VOL. 1 | ISSUE 2

MCGINNIS LOCHRIDGE

Producer's Edge

TEXAS OIL AND GAS LAW BULLETIN

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About the *Producer's Edge*

The McGinnis Lochridge Oil and Gas Practice Group publishes the *Producer's Edge* with the purpose of keeping our valued clients and contacts in the oil and gas industry updated and informed regarding interesting Texas case law, regulatory developments, as well as providing insightful articles relevant to the oil and gas community.

In this edition, we present several insightful articles, including an article covering the recent *Barrow-Shaver* opinion from the Texas Supreme Court involving the role of expert witness testimony in contract construction cases. We also included an article surveying surface use disputes, an article discussing a recent drainage/offset case, and an article discussing acreage assignment issues at the Texas Railroad Commission. In addition, we welcome a guest article from the International Trade and Transactions Practice Group, analyzing key legal factors when engaging in international oil and gas transactions. Finally, we provide a short summary of several recent Texas oil and gas cases, and a listing of oil and gas cases pending before the Texas Supreme Court.

If your friends or colleagues would like to receive the Producer's Edge, please invite them to sign up for our alerts and updates here.

If you have any comments, questions, or concerns, please do not hesitate to contact authors directly, or send an email to *oilandgas@mcginnislaw.com*.

Visit our blog, OilandGasLawDigest.com to stay up to date on case updates.

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EVENTS, PRESENTATIONS AND PAPERS:

UPCOMING

- Houston Association of Division Order Analysts, *Texas Case Law Update*, presented by Austin Brister and Marcus Eason **— August 21, 2019**
- Advanced Civil Trial Law — TexasBar CLE, *Update on Oil & Gas Law*, Houston, Texas, presented by Chris Halgren **— August 22, 2019**
- 37th Annual Advanced Oil, Gas & Energy Resources Law, *Changes to the MIPA in Horizontal Drilling*, presented by Tim George **— September 19, 2019**
- 37th Annual Advanced Oil, Gas & Energy Resources Law, *State Preemption of Local Ordinances*, presented by Bruce Kramer **— September 20, 2019**
- 37th Annual Advanced Oil, Gas & Energy Resources Law, *Trespass Cases*, presented by Donald D. Jackson **— September 20, 2019**
- McGinnis Lochridge Seminar, *Employment Law Initiatives — Now and Looking Ahead*, Houston, Texas, presented by the McGinnis Lochridge Employment, Labor and Employee Benefits Practice Group **— September 26, 2019**

RECENT EVENTS, PRESENTATIONS & PUBLICATIONS

- TELJ 9th Annual Symposium, Changing Environments: *The Future of Natural Resource Law*, panel speaker, Of Counsel Bruce Kramer **— March 29, 2019**
- 45th Annual Ernest E. Smith: Oil, Gas and Mineral Law Institute, *Railroad Commission Update*, presented by Partner Tim George **— March 29, 2019**
- Oil, Gas and Mineral Law Section of the Austin Bar Association Luncheon, *Surface Disputes*, presented by Partner, Austin Brister **— April 10, 2019**
- Donald D. Jackson quoted in *Law360*, "Permian Ripe For Mergers As Big Oil Aims For Prime Assets" **— April 15, 2019**
- Texas Tech Law School Roswell CLE, *Current Developments in Oil and Gas Law*, presented by Bruce Kramer **— May 2, 2019**
- Houston Association of Professional Landmen, 2019 Spring Seminar, *Update on Recent Texas Case Law, and Pending Cases*, presented by Partner Austin Brister and Associate Ana P. Navarrete **— May 4, 2019**
- SCG Legal 2019 Midyear Meeting, *Global Prospects for the Energy Sector*, Co-presented by Donald D. Jackson **— May 17, 2019**
- 65th Annual Rocky Mountain Mineral Law Institute, *IPAA Law Luncheon, Texas Oil and Gas Legal Update,* presented by Bruce Kramer **— July 18, 2019**
- Advanced Civil Trial Law — TexasBar CLE, *Update on Oil & Gas Law*, San Antonio, Texas, presented by Chris Halgren **— July 18, 2019**
- Austin Brister and Ana P. Navarrete article published in *Landman Magazine*, "Four Recent Drainage and Offset Cases: A Texas Litigation Trend?" **— July/August 2019**

RECENT CASES

Offset Obligations: Court Holds Offset Obligation Not Dependent on an Expectation of Profit or Actual Drainage

Bell v. Chesapeake Energy Corp, 2019 Tex. App. LEXIS 1978, 2019 WL 1139584 (Tex.Civ.App.—San Antonio, 2019, no pet)

By: Austin Brister

In the last edition of *Producer's Edge*, we surveyed several recent offset cases. Those cases illustrate that horizontal shale plays have brought several unique twists and complications, which can significantly alter the traditional notion of an "offset well." In addition, Texas courts focus on a careful reading of the actual language within an offset provision when determining both when and how to drill an offset well.

A recent case out of the San Antonio Court of Appeals, *Bell v. Chesapeake Energy Corp*, continues this trend of offset lawsuits. The *Bell* case addresses whether two different offset provisions required the lessors to prove the reasonable prudent operator standard, and how to calculate compensatory royalties for an adjacent horizontal well.

Issue 1: Whether these offset provisions require the lessors to prove the reasonable prudent operator standard?

Offset provisions sometimes (perhaps unintentionally) incorporate the reasonable prudent operator standard. This can have a material impact not only on how to drill an offset well, but also whether the lessee has the obligation to drill the offset well in the first place. Where this standard is incorporated within an offset provision, lessors are required to prove (1) actual and substantial drainage, and (2) a reasonably prudent operator would drill an offset well to prevent substantial drainage and out of a reasonable expectation of profit. As a practical matter, these two additional requirements often substantially limit a lessee's offset obligations, as they can be extremely difficult or cost-prohibitive for a lessor to establish.

The *Bell* Court carefully construed the particular language in the two lease forms at issue. The offset clause in the "Bell Lease" provided, in part:

> In the event [an Adjacent Well]...is draining the Leased Premises or is deemed draining if the Adjacent Well is located within three hundred thirty (330) feet of the Leased Premises...then Lessee [1] agrees to drill such offset wells which is [sic] reasonably designed to protect the Leased Premises from drainage, or [2] at the option of Lessee, shall pay to Lessor the Compensatory Royalties set forth below, or [3] execute and deliver to Lessor a release...

The "Ward Lease" was similar in that it also defined "deemed" drainage and gave the lessee the options to drill, release, or pay compensatory royalty. One key difference was that the offset provision in the Ward Lease did not include language referencing protection from drainage. However, a separate provision in the Ward Lease more broadly indicated a similar concept: "Lessee also hereby expressly covenants and agrees to diligently and fully explore, develop, and protect the Leased Premises as a reasonably prudent operator."

Chesapeake argued that, by describing the offset well as being "reasonably designed to protect the Leased Premises from Drainage," the Bell Lease incorporated the reasonable prudent operator standard. Chesapeake argued that the Ward lease reached the same result because its more general provision incorporated the standard into every provision in the lease.

The San Antonio Court of Appeals disagreed. The court construed the provisions, and held that they were "clear, direct, and mandatory" in describing three total conditions to the obligation and three total choices once triggered. The three conditions are: (1) the existence of an adjacent well, (2) within the trigger distances, (3) that production has begun. The three choices are (1) drill an offset well, (2) pay compensatory wells, or (3) execute a partial release.

The court explained that Chesapeake's interpretation contradicts this express language because it would impose two additional conditions and would grant an additional choice. The additional conditions are substantial drainage and reasonable expectation of profit, and the additional choice is to do nothing.

Chesapeake argued that "deemed drainage" does not mean "deemed substantial drainage." However, the court said "it would defy logic" to deem drainage to exist, but to nevertheless require the lessor to prove the extent of that drainage and require proof that an offset well would protect against that drainage and produce a profit.

The court also distinguished several prior offset cases relied upon by Chesapeake. For example, in *Mzyk v. Murphy* an offset provision incorporated the reasonable prudent operator standard because it required the lessee to "drill such offset well... as a reasonably prudent operator would drill under the same or similar circumstances." The court explained that the Bell and Ward Leases are distinguishable because they do not expressly reference the reasonably prudent operator standard, and because the *Mzyk* lease did not contain "deemed drainage" language.

As a result, the *Bell* Court held that these offset provisions do not incorporate the reasonable prudent operator standard.

Issue 2: How to calculate compensatory royalties for an adjacent horizontal wellbore

Finally, the *Bell* Court turned to whether compensatory royalties calculated on "production from the Adjacent Well" were to be based on production from the entire adjacent horizontal wellbore, or merely that portion within the triggering distances.

The court noted that the leases defined "Adjacent Well" in the singular. In addition, the definition did not depend on whether the well runs parallel to or away from the leased premises, and that a well could meet the definition even if only its surface location is within the triggering distance. As a result, the court concluded that compensatory royalties were to be computed on the basis of production from the entirety of an Adjacent Well.

CONCLUSION AND TAKEAWAYS

Landmen and lawyers alike should take note of *Bell v. Chesapeake*. It provides an illustrative example of how offset provisions can sometimes incorporate the reasonable prudent operator standard. When that standard is incorporated, it can sometimes significantly limit the scope of the lessee's obligations.

About the Author

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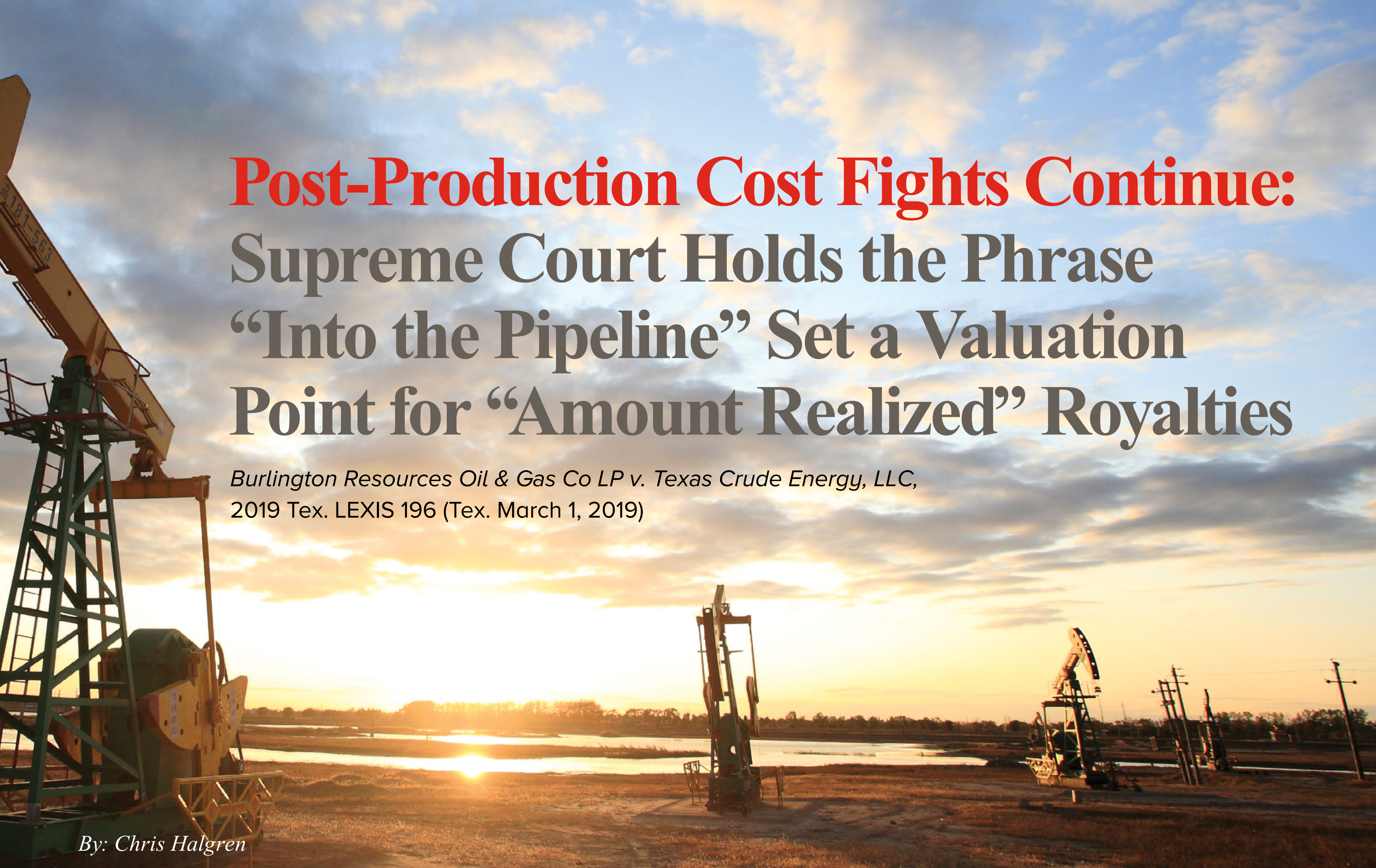

Post-Production Cost Fights Continue:

Supreme Court Holds the Phrase "Into the Pipeline" Set a Valuation Point for "Amount Realized" Royalties

Burlington Resources Oil & Gas Co LP v. Texas Crude Energy, LLC,
2019 Tex. LEXIS 196 (Tex. March 1, 2019)

By: Chris Halgren

In *Burlington Resources*, the Texas Supreme Court held that an oil and gas royalty assignment that required the royalty to be delivered "into the pipeline" permits the payor to deduct post-production costs from the royalty owners' payment, even if the agreement purports to prohibit such a deduction.

For years, Texas courts have found that when an oil and gas lease provides that royalty will be paid "at the well" or "at the mouth of the well," the lessee generally can pay royalties net of all reasonable post-production costs — even if the lease purports to prohibit such deduction. The reasoning has been that such language places the "valuation point," (ie, where the production must be valued for royalty payment purposes) at a point before any post-production costs would have been incurred. In leases with a valuation point "at the well," the Supreme Court has held that language prohibiting deductions for post-production costs as "surplusage" — or meaningless. In *Burlington Resources*, the Supreme Court held that the phrase "into the pipeline" mirrors the "at the well" designation and requires the same result.

Burlington Resources Oil & Gas LP ("Burlington") executed several agreements with Texas Crude Energy, LLC ("Texas Crude"), one of which was an assignment of an overriding royalty interest ("ORRI"). Texas Crude later assigned the ORRI to its affiliate, Amber Harvest, LLC. All ORRI assignments contained a similar "Granting Clause" and "Valuation Clause."

The Granting Clause provides:

> [Assignor] does hereby assign, transfer and convey unto [Assignee], its successors and assigns, those certain overriding royalty interests, as set out below, in the quantity described below in all oil, gas, condensate, drip gasoline and other hydrocarbons that may be produced and saved from those lands covered by those certain oil, gas and mineral leases described in Exhibit "A" attached hereto and made a part hereof for all purposes, and pursuant to the terms and conditions of the said oil, gas and mineral leases. Said overriding royalty interests shall be delivered to assignee into the pipelines,

> tanks or other receptacles with which the wells may be connected, free and clear of all development, operating, production and other costs. However, assignee shall in every case bear and pay all windfall profits, production and severance taxes assessed against such overriding royalty interest. (Emphasis added by the Supreme Court).

The Valuation Clause provides that the assignment "shall be subject to the following terms and conditions":

> The overriding royalty interest share of production shall be delivered to assignee or to its credit into the pipeline, tank or other receptacle to which any well or wells on such lands may be connected, free and clear of all royalties and all other burdens and all costs and expenses except the taxes thereon or attributable thereto, or assignor, at assignee's election, shall pay to assignee, for assignee's overriding royalty oil, gas or other minerals, the applicable percentage of the value of the oil, gas or other minerals, as applicable, produced and saved under the leases. "Value", as used in this Assignment, shall refer to (i) in the event of an arm's length sale on the leases, the amount realized from such sale of such production and any products thereof, (ii) in the event of an arm's length sale off of the leases, the amount realized for the sale of such production and any products thereof, and (iii) in all other cases, the market value at the wells. (Emphasis added by the Supreme Court).

Texas Crude sued Burlington, alleging that it was entitled to receive its royalty free and clear of post-production costs. Texas Crude argued that the Valuation Clause entitles Texas Crude to a share of royalty measured by the "amount realized" at the point of sale. It was uncontested that Burlington was selling its production downstream of the wellhead, though there was some dispute as to how for downstream production was being sold. Regardless, Burlington was incurring post-production costs prior to the point of sale and passing a portion of those costs along to Texas Crude. Texas Crude acknowledged the "into the pipeline" language, but argued that it was applicable if Texas Crude took its production in kind, which would then physically be delivered into the pipeline.

Burlington defended its decision to pay royalties net of post-production costs by arguing that the phrase "into the pipeline" is synonymous with phrases such as "at the well" or "at the mouth of the well" which previous cases have held denote the valuation point for royalty payment purposes. Burlington reasoned that the "into the pipelines" reference marks the physical location at which Texas Crude's interest in the product arises. Burlington also pointed the Supreme Court to language in other agreements entered into by the parties, which suggested that the royalty would be the "net proceeds" of the amount realized from the actual sale price.

Ultimately, the Supreme Court agreed with Burlington and held that the agreement permitted Burlington to pay royalties net of post-production costs. The Supreme Court referenced other commentators that seemed to acknowledge that the phrase "at the pipeline" can be used to identify the point where royalty is valued. Additionally, the Supreme Court explained that, though the phrase "amount realized" is used in the context of paying a cash royalty, that phrase has never been held to necessarily mean amount realized *at the p*oint of sale. After all, many cases involve royalty provisions requiring payment of royalty measured by the amount realized at the well, which would permit a lessee to tender royalties net of any post-production costs. The agreement at issue in *Burlington* did not expressly state that the "amount realized" would be determined at the point of sale. Instead, the Supreme Court concluded that in the context of these agreements, the phrase "amount realized" would be determined at the "pipeline."

While acknowledging that Texas Crude made good arguments and describing the assignment as "opaquely worded", the Supreme Court held that the proper reading of the documents was that the valuation point for royalty payments was set at the "pipeline" and permitted Burlington to pay royalties based on the amount realized from any sale, net of any post-production costs incurred between the pipeline and the point of sale.

About the Author

__Chris Halgren__ is a partner in our Houston office and a member of the Oil and Gas Practice Group. Chris represents clients in a wide variety of contract, tort, secured transactions and other civil litigation matters.

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Texas Supreme Court: Executive Duty Breached by Refusing to Lease

Texas Outfitters, Ltd., LLC v. Nicholson, 572 S.W.3d 647 (Tex. 2019)

By: Austin Brister

The Texas Supreme Court recently issued its opinion in *Texas Outfitters v. Nicholson*, addressing the duties an executive mineral owner owes to non-executive owners. The case focused on when an executive owner has a duty to sign a lease and to what extent efforts to protect or benefit the surface estate can impact this duty. The Court affirmed the trial court's judgment holding that the executive breached its duty and affirmed the trial court's award of $867,654.32 plus interest and costs.

The Essential Facts

The Carters owned the surface estate and a 50% mineral interest in the Derby Ranch in Frio County. The Hindeses owned the other 50% of the mineral estate. In 2002, for $1 million, the Carters sold the surface estate to Texas Outfitters, along with a 4.16% mineral interest and all executive rights. The Carters retained a 45.84% non-executive mineral interest.

Texas Outfitters' sole owner, Fackovec, testified that he intended to use the Derby Ranch as his residence and for his hunting business. The trial court found that Fackovec would not have purchased the ranch without the executive rights and corresponding control over future mineral development.

In 2010, El Paso offered to purchase a lease from Texas Outfitters. The Carters wanted Fackovec to accept that offer. Fackovec refused to accept that offer, testifying that he wanted to wait to try to get more money once the play matured. The trial court found that Fackovec "chose to gamble" with its interest and the Carters' much larger interest, despite knowing the Carters did not want to take that gamble, and despite knowing that additional offers were unlikely since the Hindeses had already signed a lease with El Paso.

At one point the parties reached a tentative settlement where, among other things, the Carters would agree to unspecified restrictive covenants burdening the mineral estate. These

settlement negotiations ultimately failed.

Prior to trial, Texas Outfitters reaped substantial benefits from its refusal to lease, because it was able to sell the ranch free of an oil and gas lease to the tune of $3.5 million – $2.5 million more than Texas Outfitters purchased the ranch from the Carters.

At a bench trial, the trial court determined that Texas Outfitters refused the lease in order to benefit its surface estate, and that its refusal constituted a breach of duties owed to the Carters.

Summary and Synthesis of Executive Rights Law

The Texas Supreme Court gave a thorough discussion of the nature of the duties owed by the holder of executive rights, and provided a comprehensive overview of standards and guiding principles. The Court explained that, in determining whether the executive has breached its duty in leasing or refusing to lease, "the controlling inquiry" is whether the executive engaged in acts of self-dealing that unfairly diminished the value of the non-executive interest. The Court clarified that this "controlling inquiry" applies to whether the challenged conduct consists of leasing or refusing to lease. This inquiry is "heavily dependent on the facts and circumstances."

The Court acknowledged that the parameters of this inquiry are "rarely straightforward," "difficult to determine," "imprecise," and "unsusceptible to a bright line rule." The Court discussed several prior decisions as providing "guiding principles" in the analysis. For instance, the "equal-benefits" principle holds that the executive must acquire for the non-executive every benefit that he exacts for himself. Conversely, the "no-subjugation" principle holds that an executive is not always required to subjugate the executive interest to the non-executive interest.

While these guiding principles are helpful in analyzing the "controlling inquiry," the Court explained that they "cannot be applied in a vacuum and must account for the fact that executives and non-executives often do not share in all the same economic benefits that might be derived from a mineral lease." For instance, executives often hold the exclusive right to bonus payments and/or the surface estate.

Analysis of Texas Outfitters

The Texas Supreme Court affirmed the trial court's judgment, finding that Texas Outfitters breached its duty to the Carters by refusing to lease under these circumstances.

Texas Outfitters argued that it could not have engaged in self-dealing by trying to obtain better lease terms that did not materialize. The Texas Supreme Court acknowledged that an executive generally does not breach his duty by declining a lease in honest anticipation of obtaining better terms for all (analogizing this to the "business judgment rule"). However, the trial court found that Texas Outfitters "cross[ed] the line from lawfully promoting his own surface interest to unlawfully doing so at the expense of the non-executive interest, thereby engaging in self-dealing that unfairly diminishes the value of that interest." The Court emphasized that the gamble was much larger for the Carters' interest, the Carters did not want to take that gamble, the pool of potential lessees was diminished by that time, and the trial court found that Texas Outfitters refused the El Paso lease in order to benefit its surface interest.

The Court also analogized the case with *Lesley v. Veterans Land Board*, 352 S.W.3d 479, 480-81 (Tex. 2011). In *Lesley*, a developer with executive rights entered into restrictive covenants constraining mineral development in a subdivision to protect future lot owners. The Court held that the restrictions breached the executive duties owner because the restrictions benefited the surface estate to the detriment of the non-executives, despite the fact the accommodation doctrine already provided "appropriate protection" to the surface estate. Similarly, the Carters presented evidence that other commercial hunting outfits in the area "commonly" entered into oil and gas leases with operators, and that those operators accommodated those surface uses. Another similarity is that Texas Outfitters chose to reap the benefits of an unburdened surface estate to the detriment of the Carters.

Texas Outfitters pointed to the 2003 case *In re Bass,* and argued that it should not be "forced" to lease its own interest to avoid a breach of its executive duty. In what some have interpreted as a departure from the *Bass* decision, the Court explained "We certainly do not hold that an executive must always accept an offer…But we also do not hold than an executive is never required to accept such an offer."

About the Author

Austin Brister *is a partner in our Houston office and a member of the Oil and Gas Practice Group. Austin represents oil and gas exploration and production companies and landowners in complex litigation.*

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ATTORNEY SPOTLIGHT

Bruce M. Kramer

A long-time professor at the Texas Tech University School of Law, who upon retirement taught for 10 years at Colorado University School of Law, Bruce M. Kramer is a nationally known oil, gas, energy and land use legal scholar.

He has advised companies and served as both a consulting and testifying expert witness on a wide array of legal issues and strategies in the energy arena for more than 30 years. His areas of experience include the custom and practice of the oil and gas industry as it applies to the myriad of contracts and other written instruments that are regularly used by the industry. He has also been involved in state regulatory matters with a specific concentration on oil and gas conservation statutes and regulations, including pooling and unitization. He has written extensively on the issue of the interplay between state and sub-state (county/municipal) regulation of oil and gas operations in jurisdictions throughout the United States.

Bruce is the co-author of several important legal treatises that have become the definitive references for energy lawyers and others, including The Law of Pooling and Unitization and Williams and Meyers Oil and Gas Law. The Manual of Terms which is both part of the multi-volume Williams and Meyers treatise and a stand-alone publication is widely cited in federal and state courts on matters relating to oil and gas law. Bruce is also the author of more than 70 law review articles that, along with the treatises have been cited by numerous state and federal courts. Bruce has also filed amicus briefs in several state and federal courts on important issues facing the oil and gas industry. He continues to speak at continuing legal education programs throughout the United States.

REPRESENTATIVE EXPERIENCE

Advising companies about oil and gas issues throughout the United States as they may apply to oil and gas leases, purchase and sale agreements, assignments, joint operating agreements, participation agreements, gas purchase and sale contracts, farmout agreements, area of mutual interest agreements among others.

Providing expert witness testimony in multiple cases and arbitrations involving disputes in oil and gas law, including the use of terms of art in oil and gas-related instruments, the oil and gas jurisprudence of the producing states, the appropriateness of class action litigation involving oil and gas-related disputes, royalty litigation and international petroleum transactions and serving as an arbitrator in oil and gas-related disputes.

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Railroad Commission Update: Avoiding the Prohibition Against Double-Assignment of Acreage

By: Tim George

This article features a portion of the Railroad Commission Update paper presented at the 45th Annual Ernest E. Smith Oil, Gas and Mineral Law Institute and provides an update to the Commission's prohibition against double-assignment of acreage.

Double-assignment of acreage occurs when a single tract of land is assigned to two different wells in the same RRC field for permitting, proration, and production. Historically, the RRC banned double-assignment of acreage based on the underlying premises that each well develops a single geographic tract of land and that multiple wells on that same tract might cause waste or might harm the correlative rights of operators or owners. The RRC incorporates this as a default regulatory requirement in Statewide Rule 40 to prohibit double-assignment of acreage to a "well for drilling and development, or for the allocation of allowable."[1] Under Rule 40, if an operator had previously assigned the acreage included in a tract to a well to receive an allowable in a field, then no other well could produce from that same acreage in that same field.

For decades, the RRC's entire system of regulation has been predicated on this one-tract, one-well concept as a means of protecting operators, owners, and reserves. It was applied to permitting, and it was engrained in the RRC's assignment of allowables under its computerized proration system. In recent years, however, the advent of unconventional resource development with horizontal lateral wells and fracture stimulation has brought with it a recognition that the double-assignment prohibition can sometimes be an impediment to development.

The initial problem was that acreage needed for horizontal wells was already assigned to existing vertical wells. The vertical wells continued to produce, so the rule against double-assignment made it difficult, if not impossible, to permit and produce new horizontal wells on the same acreage. In Spraberry (Trend Area) Field, the rules were amended to regulate the assignment of acreage to vertical wells separately from the assignment of acreage to horizontal wells, and this approach was incorporated into the 2016 amendments to the Statewide Rules for designated unconventional fracture treated (UFT) fields. Under this approach, the same acreage can be double-assigned simultaneously to vertical and horizontal wells in UFT fields.[2] Consequently, in Spraberry (Trend Area) field, and in any designated UFT field, it is as though the horizontal wells and the vertical wells do not see each other, which avoids the double-assignment problem for vertical and horizontal wells.

The second problem resulted from the need to develop depth-severed ownerships within thick RRC designated field intervals. In West Texas, active fields have RRC designated field intervals that are thousands of feet thick. For example, this is the situation for Spraberry (Trend Area), Wolfbone (Trend Area), and Phantom (Wolfcamp) fields. These thick field intervals create opportunities for multiple different leasehold ownerships at different depths within a single designated RRC field. For example, an oil and gas lease might contain a requirement for continuous development after the primary term in order to retain acreage and depths, and under that provision, the oil and gas leasehold covering any undrilled depths will terminate, creating a depth severance in the ownership of the right to drill within the designated RRC field. Or, an operator who has drilled some depths within a designated RRC field might elect to farmout or assign its undrilled depths to a new operator, again creating a depth severance of the right to drill in the ownership within the designated RRC field. In these situations, the new operator will need to assign acreage to a well that, although geographically on the same tract of land that the prior

[1] Statewide Rule 40(d), 16 Tex. Admin. Code § 3.40(d).

[2] Statewide Rule 40(e)(1, 2, and 3), 16 Tex. Admin. Code § 3.40.

operator has already assigned to a well in that designated RRC field, is at different depths within the RRC field interval. It is not uncommon to find at least one depth severance creating a shallow vs. deep situation. And, some tracts in the Delaware Basin are reported to have been depth severed into more than a half-dozen different depth intervals.

Again, the Spraberry (Trend Area) field rules provided an initial solution. For that field, the RRC created a second set of field numbers for use "where the ownership of oil and gas within the designated interval for Spraberry (Trend Area) Field has been divided horizontally."[3] With these field numbers, the RRC provides a mechanism for operators with ownership that is divided into shallow and deep rights.

Although the RRC recently adopted this same two-field-number approach for another field, the two-field-number approach is not considered to be a long term solution.

One advantage to this field-number method is that it works with the RRC's computerized allowable system, which is old and difficult to re-program. One disadvantage is that it provides for only two ownership depths, shallow and deep. (The RRC has not adopted a three-field-number system, although there is no apparent reason why it could not do that.)

Although the RRC recently adopted this same two-field-number approach for another field,[4] the two-field-number approach is not considered to be a long term solution. With encouragement from operators and the General Land Office (particularly for the Delaware Basin where there are many tracts with multiple depth intervals), the RRC staff initiated informal discussions with industry trade groups and stakeholders to develop amendments to Statewide Rule 40 that would make permissible multiple assignments of acreage in UFT fields where ownership of the right to drill or produce from a tract is divided horizontally. Those discussions, meetings, and exchanges of draft revisions began in 2017 and continued through 2018 and into 2019.

The process toward formal rulemaking has been steady but slow. Much of the discussion has focused on the definition of a horizontal depth severance. The RRC staff suggested a definition specifying that wells will not produce from the same productive horizon. In response, industry representatives suggested a definition that does not include reference to production. Another point of discussion has been whether notification should be sent only to operators or also to mineral interest owners of vertically adjacent intervals. There is apparent consensus, however, that notice would be sent to operators of wells in the field either on or within one-half mile of the applicant's proposed well.

Meanwhile, one Delaware Basin operator has successfully used contested case applications to request and receive exceptions to Rule 40 for wells on four specific leases.[5] Each application was unprotested, and more importantly, each was supported by the General Land Office, which had leased the State tracts to the operator. The RRC approved the applicant's suggested definition that the duplicate assignment of acreage be "required because an existing deed, lease, or other contract confines the Operator to a distinct depth interval." And, the RRC approved the applicant's suggested notification only to operators and did not require notification to unleased mineral owners.

TAKEAWAYS AND INSIGHTS

Until a more comprehensive approach is adopted, an operator can nonetheless seek relief from the Commission if an exception to Statewide Rule 40 is needed.

About the Author

Tim George *is a partner in our Austin office and a member of the Oil and Gas Practice Group. Tim represents clients before the Railroad Commission of Texas and the Texas General Land Office.*

For more information about the Railroad Commission Update contact Tim at 512-495-6047 or tgeorge@mcginnislaw.com.

[3] Oil and Gas Docket No. 7C-0297471, Rule 3, *Final Order Amending Field Rules for the Spraberry (Trend Area) Field* (Mar. 8, 2016).

[4] Oil & Gas Docket No. 01-0311764, *Application of North South Oil, LLC to Consider Creating the Proposed Luling Branyon R 40 Exc Field Pursuant to Statewide Rule 40, Caldwell and Guadalupe Counties, Texas* (June 19, 2018).

[5] Oil and Gas Docket No. 08-0311740, *Application of Rio Oil and Gas (Permian) II, LLC for an Exception to Statewide Rule 40 for the Conquista State Unit 54-1-8 Lease, Well No. 1H, Phantom (Wolfcamp) Field, Reeves County, Texas* (June 19, 2018); Oil and Gas Docket No. 08-0311741, Application of Rio Oil and Gas (Permian) II, LLC for an Exception to Statewide Rule 40 for the Expedition State Unit 71-67 Lease, Well No. 1H, Phantom (Wolfcamp) Field, Reeves County, Texas (June 19, 2018); Oil and Gas Docket No. 08-0311742, Application of Rio Oil and Gas (Permian) II, LLC for an Exception to Statewide Rule 40 for the Expedition State Unit 71-67 Lease, Well No. 2H, Phantom (Wolfcamp) Field, Reeves County, Texas (June 19, 2018); Oil and Gas Docket No. 08-0311743, Application of Rio Oil and Gas (Permian) II, LLC for an Exception to Statewide Rule 40 for the Expedition State Unit 71-67 Lease, Well No. 3H, Phantom (Wolfcamp) Field, Reeves County, Texas (June 19, 2018).

FEATURED ARTICLE

Supreme Court Splits Over Use of Expert Testimony and Other Extrinsic Evidence When Construing Obligations in Oil and Gas Agreements

Barrow-Shaver Res. Co. v. Carrizo Oil & Gas, No. 17-0332, 2019 Tex. LEXIS 688 (June 28, 2019)

By: Chris Halgren

On June 28, 2019, a divided Texas Supreme Court issued its opinion in *Barrow-Shaver Resources Company v. Carrizo Oil & Gas, LLC*, a decision that will impact what evidence a court can consider in oil and gas contract disputes and possibly how oil and gas agreements are negotiated and drafted.[1] The Court discussed the line between admissible evidence of "surrounding circumstances" and inadmissible parol evidence, when prior drafts and the use of expert testimony regarding industry custom and usage is offered to construe an unambiguous agreement. The Court also discussed the use and function of "consent-to-assign" provisions and the inability to rely on oral representations that conflict with the terms of a written agreement.

The Texas Supreme Court held that Carrizo Oil & Gas, LLC ("Carrizo") did not breach a farmout agreement by withholding consent to an assignment sought by Barrow-Shaver Resources Company ("BSR"), even if Carrizo's refusal to provide that consent was unreasonable, because the parties' agreement did not restrict Carrizo's ability to withhold consent. The Supreme Court also concluded that Carrizo did not fraudulently induce BSR into signing the agreement, even if Carrizo had orally promised that it wouldn't unreasonably withhold consent, because BSR cannot justifiably rely on Carrizo's alleged promise when that promise is not included in the written agreement.

General Overview

The dispute focused on a "consent-to-assign provision" in a farmout agreement. A prior draft of the agreement provided BSR must obtain Carrizo "written consent" prior to an assignment, but that "consent shall not be unreasonably withheld." However, the final agreement did not contain any restriction on Carrizo's ability to withhold consent. When BSR attempted to assign its interest in the agreement, Carrizo demanded $5 million. BSR claimed that Carrizo breached the agreement by unreasonably withholding its consent or, in the alternative, fraudulently induced BSR to enter into an agreement that did not expressly provide that consent could not be unreasonably withheld by promising that consent would be provided. BSR argued that a prohibition on unreasonably withholding consent should be implied into the agreement based on, at least in part, expert testimony that the custom and usage in the oil and gas industry is to imply into the agreement that consent cannot be unreasonably withheld. Carrizo argued, among other things, the removal of "consent shall not be unreasonably withheld" from the draft agreement evidences the parties' intent to contract around any sort of implied obligation.

A divided Supreme Court issued three separate opinions – a majority opinion authored by Justice Green,[2] a concurring and dissenting opinion

[1] *Barrow-Shaver Res. Co. v. Carrizo Oil & Gas,* No. 17-0332, 2019 Tex. LEXIS 688 (June 28, 2019).

[2] Joined by Justice Lehrmann, Justice Devine, Justice Blacklock, and Justice Brown.

authored by Justice Guzman,[3] and a dissent authored by Justice Boyd. The three opinions primarily disagree on what evidence is appropriate for the trial court to consider when determining whether Carrizo breached the agreement by withholding consent. All three opinions agreed the agreement is unambiguous. The majority concluded that the parol evidence rule bars admission of both the prior drafts and expert testimony of industry custom and usage. The concurring and dissenting opinion would have permitted evidence of the industry custom and usage, but agreed the prior drafts must be excluded under the parol evidence rule. The dissent would have allowed both the prior drafts and expert testimony for the purpose of determining whether industry custom and usage would prohibit a party from arbitrarily withholding consent and for purposes of determining whether BSR and Carrizo intended to contract around such a usage.

Background

Under the disputed farmout agreement, BSR could earn an interest in a 22,000-acre "Parkey Lease" owned by Carrizo in exchange for its services in drilling a producing oil and gas well. The parties negotiated the terms of the agreement, with particular attention being paid to a "consent-to-assign provision." The original draft of the agreement provided by BSR included a provision providing that BSR could only assign with Carrizo's written consent, but that "consent shall not be unreasonably withheld." BSR objected to removing a restriction on Carrizo's ability to withhold consent, but Carrizo allegedly orally represented that it would consent to a requested assignment, even if the language was not expressly in the agreement. Ultimately, the parties executed a farmout agreement that provided:

The rights provided to [Barrow-Shaver] under this Letter Agreement may not be assigned, subleased or otherwise transferred in whole or in part, without the express written consent of Carrizo.

BSR spent $22 million drilling a well, but had unsuccessful results. Raptor Petroleum II, LLC ("Raptor") approached BSR and offered approximately $27 million for an assignment of BSR's rights in the farmout. When BSR approached Carrizo to request written consent to the assignment, Carrizo responded by proposing to sell its interest in the Parkey Lease to BSR. BSR did not respond to this offer and Carrizo ultimately refused to consent to BSR's proposed assignment to Raptor, causing Raptor's offer to fall through.

BSR sued Carrizo for breach of contract, fraud, and other claims. Both parties agreed their agreement was unambiguous. BSR argued that the agreement was silent on whether Carrizo could withhold consent and sought to introduce expert testimony of the industry custom and usage to prove Carrizo breached the agreement by unreasonably withholding consent. Carrizo argued that it could withhold consent for any reason because the agreement excluded any express agreement that consent would not be unreasonably withheld.

The trial court excluded all evidence of the parties' negotiations,[4] but permitted both parties to offer expert testimony on the industry custom and usage of consent-to-assign provisions and whether such provisions would permit Carrizo to withhold consent.[5] The jury returned a verdict for over $27,000,000. The court of appeals reversed the judgment and rendered a take nothing judgment against BSR, holding that the purposeful deletion of "shall not be unreasonably withheld" in the prior drafts "conclusively established" that the parties that Carrizo could withhold consent for any reason or no reason at all.

Consent-to-Assign Provisions

The Supreme Court agreed that the consent-to-assign provision was clear and unambiguous and concluded that the agreement can and should be construed based on its plain language. Two types of consent-to-assign provisions exist — those that restrict a party's right to withhold consent and those that don't. If a contract does not expressly restrict a party's right to withhold consent, the Court will not imply any obligation to act reasonably or in good faith.

The farmout agreement required BSR to obtain Carrizo's written consent before BSR could assign its interests to Raptor. There was no restriction on Carrizo's ability to withhold consent. Therefore, the Court concluded that Carrizo could withhold consent for any reason or no reason. The Court rejected BSR's argument that a duty to act reasonably or in good faith should be implied into the contract. Accordingly, Carrizo did not breach the contract by refusing to consent to the proposed assignment. The Supreme Court reasoned that to imply an obligation that Carrizo may not unreasonably withhold consent would

[3] Joined by Chief Justice Hecht.

[4] Due to a "clerical error" the drafts were admitted into evidence and shown to the jury. The trial court gave a curative instruction to avoid a mistrial. The trial court continued to exclude any witness about the negotiations.

[5] BSR's expert witness, Bruce Kramer, is Of Counsel at McGinnis Lochridge.

be tantamount to rewriting the parties agreement.

The Line Between Surrounding Circumstances and Parol Evidence

The Supreme Court has previously held that Texas courts may properly consider "surrounding circumstances" evidence. However, the Supreme Court has cautioned, "there are limits." *See David J. Sacks, P.C. v. Haden*, 266 S.W.3d 447, 450-451 (Tex. 2008). "Extrinsic evidence cannot be used to show that the parties probably meant, or could have meant, something other than what their agreement stated." *Anglo-Dutch Petroleum Int'l, Inc. v. Greenberg Peden, P.C.*, 352 S.W.3d 445, 451 (Tex. 2011). Under the banner of "surrounding circumstances" evidence, some Texas trial and appellate courts have admitted evidence of parties' prior negotiations and evidence of industry custom and usage in the oil and gas industry for the purpose of construing unambiguous contracts. *See e.g. PNP Petroleum I, LP v. Taylor*, 438 S.W.3d 723 (Tex. App.—San Antonio 2014, pet. denied) (considering evidence of prior red-lined drafts of an unambiguous agreement and witness testimony).

The Court explained that it is proper to consider, as "surrounding circumstances," that the parties were "sophisticated oil and gas entities" that were "represented by counsel" and their "experienced representatives considered and edited drafts of the agreement before coming to a final agreement." The Court said that the surrounding circumstances provide that the consent-to-assign provision was a bargained-for exchange. This was all the Court held was proper to consider. Similarly, in *Murphy Expl. & Prod. Co.-USA v. Adams*, the Supreme Court held that it was proper to consider that a 2009 oil and gas lease was "drafted with horizontal shale drilling in mind," therefore it was proper for the Court to keep "the realities of this type of drilling in mind" when interpreting the contract." 560 S.W.3d 105, 110 (Tex. 2018).

The Court held that the court of appeals should not have considered substantive evidence of the parties' negotiations, such as the red-lined drafts. The "parol evidence rule applies to writings that evidence the creation ... of a right of obligation under the contract." The Court held that the "evidence of the parties substantive negotiations directly relates to the creation of the parties' unambiguous agreement," therefore introduction of the evidence is barred by the parol evidence rule.

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The parties' testimony of industry custom and usage was also held inadmissible. While trade usage can be a useful form of evidence in certain circumstances such as when language is "vocation or trade specific," the Court held that if the language is plainly understandable then the parties should not be permitted to offer expert testimony that would contradict or add terms to an unambiguous agreement. The Court explained that expert testimony would "likely be appropriate" if construing the "unreasonably withheld," but that it was inappropriate here because a requirement to obtain "written consent" is not industry specific and is clearly understood. The Court concluded that to accept the expert testimony offered by BSR "would make almost every term, word, or phrase in every agreement, and any obligation not in an agreement, susceptible to litigation and ultimately a jury determination based on competing expert testimony, regardless of clarity."

Justifiable Reliance

The Court rejected BSR's fraudulent inducement claim, holding that BSR could not have justifiably relied on Carrizo's alleged oral representations that it would provide consent to an assignment, even if an express restriction was not in the contract. Relying on the 2018 opinion in *JPMorgan Chase Bank, N.A. v. Orca Assets G.P., L.L.C.*,[6] the Supreme Court held that a contradiction between an oral promise and a written agreement exists when the written agreement "conflicts with the earlier representation such that a reasonable person could not read the agreement and still plausibly claim to believe the earlier representation."

The farmout's omission of any limitation on Carrizo's ability to withhold consent led the Court to conclude that BSR could not justifiably rely on Carrizo's alleged oral representations that it would provide consent if requested when the agreement did not include any express restriction on Carrizo's ability to withhold consent.

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[6] 546 S.W.3d 648, 658 (Tex. 2018)

Severed Mineral Estates and Surface Use Disputes

Part One: Extent of Implied Easement

By: Kevin Beiter and Austin Brister

Due perhaps to geologic serendipity, Texas has a long and extensive history of oil and gas exploration and production. Consequently, much of Texas' lands have experienced severance of mineral from surface estate and resulting complications of concurrent occupancy by parties whose interests are not always fully aligned. In Texas, the owner of a severed mineral interest (and its mineral lessee) generally enjoy an implied right to enter upon the surface and to use the surface estate for the purpose of exploring, drilling, producing, transporting, and marketing the minerals.[1] The Texas Supreme Court has described this implied right as "a well established doctrine from the earliest days of the common law."[2] The underlying rational is that a grant, lease, or reservation of minerals would be worthless if the grantee, reserver, or lessee did not have access to and use of the surface estate.[3]

In some cases, the extent of surface rights are defined in the deed effecting the mineral severance or in the oil and gas lease. For example, parties sometimes agree to "no surface occupancy" provisions, essentially requiring the use of directional drilling from off-site locations. Agreements of this kind are increasingly common in densely settled and urban areas. Other, more common examples include surface damage and restoration requirements, road location and maintenance provisions, and limitations on use of surface or subsurface water or handling of wastewater and materials. Of course, if the documents address these types of concerns, they are generally enforceable if clearly drafted.

However, many (particularly older legacy leases) make little or no provision for mineral surface occupancy—at least few that benefit the surface owner. Where the surface use rights are not expressly defined, Texas courts have evolved analyses to evaluate and resolve disputes that arise between surface owners and mineral owners regarding their respective rights.[4] Courts have generally held that the mineral estate's surface rights are dominant, and the surface owner may not unreasonably interfere with the reasonable use of the surface for the operation and development of the mineral estate.[5] The word "dominant" in this context means "benefited," not necessarily "superior."[6] Similarly, "[t]he surface estate is not servient because it is lesser or inferior but because it must allow the exercise of that implied right" by the dominant estate holder.[7] The mineral estate's implied right to use the surface has been interpreted rather broadly in Texas, and sometimes extends beyond mere right of access. For example, a survey of case law reveals that Texas courts have determined that mineral owners or lessees had the right to:

- determine the location of legally spaced wells;[8]
- ingress and egress across the surface to wells;[9]
- construct roads to wells;[10]
- use materials obtained from the surface in construction of roads;[11]
- drill and operate water wells, for us in primary recovery operations;[12]
- drill and operate water wells on the surface to develop the mineral right, without compensation;[13]
- dispose of salt water in an injection well where no alternative means existed on premises;[14]
- dispose of drill cuttings in open slush pits;[15]
- construct and operate pipelines to transport gas from unit including the surface owner's land;[16]

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[1] *See Warren Petroleum Corp. v. Monzingo*, 304 S.W.2d 362 (Tex. 1957).

[2] *Tarrant Cnty. Water Control & Improvement Dist. No. One v. Haupt, Inc.*, 854 S.W.2d 909, 911 (Tex. 1993).

[3] *Harris v. Currie*, 176 S.W.2d 302 (Tex. 1943).

[4] *Texaco, Inc. v. Parker*, 373 S.W.2d 870, 871 (Tex. Civ. App.—El Paso 1963).

[5] *See, e.g., Warren v. Martin*, 271 S.W.2d at 413.

[6] *Coyote Lake Ranch, LLC v. City of Lubbock*, 498 S.W.3d 53, 64 (Tex. 2016).

[7] *Id.*

[8] *Grimes v. Goodman Drilling Co.*, 216 S.W. 202, 204 (Tex. Civ. App.—Fort Worth 1919).

[9] *Ball v. Dillard*, 602 S.W.2d 521, 523 (Tex. 1980).

[10] *Davis v. Devon Energy Prod. Co.*, 136 S.W.3d 419, 425 (Tex. App.—Amarillo 2004)

[11] *B.L. McFarland Drilling Contractor v. Connell*, 344 S.W.2d 493, 496–97 (Tex. Civ. App.—El Paso 1961).

[12] *Stradley v. Magnolia Petroleum Co.*, 155 S.W.2d 649, 652 (*Tex. Civ. App.—Amarillo 1941); see also Montfort v. Trek Res., Inc.*, 198 S.W.3d 344, 355–56 (Tex. App.—Eastland 2006).

[13] *Sun Oil Co. v. Whitaker*, 483 S.W.2d 808, 811 (Tex. 1972).

[14] *TDC Eng'g, Inc. v. Dunlap*, 686 S.W.2d 346, 348–49 (Tex. App.—Eastland 1985).

[15] *Satanta Oil Co. v. Henderson*, 855 S.W.2d 888, 890–91 (Tex. App.—El Paso 1993).

[16] *Delhi Gas Pipeline Corp. v. Dixon*, 737 S.W.2d 96, 98 (Tex. App.—Eastland 1987).

- conduct geophysical explorations by seismographic tests;[17] and
- construct temporary housing.[18]

Of course, these cases are arguably limited to their unique facts, but they are instructive for purposes of this discussion. Given the breadth of this list, there are obviously many opportunities for conflicts with the rights of surface owners. While a mineral owner is obligated to act reasonably, so long as the mineral operations are conducted in a non-negligent "usual and customary manner," the fact that they inconvenience or are objectionable to the surface owner or even diminish the value of the surface estate does not alone create liability.[19]

The dominant estate doctrine, however, does have some limitations. A mineral owner or mineral lessee does not have unlimited right to enter on and use the surface estate. Instead, as discussed below, the mineral owner's use of the surface must be reasonably necessary to enjoyment of the mineral estate and its rights must be exercised reasonably. An in any event, surface and mineral owners have the right to define the nature of their respective rights in the surface; and clearly expressed obligations and agreements regarding use and occupancy of the surface estate will "trump" those implied in law.

In Texas, Generally No Obligation to Restore Surface

In Texas, mineral owners generally are not obligated to pay "surface damages" prior to commencement of mineral operations absent specific agreement.[20] Likewise, mineral owners and lessees generally do not have an implied duty in Texas to restore the surface following abandonment of operations, absent a finding that the mineral lessee carried out the operations in a negligent manner or used more of the surface than reasonably necessary.[21] As such, it is not uncommon for parties to include provisions in the oil and gas lease requiring the lessee to pay surface damages or obligating to the lessee to perform certain surface restoration measures, regardless whether the use was reasonable.

The potential for conflict arising from not addressing surface restoration in the severance document can be seen in the Texas case of *Warren Petroleum Corp. v. Monzingo*,[22] which the oil and gas leases did not expressly provide for surface restoration. The surface landowner sought to recover damages from the lessee, alleging that the lessee failed to restore the surface, leaving behind unfilled slush pits, ruts from heavy equipment, and a gravel road to the drilling site. The Texas Supreme Court held that mineral lessees have no implied duty to restore the surface, and are not liable for the costs to restore the surface absent a finding that the mineral lessee carried out the operations in a negligent manner or used more of the surface than was reasonably necessary.

This is not to say that a Texas mineral lessee is never liable for surface damages or restoration. The mineral lessee can only use so much of the surface as is reasonably necessary for the intended (and authorized) mineral operation and the use must be non-negligent. Obviously, any claim of this kind is going to be based upon the specific facts surrounding the operations and damages involved – meaning that in many cases there is likely going to be an issue of fact that will be determined by a jury.

Trespass – Use of More Than "Reasonably Necessary"

According to the Texas Supreme Court, a mineral lessee has "the right to use as much of the premises, and in such a manner, as [is] reasonably necessary to comply with the terms of the lease and to effectuate its purposes."[23] A lessee is liable to the surface owner under a theory of "trespass" if the lessee exceeds an express limitation in a lease, uses more of the land than is reasonably necessary, or uses the surface in a manner that is not reasonably necessary. To recover, the burden is generally on the surface owner to prove that the lessee's use was more than reasonably necessary.[24]

Negligence

A mineral owner or lessee is required to act non-negligently and can be liable for surface damages that are caused by negligence.[25] In exercising its right to use the surface, a lessee owes a duty to the surface owner not to negligently injure the surface estate.[26] To recover damages for negligent use of the surface, the surface owner has the burden to prove "specific acts of negligence."[27]

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[17] *Yates v. Gulf Oil Corp.*, 182 F.2d 286, 289 (5th Cir. 1950).

[18] *Joyner v. R.H. Dearing & Sons*, 112 S.W.2d 1109, 1112 (Tex. Civ. App.—El Paso 1937).

[19] *See Getty Oil Co. v. Jones*, 470 S.W.2d 618 (Tex. 1971).

[20] *Ottis v. Haas*, 569 S.W.2d 508, 514 (Tex. Civ. App.—Corpus Christi 1978).

[21] *Humble Oil & Ref. Co. v. Williams*, 420 S.W.2d at 135 (citing Meyer v. Cox, 252 S.W.2d 207 (Tex. 1Civ. App.—San Antonio 1952)).

[22] 304 S.W.2d 362 (Tex. 1957).

[23] *Humble*, 420 S.W.2d at 134.

[24] *Id.*

[25] *Id.*

[26] *Gen. Crude Oil Co. v. Aiken*, 344 S.W.2d 668, 669 (Tex. 1961).

[27] *Humble,* 420 S.W.2d at 134.

A number of cases have arisen involving loss of cattle resulting from the cattle entering the well site or drinking contaminated water around the oil well.[28] A lessee is generally under no duty to exclude cattle from the vicinity of the well, such as by constructing fences, and therefore a lessee only owes a duty to refrain from intentionally or wantonly injuring the lessor's livestock.[29]

Balancing the Interests – "Due Regard" and Accommodation Doctrine

Although the mineral estate is the dominant estate and the surface estate is the servient estate, this does not mean that the mineral estate is afforded an absolute and unrestricted right to use the surface. To the contrary, Texas courts have determined that the interests of the mineral owner and the surface owner must be balanced. Over several decades, Texas courts have developed the "due regard" rule and the "accommodation doctrine," which seek to provide a framework for striking that balance.

In the next edition of *Producer's Edge*, we will survey recent case law on the accommodation doctrine, and synthesize those cases into a refined framework for analysis.

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[28] *See, e.g.*, *Sinclair Prairie Oil Co. v. Perry*, 191 S.W.2d 484, 485 (Tex. Civ. App.—Texarkana 1945); *Trinity Prod. Co. v. Bennett*, 258 S.W.2d 160 (Tex. Civ. App.—Amarillo 1953).

[29] *Warren v. Martin*, 271 S.W.2d 410 (Tex. 1954).

INTERNATIONAL TRADE

U.S. Regulation of Cross-Border Transactions in the Oilfield Sector

By: Lindsey Roskopf and Martin Lutz

Companies considering business opportunities outside of the United States must be prepared to deal with a myriad of new laws and regulations. There may be foreign laws to contend with, of course, but there are also U.S. laws related to international trade that companies operating only domestically likely have never encountered. There are multiple U.S. government agencies that regulate the transfer of equipment, software, technology, and services from the United States to foreign countries through "export control" and sanctions regulations. These regulations cover shipments leaving the United States; shipments of certain U.S. origin goods amongst foreign countries; data transmissions from the U.S. to other countries; and the provision of services to or receipt of services from certain countries, organizations, and individuals. These regulations can even apply inside the U.S. when sharing certain information with foreign persons, including prospective business partners and investors, and they can also apply to any facilitation of foreign transactions by U.S. persons.

The energy industry is particularly affected by export controls and sanctions. First, there are many items used in the industry that require a license from the U.S. government to leave the country. In addition, there are many countries and foreign counter-parties that are subject to sanctions. The energy industry typically feels the brunt of the pain when the U.S. government uses sanctions as a foreign policy tool because a foreign country's energy industry is often an easy target when policymakers are looking to impose penalties on a particular regime. Recently, the U.S. has used sanctions to target transactions involving Petróleos de Venezuela, S.A., shipments of oil to and from Iran and Syria, and certain sectors of Russia's energy industry.

Generally, the export control and sanctions restrictions that could apply to a particular transaction fall into one of four categories: product controls, destination controls, end-user controls, and end-use controls. We examine each of these below.

Product controls

Certain products, technology, and software (collectively, "items") can require a license to be exported from the U.S. to certain countries because the U.S. wants to control the release of those items for national security and foreign policy reasons. In the oil and gas industry, such items include: down-hole drilling equipment, explosives,

vibration test equipment, valves and pumps, infrared surveillance equipment, toxic gas monitoring systems, gyros and guidance systems, lubricants and chemicals, acoustics, and robotics. The U.S. Department of Commerce's Bureau of Industry and Security (BIS) typically regulates the export of these items through the Export Administration Regulations (EAR). However, if these items also have a military application, they could be regulated by the U.S. Department of State's Directorate of Defense Trade Controls (DDTC) through the International Traffic in Arms Regulations (ITAR). Items subject to the ITAR generally require a license to most countries, but licensing requirements for controlled items subject to the EAR vary by country.

Destination controls

The ultimate destination of an item or the country involved in a transaction can create a license requirement, even if no BIS or DDTC license is required. The U.S. Department of the Treasury's Office of Foreign Assets Control (OFAC) imposes embargoes (or comprehensive sanctions) on Cuba, Iran, North Korea, Syria, and the Crimea region of Ukraine, meaning U.S. companies are generally restricted from shipping anything to these countries, directly or indirectly, or engaging in transactions that are intended to benefit these countries. For example, these controls prohibit U.S. companies from shipping any items that are intended for use in Iran, regardless of whether there are product controls. U.S. companies are also restricted from providing any services that would benefit a drilling project in Iran even if the U.S. company has no direct involvement with Iran. Although most U.S. companies know to avoid certain sanctioned markets, they are often unaware of the extent to which they are required to ensure that third parties do not resell their products to restricted destinations.

End-user controls

Exports to or dealings with certain foreign organizations or persons can create a license requirement. Multiple government agencies, including OFAC, BIS, and DDTC, maintain restricted parties listings that generally prohibit any dealings with organizations and persons included on those listings. These lists include OFAC's Specially Designated Nationals and Blocked Persons (SDN) List and BIS's Entity List. U.S. persons cannot have any dealings whatsoever with a company on the SDN List, including sales within the U.S., and may not ship any goods to a company on the Entity List, regardless of the product or destination controls. For example, an item shipped to Norway that does not require a BIS license may still be prohibited if a company on the SDN List is involved in the transaction. End-user controls would also restrict a U.S. person from providing any services to or accepting any funding from a person on the SDN List.

End-use controls

The end-use of an item can also be subject to restrictions. U.S. companies are restricted from exporting certain items that can be used in certain military, nuclear, or chemical or biological weapons end-uses. In addition, and more specific to the energy industry, U.S. companies are also restricted from providing goods and services in support of certain exploration and production projects in Russia or involving certain Russian entities outside of Russia. As such, the shipment of certain drilling pipe, which is typically not subject to product controls, could require an export license to Russia if it is used for a restricted production project.

Civil fines and penalties for violations of the EAR and OFAC's regulations can reach the greater of approximately $300,000 or twice the value of the transaction. Violations of the ITAR can reach $1,000,000. Further, due to the structure of these regulations, a single unlawful transaction can result in multiple violations. There are also criminal penalties available for willful violations. Civil and criminal penalties can be applied both to the company and to the individuals involved.

This environment creates compliance challenges for energy companies engaging in cross-border transactions and also makes U.S. energy companies a common target of government enforcement activities because of their activities in high-risk regions. As such, it is particularly important for U.S. energy companies to be aware of export control and sanctions regulations when engaging in opportunities outside of the United States so that they can ensure compliance with these complex laws and regulations.

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SCOTX Tracker

Below are very brief summaries of several oil and gas cases currently pending before the Texas Supreme Court. We have organized them by the status of their appeal, as of the date of this newsletter.

By: Ana P. Navarrete and Austin Brister

Petition Granted, Oral Argument Scheduled

Creative Oil & Gas v. Lona Hills Ranch, LLC

Lease termination case, focused on Tex. Citizens Partic. Act, including whether the "clear and specific evidence" burden was met, whether the TCPA is limited to First Amendment rights, and whether a non-beneficiary to a contract may rely upon its terms as a defense to TCPA.

ConocoPhillips v. Ramirez

Trespass to try title suit involving interpretation of will and co-tenancy accounting.

Energy Transfer Partners v. Enterprise Products Partners

Whether partnership was created, the role of profit in a partnership formation, the scope of a partner's statutory duty of loyalty, and the role of waiver in the partnership formation test.

Petition Filed, Full Merits Briefing Requested

Crimson Exploration, Inc. v. Magnum Producing, L.P.

Whether a LOI, contemplating a mineral interest transfer and farmout, formed an enforceable contract and an immediate conveyance of title. The Corpus Christi-Edinburg Court of Appeals previously held that it was effective to convey title, noting that there are no technical or formal requirements to be effective, and noting that the other party had relied on the instrument for several years.

Tel Olmos, LLC v. ConocoPhillips Company

Whether Texas law requires that a force majeure event be unforeseeable, even where the force majeure clause is silent on the issue of foreseeability.

Chalker Energy Partners v. Le Norman Operating, LLC

Whether email communications regarding proposed deal terms, without a definitive agreement, create a fact issue regarding whether the parties entered into a binding contract, even where the parties agreed in an LOI that there would be "no contract or agreement" unless and until a "definitive agreement" is reached.

Don A. Janssen v. RG Family Trust

Whether the language of a particular "subject to" clause served to merely limit the warranty clause, or whether it also served to limit the granting clause.

CCI Gulf Coast Upstream LLC v. Circle X Camp Cooley, Ltd.

Whether a "free-gas clause" is sufficiently definite to be enforceable, where it allows the lessor to take free gas for domestic or agricultural purposes, but does not specify any limit on the volume of gas the lessor may take or the geographic area where it may be used. Petitioner argues that the lessor could potentially take all the gas, causing the lease to fail to produce in paying quantities.

Tommy Yowell V. Granite Operating Company, et al.

Whether an anti-washout clause requires that the interest "re-vest" upon execution of a new lease, thereby potentially violating the Rule Against Perpetuities. Also involves questions as to whether an indemnity obligation, pertaining to "any adverse consequences arising out of or in connection with" a pending lawsuit, would include within its scope a future lawsuit regarding the same interest.

XTO Energy, Inc. v. Reilly Dillon

Whether a 1928 transaction involving 1.653 acres of mineral interests was intended to be sold free of a Deed of Trust and Vendor's Lien, interpretation of a "disposition" clause, and whether the court was required to construe the entire document in the context of all other contemporaneous transactions.

Eagle Oil v. TRO-X

Whether res judicata barred a claim royalties under a 2005 agreement for developing oil and gas interests in Pecos and Reeves Counties. The issue turns, in part, on whether the claims at issue arise out of the same transaction as the prior suit or whether they turn on conduct that purportedly occurred after that prior trial had already concluded.

Petition for Review Denied

Central Petroleum Limited v. Geoscience Resource Recovery

Personal jurisdiction issue involving a Texas company who attended two global conventions in Houston in a search for a development partner for mineral properties in central Australia.

Sandel Energy v. Armour Pipe Line Company

Whether foreign entity's forfeiture of certificate of authority to do business in Texas caused forfeiture of claim to payments overriding royalty interest.

Ambrose Claybar v. Samson Exploration, LLC

The Beaumont Court of Appeals held that an indemnity agreement between an oil company and a landowner only obligates the oil company to reimburse the landowner for third-party claims, and did not create an indemnity obligation for the oil company to reimburse the landowner for its attorney's fees and costs.

HRB Oil & Gas v. Peregrine Oil

The Houston 1st Court of Appeals held that there was a fact issue as to whether an operator could require one of its non-operators to repay allegedly overpaid revenues.

Templeton v. Lackey

Mineral title dispute, focused on the construction of a single warranty deed, where the 9th Court of Appeals held that the claim could only be brought exclusively under the Trespass to Try Title Statutes.

EP Energy v. Fairfield Industries

Breach of contract case regarding seismic data and license agreement. 14th Court of Appeals held that a fee under the contract was due every time EP's parent company experiences change in control.

Motion for Rehearing on Denial of Review

William Paul Gips v. Hahn

Title case involving partition deed signed by less than all parties and the effect of related stipulation of interest.

Virtex Operating Co., Inc. v. Robert Leon Baurle

Accommodation doctrine dispute, involving competing factual arguments and competing expert witnesses, centered around overhead power lines the mineral lessee intended to install, which the surface owner contended would interfere with its use of helicopters in hunting operations. Jury found for surface owner. The San Antonio Court of Appeals affirmed jury verdict. Lessee contended that the accommodation doctrine should not allow a hunter's occasional use require the accommodations it believed were "expensive, impractical, contingent, and novel."

Motion for Rehearing on Petition for Review Denied

Anglo-Dutch Energy v. Crawford Hughes Operating

Attorneys' fees in dispute involving oil and gas joint account.

Petition Filed, Response Requested

Crimson Exploration v. Allen Drilling

In a case involving several overlapping agreements covering differing but overlapping lands and depths, whether a merger clause in the later document as effective to preclude liability for breach of the earlier agreement.

Endeavor Energy Res.. L.P. v. Energen Res. Corp.

Whether a certain continuous development provision allowed the lessee to "bank" unused days to further extend subsequent terms.

Apache Corp. v. Bryan C. Wagner

Contract interpretation dispute, involving an arbitration provision and indemnity provision.

MISCELLANEOUS ADDITIONAL CASE HIGHLIGHTS

By: Chris Halgren and Austin Brister

Post-Production Costs

BlueStone Nat. Res. II, LLC v. Randle, No. 02-18-00271-CV, 2019 Tex. App. LEXIS 3167 (Tex. App.—Fort Worth Apr. 18, 2019, no pet. h). The court analyzed a pre-printed lease form with attached addendum containing allegedly contradictory royalty clauses. The pre-printed lease form provided that royalties would be computed based on the market value at the well. The addendum, which controlled in the event of a conflict, provided that no deduction would be permitted for post-production costs and that royalties would be computed and paid based on the "gross value received." The court held that the addendum controlled and created a "pure-proceeds measure" to compute royalties, which did not require a valuation point to be specified. The lessor argued that a valuation point was necessary and that the lease unambiguously set that point "at the well," thus post-production costs were properly netted out. However, the lessor argued, and the court agreed, that the addendum provision created a different royalty computation methodology that must be given effect because the addendum stated it controlled over the pre-printed lease form. The court noted that its holding conflicted with the holding in *GLO v. Sandridge Energy*, 454 S.W.3d 603 (Tex. App.---El Paso 2014, pet. denied) that examined a similar lease form and potentially created a conflict among the courts.

Materialman's Lien

Acme Energy Servs. v. Staley, 569 S.W.3d 831 (Tex. App.—El Paso 2019, no pet. h). Holders of a mineral lien on an oil and gas lease released the lien by resolving dispute of the underlying debt with a bankruptcy debtor after the lease had been sold to third-parties. The court held that the lienholders could not foreclose on a lien against the new owners of the lease after accepting new consideration from the original lessee in a bankruptcy proceeding. The lienholders had filed materialman's lien on an oil and gas lease to secure payment on invoices for work performed on a well. The original lessee assigned its interest in the lease to third-parties, subject to the liens, then filed for bankruptcy under

Chapter 11. To resolve a challenge to the amounts owed, the lienholders entered into a stipulation with the original lessee/debtor wherein the parties agreed to a certain amount owed on the claimed debt and that a portion would be considered a secured obligation in the reorganization plan with the remainder categorized as an unsecured obligation. The stipulation also provided that it would resolve the entire dispute over the validity of the debt, but was not intended to release the liens on the oil and gas lease now owned by the third-parties. However, the El Paso court held that by resolving the dispute over the original debt, even for a lower amount in a bankruptcy proceeding, the lienholders could no longer seek to foreclose on their lien.

Limitations for Injuries to Real Property

Swift Energy Operating, LLC v. Regency Field Servs. LLC, Tex. App. LEXIS 4370 (Tex. App.—San Antonio May 29, 2019, no pet. h). Swift's claim for trespass on its PCQ Lease was time barred because its suit was filed more than two years after Swift had notice that the plume of gas from a neighboring injection well had improperly spread into its leased premises. Because the presence of the gas plume made drilling more difficult, Swift's time to file suit began running once the encroaching gas plumed. The court noted that Swift did not plead or argue for the benefit of the discovery rule to toll the limitations period. And the evidence showed that Swift had sufficient actual notice of the infringement more than two years before filing suit. However, a different result was reached with regard to Swift's other (non-PCQ) leases. There was no evidence of when Swift's rights were interfered with by the gas plume. As a result, Swift's claims associated with its non-PCQ leases were remanded for trial.

Master Service Agreement – Right to Terminate

Polaris Guidance Sys., LLC v. EOG Res., Inc., No. 14-17-00717-CV, 2019 Tex. App. LEXIS 3051 (Tex. App.—Houston [14th Dist.] Apr. 16, 2019, no pet. h). EOG and Polaris entered into a Master Services Agreement to govern EOG's use of Polaris' well-monitoring software. Subsequently, the parties signed a License Agreement and a "Price Quote," that was made subject to the MSA and the License. When EOG later decided to discontinue its use of Polaris' software, it terminated the parties' arrangement as provided by the MSA. However, Polaris argued that the License superseded the MSA because of the presence of a merger clause. According to Polaris, EOG could not terminate the License and, as a result, EOG was obligated to utilize (and pay for) Polaris' services in perpetuity. The court disagreed, holding that all three documents must be read together and the License's merger clause did not change that result. Accordingly, the court affirmed the trial court's judgment that EOG did not breach its agreement with Polaris by terminating their agreement.

Lease Perpetuation

Cimarex Energy Co. v. Anadarko Petroleum Corp., 2019 Tex. App. LEXIS 1992 (Tex. App.—El Paso Mar. 13, 2019). Cimarex could not hold an oil and gas lease beyond the primary term based on its co-tenant's operations, resulting in the expiration of Cimarex's lease at the end of the primary term. Cimarex and Anadarko separately leased undivided minerals interests in the same property and, as a result, were mineral co-tenants. The parties did not enter into a joint operating agreement or any similar agreement whereby they would conduct joint operations on the property. Anadarko drilled two wells and tendered payment to Cimarex as a mineral co-tenant. The court held it was immaterial that Cimarex paid royalties to its lessor or that its lessor accepted those payments. The court concluded that Cimerax had to conduct its own operations, or participate under a JOA in Anadarko's operations, to perpetuate its lease.

Easements

Murphy Land Grp., LLC v. Atmos Energy Corp., 2019 Tex. App. LEXIS 3130 (Tex. App.—Tyler Apr. 17, 2019, no pet. h). Atmos' pipeline easement, including a general right of ingress and egress to access the easement, survived the termination of a later roadway easement granted by the property owner. Atmos owned a pipeline easement across Murphy's property that granted Atmos use for pipeline activities and also granted Atmos a right to cross Murphy's property to access its easement. Subsequently, the parties entered into a Roadway Lease that granted Atmos a specific roadway easement. When the Roadway Lease expired, Murphy claimed that the original pipeline easement also terminated because, according to Murphy, the two easements merged into a single estate. The court held that the pipeline easement did not terminate because it operated independently of the Roadway Lease. The two agreements did not reference each other and the court found no evidence of an intent to merge them together.

Texan Land & Cattle II, Ltd. v. ExxonMobil Pipeline Co., 2019 Tex. App. LEXIS 3989 (Tex. App.—Houston [14th Dist.] May 16, 2019, no pet. h). Dispute regarding scope of a pipeline easement from the early 1900s, granting a pipeline easement for "transportation of oil or gas." The landowner contended that "oil or gas" in this context is limited to "crude oil" and does not include refined products such as gasoline and diesel. The court conducted review of decisions from other jurisdictions, dictionaries, and other secondary sources, and concluded that the ordinary meaning of "oil and gas" included the right to transport the refined products gasoline and diesel through the pipeline.

Title Disputes

McDuff v. Brumley, 2019 Tex. App. LEXIS 1347 (Tex. App.—Amarillo Feb. 22, 2019, pet. filed). Plaintiff filed a suit to quiet title, claiming that the Plaintiff had adversely possessed the property and the Defendant's claim to title had been defeated. Although the jury found the Plaintiff had adversely possessed the property, the appellate court reversed the judgment finding title vested in the Plaintiff because the Plaintiff had failed to allege a claim for trespass to try title. A claim for trespass to try title is the sole and exclusive method to determine title. In contrast, a suit to quiet title is used to remove a cloud on title created by a facially valid instrument that is invalid or unenforceable. Because the Plaintiff prevailed on the wrong theory, the court held that judgment must be reversed and rendered in the Defendant's favor.

Ellison v. Three Rivers Acquisition LLC, 2019 Tex. App. LEXIS 1062 (Tex. App.—Corpus Christi Feb. 14, 2019, pet. filed). An oil and gas lessee operated oil and gas leases and sought to resolve a dispute over the boundary between two leases. The mineral owners executed a "Boundary Stipulation," however, the court held that the stipulation could not be used to alter the parties' respective title because the stipulation did not have words of grant. There was also no reason to construe the stipulation as a correction instrument because there was no ambiguity about the boundary in the original deed and there was no present uncertainty or dispute as to the location of the actual boundary. Based on the court's resolution of the title dispute, the case was remanded to the trial court to determine whether the lessee or the first-purchaser of production was the "payor" under Chapter 91 of the Texas Natural Resources Code. Both the lessee and the first-purchaser argued that a successor-lessee was the correct payor. The mineral owner argued that there can be multiple "payors" under Chapter 91. The court remanded the issue for further proceedings.

Rahlek, Ltd. v. Wells, 2019 Tex. App. LEXIS 4249 (Tex. App.—Eastland May 23, 2019). Warranty deed conveyed all property subject to a reservation clause that expressly reserved an interest in "all current oil and gas production" and also provided that the deed assigned to the grantee a one-eighth (1/8th) royalty on new leases. The court held that the grantor properly reserved an interest in current production, but failed to reserve any interest in any new production. Deeds pass the greatest estate, unless an interest is expressly and clearly reserved or excepted from the conveyance. While the grantor clearly reserved an interest in current production, the deed's description of an interest being assigned to the grantee could not alter the fact that granting clause purported to grant all the property.

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