TEXAS LAWYER

ALM.

texaslawyer.com | February 23, 2023

Freeze-Related Lease Litigation: The Growing Storm in the Oil Patch

Although its second anniversary is already upon us, Winter Storm Uri is only now beginning to manifest itself in lawsuits brought by royalty owners against operators and their working interest partners.

BY THOMAS CIARLONE JR. AND DEMETRI ECONOMOU

Winter Storm Uri was a natural disaster of epic proportions. It dumped record snowfall on Texas in February 2021, as millions across the state lost power. Gov. Greg Abbott issued a rare disaster declaration for all 254 counties. The Texas chapter of the American Society of Civil Engineers has projected that the ultimate cost of Uri could surpass $300 billion.

Putting this into perspective, Hurricane Katrina caused over $160 billion in damage; and the overall losses for Hurricane Harvey approached $150 billion. Worldwide, Uri is the costliest winter storm on record, not to mention the most expensive natural disaster in U.S. history.

As with most catastrophic weather events, a deluge of litigation inundated the courts in Uri's aftermath. The first salvos were hundreds of lawsuits asserting death, injury and property damage claims. They were consolidated into a multidistrict litigation in Houston, and a handful were selected as bellwether cases for early adjudication.

The plaintiffs broadly targeted the entire energy sector, naming a diverse cast of defendants beginning at the wellhead, through pipelines to power generators, all the way downstream to retail electric providers. Other defendants included transmission and distribution utilities, as well as ERCOT—the Electric Reliability Council of Texas. The gravamen of the claims was that the energy industry as a whole breached a duty to ensure uninterrupted electrical service to homes and businesses.

At the end of January, the pipeline and gas producer defendants were dismissed from the test cases, after successfully arguing that they owed no duty to the general public—and that, regardless, the nexus between their conduct and losses suffered far downstream was too attenuated to support a finding of proximate causation. Unfortunately for the industry, pipelines and producers are not yet out of the woods.

To begin with, the MDL plaintiffs are virtually certain to appeal

Courtesy photos

(L-R) Thomas G. Ciarlone Jr. and Demetri J. Economou of Kane Russell Coleman Logan PC.

the dismissal of the pipelines and producers. On this score, the Houston court of appeals may represent a more hospitable tribunal for the plaintiffs; and, in all events, the plaintiffs will get a second bite at the apple, in the form of de novo review of the MDL court's ruling that the claims against pipelines and producers have no basis in law or fact.

Several new winter storm lawsuits were recently filed by claims aggregators bankrolled by private equity firms. Although these cases bear some similarities to those on the MDL docket, and may ultimately end up there, the nature of the alleged misconduct is somewhat different.

At bottom, the plaintiffs in these cases contend that market participants (including some gas producers) enlisted the storm as a pretext for curtailing production—as part of a larger scheme for artificially inflating commodity prices, to the detriment of residential and commercial consumers of electricity. The same species of "market manipulation" claims have been copycatted and repackaged as putative class actions seeking relief on behalf of thousands of similarly situated Texans.

This is the juncture where royalty owners will stand up and take notice—and, inevitably, some of them will grow litigious. With producers accused of selling production at historically high prices (as a result of coordinated efforts to depress supply and increase demand), royalty owners will scrutinize their check stubs to ensure that they too reaped the benefits of stratospheric prices.

This could become a vexing issue for vertically integrated companies with affiliated producers, pipelines, and marketing and refining arms residing under a shared corporate umbrella. In these instances, the producer might be paid one price for gas, which is subsequently marketed and sold further downstream by an affiliate of the producer at a higher price. Royalty owners will maintain that they are entitled to payment based on the higher, downstream price.

The flip side of the coin is that some producers did not receive record-breaking prices for production during Uri, notwithstanding days in February 2021 when the market price of gas was hundreds of dollars per MMBtu. In these circumstances, royalty owners—aided by aggressive accountants who monitor their portfolios as a prelude to litigation—will cite operators for not making them even more money. Enter the implied covenant to market (and express marketing obligations in custom lease forms negotiated by sophisticated mineral lessors). To the extent operators did not capture the most sales at the highest prices, royalty owners will accuse operators of failing to adequately market their production, regardless of force majeure or other conditions on the ground.

Given the high price multiples, damages claims will be significant, even if the likelihood of success on the merits is comparatively low. As a result, royalty owners will train their sights on metering, measurement, and proceeds calculations—the basis for more traditional royalty claims which may not have been economical to pursue in a normal pricing environment, but which become more attractive against the backdrop of the winter storm. These factors will embolden royalty owners, who might otherwise keep their powder dry on the sidelines, to file suit.

Another scenario that will inspire litigation is the one in which a single mineral owner has leased to multiple operators in the same general vicinity. In this context, different operators may be paying the same mineral owner different amounts per MMBtu. If the delta is significant—as it can be during serious weather events and other periods of erratic pricing—the mineral owner may parlay the pricing disparity into a royalty underpayment claim.

This cause of action is more likely to arise out of bespoke leases that include a most-favored-nation or comparable-sales clause. These contract provisions can put operators in the unenviable position of paying royalties based on an amount far greater than the proceeds that the operator actually received for its gas.

Although its second anniversary is already upon us, Winter Storm Uri is only now beginning to manifest itself in lawsuits brought by royalty owners against operators and their working interest partners. In the months and even years ahead, however, we anticipate a cascading wave of new freeze-related royalty litigation against oil-and-gas companies with a footprint in Texas.

Thomas G. Ciarlone Jr. *and* Demetri J. Economou *are Houston-based partners at Kane Russell Coleman Logan, where they co-chair the firm's oil, gas and energy practice group. Ciarlone and Economou were members of the defense working group that helped obtain the dismissal of all claims against gas producers and pipelines in the Winter Storm Uri MDL. In June, they will be speaking about freeze-related litigation in the oil patch at the annual meeting of the American Association of Professional Landmen in Huntington Beach, California. They can be reached at tciarlone@krcl.com and deconomou@krcl.com.*