UNITED STATES DISTRICT COURT

WESTERN DISTRICT OF LOUISIANA

LAFAYETTE DIVISION

CIMAREX ENERGY CO.	*	**CIVIL ACTION NO. 11-1713 c/w 11-2146**
VERSUS	*	**JUDGE HAIK**
HAROLD P. CHASTANT, JR., INDIVIDUALLY, AS TRUSTEE OF THE HAROLD P. CHASTANT, JR. TRUST, AND AS PURPORTED CLASS REPRESENTATIVE	*	**MAGISTRATE JUDGE HILL**

CIMAREX ENERGY COMPANY'S
MEMORANDUM IN SUPPORT OF MOTION FOR SUMMARY JUDGMENT

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MAY IT PLEASE THE COURT:

These consolidated cases[1] involve a claim by Harold P. Chastant, Jr., individually and as Trustee of the Harold P. Chastant Trust ("Chastant") for additional royalties pursuant to oil and gas leases with Cimarex Energy Co. ("Cimarex"). Simply put, Chastant, lessor under an oil and gas lease, makes the unprecedented and legally insupportable demand to be paid royalties on the financial trading activity of Cimarex, its lessee.

The legal issue addressed in this motion is whether the lease between Cimarex and Chastant (the "Chastant Lease")[2] and Louisiana law obligate Cimarex to pay royalties not only on the market value of the oil or gas produced from the property subject to the Chastant Lease, but also on amounts Cimarex generated by its separate financial transactions, or "hedging activity." Under the language of the Chastant Lease, and under longstanding Louisiana law, lessors such as Chastant are entitled to royalties based on the market value of the natural gas or crude oil at the mouth of the well or in the field where it is produced. Accordingly, because there is no basis for Chastant to seek royalties on Cimarex's financial trading activities, which are separate and distinct from the production of natural gas or crude oil from the Chastant Lease, Cimarex respectfully requests that this Court grant Cimarex's Motion for Summary Judgment.

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[1] This matter consists of two consolidated cases. In the first, Cimarex filed suit for a declaratory judgment seeking a judgment declaring that Cimarex does not owe Chastant additional royalties; Cimarex's complaint was prompted by a letter sent by Chastant demanding additional royalties. Docket No. 6:11-cv-1713. In the second, Chastant filed suit for additional royalties in state court and Cimarex removed that action to this Court. Docket No. 6:11-cv-2146. Both actions seek the same allegedly underpaid royalties.

[2] A true and correct copy of the Chastant Lease is attached to Cimarex's Statement of Uncontested Material Facts.

I. BACKGROUND.

A. The Lease and Louisiana law.

The Chastant Lease and Louisiana royalty law provide that the basis for the payment of royalties is on the value of the production of natural gas and crude oil from the property covered by that Lease.[3] Neither the Lease nor the Louisiana royalty law entitles Chastant to share in Cimarex's hedging profits or losses.

Specifically, with respect to natural gas, the royalty provision of the Chastant Lease provides as follows:

> (b) On gas from or attributable to said land and sold . . . one-eighth (1/8) of the **market value at the mouth of the well** of the gas so sold . . . . The price to be used in computing the market value at the mouth of the well shall be the price received by Lessee under an arm's length gas sales contract prudently negotiated in light of the facts and circumstances existing at the time of consummation of such contract . . . . (Emphasis added.)

With respect to crude oil, the Chastant Lease provides as follows:

> (a) on oil . . . one-eighth (1/8) of that produced and saved from the land . . . . . Lessee may sell Lessor's such oil at the best market price obtainable and pay Lessor **the price received f.o.b. the leased property**, less any severance or production tax impose thereon. (Emphasis added.)

Under the Lease's clear and unambiguous royalty provisions, Chastant is entitled to be paid royalty on the market value of the natural gas or crude oil at the mouth of the well or "f.o.b. the leased property." Cimarex has paid Chastant on this basis; there is no allegation that Cimarex failed to pay royalties on the market value of the natural gas or crude oil at the mouth of the well or "f.o.b. the leased property."

Louisiana law (as discussed in detail below) is equally clear that royalties are due on the market value of the natural gas or crude oil at the well, lease, or field, where it is produced. As a

[3] The Chastant Lease is attached to Cimarex's Statement of Uncontested Material Facts.

matter of Louisiana law, royalties are a share of the production itself, which entitle the lessor to **a share of oil or gas where it is produced**, free of the expense of drilling and production.[4] Significantly, no Louisiana court has **ever** held that a lessor is entitled to a royalty payment based on anything other than the price or value of oil or gas at the well, lease, or field.

It is undisputed that Cimarex paid royalties on the market value price it received for the production sold at the Chastant Lease. Nonetheless, Chastant is asking the Court to give it more – additional royalty payments on any profits Cimarex derived from its separate financial trading activity. This novel claim for additional revenue derived from Cimarex's separate financial transactions fails as a matter of law.

B. The Financial Transactions at Issue.

Chastant claims, and Cimarex does not dispute, that Cimarex engaged in financial transactions so as to hedge its risk against fluctuations in the price of natural gas or crude oil. Cimarex disagrees, however, that royalties are due on the revenue Cimarex derived from these financial transactions.[5] As a matter of contract and law, those financial transactions have nothing to do with Cimarex's royalty obligations.[6]

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4 LA. REV. STAT. § 31:80; *Union Sulphur Co. v. Andrau*, 217 La. 662, 47 So. 2d 38 (1950); *Vincent v. Bullock*, 192 La. 1, 187 So. 35 (1939); *Shanks v. Exxon Corp.*, 2007-852 (La. App. 1 Cir. 12/21/07), 984 So. 2d 53.

5 These allegations are contained in the Chastant letter attached to Cimarex's Petition in the declaratory judgment matter filed by Cimarex.

6 A summary of those transactions is contained in Cimarex's SEC filings. Cimarex's annual 10-K reports for the 2009, 2010, and 2011 periods are attached to Cimarex's Statement of Uncontested Facts. Cimarex is only attaching the reports for these three years because any claim for underpayment of royalties is subject to a three-year prescriptive period from the date of judicial demand. *See* LA. CIV. CODE ART. 3494; *see also Board of Commissioners v. Pure Oil Co.*, 167 La. 801, 120 So. 373 (1928); *Parker v. Ohio Oil Co.*, 191 La. 896, 186 So. 604 (1939).

1. The nature of the financial transactions.

Cimarex engaged in commodities futures trading of various types as a way of hedging against the price fluctuations in oil and gas. Hedging is generally defined as "[a] risk management strategy used in limiting or offsetting probability or loss from fluctuations in the prices of commodities, currencies, or securities."[7] Specifically, to "hedge" against price risk, one enters the futures market[8] and buys a futures contract under which he obtains a contract position that minimizes risk against price fluctuations.[9]

The most important point about this hedging activity as it relates to this lawsuit is that all of this trading was purely **financial** activity. Generally, the parties engaged in financial trading are not actually buying or selling natural gas or crude oil. Instead, they are simply buying or selling financial positions. Commodities futures trading involves "derivatives," *i.e.*, "a **financial instrument** whose value derives from the value of an underlying asset, reference rate, or index."[10] Derivatives also have been described as follows: "A derivative is a bet, not an investment - a bet on the direction, dimension, duration and speed of changes in the value of another financial instrument."[11] As explained by one commentator,

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7 *Businessdictionary.com.* 2012. http://www.businessdictionary.com (24 May 2012).

8 The futures market is defined as a "[m]arket in which participants can buy and sell commodities and their future delivery contracts. A futures market provides a medium for the complementary activities of hedging and speculation, necessary for dampening wild fluctuations in the prices caused by gluts and shortages." *Businessdictionary.com.* 2012. http://www.businessdictionary.com (24 May 2012).

9 P. Johnson, Commodities Regulation, § 1.12, at 39; *See also* Commodity Futures Trading Commission, Glossary of Trading Terms 16 (1986) ("hedging" involves buying or selling futures contract opposite to position held in cash market to minimize risk of adverse price move or buying a sale of futures contract as substitute for cash transaction to take place at later date).

10 Tormey, *Note: A Derivatives Dilemma: The Treasury Amendment Controversy and the Regulatory Status of Foreign Currency Options*, 65 Fordham L. Rev. 2313, 2315 n.1 (1997) (emphasis added).

11 Tormey, *supra*, (quoting Martin Mayer, The Bankers 290 (1997)).

> Derivative securities are thus named because they "derive" their value from an underlying financial asset. Explained in basic terms, **such an investment is essentially a "bet' as to how the particular underlying asset will perform over time**. While this may sound simple enough, over twelve hundred types of derivatives exist today, many formulated by "financial laypersons" with doctorates in mathematics and physics. . . .[12]

A party can "hedge" the risk of a price fluctuation by using these financial transactions – derivatives – to provide some insurance in the event that the price of the underlying commodity – the natural gas or the crude oil – drops below a certain level. This kind of "insurance" against price fluctuations can be obtained for all kinds of commodities, including crude oil and natural gas. As one article explains,

> **Derivative contracts exist to reduce risk to economic participants**. Take, for example, a farmer who is planting wheat in the spring for harvest in the fall. This farmer does not know what the price of wheat will be in the fall, and therefore, absent a futures contract, is engaged in a highly risky endeavor. If, however, that farmer can sell ("go short") a futures contract on her crop for a fixed price for a fall delivery, then that farmer can alleviate the price risk to farming. Similarly, one can imagine how a baker who uses wheat would face a similar problem in planning his fall operations. This baker would alleviate his price risk on wheat by buying a futures contract ("going long"). In trading terminology, such a contract, between two economic parties, is called a "forward."
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> For our hypothetical farmer and baker, however, creating this forward contract may not be easy. The seller of the contract (the farmer) and the buyer (the baker) must be able to find out the existence of each other. Moreover, they must be assured that the other will not renege on their agreements. Let us assume, for example, that our farmer and baker agree to a fall contract with the purchase price of $ 3.00 a bushel. If, in the fall, the price of wheat is $ 8.00 a bushel, then the farmer has strong incentives to renege on the deal and sell her wheat elsewhere, and the baker may have little recourse.

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12 Rosenthal, *Symposium on Derivative Financial Products: Student Note and Comment: Incorporation May Not Mean Sophistication: Should There Be a Suitability Requirement for Banks Selling Derivatives to Corporations?* 71 Chi.-Kent L. Rev. 1249, 1252 (1996) (footnotes omitted) (emphasis added).

> Herein lies the role of commodity exchange. A commodity exchange creates a standardized contract, a "future" (or "option") for a particular derivative. Such a contract describes the product involved, the time of delivery or expiration, and has attached to it a variety of financial conditions designed to deter contract default. **Contracts of market participants are with the exchange, rather than with each other**. When a farmer sells a future to a baker, each party has a contract, not with each other, but with the exchange. The exchange then guarantees payment on each contract to the contract holders. Thus, instead of the farmer having an obligation to the baker, as in the forward contract, through a futures contract, the exchange itself has an obligation to the baker.
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> **The fact that the exchange holds one side of each contract obligation is an important feature in that it serves to make contracts fungible**. Assume, for example, that our farmer wishes to eliminate her short position in wheat. Without a commodity exchange, she would have to go back to the baker and renegotiate. In the world of exchanges, however, there is no such requirement. Instead, the farmer can eliminate her short position on the exchange, which essentially eliminates her obligation with the exchange, by simply buying (again, "going long") a contract equal in size to her short position.

Falvey & Kleit, *Commodity Exchanges and Antitrust*, 4 Berkley Bus. L. J. 123, 126-27 (2007) (footnotes omitted). Participants in commodities exchanges are **not** actually buying or selling product.[13] Instead, they are essentially taking economic positions, which are "closed out" on the exchange, without any product being delivered. *Id.* at 127-28.

As indicated, there are many types of financial transactions that are used to hedge, or insure against, price fluctuations. For example, an option contract provides the buyer of the contract the right, but not the obligation, to purchase or sell a particular amount of a specific commodity on or before a specific date or period of time.[14] There are two primary types of

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[13] The Transformation of Energy Markets and the Problem of Market Power, 53 B.C. L. Rev. 131, 151 (2012) ("Most futures contracts do not contemplate delivery of the commodity at expiration; instead, the parties settle only their financial differences.").

[14] Energy Hedging – Back to the Basics Part III – Options, Mar. 20 2011 found at http://www.mercatusenergy.com/blog/bid/55667/Energy-Hedging-Back-to-the-Basics-Part-III-

options: call options (also known as "caps") and put options (also known as "floors").[15] A call option provides the buyer of a call option with protection against rising prices; conversely, a put option provides the buyer of a put option with protection against declining prices.[16] Another example is a "collar" agreement, which is simply the combination of buying a call option and selling a put option, thus creating both a ceiling and a floor.[17] Conversely, a producer collar is the combination of buying a put option and selling a call option.[18] Sometimes, the options are structured in such a way that the premium of the purchased option is completely offset by the premium of the sold option, a structure known as a costless collar.[19]

While derivative trading is complex, the bottom line is clear – this hedging activity is all purely **financial** trading.[20] The parties engaged in the derivatives trading are not, through that financial activity, actually buying or selling natural gas or crude oil. Instead, oil and gas companies that engage in this kind of hedging activity with respect to natural gas or crude oil are using it as "insurance" against potential fluctuations in the **actual** price of that natural gas or crude oil. More importantly, the purely financial nature of derivatives trading is underscored by the fact that parties that have no such natural gas or crude oil production can also, and regularly do, engage in the trading of derivatives, purely as a type of financial trading for profit.[21]

Options. *See also Businessdictionary.com.* 2012. http://www.businessdictionary.com (24 May 2012).

15 *Id.*

16 *Id.*

17 *Id.*

18. *Id.*

19. *Id.*

20 Daniel F. Dooley, Morris Anderson, Impact of Commodity Volatility on Insolvency Work, 30-9 ABIJ 48.

21 The Transformation of Energy Markets and the Problem of Market Power, 53 B.C. L. Rev. 131, 150 (2012) (traders in energy commodity markets need not be oil and gas companies; they "may

Chastant was equally capable of getting the same kind of "insurance" against price fluctuations by the same kinds of financial transactions if it so chose.

2. The financial hedging done by Cimarex.

Cimarex entered into hedging contracts, specifically futures market transactions and put and/or call options, with large financial institutions to minimize the risk of market fluctuations.[22] As stated above, these transactions were purely financial and were not linked or related to the actual natural gas or crude oil production from Cimarex's leases. Chastant does not dispute that Cimarex sold the actual production – the crude oil and natural gas – at the well or Lease for the best market price it could obtain at that location.[23] Pursuant to the Chastant Lease, Cimarex delivered a fractional share of the proceeds from the sale of product as royalty payments to its lessor, Chastant. Critically, all of Cimarex's oil and gas production is sold in the field, either at the wellhead or at the tailgate of the processing plant, and Cimarex's hedging activity had no effect on the market value price Cimarex received for the production.[24] The price is determined by those purchasers on a market value basis.[25] The contracts between Cimarex and the buyer do not contain any hedging provisions; they only provide that the price is determined by the market value in the field, either at the wellhead or at the Lease.[26] Whether that price or value goes up significantly or drops precipitously, it is the basis on which Cimarex is paid for the production;

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be banks and other financial speculators interested purely in the possibility of making money by speculating in the market.").

22 *See* Affidavit of James Shonsey, attached to Cimarex's Statement of Uncontested Facts, at ¶ 9; *see also* Cimarex's annual 10-K reports for the 2009, 2010, and 2011 periods, attached to Cimarex's Statement of Uncontested Facts.

23 Affidavit of James Shonsey at ¶ ¶ 5, 6.

24 Affidavit of James Shonsey at ¶ 6.

25 *Id.* at ¶ 7.

26 *Id.*

therefore, it is also the basis for the royalty payments. Cimarex paid royalties on this amount, *i.e.*, the market price at the well, Lease, or field that Cimarex received from the purchasers.

Cimarex (XEC:NYSE), however, is a publicly-traded company that owns interests in thousands of wells in several states. At times, Cimarex made the business decision to purchase and/or sell financial instruments as insurance against significant fluctuations in the market price of natural gas or crude oil, and used its hedging activity – derivatives trading – to do that. Any party – including Chastant – was free to do the exact same thing if that party wanted to insure against price fluctuations.

Cimarex entered into these financial transactions with large banking institutions with which it had a revolving credit facility.[27] Significantly, while Cimarex did secure its financial commitments, including its financial trading obligations, to those institutions with mortgages on Cimarex's interests in its oil and gas properties, Cimarex did not sell any production to these banking institutions, nor did Cimarex pledge any production to these institutions.[28]

The settlement price of Cimarex's financial transactions was based on the first of the month index number; therefore, Cimarex would either receive money from, or owe money to, the financial institution with which it contracted, depending on the difference between the "put" it purchased or the "call" it sold and the first of the month index.[29] For example, if the market price of gas skyrocketed to $10, but Cimarex sold a "call" to the bank for $3, Cimarex would

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27 *Id.* at ¶ 9.

28 Affidavit of James Shonsey at ¶ 9. This security would be similar to a situation where Chastant mortgaged its interest in the property subject to the Lease. It does not affect the value of the production at the well, Lease, or field.

29 *Id.* at ¶ 10. *See also* Cimarex's 2011 10-K at p. 69, Note 4 (Cimarex "periodically enter[s] into derivative instruments to mitigate a portion of [Cimarex's] potential exposure to a decline in commodity prices and the corresponding negative impact on cash flow available for reinvestment. While the use of these instruments limits the downside risk of adverse price changes, their use may also limit future revenues from favorable price changes.")

owe the bank the difference; on the other hand, if Cimarex bought a "put" for $10 and the market price of gas decreased to $3, the bank would owe Cimarex the difference. These differences in the hypothetical examples form the basis for Cimarex's earnings or losses relating to its hedging transactions.[30] Regardless of the earnings or losses from the financial activity, Cimarex paid its lessors, including Chastant, based on the market price of the production that Cimarex actually received from the purchasers at the well, Lease, or field. The financial settlement, therefore, is purely financial and unrelated to whether Cimarex owns any production of the commodity being hedged. And, obviously, since these are purely financial transactions, Cimarex's hedging activities are not tied to any specific wells.[31]

Notably, virtually anyone with the financial wherewithal, regardless of whether he or she owns oil or gas interests, can engage in derivatives trading. Chastant apparently chose not to engage in its own hedging activity, but now wants to share in Cimarex's earnings related to Cimarex's hedging transactions without having to run the risk of the concurrent losses. Both the language of the Chastant Lease and Louisiana law prohibit Chastant's claim.

II. LEGAL ARGUMENT.

Royalties are that share of oil or gas production that belonged to Chastant as lessor under its Lease with Cimarex. Royalties entitle the lessor to a **share of oil or gas** where it is produced, free of the expense of drilling and production.[32] Royalties are paid either "in kind" (by giving

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30 Affidavit of James Shonsey at ¶¶ 10, 11.

31 Affidavit of James Shonsey at ¶ 12.

32 LA. REV. STAT. § 31:80; *Union Sulphur Co. v. Andrau*, 217 La. 662, 47 So. 2d 38 (1950); *Vincent v. Bullock*, 192 La. 1, 187 So. 35 (1939); *Shanks v. Exxon Corp.*, 2007-852 (La. App. 1 Cir. 12/21/07), 984 So. 2d 53.

the lessor its share of the oil or gas where it is produced) or by paying the lessor the price or value of the lessor's **share of the oil or gas** where it is produced.[33]

The premise underlying royalty payments is that oil and gas are fugacious minerals and are not capable of ownership until they are "captured," *i.e.*, produced from the ground.[34] Louisiana law has long provided that ownership of the oil or gas is divided between the lessor (Chastant) and lessee (Cimarex) where the oil or gas is produced from the ground,[35] referred to as "at the well," "at the lease," or "in the field." Because ownership of the oil or gas vests at production, when a lessor is paid for its production (rather than taking the production "in kind"), price or value also is measured at the well, lease, or field.[36]

As stated above, the royalty clauses in the Chastant Lease specify that royalties on natural gas are to be paid on the "market value at the mouth of the well" and royalties on crude oil are to be paid on the market price of crude oil "f.o.b. the leased premises." Those standard royalty provisions are in complete accord with long-standing principles of Louisiana law.

A. Every Case to Address the Issue Has Held That Royalties Are Based on Market Price or Value of Production at the Well/Lease/Field.

There is a long and unbroken line of Louisiana cases requiring royalties to be based on the actual market price or value of the oil or gas at the point of production. The seminal Louisiana Supreme Court decision is *Wall v. United Gas Pub. Serv. Co.*, 178 La. 908, 152 So. 561 (1934). In *Wall*, the lease provided for royalties on the "market price" of production, but

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33 *Wall v. United Gas Pub. Serv. Co.*, 178 La. 908, 152 So. 561, 562 (1934); *Sartor v. United Gas Pub. Serv. Co.*, 186 La. 555, 173 So. 103, 105 (1937); *Freeland v. Sun Oil Co.*, 277 F.2d 154 (5th Cir. 1960) (applying Louisiana law).

34 *Frost-Johnson Lumber Co. v. Salling's Heirs*, 150 La. 756, 91 So. 207 (1920).

35 *Wall*, 152 So. at 563 (royalties are based at the well because "that is where the parties come into ownership of the commodity, that is where title vests").

36 *Wall*, 152 So. 2d at 563; *Sartor*, 173 So. at 105; *Tyson v. Surf Oil*, 195 La. 248, 196 So. 336 (1940) (lessor was entitled to royalty based on value at the time and place of production, even when the production was sold away from the lease for a price less than its value at the well.).

was silent as to the location of the "market." The lessor in *Wall* demanded royalties on the price that the lessee received in a sale of the production two miles from the well. Based on fundamental principles of oil and gas law,[37] the Court rejected any notion that a lessor can claim royalties on anything other than the price the production will bring at the well, lease, or field:

> The reason why the division and delivery is made at the well, in cases where there is to be a division in kind [such as where the lessor takes the production in its own tanks at the lease] is that is where the parties come into ownership of the commodity, that is where title vests. The lessor and lessee are vested with title to the gas at the well or in the field in the same proportion as the oil is owned. And while there is to be no division of the gas in kind, it nevertheless is contemplated that there shall be a "division," not of the gas in kind **but of its *value* as fixed by the market price**.
>
> Now, if the division in kind, where such is contemplated, should be made at the place where ownership vests, **it follows that the division of the value or proceeds of the gas should be made there,** provided, of course, that the value of the gas can be determined, and that depends upon whether there is a "market price" for it in the field.[38]

Based on the principle that ownership of the lessor and lessee vests at production, the *Wall* Court expressly held that the use of the term "market price" in a royalty clause (such as the royalty clauses at issue here) means market price at the well/lease/field, even if that is not spelled out in the royalty clause:

> As to the price which the lessee was required to pay the lessor as a basis of settlement, the contract here involved stipulates that he should pay one-eighth of the "value of such gas" **calculated at the "market price," which means the market price at the well or in the field and not the price it would bring in some distant market.**[39]

37 *Wall* involved gas, but the Supreme Court expressly recognized that the same principles applied to crude oil production as well. *Wall*, 178 La. at 914, 152 So. at 563.

38 *Id.* (Emphasis added.)

39 *Id.* at 564 (bold emphasis added).

The Court recognized that, where there was no way to determine market value at the well/lease/field, courts must look first to nearby sales as an indication of market value, and second to a "reconstruction" approach (*i.e.*, beginning with a downstream sale price and deducting costs incurred in getting the oil or gas to the downstream market).[40] This process is an alternative method of determining the market price or market value of the actual production at the well, lease, or field because that is the basis for royalty payments under Louisiana law.

These principles have been reaffirmed time and time again. In *Sartor v. United Gas Pub. Serv. Co.*, 186 La. 555, 173 So. 103 (1937), the Supreme Court, citing *Wall*, held that, where the parties have not otherwise stipulated, "'market value' is understood to mean the current market price paid for gas at the well or in the field [*i.e.*, on the leased premises] where it is produced," and "not at some distant point in the 'field' or elsewhere, to which it is transported for sale and delivery into the pipe lines."[41] *See also*, *Tyson v. Surf Oil Co.*, 195 La. 248, 196 So. 336 (1940) (applying a reconstruction of market price at the lease because there was no direct evidence of market price at the lease). Similarly, in *Freeland v. Sun Oil Co.*, 277 F.2d 154, 159 (5th Cir. 1960), *cert. denied*, 364 U.S. 826 (1960) (applying Louisiana law), the Fifth Circuit held that royalties must be based on the value or price of the production at the time and place where it is produced, "because that is the way in which Louisiana law arrives at the value of the gas at the moment it seeks to escape from the wellhead." *See also*, *Merritt v. Southwestern Electric Power Co.*, 499 So. 2d at 210 (La. App. 2 Cir. 1986) (using a "reconstruction approach" to derive

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40 *Id.* at 563. The Court held that the party seeking to use reconstruction must prove that (1) there was no sale at the lease; and (2) there were no sales of production in nearby fields.

41 *Sartor*, 173 So. At 105, 107. *See Wall*, 152 So. at 564-65.

market price at the lease, citing *Wall, Sartor*, and *Freeland*); *Babin v. First Energy Corp.*, 96-1232 (La. App. 1 Cir. 3/27/97), 693 So. 2d 813, 815.[42]

This Court also recently reaffirmed that same principle in *Magnolia Point Minerals, LLC v. Chesapeake Louisiana, LP*, No. 11-00854 (W.D. La. July 30, 2012) (copy attached), recognizing that royalty payments are to be calculated based on "market value at the well," by using methods such as the reconstruction approach. *Id.* at p. 5 (citing *Merritt*, 499 So. 2d at 213).

In sum, Louisiana law provides that a royalty owner like Chastant is entitled to a share of the production of the natural gas or crude oil at the well, lease, or field, where and when it is produced. There is nothing in the Chastant Lease or Louisiana law permits Chastant to share in Cimarex's completely separate financial trading activities by making a royalty claim on the proceeds from those activities.

B. *Frey v. Amoco* Provides No Legal Basis for Chastant's Unprecedented Claim.

It appears that Chastant is attempting to use a single "take-or-pay" case, *Frey v. Amoco Production Company,* 92-0091 (La. 6/26/1992), 603 So. 2d 166, to support its claim that it is entitled to be paid royalties on Cimarex's separate financial trading activities. Chastant apparently is asking the Court to hold that *Frey* overruled the aforementioned long line of Louisiana cases holding that royalties must be based on the market value of the production at the lease, despite the fact that the *Frey* Court specifically cited *Wall* (*see, e.g.,* 603 So. 2d at 171, 175), and reaffirmed the principle that "the right of the owner of a royalty interest is restricted to a **share in the production** if and when it is obtained."[43] *Frey*, 603 So. 2d at 179 n. 19 (emphasis added).

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42 *See also, Coyle v. Louisiana Gas & Fuel Co.*, 175 La. 990, 144 So. 737 (1932) (on rehearing); *Crichton v. Standard Oil Co.*, 178 La. 57, 150 So. 668 (1933).

43 *Frey*, 603 So. 2d at 179 n. 19.

Moreover, recent case law demonstrates that *Frey* did not overrule the long line of cases. The United States Fifth Circuit Court of Appeal, post-*Frey*, reaffirmed the *Wall/Sartor/Freeland* principle that royalty is based on market value of **the oil or gas production** at the lease, as established either through sales in the area or a market-value reconstruction approach. *Columbine II Ltd. Partnership v. Energen Resources Corp.*, 129 Fed. Appx. 119 (5th Cir. 2005) (the lease at issue provided that "royalty interest was to be determined at the mouth of the wellhead, which under Louisiana law would have necessarily inferred that [the Lessee] was permitted to deduct postproduction costs for any efforts related to transporting the gas to the commercial marketplace," *i.e.*, a reconstruction approach (citing *Merritt*, 499 So. 2d at 214; *Freeland*, 277 F.2d at 154)). And, as stated above, this Court applied those same principles just this year in *Magnolia Point Minerals*.

Chastant apparently contends that a particular phrase in *Frey*, that a lessor is entitled to share in "economic benefits" derived solely from the leased property, overruled 75 years of Louisiana case law. Chastant claims that this phrase in *Frey* means that Chastant is entitled to share in any revenue Cimarex receives from **any** business activity that has **anything** to do with oil and gas, even if that revenue does not represent the market price or value of the production at the well, lease, or field. *Frey*, of course, says no such thing, and no subsequent case has so interpreted it.

Instead, *Frey* expressly reaffirmed the principles that (1) royalties are based on value at the leased property or at the well, 603 So. 2d at 174; and (2) the lease controls as to the basis for royalty payments, 603 So. 2d at 172. In that case, the Court was faced with a type of revenue that was received by the lessee from the purchaser in conjunction with its **sale of gas at the lease**. The Court held that neither party – neither the lessor, nor the lessee – could have contemplated that the lessee would receive a settlement payment (a "take-or-pay" settlement between the lessee and the purchaser of the natural gas) in conjunction with litigation over its contract for a sale of production that took place at the lease. 603 So. 2d at 172. Because the scenario at issue in *Frey*, consideration received through an at-the-lease sale of gas, was not specifically addressed in the lease, the Court turned to principles of Louisiana mineral law to determine if that at-the-lease consideration was subject to royalty.

The *Frey* Court began with "the fundamental principle that the lease contract is the law between the parties, defining their respective legal rights and obligations." 603 So. 2d at 172. The *Frey* Court then articulated the "economic benefits" principle as follows:

> In light of [*Henry v. Ballard & Cordell Corp.*, 418 So. 2d 1334 (La. 1982)[44]], we conclude that an oil and gas lease, and the royalty clause therein, is rendered meaningless when the lessee receives a higher percentage of the **revenues generated by the leased property** than contemplated by the lease. The lease represents a bargained-for exchange, with the **benefits flowing directly from the leased premises** to the lessee and the lessor, the latter via royalty. An economic benefit accruing from the leased land, **generated solely by virtue of the lease**, and **which is not expressly negated**, see La. Rev. Stat. § 31:3, is to be shared between the lessor and the lessee in the fractional division contemplated by the lease.

603 So. 2d at 174 (emphasis added). Thus, *Frey* expressly reaffirmed the principles that (1) the royalty can be based only on revenue that is "generated **solely** by virtue of the lease" (emphasis added), and (2) the parties can spell out in the lease how royalties are to be paid ("which is not expressly negated"). Nothing in *Frey* remotely suggests that royalty can be based on revenue generated by separate financial trading that is not generated "solely by virtue of the lease."

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44 *Henry v. Ballard & Cordell Corp.*, 418 So. 2d 1334 (La. 1982) involved an interpretation of the lease language in conjunction with the sale of gas at the lease.

Rather than re-writing long-standing principles of mineral law, as Chastant contends, the *Frey* Court affirmed them. The royalty clause in *Frey* provided for a royalty of 1/5th "of the amount realized at the well **from such sales**." 603 So. 2d at 169, n.3 (emphasis added). The Court concluded that take-or-pay settlement payments to the lessee,[45] made under a contract **for the sale of gas** at the lease, were a part of the "amounts realized at the well" under that contract for the sale of gas.[46] *See also*, *Frey*, 603 So. 2d at 180 (characterizing "these payments **as part of the total price paid for gas sold** under the contract" (emphasis added)). The lessee argued that there was no actual "sale" at the lease if there was no production, and therefore "take-or-pay" payments (payments for production the purchaser did not actually take) could not constitute the "amount realized at the well from such sales." The Court rejected that argument, and held that the "take-or-pay" payment constituted the sale, at the well, "of a specified future thing, **viz, natural gas**." 603 So. 2d at 179. What is clear throughout the opinion is that the Court viewed the amounts at issue as part of the price paid for the natural gas production because it was part of the consideration given under the contract for the sale of natural gas:

> Having determined the event triggering the obligation to pay royalty on gas occurred, viz. **the sale of gas**, we address our conclusion that the take-or-pay payments are part of the "amount realized" **from the sale of gas** to Columbia [purchaser]. We interpret the "amount realized" by Amoco [lessee] from the sale of gas to Columbia to encompass both: 1) the total price paid by Columbia for the natural gas delivered, and 2) the "economic

45 These settlement payments were for provisions of the contract specifying that the purchaser had to pay the lessee for specific volumes of natural gas regardless of whether the purchaser actually took those volumes of natural gas.

46 The gas sales contract at issue there was a long-term gas purchase contract whereby a company with a pipe line connected to the well (Columbia) bought gas at the lease under certain terms and provisions, including a "take-or-pay" provision that was at issue in that case. The Court held that the kind of contract at issue in that case was typical and prudent for a gas producer that was marketing gas at the lease, as was Amoco. The "take-or-pay" provisions required the gas purchaser to make certain payments to the producer under that gas purchase contract even if no gas was produced and delivered to the pipeline. The settlement payment at issue there related to the take-or-pay clause.

> benefits" derived from the lessee's right to develop and explore, a right conferred by the lease. (Emphasis added).

603 So. 2d at 179-180. It is patently clear that (1) the "amounts realized" in that case were derived, as the Court stated, "**solely** by virtue of the lease," 603 So. 2d at 174, not as a result of any separate financial transactions; and (2) that the "amounts realized" were amounts realized under the contract for the sale of natural gas. There is absolutely nothing in that decision that can possibly be read as overruling *Wall*, *Sartor*, *Freeland*, and that line of cases, and there is absolutely nothing in that decision that purports to hold that royalty is due on anything more than the value received from the sale of the crude oil or natural gas at the lease.

Frey, clearly, does not support Chastant's claim to royalties on Cimarex's hedging gains. Unlike the situation in *Frey*, Cimarex's hedging activities have nothing to do with the Chastant Lease. They are separate financial transactions completely independent from Cimarex's actual sales of production to a third party purchaser and the market value of that production at the Chastant Lease. Chastant's claim to royalties on that independently-generated revenue fails as a matter of law.

III. CONCLUSION.

Chastant's claim for a share of Cimarex's separate financial activities is not supported by the Chastant Lease or by Louisiana law. The Court should grant Cimarex's Motion for Summary Judgment, and hold that Chastant has no claim for royalties on Cimarex's hedging activities. Specifically, in these consolidated cases, the Court should render judgment (1) declaring that, as a matter of law, Harold P. Chastant, Jr., Individually, and as Trustee of the Harold P. Chastant, Jr., Trust (collectively, "Chastant") has no claim for royalties on Cimarex's hedging activities; and (2) dismissing with prejudice Chastant's claims for royalties on Cimarex's hedging activities.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I HEREBY CERTIFY that on September 7, 2012, I electronically filed the foregoing with the Clerk of court by using the CM/ECF system which will send a notice of electronic filing to all counsel of record.

/s/ Cheryl M. Kornick