THE DEAL'S BEEN DONE – STRATEGIES AND TECHNIQUES FOR ENFORCING HISTORIC OR ENDURING OIL AND GAS LEASES: *USE YOUR HAMMERS SO YOU DON'T HAVE TO USE THE GAVEL*

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I. Introduction

In most cases, unless a sophisticated lessor was able to negotiate terms favorable to him, the typical subsisting oil and gas lease is a lessee's form lease (such as a Producer's 88) and is generally favorable to the lessee ("oil company"). Older leases, in particular, that were drafted without the lessor having had the benefit of the industry's evolution, are particularly skewed toward the oil company's interests, such as a lower 1/8 landowner's royalty (whereas, oftentimes nowadays, a typical royalty is closer to a 1/4), the absence of a "Pugh" clause (which would require a release of leased acreage not pooled with a unit), and the absence of a continuous drilling requirement.

The underlying dynamic affecting the enforcement of historic oil and gas leases is that the value of reserves in leasehold acreage positions has risen substantially over time while the express written requirements of the leases in place have remained static. It is easy for an oil company to continue to hold the lease by producing one or two wells, or drilling a few wells every so often. In the interim, the lease, whether it covers large acreage or a small position, sits on the oil company's back burner, to be revisited when its interests are again focused on the property. At the time the original lease was granted, there was no need to explicitly address every potential issue, because the interests of the lessor and lessee were more closely aligned. Both the lessor and lessee fully intended that the oil company would remain focused on creating value from the property and all parties expected wells to be drilled, and many drilled if oil was found thereafter.

Today, we find ourselves in much more complicated relationships with our oil company lessees. These historic leases were written at a time when land, and the mineral reserves thereunder, were not as valuable especially in comparison to the cost of drilling a single well. In such situations, the courts, acting to further the policy of encouraging development and with an understanding of the business risks involved in the early years, allowed a single producing well, even in the absence of other activity, to perpetuate a lease as to hundreds or even thousands of acres. Today, that notion seems anachronistic. For starters, land has become a scarcer resource and mineral owners want it to be fully utilized – preferably in their lifetimes. Additionally, modern retrieval techniques have allowed oil and gas wells to continue producing for many, many years. There are leases from the 1910s, 20's and 30s that remain in place. Most of those leases cover large amounts of land by today's leasing standards.

So, what are your options as a lessor, or specifically for purposes of the audience of this paper, a trustee charged with administering trust assets, who believes his lessee is not living up to the express or implied terms of the lease, or that the lease may even have terminated due to lack of production? And, if you, as a lessor, were to be in a position of negotiating a new lease, what types of clauses would be important to consider? This paper will focus on techniques for bringing the lessor and lessee back into alignment in the development and management of these leases.

II. The Gavel Should be Your Last Hammer, But Why You Should Think About It First

Filing suit should be relied upon as a last resort, but to maintain its usefulness as a tool, certain issues must be anticipated and considered as soon as possible after a potential conflict is recognized. The first such issue is notice. Courts in most states require a lessor to give the oil company notice prior to enforcing a lease provision in his favor. Notice is required in Texas for most types of issues, regardless of whether there is an express notice provision in the lease. It should be noted that this is always true with respect to lease covenants, but not necessarily lease conditions (i.e. where the lease would automatically terminate but for a condition being met, such as continuous production in paying quantities), except in the case of an adverse possession claim. For this reason, it is important to take steps that put the oil company on notice and therefore shift the burden of taking action on the company.

The second consideration is the statute of limitations. Functionally, there are two types of statutes of limitations. The first type is a statutory prohibition (an absolute bar) on any claims brought after a stated time period from the onset of the action or inaction at issue. The second type of limitations, and the corollary to the first concept, relates to quieting title in real property. This type of statute of limitations functions to give a party who is seeking to quiet title a statutorily set period of time (in Texas, three, five, ten or twenty-five years) in which to seek quiet title, after which, a claim by another party for adverse possession may stand. Recently, courts are strictly enforcing the statutes of limitations and strongly disfavoring "sitting on your rights."

The four-year limitations bar for contract claims, under which many claims arising under an oil and gas lease would be subject (unrelated to a affecting the real property estate), is the first type of statute of limitations to consider.[1] The significance of this is mostly related to damages. A lessor's damages will be calculated only from four years before suit was filed until trial. For instance, suppose that you realize that two additional development wells should have been drilled nine years ago. Absent a statute of limitations, the damage calculation that a jury could award would be those royalties the landowner would have received if the two wells had been timely drilled. Expert witnesses would provide evidence of the hypothetical amount of production and pricing. The total damages would be quite large. However, the four-year statute of limitations bars any claim relating to the first five years of production - your claim has just been reduced by 5/9ths. This reality makes the lessor's decision whether or not to pursue a claim made difficult because the potential dollar recovery, as weighed against the risks of litigation, may not make sense. Thus, the statute of limitations functions to discount your remedies vis-à-vis the oil company.

The second type of limitation is the application of the three, five, ten and twenty-five year statutes of limitations pertinent to adverse possession claims. "Adverse possession" is defined as "an actual and visible appropriation of real property, commenced and continued under a claim of right that is inconsistent with and is hostile to the claim of another person."[2] It typically requires that the claim to land be long continued, open, notorious, exclusive and inconsistent with the

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1 Tex. Civ. Prac. & Rem. Code §§ 16.004(a), 16.051 (Vernon's 2002).

2 *Id.* § 16.021(1).

existence of title in the respondent.[3] "Peaceable possession" is defined as "possession of real property that is continuous and is not interrupted by an adverse suit to recover the property."[4]

Limitation upon an adverse possession in a case of this kind begins to run from the time of notice of a termination of tenancy. Actual notice is not necessary, and constructive notice will be presumed to have been brought to the owner when the adverse occupancy and claim of title to the property is long-continued, open, notorious, exclusive and inconsistent with the existence of title in others, except the occupant.[5]

The three-year statute of limitations states: "[a] person must bring suit to recover real property held by another in peaceable and adverse possession under title or color of title not later than three years after the day the cause of action accrues."[6] The five-year statute states: "(a) [a] person must bring suit not later than five years after the day the cause of action accrues to recover real property held in peaceable and adverse possession by another who: (1) cultivates, uses, or enjoys the property; (2) pays applicable taxes on the property; and (3) claims the property under a duly registered deed.[7] The ten-year statute of limitations requires suit to be brought within ten years "to recover real property held in peaceable and adverse possession by another who cultivates, uses, or enjoys the property."[8] The twenty-five year statute requires a person claiming a right in land to bring suit within twenty-five years against another who "in peaceable and adverse possession . . . holds the property in good faith and under a deed or other instrument purporting to convey the property that is recorded in the deed records of the county where any part of the real property is located."[9] Any of these statutes could be applicable in a given situation, including the twenty-five year statute, however, lessors should not operate under the belief that they have twenty-five years to bring a claim.

The courts look disfavorably upon the non-assertion of rights, and the failure of a claimant or record titleholder to assert a claim during the lessee's long-continued possession "has always been regarded as a strong circumstance tending to authorize an inference of notice of the adverse possession." [10] In fact, the jury may infer that notice of repudiation has been brought to the titleholder where there has been (1) long-continued possession under claim of ownership and (2) nonassertion of claim by the titleholder.[11]

A lessor need be aware that as soon as the lease potentially has terminated (i.e. the lessor's estate has potentially reverted) and the lessee continues to maintain "actual possession"[12] of the minerals (i.e. drilling and production of oil and/or gas) continues operations or other activity related to the leasehold interest, the lessor could be deemed to have been put on constructive notice by the oil company of adverse possession. A lessor must challenge the

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3 *Natural Gas Pipeline Co. of America v. Pool*, 124 S.W.3d 188, 194 (Tex. 2003) r'hng denied.
4 Tex. Civ. Prac. & Rem. Code § 16.021(3).
5 *Pool*, 1245 S.W.2d at 194.
6 *Id.* § 16.024.
7 *Id.* § 16.025(a).
8 *Id.* § 16.026(a).
9 Tex. Civ. Prac. & Rem. Code § 16.028(a).
10 *Moore v. Knight*, 94 S.W.2d 1137, 1140 (Tex. Com. App. - 1936).
11 *Tex-Wis Co. v. Johnson*, 534 S.W.2d 895, 901 (Tex. 1976).
12 *Hunt Oil Co. v. Moore*, 656 S.W.2d 634, 641 (Tex.App.-Tyler 1983, writ ref'd n.r.e.).

continued existence of the leasehold estate within three, five, ten or twenty-five years, depending under which statute the particular facts of the case would dictate suit should be brought.

With respect to other breaches, not necessarily related to a challenge of the real property interest itself, a lessor should be aware that it is generally required that he put his lessee on notice of such breach. This sort of notice should be in writing, and in keeping with some of the suggestions we discuss in this paper. For this reason, proper calendaring of events is especially important. Keep track of production data (on a timeline) and all correspondence with your oil company. Even if there is no explicit notice provision in the lease, most courts will "imply" a notice requirement, under the theory that the lessee and lessor have contracted to act for the mutual advantage of both parties.[13]

III. What Should You Expect From Your Current Lessee – Even Today, Even Under an Old Lease

All oil and gas leases are judged using the standard of the reasonably prudent operator, under the same or similar circumstances. The reasonably prudent operator standard is much less than a fiduciary duty, but more than just mere good faith. There are three components of a reasonably prudent operator - good faith, competence and acting with "due regard" for the lessor's interests.[14] Good faith is presumed; meaning the burden of proving bad faith rests with the lessor.[15] Bad faith is usually defined as the failure, for speculative purposes, to act to advance the mutual goals of the contractual relationship.[16] Competence is based on the manner in which others with industry expertise would act, but does not reach the level of professional liability. Whether a lessee has due regard for a lessor's interests hinges on negative inferences, and the nature of the business relationship is a factor.[17]

What can you, as a lessor expect from his current lessee? The source of this answer lies in two places: (1) the express terms of the lease (which will be guided by interpretation under a "reasonably prudent operator" standard) and (2) the law of implied covenants. In Texas, implied covenants always will be trumped by express lease terms, and are implied "in fact" – meaning they are enforced based on a contract theory (i.e. a covenant was implied between the lessee and lessor to carry out the contractual purposes of the lease). The implied in fact standard is analogous to a land transfer under deed or other instrument. We do not need to lay out every detail of the relationship between the grantor and grantee because the law and custom has arisen as to the relationship. For instance, we do not state that the grantee will be the person responsible for recording the deed and putting the world on notice of the transfer. We assume this will be the case because it is to the grantee's advantage and protection that the deed is recorded. This is the same concept that is embodied in oil and gas leases related to the timing of drilling wells, how fast they will be drilled, when they will produce and how the land will be managed. However, the requirements of the modern oil and gas business, and the demand for

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[13] *Brewster v. Lanyon Zinc Co.*, 140 F. 801 (8th Cir. 1905).

[14] *Amoco Prod. Co. v. First Baptist Church of Pyote*, 579 S.W.2d 280, 284 (Tex. Civ. App. – El Paso 1979) writ ref'd n.r.e. per curiam, 611 S.W.2d 610 (1980).

[15] *Id.* at 290.

[16] *See, e.g., Amoco Prod. Co. v. Underwood*, 558 S.W.2d 509, 512-13 (Tex. Civ. App. – Eastland 1977) *reh'g denied.*

[17] *First Baptist Church of Pyote*, 579 S.W.2d at 285.

land and lease positions have brought us to a place where the case law itself does not serve to bear significant enough leverage against lessees to continue to develop the lease for the mutual benefit of both parties.

This mutual benefit construct also is clouded by different time horizons. The oil company may have many prospects in many areas throughout in the State (and beyond) where it is focused, and it will not want to lose the opportunity to revisit the property. For this reason, a single well will hold much acreage and the oil company may not be refocused again in the area for many years. Meanwhile, the mineral owner is left owning minerals subject to a lease with little activity.

A. Express Lease Terms.

We have assumed, for purposes of this paper, that the historic leases in place have basic, lessee-favorable provisions, but lack certain "lessor friendly" terms, such as continuous drilling obligations, which would explicitly require a certain number of wells to be drilled within a given time frame; retained acreage provisions, which would require acreage to be released if it has not been developed within a stated time period; a "Pugh" clause, which would require any acreage not in a pooled unit to be released after the primary term; and other provisions related to the lessor's interest in fully developing the lease. The typical oil and gas lease deals primarily with the rights of the lessee and the duration of the estate, but speaks little to the rights of the lessor (other than the royalty clause) nor about the duties of the lessee. This is due to disproportionate bargaining power between the lessor and lessee and is necessarily skewed in favor of the oil company because it bears all the risk of any oil and gas operation. The typical historic lease left many gaps to be filled, primarily due to a recognition of the uncertainty inherent in undertaking any such operations.[18] Absent express terms for each potential scenario, the common law has stepped in to fill these gaps.

B. Law of Implied Covenants

The law of implied covenants arose not only out of a recognition that it would be to nobody's advantage to try to cover all possible scenarios that could arise during the term of an oil and gas lease, but also because of the inherent conflict between the lessor and lessee's interests. The lessor is interested in his right to receive royalty and the lessee is concerned with its bearing of all risk and costs. This fundamental tension has led to conflicts over the pace and scope of development activities.[19] The implied covenants covered below are those that the authors believe to be most relevant to enforcement of historic or enduring oil and gas leases.

1. Implied Covenant to Reasonably Develop

After the primary term, if there is no drilling requirement (and assuming there has been at least one producing well holding the lease) an oil company is bound by the implied covenant of reasonable development, which requires the drilling of additional wells to develop the property as a reasonably prudent operator would under the same or similar circumstances, taking into

[18] *See* Ernest E. Smith & Jacqueline Lang Weaver, TEXAS LAW OF OIL AND GAS § 5.1(A) (2d ed. 2007).
[19] *Id.*

consideration the interests of both the lessor and lessee.[20] In Texas, absent a contrary lease provision, a lessee has a duty to develop only *known* deposits. That means, there is no duty to explore unknown (i.e. untapped) resources.

The remedy for a breach of the implied covenant to develop is normally "the full value of the royalty lost to [the lessor] through the lessee's failure to exercise ordinary care to either develop the minerals or protect same from drainage . . . ."[21] Under the standard of care of a reasonably prudent operator under similar circumstances, a lessor must establish (1) a reasonably prudent operator would have drilled additional wells; (2) with the expectation of profit; (3) when the wells would have been drilled; and (4) the royalty that would have been obtained from the wells that should have been drilled.[22] Lease cancellation typically is not a remedy for breach of the implied covenant to develop, because the duty to develop is not a condition of perpetuation of the lease. However, under extraordinary circumstances a court may grant a conditional cancellation of the lease, either taking the form of a decree that the operator take certain acts to begin development within a certain period of time, or to cancel certain acreage or depths.[23]

2. Implied Covenant to Protect Against Drainage

An oil company must protect its lessor from being drained by other production from the same reservoir. This duty actually is a subset of the duty to develop, with the distinction being that the development required is more specific; namely, "develop" an offset well because there are reserves being drained. This duty requires a lessee to drill an offset well (even if there is an express lease clause limiting this obligation) and any other acts that a reasonably prudent operator would perform – including seeking administrative or regulatory relief, drilling additional wells or reworking existing wells and seeking voluntary unitization – regardless of whether one lessee has leased from various lessors over the same reservoir.[24]

The standard remedy for a breach of the implied covenant to protect against drainage is damages calculated as the royalty percentage that would have been paid on production from an offset well commencing at the time a well should have been drilled and placed in production.[25] This calculation of damages, therefore, requires a lessor to show that minerals are being drained from his tract, that a reasonably prudent operator would have drilled a well to protect the tract from drainage, the time at which that well should have been drilled, and the theoretical production that would have been obtained from the well. An additional option would be to seek from the oil company a release of that acreage proportional to that which would be encompassed by an offset well. Because the lessee has usurped the lessor's self-help remedy to offset the drainage by drilling a well, the acreage should be developed by drilling or given back to the lessor.

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[20] *Clifton v. Koontz*, 325 S.W.2d 684, 693-94 (Tex. 1959).
[21] *Texas Pacific Coal & Oil Company v. Barker*, 6 S.W.2d 1031, 1038 (Tex. 1928).
[22] *Browning Oil Co., Inc. v. Luecke*, 38 S.W.3d 625, 642 (Tex.App.-Austin 2000).
[23] *West Tex Land Co. v. Simmons*, 566 S.W.2d 719, 722 (Tex. Civ. App. – Eastland 1978 writ ref'd. n.r.e.).
[24] *Shell Oil Co. v. Stansbury*, 410 S.W.2d 187 (Tex. 1966), *aff'd per curiam*, 401 S.W.2d 623 (Tex. Civ. App. – Beaumont).
[25] *Id.*

3. Implied Covenant of Diligent and Proper Operation

This is the "catchall" covenant that somewhat overlaps with the reasonably prudent operator standard, but generally requires a lessee to adequately maintain the property (surface), to continue operations on wells that are capable of producing in paying quantities, to use proper (advanced) production techniques, and to seek favorable administrative or regulatory action, when necessary.[26]

IV. Description of the Problems

A. <u>You believe your lessee is not drilling an adequate number of development wells over a reasonable time period.</u>

The scenario we typically encounter in this situation is that there is a lease covering a significant amount of acreage – possibly two or three sections or even more. Or, the lease covers just enough land such that more than five or six "legal" locations (be they proration or drilling units) would be authorized by the Texas Railroad Commission. Under these facts, a number of wells should be drilled over time to "fully develop" the acreage, however, because the lease has been perpetuated past the primary term and well into its secondary term by production and/or operations, the oil company may have little incentive to continuously develop the lease. The lessor, on the other hand, would like to maximize his royalty and see as much of the land exploited as possible. The pace of drilling additional wells is at the heart of this conflict.

The first question to think about is what is "adequate"? Start with your lease to be sure there is no continuous drilling provision, or other terms guiding development. After the primary term, assuming there has been at least one producing well holding the lease, an oil company is bound by the implied covenant of reasonable development, which requires the drilling of additional wells to develop the property as a reasonably prudent operator would under the same or similar circumstances, taking into consideration the interests of the lessor and lessee.[27] A necessary condition to prove your lessee is not drilling adequate development wells, therefore, is that either your lease requires a certain number of wells to be drilled, or you know there are minerals your lessee is choosing not to exploit. The latter is the more likely scenario.

At this point, most mineral owners or account managers have some trepidation about moving forward with demanding further development. There continues to be confusion between development and exploration, and Texas law expressly, firmly and adamantly says that the oil company is under no duty whatsoever to "explore." What is the difference between development and exploration? What are known horizons, formations and zones and what are unknown? When the duty to explore was expressly negated and the duty to develop firmly embraced, geologists thought of the land as being under a finite set of geologic formations. Today, we know that oil and gas is trapped in a significant number of diverse mechanisms. There may be layers of, for example, shale, sandstone, limestone, dolomite and salt - all known as a single formation. There may be a single geologic area, such as calcium carbonate formations. Or, there may be geologic strata simply referred to by geologic age, such as Eocene, Miocene, etc. Regardless of the particular formation, the duty to develop goes to whether or not the lessee has

[26] *Amoco Prod. Co. v. Alexander,* 622 S.W.2d 563, 569 (Tex. 1981).
[27] *Id.* at 568.

sufficiently worked the field in attempting to extract the hydrocarbons in a reasonable amount of time, and not to seek out new, unproved fields. The simplest way to think about the duty to develop is to ask yourself whether the operator would have to permit the well as a "wildcat" or whether it would list a known field under its W1 Drilling Permit.

A practical method of retrieving production data is to ask your lessee, in writing, for its reserve reports. If your oil company is a publicly traded company, it will definitely have these. If the company borrowed any significant amount of money from a bank, it also will have reserve reports and/or other engineering reports. Of course, these may be confidential, but nevertheless, should be shared with the lessor in connection with discharging the oil company's duty to develop.

Recall that engineers classify proved reserves ("proved" meaning beyond a reasonable doubt that there is some probability of finding ready-to-develop hydrocarbons in a "known" area) as "proved, developed, producing" ("PDP") – being those wells that actually are online and producing such that royalties are being paid; "proved, developed, non-producing" ("PDNP") – meaning those behind the pipe or otherwise shut-in wells; and "proved, undeveloped" ("PUD") – meaning locations where there is a reasonable certainty of completing the formation for hydrocarbon production, but such completion has not yet occurred.[28] An oil company is under a duty to develop all three of these types of reserves, to put them online and turn them to sales.

Put simply, if the oil company itself and its hired engineer believe that there are PUD locations, one must ask why the company has not developed these locations when it has an absolute duty to do so. A company cannot hold proved acreage for speculation – its duty is to bring these reserves to the fore, as would the mineral owner if he had not transferred his operating rights to the lessee. The reserves categorization itself of "proved, undeveloped" says everything: the reserves have been proven and are *ready* to be developed. The only latitude the oil company should have is for a reasonable amount of time to make its business judgment of when, but not if, to deploy capital. The key here is to get to reserve or engineering reports, or force the oil company to deny the request. If the oil company has them and refuses to turn them over, this also is additional information that can be used to spur your lessee forward. The theory is that if the reserve reports really do show there are only unproven resources, then the company should not hesitate to share these. At a minimum, the reserve reports should be a standard request of operators that mineral owners should make on a yearly basis. The reports should then be reviewed for that acreage classified "PUD."

A second letter can then be sent asking the company to communicate a time-table by which it is planning to drill or to release this acreage. The result hoped for is that your lessee will be alerted that you are aware there is a duty to develop and aware there are "PUD" reserves, and will either take action to begin drilling operations, or will release the acreage, allowing you to lease to another lessee.

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[28] It should be noted that the Society of Petroleum Engineers ("SPE"), in conjunction with the American Association of Petroleum Geologists, the World Petroleum Council and the Society of Petroleum Evaluation Engineers have undertaken to revise and standardize the definitions of petroleum resources – known as the Petroleum Resources Management System ("PRMS"). The definitions in this paper are commonly used in the petroleum industry, although a new PRMS was approved by the SPE Board of Directors in 2007. A link to the new PRMS can be found at the Society of Petroleum Engineers website: http://www.spe.org/spe-app/spe/industry/reserves/prms.htm.

In addition to reserve reports, lessors should request, in writing, copies of farmout proposals with respect to their land from the oil company's files. The existence of farmout proposals would suggest that other operators are willing to take the business risk to develop the lease. Simply making the request achieves the goal of holding the oil company to its duty to develop, as one of three outcomes (all of which will provide useful information) will occur – either the oil company will report that there have been a certain number of farmout proposals, in which case you will know that it is likely a "reasonable" operator would further develop (and, therefore, it is likely your operator has not fulfilled its duty); the company will say there have been none, in which case (and assuming it is not being dishonest) you will have evidence that perhaps the leasehold has been fully developed, given the current limits of seismic and other geological data; or the company will refuse to give you any information, in which case you have strong evidence that a lawsuit prosecuting a development plan should seriously be considered.

The analysis of your request for seismic data parallels that of the farmout proposals. Once the request has been made, the oil company will respond either that there has been recent seismic testing and the geophysical manipulation of the data and associated summaries reveal the existence of likely targets; that there has been recent seismic testing and the data reveals no likely targets or; the company will refuse to provide such information - which should be thought of as reinforcing your initial concerns that the lessee is not adequately developing the leasehold. Any response or non-response by the oil company will provide excellent information that will help you determine what the next step(s) should be. The important aspect to remember is, ask appropriately specific questions, in writing, that force a response from the oil company.

You might also want to check with your neighbors, and ask them about the productivity of their wells, whether their lessees have undertaken any operations to rework the well(s), or what types of interaction they may have had with operators.

B. Are your wells still producing "in paying quantities?"

Under most oil and gas leases, after the primary term, the lease will remain in effect only to the extent that there is "production." Production has been interpreted by the courts in Texas (and most states) to mean "in paying quantities." In Texas, courts have developed the two-pronged "Koontz-Archer test" to determine "paying quantities." The first prong analyzes production over a reasonable period of time (at least a year, usually), and is defined as when revenues from production exceed operating and marketing expenses (by however small a margin).[29] If there is a profit, it will suffice to hold a lease in place. Only if the lessor can prove there has been no profit will the secondary prong be applied, which asks, using a subjective standard, whether a reasonably prudent operator would continue to operate the lease with the expectation of profit and not merely for speculation.[30] Factors considered under this analysis are (1) depletion of the reservoir; (2) price for which the lessee can sell production; (3) relative profitability of other wells in the area; (4) operating and marketing expenses for the lease; (5) lessee's net profit; (6) relevant lease provisions; (7) reasonable time limit under the circumstances; and (8) whether the lessee is holding the leases merely for speculative purposes.[31]

[29] *Gulf Oil Corp. v. Reid*, 337 S.W.2d 267 (Tex. 1960).
[30] *Koontz*, 325 S.W.2d at 684 (Tex. 1959); *Skelly v. Archer*, 356 S.W.2d 774 (Tex. 1962).
[31] *Koontz*, 325 S.W.2d at 691

The burden of proving a lease has not had production in paying quantities, when there has been *some* production, is extremely high, but use of the Koontz-Archer test as a guideline can be beneficial to know the type of information you should be seeking from the oil company. First, you must have a general sense of your lessee's revenues, and operating and marketing expenses. Revenues can be estimated based on production data and information related to market price. There are two ways to learn of the production from wells drilled on your lease – the first is to make a calculation based on your royalty payment and the second is directly from Texas Railroad Commission data (cross-referencing both is preferable).

Assume the following: the only royalty is your 1/5 landowner's royalty, there is only one working interest owner/operator, and royalty is based on the "posted market price" of oil as of the day it is run into the pipe or storage tanks. When you receive your royalty payment, you can review your check stubs and make the calculation of revenue based on market pricing. Also, visit the Texas Railroad Commission's website and print out a report of the production on your wells.[32] Study the trends over time. This is especially important when yearly income appears to be equal to or exceed operating costs. The biggest questions a lessor should be contemplating are: What are the operating costs for my well? What are the real expenses incurred by my lessee in continuing the production operations? What other costs are attributable to this well? What will the lessee say are the costs involved in going forward? The answer to these questions is deceptively simple – it is that which operators are generally, and any operator specifically, is allowing as reasonable costs to operate a well. The specifics can be found in the Council of Petroleum Accountants Societies ("COPAS") accounting procedures attached to most Joint Operating Agreements ("JOA"). JOA COPAS show what rates that operators and non-operators are agreeing are reasonable rates the operator may charge the non-operator for running the well. If there is a JOA respecting your well, then this, together with recent Joint Interest Billing ("JIB") is strong evidence of the cost side of the standards. Even without this information, current JOA COPAS give you an adequate thumbnail of what costs generally are acceptable by the industry in the local area. You will need to ask around for these.

In this case, you must continue to monitor production with an eye toward whether or not it is in paying quantities, to arm yourself with adequate information to determine if the leasehold estate may have terminated (remembering our earlier discussion related to the statute(s) of limitations). The monitoring should include cross-referencing your royalty check stub with available production information from the Texas Railroad Commission, to ensure that the

[32] The Texas Railroad Commission's website should be bookmarked on your computer. The website is: www.rrc.state.tx.us; the phone number is: 512-463-6882; fax: 512-463-7200, email: ims@rrc.state.tx.us; or you can visit them at: 1701 North Congress Ave., Austin, TX 78701; 10th Floor, Room 10-100. The hours of operation are: 8:00 am to 5:00 pm, Monday through Friday. You will need the following information to obtain RRC production data:

- County name (where property or well is located)
- Approximate date of drilling activity
- Lease or well name and well number
- Original or current operator name
- Field name and reservoir
- Commission number (API, Drilling Permit, Oil Lease number, and/or Gas ID number)
- Location (survey name, abstract, section, block, etc.)

There also is a subscriber-based service, called Drilling Info (accessible at www.drillinginfo.com) which allows the user access to a large database of U.S. oil and gas well activity, geologic data and real property records.

quantity of production on which you are receiving payment is equal to that reported. You will not be able to rely on hindsight to later claim there was a gap in production in paying quantities sufficient to establish lease termination.

Lastly, one additional thing for which you should be on the lookout if it appears your production may not be in paying quantities - you should be on the lookout for the oil company presenting you with ratifications or revivors of the lease. It would be to the oil company's advantage to acquire a ratification or revivor of the lease, in which case, any gap in production that may have terminated the lease could be overcome by such an instrument.[33]

C. <u>You want your lessee to release acreage or depths that have not been developed.</u>

Absent a lease provision to the contrary, one producing well will hold the entirety of the acreage covered by a lease. There is probably a pooling clause in the lease; however, absent such a clause a lessee has no right in Texas to pool a leased tract with other tracts. If your lease has a "Pugh" clause, requiring the release of any acreage not within a producing pooled unit, then the lease would automatically terminate as to acreage or depths not within that unit. However, if your lease does not have such a clause, and remembering that your lessee has a duty to reasonably develop the lease, it would be a good idea to request, in writing, the release of acreage and/or depths not developed.

Items to specifically address in such a letter mirror those discussed under the duty to develop, and are reiterated here briefly.

- Request reserve reports and/or engineering reports.
- Request copies of farmout proposals from the oil company's files. Simply making the request achieves the goal of forcing an answer from the oil company.
- Ask whether seismic testing recently has been done on the land and what the data reveals after being manipulated.
- Request that the oil company send you its development plan. If there is acreage not included as part of the development plan, request release of such acreage (this is true both "horizontally" and vertically").
- Use the word "notice." You should specifically state that you are putting the oil company on "notice" that you believe they need to release acreage/depths. This is especially important to lay the groundwork for a potential lawsuit for partial release.

D. <u>You are afraid you are being drained</u>.

The duty to protect against drainage is one of the duties encompassed by the duty to protect the leasehold (the other, which we will not discuss, is the duty to not depreciate the lessor's interest). This duty does not require an oil company to take a fixed set of steps, rather,

[33] Ratifications and revivors are theoretically distinct concepts, though often used interchangeably by courts. Ratifications apply only to leases that were never valid, whereas, revivors apply to leases that were valid at one time, but have expired.

the oil company must protect the lease using whatever means are appropriate. Appropriate means could include the drilling of offset wells, pooling and/or seeking administrative or regulatory relief. It is particularly important in a drainage scenario to understand your neighbors' situations. Talk to your neighbors to learn who their operators are – particularly if you learn that your oil company is also that of a neighbor. In this situation, a lessee has an equal duty to protect your interests as it does to protect that of your neighbor. If you suspect drainage and the oil company owns both your lease and the neighboring lease, you should understand a concept in Texas called "fraudulent drainage." This concept assumes that there is drainage occurring because of the conflicting interest of your lessor on both sides of the fence. Effectively, this alters the burden of proof to force the oil company proving to you that it is not draining.[34]

If you have identified a well on neighboring land that you believe is offsetting your well, additional technical information may not be needed as a threshold matter. You should immediately, in writing, put your lessor on notice to drill the offset well. This communication with your lessor is imperative. The demand to drill the offset well does not operate as a repudiation of your lease. Consequently, the lessee, upon receiving the notice, cannot do anything to harm your interest or argue it no longer owns the lease. As soon as you have sent the notice to drill the offset well, you should begin communications with the oil company to understand if it believes the suspect well is draining the acreage. Absent a more complicated circumstance, such as a single operator owning both your lease and the neighboring (draining) lease, you generally should view the oil company's decision not to drill as being reasonable. This is true, generally, in light of the oil company's economic interest in the well being substantially greater than your royalty interest. However, if the oil company believes the well is not affected by drainage, and their reasoning is because the acreage on your lease is not productive in that formation, then the oil company should be put immediately to an election to release the acreage. In other words, if it does not believe there are hydrocarbons being drained, there should be no reason for them to hold that acreage under the lease.

V. Negotiating a New Lease: An Outline of Considerations.

[34] *Alexander*, 622 S.W.2d at 569.