



January 1969

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Recommended Citation

Gene L. McCoy, *Oil and Gas*, 23 Sw L.J. 72 (1969)
<https://scholar.smu.edu/smulr/vol23/iss1/6>

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OIL AND GAS

by

Gene L. McCoy*

I. NON-PARTICIPATING ROYALTY

DURING the survey period, the supreme court decided two significant non-participating royalty cases. In the first, *Montgomery v. Rittersbacher*,¹ Montgomery owned a non-participating royalty interest, and Rittersbacher owned the balance of the mineral interest and all of the executive rights in an 80-acre tract (First Tract). Rittersbacher also owned the full mineral interest in a tract of 124.19 acres (Second Tract) which was contiguous with the First Tract. In 1951 Rittersbacher, without the joinder of Montgomery, entered into an oil and gas lease which covered both tracts. The lease contained a pooling clause and also an entirety clause which provided:

If the leased premises *are now or shall hereafter be owned* in severalty or in separate tracts, the premises, nevertheless, shall be developed and operated as one lease, and all royalties accruing hereunder shall be treated as an entirety and shall be divided among and paid to such separate owners in the proportion that the acreage owned by each such separate owner bears to the entire leased acreage.²

Sun Oil Company, assignee of the lessee, acting pursuant to the lease pooling authority, formed several units out of the lands under lease, combining portions of the land under the lease with other leased lands owned by Sun. Eighty acres of the Second Tract were included in the Crutchfield Unit, a unit composed of 320 acres. In October 1956 a producing well was completed in the Crutchfield Unit on lands other than those covered by the Rittersbacher lease, and commercial production commenced in May of 1958. Sun included the First Tract in another unit, on which a dry hole was drilled in July 1961.

In May 1964, six years after the commencement of unit production, Montgomery sued Sun Oil Company and Rittersbacher for his claimed share of the royalty accruing to the lease by virtue of production on the Crutchfield Unit. Montgomery contended that the entirety clause in the lease compelled an apportionment among the mineral and royalty interest owners on a surface acreage ratio and that, inasmuch as he had ratified the lease, he was entitled to be paid according to its terms. In other words, Montgomery claimed that the facts in question constituted a "double pooling" and that he should receive a net royalty revenue interest from all unit production, computed as: $1/16 \times 80 / 204.19 \times 80 / 320 = .006122$ R.I. Sun and Rittersbacher contended that Rittersbacher, as owner of the executive rights, had no authority to execute an oil and gas lease which would bind Montgomery's non-participating royalty interest with entirety

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¹ 424 S.W.2d 210 (Tex. 1968).

² *Id.* at 212 (emphasis added).

or pooling clauses and, in any event, Montgomery had not ratified the lease. The trial court and the court of civil appeals³ held for Sun and Rittersbacher, principally upon the grounds asserted by them. However, the supreme court reversed the lower courts and remanded for a precise determination of the percentage of unit production which Montgomery was entitled to receive, based upon Montgomery's theory of interest.

In its opinion, the supreme court stated that the concept of cross-conveyancing is still an extremely viable doctrine in any pooling situation.⁴ Also, the court reaffirmed cases⁵ holding that the owner of the executive rights cannot pool the interest of a non-participating royalty owner in the absence of that owner's consent. However, because Rittersbacher purported to bind Montgomery's interest by the entirety and pooling clauses in the lease, the court held that Montgomery had an option to ratify or repudiate the unauthorized lease. The court further held that the conduct of Montgomery, as a matter of law, constituted a ratification of the lease and entitled him to share in unit production.

There were two unauthorized poolings in *Montgomery*. The initial pooling resulted, at least according to the opinion, from the inclusion in the lease of the "now owned" entirety clause.⁶ The second pooling resulted from the lessee's exercise of the pooling power conferred by the lease pooling clause. The only other significant method by which the executive holder may attempt to pool the interest of a non-participating royalty owner is the community lease.⁷ Although the facts in *Montgomery* would have permitted the court to predicate the initial pooling upon the existence of a community lease,⁸ the court chose not to do so. Rather, it stressed

³ *Montgomery v. Rittersbacher*, 410 S.W.2d 925 (Tex. Civ. App. 1966).

⁴ See *Veal v. Thomason*, 138 Tex. 341, 159 S.W.2d 472 (1942).

⁵ *Brown v. Smith*, 141 Tex. 425, 174 S.W.2d 43 (1943). See also *Minchen v. Fields*, 162 Tex. 73, 345 S.W.2d 282 (1961).

⁶ A "now owned" entirety clause means the type quoted *supra* at note 2. *Thomas Gilcrease Foundation v. Stanolind Oil & Gas Co.*, 153 Tex. 197, 266 S.W.2d 850 (1954), established that the "now owned" language resulted in an apportionment of royalties upon the mere execution of the lease without regard to the subsequent conduct of the lessor or lessee. It is the only case, other than the principal case, with this interpretation. Cf. *Jul-Tex Drilling Co. v. Pure Oil Co.*, 201 F. Supp. 874 (D. Colo. 1962). For a discussion of this type clause and other entirety clauses, see McCoy, *The Entirety Clause—Its Current Use and Interpretation*, 12 ROCKY MT. MIN. L. INST. 317 (1967). It should be observed that pooling will not result from the more ordinary entirety clause.

⁷ It is possible, of course, that the executive owner might attempt to pool the interest of a non-participating royalty owner by attempting to commit the non-participating royalty owner's land to a field-wide type unit formed by agreement of the parties rather than under lease pooling authority. The principal case does not answer whether the non-participating royalty owner would have the right to ratify or repudiate this kind of unauthorized act. The opinion states that the option relates to "a lease containing provisions which as to his interest the holder of executive rights had no authority to insert in the lease." 424 S.W.2d at 215 (emphasis added). Thus, it may well be that an unauthorized act made without relation to the execution of the lease itself may be absolutely void and not subject to ratification.

⁸ Although *Brown v. Smith*, 141 Tex. 425, 174 S.W.2d 43 (1943), and *Nugent v. Freeman*, 306 S.W.2d 167 (Tex. Civ. App. 1957), *error ref. n.r.e.*, refused to find the existence of community leases in instances where the executive owners made leases covering two or more segregated tracts, in only one of which the non-participating and non-joining royalty owners had interests, the rationale, but not the result, of these decisions is the same as in the *Montgomery* case, *i.e.*, the executive owner is simply devoid of power to pool the non-joining non-participating royalty interest. These cases do not compel the conclusion that, with proper ratification, there may be no community lease under such facts. In this regard, see *Standard Oil Co. v. Donald*, 321 S.W.2d 602 (Tex. Civ. App. 1959), *error ref. n.r.e.*, which held that a community lease could exist under

the effect of this special entirety clause. The decision would have been more meaningful had the court adopted the community lease approach in preference to the entirety clause.⁹ And, although not fully answered by *Montgomery*, it may be hoped that any pooling resulting from an unauthorized act of the executive holder will give the non-participating royalty owner an option to ratify or repudiate the unauthorized act.

Montgomery makes it clear that the execution of an unauthorized lease by the executive holder is not a void act, and that "the non-participating royalty owner has the option to ratify or repudiate a lease containing provisions which as to his interest the holder of executive rights had no authority to insert in the lease."¹⁰ The opinion implies that there can be no partial ratification.¹¹ While not discussed, it would likewise seem to follow that there may be no partial repudiation, although *Mathews v. Sun Oil Co.*¹² indicates otherwise.

Once it has been determined that the circumstances exist which confer upon the royalty owner an option to repudiate or reject an unauthorized lease, the period of time in which the election must be made and the method by which the election is evidenced become pertinent. In *Montgomery* there was evidence that, prior to filing suit, Montgomery had made demand upon the other parties for his proportionate share of accrued royalties and that, on at least one occasion, he affirmatively stated that he was willing to ratify and would execute any necessary ratification document. Rittersbacher and Sun contended that Montgomery's statements constituted merely a conditional offer to ratify, which they never accepted. The supreme court, implying that the issue of ratification is not to be determined on ordinary contractual principles, resolved the issue with this language:

This evidence demonstrates Montgomery's intention to ratify the lease, and by filing suit to enforce the lease as written, Montgomery, as a matter of law, has exercised his option to ratify the lease. We think that the manner in which he has exercised his option is analogous to the manner by which a principal can ratify the unauthorized actions of an agent—bringing a suit to enforce the unauthorized act.¹³

It should be noted that Montgomery claimed not only that he was entitled to share in unit production, but also that he was entitled to his full one-half nonparticipating interest under the First Tract. Certainly, the

these circumstances. For a discussion generally of the community lease, see L. HOFFMAN, VOLUNTARY POOLING AND UNITIZATION 9 (1954).

⁹ Although unsupported by statistics, my general impression is that there are many more community leases than leases with "now owned" entirety clauses. Moreover, predicating the opinion on the community lease approach would have obviated the affirmation and extension of the questionable *Gilcrease* decision.

¹⁰ 424 S.W.2d at 215.

¹¹ Interestingly, Montgomery attempted what seems tantamount to a partial ratification, *i.e.*, he claimed not only that he was entitled to share in unit production, but also that he was entitled to his full one-half non-participating interest in the First Tract. The court merely stated that "Montgomery, having thus ratified the lease, is as much bound thereby as if he had joined in the original execution thereof. As long as the lease is in force, he is not free to claim his full ½ non-participating interest under 'First Tract.'" 424 S.W.2d at 215.

¹² 425 S.W.2d 330 (Tex. 1968).

¹³ 424 S.W.2d at 214.

latter claim was not compatible with a complete adoption of the unauthorized lease. The supreme court did not fully analyze this ambivalent position but merely stated that Montgomery was not entitled to an unpooled interest in the First Tract. Accordingly, we are left to surmise what conduct short of the actual filing of a lawsuit will constitute a ratification, or for that matter, a rejection of the unauthorized lease.

The most untenable part of the decision is the holding allowing Montgomery to wait six years after he had knowledge of the gas production before making his election. In a quite similar case,¹⁴ a court of civil appeals held that filing suit within two years of the commencement of production was not a sufficient ratification of the lease. There, the court stressed that after the lease had been fully developed, the non-participating royalty owner lost the right to exercise the option. Apparently, the lease involved in *Montgomery* also was fully developed and the only justification for allowing Montgomery to make his dilatory election was the failure to make an appropriate plea of laches. Chief Justice Calvert, in dissent, pointed out that in some circumstances a non-participating royalty owner with full knowledge of his rights may lose his right to ratify the lease through laches. A non-participating royalty owner who finds that he may opt between production on a non-apportioned basis from his tract or production on a pooled basis with other tracts will want to remain uncommitted for the greatest allowable period of time. The non-participating royalty owner thus will have an opportunity to watch the development of his tract compared with the development of the other tract in which he has inchoate rights to share and then, weighing the relative production, make the most propitious election. The only drawback to this approach is the holding in *Montgomery* that the election as to pooled production may not be retroactive; the court expressly found that Montgomery was entitled to royalty payments from and after the date suit was filed.

In the second non-participating royalty decision, *Mathews v. Sun Oil Co.*,¹⁵ the owners of the executive rights executed a single oil and gas lease covering two contiguous sections. The lease provided for a primary term of five years and "as long thereafter as oil, gas or other mineral is produced from the land hereinabove described."¹⁶ At the time this lease was executed there were outstanding 1/16th non-participating royalty interests in each tract, the royalty interest in each tract being owned by different parties. A well was commenced on one section prior to the end of the primary term and completed thereafter as a commercial producer. No well was drilled on the other section, and after the expiration of the primary term, the lessors and owners of the non-participating royalty in the section upon which no well had been drilled brought suit to terminate the lease insofar as it covered that section. The plaintiffs contended that the executive holder, while he had the power to execute oil and gas leases, did not possess the right to execute a lease to the detriment or disadvan-

¹⁴ *Nugent v. Freeman*, 306 S.W.2d 167 (Tex. Civ. App. 1957), *error ref. n.r.e.*

¹⁵ 425 S.W.2d 330 (Tex. 1968).

¹⁶ *Id.* at 333.

tage of the non-participating royalty owners under either section described in the lease. In the alternative, it was contended that if the executive holder did have the right to execute the lease, the effect of such lease would be a separate lease as to each section of land and, inasmuch as there was no producing well or other activity on the section owned by them, the lease terminated as to that section. The supreme court, in affirming both lower courts, held that the leased premises were to be considered as a single tract for the purposes of satisfying the habendum clause and perpetuating the lease by production.

While the opinion is limited, correctly, to the "sole issue" of the continuation of the leasehold estate, some obvious problems of pooling and apportionment of royalty are implied in the facts. One question is whether the non-participating royalty owner in *Mathews* might be entitled to a proportionate share of production from the producing tract. In light of *Montgomery*, it seems that the non-participating royalty owner, by filing suit, elected to repudiate rather than ratify the lease. Accordingly, it appears that he is not entitled to production on a pooled basis. If the conduct of the non-participating royalty owner in *Mathews* may be correctly characterized as a repudiation of the lease, it follows that an election to *repudiate*, unlike an election to ratify, is not necessarily total (*i.e.*, the habendum and "thereafter" clauses may not be repudiated).

It should be noted that *Mathews* will not preclude a non-participating royalty owner from demanding, by appropriate action, that his tract be properly developed. This conclusion is supported by the court's statement that the executive holder cannot make a lease which would "prevent, hamper or stifle production to the prejudice"¹⁷ of the non-participating royalty owner. Therefore, while the lease may be considered a single lease for the purpose of the habendum clause, apparently there are nevertheless two separate leases with respect to the obligations of the lessee. He will be required to respect the interior boundaries of the lease for the purpose of development and protection against drainage and may also have the burden to provide separate measuring tanks, records, and books in order to measure and account for the production from each tract.

It would have been gross error to find that the lease considered in *Mathews* had terminated as to both sections with respect to the entire mineral interest. Moreover, it would have been error to allow termination of the lease as to the mineral estate of the executive holder, for that would have allowed him to profit by his unauthorized act. In this regard, the court must have been influenced by the fact that even if it had granted the relief sought by the non-participating royalty owner, he would not have been directly benefitted. The court may also have been influenced by the fact that this suit was filed after production had been obtained on the lease and by the fact that the holder of the executive rights and the non-participating royalty owner were in alliance in the suit. Possibly, there may be a different result in a similar suit brought by the non-participating royalty owner where these factors are absent.

¹⁷ *Id.*

Mathews and *Montgomery* both stressed that there is some duty of fair dealing owed by the executive power to the non-participating royalty owner, although neither case fully articulated a definition of that duty.¹⁸ The supreme court presumably prefers to decide each case on an ad hoc basis. In *Montgomery* the court merely stated that the executive owner, in exercising the executive rights, "had a duty to protect the non-participating royalty owner."¹⁹ In *Mathews* the court defined the duty negatively: "[The executive owner] would not be authorized to make a contract binding upon the non-participating royalty owners which would prevent, hamper, or stifle production to the prejudice of such owners, and while he may lease and thus vest title to a working interest under such lease, he may not convey the reserved royalty interest."²⁰

II. THE DUHIG DOCTRINE

The decision of the supreme court in *Forest v. Hanson*²¹ is important because of the restriction placed upon the now familiar and quasi-ubiquitous doctrine of *Dubig v. Peavy-Moore Lumber Co.*²² An understanding of the principles of the case is facilitated by rephrasing and simplifying the facts.

A, the owner of the fee in a full section of land, deeded the entire section to B, but reserved the mineral rights in the East Half. Thereafter, B conveyed the entire section to others, and, by mesne conveyances, the section was ultimately conveyed to D. Due to an abstractor's error, the reservation of minerals in the East Half in favor of A was not included in the abstract of title; thus the reservation was not mentioned in any of the mesne conveyances into D, who presumably was unaware of it. D then conveyed to P, by warranty deed, the entire section but reserved to himself the minerals in the South Half of the section. P assumed he acquired good title to the minerals in the entire North Half, whereas the Northeast Quarter in fact was owned by A. P sued D for breach of warranty for the title failure to the minerals in the Northeast Quarter and, predicated upon the *Dubig* doctrine, claimed he was entitled to D's mineral interest in the Southwest Quarter. In other words, the plaintiff contended that inasmuch as the breach of warranty resulted in the loss to him of 160 acres (the NE/4), he would be made whole by having substituted therefor the 160 acres owned by D (the SW/4).

The supreme court rejected P's argument and held that he was entitled to money damages only for the breach. In *Dubig* the court, applying the estoppel principle of the after-acquired title cases, held that the grantor was estopped to deny ownership of the reserved interest not because the title to the disputed one-half mineral interest had been acquired after the grantor had purported to sell it, but because he had retained the very in-

¹⁸ See Elliot, *The Executive Right*, 42 TEXAS L. REV. 865 (1964); Jones, *Non-Participating Royalty*, 26 TEXAS L. REV. 569, 580-85 (1948).

¹⁹ 424 S.W.2d at 213.

²⁰ *Mathews v. Sun Oil Co.*, 425 S.W.2d 330, 333 (Tex. 1968).

²¹ 424 S.W.2d 899 (Tex. 1968).

²² 135 Tex. 503, 144 S.W.2d 878 (1940).

terest which would make his defective conveyance good. In the present case, the court noted that the grantor owned no interest in the minerals in the specific tract where title failed, and stated: "The Duhig doctrine is a doctrine of estoppel and not one of replacement."²³ The result is that the doctrine of *Duhig* is limited to instances in which the grantor retains an undivided interest in the particular tract in which title failed. Title examiners should be delighted with this holding, for had the court affirmed the opinion of the court of civil appeals, title examiners would be forced in many instances to examine title to land other than the specific one under consideration in order to determine whether the doctrine of estoppel might apply to the land under examination.

The *Duhig* doctrine was considered again by the Texas Supreme Court in *McClung v. Lawrence*.²⁴ In this case the McClungs conveyed to the Lawrences by general warranty deed, seventeen tracts of land containing approximately 1,800 acres. The deed contained this reservation:

The grantors hereby reserving unto themselves one fourth of all of the oil, gas and/or minerals in, on or upon the above described land; however the grantees herein their heirs and assigns are hereby empowered and authorized to lease said land for oil, gas or other minerals without the joinder of the grantors herein in making any such lease or leases; and it is expressly stipulated that said grantors, their heir or assigns shall not participate in any bonus or delay rentals paid grantees under any such lease or leases upon the leasing of said land the interest of the said grantors, their heirs and assigns shall be and become a 1/32 (one thirty second) royalty interest under such leases it being the intention hereby to reserve and retain in said grantors a non participating 1/32 royalty interest in and to the oil, gas or other minerals in, on or under the land hereby conveyed.²⁵

This deed was executed and recorded in May 1947. At the time the deed was executed there were outstanding mineral and royalty interests in some of the tracts but the deed made no reference or exception to those interests. The McClungs contended that they were entitled in all instances to an undivided 1/32nd royalty interest upon the leasing of the tracts by the Lawrences and they brought suit seeking such a construction. Alternatively, they sought reformation of the deed because it failed to make clear that the reservation of the non-participating royalty interest was in addition to any prior outstanding mineral or royalty interest. The supreme court held that the quoted reservation was unambiguous and should in fact be construed in favor of the Lawrences under the doctrine of *Duhig*. Thus, the 1/32nd reserved interest of the McClungs was reduced to make good any deficiency under the conveyance to the Lawrences. Furthermore, the court rejected the argument that the reservation created two interests, distinguishing *Benge v. Sbarbauer*²⁶ and similar cases. With respect to the action for reformation, the court of civil appeals had held, as a matter of law, that the parties were charged with knowledge of the

²³ *Forrest v. Hanson*, 424 S.W.2d 899, 904 (Tex. 1968).

²⁴ 430 S.W.2d 179 (Tex. 1968).

²⁵ *Id.* at 179-80.

²⁶ 152 Tex. 447, 259 S.W.2d 166 (1953); see 2 H. WILLIAMS & C. MEYERS, OIL AND GAS LAW § 340 (1959).

provisions of the deed from the date of its execution and that limitation on the claim for reformation commenced to run from the date of the execution of the deed. The supreme court distinguished the cases cited by the court of civil appeals as being cases which dealt with mineral deeds where one of the parties claimed a provision was entirely omitted, as contrasted with the situation here where the parties were alleged to have been mutually mistaken as to the legal effect of the language contained in the deed.

III. TERM ROYALTY

The stereotype printed form for conveying a term royalty generally specifies that the granted interest shall continue for a specified number of years and "as long thereafter as oil, gas or other minerals, or either of them, is produced" from the land conveyed. This language, standing alone, generally constitutes the whole content of the contract on the subject of the perpetuation of the term royalty. Our courts have quite properly and uniformly refused to abrogate this form of contract by amending or adding clauses which the parties did not spell out in the written document.²⁷

However, this rigid judicial construction is somewhat ameliorated by decisions which hold that even though the royalty deed does not expressly provide that the term royalty will continue in the event of temporary cessation of production, such language is necessarily implied. In a recent court of civil appeals opinion, where the facts showed a well which had been producing in paying quantities for more than fourteen years was shut down for a period of fifteen months and then brought back into production, the court held, as a matter of law, that the cessation of production was only *temporary* as opposed to *permanent*.²⁸

IV. LEASE CLAUSES

The important *Vela*²⁹ litigation, which should have been the catalyst for oil and gas lessors and lessees to re-examine their lease agreements, culminated this past year. The supreme court affirmed the court of civil appeals and held that the price received by the royalty owners under a long term gas-sales contract does not establish "market price" within the meaning of the royalty clause of the oil and gas lease. Rather, "market price" is to be ascertained by comparable sales of gas. In *Vela* the lessors, in 1933, executed an oil and gas lease providing for royalty on gas of "one-eighth of the market price at the wells."³⁰ In 1935 the lessees entered into a long term (life of the lease) gas-sales contract with the only purchaser who then had a pipe line in the field. The contract provided that the lessees dedicated all of the gas under the leased premises for the term

²⁷ For example, where there is no actual production but the lease covering the same land as the term royalty is being held by the payment of shut-in royalty payments, the courts repeatedly have refused to interpolate a shut-in royalty clause in the conveyance. See *Sellers v. Breidenbach*, 300 S.W.2d 178 (Tex. Civ. App. 1957), *error ref.*

²⁸ *Campbell v. Seaman*, 427 S.W.2d 705 (Tex. Civ. App. 1968).

²⁹ *Texas Oil & Gas Corp. v. Vela*, 429 S.W.2d 866 (Tex. 1968).

³⁰ *Id.* at 868.

of the lease and that the purchaser was to pay 2.3 cents per m.c.f. for all gas delivered and purchased under the contract. From 1935 all of the gas produced from the lease was marketed in accordance with this contract. Then, from 1959 to 1962, additional gas discoveries were made in the field and other purchasers entered into gas contracts providing for prices ranging from 13 to 17 cents per m.c.f. In 1964 the royalty owners brought suit against the lessees to recover alleged royalty deficiencies for the years 1960 to 1964, contending that 2.3 cents per m.c.f. did not correspond with the "market price" royalty clause of the lease. The trial court found that the market value of the gas was 13.04 cents net per m.c.f. and granted the royalty owners recovery for the difference in price for the four-year period under consideration.

In a five-to-four decision, the supreme court affirmed the district court and court of civil appeals and, in so doing, dismissed rather summarily the lessees' argument that the "market price" of gas within the meaning of the lease is the price contracted for in good faith by the lessee in pursuance of its duty to market gas from the lease. Moreover, the court stated that since none of the royalty owners ever agreed to accept royalties on the basis of the gas contract, their royalty payments should be determined by the language of the lease. The opinion affirmed the reasoning of the court of civil appeals that "market price" as used in the lease meant the "prevailing market price at the time of the sale or use,"⁸¹ and that the gas which was marketed under the long term contract was not "sold" at the time the contract was made but at the time of delivery to the purchaser. The criterion to prove "market price" was said to be "sales of gas comparable in time, quality and availability to marketing outlets."⁸² Moreover, the court stated, "the mathematical average of all prices paid in the field is not a final answer to the difficult problem of determining marketing price at any particular time."⁸³

The *Vela* opinion seemingly ignored the nature of the gas industry which requires, because of the heavy capital expenditures for pipe lines and facilities, that gas be sold by long term contracts. Moreover, the court attributed no effect to the implied duty of the lessee to market gas and use reasonable diligence to secure the highest price obtainable for the gas. Presumably, the lessees in the instant case did exercise reasonable diligence and obtained the best market price available at the time. The dissent argued quite cogently that the majority was oblivious to these vital factors. Further, the dissent stressed that since the royalty provision of the lease did not state at what point in time market price was to be determined, the court should look at the practices of the industry at the time the lease was executed in 1933. This approach, the dissent remarked, showed that the parties knew when they entered into the lease that gas would be marketed on a long term contract at a fixed price.

In an impeccable understatement, the supreme court stated that "[t]he

⁸¹ *Id.* at 871.

⁸² *Id.* at 872.

⁸³ *Id.* at 873.

lease obligation may prove financially burdensome to a lessee who has made a long-term contract without protecting itself against increases in market price."³⁴ Under the facts of the present case, the lessees will receive a total of 2.3 cents per m.c.f. and they will pay the royalty owners a total of 1.63 cents per m.c.f. (1/8th of 13.047 cents per m.c.f.). This means that the leasehold interest has been reduced from 87.5 per cent to 30 per cent and may likely mean an operating loss for the lessees. Conceivably, under the court's holding a lessee could in fact be required to pay the royalty owners more than he actually receives for the gas sold.³⁵

Vela deserves careful examination by all lessors and lessees, and the prudent lessee who finds that his lease has this objectionable royalty clause will attempt promptly to obtain modifications of the lease or perhaps, more expediently, will find methods to have the gas contract ratified by the royalty owner. Many division orders probably will now be amended to include express reference to any gas contract made by the lessee with language manifesting royalty owner approval and ratification. On the other hand, royalty owners should be warned to scrutinize carefully division orders which may contain such language.

On a collateral issue, the supreme court held that two of the royalty owners were not equitably estopped to claim they were entitled to be paid on the basis approved in the opinion even though they were at one time owners of part of the working interest and in that capacity had expressly ratified the gas purchase contract. And, on another issue, the court construed the notice of breach clause in the lease to mean that a lessor is not precluded from recovering damages for drainage which occurred prior to the time he gave written notice to the lessee under the terms of this clause of the lease.³⁶

V. LEASEHOLD ASSIGNMENTS

In three cases involving "farmouts" the dominant issue was the proper measure of damage for a breach by the assignee of the farmout agreement. In the first case, the assignee failed to give his assignor actual notice, as required by the farmout agreement, prior to dropping the assigned leases

³⁴ *Id.* at 871.

³⁵ *Query*: Would this mean the lease is subject to termination for failure to produce in "paying quantities"? See, e.g., *Clifton v. Koontz*, 160 Tex. 82, 325 S.W.2d 684 (1959).

³⁶ More specifically, the supreme court said: "The parties could not have intended that the lessor would be forever barred from recovering damages sustained prior to the giving of notice, and we hold that the first two sentences quoted above apply only to actions to cancel the lease and not to suits for damages." 429 S.W.2d at 875. The clause in question reads:

In the event lessor considers that lessee has not complied with all its obligations hereunder, both express and implied, before production has been secured or after production has been secured, lessor shall notify lessee in writing, setting out specifically in what respects lessee has breached this contract. Lessee shall then have sixty (60) days after receipt of said notice within which to meet or commence to meet all or any part of the breaches alleged by lessor. The service of said notice shall be precedent to the bringing of any action by lessor on said lease for any cause and no such action shall be brought until the lapse of sixty (60) days after service of such notice on lessee. Neither the service of said notice nor the doing of any acts by lessee aimed to meet all or any of the alleged breaches shall be deemed an admission or presumption that lessee has failed to perform all its obligations hereunder.

Id. at 874-75.

for nonpayment of delay rentals.³⁷ For this dereliction, damages were assessed on the basis of the market value (\$5.00 per acre) of the leasehold estates wrongfully terminated. The supreme court remanded the case, however, because of the introduction, over objection, of inadmissible evidence. In the other two cases the assignee failed to drill required wells. In one case the wronged plaintiff recovered nothing, apparently because he chose an improper theory of damages.³⁸ The plaintiff attempted to recover on a loss of profit theory, which required proof that he and the breaching party at the inception of the contract contemplated the operative facts upon which this measure of damage is predicated: namely, a showing that the plaintiff intended to and would have sold his retained interest at the alleged value.

The damage issue in the last case was decided in accordance with Louisiana law and is not significant for this *Survey*.³⁹ What is significant, however, is the interpretation of the word "completed" urged by the defendant-assignee. The farmout agreement provided that the assignee had no obligation to drill a second test well until the first well was "completed." The assignee contended unsuccessfully that the word "completed" meant completed as a producer and not as a dry hole, and inasmuch as the first well was dry, he had no duty to drill the second well. Under the facts of the case, the court's rejection of the assignee's argument seems correct. However, the fastidious draftsman will recognize that a different court under comparable circumstances conceivably could find the word ambiguous.

The measure of damages for breach of warranty of title as a result of a partial failure of title generally is an amount which bears the same ratio to the total consideration paid the warrantor as the value of the interest which has failed bears to the value of the whole interest purchased.⁴⁰ One civil appeals case,⁴¹ which did not question this general rule, illustrates the difficulty in proving and applying this test to a leasehold interest when the failure of title is predicated upon the existence of an outstanding sliding-scale (depending upon natural flow or artificial lift) overriding royalty. The court also held that the four-year statute of limitations, rather than the two-year statute, governs the cause of action for recovery of deficient payments brought by the overriding royalty owner.⁴²

The viability of the ordinary overriding royalty depends upon the continuation of the leasehold estate from which the override is carved. In an interesting case⁴³ involving an aggrieved overriding royalty owner, the court of civil appeals held that in a contest between the owner of the override and the working interest owner, the burden of showing that the

³⁷ *McLaughlin v. Ball*, 431 S.W.2d 305 (Tex. 1968).

³⁸ *Dunham v. Stephens*, 423 S.W.2d 957 (Tex. Civ. App. 1968), *error ref. n.r.e.*

³⁹ *Seale v. Major Oil Co.*, 428 S.W.2d 867 (Tex. Civ. App. 1968).

⁴⁰ *See Hynes v. Packard*, 92 Tex. 44, 45 S.W. 562 (1898).

⁴¹ *French v. Bank of the Southwest*, 422 S.W.2d 1 (Tex. Civ. App. 1967), *error ref. n.r.e.*

⁴² *Compare Hull v. Freedman*, 383 S.W.2d 236 (Tex. Civ. App. 1964), *error ref. n.r.e.*, which applied the two-year statute in an action by the lessee against the lessor under similar facts.

⁴³ *Gasperson v. Christie, Mitchell & Mitchell Co.*, 418 S.W.2d 345 (Tex. Civ. App. 1967), *error ref. n.r.e.*

leasehold estate was maintained in force and effect was upon the overriding royalty owner. The overriding royalty owner contended alternatively that even if the prior leasehold estate from which his override was carved had lapsed, he was entitled to have his overriding royalty interest ingrafted on a new lease taken by the same lessee some nine months after the expiration of the earlier lease. The court refused to grant this relief, stating that whether the new lease was in renewal and extension⁴⁴ of the prior lease was a fact question on which the plaintiff had not sustained the burden of proof. Moreover, the court refused to find that the override existed on a constructive trust theory.⁴⁵

VI. SURFACE RIGHTS

Sun Oil Co. v. Whitaker,⁴⁶ which portended the resolution of many of the vagaries of the conflicting rights of oil and gas operators and surface owners in and to underground fresh water, was decided by the supreme court this past year. Unfortunately, the court carefully avoided the substantive issues of the case and rested its decision on procedural grounds "neither urged on appeal by the appellee-respondent nor noticed by the court of civil appeals."⁴⁷ *Whitaker* involved the right of Sun Oil Company to use fresh water underlying its lease in its water flooding operations on the lease. At issue was an interpretation of the free use clause, which provided that "Lessee shall have free use of oil, gas, coal, wood and water from said land except water from Lessor's wells for all operations hereunder."⁴⁸ The court of civil appeals found the phrase "all operations hereunder" ambiguous and, based upon the presumed intention of the lessor and lessee at the time of execution of the lease, held that Sun did not have the right to use the water for water flooding purposes.⁴⁹ Hopefully, the important issues raised by *Whitaker* will again be before the supreme court at an early date.

In another contest between surface owner and oil and gas lessee, the supreme court reaffirmed the mineral estate's dominance, repeating the rule that a surface owner who seeks to recover from the lessee for damages to the surface has the burden to prove either specific acts of negligence or that more land was used by the lessee than was reasonably necessary.⁵⁰ In this case, Humble had constructed a road, thirty feet in width, with a gravel base and a black top surface, across the leased land to its drilling site. In constructing the road, which was built about two feet higher than the surrounding land, Humble had cut or pushed down some 315 small pine trees. There was also evidence that Humble had made deep

⁴⁴ The assignment document creating the override expressly stated that the override would apply to "a renewal or extension of primary term of any of the assigned leases on or before 90 days from the expiration date of each assigned lease." *Gasperson v. Christie, Mitchell & Mitchell Co.*, 418 S.W.2d 345, 353 (Tex. Civ. App. 1967), *error ref. n.r.e.*

⁴⁵ The court found *Sunac Petroleum Corp. v. Parkes*, 416 S.W.2d 798 (Tex. 1967), dispositive of this issue. 418 S.W.2d at 356.

⁴⁶ 424 S.W.2d 216 (Tex. 1968).

⁴⁷ *Id.* at 218.

⁴⁸ *Id.*

⁴⁹ *Sun Oil Co. v. Whitaker*, 412 S.W.2d 680 (Tex. Civ. App. 1967).

⁵⁰ *Humble Oil & Ref. Co. v. Williams*, 420 S.W.2d 133 (Tex. 1967).

ruts in the area near the drilling site which was used for parking and other vehicular purposes. Because the plaintiff introduced no proof of negligence or proof that Humble used more of the land than was reasonably necessary to conduct its operation, he did not recover.

Some erosion of the dominance of the mineral estate is reflected in an opinion by the Beaumont court of civil appeals.⁵¹ The lessee acquired in 1931 a lease covering an undivided 300-acre tract. At the time of the suit, the lease had fifteen producing wells on it, and the surface ownership had been divided among several owners. Many years subsequent to the lease, the defendant acquired the surface ownership of a 65-acre tract on which were situated three wells and a meter run. The oil and gas lessee's only means of access to these installations was over four separate roads, each of which it used daily. Prior to the defendant's purchase of the tract, these roads had always been open. The defendant, however, built a fence around his tract and placed wire gates across the roads in question. The lessee sued to enjoin the use of the gates. The lessee introduced evidence that the presence of the gates required its employees to alight from and re-enter their vehicles five times in order to service each well on the 65-acre tract. In the absence of the gates, they would be required to alight from their vehicles only once to service each well thereon. The lessee also attempted to introduce evidence showing the expense imposed on it in the operation of the 300-acre tract if barriers were erected on the balance of the land in accordance with the various surface ownership. The trial court, in connection with a special issue which inquired whether the surface owner's conduct in erecting the gates constituted an unreasonable interference with the lessee's operations, instructed the jury to weigh the injury caused to the lessee by the gates against the utility of the gates to the surface owner.⁵²

This case must be considered an aberration, for it apparently is the first to adopt a weighing of relative inconvenience and value among the surface owner and oil and gas lessee. If the tract were subdivided among a great many surface owners and each of them placed similar barriers, the expense to the lessee might become quite significant. Thus, the exclusion of testimony with regard to the hypothetical future surface use of the lease is questionable. The lessee should have the right to have the court consider the cumulative effect of actual surface interference by all surface owners on the lease.

A federal case considered a mineral deed which provided that "on grantors' request all pipe lines laid across any of said land to be tilled shall be placed below plow depth."⁵³ The oil operator argued that the term

⁵¹ *Getty Oil Co. v. Royal*, 422 S.W.2d 591 (Tex. Civ. App. 1967), *error ref. n.r.e.*

⁵² In answering the foregoing Special Issue, you are instructed that a determination of whether the erection of such gates by Defendant is 'unreasonable' involves weighing the degree of harm or inconvenience such gates cause to Plaintiff against the utility of such gates to Defendant and the suitability of other measures which would substantially serve the purpose of such gates to Defendant at less or no inconvenience or harm to Plaintiff.

Id. at 594.

⁵³ *Mobil Oil Corp. v. Brennan*, 385 F.2d 951, 952 (5th Cir. 1967). Compare *Manges v. Gulf Oil Corp.*, 394 F.2d 487 (5th Cir. 1968).

"tilled" could not mean root plowing inasmuch as the modern root plowing technique was unknown in 1926, the date of the deed. The Fifth Circuit rejected this argument and required the operator to bury its pipeline. However, the court did agree with the trial court that the plow depth contemplated was only twelve inches below the surface and not the additional depth necessary to effect root plowing.

Closely related to the surface rights of the mineral lessee are the rights of holders of pipe line easements. In *Phillips Pipe Line Co. v. Razo*,⁵⁴ Phillips in 1956 acquired a pipe line easement across river bottom land. The land, which was heavily wooded and marshy, was entirely rural in character and used only for the occasional grazing of a few head of cattle. The right of way was cleared sometime thereafter, and at the time the pipe was laid in 1960, the landowner had begun using part of the cleared right of way as a private road. In 1961 the landowner granted a second pipe line right of way to Monsanto Chemical Company. This line was to be located about 500 feet north of Phillips' pipe line. The subcontractor who cleared Monsanto's right of way obtained permission from the landowner to use the private road to bring in its equipment. In using this private road, the subcontractor's bulldozer struck the Phillips pipe line, which exploded, injuring the operator of the bulldozer. In a suit against Phillips, the injured operator recovered damages of \$304,208. The trial court found that Phillips was negligent in failing to bury the pipe line at a proper depth, in failing to inspect properly, and in failing to give proper warning of the pipe line. The Tyler court of civil appeals affirmed, although it required a remittitur of \$104,288.⁵⁵

Relying upon the 1963 opinion of *Pioneer Natural Gas Co. v. K & M Paving Co.*,⁵⁶ the supreme court reversed the lower courts and reaffirmed that a pipe line operator has a duty to avoid damages from occurrences such as leaks and breaks in the pipe which could result from the ordinary use of the surface by others. Considering the type of road overlying the pipe line and the rural location, the court concluded that the only foreseeable ordinary use was by pickup or jeep, and Phillips was therefore not obligated to bury its pipe line to protect against this extraordinary use by a bulldozer.

VII. OTHER OPERATIONAL CASES

The State of Texas levies an occupation tax on the business of producing gas amounting to seven per cent of the market value of the gas produced.⁵⁷ Among the statutory exceptions is "gas used for lifting oil."⁵⁸ In *Calvert v. Kadane*⁵⁹ the supreme court construed this exception to be inapplicable to gas consumed for fuel in an internal combustion motor used to

⁵⁴ 420 S.W.2d 691 (Tex. 1967).

⁵⁵ *Phillips Pipe Line Co. v. Razo*, 409 S.W.2d 565 (Tex. Civ. App. 1966), *rev'd*, 420 S.W.2d 691 (Tex. 1967).

⁵⁶ 374 S.W.2d 214 (Tex. 1963).

⁵⁷ TEX. TAX-GEN. ANN. art. 3.01 (1960).

⁵⁸ *Id.* art. 3.01(2)(b).

⁵⁹ 427 S.W.2d 605 (Tex. 1968).

operate a pump which "lifted" the oil on these leases to the surface. Four of the justices dissented, noting rather cogently that the majority's statutory interpretation was inordinately literal.

By virtue of article 5474,⁶⁰ a contractor who furnishes material used in the drilling of an oil well is entitled to a lien "on the whole of such land or leasehold interest therein, . . . for which said materials, machinery or supplies were furnished . . ." In a court of civil appeals opinion,⁶¹ a contractor contended that the language "the whole of such land or leasehold interest" meant the entire portion of the base lease owned by the operator to whom he furnished material. The court held, however, in view of a stipulation between the parties that the base lease owned by the same operator was known by the parties as three separate tracts, that each separate tract would be treated as an entire leasehold interest for purposes of the statutory lien. The case poses many questions as to how and when an operator may unilaterally segregate one base lease owned by him into numerous tracts for purposes of limiting statutory liens and should be a *caveat* to lenders and purchasers of less than the full base lease.

VIII. UNITIZATION, COMMUNITIZATION AND SPACING

One of the few cases construing the language of the modern unitization agreement arose this past year.⁶² The court examined and discussed several provisions of a rather standard unit operating agreement with special scrutiny of the adjustment of investment provisions. The court concluded that, under the language of this agreement, the intangible investment and inventory investment provisions of the operating agreement had to be considered together to determine whether a working interest owner was to be credited or debited for his total unit investments. In another case, construction of the participation phases of a unit agreement was not fully considered because of procedural defects.⁶³ The court comprehensively discussed estoppel as to the unit agreement.

In a rule 37 case decided during the survey period, the court attacked the Railroad Commission's determination of what constituted an illegal subdivision in the East Texas field.⁶⁴ The Railroad Commission granted a permit to a tract of .107 acres under its "long established policy" governing subdivision of tracts in the East Texas field which were created prior to the Commission's order of May 29, 1934, the date used by the Commission to determine illegal subdivisions in the East Texas field. Inasmuch as the small tract involved in this suit was created prior to that date, the Commission maintained that the permit granted for the tract was entirely proper. The court of civil appeals disagreed and held that rule 37 became applicable to the parent tract in 1931, the date it was first leased for oil

⁶⁰ TEX. REV. CIV. STAT. ANN. art. 5474 (1958).

⁶¹ *Dunigan Tool & Supply Co. v. Burris*, 427 S.W.2d 341 (Tex. Civ. App. 1968), *error ref. n.r.e.*

⁶² *Producing Properties, Inc. v. Sohio Petroleum Co.*, 428 S.W.2d 365 (Tex. Civ. App. 1968).

⁶³ *Pennzoil v. Socony Mobil Oil Co.*, 421 S.W.2d 416 (Tex. Civ. App. 1967).

⁶⁴ *Railroad Comm'n v. Humble Oil & Ref. Co.*, 424 S.W.2d 474 (Tex. Civ. App. 1968), *error ref. n.r.e.*

and gas purposes and prior to its subdivision. Therefore, this tract was not entitled to a permit as an exception to rule 37.

In an interpleader action involving ownership of royalties under a unit, Judge Goldberg wrote a most erudite opinion which he characterized as an inquiry into "the penumbral areas of the law of royalty apportionment."⁶⁵ The court held: (1) A communitized lease may exist when several lessors join in the execution of a lease even though each has a uniform undivided interest in all of the tracts included within the lease; (2) non-contiguous tracts may be the subject of a community lease even though the lack of contiguity is one factor showing the absence of a community intent; (3) a community lease may be formed even though the lease does not cover 100 per cent of the mineral interest; and (4) a community lease is not dissolved by partition where the deeds implementing the partition use language that they are "subject to" the lease.

The court's first holding is questionable and probably will cause more problems than it solves. If there is uniformity of interest, the question immediately arises why it is helpful or necessary (exclusive of the present case) to consider the act of leasing an act of communitization. This rationale must be predicated upon a determination that there are two or more "tracts" included within the leased area and will inevitably lead to hazardous definitional problems concerning "tracts." For example, if two people, each owning an undivided one-half interest in a one-acre tract of land, execute the same oil and gas lease on that one acre, can it be said that there is a communitization? Presumably, if there is any basis upon which to argue that the one acre consists of two "tracts," then under the theory of this case there would be a communitization.

IX. VACANCY STATUTE

In *Hughes v. Atlantic Refining Co.*⁶⁶ the supreme court held that in a vacancy suit the applicant may not use the device of a class action to obtain jurisdiction over persons actually named in the vacancy application previously filed by the applicant with the Commissioner of the General Land Office. Instead, the applicant must name and obtain jurisdiction over each person in the district court litigation. Moreover, in *Hughes* the plaintiff's failure to name each separate necessary party was not a fatal jurisdictional defect, and the plaintiff was therefore given opportunity on remand to name and bring in all necessary parties. Incidentally, the court took a pragmatic approach with respect to the rights of intervening parties in the Fairway Field Unit. These necessary parties number in excess of five thousand. The court indicated quite clearly that the class action procedure may be used with respect to these parties and to all other intervening parties.

⁶⁵ *Howell v. Union Producing Co.*, 392 F.2d 95 (5th Cir. 1968).

⁶⁶ 424 S.W.2d 622 (Tex. 1968).