OIL AND GAS LAW FOR THE REST OF US

I. ESTATES IN LAND

A. SURFACE ESTATE VS. MINERAL ESTATE.

— INTRODUCTION

The United States is the only country in the world where minerals belong to private landowners rather than the government. Title to land in Texas emanates directly from the sovereign to a private owner. All grants prior to 1866 were grants of the surface only with the minerals being retained by the sovereign. The Texas Constitution of 1866, however, provided that the State of Texas retrospectively granted "all mines and minerals substances therein" to the surface owner.

In a privately owned fee simple estate, a landowner owns both the surface and minerals rights, and as each is its own separate estate, each estate may be severed and fully conveyed to or owned by different parties. A severance of the mineral estate can be made in one of two ways; either an express grant of the mineral estate through a mineral deed or a lease, or by reserving the mineral estate in a conveyance of the surface estate. Note that minerals may also be transferred by devise or descent. Regardless of the method used, there can be two separate owners of the "same land".

— MINERAL ESTATE IS THE DOMINANT ESTATE

The general rule of law in Texas is that the mineral estate is the dominant estate, and the surface estate in the serviant estate. The owner of the mineral fee estate has the right to use as much of the surface estate as is reasonably necessary in order to fully develop, use and enjoy the estate. *Texaco, Inc. v. Farris,* 413 S.W.2d 147 (Tex. Civ. App. – El Paso 1967, writ ref'd n.r.e.)

Rights typically enjoyed by a mineral owner with regard to the use and enjoyment of his estate include the right to enter upon the surface for exploration and production of minerals; the right to take water from the surface and dispose of saltwater, even if doing so would make the surface unusable for farming or ranching purposes; the right to construct roads, pipelines and other structures on the property in addition to selecting drillsite locations; the right to begin operations at the mineral owner's discretion, generally without giving advance notice to the surface owner; and the right to conduct geophysical

exploration and seismic operations. (NOTE TO ME: DISCUSS LIMITATIONS AND/OR PROHIBITIONS CREATED BY OIL AND GAS LEASES.)

The mineral owner may use so much of the surface as is reasonably necessary, so long as he is not negligent in his activities, has not used more of the surface than is reasonably necessary, and that he exercises due regard for the surface of the land. *Humble Oil & Refining Company v. Williams,* 420 S.W.2d 133 (Tex. 1967).

— "DUE REGARD"

Note that due regard involves the accommodation doctrine. *Getty Oil v. Jones*, 470 S.W.2d 618, 622 (Tex. 1971). The accommodation doctrine simply provides that where there is an existing use by the surface owner which would otherwise be precluded or impaired, and where under established practices in the industry there are reasonable alternatives available whereby the minerals can be recovered, then the mineral owner may be required to use an alternative method of extraction. (NOTE TO ME: Example from *Getty v. Jones* – Getty using 17 foot tall pump jacks were interfering with the farmer's rolling irrigation system.)

Cases subsequent to *Getty*, however, demonstrate that the accommodation doctrine is not easily invoked. The surface owner has the burden of proof to show that (i) the mineral owner has other means of access and production which will not interfere with the surface owner's existing use, (ii) such other means of access and production are reasonable, and (iii) any alternative uses of the surface other than the existing end use, are impracticable and unreasonable under all of the circumstances on a fact-by-fact and case-by-case basis.

Davis v. Devon Energy Production Co., L.P., 204 W.L. 1175483 (Tex. App. – Amarillo, 2004, no pet. h.) is one of the most recent Texas accommodation doctrine cases. Devon asserted that it had a superior right to use the surface for oil and gas operations and sought to enjoin the surface user from intentionally interfering with its operations. Among other things, the surface lessor purposely made roads impassable or moved them all together. It prevented the lessee from building permanent roads. The court found that Devon's use of the surface did not impede the surface lessor and that the accommodation doctrine had not been violated.

Texas Genco, L.P. v. Valence Operating Co., 187 S.W.3RD 354 (Tex. App. – Waco 2006, pet. denied) is the one Texas case that expanded the accommodation doctrine. There, the lessor used the doctrine to force

the lessee to move a drilling site to a different location to accommodate the future expansion of a waste treatment facility. Although the lessee wanted to drill elsewhere and the conflicting improvements did not yet exist the court considered the surface user's future plans and required the lessee to use a location from which it would have to drill a directional well.

While the accommodation doctrine provides some protection, it carries a burden that is not easy to overcome. The surface owner must show that the interference with the existing operations is more than a simple inconvenience.

One other point to note with regard to execution of an oil and gas lease. In newer leases, in particular (but not necessarily) where the surface and minerals are owned by the same party, the oil and gas lease will contain detailed provisions with regard to surface use and surface restrictions, and at times even prohibitions against drilling on the surface of the leased property. (NOTE TO ME: DIRECTIONAL DRILLING OR POOLING.)

B. OIL AND GAS DISTINGUISHED FROM "OTHER MINERALS"

What does exactly does the term "other minerals" encompass?

There was a fair amount of litigation in the 1970's and 1980's with regard to what exactly the term "other minerals" encompassed. Briefly stated, the surface destruction test was the first rule espoused. *Acker v. Guinn*, 464 S.W.2d 348 (Tex. 1971). The court ruled that iron ore was not a mineral and therefore belonged to the surface owner. The court found that the term "other minerals" did not include minerals that required destruction of the surface as a method of obtaining or producing the minerals.

(NOTE TO ME: EXAMPLES SUCH AS COAL, URANIUM, SHALE, CALICHE AND OTHER "NEAR SURFACE SUBSTANCES".) Subsequently, *Reed v. Wylie*, *I*, 554 S.W.2d 169 (Tex. 1977), and *Reed v. Wylie, II*, 597 S.W.2d 743 (Tex. 1980), expanded upon the surface destruction test. The Supreme Court first said the *Acker* test did not apply to any conveyance or reservation of a substance specifically described in the conveyance or reservation regardless or whether it required surface destruction for removal. Secondly, the court said that if a substance is at or near the surface so that any reasonable method of extraction would require destruction of the surface the substance is a part of the surface as a matter of law. The court stated that deposits of lignite within 200 feet of the surface are "near surface" as a matter of law. The court further stated that if a particular substance is deemed to be a part of the surface estate by either of the above tests, additional deposits of the same substance found at the other depths are also deemed part of the surface.

In 1984, the Supreme Court in *Moser v. United States Steel Corp.*, 676 S.W.2d 99 (Tex. 1984), announced its intention to abandon the surface destruction test which it deemed "unworkable". The Court ruled that if an instrument states that a substance is a mineral, then it is a mineral regardless of its method of extraction. It also stated that if an instrument does not state that a particular substance is a mineral, then it is a mineral if it is within the ordinary and natural meaning word "mineral". If a substance is a mineral by virtue of its natural meaning, then the mineral owner can extract the substance and use as much as the surface as is reasonably necessary. The mineral owner, however, will be required to compensate the surface owner for destruction of the surface unless the substance removed was expressly granted or reserved.

Since the court was now espousing a completely new standard, in order to avoid a flood of litigation, the court stated that the new standard would only apply to all conveyances which occurred after June 8, 1983. Also, the court specifically excepted certain substances from the mineral estate and ruled that they were part of the surface estate as a matter of law, including limestone, caliche, surface shale, water, sand, gravel, near-surface lignite coal and near-surface iron ore.

(NOTE TO ME: BRIEFLY MENTION THE CREATION OF QUALIFIED SUBDIVISIONS.)

II. OIL AND GAS LEASING

— ATTRIBUTES OF A SEVERED MINERAL ESTATE

There are five essential attributes of a severed mineral estate:

1. the right to develop, including the right of ingress and egress;
2. the right to lease (the executive right);
3. the right to receive bonus payments;
4. the right to receive royalty payments; and
5. the right to receive delay rentals.

French v. Chevron, 896 S.W.2d 795. 797 (Tex. 1995).

— DEFINITIONS

Bonus Payment – The cash consideration paid to a lessor for the execution of an oil and gas lease, and is usually figured on a per-acre basis.

Royalty – the right under the lease to receive an expense free, fractional part of, or percentage of, the total production of oil and gas produced from a tract of land or lands pooled therewith.

Landowner's Royalty – the share of production received by the lessor or his successors under an oil and gas lease.

Non-Participating Royalty – the non-participating royalty, like a royalty, is an expense free interest in the oil and gas as, if and when produced. The prefix "non-participating" indicates that the holder of this interest does not share in any bonus or delay rentals, nor does the holder of a non-participating interest acquire any right to execute leases or to explore and develop. This interest is always a burden upon and is carved out of the lessor's royalty under the oil and gas lease.

A non-participating royalty can be expressed as a fixed interest, such as a 1/16 (of 8/8ths) non-participating royalty, or it can be expressed as a fraction of royalty, meaning that the holder of this interest will receive a stated fractional interest of whatever royalty is provided in the lease, such as 1/4 of the royalty. Regardless of whether it is a fixed interest or a fraction of royalty, the non-participating royalty interest is carved out of the lease royalty paid to the lessor. A non-participating royalty interest can also be perpetual in its duration, can be limited for a specific number of years (term royalty), can be limited to a specific number of years and as long thereafter as oil, gas or other minerals are produced, or it can be tied to a specific oil and gas lease, such that the term interest will expire when the lease expires.

Overriding Royalty – An overriding royalty interest is also an expense free interest in the total production of oil and gas produced, however, it is a burden against and carved out of the lessee's interest in the production. In addition, an overriding royalty interest is limited in its duration to the term of the lease which it burdens. Distinguished from a non-participating royalty interest, which in most instances is an interest in the land, rather than an interest under an oil and gas lease. The overriding royalty interest will continue in effect so long as the oil and gas lease which it burdens remains in effect, meaning that the overriding royalty interest will continue as long as there is production from the oil and gas lease to which it attaches.

Delay Rental – the sum that is paid during the primary term usually on a mineral acreage basis, for the privilege to defer drilling a well for a stated period (usually one year).

Shut-in Royalty – a payment made when a gas well, capable of producing in paying quantities, is shut-in for lack of a market for the gas (can also be shut-in due to mechanical issues, lack of a pipeline, etc.)

— LEASE TERMS

An oil and gas lease is a conveyance of real property in the nature of a fee simple determinable. That is, it is a conveyance of the oil, gas and other minerals in place for a specified period, being the primary term, and as long thereafter as oil, gas or other minerals are produced from the leased premises. (NOTE TO ME: EXPLAIN THE "STANDARD" PRODUCERS 88 FORM.)

The Granting Clause – the Lessor grants the lease to the Lessee in keeping with a conveyance of a fee simple estate (statute of frauds), usually sets forth the purpose, and describes the property.

The Mother Hubbard Clause – Follows property description, provides that if a lessor owns any property contiguous with or adjacent to the leased property, that property is also leased. Intended to include small strips or accretions which may be adjacent to the leased premises.

The Habendum Clause – makes the instrument a conveyance in fee simple determinable by limiting the term of the lease "for a number of years and so long thereafter as oil and gas are produced from the property or property pooled therewith." Breaks lease into primary and secondary terms.

> Primary term – no action is required by Lessee to maintain the Lease. (Paid-Up Lease)
>
> Secondary term – period where the Lease will expire unless some condition, such as production of oil and gas in paying quantities, exist. (Other conditions to extend the lease could include pooling, continuous development obligation or shut-in royalty. See below.)

The Royalty Clause – establishes the fractional royalty payable under the lease, the method of calculating royalty based upon "proceeds" from the production or "market value" at a specified point. Includes shut-in royalty provision and, if applicable, delay rental payment.

The Delay Rental Clause – Negates any implied duty or implied covenant to drill an exploratory test well during the first year of the

primary term. If delay rentals are not paid pursuant to the terms of the lease, the failure to pay may cause a termination of the lease because it constitutes a failure of a condition. NOT included in "Paid-Up" leases. Typically, a delay rental payment must be made before the end of the first year of the primary term of the lease in order for the lease to continue in force and effect for the second and all successive years of its primary term. (NOTE TO ME: FIVE YEAR PRIMARY TERM.

Principal Savings Clauses –

The Shut-In Royalty clause states that if a Lessee drills a well that is capable of producing minerals in paying quantities and the well is shut-in for lack of a market or maintenance, the lease will not expire and will be held in force so long as the lessee makes some nominal payment. Could be payable either during and/or after expiration of primary term.

The Operations Clause – States, that if, at the end of a primary term there is not actual production, but the Lessee is conducting "operations", as defined in the Lease, the Lease will not expire so long as drilling operations continue. (TX 0503P Form – as part of Habendum Clause) Also called Continuous Operations Clause or Continuous Development Clause.

The Dry Hole Clause – Provides that if a Lessee drills a well which fails to produce oil and gas in paying quantities, the Lessee may move forward with additional drilling within a certain period of time and the oil and gas lease will not be terminated.

The Cessation of Production Clause – Essentially codifies the temporary cessation of production doctrine by providing express terms for resuming production of a well for any reason.

The Force Majeure Clause – Purpose is to prevent termination of a Lease due to the lack of production in paying quantities when the cessation of production is beyond the control of the lessee.

The Breach Clause – Attempts to substitute a damage suit for termination of the Lease. Effective as to nonpayment of royalty and most non-performances of the Lease.

The Pooling Clause – Allows the Lessee to combine one Lessor's acreage or interest with other acreage in order to form a pooled unit. The effect of pooling is that production on any of the acreage pooled will be considered as production from the lease and will hold all of the leases included within the pooled unit. A practitioner representing a

landowner should consider using a **Pugh clause** – which is used to prevent a Lessee from using pooling to hold all of the Lessor's acreage by production when only a portion of the Lessor's acreage is included in the pooled unit. The Pugh clause will provide that only the acreage of the lease pooled is maintained by production, and as to any other acreage of the lease not pooled, the lease will terminate if production does not exist on such remaining lands or lands pooled with such remaining lands before the primary term ends.

Administrative Clauses

The Warranty Clause – Provides that the Lessor warrants title to the mineral estate and further grants the Lessee the right to discharge any mortgage or lien and be subrogated to the rights of the lienholder.

The Proportionate Reduction Clause – Provides that if the Lessor owns less than 100% of the minerals under the property, their royalties and shut-in royalties will be reduced to correspond with the percentage of the mineral estate owned by the Lessor

The Equipment Removal Clause – Gives the Lessee the specific right to remove equipment from the well site after termination of the Lease, usually within a set time period after the termination of the Lease.

The Surrender Clause – Provides that a Lessee and its successors and assigns shall have the right at any time to surrender any portion of the lands covered by the Lease in whole or in part, thereby releasing the Lessee form liability or obligation as to the acreage released and so surrendered.

Lease Memorandum Clause – Often used if the parties do not want nearby neighbors to know what deal he has agreed to with the Lessee.

— SPECIAL PROVISIONS

If representing a lessor, recommended addendums include:

Vertical and horizontal release provisions – depth limitations.
Surface use provisions/restrictions
Pooling limitation provisions
Shut-in royalty limitation provision

— IMPLIED LEASE COVENANTS

Texas Courts have established these covenants as part of all leases. Three broad categories:

1. Covenant to Develop the Premises – This covenant includes:

   (i) The duty to drill an initial well. Not really an issue in today's industry. (ii) The Covenant for Reasonable Development after Production has been Obtained –Imposes a duty upon the lessee to drill additional developmental wells as would a "reasonably prudent operator". (There could also be express lease provisions which require further development.) (iii) The Covenant to Further Explore -Development of the leased premises after the discovery of oil, gas and other minerals does not impose on the Lessee a separate obligation to further explore, the exploration obligation being encompassed within the implied obligation to develop. *Sun Exploration & Production Co. v. Jackson,* 783 S.W.2d 202 (Tex. 1989). (Sun – Large Lease (10,000+ acres), Oyster Bayou Field covering 1100 acres, fully developed. Lessor sought to have remainder of lease cancelled. Supreme Court said no implied covenant to further explore exists independent of the covenant of reasonable development.)

2. Covenant to Protect the Leasehold Against Damage – Protect the Leased premises from offset drainage. Does not require the Lessee to protect the Lessor's land from all drainage but rather substantial damage. "Reasonable prudent operator" standard. Test of profitability. *Amoco Production Co. v. Alexander*, 622 S.W.2d 563 (Tex. 1981) Could be altered by express lease provisions.

3. Covenant to Manage and Administer the Lease – Includes a duty to seek administrative relief (e.g., RRC approval to drill offset wells). Also includes duty to market production in good faith, securing the best available price, terms and conditions and giving due regard to the rights of both the Lessor and Lessee *Amoco Production Co. v. First Baptist Church of Pyote,* 579 S.W.2d 280 (Tex. App. – El Paso 1979, writ ref'd n.r.e.)

4. Other Possible Implied Obligations

   Duty to Notify – None in Texas, probably part of Implied Covenant to Manage and Administer the Lease.