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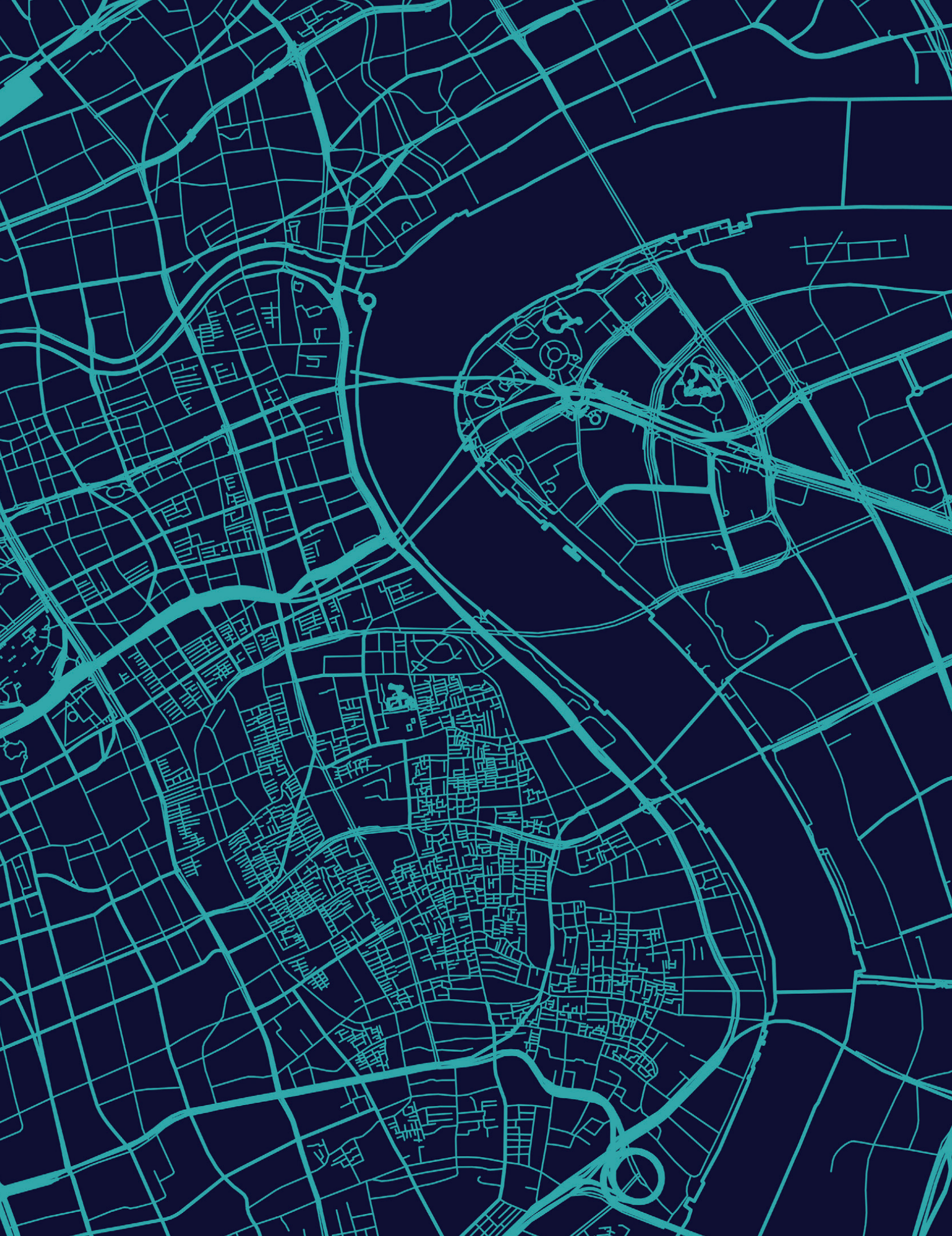
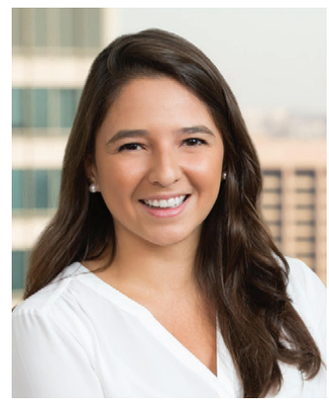


Four Recent Drainage and Offset Cases: A Texas Litigation Trend?

by/ AUSTIN BRISTER



by/ ANA NAVARRETE

Originally published in Producer's Edge. *Republished with permission.*

Four recent Texas cases have focused on the interpretation of express offset provisions in oil and gas leases. Over the last year, the Texas oil and gas industry has experienced what some commentators have called "Shale Boom 2.0," with increased drilling activity in South Texas and the Permian Basin, leading to some marketing bottlenecks and spikes in the number of drilled but uncompleted wells.

Whatever the cause, at least three reported appellate cases in the last 18 months have focused on the construction of express offset clauses in oil and gas leases. Landmen and lawyers alike should take note of these decisions, as they each underscore that Texas courts do not interpret oil and gas leases merely by reference to the industry's general rules, but instead rely on a careful analysis of the actual language used by the parties in the lease. And as one recent case illustrates, the "surrounding circumstances" of the shale boom might lead to results some would not expect.

Murphy v. Adams: 'Offset well' did not mean a well that would actually protect against drainage

In the recent case, *Murphy Expl. & Prod. Co.-USA v. Adams,*[1] the Texas Supreme Court held that, in light of the "surrounding circumstances" of the Eagle Ford Shale, the phrase "offset well" in that particular lease did not require the drilling of a well that would actually protect against drainage. Instead, the court held that "offset well" merely referred to a well drilled anywhere on the leased premises, so long as it was drilled down to the depth required under the lease.

That case involved an "offset" clause in a 2009 oil and gas lease. The majority reached its conclusion based on interpreting that term in light of the "surrounding circumstances" evidence of the discovery of the Eagle Ford and drainage patterns of horizontal shale wells.

Four justices dissented in an opinion that, among other things, criticized the majority opinion for disregarding the commonly understood meaning of the phrase "offset well," which they described as being a well designed to protect the leasehold from drainage.

The clause at issue in the *Murphy v. Adams* case read as follows:

> *... in the event a well is completed as a producer of oil and/or gas on land adjacent and contiguous to the leased premises, and within 467 feet of the premises covered by*

1 560 S.W.3d 105 (Tex. 2018).

this lease, that Lessee herein is hereby obligated to ... commence drilling operations on the leased acreage and thereafter continue the drilling of such off-set well or wells with due diligence to a depth adequate to test the same formation from which the well or wells are producing from on the adjacent acreage.

When a well on a neighboring tract triggered this clause, Murphy drilled a well 1,800 feet from the lease line and 2,100 feet away from the triggering well. Murphy argued that this well satisfied the offset well requirement because it was drilled on the leased premises and to the same depth as the neighboring well. The lessor argued the well did not qualify as an offset well because it was not designed to protect against drainage.

The majority noted that this offset clause did not expressly require that the offset well be drilled in any specific location. The majority's holding was largely founded on "surrounding circumstances" evidence — the fact that the leases were executed in 2009 and the leases were drafted with horizontal shale drilling in mind. The court noted that "commentators have recognized" that "little or no drainage will occur between the two tracts" in a shale play, assuming one is drilled and the other is not. Based on this understanding, the court concluded that the parties must have not intended for an offset well to be drilled in a location to protect against drainage, referring to any other conclusion as "illogical." The court limited its holding to "the circumstances at hand, which involve unconventional production in tight shale formations."

Four justices dissented in an opinion that complained that the majority was "explaining on behalf of Murphy" why the parties who negotiated leases (which did not include Murphy) could not have intended for the phrase "offset well" to retain its traditional meaning. The dissent concluded that the phrase "offset well" required Murphy to drill its offset well at a location where a reasonably prudent operator would drill a well to protect the leasehold from actual or potential drainage, whether or not any was occurring. The dissent complained that the court's holding effectively stripped the lessors of any leasehold protections that the offset clause could have been designed to protect and that the word "offset," as used in the lease, would have no meaning.

It should be noted that all parties agreed that this offset clause could be triggered regardless of whether

there was actual drainage, thereby distinguishing this clause from the implied covenant to protect from drainage.

It is yet to be seen whether — and to what extent — the court's willingness to interpret leases through the lens of unconventional drilling will impact other lease provisions and the role, if any, of expert engineering testimony in shaping what is seen through that lens.

Martin v. Newfield: Offset obligation not triggered due to separation by narrow strip of land

In another recent Texas case, *Martin v. Newfield Exploration Co.,*[2] the Corpus Christi Court of Appeals held that another express offset clause was not triggered because the provision indicated that a triggering well must be located on an "adjoining" tract. In that case, a narrow strip of land separated the unit containing the nearby well and the unit that contained the plaintiff's lease. The defendant oil and gas company argued that because the tracts of land were separated by this narrow strip of land, they were not truly "adjoining" and therefore the offset clause was not triggered.

In *Martin,* the clause at issue provided as follows:

> *... in the event a well is drilled on or in a unit containing part of this acreage or is drilled on acreage adjoining this Lease ... the Lessee shall spud an offset well ...*

The Corpus Christi Court of Appeals began by indicating that whether this obligation was triggered was a matter of construing "the intention of the parties as it is expressed in the lease."

The court, in turn, concluded that question was resolved by the definition of the word "adjoining." The court reviewed a few cases that previously held that "adjoining" means "lying next to, adjoining to, uniting, being in contact" as well as "touching or sharing a common boundary." Based on these definitions, the *Martin* court held that the two units were not "acreage adjoining" because they were separated by another strip of land. As a result, any "duty to prevent drainage and spud an offset well ... was not triggered as a matter of law."

2 No. 13-17-00104-CV, 2018 Tex. App. LEXIS 2435 (App. — Corpus Christi Apr. 5, 2018).

Mzyk v. Murphy: Offset obligation not triggered where reasonable prudent operator would not have drilled an offset well

In *Mzyk v. Murphy Expl. & Prod. Co.-USA*,[3] the San Antonio Court of Appeals analyzed whether an offset provision required the lessee to drill an offset well even if a reasonable prudent operator would not drill an offset well in similar circumstances. Arguing that Murphy had the obligation even if a prudent operator would not drill the well, the landowner sought $11 million in compensatory royalties and attorneys' fees.

The offset clause at issue read (in part) as follows:

> *If [...] any new well or wells is drilled [...] on adjacent lands [...] and within four hundred sixty seven feet (467') from said lands, Lessee agrees to drill such offset well or wells on said lands (or attempt to complete for production any existing offset well or wells drilled by Lessee on said lands) as a reasonably prudent operator would drill under the same or similar circumstances[...].*

The dispute focused on the effect of the emphasized language quoted here. Murphy argued that this language meant Murphy had no requirement to drill an offset well if a reasonably prudent operator under similar circumstances would not drill an offset well. The landowner, on the other hand, argued that the first part of the paragraph indicated when Murphy was required to drill an offset well, and the emphasized language merely dictated how Murphy was to drill that well.

The Court of Appeals interpreted the phrase as expressly adopting the reasonably prudent operator standard. The court further explained that, in the context of an offset obligation, the reasonably prudent operator standard also determines whether to drill an offset well, not merely how to drill an offset well.

The Court of Appeals rejected the lessor's arguments that the offset clause was drafted as a "modern lease that presumes drainage is occurring" if another well is drilled within 467 feet. The court noted that the modern clauses the landowner quoted were "substantially different" because the clause in this case "contains no language suggesting the parties agreed to a presumption of actual or substantial drainage."

The landowner also argued that Murphy should have paid compensatory royalties under another provision which specified that if Murphy did not "build an

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offset well," then it had to either pay compensatory royalties or deliver a release of the lease. However, the court disagreed, reasoning that the reference to "offset well" in that provision refers back to the offset well clause, which had incorporated the reasonably prudent operator standard.

Bell v. Chesapeake

On March 13, the San Antonio Court of Appeals issued its opinion in *Bell v. Chesapeake Energy,*[4] which also addressed whether the offset clauses at issue incorporated a requirement that a reasonable prudent operator would drill an offset well. The court again focused its inquiry closely on the specific language utilized in the leases at issue, and whether the language at issue described *when* Chesapeake was to drill an offset well, rather than merely how to drill an offset well.

Takeaways and Insights

The oil and gas industry can sometimes be heavy on jargon and the use of broad guiding principles. However, as these recent cases illustrate, Texas courts analyzing express offset provisions do not merely adopt the industry's general rules, but instead focus their analysis on the interpretation of the specific language utilized by the parties in the oil and gas lease.

These cases are a reminder that companies examining their offset obligations or negotiating new leases should pay close attention to the wording of any offset provisions, including potential references to reasonable prudent operator standards, how the provision describes when the obligation is triggered and the description of resulting obligation. Parties should also keep in mind potential arguments regarding how "surrounding circumstances" shed different light on the language. However, the sharp dissent in the *Murphy v. Adams* case is likely to motivate counterarguments disputing the efficacy of such evidence in lease construction cases. ▲

About the Authors

Austin Brister is a partner at McGinnis Lochridge. He represents oil and gas companies in high-stakes disputes involving mineral and leasehold title, royalty underpayment and calculation, lease termination and perpetuation, operator/nonoperator disputes, surface use and accommodation, and an array of other issues in the upstream oil and gas sector. When he is not in the office, Brister enjoys flying bush planes and spending time with his wife and their twin babies. He can be reached at abrister@mcginnislaw.com.

Ana Navarrete is an attorney at McGinnis Lochridge where she focuses on oil and gas litigation in South Texas and the Eagle Ford Shale. Her experience includes disputes involving title issues, drilling operations between operator and nonoperators, royalty underpayment, offset and development, cessation of production and lease termination, among other issues in the upstream oil and gas sector. She can be reached at anavarrete@mcginnislaw.com.

3 No. 04-15-00677-CV, 2017 Tex. App. LEXIS 5930 (App. — San Antonio June 28, 2017).
4 Cause No. 04-18-00129-CV (Tex.Civ.App. — San Antonio, 2019 no pet).