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STATUE OF LIMITATIONS AND DEADLINES TO CONTEST UNDERPAYMENT OF ROYALTIES

NARO COLORADO CONFERENCE
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INTRODUCTION

The Law Office of Ralph A. Cantafio, P.C. has been practicing in Steamboat Springs, Colorado continuously since 1986. A significant portion of our practice involves the representation of mineral owners who have entered into oil and gas leases and are receiving royalties. Our law practice also includes representation of oil and gas industry clients. These comments are not intended to be biased one way or the other, but instead are an attempt to provide the point of view of a practicing attorney who tries to analyze these types of issues in a non-partisan way.

As set forth below, there has long been a tension between the recipients of oil and gas royalties, one the one hand, and industry, on the other. Royalty recipients are often suspicious that they are not being properly compensated as agreed in their Oil and Gas Leases. This sentiment on the part of many royalty recipients is not new and leads to at times a deep sense of distrust between these royalty recipients and producers. Part of this is a result of an inability on the part of many to determine how their royalty was calculated.

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OVERVIEW OF PRESENTATION

The thrust of this paper addresses the accrual of the statute of limitations pertaining to oil and gas royalties in Colorado, Utah and Wyoming. Defining terms is an appropriate place to begin.

The statute of limitations is the period of time before the elapsing of which a Complaint must be filed in a court of competent jurisdiction to initiate a lawsuit or else upon the raising of a defense based upon that statute of limitations the claim is barred. Simply put, the statute of limitations is the time limit by which a lawsuit has to be filed.

The term accrual is also a term of art used by the legal profession. The accrual date is the point in time when the calculation of time is begun to determine the deadline as estimated by the statute of limitations to file the lawsuit. The determination of when a statute of limitations accrues is often a question of fact.

COMMON EXAMPLE

Let me provide a common example typically used by law school professors for their first year law students. In our hypothetical, a patient goes in for surgery. During the surgery, a surgeon accidently leaves a small sponge in the stomach of the patient. Soon thereafter, the patient begins to experience stomach pain. Ultimately, a second surgery is performed at which time it is formally discovered that the sponge was left in the patient's stomach.

The question thus becomes when the statute of limitations accrue. Does it accrue at the point in time when the sponge was left in the patient's stomach at the time of the first surgery? Does it accrue at the point in time that the patient first experienced stomach pains after that first surgery? Does it accrue at the point in time when the second surgery is completed so that the patient now knows that the cause of his stomach pain was the sponge that's left in his stomach? In theory, any of these potential times could be used to determine when the statute of limitations accrues.

It is important to understand that often it is the legislature who defines when a statute of limitations accrues as well as what the duration of the statute of limitations is for a given course of action. Each state is different as to when a cause of action accrues and how long the statute of limitations would be for a given cause of action. As you will see, the State of Wyoming has enacted legislation as it pertains to the accrual of the statute of limitations as to determining underpayment as to oil and gas royalties. Colorado and Utah have statutes of limitations that apply to oil and gas royalties, but the application of the appropriate statute of limitations has been determined not by the statute itself, but by the interpretation of the statute by the courts in those states.

COLORADO

This issue as to the accrual of the statute of limitations for alleged underpayment of oil and gas royalties has been a point of significant controversy in the State of Colorado since the Colorado Supreme Court published on July 9, 2008 its opinion in BP America Production Company v. Patterson, 185 P.3d 811 (Colorado 2008). This Colorado Supreme Court opinion reversed the previous opinion of the Colorado Court of Appeals in Patterson v. BP America Production Company, 159 P.3d 634 (Colorado Appeal 2006). This case is discussed below.

Patterson ultimately did not involve any dispute pertaining to the applicable statue of limitations. The parties agreed that the six (6) year statute of limitations set forth in C.R.S. 13-80-103.5(1)(a) was the appropriate measure of time in which to file a Complaint initiating a lawsuit involving this type of royalty claim. The parties instead disagreed as to the applicable accrual provision.

BP argued that each claim for any underpayment of royalty accrued when the monthly payment that was alleged to be underpaid became due. In contradistinction, Plaintiffs characterized their cause of action as one of breach of an express or implied contract which were ongoing claims that did not accrue until underpayments were actually discovered by the royalty recipient. The Colorado Supreme Court ultimately decided that claims for monthly underpayments should be considered to have accrued on the date the royalties became due and not upon the actual discovery of a breach.

It had previously been thought that the statute of limitations as to the statute of limitation in Colorado as to royalty payments accrued when a royalty recipient knew or should have known that they had been underpaid. This is the general standard as to a claim of breech of contract. BP instead characterized a claim of underpayment as a form of debt. Irrespective of whether or not a recipient of royalties thought he was underpaid or not, BP argued that the statute of limitations accrued when the debt was paid.

The decision in the Patterson case was a great surprise to many. It was until that time felt that because it was often all but impossible to determine whether full payment was received that the statute of limitations as a matter of fairness should not begin to run until a royalty recipient knew or should have suspected underpayment.

There have been attempts since to enact legislation to change the accrual to the knew or should have known standard, but these attempts have not been successful.

WYOMING

The Wyoming legislature has passed the Wyoming Royalty Payment Act which addresses, among other things, when the statute of limitations as to underpaid royalties run. See Wyoming Statutes Annotated 30-5-301 *et seq.* This Act is a remedial statute and is to be liberally construed to achieve its remedial purpose. See Moncrief v. Harvey, 816 P.2d 97, 103 (Wyoming 1991). This Act was enacted in 1982 with a remedial purpose to prevent oil producers from retaining "other people's money" for their own use. Independent Producers Marketing Corp. v. Cobb, 721 P.2d 1106 (Wyoming 1986).

Unlike Colorado which currently utilizes a six (6) year statute of limitations pertaining to a claim for underpayment of royalties, the statute of limitations for the underpayment of royalties in Wyoming is only one (1) year. However, unlike Colorado where accrual of the six (6) year statute of limitations begins in the month where payment is made, in Wyoming accrual begins when the underpayment is known or should have been known. The Wyoming Supreme Court in Cabot Oil & Gas Corp. v. Followill, *et al*, stated:

> Wyoming is a discovery state in which the statute of limitations is triggered when a plaintiff knows or has reason to know of the existence of a cause of action. Amico Production Company v. EM Nominee Partnership Company, 2 P.3d 534, 542 (Wyoming 2000). The remedial purposes of the act would be nullified if the discovery rule did not apply. The one year statute of limitations related to the penalty for failure to properly report under the Royalty Payment Act begins to run if, and when, the producer issues a proper report. As owners noted, failure to apply the discovery rule would encourage producers to omit deductions from royalty statements hoping that it could hide the deduction for one (1) year and avoid paying a proper royalty amount. This result is contrary to the remedial nature of the Act. See Cabot Oil, *supra* at 243.

Compared to Colorado, the Wyoming law is both stricter and more lenient. Because accrual is based on discovery, the statute of limitations does not begin to run until a royalty owner knows or should know there is an underpayment. It could be years after a payment is actually made before the statute of limitations accrue. However, once the statute of limitation starts to accrue a Wyoming claimant has one (1) year thereafter to file a Complaint.

UTAH

The state of law as to the accrual of the statute of limitations pertaining to underpayment of royalties is the most unclear in Utah. The Utah Code Annotated addresses the payment of oil and gas royalties in a most general way. U.C.A Section 40-6-1, Declaration of Interest states:

> It is declared to be in the public interest to foster, encourage, and promote the development, production and utilization of natural resources of oil and gas in the State of Utah in such a manner as will prevent waste; to authorize and to provide for the operation and development of oil and gas properties in such a manner that a greater ultimate recovery of oil and gas may be obtained and that the correlative rights of all owners may be fully protected; to provide exclusive state authority of oil and gas exploration and development as regulated under the provisions of this chapter; to encourage, authorize, and provide for voluntary agreements for cycling, recycling, pressure maintenance and secondary recovery operations in order that the greatest possible economic recovery of oil and gas may be obtained within the State to the end that the landowners, royalty owners, the producers, and the general public may realize and enjoy the greatest possible good from these vital natural resources.

U.C.A. Section 40-6-9 provides that a person legally entitled to the payment of oil and gas royalties ought to receive the same payment no later than one-hundred eighty (180) days after the first day of the month following the first day of sale and thereafter not later than thirty (30) days after the end of the calendar month within which payment is received or else the royalty and gas owner may avail themselves to remedy before the Utah Oil and Gas Board. The Utah Oil and Gas Board, after complaint and hearing, may enforce penalties including interest at a rate of one and one-half percent (1 ½%) per month and a penalty of twenty-five percent (25%), among other things if it is proven that underpayment has been made.

Furthermore, U.C.A Section 40-6-9.1 specifically requires certain information must be provided to all royalty owners upon payment including the identity of the property, the month and year of the sales including the payment, the total volume of oil and gas sold, the average price per unit of oil and gas sold, the total amount of state severance and other production taxes, a list of other deductions or adjustments, the net value of total sales after taxes or adjustment, the royalty owners interest expressed in a decimal number, the royalty owners share of the total value of sales prior to deductions, and the address at which additional information pertaining to the royalty owners interest and production can be obtained. If issues as to disclosure of this information exist, the state board exists to addresses these issues. Hence, Utah heavily relies upon an administrative law approach to resolving issues of the payment of oil and gas royalties.

Unfortunately, Utah statute does not provide much instruction as to the statute of limitations has and the underpayment of royalties. Case law interpretation thus becomes paramount. Utah does follow the "discovery rule" taking the position that the statute of limitations does not begin to run until there is a discovery of facts that form the basis of a cause of action. The Utah Court of Appeals in Frito-Lay v. Labor Commission, 193 P.3d 665 (Utah App. 2008) commented that there existed three judicially recognized situations where the discovery rule applies to the statute of limitations:

a. In situations where the discovery rule is mandated by statute;
b. In situations where the Plaintiff does not become aware of the cause of action because of a Defendant's concealment or misleading conduct; and
c. In situations where the case presents exceptional circumstances in the application of the general rule would be irrational or unjust or regardless of any showing the defendant has prevented the discovery of the cause of action.

As reaffirmed by the Utah Supreme Court in Ockey v. Lehmer, 189 P.3d 51 (Utah 2008) the equitable discovery rule operates to toll the statute of limitations until the time at which a party discovered or reasonably should have discovered the facts forming the basis for the cause of action. Hence, Utah is like Wyoming and is unlike Colorado in that the statute of limitations as to the underpayment of royalty owners knew or should have known there was an underpayment.

Interestingly, the leading case pertaining to payment of royalties for natural gas is one involving overpayment not, as one might suspect, underpayment. This is case CIG Exploration, Inc. v. Utah, 24 P.3d 966 (Utah 2001). Here CIG Exploration overpaid the State of Utah. However, the State of Utah claimed that it had no obligation to reimburse CIG Exploration even though it admitted to being overpaid. The State of Utah relied on the statute of limitations that CIG Exploration was barred from pursuing their claim for reimbursement because too much time elapsed since that cause of action accrued.

CIG Exploration argued that its lawsuit was timely because it was filed within the six (6) year statute of limitations. The Utah Supreme Court disagreed and found that the applicable statute of limitations would not be that of six (6) years pursuant to U.C.A Section 78-12-23(2). This statute provided that an action must be brought within six (6) years upon any contract, obligation, or liability founded upon a written instrument.

Interestingly, this is the type of statute of limitations relied upon in Colorado. Instead, the Supreme Court of Utah found that CIG Exploration's cause of action to recover the alleged excess royalty payments was for monies paid. The Court thus also ignored arguments of CIG Exploration as to any breach of any implied covenant of good faith and fair dealing. According to the Utah Supreme Court, CIG Exploration was required to file suit within four (4) years after last payment was made, in this case April, 1985. See U.C.A Section 78 B-2-307.

Accordingly, the statute of limitations pertaining to the payment of royalties in Utah appears to be subject to a four (4) year statute of limitation accruing upon the time the last payment was made. In this instance, it adopts an accrual standard like Colorado, but for a shorter period of time.

GENERAL COMMENTS

Analysis of statute of limitation issues need to be made against the backdrop of certain realities. It is often the case that the recipients of royalty payments have great difficulty even understanding and appropriately digesting the accounting type information provided to them at the time royalty payments are made. Even experienced legal counsel and accountants are often mystified in any attempt to understand provided financial information at the time royalty payments are being made so as to determine whether the royalty payments are in fact accurate.

This reality is complicated because it is often the case that the amount paid to any one royalty owner is not enough to warrant the retaining of professional services offered by an accountant or an attorney. On the other hand, from the point of view of the oil and gas producer the hundreds or thousands of small royalty recipients over the course of time can amount to millions of dollars. This is not only a problem for the recipients of royalties, but also creates an unnecessary level of distrust by the public pertaining to the oil and gas industry itself. To be sure, the vast majorities of those in the oil and gas industry are honest and have no difficulty paying royalty owners what is owed to them under the respective contracts. However, the information that is provided to royalty owners is often so complicated and confusing that many in the general public are left with the impression, typically false, that they are being cheated by industry. This unnecessarily creates barriers between the public and industry that benefits no one. The hallmark of bookkeeping and accounting rests upon transparency and not obstruction. It is upon this backdrop that the accrual issue must be analyzed.

By affixing a date certain to the accrual of the statute of limitations under circumstances where even many well trained professional cannot analyze information to determine whether or not the correct royalty payment is being made creates problems. The providing of a simple “black and white” statute of limitations deadline creates unintended consequences. Unlike Wyoming that adopts an accrual based upon actual discovery of a claim, Utah and Colorado unwittingly invite the potential for unnecessary lawsuits because of inflexibility pertaining to the statute of limitations. The failure to timely sue results in the likely loss of the claim. Declaratory Judgment “suits” (which asks the courts to define the rights of the parties) tend to be filed to preserve claims even if it is less than clear that there is any underpayment. Moreover, the resulting increased legal costs to both royalty owners and industry do little to promote confidence in the other. In fact, such probably increases acrimony. Further, as adopted by Colorado and Utah, it is not possible to ever raise a claim that would survive the statute of limitations that is older than six (6) and four (4) years respectively. This is troubling because there are potential claims that will never be subject to scrutiny no matter the amount of underpayment.

Existing law ought to promote the type of transparency pertaining to bookkeeping and accounting necessary to a well run industry. To this, efforts by the Utah legislature ought to be applauded. Honest and trustworthy industry representatives are encouraged to make the royalty calculations easier to comprehend and discernable for reason that by providing straight forward information arguments pertaining to when a statute of limitations begins to run leaves industry less vulnerable to litigation than those that provide information that is less easily analyzed. Of course, the fact that Utah and Colorado have a "black and white" standard as to accrual of the statute of limitations makes for a standard that is simple.

Because of the significant amounts of money that are paid annually for royalty, all of these issues are not in any fashion inconsequential. Rightly or wrongly, many who receive royalties perceive that they are not receiving what they ought to be paid because of difficulty in understanding the written materials provided at the time royalties are paid. This is unfair. It is certainly unfair to royalty owners, but is also unfair to those many in the oil and gas industry that make good faith efforts to provide to royalty recipients all the monies that are due to them. The law ought to be crafted in such a way to promote transparency and minimize the likelihood of litigation. It is important to understand that it is the role of the courts to analyze existing laws and when necessary reconcile statutes with case law. It is an unfortunate reality of appellate law that sometimes the results reached by appellate courts, while true in their legal analysis, sometimes do not result in a law that is fair or benefits that parties or society as a whole. Luckily, the legislature has the absolute ability, particularly as such pertains to statutes of limitations which are by definition created by legislatures and a product of statute, to act in any way and an environment unconstrained by limitations placed upon our appellate courts.

Ultimately, legislation ought to be enacted which is consistent with both the interests of industry and those of the recipients of royalties. Putting the onus on royalty owners to file suit within prescribe periods of time after a breach is discovered or could be discovered by the exercise of reasonable diligence in the long run protects industry members that are acting consistent with their leases, as they ought to have no fear in providing the financial information being sought as to royalty calculations in a way that would be easily understood. By providing simple and straight forward financial information the statute of limitations begins to accrue sooner as opposed to later in discovery statutes. On the other hand, those that are producing information which tends to be difficult to understand are punished because the statute of limitations will begin to run later as opposed to sooner. A concern with a "black and white" approach to that notwithstanding statutory law, there can be a disincentive to provide quality information.

FINAL COMMENTS

Any "us versus them" mentality does not do service to any of the participants in the oil and gas industry as a whole, whether that be industry or royalty recipients. The relationship between

industry and those that receive royalty payments is at the very heart of our oil and gas industry. Laws that strengthen this relationship ought to be embraced.

If you have any questions pertaining to the positions taken in this paper I would encourage you to ask. If you would like information pertaining to statute of limitations in other jurisdictions, I can provide that information as well. No matter your position on any of these issues, I encourage all of those involved in the oil and gas extraction process to communicate with your state legislators to make sure that laws are being enacted so as to promote the industry as a whole. Partisanship tends to promote inefficiency. While litigation is a terrific way to earn money for attorneys such as myself, they tend to be an awful way to resolve disputes to the actual participants. They ought to be avoided unless absolutely necessary.