THE CLASS ACTION LAWSUIT IN NORTH DAKOTA—DOES IT HAVE ANY RELEVANCE FOR ROYALTY OWNERS?

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ABSTRACT

The class action lawsuit—having long been a bastion for royalty owners seeking an advantage against oil producers—has undergone nationwide reforms in recent years. Most relevant for royalty owners are reforms impacting calculation of attorney's fees, making the class action suit a less attractive option for plaintiffs seeking to advance costs. This Article will examine the class action certification procedure, its application to the oil patch in North Dakota, and the impact case law has on calculating when and how royalty amounts will be determined. Overall, the Article will show it is more likely that North Dakota producers will not face large class action challenges in the foreseeable future.

I. INTRODUCTION

A class action lawsuit for failure to pay royalties properly, often utilized by mineral royalty owners as a bastion against the stronger and often better-financed oil company, has long been successful in states such as Oklahoma,

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but its success has diminished in states such as Texas. In 2003, Texas' tort reform proved to be a death knell for royalty owner suits. While much of Texas' revisions dealt with reform to medical malpractice suits, some of the most pertinent provisions for royalty owners are those pertaining to the award of attorney fees. The 2003 Act requires that fees be calculated on a lodestar basis,[1] and that the awarded attorney fees cannot be adjusted higher than four times the lodestar.[2] In addition for cases where non-cash awards are made, the attorneys must receive the same proportion of cash and non-cash awards as do the class.[3]

Class actions suits are very expensive to litigate, both in terms of expenses and in time expended by class counsel, as well as for Defendants' counsel but they are typically paid as the suit progresses. Generally, class counsel advance expenses which can amount to hundreds of thousands of dollars, if not more. North Dakota has a unique rule which specifically addresses the advancement of costs. The rule specifies who and when costs may be advanced once a class certification is granted.[4] While defendants do

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1. TEX. R. CIV. P. 42(i)(1) states: In awarding attorney fees, the court must first determine a lodestar figure by multiplying the number of hours reasonably worked times a reasonable hourly rate. The attorney fees award must be in the range of 25% to 400% of the lodestar figure. In making these determinations, the court must consider the factors specified in TEX. DISCIPLINARY R. PROF. CONDUCT 1.04(b). Those factors are:

> (1) the time and labor required, the novelty and difficulty of the questions involved, and the skill requisite to perform the legal service properly;
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> (2) the likelihood, if apparent to the client, that the acceptance of the particular employment will preclude other employment by the lawyer;
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> (3) the fee customarily charged in the locality for similar legal services;
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> (4) the amount involved and the results obtained;
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> (5) the time limitations imposed by the client or by the circumstances;
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> (6) the nature and length of the professional relationship with the client;
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> (7) the experience, reputation, and ability of the lawyer or lawyers performing the services; and
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> (8) whether the fee is fixed or contingent on results obtained or uncertainty of collection before the legal services have been rendered.

Stratton v. XTO Energy Inc., No. 02–10–00483–CV2012 WL 407385 (Tex. App. Fort Worth Feb. 9, 2012).

2. TEX. CIV. PRAC. & REM. § 26.003(a).

3. TEX. CIV. PRAC. & REM. § 26.003(b) (however, this provision would seldom, if ever, be applicable in a royalty class action).

4. In North Dakota, N.D. R. CIV. P. 23(q) specifically addresses the issue of who may advance costs. The rule reads:

> (1) Before a hearing under Rule 23(b)(1) or at any other time the court directs, the representative parties and the attorney for the representative parties must file with the court, jointly or separately:
>
> > (A) a statement showing any amount paid or promised them by any person for the services rendered or to be rendered in connection with the action and for the costs and expenses of the litigation and the source of all of the amounts;

attack whether the proffered class representatives will be adequate, North Dakota courts appear to have a low threshold for determining adequacy, so far as financial ability is concerned. In *Werlinger v. Champion Healthcare Corporation*, the North Dakota Supreme Court found:

> Typically, courts do not examine the financial resources of a class representative. Without contrary evidence or conduct, an affirmative demonstration of willingness or ability to pay will suffice. The record shows the named plaintiffs have already advanced money for costs of the litigation. The district court also noted its power to allow advances from class members under Rule 23(q). We are unable to say the district court abused its discretion in finding adequate financial resources.[5]

It does not appear that the North Dakota courts will look beyond the plaintiffs' affirmations that they are willing and able to advance costs.

Further, class actions typically require many years to litigate. During this time, class counsel are not only typically paying to proceed by advancing costs but are also not collecting fees. Often times, the class action litigation is so time consuming little other work can take place at the same time. In the meantime, office overhead still accumulates. The public hears of the enormous windfall these attorneys make when they collect a fee in the tens of millions of dollars. What is not so well appreciated is the risk and hardships these men and women go through before, or even if, a payday arrives. If the chance to be highly compensated does not exist, there is no incentive to take the risks involved, and a primary attraction for taking on these suits is gone.

> (B) a copy of any written agreement, or a summary of any oral agreement, between the representative parties and their attorneys concerning financial arrangements or fees; and
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> (C) a copy of any written agreement, or a summary of any oral agreement, by the representative parties or the attorneys to share these amounts with a person other than a member, regular associate, or an attorney regularly of counsel with that law firm. This statement must be supplemented promptly if additional arrangements are made.
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> (2) On a determination that the costs and litigation expenses of the action cannot be reasonably and fairly defrayed by the representative parties or by other available sources, the court may, by order:
>
> (A) authorize and control the solicitation and expenditure of voluntary contributions to defray costs from class members, advances by the attorneys or others, or both, subject to reimbursement from any recovery obtained for the class; and
>
> (B) apply any available funds that were contributed or advanced to the payment of any costs taxed in favor of a party opposing the class.

5. Werlinger v. Champion Healthcare Corp., 1999 ND 173, 598 N.W.2d 820, 828. *See* In re McDonnell Douglas Corp., 92 F.R.D. 761, 762 (E.D. Mo. 1981) (requiring plaintiffs to attest they would advance costs without requiring any documentary evidence).

The oil and gas business was virtually non-existent in North Dakota for several decades. However, with the advent of horizontal drilling and advancements in hydraulic fracturing ("fracking") technology, North Dakota is now one of the top oil producers in the United States. Bonuses[6] reach into the hundreds of thousands of dollars and twenty per cent royalty lease provisions[7] have become commonplace. As has been historically true, when the oil or gas is freely flowing, royalty owners are less likely to bring suit against their lessees.

In the current "oil boom," money is plentiful and few appear to want to complain or rock the boat. And, because of certain statutes and rulings by the North Dakota Supreme Court, even if this were to change, class actions are unlikely to gain traction. This Article will examine the class action certification procedure and its application to the oil patch in North Dakota.

II. FEDERAL RULES OF CIVIL PROCEDURE—RULE 23 AND THE CLASS ACTION

Federal Rule of Civil Procedure 23 delineates the requirements a federal district court must follow and what plaintiffs must prove in order that a class action may be certified. Should a certification order be granted, an interlocutory appeal will certainly follow.[8] Therefore, before a case reaches the real issues on the merits, much time and effort is expended and at least one appeal follows. However, it is only after this appeal process of the certification order when meaningful settlement negotiations can most often begin. Until that time, neither side can fairly determine the risks of success or defeat or the possible expanse of the suit. Both sides need to know who will make up the class and which issues the court will certify, or

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6. "The leasehold bonus is a one-time payment made to the landowner as consideration for executing the negotiated lease. The amount of the leasehold bonus depends on such factors as the proximity of the leased property to other productive property, the length of the lease term, and the amount of competition for the lease among prospective lessees." Total Petroleum, Inc. v. Dep't of Treasury, 427 N.W.2d 639, 640 (Mich. Ct. App. 1988).

7. The word "royalty" has a very well understood and definite meaning in mining and oil operations. As thus used, it means a share of the products or profit paid to the owner of the property. *See* Hinerman v. Baldwin, 215 P. 1103 (Mont. 1923). In the law of mines and mining the term "royalty" signifies that part of the reddendum, which is variable, and depends upon the quantity of minerals gotten. *See generally* Att'y Gen. of Ontario v. Mercer, (1883) 8 App. Cas. 767 (Can.); Saulsberry v. Saulsberry, 172 S.W. 932 (Ky. 1915); Maloney v. Love, 52 P. 1029 (Colo. App. 1898); Kissick v. Bolton, 112 N.W. 95 (Iowa 1907). It is held that the term has the same meaning in oil and gas leases where the lessor is entitled to a share of the product. *See generally* Horner v. Philadelphia Co., 76 S.E. 662 (W. Va. 1912); Ind. Natural Gas Co. v. Stewart, 90 N.E. 384 (Ind. Ct. App. 1910); Homestake Exploration Corp. v. Schoregge, 264 P. 388 (Mont. 1928).

8. FED. R. CIV. P. 23(f) provides that an immediate appeal from an order certifying a class may be allowed, but that an appeal will not automatically stay the proceedings.

not, before advancing further. Often several years pass from filing of the suit to the date of an appellate ruling on the issue of certification, all of which happens typically before any real discovery has begun.

States' class action procedures generally follow the federal rules, and state courts often look to federal decisions for guidance in determining whether a class action is appropriate in a given case. North Dakota is much the same with some slight differences. Under the federal rules, in order to certify a class, the trial court must find:

> (1) The proposed class is so numerous that joinder of all members is impracticable;
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> (2) There are questions of law or fact common to the class;
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> (3) The claims or defenses of the representative parties are typical of the claims or defenses of the class; and
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> (4) The representative parties will fairly and adequately protect the interests of the class.[9]

In addition to the four elements of Rule 23(a), the federal court must find that one of the alternative conditions of Rule 23(b) exists. Those alternatives are:

> (1) prosecuting separate actions by or against individual class members would create a risk of:
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> > (A) inconsistent or varying adjudications with respect to individual members of the class which would establish incompatible standards of conduct for the party opposing the class; or
> >
> > (B) adjudications with respect to individual members of the class that, as a practical matter, would be dispositive of the interests of the other members not parties to the adjudications or substantially impair or impede their ability to protect their interests;
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> (2) the party opposing the class has acted or refused to act on grounds that apply generally to the class, so that final injunctive relief or corresponding declaratory relief is appropriate respecting the class as a whole; or
>
> (3) the court finds that the questions of law or fact common to class members predominate over any questions affecting only individual members, and that a class action is superior to other

9. FED. R. CIV. P. 23(a).

> available methods for the fair and efficient adjudication of the controversy. The matters pertinent to the findings include:
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> > (A) the class members' interest in individually controlling the prosecution or defense of separate actions;
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> > (B) the extent and nature of any litigation concerning the controversy already begun by or against class members;
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> > (C) the desirability or undesirability of concentrating the litigation of the claims in the particular forum; and
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> > (D) the likely difficulties in managing a class action.[10]

In North Dakota, the rule appears slightly different from the federal rule, but its application is essentially the same. North Dakota Rule of Civil Procedure 23 lists thirteen specific criteria to be considered and (in pertinent part) reads:

> (a) Commencement of a class action. One or more members of a class may sue or be sued as representative parties on behalf of all in a class action if:
>
> > (1) the class is so numerous or so constituted that joinder of all members, whether or not otherwise required or permitted, is impracticable; and
> >
> > (2) a question of law or fact is common to the class.
>
> (b) Certification of class action.
>
> > (1) Unless deferred by the court, as soon as practicable after the commencement of a class action the court must:
> >
> > > (A) hold a hearing and determine whether or not the action is to be maintained as a class action; and
> > >
> > > (B) certify or refuse to certify it as a class action by order.
> >
> > (2) The court may certify an action as a class action if it finds that:
> >
> > > (A) the requirements of Rule 23(a) have been satisfied;
> > >
> > > (B) a class action should be permitted for the fair and efficient adjudication of the controversy; and
> > >
> > > (C) the representative parties will fairly and adequately protect the interests of the class.
> >
> > (3) If appropriate, the court may:

10. FED. R. CIV. P. 23(b).

(A) certify an action as a class action with respect to a particular claim or issue;

(B) certify an action as a class action to obtain one or more forms of equitable, declaratory, or monetary relief; or

(C) divide a class into subclasses and treat each subclass as a class.

(c) Criteria considered.

(1) In determining whether the class action should be permitted for the fair and efficient adjudication of the controversy, as appropriately limited under Rule 23(b)(3), the court must consider, and give appropriate weight to, the following and other relevant factors:

(A) whether a joint or common interest exists among class members;

(B) whether prosecuting separate actions by or against individual class members would create a risk of inconsistent or varying adjudications with respect to individual class members that would establish incompatible standards of conduct for a party opposing the class;

(C) whether adjudications with respect to individual class members as a practical matter would be dispositive of the interests of other members not parties to the adjudication or substantially impair or impede their ability to protect their interests;

(D) whether a party opposing the class has acted or refused to act on grounds that apply generally to the class, so that final injunctive relief or corresponding declaratory relief is appropriate with respect to the class as a whole;

(E) whether common questions of law or fact predominate over any questions affecting only individual members;

(F) whether other means of adjudicating the claims and defenses are impracticable or inefficient;

(G) whether a class action offers the most appropriate means of adjudicating the claims and defenses;

> (H) whether members not representative parties have a substantial interest in individually controlling the prosecution or defense of separate actions;
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> (I) whether the class action involves a claim that is or has been the subject of a class action, a government action, or other proceeding;
>
> (J) whether it is desirable to bring the class action in another forum;
>
> (K) whether management of the class action poses unusual difficulties;
>
> (L) whether any conflict of laws issues involved pose unusual difficulties; and
>
> (M) whether the claims of individual class members are insufficient in the amounts or interests involved, in view of the complexities of the issues and the expenses of the litigation, to afford significant relief to the class members.[11]

A substantive difference between the federal rule and the North Dakota rule appears to be found in North Dakota Rule of Civil Procedure 23(c)(1)(M). This provision appears to be in stark opposition to why most class actions are brought. In fact, federal jurisprudence specifically speaks to this issue and has consistently found that one of the basic rationales for the class action is to allow a mechanism for small claims to be brought in such a way as to provide relief where any one of the claims would not be of sufficient size to justify suit.[12]

A review of North Dakota jurisprudence does not reveal any class action which was determined by, or even addressed, the application of Rule 23(c)(1)(M). Nor has there been one where an absent class member attacked, successfully or otherwise, the procedure by advancing this provision. However, the North Dakota Supreme Court has specifically found that not all of the thirteen factors listed in Rule 23(c)(1) need be considered and that, when considered, some may weigh more heavily in favor of certification, while others may not.[13] It appears at this point, subsection

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11. N.D. R. CIV. P. 23(a)-(c).

12. The class suit is designed to "provides small claimants with a method of obtaining redress for claims which would otherwise be too small to warrant individual litigation." Eisen v. Carlisle & Jacquelin, 391 F.2d 555, 560 (2d Cir. 1968).

13. *See generally* Peterson v. Dougherty Dawkins, Inc., 1998 ND 159, 583 N.W.2d 626.

M is of little consequence in determining whether a class will be certified in North Dakota.

III. THE ISSUE OF COMMANALITY

In the realm of oil and gas royalty owners' class actions, a consistently uniform initial defense is lack of commonality. In the majority of cases, the issue is glossed over and has seldom served to defeat an oil and gas royalty class certification motion. Primarily this is true because lessees, while complaining in the suit of the necessity of reviewing each lease for specific contract language, do not themselves pay according to the language of each lease. Virtually without exception, regardless of whether the lease provides royalty calculation via "market value," "gross proceeds," "net proceeds," or any of several other possibilities, historically the accounting method in which royalty is calculated is identical. Therefore, the majority of courts, looking at the defendant's conduct, find that commonality is not defeated by differing lease language. For example, in *Farrar v. Mobil Oil Corporation*,[14] the appellate court stated the result this way:

> Under the facts of this case, where a purported class action claims improper deductions in calculating royalties under oil and gas leases, there is no need for individualized examination of lease formation or the intent of the parties thereto for purposes of determining predominance of common issues or manageability in certification proceedings where there has been shown a systemic common course of conduct by an oil and gas lessee in calculating royalties payable pursuant to leases to explore and develop . . . minerals.[15]

However, there is a growing minority of courts which are scrutinizing this issue more carefully. In 2012, Stephen P. Friot,[16] United States District Judge for the Western District of Oklahoma, refused to certify a class on the basis of lack of commonality. Judge Friot explained:

> Even a single common question will satisfy the commonality requirement. But as the court pointed out in *Dukes*, the commonality language of Rule 23(a) is easy to misread, since [a]ny competently crafted class complaint literally raises common 'questions.' The common contention which the plaintiff seeks to litigate on behalf of the proposed class must be of such a nature

14. 234 P.3d 19 (Kan. Ct. App. 2010).
15. *Id*. at 22.
16. The Honorable Stephen P. Friot is a 2002 George W. Bush appointee.

> that it is capable of classwide resolution—which means that determination of its truth or falsity will resolve an issue that is central to the validity of each one of the claims in one stroke. This is because: What matters to class certification . . . is not the raising of common 'questions'—even in droves—but, rather the capacity of a classwide proceeding to generate common answers apt to drive the resolution of the litigation. Dissimilarities within the proposed class are what have the potential to impede the generation of common answers.[17]

He concluded his analysis by quoting Chief Judge Miles LaGrange:

> The Court finds that the varying terms of the hundreds of leases, relating to matters such as the method for calculating royalty, allowance for post-production charges or fuel use and affiliate sales demonstrate the inability to adjudicate the claims of the named plaintiff and expect the same result to apply to all members of the proposed class. The Court finds plaintiff has failed to identify issues of fact or law that are truly common to all persons included within the class definition, or to demonstrate that, if certification was granted, that this case could proceed as a class and reliably 'generate common answers apt to drive the resolution of the litigation.' [18]

North Dakota has only had two occasions to determine whether certification of a class of oil and gas royalty owners was proper. In the first, *Ritter, Laber and Associates v. Koch Oil, Incorporated*,[19] ("*Ritter* 1") the North Dakota Supreme Court considered an order certifying a class of royalty and leasehold interests owners who complained that Koch Oil, Incorporated had not paid proper royalties. However, the issue was much simpler than most, as the disputed activity was alleged inaccurate measurement of oil by hand gauging over a period of approximately thirteen years. Thus, royalty for the entire class was alleged to be based on a base amount which was too low. The court affirmed the certification order stating:

17. Foster v. Merit Energy Co., 282 F.R.D. 541, 546 (W.D. Okla. 2012) (citations and quotation marks omitted). In his opinion, Friot also provides a good history of the development of the 'marketable product rule' in Oklahoma jurisprudence. *See* Richard A. Nagareda, *Class Certification in the Age of Aggregate Proof*, 84 N.Y.U. L. REV. 97, 132 (2009).

18. *Id*. at 560 (quoting Tucker v. BP Amer. Prod. Co., 278 F.R.D. 646, 654 (W.D. Okla. 2011). *See also* Morrison v. Anadarko Petroleum Corp., 280 F.R.D. 621 (W.D. Okla. 2012).

19. 2000 ND 15, 605 N.W.2d 153.

> We explained . . . that when a question of law refers to standardized conduct by the defendants toward members of a proposed class, a common nucleus of operative facts is typically presented, and the commonality requirement is met. Individual differences in cases concerning treatment or damages do not defeat commonality.

The district court found common questions existed:

> The claims of all the potential class members arise from the same alleged conduct by Koch . . . . There is a single type of transaction: the purchase of North Dakota crude oil at the well by Koch. There is also a single purchaser involved, Koch and a single commodity oil. All North Dakota Koch purchase practices were managed through one office located in Belfield, North Dakota.
>
> Indeed, the representatives, who represent persons and entities owning royalty interests and leasehold interests in wells only in North Dakota, allege Koch took more oil than it paid for in transactions at the well, in which hand-gauging was used to measure the oil purchased. The district court did not abuse its discretion in finding a question of law or fact common to the class.[20]

Here, the North Dakota Supreme Court focused on the behavior of the defendant in determining commonality. However, it is a much clearer choice when the question is one of how much raw product is produced rather than whether the royalty is properly calculated on that product.

In the second case, *Bice v. Petro-Hunt, LLC*[21] ("*Bice 1*"), the issue alleged by the class representatives was based on the allegation that Petro-Hunt is required to "to produce and deliver a marketable product" before any deductions can be made from royalty.[22] First, the Supreme Court noted a policy "to provide an open and receptive attitude toward class actions."[23] Petro-Hunt defended against the certification by raising the issue of differing lease provisions which obviate a "common question of law or fact," or commonality.[24] The proposed class representatives countered with the usual proposition, regardless of the lease, everyone is paid the same mantra.[25] The court sided with the royalty owners recognizing, "Petro-Hunt's

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20. *Id.* ¶¶ 7-9.
21. 2004 ND 113, 681 N.W.2d 74.
22. *Id.* ¶ 2.
23. *Id.*
24. *Id.*
25. *Id.*

standardized conduct toward the royalty owners presents a common nucleus of operative facts meeting the commonality requirement . . . ."[26] This issue on the merits of whether North Dakota will adopt the Texas or the Oklahoma position on the first marketable product rule was not addressed in *Bice 1*. Thus, North Dakota has gone the way of the majority position on this issue of commonality.

IV. THE FIRST MARKETABLE PRODUCT RULE

The issue, which is one of the most polarized between Texas and Oklahoma jurisprudence and which relates to the calculation of royalty, is the "first marketable product rule." It is also the rule which provides a solid basis for royalty disputes in jurisdictions where the rule is recognized. It generally proves to be a class action non-starter for plaintiffs in those jurisdictions which do not recognize the rule.

Oil and gas leases do not commonly contain many explicit covenants. However, courts have found various implied covenants exist *vis-a-vis* the relationship of the lessor and lessee. One of these implied covenants is the "duty to market."[27] This implied duty to market includes the duty to market at an appropriate price. It has been explained that the "lessee under oil and gas leases . . . has an implied duty and obligation in the exercise of reasonable diligence, as a prudent operator, with due regard for the interest of both lessor and lessee, to obtain a market for the gas . . . at the prevailing market price therefor."[28]

Because a royalty interest is a non-cost bearing interest, an important question raised in relationship to this implied covenant is when can a producer begin to deduct post-production costs associated with the production of oil and/or gas? As a result, the "first-marketable product rule" developed in some jurisdictions. In Texas, the question is first answered by legal definition that oil and gas is "produced" upon severance from the land, or at the wellhead.[29] The ultimate question of what constitutes a "post-production" expense, which is then legally chargeable to the royalty, is explained by the court in *Martin v. Glass*:

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26. *Id*.

27. Cook v. Tompkins, 713 S.W.2d 417, 421 (Tex. App. 1986) (citing 5 WILLIAMS & MEYERS, OIL AND GAS LAW §§ 853, 855).

28. Craig v. Champlin Petroleum Co., 300 F. Supp. 119, 125 (W.D. Okla. 1969) (citing Gazin v. Pan Am. Petroleum Corp., 367 P.2d 1010 (Okla. 1961)); *see generally* Harding v. Cameron, 220 F. Supp. 466 (D. Okla. 1963); Townsend v. Creekmore-Rooney Co., 358 P.2d 1103 (Okla. 1960); Gilmore v. Superior Oil Co., 388 P.2d 602 (Kan. 1964)).

29. Martin v. Glass, 571 F. Supp. 1406, 1415 (N.D. Tex. 1983) (citing Lone Star Gas Co. v. Murchison, 353 S.W.2d 870 (Tex. App. 1962)).

> It is well recognized and acknowledged that the working interest operator has a duty to market the product once production has been achieved. This is true when the royalty is payable in money (as opposed to in kind) because the royalty owner is so dependent upon the lessee in order to realize his royalty return. However, the duty to market is a separate and independent step, once or more removed from production, and as such is a post-production expense, and the lessee is entitled to a pro rata reimbursement.[30]

In Texas, a producer may deduct any costs associated with putting a product into marketable form. "Whatever costs are incurred after production of the gas or minerals are normally proportionately borne by both the operator and the royalty interest owners . . . [including] taxes, treatment costs to render the gas marketable, compression costs to make it deliverable into a purchaser's pipeline, and transportation costs."[31] When there is no market at the well, the value of production for the determination of royalties is accomplished either through the comparable sales method or the net-back method.[32] In *Heritage Resources v. Nationsbank*, the court explained:

> There are two methods to determine market value at the well. The most desirable method is to use comparable sales. A comparable sale is one that is comparable in time, quality, quantity, and availability of marketing outlets. Courts use the second method when information about comparable sales is not readily available. This method involves subtracting reasonable post-production marketing costs from the market value at the point of sale. Post-production marketing costs include transporting the gas to the market and processing the gas to make it marketable. With either method, the plaintiff has the burden to prove market value at the well.[33]

There are other causes of action which a Texas plaintiff might bring in a class action, such as reasonableness of deductions and perhaps affiliate transaction issues. However, without the "first marketable product rule" and with the limit set on attorneys' fees, class actions are less attractive to plaintiffs' attorneys and are less likely to be brought in Texas. On the other hand, Oklahoma still provides fertile ground for class action plaintiffs. Prior to determining what position Oklahoma would take on the first

30. 571 F. Supp. 1406, 1415, (N.D. Tex. 1983) (citations and quotation marks omitted).
31. Occidental Permian LTD v. French, 391 S.W.3d 215, 223 (Tex. App. 2012).
32. *Id.* at 220.
33. 939 S.W.2d 118, 122 (Tex. 1996) (internal citations omitted).

marketable product rule, the Oklahoma Supreme Court addressed a similar, but more limited question concerning deductions of costs from the royalty portion of production. In 1970, in *Johnson v. Jernigan*,[34] the court took up the limited question of when transportation costs may be deducted. In *Johnson*, the lease provision at question was as follows, "[t]o pay lessor for gas from each well for gas only as found, the equal one eight [sic] (1/8) of the gross proceeds at the prevailing market rate for all gas sold off the premises."[35] The court first recognized where the "market rate" is to be determined, "[it is the market rate at the wellhead or in the field that determines the sale price, and not the market rate at the purchaser's location which may be some distance away from the lease premises."[36] The common problem is that any sale may actually take place miles away, here ten miles.[37] Thus, the issue becomes whether the lessor may deduct a proportionate share of the transportation costs to transport gas away from the lease to the place of sale.

The court in *Johnson* reasoned that while a lessee must reasonably develop a commodity to bring the best possible price, that duty does not include the expense of providing off lease pipelines.[38] The court then stated:

> '[G]gross proceeds' has reference to the value of the gas on the lease property without deducting any of the expenses involved in developing and marketing the dry gas to this point of delivery. When the lessee has made the gas available for market then his sole financial obligation ceases, and any further expenses beyond the lease property must be borne proportionately by the lessor and lessee.[39]

Finally, the Oklahoma Supreme Court concluded that a lessee's duty to market ceases once the gas is available for market, after which any expenses incurred off the lease may be charged proportionately to the lessor.[40]

The Oklahoma Supreme Court later addressed the larger question of marketability and whether a royalty owner can be charged with a proportionate share of the costs required to compress the gas to a sufficient

34. 475 P.2d 396 (Okla. 1970).
35. *Johnson*, 475 P.2d at 396.
36. *Id*. at 398 (citing Katschor v. Eason Oil Co., 63 P.2d 977 (Okla. 1936); Cimarron Utils. Co. v. Safranko, 101 P.2d 258 (Okla. 1940)).
37. *Id*. at 397-98.
38. *Id*. at 399.
39. *Id.*
40. *Id*.

pressure in order that the gas enter a purchaser's lines as a certified question in the federal diversity action *Wood v. TXO Production Corporation*.[41] In *Wood*, the court recognized that Texas and Louisiana have taken a different approach to analyzing the lessee's implied duty to market resulting in what constitute "post production" costs.[42] The Oklahoma Supreme Court then chose to follow the Kansas and Arkansas rule. The court explained:

> We interpret the lessee's duty to market to include the cost of preparing the gas for market. The lessor, who generally owns the minerals, grants an oil and gas lease, retaining a smaller interest, in exchange for the risk-bearing working interest receiving the larger share of proceeds for developing the minerals and bearing the costs thereof. Part of the mineral owner's decision whether to lease or to become a working interest owner is based upon the costs involved. We consider also that working interest owners who share costs under an operating agreement have input into the cost-bearing decisions. The royalty owners have no such input after they have leased. In effect, royalty owners would be sharing the burdens of working interest ownership without the attendant rights.[43]

The court then pronounced that in Oklahoma, "the lessee's duty to market involves obtaining a marketable product."[44]

The decision opened the door for class action lawsuits to be filed, most of which result in settlement, for, while settlement is not probable before an appeal of the class certification order, it is much more likely to happen before trial. Oil companies rarely want to risk putting the issue in front of a jury, who are often more inclined to rule in favor of the local mineral owner. In 1998, the Oklahoma Supreme Court decided *Mittelstaedt v. Santa Fe Minerals*.[45] *Mittelstaedt* provides a thorough history of the development of the rule in Oklahoma and reviews both Kansas' and Colorado's position. In the end, the court provided a rule for when post—production costs may be charged to the royalty.

> In sum, a royalty interest may bear post-production costs of transporting, blending, compression, and dehydration, when the costs are reasonable, when actual royalty revenues increase in proportion to the costs assessed against the royalty interest, when

41. 854 P.2d 880 (Okla. 1992).
42. *Id*. at 882.
43. *Id*. at 882-83.
44. *Id*. at 883.
45. 1998 OK 7, 954 P.2d 1203 (Okla. 1998).

> the costs are associated with transforming an already marketable product into an enhanced product, and when the lessee meets its burden of showing these facts.[46]

However, the ruling actually raises issues beyond the basic question answered. What is a "reasonable" cost and what does "when actual revenue increases in proportion to the cost assessed against the royalty interest" mean? These are questions still open for debate.

V. INTEREST ON LATE PAYMENTS

Another issue in Oklahoma, which does not lead to large damage amounts, but is worth mentioning because it provides a solid legal claim easily proven and has little defense when alleged appropriately, is interest due for paying royalties after the statutory mandated period. The Oklahoma Production Revenue Standards Act ("PRSA")[47] explicitly describes when royalty is due to be paid to lessors and the penalties for failing to comply with the statute. Once a well is completed, an operator has six months to begin to pay royalties.[48] Thereafter, payment has to be made "not later than the last day of the second succeeding month after the end of the month within which such production is sold[,]"[49] essentially within sixty days of production. Should the operator fail to comply with the statute, the resulting penalty is the requirement of paying twelve percent interest, which is calculated from the date of first sale, not from the date the payment is first due.[50] However, an exception is allowed if there is a question of who is the proper party to be paid (i.e., a marketable title issue).[51] The late interest payment rate is then only six percent.[52] The PRSA now specifically provides that interest is to be compounded, but only annually.[53] This provision echoes a previous ruling by the Oklahoma Supreme Court which also determined that interest accrued under the act was to be compounded annually.[54]

As stated earlier, interest on late payments does not result in a huge windfall for a class of royalty owners. However, when the circumstances

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46. *Id.* at 1210.
47. OKLA. STAT. tit. 52 § 570.1 et seq. (2013).
48. OKLA. STAT. tit. 52 § 570.10(B)(1)(a) (2013).
49. OKLA. STAT. tit. 52 § 570.10(B)(1)(b) (2013).
50. OKLA. STAT. tit. 52 § 570.10(D)(1) (2013).
51. *Id.*
52. OKLA. STAT. tit. 52 § 570.10(D)(2) (2013).
53. OKLA. STAT. tit. 52 § 570.10(D)(1).
54. Maxwell v. Samson Res. Co., 848 P.2d 1166, 1171 (Okla. 1993) (the trial court in *Maxwell* had compounded the interest monthly).

exist, it does provide a claim which has no defense, except perhaps a lower rate of interest, and also provides a basis to recover attorney fees.[55] When other claims may be more tenuous and may be based in tort, having a baseline claim which bears attorney fees is always a good starting point for class action plaintiffs.

VI. NORTH DAKOTA ROYALTY OWNER CLASS ACTIONS

The case of *Ritter, Laber and Associates. v. Koch Oil, Incorporated*, is a good example of: (1) how arduous prosecuting a class action can be; (2) how a case can take on a life of its own; and (3) how very long such cases can last. *Ritter* resulted in four appeals, the last of which concluded in 2007 and which actually occurred after a settlement was reached.[56] The original case was filed in 1996.[57] Eleven years passed before the class counsel received a paycheck. However, the story even began before then as the class action emanated from the case of *Koch Oil Company v. Hanson,* a North Dakota tax commission case.[58] The *Ritter* case is not instructive here except as an example of an appeal of a certification order and how tortured these cases are.

On the other hand, *Bice v. Petro-Hunt, LLC*[59] ("*Bice 2*"), the only other oil and gas royalty class action case which has made it through appeal in North Dakota, is exactly on point. *Bice 1*, as discussed earlier, concerned the certification of a royalty owner class action. Petro-Hunt argued that because there were at least two different lease royalty clauses, the trial court had erred in its finding of commonality. The trial court agreed with the plaintiffs' position finding:

> This court is convinced that the precedential effect of this litigation combined with the history of treating all the royalty owners the same would as a practical matter be dispositive of the interests of other members not parties to this action or substantially impair or impede their ability to protect their interests. The present action also seeks declaratory relief and not just money damages. The

55. OKLA. STAT. tit. 52 § 570.14(A) (2013).

56. *Ritter 1*—Ritter, Laber & Assocs. v. Koch Oil, Inc., 2000 ND 15, 605 N.W.2d 153; *Ritter 2*—Ritter, Laber & Assocs. v. Koch Oil, Inc., 2001 ND 56, 623 N.W.2d 424; *Ritter 3*—Ritter, Laber & Assocs. v. Koch Oil, Inc., 2007 ND 163, 740 N.W.2d 67; *Ritter 4*—Ritter, Laber & Assocs. v. Koch Oil, Inc., 2007 ND 163, 740 N.W.2d 67.

57. *Ritter*, ¶ 3, 605 N.W.2d at 155.

58. 536 N.W.2d 702 (N.D. 1995) (North Dakota State Tax Commission appealed from district court judgment that reversed the Commission's 1993 order allowing assessment of additional oil extraction taxes and gross production taxes, penalties, and interest against Koch). *Id.* at 704.

59. 2009 ND 124, 768 N.W.2d 496.

> request for declaratory relief also supports the plaintiffs' argument that adjudication as a practical matter could be dispositive of the interests of non-parties.[60]

The North Dakota Supreme Court agreed with the trial court.[61] A round one win for the plaintiffs. Unfortunately for the class, they did not fare as well four years later in round two. The issue in the second appeal was whether North Dakota will follow Texas or Oklahoma in the application of the first marketable product rule. In *Bice 2*, the trial court granted Petro-Hunt summary judgment and determined that the defendant could properly calculate royalties on the basis of a "work-back" method.[62] The court stated that "[b]ecause the gas here has no discernible market value at the well, the district commercially reasonable processing costs can be deducted before royalties are calculated."[63] The facts in the case showed that the gas at issue was "sour," as it contained hydrogen sulfide and contained other valuable constituents in the gas stream, all of which had to be removed before the sweet gas could be placed into an interstate gas pipeline.[64]

The sour gas was processed off the leases at the Little Knife Gas Plant and sold at the tailgate of the plant.[65] The class argued:

> [t]he lease language "market value at the well" supports an adoption of the first marketable product rule because the casinghead gas produced at the wells is not marketable until after it is processed. Thus, . . . the logical interpretation of the lease language is to pay royalty on the market value of the gas after it has been made marketable.[66]

The evidence in this case showed that Petro-Hunt created a wellhead value for purposes of calculating royalty by "working back" from a point where the gas has an established market value—in this case at the tailgate of the processing plant.[67] "The work-back calculation deducts post-wellhead costs (aggregating, gathering, compressing, treating, dehydrating, processing, and conditioning) from the sales price of the gas, thus arriving

60. Bice v. Petro-Hunt, LLC, 2004 ND 113, ¶ 15, 681 N.W.2d 74, 79. The royalty calculation was also subject to an earlier 1983 royalty agreement with a group of royalty owners.

61. *Id.* at 82.

62. *Bice*, 768 N.W.2d at 499.

63. *Id.*

64. *Id.* at 500.

65. *Id.*

66. *Id.*

67. Brief for Appellant ¶ 32, Bice v. Petro-Hunt, LLC, 2009 ND 124, 768 N.W.2d 496 (No. 20080265).

at a "fictitious" wellhead value."[68] This method, the class argued, was susceptible to abuse because how far upstream Petro-Hunt could go in order to "work-back" was open to interpretation.[69] In their initial brief on appeal, the class proffered:

> When the work-back method is used to deduct costs incurred to obtain marketable gas, the method emasculates the plain meaning of the term "market value" as well as the plain meaning of the terms 'market price,' and 'proceeds.' By Petro-Hunt's witnesses' testimony, the gas is not marketable until it reaches the plant tailgate. Accordingly, Representatives submit that these deductions must stop at the point upstream where a marketable product is first obtained, which in this case, by Petro-Hunt's witnesses' testimony, is at the tailgate of the processing plant. Thus, no deductions are permitted in this particular situation.[70]

The class argued that by applying the plain language of the contract, or in the alternative, by construing the contract against the drafter, market value is what is acquired upon sell and no deductions should be allowed prior to this point.[71]

While acknowledging the "unsettled nature of the law" concerning the issue of "market value at the well," the North Dakota Supreme Court recognized that the majority of jurisdictions take a literal approach to "at the well" meaning "at the wellhead".[72] The Court went on to adopt the majority position. Just as the plaintiffs had argued that how far "upstream" a producer should be able to go before beginning to deduct costs, the North Dakota Supreme Court reasoned that determining when a product has become marketable can be difficult to determine.[73] In the end, the Court adopted the Texas rule and rejected the first marketable product rule.[74] By doing so, the plaintiffs' win of the previous appeal on class certification became a hollow victory.

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68. *Id.*
69. *Id.* ¶ 33.
70. *Id.*
71. *Id.* ¶ 37.
72. *Bice*, ¶ 13, 768 N.W.2d at 500-01.
73. *Id.* ¶ 17, 768 N.W.2d at 502.
74. *Id.* The class also made arguments concerning the appropriateness of certain calculations made by Petro-Hunt. The Supreme Court also agreed with the trial court in granting Petro-Hunt summary judgment on these issues.

VII. INTEREST ON LATE PAYMENT IN NORTH DAKOTA

In determining when interest for paying royalties late is due, the legislature in North Dakota is much more generous to producers as to timely payment than is Oklahoma. In North Dakota, a producer has 150 days after the product is marketed in which to pay their lessees any royalty due.[75] Therefore, a producer may use the lessor's money interest free for 149 days. However, if paid late, the rate of interest is eighteen percent, which is six percent higher than Oklahoma's rate.[76] But, unlike Oklahoma where six percent interest is due on payments withheld because of a title issue, if a North Dakota producer does not pay a royalty because of a question of marketable title, no interest is ever due.

Additionally, North Dakota, like Oklahoma, specifically speaks to the issue of the availability of an award of attorney's fees in a late payment claim.[77] Unfortunately, the statute is not clear on the starting date for the calculation of interest or whether the interest will be compounded. It reads: ". . . the operator thereafter shall pay interest on the unpaid royalties . . . at the rate of eighteen percent per annum until paid."[78] Because of the use of the word "thereafter," the producer will be able to argue that the calculation should only begin to calculate on the 151st day.

In summary, when in North Dakota, a producer has longer to pay but a higher penalty due for late payment. Where does that leave royalty owners? The most likely answer is few claims for interest only will be made, especially in a class setting. Without the larger overall claim of failing to calculate royalties properly, the late interest claim is unlikely to be brought alone. Seldom are class actions driven by a claim of failing to timely pay. When the claim does exist, it is the claim that clearly prevents dismissal on summary judgment and gives class counsel some comfort in knowing they have a claim which is bullet proof. However, it is not a claim which can likely sustain the class action.

VIII. CONCLUSION

Class actions are a tough business—they are very expensive and time consuming. In strong economic times, royalty owners do not go clamoring to bite the hands that feed them. In North Dakota, oil production is at an all-time high. Parties on all sides are reaping huge financial benefits. There

75. N.D. CENT. CODE § 47-16-39.1 (2013).
76. *Id.*
77. *Id.*
78. *Id.*

appears to be little interest in ferreting out on what basis royalty is being determined by producers and whether that basis is being calculated correctly. Without the first marketable product rule, possible class claims in North Dakota are most likely relegated to arguing whether certain marketing decisions and/or cost calculations are reasonable, which is not really a position class action counsel wants to be in. It appears that North Dakota producers need not lose much sleep over concerns of whether their lessors will be filing class actions any time in the near future.