

**Emerging Case Law Interpreting Pennsylvania's  
Minimum Royalty Act:  
58 PA. STAT. § 33**

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Throughout 2007 and into 2008, the market for natural gas leases in the Marcellus Shale region of Pennsylvania experienced a dramatic price increase. Since that time the market has decreased, and has settled at a higher rate than before 2007, yet lower than the 2008 peak. Prior to the increase, owners of natural gas rights were leasing their estates to land and gas companies for around \$25 per acre and even less. Following the increase, owners of natural gas rights in some parts of Pennsylvania were able to sign lease agreements paying over \$2,500 per acre. With this disparity, some Pennsylvania landowners have tried to invalidate or reform leases signed prior to the market increase. By doing so, most of these landowners hope to receive higher lease rates than they originally received.

One legal theory asserted by landowners to invalidate or otherwise reform these lease agreements has been through the interpretation of Pennsylvania's Minimum Royalty Act. Since March 2008, state and federal courts located in Pennsylvania have seen a number of suits involving the interpretation of minimum royalty provisions within natural gas leases. Several cases that are similar in theory yet different in specific facts and procedural stance have arisen. This article provides a brief description of the developing case law on this issue. As of this time,

Pennsylvania law remains unclear on the interpretation of the state minimum royalty provision. Both state and federal courts within the Commonwealth await a ruling by the Pennsylvania Supreme Court in the pending case of *Kilmer v. Elexco* that should clarify the statutory language.

Pennsylvania's Minimum Royalty Act, 58 PA. STAT. § 33, provides that a lease to remove natural gas "shall not be valid if such lease does not guarantee the lessor at least one-eighth royalty" of all natural gas removed from the property. The term "royalty" is not specifically defined within the provision.

The major legal issue involved in these cases generally revolves around the apportionment of what are known as "post-production" costs. The minimum royalty provision requires the landowner to be paid at least a one-eighth royalty of the gas removed, but it does not specify at which point in the production and marketing process that royalty is to be assessed. Parties involved with the industry, such as natural gas and energy companies, claim that this provision only prevents reducing the landowner's royalty for anything involved in the production of gas - the removal of it from the property. Therefore, gas companies typically argue that reducing the amount paid to landowners for a share of the post-production costs is not restricted by the provision. Conversely, the common stance of landowners is that the royalty provision protects them from being charged for any process involved in removing the gas and delivering it to a market. Landowners argue that allowing for any reductions means that there is potential for them to receive less than a one-eighth royalty. Therefore, the lease does not meet the statutory requirement of guaranteeing a one-eighth royalty.

**Kilmer v. Elexco Land Services, Inc.**, No. 2008-57 (Susquehanna Ct. Com. Pl.)

On March 3, 2009, Judge Vanston of the Susquehanna County Court of Common Pleas issued an order in favor of the defendant in *Kilmer v. Elexco Land Services, Inc.* No. 2008-57 (Susquehanna Ct. Com. Pl.), *appeal docketed* 464 MDA 2009 (Pa. Super. Ct. Mar. 10, 2009), *allocatur granted* 46 MM 2009 (Pa. June 16, 2009), *appeal docketed* 63 MAP 2009 (Pa. June 16,

2009). On March 16, after receiving notice that the plaintiff intended to appeal the decision, Judge Vanston issued an opinion stating that Pennsylvania's minimum royalty provision, 58 PA. STAT. § 33, did not "preclude parties from contracting that 'post-production' costs be factored into the determination of the amount of royalty payable under an oil or gas lease." The defendant, alleging that the leases were in fact valid under Pennsylvania law, was granted its motion for summary judgment.

At issue in *Kilmer* was a lease which initially provided lessors with a one-eighth royalty of the sales received by the lessee, less the same percentage share of all post-production costs, as well as production, severance and ad valorem taxes. The lease defined "post-production" costs as (i) all losses of produced volumes, and (ii) "all costs actually incurred by the lessee from and after the wellhead to the point of sale, including, without limitation, all gathering, dehydration, compression, treatment, processing, marketing, and transportation costs incurred in connection with the sale of such production." The plaintiff-lessors sought a declaratory judgment that the subtraction of post-production costs reduced their royalty to less than the one-eighth required by Pennsylvania's minimum royalty provision. Judge Vanston specifically noted that both parties agreed that "production" costs, those costs incurred to remove the gas from the ground, cannot reduce the royalty. Relating to "post-production" costs, Judge Vanston found that the minimum royalty provision did not prohibit the inclusion of "post-production" costs to calculate the one-eighth royalty. The court opined that the parties are free to negotiate how the royalty is to be calculated, so long as the net result is not less than one-eighth. Accordingly, Judge Vanston found that the parties negotiated for the distribution of the listed post-production costs, and refused to invalidate the lease agreement.

**Kilmer v. Elexco Land Services, Inc.**, No. 63 MAP 2009, *allocatur granted* 46 MM 2009 (Pa. June 16, 2009)

On March 10, 2009, plaintiff-appellant Herbert Kilmer filed a notice to appeal the decision of the Susquehanna County Court of Common Pleas in *Kilmer v. Elexco Land Services, Inc.* Following the filing of the notice of appeal, defendant-appellee Elexco Land Services requested that the Supreme Court of Pennsylvania exercise extraordinary jurisdiction, effectively bypassing the Superior Court. On June 16, 2009, the Pennsylvania Supreme Court granted a Petition for Exercise of Extraordinary Jurisdiction regarding the Court of Common Pleas of Susquehanna County decision in *Kilmer v. Elexco Land Services, Inc.* The parties to the Supreme Court case were directed to brief the issue: “Whether 58 P.S. § 33 precludes parties from contracting that post-production costs be factored into the determination of the amount of royalty payable under an oil or natural gas lease.” Argument is scheduled for September 16, 2009, in Pittsburgh. It is likely that the Supreme Court opinion will clarify Pennsylvania’s minimum royalty provision and help to resolve the dozens of pending suits on this issue.

**Kropa v. Cabot Oil & Gas Corporation**, No. 3:08-cv-00551 (M.D. Pa. filed Mar. 25, 2008)

On April 17, 2009, Judge Munley of the United States District Court for the Middle District of Pennsylvania denied a motion to dismiss the case of *Kropa v. Cabot Oil & Gas Corporation*, 609 F. Supp. 2d 372 (M.D. Pa. 2009). Plaintiff-lessor John Kropa signed a lease with Cabot Oil in 2006 at the rate of \$25 per acre for all 51 acres that he owned. At the time of the signing, a representative for Cabot Oil informed Kropa that he would never receive more than \$25 per acre. Kropa originally filed suit against Cabot Oil in Susquehanna County Court of Common Pleas in 2008, after the natural gas market increase raised the rates of leases being offered. In turn, Cabot Oil removed the case to federal court and filed a motion to dismiss. Kropa’s lease with Cabot Oil provided for a royalty of one-eighth of the amount realized from the sale of gas at the well, defined as the “amount realized less all costs of gathering,

transportation, compression, fuel, line loss and other post-production expenses” incurred after removal. Kropa argued that since the lease subtracted expenses from the amount realized it did not comply with Pennsylvania law which requires a lease to guarantee at least a one-eighth royalty. Cabot Oil’s counter-argument was that the royalty provision of the lease was the industry standard and complied with Pennsylvania law.

In his analysis, Judge Munley noted that Pennsylvania law requires words and phrases to be construed according to their common and approved usage; however, if technical words or phrases have acquired a peculiar meaning or are further defined, the term will be construed according to that peculiar meaning or definition. 1 PA. CONS. STAT. § 1903(a). The Court found that the lease actually did provide for a one-eighth royalty as realized at the well, but Cabot Oil deducted certain costs that were incurred after the gas left the well. These deductions caused the amount paid to the lessor to become less than one-eighth. Therefore, Judge Munley opined that if he were to view the statute under the plain meaning of the terms, the deductions would violate Pennsylvania’s minimum royalty provision.

Defendant Cabot Oil argued that industry standard from across the country’s gas producing states indicated that Kropa was in fact receiving a full one-eighth royalty. Cabot Oil alleged that the term royalty, within the oil and gas industry, has acquired a technical meaning and should be construed in that way. Under Cabot’s definition, the term royalty means the proceeds from gas sales after all production costs are paid by the gas company, and that the apportionment of post-production costs can be negotiated by the parties in the lease agreement. Plaintiff Kropa argued to the contrary, alleging that there is no nationwide agreement on the industry’s definition of royalty and that different states approach the term differently. The first approach forces non-operating interests such as landowners to bear their proportionate share of costs incurred after gas is severed at the wellhead. The second approach requires the lessee to get the gas to the place of sale in marketable form. After assessing the facts, circumstances, and arguments, Judge Munley found that it would be premature to dismiss the case as neither the

defendant nor the plaintiff had established that the term should be construed in their favor. Accordingly, the motion to dismiss was denied.

Within a footnote in his opinion, Judge Munley expressed his disagreement with the analysis of Judge Vanston in the *Kilmer* lower court opinion, described above. In contrast with Judge Vanston, Judge Munley opined, “The issue presented is whether the mandatory one-eighth royalty is achieved if post-production costs are deducted before payment. To make such a determination, it is necessary to construe the term ‘royalty’ as used in the statute. We are not convinced that merely because the statute is silent on whether post-production costs can be deducted means that such costs can in fact be legally deducted from the royalty.”

**Belcher v. The Keeton Group**, No. 3:09-cv-506 (M.D. Pa. filed Mar. 18, 2009)

On May 8, 2009, Judge Munley of the United States District Court for the Middle District of Pennsylvania declined to exercise jurisdiction in *Belcher v. The Keeton Group*, No. 3:09-cv-506 (M.D. Pa. May 8, 2009). Unlike other similar cases that were removed from state to federal court, *Belcher* was filed directly in district court. Several motions followed the filing, and a motion to stay the proceedings was filed by the defendant on April 10, 2009. In this case, plaintiff-landowners sought a declaratory judgment that the leases in which they entered with Defendant Keeton Group, LLC, were invalid as a matter of Pennsylvania law. The royalty provisions of the leases called for the lessors to be paid one-eighth of the “revenue realized” by the lessee for all gas produced and marketed. The lease defined “revenue realized” as the price the lessee received for all gas removed, less “any charges for transportation, dehydration, compression, and marketing paid by Lessee” to deliver the gas for sale. Plaintiffs contended that such reductions from the one-eighth violated the minimum royalty provision of Pennsylvania law.

Instead of ruling on The Keeton Group’s motion to stay, Judge Munley addressed the propriety of ruling on the case. Judge Munley opined that under rules of civil procedure, the

district court possessed the authority to hear the case pursuant to diversity jurisdiction. Upon continuing his analysis, however, Judge Munley stated that a federal court should decline to exercise discretionary jurisdiction when doing so would promote judicial efficiency. The plaintiffs in the case were asking the court to resolve a question of state law that has not been settled and lacks case law directly on point for the question raised. Finding that the interpretation of Pennsylvania's minimum royalty provision was more of a state interest than a federal one, Judge Munley declined to exercise his discretionary authority and dismissed the plaintiffs' complaint.

**Stone v. Elexco Land Services, Inc.**, No. 3:09-cv-264 (M.D. Pa. filed Jan. 8, 2009)

On June 1, 2009, Judge Munley of the United States District Court for the Middle District of Pennsylvania denied a motion to dismiss the case of *Stone v. Elexco Land Services, Inc.*, No. 3:09-cv-264, 2009 WL 1515251 (M.D. Pa. June 1, 2009). The original complaint was filed in the Court of Common Pleas of Susquehanna County, but was subsequently removed by the defendants to the district court pursuant to diversity jurisdiction. Plaintiff's complaint alleged that a lease agreement between the two parties did not comply with Pennsylvania law as it deducted certain post-production costs from the royalty payment, reducing it to less than one-eighth. The lease provided the lessor a one-eighth royalty, less the same percentage share of all post production costs, and the same percentage of all production, severance and ad valorem taxes. The defendants filed a motion to dismiss for failure to state a claim upon which relief could be granted.

Defendants argued that the term "royalty" meant the proceeds from the sale of the gas after all the costs of production had been paid by the gas company. Further, the defendants argued that the industry considered the distribution of post-production costs as separate and determined by other provisions of the lease. Plaintiff Stone argued to the contrary and alleged that not all jurisdictions followed this interpretation. Stone argued that jurisdictions generally

followed one of the two approaches described in the *Kropa* case, but that there was no clear consensus. Judge Munley’s discussion of the case resembled his analysis in the *Kropa v. Cabot Oil & Gas Corporation* decision. Finding no clear standard, Judge Munley denied defendant’s motion to dismiss as two separate schools of thought exist. The Court opined that in order to make a final determination it had to examine documents outside of the pleadings, and denied the motion.

**Price v. Elexco Land Services, Inc.**, No. 3:09-cv-433 (M.D. Pa. filed Mar. 9, 2009)

On July 9, 2009, Judge Munley of the United States District Court for the Middle District of Pennsylvania denied a motion to dismiss the case of *Price v. Elexco Land Services, Inc.*, No. 3:09-cv-433, 2009 WL 2045135 (M.D. Pa. July 9, 2009). The complaint was originally filed in the Susquehanna County Court of Common Pleas, but was removed to district court by the defendants pursuant to diversity jurisdiction. The lease between the two parties provided Price with one-eighth of the proceeds of the gas produced received by the gas company, less one-eighth of all post-production costs and applicable taxes. Among other claims, Price argued that the reduction of post-production costs from the royalty payments was a violation of Pennsylvania’s minimum royalty provision. Elexco argued that such reductions had become the industry standard, and therefore, provide everything required by state law.

Judge Munley’s analysis of the case was similar to his analyses in other decisions. The Court acknowledged the plaintiff’s argument that a plain reading of the lease would not comply with Pennsylvania law requiring a one-eighth royalty to be guaranteed. Judge Munley also acknowledged the defendant’s claim that the term “royalty” had acquired an industry-specific, technical definition. After his analysis, Judge Munley denied the motion to dismiss the case as filed by Elexco, opining that it would be premature to do so as both parties failed to prove that the term “royalty” should be construed in their favor.

**Kovach v. Elexco Land Services, Inc.**, No. 3:09-cv-186 (M.D. Pa. filed Jan. 29, 2009)

On April 8, 2009, Judge Conaboy of the United States District Court for the Middle District of Pennsylvania issued a motion to stay the case of *Kovach v. Elexco Land Services, Inc.* The Court issued the motion in response to the filing of the notice of appeal in *Kilmer v. Elexco Land Services, Inc.* The case is stayed pending the Pennsylvania Supreme Court's decision in *Kilmer*, and its application to the *Kovach* case.

**Humber v. Elexco Land Services, Inc.**, No. 3:08-cv-2016 (M.D. Pa. filed Nov. 6, 2008)

On April 20, 2009, Judge Kosik of the United States District Court for the Middle District of Pennsylvania administratively closed the case of *Humber v. Elexco Land Services, Inc.* The closure is not final, and either party may initiate further proceedings if they so choose. The administrative closure was brought by the filing of the notice of appeal in *Kilmer v. Elexco Land Services, Inc.*

**Lauchle v. The Keeton Group LLC**, No. 4:08-cv-1868 (M.D. Pa. filed Oct. 9, 2008);

**Beach v. MK Resource Partners II, L.P.**, No. 4:08-cv-1950 (M.D. Pa. filed Oct. 24, 2008);

**Hooker v. The Keeton Group LLC**, No. 4:08-cv-2091 (M.D. Pa. filed Nov. 19, 2008)

On June 19, 2009, Judge Jones of the United States District Court for the Middle District of Pennsylvania issued a motion to stay the three cases of *Lauchle*, *Beach* and *Hooker*. The *Lauchle* and *Beach* cases were both initially filed in the district court pursuant to diversity jurisdiction. The *Hooker* case was initially filed in the Court of Common Pleas of Lycoming County, but was removed to the district court by the defendant. All three cases have been assigned to Judge Jones, with hearing and argument dates having been consolidated.

The leases in each case vary in the exact terms used; however, the general issue is whether a one-eighth royalty paid to a landowner-lessor can be reduced by post-production cost deductions. The plaintiff-landowners sought to have the leases invalidated, arguing that any

lease allowing for post-production costs to be deducted from royalties violated Pennsylvania's minimum royalty provision. The defendants alleged that it was standard industry practice to deduct certain costs from the compensation to be paid to oil and gas lessors. Further, the defendants argued that the term "royalty," as used within the industry, has acquired a technical meaning that allows for the reduction of post-production costs. These three cases are especially large in scope, including over one hundred and sixty plaintiffs and affecting over 20,000 acres. Judge Jones issued the motion to stay following the Pennsylvania Supreme Court's grant of extraordinary jurisdiction in *Kilmer v. Elexco Land Services, Inc.*, described above.

**Aker v. The Keeton Group, LLC**, No. 3:09-cv-101 (W.D. Pa. filed Apr. 16, 2009)

On June 24, 2009, Judge Gibson of the United States District Court for the Western District of Pennsylvania issued an order to stay the case of *Aker v. The Keeton Group, LLC*. The order was in response to the Pennsylvania Supreme Court's granting of the petition to exercise extraordinary jurisdiction in the case of *Kilmer v. Elexco Land Services, Inc.*

**Carey v. New Penn Exploration, LLC**, No. 3:09-cv-0188 (M.D. Pa. filed Jan. 29, 2008);

**Bliss v. New Penn Exploration, LLC**, No. 3:09-cv-0376 (M.D. Pa. filed Feb. 27, 2009);

**Puza v. Elexco Land Services, Inc.**, No. 3:09-cv-0589 (M.D. Pa. filed Mar. 31, 2009);

**Julia v. Elexco Land Services, Inc.**, No. 3:09-cv-0590 (M.D. Pa. filed Mar. 31, 2009)

On June 30, 2009, Judge Caputo of the United States District Court for the Middle District of Pennsylvania issued an order to stay the cases of *Carey*, *Bliss*, *Puza*, and *Julia*. The motions were issued in response to the Pennsylvania Supreme Court's grant of a petition to exercise extraordinary jurisdiction to hear the case of *Kilmer v. Elexco Land Services, Inc.* Judge Caputo noted in his order that the Supreme Court's interpretation of the Pennsylvania Minimum Royalty Act may not be necessarily dispositive, but would at the least provide valuable insight into each of the four cases.

**Custer v. Powell**, No. 3:09-cv-102 (W.D. Pa. filed Apr. 16, 2009)

On July 6, 2009, Judge Gibson of the United States District Court for the Western District of Pennsylvania issued an order to stay the proceedings in the case of *Custer v. Powell*. Judge Gibson issued the order following the Pennsylvania Supreme Court's grant of the petition to exercise extraordinary jurisdiction in the case of *Kilmer v. Elexco Land Services, Inc.* The case of *Custer v. Powell* is to be stayed pending the Pennsylvania Supreme Court's interpretation of the state's minimum royalty provision relating to oil and gas leases.



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