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COMMONWEALTH OF KENTUCKY
SUPREME COURT
Case No. 2013-SC-00497-DG

NOBE BAKER, INDIVIDUALLY AND AS ADMINISTRATOR OF THE ESTATE OF JOANN BAKER, et al. — **APPELLANTS**

v.

ON REVIEW FROM COURT OF APPEALS
NO. 2012-CA-001016
HARLAN CIRCUIT COURT NO. 11-CI-00310

MAGNUM HUNTER PRODUCTION, INC. — **APPELLEE**

BRIEF OF AMICUS CURIAE NATIONAL ASSOCIATION OF ROYALTY OWNERS

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CERTIFICATE OF SERVICE

This is to certify that the original and nine (9) copies of the foregoing Brief (total of ten) on behalf of Amicus Curiae were mailed this the 27th day of August, 2014 to the Clerk, Kentucky Supreme Court, State Capitol, Rm. 235, 700 Capitol Ave, Frankfort, Kentucky 40601 with true and accurate copies to the following parties of record: Hon. James L. Bowling, Jr., Special Judge of the Harlan Circuit Court, Courthouse, Harlan, KY 40831; Anne A. Chestnut, R. Clay Larkin, 300 W. Vine St., Suite 1100, Lexington, KY 40507; Harry D. Callicotte, Senior Corporate Counsel - Land Magnum Hunter Production, Inc., 120 Prosperous Place, Lexington, KY 40509, Counsel for the Appellee; George E. Stigger, 236 Cardinal Circle West, St. Marys, GA 31558 and John C. Whitfield, 19 N Main St., Madisonville, KY 42431, Counsel for the Appellants. on this the 27th day of August, 2014.

COUNSEL FOR AMICUS CURIAE

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I. INTRODUCTION

Scene : A kitchen table in a rural county, somewhere in Kentucky, **Landman** presenting a lease to **Husband** and **Wife**, small land owners with mineral rights:

Husband : Now let me get this right, I am going to get a signing bonus of $ 10 per acre and a royalty of one eighth of all the gas you sell?

Landman: Sir, that is right, and for your 90 acre tract that would amount to $ 900.00 up front. You get to keep that whether we find gas or not. If we find gas, we will pay you royalty as long as gas is taken from the ground.

[**Husband** turns and looks at **Wife**]

Husband : We could put a down payment on that used car for Jimmie's graduation.

Wife: Dear, shouldn't you get a lawyer to look at that?

Husband : Sweetie, any lawyer is gonna charge more than $ 900.00 just to look at this huge stack of papers.

[**Landman** starts to rise impatiently from the kitchen table]

Landman: I'm sorry, but I need to meet with the Smiths next door about their lease.

Husband Sir, I am sorry to keep you, but we'll sign this paperwork right now.

This scene is occuring, more or less, across kitchen tables, coffee shops, and diners from Owenton to Cawood. This is a consequence of the modern technology that allows the efficient and safe extraction of oil and gas from shale deposits within Kentucky. What was once confined to a small part of the state near the Applachian mountains has now become a "boom" across the entire state. While the press has largely focused on the potential of the Marcellus Shale, the Devonian Shale is also a potentially large resource that covers approximately two-thirds of Kentucky. See *Analysis of the Devonian Black Shale in Kentucky for Potential Carbon Dioxide Sequestration and Enhanced Natural Gas Production* (U.S. DOE/NETL DE-FC26-02NT41442) located at http://www.netl.doe.gov/publications/proceedings/03/carbon-seq/pdfs/155.pdf. Thus the impact of energy extraction may be felt by most of the 85,500 farms and most of the landowners in this State. The Kentucky Farm Bureau's *Kentucky Agricultural Facts* states: "Kentucky agriculture is dominated by small family farms. Over 60 percent of its farms (about 54,700) have annual sales of less than $10,000." See https:// www.kyfb.com/media/files/fed/ home-page /2013 / CommodityBooklet.pdf, page 3.

From the 1980's to the early 1990's natural gas changed from a regulated industry to a largely unregulated industry. The court of appeals in Colorado has documented this transformation in sustaing a verdict in favor of a royalty owner who complained of improper deductions. See *Clough v. Williams Production RMT Company*, 179 P.3d 32, 36 (Colo.App. 2007). In *Clough*, the Court noted two key events, in 1985 and in 1992, which have affected how natural gas is sold and distributed:

> Thus, in 1985, the Federal Energy Regulatory Commission (FERC) promulgated Order No. 436, which contained an "open access" rule providing incentives for pipelines to offer gas transportation services. See Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, 50 Fed.Reg. 42408 (Oct. 18, 1985)

(codified at 18 C.F.R. pts. 2, 157, 250, 284, 375 & 381); Gen. Motors Corp. v. Tracy, supra.

In 1992, this evolution culminated in FERC's Order No. 636, which required all interstate pipelines to "unbundle" transportation services from their own natural gas sales and to provide common carriage services to buyers from other sources that wished to ship gas. See Pipeline Service Obligations, supra; Gen. Motors Corp. v. Tracy, supra. This implementing regulation dramatically changed the natural gas industry, because pipeline companies were "no longer permitted . . . to act as traditional merchants— buying gas at the wellhead and reselling the gas downstream — producers had to now market the gas themselves." Joyce Colson, Upstream, Midstream, Downstream — The Valuation of Royalties on Federal Oil and Gas Leases, 70 U. Colo. L.Rev. 563, 593 (Spring 1999); see Indep. Petroleum Ass'n v. DeWitt, 279 F.3d 1036 (D.C.Cir.2002) (noting the industry change); Office of Util. Consumer Counselor v. Bd. of Dirs., 678 N.E.2d 1127 (Ind.Ct.App.1997)(same); In re ANR Pipeline Co., 276 Kan. 702, 79 P.3d 751 (2003) (same); Colo. Interstate Gas Co. v. Wyo. Dep't of Revenue, 20 P.3d 528 (Wyo. 2001)(same).

While the technology for gas extraction has modernized, along with the distribution and processing of gas for market, the form of lease and the negotiation process with mineral owners has remained stagnant and has not modernized.

Key terms that involve the payment for oil and gas to the landowner are left to interpretation by "case law," not by the understanding of the two parties involved in the contract. Contracts that are interpreted by "case law" require consulting an experienced oil and gas lawyer. Further, the landowner that tries to drive a "hard bargain" with the energy company is at risk of having his neighbor lease and lose his gas under the "Rule of Capture". See generally *Texas American Energy Corp. v. Citizens Fidelity Bank & Trust Co.*, 736 S.W.2d 25, (Ky. 1987).

The primary issue for Amicus NARO, is that the average landowner is typically not an active participant in the oil and gas Industry. Key "industry terms" have little or no meaning to the average Kentucky land owner. Therefore, the oil and gas contracts should be unambiguous

when it comes to describing every cost that will be deducted in the processing and distribution of gas.

As such, it is the responsibility of the Lessee and the Oil and Gas industry to either explain those terms to the farm or land owner, or be subject to the doctrine of *Contra Proferentum. "Contra Preferendum" or "*Contra Proferentem" is defined by Black's Law Dictionary (9th ed. 2009) as "[t]he doctrine that in interpreting documents, ambiguities are to be construed unfavorably to the drafter." This doctrine is alive and well in Kentucky: "no rule is better established than … when a contract is susceptible of two meanings, it will be construed strongest against the party who drafted and prepared it." (Citations omitted.) *Glenmary Land Co. v. Stewart,* 290 S.W. 503, 504 (Ky. 1927)

II. ARGUMENT

A. The Lessee should describe with sufficient detail the meaning of key industry terms when it negotiates with a Lessor (e.g. Landowner of Farm Owner) that is unaware of the interpretation of these key industry terms.

The parties do not dispute that this contract is a lease of oil and gas rights from individual land owners to a company that specializes in the extraction of oil and gas. The process for obtaining an oil and gas lease involves a landman working on behalf of an oil company. *Chisholm v. Western Reserves Oil Co.*, 655 F.2d 94 .6th (Tenn. 1981). The landman then presents that lease to the landowner. While the degree of sophistication of the landowner varies, it is safe to say that an owner making less than $10,000 does not have an oil and gas attorney on retainer.

So on one side of the bargain, there is a lease that is prepared by counsel and on the other side of the bargain is a *pro-se* property owner. What is dangled before the landowner is a signing bonus and a "royalty" of 1/8th of "market price at the well for gas." The landman knows that "market price at the well for gas" is a figure that will include post processing deductions, but in the best case the landowner only knows that the market price of natural gas is what is listed in the business section of the Louisville Courier Journal, Lexington Herald-Leader, or the Wall Street Journal (see http://markets.wsj.com/us?mod=WSJ_hpp_marketdata listing natural gas at $4.00 per MCF on 08/26/2014.)

This Court has observed that contractual language requires reference not only to the language at issue, but, also the parties understanding of the key terms. *Beech Creek Coal Co. v. Jones*, 262 S.W.2d 174 (Ky., 1953.) As stated by this Court:

> 'To establish a custom it is not enough to prove the act is frequently done; it must be both alleged and proven to be certain, general, uniform, and recognized. Where it is so alleged and proven, it is a fair presumption that the parties, on entering into their engagement, do it with reference to the custom, and agree that their rights and responsibilities shall be determined by it. A practice to arise to the dignity of a custom so as to enter into and form a part of a contract must possess those elements of certainty, generality, fixedness, and uniformity, as are recognized by the law as essential to constitute a custom. A loose, variable custom or discretionary practice does not arise to the dignity of a custom so as to control the rights of the parties to a contract. If the usage leaves some material element to the right of exercising an option, or discretion, of one of the parties, it does not constitute a custom.'
>
> Ordinarily, the question presented by such conflict in the testimony of witnesses is addressed to a properly instructed jury but, here, we do not feel that the record contains proof of a quality sufficient to require such a submission. *Id.* at 177.

Custom, usage and interpretation problems within the oil and gas industry are not unique to the state of Kentucky. As in this case, the California Court of Appeals reveresed finding that certain contractual language in an oil services agreement could be considered "unambiguous."

Hayter Trucking, Inc. v. Shell Western E&P, Inc., 18 Cal.App.4th 1, 13-14 (1993). In the *Hayter Trucking* transaction, the two parties were sophisticated companies – a large oil company and a firm that serviced oil wells.

In the sister state of West Virginia, a similar problem arose with contract interpretation of a hydrocarbon lease. At issue is whether "coalbed methane" was a "coal" or a "gas". *Energy Development Corp. v. Moss*, 591 S.E.2d 135, 143 (W.Va., 2003). The Court in West Virginia recognized that latent ambiguities exist in contracts by stating:

> We also agree with the lower court that a document that may appear on its face to be free from ambiguity, may be deemed latently ambiguous. "A latent ambiguity, which does not appear upon the face of the document, however, may be created by intrinsic facts or extraneous evidence." Kopf v. Lacey, 208 W.Va. 302, 307, 540 S.E.2d 170, 175 (2000) (per curiam) (citing Black's Law Dictionary 794 (5th ed. 1979)). See also, Snider v. Robinett, 78 W.Va. 88, 88 S.E. 599 (1916) ("[when] evidence discloses a latent ambiguity, such, for instance as that there are two objects, to either of which the terms of the writing apply with equal fitness, then prior and contemporaneous transactions and collocutions of the parties are admissible for the purpose of identifying the particular object intended."); Farmers and Merchants Bank v. Farmers and Merchants Bank, 158 W.Va. 1012, 1017, 216 S.E.2d 769, 772 (1975) ("A latent ambiguity is one that is not apparent upon the face of the instrument alone and that is discovered when it is sought to identify the property, the beneficiaries, etc."); Collins v. Treat, 108 W.Va. 443, 446, 152 S.E. 205, 206 (1930) ("A latent ambiguity arises when the instrument upon its face appears to be clear and unambiguous, but there is some collateral matter which makes the meaning uncertain."). *Id.* at 143-144.

At issue in this case is the interpretation of this key industry term:: "market price at the well for gas."

Appellee and the Amici in the Court of Appeals, the Kentucky Oil and Gas Association (KOGA), presuppose that the only definition is to be derived from the "custom in the industry." But that understanding, as illustrated in *Hayter Trucking* and *Moss*, demonstrate that even counter-parties in the industry can ascribe different meanings to terms used by both parties.

B. <u>The Doctrine of Contra Proferentem should apply when the Lessor is not an member of the oil and gas industry.</u>

If an ambiguity exists, "the court will gather, if possible, the intention of the parties from the contract as a whole, and in doing so will consider the subject matter of the contract, the situation of the parties and the conditions under which the contract was written," by evaluating extrinsic evidence as to the parties' intentions. *Frear v. P.T.A. Indus., Inc.*, 103 S.W.3d 99, 106 (Ky. 2003) (quoting *Whitlow v Whitlow*, 267 S.W.2d 739,740 (Ky. 1954)).

In the context of oil and gas agreements, the problem of ambiguity in agreements is an old one. In 1912, the Pennsylvania Supreme Court resolved an issue regarding the language, "...to place, erect, and maintain upon said tract of land such pipes, tanks, and machinery as may be necessary.." *Collison v. Philadelphia Co.*,, 82 A. 474 (Pa., 1912). The *Collison* court found the agreement to be binding, but required extrinsic evidence to determine the intent of the parties at that time the contract was entered into.

The situation in this case is best analogized to the situation between an insurance company and their insured. If there is an ambiguity in the contract, it is construed against the insurer. The reason for this policy was elegantly stated in *Rice Oil Co. v. Atlas Assur. Co.*, 102 F.2d 561 (9th Cir., 1939):

> ...It is a matter of common knowledge that insurance companies prepare their own contracts of insurance. The language of the policy is their language. They do not permit the insured to have a voice in the drawing of his own contract; nor does he negotiate with reference to its terms in the sense that negotiations are carried on before agreements are reached in ordinary contracts. Joyce on Insurance, p. 594. Policies of insurance are invariably complex and are understood by laymen with difficulty, and as a result the insured generally makes a request for the kind of insurance he desires and then signs `on the dotted line' upon a formidable appearing printed form with the provisions of which the average assured has

> slight, if any, acquaintance. *Id* at 571 quoting *Montana Auto Finance Corp. v. British & Fed. Fire Underwriters, 72* Mont. 69, 232 P. 198, at page 200.

For the reasons so elegantly stated above, in cases of ambiguity the Kentucky courts, for almost a century, have construed oil and gas leases strongest against the lessee and in favor of the landowner. *Kies v. Williams,* 228 S.W. 40. 41-42 (Ky. 1921).

Here, like signing an insurance contract, the landman shows up with a thick stack of pre-printed leases and presents them to the landowner. The landowner typically has two points of concern: "How much will I get" and "When will I get it?" If there is any "haggling" it is with reference to the amount of the lease bonus. The average Kentucky landowner does not have the sophistication to request amendments to limit the deductions taken from the posted market price for natural gas.

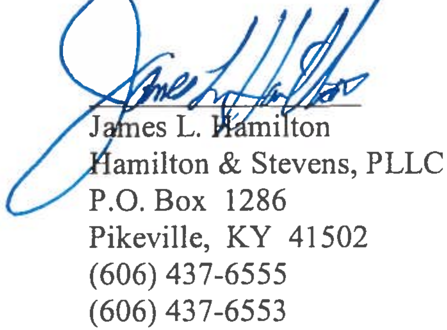
III. CONCLUSION

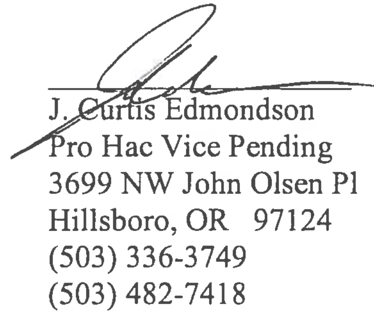
NARO is not proposing the drastic equtable remedy, whereby the parties to the oil and gas lease had such a complete misunderstanding of terms that the leases should be shredded and renegotiated. Rather, NARO, believes that the understanding of the key term, "market price of gas at the well," is a legal and evidentiary question in light of the landowner's understanding of the terms. In some cases the trial court may find the landowner is a member of the industry (e.g. a property manager employed by a private bank). In other cases, the trial court may discover that the landowner understood "market price of gas at the well" to mean, in the mind of the landowner, the market listed price for natural gas is at the Wall Street Journal.

NARO respectfully requests that this Court issue an opinion that will clarify how oil and gas lease contracts should be interpreted from the legal and evidentiary standpoint when one party is a landman and/or oil company and the other party is an unsophisticated land owner.

In the context of this instant case, vacating the judgment and remanding is necessary to develop a factual record as to the landowners understanding of these key terms.

Respectfully Submitted:





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