

**NAVIGATING THE POOLING CLAUSE WATERS:
New and Recurring Issues**

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**South Texas College of Law
Energy Law Conference
September 2-3, 2009**

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**NAVIGATING THE POOLING CLAUSE WATERS:
New and Recurring Issues¹**

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Jonathan D. Baughman

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¹ This paper has been updated from its original publication in the Rocky Mountain Mineral Law Institute. *See* 53 Rocky Mt. Min. L. Inst. §33 (2007). It was previously presented at the proceedings of the 53rd Annual Institute of the Rocky Mountain Mineral Law Foundation and was jointly authored by Jonathan D. Baughman and Mitchell Ayer. Jonathan D. Baughman is a partner in the Houston office of McGinnis, Lochridge & Kilgore, L.L.P. Mr. Ayer is a partner in the Houston office of Thompson & Knight, LLP.

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A. Introduction.

[1] Purpose of Pooling.

Voluntary pooling is an important tool for promoting conservation, avoiding unnecessary drilling of offset wells, sharing risks, and minimizing expenses. Given the skyrocketing costs to drill and complete wells, pooling is more important than ever to avoid the costs of unnecessary wells. This paper highlights some of the more frequently encountered issues that arise and does not attempt to address all of the issues that have developed over the years.²

[2] Types of Units.

Before discussing pooling clauses and the creation of a unit, one must understand the type of unit that is contemplated. The term “unit” can be confusing as, in general, there are four different kinds of units. Using Texas as an example, the first is voluntarily-pooled units, the most common, which occur through the combination of separately-owned mineral interests and leases covering different tracts of land into one “pool” or tract, usually through the execution and filing of an instrument styled a designation or declaration of unit. The second is the force-pooled unit, which results from an order of the Texas Railroad Commission under the Mineral Resource Pooling Act, TEX. NAT. RES. CODE §§ 102.001 et seq. The third is the drilling unit, which reflects the acreage assigned to a well as shown on the plat submitted to the Railroad

Commission to establish that the operator seeking to drill a well has sufficient acreage to satisfy the Commission’s density rule. The fourth is the proration unit created under Railroad Commission Rule 38(a)(2) in connection with special field-rules regarding acreage, reserves, or other factors.³ This paper will only address the first type—voluntary pooled units (sometimes referred to as contractual units).

Compulsory pooling statutes exist in all major producing states except Kansas. But Texas and California have narrowly written statutes that are seldom used.⁴ For federally owned lands, the Secretary of the Interior can condition the issuance of leases on the lessee’s promise to commit the lease to a unit or cooperative plan should the Secretary determine it is advisable or necessary to do so.⁵ But there is no federal compulsory pooling and unitization statute.

Unitization or unit operations, on the other hand, refers to the consolidation of mineral or leasehold interests covering a common source of supply. This is most often used in secondary or tertiary recovery. The primary function is to maximize production by efficiently draining the reservoir, utilizing the best engineering techniques that are economically feasible.⁶ Compulsory unitization statutes exist in all major producing states except Texas.⁷

B. Contractual Pooling Clauses.

[1] General.

Pooling occurs when two or more leases are combined for the purpose of drilling a well. The principal effect of a pooled unit is

² The scholarly literature about pooling and unitization has grown enormously in recent years. Bruce Kramer & Pat Martin’s 5-volume treatise, *THE LAW OF POOLING AND UNITIZATION* (3d ed. Matthew Bender 2006) (“Treatise”), is a good place to start. This treatise presents a well-written discussion of the pooling issues that arise most frequently. The authors have relied heavily on this treatise and it is often cited by the courts. *See also* Hoffman, *VOLUNTARY POOLING AND UNITIZATION* (1954); Pat Martin & Bruce Kramer, *Williams & Meyers OIL AND GAS LAW* § 670-670.9; Smith & Weaver, *Texas Law of Oil & Gas*, § 4.8.

³ Carroll Martin and D. Davin McGinnis, “All for One and One for All: A Primer on Pooling in Texas,” 20(3) *TEX. OIL & GAS L. J.* 1, 1 (June 2006).

⁴ Treatise § 3.02 (1).

⁵ 30 U.S.C. § 226 (elec. 2009).

⁶ Treatise § 1.02.

⁷ Treatise § 3.02(2).

that production of oil and gas from a well located on any tract included in the pooled unit will be regarded during the life of the lease as production of each and all of the tracts included in the pooled unit.⁸

Pooling clauses benefit both the lessor and the lessee. Often at the time of leasing, the lessor does not know whether the lessor's acreage will become the drill site tract. When pooling occurs, tracts from two or more leases are combined or pooled for the drilling of the well. The production and operations on the pooled unit are treated as having taken place on each tract within the pooled unit. As a result, the production on the pooled unit will maintain the leases comprising the unit. Production is shared among the tracts and leases, usually in proportion to the amount of acreage contributed to the pooled unit by each pooled tract and lease.

Some of the other legal consequences are that the life of the lease is extended as to all tracts beyond the primary term for all leases included in the unit as long as there is production. Likewise, the commencement of a well on any one of the tracts operates to excuse payment of delay rentals on all of the tracts comprising the unit. In addition, the lessee is relieved of the implied obligation of reasonable development of each tract separately. The lessee is also relieved of the obligation to drill off-set wells on other pooled tracts to prevent drainage. Each lessor gains the right to receive royalties from wells on the other tracts included in the unit.⁹

[2] Typical Pooling Clause in Lease.

While there is no standard pooling clause, the following provision contains language that one typically finds in a pooling provision:

Lessee, at its option, is hereby given the right and power to pool or combine the acreage

⁸ Southland Royalty Co. v. Humble Oil & Ref. Co., 249 S.W.2d 914, 916 (Tex. 1952).

⁹ *Id.*

covered by this lease, or any portion thereof as to oil and gas, or either of them, with other land, lease or leases in the immediate vicinity thereof to the extent, hereinafter stipulated, when in Lessee's judgment it is necessary or advisable to do so in order to properly develop and operate said leased premises in compliance with the spacing rules of the Railroad Commission of Texas, or other lawful authority, or when to do so would, in the judgment of Lessee, promote the conservation of oil and gas from said premises.

[3] Pooling Power Must Be Express.

Absent statutory authority, a lessee has no power to pool the leased tract with other tracts unless the lessor has expressly given the lessee such power.¹⁰ The pooling clause often found in the oil and gas lease gives the lessee the power to pool or combine the lessor's interest without further consent of the lessor. At the time of the execution of the lease, often neither the lessor nor the lessee knows of the particular facts upon which it will be necessary for the lessee to exercise the pooling power. As a result, the pooling authority granted is often stated in general terms.

[4] Practical Effect of Pooling.

The proper exercise of pooling clauses can have a significant impact on the allocation of royalties as well as whether production and drilling operations will be considered to have taken place on tracts other than the drill site tract. If pooling is found to be improperly done, a lessee may arguably be in the awkward

¹⁰ *Tittizer v. Union Gas Corp.*, 171 S.W.3d 857 (Tex. 2005) (court recognizing that lessee has no implied power to pool); *Jones v. Killingsworth*, 403 S.W.2d 325 (Tex. 1965) ("absent express authority, a lessee has no authority to pool").

situation of having to pay excess royalties and losing leases that it thought were being maintained by the purported pooled unit, although the Supreme Court of Texas recently held that in some situations, the expiration of a lease within a pooled unit does not automatically dissolve or affect the pooled unit.¹¹

[5] Generally—No Implied Duty to Pool Exists.

Generally, there is no duty to pool acreage and in fact most pooling clauses expressly recognize that the pooling power is optional.¹² Several Texas courts have recently reaffirmed that no implied duty to pool exists under Texas law.¹³ Other courts have likewise rejected an implied duty to pool.¹⁴

C. Construction of Pooling Authority by Courts.

It appears that the courts have strictly construed the pooling clause when an issue exists over whether a condition precedent has been satisfied whereby the unit is created. On the other hand, the courts appear to take a more liberal approach concerning the exercise of the pooling power by the lessee once all conditions precedent have been satisfied.

[1] Exercise of the Pooling Power More Than Once.

Unless limited by the language of the lease, the pooling power may be exercised more than once if done so in good faith.¹⁵ In *Texaco, Inc. v. Letterman*, the court held that

the absence of express language in the lease that the pooling power may be exercised from time to time did not evidence the parties' intent to limit the pooling power to the creation of a unit just on one occasion.¹⁶

[2] Enlargement of the Pooled Unit.

While most modern leases contain express language permitting the lessee to enlarge an existing pooled unit, issues arise as to whether a lessee may enlarge the unit when no such authority is expressed in the lease. One court that addressed this issue permitted the enlargement of an existing pooled unit when, under the particular facts, the enlargement would benefit both lessor and lessee even though the lease did not expressly permit the lessee to enlarge the pooled unit.¹⁷

[3] Reducing the Size of the Pooled Unit.

Generally, absent express language in the lease, the lessee is not permitted to reduce the size of the pooled unit unless all of the leases included in the pooled unit expressly authorize the reduction in the pooled unit or express consent is obtained from all lessors.¹⁸ The language in the lease permitting the reduction of the size of the pooled unit must be clear and unequivocal. For example, in *Grimes v. La Gloria*,¹⁹ the lease contained language permitting the lessee "to enlarge or change the shape of existing units to such different size or shape as lessee may desire." The court held that this language did not authorize the unit to be reduced in size by excluding previously pooled lands.²⁰

¹¹ *Wagner & Brown, Ltd. v. Sheppard*, 282 S.W.3d 419 (Tex. 2008).

¹² *Kinnear v. Scurlock Oil Co.*, 334 S.W.2d 521 (Tex. Civ. App.—Beaumont 1960, writ ref'd n.r.e.).

¹³ *Tittizer v. Union Gas Corp.*, 171 S.W.3d 857, 860 (Tex. 2005); *PYR Energy Corp. v. Samson Res. Co.*, 456 F.Supp.2d 786, 791-793 (E.D. Tex. 2006); *Green v. Gemini Expl. Co.*, 2003 WL 1986859 (Tex. App.—Austin May 1, 2003).

¹⁴ *See Croston v. Emax Oil Co.*, 464 S.E.2d 728 (W.Va. 1995); *Blair v. Arrow Expl. Co.*, 1995 WL 291846 (Tex. App.—Houston [1st Dist.] May 11, 1995).

¹⁵ *Texaco, Inc. v. Letterman*, 343 S.W.2d 726 (Tex. Civ. App.—Amarillo 1961, writ ref'd n.r.e.).

¹⁶ *Id.*

¹⁷ *Expando Prod. Co. v. Marshall*, 407 S.W.2d 254 (Tex. Civ. App.—Fort Worth 1966, writ ref'd n.r.e.).

¹⁸ *Ladd Petroleum Corp. v. Eagle Oil & Gas Co.*, 695 S.W.2d 99 (Tex. App.—Fort Worth 1985, writ ref'd n.r.e.).

¹⁹ *Grimes v. La Gloria Corp.*, 251 S.W.2d 755, 760 (Tex. Civ. App.—San Antonio 1952, no writ).

²⁰ *Id.*

[4] Effective Date of Pooling.

Most leases contain language whereby the creation of a pooled unit does not become effective until the pooling declaration is recorded in the applicable county or parish records. On the other hand, some leases contain clauses whereby the pooling declaration must be recorded but no mention is made as to when the declaration is effective. As shown below, the lease language can have an important impact on when the pooled unit becomes effective or effective at all.

[a] Pooling Clause Requiring Recordation.

Courts have strictly interpreted the lease language whereby the pooled unit does not become effective until filed. For example, in *Sauder v. Frye*,²¹ the parties executed a designation of pooled unit 16 days prior to the lease expiration. However, the lease designation was not recorded until a week after the lease expired. As a result, the court held that the pooling unit did not maintain the lease. In making this determination, the court relied heavily upon the language of the lease as creating a condition precedent (filing the unit declaration) to extending the lease.²²

The Texas Supreme Court in *Tittizer v. Union Gas Corp.*²³ recently addressed a situation where the unit declaration was recorded after production commenced. The lessee attempted to make the declaration retroactive to the date of first production. The lease provided that

[l]essee shall exercise said option as to each desired unit by executing an instrument identifying such unit and filing it for record in the public office

in which this lease is recorded. Each of said options may be exercised by lessee at any time and from time to time which this lease is in force, and whether before or after production has been established either on said land, or on the portion of said land included in the unit, or on other land unitized herewith.²⁴

The court held that the lessee's attempt to make the declaration retroactive was contrary to the pooling clause which the court interpreted as requiring recordation in order for the unit to become effective even though the language also permitted the lessee to exercise the power after production commenced.²⁵

[b] Pooling Clause Not Requiring Recordation or Otherwise Silent.

When the lease does not contain language making the pooled unit effective upon recordation, the courts have been less strict. An appellate court in *Tiller v. Fields*²⁶ confronted this issue. In *Tiller*, the lease stated that the lessee shall execute an instrument in writing. The lessee executed a declaration within the primary term of the lease but did not record it until over three months after it was executed. The lessee completed a well over one month before the unit declaration was recorded. The court held that the unit was valid as of the date the unit declaration was executed.²⁷ Likewise, an appellate court in Ohio ruled that a lessee had the power to pool under the pooling clause after the primary term when the well was commenced during the primary term. Apparently, the pooling clause did not place

²¹ 613 S.W.2d 63 (Tex. Civ. App.—Fort Worth 1981, no writ).

²² See also *Yelderman v. McCarthy*, 474 S.W.2d 781, 782 (Tex. Civ. App.—Houston [1st Dist.] 1971, writ ref'd n.r.e) (court held that unit designation not effective until recorded based on language of lease providing "upon such recordation the unit shall be effective...").

²³ 171 S.W.3d 857 (Tex. 2005).

²⁴ *Id.* at 860-61.

²⁵ *Id.* at 861.

²⁶ 301 S.W.2d 185 (Tex. Civ. App.—Texarkana 1957, no writ).

²⁷ *Id.*

any limitation upon when the pooling could be exercised.²⁸

In sum, the cases seem to focus on the specific language of the lease in determining the effective date of the pooled unit.

D. Contractual Limitations on Pooling.

As the pooling of tracts has become more prevalent, lessors have begun to negotiate various limitations to the pooling clause in the lease. These limitations include acreage limitations, anti-dilution provisions, and Pugh clauses.

[1] Acreage Limitations.

It is quite common for leases to contain express limitations which limit the size of the unit to be formed. For example, it is common for a lease to permit the formation of a unit of 40 acres for oil and 160 acres for gas. Often the lease permits a 10% tolerance. In deeper plays, a limitation of 640 acres is common for gas units.

[2] Anti-Dilution Provisions.

It is not uncommon for leases to contain anti-dilution provisions or restrictions on the lessee's pooling power that limit how much acreage may be pooled by the lessee for a well drilled on the lessor's property. A frequent restriction used in leases requires that the lessee include a certain percentage of the lessor's acreage in the pooled unit. For example, on a 100 acre lease, the lessor would require that if his acreage were pooled, at least 50 acres of his lease be included in the unit. This is intended to limit the amount of royalties that are diluted for a well drilled on the lessor's acreage that is pooled with other acreage.

Anti-dilution provisions should be considered in conjunction with the entire lease. For instance, in *HS Resources, Inc. v. Wingate*,²⁹ the lease originally contained 728.02 acres and contained an anti-dilution

provision which prohibited the lessee from pooling "unless all of the leased premises is located within the pooled unit for such well or within a unit for another gas well producing in commercially paying quantities from the same formation."³⁰ The pooling clause limited the size of a gas well pooled unit to 160 acres plus a 10% tolerance. The lessee created a 176 acre pooled unit for a gas well drilled on the lessor's acreage. In conjunction with creating the unit, the lessee surrendered all of the acreage surrounding the 176 acre pooled unit under the surrender provision in the lease. The court found that the lessee's exercise of the pooling power was proper and consistent with the anti-dilution provision.

In *Browning Co. v. Luecke*,³¹ the lease contained a limitation on the pooling power which provided: "if any pooled unit is created with respect to any well drilled on the land covered hereby, at least sixty percent (60%) of such pooled unit shall consist of the land covered hereby."³² The court in *Browning* faced the situation where the lessee wanted to drill a horizontal well on a pooled unit but due to the large size of the horizontal unit, the Lessors acreage contributed to the unit was less than the sixty percent limitation. In situations where a number of leases are involved, the lessee may need to amend leases prior to drilling a well in order to form a valid unit in the event the leases needed to form the unit contain conflicting anti-dilution provisions.

[3] Pugh Clause Issues.

Absent an express provision in the lease, pooling of a lease in most states preserves the entire lease even if only a portion, no matter how small, is included in the unit. For example, if the lessor leases 1,000 acres and the lessee includes only ten acres in a unit, that unit holds the remaining 990 acres. The lessor's only recourse is the implied

²⁸ *Kaszar v. Meridian Oil & Gas Enter.*, 499 N.E.2d 3 (Ohio 1985).

²⁹ 327 F.3d 432 (5th Cir. 2003).

³⁰ *Id.* At 436.

³¹ 38 S.W.3d 625 (Tex. App.—Austin 2000, pet denied).

³² *Id.* at 634 n.7.

covenant of reasonable development, or further development, in a state that recognizes such a covenant. Otherwise, the lessee has no incentive to do anything right away.

In 1947, Lawrence Pugh, a Louisiana attorney, recognized that a lease was normally held to be indivisible. He drafted a clause calculated to prevent the holding of non-pooled acreage in his clients' leases while other portions were held under pooled arrangements. So in the above example, the lessee would need to surrender the 990 acres back to the lessor that were not pooled. These clauses are termed "Pugh" clauses. The Pugh Clause affects virtually every one of the lease maintenance provisions of the lease.³³ This creates a number of issues and the courts have construed various Pugh clauses as follows:

[a] Whether the Pugh Clause Is Effective When The Conservation Commission, Rather Than The Lessee, Makes The Pooled Unit?

Generally, a Pugh clause is not applicable to an agency-established unit unless the lease clause clearly so provides.³⁴ This is so even if the lessee is the one applying for the nonconforming unit.³⁵

[b] If Acreage Of A Lease With A Pugh Clause Is Pooled During The Primary Term, Can The Unpooled Acreage Be Held After The Primary Term By The Continuous Operations Clause For Operations In The Unit?

The answer to this question may vary depending on which state's laws apply. In Louisiana, the court ruled that the "modified

Pugh Clause" had the effect of dividing the lease at the end of the primary term for acreage outside a unit and that the unpooled acreage was not held by operations in the unit.³⁶ But in North Dakota, the court held that "governmental pooling unitization orders" do not divide a lease, and production anywhere in the pooled acreage holds all leases that may be wholly or partly in the unit.³⁷

[c] Does a Pugh Clause Have A Horizontal As Well As A Vertical Effect?

Again, the answer may vary depending on which state's laws apply. The Tenth Circuit held in *Rogers v. Westhoma Oil Company*,³⁸ a case involving Kansas property, that the Pugh clause created a severance of the horizons below sea level that were not consolidated and thus leases terminated as to such horizons at the end of the primary term. But the Oklahoma Supreme Court interpreted the same Pugh clause to have only a vertical and not a horizontal effect.³⁹

[d] Does The Depth Limitation Of A Pugh Clause Apply To Compulsory Pooling By A State Agency?

No. In *Rebstock v. Birthright Oil & Gas Co.*,⁴⁰ the court faced this very issue and stated that "[I]t is well settled in Louisiana law that orders of the Commissioner of Conservation supersede the contracts of the parties, are incorporated in the contracts of lease and govern the respective rights and obligations of the parties, and production from a forced pooled unit operates as a substitute for performance of drilling operations contained in a mineral lease."

³³ Pugh clauses vary widely. Litigation turns on the specific language in the Pugh Clause at issue. Sample clauses can be found at Treatise § 9.02.

³⁴ *Bibler Bros. Timber Corp. v. Tojac Minerals, Inc.*, 664 S.W.2d 472, 474 (Ark. 1984); *Lowman v. Chevron U.S.A., Inc.*, 748 F.2d 320, 322 (5th Cir. 1984).

³⁵ *Matthews v. Goodrich Oil Co.*, 471 So. 2d 938, 943 (La. App. 1985)(the fact the order of the commission was secured upon the application of the original lessee does not alter the fact not voluntarily formed).

³⁶ *Roseberry v. Louisiana Land & Expl. Co.*, 470 So. 2d 178, 182 (La. App. 1985).

³⁷ *Edgeland v. Continental Res., Inc.*, 616 N.W.2d 861, 869 (N.D. 2000).

³⁸ 291 F.2d 726, 733 (10th Cir. 1961).

³⁹ *Rist v. Westhoma Oil Co.*, 385 P.2d 791 (Okla. 1963).

⁴⁰ 406 So. 2d 636, 641 (La. App. 1981).

[e] Does An Acreage Limitation Of A Pugh Clause Apply To Compulsory Pooling?

No. In *Gordon v. Crown Central Petroleum Co.*,⁴¹ the lease at issue had a maximum acreage limitation of 660 acres. The Arkansas Oil & Gas Commission entered an order for 727 acres. As a result, the lessor sought cancellation of the lease but the court ruled that the pooling clause referenced that it was limited by government regulations, and therefore, the Commission order took precedence over the pooling clause limitation.

E. Common Pooling Problems/Issues.

[1] Whether The Lessee Has Exercised Pooling In Good Faith.

Although the pooling clause creates a relationship that is similar to that of a principal and agent, the relationship is not measured by a fiduciary standard but rather by a good faith standard.⁴² The good faith standard placed upon the lessee's exercise of the power to pool has been described as not permitting the lessee to use "the power to pool granted by the lessor in such a way as to be beneficial to the lessee while contrary to the interest of the lessor; instead, the power to pool is to be exercised in such a way as to be mutually beneficial to lessor and lessee."⁴³ The lessee is not a fiduciary for the lessor like a trustee is but can consider its own interests.⁴⁴ The lessee's exercise of the pooling power granted in the lease is judged by the standard of what a reasonably prudent operator would do under the same or similar circumstances acting in good faith taking into account the interests of both the lessor and the lessee.⁴⁵ The lessee

⁴¹ 679 S.W.2d 192 (Ark. 1984).

⁴² *Jones v. Killingsworth*, 403 S.W.2d 325 (Tex. 1965).

⁴³ Treatise § 8.06.

⁴⁴ *Vela v. Pennzoil Prod. Co.*, 723 S.W.2d 199 (Tex. App.—San Antonio 1986, writ ref'd n.r.e.).

⁴⁵ *Circle Dot Ranch, Inc. v. Sidwell Oil & Gas, Inc.*, 891 S.W.2d 342 (Tex. App.—Amarillo 1995, writ denied);

may consider lessee's own interest as well as lessor's interests.⁴⁶ Generally, courts have recognized that, because good faith is a fact question, summary judgment on that question is inappropriate.⁴⁷ Whether the court applies a subjective or an objective standard may determine whether some of the factors listed below will be considered.⁴⁸

[2] Factors Considered in Determining Whether Pooling Clause Exercised in Good Faith.

Courts have considered certain factors in determining whether good faith existed when the pooling power was exercised. These factors are discussed below.

[a] Geological Information Known at the Time of the Pooling.

Did the lessee consider the geological information known at the time of pooling? This is a factor considered by most courts in determining whether the lessee has exercised good faith in exercising the pooling power.⁴⁹ While the failure to consider the geological information known at the time of the pooling may not as a matter of law establish bad faith on the part of the lessee, it is a factor to be considered by the jury in determining whether the lessee acted in good faith.⁵⁰ The fact that a lessee has gerrymandered or picked certain leases to comprise the unit which do not match the geology can be a factor considered in determining whether the lessee has acted in

Elliot v. Davis, 553 S.W.2d 223 (Tex. Civ. App.—Amarillo 1977, writ ref'd n.r.e.).

⁴⁶ *Elliot v. Davis*, 553 S.W.2d 223 (Tex. Civ. App.—Amarillo 1977, writ ref'd n.r.e.); *Banks v. Mecom*, 410 S.W.2d 300 (Tex. Civ. App.—Eastland 1966, writ ref'd n.r.e.); *Circle Dot Ranch, Inc. v. Sidwell Oil & Gas, Inc.*, 891 S.W.2d 342 (Tex. App.—Amarillo 1995); *Boone v. Kerr-McGee Oil Indus., Inc.*, 217 F.2d 63 (10th Cir. 1954).

⁴⁷ *Elliot v. Davis*, 553 S.W.2d 223 (Tex. Civ. App.—Amarillo 1977, writ ref'd n.r.e.).

⁴⁸ *Sotrana-Texas Corp. v. Mogen*, 551 F.Supp. 433 (D. N.D. 1981).

⁴⁹ *Elliot v. Davis*, 553 S.W.2d 223 (Tex. Civ. App.—Amarillo 1977, writ ref'd n.r.e.).

⁵⁰ *Id.*

bad faith.⁵¹ The drainage pattern of a unit well or wells may play a role in the size of the pooled unit.

In *Gorenflo v. Texaco, Inc.*,⁵² the court noted that the lessee formed a unit which constituted the most efficient drainage of the acreage involved and prevented the wasteful drilling of unnecessary wells. As one court has pointed out, the question of whether a lessee should consider scientific data in the exercise of its pooling power is relevant to determine if the pooling power has been exercised in good faith.⁵³ However, as the court noted in *Boone v. Kerr-McGee Oil Indus.*,⁵⁴ many wells are drilled in spite of geological opinions to the contrary.

[b] Purpose of the Exercise of the Pooling Power.

Is pooling exercised to prevent waste or merely an effort to maintain the applicable lease or other leases? In *Amoco Prod. Co. v. Underwood*,⁵⁵ the court found that the lessee used the pooling clause in bad faith when the sole purpose of pooling was to maintain leases. In *Underwood*, the lessee used the pooling clause to pool seven other leases with the drill site lease thereby seeking to hold acreage on the other leases that totaled over 2,252 acres. At the time of trial, the lessee had no plans to drill an additional well on any part of the 2,252 acres. The evidence also indicated that the lessee excluded approximately 90 acres of potentially productive acreage in order to include this acreage. The court affirmed the jury finding that the lessee's configuration of the unit was not established in good faith.⁵⁶

⁵¹ See *Circle Dot Ranch, Inc. v. Sidwell Oil & Gas, Inc.*, 891 S.W.2d 342, 347 (Tex. App.—Amarillo 1995, writ denied).

⁵² 566 F. Supp. 722, 727 (M.D. La. 1983).

⁵³ *Celsius Energy Co. v. Mid America Petroleum, Inc.*, 894 F.2d 1238, 1240-41 (10th Cir. 1990).

⁵⁴ 217 F.2d 63 (10th Cir. 1954).

⁵⁵ 558 S.W.2d 509 (Tex. Civ. App.—Eastland 1977, writ ref'd n.r.e.).

⁵⁶ *Id.* at 512-13.

[c] Unproductive Acreage Included.

Whether the pooled unit includes non-productive acreage can be important in determining whether the lessee has exercised the pooling power in good faith. One could argue that there must be some expectation that the acreage pooled will be productive.⁵⁷ In *Southwest Gas Prod. Co. v. Seale*,⁵⁸ the court found that the lessee acted in bad faith by knowingly including non-productive acreage in the unit. In *Southwest Gas*, the court held that the lessee violated its duty of good faith where the lessee knew that the acreage included in the unit was non-productive but included the acreage in the unit to protect the lessee from the drilling of any competing wells in the area. A lessee should consider designating a pooled unit consistent with the actual drainage pattern or area in order to avoid the allegation that non-productive acreage is included in the pooled unit.⁵⁹

[d] Timing of Pooling.

The pooling of leases immediately prior to the end of the primary term often raises questions about whether the exercise of the pooling power has been exercised for a legitimate purpose or to merely maintain the leases.⁶⁰ However, as one court has pointed out, the exercise of a pooling clause within a few months before the expiration of the lease does not turn an otherwise valid pooling decision into one of bad faith.⁶¹

⁵⁷ *Miles v. Amerada Petroleum Corp.*, 241 S.W.2d 822 (Tex. Civ. App.—El Paso 1950, writ ref'd n.r.e.).

⁵⁸ 191 So. 2d 115 (Miss. 1966).

⁵⁹ *Circle Dot Ranch*, 891 S.W.2d at 347.

⁶⁰ See *Southeastern Pipeline Co. v. Tichacek*, 997 S.W.2d 166 (Tex. 1999); *Skelly Oil Co. v. Harris*, 352 S.W.2d 950 (Tex. 1962); *Mallett v. Union Oil & Gas Corp.*, 94 So.2d 16 (La. 1957).

⁶¹ *Boone v. Kerr-McGee Oil Indus.*, 217 F.2d 63, 65 (10th Cir. 1954). See also, *Gorenflo v. Texaco, Inc.*, 566 F. Supp. 722, 727 (M.D. La. 1983) (even though unit formed to protect expiring leases, court noted evidence showed that "unit formation and well location prevented the wasteful drilling of unnecessary wells and constituted the most efficient drainage of the acreage and comported with the conduct expected of a prudent operator.").

[3] When the Pooling Declaration Conflicts with the Pooling Power in the Lease.

[a] Generally the Pooling Declaration Cannot Alter the Terms of the Lease.

Generally, the pooling declaration cannot alter the terms of the lease. In *Union Gas Corp. v. Gisler*,⁶² the court reasoned that the pooling declaration filed by the lessee attempting to make the declaration retroactive was not a contract nor even an offer of contract and was non-binding. As a result, the effective date of the unit was when the declaration was recorded as required under the lease.

[b] Hypothetical.

What happens if the unit is formed by pooling three leases and one of the leases contains an anti-dilution provision which is violated by the formation of the unit? Is the unit invalid? What if several years pass with production and payment of royalties based on the unit and the lessor with the anti-dilution provision files suit? Has the lessor waived its rights? What if one of the leases included in the unit is void? What are the potential outcomes? The answer to many of these questions is very fact specific. It is unclear under the case law whether the entire unit is invalidated or whether only the individual lease is effected.

[4] Interplay Between Pooling and Agency Action.

Pooling allows a lessee to pool the interest of the lessor. Pooling does not speak to actions of a state agency or the effects of the actions of a state agency. An agency's order for a spacing unit (pooling) would be effective in maintaining the lease even though the requirements of the pooling clause, such as recordation of the pooling, have not been

fulfilled.⁶³ Although commentators have suggested that the proper inquiry is whether the application to the state for a pooling or unitization order violates a term (usually an implied term of the lease),⁶⁴ that claim seems to be more theoretical than actual.⁶⁵ In *State Oil & Gas Board v. Crane*,⁶⁶ the lessee applied for a permit to drill a wildcat well in a drilling unit of 640 acres so that the lease could be maintained past the end of the primary term. The lessor and top lessee opposed the well but the Mississippi Supreme Court held the lessee was not exercising the pooling power of the lease but rather invoking the statutory authority of the agency.⁶⁷

[5] Nature of Unitized Title – Cross-Conveyance and the Contract Theory.

Two theories have emerged to describe the nature of the unitized title where the parties to a voluntary pooling or unitization agreement have not specified whether they intended to convey property rights. The two theories are cross-conveyance theory and contract theory. *E.g.*, if two 100 acre leases are pooled in a cross-conveyance theory state, the lessors are considered to have conveyed half their royalty interest to the other lessor. But in a contract theory state, the lessors are not considered to have conveyed their interest and pooling merely determines their contractual rights to royalty payments.

Which theory applies is important to determine who are the indispensable parties to a bad faith pooling claim. In a cross-conveyance state, the other interest owners will

⁶² 129 S.W.3d 145 (Tex. App.—Corpus Christi 2003, no pet.).

⁶³ *Petroleum Reserve Corp. v. Dierksen*, 623 P.2d 602 (Okla. 1981).

⁶⁴ Treatise § 8.04.

⁶⁵ *See, e.g., State Oil & Gas Bd. v. Crane*, 271 So. 2d 84 (Miss. 1972).

⁶⁶ 271 So. 2d 84 (Miss. 1972).

⁶⁷ *Vogel v. Tenneco Oil Co.*, 465 F.2d 563 (D.C. Cir. 1972). (The pooling clause contained a limitation of 160 acres for gas except when governmental authority permitted or prescribed a larger unit. The lessee applied for a 320 acre unit. The court said no problem.)

be indispensable since undoing a unit will take away their interests. But in a contract theory state, they may not. Which theory applies may also affect the measure of damages. If it is a cross-conveyance state and the remedy is to undo the unit and put the parties where they were originally, then the lessee may lose some acreage but should only owe royalties to the drill site tract owner. But if it is just a contractual claim for damages, then the unit is not undone, and the lessee can end up paying both the drill-site lessor on a lease basis and the rest of the royalty owners on a unit basis.⁶⁸

Contract theory states include Kansas, Oklahoma, Utah, West Virginia. Cross-conveyance states include California, Illinois, Mississippi, and Texas. The states of Louisiana, Montana, and Pennsylvania appear to be undecided. However, there is support that parties should be able to put a clause in their lease to avoid conveying their royalty interest to the others in the unit.⁶⁹

[6] Unit Termination.

With respect to contractually pooled units, the lease or unit agreement typically provides what constitutes unit termination. With respect to units created by order of the state, the state statutes typically provide what constitutes unit termination.⁷⁰ Sometimes disputes arise when a party contends a unit terminated when all but one lease terminated.⁷¹ Units can also be terminated by agreement of all the parties.

⁶⁸ These issues are discussed at length in the Treatise Ch. 19.

⁶⁹ See *LeBard v. Richfield Oil Corp.*, 364 P.2d 449 (Cal. 1961); Treatise § 19.01[3].

⁷⁰ See, e.g. La. Rev. Stat. Ann. § 30.91 (elec. 2007).

⁷¹ See *Texaco, Inc. v. Lettermann*, 343 S.W.2d 726 (Tex. Civ. App.—Amarillo 1961, writ ref'd n.r.e.). But, see *Ladd Petroleum Corp. v. Eagle Oil and Gas Co.*, 695 S.W.2d 99 (Tex. App.—Fort Worth 1985, writ ref'd n.r.e.).

F. Recently Reported Cases.

[1] Pugh Clause and Effect on Surface Access.

Another potential pitfall of the Pugh clause was illustrated in *Kysar v. Amoco Prod. Co.*⁷² In *Kysar*, the New Mexico Supreme Court in response to a certified question held that a lessee has no implied right of access over the surface of area that has been released under a Pugh clause. What made this decision particularly troubling under these circumstances was that the lessee did not locate the well on the unit acreage at the request of the lessor so as not to interfere with the lessor's cultivation of alfalfa. This result reminds one of the Polish proverb that "no good deed goes unpunished."

[2] Pooling and the Implied Duty of Reasonable Development.

In *Whitham Farms LLC v. City of Longmont*,⁷³ the lessor demanded the lessee release the portions of the lease not necessary to hold the existing well. The parties agreed it was not economically prudent for the lessee to drill anymore wells at the time. The landowner argued that because further development was not economically prudent that the lessee breached the covenant of reasonable development and the landowner was entitled to equitable termination of the lease. One of the lessee's arguments was that the pooling of one oil and gas lease with another lease negated the lessee's implied duty of reasonable development. The leases at issue had pooling provisions that permitted the lessees to pool or unitize the leases in the immediate vicinity. The lessees entered into an agreement pooling their interests and allowing them to develop the three leases as a single unit. The Colorado courts had previously held that marginal production from a single well was sufficient to hold an entire unit and demonstrate fulfillment of implied

⁷² 379 F.3d 1150 (10th Cir. 2004).

⁷³ 97 P. 3d 135, 160 (Colo. App. 2003).

covenants as to the unitized area.⁷⁴ The court of appeals affirmed the trial court's judgment that there was no breach of the implied duty to reasonably develop in light of the pooling of the leases.

[3] The Unit Operator Owes No Fiduciary Duty to Unit Interest Owners.

In *Yokel v. Hite*,⁷⁵ the plaintiffs contended a fiduciary duty arose between the parties because the unit operator had the sole discretion to determine where wells were to be drilled and which wells were to be used for injection and which for production. The plaintiffs also contended that a fiduciary relationship existed as a matter of law between the operator and a non-operator working interest owner. The court rejected both theories, holding that no fiduciary duty existed due to the status of a party being an operator.

[4] Oklahoma Statutory Operator's Lien for Unit Operations is a First and Prior Lien.

In *TCINA Inc. v. Noco Inv. Co, Inc.*,⁷⁶ the operator sued to enforce its operator lien rights against a unit interest owner for non-payment of operating expenses. A mortgage interest holder contended its earlier filed mortgage had priority over an operator's lien where the operator never filed a lien statement of record. The court held that the lien granted by the Oklahoma statute⁷⁷ grants a first and prior lien on participating interests in the unit for the operating expenses of the unit. The lien was perfected when the order approving the unit was filed of record.⁷⁸ The court distinguished this lien from a regular operators lien under Oklahoma law⁷⁹ which has been

held to require a lien notice to be filed of record and not to be automatically perfected.⁸⁰

[5] Forced Pooling Order Requiring Interest Owners Electing to Participate to Pay Operating Costs was Enforced Against Party With no Record Title Interest.

In *Harding & Shelton, Inc. v. The Prospective Inv. & Trading Co. Ltd.*,⁸¹ there was a title dispute as to whether the base leases or top leases were valid. Pitco, an entity with a disputed interest, elected to participate in a workover with the operator disputing its interest. When it appeared that the workover results were disappointing, Pitco dropped its lawsuit and no longer claimed the interest and demanded a return of its "conditional" pre-payment. Both parties contended that the other party was trying to "ride the well down." The court held that since Pitco had appeared at the commission and availed itself of the pooling order, it was bound by the order that required parties electing to participate to pay their share of the workover expenses. The court held that Pitco's arguments were an impermissible collateral attack on the agency order.⁸²

⁷⁴ See *Gillette v. Pepper Tank Co.*, 694 P.2d 369 (Colo. App. 1984); *Clovis v. Pacific Northwest Pipeline Corp.*, 345 P.2d 729 (Colo. 1959).

⁷⁵ 809 N.E.2d 721 (Ill. App. 2004).

⁷⁶ 95 P.3d 193 (Okla. App. 2004).

⁷⁷ 52 O.S. 2001 Sec. 287.8.

⁷⁸ *TCINA Inc. v. Noco Inv. Co, Inc.*, 95 P.3d 193 (Okla. App. 2004).

⁷⁹ 52 O.S. 1981 Sec. 87.1(e).

⁸⁰ *Fourth Nat'l Bank of Tulsa v. Appleby*, 864 P.2d 827 (Okla.1993).

⁸¹ 123 P.3d 56 (Okla. App. 2005).

⁸² *Harding & Shelton, Inc. v. The Prospective Inv. & Trading Co. Ltd.*, 123 P.3d 56 (Okla. App. 2005).

[6] New York Court Affirms Agency’s Decision Concerning Compulsory Unit and Royalties for Non-participating Tract Owner.

The New York compulsory pooling statute provides “[i]f one or more of the owners shall drill, equip, and operate ... a well for the benefit of another persons as provided for in an order of integration, then such owner ... shall be entitled to the share of production from the spacing unit accruing to the interest of the other person exclusive of a royalty not to exceed one-eighth of the production [until the production received] equals twice such persons’ share of the reasonable actual cost of drilling, equipping and operating the well.. This appears to be a two hundred percent non-consent penalty. But in *Caflish v. Crotty*,⁸³ the commission determined the non-consenting party was not an “owner” as defined in the statute because it did not have right to drill in the unit (through permit or sufficient acreage). Accordingly, the commission held the non-consenting party would only receive a one-eighth royalty. The non-consenting party appealed and the court gave deference to the commission’s decision.⁸⁴ The decision has been criticized as providing too much deference to the agency.⁸⁵

[7] Kansas Unitization Act Held to Apply to Dual Completion Wells.

In *Trees Oil Co. v. State Corp. Comm’n.*,⁸⁶ Trees Oil Company operated a well that was providing a positive cash flow. Chesapeake Operating Inc. proposed to unitize 17 wells, including the Trees well to conduct a waterflood project that would recover an additional 690,000 barrels of oil that would not be produced. Ninety three percent of the working interest owners and sixty-nine percent of the royalty owners were in favor of the waterflood. The Kansas compulsory

unitization act requires sixty-three percent approval. Chesapeake sought to require Trees and other non-consenting owners to be force unitized. Trees objected that the Chester and Morrow formations could not be unitized because seven of the wells had dual completions to two formations resulting in non-natural combination of two formations. Although the literal reading of the statutory language favored Trees, the court looked at the entire statute and Professor Ernest Smith’s article on the subject and concluded that the unitization would be permitted.⁸⁷

[8] Louisiana Commissioner of Conservation has Authority to Remove Unit Operator.

In *Enerquest Oil and Gas, LLC v. Asproditas*,⁸⁸ the court upheld the right of the Louisiana Commissioner of Conservation to remove a unit operator. The existing operator had no plans for the unit wells and the new operator owned a substantially greater interest in the unit. The court found that the replacement of the operator would serve to prevent waste and protect correlative rights. The court observed that the “old operator was an operator that was not operating, which in turn is wasteful to the other operators who are not recovering anything from a well that has the potential to produce recoverable reserves if reworked.”⁸⁹

[9] Texas Railroad Commission Rule Requiring Notice to Offset Operators in Order to Dissolve Units Upheld.

In 1948 the Texas Railroad Commission required 640 acre drilling units for the Panhandle West Field. Shortly thereafter more than 150 separate tracts were pooled to form 48 separate drilling units. A well is drilled on each unit. In 1997, Panterra

⁸³ 774 N.Y.S. 653, (N.Y. Sup. 2003).

⁸⁴ *Caflish v. Crotty*, 774 N.Y.S. 653, (N.Y. Sup. 2003).

⁸⁵ See 161 O&G.R. 787.

⁸⁶ 105 P.3d 1269 (Kan. 2005).

⁸⁷ *The Trees Oil Co. v. State Corp. Comm’n.*, 105 P.3d 1269 (Kan. 2005).

⁸⁸ 843 So. 2d 845 (La. App. 1st Cir. 2003).

⁸⁹ *Enerquest Oil and Gas, LLC v. Asproditas*, 843 So. 2d 845 (La. App. 1st Cir. 2003).

filed an application with the Commission for a density exception to drill an additional well on one of the units. An offset operator filed a protest and Panterra withdrew its application. Panterra then filed 48 applications to dissolve the drilling units. According to the General Counsel of the Commission this would allow Panterra to drill one well on each of the 157 component tracts because each of the tracts would become a “legal subdivision.” The Commission determined these applications were attempts to obtain exceptions to the density provisions without complying with Commission rules. The Commission refused to consider the applications unless Panterra gave notice to the offset operators and owners of unleased mineral interests. Panterra refused to give the notices and the Commission dismissed the applications. The Commission then changed its rules to require notice on motions to offset operators to dissolve units. Panterra challenged these rulings but the court upheld the commission.⁹⁰

[10] Pooling and Horizontally-Drilled Wells.

In *Browning Oil Co. v. Luecke*,⁹¹ an appellate court in Texas addressed some vexing horizontal-drilling issues in the context of a pooling dispute.⁹² The leases contained pooling provisions subject to anti-dilution clauses: “The provision [was] intended to ensure that the lessors’ share of royalties in production from any well drilled on their land is not diluted by including only a small portion of their land in a large pooled unit.”⁹³

Browning and Marathon drilled the first of two horizontal wells on the lessors’ property, which pooled the lessors’ existing leases with other leases beyond the authority of the leases.⁹⁴ Asserting that the purportedly

pooled units for the two horizontal wells violated the pooling provisions in the leases, the lessors filed suit.⁹⁵

The appellate court framed the principal legal issue as follows: “This dispute requires us to consider the applicability of these traditional oil and gas concepts to horizontal wells.”⁹⁶ The court observed that, “horizontal wells are initially drilled vertically, and then at a pre-determined point, the drillstem deviates and proceeds horizontally into the targeted formation....A wellbore can extend across several acres and several leased tracts, increasing the likelihood of recovery of minerals. Each tract traversed by the horizontal wellbore is a drillsite tract, and each production point on the wellbore is a drillsite.”⁹⁷

The *Browning* court ruled that lessees, Browning Oil Company and Marathon Oil Company, had breached the anti-dilution provisions, and that their breach had rendered the pooled units invalid.⁹⁸ “Nothing in the pooling provisions limits their applicability to vertical wells. The intent of the parties was to authorize pooling, but to prevent the dilution of the [lessors’] royalties, whether the royalties represented production from vertical wells or horizontal wells.”⁹⁹ “If these [l]essees determined that drilling a horizontal well on an eighty acre unit was economically impractical, they could have attempted to expand their pooling authority....They could have sought field-wide regulatory action and attempted to convince the Railroad Commission that providing an optional eighty acre spacing requirement for horizontal wells is imprudent....Failing that, they could have exercised the option of not drilling a well on the [lessors] tract. What they could not do was pool the [lessors’] interests beyond the

⁹⁰ *Panterra Energy Co. v. Railroad Comm’n of Texas*, 150 S.W. 3d 466 (Tex. App.—Austin 2004, no pet.).

⁹¹ 38 S.W.3d 625 (Tex. App.—Austin 2000, op. on reh., pet. denied).

⁹² *Id.* at 632.

⁹³ *Id.* at 636-37.

⁹⁴ *Id.* at 638-39.

⁹⁵ *Id.* at 639.

⁹⁶ *Id.* at 634.

⁹⁷ *Id.* at 634.

⁹⁸ *Id.* at 640-41.

⁹⁹ *Id.* at 640.

authority expressed in the leases.”¹⁰⁰

Significantly, the *Browning* court held that the traditional rule of capture applicable to vertically-drilled wells did not apply to horizontally-drilled wells because different geophysical characteristics altered recovery efficiency.¹⁰¹ The court also ruled that the lessors were not entitled to royalty on hydrocarbons produced from formations beneath the property of other landowners simply because the penetration points of the oil and gas companies’ horizontal wells were on the lessors’ land.¹⁰²

[11] Recent Texas Decisions Have Re-affirmed That The “Discovery Rule” Does Not Excuse Lessors From Complying With Statutes of Limitations.

In *Hay v. Shell Oil Co.*,¹⁰³ Shell Oil Company sold its interest in the leases in 1984. In 1989, Parker Petroleum, a subsequent lessee, obtained permission from the Texas railroad commission to reduce the Hay Unit from 704 acres to 160 acres. Parker filed a “P-15” form in November 1989 swearing that the 160 acres were reasonably productive of gas.¹⁰⁴ The Hays learned of the reduction in acreage in May 1992 by reviewing Railroad Commission records. This knowledge led them to question whether the original 704 acre unit included non-productive acreage.¹⁰⁵

The Hays sued Parker in 1995 and amended their pleadings in 1996 to include Shell Oil Company. The plaintiffs sued Shell Oil Company “for damages allegedly caused by the improper inclusion of non-productive acreage in a pooled unit”¹⁰⁶ Shell Oil Company obtained a summary judgment

based, in part, on limitations.¹⁰⁷ In affirming the lower court’s decision, the Texas appellate court first noted that the act causing the Hays’ legal injury occurred in 1977 when the original 704-acre unit was formed.¹⁰⁸ Because the Hays filed suit long after the 4-year limitations window had closed, their claims were barred unless they, as plaintiffs, proved that the “discovery rule” applied.¹⁰⁹ An exception to the statute of limitations exists under Texas law which is known as the “discovery rule.” For this rule to apply, the injury must be objectively verifiable like a sponge left in a patient. “An injury is objectively verifiable if the presence of injury and the producing wrongful act cannot be disputed, and the facts upon which liability is asserted are demonstrated by direct, physical evidence.” However, the courts in Texas have noted that a “swearing match” between experts does not suffice to establish objective verifiability.¹¹⁰

The summary judgment evidence in *Hay* included the affidavit of an expert who testified that petroleum engineering is not an exact science and that “the professional judgment of petroleum engineers often differs as to their interpretations of the nature, location, amount of discoverable reserves, and drainage areas.”¹¹¹ Controverting expert affidavits created “[e]xactly the ‘swearing match’ the supreme court determined was not objectively verifiable evidence of an injury. Expert testimony also established that petroleum engineering is an evolving, yet uncertain, science.” The court concluded that the type of injury the Hays complained of is not objectively verifiable, held the “discovery rule” did not apply, and the Hays claim was barred by limitations. The decision in *Hays* has been followed more recently.¹¹²

¹⁰⁰ *Id.* at 641-42.

¹⁰¹ *Id.* at 643-44 and 643 n.24.

¹⁰² *Id.* at 644-45.

¹⁰³ 986 S.W.2d 772 (Tex. App.—Corpus Christi 1999, pet. denied).

¹⁰⁴ *Id.*

¹⁰⁵ *Id.*

¹⁰⁶ *Id.*, 986 S.W.2d. at 774.

¹⁰⁷ *Id.* at 774-76.

¹⁰⁸ *Id.* at 776.

¹⁰⁹ *Id.*

¹¹⁰ *Id.*

¹¹¹ *Id.* at 777 (internal quotation marks omitted).

¹¹² See *Funk v. Devon Louisiana Corp.*, 2005 WL 2560107 Tex. App. (Tex. App.—Corpus Christi 2005,

[12] Even If a Lease in a Pool Expires, the Pooled Unit Continues Unless the Pooling Agreement Provides Otherwise.

In *Wagner & Brown, Ltd. v. Sheppard*,¹¹³ the Texas Supreme Court was faced with a lease within a pooled unit that expired while the pooled unit was still producing hydrocarbons. In *Wagner*, several mineral lessees entered into a unit agreement pooling a tract that ultimately resulted in two successful gas wells that were physically located on the surface of Sheppard's mineral estate. Defendant *Wagner & Brown* previously entered into an oil and gas lease with Plaintiff Jane Sheppard which specifically authorized pooling with adjacent tracts. The lease also provided, however, that if royalties were not paid within 120 days after the first gas sale, the lease would automatically terminate the next month.

After the two successful pooled unit wells were drilled, *Wagner & Brown* took over as operator of the unit from another mineral lessee. Upon assuming the role as operator, *Wagner & Brown* realized Sheppard had not been paid royalties within the time specified in the lease. *Wagner & Brown* offered Sheppard a new lease, but Sheppard (obviously) declined. The parties agreed that Sheppard's lease expired and thereafter considered her an unleased co-tenant, entitling her to a proportionate share of proceeds from minerals sold less her share of the costs of production and marketing. Sheppard filed suit, contending the pooled unit no longer existed because Sheppard herself did not sign the pooling agreement and the pooled unit wells were located on the surface of Sheppard's mineral estate that was now not subject to a lease. Sheppard also contended she was not

pet. denied) (Mem. Op) (court held that a bad faith pooling claim accrues at the time of pooling and that the "discovery rule" does not take a pooling dispute outside of Texas's four year statute of limitations).

¹¹³ 282 S.W.3d 419 (Tex. 2008).

liable for production costs incurred before or after the lease terminated. The trial court granted summary judgment in favor of Sheppard. The Texarkana Court of Appeals affirmed.¹¹⁴

The Supreme Court of Texas, however, reversed and remanded the case, holding that "while termination of Sheppard's lease changed who owned the mineral interests in the unit, it did not cause the unit to terminate because it was a pooling of lands, not just leases[.]"¹¹⁵ and "[j]ust as pooling impinges on a mineral owner's royalty interest, it also may impinge on an owner's possibility of reverter."¹¹⁶ The Court further held that "[t]he lease here allowed the Sheppard tract (rather than just the lease) to be pooled for purposes of production, and that is what the unit designation did. As termination of the lease changed none of the lands committed to the unit, we hold that it did not terminate the unit. Thus, while Sheppard is entitled as a co-tenant to 1/8th of the proceeds due to the mineral owners of her tract, that does not entitle her to 1/8th of the proceeds that must be shared with mineral owners of other tracts by the terms of the unit agreement."¹¹⁷ Consequently, Sheppard was responsible for expenses on a unit basis because the unit did not terminate.¹¹⁸ The Supreme Court of Texas also surprisingly held that Sheppard was responsible for drilling or other costs incurred *before* the lease expired because, in equity, "one who drills a well in good faith is entitled to reimbursement. . . . Similarly, a co-tenant who drills without another co-tenant's consent is entitled to reimbursement."¹¹⁹

¹¹⁴ 198 S.W.3d 369 (Tex. App.—Texarkana 2006, pet. granted).

¹¹⁵ *Id.* at 423.

¹¹⁶ *Id.* at 423-24.

¹¹⁷ *Id.* at 424.

¹¹⁸ *Id.* at 424-25, 429 ("But the lease here terminated at the very outset of production, so denying reimbursement would work a substantial forfeiture.").

¹¹⁹ *Id.* at 426.

G. Avoiding Problems: Practice Tips.

Proper drafting of the lease may avoid some of these potential problems. One should consider drafting the lease to: 1) define the “good faith” standard applicable in exercising the pooling power much like defining in what situations offset wells will be drilled; 2) adding an attorneys fee provision for the prevailing party to deter lawsuits challenging the pooling decision; 3) address the continued vitality of the unit if a well in a gas unit is completed in an oil zone; and 4) address in advance issues unique to horizontal drilling.

The lessee should also consider ways to minimize friction with the lessor. Typically, a declaration of unit is filed after a well has been drilled and the operator has decided to complete the well. If a declaration of unit is filed *after* the well is drilled, a drill site owner may contend that the lessee should have considered all the well logs, technical data, and reworked its geology before filing a unit declaration.¹²⁰ An oil and gas company that wants to eliminate this argument will consider filing a declaration of unit *before* starting to drill. On the other hand, well data from a unit well may allow the operator to form units that more efficiently and effectively develop the field.¹²¹ In fact, the data may cause the lessee to modify the size and shape of the pooled unit to enable the lessee to form a unit that most closely matches the actual drainage pattern of the well.¹²²

H. Conclusion.

The exercise of the pooling power is a useful tool for both lessors and lessees. This is especially true given the high costs of drilling wells. One should be mindful of the various courts’ interpretations of the various pooling clauses when negotiating a lease as well as when the lessee intends to exercise its pooling rights under an existing lease. This is even

more important given the changes in drilling techniques and the existence of pooling clauses which were created when many of these new drilling techniques did not exist. A good knowledge of how these clauses work provides opportunities to solve problems for skillful practitioners.

¹²⁰ See “A Primer on Pooling,” TEX. OIL AND GAS JOURNAL, Vol. 20 No. 4 p. 44.

¹²¹ *Id.*

¹²² *Id.*