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OIL & GAS LAW

INTRODUCTION

Conflicts over oil and gas interests continually arise in situations involving ownership of coalbed methane, royalty payments on settlement proceeds, and tortious interference with oil and gas leases. The Tenth Circuit addressed these conflicts during the survey period.[1] Part I summarizes the historical background and legislation surrounding oil and gas law. Part II addresses ownership of coalbed methane within the context of the multi-hundred million dollar case *Southern Ute Indian Tribe v. Amoco Production Co.*[2] Part III discusses the payment of royalties on settlement proceeds in *Harvey E. Yates Co. v. Powell*[3] and *Watts v. Atlantic Richfield Co.*[4] Part IV examines issues involving tortious interference with oil leases in *Morsey v. Chevron, USA, Inc.*[5] and *Watts v. Atlantic Richfield Co.*[6]

I. GENERAL BACKGROUND

As the natural gas industry boomed in the 1920s, inconsistent state regulations created interstate transportation problems.[7] In a series of opinions, the United States Supreme Court prohibited the states from regulating interstate gas transportation.[8] In 1938, Congress responded with the enactment of the Natural Gas Act (NGA).[9] The NGA delegated

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1. The survey period covered cases decided between September 1996 and August 1997. The Tenth Circuit addressed some oil and gas law issues not discussed in this survey. *First National Oil, Inc. v. Federal Energy Regulatory Commission*, 102 F.3d 1094 (10th Cir. 1996), addressed "spin down" authorizations. The Tenth Circuit addressed two other royalty-related issues. *Tulsa Energy, Inc. v. KPL Production, Co.*, 111 F.3d 88 (10th Cir. 1997), discussed the payment of interest accrued on royalties. *James Barlow Family Ltd. Partnership v. David M. Munson, Inc.*, 124 F.3d 1321 (10th Cir. 1997), involved royalty payments on settlement proceeds based on the interpretation of complex mineral leases.

2. 119 F.3d 816 (10th Cir. 1997).

3. 98 F.3d 1222 (10th Cir. 1996).

4. 115 F.3d 785 (10th Cir. 1997).

5. 94 F.3d 1470 (10th Cir. 1996).

6. 115 F.3d 785 (10th Cir. 1997).

7. Richard J. Pierce, Jr., *The Evolution of Natural Gas Regulatory Policy*, 10 NAT. RESOURCES & ENV'T 53, 53 (1995) ("State regulation of interstate transportation of gas created intolerable problems . . . .").

8. *Id.* The Supreme Court reasoned that the dormant commerce clause of the United States Constitution prohibited such state action. *See* Public Util. Comm'n v. Attleboro Steam & Elec. Co., 273 U.S. 83, 90 (1927); Missouri v. Kansas Gas Co., 265 U.S. 298, 308-09 (1924); Pennsylvania v. West Virginia, 262 U.S. 553, 599-600 (1923).

9. Natural Gas Act, 15 U.S.C. §§ 717-717w (1994). The Act applies to the

> transportation of natural gas in interstate commerce, to the sale in interstate commerce of natural gas for resale for ultimate public consumption for domestic, commercial, industrial, or any other use, and to natural-gas companies engaged in such transportation or sale, but shall not apply to any other transportation or sale of natural gas or to the local distribution of natural gas or to the facilities used for such distribution or to the production or gathering of natural gas.

to the Federal Power Commission the authority to set "just and reasonable" rates for the interstate resale of natural gas by pipelines and producers.[10]

Severe gas shortages due to industry regulation in the 1970s spurred Congress to enact the Natural Gas Policy Act of 1978 (NGPA).[11] Under the NGPA, Congress established the Federal Energy Regulatory Commission, giving it the authority to determine price ceilings based on gas price characteristics and the cost of locating and producing gas supplies.[12] In response to the new opportunity to purchase gas, pipelines committed to large take-or-pay clauses in supply contracts.[13] This contractual restructuring between natural gas producers and purchasers created new legal problems involving royalty obligations and take-or-pay contract provisions.[14]

This chronology set the stage for judicial resolution of royalty disputes. In addition, new problems arose with the ownership of coalbed methane and tort-based claims.

II. OWNERSHIP OF COALBED METHANE

A. *Background*

Coalbed methane (CBM) has sparked recent interest and problems.[15] CBM results from the coalification process whereby the carbonaceous matter of plants initially decays to form peat.[16] Subsequently, thousands of years of elevated pressure and temperature metamorphose the peat

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Id. § 717(b).

10. *Id.* § 717c.

11. Natural Gas Policy Act of 1978, Pub. L. No. 95-621, 92 Stat. 3350 (codified in scattered sections of 12 U.S.C.); Richard J. Pierce, Jr., *State Regulation of Natural Gas in a Federally Deregulated Market: The Tragedy of the Commons Revisited*, 73 CORNELL L. REV. 15, 19 (1987) [hereinafter Pierce, *State Regulation*]; *see also* Richard J. Pierce, Jr., *National Gas Regulation, Deregulation, and Contracts*, 68 VA. L. REV. 63, 72 (1981) ("[A] call for deregulation followed the publication of evidence linking regulation to shortages in the interstate gas market [in the 1970s]."). The NGPA functioned as a complicated compromise between gas pipeline operators and gas producers which sought to gradually phase in natural gas deregulation over the following several decades. *See id.* at 85-86.

12. Richard J. Pierce, *Reconsidering the Roles of Regulation and Competition in the Natural Gas Industry*, 97 HARV. L. REV. 345, 348 (1983).

13. Pierce, *State Regulation*, *supra* note 11, at 19.

14. John S. Lowe, *Defining the Royalty Obligation*, 49 SMU L. REV. 223, 226 (1996).

15. *See* Harry Cohen, *Developing and Producing Coalbed Gas: Ownership, Regulation, and Environmental Concerns*, 2 PACE ENVTL. L. REV. 1, 1-3 (1984). *See generally* Nancy P. Regelin, *Coalbed Gas Ownership in Pennsylvania—A Tenuous First Step with* U.S. Steel v. Hoge, 23 DUQ. L. REV. 735, 735 (1985) (commenting that the question of ownership of coalbed gas has only recently arisen). CBM is also known as "firedamp," "coalbed gas," or "coal seam gas." Jeff L. Lewin, *Coalbed Methane: Recent Court Decisions Leave Ownership "Up in the Air," but New Federal and State Legislation Should Facilitate Production*, 96 W. VA. L. REV. 631, 632 (1994).

16. Jeff L. Lewin et al., *Unlocking the Fire: A Proposal for Judicial or Legislative Determination of the Ownership of Coalbed Methane*, 94 W. VA. L. REV. 563, 572 (1992).

into coal and methane.[17] This methane, called CBM, is found within the micropores of coal.[18]

Coal mining releases CBM in two steps. First, CBM detaches from micropores and flows into larger macropores.[19] Second, the gas travels from the macropores through a series of fractures into the mine face.[20] Although most CBM stays within the coal seam, some CBM leaks into the coal strata.[21] Regular mining practices create fractures or fissures in the coal seam, which allows CBM to migrate to areas of relatively low pressure.[22] The CBM collects in these areas, creating the potential for explosions.[23] Obviously, this susceptibility to explosions is a substantial hazard for miners.[24] Deadly explosions caused by CBM occur each year.[25] In the past, miners extracted CBM from the coal mine prior to mining in order to avoid this danger.[26] Today, federal law requires ventilation of mining areas.[27]

For most of the century, the coal mining industry only thought of CBM as a hazard and a nuisance.[28] Even though miners have been suc-

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17. *Id.*

18. Stacy L. Leeds, Southern Ute Indian Tribe v. Amoco Production Company: *Judicial Construction of Coalbed Methane Gas Ownership*, 17 ENERGY L.J. 489, 490 (1996). Technically, methane is located within coal because

> biochemical and bacterial transformation [occurs] during the peat state of coal deposition and subsequently by metamorphic processes as buried peat increases in rank to become coal. Because of the fine pore structure of coal and degraded peat, sorptive capacities of such substance are very large so that much of the methane evolved during coalification is held in the peat and in the coal.

Cohen, *supra* note 15, at 4. CBM and natural gas are compositionally similar, but not identical. While methane is the primary component of each gas, CBM and natural gas can be distinguished due to the presence of other chemical compounds within these two gases. Lewin et al., *supra* note 16, at 572.

19. Lewin et al., *supra* note 16, at 573.

20. *Id.*; Leeds, *supra* note 18, at 490.

21. Lee Davidson, Comment, *Oil and Gas Law: Ownership of Coalbed Methane Gas*, 33 WASHBURN L.J. 911, 913 (1994). The coal seam is the "porous layer where solid rock is located." Leeds, *supra* note 18, at 490 n.10. The coal seam contains millions of tiny pores in which the coal is found. Davidson, *supra*, at 913 n.33.

22. Leeds, *supra* note 18, at 490.

23. Davidson, *supra* note 21, at 914.

24. *See* Lewin, *supra* note 15, at 632.

25. Regelin, *supra* note 15, at 748-49.

26. Cohen, *supra* note 15, at 2.

27. Davidson, *supra* note 21, at 914. "All coal mines shall be ventilated by mechanical ventilation equipment installed and operated in a manner approved by an authorized representative of the Secretary and such equipment shall be examined daily and a record shall be kept of such examination." 30 U.S.C. § 863(a) (1994). Additionally, Alabama requires that:

> Main fans ventilating mines shall be operated continuously, except when the mine is shut down with all power underground cut off and with all men out of the mine. When the fan is started again, the mine shall be examined for gas and other hazards by certified persons and declared safe before underground power may be restored and men other than the examiners permitted to enter the mine.

ALA. CODE § 25-9-80(i) (Michie 1992 & Supp. 1997); *cf.* Regelin, *supra* note 15, at 750 (arguing that ventilation practices waste a valuable energy resource).

28. *See* Lewin et al., *supra* note 16, at 567.

cessfully extracting marketable CBM since the 1930s and 1940s, the demand for CBM was historically low since alternative sources of oil and gas were plentiful and inexpensive.[29] After the energy crisis of the 1970s, however, the energy industry began to consider CBM a valuable and productive resource.[30]

Several factors served as catalysts for increased CBM production: technological advancements enhanced CBM as a viable energy source;[31] federal tax credits given for CBM production increased interest in the resource;[32] and environmental concerns during the 1980s turned more attention to CBM.[33] These catalysts forced advancements in CBM extraction technology[34] and increased CBM production to the point that it now constitutes approximately six percent of the United States' viable gas reserves.[35]

As CBM production became viable, mineral owners began disputing the legal issue of CBM ownership.[36] Problems exist when there is "a diversity of subsurface ownership rights, with one party holding title to the coalbed and another party holding property interest in other subsurface resources such as oil and gas . . . ."[37]

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29. *Id.*

30. *Id.* The energy crisis stimulated interest in CBM as an alternative energy resource. Davidson, *supra* note 21, at 914.

31. *See* Davidson, *supra* note 21, at 914 (suggesting that technological advancements spurred CBM exploration and production). Geological advancement also aided CBM development. Donald F. Santa & Patricia J. Beneke, *Federal Natural Gas Policy and the Energy Policy Act of 1992*, 14 ENERGY L.J. 1, 44 (1993).

32. Davidson, *supra* note 21, at 914-15; *see* Santa & Beneke, *supra* note 31, at 45. CBM qualifies for the nonconventional fuels tax credit under section 29 of the Internal Revenue Code. I.R.C. § 29 (1996). Although the statute does not expressly refer to CBM, the definition of a gaseous product in the coal strata includes CBM. Leeds, *supra* note 18, at 489 n.3.

33. *See* Lewin et al., *supra* note 16, at 583-87.

34. Davidson, *supra* note 21, at 914-15; *see also* Lewin et al., *supra* note 16, at 691 n.11 (listing various conferences held discussing CBM technology). West Virginia has recently welcomed a plan to build a $200 million power plant fueled by CBM. *Governor Announces Power Plant Plan*, (last modified Nov. 18, 1997) <http://www.state.wv.us/governor/Press/power.html>.

35. Leeds, *supra* note 18, at 489. According to the U.S. Department of Energy, the nation's coalbeds may contain as much as 850 trillion cubic feet of available methane. Regelin, *supra* note 15, at 737.

36. *See* Cohen, *supra* note 15, at 3; Leeds, *supra* note 18, at 490. Most oil and gas leases do not provide for ownership of CBM. Santa & Beneke, *supra* note 31, at 45. Most states lack legal guidance on the issue. *Id.* Some leases do contain CBM ownership provisions; however, leases are usually a standard form oil and gas lease which cannot easily be manipulated to include a CBM ownership provision. *See* Harry Cohen, *Leasing of Coalbed Methane Gas Rights—Are Oil and Gas Lease Clauses Analogous?*, 15 CUMB. L. REV. 703, 721-222 (1985). Lawyers are advised to draft CBM leases on an individual basis and to not use standard form oil and gas leases. *Id.* at 722.

37. Leeds, *supra* note 18, at 490. "A person who holds the undivided 'fee simple title' to the surface and to all coal, gas and other mineral rights in a property underlain with gas-bearing coal strata undoubtedly has title to the CBM." Lewin, *supra* note 15, at 636. The ownership problem usually arises when the mineral interests are transferred and the coal rights are severed from the gas rights. *Id.*

In 1981, the Department of the Interior attempted to resolve the ownership issue and accelerate CBM development.[38] The Solicitor of the Department of the Interior wrote a letter to the Secretary of the Interior detailing his legal opinion on the ownership issue.[39] The letter was subsequently promulgated as a Solicitor's Opinion.[40]

The Solicitor concluded that the Coal Lands Acts of 1909 and 1910 did not include CBM in the coal reservation and that the rights to CBM passed to the surface owner when the patent was first issued.[41] In reaching this conclusion, the Solicitor found several factors to be relevant. First, the Solicitor examined the physical characteristics of coal and CBM and found that CBM is separate and distinct from coal because it is a gas and potentially severable from coal.[42] Second, the Solicitor observed that CBM was considered to be a hazardous nuisance as evidenced in the legislative history of the Coal Lands Acts of 1909 and 1910.[43] Next, the Solicitor emphasized that the Uraniferous Lignite Act[44] expressly stated which minerals were subject to a reservation in the United States.[45] Finally, he supported his conclusion by relying on case law based on common law principles that a coal reservation does not include CBM.[46]

Some courts have also addressed the CBM ownership issue, relying on the physical properties of CBM and coal to resolve it.[47] The first case concerning CBM ownership, *United States Steel Corp. v. Hoge*,[48] held that ownership of CBM vested in the owner of the coal.[49] The Pennsylvania Supreme Court emphasized the physical characteristics of the CBM

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38. *See* Southern Ute Indian Tribe v. Amoco Prod. Co., 119 F.3d 816, 829 (10th Cir. 1997).

39. *Id.*

40. *Id.* The letter was promulgated without notice or comment. *Id.*

41. Ownership of and Right to Extract Coalbed Gas in Federal Coal Deposits, 88 Interior Dec. 538, 538 (1981).

42. *Id.* at 540.

43. *Id.* at 541. "When coal was reserved by the United States under the 1909 and 1910 Acts, coalbed gas was viewed not as a valuable resource, but as a nuisance, and an acknowledgement of its hazardous qualities is found in the legislative history of the Act of June 22, 1910." *Id.* The Solicitor relied on the colloquy of Congressmen Stephens and Mondell to determine that the legislative intent of the Acts limited coal ownership to coal, not CBM. *Id.* at 542.

44. 69 Stat. 679 (1955) (codified at 30 U.S.C. §§ 541-541i (1994)).

45. *Id.* at 542-43.

46. *Id.* at 544. However, the Solicitor admitted that the case was not controlling on the issue of federal lands. *Id.*

47. *See* NCNB Texas Nat'l Bank, N.A. v. West, 631 So. 2d 212 (Ala. 1993) (holding that a gas interest reservation includes CBM when the CBM migrates outside the coalbed); Vines v. McKenzie Methane Corp., 619 So. 2d 1305, 1309 (Ala. 1993) (holding that CBM ownership accompanies coal ownership); U.S. Steel Corp. v. Hoge, 468 A.2d 1380, 1383 (Pa. 1983) (holding that the coalbed owner also owns the CBM).

48. 468 A.2d 1380 (Pa. 1983).

49. *U.S. Steel*, 468 A.2d at 1383.

by specifying that the coal owner owns the CBM if it is still located within the coal seam.[50]

B. Southern Ute Indian Tribe v. Amoco Production Co.[51]

1. Facts

Between 1874 and 1880, the entire Southern Ute Indian Reservation ceded to the United States due to the discovery of mineral resources on the land.[52] The land was then opened up to homesteading and mineral exploration.[53] In 1906, President Roosevelt withdrew 64 million acres from homesteading to promote federal government interests in coal.[54] To counteract the homesteading problems, Congress enacted the Coal Lands Acts of 1909[55] and 1910[56] which allowed homesteaders to obtain patents for land subject only to a reservation of coal.[57] In 1934, Congress passed the Indian Reorganization Act,[58] which restored the tribal lands back to the Southern Ute Indian Tribe, including equitable title to the coal, subject to outstanding homestead patents.[59]

In recent decades, Amoco, the owner of oil and gas leases on the reservation lands, explored and extracted CBM from coal owned by the Southern Ute Indian Tribe (Tribe).[60] However, the Tribe claimed ownership of the CBM since it held legal title to the coal.[61] As owner of the coal, the Tribe sued, alleging that Amoco trespassed on tribal lands and coal, failed to pay a severance tax to the Tribe, and deprived the Tribe of rights in violation of 42 U.S.C. § 1983.[62] The Tribe sought remedies including a declaratory judgment giving the Tribe CBM ownership and

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50. *Id.*

51. 119 F.3d 816 (10th Cir. 1997).

52. *Southern Ute Indian Tribe*, 119 F.3d at 824.

53. *Id.*

54. *Id.* at 825.

55. 30 U.S.C. § 81 (1994). The relevant portion of the Act states:

> [A]ny person . . . may . . . upon making satisfactory proof of compliance with the laws under which such lands are claimed, receive a patent therefore, which shall contain a reservation to the United States of all coal in said lands, and the right to prospect for, mine, and remove the same.

Id.

56. 30 U.S.C. § 85 (1994). The relevant portion of the Act states:

> [U]pon satisfactory proof of full compliance with the provisions of the laws under which entry is made, and of sections 83 to 85 of this title, the entryman shall be entitled to a patent to the land entered by him, which patent shall contain a reservation to the United States of all the coal in the lands so patented, together with the right to prospect for, mine, and remove the same.

Id.

57. *Southern Ute Indian Tribe*, 119 F.3d at 825.

58. 48 Stat. 984 (1934) (codified as amended at 25 U.S.C. §§ 461-479 (1994)).

59. *Id.* However, the land was actually returned to the Indians in 1938. *Id.*

60. *Id.* at 819.

61. *Id.*

62. *Id.*

requiring tribal consent for CBM extraction.[63] In addition, the Tribe sought an order quieting title to the CBM, injunctive relief to halt CBM extraction, damages for injuries to coal, title to all exploration and production facilities on tribal lands, and costs and attorney's fees.[64] The Tribe also sued several federal defendants for breach of fiduciary duty as trustees for the Tribe.[65]

The district court held that CBM ownership rested with Amoco and granted summary judgment for the federal defendants on the breach of fiduciary duty claim.[66] The court did not address the Tribe's other claims since it found that Amoco owned the CBM.[67] The Tribe appealed.[68]

2. Decision

The Tenth Circuit reversed the district court and held that the Tribe owned the CBM.[69] The court identified the issue upon appeal as whether the Tribe, as owner of the coal, also owned the CBM.[70] The court first turned to the acts of 1909 and 1910 to determine whether Congress intended to include or exclude CBM from the statutory reservation of coal.[71] The court found no specific congressional intent to include CBM as part of coal because the plain meaning of the statutes did not define coal nor indicate a congressional intent to include CBM as part of coal.[72] CBM could not economically or efficiently be extracted from coal in 1909, and therefore, Congress was unaware of the CBM's value.[73] The court did find, however, that Congress had a broad general intent to reserve all coal with present and future economic value to the United

63. *Id.*

64. *Id.*

65. *Id.* The federal defendants included the Secretary of the Interior and the Department of the Interior's subordinate agencies. *Id.*

66. Southern Ute Indian Tribe v. Amoco Prod. Co., 874 F. Supp. 1142, 1161 (D. Colo. 1995).

67. *Id.*

68. *Southern Ute Indian Tribe*, 119 F.3d at 820.

69. *Id.* at 836.

70. *Id.* at 820.

71. *Id.* at 821.

72. *Id.* at 824. Amoco argued that Congress's use of the word "coal" specifically referred only to solid coal. Answer Brief for Amoco at 15, *Southern Ute Indian Tribe* (No. 94-1579).

73. *Southern Ute Indian Tribe*, 119 F.3d at 823 n.11. In 1909, coal degasification was possible but it required the extraction and destruction of the coal to obtain the coalbed methane gas. *Id.* In contrast, CBM drilling "for the first time allows CBM to be released from coal without bringing large volumes of coal to the surface. The technique is typically employed where the coal . . . cannot economically be mined." *Id.*

States.[74] Congress realized that "full economic realization of that benefit would require advances in technology."[75]

Amoco argued that the 1981 Solicitor's Opinion, which construed the meaning of coal within the Acts of 1909 and 1910 to exclude CBM, was controlling and should be given great deference.[76] The court, however, considered the Solicitor's Opinion to be arbitrary.[77] Accordingly, the court found that the general congressional intent behind the statutes governed this issue.[78] Therefore, the court held that coal ownership included CBM, which rested with the Tribe.[79] The Tenth Circuit reversed the district court's decision and remanded the case for further proceedings on the remaining issues.[80]

Amoco petitioned the Tenth Circuit for a rehearing en banc.[81] Amoco alleged that the three-judge panel failed to consider the meaning of "coal" and analyzed CBM *in situ* rather than at the wellhead.[82] Amoco claimed that the Tenth Circuit also ignored historic treatment of mineral reservations and erroneously refused to consider how CBM is treated under the Mineral Leasing Act.[83]

The Tribe contended that established statutory canons of construction required the court to resolve any ambiguities in favor of the government since the acts do not expressly convey CBM.[84] The Tribe also argued that since the only way to mine CBM in 1909 was through coal mining, "Congress would not have granted CBM to agricultural entry-

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74. *Id.* at 826. The court followed the Tribe's argument that Congress adopted a "broader view" that accounted for future technological advancements that would expand CBM uses. Brief of Southern Ute Indian Tribe at 33, *Southern Ute Indian Tribe* (No. 94-1579). Amoco argued that Congress chose a very narrow interpretation of coal. *Southern Ute Indian Tribe*, 119 F.3d at 825.

75. *Southern Ute Indian Tribe*, 119 F.3d at 828. "Courts have consistently construed mineral reservations in favor of the United States." *Id.*

76. *Id.* at 829. The opinion was entitled Ownership of and Right to Extract Coalbed Gas in Federal Coal Deposits, 88 Interior Dec. 538 (1981). *Id.*

77. *Id.* at 835-36. "An agency decision which is not reasoned persuades no more than it controls." *Id.* at 835.

78. *Id.* at 836.

79. *Id.*

80. *Id.*

81. Amoco's Petition for Rehearing and Suggestion for Rehearing En Banc, *Southern Ute Indian Tribe* (No. 94-1579).

82. *Id.* at 3. *In situ* means "not at the surface." *Id.* at 9. Amoco argued that since Congress used the word "coal" instead of "gas" in the acts, Congress intended "coal" to mean solid rock. *Id.* at 4.

83. *Id.* at 11, 15-16. The Mineral Leasing Act of 1920, 41 Stat. 437 (codified as amended at 30 U.S.C. §§ 181-287 (1994)). The Mineral Leasing Act construed with the acts of 1909 and 1910 would have, according to Amoco, compelled the court to consider "coal" to be solid rock. *Id.* at 15-16.

84. Tribe's Supplemental Brief Rehearing En Banc at 7, *Southern Ute Indian Tribe* (No. 94-1579).

men . . . ."[85] Moreover, since the 1909 and 1910 acts reserved "all the coal in the lands," Congress expressly retained ownership of all undiscovered coal.[86]

The Tenth Circuit granted Amoco's petition for a rehearing en banc, hearing oral arguments on March 17, 1998. The court reheard only the issue of whether "coal" included CBM under the acts of 1909 and 1910.[87]

3. Postscript: Rehearing En Banc

The Tenth Circuit, in its opinion issued on July 20, 1998, affirmed its decision granting the Tribe ownership of the CBM.[88] The court emphasized again that "ambiguity or uncertainty in the terms employed [in land grants] should be resolved in favor of the government."[89] The court restated, almost verbatim, its analysis of the plain meaning of the statutes and general congressional intent.[90]

The court expanded its previous analysis of specific congressional intent by emphasizing that on the face of the statutes, the coal was reserved for subsequent mining and removal.[91] The court concluded that the existence of alternative dictionary definitions created an ambiguity in the statutes.[92] In response to the dissent and Amoco's reliance on the fact that Congress created split mineral estates on public lands by the 1909 Act, the court relied on the Pennsylvania Supreme Court's seminal decision in *United States Steel v. Hoge*,[93] which held that the CBM contained within coal belonged to the owner of the coal estate, rather than the natural gas owner.[94] Therefore, Congress lacked the specific intent to exclude CBM from its reservations of coal.

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85. *Id.* at 15. The only way to extract CBM was through coal mining. *Id.* The right to mine also included the right to vent CBM. *Id.* at 16. Therefore, CBM ownership vested with coal ownership. *Id.*

86. *Id.* at 28. The common dictionaries and encyclopedias of the early 1900s indicate that coal contained gaseous components now called CBM. *Id.* at 29.

87. Order, *Southern Ute Indian Tribe* (No. 94-1579) (order granting rehearing en banc). The court declined to rehear argument concerning the Solicitor's Opinion.

88. Southern Ute Indian Tribe v. Amoco Prod. Co., No. 94-1759, 1998 WL 404549 (10th Cir. July 20, 1998).

89. *Id.* (quoting Burke v. Southern Pac. R.R. Co., 234 U.S. 669, 680 (1914)).

90. *Id.* at *4, *10-14.

91. *Id.* at *5.

92. *Id.* at *5-6. The court stated that

> Amoco and the dissent focus solely on the word "coal" and totally ignore what is apparent from the face of the statutes: the coal was reserved from patents issued to land claimants under the land grants of "non-mineral" lands to homesteaders; the lands had been "classified, claimed, or reported as being valuable for coal;" and the reservation of coal included "the right to prospect for, mine, and remove the same."

Id.

93. 468 A.2d 1380 (Pa. 1983).

94. *Southern Ute Indian Tribe*, 1998 WL 404549, at *8-9.

C. *Analysis*

The analysis of both the Tenth Circuit and district court centered on the definitions of coal and CBM.[95] However, the Tenth Circuit arrived at the opposite conclusion than the district court while using similar references, such as dictionaries, encyclopedias, and legislative history.[96] The district court felt that the Coal Lands Acts of 1909 and 1910 were unambiguous because Congress only intended to reserve solid rock coal exclusive of the CBM retained within the coal.[97] In contrast, the Tenth Circuit determined that the exclusion of the words "coalbed methane" from the acts created an ambiguity in the statutes because no evidence existed that Congress intended the gas owners to also own CBM, an inherent constituent of coal.[98] The existence of alternative definitions of coal and CBM also created an ambiguity in the statutes.[99]

The Tenth Circuit continued the analysis by applying the canon of statutory construction that "ambiguity or uncertainty in the terms employed [in land grants] should be reserved in favor of the government."[100] The Tenth Circuit's decision hinged on its interpretation of coal and the legislative history indicating that Congress reserved all constituents of coal, including CBM, when it reserved "all the coal" to the United States with an eye toward the future economic value of CBM and advancements in extraction technology.[101]

The Tenth Circuit's decision that a coal reservation includes CBM is not unusual. The Tenth Circuit followed other jurisdictions resolving the CBM ownership issue in favor of the coal owner by focusing on the physical characteristics of CBM and coal.[102] In its analysis of specific

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95. *See* Southern Ute Indian Tribe v. Amoco Prod. Co., 119 F.3d 816, 822-23 (10th Cir. 1997); Southern Ute Indian Tribe v. Amoco Prod. Co., 874 F. Supp. 1142, 1153 (D. Colo. 1995).

96. *See Southern Ute Indian Tribe*, 119 F.3d at 822-23; *cf. Southern Ute Indian Tribe*, 874 F. Supp. at 1153 (deciding that the Congress intended the coal to mean "solid rock fuel").

97. *Southern Ute Indian Tribe*, 874 F. Supp. at 1153.

98. *Southern Ute Indian Tribe*, 119 F.3d at 822. "[CBM] is not sufficiently like other natural gases for us to conclude that Congress unambiguously intended the owners of other natural gases to also own CBM associated with the reserved coal." *Id.*

99. *Southern Ute Indian Tribe*, 1998 WL 404549, at *5-6.

100. *Southern Ute Indian Tribe*, 119 F.3d at 821 (quoting Burke v. Southern Pac. R.R., 234 U.S. 669, 680 (1914)).

101. *Id.* at 826. The court stated:

> Rather than indicating a limited reservation of coal to the United States, the legislative history suggests that Congress adopted an interpretation of coal which encompassed both the present and future economic value of coal, including value that could only be realized through advances in technology such as those which drive the present day exploration for CBM.

Id.

102. *Southern Ute Indian Tribe*, 1998 WL 404549, at *9; *see* NCNB Texas Nat'l Bank, N.A. v. West, 631 So. 2d 212, 221 (Ala. 1993) (holding that the coal owner owns CBM contained in coal but the gas owner owns migrated CBM); Vines v. McKenzie Methane Corp., 619 So. 2d 1305, 1309 (Ala. 1993) (finding that coal ownership extends to CBM); United States Steel Corp. v. Hoge, 468 A.2d 1380, 1383 (Pa. 1983) (deciding that CBM ownership vested in the coal owner).

congressional intent, the court emphasized that extraction methods did not exist in 1909 and that CBM, an essential component of coal, was trapped within coal.[103] Although the court in its decision declined to follow these cases because the *Southern Ute* case involved a statutory analysis rather than a common law analysis, the court relied on these cases in its rehearing en banc and appropriately focused more on the physical properties and difficult extraction methods of CBM as justification for its holding that the coal owner also owned the CBM contained within the coal.[104]

Although the Tenth Circuit took a positive step toward resolving the CBM ownership issue, legal uncertainty still remains because the decision is highly fact specific and will only be applicable in situations involving the Coal Lands Acts of 1909 and 1910.[105] Lawyers and regulatory agencies will continue to struggle with the problematic application of existing oil and gas laws to CBM ownership, exploration, extraction, and production.[106] Due to varying physical conditions, oil and gas statutes do not apply to CBM, magnifying the need for specific regulation of CBM ownership through legislation.[107]

III. ROYALTY PAYMENTS FROM SETTLEMENT PROCEEDS

A. *Background*

During the 1970s and 1980s, gas purchasers frequently entered into long-term contracts including "take-or-pay" clauses with gas producers.[108] These clauses gave gas purchasers two options. The gas purchaser could take a specific quantity of gas at the maximum lawful price during each contract year,[109] or the gas purchaser could also make one annual payment to the gas producer if the quantity of gas taken fell below the minimum

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103. *Southern Ute Indian Tribe*, 119 F.2d at 823. The court stated:

> It is not reasonable to impute to Congress a desire to retain only solid rock coal constituents and to convey gaseous coal constituents when CBM is an integral component of coal and in 1909 there appears to have been no technology by which a patent holder could extract CBM from coal without damaging or destroying the coal.

Id.

104. Southern Ute Indian Tribe v. Amoco Prod. Co., No. 94-1759, 1998 WL 404549, at *8-9 (10th Cir. July 20, 1998). *Cf. Southern Ute Indian Tribe*, 119 F.3d at 828 n.17.

105. Leeds, *supra* note 18, at 500.

106. Cohen, *supra* note 15, at 15.

107. *Id.* at 15-16. Oil and gas conservation statutes prevent the loss of "oil and gas by inefficient production." *Id.* at 17. However, CBM, will not be lost if owners do not compete for it, because it must be stimulated before it can be removed. *Id.*

108. Beverly M. Barrett, Note, *Oil and Gas:* Roye Realty v. Watson*: Are Royalties Owed on all Take-or-Pay Settlements in Oklahoma?*, 46 OKLA. L. REV. 745, 745 (1993).

109. Diamond Shamrock Exploration Co. v. Hodel, 853 F.2d 1159, 1164 (5th Cir. 1988). Take-or-pay clauses required the gas purchaser to make minimum payments even if no gas was taken. Barrett, *supra* note 108, at 745.

annual contractual quantity.[110] Take-or-pay clauses "apportion the risks of natural gas production and sales between the buyer and seller."[111] Since the gas producer bore the risk of production, the gas purchaser compensated by agreeing to take a minimum quantity of gas.[112] Gas pipelines, as purchasers, also benefited from take-or-pay contracts.[113]

During the energy crisis of the 1970s, take-or-pay payments became substitutes for price competition.[114] Severe gas shortages compelled Congress to enact the National Gas Policy Act of 1978 (NGPA), which required the Federal Energy Regulatory Commission to regulate gas through classifications.[115] When the NGPA prevented gas producers from competing for prices, gas producers turned to take-or-pay clauses for protection against demand fluctuations.[116] The percentage of contracts containing take-or-pay clauses increased from twenty-five percent in the early 1970s to as much as ninety percent at the apex of the gas market.[117] When gas demand declined in the 1980s, gas purchasers found themselves saddled with enormous take-or-pay liabilities, frequently greater than their net worth.[118] Purchasers defaulted on their take-or-pay agreements, spurring enormous amounts of litigation.[119] Purchasers' potential

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110. *Diamond Shamrock Exploration Co.*, 853 F.2d at 1164. The gas purchaser can also take the oil or gas already paid for in the following years. Charles E. Harrell et al., *Securitization of Oil, Gas, and Other Natural Resource Assets: Emerging Financing Techniques*, 52 BUS. LAW. 885, 894 n.30 (1997).

111. *Diamond Shamrock Exploration Co.*, 853 F.2d at 1167 (citing Universal Resources Corp. v. Panhandle Eastern Pipe Line Co., 813 F.2d 77, 80 (5th Cir. 1987)).

112. *Id.* "[T]ake-or-pay payments are payments for the pipeline-purchaser's failure to purchase (take) gas." *Id.* (citing Pennzoil Co. v. State, No. 104-35 (Wyo. Dist. Ct. Mar. 20, 1986), *aff'd*, State v. Pennzoil, 752 P.2d 975 (Wyo. 1995)).

113. *See* Angela Jeanne Crowder, Comment, *Take-or-Pay Payments and Settlements—Does the Landowner Share?*, 49 LA. L. REV. 921, 922 (1989) ("Since gas cannot be stored, the pipelines could now take only the amounts needed and, rather than face breaching the contracts when the market demand was low, simply pay for the remaining amounts not taken.").

114. *See* Lowe, *supra* note 14, at 263 n.269 ("[I]n the 1970s . . . pipeline companies used high take-or-pay commitments as substitutes for price competition, which was barred by the federal gas regulatory scheme."); Joseph P. Tomain, *Energy Policy Advice for the New Administration*, 46 WASH. & LEE L. REV. 63, 73-74 (1989) (discussing how the effects of the oil embargo, regulation, and gas shortages in the mid-1970s encouraged oil producers and purchasers to enter into take-or-pay contracts).

115. Pierce, *supra* note 7, at 54. The categories pertain to "certain characteristics of gas supplies and the costs of producing those supplies," which FERC used to determine price ceilings. Pierce, *supra* note 12, at 348.

116. Lowe, *supra* note 14, at 227; *see also* Pierce, *supra* note 7, at 55.

117. *See* Lowe, *supra* note 14, at 227. FERC estimated that gas purchasers' take-or-pay agreements accrued between $7 and $10 billion by 1984. William H. White, *The Right to Recover Royalties on Natural Gas Take-or-Pay Settlements*, 41 OKLA. L. REV. 663, 664 (1988).

118. Lowe, *supra* note 14, at 227. Pipelines suffered losses in the form of "payments for gas not taken, above-market payments for gas that was taken, or payments to settle contract disputes." J. Gregory Sidak & Daniel F. Spulber, *Givings, Takings, and the Fallacy of Forward-Looking Costs*, 72 N.Y.U. L. REV. 1068, 1122 (1997).

119. Lowe, *supra* note 14, at 227 ("When gas demand . . . declined sharply in the early 1980s, the gas boom became a litigation boom as gas pipelines defaulted on their take-or-pay obligations . .

liability ranged from sixty to seventy billion dollars and settlement costs ranged from twelve to fifteen billion dollars.[120] The lawsuits and settlements between gas producers and purchasers sparked a new surge of litigation over whether royalty owners were entitled to a share of the producers' settlement awards.[121]

Most jurisdictions do not allow royalties for take-or-pay payments or settlements unless the payment is for gas actually produced. The Fifth Circuit in *Diamond Shamrock Exploration Co. v. Hodel*[122] held that royalties were not due on take-or-pay payments, reasoning that no gas was produced at the time a payment was made.[123] Royalties are due only when gas was produced, and production means "the actual physical severance of minerals from the formation."[124]

A minority of jurisdictions apply the "cooperative venture" theory, allowing royalties for take-or-pay payments even without the actual production of gas.[125] In *Frey v. Amoco Production Co.*,[126] the Louisiana Supreme Court applied the cooperative venture analysis.[127] The court looked at the general intent of the parties when entering into the lease, equitable principles, and economic realities of the industry.[128] If the lease was silent

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. ."). Some take-or-pay agreements allow for time to "make up" the gas not taken. White, *supra* note 117, at 663. However, if the purchaser does not take the gas within the scheduled "make up" period, the purchaser may be liable to the seller for the costs. *Id.*

120. Lowe, *supra* note 14, at 227. FERC promoted settlements by encouraging producers to offer credits against take-or-pay claims. John S. Lowe, *Current Lease and Royalty Problems in the Gas Industry*, 23 TULSA L.J. 547, 560-61 (1988) [hereinafter Lowe, *Current Lease*].

121. White, *supra* note 117, at 663-64. A royalty is the "landowner's share of production, free of expenses of production." Richard F. Brown, *Oil, Gas and Mineral Law*, 50 SMU L. REV. 1371, 1376 (1997). As one commentator stated, "royalty owners are increasingly more sophisticated and cognizant of their rights and lately have become much more litigious." Si M. Bondurant, *Royalty Owner Rights Under Division Orders*, 25 TULSA L.J. 571, 571 (1990). Another commentator suggests that courts usually do not experience problems with enforcing the terms of take-or-pay contracts as a matter of law. John Burritt McArthur, *A Twelve-Step Program for COPAS to Strengthen Oil and Gas Accounting Protections*, 49 SMU L. REV. 1447, 1455 n.9 (1996).

122. 853 F.2d 1159 (5th Cir. 1988).

123. *Diamond Shamrock*, 853 F.2d at 1164. The court held that the value of production is indeterminable until gas is taken. *Id.* at 1166-67.

124. *Id.* at 1168. "Production requires severance of the mineral from the ground." State v. Pennzoil Co., 752 P.2d 975, 979 (Wyo. 1988).

125. *See* Barrett, *supra* note 108, at 750-52. A "cooperative venture" requires the lessor to contribute the land and the lessee to contribute the expertise and capital to develop minerals for the parties mutual benefit. Crowder, *supra* note 113, at 928-29. The lease is merely a "bargained-for exchange." Patricia A. Brown, Klein v. Jones*: Equitable Right to Royalties on Take-or-Pay Settlements*, 47 ARK. L. REV. 749, 775 (1994). The cooperative venture theory is an extension of the "Harrell rule," which characterizes a gas lease as a mutually beneficial relationship between lessor and lessee. Harvey E. Yates Co. v. Powell, 98 F.3d 1222, 1231 (10th Cir. 1996). Professor Thomas Harrell coined the terms "Harrell rule" and "cooperative venture." Lowe, *supra* note 14, at 241-42.

126. 603 So. 2d 166 (La. 1992).

127. *Frey*, 603 So. 2d at 173. The court's use of the cooperative venture theory was based on unusual state statutes that could be interpreted to expand royalty obligations based on unjust enrichment. Lowe, *supra* note 14, at 257.

128. *See* Brown, *supra* note 125, at 772-73; Lowe, *supra* note 14, at 240-41; Barrett, *supra* note 108, at 750-51.

on the production of gas as a prerequisite to royalty payments on take-or-pay agreements, the court did not require actual production if such an intent could not be found in the lease negotiations or related extrinsic documents.[129] Despite the Louisiana Supreme Court's rationale, the Tenth Circuit declined to apply the cooperative venture approach and required the actual production of gas for royalties on take-or-pay payments.[130]

B. *Tenth Circuit Decisions*

1. *Harvey E. Yates Co. v. Powell*[131]

a. *Facts*

The New Mexico State Land Office issued oil and gas leases in state lands held in trust for various beneficiaries, including educational institutions.[132] Harvey E. Yates Co. (HEYCO) produced natural gas under many of these leases.[133] HEYCO entered thirty-five gas supply contracts with two pipeline companies, El Paso Natural Gas Company and Transwestern Pipeline Company.[134] The contracts included take-or-pay clauses which later became impractical as the natural gas market price dropped.[135] HEYCO settled with the two pipeline companies, but failed to pay the state royalties for settlement payments as required by New Mexico law.[136] However, HEYCO did pay royalties on gas produced after the settlements.[137]

HEYCO and the New Mexico Oil and Gas Association (NMOGA) filed a declaratory judgment action in district court against the Commissioner of Public Lands (Commissioner) to invalidate a New Mexico State Land Office regulation governing royalty payments and calculations for oil and gas leases.[138] The Commissioner filed a counterclaim in federal district court for royalty payments and damages based on HEYCO's settlements.[139] The court granted summary judgment for HEYCO on all of the Commissioner's counterclaims, determining that royalty payments

129. *See* Lowe, *supra* note 14, at 240-41.

130. Harvey E. Yates Co. v. Powell, 98 F.3d 1222, 1231-32 (10th Cir. 1996).

131. 98 F.3d 1222 (10th Cir. 1996).

132. *Harvey E. Yates Co.*, 98 F.3d at 1226.

133. *Id.* at 1227.

134. *Id.* Thirty-three of these contracts were with the El Paso Natural Gas Company and two with the Transwestern Pipeline Company. *Id.*

135. *Id.*

136. *Id.* at 1227-28.

137. *Id.* For example, HEYCO paid royalties to the state on gas produced at lower spot market prices following the Transwestern settlement. *Id.*

138. *Id.* at 1226. The case refers to the regulation as "Rule 1.059." *Id.*

139. *Id.*

were not due on the settlement proceeds.[140] The Commissioner appealed.[141]

b. *Decision*

The Tenth Circuit reversed the summary judgment in favor of HEYCO.[142] First, the court addressed whether HEYCO breached its duty to pay the state royalties on the settlement proceeds.[143] Under the plain meaning of the New Mexico statute governing oil and gas leases, the court determined that the lessee was only obligated to pay royalties on gas actually produced.[144]

The court developed a three-part framework to determine whether royalties are due on cash settlement payments from the various types of leases containing take-or-pay clauses.[145] First, the gas must be physically extracted from the ground before royalty payments are due on a production-type lease.[146] Second, cash settlements for a take-or-pay lease contract are not royalty-bearing.[147] Third, the lessee must pay the lessor royalties on a buy-down portion of a settlement payment that is a buy-down of the contract price for gas at the time of production.[148]

The court used this framework to reject the Commissioner's argument that the lease should be broadly construed with emphasis placed on the intent of the parties when entering into the lease contract.[149] The court also rejected the Commissioner's reliance on cases applying the "cooperative venture" approach to require royalty payments on take-or-pay settlement proceeds.[150] Unlike the cases on which the Commissioner relied, the New Mexico statute did not broadly define royalty payments

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140. *Id.*

141. *Id.*

142. *Id.* at 1241.

143. *Id.* at 1229. "Although the terms of the New Mexico oil and gas lease are prescribed by statute, the lease itself is a contract between the State as lessor on the one hand and HEYCO as lessee on the other." *Id.* at 1229-30.

144. *Id.* at 1230. The statute states:

> Subject to the free use without royalty, as hereinbefore provided, at the option of the lessor at any time and from time to time, the lessee shall pay the lessor as royalty one-eighth part of the gas produced and saved from the leased premises, including casing-head gas. Unless said option is exercised by lessor, the lessee shall pay the lessor as royalty one-eighth of the cash value of the gas, including casing-head gas, produced and saved from the leased premises and marketed or utilized, such value to be equal to the net proceeds derived from the sale of such gas in the field . . . .

N.M. STAT. ANN. § 19-10-4.1 (Michie 1978 and Repl. 1994).

145. *Harvey E. Yates Co.*, 98 F.3d at 1231 (citing Mandell v. Hamman Oil & Ref. Co., 822 S.W.2d 153, 164 (Tex. Ct. App. 1991); Killam Oil Co. v. Bruni, 806 S.W.2d 264, 268 (Tex. Ct. App. 1991)).

146. *Id.*

147. *Id.*

148. *Id.* The amount must reflect a "fair apportionment of the price adjustment payment over the purchases affected by such price adjustment." *Id.*

149. *Id.*

150. *Id.* at 1231-32.

and specifically linked royalty payments with gas production.[151] The court concluded that HEYCO did not owe royalty payments to the state unless gas was actually produced.[152]

Next, the court addressed whether HEYCO's settlement proceeds from El Paso and Transwestern were paid for gas production.[153] The payment of royalties depended on whether the proceeds were ascribed to take-or-pay deficiencies based on non-production or whether the proceeds were ascribed to price adjustments to be obtained in the future.[154] The court believed a genuine issue of material fact existed because the record was unclear and, therefore, remanded the case to the district court.[155]

2. *Watts v. Atlantic Richfield Co.*[156]

a. *Facts*

Several lessors of oil and gas interests (Lessors) sued Atlantic Richfield Company (ARCO) for failure to pay royalties on settlement proceeds.[157] ARCO received $300 million in recoupable payments from a settlement with a gas pipeline purchaser.[158] ARCO paid the lessors royalties on gas produced but not from the settlement proceeds.[159] The district court granted summary judgment in favor of ARCO, reasoning that ARCO's lease did not include royalty payments for settlement proceeds and the proceeds were not attributable to gas production.[160]

b. *Decision*

The Tenth Circuit addressed ARCO's duty to pay royalties.[161] These "production-type" leases only required royalty payments when gas was

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151. *Id.* at 1233 (discussing the fact that under New Mexico state law, royalties are specifically linked to gas which is produced on the leased premises). The cases cited by the Commissioner, *Frey v. Amoco Production Co.*, 603 So. 2d 166 (La. 1992), and *Klein v. Jones*, 980 F.2d 521 (8th Cir. 1992), involved constructively different statutes which did not explicitly link royalties to gas production. *Harvey E. Yates Co.*, 98 F.3d at 1233-34.

152. *Harvey E. Yates Co.*, 98 F.3d. at 1234-35.

153. *Id.* at 1235.

154. *Id.*

155. *Id.*

156. 115 F.3d 785 (10th Cir. 1997).

157. *Watts*, 115 F.3d at 789. Lessors also filed a claim, not discussed in this survey, against ARCO for failure to obtain the best price available. *Id.*

158. *Id.* The gas pipeline producer in this case, Arkla, bought gas from ARCO produced at the Wharton Field. *Id.* at 788. Litigation between ARCO and Arkla subsequently arose over Arkla's refusal to purchase gas produced at the Wharton Field, resulting in the $300 million recoupable payments. *Id.* at 788-89.

159. *Id.*

160. *Id.* at 788-89, 790.

161. *Id.*

actually produced.[162] The court determined that the district court erred in deciding that royalties were not due because payment of settlement proceeds were not included in the lease.[163] The court reasoned that the settlement proceeds must have been expressly excluded from the leases.[164] Consequently, settlement proceeds are technically for gas produced and sold.[165]

In addition, the court addressed whether the settlement proceeds were attributable to actual production.[166] The court relied on its prior decision in *Harvey E. Yates Co.* to resolve this issue.[167] However, a genuine issue of material fact existed as to whether the non-cash settlement proceeds constituted payment for produced gas.[168] The court reversed the grant of summary judgment in favor of ARCO and remanded the issue to the district court.[169]

C. *Other Circuits*

The Sixth Circuit in *United States v. Century Offshore Management Corp.*[170] faced a similar issue of whether settlement payments were royalty-bearing.[171] Century Offshore Management Corp. (Century), a natural gas producer, leased federally-owned land, subject to royalties.[172] Century contracted with Enron for the sale of gas.[173] Enron paid Century a lump sum to terminate the contracts containing take-or-pay provisions and replace them with new contracts.[174] Century failed to pay the government royalties on the lump sum payment.[175]

The court interpreted *Diamond Shamrock* to require some nexus with production and determined that the replacement contracts provided the necessary nexus between payment and production.[176] The court reasoned that the lump sum payment constituted an advance payment for

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162. *Id.* at 791. "Under the plain terms of these so-called 'production-type' leases, the lessee is not obligated to pay a royalty on the value of gas in the abstract, but only on the cash value of gas that is actually produced and sold from the leased property." *Id.* (citing Harvey E. Yates Co. v. Powell, 98 F.3d 1222, 1230 (10th Cir. 1996)).

163. *Id.*

164. *Id.*

165. *Id.* (citing *Harvey E. Yates Co.*, 98 F.3d at 1231).

166. *Id.*

167. *Id.* at 790.

168. *Id.* at 794 ("Although the district court concluded that none of the settlement proceeds were related to the production of gas, the record does not allow us to rule out such a finding. We, therefore, reverse . . . [and] remand to the district court for further proceedings on this question.").

169. *Id.*

170. 111 F.3d 433 (6th Cir. 1997).

171. *Century*, 111 F.3d at 443.

172. *Id.* at 445.

173. *Id.* at 446.

174. *Id.* at 447.

175. *Id.*

176. *Id.* at 449-50. "Though this gas was not make-up gas, it is analogous to make-up gas in the sense that though it is paid after the payment at issue, it provides a link to production." *Id.* at 450.

production sold; therefore, the lessee must pay royalties on the lump sum payment when the gas was produced.[177]

D. *Analysis*

The Tenth Circuit has developed into what some commentators call a "plain terms" jurisdiction.[178] The court will not look at the intent of the parties or other extrinsic evidence when interpreting a lease.[179] Instead, the court will look only at the plain language in the lease without considering the parties' intent or relationship.[180] Therefore, parties should carefully draft the lease to incorporate provisions for royalty payments on take-or-pay payments or settlements.[181]

The Sixth Circuit, like the Tenth Circuit, appears to be a plain terms jurisdiction requiring gas to be produced before royalties were due.[182] However, the Sixth Circuit seemed to allow a broader interpretation of production since no gas was actually produced at the time the lump sum was paid in *Century*.[183]

IV. TORTIOUS INTERFERENCE WITH OIL LEASES

A. *Background*

Oil and gas production may interfere with the oil producing capabilities of neighboring mineral leases through the use of water flood

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177. *Id.*

178. *See* Lowe, *supra* note 14, at 244. A plain terms jurisdiction defines the royalty obligation by only looking at the plain terms of the royalty clause. *Id.* One commentator contends that most courts will eventually adopt the cooperative venture approach for three reasons. *Id.* at 251-52. First, analyzing a lease as a cooperative venture is realistic because the presence, quantity, and production of minerals is uncertain. *Id.* at 252. Second, the plain terms of a lease are only helpful in the field, not to the parties. *Id.* Third, royalty has historically been payable in kind upon production. *Id.* at 252-53.

179. *Id.* at 244.

180. *Id.* According to one commentator, royalty owners are more likely to win in cooperative venture jurisdictions than in plain term jurisdictions. *Id.* at 254.

181. James E. Prince, Note, *Production, Production, What is Production?:* Diamond Shamrock v. Hodel, 1989 BYU L. REV. 1333, 1350. Royalty payments due to lessors depend largely on the terms of the royalty clause in the oil and gas lease. Arthur J. Wright & Carla J. Sharpe, *Direct Gas Sales: Royalty Problems for the Producer*, 46 OKLA. L. REV. 235, 236 (1993). Private lease holders should draft leases according to their own terms. *Id.* Parties should negotiate lease terms and expressly include the negotiation results in the lease. *See* Crowder, *supra* note 113, at 929. The parties should delete any offending clauses. *See* Bondurant, *supra* note 121, at 599. The interests of the lessee and lessor should coincide in the royalty clause, ensuring clarity. David E. Pierce, *Incorporating a Century of Oil and Gas Jurisprudence into the "Modern" Oil and Gas Lease*, 33 WASHBURN L.J. 786, 830 (1994).

182. *See Century*, 111 F.3d at 449.

183. *Id.*

projects and the drainage of oil and gas from one lease to another.[184] Such damage to production may constitute a tortious act.[185]

Lessees engaging in oil production enhancement techniques, such as subsurface fluid injection and hydraulic fracturing, which damage neighboring production, may be liable under various tort theories, such as subsurface trespass and private nuisance.[186] A typical injection method involves "pumping salt water (or other fluid) into an injection well as part of an enhancement recovery operation to 'sweep' hydrocarbons toward producing wells, thereby recovering reserves incremental to primary recovery . . . ."[187] Courts have generally held the lessee liable for subsurface trespass if the injection operations reduced the adjoining property's mineral recovery.[188]

Similarly, hydraulic fracturing invokes the same subsurface trespass claims.[189] Hydraulic fracturing pumps viscous fluids into a well bore to fracture the reservoir rock.[190] The fracture serves as a drain for oil and gas extraction.[191] However a subsurface trespass may result since the size and direction of the fracture is controlled by the compressive stress of the rock formation and not the operator.[192]

A lessee also has a duty to protect the leased property against drainage.[193] Courts recognize an implied covenant to protect against drainage, even if the term is not found in the lease.[194] Courts require the lessee to

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184. Watts v. Atlantic Richfield Co., 115 F.3d 785, 795 (10th Cir. 1997) (discussing gas drainage into surrounding leases); Morsey v. Chevron, USA, Inc., 94 F.3d 1470 (10th Cir. 1996) (discussing water flood projects); *see* Pierce, *State Regulation*, *supra* note 11, at 20-21.

185. *Watts*, 115 F.3d at 795.

186. Terry D. Ragsdale, *Hydraulic Fracturing: The Stealthy Subsurface Trespass*, 28 TULSA L.J. 311, 335 (1993).

187. *Id.* Other methods of fluid injection include "pumping salt water into a well to inexpensively dispose of 'waste' fluids in a salt water formation . . . and . . . injecting natural gas into an underground storage reservoir." *Id.*

188. *Id.* at 335-36.

189. *Id.* at 338.

190. *Id.* at 338. The "fluid is mixed with a proppant and pumped with sufficient pressure into a well bore" to create the fracture which extends into the producing area. *Id.*

191. *See id.*

192. *Id.*

193. Gerson v. Anderson-Prichard Prod. Corp., 149 F.2d 444, 446 (10th Cir. 1945). Drainage is defined as the "[m]igration of oil or gas in a reservoir due to a pressure reduction caused by production from wells bottomed in the reservoir." Bruce M. Kramer, *The Interaction Between the Common Law Implied Covenants to Prevent Drainage and Market and the Federal Oil and Gas Lease*, 15 J. ENERGY NAT. RESOURCES & ENVTL. L. 1, 1 n.3 (1995). Factors to consider when dealing with drainage include reservoir location, presence of adjoining wells draining the reservoir, and the amount of gas the wells lose from drainage. John Burritt McArthur, *The Class Action Tool in Oilfield Litigation*, 45 U. KAN. L. REV. 113, 180 (1996).

194. *See* Patrick H. Martin, *Implied Covenants in Oil and Gas Leases—Past, Present & Future*, 33 WASHBURN L.J. 639, 640 (1994) ("While some have contended that implied covenants are implied in fact, candor requires us to acknowledge that implied covenants are judicial creations . . . . [T]he courts require that the lessee conform to some standard of fair dealing with the lessor."). Courts define implied covenants as "unwritten promises" that originate from oil and gas lease ambi-

conform to a "reasonably prudent operator" standard.[195] A prudent operator's duty includes "the doing of that which an experienced operator of ordinary prudence should do" on the premises, while having due regard for the interests of both lessor and lessee.[196]

To establish a breach of an implied covenant to protect against drainage, the lessor must first establish that oil or gas has been, or is being, drained from the lease.[197] Second, the lessor must prove that drilling an offset well would abate the problem by recovering operating costs and a reasonable profit.[198] The lessee does not bear the burden, however, of an implied duty to drill an offset well if it would be economically infeasible.[199] Remedies for a breach of a drainage covenant are usually monetary damages.[200]

B. *Tenth Circuit Decisions*

1. *Morsey v. Chevron, USA, Inc.*[201]

a. *Facts*

Rhodes Field is a common underground oil supply subject to many leases.[202] Morsey owned a lease (Section 20) at Rhodes Field.[203] Chevron operated a water flood project on neighboring oil leases.[204] The previous owners of the Morsey and Chevron leases committed to a cooperative waterflood project.[205] The flood project involved the injection of water

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guities and the relationship between lessor and lessee. Lowe, *Current Lease*, *supra* note 120, at 564. Some leases include express obligations to protect against drainage. McArthur, *supra* note 193, at 180.

195. Martin, *supra* note 194, at 640-41. Courts control the lessee's behavior by imposing this standard which is analogous to tort law's "reasonable man" standard. *Id.* at 666.

196. *Gerson*, 149 F.2d at 446. "Whatever . . . would be reasonably expected of operators of ordinary prudence, having regard to the interests of both lessor and lessee, is what is required." Kramer, *supra* note 193, at 7 (citing Brewster v. Lanyon Zinc Co., 140 F. 801, 814 (8th Cir. 1905)).

197. Kramer, *supra* note 193, at 8-9.

198. *Id.* at 9.

199. *Gerson*, 149 F.2d at 446. "No obligation rests upon the lessee to carry the operations beyond the point where they are profitable to him, even if some benefit to the lessor would result from them." *Id.*

200. Kramer, *supra* note 193, at 11-12. The underlying cause of action is usually a breach of contract claim. *Id.* at 11. Royalty owners can also seek class remedies. McArthur, *supra* note 193, at 180. However, class action drainage claims often fail the numerosity element, because only one or two wells may be affected, or the commonality element, because the plaintiff's interests may not be common enough if some lessors benefit while others are hurt by drainage. *Id.*

201. 94 F.3d 1470 (10th Cir. 1996).

202. *Morsey*, 94 F.3d at 1473. The Rhodes Field produces oil from the Mississippi formation 4,450 feet underground. *Id.*

203. *Id.*

204. *Id.* at 1474.

205. *Id.* at 1473.

through pipes into the field.[206] The project recovered otherwise unrecoverable oil reserves.[207]

Morsey claimed that Chevron's flood project "interfered with and damaged the oil producing capabilities of his oil lease."[208] When Chevron used injection pumps, the fluid level of Morsey's wells dropped.[209] Morsey sued Chevron for temporary and permanent damages, damages inflicted on the leasehold prior to his acquisition, and punitive damages.[210] The district court entered summary judgment in favor of Chevron on all of Morsey's claims.[211]

b. *Decision*

The Tenth Circuit upheld the district court's grant of summary judgment in favor of Chevron on Morsey's claims.[212] The court noted that Kansas law gives leaseholders a remedy for wrongful interference with a lease.[213] Such interference includes injury to the oil producing ability of the lease.[214]

Initially, the court addressed Morsey's request for temporary damages.[215] Temporary damages limit recovery to intermittent and abatable injuries.[216] Morsey failed to bear the burden of proving that the water preventing oil production on Section 20 could be remedied, removed, or abated within a reasonable time.[217] Morsey's suggestion that the damage might be abated was insufficient.[218] Thus, the court affirmed the district court's grant of summary judgment in favor of Chevron on this issue.[219]

The court also rejected Morsey's argument that his punitive damages claim should be heard before a jury.[220] The court reasoned that since Morsey failed to prove actual, temporary damages, his claim for punitive

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206. *Id.*

207. *Id.* The water pumped into the field raised the pressure in the field forcing out reserves otherwise unrecoverable. *See id.*

208. *Id.* at 1474.

209. *Id.* Furthermore, it was determined that water from the Rhodes Unit was being communicated to the Morsey lease. *Id.*

210. *Id.* Morsey claimed that his predecessors-in-interest assigned all rights to him; therefore, he was entitled to recover damages that occurred prior to his acquisition of the leasehold. *Id.*

211. *Id.* at 1474-75.

212. *Id.* at 1477-78.

213. *Id.* at 1475. "[A] leaseholder is entitled to a remedy for wrongful interference with his or her interest in the leasehold." *Id.*

214. *Id.*

215. *Id.*

216. *Id.* at 1476 (citing McAlister v. Atlantic Richfield Co., 662 P.2d 1203, 1212 (Kan. 1983)).

217. *Id.* at 1476-77. The court stated that the possibility that the condition could reasonably be remedied, removed or abated was insufficient for proving temporary damages. *Id.* ("[P]roof of temporary damages requires more.").

218. *Id.* "Possibilities are not proof, and . . . speculation and conjecture are no substitute for evidence." *Id.* at 1477.

219. *Id.*

220. *Id.*

damages also failed.[221] The court affirmed the district court's grant of summary judgment in favor of Chevron.[222]

Finally, the court addressed Morsey's claim that his acquisition of the lease included his predecessors' right to sue for past injuries.[223] Kansas law prohibits assignment of this type of tort claim.[224] Damages to the leasehold prior to Morsey's acquisition belonged to his predecessors-in-interest and expired when the lease was transferred to Morsey.[225] Thus, the court affirmed the district court's grant of summary judgment against Morsey on this claim.[226]

2. *Watts v. Atlantic Richfield Co.*[227]

a. *Facts*

The Oklahoma Corporation Commission issued Field Rules recognizing the Arbuckle Formation as a common gas supply.[228] The Field Rules specified monthly "allowables" limiting production at each unit.[229] The Field Rules were designed to make sure each well produced only its fair share.[230] Whenever a well underproduced its allowable amount (underage), the Field Rules allowed the underage to be carried over into the next month.[231] The underages would be cancelled after exceeding a specified limit.[232]

Several of Atlantic Richfield Company's (ARCO) wells accumulated underages approaching cancellation levels.[233] To make up for the underages and satisfy the Field Rules' allowable requirement, ARCO began workover operations which increased production in these wells.[234] Lessors, who owned neighboring leases, maintained that the workovers drained gas from their wells, resulting in decreased gas production.[235] Lessors sued ARCO for uncompensated drainage, but the district court

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221. *Id.*
222. *Id.*
223. *Id.* at 1478.
224. *Id.*
225. *Id.*
226. *Id.*
227. 115 F.3d 785 (10th Cir. 1997).
228. *Watts*, 115 F.3d at 789. "[A]ny one well could ultimately drain all the gas in the formation." *Id.*
229. *Id.* "Allowables" are limits on the monthly production of gas for each unit of wells at the Arbuckle Formation. *Id.*
230. *Id.*
231. *Id.* The accumulated underage increased the limit on future production. *Id.*
232. *Id.* The Field Rules included an "Effective Date" which gave the Unit Operator from May 1, 1990, to December 31, 1991, to adjust any under and over production before the amounts were subject to cancellation. *Id.*
233. *Id.* at 789-90.
234. *Id.* at 790.
235. *Id.*

granted summary judgment in favor of ARCO because the Field Rules barred Lessors' claims.[236]

b. *Decision*

The Tenth Circuit reversed the district court's grant of summary judgment in favor of ARCO.[237] Under Oklahoma law, oil and gas leases contain an implied covenant to develop a lease as a prudent operator by protecting against drainage, and failing to do so may constitute a tortious act.[238] The court rejected the district court's reasoning that the Field Rules excused ARCO from liability and found that nothing in the Field Rules prevented ARCO from protecting against drainage.[239]

C. *Analysis*

Some commentators assert that courts are usually unwilling to assess liability due to strong public policy in favor of promoting enhanced oil and gas production.[240] Similarly, the Tenth Circuit appeared to favor production over the rights of neighboring lease owners, like Morsey.[241] Morsey bore the burden of proving that Chevron could have remedied the damage resulting from the water flood project, leaving no room for the mere possibility of abatement.[242] The Tenth Circuit will not penalize oil producers and hinder production even if the plaintiff shows that damage abatement is probable. This reasoning promotes enhanced oil and gas production.[243] Consequently, the individual lease owner will not prevail against the oil and gas company even if the lease owner's property is damaged.[244]

The Tenth Circuit in *Watts* further promoted oil and gas production by protecting leases from drainage.[245] The Tenth Circuit is willing to imply a covenant to protect against drainage despite the absence of local laws to the contrary.[246] Therefore, a lessee who is draining oil or gas from a neighboring lease will be exposed to potential liability.

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236. *Id.*

237. *Id.* at 796.

238. *Id.* (citing Morriss v. Barton, 190 P.2d 451, 457 (Okla. 1947)).

239. *Id.* at 796.

240. *See* Ragsdale, *supra* note 186, at 335 (citing Railroad Comm'n v. Manziel, 361 S.W.2d 560, 568 (Tex. 1962)).

241. Morsey v. Chevron, USA, Inc., 94 F.3d 1470, 1476 (10th Cir. 1996).

242. *See id.* at 1476-77 ("[P]roof of temporary damages requires more.").

243. *See* Ragsdale, *supra* note 186, at 335.

244. *See id.*

245. *See* Watts v. Atlantic Richfield Co., 115 F.3d 785, 796 (10th Cir. 1997) (stating that the Atlantic Richfield Company is required to comply with its implied duty to protect against drainage).

246. *Id.* at 795.

CONCLUSION

The Tenth Circuit addressed a very controversial issue regarding CBM ownership and attempted to clarify ambiguities in the statutory language used to identify coal and CBM ownership rights. The issue will remain uncertain, however, until Congress passes specific legislation governing CBM. In contrast, the court did not deviate from the established law governing royalty payments of settlement proceeds and tortious interference with oil and gas leases.

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