1993

Trail Mountain Coal Company v. The Utah Division of State Lands and Forestry; Ralph Miles, Director of the Division of State Lands and Forestry; the Utah State Board of State Lands and Forestry; the Utah Department of Natural Resources; Dee Hansen, Executive Director of the Utah Department of Natural Resources : Reply Brief

Original Brief Submitted to the Utah Court of Appeals; digitized by the Howard W. Hunter Law Library, J. Reuben Clark Law School, Brigham Young University, Provo, Utah; machine-generated OCR, may contain errors.
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DOCKET NO. 930226 CA

IN THE UTAH COURT OF APPEALS

TRAIL MOUNTAIN COAL COMPANY, Plaintiff/Appellant vs. THE UTAH DIVISION OF STATE LANDS AND FORESTRY; RALPH MILES, Director of the Division of State Lands and Forestry; THE UTAH BOARD OF STATE LANDS AND FORESTRY; THE UTAH DEPARTMENT OF NATURAL RESOURCES; DEE HANSEN, Executive Director of the Utah Department of Natural Resources, Defendants/Appellees	REPLY BRIEF OF APPELLANT Case No. 930226-CA Priority Number 15

APPEAL FROM THE SEVENTH JUDICIAL DISTRICT COURT
OF EMERY COUNTY, STATE OF UTAH

The Honorable Boyd Bunnell, Judge

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INTRODUCTION

Defendants' Brief offers this Court a set of revisionist facts as a proposed foundation for Defendants' arguments. Many of Defendants' facts are irrelevant to the legal issues presented to the Court by this case; others are not supported by the Trial Court record. In the interest of space, Plaintiff directs the Court to its Brief for a general background of the salient and relevant facts to this case.[1]

ARGUMENT

I. SCHOOL TRUST PRINCIPLES MERELY REQUIRE THE STATE TO COLLECT THE AGREED ROYALTY.

In their Brief, Defendants incredibly continue to argue that "constitutions, statutes, agreements and court imposed rules are subordinate to" the school trust doctrine (Brief of Defs. at 13). That argument has already been rejected by the Supreme Court in this case and is a gross mischaracterization of the non-Utah school trust cases upon which Defendants rely.

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1. Defendants make specific references to certain monetary figures that are taken out of context, are mischaracterized or have little to do with the issues. Plaintiff notes the following as examples: (1) no evidence was adduced by Defendants that the Fetterolf Group received any payment as an overriding royalty payment (Brief of Defs. at 8); (2) no evidence was adduced by Defendants that the Fetterolf Group received any compensation for assignment of the State Lease, Id.; (3) no evidence was adduced by Defendants to show that the proceeds from the sale of Plaintiff's coal represent gross receipts and not net profits to Plaintiff (Brief of Defs. at 12); and (4) the State's royalty is not calculated against gross receipts from a coal supply agreement but rather against the "value of the coal." Id.

A. The Supreme Court Has Addressed This Issue.

The "school trust doctrine" is nothing more than a combination of the State of Utah Enabling Act and general trust law. It is true that the Enabling Act imposes upon Defendants a trustee's duties to act in a fiduciary capacity for the school trust lands. Utah Enabling Act § 10, 28 Stat. 109; Utah Const. art. XX, § 1. That duty, however, is only the same as the duty of private trustees. NPCA v. Board of State Lands, 215 Utah Adv. Rep. 21 (Utah 1993). The State's duty was characterized by the Supreme Court in this case as follows:

> In administering the school trust lands, the state acts as trustee and its duties are the same as the duties of other trustees. [citations omitted] The state's duty of loyalty to the beneficiaries includes the duty not to act in the interest of a third party at the expense of the beneficiaries by disposing of that property for less than the agreed price.

Plateau Mining Co. v. Division of State Lands, 502 P.2d 720, 728-29 (Utah 1990) (emphasis added). Thus, contrary to Defendants' claim that "full value" is determined by some mystical undertaking, "full value" is simply the contract price.

B. Defendants Have Mischaracterized the School Trust Cases Upon Which They Rely.

It is striking how Defendants' discussion of the school trust doctrine ignores the above-quoted language from Plateau and relies instead on numerous cases from other jurisdictions. Those cases, of course, are not controlling because the scope of the school trust doctrine varies from state to state and is a product of the enabling legislation by which a state joins the Union and that state's constitution. See NPCA v. Board of State Lands, 215 Utah Adv. Rep. at 32 n.3 (Durham, J., concurring). Even if the cited foreign cases were controlling, the cases cited by Defendants do not stand for the principles cited.

For example, State v. Northwest Magnesite Co., 182 P.2d 643 (Wash. 1947), does not support Defendants' argument. In that case, the mineral lease clearly provided for payment of a 4% royalty on the sales value of the mineral after deduction of the costs of transportation and treatment. Id. The Commissioner decided to allow the lessee to also deduct its mining costs. The court held that the Commissioner could not add a deduction to the contract. Id. The court also noted, however, that "the Commissioner did have implied authority to make a reasonable administrative determination of the meaning of transportation and treatment," two terms whose meanings were ambiguous because they were not defined in the statute, regulations or lease. Id.

Similarly, Kadish v. Arizona State Land Department, 747 P.2d 1183 (Ariz. 1987) does not support Defendants' amorphous "full value" concept. The only issue in Kadish was whether Arizona could lease mineral lands without satisfying the advertisement, public auction and appraisal procedures specifically imposed by the New Mexico-Arizona Enabling Act to assure full value. See, NPCA v. Board of State Lands, 215 Utah Adv. Rep. at 32 (Durham, J., concurring). Kadish is simply irrelevant here. Id.

Both Caffall Brothers Forest Products, Inc. v. Washington, 484 P.2d 912 (Wash. 1971), and Department of State Lands v. Pettibone, 702 P.2d 948 (Mont. 1985), are also misapplied by Defendants. Caffall involved a mutual error in a public competitive bidding process for the sale of timber on state school lands. The Caffall court held the sale transaction voidable because no enforceable contract existed under the statutory bidding process. Caffall, 484 P.2d at 715-16. Again, there is no allegation in this case that the State Lease was erroneously or improperly issued. Caffall therefore does not apply.

Pettibone addressed the issue of whether water rights vest in a state lessee or the state as owner of the leased school land. The court, noting that the state is charged with "'the same fiduciary duties applicable to private trustees,'" held that the water could not be alienated without adequate compensation. Pettibone, 702 P.2d at 954 (quoting Skamania County v. Washington, 685 P.2d 576, 58 (Wash. 1984)). In other words, the water, as an interest in school lands, could not be given away. Unlike Pettibone, this case does not involve unauthorized alienation of State lands. It involves the interpretation of a fully authorized instrument granting the right to use state school lands.

II. <u>DEFENDANTS' ARGUMENT REGARDING PLAINTIFF'S VERSION OF THE FACTS BEING CONTRARY TO THE EVIDENCE WILL FAIL IN THE FACE OF A REVIEW OF THE TRIAL TRANSCRIPT AND EXHIBITS</u>.

In its opening brief Plaintiff marshals the evidence that it introduced at trial to the extent possible within this Court's page limitations. That marshalling includes quotes of and cites to the record in accordance with this Court's rules. In response, Defendants' counter with their own version of the facts supported by quotes of the Trial Court's ruling instead of the evidence that supposedly would support that ruling.

The fact that the Trial Court disregarded the evidence in this case could not be clearer in light of the court's comment at the beginning of the trial. At the beginning of the trial, the Defendants moved <u>in</u> <u>limine</u> to preclude the testimony of Charles Henderson (State Land Board Member in 1958) and Donald G. Prince (Division of Minerals employee for over 30 years), indeed, to preclude all evidence of the course of conduct between the state and all parties to state coal leases, regarding what the Royalty Clause had been intended to mean when the lease form was adopted in 1958. (R. 1449-51.) Judge Bunnell concluded to allow the testimony but stated "We'll allow you [Defendants] to put that [evidence going to the intent of the drafting of the lease form] in, but

I agree with Mr. McKeachnie, I don't think that it has any relevance; but we'll allow it in, just, like I say, to give them [the appellate court] a complete record." (R. 1774.) In light of Judge Bunnell's admitted disregard of Prince's and Henderson's testimony this Court should carefully review the evidence marshalled by Plaintiff. Upon doing so it will find that the Trial Court's ruling regarding the meaning of the Royalty Clause is supported by the evidence.

III. TRAIL MOUNTAIN HAD NO CONTRACTUAL LIABILITY TO THE STATE PRIOR TO FEBRUARY 17, 1981.

A. Whether the Trail Mountain sublease is deemed to represent a "sublease" or an "assignment" is irrelevant because the Division's own rules require a formal approval process in order to shift liability for the payment of royalties from one party to another.

Rule 13(b) of the State of Utah Rules and Regulations Governing the Issuance of Mineral Leases, which was in effect between 1979 and 1981, provided that "all assignments and subleases must be approved by the Board of State Lands or the Director; and no assignment or sublease will be effective until approval is given." (Exhibit 100.) (Emphasis added). The rule reflects the State's choice that the Division identify and contractually bind a single party responsible for obligations under a lease. That single lessee's obligations are secured by a performance bond in favor of the Division and the state. Utah Admin. R. 640-20-28(1), -(4)(1993). The bonding provisions secure compliance with the applicable terms and provisions of the lease <u>regardless</u> of the then current lessee or operator. <u>Id.</u> R. 640-20-28(4)(b).[2]

There was no conveyance of the State Lease to Plaintiff, whether by sublease or assignment, prior to January 26, 1981. At best, Plaintiff was, as recognized by the Division, the operator through whom Fetterolf operated the mine. (Exhibit 95.) Thus, there was no privity of estate between Plaintiff and the Division. Defendants concede that during the period prior to January 26, 1981, there was no privity of contract between Plaintiff and the Division. (Brief of Defs. at 8.) Without privity of estate or privity of contract, there is no legal basis for Defendants' claim against Plaintiff for pre-January 26, 1981 royalties and that claim must be dismissed.

B. <u>Defendants stipulated that the Trail Mountain Sublease was a "sublease" for all purposes of the litigation</u>.

Paragraphs 12, 17, 21 and 55 of the Stipulated Facts in the April 11, 1988 Pretrial Order reference the August 13, 1979 transaction as a sublease to Plaintiff. (R. 667-70, 682.) Copies of the referenced pages of the Pretrial Order are attached hereto under Appendix A. By now arguing that the

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2. "This bond shall be in effect even if the lessee or designated operator has conveyed all or part of the leasehold interest to a sublessee(s), assignee(s), or subsequent operator(s), until such time as the bond may be released by the state as lessor, . . . or until the bond is replaced with a new bond posted by a sublessee, assignee or new designated operator." <u>Id.</u>

Trail Mountain Sublease was actually an assignment, Defendants enthusiastically attempt to avoid the consequences of their own actions. The words "sublease" and "assignment" are legal terms of art and Defendants are represented by counsel. Whether Plaintiff is liable for pre-January 26, 1981 royalties was as much at issue in 1988 when the Pretrial Order was entered as it is now. It is disingenuous for Defendants to now claim they did not mean to stipulate that the Trail Mountain Sublease was in fact a sublease.

C. The Trail Mountain Sublease was a "sublease."

Plaintiff incurred a contractual obligation as a sublessee to the lessee, Fetterolf, to pay royalties. Defendants, without citing any authority, claim that Plaintiff's contractual obligation to Fetterolf somehow transforms Plaintiff into an assignee. There is no authority for that proposition and the argument is based on a misapprehension of the sublease/assignment distinction. The pivotal issue in distinguishing between a sublease and assignment is whether the transferor's entire estate passes under the instrument. Heiner v. S.J. Groves & Sons Co., 790 P.2d 107, 112 (Utah Ct. App. 1990). It is indisputable that the Trail Mountain Sublease was not for the entire term of the State Lease.[3] The Division, like any other lessor, must turn

3. By its terms, the Sublease remained in effect only until "all of the coal in the premises is mined to exhaustion." By contrast, by the clear terms of the State Lease, it remains in effect even after the

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to its lessee, particularly in this circumstance, where it has chosen by its own regulations to make that its exclusive remedy. Whether the lessee may then seek indemnification from the sublessee is another matter that is not at issue in this case.

IV. DEFENDANTS' CLAIMS FOR ROYALTIES ALLEGEDLY ACCRUING PRIOR TO FEBRUARY 27, 1987, ARE BARRED BY THE STATUTE OF LIMITATIONS.

The issue in this case is not, as Defendants misapprehend, whether a statute of limitations runs against school lands in such a manner to allow one in wrongful possession of school lands to divest the State of title to those lands. The issue in this case is whether the State, once it has put a party in rightful possession of school lands through a written instrument, can enforce the terms of that written instrument beyond the period of limitation.

Defendants place substantial reliance on Van Wagoner v. Whitemore, 58 Utah 418, 199 P. 670 (1921). Van Wagoner,

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coal is mined so long as annual rentals and minimum royalties are paid. (Exhibit 1.) The State Lease provides that its term is from the commencement date "and as long thereafter as said minerals may be produced in commercial quantities from said lands or lessee shall continue to make the payments required by Article III hereof." Id. (emphasis added). Article III requires the payment of rent and annual minimum royalty when the lease is not in production. Id. The State clearly understands that the term of the State Lease continues even after production ceases as long as rental and delay royalties are paid. Indeed, the State has insisted that coal operators continue to pay rentals and delay royalties after the coal is mined. (R. 664.) Therefore, the Sublease was a transfer for less than the whole lease term and is indisputably a sublease.

however, stands only for the unremarkable proposition that the State cannot be divested of title to school lands by adverse possession.[4] In this case, the right to extract coal was granted in accordance with law by virtue of the Division's issuance of the State Lease, which is merely a written contract. Under the State Lease, the lessee and its agents had the right to remove coal and once removed, that coal became the personal property of the lessee. Benton v. Division of State Lands & Forestry, 709 P.2d 362, 366 (Utah 1985). There is no claim here that the lessee under the State Lease adversely possessed the State lands by removing coal. Under the terms of the State Lease, the lessee had a contractual obligation to pay the State a royalty on coal produced and sold from the mine.[5] It is merely that contractual right to receive royalties that Defendants are attempting to enforce in this action. As discussed in Plaintiff's Brief, this action on a contract is governed by

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4. The Van Wagoner court narrowly framed the "overshadowing question" of the case as follows: "[a]re the lands in controversy subject to the statutes of limitations relied on by appellants [the adverse possession statutes] and can title thereto be acquired by adverse possession?" Id. at 422, 199 P. at 671 (emphasis added).

5. In fact, Defendants' claim against Plaintiff for the royalties on coal sold prior to January 26, 1981, does not even arise from the State Lease because, as explained above, Plaintiff was not in privity of contract or privity of estate with the Division with respect to the State Lease prior to January 26, 1981. Although Plaintiff disputes that Defendants could directly enforce Plaintiff's contractual obligation to Fetterolf. Even if it could, the action to enforce the Sublease would indisputably be an action on a written contract subject to section 78-12-23.

the six year period set forth in Utah Code Ann. § 78-12-23 (1992), which is expressly applicable to the State. Id. § 78-12-23(2).

Defendants also retreat to the law of adverse possession in their attempt to avoid Plaintiff's statute of limitations argument by claiming that the seven year limitation period of section 78-12-2 applies. The Supreme Court has narrowly framed section 78-12-2 as "in substance [providing] that the State is barred from bringing an action for the recovery of real property claimed by it," but that is wrongfully possessed by another. See Pioneer Investment & Trust Co. v. Board of Educ., 35 Utah 1, 99 P. 150, 152 (1908). This case does not involve a situation where the State has been wrongfully deprived of possession of real property and profits therefrom during a period of adverse use. This case involves rightful possession of property and the State's contractual right to receive a royalty upon the sale of Plaintiff's personal property.

Even if section 78-12-2 were to apply in this case, Plaintiff would be entitled to judgment with respect to royalties due prior to February 21, 1980 because Defendants have not disputed that they did not commence their action for royalty deficiencies until February 21, 1987.

Defendants further assert that the statute of limitations has not run in this case because the royalty payments owed by Plaintiff to the State constitute an open, current and mutual account, and statutes of limitation do not start to run until final payment. Even a cursory review of the applicable law reveals the futility of Defendants' argument. Section 78-12-32 specifically addresses limitation of actions on open accounts:

> In action brought to recover a balance due upon a mutual, open and current account, <u>where there have been reciprocal demands between the parties</u>, the cause of action shall be deemed to have accrued from the time of the last item proved on the account of either side.

<u>Id.</u> (emphasis added). In this case, there are no "reciprocal demands," but rather a unilateral demand by Defendants that the additional royalties allegedly accruing at the end of each quarter during the audit period be paid. Under the circumstances of this case, the statute of limitations ran from the end of each quarter for royalties allegedly accruing during that quarter. <u>See</u> <u>Van de Wiele v. Koch</u>, 472 P.2d 803 (Or. 1970) (involving statute of limitations on grocery store account which ran from end of each month on purchases made during that month). The requirement to pay a series of royalty payments would not constitute an open account. <u>See</u> <u>Bishop v. Parker</u>, 103 Utah 145, 134 P.2d 180 (1943).[6]

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6. <u>Wortman v. Sun Oil Co.</u>, 690 P.2d 385 (1984), the only "open account" case cited by Defendants, does not support Defendants' position. Indeed, <u>Wortman</u> held that the transactions between an oil company and royalty owners pertaining to interest on a suspended royalty payment was <u>not</u> a "mutual, open, running

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V. THE STATE IS NOT ENTITLED TO PREJUDGMENT INTEREST.

A. Interest is not collectible in this Case.

Utah law clearly prohibits imposition of prejudgment interest in this case and Defendants have not cited any controlling precedent to the contrary. Canyon Country Store v. Bracey, 781 P.2d 414 (Utah 1989); Price-Orem v. Rollins, Brown & Gunnell, 748 P.2d 475 (Utah Ct. App. 1989); Chevron Chem. Co. v. Mecham, 536 F. Supp. 1036 (D. Utah 1982). The Atlantic Richfield case cited by Defendants is not on point in this case because in the Atlantic Richfield case there was no ambiguity regarding how to allocate the royalty. 21 I.B.L.A. 98 (1975). In this case, the Trial Court found the State Lease both "ambiguous and subject to varying interpretations," and required a trial to resolve those ambiguities (R. 1675), and yet somehow sufficiently clear to allow calculation of damages before trial with mathematical accuracy. There is no argument that can support the court's inherently inconsistent position.

B. If collectible, interest would be limited to six percent.

The Supreme Court clearly rejected an argument identical to Defendants' in SCM Land Co. v. Watkins & Faber,

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account" such that subsequent royalty payments would save the royalty owners' claim from the running of a three-year statute of limitations with respect to implied contracts. Id. at 390-91.

732 P.2d 105 (Utah 1986). In SCM Land, the plaintiff and the defendant had entered into a lease in 1979, while the statutory rate of interest was six percent. The lease was silent with respect to interest on unpaid obligations. The Trial Court assessed statutory interest at the rate of ten percent on the damages that accrued after May 14, 1981, the effective date of an amendment to Utah Code Ann. § 15-1-1 (1953) raising the legal rate to ten percent. The Supreme Court, noting that section 15-1-1 specifically states that it does not apply to "any contract or obligation made before the 14th day of May 1981," reversed the trial court and held that six percent was the rate applicable to obligations under the contract. SCM Land, 732 P.2d at 108-109.

The State Lease, which was entered into before May 14, 1981, does not expressly establish an interest rate for unpaid obligations. Therefore, under Utah law, even if prejudgment interest could be awarded in this case, it could only be awarded at the rate of six percent because this rate became a contract term by operation of law.[7]

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7. In a vain attempt to avoid the SCM Land holding and charge the ten percent interest rate that became effective on May 14, 1981, Defendants rely on the following language of the State Lease:

> This lease is granted subject in all respects to and under the conditions of the laws of the State of Utah and existing rules and regulations and such operating rules and regulations as may be hereafter approved and adopted by the State Land Board. (Exhibit 1.)

By its express terms, however, section 15-1-1 states that it does not
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C. The Division may not apply the interest rates established in its own rules.

The Board's attempted increase of the interest rate clearly impaired the State Lease by tripling the rate of interest due on unpaid royalties in violation of the Contracts Clause of the United States Constitution. U.S. Const. art. I, § 10. This impairment is analogous to the impairment the Supreme Court found in United States Trust Co. v. New Jersey, 431 U.S. 1 (1977).[8] The reasoning of United States Trust applies in full force to this case. Under the United States Trust court's Contracts Clause analysis, states may not legislatively increase their financial benefits or decrease

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apply to contracts entered into before May 14, 1981. Therefore, even if that provision incorporated the 1981 amendment to section 15-1-1 into the State Lease, which it does not, that provision would not entitle Defendants to charge interest at the rate of ten percent.

8. In United States Trust the Court rejected New Jersey's attempt to invalidate its contractual obligation, stating:

> In applying this standard, however, complete deference to a legislative assessment of reasonableness and necessity is not appropriate because the State's self-interest is at stake. A governmental entity can always find a use for extra money, especially when taxes do not have to be raised. If a State could reduce its financial obligations whenever it wanted to spend money for whatever it regarded as an important public purpose, the Contract Clause would provide no protection at all.

United States Trust, 431 U.S. at 25-26.

their financial burdens solely for the sake of generating revenue. Id. at 25-26.

D. The Board does not have the authority to impose its own higher rates.

Defendants' reliance on Utah Code Ann. § 65-1-23 (1986) as the source of the Board's authority to unilaterally raise interest rates is misplaced. Administrative agencies, such as the Board, possess only such rulemaking authority as the legislature expressly delegates to them. Accordingly, as a general rule, the legislature cannot delegate to an administrative agency the authority to amend or subvert a statute. See Oklahoma Alcoholic Beverage Control Bd. v. Welch, 446 P.2d 268 (Okla. 1968). The Utah Supreme Court articulated this principle as follows: "rules and regulations of an administrative agency must conform to rather than be contrary to and inconsistent with statutory law." McKnight v. State Land Bd., 381 P.2d 726, 730 (Utah 1983).[9]

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9. Defendants apparently place reliance on the general language of section 65-1-23 to support the Board's unilateral increase of interest rates. Well established rules of construction, however, prohibit application of this section in a manner that would sanction the Board's rules. Even assuming section 65-1-23 could be applied to interest rates, the Court should subordinate the general language of those sections to the specific language of section 15-1-1, which establishes a legal rate of interest on contractual obligations in the absence of an express agreement among the parties. See Floyd v. Western Surgical Assoc., Inc., 773 P.2d 401, 405 (Utah Ct. App. 1989). Such a construction is particularly appropriate with respect to section 65-1-23, which contains the express limitation "except as otherwise provided by law," because in this case the interest rate is "otherwise provided" by section 15-1-1.

In the lone statute in which the legislature authorized the Board to set interest rates (relating to the method of payment for sales of state lands), it specifically so stated. Utah Code Ann. § 65-1-37 (1986)(repealed 1993). Nothing cited by Defendants gives the Board similar authority with respect to setting interest rates on delinquent royalties. Where the legislature expressly addresses an issue in one context and fails to address it in another, the court must give effect to the omission in the later context and presume the legislature intended the omission. See Kennecott Copper Corp. v. Anderson, 30 Utah 2d 102, 514 P.2d 217 (1973). Because the legislature expressly authorized the Board to set interest rates on unpaid debts under contracts for the sale of state lands but failed to bestow similar authority with respect to unpaid lease obligations, the Court should conclude that the Board had no authority to rewrite leases by changing interest rates.[10]

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10. It is significant that prior to 1971, not even section 65-1-37 authorized the Board to set its own interest rate for payments on state lands. Utah Code Ann. § 65-1-31 (1953). The Court should presume that the legislature did not perform an unnecessary act when it enacted a statute and that it intended to change existing law. Madsen v. Borthick, 769 P.2d 245, 252 (Utah 1988); Wetering v. Eisele, 682 P.2d 1055, 1061 (Wyo. 1984). Utah Code Ann. sections 65-1-23 and 65-1-97 (1953) existed prior to 1971. If sections 65-1-23 and 65-1-97 gave the Board authority to set its own interest rates as Defendants contend, the amendment to section 65-1-37 expressly authorizing the Board to set interest rates for purchase payments on state lands would have been unnecessary. Therefore, this Court should conclude that sections 65-1-23 and 65-1-97 do not authorize the Board by rule to unilaterally change the interest rates on its existing leases.

E. The State Lease does not require payment of a "market rate" royalty.

Finally, Defendants argue by reference to a whole chart of facts not in evidence (i.e., State Treasurer's Investment Pool statistics, Internal Revenue Service rates and Prime Lending rates) that any interest rate for delinquent payments under the State Lease below "market rates" is unconstitutional. (Brief of Defs. at 41-43.) Defendants' new theory, however, was never raised at trial, is not supported by evidence adduced, and is not based on the State Lease form, a statute or case law. Moreover, Defendants' argument undermines its claim that it is necessary for Defendants to collect 18% interest to recover "full value" because the interest rates cited by Defendants are much lower than 18%, and as this court knows, are now even lower than the 6% rate Defendants are trying to avoid.

VI. TRANSPORTATION COSTS ARE DEDUCTIBLE.

A. There is no evidence in the record that supports a finding that Plaintiff never gave Defendants its transportation cost information.

The three state auditors that reviewed Plaintiff's records did not even disclose that they were assessing royalties under the federal scheme. (R. 1809-10.) By keeping the purpose of Plaintiff's audit a secret, Defendants deprived Plaintiff of an opportunity to request that transportation costs be considered during the audit. (R. 2051-52.) The auditors asked only for gross sales value, not understanding the federal scheme that allows the transportation deduction. (R. 1789, 1799, 1940-41, 2043.) Plaintiff's transportation costs were set forth in the same reports as its tonnage and gross sales value figures, which were provided to the State's auditors in 1987. (R. 2330-2472.) Those reports were available to Defendants, but were ignored because Defendants believed that a lessee was not entitled to such a deduction. The Trial Court ruled and Defendants have not disputed on appeal that Defendants, not Plaintiff, had the burden of establishing "what the royalty rate was, and the amount owed, if any, by Plaintiff." (R. 1068.) Defendants' election to now reject the deduction even though they had the benefit of the figures necessary for the calculation should not result in a bar to Plaintiff's claim for the deduction.

B. <u>Transportation costs do not constitute value of coal for purposes of calculating royalty</u>.

Defendants hopelessly misunderstand the nature of coal sales agreements and therefore erroneously allege that Plaintiff "received credit" for transportation costs from the purchasers of Plaintiff's coal in such a manner that Plaintiff would benefit from a "double deduction." Plaintiff's coal sales agreements contain pricing provisions typical to the coal industry that provide a "base price" representing the sum of identified components (labor, taxes, equipment, depreciation, transportation, quality, insurance, etc.) and a adjustment mechanism to reflect changes in the individual components. (Exhibits 97, 98.) Certain of the components, such as transportation, represent a "service" to the purchaser, the cost of which must be added to the value of the coal as compensation for the service. Service components in the pricing mechanism represent reimbursement, not profit, to the supplier. The federal royalty scheme recognizes this by allowing a coal supplier to "backout" transportation costs from the contract price for purposes of calculating a "value" for royalty purposes. This "backout" or "deduction" is merely an accounting step to recognize the actual proceeds received under a coal supply agreement that represent the value of the coal. Plaintiff seeks nothing more from Defendants than recognition of this accounting procedure, without which Plaintiff will be required to pay a royalty on reimbursement proceeds attributable to trucking the coal to a point for distribution by railroad. Plaintiff's request takes no money from "Utah's school children" because the costs of trucking the coal is not a part of the "value" of the trust's coal.

C. Defendants misstate the facts upon which they rely.

Defendants' interpretation of both state and federal law applicable to this issue is misleading and relies on incorrect facts.

(1) "The sales price is the fairest indication of value and a percentage rate allows the royalty to fluctuate with changing market conditions." (Brief of Defs. at 45.) The "sales price" for coal is the price received for each ton of coal by Plaintiff under its coal supply agreements. However, as explained above, the so-called "sales price" is made up of value and service components, the later of which does not constitute a fair indication of value and should not bear a royalty burden.

(2) "The State coal lease form, by adopting the prevailing federal rate, does not adopt the federal method of calculating royalties." Id. This is a classic example of how Defendants have tried to "have their cake and eat it too." If the State is entitled to the benefits of the federal rate, then the State is also bound by the limitations on the federal rate. The federal regulations impose a royalty of "eight percent of the value of the coal removed from a underground mine." 43 C.F.R. § 3473.3-2 (1992). Eight percent is a number. It is not a rate. The rate is that number times the "value of the coal removed." Id. The State Lease expressly adopts the federal method. The Trial Court specifically made this finding. (R. at 2738-39.) "The prevailing federal rate during the audit period was eight percent of the value of the coal produced by the Plaintiff." ((R. at 2739)(emphasis added)). As described, "value of the coal" was determined by

deducting, among other "service components," the transportation costs from the contract price.

(3) "Plaintiff does not claim however, that it actually received or took such a deduction on its federal leases." (Brief of Defs. at 45.) Plaintiff presented unchallenged evidence at trial that it did in fact make such an adjustment for federal royalty purposes. (R. 1976.)

(4) "It is therefore possible that transportation costs were also backed out of the values used to determine the royalty owed to the State." (Brief of Defs. at 46.) Unimpeached testimony by two witnesses demonstrates that this is not true. (R. 1940-42, 1963-64.)

D. <u>Plaintiff was not required to make an application for a transportation allowance</u>.

Defendants attempt to perpetuate the Trial Court's erroneous conclusion that an allowance must be applied for and granted before transportation costs can be deducted in the calculation of value. The evidence at trial was uncontradicted that the federal coal valuation regulations promulgated in 1987 specifically identifying transportation costs as a component of value were "a continuation of longstanding MMS policy; however, there has never been explicit guidance or regulation pertaining to coal transportation allowances." 52 Fed. Reg. 1840, 1846 (1987) (attached as Appendix B); (R. 2168). Defendants' own witness, Max Nielson of the BLM, also testified that it was longstanding BLM policy to allow an automatic deduction of the costs of transporting coal to a remote point of sale in ascertaining value for royalty purposes. (R. 1841-42.)

Defendants' argument that the MMS historically never allowed a deduction for transportation is an attempt at drafting legerdemain. The 1987 regulations clearly acknowledge the past MMS "long-standing" policy to allow deducting transportation costs under coal valuation procedures and adopt a new scheme whereby prospective application is required for such allowance. 52 Fed. Reg. 1840, 1846 (1987). Copies of the referenced pages of the Proposed Rulemaking are attached hereto under Appendix B. Defendants' flagship case, Coastal States Energy Company, No. MMS-86-0149-MIN (Interior Dec. May 1, 1987), a Minerals Management Service opinion, was issued under the pre-1987 system that automatically allowed deductions from the gross value of the coal which were expended to prepare the coal for sale. 30 C.F.R. § 203.200(f), (h) (1989). If audited, the lessee was required to provide an accurate account of the deducted costs. Id.

The application and preapproval requirements did not exist during the audit period of the State Lease. Therefore, the MMS "longstanding" policy of allowing an automatic deduction for transportation costs was applicable to Plaintiff's coal operations during the audit period. The policy did not require an application to the MMS to allow the deduction. The regulations are clear on this point and Plaintiff's proposed interpretation of the regulations strains even the most liberal reading of the regulations.

CONCLUSION

The judgment of the Trial Court imposing an eight percent royalty upon Plaintiff's coal production from the State Lease for the full audit period should be reversed. This Court should find that Plaintiff is obligated to pay only those royalties at the rate and pursuant to the mechanism supported by the true administrative interpretation of the State Lease. In addition, the Court should hold that Plaintiff's royalty obligation is subject to applicable law which allows a deduction for transportation costs, the imposition of statutes of limitation and the applicability of the State's rules imposing liability on only approved assignees and does not allow application of prejudgment interest.

Respectfully submitted,

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APPENDIX A

FILED
IN THE SEVENTH JUDICIAL DISTRICT COURT OF UTAH IN AND FOR EMERY CO.

BRUCE C. FUNK, Clerk
By ______ Deputy

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IN THE SEVENTH JUDICIAL DISTRICT COURT OF EMERY COUNTY

STATE OF UTAH

TRAIL MOUNTAIN COAL COMPANY, Plaintiff, vs. THE UTAH DIVISION OF STATE LANDS AND FORESTRY, RALPH MILES, DIRECTOR OF THE DIVISION OF STATE LANDS AND FORESTRY; THE UTAH BOARD OF STATE LANDS AND FORESTRY; THE UTAH DEPARTMENT OF NATURAL RESOURCES; DEE HANSEN, EXECUTIVE DIRECTOR OF THE UTAH DEPARTMENT OF NATURAL RESOURCES, Defendants.	PRE-TRIAL ORDER Civil No. 4847 Honorable Boyd Bunnell

This matter was heard at 1:30 p.m. on October 26, 1987, before the Honorable Boyd Bunnell pursuant to Rule 16 of the Utah Rules of Civil Procedure and Rule 5.1 of the Rules of Practice in the District and Circuit Courts of the State of

880300
Clerk, Supreme Court, Utah

Recorded in Judgment Record N at Page 247
BRUCE C. FUNK, Clerk

(c) Sublease

12. On August 13, 1979, Myron F. Fetterolf subleased the State Coal Lease to Trail Mountain Coal Company, a Utah corporation. The sublease was not reduced to writing until January 26, 1981. See Plaintiff's Exhibit 20. Trail Mountain Coal Company was owned by the Fetterolf Group, Inc., a Pennsylvania corporation (80%), John L. Bell (18%) and Charles A. Bass (2%). See Page 24 of Plaintiff's Exhibit 15.

13. The State of Utah Rules and Regulations Governing the Issuance of Mineral Leases as promulgated by the Board of State Lands and Forestry provide in part:

> R632-20-22. Lease Provisions
>
> * * *
>
> 5. Assignments, Subleases and Overriding Royalties.
>
> * * *
>
> (b) Any mineral lease may be assigned or subleased as to all or part of the acreage, to any person, firm, association or corporation qualified to hold a state lease, provided, however, that all assignments and subleases are approved by the board or by the division; and no assignment or sublease is effective until approval is given. Any assignment or sublease made without such approval is void ab initio.

See Utah Administrative Code, Rule 632-20-22 (1987); formerly Rule 13 of Board of State Lands and Forestry.

14. Neither the Board nor the Division approved the sublease of the State Coal Lease from Myron F. Fetterolf to Trail Mountain Coal Company. Neither Myron F. Fetterolf nor Trail Mountain Coal Company notified the Board or the Division of the existence of the sublease. However, Mr. Fetterolf did list Trail Mountain Coal Company as the operator of the Trail Mountain Mine in a letter to the Division dated August 20, 1979. See Defendants' Exhibit 1.

15. In mid-1979, David R. Mills, Mining Engineer for the Fetterolf Group, notified the Division that Trail Mountain Coal Company intended to begin mining coal from the land covered by the State Coal Lease. The State acknowledged this notice by two letters dated June 21, 1979 and July 18, 1979. See Plaintiff's Exhibits 8 and 10.

16. In order to reach the coal in the land covered by the State Coal Lease, Trail Mountain Coal Company mined coal in adjacent land covered by Federal Coal Lease U-082996, which was also part of the Trail Mountain Mine. This mining activity on Federal Coal Lease U-082996 occurred during the period from December, 1978 through September, 1979. A royalty of 15¢ per ton was paid on this federal coal.

17. During the period from July, 1979 through January 26, 1981, coal was mined from the State Coal Lease Property by Myron F. Fetterolf, through his sublessee, Trail Mountain Coal Company. A royalty of 15¢ per ton was paid on this State coal.

18. During 1980, the Division notified Myron F. Fetterolf that the Trail Mountain Mine was in violation of certain laws. See Plaintiff's Exhibits 12, 13 and 14.

(d) Sale of Trail Mountain Coal Company

19. In January of 1981, the owners of Trail Mountain Coal Company (the "Company") sold the Company to Natomas Minerals of Utah, Inc. The transaction involved the following steps.

(1) On January 8, 1981, the Fetterolf Group, Inc., John L. Bell and Charles A. Bass sold their stock in Trail Mountain Coal Company to Natomas Minerals of Utah, Inc. and Natomas Trail Mountain Coal Company. The sale of stock was effective March 2, 1981. See Plaintiff's Exhibits 15, 20 and 21.

(2) The stock acquired by Natomas Trail Mountain Coal Company was retired, and Natomas Minerals of Utah, Inc. thereby became the sole shareholder of Trail Mountain Coal Company.

Recorded in Judgment Record N at Page 256
BRUCE C. FUNK, Clerk

(e) Assignment of State Coal Lease

20. As part of the above sale, the Estate of Myron F. Fetterolf assigned the leasehold interest under the State Coal Lease, to Trail Mountain Coal Company. See Plaintiff's Exhibits 15, 20 and 21. This assignment was executed on January 26, 1981, and was approved by the Director of the Division on February 17, 1981. See Plaintiff's Exhibits 16 and 18. The Director was not aware of any deficiency, and did not notify Trail Mountain Coal Company of any deficiency in royalty payments at the time the assignment was approved.

21. Due to the assignment of the State Coal Lease to Trail Mountain Coal Company, the Company's interest under the sublease merged with its interest as lessee under the State Coal Lease.

22. Trail Mountain Coal Company subsequently merged into Natomas Minerals of Utah, Inc., which subsequently merged into W.K. Minerals, Inc. The State's coal lease records have not been revised to reflect these mergers. The records therefore still indicate that Trail Mountain Coal Company is the lessee under the State Coal Lease. In fact, W.K. Minerals, Inc. is the actual lessee and is the proper plaintiff in this case, but W.K. Minerals, Inc. has continued to do business as

54. The Royalty Audit Report also concluded that $1,854,115.69 in interest had accrued on the unpaid royalties, and that a penalty of $16,606.76 was to be assessed. The total amount due was set at $5,222,197.20. The Director requested payment of this amount from Trail Mountain Coal Company. See Plaintiff's Exhibit 64.

55. The alleged royalty underpayments for the years 1979 and 1980 relate to a period of operation prior to the assignment of the State Coal Lease to Trail Mountain Coal Company.

(j) Interest and Penalty Calculations.

56. The Royalty Audit Report includes a charge for accrued interest on the amount the State claims to be owing. The State's demand for accrued interest is based upon the statutory rate of interest of 6% for the period from November 1, 1979 to June 30, 1981; upon the statutory rate of interest of 10% for the period from July 1, 1981 to November 30, 1982; and upon a regulation adopted by the Board of State Lands in November of 1982 purportedly imposing an 18% interest rate for the period from December 1, 1982 to October 15, 1985. There is also a penalty of 6% claimed as provided by a rule of the Division of State Lands promulgated in December, 1983.

APPENDIX B

DEPARTMENT OF THE INTERIOR
Minerals Management Service
Bureau of Land Management
AGENCY: Minerals Management Service (MMS), Interior.

30 CFR Parts 202, 203, 206, 212, and 218
43 CFR Part 3480
Revision of Coal Product Valuation Regulations and Related Topics

52 FR 1840

January 15, 1987

ACTION: Notice of proposed rulemaking.

SUMMARY: This proposed rulemaking provides for the amendment and clarification of regulations governing the valuation of coal for royalty purposes. The regulations being amended affect Federal coal leases and Indian (Tribal and allotted) coal leases (except leases on the Osage Indian Reservation, Osage County, Oklahoma).

In addition, the proposed rule establishes definitions related to the valuation of coal covered in Subpart F of Part 206.

The purpose of this rulemaking is to update, consolidate, and clarify existing regulations in order to provide industry and the public with a comprehensive and consistent coal valuation policy.

DATES: Comments must be submitted on or before April 15, 1987. The hearing is scheduled to be held on: March 3, 1987, 8:30 a.m. to 4:00 p.m., in Denver, Colorado.

ADDRESSES: Written comments may be mailed to Minerals Management Service, Royalty Management Program, Rules and Procedures Branch, Denver Federal Center, Building 85, P.O. Box 25165, Mail Stop 660, Denver, Colorado 80225, Attention: Dennis C. Whitcomb.

The hearings will be held at the following location: Denver -- Sheraton Airport Hotel, 3535 Quebec Street, Denver, Colorado.
FOR FURTHER INFORMATION CONTACT:Dennis C. Whitcomb (303) 231-3432, (FTS) 326-3432.

TEXT: SUPPLEMENTARY INFORMATION: The principal authors of this proposed rule are Earl Cox, Herbert B. Wincentsen, Thomas J. Blair, Stanley J. Brown, and William H. Feldmiller, of the Royalty Valuation and Standards Division of the Minerals Management Service (MMS) Lakewood, Colorado; and Peter J. Schaumberg of the Office of the Solicitor, Washington, DC.

are net of washing allowances.

Paragraph (d) would specify the adjustment procedure when actual allowances are different from the estimates. If the lessee overestimated costs, the lessee would be required to pay the additional royalty plus interest, For underestimates, lessees would be allowed a credit without interest. The actual procedures to adjust Form MMS-4014 will be included in the MMS Payor Handbook.

Paragraph (e) is proposed to allow the use of the same administrative or computation procedures contained in § 206.260 to determine other washing costs when valuing coal under a net-back procedure or other valuation procedure contained in Subpart F of Part 206.

Proposed § 206.261, Allocation of washed coal, is applicable to both cents-per-ton leases and ad valorem leases which produce coal that is subjected to washing. This proposed section instructs lessees on procedures of how to properly allocate washed coal tonnages back to the leases from which the coal was originally produced. The proper allocation of washed coal is essential to the proper reporting and paying of royalties.

Proposed § 206.262, Transportation allowances, would grant an allowance to lessees when it is necessary to transport coal from the lease or mine to a **wash** plant remote from the lease or mine or to a point of sale remote from the lease or mine. The proposed regulation is a continuation of **long-standing** MMS policy; however, there has never been explicit guidance or regulation pertaining to coal transportation allowances. MMS has received several inquiries in the past questioning what conditions must be present in order to obtain approval to deduct a transportation allowance. The following explanation is not intended to be conclusive or exhaustive but is intended to convey the general criteria MMS would apply to determine whether a transportation allowance is warranted. First, transportation to a point of sale on the lease or on the mine property or to a point of sale in the vicinity of, or adjacent to the leases or mine, does not qualify for transportation allowances. Second, if the transportation is part of what MMS considers normal mine operation, then no transportation costs are allowed. Normal mine operation is considered to include transportation on or about the mine. This includes transportation in the pit, from the pit(s) to the load-out silos or tipples, or to crushers or other coal preparation facilities including wash plants located on or near the mine.

A lessee would be entitled to a transportation allowance only if the value for the coal has been determined pursuant to § 206.259 at a point remote from the lease or mine. Thus, for example, if value has been determined based upon spot prices for coal at the mine, the lessee would not be entitled to a further deduction from that value. A transportation allowance would be allowed, however, in those circumstances where value is determined based upon the gross proceeds for the sale of coal at a sales point remote from the lease.

Paragraph (b)(1) proposes to limit the transportation allowance to 50 percent of the value of coal determined pursuant to § 206.259. Paragraph (b)(1) also contains a limitation on the amount of total deduction by selling arrangements for lessees that qualify for both washing and transportation allowances. As stated previously in the discussion of § 206.260(a) (washing allowances), total deductions are proposed to be limited to 75 percent of the value of coal determined pursuant to § 206.259. The 50 and 75 percent limitations contained in paragraph (b)(1) are not absolute. Paragraph (b)(2) provides for the MMS

Director to approve an allowance in excess of those limits if the lessee submits an application which demonstrates that the higher allowance is warranted and is in the best interests of the lessor.

Paragraph (c) would require that the per ton transportation costs be determined based on the full tonnage transported. Therefore, if unwashed coal is transported to a wash plant remote from the mine, the transportation cost would be determined on the total weight of material transported, including the impurities. However, paragraph (c) further provides that MMS will not participate in the costs of transporting impurities.

Paragraph (d) provides for the determination of transportation allowances under arm's-length and non-arm's-length or no contract situations, including those situations where the lessee performs the transportation service. This section is virtually the same as § 206.260(b) (washing allowances). Therefore, the preamble discussion for that section applies here.

Paragraph (e) contains reporting requirements parallel to those provided for washing allowances at § 206.260(c). The earlier discussion provided herein with regard to washing allowances is equally applicable to this subsection. The same applies to §§ 206.262(f) and (g).

Proposed § 206.263, Contract submission, would provide that lessees must submit to MMS, upon request, coal sales contracts, supply agreements, contract amendments or any other documents affecting gross proceeds, whether or not related to the sales contract. This section would further require the lessee to certify, in writing, that all requested information has been provided. If a lessee falsely certifies, it will be subject to penalties and other sanctions pursuant to applicable laws and regulations. Also, under this section, MMS would specify whether the information is to be sent to MMS or made available at the lessee's office.

This section also would require lessees to include, as part of their submittal, any other contracts, agreements, or documents that affect the gross proceeds accruing to the lessee from the sale of coal. For example, if the lessee agrees to sell coal to a utility and, as part of the agreement, the utility provides mining equipment at a reduced price, that price reduction is part of the consideration for the sale of the coal. As such, the lessee is obligated to submit information about the mining equipment agreement as well as any other sales-related documents.

Paragraph (b) would provide that lessees and other payors would be required to advise MMS whether the contract is arm's-length or non-arm's-length. A definition of arm's-length contract is proposed to be included in § 206.251. This designation is important because, for ad valorem leases, it would determine which valuation method would be used. It is not proposed to make this designation part of the certification.

The lessee's designation of a contract as arm's-length would not be conclusive. Paragraph (c) provides that MMS may later audit the contract to ascertain that the lessee's designation of the contract as arm's-length meets the criteria of MMS' arm-length contract definition.

CERTIFICATE OF MAILING

I HEREBY CERTIFY that I mailed in the U.S. mail, postage prepaid, two (2) true and correct copies of the foregoing REPLY BRIEF OF APPELLANT this 21st day of July, 1993, to the following:

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