SIGNIFICANT LEASE ACQUISITION ISSUES

FROM THE LANDOWNER'S PERSPECTIVE

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“This is like deja vu all over again.” – Yogi Berra

Four years ago I spoke on this topic to the Houston Association of Professional Landman, and it is a pleasure to be invited back, particularly since I get to visit Enron Field for the first time and see the Astros play tonight. I also enjoy the opportunity to see many of the landmen with whom I have worked over the years, either on the same side or from across the table.

This paper will be a little different than most in that I will stress the practical aspects of leasing from the landowner’s perspective rather than presenting the paper from a purely academic perspective. After all, I want you to have a practical understanding of my clients’ and my viewpoint when you come and ask me for a lease. I will also review some recent case law which affects the negotiations for an oil and gas lease, and, heaven forbid, the judicial interpretation of what we negotiate if it ever comes into dispute.

“You can observe a lot just by watchin’.” – Yogi Berra

One thing to remember in negotiating an oil and gas lease is that 99% of the time you are using an idea and a form that have already been used dozens, if not hundreds or thousands, of times. You will notice that I have not sought copyright protection for this paper because, in truth, most everything I have learned in negotiating oil and gas leases I have copied from other people and from oil and gas lease forms. So don’t be embarrassed about it – just copy away, everyone else does. If it will make you feel better, remember that it takes real skill to work through the zillions of forms that are out there in order to tailor the right lease terms and language for your particular deal. For example, if the landowner only owns a small undivided interest in a small tract, I will have sympathy for the lessee’s desire to use a uniform lease form covering the various undivided interests. In that instance it is not appropriate to use a lengthy, complicated form. If my client does not own the surface estate of the lands in question, I will try to allow the surface owner to let me know what he expects, and then incorporate that into my lease rather than put in a kitchen sink form covering all conceivable surface use issues. If my client’s tract is large, I won’t include a pooling clause, but I will consider pooling down the road if the lessee brings me his geological idea of why pooling might be necessary in a particular instance. In other words, one size definitely does not fit all when it comes to leasing a tract of land for exploration

and production, but you can, with good conscience, use a lease that is "off the rack" rather than tailor made.

"If you can't imitate him, don't copy him." – Yogi Berra

However, this is not to say that I have never had an original thought. Sometimes circumstances present themselves which require creative thinking. For example, one time my client was in the enviable position of owning a crucial block in the center of a large play in deep south Texas. I told the lessee that my client would need to receive what the market would bear in consideration for the lease, which I estimated to be $1,000 per acre bonus, a 37.5% royalty, no pooling and a deep well commitment with liquidated damages of $1,000,000 secured by an irrevocable standby letter of credit. While the lessee's president grudgingly admitted that the tract was probably worth that much in light of all of the circumstances, he advised that his shareholders might have his hide if he leased for such expensive terms. We sat down in person with a Tobin of the county in question, and tried to come up with a solution to this apparent impasse. As it turned out, my client owned other lands in an adjacent county which were held by another lessee under a lease without a Pugh Clause. The relatively shallow production on that ranch was marginal, but sufficient to hold all of the lease to all depths. While deeper wells were being drilled in the area, my client's lessee was under no obligation to drill. We were able to come up with a deal whereby the proposing lessee went to the lessee of the ranch in the other county and bought the working interest of the lease with the marginal production. We carved out proration units around the existing wells and agreed on a depth severance, and then the lessee released all the remaining lands and depths as if there were a Pugh Clause in the old lease. My client then leased the critical acreage on terms which, though lower than the market, were still quite favorable. Within six months my client leased the ranch in the adjacent county to a third party lessee which quickly commenced exploratory drilling and made a nice new field discovery. This was definitely a "win-win" for everyone. As a postscript, however, the lessee never was able to get the well drilled on the critical tract; the lease terminated before he could even get a 3-D survey completed. A few years later another company came in and drilled a nice well.

Sometimes a special lease clause will need to be drafted. The following are examples of fairly unique clauses which were drafted to cover special circumstances. Several years ago my client came to me and announced that he had

received a great lease offer. When I looked at it and recognized the lessee from prior dealings as well as bad press, I was concerned that we were “buying a lawsuit” by leasing to this lessee. I was also concerned that the proposing lessee would “flip” the lease to unsavory and financially suspect partners. However, my client still wanted to lease on what was otherwise a favorable deal. The following clauses put “teeth” into any default of the lease covenants by the lessee, and restricted his ability to sell the lease, while still giving him flexibility to drill and produce. While he did not like these provisions, he preferred them to not getting any lease at all.

> __. FORFEITURE CLAUSE: In the event Lessor considers that obligations of Lessee or implied covenants of this lease are not being complied with, Lessor shall notify Lessee in writing of the facts relied upon as constituting a breach of any expressed or implied covenants or obligations of Lessee hereunder and Lessee, if in default, shall have sixty (60) days after receipt of such notice in which to commence compliance with its obligations hereunder. If such breach is not timely cured and Lessor obtains a final judgment finding that Lessee has breached any covenant hereof, expressed or implied, then it is agreed that Lessor shall be entitled to a decree providing for cancellation or forfeiture of the lease in the event such breach is not rectified or commenced in good faith to be rectified by Lessee within sixty (60) days from the date such decree becomes final; provided, however, that failure on the part of the Lessee to cure any alleged default of any expressed or implied covenant of this lease, shall not result in Lessee forfeiting any producing oil or gas well or wells or shut-in gas well or wells and acreage allocated thereto in accordance with the formula set out in Paragraph 12 above and which zone(s) or horizon(s) is or are not then subject to breach or default. However, failure of Lessee to (1) produce oil, gas or other leased substances in paying or commercial quantities; (2) to timely and properly pay delay rentals and shut-in royalties; (3) and/or to timely commence drilling or reworking operations as provided by the provisions of this lease, shall not constitute an obligation for purposes of this paragraph as failure of Lessee to comply with such special limitations provisions shall terminate this lease, insofar and only insofar as this lease covers those lands subject to such provisions.

__. ASSIGNMENT CLAUSE: The rights and estate of any party hereto may be assigned from time to time in whole or in part and as to any mineral or horizon, provided, however, that, due to the special relationship of trust and confidence between Lessor and Lessee, any assignment, mortgage or other transfer of all or any interest in this Lease by Lessee without the prior written consent of Lessor, which consent shall not be unreasonably withheld, shall be void. As an express condition to such approval as may be granted by Lessor, Lessee shall furnish to Lessor a true or certified copy of all such proposed assignments and fully inform Lessor of the identity and address of any such assignee. These provisions shall apply to any type of assignment, sublease, conveyance or transfer of all or a portion of this Lease or rights or interest thereunder.

This latter assignment clause contains language which could be construed to create a fiduciary relationship, the breach of which can be remedied by actual and punitive damages.

"You've got to be very careful if you don't know where you are going, because you might not get there. – Yogi Berra

It is almost always the lessee who commences the negotiations with an offer to lease. While I have known lessors who have tried to "market" their land for oil and gas exploration – and I have tried this a few times myself – it usually does not work. The landowner is generally in the position of waiting for the play to come to him. The offer from the prospective lessee's landman is usually accompanied by a form of oil and gas lease. Unless the lessor is either very sophisticated or very unsophisticated in leasing, he will generally avoid even commencing the negotiation of terms until he can speak with his attorney. Since simple negotiations can sometimes mature into an offer and acceptance if the material terms are agreed upon, I advise my clients to not speak with the landman other than to forward his call to me.

Landmen, who see the benefits of getting a deal done, get understandably frustrated with lease negotiations. However, most courts will hold that a lessor's rights are limited by the exact language in the lease. As the lessor's attorney, I am obliged to look at the deal as a relationship which could last for decades instead of as an isolated transaction. For example, I know of some Woodbine production in

East Texas that is in at least its sixth decade. So, if the lease could be in effect for so long, it really deserves a lot of attention and care. This reminds me of the following quote:

"If I had known I was going to live this long I would have taken better care of myself!" – Mickey Mantle

Bear in mind the following points from the lessor's perspective when you are attempting to secure an oil and gas lease position:

Holding the Deal During Negotiations and Dealing with Multiple Lessors; The Favored Nations Clause

Oftentimes there will be multiple undivided mineral owners in a particular tract, and the lessee will not want to proceed unless it can be assured that it will receive leases from 100% of the mineral ownership. Conversely, the lessor is concerned that if he is the first to lease, there is a danger that a "holdout" lessor will be able to command better terms if it waits until the end to lease. This is a particular problem for a lessor who is acting in a fiduciary capacity: if the fiduciary does not receive the best terms in a transaction for his beneficiary, he could be liable. There are several solutions to this situation.

"When you come to a fork in the road, take it!" – Yogi Berra

One solution to this situation is for all parties lessor to participate in a simultaneous closing of the lease. This often is impractical for the multiple lessors' representatives, or perhaps is even impossible if there is a disagreement over the lease terms.

Another solution to this problem is the use of a "favored nations" clause, such as the following example:

> If, during the term of this Oil and Gas Lease or if within the period of six months before this Oil and Gas lease was delivered from Lessor to Lessee, Lessee obtains a lease from another undivided mineral interest owner or owners in the lands described herein or in lands pooled therewith which are on terms more favorable with respect to bonus, royalty, rentals or term, to such other undivided mineral owner or owners than those contained in this Oil and Gas Lease, then Lessor

shall be entitled to secure such more favorable benefits on the basis of each individual benefit. Lessee shall promptly pay such additional amounts or execute and deliver a lease amendment to Lessor with such more favorable term or terms.

A recent case interpreting the favored nations clause is Stinnet v. Colorado Interstate Gas Co., 227 F.3d 247 (5th Cir. 2000). This case stems from a series of disputes between the lessor and lessees. A settlement agreement between the parties, subsequent to the original lease, included such a "favored nations" clause (FNC). The clause provided that if lessee voluntarily paid any of its other lessors in the field a royalty based on a higher price than that received by plaintiff/lessor, lessee would pay plaintiff the same rate. Over 20 years later, the lessor and lessees entered into a Lease Amendment Agreement containing a release provision giving the lessee a release from all claims prior to 1989 arising out of the original lease. The Amendment also contained an "in lieu of" provision for all royalty payments after 1988. The lessor/plaintiff sued for underpayment of royalty and claimed the lessee had failed to provide information about royalty rates for other lessors. The court determined that a FNC does not create a fiduciary relationship, and recognized that no such relationship exists between a lessor and lessee in an oil and gas lease. The court additionally concluded that the lessors' allegations of a breach of the lessee's FNC obligations fell under the release, thus barring the claims from the original lease until 1988. The "in lieu of" clause, however, did not preclude the lessors from asserting post-1988 breaches of the FNC. But lessors were barred by quasi-estoppel from asserting post-release claims. The bottom line is that it is very difficult to anticipate every possible application of a FNC, and it may be difficult to enforce a FNC.

Another tactic used to tie up multiple lessors is to use a sight draft for the consideration which is payable over an extended period of time, such as 90 days, in order to allow the lessee to secure leases from all owners and check the title. While this would seem to be fair in some instances, my advice is to leave your sight drafts at home when you come to talk to me. I have seen way too much "cold drafting" of lessors, which for the uninitiated is when the lessee fails to pay the draft merely because he can't get his deal sold.

What does the lessor own? -- To warrant or not to warrant...

While this may sound simplistic, the first thing the landman must do is determine the mineral ownership. Reference to a regional Tobin may give some

indication of where to start, and ad valorem tax offices usually have helpful information. A title company with a good set of cards indexed by tract is worth its weight in gold, but increasingly the owners of these title companies would prefer to sell abstracts over renting time in their offices. Sometimes the only way to get the information you seek is to spend hard labor in the grantor/grantee indices. Another potential stumbling block is the delay caused by having to figure out who has the executive rights to a particular tract. Due to the complexity of title and vast amount of unrelated documents which he may have to review, the landman is feverishly working while his client is anxiously pushing to get the runsheet finished and secure leases. A particular tract may have dozens of undivided mineral interests split between multiple heirs, most of whom probably died intestate. Possession of the surface may conflict with record surface ownership, and you can bet there is not a written lease filed of record. The county clerk may have particular affections for indexing words in unusual ways (I once found an Exxon lease in a county which I shall not specify listed under "T" for "The Exxon Corporation"). South Texas is rife with tracts over which there are border disputes and claims of adverse possession. I recently worked with a team of lawyers to win a judgment in a Hidalgo County title dispute which had been in the trial court for nine years. The case went all the way to the Texas Supreme Court. See <u>Garza v. Maddux</u>, 988 S.W.2d 280 (Tex. App. – Corpus Christi 1999, <u>review denied</u>). I am familiar with cases which questioned title back to the 1800s based on a pre-partition failure to join all necessary parties. Heirs of an "illegitimate" child can claim that limitations has not run against them because they are cotenants. While this may be preaching to the choir, you need to check title very carefully or you may get a lot of egg on your face.

If you are dealing with my client and tell me that you are having a tough time with title, you may be in for a pleasant surprise as I am usually more than willing to share (without warranty, of course) any title information I have in my files with you as it will encourage and expedite leasing. In fact, I see it as an important part of my mission as the landowner's attorney to continually try to assemble title data for use in the future. That is why I always try to include the following provisions in my lease form:

> (_) The expense, if any, of any curative matters necessary to cure or correct defects in title prior to the date of this lease, shall be borne solely by Lessee. Lessee agrees to promptly furnish Lessor with a copy of any abstracts prepared covering the leased premises, as well as with any curative documents and

related work, such as run sheets, maps, title notes and other title data.

(_) If Lessee obtains a title opinion or opinions covering all or any part of the leased premises, Lessee agrees to furnish copies thereof to Lessor within ten (10) days after receipt of such opinion or opinions.

As the lessor's attorney, I am also faced with an egg in the face scenario if title fails. I therefore try to limit my clients' exposure with tough negotiations on the warranty clause. I will often take the position that the lessee has the resources to check record title better than the lessor, and therefore the risk of a failure of title should fall on the lessee. If I win this point, I try to insert the following clause in the lease in lieu of a warranty of title:

> This lease is executed without warranty of title, either express or implied. However, if Lessor owns an interest in the oil and gas in or under the leased premises less than the entire mineral fee estate, then the royalties and rentals to be paid Lessor shall be reduced proportionately as may be required by such lesser ownership. Failure of Lessee to reduce rental payable hereunder shall not impair the right of Lessee to reduce royalties. Lessor agrees that Lessee, at its option, may discharge any tax, mortgage or other lien upon the leased premises (the basis of which lien is any obligation of Lessor), and in the event Lessee does so, it shall be subrogated to such lien with the right to enforce same and apply rental and royalties accruing hereunder toward satisfying same. In the event of failure of Lessor's title, in whole or in part, Lessor's sole obligation shall be the return to Lessee of that portion of the bonus paid Lessor for the execution of this lease attributable to the acreage affected by such failure. Lessor shall never, under any circumstances, be liable to Lessee or a successor or assign of Lessee for a failure of title to the leased premises.

A recent case dealt with the issue of warranty in an oil and gas lease, Barron v. Purnell Morrow Co., 2001 WL 637818 (Tex. App. – Dallas 2001). A lessee sued lessor to recover the bonus paid upon learning that lessor had previously conveyed the property. Lessor argued she was not liable since the warranty clause had been stricken from the lease. Ruling for lessee, the court held that, under the Texas

Property Code, a grantor impliedly promises that he has not previously conveyed the estate, when, as here, the word “grant” or “convey” appears in the instrument.

Oil, Gas and Associated Substances – ONLY...

You should also bear in mind that the lessor will probably only want to lease your company his oil and gas and not his so-called "hard minerals." The infamous printed form leases, such as those created for years by the Pound Printing Company of Houston, usually contain a grant of "oil, gas and other minerals," and the instrument itself is entitled "Oil, Gas and Mineral Lease." As a general rule, I only allow my client to lease his “oil, gas and associated liquid hydrocarbons and substances.” If the lessee is interested in particular "hard" minerals, I will negotiate a separate lease which is tailored to such a transaction, which inevitably will be more destructive of my client's surface estate. Believe it or not, I once leased a clients’ land for gold exploration in Uvalde County. By specifying the minerals to be leased in advance I think that I am saving a real fight down the road in "hard mineral" country. I often insert the following language in the lease:

> Reference in this lease to "other minerals" shall be deemed to include only oil, gas and such associated liquid hydrocarbons and sulphur as may be produced therewith and extracted therefrom, and shall not include (and there is expressly reserved to Lessor) all coal, lignite, uranium, vanadium, thorium, fissionable minerals and materials, other sulphur, or any unrelated or hard minerals; and Lessor further reserves the right of ingress and egress to said lands for the purposes of prospecting, mining and recovering such other minerals.

The “flip side” of this issue has arisen also, where the lease only allows the lessee to explore on the lessor’s “minerals.” Does the mere grant of “minerals” include the right to drill for and produce oil and gas? In Colorado this issue was recently answered in the affirmative in McCormick v. Union Pacific Resources Co., 14 F.3d 346 (Co. 2000). The Colorado Supreme Court verified that Colorado follows the majority rule that deed reservations for “other minerals” reserve oil and gas. This determination applied to reservations made by a railroad company reserving “all coal and other minerals” at a time when oil and gas production was not contemplated in that area. The deeds were executed between 1906 and 1909.The majority upheld summary judgment granted in favor of the railroad: “Although the term ‘minerals’ is not inherently unambiguous and extrinsic evidence may be required to ascertain the parties’ intent in certain circumstances,

our study of Colorado legal precedent, custom, and usage convinces us that Colorado adheres to the majority rule that deed reservation language reserving 'other minerals' reserves oil and gas." A concurring opinion agreed with the result, but criticized the majority for relying on extrinsic, historical evidence. According to the concurring justices, the term "minerals" is unambiguous; therefore, the court should disregard all evidence concerning Colorado history, custom and usage.

<u>Does My Lease Automatically Grant Me the Right to Shoot Seismic?</u>

This question was recently answered in the affirmative in Louisiana. In <u>Musser Davis Land Co. v. Union Pacific Resources</u>, 201 F.3d 561 (5th Cir. 2000), the court framed the issue as "whether a lease granting the lessee the exclusive right to explore for oil and gas without defining or limiting in any way the term 'exploration' bestows upon the lessee the right to conduct seismic exploration to determine the presence of subsurface trapping mechanisms favorable to oil and gas production."After reviewing the Louisiana Mineral Code, the opinions of scholars, and the industry usages and practices, the court concluded that, "an exclusive right of exploration lease clause generally is understood to include the right to conduct seismic operations." The court also rejected the lessor's argument that the lessee's attempt to obtain a "seismic permit" from the lessor proves that the lessee did not have the sole right to conduct the survey. Instead, the court noted that lessees usually seek to obtain a permit from the landowner as an added precaution against undue interference with the surface owner's use of the premises and as a matter of courtesy to inform the owner of the time, location, and method of seismic exploration. Regarding the ownership of the data, the court determined that the lessee or assignee performing the survey owns the data.

The better practice is to deal with this issue expressly in the lease. I usually grant this right in the lease as follows:

> Lessor also GRANTS, LEASES and LETS unto Lessee the non-exclusive right to conduct exploration, geologic and geophysical surveys by seismograph (including one mile beyond the boundaries of this lease, as to any adjacent lands owned by Lessor and not under mineral lease to a third party at the date of this lease and in the event such adjacent lands are leased, Lessee will only be required to obtain such third party lessee's permission prior to conducting such seismic operations and such seismic exploration will be subject to the same conditions and obligations as those conducted on the Leased Premises,

> subject to the payment of damages to the surface estate), core test and magnetic methods, the following described land in __________ County, Texas...

Since seismic data is so valuable, however, I also like to negotiate for the following:

> If Lessee and/or Lessee's assigns acquires, conducts, participates in or underwrites any geophysical surveys on any part of the leased premises or on lands pooled herewith after the date of this Lease, then Lessee will furnish free of cost to Lessor within thirty (30) days from the date of this lease or within thirty (30) days from Lessee's own receipt of same, whichever is applicable, all seismic data and associated survey information, including but not limited to, a surveyed ownership map, topographic map and G.P.S. position map showing the location of the shot points or vibration stations and well locations, and all other survey data, tapes, and copies of processed final stacked and migrated data volumes and sections pertaining to all geophysical surveys conducted on the leased premises plus one-half (1/2) mile on each side of the boundary lines of the leased premises if the line(s) continues that distance, and on lands pooled herewith. Any of the above information so furnished Lessor by Lessee shall, if Lessee so requests in writing, be considered confidential and shall not be disclosed to third parties, other than Lessor's agents, for a period of two (2) years after the end of the primary term. In the event Lessee acquires such geophysical data under the terms of a license or other similar agreement, Lessee shall obtain for Lessor's benefit a license or extension of the license rights to Lessor so that Lessor shall receive and have use of the seismic data licensed to Lessee to the same extent and subject to the same agreements as Lessee. Furthermore, Lessee grants Lessor and its agents and contractors unlimited viewing rights and access to review any geophysical data in Lessee's possession provided that Lessor must come to Lessee's office during normal business days and hours to review same.

“Baseball is 90% mental. The other half is physical.” – Yogi Berra

I share this quote from Yogi to illustrate how confusing fractions can be to some people, and also to illustrate my point that the lessor is oftentimes the underdog in a lease negotiation. The following is a true story. About ten years ago my client, a farmer, called me out to his farm south of San Antonio during dove season, knowing full well that he could get a ton of free advice from me as long as I had the opportunity to shoot a few doves over his fields. Once the shooting stopped the inevitable requests for legal advice came from the farmer. He produced two drafts of an oil and gas lease, both of them on a Producers 88 form, for me to review. One of the leases provided for a 1/8 royalty, the other for a 1/6. He then explained that the first offer from the oil company contained the 1/6 royalty, but he told them he wasn’t interested unless they would go “up” to 1/8! After a few minutes of delivering a math lesson which was not being understood, I suggested to my farmer client that he might want to turn over all of the negotiations to me, to which he gladly agreed.

We all have heard stories about Hollywood movie producers who contract with their leading men and women to give them a percentage of the profits from their movies. Once the movies are smash hits the accountants for the producers charge so many expenses against the project that the stars never get a dime in return for their brilliant negotiations. While such scenarios may not be as blatant or obvious in the oil patch, we all know that the value of a royalty interest is drastically affected by the manner in which it is computed. I try to clarify these issues in my leases, but invariably disputes arise for a number of reasons.

One of the biggest problem areas for lessors, traditionally, is that their limited lease language did not express whether royalties would be paid on liquid by-products of gas which where processed at a plant, such as ethane, butane, propane, and additional derivatives thereof. We also are now free of federal price regulations on sales of gas, which used to cloud the issues as well. We therefore have cases such as Danciger Oil and Refineries, Inc. v. Hamill, 171 S.W.2d 321 (Tex. 1943) and Carter v. Exxon Corp., 842 S.W.2d 393 (Tex. App. – Eastland 1992), which restrict the lessor's rights to royalties on the liquid by-products of gas. I now have an express royalty provision covering the payment of royalties on such liquid by-products of processed gas, which generally is as follows:

> On condensate and all other products separated, extracted or manufactured from gas produced from the leased premises by any

> extraction, absorption, pressuring or other plant belonging wholly or in part to Lessee or any affiliated or subsidiary company, one-fourth (1/4) of the value of all such condensate and other products so separated, extracted, or manufactured, or, at Lessor's option, one-fourth (1/4) of such condensate and other products in kind shall be delivered to Lessor at the plant outlet. In the event of the blending of any part of such condensate or other products with chemical additives for making any product therefrom, the royalty on such products, whether paid in kind or at value, shall be calculated at the plant outlet on the resulting blended product, less Lessor's proportionate share of the direct cost of such chemical additives.

Many disputes over the computation of gas royalty have been fought in the courts. One area of constant battle since the 1960s is the definition of the "market value" of gas. In a rising gas market, the typical problems which arose related to a producer's selling his gas under a long-term contract at a price which eventually was lower than that which could be bought in the market. The battle has occasionally made a 180-degree turn, whereby in some instances royalty owners are fighting for the proceeds from favorable sales related to a unique marketing situation instead of what may be a generally lower market value. The result of any fight over the value of gas generally depends on the terms of the lease, and hence the negotiation of favorable terms is critical to each party. I shall digress to give you a Texas case law history of these developments in the fight over royalty valuation.

The landmark Texas case on valuation of natural gas is Texas Oil & Gas Corp. v. Vela, 405 S.W.2d 68 (Tex. Civ. App. -- San Antonio 1966), aff'd 429 S.W.2d 866 (Tex. 1968). In that case, expert witnesses were utilized to testify to market value on the basis of studies of interstate and intrastate wellhead sales in the field. The gas at issue was marketed on a "life-of-the-lease contract" and royalty owners were paid royalty based on the prices received by the producer. The market value of gas in the field rose above those contract prices and the royalty owners demanded the difference between royalties paid to them and royalties based on market value. The case was submitted to the jury for a determination of market value at the well of the gas in question. The Texas Supreme Court pointed out that determination of market value of gas at the well rested not upon the disposition of the gas in question, but upon comparable sales, and noted the evidentiary nature of comparable sales: "All parties agree that comparable sales of gas are those comparable in time, quantity, quality, and availability of marketing outlets." 429

S.W.2d 866, at 872.The Court then pointed out what it meant by the use of the term "time":

> "The gas which was marketed under the long-term contracts in this case was not 'being sold' at the time the contracts were made but at the time of the delivery to the purchaser. . . . [citing cases] . . . We agree with the Court of Civil Appeals, therefore, that the contract price for which the gas was sold by the lessee is not necessarily the market price within the meaning of the lease. . . ." [citing cases]. Id., at 871.

By the terms "quality" and "quantity" the court alluded to reserves, line pressure, and whether the gas was extremely dry or had distillate in it. Id., at 872. Finally, the court held that market value is to be determined from comparable sales of gas disposed under contracts executed at or near the time the gas in controversy is produced, not when the gas in controversy was originally committed to sale by contract. The court noted that subsequent increases in market value which make the private contractual commitment of the producer financially burdensome is no reason to compel a court to disregard the plain and unambiguous terms of the royalty clause and rewrite it to conform to the wishes of the producer. The court then instructed on the definition of market value, noting that it is the price property would bring when it is offered for sale by one who desires, but it is not obligated, to sell and is bought by one who is under no necessity of buying it. "To determine the market value of gas, the gas should be valued as though it is free and available for sale." Id., at 247. Immediately following this statement, the court noted:

> "Market value may be calculated by using comparable sales. Comparable sales of gas are those comparable in time, quality, quantity, and availability of marketing outlets. Sales comparable in time occur under contracts executed contemporaneously with the sale of the gas in question." Id., at 247.

At page 249 of the decision, the court again reiterated that "the determination of market value is not dependent on when the gas is discovered." Comparable sales are contemporary sales. The court added a qualification to its opinion. The court stated that quality involves the legal characteristics of the gas in addition to the other factors related to comparability. That is, said the court, whether the gas is sold in a regulated or unregulated market, or in one particular category of a regulated market.This language constituted dictum but presaged things to come.

There followed a series of cases which grappled with and finally resolved the complex issue of the impact of federal regulations upon market value. These cases were: First National Bank in Weatherford v. Exxon Corp., 622 S.W.2d 80 (Tex. 1981), Kingery v. Continental Oil Company, 626 F.2d 1261 (5th Cir. 1980), Bowers v. Phillips Petroleum Company, 692 F.2d 1015 (5th Cir. 1982) and Flowers v. Diamond Shamrock Corporation, 693 F.2d 1146 (5th Cir. 1982) affirmed in part and reversed and vacated in part and remanded. Each of those cases dealt with the effect of federal regulations on market value of gas at the well. While these decisions are less relevant in today's unregulated markets, they still bear mention because the doctrines on which they were based can still apply today.

In Exxon Corporation v. Middleton, 613 S.W.2d 240 (Tex. 1981), the Texas Supreme Court noted that one element of comparability is the legal characteristic of the gas; that is, whether it is sold in the regulated or unregulated market, or in one particular category of the regulated market. The court noted that gas from fields with outlets to interstate markets is different than gas with outlets only to the intrastate market. The court noted that comparability is otherwise in the eye of the expert beholder, and that objections as to comparability go to weight rather than admissibility.

Another critical issue in royalty accounting is the determination of which costs are permitted to be deducted by the lessee in the computation of royalty. In Heritage Resources, Inc. v. NationsBank, 960 S.W.2d 619 (Tex. 1997), the Texas Supreme Court attempted to determine which deductions could be taken in the calculation of royalty in order to arrive at the "market value at the well." In my opinion, the Court overlooked specific language regarding those deductions in favor of a global presumption in favor of the lessee when the language “market value at the well” is used. You will not see that language in my lease form. Instead, I make an effort to delineate what the lessor expects, as follows:

> The "value" of any gas, condensate or other products of gas for purposes of the calculation of royalty under this lease is the market value for like kind, quality and quantity of the gas at the time and place at which custody and risk of loss of the gas is transferred to an unaffiliated purchaser or at the time and place of use by Lessee (but without deduction for marketing, gathering, and transportation of the gas to the point of sale, delivery or use or any other post-production cost) and shall never be less than the total proceeds received by Lessee or by any affiliated or subsidiary company by reason of the

sale of such gas, condensate or other products and/or the dedication of reserves. The term "market value" herein shall have the meaning described in Exxon Corp. v. Middleton, 613 S.W.2d 240 (Tex. 1981), and shall not mean or be deemed modified by the definition of market value contained in the Texas Natural Resources Code §91.402 or in other Texas case law. The "total proceeds received" shall include, but not be limited to, the fair value of all consideration received by Lessee or by any affiliated or subsidiary company related to the marketing and/or dedication of gas, condensate, other products or reserves (such as take-or-pay payments, take-or-pay settlements and awards, dedication payments, advance payments, contract adjustments, gas exchange consideration, contract buy out/buy down payments and similar consideration).The holding in the case of Yzaguirre v. KCS Resources (Texas Supreme Court – Case No. 00-0829, opinion delivered on June 21, 2001) shall not apply to lessor and lessee hereunder. For the purposes of this Lease, "affiliated or subsidiary company" shall mean any entity which, by virtue of ownership, contracts or influence, does not deal on an arms length basis with Lessee. If the entity reports its federal income taxes under a consolidated return with the lessee it shall be conclusively deemed that such entity is an affiliate. Lessee shall be solely responsible for insuring that all such proceeds are received in accordance with all applicable laws and regulations. Except as specifically provided in Subsection (c) above, all royalties payable under Subsections (a), (b), (c), (d) and (e) of this Section 3 shall be without deduction for any costs of marketing, gathering, transporting, separating, processing, dehydrating, compressing, constructions, manufacturing or other post-production costs including any costs involved in making the oil or gas ready for sale or use, and the holding in the case of Heritage Resources, Inc. v. NationsBank, 960 S.W.2d 619 (Tex. 1997), shall not apply to lessor and lessee hereunder. In the event Lessor does not elect to take Lessor's royalty gas in kind as provided for herein, Lessee shall act as Lessor's representative in negotiating and implementing sales arrangements for royalty gas in accordance with principles of good faith and fair dealing and the provisions of this lease. Further, Lessee shall not be authorized to enter into any contract which would result in Lessor receiving less than the royalty share of the value (as defined above) of the gas produced from this lease at the time the gas is produced. Irrespective of any contract for the sale of

> gas from the subject lands which Lessee may enter into, Lessee's royalty obligation shall never be based upon a price which is less than the value of the gas produced from the lease as defined above. It is expressly provided that Lessee shall not have the right to dedicate the leased premises or gas reserves in and under the leased premises to the fulfillment of any public service obligation, and any dedication of gas required to fulfill Lessee's obligations under any gas purchase contract shall be specifically limited to only such gas as may be produced through the wellhead of gas wells on the leased premises during the period that this lease is being maintained in force and effect in accordance with its terms and with the lessor's express written consent.

You should note the specific language above regarding so-called "marketing affiliates." I suspect that the main reason for the creation of a marketing affiliate is to have a "profit center" for an activity, i.e. marketing gas, that the lessee is already required to do under the lease without being entitled to an additional profit. Affiliated marketing schemes have come under fire in lessor lawsuits, and several major companies have been forced either to abandon them or try another tactic due to the scrutiny and risk of loss. Alternative, more sophisticated, means of marketing have also arisen. Many companies continue to persist with using transactions for gas marketing which exclude the lessor from the full value of the royalty which he is due, and it is a subject of current litigation. If you represent a major company, be prepared to discuss this issue with your prospective lessor's attorney.

A recent case from the Texas Supreme Court is a so-called "reverse-Vela" case because it holds that, under the language of the lease in question, the lessor was not entitled to the more valuable proceeds of the sale of gas from the lease (as opposed to the lower "market value" of the gas). The issue in Yzaguirre v. KCS Resources (Texas Supreme Court – Case No. 00-0829, opinion delivered on June 21, 2001) was whether the lessor's royalty should be calculated on the basis of the lessee's contract price (the amount realized or "proceeds," which was the higher value), or the market value at the well (which was the lower value). The Court held that the lessees could properly calculate the royalties on the lower value. Neither division orders nor the implied duty to reasonably market can alter the express terms of a lease to change a market value royalty to a proceeds royalty requirement. Division orders cannot convey royalty interests or rewrite oil and gas lease contracts. Division orders are only binding for the time that they are being

acted on and will cease to be binding upon notice of their revocation. Therefore, according to the terms of the lease, the market value at the well standard controlled. Regarding evidence of “market value,” the court held that the trial court had properly excluded the lessee’s 1979 gas purchase contract, concluding it was not evidence of “market value” under these circumstances.

Another point to note in Yzaguirre is that the court rejected the lessor’s claim that venue was mandatory in the county where the wells were located under a provision of the Natural Resources Code or under a venue provision governing title to land. For that reason, suit was held to be proper in a county of a lessor’s place of business, which was the county where the lessee had filed suit first. This holding on venue is sure to encourage so-called “pre-emptive” suits by lessees who anticipate being sued by their lessors, and in my opinion will set back the integrity of the Texas judicial system by allowing “forum shopping” by lessees instead of honoring the venue provision of the Natural Resources Code which appears on its face to require suits to be filed in the county where the wells in question are located.

An interesting case on the calculation of royalty recently came down from the Colorado Supreme Court: Rogers v. Westerman Farm Co., 2001 WL 741944 (Colo., Jul 02, 2001) (NO. 99SC293). The Colorado Supreme Court looked at similar language to that reviewed by the Texas Supreme Court in Heritage, i.e. “at the well” or “at the mouth of the well,” and came to an opposite result. In Colorado when such language is used without further clarification the implied marketing covenant is deemed to control. The Court then found that the lessor is entitled to a cost-free royalty up to the point where “a marketable product is first obtained,” i.e. the logical point where the exploration and production segment of the oil and gas industry ends and the marketing of the product begins. In Rogers this point was at a pipeline far from the wellhead, to which point the royalty was cost-free.

Getting back to the negotiation of the royalty clause in the lease, some companies simply will not live with the lessor's form of oil and gas lease if they believe it is too onerous with respect to the calculation of royalty. I recently had a major company walk away from negotiations for this reason even though two direct offset locations were located on my client’s land; this opened up a great opportunity for an entrepreneurial independent, who closed the lease with me in a matter of days of the major’s walking off in a huff. Perhaps the majors’ use of marketing affiliates is so entrenched in their corporate culture, or perhaps they view their liabilities as uncertain and almost an "invitation to a lawsuit." At least

two different middle ground solutions have developed whereby these obstacles can be overcome without the lessee having to feel compelled to walk away from the bargaining table.

The use of price indices for gas is common for transactions within the industry, but the use of indices specifically with an oil and gas lease is rare but increasing. With the trading of gas as a commodity on the NYMEX, greater price speculation has followed and indexed pricing has become much more common. The most common indices relate to surveys of bid week trading on a monthly basis. These surveys are conducted by publications which, though deemed reliable by the industry, are mainly based on confidential interviews which are unverifiable. Hub indices are also used, but the prices are not averaged and therefore may be misleading on a day where there is particular price volatility. Use of futures prices as a basis for an index has problems with hypothetical versus real values. Given the problems with indices, it is remarkable that they are used so greatly in the industry. Royalty owners are probably the only group in the cycle of land to burner tip which generally do not rely on indices.

Royalty owners would be well served to use indices in one respect, which relates to the objectivity and ease of verifying the calculation of index-based royalty payments. Instead of having to sue their lessees for marketing information which those lessees fight tooth and nail from being produced, the royalty owner can simply hire an accountant, engineer, gas marketer or economist to compare the indices with the production data and do the math. In light of the tight limits placed on the construction of the statutes of limitation by the Texas Supreme Court, royalty owners are essentially placed in the dilemma of either using index-based royalties or suing their lessees for an accounting every four years. I have seen bank trust departments and fiduciaries switch to index-based royalty accounting in their leases in light of the fiduciary duty which they bear and their general reluctance to pursue litigation.

Royalty owners may also be well served to use an index if the prices quoted in that index are generally favorable compared to other factors which might go into the computation of royalty. For example, if a South Texas lessor ties his royalty to a Houston Ship Channel or Henry Hub index, with either no deductions or limited deductions from that price, he may benefit from a higher price than can be obtained as an average price in the field.

Another solution, albeit in limited circumstances, is for the lessor to rely on

its ability to market its own production. Most lease forms have for years generally allowed the lessor to take his royalty share of oil in kind if he so chose. This election arose due to tax considerations, as well as a genuine desire by the parties to allow the lessor to separately market oil, which can be gauged and stored separately without a lot of complications. Oil can be economically transported by truck, but gas cannot. It is my experience that it is only in rare circumstances that a lessor has actually taken oil in kind.

Even more rare is a lessor who takes his gas royalty in kind. Frankly, most lease forms do not give the lessor to right to take gas or liquid by-products of gas in kind. Lessees have generally been reluctant to grant this right due to safety concerns and the difficulty of metering and separately marketing gas and liquid by-products of gas, which almost always have to be piped rather than trucked.

Another reason why lessors rarely take their share of production in kind is that they do not have equal access to the markets with the major oil companies. This may be gradually changing, however, in light of developments within the FERC and gas transportation regulations which have de-monopolized the pipelines and forced them to become transporters rather than purchasers of gas. Entrepeneurial companies are currently seeking large royalty gas blocks to independently market. As these trends continues, it is conceivable that those lessors who have a significant volume interest of at least 5,000 mcf/day may be in a position to market their own gas on a favorable basis.

If the lessor wants to market his own products, he must negotiate this right as to oil, condensate, gas and liquids, and he will want to be able to access the markets through the lessee's gathering systems and pipeline rights to any plants. My experience is that lessees are reluctant to negotiate these points because they are novel, and they often recite that "safety concerns" preclude them from discussing it. It is quite common for lessee cotenants to individually market their share of production, so I argue that it can be done. This could be a developing trend in an area where it was formerly not feasible.

An alternative for a lessor and lessee who cannot agree on a formula for determining royalty is to allow the lessor to take his share of product in kind and market it himself. It is probably a good "stopgap" measure for the lessor in any event, even if he does not anticipate using it. The only downside to using it is that, if a royalty dispute ever gets into litigation, the lessee's attorney may argue that the lessor should have marketed his own gas instead of insisting on the lessee to do it

as he is required under the lease and under the implied covenant to market. I generally disregard that argument as not being credible because it is unreasonable and bears no relationship to market reality at the present time, at least for all but the most sophisticated lessors. As gas marketing becomes more “user friendly,” however, this could change over time and become viable.

Most courts have ruled that lessors are not entitled to recover royalty on “take or pay” type settlements and payments. I have therefore revised my lease form to include the following provision in the royalty clause:

> (_) TAKE OR PAY GAS CONTRACTS: In the event Lessee enters into a gas purchase contract which contains what is commonly referred to as a "take or pay provision" (such provision meaning that the gas purchaser agrees to take delivery of a specified minimum volume or quantity of gas over a specified term at a specified price or to make minimum periodic payments to the producer for gas not taken by the purchaser) and the purchaser under such gas purchase contract makes payments to Lessee by virtue of such purchaser's failure to take delivery of such minimum volume or quantity of gas, then Lessor shall be entitled to twenty-seven percent (27.00%) of all such sums paid to Lessee or producer under the "pay" provisions of such gas purchase contract. Such royalty payments shall be due and owing to Lessor within sixty (60) days after the receipt of such payments by Lessee. Any royalty payments made to Lessor under the "pay" obligation of any "take or pay" gas contract shall be applied as a credit toward Lessee's minimum royalty obligation or shut-in royalty payment privilege for any year incurred. However, it is expressly understood that no royalty shall be payable to Lessor on "make-up" volumes taken by the purchaser in recoupment of said take or pay payments except to the extent of any price differential applicable to such "make-up" volumes, as provided for in the applicable gas purchase contract. In addition, in the event any portion of such "take or pay" payments are required to be refunded to the purchaser because of the inability to deliver to purchaser recoupment volumes of for any other reasons contemplated under the terms of the applicable gas purchase contract, Lessor shall be obligated to repay to lessee its proportionate part of such refund obligation. If Lessee is not producing any quantities of gas from the leased premises but is receiving payments under the "pay" portion of such "take or pay" gas

> purchase contract provision, such payments shall not relieve Lessee of the duty to make shut-in royalty payments if Lessee desires to continue this lease, but such "take or pay" royalty payments shall be applied as a credit against any shut-in royalty obligation of the Lessee. As between Lessor and Lessee, Lessor shall be deemed a third-party beneficiary of any gas purchase contract entered into between Lessee and any first purchase of Lessor's gas and Lessor shall be entitled to twenty-seven percent (27.00%) of the value of any benefits obtained by or granted to Lessee from any first gas purchaser for the amendment, modification, extension, alteration, consolidation, transfer, cancellation or settlement of any such gas purchase contract which arises and/or transportation agreement which arises out of any claims or disputes relating to take or pay under such agreements.

A recent case dealing with the issue of whether royalty owners are entitled to share in take or pay recoveries is Goss Family Limited Partnership v. Wood, 15 P.3d 517 (Ok. App. – Div. 1 2000). The issue in this case was whether royalty owners were entitled to share in a settlement payment made to lessee from its gas purchaser, which was a non-refundable buy-out with no duty for the lessee to refund any amounts paid and no obligation for the purchaser to take any gas in the future for which it had made settlement. The lease in the case provided for royalty based on "gas produced and sold or used off the leased premises, or gas produced, saved and sold from the premises." The appellate court concluded that this case was controlled by Roye Realty & Developing Co. v. Watson, 949 P.2d 1208 (Ok. 1996). In that case, the Oklahoma Supreme Court held that a royalty owner was not entitled to share in a settlement that involved recoupable buy-downs. The lessee in this case argued that Roye was distinguishable since this case involved a non-recoupable buy-out. The appellate court disagreed. Instead, the court noted that the Oklahoma court had expressly distinguished Frey v. Amoco Production Co., 603 So.2d 166 (La. 1992). In that case, the Louisiana court concluded that an "amount realized" royalty clause allowed royalty owners to receive a portion of the settlement proceeds. Because that language was absent from the lease before this court, it concluded that the royalty owners were not entitled to share in the settlement. Therefore, the appellate court reversed the trial court's summary judgment in favor of the lessors, and held that the lessee had not breached the express or implied covenants in the lease.

Everyone who works with oil and gas leases should know that the law implies certain covenants into every lease transaction. Those covenants, generally,

are the implied covenant to "protect" the lease from drainage (i.e. to drill offsets), to market production, to reasonably develop the lease and to manage and administer the lease. The standard of these covenants is generally that of a reasonably prudent operator under the same or similar circumstances. The beauty of implied covenants is that they are flexible, and thus can respond to changes in the industry over the life of a lease. Many of my clients have properties which are encumbered by leases which were executed in the 1930s, 40s or 50s, so this ability to be flexible should not be regarded lightly.

Implied covenants are generally negated if the parties expressly provided covenants to cover the concerns addressed by the implied covenants. Thus if there is an express clause requiring the lessee to offset drainage, a court would not look to an implied covenant governing the same issue. I like to use a "compensatory royalty" formula to cover drainage situations, which are more flexible for the lessee and give him options. One version of that clause is as follows:

> (a) In the event a well or wells producing oil and/or gas in paying quantities should be brought in on adjacent land and draining the leased premises, Lessee shall immediately act to fully protect the leased premises from drainage. In fully protecting the premises from drainage Lessee expressly agrees either (a) to drill, complete and produce such offset well or wells as may be necessary or advisable in order to offset each draining well as to all depths and horizons covered hereby in which the draining well or wells are completed, or (b) to pay to Lessor an adequate sum of compensatory royalty. For purposes of this provision, it will be presumed that any well producing in paying quantities situated 700 feet or less from any boundary line of this lease is draining the lands covered hereby; provided, however, in no way does the 700 feet distance stipulation relieve Lessee of the obligation to protect the leased premises from drainage in cases where there is an offsetting well situated greater than 700 feet and draining the leased premises. In the event Lessor has reason to believe a well within 1,000 feet (but more than 700') from the leased boundary lines is draining the leased acreage and Lessee does not agree, at Lessor's request, Lessee will furnish Lessor geological and/or geophysical data and interpretations supporting Lessee's belief that such well is not draining the leased acreage together with such other information which is requested by Lessor to allow Lessor to make an independent evaluation. With regard to option (b) herein, an "adequate sum" of

> compensatory royalty is a monthly payment which is no less than the amount of royalty which would be payable hereunder to Lessor if the offsetting well requiring payment of the compensatory royalty were situated on lands covered hereby and such lands were not included in a pooled unit. Said compensatory royalty will be considered royalty within the meaning of Section 3 hereof and will serve to hold this lease in force and effect but only as to a well tract as prescribed in Section 5(c) hereof, the area of which shall be determined on the basis of the assumption that the well is the type of well completed at a legal offsetting location on the lease at the same depth as the offsetting well which requires the payment of the compensatory royalty. It shall be assumed that Lessee has agreed to pay the compensatory royalty provided for in (b) above if Lessee has not commenced drilling operations for an offsetting well on the leased premises within sixty (60) days after the commencement of actual production for market from a draining well brought in on adjacent land; provided, however, the compensatory royalties shall be paid on all production beginning with first runs from the draining well.
>
> (b) The foregoing obligations are recurring obligations and will arise upon the completion of each well on adjacent land. That is to say that Lessee's obligations to offset wells on adjacent lands shall be considered to arise with each draining well completed on the adjacent land and without regard to the existence or locations of wells on the lease at the time the draining well is completed.

My solution to the dilemma of stating express covenants or relying on implied covenants is to get both. I try to secure language such as this: "None of the covenants contained in this Lease shall negate or in any way limit or serve in lieu of any implied covenant available to Lessor."

I also have experimented with raising the lessee's duty to perform the covenants of the lease to a higher standard than that of a "reasonably prudent operator." Perhaps I will seek to secure a commitment from the lessee to treat the lessor with good faith and to deal with him fairly – what lessee would argue with that standard?

"When they boo you, you got to make 'em pay." – Satchel Paige

"Don't look back. Something might be gaining on you." – Satchel Paige

There are some provisions in the lease, such as the timely payment of royalty, which are more critical to the landowner than others. It is a sad fact that a litigious party can take the other party to court for almost any pretext, such as to get a judicial declaration of the respective rights of the parties. Such litigation can be costly, time-consuming and aggravating. In many instances a party would rather just give up than fight it out in court. Such heavy-handed litigation tactics were apparently recently employed by the lessee in Niemeyer v. Tana Oil and Gas Corp., 39 S.W.3d 380 (Tex.App.—Austin 2001, rev. denied)**.** Lessor claimed that Lessee had underpaid royalties. Lessee filed a series of very aggressive counterclaims, which apparently were intended to intimidate the lessor into capitulation. First, the lessee sought to dismiss the lessor's case because he had not given a detailed notice in advance of filing suit in order to advise the lessee that it "has not complied with all its obligations." Relying on Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 875 (Tex. 1968), the court held that the notice requirement applies only to actions to cancel the lease, not to damage suits. The lessee also claimed that the lessor, merely by filing suit, had tortiously interfered with the lessee's contract to sell its interest. Because the lessor had a right to bring the suit the court held that the lessor established a defense to the lessee's interference claim. Such heavy-handed tactics are not well-received by the landowners' bar.

As a response to the heavy handed filing of aggressive claims against landowners, and also as a result of "hardball" tactics, many landowners are now trying to include a provision in the lease which is "nuclear" in its bite: a termination clause. The following is an example from a case in which I was involved, Coastal Oil & Gas Corp. v. Roberts, 28 S.W.3d 759 (Tex. App. – Corpus Christi, pet. filed):

> "Royalties and other payments shall be due and owing to Lessor within 120 days from the date of first production . . . If Lessee wrongfully or unreasonably withholds any such payment or payments due to Lessor for a period of thirty (30) days after written demand for payment is made by Lessor on Lessee . . . at the election of Lessor this lease may be terminated."

In this case Roberts, who was serving as a Trustee of the Coates Energy Trust, the lessor, claimed that its lease with Coastal, known as the "F" lease, had terminated according to the above-referenced express language in the royalty clause. The lessee countered that the lessor had not complied with the clause, or with the provisions of the Texas Division Order statute, which entitle a payor to a signed division order under certain conditions. The trial court terminated the lease and the court of appeals affirmed.

Under the terms of the lease, royalties were due by March 19, 1998. Coastal did not pay royalties on the F-6 well by this date; therefore, Roberts sent Coastal a short written demand for payment that referenced the lease, and gave Coastal 30 days to pay. Coastal responded with a letter stating that it had and would continue to pay royalties. When Coastal failed to pay, the lessor notified Coastal that it was terminating the lease. Coastal claimed, first, that the demand was insufficient because it did not explain the amounts owed. Coastal also claimed that it needed more information since the parties had been engaged in litigation over underpayments of the E leases, which were also referenced in the demand letter. Second, Coastal claimed that it was entitled to a signed division order before disbursing royalties, therefore its failure to pay was not "wrongful." The trial court granted summary judgment terminating the lease. The Corpus Christi Court of Appeals affirmed this holding by noting that generally non-payment of royalties will not terminate a lease, but here the lease included an express condition subsequent that the lessor could terminate the lease. Rejecting Coastal's argument that the demand was insufficient, the court cited well-settled rules of document interpretation, noting "the lease required 'written demand of payment,' and did not require the lessor to explain the particulars of the breach." Additionally, the court held that because the lease clause was unambiguous evidence of dealing between the parties may not be considered.

The court also held that Coastal's failure to pay was "wrongful," as required in the termination clause, because wrongful is defined as unlawful. Coastal claimed that its failure to pay was not unlawful because it was entitled to a signed division order under the statute. The statute provides that a payee may be required to sign a division order as a condition to receiving payment if 1) the payor tenders a form set forth in the statute; or 2) as an alternative, if the payor uses a form that contains only certain listed provisions. The court disagreed with Coastal because its division order mirrored the statutory form for oil, when the F lease produced gas. Although Coastal claimed the form could be used for oil and gas, the court determined that the form only applied to oil. In reaching that conclusion, the court

noted that the form, and its introductory comments, refer only to oil, not gas, and that the term gas expressly appears when intended in other parts of the statute.

Coastal also argued that it had met the alternative requirements in the division order statute, which state that a payee must sign a tendered division order if it contains only certain listed provisions. Coastal's form included a provision requiring the lessors to indemnify Coastal for payments made and for "attorneys fees or judgments in connection with any suit that affects the owner's interest to which payor is made a party." According to the statute, a requirement that the payee indemnify the payor is permissible, "unless otherwise agreed" by the parties to the lease. In this case, the court noted the lease was expressly executed without warranty of title. Therefore, the court concluded that the parties had "otherwise agreed" that the lessor would not be required to indemnify Coastal with respect to title. In light of this conclusion, the court held that Coastal's withholding of royalty was not authorized by the statute and was therefore unlawful and wrongful. As of the submission date of this paper the Supreme Court has not ruled on Coastal's petition for review.

Sometimes it happens. Despite your best efforts to anticipate all potential problems and negotiate a fair lease, there is a dispute over whether there was a default by the lessee in a lease covenant or condition. Under these circumstances, the courts will usually look to the unambiguous terms of the lease document, and not to surrounding circumstances or other extrinsic evidence, in order to decide who prevails. The following excerpts from our brief in the case of Coastal Oil & Gas Corp. v. Roberts, 28 S.W.3d 759 (Tex. App. – Corpus Christi, pet. filed) is a good summary of these rules:

> According to accepted rules of document interpretation, courts focus on the language found within the four-corners of a document. Concord Oil Co. v. Pennzoil, 966 S.W.2d 451, 454 (Tex. 1998); Luckel v. White, 819 S.W.2d 459, 461 (Tex. 1991). In applying this four-corners approach, courts refuse to consider extrinsic evidence, such as evidence of the parties' subsequent conduct or of their own interpretation of a document. Sun Oil Co. v. Madeley, 626 S.W.2d 726, 732 (Tex. 1982) and Hitzelberger v. Samedan Oil Corporation, 948 S.W.2d 497, 507 (Tex. App. Waco – 1997, pet. denied).
>
> Despite these controlling rules, Coastal asks this court to consider extensive extrinsic evidence in interpreting the "F" lease. For

example, Coastal points to an affidavit describing conduct which occurred six years after the lease was executed by the parties. CR 2164. Yet the Texas Supreme Court has directly held that such evidence is irrelevant in the interpretation process. Sun Oil Co. v. Madeley, 626 S.W.2d 726, 732 (Tex. 1982) (refusing to consider evidence of parties' subsequent conduct when interpreting an oil and gas lease). Therefore, evidence like the Lile affidavit, which Coastal discusses for multiple pages in its brief, is simply immaterial.

Consistent with the four-corners rule, courts refuse to imply terms into documents, including leases and statutes. Madley at 733. Instead, they look to the plain meaning expressed in the writing. Smith v. Lidell, 367 S.W.2d 662, 665, 666 (Tex. 1963) (lease interpretation) and El Paso Independent School District v. Sharp, 923 S.W.2d 844, 846 (Tex. 1996) (statutory interpretation). Yet again, Coastal insists on violating the four-corners rule by asking the court to imply terms into the lease. For example, Coastal asks the court to read requirements into section 3a of the "F" lease which simply are not there. Similarly, Coastal asks the court to insert the word "gas division order form" into a section of the Natural Resources Code which plainly creates an "oil" division order form. The trial court properly rejected these arguments.

Coastal spends an inordinate amount of time arguing that the law "disfavors forfeiture." But that sound bite is irrelevant in this case for at least two reasons. First, this case involved interpretation of an express termination clause, not forfeiture. Second, Texas law rejects the notion that "equity abhors a forfeiture" when it comes to oil and gas leases. Instead, Texas views the oil and gas lease as creating a fee simple determinable, which leads to automatic forfeiture when certain conditions are breached. Luckel v. White, 819 S.W.2d 459, 464 (Tex. 1991). For example, an oil and gas lease terminates automatically when production ceases. Clifton v. Koontz, 325 S.W.2d 684, 687-88 (Tex. 1959). Moreover, Sowell and Hitzelberger, discussed above, demonstrate that Texas courts will not hesitate to enforce express lease termination provisions, such as the one contained in the "F" lease. See also Nelson Bunker Hunt Trust Estate v. Jarmon, 345 S.W.2d 579, 581-82 (Tex. Civ. App.– San Antonio 1961, writ ref'd n.r.e.); Amber Oil & Gas Co. v. Bratton, 711 S.W.2d 741, 743-44

(Tex. App. – Austin 1986, no writ); McCray v. Kelley, 130 S.W.2d 458, 462 (Tex. Civ. App.– Galveston 1939, writ dism'd); Young v. Jones, 222 S.W. 691, 694 (Tex. Civ. App.– El Paso 1920, no writ).

In this regard, Coastal's suggested distinction between cases that concern a failure of a condition of the estate granted, and cases which involve failure to pay royalty as a breach of a covenant of the estate, actually makes Coates' position stronger. See Appellants' Brief at 20 n. 6. When a lessee fails to meet a condition of the leasehold estate, notice is not typically required to terminate the lease, even when the termination may seem harsh. See 1E Smith & Weaver, Texas Law of Oil and Gas, pp. 167 and cases cited. E.g. Young, 222 S.W. at 694 ("This being the nature of the contract, equity will not relieve against the failure to exercise the option in strict accordance with its terms").

In the case at bar, on the other hand, termination for failure to pay royalties requires a written demand because of the express provision in the lease to that effect. Surely, termination without notice, as in cases involving conditions of the estate, is more onerous than termination with notice, as in the case at bar, as well as in cases like Sowell. Thus, if the law is willing to allow lease termination without any notice at all, so will the law allow a termination where there has been notice. This is particularly appropriate in cases involving the complete non-payment of royalties from producing wells. The failure to pay anything at all is a readily verifiable event, against which a prudent operator can easily guard Hence, it is not unfair to trigger termination upon complete failure to pay royalty.

“It ain’t over till it’s over.” – Yogi Berra

“What time is it, Yogi?”

– Yogi Berra: “You mean now?”

A lot of holes still get poked into the ground each year in the search for commercial production of hydrocarbons, and the owners of those minerals have an essential product that the e & p companies need to allow them to do their job. I once had a client who asked me if I thought that all of the drilling on his land and the production which was being sucked from it might cause the surface to cave in someday. I told him that it was a problem that I would like to have.

If you have a greater understanding of what the lessor is looking for, you are better armed to make a deal. I hope to meet you soon in a lease negotiation – thank you for allowing me to share my thoughts on this topic.

And now for a final word of advice:

“Work like you don’t need the money.

Love like you’ve never been hurt.

Dance like nobody’s watching.”

– Satchell Paige