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MINERAL RESOURCES

by

Fred N. Diem* and Eric T. Laity**

DURING the survey period, a number of cases were decided elaborating on the Texas law of mineral resources, especially with reference to oil and gas.¹ The cases worthy of comment fall into three categories: those dealing with the entitlements and responsibilities attendant upon the mineral estate; those dealing with the express and implied provisions of the mineral lease; and a single regulatory case noteworthy in its error.

I. THE MINERAL ESTATE

Several cases decided this year involved the interpretation of poorly drafted mineral and royalty conveyances. Practicing attorneys often encounter such instruments, and while this year's cases do not materially alter existing law, they do provide practical guidance to attorneys faced with interpretation problems. One case involving such problems was *Canter v. Lindsey*.² In 1935 Roberts conveyed to Lindsey a royalty interest. The important portions of this instrument, as set out in the opinion, read as follows:

“* * * do by these presents sell and convey unto M. C. Lindsey * * * ONE FOURTH OF ONE + EIGHTH (1/4 of 1/8) of all the oil, gas, and other minerals produced from the following described land * * *

“* * * the interest herein conveyed being an equal one fourth of one eighth (1/4 of 1/8) part of all of the oil, gas, and other minerals when same has been produced from said land, and to such extent, such part of any and all future productions of such is hereby conveyed.”³

In 1941 Roberts conveyed to Mabee a three-fourths mineral interest. This conveyance contained the following language:

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1. The following cases elaborating the Texas law of mineral resources were deemed not to merit discussion: *Texaco, Inc. v. Railroad Comm'n*, 583 S.W.2d 307 (Tex. 1979) (denial of permanent suspension of a bonus allowable rule); *Gage v. Railroad Comm'n*, 582 S.W.2d 410 (Tex. 1979) (proration order); *Exxon Corp. v. Railroad Comm'n*, 571 S.W.2d 497 (Tex. 1978) (waste exception to spacing rule); *Texas Oil & Gas Corp. v. Railroad Comm'n*, 575 S.W.2d 348 (Tex. Civ. App.—Austin 1978, no writ) (determination of net acre-feet of reservoir space, and allocation of the total to separately owned tracts for purposes of proration); *Superior Oil Co. v. Railroad Comm'n*, 571 S.W.2d 51 (Tex. Civ. App.—Austin 1978, writ ref'd n.r.e.) (permit to drill additional well refused); *Dillard v. Ball*, 570 S.W.2d 465 (Tex. Civ. App.—Eastland 1978, writ granted) (surface access to the mineral estate). Furthermore, the scope of this article does not include those cases that reflect various aspects of the oil and gas industry but that were decided under the law of contract, tort, utility regulation, bankruptcy, or international law.

2. 575 S.W.2d 331 (Tex. Civ. App.—El Paso 1978, writ ref'd n.r.e.).

3. *Id.* at 333.

[S]ave and except the royalty payable under any such lease covering . . . [the remaining 1/4 interest] . . . , all royalty accruing under any such lease on such 1/4th interest being payable to M. C. Lindsey . . . who owns an undivided one-fourth (1/4) non-participating royalty interest in the oil, gas and other minerals in said land⁴

In 1973 an oil and gas lease covering a portion of the subject property was executed providing for a 3/16 royalty, and a dispute developed over the ownership of such royalty. The plaintiff, Lindsey's successor in interest, contended that he was entitled to 1/4 of any royalty reserved, *i.e.*, 1/4 of 3/16, and that the defendant, Mabee's successor in interest, was entitled to the remaining 3/4 of 3/16 royalty. Defendant contended that in addition to 3/4 of 3/16, he was entitled to all royalty in excess of 1/4 of 1/8. Roberts' successors in interest intervened and contended that they were entitled to 1/4 of any royalty in excess of 1/8.⁵

The court of civil appeals reversed the trial court's judgment in favor of the plaintiff and rendered judgment in favor of the intervenors.⁶ The court held that the 1935 and 1941 instruments were unambiguous,⁷ that the 1935 instrument granted a 1/4 of 1/8 nonparticipating royalty interest to the

4. *Id.* The instrument then goes on to convey to Mabee the bonus, rentals, and executive rights attributable to the remaining 1/4 mineral interest but with regard to royalties recites as follows: "[B]ut with the right to receive only three-fourths (3/4) of the royalty accruing under any such lease, or leases, the remaining one-fourth (1/4) interest in such royalty being owned by M. C. Lindsey" *Id.*

5. The court expressed the various positions by the use of graphic interpretation:

The Plaintiff claims. . . .

Plaintiff	- 1/4 of 3/16 = 3/64
Defendant	- 3/4 of 3/16 = 9/64
Intervenors	- 0 = 0
	<u>3/16</u>

. . . .
The Defendant claims. . . .

Plaintiff	- 1/4 of 1/8 = 1/32
Defendant	
all royalty in excess of 1/32	3/16 - 1/32 = 10/64
Intervenors	- 0 = 0
	<u>3/16</u>

. . . .
The Intervenors claim. . . .

Plaintiff	- 1/4 of 1/8 = 1/32
Defendant	- 3/4 of 3/16 = 9/64
Intervenors	
1/4 of all royalty in excess of 1/8	1/4 of (3/16 - 1/8) = 1/64
	<u>3/16</u>

575 S.W.2d at 334.

6. *Id.* at 336.

7. *Id.* at 334.

plaintiff,⁸ and that the reference to a full 1/4 royalty in the 1941 instrument was a mere recital and as such could not serve as a conveyance.⁹ With respect to the 1941 instrument the court held that it clearly conveyed a 3/4 mineral interest to the defendant and reserved a 1/4 nonparticipating royalty interest to the intervenors' predecessor.¹⁰ The fact that the 1941 conveyance contained an erroneous recital with respect to the previously reserved royalty was immaterial.¹¹

In *Helms v. Guthrie*¹² Helms conveyed to Stern "one-fourth (1/4th) of all the oil royalty and gas royalty."¹³ Helms then conveyed to Guthrie the entire mineral estate reserving "1/2 of the 1/8 royalty."¹⁴ The Guthrie conveyance also referenced the Stern conveyance as follows: "Helms . . . conveyed to Henry Stern and wife . . . an undivided 1/4th of the 1/8th oil, gas and mineral royalty and as a non-participating royalty interest under such land, and this deed is made expressly subject to said royalty conveyance shown of record."¹⁵ Subsequently, Guthrie executed an oil and gas lease reserving a 1/8 royalty and a 1/16 of 7/8 overriding royalty interest.

Guthrie instituted litigation against Helms and Stern to determine the ownership of the royalty reserved in the oil and gas lease. The court of civil appeals, affirming the trial court, held that Stern was conveyed a "fraction of royalty" and therefore was entitled to 1/4 of the 1/8 royalty plus 1/4 of the overriding royalty.¹⁶ The holding relating to the overriding royalty is based on the Texas rule that the owner of the executive right may not reserve an overriding royalty for himself alone, and that any overriding royalty provided for in a lease executed by him accrues to the benefit of nonparticipating royalty owners in proportion to their interest.¹⁷ The

8. *Id.*

9. *Id.* at 335. The court, citing *Joiner v. Sullivan*, 260 S.W.2d 439 (Tex. Civ. App.—Texarkana 1953, writ ref'd), stated that even if the 1941 instrument had specifically attempted to reserve a full 1/4 royalty interest to the plaintiff's predecessor, the attempt would have been ineffective because Texas law is clear that a reservation or exception in favor of a third party is inoperative as a conveyance to that person.

10. 575 S.W.2d at 335.

11. *Id.* Thus, the 3/16 royalty reserved in the 1973 oil and gas lease was divided among the parties as follows:

Plaintiff	1/4 of 1/8 = 1/32
Defendant	3/4 of 3/16 = 9/64
Intervenors	1/4 of 1/16 = <u>1/64</u>

3/16

575 S.W.2d at 334-36.

12. 573 S.W.2d 855 (Tex. Civ. App.—Fort Worth 1978, writ ref'd n.r.e.).

13. *Id.* at 858 (emphasis in original).

14. *Id.* at 856.

15. *Id.* at 858 (emphasis in original).

16. *Id.* at 856.

17. *Id.* at 857 (citing *Delta Drilling Co. v. Simmons*, 161 Tex. 122, 338 S.W.2d 143 (1960); *McMahon v. Christmann*, 157 Tex. 403, 303 S.W.2d 341 (1957); *Griffith v. Taylor*, 156 Tex. 1, 291 S.W.2d 673 (1956); *Lane v. Elkins*, 441 S.W.2d 871, 874 (Tex. Civ. App.—Eastland 1969, writ ref'd n.r.e.)).

court then held that Helms was entitled to 1/2 of the 1/8 royalty because the reservation of royalty in the Guthrie conveyance was clearly the reservation of a "fractional royalty" as opposed to the reservation of a "fraction of royalty."¹⁸ Therefore, Guthrie was held to be entitled to the remaining interest, *i.e.*, 1/4 of the 1/8 royalty plus 3/4 of the overriding royalty interest.

In an interesting application of the *Duhig* rule¹⁹ Guthrie argued that the recital in the Guthrie conveyance that Stern had been conveyed only a 1/4 of 1/8 royalty interest when in fact he had been conveyed 1/4 of the royalty estate, was a breach of warranty. Guthrie further argued that he should be made whole out of Helms' reservation of a 1/2 of 1/8 royalty and should be awarded the equivalent of that portion of the overriding royalty awarded to Stern. The court of civil appeals rejected Guthrie's argument, holding that because of the specific reference to the Stern conveyance contained in the Guthrie conveyance, Guthrie was on notice of the actual content of the Stern conveyance.²⁰

A third case in this area is *Havard v. Brown*,²¹ which involved the reservation of "an undivided one-half non-participating royalty (Being equal to, not less than an undivided 1/16)."²² The plaintiff contended that this was a reservation of 1/2 of the royalties limited to being no less than a 1/16 royalty. The defendant argued that this was a reservation of a specific 1/16 royalty. The court of appeals found that the parenthetical language in the reservation could be read to support either contention, that the reservation was ambiguous, and that, therefore, extrinsic evidence could be admitted.²³ The jury had determined that the extrinsic evidence admitted at trial supported the defendant's contention that this was the reservation of a flat 1/16 royalty, and the appellate court ruled that judgment should have been entered on the jury verdict.²⁴

The past year witnessed the writing of another chapter in *Reed v. Wylie*²⁵ and in the battle between surface estate owners and mineral estate

18. 573 S.W.2d at 857.

19. See *Duhig v. Peavy-Moore Lumber Co.*, 135 Tex. 503, 144 S.W.2d 878 (1940). The *Duhig* rule provides that when there is an overconveyance in a deed with a reserved interest, so much of the reserved interest will be taken from the grantor as is necessary to make the grantee whole. See also R. HEMINGWAY, *THE LAW OF OIL & GAS* § 3.2 (1971); I H. WILLIAMS & C. MEYERS, *OIL & GAS LAW* §§ 311-317 (1959); Hemingway, *Oil and Gas, Annual Survey of Texas Law*, 33 Sw. L.J. 185, 186-87 (1979); Meyers & Williams, *Oil & Gas Conveyancing: Royalty Reservations & Failure of Title*, 36 TEXAS L. REV. 399 (1958).

20. 573 S.W.2d at 858.

21. 577 S.W.2d 757 (Tex. Civ. App.—San Antonio 1979, writ granted).

22. *Id.* at 758.

23. *Id.* at 759-60.

24. *Id.* After the survey period ended, the supreme court affirmed the court of civil appeals decision. 23 Tex. Sup. Ct. J. 161 (Jan. 19, 1980). The supreme court found the parenthetical phrase ambiguous and held that the extrinsic evidence to ascertain the intent of the parties was admissible. *Id.* at 162-63. Justice McGee, in a dissent joined by Justices Greenhill and Pope, argued that the parenthetical expression, when read with the entire reservation clause, unambiguously reserved "1/2 of royalties, with a minimum royalty set at 1/16." *Id.* at 165.

25. 554 S.W.2d 169 (Tex. 1977), replacing an earlier opinion, 20 Tex. Sup. Ct. J. 327 (May 25, 1977), *aff'g* 538 S.W.2d 186 (Tex. Civ. App.—Waco 1976).

owners over the ownership of lignite reserves. In the original version of *Reed* the Texas Supreme Court upheld the Waco court of civil appeals decision reversing and remanding a summary judgment in favor of the surface estate owner, *Reed*.²⁶ In doing so, the supreme court attempted to clarify the rule of *Acker v. Guinn*²⁷ by holding that coal and lignite are the property of the mineral estate owner under a conveyance or reservation of "oil, gas, and other minerals" unless the surface estate owner can "prove that, as of the date of the instrument being construed, if the substance near the surface had been extracted, that extraction would necessarily have consumed or depleted the land surface."²⁸

This year, on remand from the supreme court, the trial court again granted a summary judgment in favor of *Reed*, and in *Wylie v. Reed*²⁹ the Waco court of civil appeals again reversed and remanded. This time the trial court judgment recited that the coal and lignite in question lay within twenty-two feet of the surface and that numerous outcrops of coal and lignite occurred in the area of the land involved.³⁰ The trial court judgment stated that because of these facts the coal and lignite in question was "at the surface of the land" and therefore belonged to the surface estate owner as a matter of law.³¹ This judgment focused on a rather unclear statement by the supreme court in the previous *Reed* decision that "if lignite lies at the surface of the land, no further proof would be required."³²

The court of civil appeals disagreed with the trial court's conclusion that the summary judgment evidence was sufficient to show that lignite was at the surface. The court pointed out that the outcrops cited by *Reed* were not on the land in question and rejected *Reed*'s argument that proof of lignite at the surface "in the vicinity" of the tract in question was sufficient.³³ The court also rejected *Reed*'s argument that lignite at a depth of twenty feet is equivalent to lignite at the surface.³⁴ *Reed* had apparently not attempted to comply with the primary rule of the first *Reed* case. The court pointed out that *Reed* had proved that a surface-destructive method was in fact used to mine the property but had not attempted to prove that no other feasible method was available at the time of the reservation.³⁵ Thus, *Reed* based her entire summary judgment hopes on a finding that the lignite underlying the property was "at the surface" as a matter of law.

26. *Id.*

27. 464 S.W.2d 348 (Tex. 1971).

28. 554 S.W.2d at 172.

29. 579 S.W.2d 329 (Tex. Civ. App.—Waco 1979, writ granted).

30. *Id.* at 333. *Reed*'s expert testified at trial that he had seen lignite exposed on the land in question in a natural gully at a depth of 20 to 25 feet. The trial court judgment does not recite this fact, and at trial this sighting evidently evolved into a dispute over the technical definitions of the geological terms "outcrop" and "subcrop."

31. *Id.*

32. *Id.* at 334 (quoting *Reed v. Wylie*, 554 S.W.2d at 173).

33. 579 S.W.2d at 334.

34. *Id.*

35. *Id.* At the time this summary judgment was granted the property had already been strip mined. *Wylie* had presented evidence that as of the date of the reservation, 1959, underground mining was a feasible method.

The supreme court has granted writ in this case, so attorneys can look forward to a further clarification of the *Reed-Acker* line of cases.³⁶ The concern of many attorneys is that the present *Reed* test requires a difficult factual determination and will result in a flood of litigation involving experts battling over the methods of mining lignite. Such a situation may be an impediment to the orderly development of Texas lignite reserves, and the supreme court should establish a test that will allow determination of the true owner of coal and lignite as a matter of law.³⁷

II. THE MINERAL LEASE

A. *The Habendum Clause*

In *Weed v. Brazos Electric Power Cooperative, Inc.*³⁸ the San Antonio court of civil appeals considered whether a no term lease in general, and

36. 22 Tex. Sup. Ct. J. 482 (July 21, 1979).

37. The supreme court delivered its opinion on Mar. 19, 1980, after the close of the survey period. 23 Tex. Sup. Ct. J. 256 (Mar. 22, 1980). Sharing the Bar's concern that litigation over difficult factual issues would impede the orderly development of the Texas lignite deposits as an important energy source, *id.* at 258, 259, and 261 (concurring opinion), the court liberalized its earlier *Reed* opinion in three ways. First, a surface-destructive method of mining need not be the *only* process by which a disputed lignite deposit could be mined in order for its ownership to be awarded to the surface owner; a surface-destructive method need only be one of the methods of mining available. *Id.* at 258. Secondly, mining methods contemporary with the litigation over the ownership of a lignite deposit may satisfy the surface-destructive test; no longer must a court limit its examination to methods of mining contemporary with the date of the instrument of conveyance. *Id.* at 258. Thirdly, the lignite underlying the tract of land in question will be deemed to be "at the surface," even if outcroppings appear only on neighboring lands; the outcroppings need only be in the "reasonable immediate vicinity." *Id.* at 259. A corollary was suggested by the court: if the lignite deposit is "near" the surface somewhere in the reasonably immediate vicinity and could be mined by a surface-destructive method, then the lignite under the land subject to litigation will be awarded to the surface owner. *Id.* at 259. The court also added that a deposit that is within 200 feet of the surface is "near" the surface as a matter of law. *Id.* at 259. The supreme court remanded the case to the trial court for trial on an unrelated issue. *Id.* at 260.

38. 574 S.W.2d 570 (Tex. Civ. App.—San Antonio 1978, writ *ref'd n.r.e.*). The lease in question was a coal and lignite lease; however, the court rejected the plaintiff's argument that *Reed v. Wylie*, 554 S.W.2d 169 (Tex. 1977), implied that coal and lignite leases were not governed solely by oil and gas law. 574 S.W.2d at 575. The court also considered the issue of whether the *Weed* lease was a no term lease. The habendum clause of the *Weed* instrument provided that the lease would remain in force "so long as the rentals hereinafter provided for are paid and/or so long as coal, lignite, clay and other minerals (except oil and gas) are produced." *Id.* at 572. The court held that, because the habendum clause contained no language providing for termination at a specified time unless minerals were being produced, the lease was a "no term" lease. As authority for so holding, the court cited *Fox v. Thoreson*, 398 S.W.2d 88 (Tex. 1966), in which the Supreme Court of Texas distinguished "no term" leases from "definite term" or "primary term" leases. The opinion in *Fox* contains the statement that a no term lease "does not impose an obligation to drill a well or to produce oil or gas or other minerals," 398 S.W.2d at 90, followed in the next sentence by the apparently contradictory statement that a no term lease "usually imposes an obligation," *id.* at 90-91, to drill a well or commence operations which obligation can be avoided by paying rentals. The court in *Weed* explained that the "obligation" to drill or produce discussed in *Fox* referred not to a duty to perform or be liable for a breach of a contractual duty, but, rather, to a condition to the continued life of the lease. Therefore, according to the holding of the supreme court as set forth in *Fox* and explained in *Weed*, a no term lease is one that contains no language providing that, if production is not begun by a specified date, the lease shall terminate.

the lease under consideration in particular, was unenforceable because of lack of mutuality and consideration. The plaintiff contended that because of the lack of a primary term, the lease under examination lacked mutuality, was a unilateral contract, and was void since it did not obligate the lessee to produce minerals or to pay rentals. In support of her contentions, the plaintiff proposed the case of *National Oil & Pipe Line Co. v. Teel*³⁹ as the controlling authority. In *Teel* the Supreme Court of Texas had held that a no term lease was a mere contract for an option.⁴⁰ The court had stated further that, since a contract to give an option by its terms lacks mutuality and is without consideration, it is void unless it is supported by an independent consideration.⁴¹ Pointing out that there was no evidence of any independent consideration to support the lease, the plaintiff in *Weed* argued that the lease was void.

The *Weed* court, however, rejected the plaintiff's arguments and held that the lease was enforceable in the absence of allegations and proof of unreasonable delay in the commencement of development. In reaching its conclusion, the court traced decisions by the Supreme Court of Texas subsequent to its decision in *Teel*, in which that court had considered the nature of the no term lease.⁴² The *Weed* court found persuasive the detailed analysis of the problem contained in the culminating case of *Stephens County v. Mid-Kansas Oil & Gas Co.*,⁴³ holding that a no term lease effects a present conveyance of a fee simple determinable estate in minerals. The *Weed* court found additional support for its conclusion in *Texas Co. v. Davis*⁴⁴ and *Rosson v. Bennett*,⁴⁵ cases permitting deferral of drilling for a reasonable time.⁴⁶ The San Antonio court of civil appeals has thus lent credence to the Court of Claims' suggestion that *Teel* is of historical interest only.⁴⁷

B. The Royalty Clause

During the survey period, two cases elaborated the law governing royalty clauses in oil and gas leases that call for a lessor's royalty to be determined with reference to the market value of the minerals produced under the lease. These join a long line of cases that, over the years, have clarified

39. 95 Tex. 586, 68 S.W. 979 (1902).

40. *Id.* at 591, 68 S.W. at 980.

41. *Id.*

42. 574 S.W.2d at 572-75.

43. 113 Tex. 160, 254 S.W. 290 (1923).

44. 113 Tex. 321, 254 S.W. 304 (1923).

45. 294 S.W. 660 (Tex. Civ. App.—Waco 1927, no writ).

46. The court in *Weed* noted the holdings in *Davis* and *Rosson* that a no term lease does not authorize a lessee to delay development unreasonably. The plaintiff had not alleged in her pleadings or contended in her brief that the defendant lessees had delayed development for an unreasonable period of time. Whether a lessee has unreasonably delayed development is a factual question, and therefore, the court declined to hold that as a matter of law the delay in *Weed* had been unreasonable. 574 S.W.2d at 575.

47. *See* *Henley v. United States*, 396 F.2d 956, 972 (Ct. Cl. 1968).

the holding of the landmark case, *Texas Oil & Gas Corp. v. Vela*.⁴⁸ Under the holding of *Vela*, market value is not to be determined solely by the purchase price agreed upon by the lessee and the purchaser of the hydrocarbons. Rather, as a later case has stated,⁴⁹ under *Vela* the following considerations must be taken into account:

(1) the relevant marketing area is the field in which the gas was produced; (2) the market price of gas is to be determined by reference to sales of gas comparable in time, quality and availability to marketing outlets; (3) the mathematical average of all prices paid in the field is not a final answer to determining market value price at any particular time; (4) the relevant period of time to be used in determining the amount that should have been paid to the royalty owners is the specific period in question; and (5) an expert's opinion based upon a mathematical average of prices paid in the field and corroborated by comparable sales from the field during the relevant period may afford a basis for determining market price.⁵⁰

Thus, a lessee may be required to pay royalties determined with reference to a price that exceeds the price the lessee is receiving under a long-term contract with its purchaser. The market value at the time the lessee entered into a long-term contract for the sale of oil and gas produced under a lease is not determinative of the market value to be used in computing royalty payments under leases that provide for a royalty based on market value. The cases succeeding *Vela* have considered variant royalty clauses,⁵¹ as well as the content of the factors held by *Vela* to be relevant to a determination of market value.

An example of this latter type of case is *Brent v. Natural Gas Pipeline Co. of America*,⁵² a case reported during the survey period. The court in *Brent* held, among other things, that sales of intrastate gas are irrelevant to a determination of the fair market value of gas irrevocably committed to interstate commerce.⁵³ In effect, there are two distinct markets for each geographical area: the intrastate market and the interstate market. The court went on to conclude that the market value of the gas in question was equal to the price determined by the appropriate area rate promulgated by the Federal Power Commission, adjusted by the provisions contained in the applicable FPC orders.⁵⁴ The *Brent* case thus complements the hold-

48. 429 S.W.2d 866 (Tex. 1968). The *Vela* case is discussed in 3 H. WILLIAMS, OIL AND GAS LAW § 650.4 (1977). See note 71 *infra*.

49. Exxon Corp. v. Middleton, 571 S.W.2d 349 (Tex. Civ. App.—Houston [14th Dist.] 1978, writ granted).

50. *Id.* at 362.

51. See, e.g., Butler v. Exxon Corp., 559 S.W.2d 410 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.), and Exxon Corp. v. Middleton, 571 S.W.2d 349 (Tex. Civ. App.—Houston [14th Dist.] 1978, writ granted). Both cases considered the interpretation of the phrase, "off the premises," in royalty clauses that provide for a royalty with regard to gas sold off the premises that is to be computed as a fraction of the market value of the gas so sold. *Butler v. Exxon Corp.* should not be confused with Exxon Corp. v. Butler, 585 S.W.2d 881 (Tex. Civ. App.—San Antonio 1979, no writ), *infra* note 59.

52. 457 F. Supp. 155 (N.D. Tex. 1978).

53. *Id.* at 160, 162.

54. *Id.* at 162-63.

ing in *Exxon Corp. v. Middleton*,⁵⁵ rejecting the inclusion of interstate sales in the determination of the market value of gas sold exclusively on the intrastate market.⁵⁶

In the second noteworthy case in this area decided during the survey period, a formula for determining the market value of natural gas produced in a given area was approved. *Exxon Corp. v. Jefferson Land Co.*⁵⁷ held that the proper method of determining the market value of gas produced during a specific period was to add together all amounts paid for natural gas by all producers in the area in question under contracts entered into after the period commenced, and to divide this sum by the total quantity of gas produced in the area during the period under such contracts.⁵⁸ The *Jefferson Land* court also refused to award prejudgment interest against the lessee for the period ending on the date of the court's opinion.⁵⁹

C. Implied Covenants

The economic costs of a conflict of interest between lessor and lessee were the subject of a case recently decided by the El Paso court of civil appeals, *Amoco Production Co. v. First Baptist Church*.⁶⁰ The court, in effect, held that a lessor, under an oil and gas lease that provided for a royalty based upon the amount realized from the sale of minerals produced under the lease, was obligated to market the minerals for fair market value.⁶¹ In this case, the production from a single gas well developed by Amoco Production Company and other working interest owners was sold by the several working interest owners under long-term contracts to several different pipeline companies. All of these long-term contracts were similar in their provisions relevant to this litigation, except for the contract made by Amoco with Pioneer Natural Gas Company. The Pioneer contract was

55. 571 S.W.2d 349 (Tex. Civ. App.—Houston [14th Dist.] 1978, writ granted). See notes 72-75 *infra* and accompanying text.

56. *Id.* at 362. In the case of *Hemus & Co. v. Hawkins*, 452 F. Supp. 861 (S.D. Tex. 1971), the court also held that intrastate sales of gas were irrelevant to the determination of the fair market value of gas dedicated to the interstate market. The *Brent* court cited *Hemus* in support of its conclusions. 457 F. Supp. at 160. For a discussion of *Hemus*, see Hemingway *supra* note 19, at 192.

57. 573 S.W.2d 829 (Tex. Civ. App.—Beaumont, 1978). Writ of error was filed in the Texas Supreme Court on Nov. 9, 1978. 22 Tex. Sup. Ct. J. 86 (Nov. 18, 1978).

58. *Id.* at 831. Reliance on this formula may be ill-advised, however, as the supreme court is currently considering the issue of market value in *Middleton*. See notes 72-75 *infra* and accompanying text.

59. *Id.* at 832. The opinion implies that the court would be unwilling to award prejudgment interest against a lessee even in suits brought after the date of the *Jefferson Land* opinion, but before the date of a supreme court opinion finally determining an appropriate formula for ascertaining market value. *Jefferson Land* was followed on the question of prejudgment interest by *Exxon Corp. v. Butler*, 585 S.W.2d 881 (Tex. Civ. App.—San Antonio 1979, no writ), a case also decided during the survey period. Whether the *Vela* line of cases construing the "market value" type of royalty provision of an oil and gas lease should effectively be extended to the "net proceeds" type of royalty provision by means of an implied covenant was considered in *Amoco Prod. Co. v. First Baptist Church*, 579 S.W.2d 280 (Tex. Civ. App.—El Paso 1979, writ filed). See notes 60-75 *infra* and accompanying text.

60. 579 S.W.2d 280 (Tex. Civ. App.—El Paso 1979, writ filed).

61. *Id.* at 282.

remarkable in two respects. First, the Pioneer contract provided for a price that was roughly half the price paid by the other pipeline companies purchasing gas from the well. Secondly, the Pioneer contract provided for a fixed scale of negligible price increases from year to year, whereas the contracts between other working interest owners and their respective purchasers provided for annual redetermination of the price paid for gas to reflect the current market.

The First Baptist Church of Pyote was entitled to a royalty payment from its lessee, Amoco, based upon the amount realized on the sale of gas attributed to its leases. Thus, the First Baptist Church was receiving royalty payments that were at first roughly half that being received by the other royalty owners for a given quantity of gas from the same well, and that by the end of the period in question were roughly a third of the payments to the other royalty owners.

The Pioneer contract was in existence before production attributable to the First Baptist leases had begun. Once the need for marketing the gas arose, Amoco dedicated the First Baptist leases to the existing contract. In exchange, Pioneer raised the price for all gas sold under the contract from an extremely low price to approximately one-half of the market value. The First Baptist Church then brought suit against Amoco, arguing that its royalties should be based not on the price for gas actually paid under the Amoco-Pioneer contract, but rather on the fair market value of the gas. In effect Amoco had appropriated part of the potential return to First Baptist for its own benefit.

The trial court held that Amoco had breached an implied covenant to market natural gas at fair market value and awarded the First Baptist Church the difference between the fair market value in each of the years in question and the amount actually received by the Church.⁶² The trial court determined fair market value with reference to the prices paid by the other pipeline companies purchasing gas from the well and also ordered that the royalties paid to the plaintiffs in the future be based upon prices paid under one of the other long-term contracts, which the trial court specified.⁶³ The court of civil appeals affirmed the trial court's judgment,⁶⁴ except for the order of the trial court dictating that future royalties paid to the plaintiff be based on prices paid by one of the competing pipeline companies.⁶⁵ In reversing the trial court on the question of future royalties, the appellate court rendered judgment that future royalties be based on the fair market value of the gas at the time of sale. The prices paid under the long-term contracts other than the Pioneer contract would, of course, be

62. *Id.* at 283.

63. The trial court ordered that the future payments be based upon the price paid by the pipeline company purchasing the largest portion of the well's production. *Id.* at 288.

64. The opinion of the appellate court did not indicate the trial court's basis for inferring that an implied covenant to market in good faith meant that the lessor was obligated to market the gas production attributable to the lease for fair market value. Nor did the appellate court discuss this inference in its own opinion, evidently as it was not a point of appeal.

65. 579 S.W.2d at 288.

evidence useful in the determination of fair market value.⁶⁶

The court of civil appeals rejected Amoco's argument that division orders executed by the royalty owners modified its duty under the terms of the lease.⁶⁷ The court noted that the purpose of division orders was the protection of a third party purchaser and thus did not diminish the duty of a lessee to market in good faith.⁶⁸

The rationale of the appellate court focused on the conflict between the interests of the lessor and the lessee, as illustrated by the Pioneer contract. Usually, so the court reasoned, the lessor can fairly assume that the incentive provided by potential profit on the market for natural gas will be sufficient to ensure that the lessee will strive for the highest price possible for the gas.⁶⁹ The lessee's own interest will call for action that will simultaneously advance the lessor's interest. There are circumstances, on the other hand, in which the interests of the lessee and the lessor are not parallel. The unusual contract between Amoco and Pioneer reflects this problem.

The result of this case will be twofold. On the one hand, the court's holding will encourage the owners of working interests to negotiate separate contracts for each new generation of production, rather than to compromise the interests of royalty owners whose wells come into production at different times. On the other hand, owners of working interests will be pressured into negotiating competitive contracts.⁷⁰ *First Baptist Church* suggests that oil and gas leases are to be viewed as ongoing agreements that will be supplemented and interpreted by courts over the life of the agreement, rather than as short-term contracts that allocate between the parties the risk of fluctuations in the market.

Further elaboration of the implied covenant to market at fair market value will be needed to establish how objective the criteria for determining fair market value will be. The court's opinion mentions as evidence for fair market value the various factors used in the *Vela* cases, concerning market prices specific to a locale.⁷¹ Whether *Vela* will remain the principal guide is unsettled, however, because the questions raised by fair market value royalty are now being considered by the Texas Supreme Court in *Exxon Corp. v. Middleton*,⁷² a case that also considers the effect of division

66. *Id.* at 289.

67. *Id.* at 288.

68. *Id.*

69. *Id.* at 286; see H. WILLIAMS & C. MEYERS, *supra* note 19, § 856.3.

70. In this case whether Amoco had been competitively negotiating in its own interest is unclear because the court's opinion does not reveal the monetary value of the benefits received by Amoco in return for its dedication of the First Baptist leases to an existing contract.

71. The leading case, *Texas Oil & Gas Corp. v. Vela*, 429 S.W.2d 866 (Tex. 1968), held that the market price of gas should be determined by sales "comparable in time, quality and availability to marketing outlets," although other factors should be considered beyond the mere mathematical average of field prices. *Id.* at 872-73. See discussion of *Vela* test at notes 48-51 *supra* and accompanying text. See also McCoy, *Oil and Gas, Annual Survey of Texas Law*, 23 Sw. L.J. 72, 79-81 (1969).

72. 571 S.W.2d 349 (Tex. Civ. App.—Houston [14th Dist.] 1978, writ granted). This case was submitted to the supreme court on Mar. 28, 1979. 22 Tex. Sup. Ct. J. 284 (Mar. 31, 1979); see Hemingway, *supra* note 19, at 189-92.

orders on such royalties.⁷³ Although *First Baptist Church*⁷⁴ and another court of civil appeals case dealing with these problems, *Exxon Corp. v. Jefferson Land Co.*,⁷⁵ have been appealed to the supreme court, the pending *Middleton* ruling may be dispositive of the issues. The delay in the supreme court's deliberations in that case signals the importance of the forthcoming opinion.

III. REGULATION

In *Railroad Commission v. American Petrofina Co.*⁷⁶ the court of civil appeals upheld a district court judgment striking down a Railroad Commission order directing American Petrofina to plug a well. In 1962 Tenneco Oil Company drilled and completed the well in question. Sometime between 1962 and 1969 the well ceased producing, and in 1969 Tenneco assigned the lease to L & F Drilling Company. The lease subsequently expired, and in 1970 Meeker & Company obtained a new oil and gas lease. In 1973 Meeker assigned its interest in the lease to a third party who then assigned the interest to American Petrofina. The commission subsequently ordered American Petrofina to plug the subject well in accordance with the commission's rules and regulations.

In striking this order the court of civil appeals cited section 89.011 of the Natural Resources Code,⁷⁷ which requires the "operator of a well" to properly plug such well when required, and section 89.002(a)(2) of the Code, which defines "operator" as "a person who is responsible for the physical operation and control of a well at the time the well is about to be abandoned or ceases operation."⁷⁸ Relying on these sections of the Natural Resources Code the court concluded that American Petrofina was not the person responsible for the physical operation and control of the well at the time it was abandoned or ceased production and therefore was not the "operator" of the subject well.⁷⁹

While the holding in this case may be a correct application of the statutory authority cited, the result is not in the best interest of public policy

73. The court of civil appeals in *Middleton* cited the *Vela* test of market value. 571 S.W.2d at 358-62. The court further considered the effect of division orders, held that the lessors had failed to prove a lack of consideration for the orders, and concluded that the orders modified the gas royalty clause. *Id.* at 364-65. Both the market value and division order issues are before the supreme court. 22 Tex. Sup. Ct. J. 243-44 (Mar. 10, 1979). The issue of self-dealing raised in *First Baptist Church* was also present in *Middleton*, since Exxon had based its royalty on a contract with an affiliate that had received a higher price on subsequent sales. 571 S.W.2d at 358.

74. Writ of error was filed in the Texas Supreme Court on May 15, 1979. 22 Tex. Sup. Ct. J. 350 (May 19, 1979).

75. 573 S.W.2d 829 (Tex. Civ. App.—Beaumont 1978, writ filed). See notes 57-59 *supra* and accompanying text.

76. 576 S.W.2d 658 (Tex. Civ. App.—Beaumont 1978, no writ).

77. The Railroad Commission order was issued pursuant to TEX. NAT. RES. CODE ANN. § 89.011 (Vernon 1978), which provides: "The operator of a well shall properly plug the well when required and in accordance with the commission's rules that are in effect at the time of plugging."

78. *Id.* § 89.002(a)(2).

79. 576 S.W.2d at 659.

and suggests the need to amend the cited sections of the Natural Resources Code. In heavily drilled areas of Texas, such as East Texas, there exist many wells that have not been plugged and abandoned in accord with commission rules. Many of the parties who operated these wells at the time they were abandoned or ceased production have either disappeared or no longer exist. When a party purchases an oil or gas lease it will probably have actual knowledge of existing wells on the property and should at least be on notice of such wells from existing public records. If abandoned wells on the property have not been properly plugged and abandoned at the time the lease is purchased, the party purchasing the lease can take into account the costs of plugging and abandoning when negotiating the purchase price of the lease.

