TEXAS SUPREME COURT
OIL & GAS LAW UPDATE

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A. Merriman v. XTO Energy, Inc.

Merriman v. XTO Energy, Inc., 407 S.W.3d 244 (Tex. 2013).

The Texas Supreme Court decided this case just over a year ago, but it is an important reminder as to Texas law on the accommodation doctrine and the proof necessary for a surface owner to prevail against the lessee of the mineral estate.

1. Summary of the facts

This case involves the failure of a lessee to accommodate an existing use of the surface estate when locating and drilling a well. In this case, Merriman, a pharmacist and part-time cattle rancher, owned the surface of a 40 acre tract of land in Limestone County. Merriman had a house, barn, and permanent fencing and corrals that he used in his cattle operation. XTO leased the mineral estate and contacted Merriman about drilling a gas well on the tract. Merriman was opposed to the well because he claimed it would interfere with his cattle operation. XTO proceeded to drill the well anyway. After the well was completed Merriman sought a permanent injunction to require XTO to remove the well because the well allegedly interfered with Merriman's existing use of the surface.

2. Disposition in lower courts

Both sides filed motions for summary judgment. The trial court granted summary judgment in favor of XTO and the court of appeals affirmed.

3. Disposition by Texas Supreme Court

The Texas Supreme Court affirmed the summary judgment against Merriman on "no evidence" grounds holding that Merriman failed to raise a material fact issue as to whether XTO failed to accommodate his use.

<u>4. Holding and reasoning by Texas Supreme Court</u>

<u>a. Accommodation doctrine</u>

In the opinion, the Court restates Texas law regarding the accommodation of surface uses by lessees of the mineral estate. Under the accommodation doctrine, the mineral estate lessee has the right to go onto the surface of the land to extract the minerals and also has the incidental rights reasonably necessary to accomplish this. These "incidental rights" include "the right to use as much of the surface as is reasonably necessary to extract and produce the minerals." Thus, the mineral estate is "dominant" and the surface estate "subservient."

If the mineral lessee has only one viable method for extracting the minerals, the mineral lessee may use that method even if it precludes or substantially impairs an existing use of the surface estate. However, if the lessee has reasonable alternative uses of the surface to extract the minerals, one of which prevents the surface owner's existing use and one that does not, the mineral lessee must use the method that allows the surface owner to continue the existing use.

<u>b. Burden of proof in accommodation claim</u>

The Court stated that in order to obtain relief on a claim that the mineral lessee has failed to accommodate an existing use of the surface, the surface owner has the burden to prove that: (1) the mineral lessee's use "completely precludes" or "substantially impairs" the existing use; and (2) there is no reasonable alternative method available to the surface owner by which the existing use can be continued.

In order to meet the second element, the surface owner must show that the inconvenience or financial burden of using an alternative method to continue the existing use is so great that it makes the alternative method unreasonable.

Further, even if the surface owner carries this burden, the surface owner must further prove that given the particular circumstances, there are alternative reasonable, customary, and industry-accepted methods available to the mineral lessee which will allow recovery of the minerals and also allow the surface owner to continue the existing use.

c. Reasoning by the Court

The court of appeals affirmed summary judgment in XTO's favor because it found that Merriman had reasonable means of developing his land for "agricultural" purposes. The court further found that Merriman had several other tracts of land available under lease where he could conduct his ranching operations. The Supreme Court, however, did not agree with the court of appeals as to Merriman's burden.

First, the Court did not hold Merriman to the burden of producing evidence to show that he could not conduct his cattle operations on other tracts that he leased. Second, the Court further differed from the court of appeals in not requiring Merriman to show that he could use his land for other general "agricultural" purposes other than the existing use for a cattle operation. The Court held that Merriman must only show that he did not have reasonable alternatives for conducting his cattle operations on the subject tract of land.

Although the Supreme Court disagreed with the standard applied by the court of appeals, ultimately, the Court affirmed the summary judgment against Merriman because Merriman only produced evidence showing that XTO's well precludes or substantially impairs his existing use of the cattle corrals and pens and creates an inconvenience and additional financial burden to him. This evidence, however, was not sufficient because Merriman failed to produce evidence to raise a material fact issue to show that he had no reasonable alternative means of maintaining his cattle operations on the 40-acre tract. Further, even if Merriman

had met that burden, he would still have to show that XTO had other acceptable alternatives to extract the minerals without disturbing Merriman's existing use.

5. Important takeaways from the opinion

In order to prevail under an accommodation doctrine claim, a surface owner must prove that the mineral lessee's use of the property either completely precludes or substantially impairs the *existing use* and that there are no reasonable alternative methods available to continue that existing use.

B. Key Operating & Equipment, Inc. v. Hegar

Key Operating & Equip., Inc. v. Hegar, 13-0156, 2014 WL 2789933 (Tex. June 20, 2014).

On June 20, 2014, the Texas Supreme Court decided this case, reversing the courts below and holding that Key Operating has the right to use a road crossing Hegar's tract to produce hydrocarbons from a well on adjacent lands.

1. Summary of the facts

In 1987, Key began operating the Richardson No. 1 well on a 60-acre "Richardson" tract. In 1994, Key also acquired oil and gas leases on a 191-acre contiguous tract, known as the "Curbo/Rosenbaum" Tract, and began working the Rosenbaum No.2, a well that already existed on that property. That same year, Key constructed a road on the Curbo/Rosenbaum tract in order to access both the Richardson and Rosenbaum wells. The Rosenbaum well stopped producing in 2000, and Key's lease expired. In that same year, however, the owners of Key Operating purchased a portion of the mineral estate under the Curbo/Rosenbaum Tract and

leased it to Key under a lease form that allowed pooling. Key then pooled 10 acres from the Curbo/Rosenbaum tract with 30 acres from the contiguous Richardson Tract.

In 2002, the Hegars purchased 85 acres of the Curbo/Rosenbaum Tract surface. This acreage included the road that Key was using to access the Richardson No. 1 well on the contiguous tract and they were fully aware when they bought the tract that Key regularly used the road in its mineral operations. Within the next couple of years, the Hegars constructed a house on their acreage, used the same road for access, and for several years took no action to restrict Key from using the road.

Key then drilled a new well, the Richardson No. 4, on the Richardson tract. This new drilling activity caused increased traffic on the road prompting the Hegars to file suit claiming that Key was trespassing by using the road. The Hegars sought a declaratory judgment that Key had no legal right to use the surface of their land in order to produce minerals from the contiguous Richardson Tract.

<u>2. Disposition in lower courts</u>

At trial, the Hegars offered testimony from a petroleum engineer who testified that: (1) the Richardson No. 4 well was the only well located on the pooled acreage with significant production; and (2) the size of the reservoir from which it was producing was only 3.5 acres and was not draining the minerals under the Hegars' property. The trial court enjoined Key from using the section of the road on the Hegars' property, ruling that the road was not being used to support wells that were extracting minerals from the Hegar Tract and therefore Key was trespassing on the Hegars' property. The court of appeals ultimately upheld the trial court's judgment holding that because Key was only producing oil from the adjoining Richardson Tract, then Key could not use the road on the Hegars' tract.

3. Disposition by Texas Supreme Court

The Supreme Court reversed and rendered judgment for Key holding that once the pooled unit had been legally formed, Key had the right to use the surface of the Curbo/Rosenbaum tract to produce from wells anywhere on the pooled unit.

4. Holding and reasoning by Texas Supreme Court

a. Lessee's right to use the surface

Citing to *Merriman,* the Court reiterates that the mineral estate is dominant over the surface estate and that the mineral lessee's incidental rights include the right to use as much of the surface as reasonably necessary to produce the minerals.

b. Impact of pooling

The Court noted that both leases allowed pooling. The Court further noted that the primary legal consequence of pooling is that production and operations anywhere on the pooled unit are treated as if they have taken place on each tract in the unit.

c. Key's implied surface rights included use of the road

Because the two tracts were pooled, the Court held that the tracts no longer have separate identities so that production from one tract is legally considered to be production from the other tract. There is no doubt that Key would have the right to use the road to produce minerals from the Hegars' acreage. Thus, because production from the pooled part of the Richardson Tract was also deemed production from the pooled part of the Hegar tract, Key had the right to use the road to access the Richardson well.

d. Other potential claims not made – bad faith pooling; accommodation doctrine

The Court mentioned in a footnote that the legal consequences of pooling may be challenged by claiming that the lessee pooled in bad faith. However, the Hegars did not assert such a claim.

Also, the Court noted that the accommodation doctrine was not raised in the trial court, so the Court did not need to consider whether the court of appeals correctly applied the doctrine in its decision denying Key the use of the road.

5. Important takeaways from the opinion

Lessees have the same rights to use of the surface estate for all acreage contained in a pooled unit regardless of where production is obtained.

C. French v. Occidental Permian Ltd.

French v. Occidental Permian Ltd., 12-1002, 2014 WL 2895999 (Tex. June 27, 2014).

On June 27, 2014, The Texas Supreme Court of Texas decided *French v. Occidental Permian Ltd*. holding that the royalty owners were required to share in the cost of the removal of carbon dioxide (CO_2) from casinghead gas to determine the market value of the gas at the well.

1. Summary of the facts

French owns royalty interests under two leases in the Cogdell Field. In 1954, these leases were pooled to form the Cogdell Canyon Reef Unit. The purpose of the unit was to allow secondary recovery operations to increase the ultimate recovery of

oil from the formation. In the unitization agreement, the royalty owners consented to the injection of extraneous substances and gave the working interest owners discretion in determining whether and how to conduct the operations. The costs of the secondary recovery operations were not to be charged to the royalty owners except as permitted by the leases.

The initial recovery operation involved the injection of water into the reservoir and was very successful. Separating the water from the produced oil is relatively simple and the working interest owners always treated this expense as part of production (not borne by the royalty owners).

Oil production declined, however. In 2001, Oxy began injecting CO_2. into the reservoir leading to increased production but also causing the production of casinghead gas with a high CO_2 content (85%). Under the unitization agreement, Oxy could reinject the CO_2-saturated casinghead gas back into the field, but instead chose to process the gas to separate the CO_2 and extract natural gas liquids (NGLs) for sale. Oxy viewed the processes required to separate the CO_2 from the NGLs as postproduction expenses and charged them to the royalty owners. French sued Oxy for underpayment of royalties claiming that the cost of processing the casinghead gas is a cost of production that must be borne 100% by the working interest owner.

<u>2.</u> **<u>Disposition in lower courts</u>**

The trial court ruled that the costs of removing the CO_2 from the casinghead gas were production costs that should be borne exclusively by the working interest owners and awarded more than $10 million in damages to French for the underpaid royalties. The court of appeals reversed finding insufficient evidence to support the damage award but not reaching the issue of whether the cost of separating the CO_2 from the casinghead gas was a production expense.

3. Disposition by Texas Supreme Court

The Texas Supreme Court affirmed the appellate court decision holding that the royalty owners were required to share in the cost of separating the CO_2 from the casinghead gas.

4. Holding and reasoning by Texas Supreme Court

In order to reach its conclusion that the CO_2 separation process was a postproduction cost, the Court differentiated the expensive processing of the CO_2-rich casinghead gas from the relatively simple process of removing water from the oil after flooding the reservoir in secondary recovery operations. The Court recognized that unlike the process of removing CO_2 from the gas, which was complicated and "not necessary for the continued production of oil," the process of removing oil from water was relatively simple and necessary for oil production.

Additionally, the court recognized that Oxy was not obligated to remove the NGLs from the casinghead gas. It is a common practice for casinghead gas to simply be reinjected directly into the field to help increase oil production. When this is done, there are no royalties paid to the royalty owners because the gas is not marketed. In the unitization agreement, the royalty owners gave Oxy broad discretion in determining how it would conduct its secondary and tertiary removal operations, and Oxy chose to process the casinghead gas and reinject only CO_2. Because Oxy chose (but was not required) to use that process, the royalty owners received an economic benefit that they were not guaranteed.

The court ultimately decided that because Oxy was given broad discretion in managing secondary and tertiary removal operations, and because Oxy decided to (but had the option not to) process the casinghead gas which benefitted royalty

owners, then the royalty owners should be required to share in the cost of the CO_2 removal.

5. Important takeaways from the opinion

The Court endorses the use, development and implementation of new technologies that can extend the life of a reservoir while eliminating waste by labeling these expenses as postproduction costs chargeable against the royalty owner. The Court based its decision, however, upon the language of the royalty clauses in the leases and the unitization agreement. This means that these costs might be allocated differently in other cases depending upon the language of the relevant leases and agreements.

D. Cases to be decided

The Texas Supreme Court has granted petitions for review in the following cases but has not yet issued any opinions.

1. Steadfast Financial LLC v. Bradshaw

Bradshaw v. Steadfast Fin., L.L.C., 395 S.W.3d 348 (Tex. App. 2013).

On June 27, 2014, the Supreme Court granted petition for review in this case. Oral argument is set for October 15, 2014.

Bradshaw inherited a non-participating royalty interest (NPRI) in approximately 1,800 acres in Hood County reserved by her parents in two 1960 deeds. The interest was "an undivided one-half royalty (being equal to not less than an undivided one-sixteenth of all oil, gas and/or other minerals ... that may be produced)."

In 2006, Steadfast owned the surface and mineral estates that included Bradshaw's NPRI. Steadfast sold the surface to Range Resources Corporation, but reserved the mineral estate and entered into a lease with Range Production I, L.P. which provided for a 1/8 royalty. Bradshaw sued Steadfast claiming that Steadfast owed her a duty to secure a 1/4 royalty interest in the lease, which she alleged was the going rate in Hood County. Bradshaw claimed that Steadfast, as the holder of the executive rights, breached fiduciary duties owed to her by engaging in self-dealing and obtaining an excessively large bonus price and above-market price for the surface estate while reserving only a 1/8 royalty interest in the lease. The trial court granted summary judgment against Bradshaw and she appealed to the court of appeals.

The court of appeals opinion contains a lengthy and detailed analysis concerning the history of the development of the law regarding the duties owed by executive owners to the non-executive owners. Ultimately, the court concluded that Steadfast did owe a fiduciary duty to Bradshaw and that Bradshaw presented sufficient evidence to raise a fact issue as to whether or not Steadfast breached its duty.

The Supreme Court's decision in this case could involve an expansion or contraction of the duties owed by executives and potential claims by the non-executives where the executives allegedly engaged in self-interested transactions at the expense of the non-executives.

2. <u>Hooks v. Samson Lone Star, L.P.</u>

Samson Lone Star, Ltd. P'ship v. Hooks, 389 S.W.3d 409 (Tex. App. 2012).

On May 2, 2014, the Supreme Court granted petition for review in this case. Oral argument is set for September 17, 2014.

Hooks had three oil and gas leases with Samson. Hooks sued Samson under various contract and tort claims. One of Hooks' leases in Jefferson County contained a stipulation that required compensation from Samson if Samson drilled a competing well within 1,320 feet of Hooks' property line. In 2000, Samson spudded a well about 1,500 feet away from the Hooks' property line, but Hooks was unaware at the time that the well actually bottomed out within 1,320 feet of the property line. After Hooks discovered the true location of the well, Hooks sued claiming that Samson misrepresented the location of the well to Hooks to induce Hooks to agree to pool acreage and to avoid Samson's offset obligations.

Hooks was awarded $20 million on his fraud claim by the trial court. The court of appeals reversed, however, finding that Hooks' fraud claim was barred by limitations. The jury found that Hooks did not discover the true location of the well until a date within the limitations period. The court of appeals, however, found as a matter of law that through the exercise of reasonable diligence, Hooks should have known the true location of the well when the directional survey was filed with the Railroad Commission more than four years before Hooks filed the claim. Therefore, the court of appeals reversed the trial court judgment.

If this decision stands, this would reinforce the need for lessees to be vigilant as to information affecting their interests that may be filed of record and may be contrary to representations made by lessees.