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Oil, Gas and Mineral Law

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OIL, GAS AND MINERAL LAW

Richard F. Brown*

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I. INTRODUCTION

This article focuses on the interpretations of, and changes relating to, oil, gas and mineral law in Texas from October 1, 1999 through September 30, 2000. The cases examined include decisions of courts of the State of Texas and the Fifth Circuit Court of Appeals.1

II. CONVEYANCING AND TITLE ISSUES

JVA Operating Co. v. Kaiser-Francis Oil Co.2 construes the reservation of a production payment in a conveyance of leasehold interests. In March 1969, the predecessors in interest to Kaiser-Francis Oil Company ("Kaiser-Francis") unitized their leasehold interests in ten tracts of land with four other tracts for the production of oil and gas limited to the Canyon Sands formation.3 In May 1969, Kaiser-Francis executed a conveyance to the predecessors in interest to JVA Operating Company, Inc. ("JVA") and other leasehold interest owners conveying its leasehold interests in the ten tracts, but reserving a production payment of $3,900,000.00.4 In 1992, JVA drilled a well and obtained production from the Ellenberger formation, which was below the depth of the Canyon

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1. This article is devoted exclusively to Texas law. Cases involving questions of oil, gas and mineral law decided by courts sitting in Texas but applying laws of other states are not included.
2. 11 S.W. 3d 504 (Tex. App.—Eastland 2000, pet. denied)
3. See id. at 505.
4. Id. 

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Sands formation. The issue was whether the production payment was payable out of production from the Ellenberger or whether it was payable only on unitized production from the Canyon Sands.

The granting clause conveyed “The leasehold estates, described in Exhibit ‘A’ which is attached hereto and made a part hereof (hereinafter called ‘Subject Interests’).” Exhibit “A” made it clear that the “Subject Interests” were the assignor’s interests in oil, gas and mineral leases relating to the ten tracts of land. Thus, the granting clause conveyed all production at all depths.

The reservation clause immediately following the granting clause read as follows:

EXPRESSLY EXCEPTING AND EXCLUDING, HOWEVER, from this assignment and retaining and reserving unto Assignors [Kaiser-Francis], in proportion to their respective ownership, for themselves and for their several and respective heirs, personal representatives, successors and assigns, as a production payment, the hereinafter shown percentages of Net Barrels of Oil and Gas produced, saved, sold and allocated to the Subject Interests, hereinafter referred to as “Reserved Percentage of the Hydrocarbons,” from and after the Effective Date and throughout the period hereinafter specified.

“Reserved Percentage of the Hydrocarbons” was defined in excruciating detail, and the controlling language for the term “Net Barrels of Oil and Gas” was defined as follows:

(iv) The term “Net Barrels of Oil” as used herein, shall mean the quantity of oil produced, saved and allocated as provided in the Unit Agreement (as hereinafter described) . . . . The term “Net Cubic Feet of Gas,” as used herein, shall mean the quantity of gas produced, saved, sold and allocated as provided in the Unit Agreement . . .

Applying the “four corners” canon of construction, the court of appeals determined that the production payment was to be paid from hydrocarbons produced only from the Canyon Sands formation. The court of appeals noted that there was no reason for the drafter of the conveyance to refer to oil or gas “produced, saved and allocated as provided in the Unit Agreement” unless the drafter intended to limit production to the unitized Canyon Sands formation in the Unit Agreement. To adopt Kaiser-Francis’ position would have required the court to ignore that “Net Barrels of Oil” was a defined term in the conveyance. Because the conveyance expressly provided that the terms “Net Barrels of Oil” and “Net Cubic Feet of Gas” meant the quantity of oil and gas “produced, sold and allocated as provided in the Unit Agreement,” the court of appeals held that the production payment was limited to oil and gas produced as pro-

5. *Id.* at 506.
6. *Id.*
7. *Id.*
8. *JVA*, 11 S.W.3d at 506 (emphasis added).
9. *Id.* at 508 (second emphasis added).
10. *Id.*
11. *Id.* at 507.
vided in the Unit Agreement, which concerned production only from the Canyon Sands formation.12

The conveyance was obviously drafted by parties familiar with oil and gas transactions, and in many ways it is a precise instrument. Nevertheless, in stacking terms and definitions, the parties overlooked a fundamental issue the conveyance should have addressed in very simple terms. The conveyance could easily have recited that the reserved production payment “was payable from production from the Canyon Sands formation only,” or that the reserved production payment “was payable from all production at all depths from the Subject Interests.” Defined terms (e.g. “Net Barrels of Oil”) are sometimes dangerous because they can be tedious to analyze and may have unintended consequences. The risk is heightened if the fundamental terms of the instrument are not plainly and simply set forth.

Kilgore v. Black Stone Oil Co.13 considers the application of the doctrine of stare decisis to a boundary dispute. In Kilgore, the plaintiffs asserted that they owned mineral interests in the Escobeda League in Polk County and sued the defendants for conversion of gas that the plaintiffs argued belonged to them.14 Plaintiffs based their claim on an alleged conflict between the Escobeda League and three other surveys.15 Defendants argued that the appellate court case of W. T. Carter & Bro. v. Collins16 had determined in 1916 that there was no conflict between the surveys, and although the parties in Kilgore did not claim under the parties in Collins, they were bound under the doctrine of stare decisis.17 The Beaumont Court of Appeals noted that there are two divergent concepts regarding the application of stare decisis to boundary lines—the orthodox and unorthodox doctrines.18 The orthodox doctrine provides that stare decisis applies only to questions of law.19 Once the Texas Supreme Court squarely decides a legal question, the decision is precedent, binding the Supreme Court and all other lower courts when the identical question is raised in a later suit between different parties.20 Some courts of appeals have adopted the unorthodox doctrine of stare decisis and concluded that a fact issue determination—such as the fixing of boundary lines, headright surveys, or other fixed real property markers—may be binding precedent under the doctrine of stare decisis.21 Under the unorthodox doctrine, a prior ruling regarding the location of a boundary line will control the location of the same line in a second case, even though the first

12. Id. at 508.
14. Id. at 668.
15. Id.
17. Kilgore, 15 S.W.3d at 667.
18. Id. at 668.
19. Id.
20. Id.
21. Id.
case turned upon an issue of fact or the legal questions raised in the first case are not those of the second case.

The Beaumont Court of Appeals in Kilgore applied the unorthodox doctrine and resolved all issues of conflicts between the Escobeda League and the other surveys because the Collins court had ruled that there was no conflict between the Escobeda League and the other surveys.\textsuperscript{22} The court in Kilgore was also persuaded by the longstanding rule that real property issues should remain settled once an appellate court has ruled.\textsuperscript{23}

McCall v. McCall\textsuperscript{24} considers whether the words “and appurtenances thereto” contained in the granting clause of a mineral deed conveying a specifically described tract also convey royalty interests in separate tracts not specifically described in the deed.

Prior to 1975, a 3300 acre tract (both surface and minerals) was owned jointly by three parties: the Taubs, the Dwyers, and Mildred McCall (“Mildred”). The land was subject to three oil and gas leases and was included in a large producing unit known as the Bammel Field Unit. In 1975, the 3300 acre tract was partitioned into sixteen separate tracts (the “1975 Partition”).\textsuperscript{25} Under the 1975 Partition, Mildred received five tracts (“McCall Tracts”) which were burdened by a 20% royalty interest in favor of the Taubs and Dwyers.\textsuperscript{26} Likewise, the 1975 Partition awarded Mildred a 10% royalty interest in the tracts awarded to the Taubs and Dwyers (“Taub/Dwyer Tracts”). Each party thus continued to own its royalties and other benefits in each of the tracts granted to the other parties.

Soon after the 1975 Partition, Mildred conveyed the McCall Tracts by several deeds, which each stated:

\begin{quote}
[Mildred] does GRANT, BARGAIN, SELL AND CONVEY that certain tract of land containing [acreage] in Harris County, Texas, as more particularly described in Exhibit A . . . together with all improvements thereon . . . and appurtenances thereto . . . unto Grantees . . . .\textsuperscript{27}
\end{quote}

None of the deeds referenced Mildred McCall’s 10% royalty interest in the Taub/Dwyer Tracts.\textsuperscript{28} Based on the McCall deeds, Lila McCall, as one of the grantees, argued that she was entitled to an interest in the royalty on the Taub/Dwyer Tracts.\textsuperscript{29} Lila argued that “appurtenances thereto” included Mildred’s royalty interest in the Taub/Dwyer Tracts. The trial court granted partial summary judgment, declaring that the McCall deeds did not vest Lila McCall with an interest in the Taub/Dwyer

\begin{footnotes}
\item[22] Id. at 669.
\item[23] Kilgore, 15 S.W.3d at 669.
\item[24] 24 S.W.3d 508 (Tex. App.—Houston [1st Dist.] 2000, no pet. h.).
\item[25] Id. at 509.
\item[26] Id.
\item[27] Id. at 510 (emphasis added).
\item[28] Id.
\item[29] McCall, 24 S.W.3d at 511.
\end{footnotes}
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royalty interests. On appeal, Lila McCall contended Day & Co. v. Texland Petroleum, Inc. was controlling. Day & Co. is a leading Texas case on executive rights, which held that previously severed executive rights passed to the grantee under a general warranty deed, even though the executive rights were not mentioned in the deed. The court held that the executive right, although severed from the mineral estate, remained "an interest in property, an incident and part of the mineral estate like the other attributes such as bonus, royalty and delay rentals." Because the executive rights were not reserved or excepted, the executive rights were conveyed by the deed. Lila McCall argued that Day & Co. was controlling because the McCall deeds did not reserve or except the royalties on the Taub/Dwyer Tracts.

The court of appeals held that Day & Co. was distinguishable because the royalty interests Lila McCall claimed were not "appurtenant" to the mineral interests conveyed in the McCall deeds. The court cited with approval the following definition of appurtenance from Balcar v. Lee County Cotton Oil Co.:

A thing belonging to another thing as principal, and which passes as incident to the principal thing. A thing used with, and related to, or dependent upon another thing more worthy, and agreeing in its nature and quality with the thing whereunto it is appendant or appurtenant . . . . It is therefore limited to that which is necessary to the enjoyment of the principal thing granted. An appurtenance is that only which is incidental or indispensable to the proper use of the premises demised. A mere conveyance does not create an appurtenance.

The court held that nothing in the 1975 Partition or the McCall deeds supported Lila McCall's position that the royalty interests under the existing leases on the Taub/Dwyer Tracts were appurtenant to the conveyed McCall Tracts.

The case is significant for sharply limiting the meaning of "appurtenance" to that which is "incidental or indispensable to the premises demised" (although incidental seems to leave an open door) and for the court's refusal to extend the rational of Day & Co. to include royalty interests within the same unitized tract but not expressly described as part of the premises conveyed.

An adverse possessor must take actual possession of minerals under the surface by drilling and producing them in order to successfully claim

30. Id.
31. 786 S.W.2d 667 (Tex. 1990).
32. McCall, 24 S.W.3d at 514 (citing Day & Co. v. Texland Petroleum, Inc., 786 S.W.2d 667, 669 (Tex. 1990)).
33. Id.
34. Id.
36. McCall, 24 S.W.3d at 514 n.8 (citations omitted).
37. Id. at 514.
Sarandos v. Blanton holds that an erroneous vacancy award from the sovereign that purports to convey both the surface and mineral estate does not alter this requirement. Blanton traced her title back to a mineral severance by deed and reservation in 1963. Sarandos eventually acquired the surface estate and in 1975 applied to the General Land Office ("GLO") to purchase a suspected vacancy located within the tract. In 1977, the GLO awarded the vacancy to Sarandos, and the purchase price was eventually fully paid in 1996.

Between 1975 and 1996 there were various leases and conveyances by the parties, which reflected the parties' uncertainty as to the extent of their title. At least some of these transactions would suggest that Blanton acquiesced in the Sarandos claim to the alleged vacancy. However, a resurvey in 1995 revealed that the vacancy was much smaller than the Sarandos survey in 1975 had suggested, and the patent issued by the state for the vacancy to Sarandos in 1996 excluded 60.652 acres previously thought to be included in the vacancy.

This suit was filed to determine title to the 60.652 acres. It is well established in Texas "that, after the mineral and surface estates have been severed, an adverse possessor of the surface estate cannot accomplish adverse possession of the mineral estate unless he takes actual possession of the minerals under the surface by drilling and producing them for the statutorily-prescribed period." The undisputed evidence established that Sarandos never took actual possession of the disputed minerals. Sarandos argued that the drilling and production requirement should not apply in this case because he adversely possessed the disputed acreage under a vacancy award from the sovereign which purported to convey both surface and mineral estates.

The court disagreed and relied heavily on Atlantic Refining Co. v. Noel, which had a very similar fact pattern. To hold otherwise would permit the surface owner unilaterally to divest the severed mineral owner from his title based on nothing except the conduct of the surface owner, over whom the mineral owner has no right of control.

Siegert v. Seneca Resources Corp. considers whether a severed mineral estate is subject to the doctrine of accretion. A tract of land along the Brazos River was described in a 1932 deed severing the minerals as

38. 25 S.W.3d 811 (Tex. App.—Waco 2000, pet. filed).
39. Id. at 812.
40. Id.
41. Id. at 814.
42. Id. at 813-814.
43. Id. at 815 (citations omitted).
44. Sarandos, 25 S.W.3d at 818.
45. Id. at 816.
46. 443 S.W.2d 35 (Tex. 1969) (op. on reh'g).
47. Sarandos, 25 S.W.3d at 816, 817.
48. 28 S.W.3d 680 (Tex. App.—Corpus Christi 2000, no pet. h.).
containing 100 acres. A 1955 survey showed that the tract contained 181 acres. Siegert contended that the increase was due to accretion and that the doctrine of accretion is not applicable to severed minerals.

Under the doctrine of accretion, an owner of riparian land gains title to increases in his property caused by natural forces. Siegert claimed that the 1932 deed could only have reserved a mineral interest to the original 100 acre tract that was described in the deed. Following the Austin Court of Appeals in Ely v. Briley, the Corpus Christi Court of Appeals held that the doctrine of accretion applies to surface estates as well as mineral estates and that a severed riparian mineral interest is subject to accretion just as a surface estate is subject to accretion. To hold otherwise would create claims to slivers or strips of small mineral interests along river edges that would not appear in title searches and would be virtually impossible to administer or litigate. The court also held that there should be no difference between the mineral rights in unsevered riparian mineral interests and severed riparian mineral interests.

III. OIL, GAS AND MINERAL LEASES

A. Royalty Clause

_Coastal Oil & Gas Corp. v. Roberts_ construes a provision of an oil and gas lease which permits the lessor to terminate the lease for failure to pay royalties. Payment of royalties under the lease was expressly governed by a clause in the lease which provided:

Royalties and other payments for production shall be due and owing to Lessor within 120 days from the date of first production, and thereafter such payments shall be due on or before the end of the second calendar month following the month in which the production for which the royalties or payments are to be made are sold and delivered. If Lessee wrongfully or unreasonably withholds any such payment or payments due to Lessor for a period of thirty (30) days after written demand for payment is made by Lessor on Lessee at the above address (or other such address as made by specified in writing hereafter by Lessee), at the election of Lessor this lease may be terminated.

Coastal drilled a gas well on November 19, 1997. On February 28, 1998, Coastal sent division orders to all interest owners with a letter that stated that Coastal would pay royalties to the interest owners upon re-

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49. _Id._ at 682.
50. _Id._ at 683.
51. _Id._
52. _Id._ at 684.
53. _Id._
54. 959 S.W.2d 723 (Tex. App.-Austin 1998, no pet. h.).
55. _Siegert_, 28 S.W.3d at 684.
56. _Id._
57. _Id._
58. 28 S.W.3d 759 (Tex. App.—Corpus Christi 2000, no pet. h.).
59. _Id._ at 761 (emphasis added).
ceipt of a completed division order. Several of the lessors ("Coates") did not return a division order to Coastal. Under the terms of the lease, royalties were due March 19, 1998, which was 120 days from the date of first production. Coates sent a written demand for payment on March 24, 1998, stating that royalties were due and owing for the lease and that Coastal had thirty days from receipt of the letter to pay all amounts due and owing. Coastal responded in a letter dated April 21, 1998, stating that Coates' demand for payment was insufficient and deliberately vague because it did not explain the amounts owed or how Coastal had improperly calculated royalties. On May 4, 1998, Coates notified Coastal that Coates terminated the lease. The trial court granted Coates' motion for summary judgment and terminated the lease. Coastal appealed.

The Corpus Christi Court of Appeals affirmed the trial court's judgment. The court of appeals stated that termination of an oil and gas lease could only occur if there was a breach of a special limitation or condition subsequent. Non-payment of royalties is usually considered a breach of a covenant which will subject a party to liability for damages, but not lease termination, unless the lease includes a clause which makes nonpayment of royalties a breach of a special limitation or condition subsequent. The court of appeals ruled that the lease included an express condition subsequent that the lessor could terminate the lease if Coates could prove the following three elements:

- Coastal failed to pay royalties on a timely basis;
- Coates gave Coastal a written demand for payment; and
- Coastal wrongfully or unreasonably withheld payment for thirty days following the demand.

The evidence was undisputed that Coastal failed to pay royalties on a timely basis. Coastal argued that the written demand was not adequate because the demand letter failed to specify the particulars of any breach. The court ruled that the lease only required "written demand of payment" and that the demand letter complied with the terms of the lease.

The most interesting part of the case was the court's construction of the operation and effect of the Texas division order statute in determining whether Coastal "wrongfully or unreasonably" withheld payment. Because determining the meaning of "reasonably" could arguably present a fact question not subject to resolution by summary judgment, the court focused on the meaning of "wrongfully" and the Texas division order statute.

60. Id. at 762.
61. Id.
62. Id. at 761.
63. Coastal Oil, 28 S.W.3d at 763.
64. Id.
65. Id.
66. Id.
67. Id. at 764.
68. Coastal Oil, 28 S.W.3d at 765.
Coastal argued that it had withheld payment of royalty pursuant to Section 91.402(c)(1) of the Texas Natural Resources Code, which permits a payor (lessee) to withhold payments of royalties to a lessor pending receipt of a division order. Because Coastal was withholding payment pursuant to a statute, Coastal argued that withholding payment from Coates was not "wrongful or unreasonable," and because the lease expressly stated that royalty payments that were withheld pursuant to "any law, order directive or regulation of any governmental or regulatory body having jurisdiction" would not be considered "wrongful or unreasonable.”

Under Section 91.402(e) of the Texas Natural Resources Code, if a division order contains provisions in addition to any statutorily permitted provisions, the lessee cannot withhold payment solely because the lessor refuses to sign the division order. Coates asserted that it did not sign the division order because it contained an unauthorized provision regarding indemnification. Section 91.402(c)(1) permits lessees to require signed division orders from lessors, but only with certain standard provisions. One of the provisions a lessee may include is an agreement that the lessor will indemnify the lessee for payments made to the lessor, if the lessor does not have merchantable title to the production sold “unless otherwise agreed.” The lease was expressly made without warranty of title. Therefore, Coates and Coastal had “otherwise agreed” not to indemnify Coastal with respect to title. The court of appeals ruled that Coastal's division order did not comply with Section 91.402(c)(1); thus, Coastal could not withhold payments based on that statute.

Coastal also argued that it complied with Section 91.402(d) of the Texas Natural Resources Code, which provides an alternative form for division orders. However, the court of appeals stated that Section 91.402(d) applied to division orders for "oil payments only," and because the producing well was a gas well, Section 91.402(d) was inapplicable. Coastal’s division order for gas was required to comply with Section 91.402(c)(1).

The court of appeals noted that Webster's New Twentieth Century Dictionary defined wrongful as "full of wrong; unjust, unfair or injurious" and "unlawful." Because Coastal’s withholding of royalty was not authorized by Section 91.402(c)(1) of the Texas Natural Resources Code, the withholding was unlawful; therefore, the withholding was wrongful.

Coastal also was not entitled to rely on the provision of the lease permit-
ting withholding of royalty if done under “law, order, directive or regulation of any governmental or regulatory body having jurisdiction.”

The holding that Texas Natural Resources Code § 91.402(d) is applicable only to oil division orders is significant for both lessors and lessees. If a lessor includes such a cancellation clause in his lease, the lessor certainly increases lessor’s leverage over lessee to force timely payment of royalties. Termination of a producing lease for failure to timely pay royalty is draconian and fundamentally unfair but enforceable. Including a provision that the lease is without warranty strips the lessee of any reasonable opportunity to avoid the risk of wrongful payment because the lessee will have to pay every possible claimant. Obviously, the lessee should avoid leases with such clauses. Standard oil and gas leases already may be canceled for failure to timely pay delay rentals and shut-in gas payments and failure to produce in paying quantities. Agreeing to a provision canceling a lease for failure to timely pay royalties will only add more obligations and problems for the lessee. When operating leases contain similar lease cancellation provisions, the lessee should be careful in suspending royalties for any reason. The consequence could be irreversible. It should be noted that in this case Coastal made no payment, which leaves open the question of the effect of a partial payment or incorrect payment.

Intratex Gas Co. v. Beeson refuses to accept the trial court’s certification of a class in a case involving ratable takes under the Common Purchaser Act and Railroad Commission regulations from more than 900 wells. The trial court defined the plaintiff class as consisting of producers of natural gas whose gas was taken by Intratex between 1978 and 1988 in less than ratable proportions. The court found that class members must be presently ascertainable by reference to objective criteria and that a class definition which rests on the ultimate liability question cannot be objective, nor can the class members be presently ascertained. The court refused to redefine the class on appeal and remanded to the trial court.

B. Continuous Operations and Shut-In Royalty

Utley v. Marathon Oil Co. construes a continuous operations clause and a shut-in royalty clause in a lease termination case. Marathon commenced the drilling of a well late in the primary term and completed drill-
ing operations after the expiration of the primary term.\textsuperscript{87} For a period in excess of ninety days, Marathon attempted to test and complete in the Cotton Valley Lime. After expending $440,000 on testing and completion, Marathon gave up and plugged back and completed in the Bossier Sand.\textsuperscript{88} Utley contended that Marathon's attempts to complete in the Cotton Valley Lime were not in good faith or did not qualify as "continuous operations."\textsuperscript{89} The continuous operations clause was a common form clause providing that if Marathon was:

engaged in operations for drilling, mining or reworking any well or mine thereon, this lease shall remain in force so long as such operations or said additional operations are commenced and prosecuted (whether on the same or successive wells) with no cessation of more than ninety (90) consecutive days . . . .\textsuperscript{90}

The trial court instructed the jury: "that operations means actual work being done in a good faith endeavor to cause a well to produce oil and/or gas in paying quantities."\textsuperscript{91}

There was no objection or attempt to limit what evidence the jury could consider. There was a single broad form submission of the question to the jury, which asked whether operations on the well ceased for any period longer than ninety consecutive days during the time interval challenged by Utley.\textsuperscript{92} The jury answered in Marathon's favor and judgment was entered that the lease had not terminated.\textsuperscript{93}

The court described the trial as a "classic case of competing experts."\textsuperscript{94} There was a great deal of evidence from both sides as to whether the completion attempts in the Cotton Valley Lime were prudent or in good faith, but the jury ultimately believed Marathon, and the court refused to disturb that finding.\textsuperscript{95} The court apparently found little Texas authority defining "operations" in the context of a continuous operations clause. After noting the definitions accepted in other cases considering "reworking operations," and in the absence of any objection by Utley, the court simply accepted the trial court's instruction as defining the conduct which the jury could consider.\textsuperscript{96}

In addition to the completion efforts in the Cotton Valley Lime, Marathon had also been engaged in completing a pipeline to connect to the well.\textsuperscript{97} Utley contended on appeal that pipeline construction is not "operations" that will extend the lease.\textsuperscript{98} However, Utley did not object to

\textsuperscript{87.} Id. at 275-276.  
\textsuperscript{88.} Id. at 277.  
\textsuperscript{89.} Id. at 276.  
\textsuperscript{90.} Id. at 275.  
\textsuperscript{91.} Id. at 278 (emphasis added).  
\textsuperscript{92.} Utley, 31 S.W.3d at 276.  
\textsuperscript{93.} Id. at 275.  
\textsuperscript{94.} Id. at 279.  
\textsuperscript{95.} Id.  
\textsuperscript{96.} Id.  
\textsuperscript{97.} Id. at 276.  
\textsuperscript{98.} Utley, 31 S.W.3d at 277.
the charge for failure to include a limiting instruction and did not request such an instruction. Thus, it was not possible to determine what activity (completion attempt or pipeline construction) the jury considered as operations. Because the court found sufficient evidence to support the jury's finding based on the completion attempt, it never reached the pipeline construction issue.

There was also an unrelated claim in the same case for lease termination based on a failure to pay shut-in royalties. Acreage from the lease was included in multiple pooled units. Utley contended that there was no proportionate reduction clause applicable to shut-in royalties, and that the entire shut-in royalty, as expressed in dollars, must be paid as to each portion of the leased premises included in a unit, or, in other words, for each pooled unit. Apparently Marathon had made shut-in payments after making various proportionate reductions. There was no "Freestone Rider" clause in the lease providing that a well on pooled acreage would hold only pooled unit acreage. The opinion does not state all the facts because the court found that the proper payment of shut-in royalty was not a prerequisite to a judgment in this case preserving the lease. Because there was another well on the lease commenced and completed in the middle of the ninety-day window challenged by Utley, the court found that the lease was preserved by the continuous operations clause, regardless of the payment or attempted payment of shut-in royalty.

The case is significant for providing some guidance on the definition of "operations" as used in a continuous operations clause. The definition includes the concepts of "actual work" in a "good faith" effort to cause a well "to produce" in "paying quantities." Although other cases defining "reworking operations" have included as an additional element that the work be the same as that which an "ordinarily competent operator" would undertake, that element is not included in the instruction accepted by the court in Utley. However, there was no objection to the omission of that element.

IV. OPERATING, EXPLORATION AND FARMOUT AGREEMENTS

Abraxas Petroleum Corp. v. Hornburg construes the provisions of a joint operating agreement ("JOA") regarding selection of successor operators, authorization for expenditure ("AFE") letters, and the application

99. Id. at 278.
100. Id. at 279.
101. Id.
102. Id. at 280.
103. Id. at 281.
105. 20 S.W.3d 741 (Tex. App.—El Paso, no pet. h.).
of the exculpatory clause to the operator. Abraxas purchased the leasehold interest of the operator of a prolific oil lease in September 1992. Abraxas assumed responsibilities as operator, although there was no formal election of a successor operator as provided in the JOA. There was an immediate and significant decline in production. In November 1993, Abraxas notified the non-operators that all production had ceased from the four producing wells located on the lease and included an AFE which described the proposed workover procedures to restore the wells to production and the cost estimate for each well. The estimated costs to workover all four wells totaled $44,250.00, but no one well was estimated to require more than $30,000.00 (the amount requiring an AFE under the JOA). To participate in the proposed workover procedures, the AFE letter required the non-operators to pay their proportionate share of the expenses. If the non-operators declined, Abraxas, as operator, would invoke the 300% non-consent penalty under the JOA.106

None of the non-operators elected to proceed with the workover operations. Abraxas deemed the status of the non-operators to be “non-consent” under the JOA as of December 1, 1993. Although the AFE letter had listed workover procedures totaling $44,250.00 for all four wells, Abraxas actually performed only one small project in December 1993 at a cost of approximately $7,500.00. Abraxas did not notify any of the non-operators that it had decided not to complete all the proposed operations. Because of further problems with the wells on the lease, Abraxas decided to shut down the lease and to produce only one barrel from one well per day each month in order to hold the lease. Consequently, the lease was reduced from a 1,000 barrel-per-month producer when Abraxas obtained the lease, to a lease producing only 30 barrels or less of oil per month.107

The non-operators filed suit against Abraxas alleging, among other things, negligence, gross negligence, willful misconduct, breach of contract and waste.108 The trial court determined that Abraxas had never been formally selected as operator pursuant to the provisions of the JOA. The jury found that Abraxas (1) was grossly negligent in committing waste, (2) breached the JOA by sending the AFE, and (3) engaged in willful misconduct or gross negligence in failing to perform the work proposed under the AFE.109 The verdict and judgment included substantial exemplary damages in addition to actual damages and no offset was allowed for reasonable and necessary expenditures on the lease.110 The El Paso Court of Appeals affirmed the judgment of the trial court, except as to the award of exemplary damages, which it deleted.111

The court first addressed the trial court’s determination that Abraxas had never been formally selected as operator under the JOA. The court

106. Id. at 747.
107. Id. at 748.
108. Id.
109. Abraxas, 29 S.W.3d at 749.
110. Id.
111. Id. at 746.
ruled that the non-operators waived the JOA requirement that Abraxas be formally selected as operator of the Lease. The court based its holding on its prior decision in Purvis Oil Corp. v. Hillin,\textsuperscript{112} in which it held that non-operating working interest owners could waive requirements of the JOA pertaining to selection of a successor operator by permitting another party to act as operator and by accepting the benefits of that party's performance. The facts in Purvis were distinguishable because in that case the operator was actually selected, but at the time of selection, it owned no interest in the Contract Area. In Abraxas, the operator was never formally selected. The court found the distinction to be immaterial.\textsuperscript{113}

The jury finding that Abraxas committed “waste” was the only tort claim supporting the award of approximately $725,000 in exemplary damages.\textsuperscript{114} The court noted that waste includes injury resulting from a failure to exercise reasonable care in the preservation of property. However, in this case, the JOA governed the conduct of the operator with respect to production of oil from the land. The JOA gave Abraxas the contractual right to produce oil from the Lease, and although no provision specifically prohibited Abraxas from committing waste, Article V.A. of the JOA required that the operator “conduct all such operations in a good and workmanlike manner.”\textsuperscript{115} In other words, the duty violated was in contract rather than in tort, the non-operators were not permitted to maintain a common law tort cause of action for waste, and therefore the non-operators could not recover exemplary damages.\textsuperscript{116}

The court ruled that releasing an unjustified AFE could constitute a breach of the JOA:

Abraxas is correct that an AFE is an estimate or budget of proposed expenses, but that is not its sole or even its primary function. The sending of an AFE triggers the consent/non-consent provisions of the JOA and puts the receiving parties to an election of participating in the proposal or suffering a substantial penalty in the event the proposed work results in a producing well. Therefore, if an AFE is unjustified under the facts, then it may constitute a breach of the JOA to send the AFE and put the parties to that election.\textsuperscript{117}

The court found that the expert testimony offered by the non-operators constituted sufficient evidence to support the jury finding that sending the AFE letter breached the JOA.\textsuperscript{118} The expert testified that the projects proposed by Abraxas in the AFE letter were not subject to Article VI because none of them involved a reworking, deepening, or plugging back of the four wells on the lease. The proposed work concerned routine, normal repairs to the wells which Abraxas had an obligation as

\textsuperscript{112} 890 S.W.2d 931 (Tex. App.—El Paso 1994, no writ).
\textsuperscript{113} Abraxas, 20 S.W.3d at 751.
\textsuperscript{114} Id. at 753.
\textsuperscript{115} Id.
\textsuperscript{116} Id.
\textsuperscript{117} Id. at 755.
\textsuperscript{118} Id. at 758.
operator to undertake without sending the AFE. In fact, only a few months before Abraxas sent the AFE letter to the non-operators, Abraxas had done identical work on the wells and had billed the non-operators for their respective shares of the expenses through joint interest billings. The expert testimony also supported the finding of breach of contract because no single project exceeded $30,000 as required by Article VI. D.3. The court never reached the question of whether the failure to perform all the work described in the AFE was a breach of contract.

Abraxas contended that sending the AFE letter did not cause any damages to the non-operators. The court noted that sending the AFE letter triggered the contractual obligation of the non-operators to elect whether to participate in the cost of the proposed operations or suffer the 300% penalty specified in the JOA. Abraxas seized the interest of the non-operators and began appropriating their earnings. Abraxas continued to withhold the earnings even though it did not complete the operations specified in the AFE letter. Abraxas retained the interest of the non-operators until the lease had no more value. The court ruled that the evidence was both legally and factually sufficient to establish that sending the AFE letter caused damages to the non-operators. There was also a dispute as to the proper measure of damages. Abraxas contended that the issue as submitted to the jury measured damages by diminution in value rather than lost profits. The court concluded that the expert testimony, although expressed in terms of "market value," was based on calculating the reduction in the future income stream, which was the expectation interest.

Abraxas next asserted that the jury's failure to make a finding of gross negligence or willful misconduct in connection with its sending of the AFE letter precluded a finding of liability for breach of contract. Abraxas relied on Article V.A. of the JOA which contained the following exculpatory clause:

[Operator] . . . shall conduct and direct and have full control of all operations on the Contract Area as permitted and required by, and within the limits of, this agreement. It shall conduct all such operations in a good and workmanlike manner, but it shall have no liability as Operator to the other parties for losses sustained or liabilities incurred except such as may result from gross negligence or willful misconduct.

The court noted that exculpatory clauses in a contract are utilized generally to exempt one party from future liability for negligence, and the

119. Id. at 756-57.
120. Abraxas, 20 S.W.3d at 757.
121. Id. at 761.
122. Id. at 758.
123. Id. at 759.
124. Id. at 759-60.
125. Id. at 759 (emphasis added).
court found no cases discussing exculpatory clauses exempting a party from liability for breach of contract. The court concluded that the exculpatory clause was limited to claims based upon an allegation that Abraxas had failed to act as a reasonably prudent operator and did not apply to a claim that it breached the JOA. Because the exculpatory clause did not apply to a breach of contract, and the non-operators were not entitled to exemplary damages for breach of contract, the non-operators were not obligated to prove gross negligence or willful misconduct.126

The industry is sometimes loose in appointing successor operators when there is a transfer of the majority interest, and it is obvious who will be named as successor operator. This case follows existing case law in finding that the formalities of selecting a successor may be waived. The case is more significant for its finding that sending an AFE may be a breach of contract and for so readily finding causation and damages. Although not addressed in this opinion, it appears to be a foregone conclusion that this court would also find that failing to perform the work outlined in the AFE would also be a breach of contract.

Cross Timbers Oil Co. v. Exxon Corp.127 construes the removal-of-operator provisions of a Unitization Agreement and an Operating Agreement. The Unitization Agreement combined various oil and gas properties, and the Operating Agreement described how the unitized properties would be operated. Cross Timbers and Exxon were successors in interest to some of the working interest owners, and Exxon was the operator under the Operating Agreement.128

Cross Timbers asserted that two specific provisions, one from the Operating Agreement and one from the Unit Agreement, permitted the working interest owners to remove Exxon as operator by a vote of the working interest owners. The first provision, found in the Operating Agreement, stated:

3.1 Overall Supervision. Working Interest Owners shall exercise overall supervision and control of all matters pertaining to Unit Operations pursuant to this agreement and the Unit Agreement . . . .129

The second provision, found in the Unit Agreement, stated:

4.3 Change of Operating Methods. Nothing herein shall prevent Working Interest Owners from discontinuing or changing in whole or in part any method of operation which, in their opinion, is no longer in accord with good engineering or production practices. Other methods of operation may be conducted or changes may be made by Working Interest Owners from time to time if determined by them to be feasible, necessary, or desirable to increase the ultimate recovery of Unitized Substances.130

126. Abraxas, 20 S.W.3d at 759.
127. 22 S.W.3d 24 (Tex. App.—Amarillo 2000, no pet. h.)
128. Id. at 25-26.
129. Id. at 27.
130. Id. at 27.
Cross Timbers argued that the effect of these two provisions was to grant the working interest owners authority to remove the operator as part of their power to “supervise and control . . . operations” and to change the “method of operation.”131 Cross Timbers persuaded 65% or more of the working interest owners to join it in voting to remove Exxon as operator.132

Exxon refused to step down. Exxon relied on Section 7.1 of the Operating Agreement, which stated that “subject to the provisions of this agreement and to instructions from Working Interest Owners, Unit Operator shall have the exclusive right and be obligated to conduct Unit Operations,” and on Section 4.1 of the Unit Agreement, which stated that “Unit Operator shall have the exclusive right to conduct Unit Operations.”133

Cross Timbers then sued Exxon for breach of contract, contending that Exxon had violated the agreement by failing to step down as operator.134 Neither party contended that the agreements were ambiguous.135 Both Cross Timbers and Exxon moved for summary judgment and the trial court granted Exxon’s Motion for Summary Judgment and denied Cross Timbers’s Motion for Summary Judgment.136 The court of appeals affirmed the judgment of the trial court concluding that Section 3.1 of the Operating Agreement and Section 4.3 of the Unit Agreement did not grant the removal power to the working interest owners when construed in conjunction with the other sections of the two agreements.137

Article 3.2 of the Operating Agreement contained a non-exclusive list of powers extended to the working interest owners, including “the authority to determine the method of operation; the wells to be drilled; recompleted, abandoned, or changed; the amount of expenditures in excess of $25,000 which can be made; and, the ultimate disposition of unit equipment.”138 Section 4.3 of the Unit Agreement also uses the phrase “method of operation.” Neither agreement defined “operations” or “method of operation.” However, the Amarillo Court of Appeals had earlier defined “operations” to mean the “overall process aimed at achieving a particular end” in Sun Operating Ltd. v. Holt.139 Thus, “method of operation” as used in this Operating Agreement and Unit Agreement refers to how the unitized tract would be developed and how the minerals would be produced. The court of appeals ruled that the working interest owners were given the power to determine what can be done, where it can be done, and when it can be done.140

131. Id.
132. Id. at 26.
133. Id. at 28.
135. Id. at 27, n.3.
136. Id. at 26.
137. Id. at 28.
138. Id. at 27 (emphasis added).
There was no express reference among the powers extended to the working interest owners, however, as to who would carry out the development and production of the minerals. Section 7.1 of the Operating Agreement and Section 4.1 of the Unit Agreement specifically vested the right to conduct the operations in Exxon to the exclusion of everyone else. The court of appeals ruled that the Operating Agreement and Unit Agreement provided that the working interest owners could determine production and development of the minerals while the operator fulfilled their directives. Although the working interest owners could not remove the operator, they could determine what the operator would do, how the operator would do it, and when the operator would do it.\[141]

The model form operating agreements published by the American Association of Petroleum Landmen are the forms most commonly used by the industry. These printed forms have express provisions governing the removal of operator. The significance of this case is the holding that control over operations does not necessarily include control over who will operate. If there is no express removal-of-operator provision, or if the provision has been deleted, then perhaps there will be no removal of operator.

_Energen Resources MAQ, Inc. v. Dalbosco_\[142\] is an interesting case that relies upon custom and usage in the oil and gas industry to impose liability on an operator who abandons a well without notice to the non-operators. Dalbosco farmed out leases to Energen's predecessor; Energen drilled a producing well; and Dalbosco backed into a working interest at payout. No written operating agreement was ever executed. When the well stopped producing, Energen plugged and abandoned without notice to Dalbosco.\[143\]

Summary judgment for Energen in the first trial was affirmed on all claims, except as to whether there was a contractual duty based on custom and usage in the oil and gas industry, which was remanded to the trial court as an issue of fact.\[144\] At the second trial, Dalbosco was successful in obtaining favorable jury findings as to the existence of the duty to give notice based on custom and usage, and he recovered actual damages and attorney's fees.\[145\] The jury issue presented at the second trial read as follows: "Did the custom and usage in the oil and gas industry in 1981 impose a contractual duty on Defendant to provide notice to Don Dalbosco of its intent to abandon and plug the McDuffie No. 1 well before the expiration of the McDuffie lease?"\[146\]

141. Id.
142. 23 S.W.3d 551 (Tex. App.—Houston [1st Dist.] 2000, pet. filed)
143. Id. at 553.
145. Dalbosco, 23 S.W.2d at 552-53.
146. Id. at 554.
The court relied heavily upon the Texas Supreme Court opinion in Barreda v. Milmo Nat'l Bank, which held that "the general rule regarding custom and usage, in the case of contract, is that the custom and usage must be so general that both parties are presumed to be aware of the custom or usage, or that the parties have actual knowledge of the custom or usage, and the parties are charged with having contracted with reference to the custom or usage."\(^{147}\)

There were at least three witnesses who presented some evidence which tended to support Dalbosco's position as to the custom and usage in the industry. The witnesses included Energen's former attorney who testified that form operating agreements entered into over the years by Energen had notice provisions triggered by the plugging and abandonment of a well.\(^{148}\) On appeal, there was a "no evidence" point, but there was no issue challenging the sufficiency of the evidence.\(^{149}\) The court did not have any difficulty in finding some evidence of custom and usage, and therefore it overruled the "no evidence" point.\(^{150}\)

Energen sought to avoid the effect of the jury's finding by contending that there was no express jury finding that Energen knew of the existence of the custom or that Energen contracted with reference to that custom. The court found that it was not Dalbosco's burden to prove that Energen knew of the custom or contracted with reference to it, but rather it was Energen's burden to rebut the presumption that the parties specifically contracted with reference to the custom.\(^{151}\)

Energen also raised as a defense the exculpatory clause in its farmout agreement, which provided:

A. Compliance with Laws and Lease Obligations: Farmee agrees to use its best efforts to observe, perform and comply with all of the conditions and covenants, expressed and implied, of the oil and gas leases, and instruments to which such leases are subject, covering the drillsite of any well, and all laws, rules, regulations and orders, both State and Federal, relating to the ownership and enjoyment and the development and operations of the acreage covered by such leases, and Farmee will use its best efforts to maintain all rights in the acreage, but Farmee shall incur no liability to Farmor as a result of its failure to maintain the interest of both Farmor and Farmee hereunder, all or any of their rights in said acreage, or any part thereof.\(^{152}\)

The court rejected this defense and held that Dalbosco was not suing "for loss of any rights in the acreage," but "for breach of a contractual duty to give notice imposed by custom and usage."\(^{153}\) There is no further explanation of the court's reasoning, but presumably the greater part of Dalbosco's damages would be measured "by the loss of any rights in the

\(^{147}\) Id. at 556 (citing Barreda v. Mimo Nat'l Bank, 252 S.W. 1038, 1039-40 (Tex. 1923)).
\(^{148}\) Id. at 555-56.
\(^{149}\) Id. at 554.
\(^{150}\) Id. at 556-57.
\(^{151}\) Dalbosco, 23 S.W.2d at 567, n.1.
\(^{152}\) Id. at 553 (emphasis added).
\(^{153}\) Id.
acreage." The damages for failure to give notice, other than the damages for "the loss of rights in the acreage," would probably be negligible. Perhaps the court was referring to the salvage value of the personal property associated with the well, but the salvage value of a typical well would not equal 10% of the damages awarded in this case.

The value of the case as a precedent is further reduced by the fact that there was some evidence that Dalbosco and Energen's landman actually discussed and reached an express agreement on Dalbosco's right to take over the well. Thus, the holding is limited by the court's opinion that:

The presumption that the parties dealt with reference to the custom was not rebutted. To the contrary, a reasonable inference could be drawn from the "handshake deal" between Dalbosco and a representative of Energen's predecessor that the parties specifically contracted with reference to the custom.154

The case is unusual because there was no written operating agreement, there was no challenge to the qualifications of Dalbosco's experts or to the factual sufficiency of their opinions, and there may have been an express agreement on the right to take over operations. Nevertheless, the case is now some authority that the operator who plugs and abandons a well without notice to the non-operators is assuming a significant risk, unless there is some very clear contractual agreement that the operator is under no duty to give notice or to permit a non-operator to take over the well.

North Central Oil Corp. v. The Louisiana Land and Exploration Co.,155 construes an area of mutual interest agreement within a farmout agreement. North Central Oil Corporation ("North Central") and The Louisiana Land and Exploration Company ("LL&E") each claimed under almost identical farmout agreements. LL&E acquired another farmee's interest in existing leases. North Central sued LL&E, asserting that LL&E was required to offer a proportionate share of its newly acquired interests to North Central.156

The farmout agreements contained the following provision:

In the event that either party acquires an interest in oil and gas leases within the area delineated by the solid heavy line on the map attached hereto as Exhibit "F," it shall promptly offer an interest therein by notice in writing, describing the terms and conditions applicable to such acquisition, to the other party and any third parties owning interests in the Exhibit "A" and "B" leases in proportion to the ownership of each such party in said leases. Such interests shall be offered on the basis of actual costs of acquisition. Any offeree hereunder shall have ten (10) days in which to elect by written notice to offeror to participate in such acquisition. Failure to respond within said period shall be deemed an election not to participate. Each party electing to participate shall have the right to acquire an

154. Id. at 556.
156. Id. at 574-75.
interest in the proportion that its interest assigned hereunder bears to the interest of all electing parties and shall tender its proportionate share of the acquisition cost within fifteen (15) days after receipt of a formal assignment of such interest. Wolf Exploration Company shall, as to such leases, be entitled to the same overriding royalty, provided for hereinabove in paragraphs 1.1.1 through 1.1.5.157

LL&E contended that this provision applied only to after-acquired leases and not existing leases.158 North Central contended that this provision gave North Central the right to purchase a share of any interest in leases acquired by LL&E in the area.159

Although neither party had asserted that the farmout agreements were ambiguous, the court concluded that the farmouts were ambiguous and remanded because the farmout agreements were capable of two meanings that were directly opposed but equally credible.160

_Rodessa Resources, Inc. v. Arcadia Exploration and Production Co._161 considers when limitations will begin to run in cases involving fraud and fraudulent concealment. Arcadia was the operator of a well in which The Louisiana Land and Exploration Company (“LL&E”) held an overriding royalty interest with a contractual option to convert the overriding royalty to a working interest within sixty days after being notified that payout had occurred.162 Arcadia was contractually obligated to provide information in monthly statements to LL&E that would reflect the current status of payout on the well.

Arcadia stopped sending the statements showing the payout balance in 1986, and it wrote to LL&E that Arcadia believed LL&E had no right to convert its override in the well.163 Within the next year, the well was recompleted, production increased 2000%, and payout of the well occurred in 1987.164 On March 17, 1989, two years after payout, LL&E wrote Arcadia pointing out that Arcadia had not provided the requisite information about the status of payout on the well. Arcadia did not respond to the letter or to telephone calls. On May 10, 1994, five years after payout, LL&E wrote Arcadia again, and again received no response. In June 1995, LL&E prepared its own payout statement from the revenue information provided with the royalty checks, the operating expenses reflected in the statements LL&E received until 1986, and the re-completion costs obtained by LL&E from other working interest owners.165 LL&E’s own calculations were within one month of the cor-

157. _Id._ at 576.
158. _Id._ at 577.
159. _Id._ at 578; cf. _Courseview, Inc. v. Phillips Petroleum Co._, 158 Tex. 397, 312 S.W.2d 197 (1957).
160. _North Central_, 22 S.W.3d at 581.
161. 5 S.W.3d 363 (Tex. App.—Texarkana 1999, no pet. h.).
162. _Id._ at 365.
163. _Id._ at 368.
164. _Id._ at 365, 368.
165. _Id._ at 368.
LL&E and its successor sued Arcadia for breach of contract and fraud in 1995, six years after payout. The jury found Arcadia breached its contract and committed fraud, and it awarded substantial damages. However, the jury also found that LL&E, in the exercise of reasonable diligence, should have discovered Arcadia failed to provide written notice of payout on March 17, 1989, the first date LL&E sent a letter to Arcadia requesting payout information on the well. As a result of the jury finding, the trial court concluded the entire action was barred by limitations and rendered a take nothing judgment in favor of Arcadia.

A person must bring suit on a cause of action for breach of contract or fraud no later than four years after the day the claim accrues. A cause of action accrues when a wrongful act causes some legal injury even if the fact of injury is not discovered until later and even if all resulting damages have not yet occurred. In some cases, the discovery rule may defer the accrual of the cause of action if the cause of action is inherently undiscoverable and the damages are objectively verifiable. Unlike the discovery rule, which applies only if the wrongful act is inherently undiscoverable and the damages are objectively verifiable, the running of the statute of limitations in cases involving fraud and fraudulent concealment is tolled until the fraud is discovered or should have been discovered through the exercise of reasonable diligence.

A more precise issue would have inquired as to the date upon which LL&E "in the exercise of reasonable diligence, should have discovered" that Arcadia was concealing the cause of action by failing to provide written notice of the payout." The issue as submitted was not precise, but it was adequate. The court of appeals held that there was sufficient evidence to support the jury finding that LL&E should have discovered defendant's failure to provide notice of payout in 1989, when LL&E first wrote a letter requesting operating statements to Arcadia. Further, the evidence showed that LL&E could have determined payout occurred much earlier based the information provided to LL&E from Arcadia and other working interest owners. Even though LL&E should have discovered Arcadia's fraudulent concealment in 1989, suit was not filed until 1995, more than four years from the date LL&E should have known of the fraudulent concealment. Thus, limitations barred all claims. This case is significant for pointing out the distinctions between the application of the discovery rule and the deferral of the commencement of the

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166. Id.
167. Rodessa Resources, 5 S.W.3d at 365.
168. Id.
170. Rodessa Resources, 5 S.W.3d at 366.
171. Id. at 365 (citing S. V. v. R. V., 933 S.W.2d 1, 4 (Tex. 1996)).
172. Id. at 365, 366.
173. Id. at 367.
174. Id. at 368.
running of limitations in cases involving fraud and fraudulent concealment. The discovery rule and the application of statutes of limitation continue to be hot topics in oil and gas cases because relationships tend to be long term, the issues are often complex, and the damages can often be significant.

Advent Trust Co. v. Hyder is a discovery rule case. If applicable, the discovery rule tolls the running of the statute of limitations until the plaintiff actually discovered, or should have discovered in the exercise of reasonable diligence, the facts giving rise to the cause of action. In this case, the operator produced two wells as dual completions, commingling production, and failing to file the necessary forms with the Railroad Commission. The working interest owners then farmed out one of the produced zones to CPX. After drilling a dry hole, CPX discovered the prior production, sued all the working interest owners, and obtained a substantial recovery. The Railroad Commission also assessed an administrative fine against the operator. More than four years after the CPX petition was served, the non-operator working interest owners sued the operator alleging negligence, negligent misrepresentation, fraud, breach of contract, and common-law indemnity. The causes of action accrued when the CPX petition was served. The critical issue was whether the limitation period commenced when the non-operators were served with the CPX petition. The operator argued that all claims were barred by the statute of limitations. The non-operators contended that the discovery rule, fraudulent concealment, and equitable estoppel applied. The court of appeals concluded that all claims were time-barred and reversed and rendered judgment that the non-operators take nothing.

At the time the CPX petition was served, the operator told the non-operators that the filings were complete, which was the basis for the non-operators contentions of fraudulent concealment and equitable estoppel. The court held that the non-operators not only failed to properly submit the issues of fraudulent concealment and equitable estoppel but also failed to establish the necessary element of reasonable reliance. When the non-operators were served with CPX's petition, they could have searched the Railroad Commission files themselves, and at least one of them did. The non-operators could not thereafter rely upon the operator's representations that the filings were complete when the records were publicly available.
The more interesting part of the case is the court's discussion of the application of the discovery rule, and the court's almost petulant request for more guidance from the Texas Supreme Court. The supreme court's opinion in the recent case of *HECI Exploration Co. v. Neel*\textsuperscript{185} upheld a limitations defense in a suit brought by royalty owners against their lessee. The lessee discovered reservoir damage caused by an adjoining operator, sued and recovered, but never informed the royalty owners. By the time the royalty owners actually discovered the reservoir damage, it was too late for them to sue anyone. *HECI* held that the discovery rule did not apply because damage to a reservoir from illegal production is not the type of injury that is inherently undiscoverable.\textsuperscript{186}

The difficult issue for the San Antonio Court was divining the meaning of *HECI*, which stated that in certain circumstances some records of the Railroad Commission may provide constructive notice.\textsuperscript{187} In considering the meaning of *HECI*, the San Antonio Court said:

> We admit to being somewhat bewildered by this language. . . . How are royalty owners, . . . who are not knowledgeable about the state of the Railroad Commission records, able to distinguish between production records that provide constructive notice and those that do not? Rather than bringing predictability and consistency to this area of the law, we fear that placing the onus on royalty owners to hire the experts necessary to investigate whether the Railroad Commission records reveal they are being cheated is inherently unfair and unworkable in the oil and gas business environment we have come to know.\textsuperscript{188}

The San Antonio Court found that *HECI* was not controlling because a dual completion was not apparent from an inspection of the surface, nor were there any records on file with the Railroad Commission that would reveal the dual completion.\textsuperscript{189} The opinion is clearly *dicta* on this point and entirely unnecessary to the holding.\textsuperscript{190} It was unnecessary because the service of the CPX petition was all the notice that was required. However, the opinion indicates how closely a court may look at the facts of each case under the general guidelines set forth in *HECI* and the confusion that remains after *HECI* as to whether Railroad Commission records are or are not constructive notice that will defeat a claim that the discovery rule should apply.

V. DRILLING CONTRACTS

*Ken Petroleum Corp. v. Questor Drilling Corp.*\textsuperscript{191} construes the Texas

\textsuperscript{185} 982 S.W.2d 881 (Tex. 1998).
\textsuperscript{186} Id. at 886.
\textsuperscript{187} *Advent Trust Co.*, 12 S.W.3d at 539, n.1.
\textsuperscript{188} Id.
\textsuperscript{189} Id. at 539-40.
\textsuperscript{190} Id.
\textsuperscript{191} 24 S.W.3d 344 (Tex. 2000).
Oilfield Anti-Indemnity Act (“Act”). The Act requires parties to mutual indemnity agreements to agree in writing to procure insurance or self-insurance to support the mutual indemnity obligations. The agreement does not have to specify the amount of insurance to be provided, and the agreement is not void if the parties obtain differing amounts of insurance. The indemnities are void as to both parties for amounts greater than the lesser amount of insurance provided.

The court based its opinion upon an analysis of legislative history and determined that the legislature’s intent was to prevent overreaching by one party against another. There was no intent that insurance policies must match, nor did the legislature intend that the parties must adjust their insurance policy with every drilling contract. The statute requires a writing to memorialize only that “each party as indemnitee has agreed to provide” insurance or self-insurance to support the indemnity obligations.

VI. GAS CONTRACTS

El Paso Natural Gas Co. v. Minco Oil & Gas, Inc. is a take-or-pay case that turns on the good faith obligations imposed by the Uniform Commercial Code (“UCC”). During the bust of the mid-1980s, El Paso, as purchaser, and Minco, as seller, entered into a series of settlement and termination agreements that not only terminated the take-or-pay contracts but also contained a waiver or release as to El Paso for all past liabilities. To avoid the waiver or release, Minco asserted that the agreements were procured in violation of the UCC and a breach of the duty of good faith contained in the UCC.

Absent a special relationship between the parties, there is in Texas no common law duty to act in good faith. However, the buying and selling of oil and gas is a sale of goods covered by the UCC. There is a statutory duty of good faith imposed by the UCC, and whether El Paso had a statutory duty to act in good faith under the UCC was a question of law which the Texas Supreme Court reviewed de novo. The UCC clearly imposes a duty of good faith in the performance and amendment of contracts, but the issue in this case was whether the duty of good faith extends to the formation of a contract and, as a necessary corollary,
whether a release is a new contract or a modification of an existing contract.

Section 1.203 states that "[e]very contract or duty within this title imposes an obligation of good faith in its performance or enforcement."204 Section 2.103 defines "good faith" in the case of a merchant as "honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade."205 Section 1.201(19) defines "good faith" as honesty in fact in the conduct or transaction concerned.206 However, the supreme court held that this duty of good faith does not extend to the formation of a contract and a release is a contract.207 Section 1.203 imposes no good faith duty on El Paso because it applies to the performance and the enforcement of an existing contract and not to forming or procuring a contract, including a mutual release of liability.208

Section 2.209(a) states that "[a]n agreement modifying a contract within this chapter needs no consideration to be binding."209 Comment 2 to that section states that modifications made under Section 2.209(a): "[m]ust meet the test of good faith imposed by this Act. The effective use of bad faith to escape performance on the original contract is barred, and the extortion of a ‘modification’ without legitimate commercial reason is ineffective as a violation of good faith."210

The supreme court rejected the application of UCC § 2.209 because "[a] release of liability is not an agreement to modify a contract but is an agreement to completely relinquish the parties’ performance obligations to each other."211 Because the breach of duty of good faith was the only remaining basis for the judgment, the supreme court reversed and rendered judgment that the releases would be enforced.212

204. Id. at 313 (quoting TEX. BUS. & COM. CODE ANN. § 1.203 (Vernon 1994)).
205. El Paso, 8 S.W.3d at 313 (quoting TEX. BUS. & COM. CODE ANN. § 2.103 (Vernon 1994)).
206. Id. at n.12 (quoting TEX. BUS. & COM. CODE ANN. § 1.201(19) (Vernon 1994)).
207. Id.
208. Id. at 314.
209. TEX. BUS. & COM. CODE ANN. § 2.209(a) (Vernon 1994).
211. El Paso, 8. S.W.3d at 314.
212. Id. at 316.