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1990 OIL, GAS & MINERAL LAW

by

Stuart C. Hollimon*

I. ISSUES INVOLVING CONVEYANCING

DAY & Co., Inc. v. Texland Petroleum, Inc.¹ involved a declaratory judgment action brought by Day & Company and Bobby Day against Texland to determine the ownership of the executive rights² covering a ten-acre tract of land. Mildred Keaton and Francell Young, fee simple owners of an eighty-acre tract of land, conveyed the land by warranty deed to Day & Company. The deed reserved to Keaton and Young an undivided one-half mineral interest in the land, but it expressly conveyed the entire executive right in the entire tract to Day & Company. Day & Company later conveyed to John and Genelda Shoaf, by warranty deed, ten acres out of the eighty-acre tract, excepting and reserving an additional undivided one-fourth mineral interest. The warranty deed from Day & Company to Shoaf was silent with regard to the executive rights. Day & Company then executed a mineral lease on the entire eighty-acre tract to John Stringer. The Shoafs also executed a mineral lease on their ten-acre tract to Stringer. He later assigned both leases to Texland. Before Stringer's assignment to Texland, Day & Company executed another mineral lease on the eighty-acre tract to Bobby Day, contending that the lease to Stringer had expired due to nonpayment of delay rentals.

Both Day & Company and Bobby Day claimed that they owned an undivided three-fourths interest in the executive right regarding the ten-acre tract and that the Shoafs owned the remaining one-quarter interest in such right. Texland, on the other hand, contended that Day & Company owned only a one-quarter undivided interest in the executive right, with the Shoafs owning the other three-quarters interest. The trial court entered summary judgment for Texland. The court of appeals affirmed, holding that executive rights were "so significantly and intimately connected with the mineral estate as to be within the general rule that a warranty deed passes all the estate owned by the grantor at the time of the conveyance unless there are reservations or

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1. 32 Tex. Sup. Ct. J. 549 (July 12, 1989). After this material had been submitted to the publisher, the Texas Supreme Court, on motion for rehearing, withdrew the reported opinion and substituted a new opinion and judgment. See *Day & Co. v. Texland Petroleum, Inc.*, 786 S.W.2d 667 (Tex. 1990).

2. "The executive right is defined as the exclusive power to execute oil and gas leases." *Id.* at 550 (citing 2 H. WILLIAMS & C. MEYERS, OIL AND GAS LAW § 338 (1986)).

exceptions which reduce the estate conveyed."³ The lower courts, therefore, reasoned that the executive right covering the Keaton and Young undivided one-half mineral interest passed to the Shoafs under the warranty deed from Day & Company because Day & Company failed to reserve or except such right in the warranty deed.⁴

The Texas Supreme Court began its analysis of the parties' claims by setting forth the principles of law relating to the conveyance or reservation of executive rights.⁵ In accordance with such principles, the court found that Day & Company implicitly retained an undivided one-fourth interest in the executive right in the ten-acre tract, corresponding to the one-fourth mineral interest that Day & Company reserved from its conveyance to the Shoafs.⁶ The supreme court also found that the Shoafs implicitly received an undivided one-fourth interest in the executive right in the ten-acre tract that corresponded to the one-fourth mineral interest Day & Company conveyed to the Shoafs.⁷ The issue, then, was which party owned the remaining undivided one-half interest in the executive right that corresponded to Keaton's and Young's reserved one-half mineral interest in the ten-acre tract.⁸

As noted above, Texland claimed that the Shoafs owned the undivided one-half mineral interest corresponding to Keaton's and Young's reservation because the warranty deed from Day & Company to the Shoafs did not reserve or except the interest for Day & Company. Texland based its claim on the greatest possible estate rule under the Texas Property Code⁹ and common law.¹⁰ The supreme court disagreed with Texland's argument, finding that neither rule applied to executive rights.¹¹ Since the executive power is

3. *Day & Co., Inc. v. Texland Petroleum, Inc.*, 718 S.W.2d 384, 389 (Tex. App.—Amarillo 1986), *rev'd*, 32 Tex. Sup. Ct. J. 549 (July 12, 1989) (citing *Cockrell v. Texas Gulf Sulphur Co.*, 157 Tex. 10 13, 299 S.W.2d 672, 675 (1956)).

4. 718 S.W.2d at 389.

5. In the words of the court:

[The executive right] is an essential attribute of a severed mineral estate. When a mineral interest is reserved or excepted in a deed, the executive right covering that interest is also retained unless specifically conveyed. However, when a mineral interest is granted in a deed, the executive right also impliedly passes to the grantee to the extent of the grantee's interest unless specifically reserved. Therefore, whether a mineral interest is reserved or granted, the executive right is appurtenant to the mineral estate absent a contrary expression in the deed. All rights inherent in the mineral estate are impliedly reserved, excepted, or conveyed, respectively, to the extent the mineral estate itself is reserved, excepted, or conveyed.

32 Tex. Sup. Ct. J. at 550 (citations omitted).

6. *Id.*

7. *Id.*

8. *Id.*

9. "An estate in land that is conveyed or devised is a fee simple unless the estate is limited by express words or unless a lesser estate is conveyed or devised by construction or operation of law." TEX. PROP. CODE ANN. § 5.001(a)(Vernon 1984).

10. Under common law, a warranty deed passes all of the grantor's estate unless there are reservations or exceptions reducing the estate conveyed. *Cockrell v. Texas Gulf Sulphur Co.*, 157 Tex. 10, 14, 299 S.W.2d 672, 675 (1957); *Harris v. Currie*, 142 Tex. 93, 176 S.W.2d 302 (1943).

11. 32 Tex. Sup. Ct. J. at 551.

not an estate in land,¹² neither the statutory nor the common law greatest possible estate rule was applicable.¹³

The court also noted that the Shoafs bargained for an undivided one-fourth mineral interest in the ten-acre tract of land and the right to lease such interest.¹⁴ The Shoafs did not bargain for the right to lease Keaton's and Young's mineral interests in the tract. The supreme court, therefore, stated that "[a]bsent an expression to the contrary in the deed, we hold that a conveyance of a mineral interest conveys the right to lease that interest but no greater executive right."¹⁵ Day & Company's conveyance to the Shoafs of an undivided one-fourth interest in the ten-acre tract included an undivided one-fourth interest in the executive right to such tract, and reserved the remaining undivided three-fourths interest in that right to Day & Company.¹⁶

*Rogers v. Ricane Enterprises, Inc.*¹⁷ arose from a trespass to try title action concerning the partial assignment of an oil and gas lease. Superior Oil Company, through an assignment, owned the leasehold rights under a 1937 oil and gas lease (referred to as the "base lease") covering almost 8,000 acres. According to the habendum clause of the base lease, the lease would remain in effect past the primary term as long as production was continuous on any part of the acreage covered by the base lease, regardless of subsequent division of the leased premises into separate tracts. In 1949 Superior assigned its rights under the base lease in a 329.3-acre tract to Western Drilling Company.¹⁸ Western immediately drilled and completed a producing well on the 329.3-acre tract. This well continued to produce until 1961. Western became defunct in 1965. From 1961 to the time of trial, neither Western nor its shareholders drilled any additional wells on the tract.

In 1960, prior to the well's cessation of production, the president of West-

12. *Pan Am. Petroleum Corp. v. Cain*, 163 Tex. 323, 355 S.W.2d 506 (1962).

13. 32 Tex. Sup. Ct. J. at 551.

14. *Id.* at 552.

15. *Id.*

16. *Id.*

17. 772 S.W.2d 76 (Tex. 1989).

18. Such assignment provided, in part, as follows:

THIS ASSIGNMENT IS MADE SUBJECT TO THE FOLLOWING CONDITION AND PROVISION:

1.

All of the right, title, interest and privileges herein conveyed to and conferred upon Western will cease and terminate and shall revert to and revest in Superior, unless within thirty (30) days after the date hereof, Western shall commence the actual drilling for oil and gas upon the above described land at a location thereon which shall satisfy any then existing offset obligation. . . .

2.

Western shall and hereby does assume and agree to perform and discharge all of the [base] lease obligations, express or implied. . . . To this end, it is recognized by the parties hereto . . . that there now are a number of . . . off-set wells which Western shall protect against by the drilling of properly located wells on the above described land, in due and proper time, and subject to all of the applicable provisions of this agreement.

Id. at 78.

ern, signing in his individual capacity, conveyed to the Dakota Company, Inc. "all of [his] right, title and interest . . . in the [base lease] . . . insofar as said lease covers the . . . 329.3 acres . . ."19 Through subsequent assignments, Ricane Enterprises, Inc. and others, collectively referred to as the Ricane Group, acquired the Dakota Company's interest. In 1979 the Ricane Group drilled and completed a new producing well on the tract.

In 1984, Rogers and other shareholders of Western brought a trespass to try title action against the Ricane Group, seeking to recover possession of the working interest on the 329.3-acre tract. The shareholders also sought damages for conversion of oil and casinghead gas produced from the property by the Ricane Group. The Ricane Group moved for summary judgment on the following grounds: (1) automatic termination of Western's rights under the partial assignment; (2) abandonment; (3) laches; and (4) limitations. The trial court granted the motion "on the grounds urged,"20 and the court of appeals affirmed the summary judgment solely on the basis of the automatic termination theory.²¹ The appellate court determined that paragraph 2, quoted above, made the partial assignment of the base lease expressly conditioned upon Western's performance of obligations imposed by the underlying base lease.²² Because Western failed to conduct any drilling operations on the tract for almost twenty-three years following the cessation of production from the initial well on the tract, the court of appeals held that Western's rights under the assignment automatically terminated and reverted to Superior.²³

The Texas Supreme Court disagreed with the court of appeals' holding, and instead, held that paragraph 2 was a covenant and not a condition.²⁴ Referring to paragraph 1, the Texas high court noted that the parties obviously knew how to create a condition.²⁵ Since paragraph 2 contained dissimilar language whereby Western merely agreed to perform all of the obligations of the base lease, the parties intended such paragraph to act as a covenant. The court supported its holding by two general rules of construction: first, a court cannot imply terms that contradict the express language of a written contract; and, second, doubts as to construction of a provision should be resolved in favor of a covenant rather than a condition.²⁶ Based

19. *Id.*

20. *Id.*

21. *Rogers v. Ricane Enter., Inc.*, 775 S.W.2d 391 (Tex. App.—Amarillo 1987), *rev'd*, 772 S.W.2d 76 (Tex. 1989).

22. 775 S.W.2d at 394.

23. *Id.* at 395.

24. 772 S.W.2d at 79. The important distinction between a condition and a covenant lies in the appropriate remedy for the breach of each. As the court noted:

Breach of a condition results in automatic termination of the leasehold estate upon the happening of stipulated events. Breach of a covenant does not automatically terminate the estate, but instead subjects the breaching party to liability for monetary damages, or in extraordinary circumstances, the remedy of a conditional decree of cancellation.

Id. (citing *W.T. Waggoner Estate v. Sigler Oil Co.*, 118 Tex. 509, 512-14, 19 S.W.2d 27, 29-31 (1929)).

25. *Id.*

26. *Id.*

on its holding that paragraph 2 was not a condition, the court determined that Western's right under the partial assignment could not automatically terminate under such paragraph, and therefore, summary judgment could not be sustained on that ground.²⁷

The court then examined the other theories advanced by the Ricane Group to determine whether any such theories would support the award of summary judgment. With respect to its abandonment theory, the Ricane Group contended that Western and its shareholders abandoned its rights to the property in question. The Texas Supreme Court rejected such theory on the well-established principles that an interest in an oil and gas leasehold estate is an interest in real property, and that real property interests cannot be abandoned.²⁸ The Ricane Group's next ground for summary judgment contended that the doctrine of laches barred the shareholders' suit as a matter of law due to the unreasonable delay in asserting the claims to the lease in question. The Texas Supreme Court rejected this ground as well, noting that laches is not a defense in a trespass to try title suit where the plaintiff's right is based on legal title.²⁹

As a final ground in support of summary judgment, the Ricane Group contended that the three-year statute of limitation barred the shareholders' trespass to try title action.³⁰ The shareholders countered that the Ricane Group was not entitled to summary judgment because they failed to prove either title³¹ or color of title³² as a matter of law. The supreme court found that the Ricane Group did not sufficiently plead or present summary judgment evidence showing its claim of title or color of title.³³ Because they failed to meet their burden of proving adverse possession under the applicable statute, the court found that the three-year statute of limitations could not sustain the summary judgment.³⁴

Because none of the theories the Ricane Group asserted in support of its summary judgment supported such a judgment, the supreme court reversed the judgment of the court of appeals and remanded the cause to the trial court for trial on the merits.³⁵

27. *Id.*

28. *Id.* at 80.

29. *Id.*

30. TEX. CIV. PRAC. & REM. CODE ANN. § 16.024 (Vernon 1986) ("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.").

31. Title is "a regular chain of transfers of real property from or under the sovereignty of the soil." TEX. CIV. PRAC. & REM. CODE ANN. § 16.021(4) (Vernon 1986).

32. Color of title is a consecutive chain of transfers to the person in possession that "(A) is not regular because of a muniment that is not properly recorded or is only in writing or because of a similar defect that does not want of intrinsic fairness or honesty; or (B) is based on a certificate of headright, land warrant, or land scrip." *Id.* § 16.021(2).

33. 772 S.W.2d at 81.

34. *Id.*

35. *Id.*

II. ISSUES INVOLVING OIL, GAS & MINERAL LEASES

A. *Surface/Mineral Relationship*

The Fifth Circuit Court of Appeals affirmed the district court's order of denial of an injunction requiring pipeline burial in *Carrigan v. Exxon Company U.S.A.*³⁶ In this case, the Carrigans owned the surface rights in a certain tract of land. Exxon was the successor in interest to the original lessee of the mineral estate granted by the Carrigans' predecessors in interest. The property was subject to a unitization agreement that had been ratified by the Carrigans' predecessors. By their lawsuit, the Carrigans sought damages for oil and chemical spills, and litter and debris, and also sought an injunction compelling Exxon to bury all of its pipelines below plow depth, to abandon the cutoff roads it had been using, to clean up the property, and to provide safety training to the Carrigans concerning the dangers of hydrogen sulfide gas.³⁷ The district court entered judgment awarding money and damages to the Carrigans for injury to the surface of the property resulting from Exxon's use of it, but denied the Carrigans the injunctive relief they sought, reasoning that (1) the unitization agreement abrogated the provision in the original lease allowing the lessor to require the lessee to bury its pipelines below plow depth, and (2) the deeds conveyed the surface interest in the property to the Carrigans, but not the right to require the burial of pipelines.³⁸

On appeal the Carrigans argued that the trial court erred in holding that the unitization agreement abrogated the original lease provision requiring pipeline burial. They asserted that their predecessors in interest, who owned the surface estate, royalty interest, and reversionary interest in the mineral estate at the time of the execution of the unitization agreement, entered into that agreement only in their capacities as royalty interest owners, and not as owners of the surface estate. Thus, the Carrigans argued, their predecessors in interest did not abrogate their right to require the lessee to bury its pipelines, which is a right fixed to the surface estate, and that they had an express right to require such burial.

The appellate court examined the original lease to determine whether it contained an express provision requiring burial and found that it unambiguously provided such a right.³⁹ The court next examined the unitization agreement to see whether it abrogated this right. A provision in the unitization agreement provided that such agreement amended and modified all existing leases to the extent that the provisions of the leases conflicted with the provisions of the unitization agreement.⁴⁰ While the unitization agreement did not expressly address the issue of the lessor's right to require the opera-

36. 877 F.2d 1237 (5th Cir. 1989).

37. Hydrogen sulfide gas is a hazardous by-product of the production of oil and natural gas in some areas. *Id.* at 1239 n.5.

38. *Id.* at 1239.

39. *Id.* at 1240-41. The lease provided in part: "When required by lessor, lessee will bury all pipelines below ordinary plow depth . . ." *Id.* at 1241.

40. *Id.* at 1242.

tor to bury its pipelines, the issue before the Fifth Circuit became whether the terms of the unitization agreement conflicted with the original lease to such an extent that the lessor's right to require pipeline burial had been abrogated.⁴¹

In this regard, the court examined the provision in the unitization agreement governing the operator's right to use of the surface.⁴² The court found that the terms of this provision created a conflict with the pipeline burial clause of the original leases because they granted to the operator the right to use as much of the surface as might be reasonably necessary, without any provision limiting the right of such use.⁴³ This broad grant of surface usage rights, without any indication that burial of surface pipelines was required, led the Fifth Circuit to conclude that the unitization agreement allowed the operator to lay pipelines (as long as the pipelines were reasonably necessary) with no requirement that the operator bury the pipelines.⁴⁴

As additional support for this conclusion, the court noted that the unitization agreement provided the surface owners with a right to seek money damages for surface injury resulting from necessary use of the surface estate by the operator.⁴⁵ According to the court, this signified that the parties recognized the possibility that oil and gas operations would interfere with the surface use of the property, and the contract handled the matter by allowing for the payment of money damages rather than requiring pipeline burial upon demand.⁴⁶

With regard to the Carrigans' claim that their predecessors in interest did not abrogate their right to pipeline burial because they entered into the unitization agreement solely in their capacity as royalty owners, the court again turned to the terms of the unitization agreement.⁴⁷ The Fifth Circuit agreed with the Carrigans' contention that their predecessors in interest signed the unitization agreement as royalty owners.⁴⁸ The court, however, noted that the agreement defined royalty owner to include an owner of land.⁴⁹ By such

41. *Id.*

42. Article IX, paragraph 20 provided, in part, that:

The working interest owners and royalty owners, to the extent of their rights and interests, hereby grant to the Unit Operator the right to use or permit the use of as much of the surface of the land within the unit area as may be reasonably necessary for the development and operation of the unit area The Unit Operator shall have a right of way over and across such land, and the right of ingress and egress thereto and therefrom, for the laying, construction, using, maintaining, operating, changing, repairing and removing of pipelines The Unit Operator, for the joint account of the working interest owners, shall pay all damages . . . resulting from the exercise of the rights and privileges acquired under the provisions of this paragraph 20.

Id. at 1242-43.

43. *Id.* at 1243.

44. *Id.*

45. *Id.*

46. *Id.*

47. *Id.* at 1241.

48. *Id.*

49. *Id.* at 1241-42. "Royalty owner" was defined in Article I of the unitization agreement to include:

any owner who, subject to a working interest owner's right to search for and

definition, the court held that the unitization agreement signed by the Carrigans' predecessors in interest as royalty owners included the full extent of their interest in the property, including their rights relating to the ownership of the surface estate.⁵⁰

B. Lessee/Lessor Relationship

1. Lease Provisions

*Good v. TXO Production Corp.*⁵¹ involved the construction of an express covenant to protect against drainage contained in an oil and gas lease between Good, as lessor, and TXO, as lessee.⁵² Good sued TXO, alleging that TXO breached this express covenant by failing to drill a well on the leased premises as an offset to two gas wells on adjacent tracts that were draining the Upper Morrow Formation. In response to special issues and instructions, the jury found that there had not been substantial drainage from the Upper Morrow Formation, and the trial court entered a take-nothing judgment against Good.

On appeal Good contended that the trial court erred in asking the jury to find whether or not substantial drainage had occurred. She claimed that the adjective "substantial" forced her to carry a greater burden of proof than required by the express covenant contained in her lease. According to Good, the requirement of substantial drainage related only to the implied covenant to protect against drainage, and was irrelevant in the context of her lawsuit for the breach of an express covenant.

The court of appeals disagreed with Good's contentions. Recognizing that substantial drainage was one of the elements of a cause of action for breach of the implied covenant to protect against drainage, the court found that the express covenant contained in the lease at issue did not call for a different standard of conduct.⁵³ The appellate court reached this result based on the language of the express covenant that, by its own terms, incorporated the reasonably prudent operator standard.⁵⁴ The court, therefore, concluded that the express covenant provided for the same standard of protection as required under the implied covenant.⁵⁵ The express adoption of the reasonably prudent operator standard, according to the appellate court,

produce unitized substances, owns land, mineral rights, royalties, overriding royalties, payments out of production, reversionary interests, net profits interests or other similar rights in and to the unitized substances that may be produced and saved from the unit area. . . .

Id. at 1241 (Footnote omitted).

50. *Id.* at 1242.

51. 763 S.W.2d 59 (Tex.App.—Amarillo 1988, writ denied).

52. The covenant provided:

In the event a well or wells producing oil or gas in paying quantities should be brought in on adjacent land . . . and draining the leased premises, lessee agrees to drill such offset wells as a reasonably prudent operator would drill under the same or similar circumstances.

Id. at 59-60.

53. *Id.* at 61.

54. *Id.*

55. *Id.*

included an independent requirement that the drainage be substantial before the lessor could maintain an action for breach of a covenant to protect the lease against drainage, whether the covenant was express or implied.⁵⁶ The court, therefore, affirmed the take-nothing judgment.⁵⁷

*Williams v. Baker Exploration Co.*⁵⁸ presented an action by Williams and other lessors under an oil, gas, and mineral lease against Baker Exploration Company and others, as past or present lessees who owned the working interest in the lease. By their lawsuit, Williams, et al., sought damages for nonpayment and conversion of oil and gas royalties attributable to production from five wells on the lease. Williams, et al., also sued McMurrey Petroleum, Inc., which was the operator of the wells and units involved and which purchased the oil and gas produced therefrom.

Upon motion by Baker and the other past or present lessees, the trial court granted summary judgment that Williams, et al., take nothing from the lessees by their lawsuit. The trial court based its judgment solely upon the undisputed fact that the lessors had executed division orders for the sale of their oil and gas to McMurrey. Baker Exploration, et al., persuaded the trial court that the lessees' duty arising under the division order requiring the purchaser of production to make payments to the lessor superseded the lessees' duty under the lease to pay royalties to the lessors. The current and former lessees relied upon the holdings of *Exxon Corp. v. Middleton*⁵⁹ and *Cabot Corp. v. Brown*.⁶⁰

The court of appeals, however, reversed the summary judgment and remanded the case to the trial court for further proceedings.⁶¹ The court disagreed with the appellees' reading of the *Brown* and *Middleton* cases, and stated that the holdings of such cases do not excuse lessees from payment of the lessors' royalty merely because the lessors executed division orders in favor of a purchaser of the leasehold oil and gas.⁶² The court held that only an express provision in a division order could effectively release lessees from their royalty payment obligation.⁶³ Thus, the court rejected the appellees' contention that they were entitled to summary judgment as a matter of law merely because of the lessors' execution of division orders.⁶⁴

*Thomas v. Thomas*⁶⁵ presented matters of first impression to Texas courts regarding application of the free gas clause in an oil and gas lease. In 1938, J.N. Duncan, as lessor, executed an oil, gas, and mineral lease in favor of Phillips Petroleum Company, as lessee, covering the relevant tract of land in

56. *Id.*

57. *Id.* at 62.

58. 767 S.W.2d 193 (Tex. App.—Waco 1989, writ denied).

59. 613 S.W.2d 240 (Tex. 1981) (Division orders executed by royalty owners obligating the lessees to pay royalties at lower rates than those under the lease royalty clauses, are nevertheless binding on the royalty owners until revoked).

60. 754 S.W.2d 104 (Tex. 1987) (following *Exxon Corp. v. Middleton*).

61. 767 S.W.2d at 196.

62. *Id.*

63. *Id.*

64. *Id.*

65. 767 S.W.2d 507 (Tex. App.—Amarillo 1989, no writ).

Gray County, Texas. The lease contained a free-gas clause.⁶⁶ Duncan subsequently conveyed the surface and a portion of the mineral interest to Jerry Thomas, the father of appellant Stephen Thomas, and appellees Gregory Thomas and the other children of Jerry Thomas. Phillips Petroleum drilled a producing well on the leased premises; thus, production from the well perpetuated the lease.

In 1938, when Duncan and Phillips Petroleum executed the lease, no dwelling existed on the leased premises. Jerry Thomas and his wife, Patricia, placed the first house on the property in 1950 and began taking the free gas provided for in the oil and gas lease. Jerry and Patricia continued to live in the home until their deaths in 1975 and 1980, respectively. The house remained vacant following Patricia's death except for an eighteen-month period when the house was rented to a tenant.

Upon the death of Jerry Thomas, his interest in the property passed to his wife. Stephen Thomas thereafter purchased from his mother a one-acre tract within the leased premises. Stephen built a house on this tract and, in 1975, began taking free gas from the producing well for use in his home.

Following the death of Patricia Thomas, the property (less Stephen's one-acre tract) passed to Stephen and Gregory Thomas and the other children. In 1985, the Thomas heirs partitioned the surface estate of the tract, pursuant to which Stephen received certain acreage contiguous to the one-acre tract of land he had previously purchased, and Gregory and the other Thomas children received the remaining acreage, which included the producing gas well and the original Thomas dwelling built in 1950.

Phillips learned of Stephen's use of the free gas in 1986, and thereafter notified the Thomas heirs that the lease clause limited free gas to one dwelling. Phillips requested the Thomas heirs to determine among themselves which dwelling would receive the free gas. Both Stephen and Gregory, et al., claimed ownership of the right under the free gas clause. Gregory, et al., asserted entitlement to such right by virtue of being successors in interest to the surface estate where Jerry and Patricia Thomas placed the first dwelling on the property in 1950. Stephen claimed ownership of the free gas right as a result of his ownership of the only house presently occupied on the leased premises. According to Stephen, the right to free gas for the original dwelling terminated when the dwelling ceased to be occupied, and thereafter, it attached to Stephen's dwelling. Gregory, et al., brought a declaratory judgment action against Stephen in order to resolve the dispute. The trial court determined that Gregory Thomas, et al., owned the free gas interest.

Recognizing the case presented matters of first impression in Texas, the Amarillo court of appeals looked to cases from other jurisdiction for guidance and set out the general principles of the cases regarding free gas

66. The lease provided that "Lessor shall have the privilege at his risk and expense of using gas from any gas well on said land for stoves and inside lights in the principal dwelling thereon out of any surplus gas not needed for operations hereunder." *Id.* at 508 (emphasis omitted).

clauses in oil and gas leases.⁶⁷ With regard to the case at hand, the court noted that the first dwelling on the property was built in 1950 after the execution of the oil and gas lease in 1938.⁶⁸ Thus, the right to receive the free gas attached to the original dwelling in 1950.⁶⁹ The right to free gas, as an interest in real property, can only be acquired or lost by the usual methods of transferring an interest in real property, such as by gift, sale, exchange, or by adverse possession.⁷⁰ Since Gregory, et al., or their predecessors in title to the surface rights did not transfer the free gas interest to Stephen, the interest continued to be owned by Gregory, et al., as successors in interest to the surface estate where the principal dwelling was established in 1950 by Jerry and Patricia Thomas.⁷¹ The court, therefore, affirmed the trial court's judgment in favor of the successors in interest to the original principal dwelling.⁷²

Construction of a dry hole clause was at issue in *Burns v. Louisiana Land & Exploration Co.*⁷³ In 1981, Burns, as lessor, and McMoran Production Company, as lessee, entered into an oil and gas lease covering a certain tract of land. Louisiana Land & Exploration Company (LL&E) subsequently acquired certain interests in the lease from McMoran. In 1983 McMoran or LL&E re-entered a dry hole that a previous lessee drilled on the premises and commenced reworking operations. The operations were unsuccessful, and in June 1984 McMoran or LL&E again plugged and abandoned the well as a dry hole. The primary term of the lease expired in July 1984, at which time no operations were in progress on the lease. On September 2, 1984, LL&E entered the property and drilled a new well. LL&E plugged and abandoned this well as a dry hole in April 1985.

Burns brought suit against LL&E and McMoran in state court, seeking damages for trespass. Burns claimed that the lease expired on July 20, 1984,

67. As stated by the court:

It is the general rule . . . that the free gas clause in the oil and gas lease is a covenant running with the surface estate of the property. The surface estate receives the benefits and the mineral estate has the burden. Where, as here, the free gas clause is limited to the "principal dwelling," that burden to the mineral estate cannot be extended to additional dwellings without the consent of the mineral estate owner. The right to take free gas under a free gas clause in an oil and gas lease is transferrable and assignable as is any other property interest. Likewise, the burden to the mineral estate is transferrable and assignable as is any other property interest.

The settled general rule is that the right to free gas is construed as a covenant running with that portion of the land upon which the principal dwelling was located at the time the original lease was executed. When there is no dwelling in existence on the leased premises at the time of the execution of the original oil and gas lease and a principal dwelling is placed on the premises years later, the right to receive the free gas attached to that portion of the surface estate where the dwelling is located.

Id. at 509-10 (citations omitted).

68. *Id.* at 510.

69. *Id.*

70. *Id.*

71. *Id.*

72. *Id.*

73. 870 F.2d 1016 (5th Cir. 1989).

and that LL&E's drilling of a well after that time constituted trespass. Burns asserted that the trespass destroyed the speculative value in the leasehold estate. The defendants removed the case to federal court, where they filed a motion for summary judgment on the issue of liability. The district court granted this motion, holding that no trespass occurred because the lease was in effect in September 1984 when LL&E drilled the well.⁷⁴

Neither party disputed that the primary term of the lease ended on July 20, 1984. Thus, the lease was in effect at the time LL&E began drilling only if some express provision of the lease extended its term. LL&E and McMoran relied on the dry hole provision of the lease.⁷⁵ Conceding that no drilling or reworking operations were underway at the time of the expiration of the primary term, the defendants relied on the portion of the sentence allowing an extension of the lease when the lessee completed a dry hole within ninety days of the expiration of the primary term.

LL&E and McMoran asserted that they completed a dry hole on the leased premises when they terminated their unsuccessful reworking operation, and the termination was within ninety days of the end of the primary term. The drilling of the new well, commenced on September 2, 1984, was within ninety days following the termination of the reworking operations. Cessation of operations spanned fewer than 90 days. The defendants claimed that the lease was, therefore, in effect when they drilled the additional well.

To determine whether the termination of the unsuccessful reworking operations constituted the completion of a dry hole within the meaning of the lease, the Fifth Circuit first examined the lease for a definition of "completion of a dry hole."⁷⁶ Finding no such definition, the appellate court next examined the context of the lease in which the parties used the phrase "completion of a dry hole" to determine whether completion must follow the drilling of a well, as opposed to reworking.⁷⁷ The district court below noted that the second sentence of paragraph IX used the terms drilling or reworking to describe the actions sufficient to extend the lease, and that the parties used the same terms to specify the operations that must be commenced within ninety days of termination of unsuccessful operations.⁷⁸ The district court then concluded that the parties intended the general phrase "shall have completed a dry hole" to include those same operations that was re-

74. *Id.* at 1018.

75. Paragraph IX of the lease provided:

If at the expiration of the primary term, oil or gas is not being produced from the leased premises, but Lessee is then engaged in drilling or reworking operations thereon or shall have completed a dry hole thereon within ninety (90) days prior to the end of the primary term, the lease shall remain in force so long as drilling or reworking of such well or of an additional well or wells are prosecuted in good faith, with no cessation of more than ninety (90) consecutive days, and if they result in production of oil and gas so long thereafter as oil or gas is produced, subject to the provisions of Paragraph X hereof.

Id. (emphasis by the court).

76. *Id.*

77. *Id.* at 1019.

78. *Id.*

ferred to in the rest of the sentence—i.e., drilling or reworking.⁷⁹

On appeal Burns objected to the district court's interpretation, arguing that the termination of the unsuccessful reworking operation did not constitute the completion of a dry hole. Burns claimed that drilling is an element of completion. This interpretation relied on the use of the phrase "drill and abandon a dry hole" in the first sentence of paragraph IX.⁸⁰ Burns contended that the phrase "drill and abandon a dry hole" contained in the first sentence of paragraph IX was parallel to the phrase "have completed a dry hole" as used in the second sentence. The Fifth Circuit rejected Burn's argument, finding that the second sentence controlled the case.⁸¹ The immediate context of the phrase "have completed a dry hole" in the second sentence, therefore, was more significant than the terms used in the first sentence.⁸² The court further found that the immediate context supported the conclusion that the termination of operations for the drilling *or reworking* of a dry hole constituted completion of a dry hole so as to extend the lease under the applicable clause in the second sentence of paragraph IX.⁸³

The court also supported its construction of the lease as allowing an extension whenever reworking operations terminated within ninety days of the end of the primary term (without a cessation of operations of more than ninety days) by examination of paragraph X, the related lease provision referenced in the second sentence of paragraph IX.⁸⁴ First, the court recog-

79. *Id.*

80. The sentence provided:

If, prior to the discovery of oil or gas on the leased premises, Lessee shall drill and abandon a dry hole or holes thereon, or if, after discovery of oil or gas the production thereof should cease, this lease shall not terminate if Lessee commences reworking or additional drilling operations within ninety (90) days thereafter, or if it be within the primary term commences or resumes the payment or tender of rentals or commences operations for drilling or reworking on or before the rental payment date next ensuing after the expiration of ninety (90) days from the date of completion of the dry hole or cessation of production.

Id. at 1017.

81. *Id.* at 1019.

82. *Id.*

83. *Id.*

84. *Id.* at 1019-20. Paragraph X provided, in part:

If after the expiration of the primary term this lease is being maintained in force and effect, in whole or in part, it shall, except as specifically provided below, nevertheless terminate as to all of the acreage and depths covered hereby except as following: . . .

(3) This lease shall remain in full force and effect insofar as it covers all acreage then covered hereby, if at the expiration of the primary term or less than ninety (90) days prior to the expiration of the primary term Lessee is engaged in actual drilling or reworking operations on a well located on the leased premises, or on acreage pooled therewith, and shall continue so long as Lessee prosecutes such operations with due diligence and in a good and workmanlike manner in a good faith effort to establish oil and gas production from the leased premises, and so long thereafter as Lessee does not allow more than ninety (90) days to elapse between the completion or abandonment of one well drilled under the provisions hereof and the commencement of actual drilling operations of another well on said land, or acreage pooled therewith, such operations being deemed "continuous drilling operations" under the terms of this lease. . . .

Id. at 1017.

nized that paragraph X had no independent force because it merely qualified or allowed the application of extensions defined elsewhere in the lease.⁸⁵ The court held, however, that paragraph X explicitly and clearly allowed an extension of the lease if the lessee actually engaged in drilling or reworking operations within fewer than ninety days before the end of the primary term.⁸⁶ The Fifth Circuit pointed out that such language in paragraph X(3) extending the lease for reworking operations would lose its full meaning if the court restrictively construed the extension in the second sentence of paragraph IX.⁸⁷

Based on the repetition of the phrase "drilling or reworking" in the second sentence of paragraph IX, and the expansive wording of the continuous operations clause in paragraph X(3), the Fifth Circuit concluded that the phrase "completed a dry hole" as used in the second sentence of paragraph IX meant termination of unsuccessful drilling or reworking operations.⁸⁸ Since LL&E's reworking operations on the dry hole terminated within ninety days prior to the end of the primary term of the lease, and subsequent operations for the drilling of a well commenced within ninety days following the termination, the express provisions of the lease extended it beyond the primary term.⁸⁹ Consequently, the lessees committed no trespass.⁹⁰ The Fifth Circuit, therefore, affirmed the summary judgment of the district court in favor of LL&E and McMoran.⁹¹

At issue in *Sowell v. Northwest Central Pipeline Corp.*⁹² were royalties on "drips" collected in Northwest's gathering system.⁹³ In 1927 the trustees of the Burnett Trust executed a gas lease to Empire Gas and Fuel covering the Burnett Ranch. In 1936 trustees of the same Trust executed an oil and gas lease to Empire Oil and Refining covering the same lands. By 1937 Cities Service Gas Company (CSGC) owned the leasehold interest under both leases.

Soon after production of gas from the leased premises began in the late 1920s, trespassers started entering the Ranch in order to take the drips. The trespassers who took the drips often damaged the pipeline and sometimes caused fires at the drip sites. Thus, the trespassers equally concerned the Burnett Trust and the gas lessees. In 1937 the Burnett Trust and CSGC entered into an agreement by which CSGC promised to arrange for the drips to be periodically removed from the drip pots, thereby discouraging trespassers, and the Burnett Trust agreed to waive its rights to any royalties from the gasoline accumulated by such drips.

In 1953, through a series of transactions undertaken for purposes of ob-

85. *Id.* at 1020.

86. *Id.*

87. *Id.*

88. *Id.* at 1022.

89. *Id.*

90. *Id.*

91. *Id.*

92. 703 F. Supp. 575 (N.D. Tex. 1988).

93. "The drips are collected in drip pots which are located along the pipeline." *Id.* at 576 n.2.

taining Federal Power Commission price benefits, CSGC assigned all of its interest under the two relevant leases to Cities Service Gas Producing Company (Cities Producing). Cities Producing, as seller, and CSGC, as buyer, then entered into a gas purchase contract regarding the gas produced from the leases at issue and others in the area. CSGC and Cities Producing were both subsidiaries of Cities Service Company. In 1963, Conoco succeeded to the interest of Cities Producing. Northwest succeeded to the interest of CSGC in 1982.

The lawsuit by the current Burnett trustees originally included Conoco, Inc. and Cities Service Company, as defendants, in addition to Northwest Central Pipeline Corporation. Conoco and Cities Service Company, however, settled with plaintiffs, leaving Northwest as the only remaining defendant. The plaintiffs' first cause of action sought a declaration by the court that the lease obligated Northwest to pay royalties to the Burnett Trust on the drips collected in Northwest's gathering system. The Plaintiffs' second cause of action sought damages for the admitted nonpayment of such royalties. The court denied the plaintiffs recovery on such causes of action and held that Northwest was not liable for payment of liquid royalties to the trust.⁹⁴

In reaching its decision, the court reasoned that, although the 1927 gas lease entitled the Burnett Trust to receive royalties for drips, the 1937 agreement between the Burnett Trust and CSCG constituted a modification of the gas lease.⁹⁵ By an express provision in the modification, the Burnett Trust gave up its right to receive royalties on the drips.⁹⁶ The Plaintiffs argued that the modification did not constitute a waiver of its right to royalty payments because at the time it entered into the 1937 agreement the drips had no monetary value. The Plaintiffs reasoned since the drips had no value and consequently the plaintiffs could not receive any royalties from the drips, then their royalty interest was nonexistent. The Burnett trustees' argument concluded that they could not have waived a nonexistent right.

The court found such argument faulty in several respects. First, the court rejected the Burnett trustees' contention that the drips had no value, citing the undisputed evidence regarding the trespassers' conversion of such drips.⁹⁷ Even assuming that the drips had no monetary value, the court held that that fact did not mean that the plaintiffs' royalty interest was nonexistent.⁹⁸ The court noted that the plaintiffs obtained the royalty interest in the drips in 1927 when they entered into the original lease, and their interest continued to exist until 1937, when the plaintiffs relinquished their interest to CSGC.⁹⁹

Also, the court held that Northwest had no responsibility for the payment of liquid royalties to the plaintiffs because it was not in privity of contract or

94. *Id.* at 583.

95. *Id.* at 577.

96. *Id.*

97. *Id.* at 578.

98. *Id.*

99. *Id.*

in privity of estate with the plaintiffs.¹⁰⁰ Northwest was not in privity of contract with the Burnett Trust because it was not the original lessee under the 1927 gas lease or the 1936 oil and gas lease.¹⁰¹ Nor was Northwest in privity of estate with the plaintiffs during the relevant time period.¹⁰² The plaintiffs sought damages for nonpayment of royalties for the years 1978 through 1985. Northwest's predecessor in interest, CSGC, was in privity of estate with the plaintiffs for some time; however, the relationship ceased in 1953. In that year, all of CSGC's interest in the two leases transferred to Cities Producing, which later became Conoco. Northwest, through its predecessor CSGC, merely became the purchaser of gas produced from the lease. Thus, since 1953, neither Northwest nor its predecessor had responsibility for the payment of royalties to the Burnett Trust. Rather, the obligation was the responsibility of Cities Producing and Conoco. As stated above, the plaintiffs had previously settled with Conoco.

Finally, the court found that even if the 1953 assignment from CSGC to Cities Producing insufficiently discharged CSGC (and Northwest) from the obligation under the lease to pay royalties, the plaintiffs subsequently agreed to the substitution of Conoco for Northwest as lessee.¹⁰³ Since 1963, when Conoco succeeded to the interest of Cities Producing, the plaintiffs directed all of their correspondence regarding the lessee's obligations under the lease to Conoco rather than CSGC or Northwest. The plaintiffs looked solely to Conoco for compliance with the leases and payment of the royalties.

By another cause of action, the plaintiffs alleged that Northwest did not ratably take gas from the wells on the Burnett Ranch. The Burnett trustees claimed that statutory provisions and provisions under the 1953 gas purchase contract obligated Northwest to ratably take such gas. As grounds for the imposition of a statutory duty to take ratably, the plaintiffs relied on the Texas Common Purchaser Act.¹⁰⁴ Specifically, the plaintiffs asserted that Northwest violated section 111.086, which prevents discrimination in favor of one producer against another producer in the same field and discrimination between separate fields in the state. The court rejected the plaintiffs' statutory claim, holding that section 111.086 did not provide for a private cause of action for any violation thereof.¹⁰⁵ Rather, the applicable statutes provided for an administrative proceeding before the Railroad Commission or a suit by the state attorney general.¹⁰⁶

Turning to the plaintiffs' allegation of contractual duty to ratably take gas, the court noted that the 1953 gas purchase agreement between CSGC and Cities Producing did require CSGC, as buyer, to take gas in sufficient quantities to allow Cities Producing's wells to produce ratably as defined in the

100. *Id.* at 579.

101. *Id.*

102. *Id.*

103. *Id.*

104. TEX. NAT. RES. CODE ANN. §§ 111.081-097 (Vernon 1978).

105. 703 F. Supp. at 580.

106. *Id.*

contract.¹⁰⁷ The plaintiffs claimed that they were an intended third-party beneficiary to the gas purchase agreement. After examining the 1953 contract, and considering the oral testimony, the court found that the Burnett Trust failed to meet its burden of proving that it was an intended beneficiary of the contract between CSGC and Cities Producing.¹⁰⁸ At the time the parties executed the contract, Cities Producing owned the leasehold interest on nearby tracts. The contract required CSGC to ratably take gas from all of the wells in which Cities Producing had a leasehold interest and not just those on the Burnett Ranch.¹⁰⁹ The court found that this fact indicated that the contracts concerned CSGC's and Cities Producing's interests in the wells, and not the interests of individual royalty owners such as the Burnett Ranch. Moreover, CSGC's directed the promise to take ratably under the contract at Cities Producing, not at the individual royalty owners.¹¹⁰ Additionally, the testimony at trial did not support the plaintiffs' claim that they were intended third-party beneficiaries. In fact, the testimony indicated that the sole purpose for the 1953 transaction was for the benefit of CSGC.¹¹¹ The court found no evidence of any intent on the part of the parties to the contract to benefit the royalty owners.¹¹² Having found that the plaintiffs were not entitled to recover under their claims regarding liquid royalties or their claims regarding ratable take, the court dismissed the plaintiffs' causes of action.¹¹³

*Trafalgar House Oil & Gas, Inc. v. De Hinojosa*¹¹⁴ involved the enforceability of a liquidated damages provision contained in an oil, gas, and mineral lease. Trinidad De Hinojosa, lessor under an oil, gas, and mineral lease, sued Trafalgar House and other defendants, as lessees under such lease, for breach of the notice of assignment provision, and sought to recover liquidated damages specified in the lease.¹¹⁵

107. *Id.* at 581.

108. *Id.*

109. *Id.* at 582.

110. The provision in question required CSGC to take a "sufficient quantity [of gas] to allow Seller's . . . wells to produce ratably. . . ." *Id.*

111. The manager of CSGC in 1953 testified that the reason that CSGC assigned its interest in the oil and gas leases to Cities Producing, and then entered into a gas purchase contract to purchase from Cities Producing the gas that it once owned, was because of pricing benefits under the Federal Power Commission's regulations. *Id.*

112. *Id.*

113. *Id.* at 583.

114. 773 S.W.2d 797 (Tex. App.—San Antonio 1989, no writ).

115. Part of the provision in dispute was:

The right of either party hereunder may be assigned in whole or in part, and the provisions hereof shall extend to their heirs, successors and assigns; . . . In the event of assignment, LESSEE, its successors and assigns, shall give notice of the fact of such assignment and the name and address of the Assignee within thirty (30) days after such assignment; and, LESSOR shall likewise be notified upon each subsequent assignment. Upon each failure of the LESSEE, its successors and assigns, to comply with the foregoing "notice of assignment", said LESSEE, his successors and assigns shall jointly and severally forfeit and pay unto the Lessor the sum of ONE THOUSAND AND NO/100 (\$1,000.00) DOLLARS as liquidated damages.

Id. at 799.

The trial court rendered judgment in favor of De Hinojosa in the amount of \$20,600. Trafalgar House and other judgment debtors appealed, contending that the liquidated damage provision in the lease constituted an unenforceable penalty.

The court of appeals recognized that a provision for liquidated damages in a contract is enforceable if the amount provided for reasonably estimates the harm caused by a future breach, and the damages resulting from such breach are difficult to predict.¹¹⁶ Such a provision is unenforceable, however, if it is simply a penalty to induce performance of the contract.¹¹⁷

Turning to the evidence at trial regarding the liquidated damages provision, the appellate court focused on testimony from the defendants' expert witness.¹¹⁸ That witness rejected the idea that De Hinojosa could never be damaged by a breach of the notice of assignment provision. The witness, however, acknowledged that a lessor who was a lay person, like De Hinojosa, would require a lawyer or a landman to analyze any assignments and courthouse records in order to determine who had a right to be on the leased premises and who would be responsible for any damages to the property as the result of drilling operations. The expert further testified that, in the case of multiple assignments, a check of the courthouse records would not necessarily show every assignment because many assignees never record such instruments. In addition, the defendants' expert witness confirmed that his fee to read assignments and other records was \$150 an hour. Due to the fact that certain assignments may not be filed, however, the expert conceded the impossibility of accurately estimating the expense of locating and reviewing such unfiled assignments.

Turning its attention to the contractual provision at issue, the appellate court held that the liquidated damage provision at issue was narrowly drafted to take effect only upon the breach of an important contractual obligation, and not for any trivial breach of contract.¹¹⁹ The court of appeals, therefore, affirmed the trial court's judgment for De Hinojosa.¹²⁰

2. Implied Lease Covenants

In a landmark decision, the Texas Supreme Court, in *Sun Exploration & Production Co. v. Jackson*,¹²¹ withdrew its prior opinion¹²² and substituted a new opinion, holding that in Texas an oil and gas lease contains no implied covenant requiring a lessee to explore the leased premises.¹²³

In 1938, the Jackson family leased the oil, gas, and mineral right covering their 10,000-acre ranch in Chambers County to Sun Exploration & Production Company. Sun discovered the Oyster Bayou Field on the lease in 1941

116. *Id.*

117. *Id.*

118. *Id.*

119. *Id.* at 799-800.

120. *Id.* at 800.

121. 783 S.W.2d 202 (Tex. 1989).

122. 31 Tex. Sup. Ct. J. 604 (July 13, 1988).

123. 783 S.W.2d at 205

and drilled a total of sixty-five wells on the leased premises—thirty-seven of which were producing at the time of trial. All of the producing wells at the time of trial were in the Oyster Bayou Field, which covered approximately 1800 acres.

In 1979 the Jacksons denied Sun access to the south half of the lease. Sun brought an action for a judicial declaration that the lease was valid and for a permanent injunction prohibiting the Jacksons from denying Sun access to the lease. The Jacksons counterclaimed, seeking cancellation of the lease and asserting that Sun had breached implied covenants to reasonably develop and explore the lease. The jury found that Sun had not failed to reasonably develop the lease, but had failed to reasonably explore the lease. Based on these findings, the trial court rendered judgment for the Jacksons, unconditionally cancelling a portion of the lease and conditionally cancelling much of the remainder of the lease.

On appeal the court of appeals affirmed the trial court's judgment, finding a breach of an implied covenant to explore and develop the lease.¹²⁴ The court of appeals also affirmed the trial court's unconditional cancellation of most of the lease, but reversed and remanded the part of the judgment conditionally cancelling the remainder of the lease for further consideration of the reasonableness of the imposed drilling requirements.¹²⁵

The supreme court stated that the issue was "whether there exists in Texas oil and gas leases an implied covenant to explore, independent of the implied covenant of reasonable development."¹²⁶ The court found that its prior decision in *Clifton v. Koontz*¹²⁷ was dispositive of the issue.¹²⁸ The court noted that in *Clifton* it had held that no implied covenant of further exploration existed independently of the implied covenant of reasonable development.¹²⁹ The covenant of reasonable development covered all wells drilled after initial production was achieved, including additional wells in producing formations and wells in "strata different from that from which production is being obtained."¹³⁰ The supreme court then characterized its *Clifton* decision as holding that to establish an alleged breach of implied covenant of further development, the lessor must prove a reasonable expectation of profit to lessor and lessee from the drilling of additional wells.¹³¹ According to the court, if the lessor proves that a reasonably prudent operator would have drilled the well (i.e., that the operator would have a reasonable expectation of profit), then that well is within the implied covenant of reasonable development, regardless of whether the parties consider the well to be exploratory or developmental.¹³²

124. 715 S.W.2d 199, 203 (Tex. App.—Houston [1st Dist.] 1986), *rev'd*, 703 S.W.2d 202 (Tex. 1989).

125. 715 S.W.2d at 206.

126. 785 S.W.2d at 203.

127. 160 Tex. 82, 325 S.W.2d 684 (1959).

128. 783 S.W.2d at 204.

129. *Id.*

130. *Id.* (quoting *Clifton*, 160 Tex. at 96, 325 S.W.2d at 695).

131. *Id.*

132. *Id.*

Reviewing the record below, the court noted that the jury found that Sun had not failed to reasonably develop the entire Jackson lease, and held that this finding was dispositive of the case.¹³³ Having determined that no implied covenant to explore existed independently of the implied covenant for reasonable development, and that the jury had found no breach of the covenant to reasonably develop, the court held that Sun had not breached any implied lease covenant.¹³⁴

III. ISSUES INVOLVING GAS PURCHASE CONTRACTS

A. Take-or-Pay Disputes

*Lone Star Gas Co. v. G.S.G. Royalty Corp.*¹³⁵ was an appeal from a summary judgment rendered in favor of G.S.G. Royalty Corporation involving a take-or-pay gas purchase contract. Lone Star was the purchaser under the contract, and G.S.G. was an assignee of the seller. The contract required Lone Star to take or pay for (whether or not taken) all of the casinghead gas tendered to Lone Star, and seventy-five percent of the delivery capacity of the seller's gas wells. The delivery capacity was initially based on deliverability tests performed in accordance with Texas Railroad Commission rules. A contract mechanism reduced the purchaser's delivery capacity obligation if actual deliverability was less than the tested delivery capacity.¹³⁶

On appeal Lone Star claimed that the trial court erred in awarding summary judgment because G.S.G. did not establish as a matter of law that Lone Star failed to take or pay for the required volumes of gas. With respect to gas well gas, G.S.G.'s summary judgment evidence showed that Lone Star failed to take or pay for seventy-five percent of the *initial* delivery capacity. Lone Star's summary judgment response alleged that the deemed test provision operated to reduce Lone Star's minimum purchase obligations. Furthermore, according to Lone Star's summary judgment evidence, its actual purchases during the life of the contract were far in excess of the minimum obligations. With respect to casinghead gas, the contract required Lone Star to purchase all casinghead gas tendered by the seller. G.S.G.'s summary judgment proof showed that the casinghead gas delivery capacity was in excess of the amount actually purchased by Lone Star. Lone Star responded by claiming such delivery capacity irrelevant; instead the quantity of casinghead gas *tendered* controlled.

The Dallas court of appeals held that G.S.G.'s summary judgment evidence did not establish its right to recover as a matter of law for breach of the take-or-pay provisions under the gas purchase contract with respect to

133. *Id.* at 204-205.

134. *Id.* at 205.

135. 757 S.W.2d 457 (Tex. App.—Dallas 1988, no writ).

136. Such provision stated:

[I]f during any day Seller cannot deliver a quantity of gas equal to the delivery capacity determined by the next preceding test, then such reduced quantity will be deemed a new test for the purpose of establishing Buyer's minimum purchase obligation.

Id. at 458-59.

gas well gas or casinghead gas.¹³⁷ The appellate court reversed and remanded the cause to the trial court for further proceedings.¹³⁸

The main issues in *Atlantic Richfield Co. v. ANR Pipeline Co.*¹³⁹ concerned the proper construction of certain provisions in a gas purchase contract in the context of a take-or-pay dispute. ARCO, as gas producer, entered into four virtually identical gas contracts with ANR, an interstate national pipeline. The contracts obligated ANR to take a certain quantity of gas, or to pay for such gas if not taken. Although three provisions of the contracts were at issue, the court of appeals considered only two: the force majeure provision¹⁴⁰ and the royalty provision.¹⁴¹

ANR's major customer was Michigan Consolidated Gas Company (MichCon). On June 1, 1985, Federal Energy Regulatory Commission (FERC) Order No. 380¹⁴² became effective. Prior to the effective date of Order 380, MichCon contracted to pay for a certain minimum quantity of gas, regardless of whether MichCon actually took that gas. Order 380 relieved MichCon of this obligation and permitted it to purchase gas from sellers other than ANR.¹⁴³ ANR claimed that FERC Order 380 constituted force majeure under the contracts and thereby decreased the amount of gas the contract required ANR to purchase from ARCO. ARCO contended that a mere decline in sales did not constitute an event of force majeure under the contract.

137. *Id.* at 460.

138. *Id.*

139. 768 S.W.2d 777 (Tex. App.—Houston [14th Dist.] 1989, no writ).

140. The force majeure clause stated:

If either Buyer or Seller is rendered unable, wholly or in part, by force majeure or any other cause of any kind not reasonably within such party's control to perform or comply with any obligation or condition of this Agreement . . . such obligation or condition shall be suspended during the continuance of the inability so caused and such party shall be relieved of liability and shall suffer no prejudice for failure to perform the same during such period; . . . The term "force majeure" shall include, without limitation by the following enumeration, acts of God and the public enemy, the elements, fire accidents, break-downs, shut-downs for purposes of necessary repairs, relocation or construction of facilities, breakage or accidents to wells, machinery or lines of pipe, the necessity of making repairs or alterations to machinery or lines of pipe, inability to obtain materials, supplies, permits, or labor to perform or comply with any obligation or condition of this Agreement, strikes and any other industrial, civil or public disturbance, any act or omission (including failure to take gas) of a purchaser of substantial quantities of gas from Buyer which is excused by any event or occurrence of the character herein defined as constituting force majeure, and any laws, orders, rules, regulations, acts or restraints of any government or governmental body or authority, civil or military.

Id. at 780.

141. The royalty provision provided:

Seller hereby expressly reserves and excepts from the terms of this Agreement such portion of the gas produced from the reservoirs subject to this Agreement as Seller's lessor may be entitled to take or receive under the terms of Seller's leases. . . .

Id. at 779.

142. 18 C.F.R. § 154.111 (1989).

143. *Id.*

On the basis of *Burkhart Petroleum Corp. v. ANR Pipeline Co.*¹⁴⁴ the court agreed with ANR.¹⁴⁵ In that case the Oklahoma federal district court held that FERC Order No. 380 was an act of force majeure within the definition of that term in a contract containing an almost identical force majeure provision.¹⁴⁶ The Houston appellate court held that since MichCon was a purchaser of substantial quantities of gas from ANR, and that FERC Order No. 380 was a regulation of a governmental body, the force majeure provision covered the event.¹⁴⁷ Whether this force majeure event rendered MichCon or ANR unable to comply with the provisions of the contracts was a question of fact for the jury.¹⁴⁸ The jury found that ANR had not failed to comply with the take-or-pay provisions of the contract.¹⁴⁹

The appellate court next considered the royalty provision. The four contracts involved in the lawsuit covered properties located on the Outer Continental Shelf that ARCO had leased from the federal government. Under each lease the federal government reserved a one-sixth royalty that it could elect to take in kind. If the government did not take one-sixth of the gas produced, the lease obligated ARCO to sell the gas attributable to the royalty interest and pay the proceeds to the government. ANR claimed that the gas purchase contracts expressly excepted from the terms of the Agreement one-sixth of the gas produced. ARCO, however, took the position that gas was excluded from the contract under the royalty reservation only if the government elected to take its royalty by taking gas in kind. Again, the appellate court disagreed with ARCO's reasoning. The court held that ARCO's construction of the royalty reservation would significantly change the clear and unambiguous terms of the contracts.¹⁵⁰ Having overruled ARCO's other points of error, or found that ARCO had waived such points,¹⁵¹ the court affirmed the trial court's take-nothing judgment.¹⁵²

B. Other Issues

*Transcontinental Gas Pipe Line Co. v. American National Petroleum Co.*¹⁵³ involved claims by American National Petroleum Company (ANPC) and Oil Investments, Ltd. (OIL) against Transcontinental Gas Pipeline (Transco) for breach of two gas purchase contracts and tortious interference with gas balancing agreements. The first gas purchase contract was a 1981 agreement between OIL and ANPC, as sellers, and Transco, as purchaser, regarding gas produced from the Vermilion Field in Louisiana. This contract, as amended, obligated Transco to take or pay for certain minimum quantities of gas during specified time periods. It also contained a market-

144. No. 87-C-257-C (N.D. Okla. July 5, 1988).

145. 768 S.W.2d at 781.

146. No. 87-C-257-C (N.D. Okla. July 5, 1988).

147. 768 S.W.2d at 781-82.

148. *Id.*

149. *Id.* at 782.

150. *Id.*

151. *Id.* at 782-85.

152. *Id.*

153. 763 S.W.2d 809 (Tex. App.—Texarkana 1988, writ denied).

out clause allowing Transco to propose a reduced contract price based on market conditions. The contract further provided that if the the sellers found Transco's proposal unacceptable, the sellers' sole remedy was the right to release the gas from the contract.

The second gas purchase contract was a 1979 agreement between ANPC, as seller, and Transco, as purchaser, regarding gas produced from the Oakvale Field in Mississippi. This contract, as amended, did not contain a take-or-pay provision; however, Transco was obligated to take ANPC's gas ratably with other producers in the Oakvale Field. This contract contained a special provision allowing Transco, under certain conditions, temporarily to reduce the contract price in order to remain competitive with the existing market.

In 1985, Transco developed an "omnibus agreement," which it attempted to force all of its producers to execute. According to the terms of this agreement, the producers would waive all outstanding liability claims against Transco, and would agree to lower contract prices and reduce Transco's purchase obligations. In order to pressure its producers to execute the agreement, Transco began to take only three percent of the gas capacity of each nonsigning producer, regardless of the contractual obligations. ANPC and OIL refused to execute the omnibus agreement, and Transco applied its three percent take policy to the gas covered by the Vermilion and Oakvale contracts. Additionally, Transco exercised its market-out right by adoption of the market price for spot gas that was much less than the price for dedicated gas. Evidence at trial indicated that Transco paid more to producers who executed the omnibus agreement than it did to ANPC and OIL and others who refused to sign the 1985 agreement.

ANPC and OIL were parties to a gas balancing agreement with the other fractional interest owners in the Vermilion Field. ANPC was a party to a similar agreement with other owners in the Oakvale Field. As a result of Transco's three percent policy, ANPC and OIL became underbalanced in the Vermilion Field.

ANPC and OIL brought this suit against Transco. Following trial, the jury found that Transco failed to act in good faith under the Vermilion gas purchase contracts regarding its obligation to take certain minimum quantities of gas.¹⁵⁴ As damages, the jury awarded \$348,211 for Transco's failure to purchase the monthly minimum quantities, and \$352,875 for its failure to purchase the annual minimum quantities under the contract. The jury further found that Transco failed to act in good faith in its exercise of its market-out right, and the jury awarded \$637,900 as damages. Finding that Transco's actions amounted to tortious interference with the gas balancing agreements, the jury awarded \$16,000,000 in exemplary damages to ANPC and OIL.

On motion for judgment notwithstanding the verdict by ANPC and OIL,

154. By agreement of the parties, the issues regarding breach of the Oakvale contract were submitted to the court, and the court awarded \$881,172 in damages, which was not contested on appeal by Transco.

the court modified the jury award so as to provide \$783,383 in lieu of \$348,211, \$726,723 in lieu of \$352,875, and \$2,376,609 in lieu of \$637,900. The judgment also awarded ANPC and OIL attorneys' fees in the amount of \$1 million. Finally, as relevant here, the judgment made permanent a previous temporary injunction that restrained Transco from refusing to pay the proper price to ANPC and OIL under the relevant gas purchase agreements.

On appeal Transco first contended that Transco's failure to act in good faith in setting the market-out price for gas purchased did not entitle ANPC and OIL to actual damages. In a *per curiam* opinion, the Texarkana court of appeals agreed, holding that the remedy expressly provided for in the Vermilion gas purchase contract allowing sellers to release the gas from the contract was the exclusive remedy for ANPC and OIL if they were dissatisfied with the market-out price.¹⁵⁵ The exclusive contractual remedy excluded ANPC and OIL from receiving the jury award of \$637,900 for Transco's failure to use good faith in exercising the market-out right.¹⁵⁶

Transco next claimed that the trial court erred in disregarding the jury's findings as to the amount of damages for Transco's failure to purchase the contractual minimum quantities of gas. Transco did not complain of the jury's findings with respect to the Vermilion contract of \$348,211 for failure to purchase monthly minimum quantities and \$352,875 for failure to purchase annual minimum quantities. The trial court, in granting the judgment *n.o.v.* and increasing the award of damages for such breaches, based its calculation of damages on the original contract price of gas rather than the market-out price. The appellate court found this an error because the parties amended the original contract to provide for market-out prices in the absence of ANPC and OIL exercising their sole remedy.¹⁵⁷ Since ANPC and OIL failed to exercise their exclusive contractual remedy, any damage calculation for failure to take minimum quantities must be based on the market-out price elected by Transco.¹⁵⁸

Transco also claimed that the \$16 million punitive damages award was improper. The appellate court agreed, noting that exemplary damages are not recoverable for a mere breach of contract.¹⁵⁹ By analogy to the relationship between a lessor and lessee under an oil and gas lease, the court found that the Vermilion contract was "accompanied by implied covenants to act in good faith in determining the market-out price and in performing the contract . . ."¹⁶⁰ A breach of such covenant, therefore, would be contractual and would not support an award of exemplary damages absent the finding of an independent tort and resulting actual damages.¹⁶¹

The jury did find that Transco tortiously interfered with the gas balancing agreements. Nevertheless, ANPC and OIL failed to secure a jury finding as

155. 763 S.W.2d at 817-18.

156. *Id.*

157. *Id.* at 818.

158. *Id.*

159. *Id.* at 819.

160. *Id.* at 820.

161. *Id.*

to the specific amount of actual damages caused by such tortious interference. According to the appellate court, the mere finding of an independent tort without a finding of the amount of damages resulting from such tort would not support an award of exemplary damages.¹⁶² The trial court, therefore, erred in awarding such exemplary damages.¹⁶³

ANPC and OIL argued that the measure of damages for tortious interference with a contract equaled the measure of damages for a breach of the contract. They claimed that the damages found by the jury for breach of the Vermilion contract was the same as the actual damages for tortious interference with a contract. The court of appeals, however, pointed out that the claims involved two different contracts: the damages found by the jury for breach of contract related to the Vermilion gas purchase contract; whereas the claim for tortious interference related to the gas balancing agreements.¹⁶⁴ The damages under these separate theories would be different since they related to different contracts.¹⁶⁵ The court concluded that ANPC and OIL failed to present any evidence as to the existence or extent of actual damages caused by tortious interference with the gas balancing agreement and, consequently, the tort did not support the exemplary damage award.¹⁶⁶

Because Transco did not object on appeal to portions of the trial court's judgment, the appellate court affirmed the judgment with the following modifications: (1) deletion of the \$16 million exemplary damage award because of the absence of actual damages from any independent tort; (2) deletion of the damages awarded by the court for bad faith exercise of the market-out right in the amount of \$2,376,609 because the contract provided for a sole remedy other than money damages; and (3) restoration of the jury findings of \$348,211 for damages due to Transco's failure to purchase required monthly quantities, and \$352,875 for Transco's failure to take or pay for required annual minimum quantities of gas.¹⁶⁷

In *Edwards v. Lone Star Gas Company*,¹⁶⁸ the Texas Supreme Court construed the provisions of a price redetermination clause contained in two gas purchase agreements to include in the redetermined price any monthly price escalations authorized and charged under other comparable contracts, but to exclude amounts allocable to severance tax reimbursement.¹⁶⁹ Edwards, the gas producer, sued Lone Star Gas Company, the pipeline, alleging that Lone Star had breached the provisions of two gas purchase contracts by failing to pay monthly price escalations as part of a redetermined contract price, and by failing to reimburse Edwards for state severance taxes.¹⁷⁰

162. *Id.*

163. *Id.*

164. *Id.* at 821.

165. *Id.*

166. *Id.* at 822.

167. *Id.* at 826-27.

168. 782 S.W.2d 840 (Tex. 1990).

169. *Id.* at 840-842.

170. The price redetermination provisions of each contract provided for annual price redetermination as follows:

It is agreed that the redetermined price per MMBtu for such gas shall be equal

The contracts at issue were subject to section 105 of the NGPA,¹⁷¹ which imposed price ceilings on the sale of intrastate gas, but authorized the FERC to adjust the price ceiling each month for inflation. In 1980, and each year thereafter, Edwards requested that the price under the Edwards-Lone Star contracts be redetermined by reference to other contracts in which the price incorporated the monthly inflation adjustments. Lone Star refused to include the monthly inflation adjustments as a part of the redetermined price, and instead paid Edwards a flat rate equal to the dollar amount that was actually paid under the referenced contracts at the time of the redetermination.

In reviewing the issue, the supreme court found nothing in the contracts that required the redetermined price to be construed as a flat rate or prohibited a fluctuating price on a monthly basis.¹⁷² Instead, the court found that the parties agreed that price redeterminations would be made by reference to the highest price in third-party contracts without limitation.¹⁷³ On this basis, the court held that Edwards was entitled to the "price" as set forth in the referenced third-party contracts and was, accordingly, entitled to receive the monthly inflation adjustments.¹⁷⁴

Edwards also contended that the redetermined price should include reimbursement for severance taxes because one of the referenced third-party contracts included a severance tax reimbursement provision. The court, however, held that to construe the price redetermination provision under the Edwards-Lone Star contract to allow for such a tax reimbursement would be contrary to the plain language of other provisions in the contract.¹⁷⁵ Under those provisions the parties expressly agreed that Edwards would pay all taxes, including state severance taxes, and that Lone Star would reimburse Edwards only for new or increased taxes that were imposed after the execution of the contracts. Accordingly, the court held that under the express terms of the contracts at issue, Edwards was not entitled to any reimbursement of severance taxes, so long as those taxes were at or below the rate levied at the time the contracts were executed.¹⁷⁶

*Mid Plains Reeves, Inc. v. Farmland Industries, Inc.*¹⁷⁷ required the construction of a gas purchase contract, as amended by two letter agreements. In 1975, Farmland Industries entered into a contract with Lone Star Gas Company to provide up to 55 MMCF of natural gas per day. By 1986

to the highest price per MMBtu to be paid as of the first day of the period for which the redetermined price will be effective by a bona fide intrastate pipeline company for gas produced in Railroad Commission Districts 8 and 8A in the State of Texas under the terms of a contract of at least three (3) year term in effect at the time the redetermined price is to become effective. . . .

Id. at 840-841 (emphasis omitted).

171. National Gas Policy Act, 15 U.S.C. § 3312 (1988).

172. 782 S.W.2d at 841.

173. *Id.*

174. *Id.*

175. *Id.*

176. *Id.* at 842.

177. 768 S.W.2d 318 (Tex. App.—El Paso 1989, writ denied).

Farmland was only able to supply 40 MMCF of gas and it sought to obtain additional gas to sell to Lone Star under the 1975 contract. On May 15, 1987, Farmland entered into a gas purchase contract with Mid Plains whereby Farmland agreed to purchase 15 MMCF of gas per day.

By letter dated May 19, 1987, Farmland wrote to Mid Plains to clarify the May 15, 1987, agreement.¹⁷⁸ Both Farmland and Mid Plains indicated their approval of the May 19, 1987, letter. Mid Plains sent an additional letter of clarification to Farmland dated June 17, 1987.¹⁷⁹ An officer of Farmland signed the bottom of the June 17, 1987, letter indicating the acceptance of the terms of that letter.

When the additional 15 MMCF of gas was supplied to Lone Star, Lone Star refused to accept delivery. Mid Plains sued Farmland and Enerfin, Inc., which had purchased the Farmland operations and also sold gas to Lone Star. Mid Plains contended that Farmland breached its gas purchase agreement and fraudulently made misrepresentations about enforcing its agreement with Lone Star. Mid Plains further claimed that Enerfin tortiously interfered with the business relationship by persuading Farmland to disregard its contractual obligation to purchase gas from Mid Plains. The trial court granted a summary judgment denying recovery to Mid Plains.

Mid Plains argued on appeal that the trial court erred in granting summary judgment because there were material issues of fact as to each of Mid Plains' causes of action. With respect to Mid Plains' claim for breach of contract, both parties agreed that the contract and supplemental letters must be construed as one instrument, and that the contract as a whole was unambiguous. The parties, however, disagreed as to the correct interpretation of the contract. Farmland claimed that the letter of May 19, 1987, conditioned its obligations to buy gas from Mid Plains upon full and complete performance by Lone Star Gas. Since Lone Star did not purchase 55 MMCF of gas per day, Farmland claimed it had no obligation to purchase gas from Mid Plains. Mid Plains, on the other hand, claimed the correspondence of June 17, 1987, limited Farmland's release from its obligation to purchase gas only

178. The May 19, 1987, letter provided:

Farmland's performance under the captioned contract is dependent upon full and complete performance by Lone Star Gas Company under that certain residue contract dated August 29, 1975 between Farmland and Lone Star.

In the event that Lone Star does not perform in accordance with the terms and provisions of the August 29, 1975 contract, the rights and obligations under the captioned May 15, 1987 contract between the parties hereto, shall be suspended.

Id. at 320.

179. The June 17, 1987, letter provided:

I have signed your letter dated May 19, 1987 and Mid Plains understands that the above referenced contract is negated should Lone Star Gas Company refuse to accept any volume of gas from Farmland. However, should Lone Star accept 15 MMCF per day or any lesser volume, then the rights of Mid Plains under the above referenced Gas Purchase Agreement will prevail.

Id.

if Lone Star did not accept *any* gas from Farmland. Since Lone Star bought some gas, Mid Plains claimed its contract should be enforced.

The trial court appeared to have adopted Farmland's interpretation of the contract, and apparently found that no material issues remained regarding the interpretation of the June 17, 1987, letter. The court of appeals, however, sided with the interpretation of the contract urged by Mid Plains, holding that "[t]he last modification supersedes and controls any prior conflicting provision and makes Farmland obligated to buy under its contract with Mid Plains if it sells any volume of gas to Lone Star."¹⁸⁰

With respect to its claim for fraud, Mid Plains contended that a representative of Farmland promised that Farmland would sue Lone Star to enforce the 1975 contract if Lone Star did not purchase the gas that Mid Plains furnished to Farmland. Indeed, a representative of Farmland conceded that he did make such a statement. The court of appeals found that this evidence raised a fact issue regarding whether, at the time the promise was made, the promisor had the present intention to perform.¹⁸¹ Finally, as to Mid Plains' claim for tortious interference with a business relationship, the appellate court found that Farmland's affidavit in support of its motion for summary judgment did not establish as a matter of law that at least one element of the plaintiff's cause of action did not exist.¹⁸² The El Paso court of appeals, therefore, reversed the judgment of the trial court and remanded the cause for a new trial.¹⁸³

IV. MISCELLANEOUS ISSUES

A. *Gas Rights versus Oil Rights*

The Texas Supreme Court considered the relative rights of gas rights owners and oil rights owners with regard to production from the Panhandle field in *Amarillo Oil Co. v. Energy-Agri Products, Inc.*¹⁸⁴ Jewel Kimberlin and H.D. Howse owned an interest in the relevant tract of land under a 1952 oil and gas lease, and relevant assignment. That same year, Howse and Kimberlin drilled and completed a producing gas well on the tract in the Brown Dolomite Formation. The following year, Howse and Kimberlin assigned to Amarillo Oil's predecessor in interest the producing gas well and the gas rights under the lease, reserving all of the oil and casinghead gas rights. Amarillo Oil eventually acquired these gas rights. Pursuant to a farmout agreement in 1981, Energy-Agri acquired all of the oil and casinghead gas rights in the tract. In 1982 Energy-Agri drilled and completed the Kimberlin No. 2 oil well in the Granite Formation in the tract. This well produced

180. *Id.* at 321 (following WILLISTON ON CONTRACTS § 624 (3d ed. 1961)).

181. *Id.* at 322.

182. *Id.*

183. *Id.* at 323.

184. 32 Tex. Sup. Ct. J. 252 (Mar. 8, 1989). After this material had been submitted to the publisher, the Texas Supreme Court, on motion for rehearing, withdrew the reported opinion and substituted a new opinion and judgment. See *Amarillo Oil Co. v. Energy-Agri Products, Inc.*, 33 Tex. Sup. Ct. J. 623 (June 27, 1990).

very small amounts of crude oil and casinghead gas, and almost no natural gas. Energy-Agri later perforated the casing opposite the Brown Dolomite Formation, and began producing approximately 375 MCF of gas per day from the formation. Energy-Agri then drilled and completed another well on the lease, intending to perforate it as it had the Kimberlin No. 2 well.

Amarillo Oil brought suit against Energy-Agri, seeking to enjoin Energy-Agri from producing gas from the Brown Dolomite Formation, to quiet title to all of the gas in the Brown Dolomite Formation, and to recover damages for the conversion of gas produced by Energy-Agri. The trial court rendered a take-nothing judgment for Amarillo Oil based on the jury verdict, which involved classification of the relevant wells. Issues of title dispute were not presented to the jury. Upon appeal by Amarillo Oil, the appellate court dismissed the case for want of jurisdiction, stating that Amarillo Oil's lawsuit was an impermissible collateral attack on matters exclusively within the jurisdiction of the Texas Railroad Commission.¹⁸⁵

The supreme court reversed the judgment of the court of appeals, rejecting Energy-Agri's assertion that the lawsuit was solely one for classification of oil and gas wells.¹⁸⁶ Energy-Agri contended that the classification of a well determined ownership of production. According to this argument, any substance produced from a well the Texas Railroad Commission classified as an oil well belonged to the oil rights owner. Since classification of a well is a matter within the exclusive jurisdiction of the Railroad Commission, Energy-Agri therefore contended that Amarillo Oil's lawsuit collaterally attacked the Commission's classification. Amarillo Oil, on the other hand, argued that the real focus of the lawsuit involved ownership of the substances being produced, rather than the classification of the well. It denied challenging the Commission's well classifications.

The supreme court agreed, finding that the tenor of the lawsuit was one involving title to land and property rights.¹⁸⁷ Noting that the Commission has no authority to determine such issues, the supreme court found that Amarillo Oil's lawsuit was properly before the courts.¹⁸⁸ The Railroad Commission's classification of the Kimberlin wells as oil wells did not entitle Energy-Agri to all of the gas produced from such wells; rather, it merely meant that the well produced at least one barrel of crude oil for each 100,000 cubic feet of natural gas.¹⁸⁹

The supreme court then turned to the merits of Amarillo Oil's appeal. The court first focused on the term "casinghead gas," and the fact that Amarillo Oil's assignment was subject to a reservation of oil and casinghead gas rights.¹⁹⁰ Energy-Agri claimed that the term casinghead gas meant *all* of the gas produced from an oil well, as a matter of law. Amarillo Oil, on

185. 731 S.W.2d 113 (Tex. App.—Amarillo 1987), *rev'd*, 32 Tex. Sup. Ct. J. 252 (Mar. 8, 1989).

186. 32 Tex. Sup. Ct. J. at 254.

187. *Id.*

188. *Id.*

189. *Id.*

190. *Id.* at 255.

the other hand, asserted that Energy-Agri's interpretation was inconsistent with the statutory definition of casinghead gas existing at the time of the conveyance and incorrect when examined in the context of the conveyances in the parties' chain of title.

The 1953 statutory definition of casinghead gas was "any gas and/or vapor indigenous to an oil stratum and produced from such stratum with oil."¹⁹¹ The supreme court found that the statutory definition was inconsistent with the interpretation asserted by Energy-Agri.¹⁹² Additionally, the court found Energy-Agri's argument that Howse and Kimberlin intended to reserve *all* gas produced from oil wells unlikely and unjust and resulting in illogical consequences.¹⁹³

Energy-Agri's argument assumed that Howse and Kimberlin intended to convey nonexclusive rights to compete for the same substance. The supreme court noted, "[i]t would mean that the parties intended to compete for gas production under circumstances overwhelmingly weighted in favor of the oil and casinghead gas owner," because applicable spacing rules allow only one gas well per 640 acres, whereas the rules provide ten-acre spacing for oil wells.¹⁹⁴ Applicable rules, furthermore, permitted the oil rights owner to drill as close to an existing gas well as it desired.¹⁹⁵

The supreme court found a separate reason why Energy-Agri's claim to the gas produced from its oil wells must fail. The Texas Natural Resources Code provides that "[n]o person in possession of or operating an oil well may produce from the oil well gas found in a horizon productive of gas only."¹⁹⁶ The Brown Dolomite Formation under the tract contains gas only.

The supreme court then held that Energy-Agri owned, as a matter of law, only the rights to oil and casinghead gas as defined by statute.¹⁹⁷ The supreme court found that Energy-Agri had no right to produce gas from the Brown Dolomite Formation, and it remanded the cause to the trial court for determination of the damages incurred by Amarillo Oil for gas converted by Energy-Agri.¹⁹⁸

The court's opinion assumes added importance because in dictum the

191. Act of Apr. 26, 1935, ch. 120, § 2(i), 1935 Tex. Gen. & Spec. Laws 318, 319, *repealed* by Natural Resources Code, ch. 871, art. I, sec. 2(a)(2), 1977 Tex. Gen. Laws 2345, 2689 (currently codified as amended at TEX. NAT. RES. CODE ANN. § 86.002(10) (Vernon 1978)).

192. 32 Tex. Sup. Ct. J. at 255.

193. *Id.* at 256.

194. *Id.*

195. *Id.*

196. TEX. NAT. RES. CODE ANN. § 86.097 (Vernon 1978).

197. 32 Tex. Sup. Ct. J. at 257. In the words of the court:

When oil rights are severed from gas rights in a phase severance, and the parties make no attempt in the conveying instrument to do otherwise, the party who owns the rights to casinghead gas owns only that gas or vapor which is indigenous to an oil stratum and is produced from that stratum along with oil, as contrasted to gas produced from a separate gas stratum through an oil well, *i.e.*, a well with its bore bottomed in an oil producing stratum. To hold otherwise would be to render meaningless the rights of those who own gas rights.

Id.

198. *Id.* at 257-58.

court noted that its reasoning in this case was also applicable to "white oil" cases.¹⁹⁹ The court stated that "[w]hether gas is produced by perforating the well casing in gas-indigenous formations, or by liquid recovery units that turn the gas into liquid form, those who do not own the gas rights produce gas in violation of the rights of the owner."²⁰⁰

The Amarillo court of appeals considered a similar issue in *Jinkins v. Bryan*,²⁰¹ which involved interpretation of the statutory definition of dry gas.²⁰² *Jinkins and Amarala Petroleum, Inc.* owned an undivided one-sixth of an 81.25% working interest in only the dry gas under a certain tract of land. *Damson Oil Corporation* enjoyed a one-sixteenth overriding royalty of eight-eighths of the dry gas in the tract. *Bryan* owned the remaining rights to the oil, casinghead gas, and dry gas under the tract in question.

The relevant tract had four producing wells. The Herber No. 1 oil well, the Herber No. 3 oil well, and the Herber No. 5 oil well were perforated and fractured throughout the Brown Dolomite Formation and in the Granite Wash Formation. The Herber No. 1 gas well was perforated and fractured only in the top of the Brown Dolomite Formation. The gas well produced gas only; however, the Herber No. 1, No. 3, and No. 5 oil wells produced both gas and oil. *Bryan* based royalty payments to *Damson* and payments of proceeds to *Jinkins and Amarala* solely on gas production from the Herber No. 1 gas well. *Bryan* did not consider the gas produced from the Herber No. 1, No. 3, and No. 5 oil wells to be dry gas, but rather casinghead gas.

Jinkins, Amarala, and Damson disagreed. They filed suit against *Bryan* to recover damages for conversion of their gas and to have their title to gas quieted. The plaintiffs claimed that the Brown Dolomite Formation contained both gas and oil and that all gas in the formation above the gas-oil contact was dry gas. *Bryan* counterclaimed, seeking recovery of payments previously made for production from the Herber No. 1 gas well. *Bryan* asserted that, according to the statutory definition of dry gas, the gas produced from the Brown Dolomite Formation was not dry gas because the formation also produced oil. Granting *Bryan's* motion for summary judgment, the trial court rendered judgment that *Jinkins, Amarala, and Damson* take

199. The court stated:

The legal controversies currently existing in the Panhandle Field involve two practices engaged in by oil operators. One is the high perforations practice. Oil operators have been shooting perforations in the well casings in the gas formation of oil wells, higher up in the hole. The second practice is known as producing white oil, which is accomplished by condensing gas into liquids by using low temperature extraction (LTX) units. The instant case presents the high perforations practice, by which *Energy-Agri* has converted *Amarillo Oil's* natural gas. While the parties in this case do not complain of the practice of producing white oil, we note that the same legal issues that we resolve today would be presented if oil operators liquified natural gas, other than casinghead gas as defined by statute, to defeat the rights of the gas owners.)

Id. at 257 n.2 (citation omitted).

200. *Id.* at 257 (footnote omitted).

201. 763 S.W.2d 539 (Tex. App.—Amarillo 1988, writ denied).

202. "Dry gas" is "gas produced from a stratum that does not produce oil." TEX. NAT. RES. CODE ANN. § 86.002(7) (Vernon 1978).

nothing in their action against Bryan, and the court severed Bryan's counterclaim.

On appeal the issue was "whether the evidence produced, under the stringent summary judgment tests, is sufficient to establish that gas being produced from this tract is not dry gas within the purview of the statute."²⁰³ Bryan claimed that his summary judgment proof established that the wells produced oil from the Brown Dolomite Formation under the tract in question, and, therefore, the gas produced from such formation was not dry gas as a matter of law.

Jinkins, et al., on the other hand, claimed that Bryan presented insufficient evidence to meet the summary judgment tests regarding the production of oil from the Brown Dolomite Formation. Jinkins further asserted that, even if the summary judgment evidence showed that oil was being produced from the Brown Dolomite Formation, evidence did not negate the possibility that gas produced from the Brown Dolomite Formation could be dry gas. Jinkins claimed that the term "stratum," as used in the statute, did not necessarily include the entire Brown Dolomite Formation. In effect, Jinkins argued that the portion of the formation above the gas-oil contact constituted one stratum, and the remaining portion of the formation below the gas-oil contact constituted another stratum.

The Amarillo court of appeals found merit in Jinkins argument. Considering the remainder of the relevant code provision,²⁰⁴ the court noted that Texas recognizes only two generic types of natural gas—dry gas and casing-head gas.²⁰⁵ The court concluded that the legislature intended dry gas to include all gas not indigenous to an oil stratum and not produced from that stratum with oil.²⁰⁶ The court then held that separate producing horizons are possible within a single formation.²⁰⁷ In order to determine the classification of gas produced from a well, therefore, the factfinder must determine which horizon produced the gas, and the amount of corresponding oil produced from that same horizon.²⁰⁸ The appellate court found that Bryan failed to meet the summary judgment burden of proof in this regard.²⁰⁹ The court also found error on the part of the trial court in severing Bryan's counterclaim for royalties previously paid for dry gas that he claimed were not actually due.²¹⁰ The court, therefore, reversed and remanded for trial on the

203. 763 S.W.2d at 545.

204. TEX. NAT. RES. CODE ANN. § 86.002 (Vernon 1978).

205. 763 S.W.2d at 546.

206. *Id.* According to the court:

A "stratum" which is producing oil within the purview of section 86.002(7) is a producing horizon producing more than one barrel of oil to each 100,000 cubic feet of gas. Gas produced from such a horizon would be "casinghead gas" within the statutory purview. Contrariwise, gas produced from a horizon producing less than one barrel of oil to each 100,000 cubic feet of gas would be "dry gas."

Id.

207. *Id.*

208. *Id.*

209. *Id.*

210. *Id.*

merits.²¹¹

*Raw Hide Oil & Gas, Inc. v. Maxus Exploration Co.*²¹² concerned an action originally brought by the owner of the gas rights against the owner of the oil and casinghead gas rights for conversion of gas well gas. Maxus owned the rights to the gas well gas under a certain tract of land in Moore County, Texas, pursuant to a 1938 gas mining lease. The lease specifically excluded all of the oil and casinghead gas. In 1938 Maxus's predecessor in interest drilled and completed the Coffee H-1 Well on the lease, which has continuously produced gas since that time. The well was completed throughout the Brown Dolomite and Moore County Lime Formations.

In 1983, through a farmout arrangement, Raw Hide acquired all oil and casinghead gas rights under the relevant lease. Raw Hide drilled four wells on the lease in 1984. All four such wells were completed in the Brown Dolomite and Moore County Lime Formations, the same formations from which the Coffee H-1 Well had produced gas since 1938. In 1985 Raw Hide drilled and completed another well in the Brown Dolomite and Moore County Lime Formations. In that same year, Raw Hide drilled four more wells on the lease. Each of these four additional wells was perforated and fractured in the Arkosic Dolomite Formation, immediately below the Moore County Lime Formation. The perforations in these four wells were only a few feet from the bottom of the Moore County Lime Formation, and some evidence indicated that the fractures could have extended up into the Moore County Lime Formation.

Subsequent to the filing of the lawsuit, the parties entered an agreed testing order. The order permitted Maxus to conduct tests and measure gas flow from the Raw Hide wells, which Raw Hide would operate during the testing period. The average amount of oil produced during the period was 0.049 barrels per day per well. Average gas production during the same time was 225 MCF per day per well. During sixteen days of the twenty-eight-day test period, the Raw Hide wells produced no oil whatsoever.

At trial Raw Hide disputed the test results and claimed that the gathering system designed and installed by Maxus prevented oil production from the wells. In response to special issues, the jury found the Raw Hide wells capable of producing gas belonging to the owner of the gas rights, and that Raw Hide produced such gas. The jury further found that the Brown Dolomite, the Moore County Lime, and other formations under the lease did not contain oil and that 100% of the gas produced during the test period was dry gas rather than casinghead gas. With respect to Raw Hide's counterclaim, the jury found that Maxus did not convert any oil or casinghead gas from the lease. In accordance with the jury verdict, the trial court entered judgment decreeing that Maxus owned the exclusive and sole right to complete wells in and produce gas from the Brown Dolomite, the Moore County Lime, and certain other formations under the lease. The court then permanently enjoined Raw Hide from producing any gas from the formations.

211. *Id.* at 547.

212. 766 S.W.2d 264 (Tex. App.—Amarillo 1988, writ denied).

Raw Hide appealed, asserting eleven points of error. The first point considered by the appellate court presented a jurisdictional attack. Raw Hide claimed that the judgment of the trial court amounted to a collateral attack on the Texas Railroad Commission's classification of the Raw Hide Fate wells as "oil wells." The court of appeals disagreed, instead finding that the trial court properly had jurisdiction since Maxus' cause of action was one to establish the ownership of and title to gas produced from formations under the Fate lease.²¹³

By another point of error, Raw Hide contended that the trial court gave an improper definition of the term "oil" in one of the special issues submitted to the jury.²¹⁴ Raw Hide argued that the instruction was too restrictive because it required the jury to determine whether the formation could produce any oil under normal operating conditions. Raw Hide, instead, sought the statutory definition of oil as "crude petroleum oil, crude petroleum, and crude oil," or "crude petroleum oil."²¹⁵ Raw Hide claimed that the existence of any oil was a critical issue regardless of whether the oil was producible under normal operating conditions. Noting that a similar jury instruction survived attack in *Dorchester Gas Producing Co. v. Harlow Corp.*,²¹⁶ the court found that the instruction was proper. The 1938 gas lease expressly incorporated the 1938 statutory definition of casinghead gas which was "any gas and/or vapor indigenous to an oil stratum and produced from such stratum with oil."²¹⁷ Thus, the issue of whether oil in the formation was *producible* was relevant to the determination of whether gas from such formation constituted casinghead gas rather than dry gas.²¹⁸ Raw Hide raised other points of error on appeal not relevant to oil, gas, and mineral law. The court of appeals overruled each such point²¹⁹ and, accordingly, affirmed the trial court's judgment.²²⁰

213. *Id.* at 269-70.

214. The relevant special issue provided as follows:

SPECIAL ISSUE NO. 7

Do you find from a preponderance of the evidence that oil exists in any of the following formations under the Raw Hide Fate lease?

Answer yes or no as to each formation:

Red Cave Formation . . .

Brown Dolomite . . .

White Dolomite . . .

Moore County Lime above 347 feet above sea level . . .

Below 347 feet above sea level . . .

You are instructed that the word "oil" means crude petroleum oil, that is liquid both in the reservoir and at the surface, that is native to the reservoir and that is producible under normal operating conditions.

Id. at 271.

215. *See* TEX. NAT. RES. CODE ANN. §§ 85.001(b), 86.002(1) (Vernon 1978).

216. 743 S.W.2d 243, 257 (Tex. App.—Amarillo 1987, writ denied).

217. Act of Apr. 26, 1935, ch. 120, § 2(i), 1935 Tex. Gen. & Spec. Laws 318, 319, (*repealed* 1977) (currently codified as amended at TEX. NAT. RES. CODE ANN. § 86.002(10) (Vernon 1978)).

218. 766 S.W.2d at 272.

219. *Id.* at 272-80.

220. *Id.* at 280.

B. Various Agreements

In *Cambridge Oil Co. v. Huggins*²²¹ the Corpus Christi court of appeals reversed the trial court's judgment in favor of plaintiff Huggins that ordered rescission, termination, and cancellation of a farmout agreement and partial assignments of interest made thereunder and awarded Huggins \$100,000 actual damages for gross negligence and breach of fiduciary duty, and \$1,500,000 in punitive damages.²²² The appellate court then rendered judgment for Cambridge.²²³ In 1983 Huggins sold the relevant tract to Thomas O'Connor, reserving one-half of the royalty interest in the oil, gas, and minerals. Later that same year, O'Connor executed an oil and gas lease in favor of GSI, Inc. In early 1985, GSI entered into a farmout agreement with Cambridge Oil Company. Pursuant to that agreement, Cambridge completed four producing wells, and GSI made four partial assignments to Cambridge.

The farmout agreement contained a continuous development clause that required Cambridge to commence operations for the drilling of a well within 120 days from the completion of a producing well or the drilling of a dry hole. Several times during the term of the farmout agreement, Cambridge requested and received extensions of time to fulfill its development obligations. In September 1986, Cambridge sought another extension. At that time, Cambridge was six months behind in the payment of monies due under the agreement. Huggins, O'Connor, and GSI granted Cambridge's request for extension; however, as a condition to such extension, Cambridge promised to make disbursements on a timely basis.²²⁴ Cambridge failed to commence operations for the drilling of a well during the extended time period and, as a result, Cambridge lost its right to drill on any other portion of the property.

Huggins brought suit against Cambridge, seeking rescission of the farmout agreement and cancellation of assignments previously made to Cambridge under the farmout agreement. Huggins also sought damages from Cambridge, asserting that the failure to timely pay royalties constituted gross negligence and a breach of fiduciary duty that purportedly arose from the September 1986 amendment wherein Cambridge promised in writing to timely disburse future royalty payments.

Regarding Huggins' claim for rescission based on the terms of the September 1986 amendment, the court of appeals framed the relevant issue as being "whether the failure to pay royalties due under the farmout agreement ter-

221. 765 S.W.2d 540 (Tex. App.—Corpus Christi 1989, writ denied).

222. *Id.* at 542.

223. *Id.* at 545.

224. The September 1986 amendment provided:

You (Cambridge) represent and warrant that you shall in the future disburse all proceeds due us (Huggins and GSI) and the lessors (O'Connors) under the lease which is the subject of the agreement on a continuing, regular, and monthly basis and, in the event you do not disburse such proceeds then we shall at our sole option: a) exercise the rights to obtain all proceeds due us from the purchaser; or b) terminate the agreement.

Id. at 542.

minated the extension agreement of September 1986; or whether the failure to pay royalties cancelled the entire farmout agreement, including the previously assigned interest that Cambridge had already earned."²²⁵ The jury found that such failure to pay caused a termination of the entire farmout agreement and a cancellation of the prior partial assignments.

The Corpus Christi court of appeals, however, found that the contract was unambiguous as a matter of law and, therefore, the jury finding was immaterial.²²⁶ The appellate court then held that the trial court erred in rendering judgment that the failure of Cambridge to pay royalties terminated the partial assignments.²²⁷ The court examined the original farmout agreement and the subsequent amendments. No provision of the agreement, as amended, permitted cancellation of the previous partial assignments for failure to pay royalties.²²⁸ Indeed, several provisions of the farmout agreement that dealt with termination of the agreement due to failure to timely commence drilling operations recognized the continuing effect of any previous partial assignment of interest under the terms of the agreement.²²⁹

As to the trial court's judgment regarding breach of fiduciary duty, the appellate court found no evidence of the existence of a fiduciary duty.²³⁰ Huggins claimed that the extensions allowing Cambridge to continue drilling changed the relationship of the parties from a mere contractual relationship to one of confidentiality. The appellate court noted, however, that the evidence indicated just the opposite.²³¹ The September 1986 amendment, for example, illustrated the lack of a relationship of trust and confidence between the parties.²³² In the absence of evidence of the existence or breach of fiduciary duty, the court of appeals found no basis for the award of \$1 million in exemplary damages based upon such breach.²³³

Huggins' claim for gross negligence rested on the fact that Cambridge failed to pay royalties even after being paid by the gas purchaser. According to the court of appeals, however, the claim related totally to the contractual relationship between the parties under the farmout agreement.²³⁴ Reasoning that a breach of contract does not entitle an injured party to exemplary damages, even if the breach is intentional, the appellate court found that the trial

225. *Id.* at 543.

226. *Id.* at 544.

227. *Id.*

228. *Id.* at 543-44.

229. Paragraph 11 of the farmout agreement, for example, provided in part:

[I]f the operations specified are not commenced by the commencement dates and diligently pursued in a manner herein provided, or if you have not complied with each and all of the terms and provisions of this agreement, Farmor shall be relieved of any and all obligations to make the assignment(s) herein specified or any part thereof, *except for acreage already earned according to the terms of this agreement*, and the agreement shall terminate.

Id. at 543-44 (emphasis by the court).

230. *Id.* at 544-45.

231. *Id.*

232. *Id.* at 544.

233. *Id.* at 545.

234. *Id.*

court erred in awarding \$500,000 in exemplary damages for gross negligence, because Huggins failed to prove any distinct tort.²³⁵

The dispute in *Brown v. Welltech, Inc.*²³⁶ arose out of an unsuccessful deepening operation. In 1981, Brown, an independent oil operator, engaged Welltech, a drilling contractor, to re-enter and deepen a well in New Mexico. Brown and Welltech entered into an oral agreement whereby Welltech agreed to furnish the rig, certain equipment, and the crew to drill the well 700 feet deeper at a certain price per day for the first five days, and thereafter, at a slightly reduced price per day. Seven days after the Welltech crew began work on the project, a mishap occurred. While the crew pulled the drill pipe out of the hole, the elevators holding the drill pipe opened and the drill string fell back into the hole. Fishing attempts were unsuccessful, and the well was ultimately lost because of materials remaining in the hole. Brown refused to pay Welltech for its services and engaged another company to drill a replacement well.

Brown sued Welltech to recover damages arising out of the loss of the oil and gas well and for the drilling of the replacement well on theories of negligence, breach of express and implied warranties, deceptive trade practices, and others. Welltech counterclaimed against Brown for payment under the oral agreement based on allegations of a sworn account for goods and materials sold and delivered to Brown. Pursuant to jury findings, the trial court rendered judgment denying Brown any recovery on his claims, but awarding Welltech more than \$150,000 for its action on sworn account.

Brown appealed, claiming that the trial court erred in rendering a take-nothing judgment against him on the grounds that the evidence conclusively established that Welltech breached the drilling contract and caused harm to Brown. Brown also claimed that the trial court erred in entering a judgment in favor of Welltech on its claim since Welltech failed to request any jury issues regarding sworn account. Welltech countered that the take-nothing judgment for Brown was proper since Brown failed to plead breach of contract or request any jury issues on that theory of recovery. Welltech also asserted that the judgment for Welltech was proper even in the absence of jury findings because the evidence conclusively established its right to recover on sworn account.

The appellate court noted that the failure to request a special issue necessary to support an independent theory of recovery provided no grounds for a favorable judgment on that theory. The failure further left nothing for appellate review, unless the evidence conclusively proved a theory of recovery as a matter of law.²³⁷ Since both parties claimed that the evidence conclusively established their respective theories of recovery, the court examined all of the evidence to determine whether either party proved its position as a matter of law.²³⁸ One issue common to both parties' theory of recovery con-

235. *Id.*

236. 769 S.W.2d 637 (Tex. App.—El Paso 1989, no writ).

237. *Id.* at 639.

238. *Id.*

cerned the nature of the agreement between the parties.

Some evidence indicated that the contract was on a turnkey basis, whereby the drilling contractor retained sole responsibility for the job. Other evidence indicated that the contract was for day work, whereby the operator bore responsibility for losses of the sort incurred.

Brown contended that Welltech contracted to complete the 700-foot drilling job on a turnkey basis. According to this interpretation, Brown could recover from Welltech for the loss incurred during drilling operations, and Welltech could not recover on its claim for sworn account because it breached the contract by failing to reach the planned total depth. Welltech, on the other hand, claimed that it contracted merely to provide drilling services on a daily basis and, therefore, Brown retained responsibility for losses during drilling. Additionally, according to Welltech's interpretation, Brown owed Welltech for drilling services provided to Brown for a certain number of days.

After examining the evidence regarding the classification of the oral agreement at hand, the court concluded that ordinary or reasonable minds could differ as to the nature of the agreement.²³⁹ The conflicting evidence of the classification of the contract raised a fact issue.²⁴⁰ Since both parties to the lawsuit sought affirmative relief dependent upon the resolution of a factual issue, either or both should have requested that the trial court submit an appropriate special issue to the jury.²⁴¹ The failure by the parties to do so constituted a waiver of their respective grounds of recovery not conclusively established by the evidence.²⁴² Neither Brown nor Welltech conclusively established their respective theories of recovery.²⁴³ The court of appeals, therefore, reversed the trial court's judgment for Welltech on its counterclaim, and rendered judgment that Welltech and Brown both take nothing.²⁴⁴

*Fuller v. Phillips Petroleum Co.*²⁴⁵ involved the determination of whether two provisions in a joint operating agreement regarding notice of plugging and abandoning and notice of surrender of lease implied a duty on the part of the operator to notify the nonoperator of impending lease termination. Fuller and Phillips were parties to a 1964 joint operating agreement covering operations of oil and casinghead gas leases on a unit area. Phillips owned two leases within the area, and Fuller owned one lease. In accordance with the operating agreement, Phillips, as operator, drilled a well in 1964 within the unit area. This well produced oil from 1964 until January 12, 1983, when it ceased production. On or about March 13, 1983, Phillips' two leases within the unit area terminated by their express terms because of cessation of production for more than sixty days. In April 1983, Phillips notified Fuller

239. *Id.* at 640.

240. *Id.*

241. *Id.*

242. *Id.*

243. *Id.*

244. *Id.* at 641.

245. 872 F.2d 655 (5th Cir. 1989).

of its intent to plug and abandon the well, which it did despite Fuller's objections.

Fuller then brought suit against Phillips, claiming Phillips had breached the joint operating agreement by failing to notify Fuller of its intent to plug and abandon the well before the expiration of Phillips' two leases. Phillips counterclaimed, seeking damages from Fuller for his breach of the joint operating agreement by his failure to pay his proportionate share of the operating expenses. Despite a jury verdict favorable to Fuller on his claim and favorable to Phillips on its counterclaim, the district court granted the separate motions for judgment notwithstanding the verdict filed by Phillips and Fuller, thereby rendering judgment that neither party was liable to the other.

Fuller appealed, claiming that the district court erred in concluding, as a matter of law, that Phillips did not breach the joint operating agreement by failing to notify Fuller of its intent to plug and abandon the well prior to termination of Phillips' two leases. More specifically, Fuller contended that Phillips breached the operating agreement by failing to notify him that both of Phillips' leases would expire at the end of sixty days following the date on which production from the well ceased. Although the joint operating agreement contained no express provision obligating the operator to notify the nonoperator of impending lease termination, Fuller argued that the court should imply such a duty by virtue of two other provisions in the contract.²⁴⁶

The district court found that the notice of plugging provision imposed no duty on Phillips to notify Fuller of its intent to plug and abandon the well *prior* to the expiration of the underlying leases. The Fifth Circuit agreed.²⁴⁷ Article 16 required notice only of the abandoning party's intent to plug and abandon a well, not notice by that party of an impending lease termination.²⁴⁸ To bolster this interpretation, the court pointed to other provisions in the operating agreement that directly addressed the possibility of the expiration or loss of a lease.²⁴⁹ Since Phillips did notify Fuller of its intent to plug and abandon the well in accordance with the terms of article 16, albeit after termination of the two leases, Phillips did not breach the article.²⁵⁰

246. Article 16 of the joint operating agreement provided, in pertinent part, as follows:

No well . . . shall be plugged and abandoned without the consent of all parties; provided, however, if all parties do not agree to the abandonment of any well, those wishing to continue its operation shall tender to each of the other parties its proportionate share of the value of the well's salvable material and equipment . . . , less the estimated cost of salvaging and the estimated cost of plugging and abandoning.

Id. at 658 (emphasis by the court omitted). Article 23 of the operating agreement required the consent of all parties prior to the surrender, in whole or in part, of any lease affecting the unit area or, in the absence of such consent, the assignment of such leases to the non-consenting parties. *Id.* at 659.

247. *Id.* at 659.

248. *Id.*

249. These other provisions included Article 2.B "Failure of Title," Article 2.C "Loss of Leases for other than Title Failure," Article 17 "Delay Rentals and Shut-in Well Payments," and Article 22 "Renewal or Extension of Leases." *Id.* at 659 n.1.

250. *Id.* at 659.

In support of his cause of action for breach of contract, Fuller next asserted that Phillips' actions in allowing the lease to terminate due to the cessation of production constituted an affirmative surrender of the leases. According to Fuller's argument, Phillips' failure to obtain consent before its surrender constituted breach of article 23 of the operating agreement. In disagreeing with this reasoning, both the district court and the court of appeals noted a legal distinction between the terms surrender and termination.²⁵¹

The term surrender, as used in the oil and gas industry, refers to the contractual right of a lessee to relinquish voluntarily to the lessor all or part of the leased premises;²⁵² termination of a lease, as relevant to the present situation, refers to the expiration of a lease by its own terms. For example, a lease expires because its terms require the operator to maintain production or continuous operations on the leased premises past the end of the primary term.²⁵³ Since Phillips' leases expired by virtue of their own express terms, the surrender clause contained in article 23 was inapplicable.²⁵⁴ The article, therefore, did not impose a duty on Phillips to notify Fuller of the impending termination of the leases.²⁵⁵ The Fifth Circuit affirmed the judgment of the district court.²⁵⁶

C. Other Issues

*London v. Merriman*²⁵⁷ concerned the effect of an anti-communitization provision contained in an oil and gas lease. London owned two adjoining tracts of land and held the executive right to all of the minerals underlying both tracts. London further owned a three-sixteenth royalty interest under the eastern tract and a one-eighth royalty interest in the western tract. The Merrimans owned a one-sixteenth nonparticipating royalty interest in the western tract. In 1980, London executed a single oil and gas lease that covered both tracts to McCord Exploration Company. McCord subsequently completed producing gas wells on the eastern tract in which London owned the entire royalty interest. McCord drilled no wells on the western tract.

In 1983 the Merrimans filed a lawsuit against London and McCord, claiming that McCord had breached its obligation to protect the western tract from drainage caused by the production of gas from the eastern tract. The Merrimans sought damages for their share of gas royalties lost as a result of the claimed drainage. In 1984 the Merrimans obtained an order from the Railroad Commission force-pooling their royalty interest with London's, thereby enabling them to share in the royalties paid on the wells situated on the eastern tract from and after the date of the Commission's order. The Merrimans did not dismiss their lawsuit. Rather, in 1986 they

251. *Id.*

252. *Id.*

253. *Id.* at 659-60.

254. *Id.* at 660.

255. *Id.*

256. *Id.*

257. 756 S.W.2d 736 (Tex. App.—Corpus Christi 1988, writ denied).

filed an amended petition alleging, as an alternative theory of recovery, that by instituting the lawsuit they had ratified the lease executed by London. As a matter of law, they argued, the ratification caused their royalty interest to be pooled with London's as of that date. The Merrimans prevailed in their lawsuit on both the drainage and the ratification theories. They elected to have judgment entered on the basis of the latter, thus recovering their share of royalties on hydrocarbons produced and sold from the wells at issue from the date they filed suit until the effective date of the Railroad Commission's force-pooling order.

On appeal London conceded that the underlying lease contained a standard pooling provision. Under ordinary circumstances, the provision would allow nonparticipating royalty interest owners such as the Merrimans an opportunity to ratify the lease and effect a pooling of their royalty interest with London's. London, however, contended that in this instance the lease contained an express anti-communitization clause that specifically negated that result.²⁵⁸ On the basis of the anti-communitization provision, London contended that the execution of the underlying lease did not constitute an offer to the Merrimans to create a community lease by ratification. Instead, London argued, the anti-communitization clause kept the royalties separate so that only production, if any, from the western tract entitled the Merrimans to royalties.

The court of appeals rejected London's analysis, reasoning that the purported anti-communitization clause simply provided that no pooling of royalty interest occurred merely from the inclusion of the two tracts in one lease.²⁵⁹ The court agreed that no pooling had resulted merely because the lease had covered the two tracts involved, but held that pooling had resulted from the basic pooling provision contained in the lease that authorized the pooling of royalties coupled with the Merrimans' ratification of the lessee's inclusion of both tracts under the single lease instrument.²⁶⁰

258. The clause at issue provided:

If this lease now or hereafter covers separate tracts, no pooling or unitization of royalty interest as between any such separate tracts is intended or shall be implied or result merely from the inclusion of such separate tracts within this lease but Lessee shall nevertheless have the right to pool as provided above with consequent allocation of production as above provided. As used in this paragraph 4, the words "separate tract" mean any tract with royalty ownership differing, now or hereafter, either as to parties or amounts, from that as to any other part of the leased premises.

Id. at 740.

259. *Id.*

260. *Id.* at 741. According to the court:

London's lease with McCord attempted to authorize an unauthorized act, thereby offering the Merrimans an opportunity to ratify the lease. The Merrimans accepted the offer by ratifying the lease, which the trial court found occurred when suit was filed in 1983. Bringing suit constitutes an implied ratification of an unauthorized act. By ratifying the lease, the Merrimans became a party to it, and the rule that the execution of an oil and gas lease by more than one mineral interest owner effects a pooling of their interests applied.

Id. (citations omitted).

The issue in *Pickens v. Hope*²⁶¹ was whether the mineral fee owner breached a duty to the owner of a term nonparticipating royalty interest by failing to lease his land to another for the development and production of tar from a deposit of tar underlying the land, or by failing to develop and produce the tar himself. Pickens owned the surface estate of the Chaney Lake Ranch in Maverick and Zavala Counties, Texas, and the underlying minerals, subject to a 1/4th term nonparticipating royalty owned by Hope, and a like royalty owned by Oil Field Transportation Company. These nonparticipating royalty interests began on June 10, 1965, for a term of twenty years, and continued as long thereafter as oil, gas, or other minerals were produced from the land in paying or commercial quantities. Neither party disputed that the San Miguel Formation under the Ranch contained large quantities of tar. From 1976 until 1985, several pilot plants produced tar from tracts in the immediate vicinity of the Ranch. The plants demonstrated the technical feasibility of producing tar; however, none was a commercial success.²⁶² All of the pilot plants in the area were shut down before February 1985.

Although Pickens executed two oil and gas leases that excluded the tar sands and that resulted in a total of five dry holes being drilled on the Ranch, he made no effort to lease the Ranch for development of the tar sands. Indeed, the Ranch was the only tract of land in the immediate vicinity of the four pilot plants that was not under a tar lease during the relevant period. Pickens, however, did attempt to make arrangements with Conoco, and later Texas Tar Sands, for the joint development of the tar under the Ranch. Conoco first approached Pickens in June 1981 and began negotiating terms for joint development. Conoco abandoned the negotiations in March 1982 because of the economic conditions then prevailing, among other reasons.

Next, Pickens commenced negotiations with Texas Tar Sands for joint development of the Ranch, and, in June 1982, Pickens made an initial payment of \$75,000 to participate in the program. According to the planned schedule of production, initial production would begin in 1983. Due to the extensive time required to steam heat the tar so that it would flow, however, commercial production would not be possible until 1986. One of the essential requirements for the viable production of tar was a federal price guarantee.²⁶³ The general partner of Texas Tar Sands made four applications to the U.S. Synthetic Fuels Corporation from 1982 until 1985 for a price guarantee. Each application was denied, the last in March 1985. Shortly thereafter, all parties concerned abandoned the joint project. At the time of the abandonment, Pickens had spent \$650,000 on the project.

On June 10, 1985, no commercial production of minerals occurred on the Ranch and, consequently, Hope's term royalty expired. Hope asserted at trial that Pickens breached a duty owed to Hope to produce minerals from

261. 764 S.W.2d 256 (Tex. App.—San Antonio 1988, writ denied).

262. For example, Conoco, Inc. suffered a total net loss of \$36,700,000 for its two pilot plants in the area, and Texas Tar Sands, Ltd. had a net loss of \$12,000,000 from its nearby tar pilot plant operations.

263. See U.S. Synthetic Fuels Corporation Act, § 134 42 U.S.C., § 8734 (1982), *terminated pursuant to* Pub. L. 99-272, Title VII, Subtitle E, § 7403, 100 Stat. 144 (1986).

the Ranch before the expiration of the term royalty. Based on a jury verdict, the trial court rendered judgment for Hope, awarding \$1,300,000 actual damages and \$500,000 exemplary damages. Pickens appealed.

According to established Texas law, the mineral fee owner owes to the nonparticipating royalty owner a duty to exercise the executive rights to lease or develop the minerals.²⁶⁴ The standard is usually characterized as one of good faith and utmost fair dealing.²⁶⁵ Pickens and Hope, however, disagreed as to how the standard applied to Pickens. Hope contended that Pickens owed him the duty of good faith and utmost fair dealing as measured by a fiduciary duty arising out of their relationship. This interpretation followed one of the holdings in *Manges v. Guerra*²⁶⁶ that found that the relationship between the executive and the nonexecutive in that case created a fiduciary duty on the part of the executive in exercising the executive power. Pickens, on the other hand, claimed the duty owed to Hope was that of an average landowner seeking to obtain all of the benefits reasonably obtainable for himself and for his nonparticipating term royalty owners.

The San Antonio court of appeals analyzed the facts and holdings of *Manges v. Guerra*,²⁶⁷ and distinguished it on its facts.²⁶⁸ In *Manges* the relationship between Manges, the holder of the executive rights in the mineral estate, and the Guerras, the nonexecutives, was one of trust and confidence because: (1) Manges and the Guerras were equal cotenants in the mineral estate and this entitled the Guerras to one-half of all benefits to the mineral estate, including bonus, delay rentals, and royalties; (2) the Guerras' assignment to Manges of the executive right covering their interest in conjunction with the partial assignment of their mineral interest created a duty and a privilege on the part of Manges to manage the Guerras' mineral property; and (3) in his exercise of the executive right, Manges did not extract the same benefit for the Guerras as he did for himself, and, indeed, he committed specific acts of self-dealing that deprived the Guerras of bonus, delay rentals, and royalties. The appellate court held that *Manges* does not mandate a holding in every case that the executive owes a fiduciary duty to the nonexecutive.²⁶⁹

Finding the facts regarding the relationship between Pickens and Hope entirely different from those concerning the relationship between Manges and the Guerras, the court of appeals held that Pickens and Hope did not have a relationship of trust and confidence.²⁷⁰ Consequently, Pickens owed no fiduciary duty.²⁷¹ Instead, the court held the standard of duty the executive right owner owes to the nonexecutive equivalent to the duty to act as a

264. See *Schlittler v. Smith*, 128 Tex. 628, 638, 101 S.W.2d 543, 545 (Comm'n App. 1937, opinion adopted); *Morris v. First Nat. Bank*, 249 S.W.2d 269, 276 (Tex. Civ. App.—San Antonio 1952, writ ref'd n.r.e.).

265. 764 S.W.2d at 257.

266. 673 S.W.2d 180 (Tex. 1984).

267. *Id.*

268. 764 S.W.2d at 266-67.

269. *Id.* at 267.

270. *Id.*

271. *Id.* at 267-68.

reasonably prudent landowner who owned all of the mineral estate under the same or similar circumstances.²⁷²

The court held that Pickens did not breach the standard of duty owed Hope in failing to lease the Ranch for the production of *oil and gas*.²⁷³ The court based this holding upon the evidence that prior to the expiration of the term royalty interest, Pickens leased the land for the production of oil and gas, and the lessee drilled a dry hole on the premises.²⁷⁴

Next, the court determined whether Pickens breached the duty of good faith and utmost fair dealing in failing to lease the Ranch to another for the production of *tar*, or to develop the tar himself.²⁷⁵ Although evidence did show that Pickens received three offers to lease the Ranch for the production of tar, the court found no inference from this evidence that any of the possible lessees would have produced tar had they obtained such a lease.²⁷⁶ Nor could the court infer production would have continued past the expiration of the twenty-year term royalty.²⁷⁷ In Texas a lessee has no duty to produce minerals unless the lesser can prove that such operations would yield a reasonable expectation of profit to the lessee.²⁷⁸ The court, therefore, stated that Pickens was under no duty to lease the Ranch for the development of tar, because evidence showed no reasonable expectation of profit from the production of tar.²⁷⁹

The court then found that Pickens had no duty to develop the tar sands himself.²⁸⁰ The court held that the duty of an ordinary, prudent landowner in the situation where the mineral owner elected to develop the minerals himself was the same as the duty imposed upon the lessee in a lessor/lessee relationship, that is, to act as a reasonably prudent operator.²⁸¹ Finding that the production of tar was never economically feasible during any time from

272. *Id.* at 268-69. As more fully explained by the court:

The duty owed by the executive to the non-executive owner of a term non-participating royalty owner requires him to timely lease the land to another for mineral development, or to timely develop the minerals himself, if, during the term, it becomes reasonably apparent that minerals are under the land. The executive, in leasing the land, must act with reasonable regard for the interests of the non-participating royalty owner as a reasonably prudent landowner who owned all of the mineral estate would have acted under the same or similar circumstances. Matters of cash bonus, primary term, delay rentals and special provisions are matters of trading, and as long as the executive acts in good faith and with reasonable regard for the interests of the non-participating royalty owner, his judgment in leasing or refusing to lease is not subject to question, and his refusal to lease, absent arbitrariness, connivance or deliberate action calculated to deprive the non-executive of his royalty interest, will not constitute a breach of duty owed the owner of a non-participating royalty. The duty to develop known minerals by the executive depends upon economics.

Id. (emphasis omitted).

273. *Id.* at 269.

274. *Id.*

275. *Id.*

276. *Id.*

277. *Id.*

278. *Id.* at 269-70 (citing *Clifton v. Koontz*, 160 Tex. 82, 325 S.W.2d 684 (1959)).

279. *Id.* at 270.

280. *Id.*

281. *Id.*

June 10, 1965, to June 10, 1985, the appellate court held that Pickens did not breach the duty owed to Hope.²⁸²

In summary, the San Antonio court of appeals held that Hope presented no evidence that Pickens owed a fiduciary duty to Hope or that he breached such a duty.²⁸³ Also Hope presented no evidence that Pickens breached the duty of an ordinary, prudent landowner in failing to lease the Ranch to another for the production of tar.²⁸⁴ Finally, Hope failed to prove that Pickens breached the duty of a reasonably prudent operator in failing to produce the tar himself.²⁸⁵ Consequently, the evidence failed to support the jury's finding that Pickens breached the duty of "good faith and utmost fair dealing, by failing to lease or develop the oil, gas or other minerals under the Chaney Lake Ranch."²⁸⁶ Accordingly, the appellate court reversed the judgment of the trial court and rendered judgment that Hope take nothing in his actions against Pickens.²⁸⁷

*Duff v. Union Texas Petroleum Co.*²⁸⁸ involved claims for breach of a 1980 joint venture agreement between Union Texas Petroleum Corporation (UTP) and Pluspetrol S.A. The agreement related to the submission of a joint bid for an offshore oil and gas concession for an area known as Block D-1, located off the coast of the Ivory Coast of Africa. According to the terms of agreement, UTP had primary responsibility for the negotiations with Petroci, the Ivory Coast government-owned oil company, for the award of the Block. In the event that negotiations were successful and the Block was awarded to UTP, the agreement gave Pluspetrol and Fluor Oil and Gas Corporation the right to acquire from UTP a portion of the working interest. The agreement further provided that such assignments covering Block D-1 would be subject to any required approval of Petroci or the government of the Ivory Coast. Members of the bid group included UTP, Pluspetrol, Rutherford Oil and Gas Corporation, and Fluor.

In 1981 the UTP bid group filed a joint bid on behalf of the bid group and Agrip, an African-owned oil company, which joined the group at that time. Later that year the government of the Ivory Coast notified UTP that the oil and gas concession for Block D-1 would be exclusively divided between UTP, Agrip, Total, a French-owned oil company, and Petroci. This allocation denied Pluspetrol, Rutherford, and Fluor any interest in the oil and gas concession. Representatives of UTP and Pluspetrol attempted to obtain approval from the Ivory Coast government for a transfer of interest between UTP and Pluspetrol; however, the government denied the request.

Thereafter, Pluspetrol, Rutherford, and Fluor sued UTP, claiming breach of the joint venture agreement. Duff acquired Pluspetrol's rights under the contract. UTP subsequently settled with Rutherford and Fluor.

282. *Id.* at 270-71.

283. *Id.* at 271.

284. *Id.*

285. *Id.*

286. *Id.*

287. *Id.*

288. 770 S.W.2d 615 (Tex. App.—Houston [14th Dist.] 1989, no writ).

Following a bench trial, the trial court entered a take-nothing judgment. The court found that the joint venture agreement entitled Pluspetrol to assignment of a 1.59375% interest in the concession, that UTP failed to convey that interest to Pluspetrol, and that the failure was not excused by any act of state by the Ivory Coast government. The trial court also found that the failure of UTP to convey the specified percentage of interest to Pluspetrol caused no damage or harm whatsoever to Pluspetrol or Duff. After Pluspetrol filed the lawsuit, two wells were drilled in Block D-1, each resulting in a dry hole. The concession terminated shortly thereafter. The court based the finding of no damages on evidence that Pluspetrol's interest was not marketable and had no market value.

On appeal Duff complained that the evidence was legally and factually insufficient to support certain findings by the trial court. More specifically, Duff claimed that the trial court erred in finding that the interest to which Pluspetrol was entitled had no market value. The court, consequently, erred in concluding that Pluspetrol suffered no damage as a result of UTP's breach of the contract. At trial, Duff presented evidence that before the commencement of drilling, Block D-1 constituted an attractive investment opportunity for major oil companies. Indeed, in 1982 Conoco made an offer to purchase thirty percent of the oil and gas concession from the winning bid group for a price in excess of \$800,000 for each one percent interest. Duff, however, failed to present any evidence of comparable sales of an interest as small as his. UTP offered evidence explaining that since Pluspetrol's interest was so small, no market existed for such an interest prior to production. Based on this evidence, the appellate court concluded that Duff failed to establish the existence of damages as a matter of law, and therefore, the court's finding of fact controlled the issue.²⁸⁹

By crosspoints on appeal, UTP contended that the trial court erred as a matter of law when it held that UTP had breached the joint venture agreement because the act of state doctrine²⁹⁰ excused UTP's performance. UTP claimed that when the Ivory Coast government excluded the Pluspetrol group from participation in the concession and rejected UTP's request to assign interest to Pluspetrol, those acts by the government excused their breach of the joint venture agreement. The Houston court of appeals disagreed, finding that the act of state doctrine inapplicable.²⁹¹ The doctrine is applicable only where one sues a foreign government or where one challenges the validity of a foreign government's expropriation of his property.²⁹² Minor involvement of a foreign government in a conflict does not automatically invoke the act of state doctrine.²⁹³ Having overruled all of

289. *Id.* at 619.

290. According to the act of state doctrine, the courts of one country will not sit in judgment on the acts of the government of another, done within its own territory, because every sovereign state is bound to respect the independence of every other sovereign state. *Underhill v. Hernandez*, 168 U.S. 250, 252-53 (1897); *Banca Nacional de Cuba v. Sabbatino*, 376 U.S. 398, 416 (1964).

291. 770 S.W.2d at 620.

292. *Id.*

293. *Id.* (citing *Airline Pilots Ass'n v. Taca Int'l. Airlines*, 748 F.2d 965, 969-70 (5th Cir.

Duff's points of error, and UTP's crosspoints, the appellate court affirmed the judgment of the trial court.²⁹⁴

*World Hospitality Ltd., Inc. v. Shell Offshore, Inc.*²⁹⁵ required an ordering among a supplier, a lease holder, a drilling contractor, and a lender of their priorities of interest in the disbursement of proceeds from two wells off the Texas coast. Nordrill, an offshore drilling contractor, operated two rigs—the *Steeler* and the *Gulfdrill*—in the Gulf of Mexico. In 1981 Nordrill assigned to its lender, First City National Bank of Houston, Nordrill's income from the *Steeler*. In 1984, Shell entered into a master drilling contract with Nordrill pursuant to which the *Steeler* and the *Gulfdrill*, in 1985, began drilling wells for Shell on its federal lease on the outer continental shelf. World Hospitality, an offshore caterer, supplied materials and services to feed Nordrill's offshore crews. The lawsuit involved disposition of approximately \$378,000 that Shell owed to Nordrill under the master drilling contract for the *Steeler's* work. First City claimed entitlement to the funds under its 1981 assignment of the *Steeler's* proceeds. World Hospitality claimed entitlement to the money because Nordrill failed to pay World Hospitality \$90,000 for catering services in connection with the *Steeler* and \$332,000 for catering services provided to the crews of the *Gulfdrill*. Shell claimed the right to offset the amount it owed Nordrill by the amounts Nordrill owed to its unpaid suppliers.

Threatened by the filing of liens on the drill sites, Nordrill brought suit in Jefferson County, Texas, against World Hospitality and on June 17, 1986, obtained an injunction preventing World Hospitality from filing liens against Nordrill and Shell. On July 8, 1986, World Hospitality ceased supplying goods and services to Nordrill. The injunction ultimately dissolved on October 20, 1986, and shortly thereafter, on November 17, 1986, World Hospitality filed a lien claim with the New Orleans office of the Mineral Management Service. Later, on March 24 and 25, 1987, World Hospitality filed lien claims in Matagorda County and Calhoun County, Texas, respectively.

First City claimed entitlement to the funds held by Shell on the following grounds: (1) First City's assignment of proceeds from Nordrill took precedence over Shell's contract with Nordrill; (2) the objective of mineral property liens was not security for unpaid catering services; and (3) World Hospitality failed to timely perfect its liens against Shell's lease.

With respect to First City's claim of priority, First City asserted that its assignment of *Steeler* proceeds from Nordrill was superior to Shell's right of offset contained in its drilling contract with Nordrill.²⁹⁶ According to the court, Nordrill assigned to First City only the rights that Nordrill would otherwise have. Nordrill had only a conditional right to the proceeds from

1984); *Compania De Gas de Nuevo Laredo, S.A. v. Entex*, 686 F.2d 322, 325-26 (5th Cir. 1982)).

294. *Id.* at 621.

295. 699 F. Supp. 111 (S.D.Tex. 1988).

296. The master drilling contract and the drilling orders executed thereunder permitted Shell to offset any payments due to Nordrill from the *Steeler's* work by any amounts due to an unpaid supplier on the *Gulfdrill* job.

the *Steeler* job; therefore, First City got the money only if Shell owed Nordrill on their contract.²⁹⁷ Since Shell's offset against Nordrill for unpaid suppliers on the *Gulfdrill* job exceeded Nordrill's entitlement under the *Steeler* job, Shell did not owe Nordrill anything for the *Steeler* job.²⁹⁸ Consequently, the court denied First City Center's claim to any portion of the \$378,000 based on its theory that its assignment took precedence over Shell's contract with Nordrill.²⁹⁹

First City next attacked the validity of World Hospitality's liens, claiming first that statutory liens did not cover catering services and then that World Hospital failed to timely perfect its liens. First City's rationale for this attack apparently was that if World Hospitality did not have a valid lien on Shell's property, then Shell would not be permitted to offset World Hospitality's balance against the amounts it owed Nordrill. The court, however, found catering services protected by the statutory lien.³⁰⁰

Turning to First City's argument that the lien was not timely perfected, the court noted that Texas law applies to the perfection of a lien claim on the outer continental shelf adjacent to Texas.³⁰¹ In order to perfect its lien against Shell's lease, Texas law required World Hospitality to notify Shell and to file a lien claim affidavit in the real property records of the nearest county within six months following the last day it furnished labor and supplies.³⁰² Neither party disputed that the filing of lien affidavits in the Matagorda County and Calhoun County records occurred more than six months following the last date when World Hospitality supplied services. World Hospitality, however, asserted that the injunction from the Jefferson County court tolled the running of the filing deadline. Alternatively, World Hospitality claimed that the filing of its lien claim in the Mineral Management Service office within 180 days of the last supplies was sufficient to comply with the filing requirement.

The court rejected the latter argument, holding that the filing of a lien claim with the Mineral Management Service did not comply with the requirement under the Outer Continental Shelf Land Act³⁰³ of compliance with adjacent state law in perfecting a lien on an owner's leasehold interest.³⁰⁴ The court, however, agreed that the injunction prohibiting the filing of liens against Nordrill and Shell did toll the running of the filing deadline.³⁰⁵ Deducting the effective time of the injunction, World Hospitality's

297. 699 F.Supp. 112.

298. *Id.*

299. *Id.*

300. *Id.* at 113. The court held: "While a caterer may not have the traditional oil business mystique of a well logger or mudman, it had men on the job site performing an essential function. When the caterer provides victuals and personnel on the well site, its receivables support a lien." *Id.*

301. *Id.*

302. TEX. PROP. CODE ANN. § 56.021 (Vernon 1984); 43 U.S.C. § 1333(a)(2)(A) (1988).

303. 43 U.S.C. § 1333(a)(2)(A) (1988) (importing adjacent-state law to determine lien's validity).

304. 699 F. Supp. at 114.

305. *Id.*

filings in Matagorda County and Calhoun County were within six months following the date of last supply.³⁰⁶

According to these holdings, World Hospitality timely perfected its liens against Shell's leasehold.³⁰⁷ Under the terms of the master drilling contract between Shell and Nordrill, Shell could properly apply the proceeds that it would otherwise owe to Nordrill for the *Steelers* work towards the satisfaction of World Hospitality's claim for catering services provided to the *Gulf-drill* and the *Steeler*.³⁰⁸ First City's only claim was to any amounts remaining after satisfaction of Nordrill's unpaid balances to World Hospitality.³⁰⁹

306. *Id.*

307. *Id.*

308. *Id.*

309. *Id.*

