Court of Appeals, State of Michigan

ORDER

Athel E Williams v Terra Energy Ltd

Docket No. 260725

LC No. 01-009317-CK

Pat M. Donofrio
Presiding Judge

Peter D. O'Connell

Deborah A. Servitto
Judges

The Court orders that the July 25, 2006, opinion is hereby AMENDED. The opinion contained the following clerical error: Footnote 1 indicated that Ronald J. Nemeth was dismissed from the lower court action "with prejudice" when, in fact, he was dismissed without prejudice. Footnote 1 shall be amended as follows: "Although Nemeth is listed on the order being appealed, the parties stipulated in the lower court to strike his name from the caption and dismiss his claim without prejudice."

In all other respects, the July 25, 2006, opinion remains unchanged.

A true copy entered and certified by Sandra Schultz Mengel, Chief Clerk, on

AUG 0 7 2006
Date

Sandra Schultz Mengel
Chief Clerk

STATE OF MICHIGAN

COURT OF APPEALS

ATHEL E. WILLIAMS, HELEN C. WILLIAMS, DENNIS W. JONES, GOLDIE R. JONES, STEVE SMOLARZ, KATHERINE A. SMOLARZ, EDWARD J. SWITALSKI, SUSIE A. SWITALSKI, THERON P. WILLIAMS, SHERYL L. WILLIAMS, DANE K. MORSE, JOANN M. MORSE, CHESTER KOZLOWSKI, BETTY KOZLOWSKI, FRANCES NOWAK, BLACK RIVER PROPERTIES, HOOSIER ENERGY, L.L.C., SCANS INVESTMENTS, L.L.C., and NORTH HAWK, L.L.C.,

Plaintiffs-Appellees,

and

RONALD J. NEMETH,[1]

Plaintiff,

v

TERRA ENERGY, LTD., ENERGY ACQUISITION OPERATING CORPORATION, KRISTEN CORPORATION, and QUICKSILVER RESOURCES, INC.,

Defendants-Appellants,

and

CMS OIL & GAS,

Defendant.

UNPUBLISHED
July 25, 2006

No. 260725
Otsego Circuit Court
LC No. 01-009317-CK

[1] Although Nemeth is listed on the order being appealed, the parties stipulated in the lower court to strike his name from the caption and dismiss his claims with prejudice.

Before: Donofrio, P.J., and O'Connell and Servitto, JJ.

PER CURIAM.

Defendants Terra Energy, Ltd. ("Terra"), Energy Acquisition Operating Corporation ("EAOC"), Kristen Corporation ("Kristen"), and Quicksilver Resources, Inc. ("Quicksilver") (collectively "defendants"), appeal by leave granted the trial court's order granting class action certification in this dispute involving the alleged underpayment of royalties and overriding royalties on the sale of natural gas. This Court previously remanded this case to the trial court for further fact-finding.[2] Because the trial court clearly erred when it certified plaintiffs' claims for adjudication as a class action, we reverse the trial court's decision on remand and again remand this case for further proceedings.

This case involves approximately 80 gas production units operated by Terra in Otsego County. Plaintiffs are owners of leasehold interests under oil and gas leases pertaining to the 80 units, and Terra is the operator of the units. This action stems from a previous action filed against Terra and its subsidiaries, Kristen and EAOC, on behalf of the state of Michigan ("the state case"). Audits conducted pursuant to that litigation revealed that Terra had made numerous improper deductions from royalty payments owed to the state and that Terra had engaged in a series of sham transactions with EAOC and Kristen to artificially decrease the price on which it owed royalties. Plaintiffs' complaint in the instant case alleges similar wrongdoing resulting in the underpayment of royalties and overriding royalties to plaintiffs.

Defendants argue that the trial court erred by certifying this litigation as a class action. We review a trial court's decision certifying a class for clear error. *A&M Supply Co v Microsoft Corp*, 252 Mich App 580, 588; 654 NW2d 572 (2002). A factual finding is clearly erroneous if no evidence supports the finding or if there exists evidence in support of the finding but this Court is left with a definite and firm conviction that a mistake was made. *Id*.

MCR 3.501(A)(1) sets forth the requirements of a class action and provides that one or more members of a purported class may file suit on behalf of all members only if:

> (a) the class is so numerous that joinder of all members is impracticable;
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> (b) there are questions of law or fact common to the members of the class that predominate over questions affecting only individual members;
>
> (c) the claims or defenses of the representative parties are typical of the claims or defenses of the class;

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[2] *Williams v Terra Energy, Ltd*, unpublished order of the Court of Appeals, entered April 22, 2005 (Docket No. 260725).

(d) the representative parties will fairly and adequately assert and protect the interests of the class; and

(e) the maintenance of the action as a class action will be superior to other available methods of adjudication in promoting the convenient administration of justice.

A class action requires that *all* of the requirements listed in MCR 3.501(A)(1) be met and may not proceed when only some of these factors are established. *A&M Supply Co, supra* at 597. It is the plaintiffs' burden to show that all factors have been met. *Id.* at 597-598.

Defendants do not dispute the trial court's findings with respect to the numerosity requirement, MCR 3.501(A)(1)(a). Accordingly, we do not address that requirement. Likewise, we do not address plaintiffs' claims alleging that defendants charged excessive and unreasonable postproduction costs. The trial court initially determined that these claims were not suitable for class certification and declined to certify these claims. Plaintiffs did not appeal that ruling and in fact appeared to agree with that ruling on remand. Therefore, these claims are not at issue in this appeal.

I. Classification Claim

Defendants primarily challenge the trial court's ruling that plaintiffs' claim asserting that certain production costs were improperly classified as postproduction costs satisfies the commonality requirement, MCR 3.501(A)(1)(b). Defendants argue, in essence, that this requirement is not satisfied because plaintiffs' claim requires examination of each purported class member's lease, as well as other documents, and because various affirmative defenses exist that are particular to the class members and may not be asserted on a class-wide basis.

The commonality requirement necessitates that common questions of law or fact exist that predominate over individual questions. MCR 3.501(A)(1)(b); *A&M Supply Co, supra* at 599. This factor "is concerned with whether there 'is a common issue the resolution of which will advance the litigation.'" *Zine v Chrysler Corp*, 236 Mich App 261, 289; 600 NW2d 384 (1999), quoting *Sprague v Gen Motors Corp*, 133 F3d 388, 397 (CA 6, 1998). Further, this factor "requires that 'the issues in the class action that are subject to generalized proof, and thus applicable to the class as a whole, must predominate over those issues that are subject only to individualized proof.'" *Zine*, *supra* at 289, quoting *Kerr v West Palm Beach*, 875 F2d 1546, 1557-1558 (CA 11, 1989). Nevertheless, no requirement exists that "'all questions necessary for ultimate resolution be common to the members of the class.'" *A&M Supply Co, supra* at 599, quoting *Grigg v Michigan Nat'l Bank*, 405 Mich 148, 184; 274 NW2d 752 (1979).

The purported class consists of persons or entities entitled to receive royalty or overriding royalty payments. Such royalty owners are generally not responsible for production costs. Royalty owners may, however, be responsible for postproduction costs, depending on the terms of each royalty owner's oil and gas lease. Plaintiffs allege that defendants breached the lease agreements and "other agreements" by improperly deducting from royalty payments certain production costs as postproduction costs. According to plaintiffs, if the trial court determines which costs are properly classified as production costs and which are properly classified as

postproduction costs, this classification will apply to all purported class members regardless of individual differences in the leases.

The trial court determined, based on the deposition testimony of Ronald Waymire, that if Terra misclassified a certain production cost as a postproduction cost, then this classification would apply in an even manner across the board. Waymire testified that certain costs, such as salt water disposal, storage tanks, and fences, are attributed 100 percent to production across all units. Waymire further testified that labor costs are attributed in the same proportionate shares to production costs and to postproduction costs across all 20 central processing facilities and across all units. Waymire's testimony belies defendants' argument that the classification of a certain cost is not susceptible to common proofs and that classification varies from unit to unit over time. Thus, the trial court's reasoning is sound that if a certain production cost was improperly treated as a postproduction cost, it was treated as such across the board for all units.

Defendants also contend that regardless whether a certain cost is classified as a production cost or as a postproduction cost, this classification does not determine whether a deduction for the cost was made or, if made, whether the deduction comported with the individual lease terms. Defendants argue that liability necessarily depends on the terms of a particular lease and how the lease treats each specific cost. We find defendants' arguments persuasive. Given plaintiffs' claim that Terra misclassified certain production costs as postproduction costs, the effect of an alleged misclassification on the individual lease owners is relevant. Thus, it is necessary to look to the individual lease provisions regarding postproduction costs to determine whether an alleged misclassification affected a leaseholder's royalty payment in order to determine if the contract was breached. Defendants assert that eight different formulas exist for calculating royalties:

> 1. Leases requiring royalties to be calculated "at the wellhead," under which PPCs [postproduction costs] are fully deductible ("Wellhead Leases")
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> 2. Leases expressly permitting certain PPC deductions, under which specified PPCs are deductible and others are not ("Certain Express Allowed Leases")
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> 3. Leases expressly prohibiting the deduction of any PPCs, under which no PPCs are deductible ("All Expressly Prohibited Leases")
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> 4. Leases expressly allowing some PPC deductions but prohibiting others, under which the allowance of PPC deduction[s] depends upon the nature of the deduction ("Some Allowed/Some Prohibited Leases")
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> 5. Leases expressly allowing deduction of only third party PPCs ("Third Party Allowed Leases")
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> 6. Leases expressly allowing a quantity to be deducted without reference to the type of PPC ("Fixed Quantity Leases")
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> 7. Leases expressly capping only third party PPCs ("Third Party Capped Leases")

8. Leases expressly prohibiting certain "upstream" PPC deductions but allowing certain "downstream" deductions ("Downstream Allowed Leases")

Thus, if a lease expressly prohibits the deduction of any postproduction costs, such as the lease of plaintiffs Athel E. Williams and Helen C. Williams, then the improper categorization of certain production costs as postproduction costs will have no affect on royalty payments due under the lease. On the other hand, if a lease expressly allows the deduction of certain postproduction costs, such as that of plaintiff Hoosier Energy, L.L.C., then a determination must be made whether certain production costs were improperly categorized as the postproduction costs allowed to be deducted. If a cost was not improperly categorized as a postproduction cost allowed to be deducted, then the misclassification would not have affected the leaseholder's royalty payment. Accordingly, contrary to plaintiffs' argument, individual lease provisions regarding postproduction cost deductions are relevant to determining liability, i.e., whether Terra breached the leases.

Waymire's deposition testimony confirms the notion that postproduction costs are crucial in determining whether a production cost, improperly categorized as a postproduction cost, was charged to a lease owner. Waymire testified that an individual interprets the postproduction cost provisions of every lease and inputs that data into a "revenue deck," which then determines a lease owner's royalty payments based on those provisions. Thus, postproduction cost provisions are instrumental in determining whether a lease owner has been charged with production costs improperly designated as postproduction costs. Accordingly, the trial court's assertion that a misclassified cost "would lead to a uniform repayment to all members of the putative class" is simply not correct.

Plaintiffs rely on the deposition testimony of Houston Kauffman responding to a hypothetical that plaintiffs' counsel posited involving three leaseholders with differing lease royalty language. Kauffman's testimony, however, does not support plaintiffs' notion that differing lease royalty language is irrelevant. Rather, Kauffman testified that the lease owners would have to look to their specific lease provisions to determine if a certain cost was chargeable. Kauffman's testimony that none of the lease owners would have a better argument than the others appears to be based on the assumption that none of the owners should have been charged the particular cost at issue. Such testimony does not support plaintiffs' position that the specific language for calculating royalties is irrelevant and that the misclassification of production costs as postproductions costs had the same affect on all lease owners.

Plaintiffs also rely on *Duhé v Texaco, Inc*, 779 So 2d 1070, 1073 (La App, 2001), in which prospective class members filed suit claiming that the defendants underpaid gas royalties. The court affirmed the trial court's order certifying the class. *Id.*at 1087. The defendants raised the same arguments that defendants in the instant case assert. *Id.* at 1080-1081. The court stated:

> In our present case, Texaco's alleged conduct, statewide, is not going to be measured merely by its obligations under the individual leases, royalty clauses,

> and division orders. The overriding common issue is whether its Louisiana Revised Statute 31:122 duty has been honored or breached.[3] The common issue that predominates is not so much what each royalty owner was entitled to receive, but the standard according to which Texaco was obliged to pay. Therefore the differences in the individual contracts, while relevant to damages, are not so much relevant to liability. This is so, because whether the royalty owners were entitled to variations such as "prevailing market price," "best market price obtainable," "average price," "price received," "amount realized," "highest paid price," "posted market price," "average posted price," highest posted price," "prevailing posted price," or "current market value" is not the ultimate question. The claimants believe they can prove that Texaco's payment on the basis of [its subsidiary's] posted price was routinely less than any of these variations. The resolution of whether Texaco undervalued its royalty owners' oil by paying on its subsidiary's low posted price will resolve all class members' claims who were entitled to a market value payment, but received [the subsidiary's] posted price instead. This alleged conduct was homogeneous, and that is the entirety of the case. Once that question is answered, the rest is detail . . . . [*Id.* at 1084-1085.]

Thus, in *Duhé*, class-wide liability hinged on whether Texaco undervalued oil. The individual leases were not relevant to the liability determination, which involved whether Texaco breached its statutory duty by paying royalties based on its subsidiary's posted price. If the statutory duty was breached, liability ensued regardless of the individual lease provisions.

Unlike *Duhé*, the instant case does not involve a question which, if answered affirmatively, establishes class-wide liability. If the trial court determines that Terra has been improperly categorizing certain production costs as postproduction costs, this determination would not establish liability. Rather, in that event, each lease would have to be examined to determine whether the misclassification of a particular cost affected that lease owner's royalty payment in order to determine whether a breach of the lease occurred. Therefore, *Duhé* is distinguishable. Moreover, case law establishes that when a lease-by-lease inquiry is involved, individual rather than common issues predominate, and certification is improper. *Union Pacific Resources Group, Inc v Neinast*, 67 SW3d 275, 284 (Tex App, 2001).

Defendants also argue that affirmative defenses exist that will predominate and require a class member by class member examination. In particular, defendants rely on lease provisions releasing Terra from liability upon assignment of a lease, such as the provision in the lease of plaintiffs Theron and Sheryl Williams. Defendants further note that certain leases, also like that of Theron and Sheryl Williams, require that pre-suit written notice of any complaints be given before filing suit. Affirmative defenses are an appropriate consideration in making class action certification determinations. *Waste Mgt Holdings, Inc v Mowbray*, 208 F3d 288, 295 (CA 1,

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[3] According to the *Duhé* court, "Louisiana Revised Statute 31:122 recognizes the implied obligation to market diligently the minerals discovered and capable of production in paying quantities in a manner of a reasonable, prudent operator." *Duhé, supra* at 1082.

2000).[4] As with the determination whether the individual lease owners were affected by a misclassification of costs, determining whether certain defenses are applicable will require the examination of individual leases. Not every purported class member will be subject to the same defenses, which vary among the class members.

Because questions involving liability and defenses will require an examination of the language contained in each particular lease, plaintiffs have failed to satisfy the commonality requirement. The issues pertaining to plaintiffs' misclassification claim are not subject to generalized proof. Even if plaintiffs prove that certain costs were misclassified on a class-wide basis, an examination of the individual leases would be required to determine if and how that misclassification affected the individual lease owners. Thus, the determination whether Terra breached the leases could be made only by individualized proof. Moreover, Terra's defenses largely require examination of the individual leases as well. Therefore, plaintiffs failed to show that common issues, rather than individual issues, predominate this litigation.

Because *all* requirements of MCR 3.501(A)(1) must be met for a class action to proceed, *A&M Supply Co, supra* at 597, the trial court clearly erred by certifying plaintiffs' classification claim. In any event, it also appears that plaintiffs have failed to satisfy the typicality requirement for the same reasons. The claims of the representative parties do not appear typical of the claims of the class because of the individual differences between the leases of the purported class members. If liability is established with respect to one lease, liability would not necessarily be established with respect to the others.

Further, it is arguable whether maintaining this litigation as a class action is superior to other methods of adjudication. Although the issues involved in this case are complex and litigation of separate claims would likely be very expensive, it appears that this litigation would be unmanageable as a class action, given the varying lease terms that determine liability and applicable defenses. Even if this case were to proceed as a class action, it would essentially comprise the individual litigation of each lease owner's claims rather than the resolution of all class members' claims as a whole.

Because plaintiffs failed to establish the commonality, typicality, and superiority requirements for class certification, the trial court clearly erred by certifying plaintiffs' classification claim, encompassing counts I, VIII, and IX.

II. Marketing Claim (Sham Transactions)

Plaintiffs' "marketing claim" refers to their allegations that Terra engaged in sham transactions with EAOC and Kristen to artificially depress the price on which royalties and overriding royalties were based. Plaintiffs allege that Terra engaged in sham transactions involving Kristen and EAOC in December 1991, February 1992, March 1992, and August 1992.

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[4] Because of the paucity of case law construing MCR 3.501, Michigan courts may rely on federal cases construing the similar federal court rule, FR Civ P 23, for guidance. *Zine, supra* at 287 n 12.

Plaintiffs further alleged that these transactions involved EAOC selling gas to Michigan Consolidated Gas Company ("MichCon") under EAOC's contract with MichCon, but that Terra paid royalties based on a lower price than the price that MichCon paid for the gas.

The evidence shows that many of the named plaintiffs had not yet acquired their royalty interests at the time of the alleged sham transactions in 1991 and 1992. For example, plaintiffs Dennis and Goldie Jones, Katherine and Steve Smolarz, Theron and Sheryl Williams, Dane and Joann Morse, and Black River Properties did not acquire their interests until after the alleged sham transactions. Therefore, these plaintiffs could not have been affected by the transactions.

Defendants also argue that only certain wells on certain leases at certain times generated gas sold to MichCon under its contract with EAOC. According to the EAOC/MichCon contract, EAOC was to deliver a certain maximum amount of gas to MichCon each day from wells delivering gas to certain specified delivery points. Defendants argue that plaintiffs failed to show that all leases involved gas that was sold under the EAOC/MichCon contract and that class members who were unaffected by the alleged sham transactions and ultimate sales to MichCon have no claim. Defendants rely on the affidavit of David Russell, stating that in order to establish plaintiffs' claim, it is necessary to determine the proportion of each unit's monthly gas sales allocated to the EAOC/MichCon contract and that this figure will not be consistent across all units or over time.

In addition, defendants produced evidence showing that some leases contain express provisions for calculating royalties from affiliate sales transactions and that other agreements exist that require marketing at prices under separate contracts. Defendants rely on Kauffman's affidavit averring that some leases contain provisions stating that if gas is sold to an affiliated entity, royalties are paid based on the market value at the mouth of the well. Defendants also rely on a letter from Terra to Dr. Kwang S. Kim and Mr. Ro J. Park, stating that Terra agreed to market gas belonging to these individuals under the terms of its Consumers Power Midland Co-Generation Plant gas contract. Thus, it appears that plaintiffs' marketing claim cannot be established with common proofs and would require a class member by class member inquiry.

Plaintiffs failed to present evidence rebutting the evidence discussed above and failed to address defendants' arguments in their brief on appeal. On the basis of the evidence defendants presented, we hold that plaintiffs' marketing claim fails to satisfy the commonality requirement. Plaintiffs cannot establish their claim by generalized proofs because it must be determined individually whether each lease involved units that produced gas for the EAOC/MichCon contract, and affected units changed over time. It must also be determined on a lease-by-lease basis whether lease owners acquired their royalty interests before the alleged sham transactions at issue. Finally, it must be determined on an individual basis whether provisions for calculating royalty payments and marketing gas rendered any alleged sham transaction irrelevant to a particular lease owner's royalties. Thus, common questions of law or fact do not predominate over individual questions. MCR 3.501(A)(1)(b); *A&M Supply Co, supra* at 599.

For the same reasons, plaintiffs' claim is not typical of the class. It appears that not all plaintiffs were affected by the alleged sham transactions. Indeed, it appears that not all plaintiffs had even acquired their royalty interests by the time of the alleged sham transactions occurring in 1991 and 1992. Because of these individual questions, plaintiffs have also failed to establish that a class action is the superior method of adjudication. Finally, the representative parties cannot

fairly and adequately protect the interests of the entire class when the lease owner's interests vary from lease to lease. Accordingly, the trial court clearly erred by certifying plaintiffs' marketing claim, encompassing counts II, IV, VIII, and IX.

III. Other Claims

Plaintiffs' breach of promise claim is based on Terra's August 20, 1997, letter to royalty owners indicating that in response to the audit at issue in the state case, it would voluntarily extend any adjustment necessary to all class members. In addition, plaintiffs' claim alleging fraud, misrepresentation, and active concealment asserts that Terra failed to adequately disclose, intentionally misrepresented, and actively concealed all deductions and that it failed to pay royalties based on actual proceeds. Fraud claims are not appropriate for determination in a class action because such claims require individual proof of reliance. *Freeman v State-Wide Carpet Distributors, Inc*, 365 Mich 313, 320-321; 112 NW2d 439 (1961); *Sprague, supra* at 397; *Van Vels v Premier Athletic Ctr of Plainfield, Inc*, 182 FRD 500, 509 (WD Mich, 1998). Therefore, plaintiffs' claim alleging fraud, misrepresentation, and active concealment is not appropriate for determination in a class action. Likewise, plaintiffs' breach of promise claim is not susceptible to class action certification because royalty owners' reliance on the August 20, 1997, letter is essential to the claim. In any event, evidence showed that not all named plaintiffs received the letter.

Plaintiffs' third-party beneficiary claim alleges that plaintiffs were third-party beneficiaries of Terra's joint operating agreements with other working interest owners and that Terra breached these joint operating agreements by failing to pay royalties or overriding royalties in accordance with lease provisions "or other agreements." In order to establish their third-party beneficiary claim, plaintiffs must necessarily prove their underlying allegation that Terra failed to pay royalties and overriding royalties as required under lease provisions or provisions stated in other agreements. We have previously held that plaintiffs failed to satisfy the requirements for class certification regarding this underlying issue because of the numerous individual questions that predominate this litigation. Accordingly, if the underlying issue is not appropriate for adjudication in a class action, it follows that plaintiffs' third-party beneficiary claim, resting on their underlying claim, is likewise not appropriate for resolution in a class action.

Plaintiffs' breach of fiduciary duty claim necessarily depends on the individual lease terms or terms of other individual agreements because plaintiffs' complaint specifically alleges Terra's failure to act "in accordance with the lease terms and other agreements." Further, to the extent that this claim is based on the alleged sham transactions, it fails to satisfy the requirements for class certification because, as previously discussed, plaintiffs' underlying marketing is inappropriate for determination on a class-wide basis.

Finally, plaintiffs allege, alternatively to their classification claim, that defendants breached the lease agreements and other agreements because the leases do not allow for the deduction of any postproduction costs. To the contrary, the overwhelming majority of leases do allow for the deduction of certain postproduction costs. Therefore, this claim is not susceptible to common proofs and is not appropriate for determination in a class action.

This Court having previously vacated the trial court's original order certifying the class,[5] we reverse the trial court's certification decision on remand and remand for further proceedings. We do not retain jurisdiction.

/s/ Pat M. Donofrio
/s/ Peter D. O'Connell
/s/ Deborah A. Servitto

[5] See note 2, *supra*.