

IN THE SUPREME COURT OF ALABAMA

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CASE NUMBER: 1031167

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EXXON CORPORATION,

Appellant,

v.

STATE OF ALABAMA DEPARTMENT OF CONSERVATION  
AND NATURAL RESOURCES, et al.,

Appellees.

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ON APPEAL FROM THE 15TH JUDICIAL CIRCUIT  
(MONTGOMERY COUNTY) CV 99-2368

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**BRIEF OF APPELLEES STATE OF ALABAMA DEPARTMENT OF  
CONSERVATION AND NATURAL RESOURCES, et al.**

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**ORAL ARGUMENT REQUESTED**

STATEMENT REGARDING ORAL ARGUMENT

The State respectfully requests oral argument in this case. The State believes that oral argument would help illuminate the numerous factual and legal issues addressed in the briefs and thereby aid the Court's consideration of this matter. Accordingly, the State stands ready to assist this Court at oral argument as the Court may wish.

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## STATEMENT OF THE CASE

Although the State is a regular litigant in the courts of Alabama, it now stands before this Court in a role to which it is unaccustomed: the plaintiff in a breach of contract and fraud action against what is probably the largest publicly traded company on earth in terms of revenue and profit. Very rarely does the State bring its commercial grievances to its courts for redress, for it much prefers compromise over litigation and would impose on Alabama's precious judicial resources only in the most extraordinary of cases. This is such a case.

This case is extraordinary not because of the size of the punitive damages award, although \$3.5 billion is, to be sure, an extraordinary sum of money. No, this case is extraordinary because Exxon's conduct in its commercial dealings with the State amply warrants such a sanction.

The Court has by now read Exxon's brief, and so it knows that there is no gray, only black and white, in Exxon's argument. According to Exxon, not only is it entitled to a judgment as a matter of law on the State's breach of contract claim, but the State's fraud claim is not supported by **any evidence at all**. Rather, Exxon "had nothing to hide and hid nothing." Brief of Appellant Exxon Mobil Corporation ("Br.") 29. Indeed, Exxon

says that it engaged in "complete candor" in its dealings with the State. Br. 69. If these claims are true, then it must follow that the State's fraud claim is itself a massive fraud, with Exxon its victim. It must also follow that the jury and the court below either were in on the State's fraud or were hoodwinked by it, for they found that the evidence clearly and convincingly proved that Exxon committed fraud at the highest corporate ranks.

Exxon's royalty obligation under its leases with the State is about as clear as language can be made to be. The lease was drafted by the Department of Conservation and Natural Resources ("DCNR") specifically to require that royalties be calculated and paid as a percentage of "the *gross proceeds* from all ... gas ... produced and sold from the leased area at the [higher of the] price received therefor or at the best price realizable." PX50. It also specifically requires Exxon to pay royalty on any gas used as fuel. To eliminate any possibility that the plain language of the lease could be misconstrued against the State's royalty interest, the DCNR lease form provides that "[i]n cases of ambiguity, the lease always shall be construed in favor of the lessor and against the lessee." *Id.* Notwithstanding Exxon's attempt to re-write the lease under the guise of "con-

struing" it, the evidence establishes that Exxon breached the lease in numerous respects.

The fraud issue in this case is whether Exxon deliberately defrauded the State in the course of breaching its contractual obligations. Exxon insists that breach of contract is not fraud. The State has never contended otherwise, and has instead consistently acknowledged that it must prove each and every element of fraud. The evidence clearly and convincingly does just that.

The story of Exxon's secret scheme to cheat the State out of its bargained-for royalties is written in the record of this case largely in Exxon's own hand, in a series of internal documents establishing that Exxon indisputably knew its precise obligations under the leases, but its senior executives plotted a strategy to surreptitiously evade those obligations. That story, in brief compass, is this: Exxon signed the leases knowing full well that the royalty provisions did not permit "cost-netting" or free use of gas; Exxon unilaterally decided to cheat DCNR by secretly cost-netting and not paying royalty on gas used as fuel; to justify its royalty underpayments, Exxon cooked up a secret "interpretation" of the leases that it knew to be in conflict with the plain language and clear intent of the royalty

provisions and with the State's clearly expressed understanding of those provisions; Exxon misrepresented to DCNR that it was not cost-netting and was paying royalty on gas used as fuel; Exxon calculated that DCNR's overworked and "inexperienced regulatory staff" was unlikely ever to discover that Exxon was secretly shortchanging the State; Exxon concluded that its scheme had no downside, for even if discovered, DCNR's "inexperienced regulatory staff" would likely settle for a fraction of the amount owed, and in any event, Exxon's maximum exposure was limited to the amount of the "underpayments" plus 12 percent simple interest (an amount that was below Exxon's rate of return on the withheld funds).

In short, Exxon's claim that this is just an "ordinary business dispute" was and continues to be the heart of its fraudulent scheme. The State saw through it, the jury saw through it, and the trial court saw through it. Exxon's last hope is that this Court will not see through it, and that the "no downside" premise of its decision to cheat the State will be vindicated.

As part of its latest effort to escape liability, Exxon presents what can only be called a caricature of this Court's decision in *Hunt Petroleum Corp. v. State of Alabama*, 2004 Ala.

LEXIS 106 (Ala. Apr. 30, 2004) (to be published as 901 So.2d 1). As Exxon reads *Hunt*, there can be no reliance, and therefore no fraud, if "all payments [a]re subject to audit." Br. 2. Only if a counterparty has agreed "to accept the defendant's payments or statements without verification" might there be any claim of fraud. Br. 53. This reading of *Hunt* makes the law governing contracts the law of the jungle - licensing risk-free fraud under cover of contract "interpretation" and declaring open season on any counterparty whose practical ability to audit may be limited.

We submit that this is not law, in Alabama or in any other place that is governed by law. This is the absence of law. Unless we are wrong about that, the only question concerning reliance is whether the State relied on Exxon's scheme to misrepresent and suppress tens of millions of dollars in underpayments, accepting Exxon's payments as just what they purported to be - full and fair payments of what was owed. That question was posed to a jury -- a jury of good and decent Alabamians from all walks of life -- and it was, again quite properly, answered in the affirmative. Nothing in *Hunt* -- or any other decision -- calls the jury's resolution of that issue into question.

Finally, it remains for this Court to determine what the

sanction for Exxon's reprehensible conduct should be. It is true that the punitive damages award is virtually unprecedented, but so is the scale of the wrong to be punished and the size of the wrongdoer. As this Court has often noted, punitive damages "ought to be large enough to hurt," they "ought to sting in order to deter." *Green Oil Co. v. Hornsby*, 539 So.2d 218, 222 (Ala. 1989) (quoting *Ridout's-Brown Service, Inc. v. Holloway*, 397 So.2d 125, 127-28 (Ala. 1981)). But how does one punish, how does one deter, the most profitable publicly traded corporation in the world?

Exxon has admitted its ability to pay the judgment. Indeed, at the time of trial Exxon's operations generated revenue of over \$3.5 billion in only 6 days, and it earned profits exceeding that figure in approximately 2 months. The financial impact on Exxon of the jury's punitive damages award is the equivalent of a small fine on an Alabama family of four earning the median household income. And the evidence showed that Exxon stood to gain almost \$1 billion if its cheating had not been discovered. Thus, when measured, as it must be, against Exxon's upside from its fraudulent scheme, the punitive damages award bears a ratio of less than four-to-one to the potential harm that Exxon's fraud would have caused.

Large wrongs warrant large punishments, and punishing a large corporation requires a large award. Here, the jury's punitive damages award was commensurate with the size of the wrong, and of the wrongdoer.

**STATEMENT OF ISSUES PRESENTED FOR REVIEW**

1. Is Exxon entitled to judgment as a matter of law with respect to the proper construction of the royalty provisions of the leases at issue in this case?

2. Did the State present substantial evidence in support of its fraud claims?

3. Is the State bared as a matter of statutory or constitutional law from receiving punitive damages when it has been defrauded?

4. Is the punitive damages award in this case subject to a statutory or "public policy" cap?

5. Is the punitive damages award in this case unconstitutionally excessive?

**STATEMENT OF FACTS<sup>1</sup>**

Ignoring the standard of review, Exxon presents the facts

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<sup>1</sup> This brief cites the trial transcript as "R\_\_\_," the first *Hammond* hearing transcript as "1HG\_\_\_," the second *Hammond* hearing transcript as "2HG\_\_\_," the State's trial and *Hammond* hearing exhibits as "PX\_\_\_" and "HPX\_\_\_" respectively, and Exxon's trial and *Hammond* hearing transcripts as "DX\_\_\_," and "HDX\_\_\_," re-

in a light least favorable to the State, and omits any reference to facts and inferences supporting the verdict. Accordingly, the State presents a correct Statement of Facts setting forth the facts and reasonable inferences that were or could have been found by the jury and the trial court.

I. THE LEASE TRANSACTIONS.

After the 1979 discovery in Mobile Bay of one of the largest reserves of natural gas ever found in the United States, numerous companies, including Exxon, began clamoring to lease the Mobile Bay fields from the State. R1567-68 (Macrory); R1282 (Hite). In preparing for what everyone knew would be a major lease sale, DCNR, and in particular its chief legal counsel, Robert Macrory, undertook a painstaking review of the State's lease form to determine how it could better protect the State's interests. C2282. Macrory concluded that the royalty provisions of the State's existing lease favored the interests of lessees (the oil companies) rather than the lessor (the State). C2282; R1583-86, 1589, 1596 (Macrory). Macrory spent a year researching, drafting and revising a unique, State-friendly lease designed to maximize the State's royalty interests. R1593-94 (Macrory).

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spectively.

At that time, most of the standard lease forms - including the so-called "Producers 88" form - were prepared by the oil companies and, not surprisingly, favored their interests. C2282; R1669-71 (Burney). For example, many calculated royalty by valuing gas "at the well" or "at the wellhead" - that is, before the gas was gathered, treated, and processed into a marketable product. See PX211 (example of "Producers 88" lease); R1671-72 (Burney). Such "at the well" royalty provisions thus allowed the lessee to "cost-net" - that is, to deduct gathering, processing, and treatment costs from sales proceeds. R1427-28 (Weaver); R1672-74 (Burney). Another standard clause in such lessee-friendly leases, the "free use of fuel" clause, allowed lessees to use gas, royalty-free, as fuel. R1459 (Weaver).

Macrory's carefully crafted lease form was designed to eliminate cost-netting and free use of fuel in the calculation of the State's royalties. C2282. In fact, the royalty provisions of DCNR's lease are the "polar opposite" of those in standard oil company leases. R1721 (Burney). DCNR's lease unambiguously requires that royalty be calculated on the lessee's "gross proceeds" from gas and condensate<sup>2</sup> produced, without al-

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<sup>2</sup> Fresh diesel is regularly injected into the pipelines to prevent clogging from naturally occurring diamondoids in the gas stream. This treating process causes condensate to fall out of

lowing the lessee either to deduct costs from gas sales proceeds or to use gas as fuel without paying royalty. Two of the nation's foremost oil and gas lease scholars testified that the DCNR lease form is one of the best lessor leases they have ever seen. R1678 (Burney); R1464-66 (Weaver).

Paragraph 5(a) of the lease sets forth the primary royalty obligation for all gas produced from the leased area:

5. When production of oil, gas or any other liquid or gaseous hydrocarbon mineral from the leased area is obtained, LESSEE agrees to pay or cause to be paid to LESSOR, during the term hereof, the following royalties:

(a) The value of \_\_\_ of the gross proceeds from all oil, distillate, condensate, gas, natural gasoline, or other product covered by this lease, produced and sold from the leased area at the price received therefor or at the best price realizable in the exercise of reasonable diligence, whichever is higher; however, if any oil or gas is produced from any well drilled, whether or not sold or used off the leased area, LESSEE agrees to pay to LESSOR royalty on the oil or gas produced on the above basis, except that no royalty shall be due for gas produced and flared for well testing purposes.

PX50 (emphasis added).

Paragraph 5(b) requires the payment of additional royalties on marketable products not covered under Paragraph 5(a):

(b) If gas, of whatsoever nature or kind, ... is used, on or off the leased area, by the LESSEE for purposes (including the manufacture or extraction

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the gas stream. The condensate is then mixed in with spent diesel and is sold as slop oil. R1295-97 (Hite).

therefrom of gasoline or other products not covered by the royalty provisions of subparagraph (a) above) other than solely in the development and operation of the leased area as provided herein, LESSEE shall pay \_\_\_ of the net amount realized by LESSEE or affiliate from the sale or disposition of the manufactured or extracted products and \_\_\_ of the best price realizable in the exercise of reasonable diligence for all gas used and not sold. On all residue gas sold by LESSEE or affiliate after manufacture or extraction of products, royalty shall be paid under subparagraph (a) in addition to the royalty on manufactured or extracted products.... The phrase "net amount realized" shall be arrived at by establishing the gross sales values of the manufactured or extracted products realized by LESSEE or affiliate and deducting therefrom the reasonable direct costs of manufacture and transportation from the leased area incurred by LESSEE or affiliate.

PX50 (emphases added).

Paragraph 5(c), the "in kind" royalty provision, provides still more confirmation that the State's lease form does not allow cost-netting:

(c) ... LESSOR may at its option, ... require at any time or from time to time that payment of all or any royalties accruing to LESSOR under the lease be made in kind. If, and whenever, LESSOR elects to exercise this option to take royalty in kind, LESSEE, shall deliver same to LESSOR either at the leased area or the recycling or processing plant as the case may be, or to the credit of LESSOR in pipelines to which these points are connected, **free of costs** except as provided for hereinabove.

PX50 (emphasis added).

Paragraph 6, which requires the submission of reports and retention of records relating to gas production and royalty pay-

ments, also reinforces Exxon's obligation to pay royalties on the basis of gross proceeds:

6. [Royalty] payment shall be accompanied by the affidavit of the LESSEE ... showing (1) **the gross amount of production, (2) disposition, and (3) the gross sales value or proceeds received**, of all oil, gas or any other liquid or gaseous hydrocarbon mineral, and their respective constituent products, produced from the leased area or acreage pooled therewith. **LESSEE shall retain for not less than two (2) years a copy of all documents, records or reports confirming the gross production, disposition and gross sales values or proceeds received, ... and any other reports or records which the State Lands Division may require to verify said gross production, disposition and gross sales values or proceeds received;** and all such records shall at all times be subject to inspection and examination by the Commissioner of Conservation and Natural Resources or his duly authorized representative. **The LESSEE shall bear all responsibility for paying or causing all royalties to be paid as prescribed by the due date provided herein.**

PX50 (emphases added).

Finally, Exxon's brief hurries past a critical (and dispositive) provision of DCNR's lease form: Paragraph 27, the "ambiguity clause." This paragraph provides that "[i]n case of ambiguity, this lease **always** shall be construed in favor of LESSOR and against LESSEE." PX50 (emphasis added). See C2285.<sup>3</sup>

DCNR made copies of its new lease form available to the major oil and gas companies (including Exxon) well in advance of

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<sup>3</sup> See also R2927 (Pierce) (Exxon's lease expert's report did not address impact or effect of ambiguity clause).

the 1981 lease sale. R1608-10 (Macrory). At no point before the sale did Exxon object to the lease form or question its meaning. R1643-44 (Macrory).

Exxon's bid documents, which were based on a form prescribed by DCNR, confirmed that Exxon understood both that royalties would be based on gross proceeds from gas sales and that Exxon would not be entitled to the royalty-free use of gas. Those bids made clear that Exxon would pay as royalty a flat percentage of all gas produced, and did not suggest that Exxon could deduct any costs from the sales proceeds. See, e.g., PX43. They also made clear that Exxon would pay as royalty a flat percentage of gas "used on or off the leased area." *Id.*

Seven of Exxon's bids were accepted by DCNR in 1981. PX6-12. In connection with the award of these seven leases, Exxon agreed to pay the State approximately \$250 million in nonrefundable, up front "bonus" payments," *id.*, money it unquestionably would not have paid had it any questions about its royalty obligations.

The State conducted a second major offshore gas lease sale in 1984. While the royalty provisions were the same, the 1984 lease form includes "payout" provisions, which allow the lessee to benefit from a lower royalty rate until it recoups certain

specified costs. See, e.g., PX15 at ¶ 5(a) (specifying royalty rate of "20% until payout, thereafter 25%"). The lease is quite clear regarding how payout would work:

As used in Paragraph 5, the word "payout" shall mean "the point in time when the LESSEE has recovered from production, after deduction of state royalty, severance and production taxes, **the direct expenses incurred in actually drilling wells on the leased area** beginning, for each well, with the spud date and ending on the date each well is ready to be put into production." The cost of pipelines and treatment facilities are expressly excluded as recoverable expense items.

PX15 at ¶ 29(1) (emphasis added).

Exxon was ultimately awarded fifteen additional leases in the 1984 lease sale. R1799-1800 (Macrory). Exxon agreed to pay approximately \$329.5 million in nonrefundable bonus payments. *Id.* Macrory testified that, had Exxon submitted bids in 1981 or 1984 indicating an intention either to deduct expenses from royalty or to use gas for free, he would have recommended that DCNR reject Exxon's bids as contrary to the lease form. R1793 (Macrory).

Throughout the 1980s and into the mid-1990s, Exxon constructed infrastructure to handle the production, treatment, and sale of Mobile Bay gas. This infrastructure included wells, production platforms, pipelines, and Exxon's Onshore Treating Facility ("OTF"). R1202-03 (Hite). Because virtually all of

the gas produced from the Exxon wells is "sour," it must be treated and "sweetened" in order for it to be marketable. R1206, 1211, 1222-28, 1268-69 (Hite). The treatment of sour gas actually begins at the offshore platforms. The gas is then transported by pipeline to the OTF, where it is further processed and where impurities such as hydrogen sulfide are removed. R1270 (Hite). The gas can then be sold either at the "tailgate" of the OTF or beyond the "tailgate." R1212 (Hite).

## II. EXXON ADOPTS ITS SCHEME TO DEFRAUD THE STATE.

As the time for Exxon to begin producing gas and paying royalties drew near, Exxon devised a strategy to covertly underpay royalties by taking improper deductions, using gas for free, and hiding those facts. C2292-93; PX182. The cornerstone of this scheme was its calculated decision to surreptitiously adopt an "interpretation" of the leases that was known by Exxon to be at war with the plain language of the leases, with the State's understanding of what the leases required, and Exxon's own understanding of what the leases required.

The jury and the trial court also found that Exxon concluded that its scheme was essentially risk free: Exxon calculated that because the State had an overextended and "inexperienced" regulatory staff and was thus easy prey, PX182, Exxon had

an excellent chance of never getting caught, and thus keeping as profit royalty payments that it knew belonged to the State. But even if it did get caught, Exxon believed it would, at worst, merely be forced to pay back the withheld royalties, plus 12% simple interest. C2294 (citing PX182); R1033 (Condray).

The downside associated with any detection of its underpayment was non-existent from Exxon's perspective: it was certain that the very most it would have to pay the State would be what it already owed, the amount of its underpayment. It was far more likely that the State would be willing to settle for a fraction of that; and, even if the State sued and won, Exxon knew that its return on the monies it withheld would in any event substantially exceed the 12% simple interest penalty it might ultimately have to pay. [See [R1031-35 (Condray); R2375-76 (Solomon); R3255-57 (Griggs); HR365-69 (Solomon)].

C2294.

Exxon's internal documents reveal that it fully understood that the leases did not allow it to use gas for free or to deduct treatment or processing expenses in calculating royalties. See C2293. For example, in February of 1988 Exxon's Mobile Bay Project Manager, R.J. Kartzke, wrote to an official at the Alabama Oil and Gas Board ("AOGB"), outlining a number of recommendations that Kartzke believed "would make Alabama more competitive with respect to oil and gas development." PX73. Among Exxon's points relating to "Royalty Valuation" was the complaint that the "current lease form does not permit deductions from

proceeds for unusual development costs or expenses." *Id.* Similarly, in an internal "synopsis" of the DCNR leases, Exxon summarized the royalty provisions as follows:

**Royalty is the stated fraction of the Gross Proceeds of any substance produced and sold, computed at the price received or the best price realizable in the exercise of reasonable diligence, whichever is the higher.**

**Royalty is also due on any gas used and not sold unless used solely in the development and operation of the leased area.**

PX151 (emphases added). And another internal Exxon document from 1990 confirmed that deductions were impermissible, noting that "0.0%" of Exxon's expenses were available for "cost netting." PX179<sup>4</sup>; R2406-07 (Solomon).

Moreover, DCNR officials emphasized to Exxon, before production began, that the lease clearly disallowed practices such as cost-netting. Jim Griggs of DCNR, for example, testified that in discussions with senior Exxon officials, he confirmed that the lease did not allow deductions in the calculation of royalties on gas sales. R3173-74 (Griggs); see R3179 (Griggs) (Exxon "knew what our position was, and they knew what the lease said."). In addition, Exxon's Senior Vice President, Ansel

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<sup>4</sup> Exxon complains that the State "plucked" this document from its context within a larger "funding support book," Br. 20 n.7, but it never explains how that "context" changes the meaning of the document.

Condray, testified that during the years leading up to production, Exxon cultivated a close relationship with the State, and that the State understandably believed that it could rely on Exxon's statements. See R969-71, 1044 (Condray).

Thus, Exxon fully understood that the lease prohibited cost-netting and royalty-free use of gas, that the State interpreted the lease the same way, and that the State had a right to rely on Exxon's honesty and good faith. Yet, even during this pre-production phase, Exxon was already planning how to underpay and hide that fact. An Exxon document prepared in 1988 relating to "expenses that can be deducted before royalty payment" identified only one deduction that was supposedly "allowed" under the leases. DX733 at EXAL 0039335. Exxon nevertheless listed sixteen "production" and "marketing" expenses that it "will attempt" to deduct when production began. *Id.*

In 1993, as the time for production - and payment - approached, Exxon finalized and adopted its plan to cheat the State. Once again, the story unfolds in Exxon's own internal documents, which themselves frame Exxon's plan in terms of the "underpayment" of royalties to the State. Throughout that year, senior Exxon officials conducted "financial risk analyses" regarding how to calculate royalties under the leases. These dis-

cussions culminated in a presentation ("the Condray documents," PX182) to Ansel Condray. The Condray documents make clear that the paramount factors Exxon considered were not the leases' actual provisions and meaning, but rather Exxon's anticipated gain relative to its chances of success against the State's inexperienced regulatory staff.

The Condray documents advocated an "aggressive" approach that would "'pursue all possible cost netting items with a 25% or greater chance of success.'" PX182. They candidly acknowledged that the "gross proceeds" language of Paragraph 5(a) was "probably meant to disallow gas and C&C cost netting,"<sup>5</sup> but stated that the lease would "allow some deductions" if "interpreted" as providing for gas valuation "at the well." PX182. The materials identified seven categories of "royalty reduction" measures that, if taken, would cut Exxon's estimated \$40 million annual royalty payments almost in half. Exxon ultimately elected to pursue five such measures, including deducting its "transportation and treating" costs and paying no royalty on gas used as fuel. PX182 at EXAL 0045770. Exxon estimated that these measures would reduce its annual royalties by \$3 million, but as both the jury and the trial court found, Exxon expected

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<sup>5</sup> "C&C" referred to "crude and condensate." R1013 (Condray).

that these gains both would "compound over time" and would increase over the life of the lease, "during which time Exxon projected that gas prices would substantially rise and its underpayments could steadily expand." C2294. See also PX149; PX178; R2424-27, 2509 (Solomon).

The Condray documents also establish that a key factor in Exxon's analysis of its "chance of success" was its determination that Alabama had "inexperienced regulatory staff and processes." PX182. Thus, Exxon believed the State's "inexperienced regulatory staff and processes" were unlikely to detect Exxon's royalty underpayments.<sup>6</sup> C2294.

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<sup>6</sup> At the first trial, Exxon made no attempt to explain the reference to Alabama's "inexperienced regulatory staff and processes." After the first jury verdict, however, Exxon began to offer contradictory, and increasingly unbelievable, explanations of the reference. Exxon first claimed in a press release that the phrase referred to an explanation of why the State's lease form was supposedly ambiguous. R1027-28 (Condray). Condray admitted that even he did not agree with that explanation. See 1HG385-87 (Condray); R1028 (Condray). The explanation that Condray offered, however, was even more far-fetched. According to Condray, the author's only point was that because Alabama's regulatory staff was inexperienced, Exxon expected the staff to take a long time to audit Exxon's royalty payments, and that Exxon expected Alabama's staff to be "very, very careful and cautious." 1HG383 (Condray). See also R1023-26 (Condray). Exxon continued its revisionist approach in its first appeal to this Court in 2001, suggesting (without any evidentiary support) that the fact that Alabama's audit staff was "inexperienced" meant that DCNR was likely to "seek outside assistance" and would "hir[e] an aggressive outside auditor." Brief of Appellant Exxon Corporation at 23 n.12; *Exxon Corp. v. DCNR*, No.

Finally, the Condray documents stressed that Exxon's "financial exposure" in the event that its underpayments were detected was only the "underpayment plus 12% annual interest." PX182 (emphasis added). See also R1033 (Condray). The possibility of paying 12% simple interest on any underpayments that were discovered did not deter Exxon, in part because it knew it could make a higher return over the many years it could stall a day of judgment. C2294-95. See *infra* at 49, 143. Simply put, Exxon concluded that cheating the State was a no-lose proposition. C2295.<sup>7</sup>

That Condray himself settled upon Exxon's fraudulent course of action is itself quite telling. One Exxon witness, Robert Bremer, testified that he had never heard of another instance in which the question of whether deductions were allowable under a lease was resolved at such a senior level of management. R833-

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1001053 ("2001 Br."). Exxon has now come full circle, as its most recent brief does not even attempt to explain what the reference to "inexperienced regulatory staff and processes" means.

<sup>7</sup> Exxon notes that it knew that the State was auditing Shell, which had decided **not** to "pursue cost-netting deductions." Br. 22. Exxon suggests that the Condray documents "indicated" that "no auditor would miss that Exxon computed royalties differently from Shell under the same lease form." Br. 22. The Condray documents "indicated" no such thing. In fact, as discussed, the reference to the State's "inexperienced" staff and processes "indicated" precisely the opposite. And, if anything, the fact that Shell was taking the **correct** approach to cost-netting would make it **less**, not more, likely that DCNR would suspect that

34 (Bremer). See also R1001 (Condray).

### III. EXXON IMPLEMENTS ITS SCHEME TO UNDERPAY.

Beginning with its initial royalty payments in late 1993, Exxon has paid royalties based upon the unreasonable lease "interpretation" adopted in 1993. Exxon has thereby cheated the State out of tens of millions of dollars, and it would have continued to cheat the State out of hundreds of millions if its scheme had not been uncovered by unanticipated developments at DCNR.

#### **A. Exxon's "Cost Netting" Practices.**

Despite Exxon's clear obligation to pay royalties based upon the "gross proceeds" realized from gas sales, Exxon has deliberately deducted millions of dollars of direct, indirect, and entirely unrelated expenses from its "gross proceeds." The scope and magnitude of its improper deductions began to come into focus just weeks before the first trial, when the State took the deposition of Exxon accountant Robert Bremer. See C2300. In his video deposition, which was played to the jury, Bremer revealed whole categories of secret deductions:

- Costs of cleaning sour gas at the OTF
- Onshore and offshore labor costs
- Labor costs for helicopter pilots, engineers, and permitting personnel

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Exxon was not doing the same.

- Office overhead and employee benefits
- Diesel fuel costs
- Office space and other expenses at Exxon's division headquarters in New Orleans
- Labor costs of accounting personnel based in Houston
- Expenses associated with work and crew boats
- Off-premises training expenses
- Vehicle and other travel costs
- Vehicle depreciation
- Cell phones and beepers
- Catering and maid services
- Electricity and water expenses
- "Miscellaneous" other expenses

R767-821 (Bremer).

Furthermore, "an even more outrageous set of deductions remained suppressed until Exxon's disclosures **in September 2003 on the eve of the second trial.**" C2300 (emphasis added). Such deductions included expenses for an outing to the Grand Casino Biloxi, "community relations" (including golf tournaments and charitable donations), landscaping, t-shirts, and purchases at Wal-Mart. C2286. See R2060-70 (Snyder); R2399-400 (Solomon).<sup>8</sup>

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<sup>8</sup> Exxon argued below that evidence of its specific deductions served no probative purpose, because the State has always contended that the leases allow no deductions of any type. But evidence as to the specific deductions Exxon actually took, including numerous deductions having nothing to do with gas treatment, is probative of the reasonableness and internal consistency of Exxon's supposed "lease interpretation." More importantly, such evidence is clearly probative of Exxon's intent to defraud the State. This evidence is also indisputably probative of whether Exxon continued to misrepresent and to suppress material facts long after it claims that any fraud it may have committed ceased.

Moreover, for at least a portion of the first three years of production, 1993-95, Exxon even "double-dipped" by first using gas as fuel without paying the State's royalty, and then deducting the nonexistent "cost" of that fuel from the State's royalty. R2404-05 (Solomon).

Saul Solomon, a certified public accountant and certified fraud examiner, testified that the unpaid royalties, plus interest, stemming from the improper deductions he was able to uncover so far totaled approximately \$45.0 million through 2002. PX251; R2373 (Solomon).

**B. Exxon's Royalty-Free Use Of Gas As Fuel.**

The leases affirmatively obligate Exxon to pay royalties, with certain limited exceptions, on all gas "used on or off the leased area." PX50. Exxon nonetheless failed to pay royalties on huge quantities of gas used by Exxon as fuel. R2404-05, 2408-09 (Solomon). Indeed, to satisfy its voracious appetite for gas, Exxon drilled a shallow "Miocene" well that produces "sweet" gas, which it has consumed virtually in its entirety, **royalty-free**. R1286-87, 1300-01 (Hite); R918-21 (Woodbury). Exxon's failure to pay royalties on all gas produced cost the State approximately \$23.9 million in unpaid royalties and interest through 2002. PX251; R2373 (Solomon).

**C. Exxon's Failure To Pay Royalties On Condensate And Sulfur.**

Although Paragraph 5(a) requires Exxon to pay royalties on its "gross proceeds" from condensate sales, Exxon deducts the costs of diesel and other items, and thus only pays royalty on condensate when its proceeds exceed its costs. Solomon calculated that the State's actual damages (with interest) through 2002 from Exxon's underpayment of condensate royalties came to approximately \$1.1 million. PX251; R2373 (Solomon).

Sulfur is a by-product of the treatment of sour gas. R1269-70, 1275 (Hite). Despite its clear understanding that royalties were to be paid on gross proceeds, Exxon contrived the notion that sulfur was a "manufactured product" in an attempt to bring sulfur within Paragraph 5(b). R2864-69 (Pierce). The jury and trial court found that sulfur is instead covered by Paragraph 5(a), which requires Exxon to pay royalties based on gross proceeds from sales of gas and its constituent products, including sulfur. See also R1844 (Macrory); R1433 (Weaver) (sulfur is not considered a manufactured product in the industry). Through 2002, the State's damages, with interest, from Exxon's treatment of sulfur royalties amounted to approximately \$7.3 million. PX251; R2373 (Solomon).

**D. Exxon's Nonpayment Of Royalties On Electricity.**

Exxon's generators at its OTF are fueled by Mobile Bay gas. R1300-01 (Hite); R1945-46 (Macrory). Exxon sells surplus electricity to Alabama Power Company. R1641 (Macrory); R805, 822 (Bremer). While Exxon has paid royalty on the gas used to generate the surplus electricity sold to Alabama Power, it has deliberately not paid royalties on the proceeds from electricity sales, even though electricity is a "manufactured product" within the meaning of Paragraph 5(b) of the leases. R1641-42 (Macrory). See also R1434 (Weaver) (electricity is considered a manufactured product in the industry). Exxon's refusal to pay the proper royalties on electricity has cost the State approximately \$4.6 million through 2002. PX251; R2373 (Solomon).

**E. Payout.**

The 1984 leases provide that Exxon pays a lower royalty rate only until it recoups its direct costs of "actually drilling wells on the leased area." PX15 (emphasis added). But Exxon has been allocating "drilling" costs to State "payout" leases where no actual wells exist. R1479-82 (Weaver). Exxon then pays the State the lower royalty rate as if a payout period is occurring -- i.e., as if Exxon were "actually drilling wells on the leased area." *Id.*; R2397 (Solomon). In addition, Exxon

has been deducting costs for purposes of determining payout that are not allowed by the leases. R3272 (Griggs). The State's actual damages (with interest) from Exxon's treatment of payout amounted to approximately \$20.4 million. PX251; R2373 (Solomon).

#### IV. EXXON'S CONCEALMENT AND COVER-UP.

Exxon's scheme to deliberately underpay royalties depended upon its plan to prey upon the State's "inexperienced regulatory staff and processes." PX182. Its scheme involved concealing the true nature and extent of its deliberate underpayments, first by failing to provide any required reports relating to its production, and then by submitting incomplete, inaccurate, and deceptive reports, and by making misleading representations to DCNR about the contents of the reports that were eventually provided. See, generally R2403-06 (Solomon) (discussing misleading nature of Exxon's reports).

##### A. Exxon's Royalty Reporting To DCNR.

For more than a year after production began, Exxon's reporting personnel were instructed not to provide to DCNR any of the reports that were required under the leases. R2289 (Cone); DX391. Exxon provided only its royalty payments, with no supporting documentation that could have revealed to DCNR that those payments had been secretly reduced by Exxon's improper de-

ductions and by Exxon's deliberate nonpayment of royalties on such items as fuel gas, condensate, sulfur, and electricity. R2249-51 (Cone).

In late 1994 Nancy Cone joined DCNR as a revenue analyst. She noticed that unlike the other oil companies, Exxon had not filed reports, and she began inquiries. R2249 (Cone). Cone insisted that Exxon begin providing the required reports, and in 1995 it began providing reports that it stated contained the gross production and proceeds information required under the leases. R2249-72 (Cone).

Exxon asserts that it informed Cone in February 1995 that it was interpreting the leases to allow it to use fuel royalty-free and to take deductions from its royalty payments. Br. 35. But even after Exxon was forced to begin providing the reports, it continued to provide misleading information regarding production and sales, and in this manner continued to conceal and suppress the full scope and extent to which it was underpaying royalties. In particular, despite its promise in Paragraph 6 to report the "gross amount of production" and the "disposition" of all gas produced, Exxon's royalty reports, it turns out, did not disclose **either** the gross amount of production **or** the disposition of all gas produced. Rather, they disclosed some volume

information relating only to the gas on which Exxon chose to pay royalties. See C2299; R2074-78, R2090-92 (Snyder); R2404, R2408-09 (Solomon). The fact that the royalty reports did not disclose the true gross production and disposition of the gas is not apparent on the face of the reports.

Nor did the royalty reports disclose either the sales prices obtained by Exxon for the gas that it sold, or the value of the gas that Exxon used as fuel or for other purposes. See generally R2408-10 (Solomon). Thus, the royalty reports contained no information from which DCNR could have determined whether Exxon was paying royalty on the basis of the higher of the gross proceeds received from sales or the best price realizable by Exxon.

To make matters worse, Exxon misled DCNR by claiming that items such as OTF and platform fuel were in fact reported in the "residue" column of the royalty reports. R2259-64, R2270-71 (Cone); PX67. Exxon represented to DCNR that its reports accurately reflected all of Exxon's gross production under the leases, and that the "residue" column of the reports would serve as a "catch-all" category that captured, among other things, the volumes of gas used as fuel. R2262-63, 2270-71 (Cone); R2093-94 (Snyder).

It was only much later, during DCNR's audits, that the State learned that Exxon's reports did not, as represented, contain information regarding the huge amounts of gas that Exxon was using, royalty-free, as fuel. Frank Snyder, DCNR's in-house auditor, testified that only after the first audit did he discover that internal Exxon documents contained secret codes for fuel use that did not appear anywhere on Exxon's reports to DCNR. R2047-48, 2079-83, 2092-94 (Snyder); C2300.

Exxon seeks to attach special significance to Cone's March 24, 1995, memo summarizing her February 27 meeting with Exxon employees. See Br. 66 n.26 (discussing PX67). Exxon argues that the reference in the memo to Exxon "reporting only co-generation plant fuel" necessarily means that Exxon must have corrected its representation at the meeting that fuel volumes would be reported in the "residue" column of future royalty reports. *Id.* But this argument mischaracterizes this document and ignores Cone's testimony. While the memo observed that there is a column on the royalty report for co-generation plant fuel, the memo did not state that Exxon was seeking to correct its earlier representations that the "residue" column included all gas not otherwise reported in the statements. And Cone's testimony makes clear at a minimum that, regardless of what

Exxon reported in royalty reports filed prior to the February meeting, the Exxon employees at that meeting represented to Cone that Exxon intended to report plant and platform fuel in the "residue" column in subsequent reports. That representation, it turned out, was false. C2301-02.

Cone's testimony on this issue is reinforced by the March memo itself, which states that one of the "additional points discussed" at the meeting was that "gross values and volumes must be shown on the statements." PX67. Moreover, Exxon's reading of Cone's memo is inconsistent with other testimony establishing that even at the time of the State's first audit of Exxon in 1996, the State was led to believe that the "residue" column included all gas not otherwise reported. See R2075-83 (Snyder).<sup>9</sup>

Exxon emphasizes that the DCNR royalty reports contained separate columns headed "gross value" and "netted gross value," which, it says, served to disclose to DCNR that Exxon was engaging in cost-netting. Br. 34. As an initial matter, it is note-

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<sup>9</sup> Exxon seeks refuge in the fact that Cone's March 24 memo refers to the fact that Exxon was taking some deductions. The fact that, when pressed, Exxon finally disclosed that it was taking some deductions does not at all prove that Exxon had disclosed, in March of 1995, the full extent of its improper deductions. See also R1962-63 (Macrory) (reference in memo to deductions could have been referring to Paragraph 5(b) of lease,

worthy that the State's outside auditors repeatedly asked Exxon to explain and document the meaning of the terms used in the royalty reports, but never received a straight answer. R2095 (Snyder); 1HG794 (Solomon); R2398-2400 (Solomon). More importantly, it is undisputed that Exxon was allowed to take certain limited deductions for purposes of calculating royalty. Thus, Exxon was allowed to deduct **post-tailgate** transportation expenses - *i.e.*, the cost of transporting treated gas from the OTF to the purchaser. R2476 (Solomon); 1HG794 (Solomon). Paragraph 5(b) also allowed Exxon to take deductions with respect to certain manufactured products. R1784 (Burney).

Given the agreed-upon deductibility of such costs, the mere fact that the DCNR royalty reports included both "gross value" and "netted gross value" columns would not have informed DCNR that Exxon was doing anything other than deducting post-tailgate transportation costs.<sup>10</sup> In fact, Exxon did not make clear until **after the first trial** that the aggregate figures in the "gross value" column were already **net** of transportation costs. 1HG794

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which allows deductions on manufactured products).

<sup>10</sup> Cf. C595 (Clerk's record relating to 2001 appeal) (referencing Exxon discovery response indicating that "[t]hird party transportation costs" were "considered" by Exxon when calculating "wellhead" value of gas).

(Solomon) R2380 (Solomon).<sup>11</sup> Exxon never explains why it would have been obvious to DCNR that (1) Exxon's **proper** deduction of post-tailgate transportation costs would **not** be reflected on the reports; (2) a column labeled "gross value" would actually be **net** of such properly deducted costs; and (3) a column labeled "netted gross value" would actually reflect "gross value" net of **improper** deductions.

The Condray documents also establish that Exxon's decision to secretly violate the lease provisions regarding payout and to misrepresent that it was paying royalties in accordance with the only proper interpretation of the lease was part and parcel of Exxon's fraudulent scheme. These documents show that Exxon calculated its "exposure" for payout as "\$13.3M." Of that amount, Exxon proposed to "sav[e] \$11M" with its "aggressive" approach. PX182 at EXAL 0045765.

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<sup>11</sup> Because Exxon would not provide sufficient information, Solomon initially believed that "gross value" figures included post-tailgate transportation expenses but that the "netted gross" figures did not, and so he deducted those amounts in his damages calculations for the first trial. Only afterward did he learn that Exxon's "gross value" was already net of post-tailgate transportation, and that by giving Exxon this deduction a second time, he had understated unpaid royalties by \$9 million. R2380 (Solomon). Solomon also testified that it was "presumptuous" for Exxon to assert that the State would have been able to tell that the difference between "gross" and "netted gross" was cost-netting. R2471 (Solomon) ("[I]t's certainly not clear" from the royalty report).

The Condray documents prove that Exxon understood that only expenses associated with "actually drilling wells on the leased area" could be considered for payout purposes. PX182 at EXAL 0045773. The documents also acknowledged that while "four leases have a provision for the royalty to escalate ... at payout," "[t]wo of four leases do not have a well, but are unitized." PX182 at EXAL 0045774. That should have been the end of the matter: Exxon could apply the payout royalty to the two leases with wells but not to the two leases without wells.

But Exxon went on to outline several different "[a]pproach[es]" Exxon could take with respect to payout. PX182 at EXAL 0045774. The first "[a]pproach" was the "[l]ease basis approach," which was, as its name suggests, the approach that would actually comply with the clear terms of the lease. Exxon acknowledged that this was the "strictest interpretation," and that it limited recoverable costs to "on-lease, post-spud drilling and completion expenditures." *Id.*

Exxon then outlined what it called the "unit basis approach." *Id.* In this "[a]pproach," the recoverable expenses included in the calculation of payout would still be "[l]imited to well costs from spud to completion," *id.*, as clearly required by the lease. But the approach would "[r]ecognize[] impact of

unitizations based on tract participations." *Id.* That is, Exxon would pretend that it had drilled wells on the two leased areas that did not have wells.

Exxon's self-awareness of its deceit is evidenced by its third "approach," entitled the "unit basis approach -- items not specifically excluded." Exxon not only adopted the fictitious unit basis approach discussed above, but also attempted to identify expenses that supposedly constitute drilling a well: "well templates, fileasehold [sic], offshore production platforms, pre-spud rig mods/mobilization and site prep, and dry holes drilled within unit boundaries." *Id.* Exxon's only justification for this approach was that it was "[c]ontingent upon interpretation" of the lease language limiting recoverable costs to those "ending on date each well is ready to be put into production" and making clear that the "cost of pipelines and treatment are expressly excluded as recoverable expense items." *Id.* In other words, even though these items were not "direct expenses incurred in actually drilling wells on the leased area," they were expenses that Exxon incurred offshore during the time it was drilling wells on any of the DCNR leased areas, and therefore, Exxon reasoned, before "the date each well is ready to be put into production." PX182 at EXAL 0045773. Exxon further de-

terminated that because these expenses, unlike "[t]he cost of pipelines and treatment," were not "expressly excluded," they were somehow "included" in the cost of "actually drilling wells on the leased area." *Id.*

Thus, Exxon decided to pursue not only the most "aggressive" approach, but one based on a secret lease "interpretation" that made a mockery of the lease's requirements. A well drilled on another leased area, for Exxon, is a well drilled on this leased area; and the "direct expenses incurred in actually drilling a well on the leased area" include, for Exxon, the expense of building something else, somewhere else. Exxon underpaid the State the reduced payout royalty on the two leased areas without wells, confident that the State's inexperienced staff would never be the wiser.

Exxon says that a "report" it provided to DCNR in 1990 supposedly disclosed how it proposed to handle payout issues. Br. 36-37 (citing DX1191A). But Exxon ignores that DCNR **rejected** Exxon's approach and informed Exxon that payout would be controlled by the lease's clear provisions. R3217-18, R3274 (Griggs). As the trial court noted, "Exxon did not thereafter indicate that it would nonetheless be pursuing the 'aggressive' 'approach' to payout that had been specifically rejected by the

State, plainly departed from the terms of the lease, and could not plausibly ground Exxon's underpayments." C2309.

**B. Exxon's Reports To AOGB.**

Exxon contends that it met its obligations to DCNR by providing reports about its production under the leases to a different state agency, the AOGB. Br. 29-30. This contention ignores that the leases unambiguously obligated Exxon to provide the required information regarding gross production to DCNR, not AOGB. See PX50 at ¶ 6. Notably, all other companies that entered into Mobile Bay gas leases filed their royalty reports with DCNR, notwithstanding that they also provided certain reports to AOGB. R2249-50, 2289 (Cone).

Moreover, David Bolin, the AOGB official whom Exxon called as a witness, testified that AOGB's responsibilities have absolutely nothing to do with the interpretation or enforcement of Exxon's leases with the State or with Exxon's payment of royalties to the State. R2748-52, 2760-61 (Bolin). See also R1557-58 (Macrory); R2101-02 (Snyder). Those responsibilities reside exclusively with DCNR.

Exxon notes that DCNR filed a comment with AOGB approving of the proposed metering and allocation plan for Exxon's leases. Br. 29-30. Given that allocation of Mobile Bay gas among vari-