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Christopher L. Halgren
MCGINNIS LOCHRIDGE
711 Louisiana, Suite 1600
Houston, Texas 77002
(713) 615-8539
chalgren@mcginnislaw.com

INTRODUCTION

This paper provides a summary of selected opinions issued by Texas appellate courts and the Texas Supreme Court from March 2014 through March 2015 which are of interest to the oil and gas industry. Further, this paper provides a brief update on the progress of certain proposed legislation which (as of the date of this paper) are being considered by the Texas Legislature.

TABLE OF CONTENTS

Clay Exploration v. Santa Rosa Operating

442 S.W.3d 795 (Tex. App.—Houston [14th Dist.] 2014, no pet.)

A lease executed by a court-appointed receiver was voided by the trial court and was held to convey no title to Clay Exploration ("Clay"). On appeal, the trial court's order was affirmed because the receiver exceeded his authority, which the appellate court found had lawfully been limited by the order creating the receivership.

In 1999, Marathon Oil Company ("Marathon") filed a petition for appointment of a receiver (the "1999 Receivership Action") under Tex. Nat. Res. Code § 64.091(b), which, if approved by the court, would permit the receiver to execute an oil and gas lease on behalf of unknown or unlocatable mineral owners.

The trial court granted Marathon's petition and appointed Mr. Charles Ketchum to serve as receiver. Pursuant to the court's order, Mr. Ketchum was authorized to "deliver a mineral lease, or leases, with pooling authority . . . unto Marathon Oil Company," covering the interests of the Defendants (who were the unknown or unlocatable mineral owners). The court's order further provided that the Receiver must report the terms of the lease to the court for confirmation or disallowance. Marathon did not drill any wells and its lease expired.

Several years later, in or around 2011, Clay and Santa Rosa Operating, LLC ("Santa Rosa") sought to lease mineral interests in the same 102-acre area that was subject to Marathon's 1999 Receivership Action. Clay contacted the original receiver, Mr. Ketchum, and obtained a mineral lease covering the interests subject to the 1999 Receivership Action. Mr. Ketchum executed and delivered a lease to Clay and also accepted the bonus money on behalf of the unknown heirs, which he deposited in the registry of the court.

In response to the receivership lease acquired by Clay, Santa Rosa filed an intervention in the 1999 Receivership Action and requested that the court (i) set aside the receivership because some of the unknown heirs had been located and (ii) to declare the Clay's receivership lease invalid. Santa Rosa argued that Clay's receivership lease should be declared invalid because Clay was aware that the heirs of Frederick Kastan (one of the originally unlocatable mineral owners) had been identified, located, and executed leases to Santa Rosa. In addition, Santa Rosa argued that Clay's receivership lease should be invalidated because the 1999 order creating the receivership limited the receiver's authority by providing that a lease could only be executed to Marathon. Santa Rosa argued that any receivership lease executed to any party other than Marathon would be unauthorized by the court's 1999 order. Clay filed a motion with the court requesting confirmation of its receivership lease, arguing that without an express prohibition in the 1999 order, the receiver was empowered to execute future leases to third-parties by the TEX. CIV. PRAC. & REM. CODE.

The trial court denied Clay's motion to confirm the receivership lease and instead granted Santa Rosa's motion to invalidate it. Clay filed an appeal. The appellate court considered two issues. First, whether the receivership created in 1999 terminated when the receiver executed the original leases to Marathon. Second, if the receivership did not terminate, whether the receiver was authorized to enter into future leases with companies other than Marathon. The court did not consider issue of ownership of the purported heirs located by Santa Rosa because the issue had been severed and remained in the trial court.

Primarily, a receiver's authority is derived from two places: the court order creating the receivership and Section 64.091 of the Texas Civil Practice and Remedies Code. In general, "[a] receiver has only that authority conferred by the Court's order appointing him." *Ex Parte Hodges,* 625 S.W.2d 304, 306 (Tex. 1981). Further, once created, the receivership "continued as long as the defendant or his heirs, assigns, or personal representatives fail to appear in court in person or by agent or attorney to claim the defendant's interest." Tex. Civ. Prac. & Rem. Code § 64.091(e). Although Santa Rosa claimed that it located and acquired leases from one of the defendants to the 1999 Receivership Action, the appellate court held that the 1999 receivership remained in effect until those persons appeared in court and established their claim of title. Because this had not been done, the 1999 receivership was still in effect.

While concluding that the receivership remained valid, the appellate court concluded that the receiver was not authorized to execute future leases, let alone to entities other than Marathon. Clay argued that Section 64.091 of CIVIL PRACTICE & REMEDIES CODE granted broad authority to receivers and that this statutory grant cannot be defeated by a trial court order. While agreeing with Clay that broad powers are available to a receiver, the appellate court disagreed that these powers could not be restricted by court order. As a result, the appellate court held that Ketchum had no authority in 2011 to execute a mineral lease to Clay on behalf of the unknown mineral owners and affirmed the trial court's rulings.

Rippy Interests, LLC v. Nash

2014 WL 4114328 (Tex. App.—Waco Aug. 21, 2014, pet. filed)

U.S. KingKing, LLC ("KingKing"), the owner of a top lease, sought a court order terminating a prior lease on the basis that the owner of the earlier lease, Rippy Interests, LLC ("Rippy"), had either failed to timely commence "operations for drilling" or failed to conduct operations without a cessation of more than 90 days. The court concluded that Rippy timely commenced "operations for drilling," but that a jury would have to determine whether the "lessor repudiation doctrine" applied to toll Rippy's obligations to continue operations without a cessation of more than 90 days, focusing on whether "unqualified notice" of repudiation was given and whether the lessee waived the repudiation defense by continuing operations for weeks after alleged repudiation..

On January 18, 2006, William L. Nash, John Nash, and Charles Nash collectively granted an oil and gas lease to Range Production I, L.P. ("Range"). The lease (hereinafter, the "Range Lease") provided for a three-year primary term, plus an option to extend the primary term for an additional two years. Range ultimately exercised the option, thereby extending the primary term to January 18, 2011.

In or around September 2009, Range assigned the Range Lease to Rippy. In September 2010, Rippy received a drilling permit for a well on the lease. Also in September 2010, the Nashes executed a top lease to KingKing. The top lease (hereinafter, the "KingKing Lease") was expressly subordinate to the Range Lease and was to become effective only upon the expiration of the Range Lease.

On January 1, 2011, just seventeen days before the Range Lease's primary term would end, Charles Nash called KingKing to inform them that "we might have a problem" because Rippy was starting to work on the property. On January 7, 2011, Charles Nash signed a damage release and acknowledgement payment for wellsite-pad construction and access road use. On the last day of the primary term, Rippy had started construction on the well pad, but nothing was complete. The next day Charles Nash placed a lock on the gate to the site. Nash said he locked the gate because "he wanted Rippy and KingKing to communicate because he did not know which lease was valid." A KingKing employee and a KingKing attorney had allegedly informed Nash that they did not believe Rippy's actions were sufficient to maintain the Range Lease.

Rippy, initially undeterred by Nash's conduct, cut the lock and entered the property, prompting Nash to call the police. No arrests were made. Rippy continued its operations on the property. A rig was brought in and drilling was commenced shortly thereafter. Rippy drilled a 7,900-foot pilot hole and planned to evaluate the well bore and set cement plugs (which Rippy did), and then bring in a bigger drilling rig to drill a 3,500 foot lateral. However, Rippy did not drill the lateral. Rippy alleged that it did not to drill the lateral because of Nash's challenge to Rippy's title. When examined during a deposition, Rippy's representative testified that the challenge to the title occurred when Charles Nash placed a lock on the gate and called the sheriff's department. It was also alleged that Charles Nash indicated to a Rippy representative that Mr. Nash "felt like the lease expired."

The appellate court concluded that Rippy's operations were sufficient to perpetuate the Range Lease beyond the primary term. The trial court focused on the fact that, by the end of the primary term, Rippy had hired a drilling contractor, solicited and received a bid for a drilling rig, hired contractors to prepare a well site, started construction on the well site, started construction on a road, and Rippy set a conductor pipe. The court also noted that Rippy continued its efforts and actually drilled a pilot hole. The trial court found (and the appellate court affirmed) that these actions constituted "operations for drilling" as a matter of law.

After finding that Rippy's conduct did perpetuate the lease beyond the end of the primary term, the court then addressed whether the Range Lease terminated when Rippy ceased its operations after drilling the pilot hole. Although the Range Lease provided that it would terminate upon a cessation of activities of more than 90 days, Rippy argued that it was relieved of its obligation to continue operations because of Charles Nash's alleged repudiation of the lease. The *Rippy* court noted the general rule is that a lessor who wrongfully repudiates the lessees' title by an "unqualified notice" (generally, an affirmative statement of fact rather than a conditional statement or an opinion) that the leases are forfeited or have terminated cannot complain if the latter suspends operations under the lease pending a determination of the controversy.

The trial court had granted summary judgment for KingKing, apparently finding the doctrine did not apply. However, the appellate court found that two issues should have prevented the trial court from granting summary judgment against Rippy. First, the court found that there was a genuine issue of material fact as to whether Charles Nash gave "unqualified notice" that he believed the Range Lease terminated. The court held that a reasonable jury could conclude that Charles Nash gave "unqualified notice" by placing a lock on the gate, calling the police to arrest Rippy's workers, and by allegedly indicating to Rippy that he believed the Range Lease terminated.

Second, the *Rippy* court found that summary judgment against Rippy was improper on the issue of "reliance." Rippy contended that it stopped all its operations after drilling the pilot hole because of Charles Nash's alleged repudiation of the lease. In opposition, KingKing and the Nashes argued that Rippy waived the affirmative defense of repudiation because Rippy failed to cease its operations when the Range Lease was allegedly repudiated by Charles Nash. KingKing also claimed that Rippy admitted its decision to cease operations was driven by factors other than the alleged repudiation. However, the appellate court concluded that Rippy's continued operations would not, as a matter of law, waive Rippy's ability to rely on the repudiation defense. Instead, the issue must be submitted to the jury, especially in light of the testimony of Rippy's representative wherein he unequivocally testified that the alleged repudiation was the sole basis for the cessation in operations.

Landover Production Company, LLC v. Endeavor Energy Resources, LP
2014 WL 5563454 (Tex. App.—Eastland October 31, 2014, pet. denied)

Endeavor Energy Resources, LP and a working interest owner (collectively, "Endeavor") owned an oil and gas lease covering 80 acres. Landover Production Company, LLC ("Landover") owned a top lease covering the same 80 acres. Landover contended that Endeavor's lease terminated when there was a cessation of production from May 2001 through August 2001. At trial, the jury found against Landover and concluded that the cessation of production was excused under the temporary cessation of production doctrine ("TCOP"), or even if the lease had expired, then Endeavor had obtained superior title to Landover by adverse possession. Landover appealed only the TCOP issue.

The dispute centered on a portion of the lease which provided that the lease could be perpetuated "[i]f at the expiration of the primary term oil and gas is not being produced on said land but Lessee is then engaged in drilling or reworking operations . . . ." The lease contained no "savings clause" which would apply during the secondary term. The court explained that, in the absence of any saving clause, an oil and gas lease will automatically and immediately terminate if production ceases during the secondary term. While Endeavor admitted that the lease contained no savings clause, the lease would be maintained under Texas' TCOP doctrine. As noted by the *Landover* court, under the TCOP, the "automatic termination rule is relaxed if the lessee can prove that the cessation of production is temporary and is due to sudden stoppage of the well, some mechanical breakdown of the equipment used therewith, or the like." The lessee must also prove that it acted with diligence and remedied the cause of the temporary cessation and resumed production within a reasonable time.

Endeavor alleged that the cessation of production was caused by a hole that developed in the heater-treater, which is used to separate the oil from the water. Testimony showed that, because of the hole in the heater-treater, the oil could not be made marketable and was being spilled onto the surface. Endeavor produced evidence that several attempts were made to repair the broken equipment. During each repair attempt, the well had to be turned off. The first attempts were unsuccessful and later attempts were delayed by bad weather. While Endeavor was required to prove it acted with diligence, Landover's only complaint was that Endeavor could have used other methods, but those methods were not utilized. The *Landover* court held that Endeavor had no burden under the facts of the case to utilize the alleged methods referenced by Landover.

Affirming the jury's verdict on the TCOP issue, the *Landover* court noted that the adverse possession finding had not been appealed and judgment for Endeavor was required anyway.

PNP Petroleum I, LP v. Taylor

438 S.W.3d 723 (Tex. App.—San Antonio 2014, pet. filed)

The dispute in *PNP Petroleum* concerned whether the term of an oil and gas lease was extended by a shut-in royalty payment made by the lessee. PNP Petroleum I, LP ("PNP") entered an oil and gas lease dated June 1, 2009, which provided, among other things, that PNP could tender a "shut-in well royalty payment" to extend the term of the lease "[i]f, at the expiration of the primary term there is located on the leased premises a well or wells **not** producing oil/gas in paying quantities." (emphasis added).

At the time the lease was executed, there were thirteen wells on the property which were not producing. The wells had been drilled by a prior lessee whose lease had expired. Less than a month before the end of the primary term, PNP informed the lessor of its intention to exercise its rights under the lease to tender a shut-in royalty payment. The lessors, believing that the provision was not applicable to the thirteen old wells, rejected the payment and informed PNP they contended the lease would expire at the end of the primary term absent proper extension. PNP then filed suit for declaratory relief.

The parties filed cross-motions for summary judgment, asking the court for judgment in their favor, respectively. The lessors argued that PNP's payment of a shut-in royalty was improper under Texas law because there was no well on the property "capable of" producing in paying quantities which had been shut in, a requirement that will generally be implied into a shut-in royalty provision as a matter of law. The trial granted the lessors' motion for summary judgment. However, seven months later PNP filed a motion to reconsider the summary judgment ruling, attaching an affidavit describing the lease negotiations which culminated in the language included in the shut-in provision. The trial court denied PNP's motion, struck the affidavit from evidence, and maintained its prior ruling.

On appeal, the San Antonio court reviewed the affidavit and drafts of the lease, concluding that the trial court had erred in striking them under Texas parol evidence rule and other evidentiary objections. The court concluded that recent Texas Supreme Court authority, as well as an opinion from the San Antonio court, supported PNP's argument that contract negotiations should be considered as "surrounding circumstances" when construing the language of the lease.

PNP's evidence of the lease negotiations included draft leases which reflected that the language "capable of" had been stricken from the agreement and the word "not" was inserted in its place. The result was a shut-in royalty provisions that permitted the lessee to tender payment if there was "a well or wells **not** producing" in paying quantities, rather than only if there was a well "capable of producing" in paying quantities. PNP argued that the earlier drafts of the lease supported PNP's position that the parties intended that shut-in royalty payments could be made even if there was no well capable of producing in paying quantities.

The San Antonio court agreed with PNP, concluding that the parties, in their negotiations, deviated from the general law which would require a court to engraft into the lease the requirement that a well be "capable of" producing in paying quantities. The court held that the evidence established that the parties did not intend to apply the oil and gas industry's generally accepted meaning of the term "shut-in royalty." In so concluding, the San Antonio court held that PNP properly tendered the shut-in payment, thereby extending the term of the lease, as there was no well capable of producing in paying quantities at the expiration of the primary term.

Chesapeake Exploration, LLC, et al. v. Energen Resources Corporation, et. al.
445 S.W.3d 878 (Tex. App.—El Paso 2014, no pet.)

This case involved the construction of two oil and gas leases executed in 1976 (hereinafter, the "1976 Leases") and their effect on a 640-acre section of land covered by the leases, referred to as Section 25. Section 25 had been pooled into two separate pooled units, one including 80 acres from Section 25 and 560 acres from Section 18 and the second unit containing 540 acres from Section 25 and 80 acres from Section 18. One of the units was still producing at the time of trial, but all production from the other unit had ceased completely in 1988.

The 1976 Leases provide that when continuous development ends, the leases would terminate as to all acreage except for:

> "[E]ach proration unit established under ... [the] rules and regulations [of the RRC ...] upon which there exists (either on the above described land or on lands pooled or unitized therewith) a well capable of producing oil and/or gas in commercial quantities ...."

The issue before the court was whether, under the foregoing language, the 1976 Leases remained in effect as to all of Section 25 (which was designated as the proration unit of a well which ceased to produce) or only as to an 80-acre portion of Section 25 included in the unit with a producing well. The plaintiffs (collectively, "Energen") were the owners of the 1976 Leases and claimed that they were still valid as to the entirety of Section 25. The defendants (collectively, "Chesapeake") argued that the 1976 Leases terminated as to all of Section 25, except for the 80-acres within the producing unit.

The dispute centered on whether the 1976 Leases' partial termination clause provided for a "rolling" termination, meaning that lands could be released at various points after the end of the primary term, or rather whether the clause provided for a one-time termination, meaning that partial termination would occur once and only once.

The court held that, after harmonizing the lease language, the partial termination clause was not a "rolling" termination provision, as urged by Chesapeake. Essentially, Chesapeake had argued that the retained acreage clause in the 1976 Leases must be read to require a "rolling" termination of non-producing proration units, such that production from a pooled unit will not maintain the leases as to proration units that ceased to exist. The court disagreed, concluding that the leases were maintained, not by the *existence* of the proration units, but by the presence of a producing well on lands designated as a proration unit. The court said that if the parties to the 1976 Leases had wished to provide for continual relinquishment of non-producing proration units, so that a proration unit would no longer be subject to the lease once production had ceased on that particular unit, they could have done so by including such language. The court stated it would not re-write the lease to change the parties' agreement.

The court did find "equitable appeal" in Chesapeake's argument that the parties would not have intended for one well in a single unit to hold non-producing acreage outside the unit indefinitely. However, the court maintained that such an alleged intention was contradicted by the express terms of the leases which, according to the court, described partial termination as a one-time event which occurred at the end of continuous development. The court noted that the plain, grammatical language shows that the parties intended the leases to continue as to each designated proration unit if the unit had a well capable of producing gas in commercial quantities when continuous development ceased. Because the language concentrates on whether a well is "capable of" producing rather than *actually* producing, the court concluded that the mere cessation of production from a well was not sufficient to trigger the retained acreage clause.

BP America Production Co. v. Laddex, Ltd.

2015 WL 691212, (Tex. App.—Amarillo, February 17, 2015, no pet. h.)

BP America Production Company ("BP") acquired an oil and gas lease (the "Arrington Lease") on which there was one producing well. The well produced consistently until 2005, which production slowed significantly. However, production increased in November 2006 and began producing at levels equivalent to the production obtained prior to the 2005 slowdown.

In 2007, the landowners executed a top lease with Laddex, Ltd. ("Laddex"). The top lease provided that it would not become effective unless and until either BP executes a release of the Arrington Lease or if the Arrington Lease is declared terminated by a court judgment. Shortly after obtaining its top lease, Laddex filed suit against BP, alleging that the Arrington Lease terminated for failing to produce in paying quantities in the 15-month span between August 2005 and November 2006. The case was submitted to a jury who determined that the Arrington Lease terminated during the 15-month span where production had slowed.

BP appealed, arguing that the trial court erred by restricting the jury's review to the 15-month period of slow production, because the well experienced much higher levels of production in the months prior to and immediately after that 15-month span. The appellate court described the analysis of whether a mineral lease should be terminated as being assessed through a two-step determination of profitability: (1) viewed over a reasonable period of time, did the lease cease to pay a profit after deducting operating and marketing expenses, in other words, did the lease cease to produce in paying quantities; and (2) would a reasonably prudent operator continue to operate under the lease for profit and not merely for speculation.

The Amarillo court held that it was reversible error for the trial court to exclude from the time period considered the profitable months following the 15-month slow down. The court reasoned that "[c]ertainly, evidence that a lease had returned to profitable production is material to the determination of whether a jury question inquires about a period that is reasonable under the circumstances." Based on this reasoning the Amarillo court held that the trial court failed to properly instruct the jury on the law and that the trial court's judgment should be reversed and remanded for additional proceedings.

Lightning Oil Company v. Anadarko E&P Onshore, LLC

2014 WL 5463956 (Tex. App—San Antonio October 29, 2014, pet. filed)

The San Antonio court was tasked with determining whether Anadarko E&P Onshore, LLC ("Anadarko") should be prohibited from drilling through Lightning Oil Company's ("Lightning") mineral estate, without Lightning's permission. The court was not deciding whether Anadarko's conduct would be an illegal trespass (as alleged by Lightning)—only whether a temporary injunction should be issued. Finding that Lightning could achieve an adequate remedy at law if Anadarko committed unlawful conduct, the court declined to issue a temporary injunction order.

Lightning owned two leases (collectively, the "Cutlass Lease") which covered approximately 3,251.53 acres in Dimmit County, Texas. To the south of Lightning's mineral estate lies the Chaparral Wildlife Management Area ("Chaparral WMA") which is a wildlife sanctuary managed by the Texas Parks and Wildlife Department ("TPWD"). The TPWD owns the surface estate of the Chaparral WMA and 1/6 of the mineral estate. The other 5/6 of the mineral estate is owned by members of the Light family, some of whom formed Lightning Oil.

In October 2009, Anadarko obtained an oil and gas lease covering the Chaparral WMA which required Anadarko to utilize off-site drilling locations "when prudent and feasible," and to obtain authorization from the Chaparral WMA land manager and comply with all other restrictions before planning any on lease drill sites. At the time of the appeal, Anadarko had not constructed any surface locations on the Chaparral WMA surface and was then engaged in negotiations for a surface use agreement. All drilling activity was commenced from surface locations on the neighboring Rancho Encantado.

The dispute arose from Anadarko's plan to drill as many as 15 wells from surface locations located on the Briscoe Cochina East Ranch, where Lightning owned the mineral estate. Anadarko obtained permission from the surface owner and entered into a surface use agreement and a subsurface use agreement. No permission was obtained from Lightning. When Anadarko entered the property and placed stakes to mark the site of a proposed well pad, Lightning opposed Anadarko's plans and staked its own proposed well site, the Cutlass Well No. 3, at the same surface location.

Lightning filed suit, claiming that Anadarko's proposed conduct would constitute a trespass of Lightning's mineral estate. Further, Lightning asked the trial court to enjoin Anadarko's proposed plans, arguing that imminent and irreparable injury would be caused by the alleged trespass. The trial court held a hearing on Lightning's application for a temporary injunction, which it denied. Lightning appealed the denial of this requested relief. The trial court had not yet reached the merits of Lightning's substantive claims and the merits were not before the court on appeal.

A temporary injunction is an extraordinary remedy whose purpose is to preserve the status quo of the litigation pending a trial on the merits. To obtain a temporary injunction, an applicant must plead and prove three elements: (1) a cause of action against the defendant; (2) a probable right to relief; and (3) probable, imminent, and irreparable injury in the interim. The appellate court declined to address whether Anadarko's proposed plan, if accomplished, would be an unlawful trespass of Lightning's mineral estate because the issue needed to be resolved by the trial court. Instead, the appellate court chose only to review whether Lightning proved that it would be exposed to "probable, imminent, and irreparable injury" in the absence of a temporary injunction.

Lightning submitted evidence that Anadarko's proposed plan caused three areas of concern: (i) the potential use of inadequate casing by Anadarko which, if they were conducting fracing operations, could cause the fracing fluids to leak out and damage the hydrocarbon formations on Lightning's mineral estate; (ii) the lease obligation to drill one or more offset wells to prevent drainage from Anadarko's wells, at a cost of "millions of dollars" to Lightning; and (iii) the placement of Anadarko's drill pipes, or wellbore, in a location that would interfere with Lightning's planned wells, disrupting Lightning's drilling plan and creating additional costs in adjusting its plan.

The *Lightning* court found that the potential injuries alleged by Lightning were insufficient to support the entry of a temporary injunction because the alleged injuries could be compensated by money damages. The court explained that a temporary injunction should only be issued in situations where the anticipated injury could not be adequately compensated in damages or if the damages cannot be measured by any pecuniary standard. Further, an applicant (such as Lightning) must prove that it has "no adequate remedy at law" for the anticipated injury, meaning no remedy which would provide "complete, practical, and efficient to the prompt administration of justice as equitable relief."

In affirming the trial court's denial of the temporary injunction, the *Lightning* court noted that Lightning's own witnesses conceded that much of the alleged harm, if it occurred, could be quantified by money. Further, Lightning admitted that, although possible, it was unlikely that Anadarko would lose control of a well and damage Lightning's mineral estate. Further, Lightning admitted that Anadarko's proposed surface locations would not interfere with Lightning's proposed Cutlass No. 3 Well and any future interference would, at worst, merely increase Lightning's drilling costs. Finally, in regard to Lightning's claims that Anadarko's wells would trigger Lightning's offset obligations, at a substantial financial cost, Anadarko was able to establish that Lightning's offset obligations could likewise be triggered in the same manner if Anadarko drilled its wells from a different surface location.

Lightning has filed a petition for review with the Texas Supreme Court. After there is a final determination on Lightning's application for a temporary injunction, the case will return to the trial court for a determination on the merits.

City of Lubbock v. Coyote Lake Ranch, LLC
440 S.W.3d 267 (Tex. App.—Amarillo, pet. filed)

In *Lubbock v. Coyote Lake Ranch*, the Amarillo court of appeals was asked to determine whether the "Accommodation Doctrine" (which requires the owner of a severed mineral estate to accommodate pre-existing surface uses in certain circumstances) applies to the relationship between a surface owner and the owner of a severed groundwater estate. The Amarillo court concluded that existing case law did not support extending the doctrine to cover a severed water estate. Further, the court stated that, if the doctrine should be extended, the decision to do so should come from either the Texas Supreme Court or the Legislature because of the impacts such a change could have on existing water law.

The groundwater estate in land owned by Coyote Lake Ranch ("CLR") had been severed in 1953 and conveyed to the City. In 2012 and 2013, the City proposed and began implementing a well field plan on CLR's property. CLR filed suit, alleging that the City's activities on its property were unlawful and did not accommodate the pre-existing use of the surface. CLR filed an application for a temporary injunction, asking the trial court to enjoin the City from performing additional activities on CLR's property until after a trial on the merits. The trial court granted CLR's application.

On appeal, the appellate court reviewed the trial court's order granting a temporary injunction prohibiting the City from taking certain activities relating to further development of its water plan on land which was owned and used by CLR. In performing its review, the appellate court concluded that the Accommodation Doctrine, a legal doctrine applicable to the relationship between the owners of the surface estate and a severed mineral estate, was the sole underlying basis for the trial court's order granting the temporary injunction. Accordingly, the appellate court limited its review to the issue of whether the Accommodation Doctrine could apply to a dispute between a surface owner and the owner of a severed groundwater estate.

CLR argued that ownership of the water estate has historically been analogized to ownership of the mineral estate and relied heavily on the Texas Supreme Court's opinion in *Edwards Aquifer Auth. v. Day*, 369 S.W.3d 814 (Tex. 2012). CLR argued that the *Day* opinion establishes that issues related to mineral ownership should be analogized to issues related to groundwater ownership. However, neither *Day* nor any other case reviewed by the appellate court expressly provided that the Accommodation Doctrine should apply to the relationship between the owner of the surface estate and the owner of the groundwater estate. The appellate court declined to read *Day* in a manner that would support extending the doctrine as requested by CLR.

Unit Petroleum Company v. David Pond Well Service, Inc.
439 S.W.3d 389 (Tex. App.—Amarillo 2014, pet. filed)

In or around 2005, Unit Petroleum Company ("UPC") acquired an oil and gas lease (the "Unit Lease") granted by Everett and Lora Tarbox. The Unit Lease contained a reservation of the wellbore of the Tarbox Unit #1 Well, which the Tarboxs reserved the right to operate. Shortly after the Unit Lease's execution, the Tarboxs executed a Wellbore Oil and Gas Lease with David Pond Well Service ("Pond") which covered the wellbore of the Tarbox Unit #1 Well (the "Wellbore Lease"). The parties disputed whether UPC could reduce the proration unit for Pond's well. The court held that, pursuant to the terms of the applicable agreement, UPC could reduce the size of the proration unit subject to an implied duty to Pond to ensure that sufficient acreage was dedicated to the well so that it could legally produce.

Between 2008 and 2010, UPC drilled three wells on its lease. After the wells started producing, Pond claimed that the production rate of the Tarbox Unit #1 Well dropped. Pond contacted the Texas Railroad Commission and alleged that UPC's wells were in violation of existing proration unit designations. In response, UPC filed an application to establish new proration units for UPC's three wells and the Tarbox Unit #1. In its application, UPC requested that the proration unit for the Tarbox Unit #1 be reduced from 80 acres to 40 acres. When Pond filed a complaint with the Texas Railroad Commission, UPC withdrew its Application and instead filed suit requesting, among other things, that a trial court determine the parties' respective property rights.

At trial, Pond stipulated that the Wellbore Lease granted an interest only in the wellbore itself and did not include any other interest. The trial court found in favor of Pond, concluding that Pond had a vested interest in the original 80-acre proration unit assigned to its well and that UPC was estopped from asserting ownership of an exclusive right to designate a proration unit of Pond's wellbore. Pond had argued that, although its lease was merely an interest in the wellbore itself, it was still vested with an appurtenant right to make operational decisions such as the amount of acreage to be assigned to an applicable proration unit.

The appellate court disagreed with Pond and reversed the trial court's judgment, holding that UPC had the exclusive right to designate a proration unit for Pond's well. The court reasoned that the lessee of an oil and gas lease succeeds to the lessor's ownership of the mineral estate and all rights that come with it, including the executive right and the right to develop the property. In light of the parties' stipulation Wellbore Lease merely reserved an interest in the wellbore itself, not the surrounding mineral estate, the court concluded that Pond did not acquire any executive rights or right to develop the property. Instead, the appellate court concluded that those rights vested in the owner of the mineral estate, which was UPC.

Pond also argued that it acquired the exclusive right to amend the original 80-acre proration unit when the Texas Railroad Commission approved Pond's P-4 permit to become the operator of the Tarbox Unit No. 1 Well. However, the appellate court disagreed, concluding that a permit from the Texas Railroad Commission was merely a "negative pronouncement" that did not grant Pond any affirmative rights to occupy the property.

Although the court found that UPC had the exclusive executive right to establish a proration unit encompassing any part of its leasehold estate, the appellate court concluded that UPC's rights were encumbered by an implied duty to the owner of the reserved wellbore to designate a sufficient amount of acreage to permit the owner (Pond) to lawfully produce oil and gas from its well. At least in part, the court's conclusion was based on the language of the Wellbore Lease which reserved to the Tarboxs, or their assigns, the right to produce from the Well. The court noted that the State of Texas and the applicable Special Field Rules require that a certain amount of acreage be attributed to a well in order to obtain an allowable for production. As a result, the court held that UPC was required to allocate at least the minimum amount of acreage to the Tarbox Unit No. 1 Well so that it could be lawfully produced.

French v. Occidental Permian, Ltd.

440 S.W.3d 1 (Tex. 2014)

In *French*, the Texas Supreme Court examined the royalty provision in two oil and gas leases to determine whether a lessee could deduct the costs and expenses of removing CO_2 from the gas stream when the CO_2 had been injected into the reservoir as part of a secondary recovery effort. The Supreme Court held that the expenses were properly deducted.

The plaintiff-lessors (collectively, "French") owned the royalty interests in two oil and gas leases, the "Fuller Lease" and the "Cogdell Lease" which were executed in 1948 and 1949, respectively. Occidental Permian, Ltd. ("Oxy") owned the working interest. The Fuller Lease provided for a royalty "on gas, casinghead gas or other gaseous substance produced from said land and sold or used off the premises or in the manufacture of gasoline or other products therefrom" equal to the "market value at the well of one-eighth (1/8) of the gas so sold or used." The Cogdell Lease provided for a royalty of "1/4 of the net proceeds from the sale" of "gasoline or other products manufactured and sold" from casinghead gas "after deducting [the] cost of manufacturing the same."

Although having different royalty provisions, the *French* court found that both leases provided that the royalty owner would not bear any production expenses but would bear at least some post-production costs. In regard to the Fuller Lease, the royalty was to be calculated "at the well." The Supreme Court has previously ruled that this language results in the royalty owner bearing post-production costs incurred downstream from the wellhead. *See Heritage Res., Inc v. Nationsbank*, 939 S.W.2d 118 (Tex. 1996). In regard to the Cogdell Lease, the court also concluded that royalty payment would bear post-production costs because royalty was calculated at the point of sale, after deducting the cost of manufacturing the same. Therefore, both royalty payments would be net of all post-production costs incurred prior to the point of sale.

In the 1950s, just a few years after the leases were executed, the operator obtained permission to perform secondary recovery operations to increase production. The operator performed a "water flood," where water is injected into the reservoir resulting in increased pressure and (hopefully) increased production. The operation was successful and continued into the 1990s. A byproduct of this technique is that a great deal of water will be produced with the oil and must be separated. The royalty owners were never charged with any expenses associated with separating the water and oil.

In or around 2001, Oxy began using a new method of secondary recovery. Instead of injecting water, Oxy began injecting CO_2 into the reservoir. The court noted that there were 106 active wells in the unit affected by the operation and all would have declined to uneconomic levels but for the CO_2 flood performed by Oxy.

Before the CO_2 flood, the casinghead gas produced by Oxy was only 2% CO_2 and was processed at the nearby Fuller Gasoline Plant. However, after the CO_2 flood began, the casinghead gas produced from the wells contained 85% CO_2. The Fuller Gasoline Plant could not process casinghead gas with such a high levels of CO_2. As a result, Oxy contracted with Kinder Morgan to build a new plant. At a cost of millions of dollars, Kinder Morgan constructed a plant capable of removing at least 90% of the CO_2 and most of the H_2S from the casinghead gas for reinjection. The plant was also able to extract about two-thirds of the NGLs. Kinder Morgan contracted with Torch Energy to have the casinghead gas processed further at the Snyder Gas Plant where the rest of the CO_2 and H_2S would be removed for reinjection, and the rest of the NGLs are extracted.

Oxy paid royalty to French based on 70% of the NGLs produced, but not on the other 30% which was paid to Kinder Morgan in kind as part of Kinder Morgan's compensation. Likewise, Oxy did not pay any royalty on any residual gas, 100% of which was given in kind to Kinder Morgan. Oxy considered a monetary fee paid to Kinder Morgan to be a production expense, and did not charge it to French.

French filed suit, claiming that Oxy was underpaying royalties because it failed to pay any royalty on the 30% of the NGLs or any of the residual gas paid to Kinder Morgan in kind. The parties agreed that removal of indigenous H_2S was a post-production expense and should be deducted from the royalty. However, French argued that removal of the extraneous substances should be borne by Oxy. French relied on the Texas Supreme Court's opinion in *Humble Oil & Refining Company v. West*, 508 S.W.2d 812 (Tex. 1974) which concerned the co-mingling of extraneous gas with native gas. The Supreme Court agreed that, under *West*, French was entitled to royalty on the non- CO_2 portion of the casinghead gas, but the court disagreed that the *West* case provided guidance on who should bear the cost of separation of the extraneous substances.

French also analogized the removal of the CO_2 with the removal of water when water flood operations were performed. French argued that the costs of the water separation was never charged to the royalty owners and the cost of CO_2 removal should likewise be borne by the working interest owners. Here, the Supreme Court disagreed. First, the court noted that both the water flood and CO_2 flood were necessary for continued oil production. However, although separating the water from the oil is necessary to render the oil marketable, separation of the CO_2 was unnecessary as the gas stream could be re-injected as-is. Further, the court noted that Oxy was not obligated to separate the CO_2 from the NGLs, but doing so (at a substantial cost) benefited both Oxy and French.

The court held that "under these circumstances" French, having given Oxy the right and discretion to decide whether to re-inject or process the casinghead gas, and having benefitted from that decision, must share in the cost of CO_2 removal. Oxy acknowledged that part of Kinder Morgan's fee must be considered to be a production cost since it is aimed at returning some CO_2 to the field for re-injection. However, Oxy argued that the monetary fee paid to Kinder Morgan, which was not charged to French, covers those expenses. The court noted that French did not challenge whether the remaining part of Kinder Morgan's fee was excessive, only that the fee should not be chargeable to the royalty owners at all. Because the issue was not raised, the court would not address it.

Chesapeake Exploration Co. v. Hyder
427 S.W.3d 472 (Tex. App.—San Antonio 2014, pet. granted)

The dispute between the parties arose from each party's interpretation of the royalty and overriding royalty clauses. Appellants (collectively, "Chesapeake") contended the royalty clause applicable to the wells on the leased premises allowed them to deduct Appellees' (collectively, "Hyder") share of post-production costs and expenses incurred between the "point of delivery" and the "point of sale" from Hyder's royalty payment. Hyder contended that the expenses could not be deducted from its royalty share, regardless of where they were incurred. The appellate court held for Hyder and Chesapeake petitioned the Texas Supreme Court for review, which has been granted. On March 24, 2015, the Supreme Court heard oral arguments.

The dispute involved four affiliated entities. Chesapeake Operating, Inc. ("COI") was responsible for producing oil and gas from the wells. Chesapeake Energy Manufacturing, Inc. ("CEMI") purchases the gas from COI and processes it. Chesapeake Midstream Partners ("CMP") does not take title to the gas at any point, but is responsible for gathering the gas and transporting it to a central point. COI and Chesapeake Exploration, Inc. were lessees under the lease in dispute (the "Hyder Lease").

Chesapeake made royalty payments to Hyder based on a weighted average sales price calculated on the sale price when gas is sold by CEMI to various third-party purchasers at a downstream sale point. The royalty on gas was governed by the following provision

> (b) for natural gas, including casinghead gas and other gaseous substances produced from the Leased Premises and sold or used on or off the Leased Premises, twenty-five percent (25%) of the price actually received by [Chesapeake] for such gas .... *The royalty reserved herein by [Hyder] shall be free and clear of all production and post-production costs and expenses, including but not limited to, production, gathering, separating, storing, dehydrating, compressing, transporting, processing, treating, marketing, delivering, or any other costs and expenses incurred between the wellhead and [Chesapeake's] point of delivery* ***<u>or</u>*** *sale of such share to a third party.* [emphasis added]

Chesapeake acknowledged that costs and expenses incurred before the gas is extracted are not charged against Hyder's royalty interest. Chesapeake argued, however, that the royalty provision permits the deduction of post-production costs and expenses, such as transportation costs, incurred between the point of delivery and the point of sale. Chesapeake's primary argument was that the disjunctive "or" used between "point of delivery or sale" permitted Chesapeake to choose to calculate Hyder's royalty at either the point of delivery or the point of sale. Chesapeake argued that if it elected to calculate the royalty at the point of delivery (which occurred first), then it could deduct expenses incurred after that point.

The San Antonio court rejected Chesapeake's interpretation for two primary reasons. First, the royalty provision provided that the royalty payment would be "free and clear" of post-production costs and the court found that the language must be interpreted broadly. The court commented that Chesapeake's proposed construction of the royalty provision would ignore the "free and clear" language in the lease. Second, the court noted that the Hyder Lease provided that the Texas Supreme Court's holding in *Heritage Resources, Inc. v. Nationsbank*, 939 S.W.2d 118 (Tex. 1996) would have no application to the lease. In *Heritage Resources*, the Supreme Court held that a "No Deductions" provision was mere surplusage (i.e., had no effect) because the royalty was to be calculated "at the well" and there would be no post-production costs before that point. The *Hyder* court stated that its holding in favor of Hyder was "reinforced" by the parties' agreement that the *Heritage Resources* case should not apply and therefore the broad "no deductions" provisions in the Hyder Lease must be enforced and not rendered surplusage by the court.

Chesapeake Exploration, LLC v. Warren
759 F.3d 413 (5th Cir. 2014)

The Fifth Circuit reviewed the trial court's order granting a motion to dismiss a lawsuit brought by royalty owners claiming that Chesapeake Exploration, Inc. ("Chesapeake") underpaid royalties by improperly deducting post-production costs. Distinguishing the *Hyder* case, the Fifth Circuit held that the *Heritage Resources* case controlled, at least to one of the leases at issue.

The dispute involved the "Warren Leases" and the "Javeed Lease." The Warren Leases provided that royalty was to be calculated at the "mouth of the well," but also provided that "Lessor will, however, bear a proportionate part of all those expenses imposed upon Lessee by its gas sale contract to the extent incurred subsequent to those that are obligations of Lessee . . . ." The Warrens acknowledged that the language in their lease was functionally equivalent to the royalty provision analyzed by the Texas Supreme Court in *Heritage Resources, Inc. v. Nationsbank*, 939 S.W.2d 118 (Tex. 1996) and would generally permit Chesapeake to deduct all post-production costs incurred after the wellhead, despite the presence of a "no deductions" provision. The Warrens argued that the latter part of the provision, specifying a specific expense which could be charged against the royalty interest, distinguished the Warren Leases from the lease in the *Heritage* case.

The Fifth Circuit rejected the Warrens' arguments and held that the *Heritage* case controlled. While the Warren Leases contained an additional provision specifying costs which would be borne by the royalty owner, the court concluded this language could not be read to limit the costs which could be deducted. Instead, the court concluded that the provision requiring the lessor to bear proportionate costs incurred under the lessee's gas sales contracts specified costs which could be deducted from the royalty owner's interest, but did alter or limit the other costs which could be properly deducted. The Fifth Circuit also dispensed with the Warrens' reliance on the San Antonio court's opinion in the *Hyder* case, noting that the language in the Hyder Lease and the Warren Leases "differ markedly." However, the Fifth Circuit noted that the Warrens made no mention as to whether there were multiple Chesapeake affiliates involved, an issue relevant in the *Hyder* case.

The *Warren* court reversed the trial court's decision to dismiss the Javeeds' claims. The court pointed out that the Warrens and the Javeeds initially filed a joint brief in which they analyzed only the language in the Warren Lease. However, as noted by the court, the two leases had materially different language. Specifically, the Javeed Lease provided that the Javeeds' royalty would be calculated at the *point of sale*, not at the wellhead as required in the Warren Lease. The court found that this distinction was sufficient to permit the Javeeds to have their day in court. Therefore, their claims were reinstated and the cause was remanded to the trial court for a determination on the merits.

KCM Financial LLC v. Bradshaw
2015 WL 1029652, --- S.W.3d --- (Tex. Mar. 6, 2015)

In *Bradshaw*, the plaintiff NPRI owner ("Bradshaw") brought a breach of fiduciary duty claim against the executive right holder ("Steadfast") claiming that Steadfast breached his duty to the plaintiff by executing a lease with a royalty rate that was allegedly below market and a signing bonus that was allegedly above market. The Supreme Court held that evidence that a higher royalty was attainable is neither conclusive proof nor wholly irrelevant to determining whether the executive breached its duty to the non-executive. Instead, it is only evidence of possible self-dealing which must be evaluated by a jury.

Under the terms of the mineral lease, Steadfast reserved a 1/8 royalty and obtained a lease bonus of $7,505 per acre. Bradshaw was entitled to 1/2 of the 1/8 royalty, or 1/16, in accordance with the terms of deeds by which the non-executive obtained her NPRI. The other words, 1/2 of the 1/8 royalty belonged to Steadfast, who assigned it to numerous other individuals and entities ("third party royalty owners"). Bradshaw sued the third-party royalty owners, requesting the imposition of a constructive trust on the proceeds received by them. Bradshaw argued that the third-party royalty owners received money which, but for Steadfast's allegedly wrongful conduct, would have been paid to Bradshaw.

The threshold issue in this case is whether evidence exists from which a jury could conclude that Steadfast breached a duty to Bradshaw in negotiating the terms of the mineral lease with Range. Among other arguments, Steadfast contends that there is no *per se* duty to obtain the highest possible royalty and that, as a matter of law, it properly discharged its duty to Bradshaw by obtaining the minimum royalty required by deed which created Bradshaw's interest. Bradshaw responded that there was at least some evidence Steadfast engaged in self-dealing to her detriment by securing a large bonus for itself in exchange for a below-market royalty.

The Supreme Court noted that the relationship between an executive and a non-executive has been described as fiduciary in nature. Although "[a] fiduciary duty often requires a [fiduciary] to place the interest of the other party before his own," the Supreme Court has clarified that its precedent in cases such as *Andretta*, *HECI*, and *Manges* did not incorporate a requirement that the executive subordinate its interest to the interests of the non-executive. In evaluating whether an executive has breached a duty owed to a non-executive, the court explained, evidence of self-dealing can be pivotal.

The court concluded that, in ascertaining whether the executive breached its duty to the non-executive, the controlling inquiry is whether the executive engaged in acts of self-dealing that unfairly diminished the value of the non-executive interest. While the duty has never been specifically defined, the court explained that these tenets should guide the analysis.

Finding there was some evidence that a one-quarter rate was at least attainable, if not ubiquitous, and that the deal may have been deliberately structured to reduce the Bradshaw's royalty, the court held that it was improper for summary judgment to be granted against Bradshaw. However, the Texas Supreme Court held that Bradshaw take nothing on her claims against the third-party royalty owners. In reaching its holding, the Texas Supreme Court explained that a "constructive trust is an equitable, court-created remedy designed to prevent unjust enrichment" which has "historically been applied to remedy or ameliorate harm arising from a wide variety of misfeasance." The Court explained that the reach of the remedy is limited, and that the following elements must be established: "(1) breach of a special trust or fiduciary relationship or actual or constructive fraud; (2) unjust enrichment of the wrongdoer; and (3) an identifiable res that can be traced back to the original property." "In weighing the imposition of a constructive trust, a court will identify whether a wrongful taking has occurred."

Importantly, in rejecting the plaintiff's claims against the third party royalty owners, the Texas Supreme Court stated, "[a] constructive trust is not merely a vehicle for collecting assets as a form of damages" and "may not be imposed simply because doing so, from an accounting perspective, [will] make Bradshaw whole or close to whole."

Butler v. Horton

447 S.W.3d 514 (Tex. App.—Eastland 2014, no pet.)

The *Butler* court reviewed the language of a mineral deed to determine whether the grantor reserved a fixed 1/16th fractional royalty or whether the reservation was a floating one-half of any royalty provided in a mineral lease. The reservation provided as follows:

> "There is excepted from this conveyance and reserved unto ... grantors, their heirs and assigns, ***one-half of the usual 1/8th royalty*** on all oil, gas, casinghead gas, and gasoline, and ***one-half of the usual and customary royalty*** on sulphur, coal, uranium, and all other minerals in, on, or under, or that may be produced from the above described land; ***it being understood . . . that the Grantors, their heirs or assigns, shall be entitled to one-half of any bonus payments or delay rentals which may be paid*** in connection with any lease on the property, and that ***in the event of production from said land . . . the Grantors, their heirs or assigns, shall be entitled, free of cost, to one-half of the royalty on said minerals, as provided above***[.]" (emphasis added).

The Appellants argued that the phrase "provided above" clarified the parties' agreement that the interest reserved in favor of the grantor was a floating one-half of any royalty provided in any mineral lease. The Appellees, who were the successors to the grantee, argued that the phrase "provided above" referred only to the royalty interest described as being "one-half of the usual 1/8th royalty."

The Eastland court of appeals acknowledged that the phrase "one-half of the usual 1/8th royalty," under different circumstances, can be held to refer to a fixed interest. However, the court declined to interpret the "provided above" language as being restricted only to the first reference to a reserved interest. The court instead concluded that the phrase referred to the entire provision, which repeatedly provides that one-half of various mineral attributes are reserved. Harmonizing the language of the deed, the court held that the deed reserved a floating royalty interest equal to one-half of the royalty provided in an oil and gas lease.

Dawkins v. Hysaw

450 S.W.3d 147 (Tex. App.—San Antonio 2014, pet. filed).

In *Dawkins*, the San Antonio court interpreted the language in a Will which devised certain royalty interests between three children. The trial court found that the Will provided for a "floating royalty," where each of three children share equally, in 1/3 parts, any royalty provided in a mineral lease. The San Antonio court reversed and rendered judgment concluding that, even though the intent was possibly for the children to share equally, the plain and unambiguous terms of the instrument provided differently.

At the time of the execution of the Will, Ethel Nichols owned three tracts of land in Karnes County, Texas. She devised fee simple title in the surface estate to each of her children as follows: to Inez, 600 acres out of the 1,065 acre tract; to Dorothy, 465 acres out of the 1,065 acre tract; and to Howard, the 200 and 150 acre tracts. In a separate provision, Ms. Nichols provided that the owner of the surface estate would also own the mineral estate, however, ownership would be subject to non-participating royalty interests devised to the other children. Therefore each child would inherit the surface and mineral estate in the specified property, as well as a non-participating royalty interest in the properties owned by their siblings.

The dispute concerned whether the non-participating royalty interests described in the Will were a fixed 1/3 of 1/8 royalty, or rather should be interpreted as a floating 1/3 royalty interest. The Will provided that each of Ms. Nichols's three children was to "have and hold an undivided 1/3 of an undivided 1/8 of all oil, gas or other minerals in or under or that may be produced from any of the lands described in her Will." In describing these interests, the Will provided that each child was to be entitled to a non-participating royalty interest in the lands devised to their siblings. The interest was described as being "one-third of one-eighth royalty, provided that there is no royalty sold or conveyed by [Ms. Nichols]." However, the Will also provided that if Ms. Nichols sold any of the royalty estate during her lifetime, then each of her children would share any remaining interest in equal 1/3 interests.

Ms. Nichols did make a conveyance during her lifetime of some of the mineral interests in the 200-acre and 150-acre tracts. Accordingly, the appellate court found that all of the children were to inherit equal 1/3 interests in those tracts.

In regard to the third tract, the Appellees claimed that the royalties should also be split equally in the remaining tracts, contending that the phrase "one-third of one-eighth" royalty should be understood to devise a floating 1/3 royalty interest rather than a fixed 1/24 royalty interest. Further, they argued that the language of the Will showed an intent that Ms. Nichols desired for all of her children to share the royalty estate equally and alluded to the fact that at the time the Will was drafted, "1/8" was the usual royalty.

In rejecting the Appellees' arguments, the court stated that "whatever subjective intent for distributing royalties one might discern from [Ms. Nichols'] will cannot overcome the clear and unambiguous language of the first and second provisions that describe a fractional royalty." In a footnote, the court went on to acknowledge that the Appellees were correct that the usual royalty was 1/8 in the 1940s when the lease was drafted and it was "likely [that the Will] was drafted under that assumption." However, the court concluded that even if Ms. Nichols' true intent was for her children to share the royalties equally, the court could not compel them to do so because of the contrary language in the Will itself.

In reaching its holding, the court concluded the Will's plain language devised all Ms. Nichols' rights in the specified surface estate—and its corresponding mineral estate—to each surface estate devisee subject to the two fractional royalty interests—fixed fractions of 1/24 of production—reserved for the devisee's siblings. The court also concluded that for the 200 acre and 150 acre tracts, each of Ms. Nichols' children are entitled to share equally in any and all royalty earned from those tracts.

Key Operating & Equipment, Inc. v. Hegar
435 S.W.3d 794 (Tex. 2014)

Surface owners Will and Loree Hegar disputed the right of Key Operating & Equipment, Inc. ("Key") to travel across their property to reach Key's well on a neighboring tract. Key had pooled the Hegar's tract with the neighboring tract. The Hegar's contended that Key's use of their property was unlawful because Key's well was not draining their tract. The Supreme Court rejected the Hegar's argument, concluding that Key had the right to reasonable use of all tracts pooled into the unit.

Key began operating the Richardson No. 1 Well in 1987 on the 60-acre Richardson tract. In 1991, Key acquired a lease covering the contiguous 191-acre Curbo/Rosenbaum tract and began reworking an existing well known as the Rosenbaum No. 2. In concert with its reworking operation, Key constructed a road across the Curbo/Rosenbaum tract that permitted Key to travel to both wells. The Rosenbaum No. 2 ceased producing in or around 2000 and Key's lease covering the Curbo/Rosenbaum tract expired. Key's then owners purchased a 1/8 mineral interest in the Curbo/Rosenbaum tract and leased it to Key. Key then pooled 10 acres of the Curbo/Rosenbaum tract with 30 acres from the Richardson tract. The Richardson No. 1 was the unit well and Key continued to use its road on the Curbo/Rosenbaum tract to reach its well.

In 2002, the Hegars bought 85 acres of the Curbo/Rosenbaum tract which included the road Key used to access the Richardson No. 1 Well. The Hegars were aware that Key used the road as part of its mineral operations and initially made no objection. The Hegars built a house and used Key's road for access. A few years later Key drilled the Richardson No. 4 well in the existing unit. The Hegars objected to the increased traffic related to the new well and brought suit against Key, claiming that Key's use of the road constituted an illegal trespass. At trial, the Hegars presented expert testimony from a petroleum engineer who stated that the Richardson No. 4 well produced from a small reservoir and was not draining the Hegar's property.

The Supreme Court rejected Hegar's arguments and held that Key had the right to continue its use of the road. The court's conclusion was based on Key's pooling authority, which permitted Key to pool its leases and then use the entire surface estate for its operation of the pooled units. The court affirmed the primary legal consequence of pooling, which is that production from anywhere on a pooled unit is treated as production on every tract in the unit. Hegar did not claim that Key was prohibited from producing its tract, only that Key was not actually producing from the tract. The Supreme Court concluded that whether their property was actually being drained by the well was irrelevant to the Hegar's trespass claim.

In a footnote, the court noted that the legal consequences of pooling may be challenged by means of a claim that the lessee pooled in bad faith. The Hegars did not assert a bad faith pooling claim, so the court did not address this issue.

Charles G. Hooks, III, et al. v. Samson Lone State, Limited Partnership n/k/a Samson Lone Star, LLC

2014 WL 393380 (Tex. January 30, 2015)[1]

The *Hooks* case touches on a myriad of oil and gas issues such as, but not limited to, pooling, royalty payment calculations, limitations on fraud and breach of contract claims, most favored nations provisions, and offset obligations.

Petitioners (collectively, "Hooks") sued the Respondent ("Samson") alleging, among other things, breach of contract for failure to pay royalties, failure to pay royalties as required by the Texas Natural Resources Code, fraud, fraudulent inducement, and statutory fraud. The claims centered around three oil and gas leases that Hooks, as lessor, executed with Samson, the lessee, in 1999. Two of the leases were in Hardin County, Texas (the "Hardin County Leases") the third lease was in Jefferson County, Texas (the "Jefferson County Lease").

The fraud claim related to the Jefferson County Lease, which Hooks alleged he was fraudulently induced to amend. The lease, which prohibited pooling, provided that if a gas well were completed within 1,320 feet of Hooks' lease line Samson would either drill an offset well, pay Hooks compensatory royalties, or release the offset acreage. In 2000, Samson drilled a well that bottomed 1,186 feet from Hooks' lease, triggering the offset obligation provision. Instead of complying with the lease, Samson, in 2001, asked Hooks to amend the Jefferson County Lease to permit Samson to pool part of the lease into a unit associated with the new well. Hooks requested a plat disclosing the bottom hole location of the well. Samson provided a plat which incorrectly showed the well to be bottomed outside of the 1,320-foot buffer zone. The Supreme Court noted that a plat with the same "false" information had also been filed with the Railroad Commission.[2]

At trial, the jury found in favor of Hooks on his fraudulent inducement claim. On appeal, the First Court of Appeals reversed and rendered that Hooks take nothing on his claim because, according to the appellate court, the claim was barred by the applicable statute of limitations because Hooks could have learned of his alleged cause of action from the information on file with the Railroad Commission. The Texas Supreme Court reviewed this determination and concluded that Samson's conduct tolled the statute of limitation on Hooks' fraud claim. While the Supreme Court noted recent decisions which provide that the public is charged with constructive knowledge of public records as a matter of law, the court concluded that the same result should not automatically follow when the public records contain "false information." The court concluded that the presence of false information in the public records meant that a jury must determine when a person acting with reasonable diligence would uncover an alleged fraud. Because the jury in *Hooks* had already found that Hooks had acted with reasonable diligence in uncovering the fraud, the Supreme Court reversed the lower court's holding that Hooks' fraud claim was time barred.

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[1] The author's law firm, McGinnis Lochridge, represents the Petitioners in this dispute.

[2] The court also commented, without deciding, that an older plat on file with the Commission disclosed that the bottom hole of the well was within the buffer zone. The parties disputed the existence of the older plat, but the court assumed it existed as the fact was not relevant to the ultimate holding.

A second issue addressed in the *Hooks* case was whether Samson breached all three leases by failing to honor a Most Favored Nations clause. All three leases provided that Hooks was to receive a 25% royalty on gas, but that Samson must increase Hooks' royalty if Samson entered into an oil and gas lease within three miles of the Hooks leases which provided for a higher royalty. In 2003, Samson negotiated a Pooling Agreement with the State of Texas on lands within three miles of the Hooks leases. Samson had an existing lease with the State providing for a 25% royalty. However, to induce the State to execute the Pooling Agreement, Samson increased the State's revenue interest in the unit so that it would receive greater royalty payment. Considering the size of the State's tract relative to the size of the unit, the State was paid the equivalent of 28.28896% royalty. Samson argued that the Pooling Agreement did not trigger the most favored nations provision in the leases because it applied to higher royalties paid under a "lease" while Samson was paying a higher royalty under a "pooling agreement." The Supreme Court found this to be a distinction without a difference and held that Samson's grant to the State of an increased unit revenue interest resulted in an increase to the State's royalty interest, triggering Samson's obligations under the most favored nations provision.

A third issue addressed by the court was Hooks' claim that Samson unlawfully "unpooled" his leases from the BSM A-1 Unit. Samson had designated the BSM A-1 Unit, which included the leases, and drilled the BSM A-1 Well. Realizing that it could not obtain pooling authorization from a drill site tract owner, Samson "amended" the unit designation to "unpool" the BSM A-1 Well, leaving it a lease well. Samson placed the lease, and others affected by the "amendment" in the Joyce Du Jay No. 1 Unit. The court noted that Samson told Hooks and others that the change was an "amendment and name change," thereby, according to the court, placing Hooks on notice that something had changed. Without deciding whether Samson had the authority to amend BSM A-1 Unit in the manner it did, the *Hooks* court held that Hooks had ratified Samson's conduct by accepting royalties from the new unit and refraining from challenging the new unit, after being placed on notice of the change by Samson.

An additional issue related to the offset provisions contained in the Hardin County Leases. The offset provision required Samson to elect one of three different options if a well was drilled within 1,320 feet of Hooks' lease line: (i) drill an offset well within 90 days; (2) release the acreage within 90 days; (3) or pay Hooks compensatory royalties. Samson claimed that its failure to elect any option resulted in a presumption that Samson elected the cheapest option, here being the option to release acreage. The court noted that the issue had not been addressed by the Texas Supreme Court since 1849. Rejecting Samson's arguments, the court concluded that, assuming that Samson breached, then by waiting without performing the first two alternatives which required action within 90 days, Samson impliedly elected to perform the third and only option remaining after the first 90 days passed — payment of compensatory royalty.

Samson has filed a motion to reconsider in the Texas Supreme Court.

LEGISLATIVE UPDATE (AS OF APRIL 14, 2015)

There are currently several bills pending before the Texas Legislature which should be of interest to the industry and royalty owners. No final action had been taken at the time this paper was prepared. However, the following bills should be watched closely and can be monitored at http://www.legis.state.tx.us/billlookup/billnumber.aspx:

- **Preemption of Local Regulation of Hydraulic Fracturing**

House Bill 40 and Senate Bill 1165 would preempt local regulation of hydraulic fracturing. The bills seek to limit the power of a municipality or other political subdivision by preempting all regulations placed on oil and gas operations, except those which occur at or above the surface. Further, local regulations must be "commercially reasonable" and cannot "effectively prohibit" oil and gas operations conducted by a reasonably prudent operator. Both bills have made it out of committee.

Two similar bills, House Bill 539 and House Bill 540 are pending in committee. House Bill 539 would authorize local municipalities to regulate subsurface oil and gas operations, but only after a municipality provides the Legislative Budget Board with a fiscal note (identifying, among other things, lost revenues to the State and local governments as well as lost royalties to the public) and an equalized educational impact study (identifying, among other things, negative impacts to school districts). House Bill 540 would apply if a municipality authorizes measures to enact or repeal local ordinances to be raised by petition. Before ordering an election, the bill would require the municipality to obtain on opinion an opinion from the attorney general as to whether the measure would be in violation of the Constitution (State or Federal) or other rule or Statute as well as determine whether the measure would constitute a taking of private property.

- **Allocation Wells**

House Bill 1552 and Senate Bill 919 would authorize the drilling of "allocation wells," unless expressly prohibited by the terms of an oil and gas lease. Further, the lessee/operator would be authorized to determine the method by which royalties are allocated, but written notice of this method must be sent to each affected royalty owner. Any existing agreement providing for an allocation method will prevail over the method selected by an lessee/operator. If a royalty owner objects to the allocation method, the royalty owner may petition the Railroad Commission for a determination as to whether, among other things, the allocation method accurately attributes to each royalty owner its fair share of production. Both bills are still in committee.

- **Division Orders**

House Bill 3068 and Senate Bill 402 would require a "Payor," upon request by a royalty owner, to disclose the formula used to calculate the royalty owner's decimal revenue interest reflected on a division order. If the interest is subject to a pooling or unitization agreement, the Payor would be required to provide "detailed information" regarding where in the real property records an instrument can be found which shows the calculation formula. Both bills are still in committee.