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SMU Law Review

Volume 35
Issue 1 *Annual Survey of Texas Law*

Article 6

1981

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Recommended Citation

Fred N. Diem & Eric T. Laity, Note, *Mineral Resources*, 35 Sw L.J. 177 (1981)
https://scholar.smu.edu/smulr/vol35/iss1/6

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MINERAL RESOURCES

by

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

DURING the survey period, a number of cases were decided regarding the Texas law of mineral resources. The cases of significance fall into two categories: those dealing with the entitlements and responsibilities attendant upon the mineral estate, and those dealing with the express and implied provisions of the mineral lease.

I. THE MINERAL ESTATE

The significant developments in the jurisprudence of the mineral estate were a response to the lignite question in East Texas and an interpretation of the standard of utmost fair dealing in connection with executive rights.

A. *Surface Deposits of Minerals*

This year witnessed the second chapter in the battle between surface estate and mineral estate owners over the ownership of surface mineable minerals such as coal, lignite, and iron. In *Reed v. Wylie*[1] (hereinafter referred to as *Reed II*) the Texas Supreme Court corrected, modified, and attempted to explain its first opinion in *Reed v. Wylie*[2] (hereinafter referred to as *Reed I*). In so doing, however, the court may have created the necessity for a third opinion to explain certain statements in *Reed II*.

In *Reed II* the court expressly overruled the surface-destruction rule set forth in *Reed I*.[3] The rule set forth in *Reed I* was as follows: "[T]he surface estate owner must 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."[4] The new rule set forth by the court is that when the deposit lies near the surface, the substance will not be granted or retained as a mineral if the surface owner proves that any "reasonable method of production" would destroy or deplete the surface, including methods in existence as of the date of the litigation.[5] This new rule rescinds the two most rigorous requirements of the previous rule.

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1. 597 S.W.2d 743 (Tex. 1980).
2. 554 S.W.2d 169 (Tex. 1977).
3. 597 S.W.2d at 747.
4. 554 S.W.2d at 172.
5. 597 S.W.2d at 747.

The first requirement rescinded by the new rule obligated the surface owner to prove that the *only* method of removal of the substance was by surface-destructive methods.[6] The new rule requires only that the surface owner prove that there exists a "reasonable method of production" that would destroy or deplete the surface.[7] The second requirement rescinded by the new rule necessitated that the method of production that would destroy or deplete the surface be in existence as of the date of the instrument being construed.[8] If this requirement had been retained, it would have led to further ridiculous battles between experts over the state of the art of mining decades ago.[9]

In addition to revising the surface-destruction rule, the court, in an apparent effort to reduce further the burden of the surface owner in these disputes, attempted to clarify and expand the "at the surface" rule set forth in *Reed I*. In doing so the court has probably created the need for further explanation of the *Reed* rules. The rule concerning the burden of the surface owners, as set forth in *Reed I*, was that if lignite lies "at the surface of the land," no further proof will be required to establish the title of the surface owner.[10] In applying the "at the surface" rule, the court in *Reed II* pointed to significant facts relating to the property in question: outcrops of lignite in a gully on the property and within one-half mile of the property; the existence of oxidized lignite within seven to eight feet of the surface of the property; and the existence of hard mineable lignite within twenty feet of the surface of the property.[11] The court also recognized that when lignite is exposed to moisture near the surface, it oxidizes and becomes a low grade lignite, commonly called "smut" or "clinker."[12] The court noted that because of this deterioration at the surface, lignite is rarely visible to persons walking on the surface.[13]

The court stated that in using the phrase "at the surface" in *Reed I* it did not mean "on top of the surface" but instead used the word surface "as having some depth."[14] Applying this rule, the court held that the facts in *Reed II* were sufficient to establish that lignite was "at the surface" as a matter of law.[15] By holding that it is not necessary that the substance outcrop on the surface of the property in question, but rather that it is sufficient if the substance is at the surface in the "reasonably immediate vicinity,"[16] the *Reed II* court further expanded the phrase "at the surface." Thus, it would appear that if the surface owner can establish that an out-

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6. 554 S.W.2d at 172.
7. 597 S.W.2d at 747.
8. 554 S.W.2d at 172.
9. *See* Moser v. United States Steel Corp., 601 S.W.2d 731, 733 (Tex. Civ. App.—Eastland 1980, writ filed); Riddlesperger v. Creslenn Ranch Co., 595 S.W.2d 193, 197 (Tex. Civ. App.—Tyler 1980, writ ref'd n.r.e.).
10. 554 S.W.2d at 173.
11. 597 S.W.2d at 745.
12. *Id.*
13. *Id.* at 745-46.
14. *Id.* at 746.
15. *Id.*
16. *Id.* at 748.

crop exists within approximately one mile of the property in question, he can prevail as a matter of law.[17]

The confusion in the court's opinion is created by a remark immediately following its discussion of outcrops in the reasonably immediate vicinity. In the same paragraph the court states: "The same would be true if the substance had been near the surface. A deposit which is within 200 feet of the surface is 'near surface' as a matter of law."[18] There is no explanation of this language; however, the court does include a footnote that refers the reader to pages 180-81 of Justice Daniel's dissenting opinion in *Reed I*.[19] In this portion of his dissenting opinion, Justice Daniel argued that if the substance could be shown to exist "at or near the surface," then the substance should belong to the surface owner as a matter of law.[20] Therefore, the court in *Reed II* may be holding that if a substance lies between the surface and 200 feet below the surface, the substance belongs to the surface owner as a matter of law, and that in such event the surface owner is not required to present any proof relating to mining methods.[21] Whether the court has adopted Justice Daniel's argument is unclear, and further cases will be required to clarify the court's language with regard to deposits within 200 feet of the surface.

An appropriate case for clarifying this issue was recently handed down by the Eastland court of civil appeals. In *Moser v. United States Steel Corp.*[22] the court, applying the rules set forth in *Reed II*,[23] awarded uranium deposits to the mineral estate owners because, as a matter of law, the only reasonable method of extracting the uranium at the time of trial was by solution mining, a non-surface-destructive method.[24] In the instant case, however, the uranium deposits occurred under the subject property at a depth of 193 feet.[25] If the supreme court in *Reed II* intended to hold that deposits lying between the surface and a depth of 200 feet belong to the surface owner as a matter of law, then the uranium deposits in dispute in *Moser* should have been awarded to the surface estate owners. A writ of error has been filed in *Moser*,[26] giving the supreme court an opportunity to clarify the point.

Two other cases decided this year offer guidance to attorneys drafting

17. The court pointed out that there was an outcrop within one mile of the property in question in Acker v. Guinn, 464 S.W.2d 348 (Tex. 1971). 597 S.W.2d at 748. How far from the property an outcrop can appear and still be within the "reasonably immediate vicinity" is a question of fact. *See id.*

18. 597 S.W.2d at 748 (footnote omitted).

19. *Id.*; *see* 554 S.W.2d at 180-81.

20. 554 S.W.2d at 181.

21. The court reaffirmed part of its opinion in *Reed I* to the extent that if the surface owner can prove title to a substance under the *Reed* rules, the surface owner owns the substance at whatever depth it may be found. 597 S.W.2d at 748.

22. 601 S.W.2d 731 (Tex. Civ. App.—Eastland 1980, writ filed).

23. 597 S.W.2d at 743.

24. 601 S.W.2d at 734.

25. *Id.* at 733.

26. 23 Tex. Sup. Ct. J. 581 (Sept. 13, 1980) (filed Aug. 29, 1980).

instruments either granting or reserving minerals.[27] These cases indicate that if the intent of such an instrument is either to grant or reserve all minerals, regardless of the method that may be used to mine them, the instrument should expressly track the language of *Reed I*.[28] Such instruments should explicitly state that it is the intent of that instrument either to grant or to reserve "all minerals lying upon the surface or at any depth and including those minerals which may be produced by open pit or strip mining."[29]

B. *Executive Rights*

The nature of the duty owed to owners of nonparticipatory interests by a holder of the executive right to lease is uncertain.[30] The few cases on the subject suggest several different standards of care. At one extreme are cases that hold that the duty of the executive holder borders on that of a fiduciary.[31] At the other extreme, the holder of the executive right is held only to a standard of ordinary care and good faith.[32] An intermediate position has been suggested under the label of "utmost fair dealing" or "utmost good faith."[33] This position is similar to an ordinary, prudent landowner test.[34] Under this intermediate view, if an ordinary, prudent landowner who was not burdened by an outstanding nonexecutive interest would have acted differently from the landowner in question, and if the executive's course of action results in harm to the nonexecutive interest, then the holder of the executive right to lease would be liable.[35] *Kimsey v. Fore*,[36] a recent case decided by the Beaumont court of civil appeals, supports the intermediate position and lends credence to the proposition that the standard of utmost fair dealing should be interpreted along the lines of the ordinary, prudent landowner commentary.

In *Kimsey* the predecessor in interest to the plaintiffs had purchased a term royalty from the predecessor in interest to the defendant lessors. The term royalty was for a period of five years, and thereafter so long as there

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27. Sheffield v. Gibbs Bros. & Co., 596 S.W.2d 227 (Tex. Civ. App.—Houston [1st Dist.] 1980, no writ); Riddlesperger v. Creslenn Ranch Co., 595 S.W.2d 193 (Tex. Civ. App.—Tyler 1980, writ ref'd n.r.e.).

28. Sheffield v. Gibbs Bros. & Co., 596 S.W.2d 227, 229-30 (Tex. Civ. App.—Houston [1st Dist.] 1980, no writ); Riddlesperger v. Creslenn Ranch Co., 595 S.W.2d 193, 198 (Tex. Civ. App.—Tyler 1980, writ ref'd n.r.e.).

29. Reed v. Wylie (Reed I), 554 S.W.2d 169, 172 (Tex. 1977).

30. For a survey of the cases on the subject of the duties incumbent upon the executive, see 2 H. WILLIAMS & C. MEYERS, OIL AND GAS LAW § 339.2 (repl. ed. 1977).

31. *See, e.g.*, Hollister Co. v. Cal-L Exploration Corp., 26 Cal. App. 3d 713, 721, 102 Cal. Rptr. 919, 924 (1972); First Nat'l Bank v. Evans, 169 S.W.2d 754, 755 (Tex. Civ. App.—Eastland 1943, writ ref'd) (dictum).

32. *See* Wintermann v. McDonald, 129 Tex. 275, 286, 102 S.W.2d 167, 173 (1937).

33. *See* Federal Land Bank v. United States, 168 F. Supp. 788, 791 (Ct. Cl. 1958); Schlittler v. Smith, 128 Tex. 628, 631, 101 S.W.2d 543, 544 (1937); Morriss v. First Nat'l Bank, 249 S.W.2d 269, 275 (Tex. Civ. App.—San Antonio 1952, writ ref'd n.r.e.).

34. This similarity is advocated in H. WILLIAMS & C. MEYERS, *supra* note 30, § 339.2, at 209-10.

35. *Id.* at 210.

36. 593 S.W.2d 107 (Tex. Civ. App.—Beaumont 1979, writ ref'd n.r.e.).

was production from the tract of land in question. At the time of the conveyance of the term royalty, a well was being drilled on the land, which later produced hydrocarbons from two different sands. The well was subsequently abandoned because of mechanical difficulties, and the lease under which the well had been drilled expired. The expiration of the lease took place approximately two years after the conveyance of the term royalty. For one year afterwards, the defendant lessors refused to execute any of a series of increasingly lucrative leases offered to them by the ultimate lessees. During the fourth year of the term royalty, the defendant lessors did execute a lease containing terms that, with one exception, were much less favorable than the leases previously offered. In the executed lease the primary term was extended from two years to three years, and the delay rental per acre was reduced to less than one-twelfth of that offered earlier. The executed lease, however, effectively insured that no production would take place on the tract in question until the term royalty had expired. This delay was accomplished by stipulating that any royalty to be paid with regard to production under the lease would in no way reduce the lessors' receipt of a full one-eighth portion of the hydrocarbons produced. If production were begun before the expiration of the term royalty, the lessees were obligated to pay the term royalty out of their own share of production. With this potential penalty in mind, the lessees began their drilling operations on the tract adjacent to the Fore tract and refrained from drilling on the Fore tract until after the term royalty had expired. Production was subsequently obtained from two wells on the Fore tract. Expert testimony established that the lessees had not been reasonably prudent operators in that they had failed to drill first on the Fore tract where a productive sand was known to be located.[37] A verdict favorable to the plaintiffs was returned by the jury. The trial court refused to enter judgment upon that verdict, and granted the defendants' motion for judgment non obstante veredicto.[38]

The court of civil appeals determined that the standard of utmost fair dealing is an implied covenant arising from royalty deeds and is imposed upon the owners of an executive right to lease.[39] Because the court was not convinced that the standard of ordinary care and good faith truly characterized the duty incumbent upon the executive owner,[40] the court overturned the trial court's grant of the motion for judgment non obstante veredicto.[41] In addition to directing that judgment be entered against the lessors, the court of civil appeals directed that judgment be entered against the operator for breach of the implied covenant of reasonable development

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37. *Id.* at 109.

38. *Id.* at 107.

39. *Id.* at 111. In support of its conclusion, the court cited Schlittler v. Smith, 128 Tex. 628, 101 S.W.2d 543 (1937), and Portwood v. Buckalew, 521 S.W.2d 904 (Tex. Civ. App.—Tyler 1975, writ ref'd n.r.e.). 593 S.W.2d at 111.

40. 593 S.W.2d at 112.

41. *Id.* at 113.

and against the lessees for inducing breach of a contractual relationship.[42] The criterion for measuring damages is not evident from the court's opinion.

The matter of executive rights was also discussed by the Eastland court of civil appeals. In *Bullard v. Broadwell*[43] the court held that the defendant's executive right to lease the mineral estate, of which a one-third interest belonged to the plaintiff, did not absolve him from the cotenancy rule if the defendant executive developed the mineral estate himself.[44] Rather than the one-third of one-eighth royalty that would be owed to the plaintiff if the property were developed by a lessee, the court ruled that the plaintiff was entitled to one-third of the hydrocarbons produced from the land less his pro rata share of the reasonable development and marketing expense.[45] The defendants were of course held entitled to recover all of the reasonable costs of drilling, completing, and operating the well.[46]

II. THE MINERAL LEASE

During the survey period, Texas courts dealt with the subjects of market value royalty clauses and field-wide drainage.

A. *The Royalty Clause*

On October 1, 1980, the Texas Supreme Court delivered its long-awaited opinion in the case of *Exxon Corp. v. Middleton*.[47] The case is a significant contribution to the interpretation of clauses in mineral leases that provide for a royalty to be computed on the basis of the fair market value of the hydrocarbons produced under the lease. The *Middleton* decision puts to rest two long-standing points of contention regarding such royalty clauses and makes substantial strides towards solving two other troublesome aspects of fair market value royalty clauses.

The first matter put to rest by the *Middleton* decision concerns the meaning of the phrase "at the well." The scope of that phrase is of some importance, since a number of the fair market value royalty clauses being litigated provide for alternate computations of royalty. Such clauses provide that if the hydrocarbons are sold "off the premises," the royalty is to be computed with reference to their fair market value; if, however, the hydrocarbons are sold "at the well," the royalty is to be computed with regard to the monetary proceeds from the sale. One court has held that the phrase "at the well" refers to the entire field of production, and in so holding has denied arguments of counsel that the phrase is merely complementary to the phrase "off the premises."[48] This interpretation of the scope of

42. *Id.* at 114.
43. 588 S.W.2d 398 (Tex. Civ. App.—Eastland 1979, writ ref'd n.r.e.).
44. *Id.* at 399.
45. *Id.* at 400.
46. *Id.*
47. 24 Tex. Sup. Ct. J. 6 (Oct. 4, 1980).
48. Butler v. Exxon Corp., 559 S.W.2d 410, 414 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.).

the two phrases would mean that both methods of royalty calculation apply to at least part of the production from a given geological formation.

In *Middleton*, however, the Texas Supreme Court held to the contrary.[49] The court found the two phrases "off the premises" and "at the well" to be mutually exclusive, but complementary, terms.[50] Therefore, the court reasoned, the phrase "at the well" refers to all hydrocarbons sold on the leased premises.[51] As a result, if the royalty clause is phrased in terms of the leased premises, then the fair market value royalty provision would apply to all production sold off the leased premises, regardless of whether that production is sold within or without the producing field. Likewise, if the royalty clause is phrased in terms of the unitized premises of which the leased tract is simply a part, then all hydrocarbons sold on the unit are subject to the "at the well" royalty computation and hydrocarbons sold off the unit are subject to the "off the premises" royalty computation. The supreme court specifically disapproved the decision in *Butler v. Exxon Corp.*[52] that had held otherwise.[53]

The second matter laid to rest by the supreme court in *Middleton* was the effect of division orders on fair market value royalty clauses. It has been argued before lower courts that a division order executed by the lessor was an effective amendment to the lease and abrogated any fair market value royalty clause that the lease might contain.[54] The supreme court held that a division order sent by a lessee to its lessor and executed by the latter had no effect whatsoever on a fair market value royalty clause.[55] The court gave two reasons for its decision. First, the court stated that, as between lessors and lessees, it is not generally their intention that a division order should amend an oil and gas lease;[56] a division order is customarily executed for the benefit of third parties and it makes no difference in the entitlements and responsibilities of lessors and lessees, as among themselves.[57] The second reason given by the court is more trenchant: if the division order was intended to be an amendment to the applicable oil and gas lease, it was rendered ineffective under general principles of contract law because it was unsupported by any consideration.[58]

In addition to defining the scope of the phrase "at the well" and ruling on the effect of a division order upon an oil and gas lease, the Texas Supreme Court also made progress in clarifying the factors that enter into

49. 24 Tex. Sup. Ct. J. at 8.
50. *See id.*
51. *Id.*
52. 559 S.W.2d 410 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.).
53. 24 Tex. Sup. Ct. J. at 8.
54. *See* Amoco Prod. Co. v. First Baptist Church, 579 S.W.2d 280, 288 (Tex. Civ. App.—El Paso 1979, writ ref'd n.r.e.); Exxon Corp. v. Middleton, 571 S.W.2d 349, 363-65 (Tex. Civ. App.—Houston [14th Dist.] 1978), *aff'd in part, rev'd and remanded in part, and severed and remanded in part*, 24 Tex. Sup. Ct. J. 6 (Oct. 4, 1980).
55. 24 Tex. Sup. Ct. J. at 13-15.
56. *Id.* at 13-14.
57. *Id.*
58. *Id.* at 14.

the computation of the market value of hydrocarbons. The court first made reference to *Texas Oil & Gas Corp. v. Vela*,[59] in which the court had ruled that market value was to be determined by examining comparable sales in relevant markets.[60] The *Middleton* court repeated the four factors that might be used to establish comparability: timing; the quality of the hydrocarbons being sold; the quantity of the hydrocarbons being sold; and the access of the hydrocarbons to a marketing system.[61] Concluding that the determination of market value ought not to include prices obtained for interstate sales or prices obtained under long-term contracts entered into prior to the period of time covered by the litigation,[62] the supreme court expressly endorsed the method of calculation used by the lessor's expert witness.[63] The expert witness had chosen as the relevant market area for the hydrocarbons in contention the Texas Railroad Commission's Districts Two, Three, and Four, three contiguous districts viewed by the industry as the relevant market for gas produced along the Texas Gulf Coast. The expert then took the arithmetical average of the three highest prices, adjusted for the energy value of the gas, paid from quarter to quarter for any quantity of gas sold anywhere in the relevant market area.[64]

Despite this progress in clarifying the *Vela* doctrine, further court opinions will be necessary. The supreme court's language in its discussion of interstate gas seems to import unexamined assumptions into the *Vela* formula. The court considers interstate gas prices irrelevant to the royalty computations of the *Middleton* case because natural gas sold to interstate users is "not comparable in quality" to natural gas sold to intrastate users.[65] As is discussed below in connection with *First National Bank v. Exxon Corp.*,[66] such language seems to confuse the analysis of both the factor of comparable time in the *Vela* formula and the possible federal interest that may be present in fair market value royalty cases.[67]

Another helpful contribution of the *Middleton* opinion that might require further clarification is the matter of pre-judgment interest. In its opinion, the supreme court declined to award pre-judgment interest to the *Middleton* lessors, stating that the amount of damages was not determina-

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59. 429 S.W.2d 866 (Tex. 1968).
60. *Id.* at 872.
61. 24 Tex. Sup. Ct. J. at 10-11.
62. *Id.* at 11.
63. *Id.*
64. *Id.* at 10-11.
65. *Id.* at 11. *But see id.* at 12, wherein the supreme court states:

> Exxon's methods of calculating royalties reflect one market value for gas produced from wells discovered before January 1, 1972 and another market value for gas discovered and produced after that date. This distinction is inconsistent with our holdings that under the White and Middleton royalty clause gas is sold when delivered and market value is determined from sales comparable in time, quantity, quality, and availability of markets. The determination of market value is not dependent on when the gas is discovered.

66. 597 S.W.2d 783 (Tex. Civ. App.—El Paso 1980, no writ); *see* notes 72-88 *infra* and accompanying text.
67. 24 Tex. Sup. Ct. J. at 12.

ble at the outset of the litigation.[68] The reason that damages were not determinable, the court wrote, was that the method for calculating the market value of hydrocarbons was uncertain at that time.[69] As the court writes elsewhere in its opinion that the market value of gas is primarily within the domain of expert witnesses,[70] the formula for determining market value in any particular piece of litigation would seem to be an object of contention itself. It would appear, therefore, that pre-judgment interest will never be awarded in a dispute over a fair market value royalty clause.

The question of how the Texas Supreme Court will interpret fair market royalty clauses with regard to natural gas sold to interstate users becomes increasingly important, as various state and lower federal courts consider the matter with conflicting results.[71] One Texas state court case was decided during the survey period. In *First National Bank v. Exxon Corp.*[72] the El Paso court of civil appeals affirmed the trial court's conclusion that royalties owed to a lessor by virtue of natural gas that had been marketed through interstate sales were to be determined without regard to the prices paid for natural gas sold within Texas, and further, without regard to prices paid for natural gas of a vintage, as determined by the Federal Energy Regulatory Commission, other than the vintage of the gas produced from the leased premises.[73] In support of its affirmation the court cited two federal district court cases,[74] which in turn had made two assumptions: that natural gas sold outside of Texas by a natural gas supplier subject to federal regulations is a different commodity than natural gas marketed wholly by means of sales within the state;[75] and that the sense of the word "market," as used to refer to a set of consumers with a particular trait, is identical to the sense of that word as used to refer to an economic model.[76]

The *Vela* doctrine[77] on its face would seem to require that royalties computed under a fair market value lease provision be identical in amount

68. *Id.* at 15.
69. *Id.*
70. *Id.*
71. *Compare* Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155 (N.D. Tex. 1978) (only sales of interstate gas used to determine market value), *aff'd sub nom.* Kingery v. Continental Oil Co., 626 F.2d 1261 (5th Cir. 1980) *and* Hemus & Co. v. Hawkins, 452 F. Supp. 861 (S.D. Tex. 1978) (interstate market only relevant market to determine value) *with* Kingery v. Continental Oil Co., 434 F. Supp. 349 (W.D. Tex. 1977) (market value established by intrastate sales), *rev'd*, 626 F.2d 1261 (5th Cir. 1980). *See also* Lightcap v. Mobil Oil Corp., 221 Kan. 448, 562 P.2d 1 (market value determined by free market prices without regard to regulated prices), *cert. denied*, 434 U.S. 876 (1977).
72. 597 S.W.2d 783 (Tex. Civ. App.—El Paso 1980, no writ).
73. *Id.* at 785-86.
74. Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155 (N.D. Tex. 1978), *aff'd sub nom.* Kingery v. Continental Oil Co., 626 F.2d 1261 (5th Cir. 1980); Hemus & Co. v. Hawkins, 452 F. Supp. 861 (S.D. Tex. 1978).
75. Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 160 (N.D. Tex. 1978), *aff'd sub nom.* Kingery v. Continental Oil Co., 626 F.2d 1261 (5th Cir. 1980); Hemus & Co. v. Hawkins, 452 F. Supp. 861, 862 (S.D. Tex. 1978).
76. Brent v. Natural Gas Pipeline Co. of America, 457 F. Supp. 155, 160 (N.D. Tex. 1978), *aff'd sub nom.* Kingery v. Continental Oil Co., 626 F.2d 1261 (5th Cir. 1980); Hemus & Co. v. Hawkins, 452 F. Supp. 861, 862 (S.D. Tex. 1978).
77. Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866, 872 (Tex. 1968).

regardless of whether the natural gas is sold to an intrastate customer or to an interstate customer.[78] The regime of price regulation under which the lessee might operate, without more, does not govern the relationship between a lessee and its lessor.[79] This would seem analogous to the *Vela* doctrine's denial that a long-term contract into which a lessee may have entered to market its hydrocarbon production binds a third party like the lessor.[80] Furthermore, if the *Vela* formula for computing fair market value royalties were interpreted in such a manner that interstate prices should indeed be taken into account, the *Vela* doctrine's emphasis on not using prices obtaining under old, long-term contracts suggests that only the price of new vintage gas should be used in the *Vela* computation.[81] Thus, courts holding that the fair market value royalties for interstate gas should be computed in a manner different from the manner in which the fair market value royalties of intrastate gas are computed must anticipate that the Texas Supreme Court will likely qualify the *Vela* doctrine in its application to interstate natural gas. Whether or not the *Vela* doctrine should be amended is, of course, a separate question: one that would seem worthy of express analysis rather than assumptions.

First National Bank v. Exxon Corp. is notable for the dissenting opinion of Justice Osborn.[82] In addition to providing a helpful analysis of the *Vela* doctrine as it would apply to interstate natural gas,[83] Justice Osborn points out that the higher royalty costs that would be incurred by lessees if the *Vela* doctrine were applied strictly would produce no hardship for lessees because such costs can be reflected in the federally regulated price.[84] Justice Osborn also writes that a basis other than the *Vela* doctrine exists for computing fair market value royalties with regard only to prices obtaining on the uncontrolled market.[85] He notes that this second basis is the value of uniformity among the states; the two states that have already concluded the judicial development of the fair market value royalty for interstate gas have dictated that prices on the uncontrolled market are the appropriate criteria for determining fair market royalties for interstate natural gas.[86] A final contribution by Justice Osborn is his reminder that classification of natural gas sold to interstate customers as a different commodity, or as a commodity sold on a different market, than natural gas sold to intrastate

78. *See* notes 59-61 *supra* and accompanying text.

79. *See* Mobil Oil Corp. v. FPC, 417 U.S. 283, 328 (1974), *aff'g sub nom.* Placid Oil Co. v. FPC, 483 F.2d 880 (5th Cir. 1973).

80. *See* Exxon Corp. v. Middleton, 24 Tex. Sup. Ct. J. 6, 9 (Oct. 4, 1980).

81. *See* First Nat'l Bank v. Exxon Corp., 597 S.W.2d 783, 788, 792 (Tex. Civ. App.—El Paso 1980, no writ) (Osborn, J., dissenting).

82. *Id.* at 787-94.

83. *Id.* at 789-92.

84. *Id.* at 791. In support of his conclusion Justice Osborn cites Mobil Oil Corp. v. FPC, 417 U.S. 283, 328 (1974), *aff'g sub nom.* Placid Oil Co. v. FPC, 483 F.2d 880 (5th Cir. 1973). 597 S.W.2d at 791.

85. 597 S.W.2d at 791-92.

86. The two states are Kansas and Montana. *See* Lightcap v. Mobil Oil Corp., 221 Kan. 448, 562 P.2d 1, 2, *cert. denied*, 434 U.S. 876 (1977); Montana Power Co. v. Kravik, 586 P.2d 298, 301-02 (Mont. 1978).

customers, is circular in reasoning.[87] The distinction between interstate and intrastate natural gas is a creation of the law and is not reflected by a difference in the economic use of the two "kinds" of natural gas. In order to reach the conclusion that fair market value royalties for interstate gas should be computed in a manner different from the manner in which fair market value royalties for intrastate gas is computed, one first must be willing to conclude that federal interests dictate that royalty owners should be subject to the federal regulatory regime, a conclusion that would contradict *Mobil Oil Corp. v. FPC*.[88] One also must be willing to conclude that state courts may properly create federal law.

These considerations have received little attention in the various discussions to date on the question of fair market value royalties for interstate natural gas. Every court, however, must concern itself with these considerations, even if only implicitly. The first concern is in defining the role state courts may play in formulating the interests of the federal system. The second concern is in clarifying the extent to which a state court, in developing the common law, should take into account federal interests. Although the relationship between federal and state law is an important factor, the ramifications of *Erie Railroad Co. v. Tompkins*[89] sometimes are overlooked by counsel in their arguments before state courts. The scholarly writings on the subject have found the question to be a difficult one. One well-known position advocates that state law should be rather comprehensive in its treatment of local concerns, leaving federal law in an interstitial position, to be applied by either state or federal courts only when, and to the extent that, the Congress clearly intends.[90] If this is a sound view of the creation and role of federal interests in state law, then the Texas Supreme Court could reasonably decide that the *Vela* doctrine as applied to interstate natural gas dictates that royalties be computed only with regard to prices obtaining on the intrastate market. Alternately, if a cogent argument could be made that federal interests dictate that fair market value lease provisions effectively should be amended when the gas is committed to the interstate market, then the court could rule that the computation of royalty payments should be made with reference to regulated pricing only.

B. *Implied Covenants*

In *Amoco Production Co. v. Alexander*[91] one of the Houston courts of civil appeals held that a lessee's duty to protect its lessor's premises from drainage obligates a lessee not only to protect the leased premises from

87. 597 S.W.2d at 790 (Osborn, J., dissenting).
88. 417 U.S. 328 (1974).
89. 304 U.S. 64 (1938).
90. This position may be attributed to Professors Donald T. Trautman and Arthur T. von Mehren of the Harvard Law School. *See* A. VON MEHREN & D. TRAUTMAN, THE LAW OF MULTISTATE PROBLEMS 1036-1120 (1965); Trautman, *The Relation Between American Choice of Law and Federal Common Law*, 41 LAW & CONTEMP. PROBS. 103, 111-26 (1977).
91. 594 S.W.2d 467, 473 (Tex. Civ. App.—Houston [1st Dist.] 1979, writ granted).

drainage by wells on adjacent property, but to protect the leased premises from field-wide drainage as well.[92] The court also ruled that the duty to protect against drainage cannot be limited by contract between the parties.[93] The court further wrote that the duty of a lessee to protect its lessor from field-wide drainage is not ameliorated by the Texas Railroad Commission's spacing rules, if those rules provide for exceptions, and if facts exist tending to show that such exceptions would have been granted by the commission.[94]

The facts of *Alexander* were especially favorable to the plaintiff. The defendant lessee held about eighty percent of the leases in the Hastings West Field of Brazoria County, Texas. The Hastings West Field is an active water-drive field, the producing formation of which rises in elevation from one end to the other. The Alexander lease was at the lower end of the formation, with the remainder of the defendant's leases being situated at the higher end of the formation. Between the Alexander lease and the other Amoco leases lay leases owned by Exxon Corporation, a major competitor of Amoco Production Company. During the period in question, Amoco deliberately engaged in a major "plug-back" program to draw as much of the hydrocarbon reserve from the lower end of the field where the Exxon leases and the Alexander lease lay, to the higher end of the formation where Amoco would then extract the minerals.[95] The effects of this plug-back program were two in number, both of which Amoco was aware. First, Amoco extracted hydrocarbons that otherwise would have been produced from the leases of its competitor, Exxon. Secondly, by extracting hydrocarbons from the higher end of the formation that otherwise would have been produced from the Alexander lease, Amoco was able to increase its share of the proceeds from the sale of those minerals. This was true because the Alexanders enjoyed a greater percentage royalty than did any of Amoco's other lessors, all of whom had a uniform royalty provision in their leases.[96] Amoco, therefore, not only redistributed mineral wealth among its lessors, but also redistributed potential income from one of its lessors to itself. The Alexanders repeatedly requested that Amoco rework the wells on their lease to stem the dramatic fall in hydrocarbon production from their property. Amoco refused.

The appellate court upheld the trial court's award of exemplary damages to the Alexanders, in addition to actual damages.[97] Although the plaintiffs had brought their action on both contract and tort theories, the appellate court's opinion does not delineate between such theories,[98] nor does the opinion furnish a basis for an award of exemplary damages other

92. *Id.* at 473.
93. *Id.*
94. *Id.* at 475.
95. *Id.* at 470.
96. *Id.* at 479.
97. *Id.* at 480.
98. *See id.* at 471-74.

than its citation to two rather unusual cases.[99] A legal basis for an award of exemplary damages might arise from the hybrid nature of implied covenants in oil and gas law. Although clothed in the language of contract, such implied covenants impose duties that are consonant with conceptions of tort law. The fact that the duty incumbent upon Amoco could not be waived by contract[100] would seem to indicate that the implied covenant to protect one's lessor from field-wide drainage is susceptible to recharacterization as a part of the law of torts.

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99. *See id.* at 479-80. The court cites Montgomery Ward & Co. v. Scharrenbeck, 146 Tex. 153, 204 S.W.2d 508 (1947) (facts suggest that consequential damages, rather than exemplary damages, were the actual underlying theory of recovery), and Pan Am. Petroleum Corp. v. Hardy, 370 S.W.2d 904 (Tex. Civ. App.—Waco 1963, writ ref'd n.r.e.) (a case involving fraud on the part of the defendants). 594 S.W.2d at 479-80.

100. 594 S.W.2d at 473.