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In the Supreme Court of Appeals of West Virginia

FRANCIS KAESS,
Petitioner,

v.

BB LAND, LLC,
Respondent.

Certified Questions from Civil Action No. 1:22-cv-51
United States District Court for the Northern District of West Virginia

# Respondent's Brief

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## Certified Questions

The United States District Court for the Northern District of West Virginia certified the following questions to this Court:

**Question 1:** Is there an implied duty to market for leases containing an in-kind royalty provision?

**Question 2:** Do the requirements for the deductions of post-production expenses from *Wellman v. Energy Resources, Inc.*, 557 S.E.2d 254 (W. Va. 2001) and *Estate of Tawney v. Columbia Natural Resources*, 633 S.E.2d 22 (W. Va. 2006), apply to leases containing an in-kind royalty provision?

## Statement of the Case

### I. Procedural History

Petitioner Francis Kaess filed suit against BB Land seeking damages, in relevant part, for post-production expenses deducted from his royalty share of the production. [J.A. 1–90].

BB Land filed a motion for summary judgment related to the propriety of the deductions under the parties' in-kind oil and gas lease, which was denied by the district court based on rulings recently issued by a different judge in the Northern District of West Virginia. [J.A. 91–165].

On the same day that the district court certified these questions, it also granted petitioner leave to file a motion for summary judgment on these issues. [J.A. 321–41].

The case is currently stayed pending this Court's answers on the certified questions. [J.A. 342].

## II. STATEMENT OF FACTS

Many oil and gas leases in West Virginia provide that the lessee (the oil and gas producer) must pay to the lessor (the mineral owner) a royalty consisting of a monetary share of the *proceeds* the lessee received from the sale of the oil and gas produced under the lease. However, other oil and gas leases contain different royalty provisions, including an "in-kind" royalty provision whereby the lessor is entitled to take a portion or part of the physical oil or gas that is produced from the well rather than merely receiving its share of the proceeds from the lessee's marketing of that production.

As relevant here, Kaess and BB Land are parties to a January 6, 1979 oil and gas lease under which the original lessors, Robert S. Butcher and Fay R. Butcher, agreed to take their royalty in kind. [J.A. 48]. The royalty provision therein provides that the lessor is to receive "the equal one-eighth (1/8) part"—not one-eighth (1/8) of the proceeds received—so the subject royalty provision is classified as an in-kind royalty provision. [J.A. 49]. *See, e.g.,* Syl., *Horner v. Phila. Co. of W.Va.*, 71 W. Va. 345, 76 S.E. 662 (1912) (recognizing that similar language is indicative of an in-kind lease).

Contrary to Kaess's suggestion to this Court (Petitioner's Br. at 7 n.2), Kaess has—in judicially deemed admissions—previously conceded that the lease entitles him to receive his royalty in kind, as opposed to a percentage of the proceeds received by BB Land [J.A. 184–85, 225, 227, 256–58].

Kaess did not, however, take his royalty share of the production in kind. [J.A. 208]. Thus, in order to avoid waste, his royalty share was gathered, processed, transported, and marketed by BB Land. [J.A. 208, 315]. BB Land paid Kaess the proceeds from his royalty share after deducting the post-production expenses incurred—the same expenses Kaess would have incurred had he taken his royalty in kind pursuant to the lease. [J.A. 208]. Nevertheless, Kaess contends that BB Land was not permitted to deduct any expenses from the proceeds received for the sale of his royalty share, after he failed to take the royalty in kind [J.A. 9].

## Summary of Argument

Under West Virginia law, an oil and gas lease that is based on proceeds is deemed to impose on the lessee—i.e., the oil and gas producer—an implied duty to market the oil and gas produced. *See Wellman v. Energy Res., Inc.*, 210 W. Va. 200, 211, 557 S.E.2d 254, 265 (2001). That means, according to this Court, that "if an oil and gas lease provides for a royalty based on *proceeds* received by the lessee, unless the lease provides otherwise, the lessee must bear *all costs* incurred in exploring for, producing, marketing, and transporting the product to the point of sale." *Id.* at 202, Syl. Pt. 4, 557 S.E.2d at 256, Syl. Pt. 4 (emphasis added). In short, the royalty is calculated based on the *gross* proceeds of production. If the lease provides otherwise, however, the lessee need not bear all such costs but may deduct from the gross proceeds "those costs to the extent that they were actually incurred and they were reasonable." *Id.*, Syl. Pt. 5, 557 S.E.2d at 256, Syl. Pt. 5.

In *Estate of Tawney v. Columbia Natural Resources, LLC*, this Court held that the lease's language must satisfy three requirements in order for the lessee to allocate post-production costs to the lessor and calculate royalties based on the resulting *net* proceeds:

(1) The lease must "expressly provide that the lessor shall bear some part of the costs incurred between the wellhead and the point of sale";

(2) The lease must "identify with particularity the specific deductions the lessee intends to take from the lessor's royalty"; and

(3) The lease must "indicate the method of calculating the amount to be deducted from the royalty for such post-production costs."

219 W. Va. 266, 268, Syl. Pt. 10, 633 S.E.2d 22, 24, Syl. Pt. 10 (2006).

The present case—unlike *Wellman* and *Tawney*—does not involve a lease where the royalty is based on *proceeds* received by the lessee. Rather, the lease at issue has an "in-kind" royalty provision. Under an in-kind royalty provision, the lessor receives a royalty share of the *actual physical production*—i.e., a portion of the oil and gas produced, as opposed to the proceeds therefrom. But if the lessor fails to take its royalty share in kind, and the producer (the lessee) incurs the costs of gathering, processing, transporting, and marketing the lessor's royalty share, who bears those costs?

This Court has not considered this question. The answer depends upon: (a) whether the implied duty to market applies to leases with in-kind royalty provisions, and (b) whether the requirements for the deduction of post-production costs from *Wellman* and *Tawney* apply to leases containing in-kind royalty provisions.

Pursuant to persuasive authority from Oklahoma, on which this Court has previously relied, leases with in-kind royalty provisions impose no implied duty

to market. And because no implied duty to market exists, the lessee under an in-kind lease can deduct post-production costs regardless of whether the lease language satisfies the *Tawney* requirements.

In short, absent other lease language, the lessor under an in-kind lease is responsible for gathering, processing, marketing, and transporting its royalty share of the production. If the lessor sits on its hands and elects *not* to take its royalty share in kind, it cannot then demand that the lessee alone bear those costs. The lease language contains no such obligation, and West Virginia law should not imply such an obligation.

## Statement Regarding Oral Argument

Pursuant to Rule 20 of the West Virginia Rules of Appellate Procedure, oral argument is appropriate in this case since this case involves an issue of first impression with regard to the application of the implied duty to market and the requirements of *Wellman* and *Tawney* as it relates to in-kind royalty provisions.

# Argument

## I. STANDARD OF REVIEW

West Virginia Code section 51-1A-3 provides that this Court "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." Both requirements are satisfied here.

First, as the certification order provides, the answers to the certified questions "determine whether [BB Land] was permitted to deduct post-production costs from [Kaess's] royalties." [J.A. 315]. Further, because there is no factual dispute that BB Land deducted certain post-production expenses from Kaess's royalty payments, the certified questions are "purely legal questions involving West Virginia oil and gas law." [J.A. 315].

Second, as the certification order further provides, this Court has not addressed whether the implied duty to market applies to in-kind leases or whether the *Wellman* and *Tawney* requirements extend to in-kind leases. [J.A. 315]. Thus, there is no controlling appellate decision, constitutional provision, or West Virginia statute addressing the deduction of post-production expenses under an in-kind lease.

In the absence of this Court's guidance, the Northern District of West Virginia has answered these questions of West Virginia law incorrectly, holding that "*Wellman* and *Tawney* apply regardless of whether plaintiffs' leases are in kind or proceeds leases." *Hopper v. Jay-Bee Oil & Gas Inc.*, Nos. 5:20-CV-101 and 5:20-CV-110, 2022 WL 19403556, at *3 (N.D. W.Va. Nov. 22, 2022) (Bailey, J.); *Carolina Mineral Partners LLC v. Jay-Bee Prod. Co.*, No. 5:23-CV-214, 2023 WL 7391872, at *3–5 (N.D. W. Va. Oct. 19, 2023) (Bailey, J.); *see also* J.A. 265–67 (following *Hopper* as the only available authority on this point but certifying the questions to this Court).

This Court, and this Court alone, is the final arbiter of these important questions of West Virginia law.

## II. THE ORIGINS OF THE IMPLIED DUTY TO MARKET IN WEST VIRGINIA.

As this Court has recognized, critics of West Virginia oil and gas law point to an apparent "unwillingness to accept the realities of deregulation in the natural gas market [rather] than from implied covenant law." *Leggett v. EQT Prod. Co.*, 239 W. Va. 264, 277, 800 S.E.2d 850, 863 (2017) (citation omitted). Thus, the starting point for this analysis must begin with a brief history of deregulation, and this Court's seminal opinion in *Wellman*, in which the implied covenant to market was first recognized under West Virginia law.

### A. Congress's deregulation of the natural gas industry created an entirely new body of oil and gas law.

In 1938, the Natural Gas Act, 15 U.S.C. § 717, et seq., authorized the Federal Power Commission to regulate pipeline rates for transportation and resale of natural gas. *See Clough v. Williams Prod. RMT Co.*, 179 P.3d 32, 35–36 (Colo. Ct. App. 2007).[1] However, because the Act did not require interstate pipelines to offer transportation services to third-party gas shippers, the pipelines were able to use their influence over gas transportation to create and maintain a monopoly in the market for the purchase of gas at the wellhead. *Id*. at 35.

Congress took the initial step to increase competition in the natural gas market by enacting the Natural Gas Policy Act of 1978, 15 U.S.C. § 3301, et seq., intending to phase out the regulation of wellhead prices charged by producers of natural gas, and to promote gas transportation by interstate and intrastate pipelines for third parties. *Id*. However, when providing common carriage affected their own sales, pipelines were reluctant to do so. So, in 1985, the Federal Energy Regulatory Commission (FERC) promulgated Order No. 436, which contained an "open access" rule incentivizing pipelines to offer gas transportation services. *Id*.

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[1] This Court cited to the *Clough* opinion in *Leggett*, recognizing that the opinion succinctly states the history of deregulation. *See Leggett*, 239 W. Va. at 271 n.10, 800 S.E.2d at 857 n.10.

In 1992, FERC promulgated Order No. 636, requiring all interstate pipelines to "unbundle" transportation services from their own natural gas sales and to provide common carriage services to buyers who shipped gas from other sources. *Id*. "The deregulation of the natural gas industry is considered the major catalyst for the current wave of royalty litigation because, before deregulation, buyers purchased gas at or near the wellhead, thereby absorbing most post-wellhead costs." *Id*. at 36.

After deregulation, producers began marketing their own gas—and many producers now elect to process and transport gas downstream to obtain a better price. *See Garman v. Conoco, Inc.,* 886 P.2d 652, 653–54 (Colo. 1994) (describing examples of post-production processing and transportation activities producers may undertake to sell at a higher price away from the wellhead). As a result, the question arose as to *who* was responsible for the costs of gathering, processing, transporting, and marketing the gas downstream to the ultimate point of sale.

### B. West Virginia's adoption of the implied duty to market for proceeds leases.

When gas was routinely sold at the wellhead, the implied duty to market was neither considered nor litigated. Following deregulation, questions arose as to whether producers were obligated to market the oil and gas produced; if so, who was responsible for the costs associated with these marketing efforts—especially in light of the higher sales prices that could be obtained downstream.

In the landmark case of *Wellman v. Energy Resources, Inc.*, 210 W. Va. 200, 557 S.E.2d 254 (2001), this Court first examined those questions in the context of a lease containing a royalty provision based on the proceeds received from the sale of the oil or gas (i.e., a proceeds lease). The Court surveyed the highest courts from the states of Texas, Louisiana, Colorado, Kentucky, Kansas, Oklahoma, Arkansas, and North Dakota. *Id*. at 210–213, 557 S.E.2d at 264–67. The Court acknowledged that while "Texas and Louisiana[] have recognized that a lessee may properly charge a lessor with a *pro rata* share of such 'post-production' (as opposed to production or development) costs . . . a number of other states have rejected this position where a lease . . . calls for the payment of royalties on the basis of what the lessee receives from the sale of oil and gas." *Id.* at 210, 557 S.E.2d at 264. The Court immediately recognized that it was the language of the royalty provision that would drive the analysis, noting that "[w]here leases call for the payment of royalties based on the value of oil or gas produced, and sold directly . . . there are possibly different issues." *Id*. at n.3, 557 S.E.2d at n.3.

As this Court continued its survey of the states that prohibit charging a lessor for post-production expenses, it noted that the rationale for such a holding was "the idea that the lessee not only has a right under an oil and gas lease to produce oil or gas, but he also has a duty, either express, or under an implied

covenant, to market the oil or gas produced" (i.e., the implied duty to market). *Id.* at 210, 557 S.E.2d at 264. "The rationale proceeds to hold the duty to market embraces the responsibility to get the oil or gas in marketable condition and actually transport it to market." *Id.*, 557 S.E.2d at 264. The Court thus concluded "that the rationale employed by Colorado, Kansas, and Oklahoma in resolving the question of whether the lessor or the lessee should bear 'post-production' costs is persuasive." *Id.* at 211, 557 S.E.2d at 265.

Accordingly, in *Wellman*, this Court held that "if an oil and gas lease provides for a royalty based on proceeds received by the lessee, unless the lease provides otherwise, the lessee must bear all costs incurred in exploring for, producing, marketing, and transporting the product to the point of sale." *Id.* at 202, Syl. Pt. 4, 557 S.E.2d at 256, Syl. Pt. 4. The Court further clarified that if the lease provides otherwise, only reasonable and actually incurred expenses may be deducted. *Id.* at Syl. Pt. 5, 557 S.E.2d at 256, Syl. Pt. 5.[2]

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[2] This Court has recognized that certain authors have been critical of *Wellman* for the Court's "dogged devotion to Professor Donley's, pre-deregulation 1951 treatise *The Law of Coal, Oil and Gas in West Virginia and Virginia*." *See* Leggett, 239 W. Va. at 277, 800 S.E.2d at 863. However, a closer review of Donley's treatise reveals that prior to *Wellman*, no West Virginia court had expressly recognized the implied duty to market. Although this Court relied on Sections 70 and 104 of Professor Donley's treatise for the proposition that West Virginia, like other states, "holds that a lessee impliedly covenants that he will market oil or gas produced" (*Wellman*, 210 W. Va. at 211, 557 S.E.2d at 265), Section 70 does not mention an implied duty to market in West Virginia, and Section 104's reference to an implied duty to market is unsupported by *any* West Virginia law or case, instead citing to a treatise by W.L. Summers, *The Law of Oil and Gas* § 400 (2d ed.). *See generally* Donley, *The Law of Coal, Oil and*

### C. Since *Wellman*, this Court provided further clarity on the deduction of post-production expenses.

Following this Court's decision in *Wellman*, the Court has considered other certified questions related to the deduction of post-production expenses. In *Estate of Tawney v. Columbia Natural Resources LLC*, the Court provided further clarity on what must be included in a proceeds lease to allocate certain post-production expenses to the lessor, holding that a lease must (1) "expressly 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"; and (3) "indicate the method of calculating the amount to be deducted from the royalty for such post-production costs." 219 W. Va. 266, 267, Syl. Pt. 10, 633 S.E.2d 22, 23, Syl. Pt. 10 (2006).

More recently, in *SWN Production Company, LLC v. Kellam*, this Court held that "[t]hese holdings firmly cemented West Virginia as a 'marketable product

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*Gas in West Virginia and Virginia* §§ 70, 104. Section 400 of Summers' book discusses the implied covenant to market oil or gas produced generally and cites three West Virginia cases—none of which addresses an implied duty to market or the marketable product rule. *See Lowther Oil Co. v. Miller-Sibley Oil Co.*, 53 W. Va. 501, 44 S.E. 433 (1903) (discussing implied duty to develop and abandonment of lease, only); *Doddridge Cnty. Oil & Gas Co. v. Smith*, 154 F. 970, 979 (C.C.N.D. W. Va. 1907) (stating that lessors remedy for failure to further develop a leased premises or to protect the lines from drainage is an action at law for damages, and not forfeiture of the lease); *Kellar v. Craig*, 126 F. 630, 633 (4th Cir. 1903) (discussing implied covenants to "protect the lines of and well develop the land leased," only).

rule' state, meaning that the lessee bears all post-production costs incurred until the product is first rendered marketable, unless otherwise indicated in the subject lease." 247 W. Va. 78, 83, 875 S.E.2d 216, 221 (2022). Notably, courts and scholars alike have interpreted the holdings of *Wellman* and *Tawney* to extend the implied duty to market *beyond* the marketable product rule (i.e., when the product is first rendered marketable), recognizing that both *Wellman* and *Tawney* seem to impose the implied duty to market in West Virginia until the point of sale, even if that occurs further downstream from the first available market. *See, e.g.,* Owen L. Anderson, *Marketable Product: What Did Kuntz Say? What Did Merrill Say?*, 1 OIL & GAS, NAT. RES. & ENERGY J. 43, 46 (Jan. 2015) ("At the other extreme is West Virginia, where the court essentially held that royalty is payable at the ultimate point of an actual arm's-length sale, no matter how far downstream of the well that such a sale might occur—apparently even if the actual sale occurs at a location beyond an established market closer to the well."); *see also Wellman*, 210 W. Va. at 211, 557 S.E.2d at 265; *Tawney*, 219 W. Va. at 274, 633 S.E.2d at 30.

However, the trilogy of *Wellman*, *Tawney*, and *Kellam* all have one thing in common that is not present in the current dispute: the royalty provisions at issue provided for a royalty based on the *value* of the production. There was no

question that the lessor would receive its royalty share as a monetary payment (i.e., dollars), rather than in kind as is present here.

Certainly, oil and gas leases exist whereby the royalty is directly derived from the amount of money received from a sale. *See Corder v. Antero Res. Corp.*, 57 F.4th 384, 393 (4th Cir. 2023) (recognizing certain leases expressly calculate royalties "based on the 'proceeds' from the sale of gas"). But other leases omit the word "proceeds" and instead presume to calculate the royalty based on the "'value' of gas at the wellhead." *Id.* at 394. Such leases may not be considered "proceeds leases" by industry standard, but they still meet the dictionary definition of "proceeds" [3] when the gas is converted into money.

This Court, however, has never considered a situation whereby the parties agree that the lessee will ***not*** convert the gas into money. A situation where the lessee will provide the lessor with the opportunity to take his royalty as a physical part of the production (i.e., in kind), thereby permitting him to market and sell it himself. Accordingly, issues remain for this Court's consideration to provide clarity on the application of West Virginia's implied duty to market, if at all, in

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[3] The common meaning of the term "proceeds" is more broad, i.e., "[t]he value of land, goods or investments when converted into money; the amount of money received from a sale." *Proceeds*, BLACK'S LAW DICTIONARY (11th ed. 2019).

the context of in-kind leases. As such, the Court should consider, and answer, the questions certified by the district court.

## III. THE IMPLIED DUTY TO MARKET DOES NOT APPLY TO AN IN-KIND ROYALTY PROVISION.

### A. This Court has not determined whether a duty to market applies to in-kind leases.

This Court's prior decisions in *Wellman* and *Tawney* are based on a simple premise: "The rationale for holding that lessee may not charge a lessor for 'post-production' expenses appears to be most often predicated on the idea that the lessee not only has a right under an oil and gas lease to produce oil or gas, but he also has a duty, either express, or under an implied covenant, to market the oil or gas produced." *Wellman*, 210 W. Va. at 210, 557 S.E.2d at 264. However, in both *Wellman* and *Tawney*, this Court specifically noted that this rule applies to leases providing for "a royalty based on ***proceeds*** received by the lessee." *Tawney*, 219 W. Va. at 272, 633 S.E.2d at 28 (quoting Syl. Pt. 4, *Wellman*, 210 W. Va. at 202, 557 S.E.2d at 256) (emphasis added).

As West Virginia courts have long recognized, the following language is indicative of an in-kind lease:

> The lessee shall deliver to the credit of the lessor free of cost, into the pipeline to which he may connect his wells, the equal one-eighth (1/8) part of all oil and gas produced and saved from the leased premises.

*See, e.g., Horner v. Phila. Co. of W.Va.*, 71 W. Va. 345, 76 S.E. 662 (1912).

Courts and scholars alike are in accord. *See Wall v. United Gas Pub. Serv. Co.*, 152 So. 561, 562 (La. 1934) (finding an in kind lease where "[t]he royalty clause in the leases provides that in case oil is discovered the lessees shall deliver to the credit of the lessors, free of cost, in the pipe line to which he may connect his wells, the equal one-eighth part of all oil produced and saved from the leased premises"); *Blasi v. Bruin E&P Partners, LLC*, 959 N.W.2d 872, 877 (N.D. 2021) ("The oil royalty clause requires the lessee 'to deliver' a fraction of 'all oil produced.' In other words, it requires an in-kind delivery at a specified location."); Nancy Saint-Paul, *Introduction to Calculation of Oil and Gas Royalties*, 3A SUMMERS OIL AND GAS § 33:1 (3d ed.) ("Royalty in kind is 'to be delivered at the wells or to the credit of Lessor into the pipelines to which the wells may be connected.'"); Eugene Kuntz, *Treatise on the Law of Oil and Gas* § 40.5(a) (2019) ("If the royalty clause provides for delivery of royalty gas to the lessor's credit free of cost in the pipeline to which the well is connected, the parties contemplate a delivery of royalty gas at the well").[4]

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[4] Although Kaess contends that the lease should be "liberally construed in favor of the lessor, and strictly as against the lessee" (Petitioner's Br. at 9) (quoting *Tawney*, 219 W. Va. at 268, 633 S.E.2d at 24), this general rule only applies "when there is ambiguity as to the meaning of the lease terms." *K & D Holdings, LLC v. Equitrans, L.P.*, 812 F.3d 333, 339 (4th Cir. 2016). "Where the intent of the parties is clear, [the Supreme Court of Appeals of West Virginia] will not use the vehicle of interpretation to relieve one party of a bad bargain." *Id.* at 339–40 (quoting *Pechenik v. Baltimore & O.R. Co.*, 157 W. Va. 895, 205 S.E.2d 813, 815 (1974)).

While Kaess may now suggest otherwise (Petitioner's Br. at 7 n.2), this issue was previously conceded and determined by the trial court in this case. [J.A. 184–85, 225, 227, 256–58]. Moreover, as this Court recognized in *Kellam*, it is the duty of the trial court to interpret the individual contract, and the duty of this Court to set forth the law of the State. 247 W. Va. at 81, 89, 875 S.E.2d at 219, 227 (2022) ("In reviewing the parties' briefs and the district court's certification order, we believe these questions can only be answered by looking to the individual lease at issue and other relevant evidence, thus rendering them, in some instances, questions of contract interpretation which we cannot answer.").

Because the lease between BB Land and Kaess contains an in-kind royalty provision, the question here is whether a duty to market the oil and gas produced applies when the parties expressly and unambiguously agreed that the lessor's obligation is to simply deliver "one eighth (1/8) part of [the oil or gas] produced" into "the pipe line to which he may connect his wells." *See* J.A. 49. This question has *not* been addressed by this Court.

This Court, however, has recognized that "[i]mplied covenants . . . are only justified on grounds of legal necessity, and to effectuate the purpose of the contract." *Leggett v. EQT Prod. Co.*, 239 W. Va. 264, 275, 800 S.E.2d 850, 861 (2017) (citation omitted) (overruled on other grounds by statute). The operative

question is thus whether the application of the implied covenant to market effectuates the purpose of a contract providing that the lessor will take its royalty in the form of a physical product, which it is then free to market in any manner it sees fit.

### B. The Oklahoma Supreme Court determined that the implied duty to market does not apply to leases containing in-kind royalty provisions.

This Court previously relied on reasoning from the Oklahoma Supreme Court when it adopted the implied duty to market. *See Wellman*, 210 W. Va. at 210–11, 557 S.E.2d at 264–65. Oklahoma law is clear, however, that there is ***no*** duty to market under an in-kind royalty provision. *See XAE Corp. v. SMR Prop. Mgmt. Co.*, 968 P.2d 1201, 1202 (Okla. 1998). Although Oklahoma is a marketable-product state[5], the Oklahoma Supreme Court held that "there is ***no*** implied covenant to market applicable . . . because the interest was an in-kind interest deliverable at the wellhead." *Id.* (emphasis added).

[5] The marketable-product rule in every other jurisdiction provides that the working interest owner must bear the costs of getting the gas to a marketable condition and marketable location, but once the gas is marketable, additional costs to improve or transport the gas must be shared proportionately between the working interest owner and the royalty interest owner. *See Kellam,* 247 W. Va. at 83, 875 S.E.2d at 221 ("[A] 'marketable product rule' state [means] that the lessee bears all post-production costs incurred until the product is first rendered marketable . . .").

In *XAE*, the parties agreed that the royalty clause created an in-kind interest, meaning that the "royalty granted was a fraction of the gas produced rather than of the gas sold." *Id*. Because the royalty owners did not take their share of the gas in kind, the question was whether the producer was permitted to deduct the royalty owners' "share of the costs incurred in gathering, processing and compressing gas produced from the subject wells." *Id*.

The royalty owners urged the Oklahoma Supreme Court to adopt the same reasoning it had employed in prior royalty cases where it announced the implied marketability rule, contending that "the 'production' process does not end until a marketable product has been obtained" and that the producer "was required to bear the costs of making it marketable." *Id*. at 1203. The plaintiffs in *XAE* relied on three cases: *TXO v. Comm'rs of the Land Office,* 903 P.2d 259 (Okla. 1994); *Wood v. TXO Prod. Corp.,* 854 P.2d 880 (Okla. 1992); and *Clark v. Slick Oil Co.,* 211 P. 496 (Okla. 1922). Notably, the *Wood* opinion is the same case that this Court relied on in *Wellman*. *See Wellman*, 210 W. Va. at 210, 557 S.E.2d at 264.

While the Oklahoma Supreme Court acknowledged that it had "decided the royalty owner cases based upon the implied covenant to market of the oil and gas leases," the court held that "[t]here is no duty either express or implied on the lessee in the case . . . to do other than deliver the gas to the overriding

royalty owners in kind." *XAE Corp.*, 968 P.2d at 1207. And "[t]he overriding royalty owners' decision ***not*** to take the gas in kind does ***not*** impose different duties on the lessee." *Id*. (emphasis added). As such, because the "royalty interest in the case [was] an in-kind interest deliverable at the wellhead, the costs thereafter were properly deducted before the royalty was paid." *Id*. at 1208.

In reaching its decision, the XAE court relied on Professor Kuntz's oil and gas treatise, quoting the following passage:

> In the instance where oil and/or gas is to be delivered in kind, the owner of the overriding royalty is entitled to have the specified share delivered to such owner or to the pipeline free of all costs including costs of secondary recovery operations. The lessee is not, however, required to store oil, and if storage tanks are constructed, the overriding royalty must bear its share of the costs of construction. The lessee is to account for production or its proceeds if sold at the mouth of the well. If any costs are incurred beyond that point, they should be shared. It follows that, if overriding royalty oil and/or gas is to be delivered in kind, the owner of that interest may make arrangements for sale of the oil or gas or join in any gas purchase contract made by the lessee.

*Id*. (quoting Eugene Kuntz, *Treatise on the Law of Oil and Gas* § 63.2 (2019)).[6] This Court also routinely relies on Professor Kuntz in oil and gas cases, citing to his work in *Wellman*, 210 W. Va. at 205–06, 557 S.E.2d at 260–61 and *Kellam*, 247

[6] *See also* Eugene Kuntz, *Treatise on the Law of Oil and Gas* § 40.5(a) ("If the royalty clause provides for delivery of royalty gas to the lessor's credit free of cost in the pipeline to which the well is connected, the parties contemplate a delivery of royalty gas at the well, and the lessee is not required to construct at the lessee's own expense a feeder line in order to deliver lessor's royalty gas to a distant pipeline.").

W. Va. at 93, 875 S.E.2d at 231 (Hutchison concurring) ("Another titan of oil and gas law, Professor Eugene Kuntz . . . .").

Although the Oklahoma Supreme Court held that "the implied covenant to market cannot be enforced by the overriding royalty interest owners," the court's analysis did not end there—the court went on to analyze the in-kind royalty provision, further holding that "[t]here is no duty either *express or implied* on the lessee in the case at bar to do other than deliver the gas to the overriding royalty owners in kind." *XAE Corp.*, 968 P.2d at 1207 (emphasis added). And because "the obligation [was] merely to deliver the gas in-kind when production [was] obtained," the court held that any costs incurred thereafter "were properly deducted before the royalty was paid." *Id.* at 1208.

In *Wellman*, this Court expressly relied on Oklahoma's "persuasive" rationale in holding that under a proceeds lease there exists an implied duty to market oil or gas that is sold by a lessee. 210 W. Va. at 210–11, 557 S.E.2d at 264–65 ("This Court believes that the rationale employed by . . . Oklahoma in resolving the question of whether the lessor or the lessee should bear 'post-production' costs is persuasive."). Although this Court has not previously considered whether the implied duty to market applies in the context of in-kind royalty provisions, the Court's prior reliance on Oklahoma royalty law provided contracting parties in West Virginia with some guidance on this issue. To now

abandon Oklahoma's persuasive authority would create further confusion and unintended consequences for parties who acted under Oklahoma's settled guidance.

Based on the persuasive reasoning from *XAE*—and the express language of the in-kind royalty provisions—this Court should find that the implied duty to market does *not* apply when a lease contains an in-kind royalty provision.

**C. The lease does not contain an express duty to market.**

Petitioner erroneously contends that the royalty provision itself enacts the implied duty to market, failing to recognize that if that were true it would be an *express* duty to market. *See* Petitioner's Br. at 8. Implied duties arise only when the agreement is silent as to such a duty. *Leggett*, 239 W. Va. at 275, 800 S.E.2d at 861 ("Implied covenants have been frequently referred to as contractual 'gap-fillers' utilized to implement the parties intentions where not otherwise stated . . ."). And here, the agreement only obligates the lessee to deliver "one eighth (1/8) part of [the oil or gas] produced" into "the pipe line to which he may connect his wells." *See* J.A. 49. Once BB Land delivered the gas from the well to the connected pipeline, BB Land's only obligation was satisfied.

The implied duty to market was essential to this Court's holdings in both *Wellman* and *Tawney*, and the first question here is thus whether this implied duty exists when the subject lease contains an in-kind royalty provision. As the

amicus brief in this case references, in-kind royalty provisions are more common with oil production (which is also included in the subject lease). If the obligation of the lessee is to simply deliver the oil into the tanks, there can be no implied duty to then market the oil. The same is true of gas. The parties agreed that the lessor would take his royalty as part of the production after it was extracted from the ground, free of costs. Based on the plain language of the agreement, this is the point where the lessee's obligations end, and requiring anything further is tantamount to re-writing the parties' agreement.

Kaess's contention that the lease language implies a duty to market through the language "produced and marketed" also ignores that the royalty provision in the subject lease gives Kaess both an in-kind royalty and a right to free gas—a common provision in the 1970s. Free gas provisions were common during the time when this lease was negotiated because many homes located on the leased lands depended on gas wells to provide the gas to light and heat their homes. *See Bassell v. W. Va. Cent. Gas Co.*, 86 W. Va. 198, 199–200, 103 S.E. 116, 117–18 (1920) (recognizing that the free gas provision was customarily inserted in all gas leases, not to control production or operation of the wells in any sense, but to secure free gas for domestic purposes). At its most basic level, the free gas provision, which is not limited or confined by the 1/8th in-kind royalty, ensures

that the lessor has enough gas to heat and light its home—even if 1/8th part of the production does not provide a sufficient volume to do so.

The original lessor contracted to receive "free gas from any such well or wells for heating and lighting any building." [J.A. 49]. Lessor's entitlement to this gas is separate and apart from its right to take 1/8 part in kind as demonstrated by the conjunction "and" between the two phrases. [J.A. 49]. Obviously, the "free gas" produced from the well(s) subject to the lease will have to be produced before the lessor can utilize it to heat and light his building, but it will not be marketed by anybody in any form. The only gas that will be marketed is the gas left over after the lessor has consumed its "free gas." It is from this remaining gas stream that will ultimately be produced and marketed that the lessor is entitled to a 1/8th part.

## IV. THE REQUIREMENTS FROM *WELLMAN* AND *TAWNEY* DO NOT APPLY WHEN THE PARTIES AGREED TO AN IN-KIND ROYALTY PROVISION.

### A. Similar to flat-rate leases, parties to in-kind leases did not contemplate that the lessee would have the oil or gas in its possession after it was produced from the ground.

This Court has already recognized that the requirements of *Wellman* and *Tawney* do not apply to every type of oil and gas lease. In *Leggett*, this Court considered certified questions from the Northern District of West Virginia related to the propriety of deducting post-production expenses from the lessor's royalty under flat-rate leases, i.e., leases that provided for payment of a sum

certain per well, per year. 239 W. Va. at 267, 800 S.E.2d at 853. West Virginia Code section 22-6-8(e) effectively converted these flat-rate royalty provisions to a royalty equal to "no less than one-eighth of the total amount paid to or received by or allowed to [the lessee] at the wellhead for the oil or gas so extracted, produced or marketed." *Id.*, 800 S.E.2d at 853 (internal quotations omitted). "In short, to get a permit to re-drill wells governed by a flat-rate lease, the lessee must agree to pay[7] the lessor a one-eighth royalty instead of a flat rate." *Id.* at 271, 800 S.E.2d at 857.

Thus, the relevant certified question was whether under flat-rate leases, a lessee "may deduct post-production expenses from his lessor's royalty." *Id.* at 268, 800 S.E.2d at 854. While criticizing the Court's prior holdings from *Wellman* and *Tawney*—specifically noting the Court's decision to extend the marketable product rule to the point of sale—the *Leggett* Court held that those oil and gas leases governed by West Virginia Code section 22-6-8(e) "may be subject to pro-rata deduction or allocation of all reasonable post-production

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[7] Notably, under well-established West Virginia law the word "pay" is not exclusive to money, as an obligation can be payable in kind. For example, in *Johnson v. Sanger*, this Court recognized that a deed that conveyed certain minerals but reserved "enough coal for the ordinary consumption of eight families," created a right that was "***payable*** in coal in kind." 49 W. Va. 405, 408, 38 S.E. 645, 648 (1901) (emphasis added). Similarly, in *Musgrave v. Musgrave*, this Court recognized that certain rights are "***payable*** in corn, grass, hops, wood, milk, pigs and the like, as well as in money." 86 W. Va. 119, 123, 103 S.E. 302, 306 (1920) (emphasis added).

expenses actually incurred by the lessee," thus sanctioning the "net-back" and "work-back" methodologies under these leases. *Id.* at 282, 800 S.E.2d at 868.

In recognizing that implied covenants are justified only "to effectuate the purpose of the contract," this Court openly acknowledged that "at the times these leases were executed, the parties contemplated neither the marketing of the product and any implied covenants thereof, nor cost allocation because the leases were flat-rate leases" and because "[t]he lessor's royalty issued irrespective of production . . . post-production costs and the marketing efforts of the lessor [were] irrelevant to both parties for purposes of the lease." *Id.* at 275–76, 800 S.E.2d at 861–62.

Indeed, the application of an implied covenant *cannot* contravene the plain language of the parties' obligations. *See Fraternal Order of Police, Lodge No. 69 v. City of Fairmont*, 196 W. Va. 97, 101, 468 S.E.2d 712, 716 (1996) ("[W]e are to ascertain the meaning of the agreement as manifested by its language. Our task is not to rewrite the terms of contract between the parties; instead, we are to enforce it as written.").

Just as in *Leggett*, the parties here did not consider post-production costs at the time the lease was executed in 1979. Not only was the lease signed prior to deregulation, but the parties also expressly agreed that the lessor would take its royalty as a physical "part" of the production. Because the lessor was taking

a part of the production, the parties also understood that the lessor was responsible for its own marketing and any costs associated therewith.

### B. The requirements from *Wellman* and *Tawney* should apply only where the royalty is based on the proceeds received rather than a portion of the physical production.

In *Tawney*, this Court held that, in order to permit deduction of post-production costs, the lease must specifically provide the category of costs to be deducted and indicate the method of calculation to be implemented in determining the amount to be deducted. 219 W. Va. at 268, Syl. Pt. 10, 633 S.E.2d at 24, Syl. Pt. 10. In arriving at this decision, *Tawney* quoted from and relied upon *Wellman*'s holding that an implied duty to market exists in West Virginia, and thus, under a proceeds lease, the lessee bears the post-production costs. *Wellman*, 210 W. Va. at 211, 557 S.E.2d at 265. Notably, *Tawney* specifically quoted the following sentence from *Wellman*:

> "If an oil and gas lease provides for **a royalty based on <u>proceeds</u> received by the lessee**, unless the lease provides otherwise, the lessee must bear all costs incurred in exploring for, producing, marketing, and transporting the product to the point of sale."

*Tawney,* 219 W. Va. at 272, 633 S.E.2d at 28 (quoting *Wellman*, 210 W. Va. at 202, Syl. Pt. 4, 557 S.E.2d at 256, Syl. Pt. 4) (emphasis added). Accordingly, on its face, the *Tawney* decision acknowledged that *Wellman*'s conclusion was based on a "proceeds" lease—not an in-kind lease.

Recently, however, the Fourth Circuit acknowledged that "*Tawney* was not limited to 'proceeds' leases." *Corder v. Antero Res. Corp.*, 57 F.4th 384, 394 (4th Cir. 2023). Even if *Tawney*'s rule may extend beyond proceeds leases, this does not logically mean that *Tawney* applies to in-kind leases. Indeed, *Corder* recognized that *Tawney*'s "analysis . . . applies with equal force to leases that calculate royalties based on the '***value***' of gas at the wellhead." *Id*. (emphasis added). However, an in-kind lease does not base its royalty on the "value" of the gas at all, but rather on the "volume" of the gas, regardless of value.

Not only do *Wellman* and *Tawney* go further than the marketable-product rule, but the implied duty to market underlying this same rule does not logically apply to an in-kind lease because the parties expressly agreed that the lessee will deliver to the lessor a portion of the physical oil or gas so that the lessor can market the oil or gas itself. Thus, the implied duty to market is not implicated in an in-kind lease. As the Oklahoma Supreme Court aptly stated in *XAE*: "There is ***no duty either express or implied on the lessee*** in the case at bar to do other than deliver the gas to the overriding royalty owners in kind. The overriding royalty owners' decision not to take the gas in kind does not impose different duties on the lessee." 968 P.2d at 1207 (emphasis added).

Finally, the Fourth Circuit's recognition that *Tawney* requires post-production deductions to be specifically identified in order to be taken, begs the

question: If the parties intended that the lessor would take their oil and gas in kind, why would there ever be a discussion as to post-production costs? The parties did not contemplate that the lessee would have the oil or gas in its possession after it was produced from the ground, and as such, it was never contemplated that the lessee would incur any post-production costs on behalf of lessor. Just as this Court found in *Leggett* when addressing flat-rate leases, "at the times these leases were executed, the parties contemplated neither the marketing of the product and any implied covenants thereof, nor cost allocation because the leases were flat-rate leases" and as such "post-production costs and the marketing efforts of the lessor [were] irrelevant to both parties for purposes of the lease." 239 W. Va. at 276, 800 S.E.2d at 862. It was only after the lessor failed to take its gas in kind that post-production costs would accrue.

Based on the foregoing, the requirements from *Tawney* and *Wellman* would apply only where a lease provides for a royalty to be based on the *value* of the proceeds. Where, as here, a lease specifies that a royalty is to be made in kind and based on the *volume* of oil or gas produced, the requirements from *Tawney* and *Wellman* should not apply because the lessee's only obligation is to tender a royalty to the lessor in the form of physical oil or gas.

### C. Because the duty to market is inapplicable, the lessee is entitled to deduct post-production expenses if the lessor does not take its share of the production.

When a lessor under an in-kind lease fails to take its share of the production in kind, the lessee may sell said production on behalf of the lessor:

> [W]hen [the lessor/royalty owner] failed either to provide storage or to arrange for the marketing of his share of the royalty oil, **not only was [the lessee] impliedly authorized to sell it as his agent, but it became its duty so to do**. Indeed there was no other practical way for [the lessee] to take care of the royalty oil so as to avoid waste and loss; and there was no other way for it to comply with its lease covenant to deliver the royalty oil in the pipe line to the credit of the royalty owners.

*Wolfe v. Prairie Oil & Gas Co.*, 83 F.2d 434, 437 (10th Cir. 1936) (emphasis added). And in this situation, the lessee and lessor are both responsible for their pro-rata share of post-production costs incurred to get the oil and/or gas to market. *See, e.g., XAE Corp.*, 968 P.2d at 1208 ("[R]oyalty interest in the case at bar is an in kind interest deliverable at the wellhead, the costs thereafter were properly deducted before the royalty was paid.").

This scenario is what also happened in this case. When the natural gas was produced, Kaess did not arrange to take his share of the production in kind or otherwise market his share of the production. BB Land was, therefore, implicitly authorized to sell Kaess's in-kind royalty (i.e., Kaess's pro-rata share of production) to avoid waste and loss to Kaess's detriment. As a result, BB Land went beyond what it was contractually obligated to do under the terms of this

in-kind lease (i.e., deliver the royalty oil and gas in kind). And, in selling Kaess's share, BB Land was entitled to deduct its reasonable post-production costs from the monetary royalties paid to Kaess.

If Kaess had taken his royalty share in kind, he would have incurred expenses for gathering, processing, marketing and transportation. Due to economies of scale, Kaess likely obtained a cost advantage from BB Land handling the marketing of the produced oil and gas, rather than Kaess incurring post-production costs for his smaller pro-rata share of production on his own. To now force BB Land to bear the expenses for Kaess's royalty share necessarily places Kaess in a better position than if he would have taken his share of the production in kind—as contemplated by the parties in the lease.

### D. Under an in-kind royalty provision, courts agree that the lessee's obligation ends at the point where the lessor is contractually required to take possession of the oil or gas.

Courts in other jurisdictions have similarly held that under an in-kind lease, the lessee's obligations stop at the mouth of the well, and any downstream costs to get the product to market are equally shared between the lessee and lessor.

For example, in *Vedder Petroleum Corp. v. Lambert Lands Co.*, the California Court of Appeals analyzed an in-kind royalty provision specifying that the lessee shall pay to the lessor as royalty one-sixth of the value of all oil produced "or at

Lessor's option . . . deliver into Lessor's tanks . . . or to pipe line within one mile of premises from which oil is being produced." 122 P.2d 600, 602 (Cal. 1942). Based on this language, the court determined that the lessor was "entitled to his royalty share in kind as the oil came from the well, if he so desired." *Id*. at 604. If, however, the lessor elected to receive payment for the value received by the lessee for the sale of the oil, then the lessor was responsible for its proportionate share of the dehydrating expense because, under the terms of the lease, the lessee has no duty to bear such expense. *Id*. at 604–05. In reaching its conclusion, the court stated:

> Under the terms of said lease, lessor could not require lessee to clean the oil before delivery of its royalty share in kind. As we view the matter, respondent should either pay its proportionate share of the dehydrating expense or should elect to receive its royalty share of the oil in kind, in its crude state, as produced from the wells. There is nothing in the stipulated facts nor in the lease itself to justify the conclusion that there was any duty on the part of the lessee to bear the expense of dehydrating appellant lessor's royalty share of the oil produced from wells on the premises, and, **if the duty to clean the oil is absent when the royalty oil is delivered in kind, it is also absent when the proportionate share of the value of such royalty oil is to be paid in cash**.

*Id*. (emphasis added).

Similarly, in *Burlington Resources Oil & Gas Co. LP v. Texas Crude Energy LLC*, the Supreme Court of Texas analyzed a royalty provision that called for the delivery of the royalty share of the oil or gas "into the pipeline, tank or other receptacle to which any well or wells on such lands may be connected, free and

clear of . . . all costs and expenses." 573 S.W.3d 198, 201 (Tex. 2019). The royalty owner, however, took its royalty payments in cash rather than in kind. *Id*. at 202. The trial court held that the provision did *not* allow for the deduction of post-production expenses, but the Supreme Court of Texas reversed, holding that the royalty provision clearly contemplated delivery of the oil or gas at the well (i.e., in kind), and thus post-production expenses were properly deducted from the royalty payment. *Id*. at 211–12.

More recently, the Supreme Court of Texas analyzed an in-kind lease to determine what, if any, post-production expenses may be deducted from a royalty payment. *See Nettye Engler Energy, LP v. BlueStone Nat. Res. II, LLC*, 639 S.W.3d 682 (Tex. 2022). The court framed the issue as follows:

> This mineral dispute involves a frequently litigated issue: whether and to what extent a royalty interest bears a proportionate share of postproduction costs. Here, the deed conveying the mineral estate reserved a nonparticipating royalty interest "in kind," which means that, unlike a monetary royalty, the grantor retained ownership of a fractional share of all minerals in place. The deed required delivery of the grantor's fractional share "free of cost in the pipeline, if any, otherwise free of cost at the mouth of the well or mine."

*Id*. at 684. And the court held that under this royalty provision, the lessee "satisfies its obligation to deliver [the lessor's] share of production 'free of cost in the pipe line' by accounting for [the lessor's] fractional share on a net-proceeds basis that deducts from gross sales proceeds the postproduction costs incurred after delivery in the gas gathering system on the wellsite premises." *Id*. at 696.

As the above authorities demonstrate, there is widespread agreement among courts that if a lessee's royalty obligation arises solely out of a lease that contains an in-kind royalty provision, then the lessee's obligations to the lessor end at the point where the lessor is contractually required to take possession of the oil or gas.

A lessor's decision *not* to take the gas in kind does not, and should not, impose additional obligations on the lessee. To hold otherwise would create a rule of law that permits a lessor to achieve greater benefits from non-performance of its agreement than through performance. If the lessor takes its royalty in kind as agreed, it will necessarily have to incur post-production costs to achieve a higher sales price further downstream. A lessor cannot avoid such costs by simply refusing to take the royalty as agreed upon. *See, e.g., Miller v. Wesbanco Bank, Inc.*, 245 W. Va. 363, 392, 859 S.E.2d 306, 335 (2021) ("It is a fundamental principle of the law of contracts that a plaintiff is only entitled to such damages as would put him in the same position as if the contract had been performed.") (citation omitted).

## Conclusion

For the reasons stated above, BB Land respectfully requests that the Court answer the certified questions, finding that the implied duty to market does not apply when the parties agreed to an in-kind royalty provision and that because the implied duty to market does not apply, and the parties expressly agreed that BB Land's only obligation was to deliver a portion of the physical oil or gas into the pipeline, the requirements from *Wellman* and *Tawney* for the deduction of post-production expenses also do not apply.

Respectfully submitted,

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## Certificate of Service

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