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**ANSWERS TO COMMON QUESTIONS ROYALTY
AND SURFACE OWNERS HAVE CONCERNING
THE ACTIONS OF OIL COMPANIES**

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**BRUCE MONNING
BROOKE J. DAVES**

**MONNING & WYNNE, L.L.P.
1901 N. Akard
Dallas, Texas 75201-2305
214 871 7171 Phone
214 871 7179 Fax
www.monning.com**

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Bruce Monning graduated from Southern Methodist University (1970) and Southern Methodist University Law School (1972). He has been Board Certified in Civil Trial Law since 1981.

Brooke J. Daves graduated from Baylor University, *magna cum laude* (1998) and Harvard Law School, *cum laude* (2002).

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Royalty and surface owners often are mistaken about or simply unaware of their rights in relation to the oil companies with leases on their land. Hopefully this memorandum will provide quick answers to the most common questions that arise in this context.

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1. What rights does an oil and gas company have respecting my surface estate? Can it interfere with something I am already doing on my land?

As with any contract, the parties to an oil and gas lease are generally free to negotiate specific rights and duties, such as specific provisions concerning the oil company's rights to use the surface. However, if the mineral owner and the oil company enter into an ordinary oil and gas lease without special provisions for surface damages but only the general granting language of "other minerals," the common law that has developed around this phrase determines the rights of the operator with respect to the surface. Texas cases have held the operator is not liable under such a lease for damage to the surface (which may include the lateral surface, the subsurface, and the superadjacent airspace) if the use was reasonable, the operator was not negligent in conducting its operations, and the operator reasonably accommodated the rights of the surface owner.

A. Reasonable Use. The oil and gas company is not liable for damage resulting from uses that are *reasonable and necessary for the exploration and production of minerals*. *Humble Oil Refining Co. v. Williams*, 420 S.W.2d 133, 134 (Tex. 1967). Any use in excess of what is reasonable and necessary is considered a trespass. *Brown v. Lundell*, 344 S.W.2d 863 (Tex. 1961). It is often a question of fact in each particular case as to what and how much is reasonable and necessary. For example, the courts have held that the right to reasonable use includes the right of the operator to choose locations for his wells at his discretion, subject only to any limitations in the lease itself. *See, e.g., Gulf Oil Corp. v. Walton*, 317 S.W.2d 260 (Tex. Civ. App—El Paso 1958, no writ); *Otis v. Haas*, 569 S.W.2d 508 (Tex. Civ. App.—Corpus Christi 1978, writ ref'd n.r.e.); *but see Section C infra*, regarding the accommodation doctrine. Generally, the courts have been willing to allow extensive use of the surface based on the mineral owner's right to reasonable use of the surface. *See* Terry I. Cross, PURPOSEFUL ACCOMMODATION—PLANNING FOR CO-EXISTENT SURFACE AND MINERAL DEVELOPMENT (2005) (on file with TexasBarCLE) for additional cases and discussion.

B. Negligence. The oil and gas company's use of the surface also must not be negligent. The most common cases alleging negligence by the operator involve oil or salt water spills. However, to prove negligence the surface owner must allege and

prove specific acts of negligence that caused the spill. The fact that oil was spilled does not raise a presumption that the operator was negligent. *Warren Petroleum Corp. v. Martin*, 271 S.W.2d 410 (Tex. 1954). Even more, in *Jones v. Nafco Oil & Gas, Inc.*, 380 S.W.2d 570 (Tex. 1964), the Court held that the surface owner failed to prove the damage was the result of negligence, even though it was shown that the operator intentionally released condensate and salt water on the ground, and those liquids flowed beyond the fenced boundary. This line of cases is based on the general acceptance that spills will happen from time to time, and the operator should only be liable for those clearly shown to flow from the operator's negligence. Even so, the courts have on occasion upheld a jury's finding of negligence on the part of the operator, such as when an operator placed salt water in an unlined earthen pit that leaked into an underground fresh water stream. *Brown v. Lundell, supra*, 344 S.W.2d at 866-67 (Tex. 1961). Both the lessor and the surface owner can recover damages for negligent operations by a lessee. *Id.*

C. Accommodation Doctrine.

As stated by the Supreme Court:

[W]here there is an existing use by the surface owner which would otherwise be precluded or impaired, and where under the established practices in the industry there are alternatives available to the lessee whereby the minerals can be recovered, the rules of reasonable usage of the surface may require the adoption of an alternative by the lessee.

Getty Oil Co. v. Jones, 470 S.W.2d 618, 622 (Tex. 1971). Prior to the *Getty Oil* decision, the general concept existed that the mineral owner's right to reasonable use of the surface was constrained by the obligation to exercise such right with "due regard" for the rights of the surface owner. *Humble Oil & Refining Co. v. Williams*, 420 S.W.2d 133 (Tex. 1967); *General Crude Oil v. Aiken*, 344 S.W.2d 668 (Tex. 1961); *Brown v. Lundell, supra*, 344 S.W.2d at 866 (Tex. 1961). *Getty Oil* provided a concrete example of at least one way in which this obligation to have "due regard" for the surface owner could manifest itself. In *Getty Oil* the court held that the operator

could not use pumping units that interfered with an irrigation system installed by the surface owner prior to the installation of the pumping units. 470 S.W.2d at 622. Although the availability of alternatives to the operator and the pre-existing use by the surface owner were both elements the court found important to its decision, the opinion focused more on the availability of alternatives than the pre-existing use and also specifically stated that the decision under the accommodation doctrine was not to be one of weighing the harm to the surface owner against the harm to the operator. *Id.* at 623. Accordingly, the significance of the pre-existing use is unclear.

Jury findings: (1) that the surface owner has an existing use of the surface that would be impaired by oil and gas operations and (2) there are other established industry practices that would provide an reasonable alternative for the oil and gas operator to accomplish its purpose will support injunctive relief requiring accommodation. *Texas Genco, LP v. Valence Operating Co.*; No. 10-04-00365-CV Tex. App. Lexis 448 *10 (Tex. App. -- Waco, January 18, 2006, no pet.) (permanent injunction issued compelling operator to drill horizontal well, under ash disposal landfill associated with surface owner's coal-burning electric plant).

2. What remedies am I entitled to if I think the oil company's use of my surface estate was excessive?

If the operator's use of the surface estate is excessive, the surface owner may seek an injunction enjoining the operator from continuing the excessive use. *Getty Oil Co., supra*, 470 S.W.2d at 619. In addition, the surface owner can seek damages, which vary depending on whether the injuries to the land are permanent or temporary. Classifying damage to land as either permanent or temporary depends on the frequency of the injury. *Schneider Nat'l Carriers, Inc. v. Bates*, 147 S.W.3d 264, 281 (Tex. 2004). In general, if the injury has occurred several times and is likely to continue, the damage is considered permanent, but if the injury has occurred only once or on irregular or intermittent occasions, the damage is usually considered temporary. *Id.* If the damage is determined to be permanent, the surface owner may recover from the oil company damages for the decrease in market value of the property. *Bay Petroleum Corp. v. Crumbler*, 372 S.W.2d 318, 320 (Tex. 1963). Such a calculation is considered to already take into account loss of use and enjoyment. *Vestal v. Gulf Oil Corp.*, 235 S.W.2d 440, 442 (Tex. 1951). If the

damage is determined to be temporary, damages are measured by considering recovery for loss of use and enjoyment and cost of repair. *Id.* Damages may also be recovered for personal injuries and damage to personal property. *City of Uvalde v. Crow*, 713 S.W.2d 154, 158-59 (Tex. App.—Texarkana 1986, writ ref'd n.r.e.).

3. Once production from a well stops altogether, or if it never really begins, how can I tell whether the lease has ended?

The answer will vary, depending on what the habendum clause says. If it requires actual production (as most leases do), the Texas rule is more strict than if it requires only the capability of production.

A. Leases that last "as long as oil or gas is produced."

In Texas . . . a habendum clause [that says 'as long thereafter as oil, gas or other mineral is produced'] requires actual production in paying quantities. [A] lease that lasts 'as long as oil or gas is produced' automatically terminates if actual production permanently ceases during the secondary term.

Anadarko Petroleum Corp. v. Thompson, 94 S.W.3d 550, 554 (Tex. 2002).

This means that any cessation of actual production will terminate the lease unless either (1) it is merely a "temporary cessation of production," or (2) an express "cessation of production" or other savings clause was written into the lease. *Anadarko, supra*, 94 S.W.3d at 554.

1. A "temporary cessation of production" will not cause termination of the lease. *Watson v. Rochmill*, 155 S.W.2d 783, 784 (Tex. 1941).
 - a. Classically, "temporary cessations were limited to a "sudden stoppage of the well or some mechanical breakdown of the equipment . . . or the like," as opposed to temporary cessations for economic reasons. *Id.*; see *Natural Gas Pipeline Co. v. Pool*, 124 S.W.3d 188, 203-04 (Tex. 2003), Jefferson, J., dissenting.

- b. The most recent Texas Supreme Court opinion dealing with the issue, *Ridge Oil Co. v. Guinn Invest.*, 148 S.W.3d 143 (Tex. 2004), contains extensive dicta that indicates a cessation may be temporary if production ceases for reasons other than sudden stoppage. The Court cited the following examples of temporary cessations that did not involve a sudden stoppage or mechanical breakdown:
- i. Litigation and gas line obstructions (*Midwest Oil Corp. v. Winsauer*, 323 S.W.2d 944, 945-46 (Tex. 1959));
 - ii. The well began producing sand, water and sediment that cut off connection to the gas, with recovery efforts having been undertaken (*Stuart v. Pundt*, 338 S.W.2d 167, 168 (Tex. Civ. App.—San Antonio 1960, writ ref'd.));
 - iii. Inadequate gas pressure to enter lines that was promptly and successfully remedied with a compressor (*Cobb v. Natural Gas Pipeline Co.*, 897 F.2d 1307 (5th Cir. 1990)); or
 - iv. Gas pipeline contract expired and new contract was negotiated (*Casey v. Western Oil & Gas, Inc.*, 611 S.W.2d 676 (Tex. Civ. App.—Eastland 1980, no writ)).

The dicta concludes that foreseeability and avoidability are not essential elements of the temporary cessation of production doctrine. *Ridge Oil, supra*, 148 S.W.3d at 152.

2. Even when a temporary cessation of production occurs, the lessee must use diligence to remedy the defect and resume production within a reasonable period of time. *Watson v. Rochmill, supra*, 155 S.W.3d at 784; *Cobb, supra*, 897 F.2d at 1309.
3. Where the evidence conflicts regarding the issue of cessation, it is a fact question. The lessee has the burden to prove it exercised diligence to regain production. *Bradley v. Avern*, 746 S.W.2d 341, 343 (Tex. App.—Austin 1988, no writ).

B. Leases that last "as long as oil or gas can be produced." A habendum clause that says "as long thereafter as gas is or can be produced" is sustained by a well that is "actually producing or capable of producing gas." *Anadarko*, 94 S.W.3d at 557 (*emphasis added*). "Capable of production" is construed to mean "a well that will produce in paying quantities if the well is turned 'on' and it begins flowing, without additional equipment or repair." 94 S.W.3d at 558.

1. A well is incapable of production if the lessee removes the equipment and abandons efforts to produce (*Texas Co. v. Davis*, 254 S.W. 304, 309; affirmed on rehearing 255 S.W. 601 (Tex. 1923)); or if the underlying reserves are depleted (*Pack v. Santa Fe Minerals*, 869 P.2d 323, 327 (Okla. 1994)).
2. On rehearing, the five justices from the *Anadarko* court said *Anadarko* had not overruled the long-standing rule in *Clifton v. Koontz*, 325 S.W.2d 684 (Tex. 1959) (further discussed in Question 4 below), that "there must be facilities located near enough to the well that it would be economically feasible to establish a connection so that production could be marketed at a profit." *Anadarko*, *supra* 94 S.W.3d at 559.

The test is "whether there is a reasonable basis for the expectation of profitable returns from the well" as opposed to continuing "to operate [the] well merely for speculation." *Id.*

4. If the wells on a lease produce only a small amount of revenue each month, is it possible the lease may have terminated?

Yes. Only production in "paying quantities" will sustain a lease beyond the primary term. *Garcia v. King*, 164 S.W.2d 509 (Tex. 1942).

- A. There is a two-part test to determine whether the wells on a particular lease are producing in paying quantities. First, the wells on the lease, over a "reasonable" period of time, must have operated at a profit. If so, that by itself is enough to sustain the lease. Second, even if there is no actual profit over a reasonable period of time, the lease can still continue if the court determines a reasonably prudent operator would continue to operate the well, for profit and not for speculation. As the

Supreme Court said in the leading case on the issue: "The lessors should not be required to suffer a continuation of the lease after the expiration of the primary period merely for speculative purpose on the part of lessees." *Garcia v. King*, 164 S.W.2d 509, 513 (Tex. 1942).

1. In determining whether the lease operates at a profit, one begins with totaling the gross revenues paid with respect to the working interest. *Clifton v. Koontz, supra*, 325 S.W.2d at 691 (Tex. 1959). Overriding royalty paid out of the working interest is included as a component of gross revenues. *Id.* at 693. Royalty paid to the lessor is not. *Garcia v. King, supra*, 164 S.W.2d at 510.
 2. Next, all lifting and production costs are deducted. Drilling and completion costs are not deducted. *Clifton v. Koontz, supra*, 325 S.W.2d at 692. Examples of items deducted are: operating labor, power, supplies, severance taxes, property taxes, licenses and permits, replacement and repair of equipment, maintenance and repair of roads, fences and gates, telephone (R. Hemingway, OIL AND GAS LAW AND TAXATION, §6.4 at 258 (4th ed. Thomson West 2004)), depreciation of producing equipment (*Clifton v. Koontz, supra*, 325 S.W.2d at 692; *Skelly Oil v. Archer*, 356 S.W.2d 774, 781 (Tex. 1961)); and a pro rata share of administrative overhead (*Skelly*, 356 S.W.2d at 781-82; and *Sullivan & Garnett v. James*, 308 S.W.2d 891, 893 (Tex. Civ. App.—San Antonio 1957, writ ref'd n.r.e.)).
 3. If the arithmetic results in a profit, however small, the lease is sustained in the secondary term. *Garcia v. King*, 164 S.W.2d at 511.
- B. The following factors are considered in determining whether a reasonably prudent operator would continue to operate the well for profit and not for speculation:

The depletion of the reservoir and the price for which the lessee is able to sell his produce, the relative profitableness of other wells in the area, the operating and marketing costs of the lease, his net profit, the lease provisions, a reasonable period of time under the circumstances, and

whether or not the lessee is holding the lease merely for speculative purposes.

Clifton v. Koontz, supra, 325 S.W.2d at 691.

5. If I think the lease may have terminated, but the oil company is still operating, how long do I have before I must file suit?

The safest practice is to file suit within three years after the lease is terminated. "Once the lease is terminated, the oil company has no interest whatsoever in the mineral, and the entire mineral estate reverts to the lessor." *Natural Gas Pipeline v. Pool, supra*, 124 S.W.3d at 194. At that point, the lessor has the exclusive right to all the proceeds from production, subject only to an equitable accounting to the former lessee for the actual cost of production. *Id.* at 197. If the oil company continues to produce, it does so in contravention of the lessor's ownership. That means the lessee who continues to operate the well does so as a trespasser. If the operator continues long enough, it will re-establish the lease by adverse possession. *Id.* In *Pool* the Court held the oil company had, as a matter of law, re-established its fee simple determinable interest in the mineral estate by adverse possession, with the same terms and conditions as were contained in the original lease. *Id.* at 199.

The shortest real estate statute of limitation is three years, which requires a claim under title that connects with the sovereignty of the soil or under color of title, which may include valid, but unrecorded instruments. TEX. CIV. PRAC. & REM. CODE §16.021, and §16.024. Next is the five-year statute, which requires a duly registered deed and payment of all property taxes. *Id.* at §16.025(a). The principal adverse possession statute is ten years, which requires peaceable and adverse possession by one who "cultivates, uses, or enjoys" the property. *Id.* at §16.026(a).

A lessee who holds over after the fee interest has reverted to the lessor must in some manner repudiate the lessor's mineral interest before the adverse possession statute will begin. *Natural Gas Pipeline v. Pool, supra*, 124 S.W.3d at 195. Repudiation of the lessor's mineral interest may be inferred by the lessee's long-continued production and sale of the minerals. *Id.* at 194. Although the Court stated that "all of the requirements of the three-, five- and ten-year statutes of limitations were met" in *Pool* (*Id.* at 198), it is not clear how the Court concluded that possession following reversion of a determinable fee is a claim *under* either "title or color of title" or a "duly registered deed,"

so as to satisfy the three- and five-year statutes. TEX.CIV.PRAC. & REM. CODE §§16.024, 16.025(a)(3). "When a lease expires, [t]he estate which was granted has merely run its course." *Duke v. Sun Oil Co.*, 320 F.2d 853, 858 (5th Cir. 1963). The recorded (and later terminated) lease affords no new constructive notice to the owner of the possibility of reverter that would justify the reduced limitations provided. In fact, later in its opinion, the *Pool* Court added that because "adverse possession under the ten-year statute was conclusively established, . . . [the Court] need not consider whether there was error in the charge to the jury regarding the three- and five-year statutes of limitations." *Id.* at 201.

6. How long can the oil company hold my lease by paying only shut in royalties?

Most printed form shut in royalty clauses are not limited as to time. Nonetheless, respectable authority suggests the lessee has only a reasonable time to begin marketing production.

In any situation where oil is stored rather than sold or a well capable of producing in paying quantities is shut in, an undue delay in finding a purchaser may give rise to a claim that the marketing covenant has been breached. Courts and commentators are generally in agreement that a lessee is obligated to market production from a gas well within a reasonable time. What constitutes an unreasonable delay is, of course, a question of fact, which depends on the circumstances of each case. The current market price of gas and reasonable projections of what may happen to the price in the future are factors, which should have a bearing on this determination.

E.E. Smith and J. L. Weaver, TEXAS LAW OF OIL AND GAS, §5.4(B) at 5-44—5-45 (2d ed. LexisNexis 2005) The Supreme Court's opinion on rehearing in *Anadarko* leaves little doubt that the oil company's implied duty to market the gas reasonably limits its ability to sustain a lease based only on the capability of production. *Andarako, supra*, 94 S.W.3d at 559-560. In such a case however, the royalty owner's normal remedy is a claim for damages, not termination. *Id.*

There are other points to remember about shut in royalties.

Shut in royalties cannot sustain a lease if the gas well is not capable of producing in paying quantities. *Kidd v. Hoggett*, 331 S.W.2d 515, 519 (Tex. Civ. App. –San Antonio 1959, writ ref'd n.r.e.), Pope, J. Unlike production royalties, failure to timely pay shut in royalties results in termination of the lease. *Freeman v. Magnolia Petroleum Co.*, 171 S.W.2d 339, 341-42 (Tex. 1943) and *Gulf Oil Corp. v. Reid*, 337 S.W.2d 267 (Tex.1960). Respected secondary authority and cases from other states have held that a shut in royalty clause could be worded in such a fashion that failure to timely pay royalty would not result in termination. *Hemingway, supra*, 6.5 at 277-78.

The language of the shut in royalty clause must be carefully examined. Many wells produce both oil and gas. Some shut in royalty classes apply to wells that produce gas only. E.g. *Duke, supra*, 320 F.2d at 858. If there is no immediate market for the gas, and it must be recycled to sell the condensate that is produced with the gas, those recycling costs must be deducted in determining whether the well is producing in paying quantities. *Id.* at 862-63.

7. My lease has been pooled with other leases that seem more calculated to tie up the most property; rather than recover the oil and gas efficiently. How can I know whether the oil company has the right to do this?

Pooling clauses are included in most leases to enable the oil company to efficiently produce the minerals located in the leased area. The oil company only has a right to pool if it is expressly granted in the lease, and pooling requires that these lease terms be followed precisely. *Jones v. Killingsworth*, 403 S.W.2d 325 (Tex. 1965).

Even if the lease contains an express right to pool, the exercise of that right is subject to an implied duty to pool in fairness and good faith. *Elliott v. Davis*, 553 S.W.2d 223, 226-27 (Tex. Civ. App. -- Amarillo 1977, writ ref'd n.r.e.). It must also be done in strict accordance with the pooling clause in the lease. *Browning Oil Co. v. Luecke*, 38 S.W.3d 625, 640-42 (Tex. App. – Austin 2000, pet. denied). The duty to pool in good faith has been interpreted as an obligation for the oil company to act as a reasonably prudent operator under the same or similar circumstances, giving due regard to the owner's interest as well as its own interest. *Amoco Prod. Co. v. Alexander*, 622 S.W.2d 563, 570-71 (Tex. 1981); *Circle Dot Ranch, Inc. v. Sidwell Oil & Gas, Inc.*, 891 S.W.2d 342, 346 (Tex. App.-Amarillo 1995, writ denied).

The question of whether the oil company pooled the lease in good faith is one of fact, dependent on the particular circumstances of the case. However, some circumstances that have been considered to be probative and sufficient to support a finding of improper pooling are:

- Drawing boundaries of a pooled unit to perpetuate as many leases as possible rather than to accomplish a permissible pooling goal, *Elliott v. Davis*, 553 S.W.2d 223, 226-27 (Tex. Civ. App. -- Amarillo 1977, writ ref'd n.r.e.)
- Gerrymandering of unit boundaries—pooling small portions of several leaseholds to form a proration unit that could have been formed from one or fewer leaseholds, *Circle Dot Ranch, supra*, 891 S.W.2d at 347.
- Express statements that unit boundaries have been drawn to maintain leases, *Amoco v. Underwood*, 558 S.W.2d 509, 512-13 (Tex. Civ. App.- Eastland 1977, writ ref'd n.r.e.).
- Pooling an undrilled tract shortly before the end of the primary term, *Elliott v. Davis*, 553 S.W.2d at 227; *Circle Dot Ranch*, 891 S.W.2d at 347
- Failure to consider geological factors in forming the unit, *Elliott*, 553 S.W.2d at 227
- The absence of plans for additional development, pooling portions of leases with smaller royalties with a well-site lease that has ample acreage to support the well, *Amoco v. Underwood*, 558 S.W.2d at 511-12
- Exclusion of productive acreage located near the well, and inclusion of unproductive acreage or of acreage which is probably not within the well's drainage pattern, *Circle Dot Ranch*, 891 S.W.2d at 347
- Rejection of the pooled unit by the Railroad Commission is relevant but is not a determinative factor, *Elliott v. Davis*, 553 S.W.2d at 226

8. What remedies are available to me if the oil company pooled my lease with others in bad faith?

The mineral owner may cancel the pooled unit as to his particular lease, if no well is located on the owner's land. *Elliot v. Davis, supra*. In addition, the mineral owner may be entitled to damages, which will vary, depending upon the circumstances of each case. The objective is to award the lessor those royalties that it would have been due under the lease had the lease not been improperly pooled. *Browning, supra*, 38 S.W.3d at 642-47 (lessor of one tract with one drainhole out

of several drainholes in a horizontal well is entitled to royalty on production attributed with "reasonable probability" to lessor's tract; the "fact that exact amount of oil produced cannot be precisely determined is no reason for denying recovery").

9. What are implied covenants in an oil and gas lease?

The three implied covenants acknowledged by the Texas Supreme Court are (1) the covenant to develop the premises, (2) the covenant to protect the leasehold, and (3) the covenant to manage and administer the lease. *Amoco Prod. Co. v. Alexander, supra*, 622 S.W.2d at 567. Included within the covenant to manage and administer are the duties to operate reasonably, to market reasonably, to seek favorable administrative action, and to use successful new technology. *Smith and Weaver, supra*, § 5.1(B) at 5-5; and *Yzaguirre v. KCS Resources, Inc.*, 53 S.W.3d 368, 373 (Tex. 2001).

Implied covenants have traditionally been a part of Texas leases. "A covenant will not be implied unless it appears from the express terms of the contract that 'it was so clearly within the contemplation of the parties that they deemed it unnecessary to express it' and therefore they omitted to do so, or 'it must appear that it is necessary to infer such a covenant to effectuate the full purpose of the contract as a whole as gathered from the written instruments.'" *HECI Exploration Co. v. Neel*, 982 S.W.2d 881, 888 (Tex. 1998) (quoting *Danciger Oil & Refining Co. of Tex. v. Powell*, 154 S.W. 632, 635 (Tex. 1941)). "[T]here is no implied covenant when the oil and gas lease expressly covers the subject matter of an implied covenant." *Yzaguirre, supra*, 53 S.W.3d at 373.

10. What duties does the oil company have to prevent drainage from my lease?

The implied covenant of the oil and gas company to protect the leasehold includes the duty to act as a reasonably prudent operator would to prevent substantial drainage of oil or gas from the lease. This duty extends not only to a localized occurrence across the lease line, but also to field wide drainage. "Substantial drainage" means drainage of oil or gas from the lease that is more than minor drainage. Various ways in which the oil company could prevent such drainage include: (1) drilling additional wells; (2) re-working existing wells; (3) drilling replacement wells; (4) seeking exceptions or other relief, as may be necessary, from the Railroad Commission or other administrative agencies; (5) seeking voluntary unitization; (6) seeking compulsory

pooling; or (7) taking other action. However, a reasonably prudent operator is only required to take such action(s) if there is a reasonable expectation of making a profit after deducting all operating expenses and capital costs associated with such actions. *Amoco Prod. Co. v. Alexander, supra*, 622 S.W.2d at 568 .

11. What remedy do I have if the oil company failed to prevent substantial drainage as a reasonably prudent operator would?

The measure of damages for the oil company's failure to prevent substantial drainage as a reasonably prudent operator would is the royalty lost on past and future production by such failure. *Mandell v. Hamman Oil & Refining Co.*, 822 S.W.2d 153, 164 (Tex. App.-Houston [1st Dist.] 1991, writ denied); *Wes-Tex Land Co. v. Simmons*, 566 S.W.2d 719, 721 (Tex. Civ. App. -- Eastland 1978, writ ref'd n.r.e.). Proof of lost royalty requires expert geological and/or petroleum engineering testimony.

One should not undertake such a case without making sure the expert's testimony is based upon reliable data, sound scientific methods and procedures, and that there is no analytical gap in the expert's reasoning. *Kerr-McGee Corp. v. Helton*, 133 S.W.3d 245 (Tex. 2004). It would be foolhardy to undertake such a case without understanding *Kerr-McGee v. Helton*. The goal is to use expert testimony that is based on methods that are used in the industry to make the same decision. *Id.* at 261-62, Hecht J. concurring. Or, as described by Justice Brister, the "expert's failure to explain how various factors affected his calculations rendered [his] opinion unreliable." *Neeley v. West Orange Cove Consol. Sch. Dist.*, 176 S.W.3rd 746, 812 (Tex. 2005), Brister J. dissenting.

12. Does the oil company have a duty to drill, whether it is an exploratory well or development well?

Maybe, but it would be hard to force them to drill. The implied covenant of the oil and gas company to develop the premises includes a duty to drill any and all wells that a reasonable and prudent operator would drill under the same or similar circumstances, with a reasonable expectation of profit. This duty to drill extends to both already producing formations or strata, and also other formations or strata that in reasonable probability exist and are known to be capable of production. *Sun Exploration & Prod. Co. v. Jackson, supra*, 783 S.W.2d at 204. The considerable practical burden of establishing the

necessary facts with expert testimony that meets the “exacting standards” of *Kerr-McGee v. Helton, supra*, apply here as well.

13. What remedy do I have if the oil company breached its duty to drill wells that a reasonable and prudent operator would drill?

The two remedies available to the mineral owner are monetary damages or, in extraordinary circumstances, a conditional decree canceling the lease. The mineral owner is generally required to seek monetary damages, unless it conclusively appears that such damages cannot be ascertained with the degree of certainty required in such situations. *Christie, Mitchell & Mitchell Co. v. Howell*, 359 S.W.2d 658, 660 (Tex. Civ. App. -- Fort Worth 1962, writ ref'd n.r.e.). If the mineral owner wants cancellation of the lease instead, he bears the burden of showing that monetary damages cannot be determined with reasonable certainty. Only if the mineral owner makes this showing is he then entitled to seek a cancellation of the lease. Moreover, Texas generally follows the view that conditional cancellation is the preferred remedy when cancellation is sought, but the cases suggest that under some circumstances, absolute cancellation might be appropriate, if it appears that conditional cancellation would be futile. See generally *W. T. Waggoner Estate v. Sigler Oil Co.*, 19 S.W.2d 27 (Tex. 1929); see also the Court of Appeals opinion in *Sun Exploration & Prod. Co. v. Jackson*, 715 S.W.2d 199, 205-06 (Tex. App.--Houston [1st Dist.] 1986), reversed on other grounds, 783 S.W.2d 202 (Tex. 1989).

Monetary damages are measured by the amount of royalty the mineral owner would have received from the wells if the oil company had drilled them as it should have. If the wells that the mineral owner alleges should have been drilled have a projected period of production that extends into the future past the date of trial, then he is entitled to both the past and the future income stream for the well or wells, with the future income stream being discounted back to a present value at the time of trial. The mineral owner may also be able to obtain prejudgment interest on the portion of the verdict reflecting royalty that the mineral owner would have received up until time of trial, *i.e.*, the past income stream.

14. Does the oil and gas company have a duty to market the oil and gas reasonably?

Yes, the implied covenant to manage and administer the lease includes the duty to market the oil and gas reasonably. *Yzaguirre, supra.*, 53 S.W.3d at 373. Normally that means the lessee must act as a

reasonably prudent operator, e.g., to install pumps on an oil well. *Rhoads Drilling v. Allred*, 70 S.W.2d 576, 584-85 (Tex. 1934). Where royalty is based on market value, the lessee has the duty to obtain the best current market price reasonably available. *Cabot Corp. v. Brown*, 754 S.W.2d 104, 106 (Tex. 1987). But where, due to fortuitous circumstances, the lessee under a lease that bases royalty on market value is actually receiving more than the current market price for gas, it may base its royalty payment on market price and not the amount realized. *Yzaguirre, supra*, 53 S.W.3d at 374. Where the lessee is a purchaser or where it has an interest in the sale that differs from lessor's, the lessee must exercise good faith in marketing the gas. *Amoco Prod. Co. v. First Baptist Church of Pyote*, 579 S.W.2d 280, 287 (Tex. Civ. App.--El Paso 1979, writ ref'd n.r.e.), *per curiam*, 611 S.W.2d 610 (Tex. 1980).

15. I received a division order from an oil and gas company that concerns my royalty interest. Should I sign it?

One can be comfortable signing a division order if: (1) the division order contains no provision other than those prescribed by Texas' Division Order Statute, TEX. NAT. RES. CODE §91.402, and (2) the ownership interest is correctly reflected.

A. Provisions permitted by the Division Order Statute.

§ 91.402 (c)(1) allows the royalty payor to insist upon a division order with only the following provisions as a condition of payment:

- Effective date
- Property description
- Type of production
- Fractional interest claimed, agreement to notify payor one month before any sale, and undertaking to indemnify payor if payee does not have merchantable title to interest certified
- Authorization to suspend payments in event of dispute over ownership
- Payee's name, address, and tax identification number

- Provision for valuing and timing payments

B. Risks associated with confirming an erroneous interest:

If an operator fails to pay or underpays a royalty owner who has not executed a division order, the royalty owner is clearly entitled to receipt of back payments for the period allowed by the four-year statute of limitation. . . . Where the royalty owners have themselves contributed to the erroneous allocation of payments by signing division or transfer orders that the operator relies on in overpaying one royalty owner and underpaying another, the underpaid owner's recourse is against the party who benefited from the error, rather than the operator,

Smith and Weaver, supra, §6.5E at 6-26-6-27, citing *Harrison v. Bass Enters. Prod. Co.*, 888 S.W.2d 532, 537-38 (Tex. App.-- Corpus Christi 1994, no pet.); and *Chicago Corp. v. Wall*, 293 S.W.2d 844, 847 (Tex. 1956).

- C. See footnote 1 to paragraph 16(B)(2) below for specific language to insert into any division order between someone other than lessor and a royalty recipient.

16. I received a division order years ago from an oil and gas company and signed it. Now I am wondering if I should have done so. What are my rights at this point?

- A. Binding Until Revoked. Both case law and the Texas Division Order Statute support the general rule regarding division orders that they are binding until revoked. See *Exxon v. Middleton*, 613 S.W.2d 240 (Tex. 1981); TEX. NAT. RES. CODE ANN. §91.402(g). Accordingly, a royalty owner (or the oil and gas company) may revoke the division order at any time upon 30 days written notice.

B. Limitations on the General "Binding Until Revoked" Rule.

1. The Gavenda Exception: The oil company cannot retain the benefits of a division order that incorrectly allocates payments among the various interest owners. *Gavenda v. Strata Energy, Inc.*, 705 S.W.2d 690 (Tex. 1986) (division

order understated royalty due lessor, and did not pay the additional amount to other royalty owners).

2. Statutory Restrictions: TEX. NAT. RES. CODE § 91.402(h) states that:

(a) the execution of a division order between a royalty owner and the lessee or between a royalty owner and a third party shall not change or relieve the lessee's specific, express or implied obligations under an oil and gas lease, and (b) any provision of a division order between the royalty owner and the lessee that is in contradiction with any provision of the lease is invalid to the extent of such contradiction.¹

Even so, a division order may be used to clarify royalty settlement terms in the oil and gas lease. TEX. NAT. RES. CODE ANN. §91.402(i). One appeals court has held that the lessee cannot rely upon a third party division order to escape liability for failing to pay the interest owner's royalties under the lease. See *Williams v. Baker Exploration Co.*, 767 S.W.2d 193 (Tex. App.—Waco 1989, writ den'd).

17. I sold some royalty to someone who offered by mail to buy it. I now feel as if they did not tell me everything they knew about the property. Is there any way I can get my interest back?

You can if the purchaser used any form of deception, either express or by failure to provide material information. In addition to common law fraud and statutory real estate fraud, both of which normally require express misrepresentations, the Texas Securities Act and the Texas Theft Liability Act provide causes of action under certain circumstances for failure to disclose material information.

¹ The portion of §91.402(h) discussing the invalidity of any contradictory provisions in the division order only applies, by its terms, to division orders between royalty owners and lessees. A third party purchaser may be protected by the division order until it is revoked, even if it contradicts the lease. Therefore, it is suggested that, when a mineral owner signs a division order with a third party purchaser, rather than the lessee, the mineral owner insert a statement in the division order that any provision of the division order that contradicts the lease shall be disregarded, and the lease shall control in the event of any conflict between the two documents.

- A. The Securities Act entitles a seller of a “security” to either rescind a sale or recover damages from a buyer who failed to “state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.” TEX. REV. CIV. STAT. ANN. art. 581.33(B). A buyer who did not know of the omission or could not have known about it by exercising reasonable care will not be liable. *Id.*

TEX. REV. CIV. STAT. art. 581-4 defines “security” as, among other things, any “certificate or any instrument representing any interest in or under an oil, gas or mining lease, fee or title.”

While this definition appears to clearly include an oil and gas lease, it has been held that a purchase or sale of an oil and gas lease is not a security subject to the Act. *See Allen v. Sorenson*, 388 S.W.2d 757, 759 (Tex. Civ. App.—Beaumont 1965, writ ref’d n.r.e.); *Culver v. Cockburn*, 127 S.W.2d 328, 330 (Tex. Civ. App.—Galveston 1939, writ dism’d). Those cases involved the creation of a new oil and gas lease, or in the words of the Dallas Court of Appeals, the “purchase or sale” of a lease. *Rose v. State*, 716 S.W.2d 162, 166 (Tex. Crim. App 1986), *cert. denied*, 486 U.S. 1055. On the other hand, Texas courts have clearly held that an *assignment* of an oil and gas lease is a security subject to the Texas Securities Act. *Id.*; *see also Kadane v. Clark*, 143 S.W.2d 197, 199 (Tex. 1940); *Muse v. State*, 132 S.W.2d 596, 597 (Tex. 1939).

- B. The Theft Liability Act provides that “a person who commits theft is liable for the damages resulting from the theft” plus “reasonable and necessary attorneys fees.” TEX. CIV. PRAC. & REM. CODE §134.003(a), 134.005(b).

Theft means, among other things, unlawfully obtaining property as described by TEXAS PENAL CODE §31.03. TEX. CIV. PRAC. REM. CODE §134.002(2). Penal Code §31.03 provides that

A person commits an offense if he unlawfully appropriates property with intent to deprive the owners of property. Appropriation is unlawful if (1) it is without the owner’s effective consent. Consent is not effective if it is induced by deception . . .

“Deception” means

- (a) creating or confirming by words or conduct a false impression of law or fact that is likely to affect the judgment of another in the transaction, and that the actor does not believe to be true;
- (b) *failing to correct a false impression of law or fact that is likely to affect the judgment of another in the transaction, that the actor previously created or confirmed by words or conduct, and that the actor does not now believe to be true. . . .*

Tex. Penal Code §31.01(1) (*emphasis added*).

- C. No determination has yet been made whether either the Securities Act or the Theft Liability Act are subject to the proportionate responsibility statute (TEX. CIV. PRAC. & REM. CODE ch. 33). The proportionate responsibility statute applies to any cause of action based in tort. *Id.* at §33.002 (a). It has been held that the proportionate responsibility statute does *not* apply to statutory real estate and securities fraud, because of the long-standing tradition that negligence is not a defense to a fraud claim and the legislature did not include statutory fraud within the proportionate responsibility statute as it did the DTPA. *Davis v. Ethridge*, 85 S.W.3d 308, 311-12 (Tex. App.--Tyler 2001, pet denied).

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