PENN ROAR

Pennsylvania's Royalty Owners Action Report

October 2013
Volume 3
Issue 5

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Inside This Issue

Page 2... A Message from NARO-PA VP, Trevor Walczak

Page 3... Outline and Impressions of Proposed Class Action Settlement in Demchak v. CHK

Page 7... Review of Class Action Procedures and Proposed Chesapeake Class Action Settlement

Page 12... Gas Leasing 101: The Market Enhancement Clause

Page 13... Common Royalty Owner Questions and Concerns About the CHK Settlement

Page 15... Legislative Update

Page 17... NARO-PA VP's Talking Points Memo

Page 18... Has Forced Pooling Come to PA With SB 259?

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Chesapeake Files Class Action Settlement Over Post-Production Cost Deductions

By: John Shoemaker; Greevy & Associates

Chesapeake Appalachia LLC is the defendant in a class-action lawsuit seeking a ruling that the deduction of various post-production costs from royalty payments violates the so-called "market enhancement" clause. The lawsuit was filed August 30, 2013, in the United States District Court for the Middle District of Pennsylvania.

Pennsylvania law has for decades permitted oil and gas drillers to deduct certain post-production costs-the costs of gathering and transporting the gas to market-from a landowner's royalties. Costs are deducted in proportion to the royalty percentage. Thus, if the lease provides a one-eighth royalty, the lessor bears one-eighth of allowable post-production costs. For most lessors, the Pennsylvania Supreme Court's holding in *Kilmer v. Exleco Land Services* cemented that law even more firmly. Lessors with the market-enhancement clause, however, insist that their leases override the default rule.

The lawsuit does not affect landowners without a market-enhancement lease.

Market enhancement clauses typically prohibit deduction of costs of gathering, treating, dehydrating, compressing, and transporting the gas to transform the product into marketable form.

The clause typically expressly permits deduction of other costs which enhance the market value of the product.

Filed simultaneously with the plaintiff's; complaint was a motion to approve a settlement of the lawsuit. According to documents filed with the court, Chesapeake does not oppose the settlement.

Under the proposed settlement, Chesapeake would continue to deduct post-production costs, but would absorb 27.5% of what it considers to the landowner's share. Landowners would continue to bear 100% of what Chesapeake considers to be the landowner's share of the cost to transport gas in an interstate pipeline.

Also under the proposed settlement, Chesapeake would refund 55% of costs already deducted. According to documents filed with the court, the lead plaintiffs will request that up to one third of the costs refunded be awarded to plaintiff's attorneys as fees. They would additionally request up to one third of funds recovered for a five-year period following settlement. The documents indicate that Chesapeake would pay no part of those fees. A new deduction could appear on

landowner's; royalty checks to pay those attorney's fees.

According to the complaint filed with the court, the plaintiffs are represented by Michelle R. O'Brien, Esq., of Moosic, and attorneys from Philadelphia, Mississippi, New York City, and Washington DC.

Generally, each landowner with an oil and gas lease with a market enhancement clause who has begun to receive production royalty checks would be a member of the proposed class. Landowners who had not begun to receive royalties before the effective date of the settlement would be excluded from the class. Any party otherwise included in the class may choose to opt out of the class. Documents filed with the court indicate that Chesapeake may terminate the settlement if 5% or more opt out.

Any party included in the class would lose his right to arbitrate or litigate the matter with Chesapeake outside the class-action suit. Neither the class nor the settlement is approved by the court. If the court certifies the class, class members will receive a written notice and a questionnaire from a court-appointed settlement administrator via mail.

The plaintiffs and the defendant have moved the court to set a hearing date relative to the proposed settlement but no date has been fixed yet. Several parties have sought to intervene in the case, and it looks like their motions may have to be resolved before the suit moves forward.

Settlement has not been approved yet, the class is not yet certified, and no deadline is fixed for opting out.●

A message from NARO-PA Vice-President, Trevor Walczak

NARO-PA has taken no position, either for or against, the proposed settlement. Remaining part of the class or opting out of the settlement is a decision that needs to be made by each individual royalty owner, in accordance with their individual situation. NARO-PA, in keeping with its stated mission of educating royalty owners, is providing relevant information regarding the settlement in an effort to help PA royalty owners make an informed decision based on all of the facts surrounding the settlement. Royalty owners are encouraged to seek legal council from an oil and gas attorney familiar with this settlement, to determine if remaining part of the class is right for them.

Royalty owners should never be passive in the management of their mineral estate and they should never be encouraged to receive royalties without having to do anything. NARO-PA is an educational resource which helps mineral owners maximize their mineral estate and issues like this represent the need to be engaged in active management because of the financial implications

For more information regarding the settlement read:

http://thetimes-tribune.com/news/business/chesapeake-to-pay-7-5-million-to-settle-post-production-cost-suit-1.1544612

http://triblive.com/business/headlines/4648694-74/settlement-chesapeake-company#axzz2iJ2MIVrx

http://stateimpact.npr.org/pennsylvania/2013/09/03/chesapeake-energy-agrees-to-pay-7-5-million-to-settle-royalty-lawsuit/

http://stateimpact.npr.org/pennsylvania/2013/09/20/royalty-group-urges-landowners-to-pay-close-attention-to-chesapeake-settlement/

http://thetimes-tribune.com/news/attorney-challenges-natural-gas-lease-settlement-1.1558107

October Guest Editorial:
OUTLINE AND IMPRESSIONS OF PROPOSED CLASS ACTION SETTLEMENT IN DEMCHAK v. CHESAPEAKE

By: Douglas A. Clark, Esq., the Clark Law Firm

Introduction and Brief History

Our legal team has been working diligently over the past year gathering information and thoroughly researching the issue of Chesapeake and other company's actions of deducting post-production costs from royalty payments for landowners with Oil and Gas Leases containing the Market Enhancement Clause ("Market Enhancement Clause") or similar clauses.

The Clark Law Firm's Class Action Arbitration Action Filed April 1, 2013

On April 1, 2013 we formally filed an action with the American Arbitration Association ("AAA"). In our AAA filing we assert that Chesapeake and other gas companies have breached certain Oil and Gas Leases by taking inappropriate and unauthorized deductions of post-production costs from landowner's royalty payments. ***There are thousands of leases containing the Market Enhancement Clause or similar clauses.***

Our position is that a gas company cannot lawfully deduct ANY post-production costs from Oil and Gas Leases that contain the Market Enhancement Clause or similar provisions.

We believe that landowners with the Market Enhancement Clause and similar royalty clauses are entitled to 100% of the post-production costs that have been deducted to date and will be deducted in the future.

Our April 1, 2013 AAA filing seeks class action status on behalf of any and all landowners receiving royalty deductions with the Market Enhancement Clause or similar provisions.

Chesapeake Takes 100% of Deductions

While Many Other Gas Companies Take NO Deductions Under the Market Enhancement Clause and Similar Clauses

Chesapeake takes the position that they are entitled to deduct 100% of post-production costs incurred from anyone with the Market Enhancement Clause or similar provisions. ***It is extremely important to note that several other companies have taken a completely different position and***

Continued to page 4

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do not take any deductions from landowners with the Market Enhancement Clause or similar provisions. From our experience it appears that Statoil, Mitsui, Cabot, Southwestern, SWEPI, WPX, Talisman, Ultra and others are not taking any deductions whatsoever from landowners with the Market Enhancement Clause or similar provisions.

Summary of Proposed Chesapeake Class Action Settlement Filed on August 30, 2013

On Friday August 30, 2013, a Class Action Complaint and Proposed Settlement with Chesapeake were simultaneously filed in the United States District Court for the Middle District of Pennsylvania. *See Demchak Partners Limited, Limited Partnership, et. al, vs. Chesapeake Appalachia.* It is noted that neither the Plaintiff's filings nor Chesapeake's filings informed the federal court of our outstanding AAA class action litigation filed approximately five months earlier, on April 1, 2013.

We strongly believe that the Proposed Settlement is entirely insufficient and completely inadequate to compensate Pennsylvania landowners with the Market Enhancement Clause or similar provisions.

Outline of the Demchak Proposed Settlement Terms Approved by Chesapeake

With regard to the proposed class action settlement agreed to by Chesapeake, the broad terms of the proposed settlement agreement are as follows:

1. ***55% Refund of Deductions Taken Prior to September 1, 2013***
   Chesapeake will refund landowners 55% of past deductions that Chesapeake has taken prior to September 1, 2013. If the requested attorney fees are approved, Landowners will receive 36.685% of past deductions taken prior to September 1, 2013;

   FOR EXAMPLE: *If a landowner had $10,000.00 of post-production costs deducted prior to September 1, 2013, landowners will receive $3,668.50 of the $10,000.00 in deductions that were taken prior to September 1, 2013.*

2. **Chesapeake will take 72.5% of future Deductions for the Lifetime of the Lease**
   After September 1, 2013, Chesapeake will take deductions at the rate of 72.5% of all post-productions incurred compared to previously taking 100% of all deductions. Chesapeake will deduct 72.5% of all post-production costs **for the lifetime of the Landowner's Oil and Gas Lease**.

   This will mean that landowners leased with Chesapeake will only receive 27.5% of post-production costs while many other companies are not taking ANY deductions from landowners with the Market Enhancement Clause or similar language. This 27.5% figure will be reduced to 18.3% for up to the first 5 years if the requested attorney fees are approved.

   FOR EXAMPLE: *If there are $1,000.00 of post-production costs charged to a landowner in a given month, for up to five years while attorney fees are taken, landowners will receive $183.00 of the $1,000.00 in deductions.*

   If approved, after the five years of attorney fees are paid, landowners will then receive 27.5% of the total post-production costs that were being deducted and Chesapeake will deduct and keep 72.5% of all post-production costs incurred **for the lifetime of the lease**.

   FOR EXAMPLE: *If there are $1,000.00 of post-production costs charged to the landowner in a given month, after the five year attorney fee period, the landowner will receive $275.00 and Chesapeake will deduct and keep $725.00 from this payment. This 27.5% pay-out will remain* ***for the lifetime of production under the terms of the landowner's lease.***

3. **Summary of Attorney Fees Requested by Demchak Class Attorneys**
   The attorneys representing the Demchak Plaintiffs have requested court approval for the following attorney fees:

   a. **Attorney Fees on Lump Sum Past Deduction Payment**:
      33 1/3% or 1/3rd attorney fees on landowner's past recovery of 55% of all past deductions taken prior to September 1, 2013. It is estimated by Demchak class counsel that the 55% of all past deductions

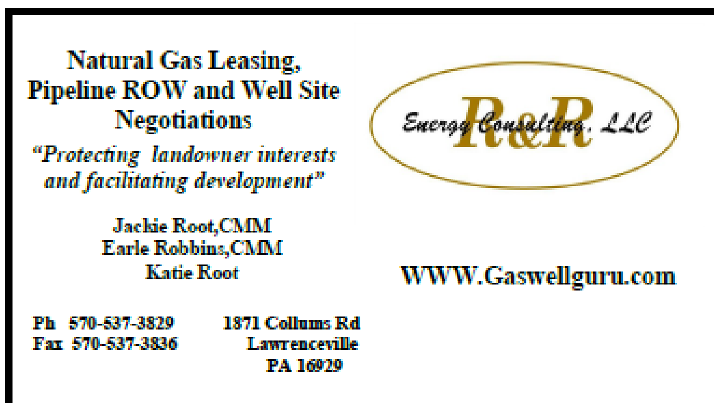
Continued to page 5

is 7.5 million dollars. The Demchak attorneys will receive 1/3 of all past production taken, or 2.5 million dollars if the Demchak's estimate of prior deductions taken is correct. Landowners will then divide the remaining 5 million dollars such that, after legal fees, each landowner who had deductions taken prior to September 1, 2013 will receive 36.685 % of past deductions taken by Chesapeake.

It is important to remember that this 55% payment is only for landowners who Chesapeake took deductions prior to September 1, 2013. After September 1, 2013, Chesapeake will only pay the landowner 27.5% of post-production cost deductions, which will be reduced to 18.3% for up to five years while attorney fees are taken.

We believe that the 7.5 million dollar figure is a low estimate of the total deductions taken by Chesapeake prior to September 1, 2013. We believe that this number is a low estimate which may mislead landowners from fully appreciating the magnitude of the deductions at issue. It is important to note that the 7.5 million dollar figure is not Chesapeake's estimate, but the Demchak attorneys' estimate. Certainly Chesapeake is in the best position to provide an estimate of the total past deductions taken under the Market Enhancement Clause or similar provisions, but Chesapeake has not provided the federal court an estimate of past post-production costs taken prior to September 1, 2013.

Also, the 7.5 million dollar post-production costs figure covers only a few years of deductions from the time royalties started to be paid to Pennsylvania landowners up to September 1, 2013. This cumulative amount of post-production costs ultimately incurred in Pennsylvania may exceed 1 billion dollars when you consider that gas production in its infancy and deductions for post-production costs under the Market Enhancement Clause will now be incurred for 20-50 years per well based on current estimates of well life expectancy..



4. **What Leases are Covered by this Settlement?** It is critical to note that landowners with the Market Enhancement Clause or similar language are included in this proposed class action settlement **even if they have not yet received any royalty payments from Chesapeake**. As one common example, the Wyoming County Landowner Group leases currently held in whole or in part with Chesapeake are covered under this proposed class action settlement, **even if the landowner is not yet receiving royalties.** There are thousands of leases impacted by this proposed settlement and many landowners leased with Chesapeake who have not received a royalty payment will be covered by this proposed settlement.

Our Current Position Regarding the Proposed Settlement

It is our position that this proposed settlement is entirely insufficient and wholly inadequate to compensate Pennsylvania landowners with the Market Enhancement Clause and similar language. Although there are never guarantees, we strongly believe in our legal position and feel landowners with the Market Enhancement Clause or similar provisions should not share in ANY post-production costs. Again, the vast majority of gas companies we have seen are not currently deducting post-production costs under the Market Enhancement Clause or similar language.

This proposed settlement may cause all other gas companies operating in Pennsylvania to rethink their position and start deducting post-production costs from landowners with the Market Enhancement Clause or similar language.

We are extremely concerned that other companies,

Continued to page 6

Impressions of Proposed Class Action Settlement in Demchak v. Chesapeake… ***continued from page5***

including Statoil and Mitsui, will follow Chesapeake and start taking post-production deductions from landowners with the Market Enhancement Clause. If this settlement is approved, it may trigger many other companies to start deducting 100% of post-production costs in an effort to force landowners to settle for significant reductions in their royalty payments. Although this settlement does not cover landowners who are not leased in whole or in part to Chesapeake, we believe that all landowners have reason for concern as to whether this proposed settlement may impact their leases with other companies in the future.

How does a company explain to its shareholders that they should incur 100% of all post-production costs while Chesapeake incurs only 27.5% of post-production costs?

I encourage all landowners to educate themselves and thoroughly review all aspects of the proposed settlement and make the best individual decision for themselves and their families. ●

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NARO-PA Welcomes Two New Regional Board Members

We are excited to announce that **Joseph Zuber,** of Montrose, was elected as a Northeast Regional Board Member and **Lynne Seligman** was elected as a Southeast Regional Board Member. She lives in Kennett Square, which is a suburb of Philadelphia, but she owns property in Sullivan County.

Since Joe became a NARO-PA member in March of 2012, he has been the driving force behind the success of the NE regional coffeehouse meetings and our NE membership surge. He is a motivated team member and is a dedicated ambassador for NARO-PA.

Lynne is committed to shoring-up our SE region by initiating regular coffeehouse meetings in the SE in an effort to reach people who live there, but own property in the Marcellus region. She feels her biggest challenge is getting reliable information about drilling to the people of the SE since the media has such an established anti-gas agenda.

October Guest Editorial:
REVIEWS OF CLASS ACTION PROCEDURES AND PROPOSED CHESAPEAKE CLASS ACTION SETTLEMENT

By: Francis P. Karam, Esq.

On August 30, 2013, Chesapeake Corporation and Demchak Partners (The Demchak Plaintiffs) announced the simultaneous filing and settlement of a class action of claims that Chesapeake had been wrongfully taking deductions from the Royalties of landowners whose gas leases contain a “Market Enhancement Clause.” The Market Enhancement Clause forbids Chesapeake from taking deductions from royalties before gas is in “marketable condition.”

This article will focus on Class Action procedure, rather than the underlying case, and attempt to explain class actions generally and specifically the terms and status of this class action, which has far reaching economic significance in this region, well into the future.

What is a Class-Action?

A class-action is a legal case where one or a few persons with a particular claim act as representatives of a large group of persons with the same or similar claim, who are not in court. The representatives are called lead plaintiffs, or class representatives. All other persons in the class are called “absent class members”. It is important to understand that absent class members---if they do not affirmatively “opt-out”--- are bound by the outcome of a class-action just as if they were in court themselves. In other words if there is a judgment or settlement, it applies not only to the representatives who have been in court on the case but everyone in the class. Because the judgment of a class-action is binding on all absent class members there is a higher level of court supervision of a class-action than in a singular case.

One way in which A court supervises a class-action is that it must approve a settlement. The court must determine that the settlement is fair and adequate (that the money paid in exchange for the settlement is enough). Another important aspect of court supervision is the selection of attorneys to represent the class members. A court must determine both that the attorneys are qualified, and that they will do the best job of representing the class. A court will also look at any proposed legal fee to make sure that it does not give a windfall to the class lawyers by giving them a lot of money for a little bit of work.

What is a Class-Arbitration?

Like a class action, a class arbitration is a case in which a few representatives begin an arbitration on behalf of a large number of persons who have the same claim, and who also, all have an arbitration agreement with the defendant. In Pennsylvania, virtually every lease with a Market Enhancement Clause, also has an arbitration agreement.

On April 1, 2013 we (Attorneys Douglas Clark, Gerard Karam and I) formally filed an action with the American Arbitration Association ("AAA"). In our case Dr. Russell Burkett and his wife Gayle are the lead representative plaintiffs. In our AAA filing we assert that Chesapeake and other gas companies have breached certain Oil and Gas Leases by taking inappropriate and unauthorized deductions of post-production costs from landowner's royalty payments.

Our AAA filing seeks class action status on behalf of any and all landowners receiving royalties with the Market Enhancement Clause or similar provisions. We maintain that our AAA class action arbitration filing is currently the most effective vehicle for bringing these claims against Chesapeake.

Class Action Settlement vs. Class Arbitration

What is the difference and why not use the class action filed in court? The basic difference is that the class action in court can only go forward if Chesapeake allows it to go forward. Since all plaintiffs—both the Demchak Plaintiffs and the Burkett Plaintiffs have arbitration clauses, Chesapeake can dictate the terms of the class action settlement. If it does not like the terms, it can take its ball and go home and the Demchak Plaintiffs cannot force it to give up information in discovery or to settle on better terms.

In arbitration, however, the Burkett plaintiffs can do just about anything that they could do in a court of law, such as pursue discovery and attempt to gain leverage against Chesapeake for a better settlement. Of course there is no guarantee that the Burkett plaintiffs would win, but they at least have the chance to win. The Demchak plaintiffs must take Chesapeake's offer or not. They have no legal means to get evidence, or to win a case, only to settle or go away.

Class-Action Settlement Procedure

Rule 23 of the Federal Rules of Civil Procedure sets out the procedure for court approval of a class-action settlement. First the parties that agreed on the settlement, usually plaintiffs' counsel and the defendants file a motion for preliminary approval of the settlement. A court will look at this, and if there are no objections to it will generally grant preliminary approval to a settlement. But preliminary approval is not a certainty, especially if there are questions about the ultimate validity of the settlement.

If the court does grant preliminary approval, it will require class legal counsel to send out a written notice to all class members describing the settlement and describing what will be released or given up by the absent class members in exchange for the settlement.

After the notice is sent out, there is a period of time during which any class member or their attorney may take one of two actions: First they may "opt-out" of the settlement meaning they write to the court and say they do not want to be part of the class-action settlement and would prefer to pursue the case individually on their own. Second, class member or their attorney may object to the settlement and attempt to convince the court that there should be no settlement at all on the grounds that the settlement is not fair or that it does not provide adequate compensation to the absent class members.

The most important thing for class members to understand is that in this type of class-action, if they do nothing they will automatically become part of the class and will be forever bound by the settlement.

Summary of Proposed Settlement Filed on August 30, 2013

On Friday August 30, 2013 a Class Action Complaint, proposed settlement, and related documents were filed in the United States District Court for the Middle District of Pennsylvania. With regard to the proposed class action settlement agreed to by Chesapeake, the broad terms of the proposed settlement agreement are as follows:

Who Does the Settlement Cover?

The Settlement applies to anyone who has a Pennsylvania lease that contains a Market Enhancement Clause or any similar clause that prevents Chesapeake from taking post-production deductions from royalties.

It applies to any lease that Chesapeake owns in whole or in part, according to the business records of Chesapeake.

It includes leases that have not yet received royalty payments, as long as those leases are owned in whole or in part by Chesapeake as of August 30, 2013.

It does not include any lease in which Chesapeake has not made a royalty payment and which Chesapeake has sold or assigned as of August 30, 2013.

What do Landowners Get from the Settlement?

1. Chesapeake will refund landowners 55% of past deductions that Chesapeake has taken prior to September 1, 2013.

2. Chesapeake will continue to take deductions at the rate of 72.5% of all post-productions incurred compared to previously taking 100% deductions; This will mean that landowners will receive 27.5% of what had previously been deducted, on a going forward basis.

3. Moving forward, landowners will receive 27.5% of the total post-production costs that were being deducted:

For example, if there are $1,000.00 of post-production costs in a given month, the landowner will now receive $275.00 and Chesapeake will continue to deduct $725.00 from this payment. (We maintained in our AAA filing that landowners are entitled to the entire 100% of all post-production costs deducted under the MEC or similar provisions);

4. The attorneys representing the Plaintiffs have requested court approval for the following attorney fees:

33 1/3% of the past recovery for 55% of all past deductions taken.
-It is estimated that the 55% of all past deductions taken that will be returned to all Pennsylvania landowners as a result of the proposed settlement is 7.5 million dollars. This means that after legal fees, approximately 36.3% of past deductions would be distributed, if this settlement is confirmed.

33 1/3 % of all future payments to landowners under the terms of this settlement for a period as long as the next 5 years, if the court approves. If they received the fee for 5 years, that means that the landowner would receive, for the next five years, after legal fees, 18.15% of what Chesapeake had been deducting. After 5 years, you would receive 27.5%.

The Class Action Release: What Do Landowners Give Up?

If the class action is approved and if a landowner does not opt-out, in return for the benefits above, the landowner will give up, for all time, the following:

1. ***"any and all claims and causes of action related to the calculation, payment, and/or reporting of Royalty payments made by Chesapeake".*** Thus the proposed settlement releases acts far beyond the wrongful taking of deductions under the Market Enhancement Clause and in fact impacts other lease provisions relating to royalties that are common in leases.

2. The release also releases unnamed parties and partners of Chesapeake who at this time may not even be taking deductions under the MEC ***" either on its own working interest share or on behalf of other working interests, on Gas produced pursuant to a Pennsylvania Lease"*** We do not know who or what these entities are, but they may include other companies who are currently not taking deductions. (*Proposed Settlement Agreement, Clause 1.34*).

Continued to page 10

Continued from page 9

3. The release releases claims far beyond those in the complaint: "**claims for breach of contract, conspiracy, breach of implied duties and covenants, unjust enrichment, *accounting*, and injunctive relief"** (*Proposed Settlement Agreement, Clause 1.34*). (emphasis added) Most troubling is that this release takes away from Lessors their right to an accounting as to all aspects of their royalty payments, a right in no way connected to the Market Enhancement Clause.

4. The release releases unnamed Chesapeake affiliates and acts by prohibiting: "challenges to the manner in which sales are made to an affiliated entity, if any, and challenges to the reasonableness of Post-Production Cost deductions." (*Proposed Settlement Agreement, Clause 1.34*).

5. Additionally, the proposed settlement seeks to "**fully and forever release and discharge Defendant, and its parents, affiliates, and subsidiaries, and their respective predecessors, successors, assigns, present, former and future officers, directors, employees, agents, any third party payment processors, independent contractors, successors, assigns, attorneys and legal representatives (collectively, "Defendant Releases") from any and all of the Settled Claims**." (*Proposed Settlement Agreement, Clause 11.1.1*)

Current Status of the Class Arbitration and the Class Action

We are seeking to continue to pursue our class arbitration to get better terms from Chesapeake. Although our Class Action is in a preliminary stage, we have three distinguished retired judges as arbitrators, and we're in the process of briefing the key issue of whether this case could proceed in arbitration as a class action, and who (arbitrators or judge) would make that initial decision. The arbitrators have ordered Chesapeake to file a brief on October 20, and briefing will end in late November. If the arbitrators rule against Chesapeake, Chesapeake could ask a court to overturn their ruling.

In this case, we have taken the somewhat unusual step of moving to intervene in the Demchak case as a full participant in the case, and asking the court to transfer the whole case to arbitration, since the leases have arbitration clauses and we have begun a class action in arbitration five months before the Demchak case was filed. We are asking the court to delay any decision on preliminary approval of the settlement until the arbitration is finished. Those motions are also under court consideration, and briefs will all be filed into November of this year.

Ultimately, a court will decide if the arbitrators have made a ruling within their powers, and whether the case will go forward in arbitration or whether the settlement as it now stands, is the end. ●

Editor's note: *In the Legal Brief section of the July 2013 issue of PennROAR, we recognized that a group of Pennsylvania landowners had brought an arbitration claim against Chesapeake Corp. for wrongfully taking deductions from gas lease royalties. The arbitration seeks class action status on behalf of all Pennsylvania landowners from whom Chesapeake is taking royalty deductions, and who have lease clauses that prohibit deductions out of gas royalties.*

The arbitration claim was filed on April 1, 2013 by three law firms, The Clark Law Firm, of Peckville Pa., Mazzoni Karam Petorak & Valvano of Scranton, Pa. and Law Office of Francis P. Karam, Esq. P.C., New York, N.Y., who have submitted these October Guest Editorials. PennROAR recognizes that the outcome of the Demchak settlement could potentially affect the outcome of the arbitration claim filed by The Clark Law Firm, of Peckville Pa., Mazzoni Karam Petorak & Valvano of Scranton, Pa. and Law Office of Francis P. Karam, Esq. P.C., New York, N.Y., and I feel their perspective is important to include in this debate, since, as stated, they have intervened in the Demchak v. Chesapeake settlement. ●

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Gas Leasing 101: The Market Enhancement Clause

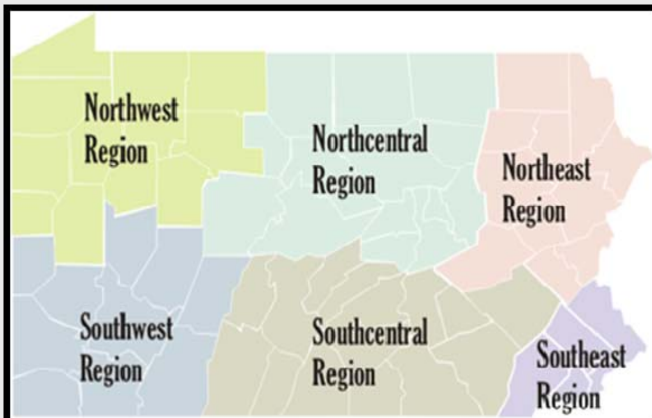
The following are examples of a common Market Enhancement Clause and Ready for Sale or Use Clause:

Market Enhancement Clause

MARKET ENHANCEMENT CLAUSE: It is agreed between the Lessor and Lessee that, notwithstanding any language herein to the contrary, all oil, gas or other proceeds accruing to the Lessor under this lease or by state law shall be without deduction, directly or indirectly for the cost of producing, gathering, storing, separating, treating, dehydrating, compression, processing, transporting, and marketing the oil, gas and other products produced hereunder to transform the product into marketable form; however, any such costs which result in enhancing the value of the marketable oil, gas or other products to receive a better price may be deducted from Lessor's share of production so long as they are based on Lessee's actual cost of such enhancements. However, in no event shall Lessor receive a price that is less than, or more than, the price received by Lessee.

Ready for Sale or Use

Royalties shall be paid without deductions for the cost of producing, gathering, storing, separating, treating, dehydrating, compressing, transporting, or otherwise making the oil and/or gas produced from the leased premises ready for sale or use. All oil and/or gas royalty shall be delivered free of cost in the tank or pipeline (for oil) and into the pipeline (for gas), with the exception of the Lessor's prorated share of any taxes, measured by volume, on the oil and/or gas royalty.●



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COMMON ROYALTY OWNER QUESTIONS AND CONCERNS ABOUT THE CHK SETTLEMENT

By: Douglas A. Clark, Esq., the Clark Law Firm

"Does this proposed settlement apply to me if I am currently leased to Chesapeake with a Market Enhancement Clause and I have not yet received any royalty checks from Chesapeake?"
*Answer: YES! **If this settlement is approved by the court, then it will apply to everyone leased to Chesapeake who has a market enhancement clause or similar clause in their lease or addendum.** This is true whether or not you are currently receiving royalty payments from Chesapeake. The proposed settlement, if accepted and approved by the court will apply to everyone who has a Market Enhancement Clause, or similar clause in their lease or addendum.*

"I have an addendum to my lease and that wasn't mentioned at all in the article; I don't think this applies to us."
Answer: The proposed settlement, if accepted and approved by the court will apply to everyone currently leased to Chesapeake who has a Market Enhancement Clause, or similar clause in their lease or addendum. If the court approves the settlement the only way to avoid it will be to proactively inform the court that you want to "opt out" of the settlement.

"Is this proposed settlement final? If not, what are the procedures moving forward?"
*Answer: This is a proposed class action settlement. It is not a settlement unless and until a court approves it. There is usually a time period of 4-6 months between the first announcement of a settlement and its final approval by a court. Class action procedures allow anyone who disagrees with the settlement to go into court. We believe that this settlement is inadequate and too favourable to Chesapeake. Class action procedures also allow anyone who disagrees with the settlement to "opt-out" to pursue their case individually. **Anyone who does not object or opt-out will be bound by the settlement and will no longer have the right to sue Chesapeake for taking wrongful deductions**.*

"Is Chesapeake going to pay 72.5% of the deductions they have been taking going forward?"
*Answer: NO, the opposite. **Chesapeake will now deduct 72.5% of the post-production costs**. Chesapeake has been deducting 100% of the post production costs.*

"Am I getting everything back from Chesapeake based on this settlement?"
Answer: NO. You are not getting everything back from Chesapeake based on the settlement. There is a settlement estimate of approximately $7.5 million for past deductions. We believe that this estimate is low. This represents, according to Demchak's class attorneys' estimate, 55% of past deductions taken as of September 1, 2013. Out of this 7.5 million, if this settlement is approved, the Demchak lawyers will take 33 1/3% that is $2.5 million. That leaves $5 million to be distributed to everyone who has had deductions taken. That means that if you accept the settlement you will receive, after legal fees about one third of the past deductions that Chesapeake has taken from you.

"What deductions will Chesapeake take moving forward after the settlement?"
Answer: Chesapeake will continue to take deductions for gathering, compression and other post-production costs, but will simply reduce the deductions it is taking by the percentage of 27.5%.

Continued to page 14

Common Questions and Concerns about Settlements Continued from page 13

"I am afraid that once this settlement goes through, the other companies who have bought parts of my lease, like Statoil or Mitsui, will now begin taking post-production deductions when they were not taking deductions in the past. Could this happen?"
Answer: That is a very good point and something we fear as well. We are very concerned about this possibility and it will be one of the most significant points that we bring up before the judge when we go into court to disagree with the proposed settlement.

"On what lease terms will Chesapeake be allowed to take the post-production deductions under after this?"
Answer: Chesapeake will be allowed to take any post-production cost deduction it has been taking in the past under the Market Enhancement Clause or similar language, but must reduce these deductions by 27.5%. By way of an example, if you had $1,000.00 taken in one month for post-production costs in the past, Chesapeake would now take $725.00 in deductions. You would receive $275.00 out of the $1,000.00 post-production costs. (Note that this calculation does not consider legal fees).●

"I'm thinking about signing a gas lease agreement in the Marcellus Shale region. Where do I go from here?"

Sometimes good things happen that you haven't planned for – and they happen quickly. Signing a lease agreement for shale drilling may be one of those things. Now you're looking at opportunities you never dreamed of, and you want to make the right decisions.

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Legislative Update:

Bill to Clarify Royalty Minimums Introduced in State House

Press Release: 9/30/2013

Rep. Garth Everett

HARRISBURG – Legislation that seeks to protect the interests of landowners with royalty agreements has been introduced in the state House, according to four members of the Pennsylvania House of Representatives who are spearheading the measure.

House Bill 1684, sponsored by Reps. Garth Everett (R-Lycoming), Matt Baker (R-Bradford/Tioga), Tina Pickett (R-Bradford/Sullivan/Susquehanna) and Sandra Major (R-Susquehanna/Wayne/Wyoming), seeks to clarify state law regarding the minimum royalty payment for landowners so that the deduction of post-production costs from unconventional wells may not result in royalty payments less than the guaranteed minimum.

"My colleagues and I have heard from hundreds of lease holders here in the Marcellus Shale area whose royalty payments are below the guaranteed state minimum – all because of post-production costs," Everett said. "Our issue with this is that these landowners were never given notice from the gas companies about how these post-production costs were to be deducted, and to us, that is not operating in good faith. We want residents to be treated fairly, and that is the intent behind our legislation."

According to a 1979 state law, a minimum royalty payment of one-eighth for oil, natural gas, or gas of any other designation was guaranteed, helping to ensure fairness and protect landowners from deceptive leases.

"This legislation is all about protecting the rights of consumers, ensuring they have all the facts and guaranteeing royalties that are rightfully theirs," Pickett said. "The minimum royalty of 12.5 percent should be upheld by law as just that – the minimum. All costs charged back to the landowner beyond the amount guaranteed in state law should be fully clarified so that everyone is apprised of all costs."

In the past few months, some natural gas companies have attempted to reduce royalties below the statutory minimum by transferring post-production costs to royalty owners. These are costs that are incurred between the wellhead and a final market point of sale and typically include dehydration and transportation. When these expenses are deducted, final payments often result in royalty shares of less than one-eighth, which is equivalent to about 12.5 percent.

"This is an issue that was brought to our attention some time ago by landowners who noticed a discrepancy in their payments," said Baker. "Those of us in the northern tier joined together to draft this measure and rally support for this legislation. I am pleased we are making such swift progress in having this move through the Legislature."

"Landowners simply want to be treated fairly and receive the amount of payment they were promised when they entered into their agreement with the natural gas companies," said Major. "This measure will ensure Pennsylvania landowners are protected from these types of unfair practices."

The legislation, which has bipartisan support from nearly two dozen lawmakers, has been referred to the House Environmental Resources and Energy Committee for study and consideration.●

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NARO-PA Vice-President's Talking Points Memo: Post-Production Costs and Minimum Royalties

The issue of post-production costs being deducted from royalty checks is the biggest issue facing royalty owners in Pennsylvania today. The abuse is costing Pennsylvania royalty owners tens of thousands of dollars each year.

Unfortunately, this issue is one of the growing pains that accompany the transformational phenomenon that the Marcellus shale has meant for us. Yes, our laws do need to catch up to the technology, and when we have the opportunity, we need to draft clear, concise, gas law that protects royalty owners, the people who are on the front lines of energy independence.

The often referenced "Kilmer vs. Elexco" decision allowed for deductions taken from royalty checks to yield royalty owners less than the state minimum royalty of 12.5%, however, it stopped short of defining what "royalty" is defined as. The judge in that decision noted that the job of defining royalty was actually within the power of the legislature to clarify.

It is NARO-PA's position that natural gas is not a marketable product until it is both in a marketable physical condition and has been brought to a commercial marketplace. Natural gas has no value at the wellhead because a well owner cannot put it in a barrel, like oil, and drive it somewhere else to sell it.

As the battle over unauthorized deductions has heated up, the calls for the legislature to step up in a meaningful way has also risen to a fever pitch, especially in Bradford County, the state's top producing county.

The Marcellus region has some hard working Senators and Representatives, and NARO-PA is proud to have been included in the debate over how to address this issue legislatively, moving forward. This work has culminated in the introduction of HB1684 which has been co-sponsored by many of our Marcellus caucus from the northeast and northcentral region.

As an education, outreach and advocacy organization, NARO-PA will continue our work in Harrisburg to bring the stories of Pennsylvania's mineral owners to the entire legislature, but we need your support. We need royalty owners to be engaged and actively involved in managing their mineral estate because of the value it holds to them, their family, and the future of Pennsylvania. All too often, the debate over natural gas is portrayed as the industry vs. the anti's. Unfortunately, the royalty owner's perspective is often overlooked in the debate. NARO-PA is forcing our way into the conversation on behalf of the Pennsylvania royalty owner.

The bill is straightforward in its approach and makes a bold statement through the adoption of the "first marketable product doctrine" that Pennsylvania is taking a stand for its citizens. Pennsylvania's royalty owners are the keystone to our energy independence and they need to be treated fairly.

Particularly one operator, with their mistreatment of their mineral partners, has made this legislation necessary. Most Marcellus operators agree with our definition of royalty, which is demonstrated by the fact that they do not take deductions for "post-production costs" as they do not feel they are entitled to take those deductions. Even CHK's partners on their Marcellus wells were not taking these deductions on the very same wells. Not passing this bill sends a signal to those operators that mistreatment of their mineral partners is ok in the eyes of the legislature.

Unfortunately, inaction by the legislature in correcting this abuse a timely manner is leading to other operators beginning to follow CHK's lead. The sooner we correct the problem, the easier it will be to wean the abusers off the unwarranted deductions and the fewer PA citizens will be hurt.

First Marketable Product legislation following NARO-PA's suggestions simply clarifies and defines royalty so that no operator can take advantage of royalty owners, acknowledging that a court challenge sets up a "David vs. Goliath" scenario in the court system.

Under the system that Chesapeake, and others, are working under, there are no checks and balances to keep post-production costs down on behalf of the royalty owner. What has made all of this so egregious is, a wholely-owned subsidiary of CHK charges CHK, in many cases, exorbitant fees for gathering lines, and the operator (CHK) passes those costs onto the royalty owner. In documents submitted to the Senate's Environmental Resources and Energy Committee, in their public hearing, CHK was charging some royalty owners \$2.72/MMBtu while the handful of other companies were in the range of \$0.44-\$0.56/MMBtu. By adopting the "first marketable product doctrine," the free-market helps to keep costs down because there is no one to pass those costs down to. ●

Has Forced Pooling Come to Pennsylvania With SB 259?

By Robert J. Burnett, Houston Harbaugh

Imagine you own a 95-acre farm in Washington County, Pa. The farm has been in your family since the 1930s. Your great-grandfather signed an oil and gas lease with a local driller back in 1954. Two shallow wells were drilled in the late 1950s and have produced modest gas royalties ever since. You are quite satisfied with the minimal surface disruption caused by the two shallow wells and have no interest in hosting a large Marcellus well-pad site on your property.

Some years later, your lease is acquired by a large Texas-based driller who also has leased your neighbor's tracts to the north and east. One morning, you receive a letter from this driller advising you that your property has been combined with the neighboring tracts and that a Marcellus well pad will be constructed on your property in the next six months. You review that 1954 lease and see no clause authorizing or permitting the driller to pool your property with adjacent tracts. Can they do this without your consent? Thanks to SB 259, the answer is now yes.

On July 9, Governor Tom Corbett signed SB 259 into law. Make no mistake, this bill is controversial and will have a dramatic effect on thousands of existing oil and gas leases throughout Pennsylvania. The bill itself was originally introduced as a means to bring uniformity and clarity to the periodic royalty statements issued to landowners. At the 11th hour, the bill was amended and Section 2.1 was added.

Proponents claim that this section merely provides a formula to allocate royalties in the era of horizontal drilling and nothing else. This is wishful thinking. With one stroke of the pen, Corbett unilaterally changed thousands of existing oil and gas leases and authorized a form of forced pooling.

In order to appreciate the impact of SB 259, one must first understand the concept of pooling and the typical pre-Marcellus Shale oil and gas lease. In simplest terms, pooling is the consolidation of separate, individual parcels to form a single production unit. There are two types of pooling: (1) voluntary and (2) compulsory or forced pooling.

Compulsory pooling arises when state-imposed spacing requirements necessitate the creation of a formal unit. Many oil and gas jurisdictions have adopted well spacing requirements that regulate and limit the density and location of wells within a designated reservoir. This is because too many wells in close proximity to one another can actually hinder hydrocarbon production and result in waste. Compulsory pooling, through well spacing orders, seeks to avoid overdrilling by regulating the distance and space between wells.

Because a well spacing order may preclude drilling on one or more tracts, the creation of a production unit gives those locked-out landowners the opportunity to share in hydrocarbon production even though no well will be located on their land.

As the name implies, compulsory pooling is implemented by a state agency or board after consideration of a petition or application. It is compulsory in the sense that the landowner's property is automatically combined with nearby acreage once the well spacing order is granted. Depending on the jurisdiction, the landowner will either receive a proportionate share of the unit's production royalties based on the ratio of actual acreage in the overall unit or a payment based on some other fixed formula. Many compulsory pooling statutes even apply to acreage not under lease.

Voluntary pooling, on the other hand, involves a private lease agreement between a landowner and a driller whereby the landowner allows the driller to combine his or her leased acreage with adjoining leases into a production unit. No state agency is

Continued to page 19

involved. The terms and conditions of the pooling clause are therefore carefully negotiated between the driller and the landowner.

In return for granting the power to pool his or her lease, the landowner will receive a production royalty from any well located within the production unit. The royalty, however, must be shared with the other landowners in the production unit based on each landowner's proportional share of unit acreage. Many courts have described the effect of pooling as a cross-conveyance of each landowner's oil and gas interests, as in *Montgomery v. Rittersbacher*, 424 S.W.2d 210 (Tex. 1968), where the court held that "pooling effects a cross-conveyance among the owners of minerals under the various tracts ... so that they all own undivided interests under the unitized tract."

Therefore, once pooled, the landowner ceases to own the full, undivided interest underneath his or her tract.

Prior to SB 259, the predominant form of pooling in Pennsylvania has been voluntary pooling because Pennsylvania's compulsory pooling statute, known as the Oil and Gas Conservation Law, is limited and only applies to wells that penetrate the deep Onondaga formation.

While there are no precise well spacing or density requirements in the Conservation Law itself, the Department of Environmental Protection has discretion to implement spacing rules and election rights upon consideration of an appropriate petition. Again, such a petition can only be filed if the driller is contemplating a deep well. Because of its limited application, compulsory pooling under the Conservation Law is extremely rare. Since the Marcellus Shale formation sits just above the Onondaga formation, it is not subject to the Conservation Law.

In Pennsylvania, if the landowner does not negotiate a pooling clause in his or her lease, the driller cannot pool or combine the landowner's acreage unless the DEP issues an integration order under the Conservation Law. This is consistent with most oil and gas jurisdictions in the United States, as in *Tittizer v. Union Gas*, 171 S.W.3d 857 (Tex. 2005), in which the court held that "a lessee has no power to pool without the lessor's express authorization, usually

Killingsworth, 403 S.W. 2d 325 (Tex. 1965), in which the **court held that "absent express authority, a lessee** has no authority to pool." As noted, the Conservation Law simply does not apply to most oil and gas leases in Pennsylvania and is almost never used. As such, power to pool must be expressly granted in the parties' lease.

Horizontal drilling of the Marcellus Shale formation cannot occur without a valid pooling clause. This is because the horizontal wellbore, which can exceed 5,000 feet in length, will likely pass through a number of separately owned parcels. Each parcel must be under lease and each lease must authorize pooling. Each tract under which the horizontal wellbore passes is considered a drill site, as in *Browning Oil v. Luecke,* 38 S.W.3d 625 (Tex. App. – Austin 2000), where the court held that "each tract traversed by the horizontal wellbore is a drillsite tract and each production point on the wellbore is a drillsite." Gas extracted from one section of the wellbore is commingled and combined with gas extracted from other sections of the wellbore. Therefore, unless the landowner has agreed to pool his or her acreage, and essentially share his or her gas production with others, the horizontal wellbore cannot pass underneath his or her property.

This is where SB 259 changes everything. Many older oil and gas leases, especially in Western Pennsylvania, either contain no pooling clause or contain a very narrow clause authorizing only the pooling of the deep Onondaga formation. The pooling clauses in these older leases simply do not allow the driller to pool the Marcellus Shale or shallower formations.

Recognizing this legal and operational limitation, drillers over the last five years have reached out to landowners in an effort to amend and modify their older leases by inserting language that expressly allows the pooling of these hydrocarbon formations. These lease modification agreements are routinely negotiated between landowners and drillers and provide an opportunity for both parties to modernize the entire lease, including the lease's economic terms. SB 259 will allow drillers to bypass this process completely and proceed with **horizontal** drilling without the need of a valid pooling clause.

Continued to page 21

How does SB 259 do this? Section 2.1 simply unilaterally modifies every existing lease to allow for horizontal drilling:

"When an operator has the right to develop multiple contiguous leases separately, the operator may develop those leases jointly by horizontal drilling unless expressly prohibited by a lease."
By virtue of this language, a pooling clause is no longer needed. All the driller needs is "multiple contiguous leases" and it can commence horizontal drilling under those tracts. This language is, quite simply, a game changer.

Proponents of SB 259 contend that Section 2.1 is not forced pooling. They are partially correct. It may be worse. Now a driller can essentially force-pool multiple parcels for horizontal drilling without any regulatory oversight or control. Recall that under the Conservation Law, the compulsory pooling mechanism is at least implemented and monitored by the DEP. Remarkably, there is no regulatory component to SB 259. Drillers now have unlimited power to pool and combine leases without any statutory limitations or parameters. The potential for abuse is staggering.

What is equally alarming is that the broad language of Section 2.1 could theoretically be used to justify any operation related to horizontal drilling. For example, if a landowner opposes the location of a water impoundment or a compressor facility on his or her property, the driller could argue that it has the absolute right to install those facilities, as part of its horizontal drilling operations, under Section 2.1. The same theory could be used to support seismic testing or the construction of access roads. In short, there is grave concern that Section 2.1 will be used to authorize surface operations and activities that were never contemplated or permitted by the parties' existing lease.

SB 259 is bad for landowners, is bad policy and sets dangerous legislative precedent. Section 2.1 rewrote thousands of existing leases by allowing horizontal drilling without an agreed-upon pooling clause. At a time when the regional energy industry badly needed certainty, this bill created more uncertainty and confusion going forward and will unfairly alter the landowner-driller relationship. ●

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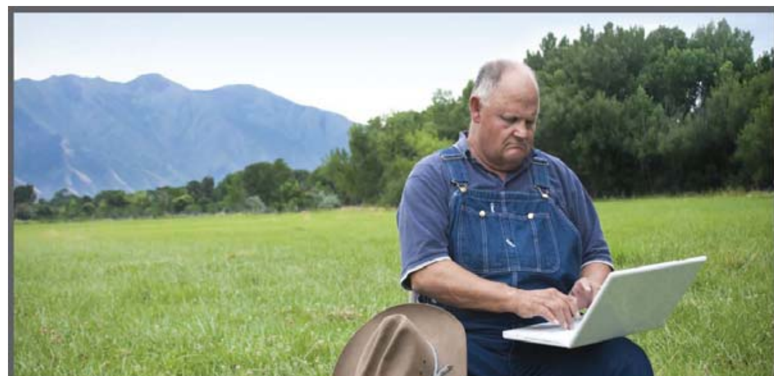

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