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OIL AND GAS

by

Richard W. Hemingway*

In accordance with the traditions established by the Annual Survey issue this Article includes those cases and other developments from Texas during the preceding year that are significant. Not all cases are included. The responsibility for selection and for any omissions is that of the author. In addition to a small section on miscellaneous cases, recent developments in the following areas are treated: the mineral estate; oil and gas leases; regulation cases; and legislation.

I. THE MINERAL ESTATE

The cases in this section deal with the mineral estate, interests therein, and the relationship of the mineral estate to the surface estate.

The most important case in this area, and perhaps in the entire oil and gas field, during the last year, was that of Reed v. Wylie.1 The question presented was whether the grantor of the surface estate retained an interest in the coal and lignite by reserving one-fourth of the “oil, gas and other minerals.” In dealing with the case, the Texas Supreme Court re-examined and reaffirmed the landmark decision of Acker v. Guinn.2

In Reed v. Wylie executed a deed conveying 223.385 acres of land to Baker. Baker’s interest at the time of suit was owned by Bette Reed, Trustee. The deed contained the following reservation:

In addition to the above and foregoing exception there is hereby excepted and reserved to the Grantors herein a one-fourth (1/4) undivided interest in and to all oil, gas and other minerals on and under the land and premises herein described and conveyed; and it is hereby expressly agreed and understood that Grantors herein, their heirs and assigns shall have, and they hereby have the right of ingress and egress for the sole and only purpose of mining and operating for oil, gas and all other minerals, on and under said land, and to produce, mine, save and take all usual, necessary and convenient means for working, preparing and removing said minerals from under and away from said land and premises.3

Reed instituted suit seeking a declaratory judgment that she, as owner of the granted surface estate, owned all the coal and lignite on the land. The trial court granted a summary judgment in her favor, but the court of appeals held the judgment was not supported by the evidence and remanded the case for trial.4 The Texas Supreme Court affirmed the remand, but found it

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1. 554 S.W.2d 169 (Tex. 1977).
2. 464 S.W.2d 348 (Tex. 1977).
3. 554 S.W.2d at 170 (emphasis added).
necessary to clarify its statement in *Acker* that "[u]nless the contrary intention is affirmatively and fairly expressed, therefore, a grant or reservation of ‘minerals’ or ‘mineral rights’ should not be construed to include a substance that must be removed by methods that will, in effect consume or deplete the surface estate."

The trial court had interpreted the statement to mean that surface ownership consisted of all of the coal and lignite that *may* be removed from the land by open pit or strip mining methods. Both a concurring and dissenting opinion in the court of appeals, however, stated that the surface ownership of coal and lignite consists only of products that *must* be removed by open pit or strip mining methods.

In affirming and restating the rule established in *Acker*, the Texas Supreme Court laid down several guidelines:

1. The *Acker* rule is applicable in those cases where the parties have not specifically reserved the substances in controversy, nor expressly reserved all minerals lying upon the surface or at any depth, including those minerals which may be produced by open pit or strip mining. The court more specifically stated: "We are inclined to believe that in most of these cases of unnamed minerals which later become very valuable, the subsequent controversy decides which party will be enriched by a substance which took no part in the intention or bargaining of the parties to the instrument of conveyance."

2. The use of the word "mineral" by the parties in a conveyance is not to be construed to include near-surface substances whose removal will consume or deplete the surface estate.

3. A substance *is not a mineral* if substantial quantities of that substance lie so near the surface that the production will entail the stripping away and substantial destruction of the surface.

4. If condition (3) applies, the following are immaterial: availability of methods of restoration or reclamation; the unexpressed knowledge or intention of the parties; and, the value of the substance.

5. The right to produce the substance is not divided. If the production of any of the substance results in the stripping away or substantial destruction of the surface, the entire deposit of the substance, at any depth, is part of the surface estate.

6. The burden of proof is on the surface owner to prove that, as of the date of the instrument in question, extraction of the near-surface substance would *necessarily* have consumed or depleted the land surface.

Justice Greenhill, in his concurring opinion,7 differed with the majority as to the nature of the burden of proof required to bring the substance within the *Acker* rule. In his opinion the effect of the majority opinion is that the surface owner must show that the only method of extracting the substance would be deleterious to the surface estate. He would impose a less onerous burden of proof: the surface owner should be required to show that *any*

5. 554 S.W.2d at 172.
6. *Id.* at 171.
7. *Id.* at 173.
reasonable method of production would have destroyed or depleted the surface estate.

While Reed was on appeal the Austin court of civil appeals decided DuBois v. Jacobs. The reservation in DuBois was essentially the same as that construed in Reed: a reservation of "an undivided one-half (1/2) royalty of all the oil, gas and/or other minerals in, to and under or that may be produced from the above described properties." Suit was brought by grantees for a declaratory judgment that the reservation did not include coal, lignite, sand, and gravel. After remand from an earlier appeal, the trial court entered judgment that the mineral interest reserved did not include "any sand, gravel, coal or lignite." No evidence was entered in the trial court concerning the state, location, or methods of removal of any of the substances involved.

On the second appeal the judgment of the trial court was modified to remove mention of any specific substances, and reaffirmed. The court applied the Acker rule and held that the deed did not reserve any substances that must be produced in such manner as to destroy, deplete, consume, or substantially impair the surface.

Although the construction of the deed is in accordance with the holdings of Acker and Reed, it does little to resolve the controversy between parties as to particular substances. Whether particular substances were at issue in DuBois does not appear from a reading of the opinions. Therefore, in later litigation the surface owner will have to meet the burden of proof stated in Reed as to any particular substance.

In the case of Exxon Corp. v. West the Houston court of civil appeals dealt with the problem of proof of the amount of native gas in an underground reservoir at the time that extraneous gas is stored and commingled with the native gas. In a prior appeal, the Texas Supreme Court stated that:

"[I]t is our view that the act of commingling native and extraneous gas did not impose upon Humble the obligation of paying royalties on all gas thereafter produced from the reservoir, if the evidence establishes with reasonable certainty the volume of gas reserves upon which the Wests would have been entitled to royalties, absent injection of extraneous gas. The burden of this showing devolves upon Humble after proof by the Wests of their royalty interest together with proof of Humble's commingling of extraneous and native gas. The threshold question for determination is whether the requisite computation of reserves is capable of establishment with reasonable certainty; and, if so, the further question to be resolved is whether the burden defined above is discharged by Humble under the evidence."

At the second trial of the case, Exxon, as successor to Humble, used a geologist and a petroleum engineer, both of whom were in the employ of Exxon, to testify as to the amount of gas in the reservoir at the time of injection. The opinion of the experts was that at the outside limit no more than 95.3 BCF (billion cubic feet) of gas could have been in place at the

9. Id. at 149.
10. 543 S.W.2d 667 (Tex. Civ. App.—Houston 1st Dist.) 1976, writ ref'd n.r.e.).
commencement of the commingling of the native and extraneous gas. Exxon stipulated that it would be willing to pay royalty on the basis of the maximum or total amount of gas in place at the time storage operations were commenced.

West contended that Exxon had not met its burden of proof because the testimony of the experts was suspect since they were employees of Exxon, and their opinions were not factually supported. The court of appeals acknowledged the rule that opinion testimony is not binding on the trier of fact when more than one conclusion can be drawn from the facts, especially so where the experts are in the employ of the party who is offering the testimony. Here, however, the testimony extended the parameters of the reservoir to the "bounds of reason" and was uncontradicted either by direct testimony or by inference. Thus, the only reasonable conclusion that could be drawn was that afforded by the opinions of the Exxon witnesses. Because West had the opportunity to present evidence in contradiction of the testimony of Exxon's witnesses and did not, such failure constituted effective corroboration of such testimony.

In *Hamman v. Ritchie*, which dealt primarily with the effect of dispositions under a will, a question was presented as to the duty, if any, of a co-tenant of a fractional interest in the mineral estate to join in the execution of an oil and gas lease with other co-tenants of fractional interests in the mineral estate. The court held that no such duty exists, in the absence of other factors, since one co-tenant is not the trustee of such an interest or in a fiduciary relationship with the other co-tenants in the minerals. The case is in accordance with existing law.

One court of appeals case, *Crawford Energy, Inc. v. Texas Industries, Inc.*, dealt with the application of article 4644 of the Texas Civil Statutes which states:

No injunction or temporary restraining order shall ever be issued prohibiting subsurface drilling or mining operations on the application of an adjacent landowner claiming injury to his surface or improvements or loss of or injury to the minerals thereunder, unless the party against whom drilling or mining operations is alleged as a wrongful act is shown to be unable to respond in damages for such injury.

The dispute was between TXI, the owner of the rights to remove all rock and stone situated on the land involved, and the oil and gas lessee, Crawford Energy, Inc. The lease to TXI contained the following reservation:

The right to use said lands and premises for grazing and any other purpose not inconsistent with the rights herein granted to said lease and especially . . . the right to drill . . . wells for oil and gas on said lands, provided such wells shall be so located . . . as not to interfere with the . . . operations of . . . lessee and his successors and assigns under said lease. But, it is expressly agreed and understood that no use of said lands by the lessor shall in any manner interfere with the rights herein granted to the lessee, his successors and assigns.

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12. 547 S.W.2d 698 (Tex. Civ. App.—Fort Worth 1977, writ ref'd n.r.e.).
15. 541 S.W.2d at 465 (emphasis added).
TXI and Crawford could not agree upon the location of drilling sites for oil and gas development. When Crawford commenced drilling operations TXI sought and obtained a temporary restraining order, which after a hearing became a temporary injunction. The injunction extended to all drilling operations except well number two, which was excluded. At the time, Crawford was conducting drilling operations upon well number one which was affected by the order.

On appeal Crawford argued that no injunction could be issued unless TXI demonstrated that he was unable to respond in damages, as required by article 4644. Crawford’s position was that the case of *Winslow v. Duval County Ranch Co.* provided that where two different lessees are present on the same land the statute applied. The court distinguished *Winslow,* however, and held that the definition of “adjacent landowners” in article 4644 did not include leasehold interests in the same tract of land.

Crawford also argued that although TXI had shown a property interest to be protected there was no showing of probable injury. The court upheld this contention. The testimony of TXI stated that no injury would occur unless quarrying operations were within 400 feet of a producing well. The evidence revealed that quarrying operations were 2000 feet away from the drill site and would take some ten years to come within the danger area. The court denied TXI’s contention that the negative covenant had been breached since there was no showing that there was a distinct or substantial present interference with the quarrying operations by the oil and gas operations. The order of the trial court was, therefore, reversed and the injunction was dissolved.

A rather unusual situation was encountered in the case of *Extraction Resources, Inc. v. Freeman.* Grantor owned at the time of conveyance a one-sixteenth non-participating royalty interest in five sections of land in Winkler County, Texas. Grantor conveyed 366 deeds in an attempt to divide the royalty interest he had obtained. Each deed was titled “Royalty Deed” but conveyed the following interest in various parts of the five sections of land:

One sixty-fourth interest in and to all of the oil, gas and other minerals in and under and that may be produced from the following described lands, situated in Winkler County, Texas, to-wit: . . . [description], together with the right of ingress and egress at all times for the purpose of mining, drilling and exploring said lands for oil, gas and other minerals, and removing the same therefrom.

Although the deed was in the form of a mineral conveyance, the court held that only a royalty interest was passed because one can only convey what one owns.

A lease had been executed prior to the grants which provided for a three-

16. 519 S.W.2d 217 (Tex. Civ. App.—Beaumont 1975, writ ref’d n.r.e.).
17. The plaintiff in *Winslow* had sold 44,000 acres of an 144,000-acre tract but held a lease to the grazing rights in the smaller tract. The lease had expired by the time of the suit, however, and the plaintiff was an “adjacent landowner” within the meaning of the statute. See also *Hastings Oil Co. v. Texas Co.,* 149 Tex. 416, 234 S.W.2d 389 (1950).
19. *Id.* at 158.
sixteenth landowner's royalty interest. It was argued that the deeds collectively passed only one-sixty-fourth of the royalty interest to the grantees, leaving a royalty residue in the grantor. The court held that any doubt should be resolved against the grantor and that the deeds should be construed as passing the greatest estate possible. Hence, each deed was construed as passing a one-sixty-fourth royalty interest and therefore no residue was left in the grantor.

It was further argued that the gas production royalty under the deeds was payable in kind, since the deed under which the grantor claimed provided that he would receive "one-sixteenth of all the oil, gas or other minerals, the same to be directed to the grantee, his heirs or assigns."\(^{20}\) It was contended that "directed" was synonymous with "delivered." The court rejected this contention on the ground that the royalty was entirely dependent upon the terms of the lease executed by the holder of the right to lease. The court held that since the royalty upon gas in the lease was payable in money, money was what the grantees and their successors were entitled to have directed to them.

II. OIL AND GAS LEASES

Habendum Clause Cases. Where a lease exists upon an undivided mineral interest in a tract of land, the lessee must satisfy the terms of the lease himself, or through another acting for the lessee. This is generally done by the use of a joint operating agreement in which one lessee of an undivided interest, designated as the operator, drills and develops the mineral estate and the other non-operators contribute to the costs of development. Under the agreement the well becomes the well of all members to the agreement. Another method of satisfying the obligations of the lessee of a partial interest lease is through pooling provisions contained in the lease.

In the early Oklahoma case of Earp v. Mid-Continent Petroleum Corp.,\(^{21}\) the question was raised whether the lessee of a mineral co-tenant must operate for himself in order to keep its lease alive, or whether the acts and operations of a lessee of another co-tenant would be sufficient. The problem arose because most oil and gas leases are worded so that production or operations to keep the lease alive relate "to the land" and not to each lessee. The Earp case, however, held that such operations must be done by the individual lessee. This was thought to be the law Texas courts would apply.\(^{22}\)

The case of Hughes v. Cantwell,\(^{23}\) decided by the El Paso court of appeals, appears to be the first Texas case dealing directly with this question. During the primary term of a partial interest lease, the lessee did not pay the required delay rental payment when due. Atlantic, owner of the major interest in the mineral estate, invited the lessee to join in the drilling of

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20. Id. at 160 (emphasis added).
22. In Willson v. Superior Oil Co., 274 S.W.2d 947 (Tex. Civ. App.—Texarkana 1954, writ ref'd n.r.e.), the court held a lease was kept alive when the lessee entered into a joint operating agreement with the lessee of another undivided interest and paid his proportionate share of the cost of drilling a producing well on the common property.
23. 540 S.W.2d 742 (Tex. Civ. App.—El Paso 1976, writ ref'd n.r.e.).
a well on the lease. Lessee refused. The well, drilled midway during the year for which delay rentals had not been paid by the lessee, was a rich producer. Upon trial it was held the lease terminated and this holding was affirmed on appeal.

The lessee contended that the partial interest lease was kept alive by Atlantic's drilling under the following lease clause:

5. If operations for drilling are not commenced on said land or on acreage pooled therewith as above provided on or before one year from this date the lease shall then terminate as to both parties, unless on or before such anniversary date Lessee shall pay or tender to Lessor

This contention was based upon the omission of the words "by the lessee" after the word "commenced" in the above clause. The court held that from a reading of the lease as a whole the obligations to be performed were those of the lessee. The court also stated: "As to this undivided interest, the Lessee had the exclusive control. This exclusive letting to him evidences an intention that the obligations were his alone, and that the acts of third parties or strangers to the contract would not suffice to meet his requirements of performance." The decision is in accord with authority generally and cites with approval the rule in Mattison v. Trott.

Another case dealing with the cessation of production in paying quantities under an oil and gas lease is Bell v. Mitchell Energy Corp. The case involved the application of the doctrine in Clifton v. Koontz, which held that when there existed marginal production under an oil and gas lease, the production was in paying quantities if a reasonably prudent operator, under all relevant circumstances, would continue the operation of the lease.

In Bell production in paying quantities of gas on the particular well was questioned for the period from January 1973 through September 1973. The lessee stated that the well showed an accounting loss of $412.00 for the first nine months of 1973, and that he intended to abandon it and reassign it to defendants, which he subsequently did. Prior to reassigning the lease, however, the lessee renewed his gas sales contract with Tennessee Gas Pipeline Company, effective January 1, 1973, with a price increase from 16¢ per MCF to 24¢ per MCF. This increase was conditioned upon FPC approval which the lessee requested on March 27, 1973. The increase was granted on June 12, 1973, effective retroactively to April 30, 1973. Lessee testified that he was not informed about the approval of the price increase until after he had decided to abandon the well and reassign it to defendants herein. The opinion of the lessee was based upon the 16¢ per MCF gas price, and he did not testify as to the possible result and intention relative to the 24¢ gas price. Evidence was offered showing that the lease had produced a profit for every calendar year from September 1971 through April 1975.

Lessor brought suit against defendant assignee to cancel the lease for

24. Id. at 743.
25. Id. at 744.
26. 262 F.2d 339 (5th Cir. 1959).
28. 160 Tex. 82, 325 S.W.2d 684 (1959).
failure of the lease to produce in paying quantities during the year 1973. In
the trial court the jury determined that the well had not ceased producing in
paying quantities from the period from September 1, 1971, to May 9, 1975,
and judgment was entered accordingly. This holding was affirmed by the
court of appeals. The court held that the jury was entitled to take into
consideration the increased price for gas, even though the operator may not
have been aware of the price increase until after he elected to reassign his
interest to defendants.

Although not an oil and gas lease case, *Braslau v. Amoco Production
Co.* is discussed in this section because it concerns the termination of term
royalty deeds where production has ceased under the lease after the primary
term of the deed. The deeds conveyed royalty interests for a "period of
fifteen years from the date hereof and as long thereafter as oil, gas, or other
minerals or either of them, is produced or mined from the lands described
herein in paying or commercial quantities."  

Production under the oil and gas lease terminated between November 13,
1972, and February 24, 1973. The lessee began reworking operations on the
well on November 14, 1972, but ceased on December 11, 1972, after the
casing collapsed. Lessee then commenced new drilling operations to another
reservoir, which was completed as a producer with actual production
commencing on February 24, 1973. The trial court held that the term deeds
did not terminate as the cessation was temporary and that production was
restored within a reasonable time.

The judgment of the trial court was reversed by the court of appeals on
the ground that production had ceased and the cessation was not temporary.
The court cited and distinguished two prior Texas cases, *Midwest Oil Corp.
v. Winsauer* and *Stuart v. Pundt*, which held that the term deed would
not terminate where the stoppage in production was due to litigation and
mechanical breakdowns and the lessee diligently worked to restore produc-
tion under the lease within a reasonable time. The court said in neither case
did the court find the stoppage to be temporary where new production was
from a different sand. The court pointed out that continuous drilling clauses
are usually found in oil and gas leases and in term deeds and could have been
inserted by the parties to prevent termination in this situation. Writ of error
has been granted by the Texas Supreme Court.

**Royalty Clause Cases.** In the last few years cases have been reaching the
courts dealing with the problem of the royalty liability of the lessee where an
oil and gas lease provides for payment of gas royalty based upon market
value at the well when gas is dedicated and sold into interstate commerce
under long-term contracts of sale. At the time that the leases were drafted
the price for the sale of gas into interstate commerce was generally higher
than the price received for the sale of gas intrastate. This price situation,

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30. Id. at 261.
31. 159 Tex. 560, 323 S.W.2d 944 (1959).
32. 338 S.W.2d 167 (Tex. Civ. App.—San Antonio 1960, writ ref’d).
however, has drastically changed in the last several years. Royalty owners began to sue for the difference in royalty paid upon the price received for gas dedicated and sold in interstate commerce and the much higher price of gas sold in the same fields intrastate. In the landmark case of *Texas Oil & Gas Corp. v. Vela* the Texas Supreme Court held that under a market value gas royalty clause, royalty must be paid on the higher intrastate rate of gas sold in the field.

In this continuing saga the case of *Kingery v. Continental Oil Co.* was brought in the United States District Court, El Paso Division. The case was similar to *Vela* in that the royalty was paid under a market value clause on separator residue gas being sold to Transcontinental Gas Pipeline Corporation and dedicated into interstate commerce.

The lessee argued that the execution of the gas sales contract constituted the sale of the entire body of gas to be produced under the lease, in which case the price provided for in the long-term sales contract would apply to all gas produced. The lessee also contended that the lessors had ratified the royalty payments by executing gas division orders in 1951 and 1952, and that the four-year statute of limitations applied to any liability for insufficient royalty payments.

The district court held that the lessee was liable for the payment of royalties on the basis of the "market value" royalty provisions of the lease which applied to "gas sold or used off the premises," as the sale point of the gas was over three miles from the lease. Furthermore, the court held that the execution of a gas sales contract did not constitute a completed sale, but that it was an executory contract with an executed sale of gas being effected only at the time, or times, of delivery to the purchaser. No ratification of royalty payments by lessee upon a "proceeds" basis resulted by execution of the division orders. They were superseded by an amendment of the gas sales contract in 1970, after which no new gas division orders were executed. The four-year statute of limitations did, however, apply to the deficiency in royalty payments.

Another case dealing with the problem of the price squeeze on the lessee as to royalty liability under a market value clause is *Pennzoil Producing Co. v. FPC* decided by the Fifth Circuit Court of Appeals. In a settlement agreement resulting from a suit brought by the royalty owners for royalty based upon intrastate rates it was agreed that the lessee would pursue one of two alternatives. First, the lessee would pay a higher royalty and ask the FPC to increase the ceiling gas price to be paid by the gas purchaser in order to pass the incremental royalty costs on to the customer. Secondly, royalty gas would be delivered in kind to the royalty owner, and a request would be made to the FPC for abandonment from interstate commerce of that portion of the gas attributable to the royalty interests. The Commission denied both forms of relief on the grounds that it lacked authority to allow such a rate increase in kind to the royalty owner, and a request would be made to the FPC for abandonment from interstate commerce of that portion of the gas attributable to the royalty interests. The Commission denied both forms of relief on the grounds that it lacked authority to allow such a rate increase in kind to the royalty owner, and a request would be made to the FPC for abandonment from interstate commerce of that portion of the gas attributable to the royalty interests.

33. 429 S.W.2d 866 (Tex. 1968).
35. 553 F.2d 485 (5th Cir.), modified, 558 F.2d 816 (5th Cir. 1977).
and that abandonment could not be allowed due to present or future public convenience or necessity.

The Fifth Circuit held that the Commission had authority to consider the increased royalty expense of the lessee, in a market value lease, as one of the components of a producer’s cost. The court further stated that interstate rates are set on a cost-plus-profit approach and the incremental royalty costs did not increase the lessee’s profits but merely maintained the margins already determined by the Commission to be just and reasonable.

The court suggested the Commission should examine its authority to permit abandonment in light of the reversal of the Commission’s decision in *Southland Royalty Co. v. FPC* holding that gas dedicated to interstate commerce would not be trapped beyond the termination of the leases. In a later opinion on petition for rehearing, the court amended its original opinion to remove the effect and consideration of the *Southland* case and its effects upon a lease which was not of a fixed term. Consequently, the opinion is supportive only of the first alternative, the pass through of the increased royalty costs. The case was remanded for further consideration by the Commission.

**Pooling and Unitization.** The case of *Mengden v. Peninsula Production Co.* dealt with the recoupment of certain drilling costs under farmout agreements where assignors would “back in” to a one-fourth working interest on gas production and terminate the assignee’s interest thereunder. The producing gas units were created out of approximately equal acreage from both “A” and “B” lease acreage under two farmout agreements held by assignee Mengden. All producing wells in interest were located on the “A” lease acreage. The farmout of the “A” lease acreage contained the following clause:

> In connection with the foregoing, it is understood that if you complete any gas well or wells in the Escondido Sand under such lease premises then in lieu of the aforerecited recovery of costs incurred thereon you will be entitled to recover $70,000 times the number of such wells on the production accruing to a 49/64th of 8/8ths net working interest therein from such wells before such assignment terminates [reverts] in part as aforeprovided for.

The farmout agreement of the “B” lease acreage did not contain a similar clause. The question involved was whether 100% of production from the wells should be applied to “A” leases in the recoupment of costs under the “number of such wells” clause, or whether only that fifty percent portion properly allocated to “A” lease acreage from unit production under the “production accruing” clause should be so applied.

The Texas Supreme Court reversed both the trial court and the court of appeals and held that the production was to be apportioned between the

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two leases in the amount of acreage contributed to the producing units. The court determined that the per-well recoupment clause did not alter the normal effect of pooling under the lease clauses.

**Delay Rental Payment or Bonus.** *Brannon v. Gulf States Energy Corp.*\(^{41}\) raised the question of whether a payment made by a later lessee constituted delay rental due on a former lease, or a bonus in consideration for executing a new lease.

Lessor, Clara O. Martin, executed an oil and gas lease on November 20, 1973, to one Mary L. Elliott, which was later assigned to Master Drillers, Inc. The delay rental due November 20, 1974, was never paid by Master Drillers. Mrs. Martin received a check, however, written by the president of Gulf States Energy Corporation, dated January 17, 1975, together with a letter stating that the payment was for “lease rental.” The check was accepted by Mrs. Martin and a lease executed to Gulf States on July 9, 1975.

At trial conflicting affidavits executed by the seventy-six year old Mrs. Martin were introduced, as well as testimony that the payment of $202.00, the same amount as the delay rental payments in the Martin-Elliott lease, was in consideration of the execution of a new lease and not the late payment of delay rentals under the earlier lease.

A take nothing judgment was entered in the trial court against the plaintiffs, claimants under the earlier Martin-Elliott lease. The judgment was affirmed by the court of appeals. The court held that testimony as to the nature of the payments made did not violate the parol evidence rule. Writ of error has been granted by the Texas Supreme Court. The case is an excellent example of a situation where a little care in draftsmanship might have prevented litigation.

**Joint Venture—Constructive Trust.** In a recent Texas Supreme Court case, *Rankin v. Naftalis*,\(^{42}\) Rankin, the owner of the Melton lease, entered into a sharing agreement with Dr. Naftalis and others. Rankin would act as operator in developing the lease and the others agreed to contribute to the cost of a well in return for a fractional interest in the lease. While drilling the well, which was later brought in as a marginal producer, Rankin mentioned that he would acquire the Orsak lease for the parties' mutual benefit. Rankin did purchase the lease, but he acquired it in his own name. After Rankin drilled a successful producing well on the Orsak lease, Dr. Naftalis, and others, sued and asserted a constructive trust in three-fourths of the Orsak lease and well. These were the same proportions of ownership as in the Melton lease.

The trial court rendered a take nothing judgment against plaintiffs. This was ultimately affirmed by the Texas Supreme Court. In finding that no constructive trust existed relative to the Orsak lease, the court stated that this case did not involve any of the following situations:

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42. 557 S.W.2d 940 (Tex. 1977).
(1) A case where defendant is charged with actual fraud.

(2) A case where the alleged trust concerned or the trustee reacquired the original property that was covered by a confidential arrangement.

(3) A case where the original contract embraced a general business venture for the continued acquisition of mineral lands.

(4) A case where the lessee acquired a lease on the basis of information he received in drilling the previous well.

The court pointed out that there must be proof that the fiduciary relationship created included within its scope the transaction involved. Here the written contract and operating agreement, and therefore the fiduciary relationship, involved only the Melton lease. The agreement did create a fiduciary relationship, but it was limited to the Melton lease or matters growing out of the Melton lease transaction.

The court noted further that although subjective trust, cordiality, and the trust which prevails between businessmen form the foundation of an ordinary contract, they afford no basis for the imposition of an oral trust that thwarts the Statute of Frauds. Lastly, the court declared that no partnership is created by the use of a joint operating agreement in developing a particular property.

Miscellaneous Cases Dealing With Oil and Gas Leases. In H & R Oils, Inc. v. Pioneer American Insurance Co. mortgagee of the oil and gas leasehold estate brought suit against H & R Oils, Inc. for appointment of a receiver to prevent diminution in value of its security interest. In this case the plaintiff insurance company was the lien holder on a leasehold estate where it had, from time to time, furnished funds for the development of the lease. The lease terminated when, after the end of the primary term, more than sixty days elapsed without reworking operations or production in paying quantities upon the lease.

The land was then leased to defendant, H & R Oils, Inc., who went into possession and regained production. The lien holder then brought this suit against the second lessee. The trial court appointed a receiver to take possession of the lease and equipment, and to collect proceeds from the sale of the production. On appeal the order was vacated. The court of appeals ruled that the lien holder lost whatever interest it had in the original lease upon the termination of the lease and it had no interest in the new lease. The new lessee had disclaimed any interest in any of the personal property of the original lessee except casing and in-hold equipment, for which it agreed to pay the lien holder the salvage value. The appointment of a receiver was, therefore, not necessary to preserve the personal property.

III. Regulation Cases

Superior Oil Co. v. Railroad Commission of Texas involved rule 11 of the Commission; this rule relates to approval of the bottom hole location of

43. 541 S.W.2d 665 (Tex. Civ. App.—Forth Worth 1976, no writ).
44. 546 S.W.2d 121 (Tex. Civ. App.—Austin 1977, writ ref’d n.r.e.).
45. Rule 11, Statewide Rules, Tex. R.R. Comm’n, Oil & Gas Div.
a deviated well. In this case Kimball was granted a rule 37 permit authorizing him to drill a unit well at a surface location 990 feet from Superior's lease line. Superior did not protest the granting of the permit at the rule 37 hearing.

Kimball, after notice to and permission from the Commission, deviated the well twice to avoid equipment loss in the hole. As completed, the well was drilled to a depth of 12,544 feet and the bottom hole deviated some 820 feet from the vertical. Kimball subsequently had a hearing before the Commission under rule 11 to show cause for the deviation so that an allowable would be assigned to the well. The rule provides that: "The operator proceeds with the drilling of a deviated well under such circumstances at his own risk, and should he fail to show good and sufficient cause for such deviation, no permit will be granted for the production of the well."46

Superior attempted to introduce evidence before the Commission of waste, confiscation, and that the well as deviated would give Kimball "an unfair competitive advantage." The evidence was excluded. Superior appealed to the district court of Travis County on the ground that the order of the Commission approving the bottom hole location was arbitrary and capricious because the Commission refused to consider such evidence. In upholding the Commission's order the court stated that such evidence is not admissible in a rule 11 hearing.

The court of appeals affirmed the district court ruling on the ground that evidence of drainage and unfair competitive advantage are not factors to be considered in a rule 11 hearing. The court also found that the order of the Commission was supported by substantial evidence. In a hearing on the approval of a bottom hole location under rule 11, the operator will have an allowable assigned to the well under the field rules if it can demonstrate "good and sufficient cause" for the deviation and if the bottom hole location is a "reasonable" location. There is no provision under rule 11 that the operator justify its allowable in order to obtain approval of the bottom hole location of the well.

*Imperial American Resources Fund, Inc. v. Railroad Commission*47 involved a case of first impression dealing with the application of the newly enacted Administrative Procedure Act (APA)48 to appeals from the Texas Railroad Commission. Imperial filed suit in the district court of Travis County complaining of an order of the Commission granting BTA Oil Producers the right to drill a rule 37 well 1320 feet from Imperial's lease line. BTA's application was granted by the Commission on the ground that the well, as so located, would penetrate the area of higher structure and good sand permeability, and BTA would thus obtain a reasonable opportunity to produce the products under its lease.

Imperial opposed the application contending the order was confiscatory as to Imperial's well drilled to the north on the adjoining tract. After the

46. *Id.*
47. 557 S.W.2d 280 (Tex. 1977).
order was entered by the Commission, Imperial filed suit to enjoin enforcement of the Commission's decision. The trial court denied relief and Imperial brought a direct appeal to the Texas Supreme Court as permitted under article 1738a,49 and rule 499a50 of the Texas Rules of Civil Procedure. Imperial argued that the findings of fact of the trial court were not sufficient under the APA and, therefore, the order was not supported by substantial evidence.

The case is of importance as it discusses in some detail the application of the APA to appeals from the Commission. Prior to the APA a substantial evidence review of an order of the Commission was made by the district court of Travis County. The court could sit alone or, if requested, the review would be before a jury. The evidence upon which the review was based, however, was adduced de novo in the trial court. The record before the Commission was not admissible and the evidence considered by the trial court had to conform to the judicial rules of evidence. As pointed out in the Imperial case, review of the Commission's orders is still initiated under section 8 of article 6049(c),51 but the review procedure has been changed by sections 16 and 19 of the APA.52

Under the new provisions a substantial evidence review is made by the district court of Travis County sitting without a jury upon the record made before the Commission. There is, however, provision for the introduction of additional evidence in the trial court where such evidence is material and good reason exists for the failure to present the evidence before the Commission.

The court in Imperial restated the scope of review under the substantial evidence rule, citing the following statement from the case of Auto Convey Co. v. Railroad Commission:

In a judicial review of a Railroad Commission order, it is well settled that the court does not substitute its judgment for that of the administrative agency. In this regard, the question for the courts is whether the contested order is reasonably supported by substantial evidence. In appeals, the burden is upon the complaining parties to show an absence of substantial evidence and that the orders are unreasonable and unjust to them . . . . Where there is substantial evidence which would support either affirmative or negative findings, the order might have arrived at a decision contrary to that which the court might have reached. The correct test is whether the evidence as a whole is such that reasonable minds could have reached the conclusion that the Railroad Commission must have reached in order to justify its action.53

As under the previous procedure, the reviewing court may not substitute its judgment for that of the Commission. But if the order is beyond the authority of the Commission, confiscatory, discriminatory, or not supported by substantial evidence, the cause must be remanded to the Commission for further determinations.

49. Id. art. 1738a (Vernon 1962).
52. Id. art. 6252—13a, §§ 16, 19 (Vernon Supp. 1978).
53. 507 S.W.2d 718, 722 (Tex. 1974).
Here the court found that the order of the Commission was supported by substantial evidence and that the findings of fact were sufficient, clear, and explicit. The court did hold that one particular finding of fact was improper. The source of that finding was stated to be “[r]ule 37 records of the Railroad Commission.” Yet, none of the records were placed in evidence nor were the parties notified of the specific records which the Commission took notice of as required by section 14(q) of the APA. No reversal or remand was required, however, as no harm or prejudice was shown to result from the failure of the Commission to give such notice.

Another interesting case in the regulatory field concerned whether a lessee could dedicate gas produced under a long-term lease into interstate commerce and bind the reversionary interest to that dedication after the lease terminated. In *Southland Royalty Co. v. FPC* lesseors in the middle 1920’s executed leases with fixed fifty-year terms. The lessee, Gulf, unqualifiedly dedicated the gas into interstate commerce, and after the decision in the case of *Phillips Petroleum Co. v. Wisconsin*, received a certificate of public convenience and necessity from the FPC. Southland became the owner of the reversionary interest under the lease. Prior to the expiration of the fifty-year term of the lease, Southland entered into contracts with another pipeline purchaser for the sale of the gas into the Texas intrastate market where higher prices could be obtained for the sale of the gas.

Gulf’s pipeline purchaser, El Paso Natural Gas Co., petitioned the FPC contending that Southland could not sell its gas in the intrastate market without first obtaining FPC approval. The FPC so held on the grounds that the gas had been entirely and unqualifiedly dedicated by Gulf into interstate commerce and could not be removed therefrom without approval by the FPC under abandonment procedures, section 7(b), of the Natural Gas Act.

The FPC order was reversed on appeal to the Fifth Circuit Court of Appeals.

The court held that since Gulf’s right as lessee under the fixed term leases was limited, it could only dedicate its interest in the gas and not that of the reversioners: “Since Gulf never was possessed of rights in the gas under the leasehold lands which could survive the termination of its 50-year lease, it never could create rights in a third person to that same gas.”

The court also held that Southland’s acceptance of royalty under Gulf’s lease did not serve as a ratification of the dedication by Gulf into interstate commerce of the reversionary interest of Southland. Writ of certiorari has been granted by the United States Supreme Court.

**IV. OTHER MISCELLANEOUS CASES**

Without extended discussion, cases are noted that may be of interest to the reader. In *Southern Natural Gas Co. v. FPC* it was held that a private three-priority curtailment plan in the sale of gas based on the type of

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55. 543 F.2d 1134 (5th Cir. 1976), cert. granted, 97 S. Ct. 2970, 53 L. Ed. 2d 1091 (1977).
58. 543 F.2d at 1137.
59. 547 F.2d 826 (5th Cir. 1977).
customer to whom gas would be sold, rather than upon the basis of "end use," was not invalid on the ground that it violated the general policy of the FPC. The policy of the FPC does not preclude different arrangements where exceptional circumstances may be shown.

In *Lower Colorado River Authority v. Coastal States Gas Producing Co.* the trial court awarded over twenty-five million dollars in damages to an electric utility company for breach of contract due to a price increase over the contract provision. On appeal the judgment of the trial court was reversed and remanded with directions that the utility company take nothing. The Texas Supreme Court found no reversible error and affirmed the judgment of the court of appeals.

In the case of *Polk County v. Tenneco, Inc.* the pipeline company made a direct attack upon a county ad valorem tax plan method of valuation. The method of valuation, derived by an expert from a popular financial magazine, was based upon the capitalization of income at a 7.6 rate. When the court of appeals applied the rate to the net book value used by the FPC in rate making, it yielded an income higher than that earned by the pipeline company. The court of appeals thereupon reversed and rendered the judgment of the trial court. The Texas Supreme Court reversed and remanded the case on the ground it was error for the court of appeals to equate net book value with market value.

V. LEGISLATION

Legislation affecting oil and gas development and operations by the 65th Legislature included the following:

(a) Loans For Oil and Gas Purposes-Interest, chapter 673, H.B. No. 1883, added as subsection (c) to article 5069—1.07, a provision raising the usury limit on interest that may be charged on loans to any person, to the same rate as the corporate (except non-profit corporations) interest rate, where the loan is in the principal amount of at least $500,000 and is for the purpose of direct or indirect exploration and development of oil and gas properties.

(b) Natural Gas-Waste and Limitation of Escape, chapter 731, H.B. No. 2254, amending sections 3 and 7, article 6008, to authorize the Commission to permit the escape into the air of gas for cleaning, stimulating, and treating a well, or repairing or modifying a gas gathering system.

(c) Underground Natural Gas Storage and Conservation Act, chapter 366, S.B. No. 801, article 6066e, sections 1 to 15, is a new enactment relating to the construction and operation of underground storage facilities for gas, under the jurisdiction of the Railroad Commission, giving the "storer" the power of eminent domain as to such facilities, and incorporating the case law definition of injected natural gas as personal property.

60. 551 S.W.2d 340 (Tex. 1977).
62. 554 S.W.2d 918 (Tex. 1977).
64. TEX. REV. CIV. STAT. ANN. art. 5069—1.07(c) (Vernon Supp. 1978).
65. Id. art. 6008, §§ 3, 7.
66. Id. art. 6066e, §§ 1-15.
(d) Natural Resources Code, chapter 871, S.B. 1207, is a compilation into a single codification of the existing statutes relating to the public domain, restated in modern English, without substantive change. Topics include: the public domain; its definition and administration; oil and gas; mines and mining; geothermal energy and associated resources; timber; resources programs including the Veterans Land Board; and acquisition of resources and heritage.
