

# OIL AND GAS DISPUTES

*BETTER KNOWN AS,*

*“WHEN WHAT CAN GO WRONG,  
DOES GO WRONG”*

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## TABLE OF CONTENTS

I.	Lawsuits Connected with the Termination of the Mineral Lease.....	1
A.	Continuation of lease by production in “paying quantities”.....	1
B.	Continuation of lease through savings clauses .....	2
1.	Commencement of operations before expiration of primary term .....	3
2.	Well is shut-in before expiration of primary term .....	3
3.	Well cannot produce because of “force majeure”.....	5
4.	That “cessation of production” was only temporary .....	6
II.	Lawsuits That Result from Unauthorized Presence.....	6
A.	Physical trespass .....	6
B.	Trespass to try title.....	8
C.	Action to quiet title .....	9
D.	Declaratory judgment actions .....	10
III.	Failure to Pay as Required (or “Show Me the Money!”) .....	11
A.	Determining the proper percentage: the fractional vs. fraction-of problem .....	12
B.	Determining the proper value on which to calculate royalties .....	12
1.	What costs can be deducted from proceeds? .....	13
2.	Proper measurement of the mineral’s value (“market value” or “amounts realized”) .....	14
C.	Whether royalties are due on other proceeds.....	16

IV.	Lawsuits for Breach of Implied Covenant to Act as a Reasonably Prudent Operator .....	17
A.	Implied covenant to manage and administer .....	17
B.	Implied covenant to protect from drainage.....	18
C.	Implied duty to pool in good faith .....	20
D.	Implied duty to develop minerals .....	20
V.	Other Pitfalls That Could Lead to Litigation .....	21
A.	Disputes over surfaces .....	21
B.	Lawsuits over “waste” of minerals – a possible post-lease dispute	22
C.	Lawsuits over whether there is a lease to begin with .....	23
VI.	Resolution of Disputes.....	23
	Conclusion .....	24

## OIL AND GAS DISPUTES

### *BETTER KNOWN AS, “WHEN WHAT CAN GO WRONG, DOES GO WRONG”*

As with almost any discussion with a lawyer, we must begin with a “disclaimer”: this article is intended merely to introduce a few of the potential lawsuit areas facing the oil and gas industry in Texas, with a slant towards some that are particularly likely to arise in the Barnett Shale. However, the specific documents governing the parties – the leases, the deeds, the joint operating agreements – can and will change the application of the general principals, sometimes drastically for the good, sometimes drastically for the bad. To get more specific advice, gather all the relevant documents and background facts and consult with your favorite lawyer.

#### **I. Lawsuits Connected with the Termination of the Mineral Lease**

##### **A. *Continuation of lease by production in “paying quantities”***

An issue oil and gas practitioners expect to see with more frequency when the market for new leases heats up is whether an older lease can be terminated. In the technical sense, a mineral lease is not a true lease. Instead, a mineral lease grants the lessee a fee simple determinable interest in the mineral estate with a possibility of reverter in the lessor. *Natural Gas Pipeline Co. of Am. v. Pool*, 124 S.W.3d 188, 192 (Tex. 2003); *Stephens County v. Mid-Kansas Oil & Gas Co.*, 113 Tex. 160, 254 S.W. 290, 295 (1923).

Because the overriding goal in mineral leasing is to generate profit for both the lessor and the lessee, a lessee is not permitted to hold a lease after its primary term if he is holding it only for speculation; in other words, holding it only in the hope that minerals will be produced. *Clifton v. Koontz*, 160 Tex. 82, 325 S.W.2d 684, 691 (1959). In such a case, the minerals will revert to the lessor – that is, the lease will expire – if no minerals are actually being produced after the lease’s primary term. *Sellers v. Breidenbach*, 300 S.W.2d 178, 179 (Tex. Civ. App.—San Antonio 1957, writ ref’d) (expiration must be judged by the well’s actual production, not its capabilities of production). The courts have further held that not only is hope or expectation of mineral production not enough to hold the lease, actual production is not enough unless it is in “paying quantities.” *Clifton*, 325 S.W.2d at 691. What qualifies as “paying quantities” has and undoubtedly will continue to spawn litigation.

A well produces in “paying quantities” for purposes of continuing the lease if the value of the oil and gas produced creates a profit, however small, after

deducting the costs of lease operation and marketing without regard to whether the cost of drilling, testing, completing and equipping the well are ever recovered and without regard as to whether the undertaking as a whole will ultimately result in a loss. *Clifton*, 325 S.W.2d at 691; *Evans v. Gulf Oil Corp.*, 840 S.W.2d 500, 503 (Tex. App.—Corpus Christi 1992, writ den.); *Pshigoda v. Texaco, Inc.*, 703 S.W.2d 416, 418 (Tex. App.—Amarillo 1986, writ ref'd n.r.e.). Even marginal profit, however, may not be enough to count as “paying quantities” unless it is determined that a reasonably prudent operator would have operated the lease during the relevant period for the purposes of making the lease profitable, as opposed to merely holding the lease for speculation. *See Clifton*, 325 S.W.2d at 691.

As a result, terminating a lease for lack of production requires a fact-intensive investigation with a finding of both (1) that actual production from the well over a reasonable period of time would not yield a profit after deducting operating and marketing costs, and (2) that a prudent operator would not continue, for profit and not for speculation, to operate the well as it has been operated. COMM. ON PATTERN JURY CHARGES, STATE BAR OF TEX., OIL AND GAS PATTERN JURY CHARGES 4.e.7; *Clifton*, 325 S.W.2d at 691. Without both of those findings, the lease will terminate after the primary term unless the lease can be perpetuated by a “savings clause.” *Watson v. Rochmill*, 137 Tex. 565, 155 S.W.2d 783, 784 (1941).

### ***B. Continuation of lease through savings clauses***

If the lease does not “produce in paying quantities” the lease may still be perpetuated under one of the typical “savings clauses” in the lease, in which certain circumstances will substitute for production. *See generally, Fox v. Thoreson*, 398 S.W.2d 88, 91 (Tex. 1966). Of crucial importance in these savings clauses is the actual language used in the lease itself. In interpreting that language, contract interpretation issues come into play, such as the concept that the courts will work to interpret a lease in such a way so as to avoid forfeiture in the absence of clear language. *Anadarko Petroleum Corp. v. Thompson*, 94 S.W.3d 550, 554 (Tex. 2002). On the other hand, there are contractual interpretation rules that require ambiguous contractual language to be construed against the drafter, which is usually the lessee. *See Temple-Eastex, Inc. v. Addison Bank*, 672 S.W.2d 793, 794 (Tex. 1984). Additional rules of contract construction require the courts to use words’ plain and ordinary meaning and to give effect to all the words so that none are rendered meaningless. *E.g., Valence Operating Co. v. Dorsett*, 164 S.W.3d 656, 662 (Tex. 2005). Even with these contract construction tools, however, whether the savings clauses will perpetuate the lease remains a source of frequent litigation.

### ***1. Commencement of operations before expiration of primary term***

Many leases provide that “commencement” of operations before the expiration of the primary term is sufficient to continue the lease until production stops being “in paying quantities.” But what constitutes “commencement”? Sometimes, the courts will take hints from the specific language or definitions in the lease. For example, in *Veritas Energy v. Brayton Operating Corp.*, No. 13-06-061-CV, 2008 WL 384169, at \*2 (Tex. App.—Corpus Christi Feb. 14, 2008, pet. denied), the lease used the language of “commencement of *drilling operations*” as what would extend the lease. Focusing on that language, the court found that clearing for a road near the end of the lease’s primary term did not constitute “drilling operations” and thus, was not sufficient to prevent the lease from terminating. *Id.*

Although specific language is crucial, the courts have also imposed a “good faith and reasonable diligence” gloss on “commencement” of operations. *Guleke v. Humble Oil & Refining Co.*, 126 S.W.2d 38, 41–42 (Tex. Civ. App.—Amarillo 1939, no writ) (to preserve the lease, operations must be continued with reasonable diligence). As stated by another court, “There can be no commencement of a well within the meaning of an oil and gas lease unless work incident to the drilling of an oil and gas well is being performed with the good faith intention to pursue with diligence the drilling of a well to such a depth as an ordinarily prudent operator would drill under the same or similar circumstances in search for oil or gas in paying quantities.” *Gier-Gackson, Inc. v. James*, 160 F. Supp. 524, 529 (E.D. Tex. 1958) (citations omitted). In other words, there must be a real intent, and a real chance, of getting a producing well in order for the court to find “commencement” of activities sufficient to prevent termination.

### ***2. Well is shut-in before expiration of primary term***

Completed wells that are capable of producing in paying quantities, but are not actually producing, is not “production” sufficient to keep the lease in force after its primary term. *Anadarko Petroleum Corp. v. Thompson*, 94 S.W.3d 550, 557 (Tex. 2002) (citing *Peveto v. Starkey*, 645 S.W.2d 770, 771 (Tex. 1982)). Such wells can only perpetuate the lease if they qualify as “shut-in” under the relevant lease savings provision, *and* the contractually required shut-in payments are made. *See Peveto*, 645 S.W.2d at 771. To qualify as shut-in, the well must be “capable” of producing in “paying quantities” at a certain time.

“**Capable.**” Texas courts consistently distinguish between actual production and capability of production by contrasting what is being produced at the relevant time (actual production) with anticipated future production

(capability of production). *See id.* (permitting well to be “shut-in” because there was no available pipeline); *Stanolind Oil & Gas Co. v. Barnhill*, 107 S.W.2d 746, 749 (Tex. Civ. App.—Amarillo 1937, writ ref’d) (permitting shut-in because of lack of available market). Whether a well is “capable” of production is determined by whether it is capable of producing in paying quantities without additional equipment or repairs. *See Anadarko*, 94 S.W.3d at 558. In illustration of the “capable of production” concept, the Texas Supreme Court has adopted and lower courts have been following the standard that a well is only capable of producing if the well would begin flowing by the simple act of turning it “on.” *See also EOG Resources, Inc. v. Killam Oil Co., Ltd.*, 239 S.W.3d 293, 302–03 (Tex. App.—San Antonio 2007, pet. denied) (applying *Anadarko* test of whether the well will flow when the switch is turned “on”).

This now oft-repeated test for capability – being able to flow by merely turning the well “on” – may be potentially devastating in areas such as the Barnett Shale, where wells typically do not flow unless they are fraced. Thus, because such wells need something more than simply being turned on, at least one court of appeals decision has found that un-fraced shale wells cannot be considered “capable of producing” and so will not qualify as shut-ins to preserve a lease beyond the primary term. *AFE Oil & Gas, L.L.C. v. Armentrout*, No. 2-07-100-CV, 2008 WL 623980, at \*3–5 (Tex. App.—Fort Worth, Mar. 6, 2008, pet. denied).

**“Paying quantities.”** “Capability of production,” by itself is not enough to qualify a well as “shut-in”; the well must be capable of producing in “paying quantities.” “Paying quantities” is not the same analysis as whether the well as a whole is profitable. Instead, “paying quantities” means a profit, however small, over current operating expenses, without regard to whether it will ever repay the original drilling costs. *Clifton v. Koontz*, 160 Tex. 82, 325 S.W.2d 684, 690–91 (1959) (citing *Garcia v. King*, 139 Tex. 578, 164 S.W.2d 509, 511 (1942)). Significantly, even if the lease does not provide what type of production the well must be capable of to qualify as shut-in, the courts have held that “capable of production” necessarily means producing in paying quantities. *Garcia*, 164 S.W.2d at 511 (holding that, where a lease term was for ten years and “as long thereafter as oil, gas, and other minerals is produced from said land hereunder,” “produced” meant “produced in paying quantities”).

**“At the relevant time.”** The third qualification for a well to preserve a lease by reason of being “shut in” concerns at what moment in time the well must be “capable” of production in paying quantities. In a 2007 Waco case, the dispute was whether “capability of production” was measured at the time the well was shut in, or at the end of the lease’s primary term. The court relied heavily on the exact language in the lease, which began with, “If at the end of the primary term .

. . . one or more wells . . . are capable of producing . . . in paying quantities.” *Chesapeake Exploration Ltd. Partnership v. Corine, Inc.*, No. 10-06-00265-CV, 2007 WL 2447293 at\*2–3 (Tex. App.—Waco Aug. 30, 2007), *judgment set aside by agreement of parties*, 2007 WL 2729576 (Tex. App.—Waco Sept. 19, 2007). The court found the language dictated that “end of the primary term” was the moment at which “paying quantities” had to be determined. Although specific lease language may modify this, the majority of leases most likely use this type of introductory language for the shut-in provision. This will be important for upcoming lease termination arguments, since on-going profitability is directly related to the price of gas; if gas prices remain depressed, it will be that much more difficult for a shut-in well to meet the “paying quantities” portion of the tests.

### ***3. Well cannot produce because of “force majeure”***

Another attempt to keep leases in force after the primary term can be found in the “force majeure” clauses. “Force Majeure” is a French term generally translated to mean “superior force” or “act of God.” These provisions are nearly always inserted in leases, but seldom used successfully. The purpose of a force majeure clause is to excuse non-performance of the lease when that performance is prevented by unforeseen events that are beyond the control of the parties, such as hurricanes or other catastrophic events. The general key is that the provision is meant to protect only those non-performances caused by circumstances beyond the reasonable control of the lessee or when non-performance is caused by an event that is unforeseeable at the time the parties entered the contract. *Hydrocarbon Mgmt., Inc. v. Tracker Exploration, Inc.*, 861 S.W.2d 427, 435–36 (Tex. App.—Amarillo 1993, no writ) (citing *Valero Transmission v. Mitchell Energy*, 743 S.W.2d 658, 663 (Tex. App.—Houston [1st Dist.] 1987, no writ). Applying these principals, the court in *Moore v. Jet Stream Investments, Ltd.*, 261 S.W.3d 412 (Tex. 2008), refused to excuse performance under a force majeure provision because although performance was prevented by the lack of compliance with a new, unforeseen Railroad Commission (“RRC”) regulation requiring “financial assurance,” it was within the operator’s power to have effected compliance. *Id.* at 421–22.

#### 4. *That “cessation of production” was only temporary*

The courts have also permitted a lease to be preserved beyond the primary term on grounds that the lease is still deemed to be “producing” even though it is technically not, if the cessation is only “temporary.” This doctrine is a recognition of the reality that due to a variety of circumstances, wells simply cannot flow every single day without at least occasional interruption for things like the need mechanical repairs. *See Ridge Oil Co. v. Guinn*, 148 S.W.3d 143, 151 (Tex. 2004) (temporary cessation doctrine applies even if not mentioned in lease, as long as there are no provisions to the contrary). However, the doctrine is not limited to only sudden stoppage or mechanical breakdowns, but is a fact-specific analysis of whether the cessation is permanent or is something that is subject to remedy and the remedy is in fact being pursued. *See id.* at 152 (noting with approval other cases finding that whether stoppage was temporary in circumstances including lawsuits, obstructions in gas lines, collapsed well casing that required the well to be plugged and a new one drilled, the expiration of a pipeline purchaser agreement, and a lack of well pressure that kept the well from flowing). As more specifically stated by the *Ridge* court, circumstances in which the doctrine applies are not limited to those in which cessation has been sudden, unforeseen, or unavoidable; thus “foreseeability and avoidability are not essential elements of the [temporary cessation of production] doctrine.” *Id.* at 152. As a result, the potential breadth of this doctrine may actually exceed the scope of other savings provisions and be used to preserve quite a few leases when well production is halted after the expiration of the primary term.

## II. **Lawsuits That Result from Unauthorized Presence**

If the lessor is unable to preserve his lease, or the operator finds himself on or under land to which he has no possessory right, lawsuits are probable. The most likely causes of action will be for trespass, trespass to try title, and quiet title, although for reasons we will discuss, most of these lawsuits will also be couched in terms of requesting what is termed “declaratory” relief.

### A. *Physical trespass*

Lawsuits alleging physical trespass can arise when the lessee did not initially obtain good title, the operator caused some physical invasion of unleased lands, or the lease has terminated but the (former) lessee did not timely depart the property. *See, e.g.*, RESTATEMENT (SECOND) OF TORTS §158 cmts. h-k (1965) (personal entry, things, third persons). The trespass cause of action permits the plaintiff to seek an injunction to stop the invasion, as well as monetary damages caused by someone else’s “possession” or use of the plaintiff’s property. *E.g.*, *City of Arlington v. City of Fort Worth*, 873 S.W.2d 765, 769 (Tex. App.—Fort

Worth 1994, no writ). In addition, if the trespass was done with malice, punitive damages may be available. *See, e.g., Cargal v. Cargal*, 750 S.W.2d 382, 385 (Tex. App.—Fort Worth 1988, no writ). Operators often feel insulated from these causes of action if they have obtained drilling permits. Unfortunately, however, an RRC permit for the well does not insulate the operator from civil liabilities. *Berkley v. R.R. Comm'n of Tex.*, No. 07-07-0292-CV, 2009 WL 839064 at \*2 (Tex. App.—Amarillo, Mar. 31, 2009, no pet.) (Rule 37 exception does not excuse or forgive trespass).

There are some crucial, still-developing issues in the physical trespass arena. The issue most under discussion in areas where fracing is common is whether injected frac fluid forced onto adjoining property can be a trespass. At least one older case indicated that subsurface trespass by injected sand material could be a trespass. *Gregg v. Delhi-Taylor Oil Corp.*, 344 S.W.2d 411, 416 (Tex. 1961). However, the recent *Garza* case has cast doubt on – but not settled – whether fracing material invading another's land can be a trespass. In *Garza*, royalty owners of a neighboring tract sued when fracing material invaded their lands. The Court specifically refused to decide whether that would be a trespass of a possessory interest. *Coastal Oil & Gas Corp. v. Garza Energy Trust*, 268 S.W.3d 1, 12 (Tex. 2008). Because the plaintiffs in *Garza* were royalty owners and thus held no current right to possess the minerals, they were required to prove they had suffered actual damages as one of the elements of their trespass cause of action. *Id.* at 9–11. However, because the rule of capture meant that the royalty owners had not sustained damages since they had not “lost” any gas, the *Garza* Court held that the royalty owners could not prove their cause of action for trespass. *Id.* at 12–13. This ruling, however, does not resolve whether a person with possessory rights to the minerals – such as an operator or simply an unleased mineral owner – would be able to prove a physical trespass.

Another potentially troubling trespass issue for operators is what happens when a non-producing portion of a horizontal drill pipe passes underground through non-leased property. This area remains unsettled, with courts opining on all sides. As a result, if a drill pipe actually traverses a piece of unleased property, even if the pipe is not in a producing zone, the operator may find itself defending against an injunction to stop drilling. There is at least some authority that mineral owners whose lands are not being produced, but whose property is crossed by horizontal well bores, may enjoin the trespass or seek damages regardless of whether the pipe is in the correlative zone. *See Chevron Oil Co. v. Howell*, 407 S.W.2d 525, 528 (Tex. Civ. App.—Dallas 1966, writ ref'd n.r.e.) (upholding an injunction against drilling operations because of the “inevitable” damage to the subsurface formation whenever a well is drilled). On the other side of the legal fence is *Humble Oil & Refining Co. v. L&G Oil Co.*, 259 S.W.2d 933, 938 (Tex. Civ. App.—Austin 1953, writ ref'd n.r.e.), which refused to let a

mineral owner enjoin drilling unless it could show that the drilling would interfere with that mineral owner's ability to develop minerals.

If drilling pipe *is* in the correlative zone, in addition to facing injunctions, the operator may face potentially huge damages. Courts have held that damages can be 100% of *all* production unless the operator can prove to a reasonable certainty the proportion of production attributable to the unleased tract, which can be a difficult and expensive burden of proof. *See Humble Oil & Refining Co. v. West*, 508 S.W.2d 812, 818 (Tex. 1974). For a potentially contrary view, *see Browning Oil Co. v. Luecke*, 38 S.W.3d 625, 640–41 (Tex. App.—Austin 2000, pet. denied). In the *Luecke* case, the court did not permit the lessor to recover damages of 100% of all production, but instead only the production attributable to the portion of the horizontal drainhole actually under the lessor's acreage. Notably, however, the plaintiff in *Luecke* was suing for breach of a lease's pooling provision, not for trespass, and the court's calculation of damages was directly tied to the lease in effect. That distinction may make the court's apportionment of production inapplicable to trespass cases.

Obviously, if the 100% of production rule is found to apply or the operator cannot prove what percentage of production comes from the trespassed tract, damages can be large. But it can get even more expensive if the well violated its RRC permit, because such a trespass is very likely to found to be in "bad faith." "Bad faith" is crucial in trespass actions because it controls whether the trespassing operator can deduct drilling and operating costs. "Good faith" is determined by whether the operator had a reasonable, but incorrect, belief that his title permitted him to be on that land. *See, e.g., Right of Way Oil Co. v. Gladys City Oil, Gas & Mfg. Co.*, 157 S.W.737, 740 (Tex. 1913); *Bender v. Brooks*, 103 Tex. 329, 333, 157 S.W.2d 168, 170 (1910). In short, there is a substantial risk that unpooled interests along the path of a horizontal drainhole will have to be paid as if it were a drill site. *Am. Trading & Prod. Corp. v. Phillips Petroleum Co.*, 449 S.W.2d 794, 798 (Tex. Civ. App.—El Paso 1969, writ ref'd n.r.e.).

### ***B. Trespass to try title***

The purpose of a trespass to try title cause of action is to regain title and possession of land. Thus, it typically arises if the lease terminates, or there is some other alleged defect in the title. Unlike many causes of action, the elements and procedure are specifically set out by statute. TEX. PROP. CODE § 22.001 (Vernon 2000) ("A trespass to try title action is the method of determining title to lands, tenements, or other real property.") Thus, when the landowner is attempting to have its title adjudicated and regain possession of the minerals – for example, because the lease has terminated – a trespass to try title is the proper procedural mechanism. *Martin v. Amerman*, 133 S.W.3d 262, 267 (Tex. 2004).

A suit to resolve a dispute over title to land is, in effect, a trespass to try title action regardless of the form the action takes and whether legal or equitable relief is sought. *Bell v. State Dep't of Highways & Pub. Transp.*, 945 S.W.2d 292, 294 (Tex. App.—Houston [1st Dist.] 1997, writ denied), *abrogated on other grounds by Harris County v. Sykes*, 136 S.W.3d 635 (Tex. 2004). To recover in a trespass to try title suit, the plaintiff has the burden to prove its title by: (1) a regular chain of conveyances from the sovereign; (2) a superior title out of a common source; or (3) prior possession that has not been abandoned. *Rogers v. Ricane Enterps., Inc.*, 884 S.W.2d 763, 768 (Tex. 1994).

The Texas Supreme Court has held that because the trespass to try title statute states it is “*the*” method for determining title disputes, it is therefore the exclusive mechanism for those types of disputes. *Martin v. Amerman*, 133 S.W.3d 262, 264–65 (Tex. 2004) (boundary dispute is properly a trespass to try title action). This is of crucial importance to the parties because it means that no attorney’s fees will be recoverable, no matter what the outcome. *Id.* at 267. As a practical matter, that means that the dispute must involve property of sufficient value that it justifies litigation regardless of the unrecoverable expense of attorney’s fees.

### C. *Action to quiet title*

A suit to quiet title is an equitable action intended to remove a “cloud” on title. A “cloud” is any deed, contract, judgment or other instrument not void on its face that purports to convey any interest in or make any charge upon the land of a true owner. *See, e.g., Best Inv. Co. v. Parkhill*, 429 S.W.2d 531, 534 (Tex. Civ. App.—Corpus Christi 1968, writ dism’d w.o.j.). As a more recent court stated, “A suit to quiet title is an equitable action that involves *clearing* a title of an invalid charge against the title.” *A.I.C. Mgmt. v. Crews*, No. 01-03-01178-CV, 2005 WL 267667, at \*3 n.8 (Tex. App.—Houston [1st Dist.] Feb. 3, 2005), *rev’d on other grounds*, 246 S.W.3d 640 (Tex. 2008). In most oil and gas-related lawsuits, a trespass to try title action will also include a quiet title claim because in both, an owner sues to recover immediate possession of land unlawfully withheld. *Katz v. Rodriguez*, 563 S.W.2d 627, 629 (Tex. Civ. App.—Corpus Christi 1977, writ ref’d n.r.e.) (noting that a trespass to try title suit affords a legal remedy by statute and a suit to quiet title affords an equitable remedy, but both are actions to recover possession of land unlawfully withheld). By contrast, a trespass to try title action is the exclusive appropriate cause of action if the defendant is in actual possession of the property interest and the plaintiff wishes to have the court adjudicate rival claims to title and right of possession. *Yoast v. Yoast*, 649 S.W.2d 289, 292 (Tex. 1983). A prevailing party’s remedy in a suit to quiet title is title to, and possession of, the real property interest at issue in the

suit. See *Florey v. Estate of McConnell*, 212 S.W.3d 439, 449 (Tex. App.—Austin 2006, pet. denied).

Of importance to litigants is that neither damages nor attorney’s fees are available on a suit to quiet title. *Pampell Interests v. Wolle*, 797 S.W.2d 392, 395–96 (Tex. App.—Austin 1990, no writ); *Ellis v. Waldrop*, 656 S.W.2d 902, 905 (Tex. 1983) (suits to quiet title are only in “equity,” which means that damages are not available). However, a suit to quiet title differs most from a trespass to try title suit in that there is no statute that makes it the exclusive cause of action, as there is with trespass to try title suits. Thus, it will arguably still be permissible to frame a quiet title action as a declaratory judgment action, which may allow the recovery of attorney’s fees.

#### ***D. Declaratory judgment actions***

Declaratory judgment actions are generally not considered a cause of action in and of themselves; instead they are a procedural vehicle for obtaining relief. But “dec actions,” as they are called, can be extremely important in oil and gas litigation because of this procedure’s arguably most important feature to litigants: the winners’ ability to recover its attorney’s fees, which are generally unrecoverable under the majority of causes of action that involve oil and gas disputes other than those involving failures to pay, discussed below.

Specifically, the declaratory judgment statute states that “[a] person interested under a deed, will, written contract, or other writings constituting a contract or whose rights, status, or other legal relations are affected by a statute [or] contract” may “have determined any question of construction or validity arising under the instrument, statute, [or] contract . . . and obtain a declaration of rights, status, or other legal relations thereunder.” TEX. CIV. PRAC. & REM. CODE ANN. § 37.004(a) (Vernon 2008). The act then further authorizes the court to award “costs and reasonable and necessary attorney’s fees as are equitable and just.” TEX. CIV. PRAC. & REM. CODE § 37.009. While that provision does not guarantee recovery of legal expenses, nor even recovery of the entire amount, it at least provides litigants with the hope that the amounts they seek to recover as damages will not be eaten away by legal fees spent to collect those amounts.

As a result, most litigants disputing leases will cast at least one portion of their pleadings as a request for declaratory relief and this is generally permissible. *Anderson v. McRae*, 495 S.W.2d 351, 356 (Tex. Civ. App.—Texarkana 1973, no writ) (stating that “the existence of another adequate remedy does not bar the maintenance of an action for declaratory relief”). However, the availability of declaratory judgment actions has been cast into doubt by *Martin v. Amerman*, 133 S.W.3d 262, 267 (Tex. 2004), holding that a boundary dispute was properly a

trespass to try title action, and thus, declaratory relief (and recovery of attorney's fees) was not available.

Even after that the *Martin* case, however, some courts *have* permitted declaratory judgment actions – and the award of attorney's fees – as long as the parties can frame their dispute something more than just title and possession of real property. *See, e.g., Max Duncan Family Investments, Ltd. v. NTFN, Inc.*, 267 S.W.3d 447, 453–54 (Tex. App.—Dallas 2008, pet. denied) (because action concerned validity of real estate note, declaratory judgment action was proper and attorney's fees were recoverable).

Thus, stated broadly, a declaratory judgment action may be sought in any case in which the declaration being sought is not tied only to the recovery of possession of real property or the vesting of title. Such permissible declaratory judgment claims might include requests to construe the lease to determine if the instrument is valid, whether a lease conveys a certain amount of interest, or the proper interpretation of the lease's provisions. *See, e.g., Plainsman Trading Co. v. Crews*, 898 S.W.2d 786, 788 (Tex. 1995) (issuing declaratory judgment determining surface owner's interest in uranium); *Duncan Land & Explor., Inc. v. Littlepage*, 984 S.W.2d 318, 333–34 (Tex. App.—Fort Worth 1998, pet. denied) (termination of oil lease based on quiet title and slander of title claims brought as declaratory judgment action). But, if the parties do not dispute the lease's interpretation and the real dispute is whether certain activities fit within the lease, the court will most likely hold, as the appellate court in a recent case did, that a declaratory judgment action is not permitted, and so neither are attorney's fees. *BP America Production Company v. Marshall*, No. 04-06-00478-CV, 2008 WL 5169635 at \*15–16 (Tex. App.—San Antonio Dec. 10, 2008, TEX. R. APP. P.53.7(f) motion granted (extending time for parties to file petition)).

### **III. Failure to Pay as Required (or “Show Me the Money!”)**

Happily for most operators, most modern leases explicitly provide that failures to pay proper amounts gives royalty owners only a right to sue, and *not* the right to terminate the lease. Still, determining that proper amount is not always as easy as it seems, and issues relating to royalties, marketing and post-production costs permeate the oil and gas industry and are frequently litigated.

**A. *Determining the proper percentage: the fractional vs. fraction-of problem***

Although the percentage of royalty would seem to be an easily determined issue, slight variations in wording can make huge differences – and thus lead to huge litigation. One of the issues frequently encountered is whether a reservation of minerals is a fractional royalty or a fraction *of* royalty. A “fractional royalty” interest entitles the owner to the specified fractional amount stated in the deed and remains constant regardless of the amount of royalty contained in a subsequently-negotiated oil and gas lease. On the other hand, a “fraction *of* royalty” conveys a fractional share of the royalty that is contained in an oil and gas lease: the fraction is not fixed, but rather “floats” in accordance with the size of the landowner’s royalty contained in the lease. In addition to the landowner’s royalty, the fraction of non-participating royalty (“NPRI”) also shares proportionally in any overriding royalty interest reserved in the oil and gas lease, and the holder of the executive right owes a duty to the NPRI owner in establishing the landowner’s royalty in an oil and gas lease. The amount to be paid to the owner is determinable upon the execution of some future lease and is calculated by multiplying the fraction in the royalty reservation by the royalty provided in a lease. *See Range Resources Corp. v. Bradshaw*, 266 S.W.3d 490 (Tex. 2008).

In the *Range Resources* case, the court applied the “four corners” rule to construe the deeds at issue to make the “fractional vs. fraction of” determination. The four corners rule states that the court is to look at the objective intent as expressed in the writing itself, instead of the parties’ subjective intent. The deeds at issue provided “The Grantors herein reserve ... an undivided one-half (½) Royalty (Being equal to but not less than an undivided one-sixteenth[h] (1/16)[l]) of all the oil, gas and/or other minerals in, to, and under or that may be produced from said . . . land.” Note that the royalty language did not say “one-half OF Royalty,” which is what led to the parties’ dispute over what the lease had intended. Ignoring testimony about the parties’ intent and using only the four-corners interpretation rule, the court relied on the “not less than” language to find that that the royalty calculation was not intended to be fixed, which thus meant that the interest was a fraction *of* royalty. *Id.* at 496–97.

**B. *Determining the proper value on which to calculate royalties***

Once the proper royalty percentages are established, the next fertile ground for dispute is determining the value to which that percentage will be applied. One aspect of royalty valuation litigation that makes it particularly dangerous is that, unlike disputes over title, it is statutorily mandated that attorney’s fees *are* recoverable and in fact *must* be awarded. TEX. NAT. RES.

CODE § 91.406 (Vernon 2001). This section of the Natural Resources Code provides that, in a suit to collect proceeds and interest from the sale of oil and gas, the court *shall* include in any final judgment in favor of the plaintiff an award of reasonable attorney’s fees. *Id.* Under this statute, the court must award attorney’s fees in “any final judgment in favor of the plaintiff.” *See, e.g., Green Int’l., Inc. v. Solis*, 951 S.W.2d 384, 390 (Tex. 1997). “Applying the plain meaning of the word ‘favorable,’ we consider any judgment ‘favorable’ to the plaintiff when he obtains a measure of relief which leaves him in a better position than he held before filing suit.” *Headington Oil Company, L.P. v. White*, No. 14-07-00050-CV, 2009 WL 783338, at\*10 (Tex. App.—Houston [14<sup>th</sup> Dist.] Mar. 26, 2009, no pet.). This “judgment in favor of” standard is something far less than the “prevailing party” standard applied by the courts in other contexts. In other words, if the plaintiff gets *anything* in his lawsuit, regardless of whether others would consider that the plaintiff “won” or even “succeeded,” he will be awarded attorney’s fees.

### ***1. What costs can be deducted from proceeds?***

Other than increasing the fractional royalty that is set out in the lease, one of the most common attempts to increase the dollars paid to the royalty owners is an attempt to relieve the lessor from any share of the cost of transporting and marketing the gas after it is produced. “Produced” means the moment when the gas is severed from the soil at the wellhead. *Blackmon v. XTO Energy, Inc.*, 276 S.W.3d 600, 604 (Tex. App.—Waco 2008, no pet.). Typically, royalty amounts are not reduced by production costs, which are the costs to bring the minerals to the surface and include costs to drill and complete the well, and the ongoing costs of operating the well. *Heritage Resources, Inc. v. NationsBank*, 939 S.W.2d 118, 122 (Tex. 1996). Post-production costs include the cost of dehydrating, compressing, gathering, treating, processing, and transporting the gas from the wellhead to market. *Judice v. Mewbourne Oil Co.*, 939 S.W.2d 133 , 135 (Tex. 1996).

Because gas cannot be economically stored at the well, it must be transported and treated to render it marketable; thus, the cost of transportation and treatment will make the price received at the wellhead necessarily less than the price of the gas ultimately sold after transportation and processing. That is why a royalty based on value “at the well” gives the lessee the right to deduct from its actual sales price the lessor’s pro-rata share of the post-production costs. *See Piney Woods Country Life School v. Shell Oil Co.*, 726 F.2d 225, 231 (5th Cir. 1984), *cert. denied*, 471 U.S. 1005 (1985). Thus, post-production costs – those expenses incurred *after* bringing the gas to the surface, including all those costs necessary to make the gas marketable or deliverable – are deducted before

royalties are calculated. *Heritage Resources, Inc. v. Nationsbank*, 939 S.W.2d 118, 122 (Tex. 1996).

The basic principal that royalties are measured at the moment of production causes confusion when the parties attempt to change the allocation of post-production costs. This is because a provision eliminating post-production costs is arguably not effective if the royalty is determined “at the well.” In other words, because the vast majority of leases determine royalty as the gas passes through the mouth of the well, any provisions attempting to change calculations that occur after the gas leaves the wellhead are mere “surplusage” and not effective, according to the Texas Supreme Court. *Heritage Resources, Inc. v. NationsBank*, 939 S.W.2d 118, 122–23 (Tex. 1996). The court in *Heritage* found that “at the well” language in the lease means just that, regardless of later language prohibiting deduction of post-production costs. Since the *Heritage* decision came down, however, many parties have been crafting different language that may or may not be successful in prohibiting deduction of post-production costs.

## **2. *Proper measurement of the mineral’s value (“market value” or “amounts realized”)***

Texas courts have established that where royalty is to be based on “market value,” the gas must be valued when it is produced and sold, rather than at an earlier time when it may have been committed for sale under a long-term contract, no matter how advantageous that contract seemed at the time. *Texas Oil & Gas Corp. v. Vela*, 429 S.W.2d 866 (Tex. 1968); *Exxon Corp. v. Middleton*, 613 S.W.2d 240 (Tex. 1981). A “market value” or “market price” clause requires payment of royalties based on the prevailing market price for gas in the vicinity *at the time of sale*, irrespective of the actual sale price. *Yzaguirre v. KCS Resources, Inc.*, 53 S.W.3d 368, 372 (Tex. 2001). The market price may or may not reflect the price the operator actually obtains for the gas, which, depending on prices at the relevant times, may work to the advantage of the royalty owner, or to the lessor. *Id.* at 372–73. On the positive side of using “market value,” the operator will have no independent duty to obtain a better price for the gas because market value is deemed to be “objective” and is not dependant on what the lessee actually receives for the production. *Bowden v. Phillips Petroleum Co.*, 247 S.W.3d 690, 699 (Tex. 2008).

On the negative side, the debate over determining “market price” has been the subject of lawsuits for decades. Lessors argue that market price simply means the market value of the gas at the time it is produced and sold. Lessees argue that in a market where a majority of gas is sold under bulk gas purchase contracts, as long as a lessee can demonstrate that it acted as a reasonably prudent

operator in entering into the bulk gas purchase contract, the price received under the contract should be deemed at the “market value.” In either case, determining all the factors necessary to conclude what the “market value” is can be difficult and time-consuming.

As a general rule, the market price of gas is determined by sales of gas comparable in time, quality, and availability to marketing outlets. *Texas Oil & Gas Corp. v. Vela*, 429 S.W.2d 866 , 872 (Tex. 1968). The progeny of cases spun off from *Vela* have compiled multiple considerations in determining the market price for gas, including comparing the relevant “market” or “area” for the gas being sold which is at least as large as the field in which the gas was produced but could be as large as the entire Gulf Coast. *See Exxon Corp. v. Middleton*, 613 S.W.2d 240 , 247 (Tex. 1981) (upholding as evidence testimony of expert who used entire Texas Gulf Coast as relevant marketing area). Ideally, market value will be determined from an identical arms-length transaction that occurred at the same time the gas subject to the disputed royalty was produced and sold. Unfortunately, such evidence is unlikely to be readily available, and so the courts rely on comparable sales. *Id.* Comparable sales raise the rather fact-specific issue of having multiple factors to compare. *See Kramer, Bruce, Interpreting the Royalty Obligation: What a Novel Idea*, 35 Tex. Tech L.R. 223 (2004). Those factors may include:

- (a) The volume available for sale. Generally, the greater the volume or reserves, the greater the price the seller could command;
- (b) The location of the leases or acreage involved, whether in a solid block or scattered, and their proximity to prospective buyers' pipelines;
- (c) The delivery point of the gas produced and sold;
- (d) The post-production costs incurred to market the gas;
- (e) Heating value, or purity of the gas;
- (f) Deliverability of the wells. The larger the volume that could be delivered from a reserve, the greater the price the seller could command; and
- (g) Delivery or rock pressure. The higher the pressure, the less compression for transportation is required.

As one can see from the multiple factors that can be used to determine market value, a risk of using “market value” formulations to determine royalties is that it most likely requires expensive expert testimony at trial for both parties.

*Exxon Corp. v. Middleton*, 613 S.W.2d 240, 246 (Tex. 1981). Even before trial, however, it is impractical for the accounting department of a corporation to use any value different than the one it actually receives to calculate royalties, thus leaving itself open to the charge that the price it received was lower than “market value.”

Perhaps because of the difficulties in calculating market value, some leases provide that royalty is to be calculated from the “proceeds” or “amount realized” by the lessee. (Indeed, many leases use both valuation methods: one for gas sold on the premises, one for gas sold off the premises.) “Proceeds” or “amount realized” clauses require measurement of the royalty based on the amount the lessee actually receives under its sales contract for the gas. *Union Pac. Res. Group v. Hankins*, 111 S.W.3d 69, 72 (Tex. 2003) (citing *Yzaguirre*, 53 S.W.3d at 372). This formulation carries its own risks, however, because lessees using this method are then charged with the implied duty to use due diligence to market the gas at the best possible price. (See discussion on implied duties, below.) Such determinations can and will be fact-intensive and give potential litigants several grounds on which to fight.

### ***C. Whether royalties are due on other proceeds***

Broad language allowing royalties on any value received as a result of lessee’s interest in the property may permit the lessor to recover royalties on funds the lessee receives from activities other than simple production. This was an issue in the 1990s, where royalty owners in multiple cases sued to collect their share of proceeds from take-or-pay payments. Those cases were generally resolved by court pronouncements that a take-or-pay payment was not a “payment for the sale of gas . . . [r]ather, it is a payment for the exclusive dedication of reserves for a fixed period of time.” *Lenape Resources Corp. v. Tennessee Gas Pipeline Co.*, 925 S.W.2d 565, 570 (Tex. 1996). Since that time, however, many lessors have broadened the royalty provision to include a royalty on any value “attributable” to the lease or “realized from and accruing to the minerals.” To further complicate matters, the gas contracts lessees are entering into have continued to evolve and include such things as demand charges, management fees, supply bonuses and liquidated damages, and some producers have entered into derivative or futures contracts for production. Depending on your perspective – and the specific language of the lease – some or all of these are arguably tied to or resulting from “production,” but no case law has yet specifically resolved these issues.

A similar issue is whether royalties are due on other substances taken out of the well, such as hydrogen sulfide, carbon dioxide, and helium. There is at least an argument that royalties are not required on separate elements of

production, if they are separated after the point that the lessee has “paid” for the production. As stated by one court, “Unless otherwise specified in the mineral lease, generally, the lessee or producer will bear both the cost and benefits from processing and treatment of those minerals after the initial production. We have explained that ‘[h]aving bought and paid for such gas [the lessee] owned the same, including all of its constituent elements, and therefore had the lawful right to make such use of it as it might deem proper.’” *Bowden v. Phillips Petroleum Co.*, 247 S.W.3d 690, 706 (Tex. 2008). However, if the lease provides for royalty on all “oil and gas and other minerals,” the issue remains open. Because whether royalties accrue on these types of items remains to be litigated, it behooves the careful operator and lessor to pay close attention to the lease’s provisions and their precise effect prior to the time these disputes develop.

#### **IV. Lawsuits for Breach of Implied Covenant to Act as a Reasonably Prudent Operator**

Being liable for breaching covenants that are not actually in the lease can catch operators by surprise. However, the easiest remedy lies in the old admonition that an ounce of prevention is worth a pound of cure. The Texas Supreme Court has held that because implied covenants are intended to protect against lessee self-dealing and negligence, they are unnecessary where the parties have expressly agreed on what duties are owed. *Yzaguirre v. KCS Resources, Inc.*, 53 S.W.3d 368, 373–74 (Tex. 2001). As stated by the Supreme Court, “We have imposed implied covenants only when they are fundamental to the purposes of a mineral lease and when the lease does not expressly address the subject matter of the covenant sought to be implied.” *HECI Exploration Co. v. Neel*, 982 S.W.2d 881, 889 (Tex. 1998). What these courts are telling us is that we can prevent covenants from being implied if we place express covenants on the same matter in the lease.

Where there is no lease provision setting out specific duties, operators must perform as a “reasonably prudent operator” (“RPO”). An RPO is defined in the pattern jury charges as: “an operator of ordinary prudence, that is, one having neither the highest or the lowest prudence, but an operator of average prudence and intelligence, acting with ordinary diligence under the same or similar circumstances. A reasonably prudent operator must consider and give due regard to the Lessor’s interest as well as its own interest.” COMM. ON PATTERN JURY CHARGES, STATE BAR OF TEX., OIL AND GAS PATTERN JURY CHARGES 4.d.3.

##### ***A. Implied covenant to manage and administer***

Probably the broadest common implied duty concerns the duty to manage and administer the lease. *Yzaguirre, Inc.*, 53 S.W.3d at 374. This duty includes

the duty to market production in good faith, *Bowden v. Phillips Petroleum Co.*, 247 S.W.3d 690, 708 (Tex. 2008), which means that the operator is obligated to obtain the best available price, terms and conditions. See *Cabot Corp. v. Brown*, 754 S.W.2d 104, 106 (Tex. 1987); *Amoco Production Co. v. First Baptist Church of Pyote*, 579 S.W.2d 280 286 (Tex App.—El Paso 1979, writ ref'd n.r.e.). However, this duty will not be implied if the royalty is calculated from “market value” which is “objective” enough that there is no independent duty to obtain a better price. *Bowden*, 247 S.W.3d at 701.

In *Yzaguirre*, the Texas Supreme Court addressed the covenant to market in the implied covenant to manage and administer. *Yzaguirre*. 53 S.W.3d 368. The oil and gas leases involved in that case had bifurcated royalty clauses, in which the royalties on gas sold at the well are based on the amount realized, while the royalties on gas sold off the premises are based on market value. KCS Resources entered into a long-term gas sales contract that provided for the sale of gas away from the well—thus, royalties were to be based on market value of the gas produced. Over time, the long-term gas contract price entered into by KCS Resources resulted in the price paid for the gas greatly exceeding the market value of the gas, but the plaintiffs were only being paid on the market value.

The royalty owners sought to rewrite the contract using the implied marketing covenant. The Court rejected the attempt, holding that the lessor does not need the protection of an implied covenant because the lease specifically sets out the price benchmark used to pay royalties—market value. The *Yzaguirre* court solidified that the implied covenant to manage and administer a lease serves to protect a lessor from a lessee's self-dealing or negligence. The implied covenant does not override the express terms of the gas lease whenever a lessee negotiates a sales contract that turns out to be especially lucrative. *Id.* at 374.

The duty to obtain the best available price will be imposed in a “proceeds” or “amount realized” lease because the royalty calculation is based on the amount the lessee in fact receives under its sales contract for the gas. *Union Pac. Res. Group v. Hankins*, 111 S.W.3d 69, 72 (Tex. 2003) (citing *Yzaguirre*, 53 S.W.3d at 372). This will be particularly dangerous to a producer who sells production to an affiliated entity because it may appear to be a sweetheart deal.

#### ***B. Implied covenant to protect from drainage***

Another frequent implied duty is to protect the leased premises from substantial drainage. *See Amoco Production Co. v. Alexander*, 622 S.W.2d 563, 568 (Tex. 1981); *Kerr-McGee Corp. v. Hilton*, 133 S.W.3d 245, 253–54 (Tex. 2004). Lessees that own several leases in a field must protect each lease from drainage as if it were the only lease owned in the field. *Alexander*, 622 S.W.2d at 569. Note also that the implied covenant to protect a lease from drainage extends not only to a localized occurrence across the lease line, but also to field-wide drainage. *Id.* at 568.

To succeed in proving that the operator failed to prevent drainage, the interest holder must prove both substantial drainage *and* that a reasonably prudent operator would have acted to prevent the drainage. The acts that an operator can take as an RPO include re-working existing wells, seeking regulatory action, and seeking voluntary or even forced pooling. In order for an RPO to be required to drill an offset well, the lessor must also prove that the well would have a reasonable expectation of profit after *all* expenses, including those of drilling. *Alexander*, 622 S.W.2d at 568.

Pooling may be an especially helpful method for operators to satisfy their implied duty to protect against drainage. *See Southeastern Pipe Line Co., Inc. v. Tichacek*, 997 S.W.2d 166, 170 (Tex. 1999) (noting that pooling is an acceptable and common protective measure to prevent drainage). Thus, when lands in which the lessee has an interest are being drained, the lessee may be required to exercise pooling authority, or seek it where it is not already given, when a profitable well cannot be drilled to protect the non-drill site tract. For example, in *Tide Water Associated Oil Co. v. Stott*, 159 F.2d 174 (5th Cir. 1946), the court found in a gas cycling project that the operator fulfilled its implied covenant to prevent drainage by offering to pool. *See id.* at 178. Notably, other jurisdictions facing this question have imposed this obligation. *See, e.g., Breaux v. Pan American Petroleum Corp.*, 163 So.2d 406, 415–16 (La. App. 1964); *Gilham v. Jenkins*, 244 P.2d 291, 294 (Okla. 1952).

The primary legal consequence of pooling is that production and operations anywhere on the pooled unit are treated as if they have taken place on each tract within the unit. *See Southland Royalty Co. v. Humble Oil & Ref. Co.*, 151 Tex. 324, 249 S.W.2d 914, 916 (1952); 1 ERNEST E. SMITH & JACQUELINE LANG WEAVER, TEXAS LAW OF OIL AND GAS § 4.8, at 225–26 (1996) (stating that “production from the unit well is deemed to have taken place on all leases pooled into the unit”). If the lessee pools in good faith, the lessee is relieved of the obligation to reasonably develop each tract separately, or to drill off-set wells on other tracts included in the unit to prevent drainage by a well on one or more of such tracts. *See Southland*, 249 S.W.2d at 916. In other words, there can no longer be drainage of the individual leases by a unit well, only drainage of the

unit by wells located outside the unit. *See id.* Thus, an operator may be able to use pooling, and perhaps even an offer to pool regardless of whether the offer is accepted, to protect itself from a suit for breach of the implied covenant to prevent drainage.

### **C. *Implied duty to pool in good faith***

***Pool in good faith.*** A lessee has no power to pool without the lessor's express authorization, which is usually contained in the lease's pooling clause. *See Jones v. Killingsworth*, 403 S.W.2d 325, 327 (Tex. 1965). For pooling to be valid, it must be done in accordance with the method and purposes specified in the pooling agreement. *See id.* at 327–28. As an additional requirement, however, courts have imposed the duty to pool in good faith. *See Circle Dot, v. Sidwell Oil & Gas, Inc.*, 891 S.W.2d 342, 346 (Tex. App.—Amarillo 1995, writ denied) (lessee's pooling decision will be upheld absent bad faith); *Elliott v. Davis*, 553 S.W.2d 223, 226–27 (Tex. Civ. App.—Amarillo 1977, writ ref'd n.r.e.). This means that when an operator has the power to pool, it must do so as an RPO, and not for the sole purpose of maintaining leases beyond their primary terms or to penalize lessors. *See Southeastern Pipe Line Co., Inc. v. Tichacek*, 997 S.W.2d 166, 170 (Tex. 1999); *see also Coastal Oil & Gas Corp. v. Garza Energy Trust*, 268 S.W.3d 1, 21 (Tex. 2008) (upholding a jury's finding of bad faith pooling when the lessee drilled a well and pooled specific leases in a manner that significantly reduced the lessor's royalty while freeing lessee of significant royalty obligations).

If it is found that the lessee did pool a lease or multiple leases in bad faith, production will be considered to take place only on the actual tract upon which holds the well, and production from a unit well will not maintain off-site leases. *Id.* The effect of this is that the lessee is now required to protect the off-site leases from drainage from the former pooled tract's well. This will cause the lessee to drill one or multiple additional wells, or if the primary term on the off-site lease has expired, the lessor will be released from the initial lease and be free to re-lease its minerals. *See id.*

### **D. *Implied duty to develop minerals***

A third frequent allegation is that the operator failed to develop discovered minerals as would an RPO. *See Sun Exploration & Production Co. v. Jackson*, 783 S.W.2d 202, 204 (Tex. 1989). This may mean developing both producing and non-producing formations. *Id.* at 204–05. As with the other implied duties, the touchstone is this: if an RPO would have done it, the lessee must do it too, or face a lawsuit seeking damages. Texas does not impose a separate implied duty upon a lessee to further explore the leasehold premises; the law recognizes only

an implied obligation to reasonably develop the leasehold, which means that the operator must drill if it can be shown that there is a reasonable expectation of profit. *Id.*

## V. Other Pitfalls That Could Lead to Litigation

### A. *Disputes over surfaces*

In the oil and gas industry, it is well known that the mineral estate is dominant, which means that the mineral owner has the right to use as much of the surface as may be reasonably necessary to profit from the mineral estate. *See Acker v. Guinn*, 464 S.W.2d 348, 352 (Tex. 1971); *see, e.g., Getty Oil Co. v. Jones*, 470 S.W.2d 618, 621 (Tex. 1971); *Ball v. Dillard*, 602 S.W.2d 521, 523 (Tex. 1980) (surface owner may not unreasonably interfere with the mineral estate). Nevertheless, mineral dominance is not absolute, and courts have enforced multiple municipal restrictions on drill sites, as well as creating the “accommodation doctrine.” *See Valence Operating Co. v. Texas Genco, LP*, 255 S.W.3d 210, 215–16 (Tex. 2008).

The accommodation doctrine requires that the mineral owner exercise due regard for reasonable uses of the surface, and permits the surface owner to enjoin and impose “reasonable” restrictions on a lessee’s use of the surface. *Sun Oil Co. v. Whitaker*, 483 S.W.2d 808, 810–11 (Tex. 1972); *Getty Oil*, 470 S.W.2d at 621–22. When there is an existing use of the surface that would be precluded or impaired by the lessee’s operations, or the lessee has an acceptable alternative operation that would not impair the surface use, the lessee may be required to adopt the alternative. This is also grounds for recovering damages. *See Ball*, 602 S.W.2d at 523.

The accommodation doctrine is especially important in urban areas, where producers are much more likely to encounter pre-existing surface activities that could require accommodation both as to placement of the drill site and as to the type of well drilled. *See Valence Operating*, 255 S.W.3d at 217–18 (permitting surface owner to force the use of horizontal drilling, apparently at the mineral owner’s expense, so long as the surface owner shows that the alternative drill site is located on the lease itself). In addition, a recent as-yet unreported Fort Worth case introduced a novel spin on the accommodation doctrine: there, the landowner plaintiffs successfully sued and were awarded large damages by proving that the operator’s proposed well site on their as-yet undeveloped land tortiously interfered with the landowner’s mixed-use development plans.

Yet another restriction on an operator’s surface use can be found in Texas Natural Resources Code § 92.001 et seq., which allows surface owners of certain

subdivisions to restrict oil and gas development by designating a limited number of drilling and exploration sites. The statute, however, is limited to “qualified” subdivisions, which is defined to mean tracts of land under 640 acres that are in a county of at least 400,000 people or in a county with a population of over 140,000 that borders on a county with a population of over 400,000. According to 2000 Census data, the total of counties in which this statute can be used is 15 out of a total of 254 counties.<sup>1</sup>

Another potential surface-use pitfall can arise for horizontal wells. If the minerals were severed from the surface prior to pooling, the surface owner may be able to enjoin or seek damages from development efforts that include minerals from other tracts. *See, e.g., Property Owners of Leisure Land, Inc. v. Woolf & Magee*, 786 S.W.2d 757, 760 (Tex. App.—Tyler 1990, no writ) (surface may not be used to develop minerals from other tracts unless those mineral interests are pooled). This is even more certain if a surface is being used to site a horizontal well that produces *only* from other tracts, in which case the operator will be subject to lawsuits seeking to enjoin operations or trespass damages. *See Robinson v. Robbins Petroleum Corp.*, 501 S.W.2d 865, 868 (Tex. 1973) (holding that the severed surface of one tract may not be used for oil and gas operations on adjacent tracts without the surface owner’s permission).

#### **B. Lawsuits over “waste” of minerals – a possible post-lease dispute**

The Texas Natural Resources Code creates a private cause of action for mineral owners if the operator commits “waste” of minerals. Unfortunately for the operator, “waste” is defined broadly, and includes among other wasteful actions, “operating a well in a manner that reduces or tends to reduce the total ultimate recovery of oil or gas.” Plaintiffs have been able to use that statute to sue their operator after the operator improperly plugged marginally producing wells and abandoned the property. *See Exxon Corp. v. Miesch*, 180 S.W.3d 299, 317–19 (Tex. App.—Corpus Christi 2005), *rev’d on limitations grounds, Exxon Corp. v. Emerald Oil & Gas Co.*, 52 Tex. Sup. Ct. J. 467, 2009 WL 795668, (Tex. Mar. 27, 2009). Other uses of this statute may be limited only by creative plaintiffs’ imaginations, and perhaps a plea to the courts that they restrict recoveries to only those actions that would not have been taken by that fictional “reasonably prudent operator.”

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<sup>1</sup> According to the 2000 Census, those counties with population over 400,000 are Bexar, Collin, Dallas, Denton, El Paso, Harris, Hidalgo, Tarrant, and Travis. About Texas, <http://www.tsl.state.tx.us/ref/abouttx/popenty32000.html> (last visted May 27, 2009). The counties that border those counties and that also have a population of over 140,000 are Montgomery; Galveston; Brazoria Fort Bend; Cameron; and Williamson. Census Finder, <http://www.censusfinder.com/maptx.htm> (last visited May 27, 2009).

### **C. *Lawsuits over whether there is a lease to begin with***

On the flip side of those mineral owners seeking to terminate leases is what may be a lurking issue in the Barnett Shale from the Autumn 2008 when the prices of oil and gas fell so precipitously that many operators abandoned leasing activities in mid-stride. Those leasing activities were halted so abruptly that in many instances, lessors had already executed leases before they were told by the operators that the lease would not be honored and signing bonuses would not be paid. If general contract construction rules are applied, that would mean that the leases and offers to pay bonuses, once delivered to the landowners, constituted an “offer to contract,” which could be accepted for a reasonable period of time unless revoked before acceptance. *See, e.g., Valencia v. Garza*, 765 S.W.2d 893, 896–97 (Tex. App.—San Antonio 1989, no writ). If so, landowners that signed leases before being told the offer was being revoked may have enforceable leases and enforceable agreements to pay bonuses. Whether this is so will depend on numerous situation-specific facts, including, for example, if the lease was delivered with a sight draft that contained a provision permitting it to not be honored “for any reason” and which might permit unilateral cancellation of the lease and the bonus. *See Spellman v. Lyons Petroleum, Inc.*, 709 S.W.2d 295 (Tex. App.—Houston [14<sup>th</sup> Dist.] 1986, no writ) (leases and drafts do not create binding contracts until actually funded); *see also* Laura A. Lesikar & Terry I. Cross, *Paying Lease Bonus with Time Drafts - Inspection Report of a House of Cards*.

## **VI. Resolution of Disputes**

Disputes may be inevitable, but lawsuits are not. Any good lawyer will tell you there are simply some disputes not worth pursuing, and even those that are worth pursuing can often be settled. There are many mechanisms to assist in resolving disputes, ranging from simply negotiating with the other party, to engaging in non-binding, pre-suit mediation, to permitting an arbitrator to decide your issue.

Mediation can take many forms. Typically, mediation is simply assisted negotiations between the parties, usually with a mutually selected mediator, although courts often appoint them. Mediation is as flexible as imaginations, and can even include procedures such as mini-trials to the mediator, who then issues a non-binding “opinion decision” to guide the parties in their negotiations. Depending on the personalities and issues involved, it is likely that some form of mediation will prove helpful to resolving the case and reaching a settlement. If the parties cannot reach agreement and case then goes on to trial, at least a party can be assured that it did everything it could to avoid that expense.

In contrast to mediation where the parties themselves ultimately decide the resolution, there is also arbitration, where an appointed or selected arbitrator decides the case for the parties. It has been fashionable for some time now for all commercial contracts to automatically have an arbitration provision. People usually insert such provisions in a knee-jerk reaction to avoid what they perceive as “litigation costs” or the risk of bad judges or “run away juries.” So far, arbitration provisions are not often seen in mineral leases, but are appearing with more regularity in other oil and gas documents, such as joint operating agreements.

Although the purpose behind seeking arbitration is usually a desire to control the outcome and the costs, the reality is that arbitration cannot guarantee avoiding any of those risks or costs, or even guarantee that it will proceed faster than a more traditional lawsuit. As opposed to a mediator, an arbitrator (or an arbitration panel) has absolute, full discretionary control over costs and speed. That means that parties may have limited – and sometimes no – ability to obtain information from the other side before the arbitration. Conversely, parties may be subjected to unlimited, never-ending, harassing discovery, with no opportunity to punish the other side for its harassment. More unexpectedly, the arbitrator’s absolute discretion means that there is no ability of appeal, even if the arbitrator refuses to abide by his own rules or decides the dispute horribly contrary to the evidence. In short, few people appreciate the gravity of the decision to make arbitration mandatory until they have unfairly lost the arbitration or spent more on it than they would have in litigation.

### **Conclusion**

As in any relationship where the monetary stakes – or dreams – are high, the risks of disputes are also high. But careful consideration of possible issues, careful drafting to apportion duties, and then careful attention to disputes that appear to be developing, can give your trial lawyer the tools he – or she – needs to win your case for you.

