Leases Bice v. Petro-Hunt, L.L.C.*, 2009 Nd 124, 768 N.W.2d 496, 85 N.D. L. REV. 919, 924 (2009); Edward B. Poitevent, II, *Post-Production Deductions from Royalty*, 44 S. TEX. L. REV. 709, 716 (2003).[5]

Second, *Tawney* announced—with no basis or explanation—three new requirements for rebutting *Wellman*'s default rule: that the lease (1) "provide that the lessor shall bear some part of the costs incurred between the wellhead and the point of sale"; (2) "identify with particularity the

---

[5] *Leggett* is far from alone in criticizing *Tawney* in this regard. Williams & Meyers, *Oil and Gas Law*, one of the leading treatises in the United States on oil and gas law, has also sharply criticized *Tawney*'s understanding of the phrase "at the wellhead":

> The ultimate issue was whether the terminology used in the lease that referred to the well was sufficient to overcome the implied covenant to market. (citation omitted). . . . [T]he court's conclusion that use of "wellhead" language was ambiguous leaves one scratching one's head as to whether the court was really looking at a bargain struck between the parties of just imposing what it perceived to be a "fair" and/or "equitable" result. For example, the court concluded that "wellhead" language lacks "definiteness" and is "imprecise." If anything, the term "wellhead" is very precise and definite because it is a clearly recognizable place which even laypersons can understand.

Williams & Meyers, *Oil and Gas Law*, § 645.2, at page 614.12(3).

specific deductions the lessee intends to take"; and (3) "indicate the method of calculating the amount to be deducted from the royalty for such post-production costs." *Tawney*, 219 W.Va. at 274, 633 S.E.2d at 30. In doing so, *Tawney* held that even language expressly charging lessors with post-production costs was not enough—the lease had to contain such language *and* "identify with particularity the specific deductions the lessee intends to take" *and* "indicate the method of calculating the amount to be deducted." *Id.*

Tawney cited no basis for these latter two requirements—it apparently pulled them out of thin air. Worse still, *Tawney* provided no further guidance on these requirements, causing future courts to parse the words in *Tawney*'s opinion like a legislative code. *See, e.g., Young v. SWN Prod. Co.*, No. 5:17-CV-82, 2018 WL 11218647, at *3 (N.D. W. Va. Apr. 11, 2018), *vacated and remanded sub nom. Young v. Equinor USA Onshore Properties, Inc.*, 982 F.3d 201 (4th Cir. 2020) (examining dictionary definitions for the terms "method" and "calculate").

Ultimately, both *Wellman* and *Tawney* are contrary to a core principle of the law of contracts. As discussed above, implied covenants only serve as gap fillers or as a tool to resolve a contractual ambiguity. *Leggett*, 239 W. Va. at 275, 800 S.E.2d at 861. When a contract has express unambiguous terms governing an issue, there is no role for an implied covenant to alter or displace the express terms. *Thompson Dev., Inc.*, 186 W. Va. at 485, 413 S.E.2d at 140.

Wellman and *Tawney*, however, turn this rule on its head. Those cases require a lessee to bear all post-production costs unless a lease includes not only express language, but language that meets a heightened standard of clarity. Instead of limiting the implied covenant to its role as a gap filler or use when a contract is ambiguous, *Wellman* and *Tawney* require extra clear language. For all other contracts, West Virginia law provides that a parties' obligations begin and end with the express, unambiguous terms of a contract. *Wellman* and *Tawney* are an anomaly with respect to one issue (post-production costs) in one kind of contract (oil-and-gas leases).

Additionally, *Wellman* and *Tawney* run directly contrary to clear legislative policy, and the windfall they provide to lessors has negative implications for oil-and-gas production in this State more generally. With the "shifting of post-production costs to lessees, natural gas leases cease to produce in paying quantities earlier in their productive life, resulting in physical waste due to premature abandonment of otherwise recoverable natural gas reserves." John W. Broomes, *Waste Not, Want Not: The Marketable Product Rule Violates Public Policy Against Waste of Natural Gas Resources*, 63 KAN. L REV. 149, 150 (2014). But the West Virginia Legislature has stated "[i]t is hereby declared to be the public policy of this state and in in the public interest to . . . (2) prohibit the waste of oil and gas resources . . . ." W. VA. CODE § 22C-9-1(a); *see also id.* § 22C-9-6 ("Waste of oil or gas is hereby prohibited.").

Overruling *Wellman* and *Tawney* would bring an end to the "chaos" in the law that this Court noted in *Leggett*. 234 W. Va. at 277, 800 S.E.2d at 863 (quoting Keeling & Gillespie, *The First Marketable Product Doctrine: Just What is the 'Product'?"* 37 ST. MARY'S L.J. at 79, 80). It would also bring the law of this State in accord with its neighboring states of Ohio and Pennsylvania, neither of which follow the marketable-condition rule. *Cunningham Prop. Mgmt. Tr. v. Ascent Res. - Utica, LLC*, 351 F. Supp. 3d 1056, 1062 (S.D. Ohio 2018) (dismissing claim that lessee improperly deducted post-production costs when lease provided that royalty would be based on a "wellhead price"); *Canfield v. Statoil USA Onshore Properties Inc.*, No. CV 3:16-0085, 2017 WL 1078184, at *23 (M.D. Pa. Mar. 22, 2017) ("Post-*Kilmer*, it is clear that Pennsylvania does not follow the First Marketable Product Doctrine and that Pennsylvania allows lessors and lessees to contract royalties based on a wellhead price").

SPC and Equinor respectfully submit that the Court should now take the step it held back from in *Leggett*, overrule *Wellman*'s and *Tawney*'s version of the implied duty to market, limit the duty to the obligation to obtain the best reasonable price obtainable, and leave the question of the allocation of post-production costs to be determined by the plain language of the parties' lease.

3. <u>The district court's policy concerns cannot justify using implied covenants to override a contract's express terms.</u>

In its certification order, the district court urges this Court to reaffirm *Wellman* and *Tawney* for several policy reasons. App. 124. But none of these reasons can justify a departure from the fundamental rule that the plain, express terms of a lease (like any other contract) must be given effect and cannot be modified or displaced by implied duties. *See Cotiga Development Co. v. United Fuel Gas Co.*, 147 W.Va. 484, 494, 128 S.E.2d 626, 634 (1963) (holding that "any difficulty or hardship" imposed by a lease provision "cannot serve to alter the plain provisions of the lease); Syl. Pt. 7 *Huffman*, 851 S.E.2d at 783 ("It is not the right or province of a court to alter, pervert or destroy . . . unambiguous language in [the parties'] written contract . . . ."); *see also*, Section V.B.1, *supra*. And in any event, each of these policy concerns is misplaced.

To begin, the district court argues that "many of these leases are entered into with unsophisticated individuals who lack the expertise and experience to understand the terms of the lease." App. 124. But West Virginia law already protects such individuals through the general rule that any ambiguity in a contract, including oil-and-gas leases, be construed against the lessee if the lessee drafted it. Syl pt. 3, *CONSOL Energy, Inc. v. Hummel*, 238 W. Va. 114, 114, 792 S.E.2d 613, 613 (2016) ("Uncertainties in an intricate and involved contract should be resolved against the party who prepared it."); *see also* Syl., *Martin v. Consol. Coal & Oil Corp.*, 101 W. Va. 721 (1926) (stating that oil-and-gas leases "be liberally construed in favor of the lessor, and strictly as against the lessee."). In light of this preexisting protection, there was no need for

Wellman and *Tawney* to impose an *additional* presumption against lessees on the specific issue of post-production costs.

Similarly, the district court worries that lessees could game the system by selling oil and gas to alter-egos or affiliates at artificially low prices, or by deducting "indirect costs that are unrelated to the true post-production costs." App. 124. But here, too, other aspects of West Virginia law adequately address these concerns: lessees can only deduct post-production costs that were both "actually incurred" and "reasonable." *Leggett*, 239 W.Va. at 282, 800 S.E.2d at 868. In addition, lessors are free to challenge affiliate transactions if they are substantively unfair.[6]

The law already provides protections from the potential abuses the district court is concerned might occur. What the law should not do, however, is allow courts to use implied covenants to rewrite the express terms of a contract to create what a court believes is a more fair contract.

C. Assignments of Error No. 2 and 3: If this Court does not overrule *Wellman* and *Tawney*, it should confirm that *Young*'s interpretation of those cases is correct.

If the Court overrules *Tawney* and *Wellman*—and holds that there is no default rule that lessees pay 100% of post-production costs—then *Tawney*'s three-factor test for determining when

---

[6] *See Henceroth v. Chesapeake Exploration, LLC*, 814 F. App'x 67, 72 (6th Cir. 2020) (affirming summary judgment dismissing lessor's claims that lessee underpaid royalties based on sale to affiliated entity because lessor failed to present evidence that would justify veil piercing or alter ego). *Richards v. EQT Prod. Co.*, 2018 WL 3321441, at *4–5 (N.D. W. Va. 2018) (denying lessors' summary-judgment motion claiming improper royalty calculation arising from an inter-affiliate sale because the lessors failed to allege facts or set forth evidence "to overcome the presumption that the two [affiliated] entities are separate and that their corporate form should not be disregarded" and holding that lessee could base royalties on a wellhead price provided for in an inter-affiliate gas sales contract because "the gas is, in fact, sold at the wellhead"); *Leggett*, 239 W. Va. at 283, 800 S.E.2d at 869 (Workman, J., concurring) (explaining that an oil and gas lessor alleging that lessee's cost deductions were "artificially inflated" or not "commercially reasonable" can consider whether a lessees' affiliate profiting from post-production costs).

a lease's language rebuts that default rule is moot. That, in turn, would moot questions 2, 3, and 4 certified by the district court because these three questions are all directed to what *Tawney*'s three-factor test requires.

But to the extent the Court maintains the default rule from *Wellman* and *Tawney*, the Court should reject the district court's overbroad interpretation of these decisions and instead read them as the Fourth Circuit did in *Young*. *Young* held that a lease like the Kellam lease, which expressly states that certain post-production costs can be deducted when calculating royalties, is clearly sufficient.

Under *Tawney*, three requirements must be satisfied to allow deduction of post-production costs from the lessor's royalty. The language must:

> [1] provide that the lessor shall bear some part of the costs incurred between the wellhead and the point of sale, [2] identify with particularity the specific deductions the lessee intends to take from the lessor's royalty (usually 1/8), and [3] indicate the method of calculating the amount to be deducted from the royalty for such post-production costs.

Tawney, 219 W. Va. at 274, 633 S.E.2d at 33. Although *Tawney* offered no guidance as to what these requirements actually mean in practice, it did explain that their purpose was to notify the lessor as to "*how*" and "*by what method* the royalty is to be calculated." *Id.* at 272, 633 S.E.2d at 28.

In *Young*, the Fourth Circuit correctly explained that all *Tawney* ultimately requires is that the lease "identify *which* costs and *how much* of those costs will be deducted from the lessor's royalties." 982 F.3d at 208. It further explained that "*Tawney* doesn't demand that an oil and gas lease set out an Einsteinian proof for calculating post-production costs," and that a "simple formula" specifying the proportion of post-production costs to be borne by the lessor was sufficient. *Young*, 982 F.3d at 208. This straightforward, commonsense interpretation of *Tawney* adequately informs the lessor as to "how" and "by what method the royalty is to be calculated." *Tawney*, 219 W. Va. at 272, 633 S.E.2d at 28.

Thus, even if the implied covenant to market obligates a lessor to make gas marketable, which it does not, this Court should make clear that the law does not require that a lease must include magic words or provide a detailed mathematical formula for how to calculate post-production costs in addition to express language authorizing the deduction of post-production costs. Or, to use the language of the Fourth Circuit, "*Tawney* doesn't demand that an oil and gas lease set out an Einsteinian proof for calculating post-production costs." *Young*, 982 F.3d at 208.

The Kellams' lease clearly satisfies this test. It provides that the Kellams' royalty is determined by (a) taking the proceeds received from the sale of oil and gas produced from the leased premises, (b) deducting the charges for transporting, dehydrating, and compressing the oil and gas produced from the leased premises to deliver them to the point of sale, and (c) then multiplying that number by the royalty fraction. App. 57. And, if the royalty owner owns less than all of the total pooled acreage, Paragraphs 10 and 11 provide that the royalty owner only bears the costs attributable to their fractional share of the pooled acreage. App. 58. In other words, the unambiguous language of the lease states that costs will be deducted (satisfying *Tawney*'s first requirement), identifies the types of costs to be deducted (satisfying *Tawney*'s second requirement), and explains how to determine what portion of the costs will be shared with the royalty owner (satisfying *Tawney*'s third requirement). *Young* correctly held that *Tawney* requires nothing more.

By contrast, the district court's interpretation of *Tawney* would override the express intention of the contracting parties. To hold otherwise and require even more clarity as to post-production costs would be inconsistent with basic principles of law governing contracts as set forth above. *See*, Section V.B.1, *supra*. In particular, it would permit an implied covenant to alter or override the plain terms of a lease, which this Court has unequivocally held is not the law of this State. *Thompson Dev., Inc.*, 186 W. Va. at 485, 413 S.E.2d at 140. When a lease (like the Kellams') is unambiguous, the court need do nothing more than apply the lease's plain language.

Taking the district court's view would also make this State an outlier even among the handful of other states that apply the implied covenant to market to post-production costs. Courts in other states readily conclude that leases with express language that states post-production costs will be deducted is sufficient to displace the marketable-condition rule. *See, e.g., Reirdon v. Cimarex Energy Co.*, 2019 WL 1302550, at *5 (E.D. Okla. 2019) (holding that royalty provisions stating that "a fair and reasonable charge for gathering, compressing and making merchantable such gas" may be deducted was sufficient to permit deduction of such costs). They do not require *extra* clarity or Einsteinian formulas. To hold that the Kellams' lease does not allow deduction of post-production costs would make this State an outlier.

In sum, if this Court does not overrule *Wellman* and *Tawney*—which it should, *see* Section V.B, *supra*—it should at least confirm that *Young*'s commonsense reading of these cases is correct. Under this interpretation, the answer to the district court's second certified question—"[w]hat is meant by the 'method of calculating the amount of post-production costs to be deducted?"—is simply that the lease must indicate "*how much*" of these costs will be attributed to the lessor. *Young*, 982 F.3d at 208. And the answer to the district court's third certified question—"[i]s a simple listing of the types of costs which may be deducted sufficient to satisfy *Tawney*?"—is that a simple listing of costs would satisfy *Tawney*'s first requirement (that the lease "expressly provide that the lessor shall bear some part of the [post-production] costs"), and *Tawney*'s second requirement (that the lease "identify with particularity the specific deductions the lessee intends to take from the lessor's royalty"). 219 W.Va. at 274, 633 S.E.2d at 30. The lease would also have to satisfy *Tawney*'s third requirement (that the lease "indicate the method of calculating the amount to be deducted," *id.*), as discussed above.

In addition, if this Court does reaffirm *Wellman* and *Tawney*, it should also clarify the outer boundaries of this doctrine. *First*, this Court should confirm that the default rule these decisions embrace (that the lessee bears 100% of post-production costs) applies only until the oil or gas reaches the first available market, as opposed to the "point of sale" unless the lease otherwise specifies a different point where the gas is to be valued or sold. Although the syllabus points in *Wellman* and *Tawney* arguably suggest otherwise,[7] when those cases "are read in their entirety, it becomes clear that lessees must bear the costs of bringing gas *to the market*, not to a point of sale," *W.W. McDonald Land Co. v. EQT Prod. Co.*, 983 F. Supp. 2d 790, 800 (S.D.W. Va. 2013), *opinion clarified* (Jan. 21, 2014). This limitation is evident from *Tawney*'s facts, as *Tawney* addressed only the costs of delivering gas to a particular transmission line, which represented the first market rather than the ultimate point of sale. *Id.* ("The only way to reconcile *Tawney*'s facts—only the costs of bringing the gas to market—with the 'point of sale' language in *Tawney*'s syllabus points is to assume *Tawney* applies to the costs incurred in bringing the gas to market, not to a point of sale."). In addition, "both *Tawney* and *Wellman* are premised on the implied duty to market gas produced," which—as the name indicates—applies only until the first market, not to the point of sale. *Id.*

---

[7] Syl. Pt. 4, *Wellman*, 210 W.Va. at 203, 557 S.E.2d at 256 ("[T]he lessee must bear all costs incurred in exploring for, producing, marketing, and transporting the product to the *point of sale.*") (emphasis added); Syl. Pt. 1, *Tawney*, 219 W.Va. at 267, 633 S.E.2d at 23 (same).

Second, this Court should reaffirm that the default rule from *Wellman* and *Tawney* applies, if at all, only to certain proceeds leases (which calculate royalties based on the lessee's proceeds from an actual sale), as opposed to market-value leases (which calculate royalties based on the market value of the oil or gas). By their own terms, *Wellman* and *Tawney* are limited to leases that "provide[] for a royalty *based on proceeds received* by the lessee." Syl. Pt. 4, *Wellman*, 210 W.Va. at 203, 557 S.E.2d at 256 (emphases added); Syl. Pt. 1, *Tawney*, 219 W.Va. at 267, 633 S.E.2d at 23 (same). And *Wellman* expressly "excluded" from its discussion market value leases that instead "call for the payment of royalties based on the value of oil or gas produced," as they present "possibly different issues." *Wellman*, 210 W.Va. at 210 n.3, 557 S.E.2d at 264 n.3.

D. Assignment of Error No. 4: There is no distinction between direct and indirect post-production costs as posited by the district court.

The final question certified by the district court asks whether deductible post-production costs are limited to "direct" costs or can include "indirect" costs as well. App. 105. This question, however, is but another version of the district court's view that for a lease to indicate a method for calculating royalties, it must not only provide a mathematical formula that must address such minutiae as whether the deducted costs will include so called "indirect costs" such as "meals and entertainment, uniforms, meter operations and repair, personal property taxes, personnel costs, production management costs, depreciation, and return on investment." *Id.* at 25.

The district court's inquiry, however, is wholly misplaced because *Tawney* does not impose the "Einsteinian proof," *Young*, 982 F.3d at 208, that the district court believes is required. The lease at issue in this case says exactly what costs may be deducted: "charges for transportation, dehydration and compression paid by Lessee to deliver the oil, gas, and/or coalbed methane gas for sale." App. 57. While the district court characterizes certain aspects of the cost of providing such a service as "indirect cost," there is nothing in *Wellman*, *Tawney*, or anywhere else that would distinguish between so-called direct and indirect costs. If a cost is incurred to provide transportation, dehydration, and compression it may be deducted. This is true whether is a payment to a third-party service provider, capital expenditures to build the facilities need to provide the service, operating expenses necessary to operate and maintain the facilities and provide the service, or any other cost that must be incurred to provide the identified services.

Contrary to the district court's incorrect belief, this does not leave royalty owners defenseless from improper deductions. If a deducted cost is not "actually incurred" or is not "reasonable," the law precludes such a deduction. *Leggett*, 239 W.Va. at 282, 800 S.E.2d at 868. And if a deduction falls outside the scope of costs identified in the lease, then a claim for breach of contract may exist. But under a lease such like the one here, a lessee may deduct all of the reasonable, actually incurred costs associated with transporting, dehydrating, and compressing gas produced from the leased premises. Whether a deducted compression charge, for example, includes costs that are for something other than compression is nothing more than a question of fact that would need to be resolved if such an allegation was made.

Of course, if this Court either overrules *Tawney* or holds it has no application to leases (like the one at issue in this case) that expressly address the deduction of post-production costs, the Court need not address this issue at all. It is only if the Court holds that *Tawney* requires leases to do more than unambiguously provide for the deduction of post-production costs that the Court need even address this question.

VI. Conclusion.

Petitioners respectfully request that the Court overrule *Wellman* and *Tawney*, hold that the marketable condition rule as stated in *Wellman* and *Tawney* is not the law of this State, and that whether a lessee may deduct post-production costs when calculating royalties must be determined by the terms of the lease according to general principles of contract law. Petitioners further request that the Court hold that the Kellams' lease in this case unambiguously allows for the lessee to deduction "charges for transportation, dehydration, and compression paid by Lessee to deliver the oil, gas, and/or coalbed methane gas for sale."

To the extent the Court holds that *Wellman* and *Tawney* remain the law of this State, Petitioners respectfully request that the requirement that a lease "indicate[] the method for calculating the amount to be deducted from the royalty for such post-production costs" does not require a mathematical formula but, as explained by the Fourth Circuit in *Young*, "merely requires that an oil and gas lease that expressly allocates some post-production costs to the lessor identify *which* costs and *how much* of those costs will be deducted from the lessor's royalties." *Young*, 982 F.3d at 208. Petitioners request all further relief this Court deems appropriate, equitable, and just.

PETITIONERS SWN PRODUCTION COMPANY, LLC and EQUINOR US ONSHORE PROPERTIES INC.

By Counsel:

Timothy M. Miller (bmn)

Timothy M. Miller
(WVSB ID No. 2564)
Jennifer J. Hicks
(WVSB ID No. 11423)
Katrina N. Bowers
(WVSB ID No. 12337)
BABST, CALLAND, CLEMENTS & ZOMNIR, P.C.
BB&T Square Suite 1000
300 Summers Street
Charleston, WV 25301
681-205-8888
681-205-8814 (fax)
tmiller@babstcalland.com
jhicks@babstcalland.com
kbowers@babstcalland.com

Elbert Lin
(WVSB ID No. 12171)
Riverfront Plaza, East Tower
HUNTON ANDREWS KURTH LLP
951 East Byrd St., 18th Fl.
Richmond, VA 23219
804-788-7202
elin@huntonak.com

Marc S. Tabolsky
(pro hac vice pending)
SCHIFFER HICKS JOHNSON PLLC
700 Louisiana, Suite 2650
Houston, TX 77002
713-357-5150
mtabolsky@shjlawfirm.com

IN THE SUPREME COURT OF APPEALS OF WEST VIRGINIA

No. 21-0179

SWN PRODUCTION COMPANY, LLC and
EQUINOR USA ONSHORE PROPERTIES INC.
Petitioners,
v.
CHARLES KELLAM, PHYLLIS KELLAM,
and other persons and entities similarly situated,
Respondents,

***Upon Certified Questions from the United States District Court for the Northern District of West Virginia,* Case No. 5:20-cv-85**

CERTIFICATE OF SERVICE

I hereby certify that on December 27, 2021, I filed by hand delivery the foregoing **OPENING BRIEF OF PETITIONERS SWN PRODUCTION COMPANY, LLC AND EQUINOR USA ONSHORE PROPERTIES INC.** A complete copy of **OPENING BRIEF OF PETITIONERS SWN PRODUCTION COMPANY, LLC AND EQUINOR USA ONSHORE PROPERTIES INC.** has been sent by electronic mail and regular U.S. mail to the following:

James G. Bordas III, Esquire (WV Bar No. 8518)
Bordas & Bordas, PLLC
1358 National Road
Wheeling, WV 26003
jbordasiii@bordaslaw.com
Counsel for Respondents

Timothy M. Miller
Timothy M. Miller (WVSB ID No. 2564)
Jennifer J. Hicks (WVSB ID No. 11423)
Katrina N. Bowers (WVSB ID No. 12337)
Babst, Calland Clement & Zomnir, P.C.

BB&T Square
300 Summers Street, Suite 1000
Charleston, WV 25301
681-205-8888
681-205-8814 (fax)