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## Oil, Gas, and Mineral Law

Eric T. Laity

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# OIL, GAS, AND MINERAL LAW

by

Eric T. Laity\*

**T**HIS Article surveys the significant developments of the past year in the Texas law of oil, gas, and minerals. The Article limits its analysis to Texas and federal court decisions and Texas Legislative acts.<sup>1</sup>

## I. CASES

### A. Conveyancing

*Mineral Reservations.* In *Patrick v. Barrett*<sup>2</sup> the Texas Supreme Court considered a case in which a grantor reserved one-half of a mineral estate encumbered by a previously reserved royalty interest. The court held that the grantor reserved one-half of the royalty under any subsequent oil and gas lease when the grantor expressly excepted the previously reserved royalty interest from the general conveyance.<sup>3</sup> In a 1950 deed the Patricks conveyed a tract of land to the Barretts subject to various exceptions and reservations. The deed excepted a one-sixteenth royalty interest that had been reserved by the Tuers, who had granted the land to the Patricks. The deed also provided for an exception and reservation to the Patricks, their heirs, and assigns of an undivided one-half interest in the mineral estate, except a one-thirty second royalty interest in the mineral estate, which the Patricks specifically conveyed to the Barretts.<sup>4</sup>

Both the Patricks and the Barretts conceded in their briefs that in 1950 oil and gas leases for land in their locale usually provided for a landowner royalty of one-eighth. The Patricks and the Barretts disputed, however, the share of royalties the Barretts were entitled to under an oil and gas lease

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\* B.A., J.D., Harvard University. Attorney at Law, Thelen, Marrin, Johnson & Bridges, Houston, Texas.

1. The law of oil, gas, and minerals historically focused only on the exploration and production of minerals and hydrocarbons. Pursuant to this tradition, the law of oil, gas, and minerals has not included the legal aspects of the transportation, refining, and marketing of minerals and hydrocarbons. The organization and financing of enterprises that conduct these activities also are not within the ambit of oil, gas, and mineral law. This Article preserves the traditional focus on exploration and production.

2. 734 S.W.2d 646 (Tex. 1987).

3. *Id.* at 648.

4. This account of the facts of the case is synthesized from the opinions of the Texas Supreme Court and the Beaumont Court of Appeals. *Patrick v. Barrett*, 724 S.W.2d 418 (Tex. App.—Beaumont 1987), *rev'd*, 734 S.W.2d 646 (Tex. 1987). This Article simplifies the facts of the case for the purposes of the Survey. The Barretts making the appeal are the successors in interest to the grantees under the Patricks' deed. The Patricks in this suit are the successors in interest to the Patricks who signed the deed in contention.

given on the property. The Patricks argued that their reservation of one-half of the mineral estate also reserved to them one-half of any landowner royalty payable under a lease. According to the Patricks, the one-sixteenth royalty interest reserved by the Tuers and duly excepted by the Patricks in their conveyance to the Barretts should be charged entirely against the Barretts' one-half of the mineral estate. Under this position, the specific grant by the Patricks to the Barretts would have left the Patricks with a share of the landowner royalty under any oil and gas lease equalling one-half of the royalty less one-thirty second of all production under the lease. In the case of a lease providing for a one-eighth landowner royalty, the lease would entitle the Patricks to one-thirty second of all production under the lease and entitle the Barretts to the same fraction of production. In the case of a lease providing for a landowner royalty of three-sixteenths, the 1950 deed would entitle the Patricks to one-sixteenth of all production under the lease and entitle the Barretts to one-thirty second of all production.<sup>5</sup>

The court of appeals disagreed with the Patricks' argument.<sup>6</sup> The court of appeals cited *Benge v. Scharbauer*<sup>7</sup> for the proposition that unless the parties clearly agreed otherwise, a grantee received a royalty interest proportionate to the mineral interest he received in the deed.<sup>8</sup> *Benge* arguably supports the court of appeal's statement if the royalty interest to which the court of appeals refers is an interest in the landowner royalty specified in an oil and gas lease and if the grantee denotes the person receiving the benefit of a conveyance or reservation. A fuller statement of the court of appeal's proposition would be that unless the parties clearly agree otherwise, a person receives a share in the landowner royalty under a lease proportionate to the mineral interest he receives or reserves in the deed.<sup>9</sup>

The court of appeals applied the *Benge* rule to the Barretts' deed with surprising results. According to the court, when the Patricks conveyed one-half of the mineral estate by means of the 1950 deed, they conveyed to the Barretts one-half of the remaining one-sixteenth royalty interest.<sup>10</sup> The court failed to conclude, at that point in its analysis, that the Barretts received a one-half interest in any landowner royalty payable under a lease or that the one-sixteenth royalty interest held by the Tuers should be charged against the Patricks' one-half interest in such landowner royalties.<sup>11</sup> The court also failed to find that the Patricks retained a one-half interest in any landowner royalty payable under a lease or that the one-sixteenth royalty interest held by the Tuers should be charged against the Barretts' one-half

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5. 734 S.W.2d at 648. After the Patricks conveyed the land to the Barretts in 1950, the Tuers conveyed their one-sixteenth royalty interest to the Patricks. This Article, however, will treat that one-sixteenth royalty interest as separate from the interests retained by the Patricks under their 1950 deed to the Barretts.

6. 724 S.W.2d at 419.

7. 152 Tex. 447, 259 S.W.2d 166, 169 (1953).

8. 724 S.W.2d at 419 (citing *Benge*, 152 Tex. at 453, 259 S.W.2d at 169).

9. *Id.*

10. *Id.*

11. *Id.*

interest in such landowner royalties.<sup>12</sup>

The court of appeals mistakenly believed that the *Benge* rule stated that a party to a deed receives a share in the remainder of the landowner royalty (after the prior rights of third parties are satisfied) proportionate to the mineral interest he receives or reserves in the deed.<sup>13</sup> Under this incorrect interpretation of the *Benge* rule, the conveyance would have to include an express agreement between the parties in order to entitle the grantor to one-half of the total landowner royalty under his reserved one-half mineral interest. The result in *Benge* contradicts this interpretation of the *Benge* rule.<sup>14</sup> Under a correct interpretation of *Benge*, the Patricks would be entitled to one-half of the total landowner royalty, unless their deed to the Barretts expressly stated otherwise. After concluding that the Patricks retained only a one-half interest in the remaining one-sixteenth royalty interest, the court of appeals held that the Patricks' grant of a one-thirty second royalty interest to the Barretts in the deed left the Patricks with no interest at all in the landowner royalties payable under a lease.<sup>15</sup> The Barretts, therefore, retained the entire remaining one-sixteenth royalty interest.<sup>16</sup>

The Texas Supreme Court reversed the judgment of the court of appeals.<sup>17</sup> The supreme court failed to take issue with the manner in which the court of appeals applied the *Benge* rule. Rather, the supreme court found an express statement in the Patricks' deed that non-proportionate shares of royalty were conveyed.<sup>18</sup> The supreme court found that the express exception of a royalty interest in favor of the Tuers constituted an express statement.<sup>19</sup> The 1950 deed, therefore, provided that the Patricks and the Barretts each held a one-thirty second royalty interest.<sup>20</sup>

The result in *Barrett* is incorrect in one regard. An oil and gas lease may provide for a landowner royalty greater than one-eighth.<sup>21</sup> The court, therefore, should not have declared the Patricks the owners of a one-thirty second royalty interest under the 1950 deed. Under the court's reasoning, the Patricks were entitled to one-half of the landowner royalty payable under whatever lease then in force, less a one-thirty second interest in favor of the Barretts, in production from the lease.<sup>22</sup> The Barretts were entitled to the same amount: one-half of the landowner royalty under the lease, less a one-sixteenth royalty interest in favor of the Patricks' own grantor, plus the one-thirty second royalty interest granted to the Barretts under the 1950 deed from the Patricks.

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12. *Id.*

13. *Id.*

14. 152 Tex. 447, 453, 259 S.W.2d 166, 169 (1953).

15. 724 S.W.2d at 419.

16. *Id.*

17. 734 S.W.2d at 648.

18. *Id.*

19. *Id.*

20. *Id.*

21. See 724 S.W.2d at 421-22 (Brookshire, J., dissenting) (stating that the actual landowner royalty specified in the applicable lease is one-sixth).

22. 734 S.W.2d at 648.

*Inconsistent Granting and Future-Lease Clauses.* In *Hawkins v. Texas Oil and Gas Corp.*<sup>23</sup> the Waco Court of Appeals held that a deed conveyed a permanent one-thirty second royalty interest. The granting clause of the deed conveyed a one-thirty second royalty interest in the property. The "subject-to" clause of the deed further provided that the conveyance included one-fourth of the one-eight royalty under the existing lease. A third clause of the deed reserved the executive rights and delay rentals to the grantors.<sup>24</sup> The future-lease clause of the deed, however, stated the parties' agreement that upon the expiration of the then-current lease, the grantees would own a one-half interest in the minerals underlying the described property.

The *Hawkins* court examined three separate methods of analysis that the Texas Supreme Court had previously used in reconciling apparently conflicting deed provisions.<sup>25</sup> These three methods of analysis originated in *Hoffman v. Magnolia Petroleum Co.*,<sup>26</sup> *Alford v. Krum*,<sup>27</sup> and *Garrett v. Dils Co.*<sup>28</sup> In *Hoffman* the Texas Commission of Appeals formulated the two-grant theory, under which the court resolved an apparent inconsistency between the granting and the subject-to clauses of a deed by determining that the parties intended two separate conveyances.<sup>29</sup> The *Hoffman* court held that the deed conveyed an interest in the royalties payable under the current lease and that it also conveyed a separately measured interest in the reversionary interest in the mineral estate.<sup>30</sup>

In *Alford* the Texas Supreme Court resolved an inconsistency between a deed's granting clause and its future-lease clause in favor of the granting clause.<sup>31</sup> The granting clause, the court stated, contained the parties' "key expression of intent."<sup>32</sup> The court said that the parties merely intended the future-lease clause to explain or restate the operative effect of the grant in the event of the termination of any present lease and the execution of any future leases.<sup>33</sup> The *Hawkins* court concluded that *Alford* did not overrule the two-grant doctrine.<sup>34</sup>

The *Garrett* case involved a deed containing a granting clause that conflicted with both the subject-to clause and the future-lease clause. The *Garrett* court held that the parties intended to convey the interest described in the subject-to and future-lease clauses rather than the interest set forth in the

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23. 724 S.W.2d 878, 888 (Tex. App.—Waco 1987, no writ).

24. Compounding the confusion, this third clause also provided that the grantees were to receive one-fourth of all minerals produced under any future lease.

25. 724 S.W.2d at 883-88.

26. 273 S.W.2d 828, 830 (Tex. Comm'n App. 1925, holding approved).

27. 671 S.W.2d 870, 872-73 (Tex. 1984).

28. 157 Tex. 92, 96-97, 299 S.W.2d 904, 907 (1957).

29. *Hoffman*, 273 S.W.2d at 830.

30. *Id.* at 830-31.

31. *Alford*, 671 S.W.2d at 872-73.

32. *Id.* at 872.

33. *Id.* at 873 (citing R. HEMINGWAY, THE LAW OF OIL AND GAS § 9.1, at 411-13 (1971); 3A W. SUMMERS, THE LAW OF OIL AND GAS § 6.06, at 375-82 (1927)).

34. *Hawkins*, 724 S.W.2d at 886.

granting clause.<sup>35</sup> The granting clause was the only provision in the deed inconsistent with the other deed provisions, which all described an interest different from the interest mentioned in the granting clause.

The *Hawkins* court held that the deed's granting clause controlled and cited *Alford* in support of its holding.<sup>36</sup> The *Hawkins* court refused to apply the two-grant doctrine employed by the *Hoffman* court.<sup>37</sup> The *Hawkins* court applied the *Alford* doctrine for two reasons. First, the *Hawkins* court distinguished the provisions of the *Hawkins* deed from the deed provisions in *Hoffman* and other cases applying the two-grant doctrine.<sup>38</sup> The *Hawkins* court distinguished *Hoffman* since *Hoffman* did not involve inconsistent clauses purporting to measure the mineral interest received by the grantee after the expiration of the current lease on the property.<sup>39</sup> Second, the *Hawkins* court noted the similarities between the provisions of the *Alford* deed and the *Hawkins* deed.<sup>40</sup> The *Hawkins* court concluded that the application of *Alford* voided the future-lease clause in the *Hawkins* deed to the extent it was inconsistent with the granting clause.<sup>41</sup> The court then suggested that because the *Hawkins* deed's reference to a mineral interest was void and because the *Hawkins* grantees therefore received only a royalty interest, the court did not need to apply the two-grant theory.<sup>42</sup> The court's opinion suggests, therefore, that the *Alford* approach is a threshold test that courts must apply before resorting to the two-grant theory. The *Hawkins* court also cited *Garrett* in support of its holding that the granting clause controlled the interpretation of the deed.<sup>43</sup> In citing *Garrett*, the *Hawkins* court noted that the *Hawkins* deed specifically denied the grantees any interest in future delay rentals.<sup>44</sup> If the grantors had intended to convey a mineral interest rather than a royalty interest to the grantees, then the grantees would have

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35. 157 Tex. at 96-97, 299 S.W.2d at 907.

36. 724 S.W.2d at 886.

37. *Id.*

38. *Id.*

39. *Id.* The granting clause and the future lease clause of a deed both give indications of the grantor's intentions concerning the quantum of interest the grantee will enjoy upon the current lease's expiration. The *Hawkins* court stated:

Unlike the deed in *Alford v. Krum*, none of the decisions highlighted above as illustrating the two-grant theory involved an expansion or limitation of the granting clause by a subsequent clause in the deed. Instead, the second grant was compatible with and in addition to whatever interest was conveyed by the granting clause. This cannot be said of the deed in *Alford v. Krum* nor of the [*Hawkins* deed].

*Id.* The court's intended meaning is difficult to ascertain from the quoted language.

40. *Id.* The court's statement may reflect the court's observation that the same pairing of clauses in the two deeds were inconsistent. Language elsewhere in the opinion, however, suggests that the court believed that precedent dictated a determination that an inconsistency existed between the *Hawkins* deed's granting clause and its future-lease clause. See *Id.* at 883. For example, the court stated that "the granting clause conflicts irreconcilably with the future-lease clause, based on the decision in *Alford v. Krum*, and the granting clause must prevail to the extent of the conflict." *Id.*

41. *Id.* at 886.

42. *Id.* at 888.

43. *Id.*

44. *Id.*

received an interest in the delay rentals.<sup>45</sup>

### B. Mother Hubbard Clauses

In *Jones v. Colle*<sup>46</sup> the Texas Supreme Court held that a Mother Hubbard clause in an oil and gas lease only covers relatively small tracts of land that may exist unknown to one or both of the parties to a lease. One of the parties' clear expression of an intention to include in the lease a larger tract known to him is irrelevant to the scope of the Mother Hubbard clause.<sup>47</sup> The mineral interest disputed in *Jones v. Colle* was leased from Winifred Curry. Curry owned mineral interests in two adjoining tracts of land, one consisting of 68.72 acres and the other consisting of 49.34 acres. Curry owned only part of the minerals under each tract. In the first tract Curry owned 28.84 mineral acres, and in the second tract Curry owned 20.7 mineral acres. Combined, Curry's mineral interests in the two tracts amounted to 49.54 mineral acres.

In 1978 Colle obtained a receivership lease from the appropriate district court that purported to cover 49.34 mineral acres under Curry's first tract. Although the Colle lease did not describe the second tract as part of the land covered by the lease, the Colle lease did include a Mother Hubbard clause providing that the lease also included additional land contiguous or adjacent to or adjoining the land purported to be conveyed if the lessor owned the additional land or claimed it by limitation, prescription, possession, reversion of an unrecorded instrument, or if the lessor had a preferential right of acquisition. Colle knew of the existence of both tracts of land and had prepared the receivership lease.

Five years later, Curry gave an oil and gas lease to Jones covering both tracts of land. Jones and Colle each believed himself to be the first lessee of Curry's mineral interest in the second tract. Colle argued that the Mother Hubbard clause in his receivership lease was sufficient to convey Curry's mineral interest in the second tract to him, since the reference in the receivership lease to 49.54 mineral acres clearly showed an intention to cover Curry's interest in both tracts. In response, Jones relied on *Smith v. Allison*,<sup>48</sup> in which the Texas Supreme Court stated that the purpose of a Mother Hubbard clause was "to prevent the leaving of small unleased pieces or strips of land, . . . which may exist without the knowledge of one or both of the parties by reason of incorrect surveying, careless location of fences, or other mistakes."<sup>49</sup>

The Texas Supreme Court ratified the *Allison* court's language, and held that a Mother Hubbard clause only covers property not described in the conveyance when the property consists of small unleased pieces of land that

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45. *Id.*

46. 727 S.W.2d 262, 263 (Tex. 1987).

47. *Id.*

48. 157 Tex. 220, 301 S.W.2d 608 (1957).

49. *Id.* at 229, 301 S.W.2d at 615 (citing *Sun Oil Co. v. Bennett*, 125 Tex. 540, 549, 84 S.W.2d 447, 452 (Tex. Comm'n App. 1935)).

may exist without the knowledge of one or both of the parties.<sup>50</sup> The *Colle* court further held that a clear intention to convey a larger tract of land than that specifically described in the conveyance will not expand the scope of the Mother Hubbard clause.<sup>51</sup>

### C. *Paying Quantities, Commercial Quantities, and Unprofitable Operations*

In *El Paso Natural Gas Co. v. American Petrofina Co.*<sup>52</sup> a Texas court of appeals held that, in determining whether the operation of a well on the lease had become unprofitable for the assignee under a reassignment clause of the assignment, a court may consider as a cost an overriding royalty in favor of the assignor of the oil and gas lease. The court held that the anticipated costs of drilling a development well, together with the cost of the overriding royalty, could be taken into account in determining whether production in commercial quantities was likely from undeveloped acreage under a separate reassignment clause of the assignment.<sup>53</sup> *El Paso Natural Gas* ("El Paso") took an assignment from American Petrofina comprising several oil and gas leases covering land located in the San Juan Basin of New Mexico.<sup>54</sup> In return for the assignment, American Petrofina retained an overriding royalty in each lease. The lease defined the overriding royalty in terms of a special dollar amount for each thousand cubic feet of gas produced under the lease, rather than as a percentage of production. The amount of the overriding royalty was subject to escalation over time and was subject to arbitration after an initial term. After an unusual and complicated series of events, El Paso's cost from the overriding royalty became greater than the proceeds from the gas.

El Paso tendered a reassignment of the leases to American Petrofina. The terms of the original assignment entitled El Paso to reassign any well and its proration unit to American Petrofina if the well became unprofitable for El Paso. *American Petrofina* relied on *Clifton v. Koontz*<sup>55</sup> for the proposition that a court could not consider an overriding royalty as a cost in determining whether a lease was operating at a profit. If each well produced in paying quantities, American Petrofina argued, the well operated at a profit.

The court rejected American Petrofina's arguments and held in favor of El Paso.<sup>56</sup> The court distinguished *Koontz* because that case involved the question of whether a lease was producing in paying quantities, rather than the question of whether it was operating at a profit.<sup>57</sup> If a lease<sup>58</sup> had to cease

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50. *Colle*, 727 S.W.2d at 263.

51. *Id.*

52. 733 S.W.2d 541, 543-48 (Tex. App.—Houston [1st Dist.] 1986, no writ).

53. *Id.* at 549.

54. The facts of this case have been simplified considerably for discussion.

55. 160 Tex. 82, 92-93, 325 S.W.2d 684, 692-93 (1959).

56. *El Paso*, 733 S.W.2d at 549, 555-56.

57. *Id.* at 549.

58. The court did not distinguish between leases and wells in its discussion of unprofitable operations.

production in paying quantities before the lease could be considered unprofitable, the court said, the reassignment clause would be meaningless.<sup>59</sup> If a lease stopped producing in paying quantities, then the lease would terminate according to its terms, and there would be nothing to reassign to American Petrofina.<sup>60</sup> The court held that the cost of the overriding royalty could be considered in determining whether a well was operating profitably.<sup>61</sup>

The terms of the original assignment entitled El Paso to reassign to American Petrofina any drilling unit in the event development near the unit demonstrated the unit would not produce gas in commercial quantities.<sup>62</sup> The court of appeals held that an operator may consider the cost of drilling and equipping a well, in addition to the cost of the overriding royalty, in assessing whether the acreage will produce in commercial quantities.<sup>63</sup> In this case of first impression with regard to defining production in commercial quantities, the court of appeals held that the cost of drilling and equipping a well could be considered only if such expense had not yet been incurred by the lessee.<sup>64</sup> The court's opinion suggests that, in general, if an operator has already drilled and completed a well, the operator cannot include the expense of drilling and equipping in determining whether the well will produce in commercial quantities.<sup>65</sup>

Under the reassignment clause for unprofitable wells, American Petrofina had the option to sell gas from any reassigned wells to El Paso for the highest price El Paso or any other bona fide pipeline company paid for gas of like quality in the field. Because of the costs associated in building pipelines, El Paso had a competitive edge in bidding to purchase the production from the reassigned wells. In effect, the combination of the option to sell reassigned gas to El Paso and the reassignment clause gave El Paso an effective cap on the royalty burden encumbering El Paso's ownership of the wells subsequently reassigned to American Petrofina. Once the royalty burden increased to a level in excess of the prevailing field price for gas, El Paso could reassign the wells without jeopardizing the flow of production from those wells into its pipeline system. Despite the change in ownership of the wells and the attendant shift from El Paso to American Petrofina of the monetary obligation to pay landowner royalties and of the operator responsibilities, the net economic effect on El Paso of the reassignment was the lowering of its costs associated with production from the wells.

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59. 733 S.W.2d at 548.

60. *Id.*

61. *Id.* at 547.

62. More specifically the reassignment clause permitted El Paso to reassign a drilling unit in the event that operations on nearby property demonstrated that the unit would not produce from the Mesaverde Formation. If El Paso reassigned the drilling unit, the reassignment relieved El Paso of its obligation to test the Mesaverde Formation. The lease entitled El Paso to retain any wells within the units producing from different formations.

63. 733 S.W.2d at 549.

64. *Id.*

65. *See id.*

*D. Royalties on Sour Gas*

In *Schwartz v. Prairie Producing Co.*<sup>66</sup> the Houston Court of Appeals held that a landowner royalty on hydrogen sulfide gas produced from a gas well was to be computed under the gas royalty clause of the governing lease rather than under the lease's sulphur royalty clause. The Schwartz leases produced sour gas, which is a mixture of natural gas and hydrogen sulfide gas. Pursuant to a contract with Cities Service Co., Prairie Producing delivered the sour gas to Cities Service at the wellhead. Cities Service then transported the sour gas to its processing plant and extracted elemental sulphur from the hydrogen sulfide gas. Cities Service kept a small portion of the sulphur that it extracted and delivered the bulk of the sulphur back to Prairie Producing for sale to third parties. The *Schwartz* court characterized the transaction between Prairie Producing and Cities Service as a sale by Prairie Producing of hydrogen sulfide gas to Cities Service,<sup>67</sup> although the court did not specifically discuss the terms of the parties' agreement. The court failed to discuss the disposition of the natural gas that remained after extraction of the hydrogen sulfide and the method for calculating the landowner royalty on the sweet natural gas.

The Schwartz leases provided for a landowner royalty of one-fourth of the amount Prairie Producing realized from selling the gas at the wellhead. The leases also provided for a landowner royalty of one-fourth of the gas's market value at the wellhead if Prairie Producing used the gas off the lease or in manufacturing gasoline or other products. Finally, the Schwartz leases provided for a landowner royalty of one dollar per long ton on sulphur mined and marketed. Prairie Producing tendered a landowner royalty of one dollar per long ton of sulphur extracted from the sour gas to the Schwartzes. The Schwartzes refused the payments and claimed a landowner royalty of one-fourth of the value Prairie Producing received for the hydrogen sulfide gas. The Schwartzes contended the value of the hydrogen sulfide equalled one-fourth of Prairie Producing's net proceeds from the sale of the elemental sulphur Cities Service delivered to Prairie.

The *Schwartz* court stated that the issue was whether the Schwartzes should have received landowner royalties under the hydrogen sulfide gas clause or under the sulphur clause of the leases.<sup>68</sup> The court of appeals held that hydrogen sulfide gas was the substance produced by the well and that the landowner royalties should, therefore, be computed under the gas royalty clause.<sup>69</sup> The court reasoned that sulphur was not actually mined, but was extracted from the hydrogen sulfide gas.<sup>70</sup> The court's decision accords with the Fifth Circuit's decision in *First National Bank v. Pursue Energy*

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66. 727 S.W.2d 289, 292 (Tex. App.—Houston [1st Dist.] 1987, no writ) (citing *First Nat'l Bank v. Pursue Energy Corp.*, 799 F.2d 149, 152-53 (5th Cir. 1986)).

67. *Id.* at 292 n.1 (stating the case involved a sale of hydrogen sulfide gas rather than a sale of sulphur).

68. *Id.* at 290.

69. *Id.* at 292-93.

70. *Id.*

*Corp.*<sup>71</sup> The *Schwartz* court noted that it was faced with a legal issue and royalty clause identical to those faced by the *Pursue* court.<sup>72</sup>

Prairie Producing relied on *Southland Royalty Co. v. Pan American Petroleum Corp.*<sup>73</sup> for the proposition that a producer could characterize a natural gas well as a mine. Prairie Producing argued that the language of the sulphur royalty clause in the *Schwartz* leases included sulphur produced from hydrocarbon wells. The *Schwartz* court rejected Prairie Producing's argument and refused to extend the *Southland Royalty* holding to the facts in *Schwartz*.<sup>74</sup> The *Schwartz* court cited the general rule that mineral leases are strictly construed in favor of the lessor.<sup>75</sup> The plurality opinion in *Schwartz* limits the case's precedential value.<sup>76</sup>

### E. Forced Pooling

In *Buttes Resources Co. v. Railroad Commission*<sup>77</sup> the Houston Court of Appeals held that a voluntary offer to pool was not unreasonable under the Texas Mineral Interest Pooling Act (the "MIPA")<sup>78</sup> if the offer did not include a risk premium for drilling and completing the well. The *Buttes* court held that a voluntary offer to pool was not unreasonable if it proposed to include within the pooled unit unproductive acreage once capable of producing from the reservoir underlying the proposed unit.<sup>79</sup> *Buttes Resources* operated a voluntarily pooled gas unit of 179 acres on which the Drisdale No. 1 gas well had been drilled. Adjacent to the Drisdale No. 1 unit were fifty-five acres located above the Drisdale reservoir. The adjacent fifty-five acres were downfield from the producing unit, and production from the Drisdale No. 1 well drained gas from the fifty-five acres tract, causing water to replace the drained gas. The geological structure of the reservoir, therefore, was such that the adjacent fifty-five acres "watered out" the Drisdale No. 1 unit produced gas.

*Buttes* at one time had leased the fifty-five acres. *Buttes* chose not to pool the fifty-five acres with the Drisdale No. 1 unit and permitted the leases to expire. J.L. Schneider, Jr., another defendant in the action, then leased the fifty-five acres and offered to pool his fifty-five acres with the Drisdale No. 1 unit. *Buttes* refused the offer. At the time of Schneider's offer, thirty-three

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71. 799 F.2d 149, 150-51 (5th Cir. 1986).

72. 727 S.W.2d at 291.

73. 378 S.W.2d 50, 55-56 (Tex. 1964).

74. 727 S.W.2d at 292-93.

75. *Id.* at 291-93 (citing *Clark v. Perez*, 679 S.W.2d 710, 714 (Tex. App.—San Antonio 1984, no writ)).

76. The three justices on the appeals panel split on the result in the case. Justice Cohen wrote the panel's opinion. Justice Dunn concurred in the court's decision to reverse the summary judgment, but would have held that the royalty clauses were ambiguous. *Id.* at 293. Justice Bass dissented, considering the issue to be the appropriate manner in which to calculate the landowner royalty on the sulphur mined from the leases. *Id.* at 293-94.

77. 732 S.W.2d 675, 678 (Tex. App.—Houston [14th Dist.] 1987, no writ).

78. TEX. NAT. RES. CODE ANN. §§ 102.001-.112 (Vernon 1978).

79. 732 S.W.2d at 678.

acres had watered out, leaving only twenty-two acres of the original fifty-five acres productive.

Schneider's voluntary pooling proposal included all fifty-five acres in the enlarged unit. Schneider also proposed that each working interest owner in the additional fifty-five acres reimburse the existing participants for the new participant's share of the drilling and completion expenses of the Drisdale No. 1 well. Each new interest owner's share of the expense would be calculated based on his pro rata share of the acreage in the enlarged unit. Each new interest owner could elect either to pay his share of the drilling and completion costs in cash shortly after the enlarged unit became effective or to direct Buttes to recover from the new owner's share of production. If a new interest owner chose to have his share of drilling and completion costs withheld from future production, then Buttes would also be entitled to withhold an additional amount equal to the new interest owner's share of the drilling and completion expenses. The parties referred to this additional amount as a risk penalty. If a new interest owner chose to pay his share of drilling and completion expenses in cash, he would not be required to pay a risk penalty.

Since Buttes refused Schneider's offer to pool, Schneider obtained a Texas Railroad Commission pooling order that was retroactively effective. On appeal, the district court upheld the pooling order, but changed the effective date so that the order was not retroactive.<sup>80</sup> Buttes appealed and argued that the Railroad Commission should not have issued the pooling order. Schneider and the Texas Railroad Commission appealed the district court's changing of the pooling order's effective date.

Under the Texas Mineral Interest Pooling Act,<sup>81</sup> an interest owner seeking to force pooling of his acreage with an existing unit by means of a compulsory pooling order must first make a fair and reasonable offer to pool voluntarily.<sup>82</sup> The statute does not define a fair and reasonable offer for voluntary pooling. Moreover, the Texas Supreme Court has declined to define a fair and reasonable offer.<sup>83</sup>

The Texas Supreme Court stated, however, that the pooling offer must be one that considers the relevant facts existing at the time of the offer that a reasonable person entering into a voluntary agreement concerning oil and gas properties would consider important.<sup>84</sup> In contesting the Railroad Commission's compulsory pooling order, Buttes argued that Schneider's offer was unreasonable because it did not provide for cash payments to Buttes as a risk penalty for drilling the wildcat Drisdale No. 1 well. The *Buttes* court acknowledged that a risk penalty might be a necessary factor in voluntary offers to pool when the party seeking to join an existing unit originally had been entitled to join in the drilling of the well.<sup>85</sup> A risk factor recognizes

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80. *Id.*

81. TEX. NAT. RES. CODE ANN. §§ 102.001-.112 (Vernon 1978).

82. *Id.* § 102.013(b).

83. *Carson v. Railroad Comm'n*, 669 S.W.2d 315, 316 (Tex. 1984).

84. *Id.* (cited by *Buttes*, 732 S.W.2d at 678).

85. *Buttes*, 732 S.W.2d at 678.

that the party seeking to join the unit previously had an opportunity to delay his decision to share in the cost of the well until he determined whether or not the well would be productive.<sup>86</sup>

In this case, however, Schneider did not hold leases to the adjacent fifty-five acres when the Drisdale No. 1 well was drilled. In addition, the offer of a risk penalty recoverable only out of production, and then only in the event that the new interest owner failed to pay his share of the drilling and completion costs in cash, matched the manner in which the MIPA directs the Texas Railroad Commission to handle costs, penalties, and methods of payment in its compulsory pooling orders.<sup>87</sup> The *Buttes* court held, therefore, that Schneider's offer of voluntary pooling was not unreasonable for failing to provide a risk cash penalty.<sup>88</sup>

Buttes also argued that Schneider's offer was unreasonable because it proposed to add all fifty-five acres to the existing unit, even though thirty-three acres were no longer productive. The court rejected Buttes' arguments for two reasons. First, the court noted that the Texas Railroad Commission usually includes all of the originally productive acreage in water-drive reservoirs when it computes production allowable.<sup>89</sup> The court noted that although the commission had ordered only the twenty-two productive acres to be pooled with the existing unit, the commission gave Buttes the option to add all fifty-five acres to the unit.<sup>90</sup> If Buttes exercised that option, the court noted, all 55 acres would be assigned to the unit for proration purposes.<sup>91</sup> As a second reason for rejecting Buttes's argument, the court noted that Buttes might have wrongfully drained the adjacent fifty-five acres.<sup>92</sup> The court could consider the fact that Buttes had drained the fifty-five acres without compensating the landowners in determining the reasonableness of Schneider's voluntary pooling offer.<sup>93</sup>

## II. STATUTES

### A. *Business and Commerce Code*

The Texas Legislature enacted a number of significant statutes during the Survey period. The legislature amended section 9.319 of the Texas Business and Commerce Code to grant, in certain instances, an automatically perfected security interest to an interest owner to secure his operator's obligation to remit the interest owner's share of production proceeds.<sup>94</sup> The statute expanded the definition of a first purchaser to include an operator receiving production proceeds from a third-party purchaser acting in good

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86. *Id.*

87. TEX. NAT. RES. CODE ANN. § 102.052(a) (Vernon 1978).

88. 732 S.W.2d at 678.

89. *Id.*

90. *Id.* at 679.

91. *Id.*

92. *Id.*

93. *Id.*

94. TEX. BUS. & COM. CODE ANN. § 9.319(a) (Vernon Supp. 1988).

faith under a division order, or other agreement, signed by the operator.<sup>95</sup> If a third-party purchaser pays the production proceeds jointly to the operator and the interest owner, however, it appears that the statute does not deem the operator to be a first purchaser.<sup>96</sup>

The legislature also amended section 9.319 of the Business and Commerce Code to remove an interest owner's right to insist that a third-party purchaser deliver proceeds from oil production only to the interest owner (and not to the operator) if the third-party purchaser wishes to terminate the interest owner's section 9.319 security interest.<sup>97</sup> Under the amended statute a third-party purchaser may cut off an interest owner's section 9.319 security interest by delivering the interest owner's proceeds either to the operator alone (in which case the operator becomes the first purchaser) or jointly to the interest owner and the operator.<sup>98</sup>

### B. Natural Resources Code

In another significant legislative act, the Texas Legislature granted the power of eminent domain to the state and its lessees to enable them to obtain easements permitting access to minerals dedicated to the Permanent School Fund.<sup>99</sup> Various restrictions apply to this new statute.<sup>100</sup> Additionally, the legislature increased from sixty percent to eighty percent the portion of the bonus, delay rentals, and royalties payable to the state under leases executed on or after September 1, 1987, by surface owners as agents of the state covering minerals, other than oil and gas, reserved by the state.<sup>101</sup> The legislature also enacted penalties and other measures to deter surface owners of Relinquished Act lands from breaching their fiduciary duty to the state.<sup>102</sup>

The legislature also gave the School Land Board discretion to temporarily reduce the gas royalties payable under leases of gulf lands if the leases provide for royalty over twenty-five percent and meet specified conditions.<sup>103</sup> The amount of the temporary reduction is linked to the price of natural gas.<sup>104</sup> The legislature also authorized the commissioner of the General Land Office to allow payment of compensatory royalties as a substitute for drilling offset wells to prevent drainage from public school, gulf, and Relinquishment Act lands.<sup>105</sup>

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95. *Id.* § 9.319(q)(3).

96. *See id.* § 9.319(1)(1).

97. Act of Aug. 29, 1983, ch. 807, § 1, 1983 Tex. Gen. Laws 4657, *repealed by* Act of Sept. 1, 1987, ch. 601, §§ 1, 2, 1987 Tex. Gen. Laws 4715.

98. TEX. BUS. & COM. CODE ANN. § 9.319(1)(1) (Vernon Supp. 1988).

99. TEX. NAT. RES. CODE ANN. § 11.079(a) (Vernon Supp. 1988).

100. *Id.* § 11.079.

101. *Id.* § 53.065(b).

102. *Id.* § 52.189(d) (ten percent penalty); § 52.188(d)(2) (landowner owes state twice consideration received by surface owner upon subsequent assignment of lease assigned to surface owner without prior consent of General Land Office); *see id.* § 53.074 regarding state-owned minerals other than oil and gas.

103. *Id.* § 52.036.

104. *Id.*

105. *Id.* §§ 52.034(d) and 52.173(d).

