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CASE LAW UPDATE & LITIGATION TRENDS

Thomas A. Daily

**RECENT DEVELOPMENTS IN OIL AND GAS LAW—ARKANSAS AND BEYOND
BY THOMAS A. DAILY¹**

With one exception, the severance tax, it has been a pretty quiet year so far in Arkansas, though, with the legislature in session, that could change any minute. Luckily, cases from other states more than fill the void. Here we go!

ARKANSAS LEGISLATURE, IN SPECIAL SESSION, RAISES GAS SEVERANCE TAX

Unless you were comatose you already know about this one. A special legislative session was convened by the Governor, in the face of a threat from a former wannabe governor, to finance an initiated act campaign. Its purpose, and result: get some real tax money out of the only thing keeping Arkansas' pitiful economy running, natural gas exploration. At the end, a compromise bill was enacted. By Act No. 4 of 2008, the Arkansas General Assembly increased the rate of Arkansas' natural gas severance tax, from 3/10 of 1 cent per MCF to a maximum rate of 5% of the market value of the gas produced, effective January 1, 2008. The 5% rate does not apply to all wells, however.

The act creates four categories of wells: High-Cost Gas Wells, New Discovery Wells, Marginal Wells and just plain wells.²

A "High-Cost Gas Well" is a well producing from unconventional formations (i.e. shale or coal formations), a well producing from deeper than 12,500 feet (subsurface), a well which produces from "Tight Gas Formations" (to be defined by the Arkansas Oil and Gas Commission) and a well producing from geopressured brine. Production from High-Cost Gas Wells will be subject to a rate of 1.5% of market value for the first 36

¹Member, Daily & Woods, P.L.L.C., Fort Smith, Arkansas.

²The few which do not fit into another category.

production months. That period can be extended for up to 12 additional months or until "Payout" (a term undefined in the act) of the well, whichever first occurs.

A "New Discovery Well" is a newly drilled "Conventional" (i.e. not "High-Cost") well. Production from New Discovery Wells will be taxed at a rate of 1.5% of market value for the first 24 production months.

A "Marginal Well" is a "High Cost Well" which is incapable of producing more than 100 Mcf per day or a "Conventional Well" that is incapable of producing more than 250 Mcf per day. Marginal Gas will be taxed at a rate of 1.25% of market value.

The owners of those few wells which do not meet any of the above criteria will have the privilege of paying 5% of market value. That is really not such tough duty if you remember that those few wells are, by definition, the very best wells in the state.

**U. S. DISTRICT COURT HOLDS THAT OIL AND GAS WERE
"MINERALS," UNDER STROHACKER, IN WHITE COUNTY, IN 1933**

*Usery, et al. v. Anadarko Petroleum Corporation, et al.*³ is another decision involving whether oil and gas were considered to be minerals, in legal and commercial usage, at a given time and place in Arkansas. The importance of the question is that because of the case of *Missouri Pacific Railroad, Thompson, Trustee v. Strohacker*,⁴ its answer is determinative of whether those substances were successfully conveyed in a deed or reservation of "minerals" without specifying which minerals.

The reservation in question was in a 1933 conveyance out of the Missouri Pacific

³USDC Case No. 4:07CV01185-WRW (E.D. Ark. 2008).

⁴228 Ark. 632, 152 S.W.2d 557 (1941).

Railroad Company, Anadarko's predecessor. The question presented is nearly identical to that answered, for Faulkner County as of 1938, by another judge of the same court in *Webco, Inc., et al. v. Upland Industrial Development Company*,⁵ just last year. Those bookend cases are the easy ones.⁶ Yet to be decided are other lawsuits pending in circuit courts in the shale counties with reservation dates closer to the turn of the former century.

As was observed in this space last year, there has never been an Arkansas Supreme Court *Strohacker* decision holding that oil and gas were considered "minerals" before 1900 nor one holding that oil and gas were not considered "minerals" after that date. There is no value, in property law, to uncertainty how a court might decide such a fact intensive issue in every unique setting. The wise words of the late Justice McFadden, whose two lucid dissenting opinions in *Stegall v. Bugh*, 228 Ark. 632, 210 S.W. 2d 351 (1958), and *Ahne v. The Reinhart and Donovan Co.*, 240 Ark. 691, 401 S.W. 2d 565 (1966), urged the rest of the court to stop "drifting like a ship without a rudder" and adopt a statewide date for oil and gas recognition as a rule of property:

In short, I still insist that I was right in my dissent in *Stegall v. Bugh*, *supra*. I probably will not be on this Court when another mineral reservation case arises; but I predict that at some time the Court must fix a statewide date when it was generally recognized that oil and gas were minerals. We have before us in the case at bar as fine a record as will ever be presented on this question; and I think this is the time when it should be done; and I would still insist on January 1, 1900, as such date - or, if the "beginning of

⁵USDC Case No. 4:07-CV-00035 GTE (E.D. Ark. 2007).

⁶At least one would think so. At latest report the *Urserly* decision is on its way to the Eighth Circuit Court of Appeals. Duh!

the century" is considered a more poetic date, then Jan. 1, 1901, would satisfy the situation. (240 Ark. at 701.)

It is respectfully submitted that Justice McFadden was right in 1958, Justice McFadden was right in 1966, and the spirit of Justice McFadden residing in those of us left having to figure out who-owns-what are right today. **Please**, your collective honors, pick one of his alternative dates, statewide, and drift no more.

ARKANSAS COURT OF APPEALS GIVES LIMITED EFFECT TO UNPROBATED WILL

*Osborn v. Bryant*⁷ involved Lacy Bryant's will, which left the property in question to his widow, Naomi, for life, with remainder to one of his eight surviving children, Osborn, should she elect to pay the remaining heirs \$200 per acre. Otherwise, the remainder went to Bryant's descendants, per stirpes. The will was filed, attached to a petition for distribution of small estate, pursuant to ACA § 28-40-101, as was an executed and acknowledged Proof of Will. Notice to creditors was published, as well, but there was never a probate court order admitting the will to probate. After Naomi died, Osborn executed an "Administrator's Deed" in favor of herself although, of course, she held no such court appointment.⁸

In a challenge from several of the other heirs at law, the trial court refused to honor the unprobated will. The Court of Appeals reversed, noting an exception in ACA § 28-40-104, the statute which generally refuses to recognize an unprobated will, for

⁷ ___ Ark App. ___, ___ S.W.3d ___ (No. CA-080589, 2009).

⁸Curiously, the opinion never tells us whether Osborn paid the \$200 per acre. We assume she did so.

wills attached to ACA § 28-40-101 affidavits.

DIVIDED TEXAS SUPREME COURT DENIES “TRES-FRAC” LIABILITY

Perhaps 2008's most important judicial development was the Texas Supreme Court's long awaited decision in *Coastal Oil & Gas Corp. et al. v. Garza Energy Trust, et al.*⁹ One of Texas' esteemed courts of appeals had mostly approved a jury verdict which included 10 million dollars punitive damages against Coastal for fracing a well in such a way that fluids and prop material crossed a unit line and enhanced the flow of gas across that line into Coastal's well. Since Coastal operated both units the case was complicated by charges of violation of the covenant against drainage and other theories. The Texas Supreme Court was bitterly divided on this one. The majority (five justices) announced out a new Texas rule of law that recovery of gas by fracing is protected by the Rule of Capture. A concurring justice argued that the Rule-of-Capture analysis was unnecessary, because, in his view, subsurface fracing was simply not actionable trespass for public policy reasons. Three justices, including the chief justice, joined in a dissenting opinion which would have permitted “tres-frac” liability, but expressed doubt as to punitive damages, given the inference that Coastal had not acted in bad faith.

A virtual who's who of Texas oil and gas interests had filed amicus briefs. These opinions are lengthy, but well worth reading.

OKLAHOMA APPELLATE COURT AFFIRMS NON-CONSENTING OWNERS' RIGHT TO VOTE FOR OPERATOR REMOVAL— REFUSES TO PERMIT

⁹51 Tex. Sup. Ct. J. 1258, 268 S.W.3d 1 (2008).

CONTRACT SUIT FOR CONVERSION OF ROYALTIES NOT PAID

In *Tarrant v. Capstone Oil & Gas Co.*¹⁰ the Oklahoma Court of Civil Appeals answered two unrelated questions: do non-consenting parties get to vote in an election to remove a grossly incompetent operator and may royalty owners use the tort theory of conversion in a suit against the same operator for underpayment of royalties. The answers are "yes" and "no."

The court noted the scarcity of legal precedent on the JOA question. Then, adopting the rationale of a similar Texas Court of Appeals decision,¹¹ the court held that the non-consenting parties retained enough interest to justify a conclusion that they could vote in such elections.

Then, in a remarkably lucid observation, the court noted that the right to receive royalty was a contract right. Thus, breach of contract,¹² not the tort theory of conversion, was the royalty owners' exclusive remedy.

Both rulings appear to be sound. Neither issue has been litigated in Arkansas.

TEXAS COURT OF APPEALS AGREES THAT RESERVE CALCULATION DATA IS TRADE SECRET, PROTECTED FROM DISCOVERY

One of the hardest things for a plaintiff in a case involving alleged loss of production is to prove damages. Engineering studies designed to calculate, for

¹⁰2008 Ok. Civ. App 17, 178 P.3d 866 (2007).

¹¹*Hill v. Heritage Resources, Inc.*, 964 S.W.2d 89 (Tex.App. 1997).

¹²Enhanced by interest, damages for injury or property arising from the violation, litigation costs and attorneys fees, under a statute (52 O.S. 2001 § 570.14 (A) and (C)) which is similar to ACA § 15-74-604.

example, what a well would have recovered had it been drilled to protect from drainage are expensive. Potentially a simple fix, for the plaintiff, is to discover the defendant producer's own reserve studies which, if the defendant is a public company, always exist.

The modern norm, where discovery is concerned, is laze fare. Generally, if they ask, you have to tell. If you think the information is a trade secret, the publication of which will damage you, your remedy is a protective order limiting the use of the information to the litigation itself. The remedy of the protective order is often less than completely satisfactory. Such orders are near impossible to enforce. Once the information is out, protecting it can be compared to unringing a bell.

Remember, also, that discovery of the defendant's work product is not the only way for the plaintiff to come up with proof of alleged damages, just a really easy way. No one seriously argues that the fundamental production data used to calculate recoverable reserves is secret. Indeed, it is publicly available. The issue is simply a matter of convenience and economy.

Well, ring up one for the defense. In *In Re XTO Resources I, LP, etc.*¹³ XTO managed to successfully prevent discovery of such materials. In Texas, if material constitutes a "trade secret" the burden shifts to the party seeking discovery to establish that the information is necessary for a fair adjudication of a claim or defense in the litigation. Since the raw data was publicly available, that was not the case.

¹³248 S.W.3d 898 (Tex. App. 2008).

TEXAS APPEALS COURT LIMITS DEFINITION OF "COMMENCING DRILLING OPERATIONS"

One of the unwritten rules of the oil and gas business is: Always put off until the last possible minute anything which will go there. Thus, an inordinate number of lawsuits involve a determination of what activity, on or near the last day of a lease term, will qualify as "commencing operations," so as to perpetuate the term. In *Veritas Energy, LLC v. Brayton Operating Corp, et al.*,¹⁴ the Corpus Christi-Edinburg division of the Texas Court of Appeals decided that Veritas' activities in dragging the grass with a backhoe to mark the location of a road does not qualify. Thus, the lease expired. After that, Veritas drilled the lessors a free well.

TEXAS COURT OF APPEALS REMINDS US THAT YOU CAN ONLY SHUT-IN A COMMERCIAL WELL

AFE Oil and Gas, L.L.C. operated a well in the Barnett Shale play which ceased to produce in paying quantities. Apparently, commercial production could have been restored had AFE re-fraced the well. For some reason, it chose not to do so. Rather, AFE acid perforated the well, called it a shut-in gas well and tendered shut-in royalties, which the lessors refused. Litigation followed, resulting in a jury determination that the well was still incapable of commercial production. Therefore, as a matter of law, the shut-in royalty clause could not be employed to perpetuate the leases. The Texas Court of Appeals, Fort Worth District affirmed in *AFE Oil and Gas, L.L.C., et al. v. Armentrout, et al.*¹⁵ What is so hard to understand here? You can only shut-in a well

¹⁴ ___ S.W.3d ___ (Tex. App. 2008).

¹⁵ ___ S.W.3d ___ (Tex. App. 2008).

which can, right then and there, produce in commercial quantities. Dead wells and broken wells are not candidates.

**TEXAS COURT OF APPEALS HOLDS THAT CONTRACT CONDITION,
“APPROVAL OF TITLE,” IS SUBJECTIVE, NOT OBJECTIVE**

Approval of title is a common condition of an offer to purchase an oil and gas lease or other mineral interest. Therein lies a question. Is “approval” measured subjectively (the purchaser can disapprove for any reason or, for that matter, no good reason) or objectively (the purchaser can only disapprove if there is a title defect which others would recognize)? In *Massey v. Southwest Petroleum Company*¹⁶ the Dallas District of the Texas Court of Appeals appeared to accept the subjective standard. Massey’s interest was subject to unrecorded agreements, but the evidence was that they would not have interfered with Southwest’s ownership interests. Nevertheless, Southwest was not required to perform because it unilaterally decided it did not like the title.

ANOTHER TEXAS COURT OF APPEALS EXPLAINS “WELLBORE” RIGHTS

One of the mistakes that those of us who have worked in the oil and gas industry for most of our adult lives make is to assume that everyone understands the language of the industry the same way. Trial lawyers like it that way.¹⁷ The facts of *Petro Pro*

¹⁶ ____ S.W.3d ____ (Tex. App. 2008).

¹⁷If everyone understood their contracts the same way, there would not be much to lawyer about.

*Ltd, et al. v. Upland Resources, et al*¹⁸ describe a pretty common transaction. The working interest owners within a unit containing the King "F" No. 2 Well,¹⁹ and other wells, decided they no longer wanted the King "F" No. 2 and sent it to auction. The resulting assignment to the high bidder, Petro Pro's predecessor, assigned all of the assignors' rights "insofar and only insofar as said leases cover rights in the wellbore of the King "F" No. 2 Well." Now what does that mean?

In litigation, the assignors contended that Petro Pro had the right to produce the existing perforated formation within the wellbore, the Cleveland Zone, and nothing else. Petro Pro, on the other hand, contended that it could produce anything which could be reached from the wellbore and that its rights included the power to deepen the wellbore or even to drill out one or more horizontal extensions therefrom.

The Texas Court of Appeals, Amarillo, held that neither was correct. Petro Pro can produce all the gas, from whatever zones it chooses, that the wellbore can produce without extending the wellbore vertically or horizontally, but had no right to extend the wellbore.

TEXAS COURT OF APPEALS REFUSES TO GIVE LIBERAL CONSTRUCTION TO PUGH CLAUSE

*El Paso Production Oil & Gas, et al. v. Texas State Bank, et al.*²⁰ involves a Pugh clause in identical leases "[T]his lease shall terminate...if Lessee fails to continue to

¹⁸ ____ S.W.3d ____ (Tex. App. 2007).

¹⁹A bit of a dog, producing marginally from something called the Cleveland Formation.

²⁰ ____ S.W.3d ____ (Tex. App. 2007).

develop...except as to lands covered by this lease which are...included within a pooled unit." The problem came when El Paso formed units which were depth limited. The lessors contended that those facts caused the Pugh language to operate vertically as well as horizontally. The Texas Court of Appeals disagreed, holding that "lands" meant "lands."

COLORADO COURT OF APPEALS REFUSES NOVEL USE OF PRIVATE CONDEMNATION RIGHT

Akin and Stepe own Colorado property upon which a gas well is located. Apparently the production from the well is not unitized. The nearest interstate pipeline is a little over three miles away from Akin and Stepe's property. They sought to condemn a private right-of-way across neighboring tracts in order to lay a pipeline connecting the well to market. Colorado, like Arkansas, has a statutory condemnation procedure enabling a landlocked owner to have ingress and egress to his property by condemning a "way of necessity."

In *Akin and Stepe v. Four Corners Encampment, et al.*²¹ the Colorado Court of Appeals squashed that idea. Private "ways of necessity" are passages for transporting humans, not gas.

KENTUCKY COURT OF APPEALS HOLDS THAT "DRILLING OPERATIONS" DO NOT INCLUDE RESTORING PRODUCTION IN EXISTING WELL

Heer obtained a lease from the Fraser Sisters which included the condition that "[i]f no well be commenced...this lease shall terminate as to both parties." Heer then

²¹ ____ P.3d ____ (Colo. App. 2007)

reestablished production²² from an existing well on the lease premises, but drilled no new well during the primary term. In *Heer v. Fraser, et al.*²³ the Kentucky Court of Appeals affirmed a lower court ruling that Heer's activities did not satisfy the drilling obligation of the lease and kicked him out.

LOCK UP ANYTHING OF VALUE, THE LEGISLATIVE FOLLIES ARE BACK IN TOWN

Did I mention that 2009 is an odd numbered year? That said, citizen legislators, familiarly clad in Big Smiths and snake skin boots, are roaming beneath that big pretty dome overlooking downtown Little Rock. As we write, it is too early to have much to say except "WATCH OUT." More will be known when we see one another in Hot Springs.

²²Apparently commercial, but barely so.

²³ ____ S.W.3d ____ (Ky. App. 2008).