

No. 1031167

SUPREME COURT OF ALABAMA

EXXON MOBIL CORPORATION,  
Appellant;

vs.

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

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REPLY BRIEF OF APPELLANT EXXON MOBIL CORPORATION

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

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## SUMMARY OF THE ARGUMENT

The State's Brief (SB) claims to distinguish between fraud and breach of contract, but indiscriminately blurs the distinction with accusations of "cheating" and "scheming" - just as it did at trial. The State vainly asserts that *Hunt Petroleum Corp. v. State*, 901 So.2d 1 (Ala. 2004), does not control, but does not ask the Court to overrule it. The State has no escape from *Hunt*.

The State knows it must show clear and convincing evidence of fraud. But it ignores the evidence negating **any** plausible inference of reliance, misrepresentation, suppression or fraudulent intent. The State cannot escape its own documents and testimony disclaiming reliance and acknowledging that Exxon told the State Exxon's position on the disputed contract issues more than a year before the State audited. Exxon Brief (EB), App. Tabs 3-4.

The State further asserts that no one could reasonably contest its lease interpretation, but asks the Court to affirm based on federal "marketable product" regulations and out-of-state implied covenants never recognized in Alabama. Substituting bluster for analysis, the State disregards the relevant lease language and case law.

And while the State asserts (wrongly) that only a gargantuan punitive damage award can create a financial "downside" for alleged "cheating" on contracts by parties like Exxon, the State advances a theory of punishment that throws applicable punitive damages law out the window. The State's real argument boils down to the unconstitutional proposition that any award Exxon can afford is permissible.

The list could go on. But any reasonable review of the record shows that the State's fraud and punitive damages claim is beyond the pale. The State posits that Exxon "schemed" to do the impossible -- i.e., hide its contract position for the 30-year life of the leases -- when the evidence shows just the opposite. The State, for its part, did not rely on Exxon's payments or reports but conditioned its "acceptance" of every one of them on audit.

The State asserts **exactly** the same "fraud" claim that this Court soundly rejected in *Hunt*. This Court should apply *Hunt*, reaffirm the distinction between contract and tort, and put an end, once and for all, to the State's improper litigation strategy of suing every Mobile Bay producer for "fraud" manufactured from whole cloth.

Likewise, the Court should enter judgment for Exxon on the contract claims in accordance with the lease language, case law and relevant record evidence. Exxon has invested over \$2 billion in Mobile Bay and has paid the State over \$1.3 billion in bonuses and royalties. While the parties dispute only a fraction of the overall royalty obligation, this Court's resolution of the lease issues will end the dispute and provide a definitive basis for computation of royalties in the remaining years of these leases.

#### **ARGUMENT**

##### **I. THE STATE'S FRAUD CLAIM FAILS AS A MATTER OF LAW.**

###### **A. The Court Reviews the Legal Sufficiency of the Evidence De Novo, Applying the Clear and Convincing Evidence Standard.**

The State accuses Exxon of disregarding the applicable standard of review. Not so. As the State concedes (SB 95), since this is a punitive damages case, the question on appeal is whether a reasonable and fair-minded jury could find "gross, oppressive, or malicious" fraud by "clear and convincing" evidence. *Morgan Keegan & Co. v. Cunningham*, 2005 WL 1189584 at \*4 (Ala. May 20, 2005); see also *Cessna Aircraft Co. v. Trzcinski*, 682 So.2d 17, 19 (Ala. 1996)

("clear and convincing" standard applies to review of sufficiency of evidence for punitive damages); EB46, 51-52.<sup>1</sup>

Exxon's opening brief fairly lays out (with citations to evidence) the relevant facts that overwhelmingly negate any such inference. EB19-46, 51-69. By contrast, the State often cites nothing for its factual assertions, or cites evidence that does not support its hyperbolic inferences. At key junctures, the State cites not evidence but the trial court's post-trial order, which adopted largely verbatim a flagrantly argumentative draft prepared by the State's lawyers. *E.g.*, SB85-86 (characterizing alleged fraud evidence); see EB8.

This mode of presentation does not advance the inquiry on appeal. The trial court did not find the facts at trial, and this Court must determine the legal sufficiency of the fraud evidence, *de novo*, from the underlying evidentiary record. *Ex Parte Norwood Hodges Motor Co.*, 680 So.2d 245, 249-50 (Ala. 1996). Indeed, this Court should take the State's frequent citations to the lawyer-drafted

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<sup>1</sup> In this brief, rather than repeating all of the record citations provided in its opening brief, Exxon will cite, where applicable, the pages of its opening brief (EB) where the relevant record citations appear.

post-trial order (C2274-2335) as red flags that the record does not support the inferences the State urges. The order is not evidence, but is the State's own over-the-top argument to the trial court.<sup>2</sup> And even if the trial court adopted the State's argument, the trial court's view of the evidence is irrelevant to this Court's *de novo* review.

**B. The State Has Failed to Present Legally Sufficient Evidence of Reliance.**

Tellingly, the State does not reach the most clearly dispositive issue in this appeal -- the legal sufficiency of the reliance evidence under *Hunt* -- until page 95 of its 149 page brief. The State has no answer to *Hunt*. Despite its contrary protestations, the State has no more reliance evidence here than it did there, and the affirmative evidence of the State's *non*-reliance is much greater.

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<sup>2</sup> See *Bill Heard Chevrolet Co. v. Dixon*, 819 So. 2d 34, 41 (Ala. 2001) ("strongly discourag[ing]" entering orders drafted by one of the parties (in the context of class certification) and holding that the trial judge's "duty to conduct a rigorous analysis" is "non-delegable"); see also 9 James Wm. Moore, *Moore's Federal Practice* §52.31[9][b] (3d ed. 1998) (reviewing courts "scrutinize verbatim findings very closely").

## 1. No Actual Reliance

The State and its *amici* repeatedly take Exxon to task for supposedly arguing that under *Hunt*, the mere right to audit precludes legal reliance. The State calls this a "caricature" of *Hunt*. SB4. The *amici* State agencies (but notably not the appellee State agency, DCNR) assert that if *Hunt* actually holds this, the Court should overrule it. Brief of Retirement Systems of Alabama, *et al.*, at 30-35.

Either way, the State is attacking a straw man. *Hunt* does not hold, and Exxon does not need to argue, that the mere opportunity to audit precludes an inference of legal reliance. Under *Hunt*, it was the State's **exercise** of that right, and more particularly the State's refusal to accept the accuracy of payments or reports without verification, that precluded such an inference. The State did not treat Exxon's payments and reports any differently from *Hunt*'s.

Trying to follow the State's reliance argument is like chasing a phantom. The State appears to contend that mere "acceptance" of alleged underpayments is reliance. SB111. But "receipt" and "deposit" are not "acceptance." In contract law, acceptance signifies intent to be bound. Here, the State, anticipating a dispute, conditioned its

acceptance of Exxon's payments on an audit process. It engaged in that audit; it asserted its contract interpretations (which differed from Exxon's); it billed Exxon for "underpayments" and penalties; and it asserted contract claims that were not diminished in any way by its interim "acceptance." This is the opposite of reliance.

As in *Hunt*, the State emphasizes conclusory testimony by State officials that they "relied" on the accuracy of Exxon's payments and reports and "assumed" or "expected" that the payments and reports would correctly reflect the amount Exxon allegedly "knew" was due. SB96-98 & n.57. *Hunt* unequivocally holds, however, that such testimony cannot establish reliance-in-fact when the evidence also shows -- as it overwhelmingly does here (EB55-58 & n.22) -- that the State always intended to audit and to verify every payment and report (and did so). As the Court stated:

The fact that the State always planned to audit Hunt indicates that the State did not simply "assume" that the royalty reports were correct.... [T]he State ... "was unwilling to accept the statement[s] of [Hunt] without verification." ... [T]hat verification was to take the form of an audit. The State always intended to obtain that verification, and it did in fact audit the gas production and the royalty payments.

901 So.2d at 7 (citation omitted).

In response, the State emphasizes a snippet of testimony from Griggs, who confirmed that "our plan had been to audit every time period, it still is to audit every time period," but added that "[w]e weren't sure we were going to be able to audit every time period because we might not have the money to do it." SB100. Without dispute, however, the State **did** audit every time period (PX253-273), and did **not** accept Exxon's payments and royalty reports as accurate statements of what Exxon owed. EB39-40, 57-58; PX67; DX371, 374A. These facts preclude any inference of actual reliance.

Equally non-probative of actual reliance is the State's oft-repeated argument -- highlighted in snippets of testimony from Griggs and Snyder -- that the State's auditors "had no alternative but to rely on Exxon's royalty payments and reports" because "Exxon is in control of all the information and documents" and the State's "auditing ability was limited" such that "our auditors couldn't possibly look at every piece of paper for every day." SB98-100. This argument is a *non sequitur*.

The entire purpose of the State's audits was to go **behind** Exxon's payments and royalty reports to determine

whether Exxon owed more. To that end, the auditors used Exxon's royalty reports only to determine the dollar amount of royalties Exxon had already paid (which no one claims the reports misstated). As the audit workpapers show, to determine whether Exxon owed additional royalties, the State's auditors recalculated the monthly volumes from Exxon's production records,<sup>3</sup> multiplied the volumes by prices from Exxon's monthly gas marketing records, applied the pertinent royalty percentages, and subtracted what Exxon had already paid. PX253 at \*1-\*114.<sup>4</sup>

In other words, the State's auditors were not misled by Exxon's payments and royalty reports. Just as one would expect, they applied the State's lease interpretation to the underlying volume and sales information and computed

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<sup>3</sup> In accordance with the State's lease interpretation, the auditors included fuel gas volumes, which Exxon reported monthly to AOGB but did not, as Exxon had previously told Nancy Cone, include in its royalty payments or reports to DCNR. PX67; PX253 at \*4-\*33.

<sup>4</sup> Exxon also gave the auditors detailed cost netting records and a description of its cost netting methodology. *E.g.*, PX1324 (computation detail for 1993-95 cost netting rates and description of methodology); DX1192 (computation detail for 1996-97 cost netting rates); DX1248 (additional description of cost netting methodology). The auditors made no use of that information in their royalty calculations, however, because the State's lease interpretation disallowed **all** cost netting. EB41-42.

the State's claim. No one contends that Exxon falsified or withheld its underlying production and sales records. They all appear in the audit workpapers. As State auditor Snyder admitted, the State had no difficulty quantifying its claims in the very first audit:

Q. So it's true that by February of 1997 the state had identified and put numbers on all of the issues that we're fussing about today in this lawsuit?

A. Yes.

R2202-03 (Snyder). This is again the opposite of reliance.<sup>5</sup>

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<sup>5</sup> This is not to say that the State's auditors always computed the State's claims **correctly**. In several respects, they grossly overreached. As discussed in Exxon's opening brief, the State initially multiplied Exxon's total monthly gas volume by the highest price Exxon obtained during the month for **any portion** of the gas. EB42-43. This facially invalid interpretation of the lease's "best price realizable" clause, which the State finally abandoned before the first trial after its witnesses disavowed it, inflated the State's pre-litigation audit demands by over 300%. EB45-46. In the first trial, the State's damages expert, Solomon, still overstated the State's royalty claim by some 30% because of errors he made in converting Exxon's production volumes from Mcf to MMBtu. EB5-6 & n.5. And having been forced to correct that error in the second trial, the State and Solomon continue to overreach by claiming royalties on sample-based estimates of full wellstream gas production that are indisputably less accurate than the directly metered gas volumes provided to the auditors. EB84-88; pp. 59-60, *infra*.

## 2. No Detrimental Reliance

The record further negates the State's assertion that it relied **detrimentally** on alleged deficiencies in Exxon's royalty payments or reports. The State points to speculative testimony, already discussed in Exxon's opening brief, that it might have audited sooner if it had known Exxon was cost netting and using free fuel. SB100. The State also asserts that Exxon's failure to disclose its position made audits more expensive because the State had to hire an outside expert to conduct them. But the State's own documents show conclusively that even though Exxon **told** the State, in early 1995, that Exxon was taking deductions from gross proceeds and not reporting or paying royalties on fuel gas (other than co-gen fuel), the State waited over a year to commence an audit. EB61-62. Moreover, the delay was "not the fault of any oil or gas company." DX157. And there is no evidence that the audits cost more than they would have if Exxon had disclosed its contract position earlier. On the contrary, the State's internal documents show that it decided to hire an outside expert in early 1993, after the initial Shell audit, **before** Exxon's production and payments even began. EB38-39.

Even farther afield is the State's assertion that it detrimentally relied because "Exxon's fraud deprived the State for years of the ability to bring a legal action for breach of contract." SB100. The State's counsel told the jury that the State learned of the alleged fraud no later than February 1997, when it completed the first audit. EB6. Yet the State did not sue until mid-1999, over two years later. EB4. Exxon's alleged fraud obviously had nothing to do with any delay in suit.

The State likewise cannot show detrimental reliance based on its alleged incorporation of royalty payments into its budgeting. EB62-63. The State asserts that reliance exists because "the State would have altered its budget projections if the royalty payments reflected the amount that was actually due." SB98. But as *Hunt* explains, the relevant question is whether the State would have increased or otherwise altered its budget projections if it had known that the payments did **not** reflect the amount it thought due. 901 So.2d at 8. As in *Hunt*, the record contains **no** evidence that the State would have done so, and no evidence that it did so even after asserting claims for tens of millions of dollars in underpaid royalties.

Similarly, the State has not shown that it did anything with Exxon's written royalty reports except to file them away for later use in the audit. EB63-64. The State does not deny that no one in DCNR looked for Exxon's reports before DCNR hired Nancy Cone in late 1994. SB97 n.58. And the State acknowledges that no one *but* Cone (who merely transferred the figures to a spreadsheet showing wire transfers by lease) looked at the reports before the State began auditing. SB97 n.59; EB 63 & n.25.

The State argues implausibly that Cone's review establishes reliance because other State employees relied on Cone to "let them know if there were any problems with the reports." SB97 n.59. True, after she developed the reporting format with Exxon in early 1995, Cone wrote a memorandum to her superiors at DCNR. PX67. True, others read Cone's memorandum, but the key fact is that she told them what Exxon was reporting and not reporting, and paying and not paying, and she expressly confirmed that the State was *not* relying on Exxon's reports or Exxon's payments to determine what Exxon owed. *Id.*; EB30-36. Far from establishing reliance, Cone's memorandum conclusively *negates* it. EB39-40, 63.

In the end, the State is left with its argument, identical to the argument this Court rejected in *Hunt*, that the State relied to its detriment "in that it continually surrendered its valuable gas to Exxon on the erroneous understanding that Exxon was honestly fulfilling its side of the exchange." SB100-101. But without a showing that the State would have done anything differently if it had known Exxon's position earlier, this formulation simply takes "detriment" out of the equation. In *Hunt*, this Court aptly characterized the State's proposal as a "no-reliance fraud standard" that would bring about a return to the "mischief precipitated by the relaxation of the reasonable-reliance standard," an "experiment in fraud liability" the Court had "expressly rejected." 901 So.2d at 9, n.8.

The State and its *amici* criticize *Hunt* at length, asserting that the decision is bad policy and contrary to law. But these arguments are not new and certainly not improved by repetition in multiple simultaneous briefs. Indeed, the arguments track almost precisely the arguments and case citations discussed in the *Hunt* dissent, which

garnered only one vote, and which the majority of this Court obviously rejected.<sup>6</sup>

*Hunt* did not change existing Alabama law, but merely enforced the longstanding common law fraud requirement of detrimental reliance, citing multiple Alabama precedents for every point of the discussion. 901 So.2d at 4-9. The cases cited by the State and the *Hunt* dissent, many from other jurisdictions, are readily distinguishable.

In *Gregory*, for example, the defendant fraudulently induced the plaintiff royalty holder **not** to exercise its audit rights. 38 F.Supp.2d at 612. That did not occur here. In *Braswell*, the defendant falsified underlying

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<sup>6</sup> See *Hunt*, 901 So.2d at 24-25 (Johnstone, J., dissenting) (citing and discussing *Shades Ridge Holding Co. v. Cobbs, Allen & Hall Mortgage Co.*, 390 So.2d 601 (Ala. 1980); *Johnson v. Shenandoah Life Ins. Co.*, 281 So.2d 636 (Ala. 1973); *Williams v. Bedenbaugh*, 110 So. 286 (Ala. 1926); *Earle, McMillan & Niemeyer v. Dekle*, 418 So.2d 97 (Ala. 1982); *Holeman v. Quick*, 21 So.2d 839 (Ala. 1945); *Braswell v. ConAgra, Inc.*, 936 F.2d 1169 (11th Cir. 1991); *Reis v. Peabody Coal Co.*, 997 S.W.2d 49 (Mo. Ct. App. 1999); *Johns Hopkins Hosp. v. Peabody Coal Co.*, 920 F.Supp. 738 (W.D. Ky. 1996); *Morrill v. Becton, Dickinson & Co.*, 747 F.2d 1217 (8th Cir. 1984); *L.C.L. Theatres, Inc. v. Columbia Pictures Indus., Inc.*, 421 F.Supp. 1090 (N.D. Tex. 1976), *aff'd in relevant part*, 566 F.2d 494 (5th Cir. 1978); *Gregory v. Chemical Waste Mgmt. Inc.*, 38 F.Supp.2d 598 (W.D. Tenn. 1996); and *Metro-Goldwyn-Mayer, Inc. v. Antioch Theatre Co.*, 367 N.E.2d 247 (Ill. App. Ct. 1977)).

measurements. 936 F.2d at 1174 (rigged chicken weighing scales). That too did not occur here. Importantly, *this Court in Hunt* expressly rejected *Braswell's* statement of a relaxed reliance requirement as contrary to Alabama law. 901 So.2d at 9, n.8.

In *Morrill*, a non-Alabama case, the plaintiff relied on the defendant's false assurances that it had not changed a longstanding and mutually understood method of computing and reporting patent royalties. 747 F.2d at 1221. In *Reis*, the plaintiff relied on a disclosure misrepresenting how an accompanying payment was calculated. 997 S.W.2d at 64. And in *Johns Hopkins*, the plaintiff **lacked** the audit rights needed to verify the accuracy of the alleged misrepresentations. 920 F.Supp.2d at 743.<sup>7</sup>

None of these cases supports the "no-reliance fraud standard" that the State advocates here. Moreover, the State has now made and lost these arguments, citing the same authorities, not once but twice. This Court rejected them first in the main *Hunt* opinion, and rejected them

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<sup>7</sup> *Thomas v. Henderson*, 297 F.Supp.2d 1311 (S.D. Ala. 2003), held only that a plaintiff had adequately **pleaded** reliance notwithstanding his own partial investigation.

again when it denied the State's lengthy application for rehearing, obviously written with this case in mind. The legal standard the Court has twice held applicable to Hunt must also apply to Exxon. After all, the State is the plaintiff here as in *Hunt*, the State made virtually the same evidentiary showing as in *Hunt*, and the State handled the receipt of Exxon's monthly royalty payments and reports no differently than it handled Hunt's.

Tellingly, the only new authority the State or its amici cite is not a fraud case at all, but a case under the federal False Claims Act. *United States ex rel A+ Homecare, Inc. v. Medshares Mgmt. Group, Inc.*, 400 F.3d 428 (6th Cir. 2005). The case could hardly be less apposite. As the opinion makes plain, the False Claims Act does not require reliance in the common law sense, but imposes liability based on wrongful intent and potential effect. 400 F.3d at 445. Alabama has no False Claims Act. The State sued Exxon for common law fraud, and with that claim comes the obligation to prove reliance. The State did not do so in *Hunt*, and it has not done so here.

### 3. No Reasonable Reliance

The State is virtually silent on the final required component of legal reliance -- that any reliance must be **reasonable**. It is not hard to see why. The State does not and cannot explain, for example, how it could reasonably assume that Exxon would compute payout recoveries in accordance with the State's lease interpretation when Exxon indisputably sent the State payout statements -- before production began -- that clearly showed Exxon was **not** computing the recoveries in accordance with the State's interpretation. EB26-27 & 36-37; DX1191A.

The State's only response is that Griggs told Exxon he disagreed with Exxon's payout position. SB36. This is another *non sequitur*. Unless Griggs received an assurance that Exxon would adopt the State's position (and there is no evidence that he did), it only shows that any reliance by the State would have been even **less** reasonable.

Likewise, the State does not and cannot explain how it could reasonably assume that royalties Exxon initially paid via bare wire transfers conformed with the State's lease interpretation when the State already knew that two other producers, Shell and Amoco, had construed the lease

differently from the State. EB64-65; DX1225; PX182. The State's Brief nowhere even acknowledges this evidence.<sup>8</sup>

Further, the State never explains how it could reasonably rely on bare wire transfers at all. DX546 (recognizing need for, and importance of, thorough audits of initial offshore production). The State asserts, again, that at some unspecified time before production, Griggs told Exxon that he thought the lease did not permit cost netting. SB17. But again there is no evidence that Griggs ever received back any communication or assurance that Exxon agreed with his position or would adopt it.

Moreover, Griggs himself prepared contemporaneous documents, before Exxon's payments began, that indicate he fully expected Exxon to cost net. In an October 1993 memorandum and worksheet projecting gas revenues from Exxon's Tract 113/114 Unit, Griggs estimated that Exxon's processing costs would reduce the average \$2.50/mcf gas price used to compute the State's royalty by \$0.50/mcf.

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<sup>8</sup> DX1225, which shows that the State knew Amoco was cost netting, lacks a date. But Snyder acknowledged that the document was prepared in connection with the initial audit of Shell and Amoco (Shell's working interest partner) in early 1993 (see DX157), almost a year **before** Exxon started paying royalties. R2114:5-10 (Snyder).

DX624. At trial 10 years later, Griggs speculated that he might have included these costs as an estimate of allowable deductions he thought Exxon might take under ¶5(b) for the costs of manufacturing other products from gas. R3192:6-17. But the document on its face is a projection of revenues from **gas**, not revenues from higher value products, and it uses gas prices, not product prices, as the basis for the computation. On its face, the computation could not refer to anything **other** than gas cost netting. And Griggs admitted he had no idea whether Exxon proposed to make products with the gas. R3192:18-25.<sup>9</sup>

Finally, the State cannot explain how it could reasonably assume that Exxon's payments conformed with the State's current lease interpretations after early 1995, when Exxon began sending royalty reports showing that Exxon

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<sup>9</sup> Strikingly, the author of the 1981 lease form, Macrory, used the same \$0.50 deduction in a mid-1980s handwritten projection of State royalties from estimated Mobil gas sales under the 1981 form. DX1217; R1930:6-21. At trial, Macrory claimed that Mobil had supplied the \$0.50 cost netting figure and he had just written it down. R2003:25-2004:5. But he admitted that he had deducted the \$0.50 in the handwritten computations he prepared of the projected State royalties. R2013:25-2014:14 & 2015:25-2016:11. Again, the State's own documents show that the State fully expected the producers to cost net under the 1981 form.

took deductions from gross proceeds, and Exxon **told** the State that it was not paying royalties on fuel gas (other than co-gen fuel), and Exxon also **told** the State how it was paying royalties on sulfur and condensate. EB35-36; PX67.

The State argues that the royalty reports did not necessarily show Exxon was cost netting, because the difference between gross and "netted gross" proceeds could have indicated permissible deductions for post-tailgate transportation costs. SB31-32. This is both disingenuous and wrong. No State official testified to mistaking these deductions for post-tailgate transportation costs rather than pre-tailgate gathering and treating costs. On the contrary, Cone's memorandum stated that the State did **not** accept the validity of the deductions and would investigate them when it audited. PX67.

Moreover, the reports on their face showed that the deductions could **not** be for post-tailgate transportation, because they applied to co-gen fuel gas as well as sales ("residue") gas. Exxon used the co-gen fuel gas to power electrical generators and never transported it past the OTF tailgate. EB13-14. Because the reports showed differences between gross and "netted gross" values for co-gen fuel gas

as well as residue gas, they disclosed unambiguously that Exxon was netting **pre**-tailgate costs. PX242.<sup>10</sup>

In short, the State could not reasonably assume either before **or** after Exxon started providing royalty reports that Exxon was computing royalties in conformance with the State's lease interpretation. The evidence cannot support an inference of **reasonable** reliance, and this independently defeats the State's fraud claim.

**C. The State Has Failed to Present Legally Sufficient Evidence of Misrepresentation, Suppression, or Fraudulent Intent.**

Although lack of reliance alone defeats the State's fraud claim, the State's brief also fails to identify any clear and convincing evidence of misrepresentation, suppression, or fraudulent intent. This too defeats the claim.

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<sup>10</sup> The State also suggests that the deductions on the gas royalty reports could have been mistaken for permissible cost netting, under ¶5(b), of expenses for manufacturing other products from gas. SB32. Again, the suggestion is specious and the inference implausible. On their face, the reports are for gas royalties, not product royalties. PX242. When Exxon made a product from gas (sulfur from H<sub>2</sub>S), it filed separate reports. PX67; PX256 at \*258.

## 1. No Misrepresentation or Concealment

The State's brief repeatedly asserts that Exxon made material misrepresentations, but never identifies what they are. Exxon's wire transfers contained no representations of any kind. Likewise, Exxon's royalty reports accurately showed the gross values, netted gross values and volumes for the gas on which Exxon paid royalties. Unlike the royalty reports in *Hunt*, Exxon's reports did **not** fail to disclose the deductions from gross values, which appeared on the face of the reports. The State challenges the propriety of the deductions, but it has never claimed or shown that the reports did not correctly state their amount.

The State cites testimony from Solomon that the reports were incomplete and misleading (SB27-29), but the testimony is disingenuous. For example, Solomon calls the reports incomplete because they do not include fuel gas volumes on which the State contends Exxon owes royalties. This ignores that Exxon told the State, when it developed the reporting format with Cone, that it was not going to pay royalties on those volumes or include them in the royalty

reports. PX67. The State may disagree with that decision, but Exxon did not misrepresent it.<sup>11</sup>

Solomon also complains that the reports did not reveal the precise nature of the deductions. SB31-32. But the reports plainly disclosed that Exxon was cost netting, and there was no requirement, contractual or otherwise, that the reports include more detail. Under ¶6 of the lease, those details were and are matters for the auditors. The same is true of payout calculations, for which the lease imposes no reporting requirements at all. DX1195.

In truth, the Cone memorandum completely defeats the State's fraud claim. As discussed in Exxon's opening brief, it shows that Exxon fully disclosed the material issues now in dispute. EB33-36; PX67. Likewise, the 1990 payout memorandum shows conclusively that Exxon disclosed its position on payout. EB36-37; DX1191A.

The State has no answer to these documents, so, like a child whistling past the graveyard, it simply wishes them

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<sup>11</sup> Solomon also noted that some of Exxon's sulfur royalty reports erroneously showed "zero" in the volume column (e.g., DX13A at \*436), but he omitted to say that they accurately reported gross values (obviously indicating positive volumes), and that actual sulfur volumes appeared in Exxon's monthly AOGB plant reports (e.g., DX1203).

away.<sup>12</sup> Pretending the Cone memorandum does not exist, the State argues that Exxon concealed both its free fuel usage and its cost netting, even though the record does not remotely support either claim. On fuel usage, the State invents a claim that Exxon misrepresented to Cone that volumes included in the "residue" column of the royalty reports included not only sales gas on which Exxon paid royalties, but also platform and OTF fuel gas on which Exxon did not. As already shown in Exxon's opening brief, the relevant documents and testimony negate this claim, and no amount of whistling can make this evidence disappear. EB66 & n.26. Cone's memorandum correctly reported that Exxon was "reporting **only** co-generation plant fuel on the statements" because "Exxon management had made the decision to pay on co-gen fuel **only**." PX67 (emphasis added).<sup>13</sup>

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<sup>12</sup> As already noted, the State does not even attempt to answer the payout memorandum except to say that Griggs disagreed with Exxon's position (thus confirming he was not misled about it). SB36 & 86. The State's quasi-sinister recitation of the innocuous payout discussion in the Condray package (PX182; see SB33-37) adds nothing, because the State knew Exxon's payout position before production began. DX1191A. No fraud claim on payout is possible.

<sup>13</sup> The suggestion that "residue" would include fuel gas also conflicts with the language of the lease, which defines

The record also contradicts the State's assertion that Exxon promised Cone it would add those **non**-royalty bearing volumes to its royalty reports. SB30-31, 90. As is plain from both the face of the reports (which multiply the stated values for all combined volumes by the applicable royalty percentages) and from Cone's documents, the purpose of the reports was to show the "volumes," "gross values" and "net values" (also called "netted gross" values) for the gas on which Exxon paid royalties. PX66-67. Exxon's initial draft reports included only the "netted gross" values; Cone requested that Exxon add the corresponding volumes and gross values, which Exxon did. EB33-34; PX66-67. Without dispute, the State accepted Exxon's royalty reports in this mutually agreed format, subject to audit, for the next six years. EB33-34.

Equally meritless is the State's attempt to infer fraud from Exxon's use of internal accounting codes to track its usage of fuel gas not included in the royalty reports. State auditor Frank Snyder testified that he "discovered" these so-called "secret codes" during the initial audit in

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"residue" as gas that is sold rather than used as fuel or to make products (see ¶5(b)).

late 1996. SB30. Before he learned about these codes, he mistakenly believed that Exxon included platform and OTF gas in its royalty reports to DCNR. *Id.* But if Snyder believed that, it was only because he had not talked with Cone or read her memorandum, or otherwise informed himself of what DCNR's senior officials Griggs and Macrory, who had read the memorandum, already knew. EB61 & n.24; R2162. As Cone's memorandum shows, Exxon had told the State more than a year earlier that its royalty reports did **not** include these volumes. Obviously, Exxon had to keep track of its usage of fuel gas -- among other things it reported that usage every month to AOGB. EB29-31. Exxon provided this information to Snyder in the audit; no evidence suggests Exxon sought to withhold it. R2081:13-2083:9 (Snyder). And in view of Snyder's testimony that he did not review any of DCNR's files or talk with Cone before commencing the audit, his **personal** lack of knowledge of matters Exxon had disclosed to others at DCNR obviously cannot support an inference of fraudulent concealment.<sup>14</sup>

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<sup>14</sup> Similarly, all the questions put to Macrory about whether Exxon "informed" him of various matters prove nothing, as the State never showed that Macrory made any inquiries of Exxon.

Of course, all of the State's arguments about Exxon's fuel gas usage overlook that the State at all times had complete access to Exxon's monthly reports of that usage to AOGB. The State correctly notes that AOGB has no responsibility for collecting royalties, but that is not the point. DCNR knew, because it reviewed and commented on Exxon's AOGB-approved procedures for measuring and reporting its Mobile Bay production, that Exxon filed sworn monthly reports breaking out its usage of both platform and OTF fuel. EB29-31. If DCNR wanted information about the volume of such usage, it had only to call AOGB on the telephone or download the information from AOGB's website.<sup>15</sup> Again, no inference of fraudulent concealment is possible.<sup>16</sup>

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<sup>15</sup> Attempting to avoid the obvious import of this point, the State argues that AOGB reports show volume only by well rather than by lease (SB39), but the conversion is merely a matter of summing the production of wells in a given unit and applying unit allocation percentages available to DCNR. The State also asserts that AOGB reports of sales volumes did not always match sales volumes reported to DCNR (SB40 n.15), but the State's cryptic footnote does not give enough information to analyze the comparison and determine the possible reasons for such a discrepancy (for example, miscomparison of gross production with dispositions or other possible errors).

<sup>16</sup> The State and the *amici* State Attorneys General argue that courts should not automatically impute knowledge of one state agency to another, but that is not Exxon's

The State's arguments about alleged fraudulent concealment of cost netting are equally makeweight. The State asserts that even if Exxon's royalty reports disclosed that it was cost netting, Exxon never gave the State "straight answers" about the nature of the deductions, and the State did not learn of the full "scope and magnitude" of the deductions until it took discovery in this case. SB22-24, 31-32. The argument is both unsupported and irrelevant. It says nothing about fraud, but much about the State's misleading jury strategy.

Exxon did not conceal its cost netting information. As already noted, Exxon provided the State's auditors, during the first audit in 1996, with both a description of its cost netting methodology and the computational detail for its 1993-95 cost netting rates. DX1324. Exxon provided similar information during later audit periods (e.g.,

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argument. The evidence shows that DCNR fully understood what information was available at AOGB, and used it during the audit. In fact, the State's files contained an AOGB report that Exxon had faxed directly to Griggs in September 1994 (DX1203), before Cone first met with Exxon. EB29-32.

DX1192; DX1248), as well as interrogatory answers detailing its methodology at length. DX1343.<sup>17</sup>

The auditors made no use of this information because the State took the blanket position that the lease disallowed cost netting altogether. The State likewise made no use of Exxon's cost netting particulars in its damage claim at trial, which also disallowed all cost netting. But the State's lawyers and Solomon made extensive use of the information in pursuit of their jury strategy of trial by innuendo.

For example, the State played deposition testimony by Exxon's cost accountant, Robert Bremer, about general categories of captured costs including helicopters, pilots, boats, and other items. SB23-24. Bremer was not asked whether particular items entered into the actual cost

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<sup>17</sup> Exxon used a standard cost netting approach, consistent with the COPAS industry guidelines, that recorded the costs Exxon actually incurred (e.g., chemicals, equipment, supplies, transportation, facilities, maintenance, labor, benefits, allocated overhead) and divided them among specified operations (e.g., offshore wells, offshore platforms, offshore gathering system, and onshore treatment facility). R3064:22-3065:1, 3067:2-25, 3092:12-16 (Hand); DX1105. Consistent with management's lease interpretation, Exxon limited cost netting deductions under the 1981 lease form to non-capital costs of the offshore gathering system and the OTF. EB22-24.

netting calculations for the State leases, and many of them did not. R3095:4-23 (Hand); DX 1343 at ¶10(q).<sup>18</sup> The testimony had no bearing whatsoever on the State's calculation of its damages. Nevertheless, the State's lawyers and Solomon argued without foundation that Exxon deducted all manner of such costs, hoping that the jury would find them extreme.<sup>19</sup>

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<sup>18</sup> In general, the cost netting computations for the 1981 leases included very limited offshore expenses, because operation and maintenance of the offshore gathering system was the only offshore activity included in the rate. Bremer made clear throughout his testimony that, consistent with Exxon's interpretation of the State leases, Exxon would deduct only non-capital expense items (or portions of items) reasonably allocable to the operations of the gathering system or the OTF. See, e.g., R767:7-772:4, 774:13-17, 775:18-776:2, 777:13-18.

<sup>19</sup> In a similar vein, the State had Solomon scour Exxon's cost netting records and pick out a handful of "sound bite" items it attacked as "outrageous," when in fact they were insignificant and innocuous. What the State describes as "outing to Grand Casino Biloxi," for example, was a \$6000 meal expense associated with an OTF employee and contractor safety and appreciation event (no gambling or alcohol). The event was legitimately related to OTF operations (where safety is a paramount concern), and the amount was in any event too small to impact the cost netting rate one way or the other. R3100:10-3101:7, 3103:23-3104:16 (Hand). The other items highlighted by the State (e.g., OTF grounds maintenance) were similarly innocuous and insignificant. R3147:5-12 (Hand). And the claim that Exxon included community relations contributions in the cost netting rate was unsupported. R3107:20-3108:15 (Hand).

The State also accused Exxon of instances of "double dipping" on fuel gas (that is, taking a cost netting deduction for free fuel), failing to pay royalties based on market rates in sulfur sales to affiliates, and even speculating in derivatives. SB24, 45 n.18. But none of these charges is borne out by the underlying documents, which were not hidden but produced in audit.<sup>20</sup> Indeed, the documents on their face show the opposite of what the State claims, proving only the State's penchant for making reckless accusations without proof.<sup>21</sup>

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<sup>20</sup> The State tried to create the false impression that Exxon did not cooperate with the auditors, a claim no one made until the second trial. R2985:8-2999:14 (Dykhuizen). The contemporaneous documents prove otherwise. During the audits themselves, the State and its auditors thanked Exxon, in writing, for its cooperation and assistance. DX371, DX374A. Even Solomon, whose increasingly onerous pretrial demands for examination of Exxon's accounting records in 2003 kept Exxon's audit department busier than did the auditors from the federal government and all the other 49 states combined (see DX1328, DX1329, DX1331, DX1333, & DX1335; R2969:25-2970:20 (Dykhuizen), thanked Exxon in writing for its cooperation. DX1330, DX1332, & DX1334; R3005:18-3006:1 (Dykhuizen).

<sup>21</sup> **Derivatives:** Exxon occasionally used a gas price futures contract when requested by a customer. Exxon notified the State in advance and always paid royalty on the higher of the actual price or the futures contract price, so the State bore no risk. R3010:5-3015:23 (Dykhuizen). **Sulfur affiliate sales:** Exxon sold sulfur through its affiliate Exxon Chemical (a fact disclosed on every monthly AOGB

## 2. No Suppression

The State has also failed to present facts sufficient to support a contention that Exxon had an extracontractual duty to disclose. Conceding that the parties had an arm's length commercial relationship, the State asserts that Exxon nevertheless had an independent duty to disclose arising from its "complete control over the information relating to its royalty underpayments." SB91 n.52.

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report), but paid royalty on market prices obtained by Exxon Chemical in sales to third parties. R3009:6-19 (Dykhuisen). In an accusation Exxon heard for the first time at trial (R3262:1-3263:8, 3266:13-3268:18 (Griggs)), the State claimed that Exxon had not always paid royalty based on the higher third party price. It turned out that during the month in question, Exxon Chemical had merely given a customer a lower price to make up for overcharging the customer the previous month. R3370:17-3374:4 (Borden); see also DX1344, DX1345, DX1347, and DX1348. **Double dipping:** When production began in October 1993, Exxon included OTF fuel in the cost netting rate but paid royalty on it. DX1324 at \*2, \*5. Beginning in 1994, Exxon changed its accounting for OTF fuel, no longer paying royalty on it, but also removing it from the cost netting rate (with a tax adjustment). *Id.* at \*2 ("Fuel - Effective with current [1994] rates, royalty will not be paid on OTF fuel"), \*26 ("fuel - sev tax" subtracted from state royalty cost netting rate). Exxon likewise did not include fuel in the cost netting rate for 1995 (*id.* at \*41) and has not done so since. At **no** time did Exxon claim a cost netting deduction for free fuel. Notably, not one of these unsubstantiated allegations made a single penny of difference to the State's damage claim. All were flagrant attempts to mislead the jury and inflame it against Exxon.

This argument overlooks ¶6 of the lease, which gives the State a broad contractual right of access to relevant information in Exxon's possession. Having obtained that right by contract, the State cannot contend that control over information imposes on Exxon an independent disclosure duty sounding in tort. *Hendrickson v. Peabody Coal Co.*, 37 F.Supp.2d 947, 954-55 (W.D. Ky. 1997) (rejecting argument that "superior knowledge obligates [lessee] to disclose material facts regardless of whether there is a fiduciary relationship between the parties"). Exxon had no duty to disclose, and the State therefore has no suppression claim.

### **3. No Fraudulent Intent**

Finally, the State has utterly failed to identify facts sufficient to constitute clear and convincing evidence of fraudulent intent. See *Cunningham*, 2005 WL 1189584 at \*7 (reversing judgment for punitive damages for lack of clear and convincing evidence of fraudulent intent).

The State begins with the assertion that Exxon had no plausible good faith basis for its position on any of the disputed lease issues. This is an issue of contract, not fraud, but either way the State's assertion is patently absurd. As Exxon's discussion of the contract issues makes

plain, Exxon had (and has) much more than a good faith position on each of the disputed lease issues. EB70-99. Moreover, Exxon's positions are wholly consistent with the positions taken by the State's own employees in pre-litigation documents.<sup>22</sup> See DX203, DX243, DX624, DX1225.

Nor does such an inference remotely arise from Exxon's decision documents. The State emphasizes a base case spreadsheet taken from Exxon's 1990 project funding book that assumed "zero" cost netting (except sulfur). PX179. But as Exxon has shown (EB19-20), the funding book as a whole shows that Exxon considered but did not need to resolve the lease questions in 1990. The lease issues were identified and ranked on an "allowed/not allowed/will attempt" basis in the funding book workpapers. *Id.* But because the base (decisionmaking) case showed that the project would be profitable even with "zero" cost netting, Exxon proceeded with project funding without resolving the "will attempt" issues. *Id.* Exxon deferred decision on the

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<sup>22</sup> Also, the drafter of the lease testified that he believed, as did Exxon, that sulfur was a manufactured product under ¶5(b) until he talked with a Tuscaloosa lawyer who convinced him otherwise in 1996. R1943:2-1944:19 (Macrory).

"will attempt" lease issues until 1993, when the decision came to management in the Condray briefing package. *Id.* The funding book documents thus cannot remotely constitute clear and convincing evidence of fraudulent intent.<sup>23</sup>

The same is true of the 1993 briefing package. Based on a single reference to "inexperienced regulatory staff and processes," (PX182 at 0045769), the State reads this document as a roadmap to a "secret scheme" to underpay royalties for 30 years. The State takes Exxon to task over

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<sup>23</sup> Nor can any of the other stray documents cited by the State. Exxon's bid letters (PX28-47) followed a State prescribed form and were expressly subject to the lease terms, including the provisions authorizing cost netting and free fuel. SB13; PX110. The State asserts that Macrory would not have approved Exxon's bid if he had known that Exxon intended to take deductions (SB14), but the State has offered no evidence of Exxon's pre-contractual intent and has never pleaded or pursued a claim for fraud in the inducement. Indeed, the State has disavowed any such claim. SB108 n.67. Also not probative of anything is PX151, a shorthand summary of the lease terms that mentions gross proceeds but does not analyze the point at which the lease requires their valuation. And the same holds for PX73, a 1988 letter noting that the lease does not permit deductions for "unusual development costs." In the oil and gas industry, "development" means bringing wells into production. R2635:8-21 (Kahn); see PX13 ¶29(2) (describing continuous development program required by State leases). Exxon has never interpreted the lease to allow deductions for development costs, and likewise has never interpreted it to allow deductions for the enormous post-production capital costs of the gathering system and the OTF.

this phrase, as if it were Exxon's burden to prove it did **not** support that extravagant inference, but of course the State has it backwards. The State has the burden of proof, and the inference it urges the Court to accept is totally and completely implausible.<sup>24</sup> In any event, a single ambiguous phrase in a perfectly ordinary and benign business review document cannot rise to the level of "clear and convincing" evidence sufficient to support a punitive damages award. See *Cunningham*, 2005 WL 1189584 at \*4-\*7.

In fact, everything about the document negates the State's argument. The document does not project royalty savings for 30 years, but for one year. It notes that the State is expected to audit within one year of first production. It indicates that State auditors have already audited two other producers (Shell and Mobil) on issues including cost netting, free fuel, sulfur manufacturing and condensate. It notes that Shell's conservative position on cost netting "sets a difficult precedent with the state."

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<sup>24</sup> The reference appears in a bullet point noting that there is "no Alabama case law on point" construing the lease. In context it would appear to be nothing more than an observation that neither the case law nor the regulators could likely provide decisive interpretive guidance.

PX182 at 0045778. And it observes that the financial exposure of underpayment is 12% interest, more than double Exxon's borrowing cost. Everything about the document suggests a short term decision made with the expectation that the issues would be joined in a prompt audit.

The document also contradicts the State's arguments about Exxon's financial motives. The State argues that Exxon entered the alleged scheme because it stood to gain \$930 million. That figure is of course a fiction; instead, it is almost four times the projected net present value of the entire project at the time of funding in 1990. EB20. Needless to say, it appears nowhere in the 1993 briefing.

Further, the evidence contradicts the State's assertion that the document shows Exxon based its lease position solely on profit, without regard to the merits. As the State admits, the document outlined \$19.4 million in potential State royalty savings, but Exxon adopted interpretations projected to produce only \$3 million in savings. SB19. If the State were correct that Exxon based its decisions on profit without regard to merit, then Exxon would have taken the full \$19.4 million.

The State has no answer to any of these points. The State argues that 12% financial exposure really means "no downside" because Exxon's internal rate of return exceeds 12%, but the argument is just bad economics. As discussed *infra*, and as any first year economics student knows, the proper comparison is *marginal* return, not internal return. In Exxon's case that equates to a borrowing cost significantly lower than 12%. HDX290 at 10.

The State likewise has no answer for what happened next. Contrary to the plan the State posits, Exxon did not try to conceal its lease interpretation for 30 years, but volunteered it to Nancy Cone within a year and began supplying reports disclosing its deductions. If Exxon really planned to defraud the State for 30 years, why did it not conceal the information from Nancy Cone when she called? Why did it not conceal the information from the State's auditors?

The answer is that Exxon never had such a plan. There is no evidence of it and certainly no evidence that meets the clear and convincing evidence requirement. What ultimately defeats the State's case is the utter

implausibility of its theory. This too requires judgment for Exxon on the fraud and punitive damage claim.

## II. EXXON IS ENTITLED TO JUDGMENT ON THE LEASE INTERPRETATION CLAIMS.

### A. Exxon Has Preserved Its Contract Claims.

The State does not seriously dispute Exxon's position that uncommunicated intent testimony and legal opinions on the ultimate contract issues cannot support the contract verdict. Instead, the State contends that Exxon waived its contract arguments by allegedly not presenting them below or in the first appeal. The State also suggests that ¶27, the reverse *contra proferentem* clause, is dispositive of all issues. These arguments are wrong.

The touchstone for determining whether an issue has been preserved for appeal is whether the trial court was presented with an opportunity to rule on the issue.

The function of an appeal is to obtain judicial review of the adverse rulings of a lower court; thus, it is a well-settled rule that an appellate court's review is limited to only those issues that were raised before the trial court. Issues raised for the first time on appeal cannot be considered. However, the rule requiring adherence to the theory relied upon below ... does not mean the parties are limited in the appellate court to the same reasons or arguments advanced in the lower court upon the matter or question in issue.

*Beavers v. County of Walker*, 645 So. 2d 1365, 1372 (Ala. 1994) (citations omitted). The grounds for a motion for judgment as a matter of law must be clearly and specifically presented. *Id.* at 1365; *Flagstar Enterprises, Inc. v. Davis*, 709 So. 2d 1132, 1141 (Ala. 1997); *Breland v. Ford*, 693 So.2d 393, 396 (Ala. 1996). Whether the presentation suffices to preserve an issue for appeal ultimately turns on whether it was "sufficiently precise to afford the opposing party and the judge the opportunity to properly respond." *Smith v. Northwest Fin. Acceptance, Inc.*, 129 F.3d 1408, 1415 (10<sup>th</sup> Cir. 1997).

Exxon filed a trial brief, motions for judgments as a matter of law before and after the verdict, a brief in support of its judgment as a matter of law (which the State does not mention), and a motion to amend findings and judgment on declaratory judgment. As the State notes, Exxon asserted that there was insufficient evidence to support each of the State's contract claims - cost-netting, fuel, lost gas, sulfur, electricity, condensate, and payout. But that was not all Exxon said. For example:

- On cost netting, Exxon argued that "[a]pplication of established rules of construction and admitted custom and practice