Recent Developments in Natural Resource Law - Circa 1999

Thomas A. Daily

Follow this and additional works at: http://scholarworks.uark.edu/anrlaw

Part of the Natural Resources Law Commons, and the Oil, Gas, and Mineral Law Commons

Recommended Citation
http://scholarworks.uark.edu/anrlaw/46

This Article is brought to you for free and open access by the School of Law at ScholarWorks@UARK. It has been accepted for inclusion in Annual of the Arkansas Natural Resources Law Institute by an authorized administrator of ScholarWorks@UARK. For more information, please contact scholar@uark.edu, ccmiddle@uark.edu.
RECENT DEVELOPMENTS

Thomas A. Daily
It was a fairly slow news year for Arkansas mineral law if you look only at the 1999 decisions of the appellate courts. Consider, however, the myriad of exciting issues in three cases tried in 1999, and currently on appeal, and things get a lot more interesting. First, though, out with the old:

**UNPUBLISHED DECISION IN EIGHTH CIRCUIT ENDS BRINE DISPUTE BETWEEN MURPHY OIL AND GREAT LAKES AND DISAPPOINTS BOTH**

Way back in 1995, Great Lakes Chemical Corporation began a program to expand its brine-to-bromine operations in Union County. Needed for that expansion were leases covering about 40,000 previously unleased acres in the vicinity of Great Lakes' West Plant, located just east of the Union/Columbia County line, between El Dorado and Magnolia.

Unfortunately for Great Lakes, the biggest block of unleased brine rights within the play was owned by Murphy Oil Corporation. Not surprisingly, Murphy's idea of the value of a brine lease was considerably higher than anything Great Lakes was willing to pay. Moreover, Murphy realized that Great Lakes needed to control at least 75% of the acreage in its proposed West Plant Unit as a jurisdictional prerequisite to the integration of Murphy's interest. So Murphy began its own brine leasing effort, seeking to prevent unitization and to thus bring Great Lakes to Murphy's table. Ultimately, though, Great Lakes got enough acres to unitize its field. The Oil and Gas Commission

---

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

2 Through its Deltic Timber subsidiary. Murphy has since spun off Deltic as a separate public company, but kept all mineral interests, including brine, in Murphy.
formed the West Plant unit and integrated Murphy's interest.  

Along the way Murphy concluded that more than expansion was involved. It decided that Great Lakes' prior operations had, for many years, caused reinjected processed brine to displace bromine rich brine from beneath Murphy acres. Murphy's brine trespass suit was heard in a bench trial by U. S. District Court Judge Harry Barnes. It resulted in a decision which found Great Lakes liable, not for trespass but for unjust enrichment. However, because almost all of Great Lakes' actions were determined not to be in bad faith, Judge Barnes awarded only a small fraction of the damages sought by Murphy.

Both sides appealed to the Eighth Circuit. Murphy contended both that Judge Barnes should have found bad faith trespass and that he erroneously based damages upon royalties lost by Murphy, rather than the value of bromine within the displaced brine. For its appeal, Great Lakes contended that Judge Barnes went far beyond existing law in finding that it was liable at all, arguing that its operations were protected by the rule of capture. The issues raised by those appeals were thoroughly discussed in this space at the 1999 Natural Resources Law Institute. That discussion will not be repeated here. Suffice to say that both sides were disappointed when the Court of Appeals, apparently overwhelmed by the complexity of the case, affirmed Judge Barnes without as much as an opinion of its own.

---

3 A.O.G.C. Case No. BU3-95. The AOGC did, however, base the bonus paid for integrated acres upon the highest bonus paid by Murphy offered in its arbitrage inspired leasing effort rather than that consistently paid by Great Lakes.


5 Daily, Recent Developments - An Overview of New Cases, Legislation and Regulations Affecting the Oil and Gas Industry, 1999 ARKANSAS NATURAL RESOURCES LAW INSTITUTE.
Another interesting mineral law issue, discussed twice before in this space,\(^6\) involves the ownership of coal bed methane as between the owners of oil and gas and the coal owner. It was contested in a federal case because the coal owner was the Ute Indian Tribe. The case is important to us because the Ute Tribe’s patent coal reservation was identical to reservations for the benefit of the Five Civilized Tribes covering many acres in eastern Oklahoma. Several attorneys, including this author, have opined that coal bed gas belonged to the gas owner rather than to the tribes, relying, in part, upon a 1981 U. S. Solicitor of the Interior’s opinion to that effect.

When the Government, acting on behalf of the Ute Tribe, claimed differently, the U. S. District Court ruled for the gas owner.\(^7\) However the Tenth Circuit reversed that ruling, holding that coal bed methane was included within the tribal reservation of coal.\(^8\) Finally, the United States Supreme Court reinstated the decision of the trial court in a 7-1 decision.\(^9\) The Court observed, somewhat sarcastically: “On the day the Government’s response to Petitioner’s certiorari petition was due, the Solicitor of the Interior withdrew the 1981 opinion in a one line order—The United States now supports the Tribe’s position—"\(^10\)

\(^6\) Daily, Recent Developments - A Review of Cases, Legislation and Regulations Affecting the Natural Resources Industries, 1998 ARKANSAS NATURAL RESOURCES LAW INSTITUTE; Daily, Recent Developments - An Overview of New Cases, Legislation and Regulations Affecting the Oil and Gas Industry, 1999 ARKANSAS NATURAL RESOURCES LAW INSTITUTE.


\(^8\) Southern Ute Indian Tribe v. Amoco Production Co., 119 F.3d 816 (10th Cir. 1997).


\(^10\) Id., 144 L. Ed.2d at 29.
In February, 1985, TXO Production Corp. (predecessor of Sonat Exploration Company) drilled a gas well called the “Dill ‘A’ No. 1” in Sebastian County, Arkansas. Although the well was never a barn-burner, its initial production was clearly sufficient to return a profit and thus to maintain Sonat’s leases. However, beginning in 1992, after the primary terms of those leases had expired, production from the well began to decline dramatically. For instance, 1992 production was only about one-half of that recorded in the previous year. Production soon declined to a rate of only about ten MCF per day.

Starting in 1993, monthly operating expenses exceeded revenues (particularly considering the administrative overhead expense which Sonat’s operating statements charged to the well). Indeed, for at least the two years, from April 1994 through April 1996, the well lost money even without considering administrative overhead and other indirect expenses.

In early 1996 the Sonat employees responsible for the well concluded that the well was no longer commercially productive and should be plugged. On January 17 of that year Sonat’s engineer in charge of the well submitted a “Recommendation to P&A” form, writing: “Uneconomic in current completion—no more potential. No behind pipe potential.” On March 1, the same engineer again recommended that the well be plugged. On March 14, another Sonat employee, a geophysicist, wrote a memo noting that plugging the well would require Sonat to write off a booked PUD11 attributable to the Dill “A” unit. On the bottom of that memo Sonat’s mid-continent land manager responded: “Looks like leases are probably gone anyway with only 10 MCF/D production.” By letter dated March 28, Sonat proposed plugging of the well to the only other participant, Tiros Exploration Company stating: “In Sonat’s opinion, this well has become uneconomical to operate... .” On April 30, Sonat shut in the Dill “A” Well giving, as its official

11 Proven undeveloped reserves.
reason, the oxymoron, "T&A."\textsuperscript{12}

Another company, Freedom Energy Inc., has a prospect for a new well in another part of the Dill "A" unit. Beginning in 1994, Freedom began requesting Sonat for a farm-out of its leases so that Freedom could drill that prospect. Sonat declined, largely because it was then considering its own redrill within the unit.\textsuperscript{13} As soon as Freedom learned of Sonat's plan to plug the Dill "A" Well it began taking its own leases and lease options from the mineral owners.

Tiros Exploration Company did not respond to Sonat's plugging proposal. Instead, Ross Explorations, Inc., a company related to Tiros, offered to purchase the Dill "A" Well from Sonat for $1,000, and to assume responsibility for ultimately plugging the well.\textsuperscript{14} Sonat accepted Ross' offer and assigned its leases to Ross, without warranty. Ross then restored production from the well and has since operated it at a small, but apparently steady, profit, largely because Ross' operating expenses are but a fraction of Sonat's and, for that matter, those of most other operators. Also, soon after buying Sonat's leases, Ross entered into an agreement to farm them out to still another company, Hoover/Wilson Exploration Company, which had proposed a new well very similar to Freedom's prospect. That farm-out agreement would have yielded Ross a carried interest in Hoover/Wilson's new well worth approximately $125 per acre.

Freedom sued Ross in Chancery Court for a declaratory judgment that the old Sonat leases had expired for failure of the Dill "A" Well to produce in commercial quantities. Ross' defense revolved around the fact that Ross had lately been able to operate the well at a profit by eliminating most operating expenses. Also, Ross branded Sonat's profit and loss statements as unreliable\textsuperscript{15}

\textsuperscript{12} T&A means "temporarily abandoned," an impossibility.

\textsuperscript{13} Later abandoned, apparently for budgetary reasons.

\textsuperscript{14} Sonat's plugging AFE projected the plugging costs to be $12,500.

\textsuperscript{15} It is well known throughout the mid-continent that Sonat's accounting department was inept, at best.
and thus contended that Freedom had failed to meet its burden of proof. Finally, Ross argued that a prudent operator would have continued to operate the well, notwithstanding its lack of profitability. After a three-day bench trial the Chancellor agreed with Freedom. The Chancellor ruled, specifically, that even without considering administrative overhead and other arguably indirect expenses to which Ross objected, the well had lost money over the two year period immediately prior to its shutting-in. He held, as a consequence, that the old leases had expired prior to the assignment from Sonat to Ross. Thus, Ross' profit since assuming operations was irrelevant.

Ross appealed to the Arkansas Court of Appeals but the Supreme Court accepted certification of the case because of the legal issues involved. The appeal presented three issues:

1. **How Much Proof Is Enough to Meet the Plaintiff's Burden of Showing That a Well Is Not Capable of Commercial Production?**

Proof of facts in any lawsuit involves a cost/benefit comparison. Given time and lots of money virtually any case can be more thoroughly presented. On the other hand, it makes no sense to spend more money trying a case than the case is worth. Freedom proved that Sonat thought the Dill “A” well was non commercial and that Sonat's admittedly undetailed profit and loss reports supported that conclusion. It also proved that those profit and loss statements are materially accurate and are relied upon by Sonat for joint interest billings and to internally determine profitability of individual wells. Ross argued that is not enough. It contended that without proving each individual increment of each line item on Sonat's profit and loss statement, Freedom could not have proven that all expenses charged to the well by Sonat were direct costs of operation. Ross rejected the application of any indirect costs, a position supported in the majority of jurisdictions.17

---

16 Apparently largely because of the unit's redrill potential, rather than out of any hope to enhance production from the Dill “A” well itself.

2. **What Is an Appropriate Time Period over Which to Compare Expenses to Revenues?**

The two year period over which the chancellor compared revenues to expenses is fairly typical of that found in the case law. Obviously other periods would have been more favorable to Ross. Ross argued alternatively that the court should have required the inclusion of earlier months, before the well’s production suffered from substantial depletion of its reservoir and that the court should have considered later months, after Ross reopened the well.

3. **Should the Arkansas Court Adopt the “Prudent Operator Test” and If So, Does it Change the Outcome of the Case? (I.e., Is the Prudent Operator in Question the Actual Operator or Is it Some Potential Future Operator Who Can Operate More Cheaply?)**

Arkansas' two previous "paying quantities" cases fail to even mention the "Prudent Operator Standard." However, that may be more the fault of bar than bench since there is no indication that it was argued in either of those cases. That test, most clearly enunciated in the Texas case of *Clifton v. Koontz* has been adopted by a large majority of oil and gas jurisdictions. Its application would likely not have changed the result in either prior Arkansas case. The *Clifton* court stated the test as follows:

In the case of a marginal well, such as we have here, the standard by which paying quantities is determined is whether or not under all the relevant circumstances a reasonably prudent operator would, for the purpose of making a profit and not merely for speculation, continue to operate the well in the manner in which the well in question was operated.

In determining paying quantities, in accordance with the above standard, the trial court necessarily must take into consideration all matters which would influence a reasonable and prudent operator. Some of those factors are: The depletion of the reservoir and the price for which the lessee is able to sell his produce, the relative profitableness of other wells in the area, the operating and marketing costs of the

---


19 325 S.W. 2d 684 (Tex. 1959).

company's assets were transferred to two subsidiaries. SEECO, Inc., received all the assets related to Arkansas Western's gas exploration and production business and a new subsidiary, which was given the old name "Arkansas Western Gas Company," received the public utility business. As a condition for approval of the reorganization the Arkansas Public Service Commission ("PSC") required SEECO and Arkansas Western to enter into a long-term gas purchase contract known as "Contract 59," for the purpose of providing a dedicated supply of gas to Arkansas Western's retail customers. SEECO dedicated acreage in Franklin, Johnson, Washington, Crawford, and Logan Counties to Contract 59. Those leases included fixed rate, market value and proceeds type leases.

Contract 59 provided for gas prices based upon the maximum lawful price allowed under the Natural Gas Policy Act. The contract further provided that upon deregulation either party could demand a redetermination of the contract price up to the highest price then being paid for gas in the five county area. The contract also contained take-or-pay provisions.

Most importantly, Contract 59 contained a "regulatory-out" clause. The PSC has authority to set the price that Arkansas Western charges rate-payers for gas. Thus, the PSC had the right to disallow (for ratemaking purposes) any price paid by Arkansas Western to SEECO which the PSC considered to be excessive. Arkansas Western could then use the regulatory-out clause to force SEECO to take the PSC's reduced price or, at SEECO's option, terminate the contract altogether.

Often during the term of Contract 59 SEECO allowed Arkansas Western to phase in price escalations at a slower rate than it might otherwise have demanded. In December 1984, in response to market changes, SEECO and other non-affiliated producers agreed to freeze the contract price at $3.85. Moreover, the jury apparently believed that SEECO never sought enforcement of the take-or-pay provisions of Contract 59.

In 1990 the PSC opened a review of the prudency of the price Arkansas Western was
lease, his net profit, the lease provisions, a reasonable period of time under the circumstances and whether or not the lessee is holding the lease merely for speculative purposes.\footnote{21}{325 S.W. 2d 684 at 691.}

In a post-trial motion Ross implored the Chancellor to find that a prudent operator would have continued to operate the Dill "A" Well. It then urged on appeal that his failure to do so amounted to error. Freedom did not disagree with the proposition that the Arkansas Court should adopt \textit{Clifton v. Koontz}. It simply urged that Sonat was a prudent operator when it concluded that the well was incapable of commercial production.

The Supreme Court affirmed the Chancellor.\footnote{22}{Ross Explorations, Inc. v. Freedom Energy Inc., _____ Ark. _____, _____ S.W.2d _____ (2000).} In an opinion by Justice Smith which recited many of the facts, the Court found that there was ample evidence to support the Chancellor's decision that the Dill "A" Well was losing money. It also held that the appropriate time period for such a measure must be determined on a case-by-case basis and that the 24 month period used by the Chancellor was appropriate under the facts of the case.

Unfortunately, the Supreme Court refused to address the prudent operator issue, holding that Ross had not properly presented that legal issue to the trial court in such a way as to preserve it for appeal:

Viewing the current landscape of oil and gas law, it may well be advisable and appropriate for this court to adopt the prudent-operator rule. However, we will only do so when the matter is properly before us.\footnote{23}{Id.}

Now, as promised, in with the new:

\textbf{RUNAWAY JURY AWARDS RECORD VERDICT IN ROYALTY OWNER CLASS ACTION AGAINST INTEGRATED GAS PRODUCER}

In 1978 the public utility company formerly known as "Arkansas Western Gas Company" reorganized into a holding company and changed its name to Southwestern Energy Company. The

\footnote{21}{325 S.W. 2d 684 at 691.}

\footnote{22}{Ross Explorations, Inc. v. Freedom Energy Inc., _____ Ark. _____, _____ S.W.2d _____ (2000).}

\footnote{23}{Id.}
paying for gas under Contract 59. SEECO intervened in the proceeding, arguing that the $3.85 price which it was then receiving should not be disallowed by the PSC for purposes of pass-through to Arkansas Western's rate-payers. In late 1993, the PSC found the $3.85 price to be too high and in violation of A.C.A. § 23-103, which requires gas utilities to buy gas from the "lowest or most advantageous market." SEECO, Arkansas Western, the PSC staff and the Attorney General then entered into a settlement which provided that the Contract 59 price would thereafter be fixed on a monthly basis at a premium over a market index price and that the take-or-pay provision would be eliminated. Pursuant to that settlement the Attorney General waived demand for refunds to rate-payers and SEECO waived any demand for existing liabilities of Arkansas Western under Contract 59. This settlement was ultimately approved in its entirety by the PSC.

In 1996 a lawsuit was brought by Alan Hales, et al, against SEECO, Arkansas Western, and their parent company. This lawsuit, which was ultimately certified as a class action,24 alleged breach of express contract provisions, breach of implied contract provisions, fraud, fraudulent concealment, conspiracy, and tortious interference with contract. In reality, all of these theories depend upon whether SEECO was under a duty to demand strict enforcement of Contract 59 and, having failed to do so, owed royalties on the proceeds of gas and take-or-pay payments which it gave up when it did not insist on strict enforcement of Contract 59.

After a lengthy trial the jury returned a verdict for the class on all class theories, granting a damage award slightly over sixty-two million dollars. The trial court then added thirty-one million dollars worth of prejudgment interest. The resulting ninety-three million dollar judgment is earning interest at ten percent as we speak. Southwestern is a reasonably prosperous combination of an independent gas producer and a public utility. However, if the full amount of the jury's verdict is upheld it will be dealt a real blow.

24See SEECO, Inc. v. Hales, 330 Ark. 402, 954 S.W.2d 434 (1997), which upheld class certification of this case.
This is a very complicated case. Southwestern's appeal raises many issues. We will
discuss some of those that are important to natural resources law.

1. WHAT IS THE REAL NATURE OF THE CLASS' LEGAL THEORY?

Clearly, a gas marketing decision that does not meet the prudent operator standard would
subject Southwestern to liability for breach of the implied covenant to market on favorable terms.
The class' complaint pleads such a theory but also alleges breach of express contract and various
fraud-based torts. These tort theories are particularly important because they allowed venue to be
fixed in Sebastian County rather than Washington County. The class' express contract
argument is based on the class' interpretation of Hillard v. Stephens, with which the trial court
agreed. The trial court apparently ruled that Hillard held that the "market price" for gas was
necessarily the contract price and that the parties were precluded from amending the contract price
downward for any reason. Therefore, according to the class, any deviation from the gas purchase
contract was an express violation of the lease contract. That is a strained interpretation of Hillard
for certain. Hillard simply held that the price received under a long-term gas purchase contract,
entered into prudently and in good faith, meets the definition of "market price" for royalty purposes,
notwithstanding the fact that the general market value of gas may have since escalated.

The class' tort theories make even less sense to this author. They seem dependent upon
the class' theory that SEECO was a fiduciary with respect to its royalty owners and owed a
continuing duty to confess to the royalty owners that it was not strictly enforcing Contract 59. Such


26Washington County would presumably be a better forum for Southwestern because it
is populated with Arkansas Western's rate-payers rather than SEECO's royalty owners.

27It should be noted that actions in express contracts have a five-year statute of
limitations while implied covenant litigation, at least arguably, has a three-year limitations
period.

28276 Ark. 545, 637 S.W.2d 581 (1982).
a fiduciary theory has little or no judicial support. Thus, it seems that the class' only real theory is breach of the implied duty to market on favorable terms.

2. What is a Prudent Operator?

SEECO argues on appeal that in evaluating its conduct the court should have determined what a prudent operator under SEECO's circumstances (affiliated with the purchaser and under PSC scrutiny) would have done. The class contends that the "prudent operator" is an operator unrelated to its purchaser. This is an interesting question upon which there is little or no case law. SEECO also argues that the PSC's 1993 order disallowing the $3.85 price as "too high" establishes, as a matter of law, that SEECO was a prudent operator when it agreed to accept that price in the first place. Of course, non-affiliated operators had also agreed to that $3.85 price freeze, but the jury was not allowed to hear their testimony. SEECO's argument makes sense.

3. Isn't There a Statute of Limitations on This Stuff?

The class managed to secure a finding from the jury that SEECO had affirmatively concealed the class' cause of action and thus none of the class damages were barred by limitations. In actuality, most of this "concealment" was really failure to reveal. If the Supreme Court reverses on this issue, Southwestern will save a lot of money.

4. What About SEECO's Fixed Rate Lessors?

A portion of SEECO's leases called for fixed rate royalties rather than proceeds or market value based royalties. In spite of those fixed royalty provisions, SEECO has, for many years, paid royalties based upon sale proceeds to all lessors, regardless of the type of lease. The trial court granted a directed verdict that these payments of royalties based upon proceeds converted the fixed price leases to proceeds leases. SEECO had argued that they were mere voluntary payments of monies in excess of those required under the leases and, therefore, that its failure to strictly enforce Contract 59 merely reduced a windfall that those lessors were not entitled to.

5. WHAT IS REALLY THE ARKANSAS LAW ON ROYALTIES BASED UPON TAKE-OR-PAY SETTLEMENTS?

In *Kline v. Jones*\(^ {30} \) and *Kline v. Arkoma Production Company*\(^ {31} \) the Eighth Circuit Court of Appeals ruled that the Arkansas Supreme Court would award royalty payments on take-or-pay settlements. Arkansas and Louisiana are thus in a minority of two jurisdictions on this issue.\(^ {32} \) SEECO has asked the Arkansas Supreme Court to reject the *Kline* holding and disallow the judgment for royalties on take-or-pay payments that SEECO was allegedly entitled to under Contract 59 but failed to enforce. This author believes that SEECO is right on that issue because that gas, being, by definition, unproduced, remains in the ground available for royalties when its production occurs.

6. WHAT DIFFERENCE DOES THIS “REGULATORY-OUT” BUSINESS MAKE?

As noted above, this is really just a breach of “implied covenant to market” case with an interesting statute of limitations issue. SEECO’s defense is that it acted as a prudent operator since insisting on strict enforcement of Contract 59 would have resulted in the PSC’s disallowance of SEECO’s price which would have caused Arkansas Western to further reduce the price under the regulatory-out clause. In other words, SEECO says that it got as much for its gas as it reasonably thought it could get and that to demand more would have been counter-productive. That argument makes sense. It would have been bolstered by the testimony of representatives of other companies which also granted price and take-or-pay concessions to Arkansas Western during the same time frame, but the trial court barred all such testimony as irrelevant.

\(^{30}\) 980 F.2d 521 (8th Cir. 1992)

\(^{31}\) 73 F.3d 779 (8th Cir. 1996)

\(^{32}\) See *Almeda Corp. v. Transamerican Natural Gas Corp.*, 950 S.W.2d 93 (Tex. App.-Houston 1997); *Roye Realty & Developing, Inc. v. Watson*, 949 P.2d 1208 (Okla. 1996).
7. So Now What?

This author believes that the trial court committed plenty of errors. There are lots of good reasons to reverse the judgment, including reasons unrelated to the natural resources law issues.

**Sunbelt Exploration Appeals Summary Judgment Dismissing Its Implied Covenant Claim Based Upon Prior Sunbelt Case**

The undisputed top leasing championship of the 1990's goes to a Tulsa company, Sunbelt Exploration, Inc. Sunbelt's *modus operandi* was to identify a producing unit where there was production in an offsetting unit from one or more geological formations which did not produce in the identified unit. It then secured top-leases from mineral owners within the identified unit and brought suit for lease cancellation and damages based upon alleged breach of implied covenants to develop and/or protect from drainage. Not surprisingly, the operator of the target unit was almost always one of the Arkoma Basin's long-time producers, Stephens Production Company, SEECO, Inc. or Arkla Exploration Company (or its successors). After all, much of the traditional Arkoma Basin "fairway" is controlled by those three entities.

Often, Stephens' and SEECO's response to Sunbelt's top leasing was to ignore Sunbelt and, if the top-leased units had redrill potential, to drill new wells. When Sunbelt then sued Stephens\(^{33}\) and SEECO\(^{34}\) respectively, it not only sought cancellation of those companies' underlying leases, but also claimed that the drilling of the new wells constituted willful trespass so that Sunbelt was entitled to all gas produced from the new wells without any obligation to reimburse Stephens or SEECO for the cost of drilling them.

Each of Sunbelt's top leases was taken between 1985 and 1991, and contained the following paragraphs:


\(^{34}\) *Sunbelt Exploration Company, et al. v. SEECO, Inc.* (Franklin County Chancery Court Case No. E-92-66 (Ozark District))
This lease is subject to any rights existing in that certain lease covering the above-described land recorded in Book [], Page [], and the primary term of this lease shall not commence until the earlier of (1) termination of said prior lease of record, or (2) two years from the date hereof.

This lease shall remain in force for a primary term of three (3) years and as long thereafter as oil, gas or other hydrocarbons is produced from said leased premises or from lands pooled therewith.

While both of Sunbelt's lawsuits were filed in 1992, for reasons known only to Sunbelt, they were allowed to languish in their respective courthouses until 1998 and 1999, respectively, when first Stephens and then SEECO filed Motions for Partial Summary Judgment. These virtually identical motions sought summary judgment that:

1. The primary terms of Sunbelt's top leases began two years after they were taken, lasted three years thereafter, and expired without the leases having ever vested. Therefore Sunbelt had lost standing to be a party to the action.

2. Willful trespass, under the circumstances, was a legal impossibility since the underlying leases were valid until and unless they were either surrendered or judicially cancelled, neither of which had occurred.

The chancellor granted the Motions for Partial Summary Judgment in both cases in all respects.

Inexplicably, while Sunbelt did not appeal from the chancellor's ruling in the Stephens case, it did appeal from the identical ruling in the SEECO case.

Apparently, Sunbelt's argument is that when SEECO allegedly violated implied lease covenants, SEECO's underlying leases automatically self-cancelled, thus causing Sunbelt's top leases to vest and causing SEECO to be a trespasser. Ironically, Sunbelt's argument may well be refuted by the Arkansas Supreme Court's decision in another Sunbelt case, Sunbelt Exploration Company v. Stephens Production Company. In that Sunbelt decision, the Arkansas Supreme Court said:

Sunbelt's interest under a top lease cannot become effective until either Stephens concedes abandonment and voluntarily relinquishes possession, or there is a

35 In both cases the Honorable Richard Gardner.

judicial determination that Stephens’ leases are cancelled.\textsuperscript{37}

In a paper presented to this Institute in 1998, Professor Norvell observed:

Cancellation of an oil and gas lease is an equitable remedy and is the appropriate remedy for breach of the implied covenant of reasonable development. Although Sunbelt mentioned ejectment in its pleadings, Sunbelt’s request for cancellation of Stephens leases is appropriate and controlling and the cause of action is equitable. Likewise, Sunbelt’s top leases only become possessory when Stephens either concedes abandonment and voluntarily relinquishes possession of the leases or they are judicially cancelled.\textsuperscript{38}

**PROCEDURALLY FLAWED APPEAL SEeks TO TEST THE CONSTITUTIONALITY OF THE ARKANSAS OIL AND GAS CONSERVATION ACT**

Lindquist and Moore are the owners of about 450 net mineral acres in a drilling unit in the south part of Sebastian County, Arkansas. When they were unwilling to execute an oil and gas lease or agree to participate in a well proposed by Freedom Energy Inc., Freedom filed an application for the integration of their interest before the Arkansas Oil and Gas Commission.\textsuperscript{39}

Lindquist was present at the Commission’s hearing on Freedom’s application without counsel, and he later admitted that he had spoken to and obtained advice from an attorney prior to the hearing. Significantly, he made no objection to the notice that he was given, nor did he raise any of the constitutional arguments which he later attempted to raise on petition for judicial review. The Oil and Gas Commission granted Freedom’s application and entered an order which required Lindquist and Moore to select one of four alternatives:

1. They could participate in the cost of drilling and operating the well, and if the well was successful, would be entitled to receive 100\% of the proceeds of their interest in the well.

2. They could lease their lands to Freedom for a bonus payment of $100.00

\textsuperscript{37} Id. at 320 Ark. 304.

\textsuperscript{38} Norvell, DRAINAGE, DRILLING UNITS AND CONSERVATION AGENCY ORDERS: SUNBELT EXPLORATION CO v. STEPHENS PRODUCTION CO., 1998 Arkansas Natural Resources Law Institute.

\textsuperscript{39} Arkansas Oil and Gas Commission Order Reference No. 90-98 (October 27, 1998).
per net acre and a royalty of 1/8.

(3) They could lease their interest to Freedom for no bonus, but for a royalty of 1/4.

(4) They could have 7/8 of their interest temporarily transferred to Freedom. If and when the proceeds of such 7/8 interest recouped 600% of the cost which Lindquist and Moore would have paid as their share of drilling-related costs, had they participated, it would then be returned to Lindquist and Moore who would thereafter be participants in the well, responsible for future operating costs, and entitled to share in production as though they had participated in the well. This 600% is called the risk factor penalty. It should be noted that it only applies to 7/8 of Lindquist and Moore's interest and that they would, nevertheless, receive a 1/8 royalty on any production during the recoupment period.

The order further provided that, upon the failure of Lindquist and Moore to affirmatively elect, they would be deemed to have elected to have leased to Freedom for a bonus of $100.00 per acre and a royalty of 1/8.

Within the time provided by the A.O.G.C. order, Lindquist and Moore affirmatively elected alternative number 4. This is known as an election to "go non-consent." Then, having so elected, Lindquist and Moore filed a timely petition for judicial review in the Chancery Court of Sebastian County. In that petition, they sought to raise a plethora of constitutional arguments: the notice given to them was insufficient; they did not have time to hire a lawyer to represent them at the hearing or retain an expert witness; 600% risk factor penalty is unreasonable as a matter of law; 600% risk factor penalty constitutes a usurious loan of money in violation of the Arkansas Constitution; the Oil and Gas Commission is composed of all white males involved in the oil and gas business and does not represent a cross-section of the community and, as such, is unconstitutional; the integration process constitutes an unconstitutional taking of property without just compensation and without due process of law and is thus unconstitutional; the integration process constitutes a taking of property by condemnation which is unconstitutional because it does not provide for a valuation of the property by a jury; the Commission's order was not based upon substantial evidence.
After receiving briefs and a hearing at which he permitted some testimony, the Chancellor dismissed Lindquist and Moore’s petition for judicial review. He determined that there was ample evidence to support the Commission’s findings. He refused to consider Lindquist and Moore’s other arguments because they had failed to raise them before the Commission. In *McQuay v. Arkansas State Board of Architects*, the Arkansas Supreme Court held that an administrative decision will not be set aside upon a ground, including a constitutional ground, not presented to the agency. As a consequence, the Circuit Judge refused to hear Lindquist and Moore’s constitutional arguments.

Lindquist and Moore have appealed to the Arkansas Supreme Court. On appeal they contend that the allegedly unconstitutional nature of the integration proceeding is such that it deprives the Oil and Gas Commission of jurisdiction over them and, according to Lindquist and Moore, notwithstanding the *McQuay* decision, lack of jurisdiction can be raised at any time.

It seems very unlikely that the Supreme Court will back away from *McQuay* far enough to allow Lindquist and Moore’s appeal to be considered on the merits. However, after considerable research and even some thought, this author has concluded that the integration process is completely constitutional.

The reason for that conclusion is founded in the rule of capture which was first recognized by the Arkansas Supreme Court as the law of the State of Arkansas in 1912:

In the case of *Brown v. Spillman*, 155 U.S. 65, in speaking of the characteristics of oil and gas as property, and the ownership thereof, the Supreme Court of the United States said:

Petroleum, gas and oil are substances of a peculiar character.

* * *

They belong to the owner of land, and are part of it so long as they

---

40 The Hon. J. Michael Fitzhugh.

are part of it or in it or subject to his control; but when they escape and go on to other land or come under another's control, the title to the former owner is gone. If an adjoining owner drills his own land and taps a deposit of oil or gas extending under his neighbor's field, so that it comes into his well, it becomes his property.\textsuperscript{42}

Reasoning that the rule of capture precluded a landowner from having a protectable property right in oil and gas temporarily in place under his property, the United States Supreme court upheld the Indiana conservation statute against constitutional challenges in Ohio Oil Company \textit{v. Indiana}.\textsuperscript{43} In that case, the court concluded that there was no "taking" because the rule of capture left the plaintiff with no property right which could not already be legally appropriated. Thus, the Indiana statute in question laudably protected, rather than took the plaintiff's interest.

While the Arkansas Supreme Court has never directly ruled upon the constitutionality of the entire Oil and Gas Conservation Act, it has upheld the constitutionality of compulsory field-wide unitization.\textsuperscript{44} Indeed, in \textit{Jameson v. Ethel Corporation},\textsuperscript{45} the Arkansas Supreme Court spoke of Arkansas' unitization laws in the following glowing terms:

While Arkansas' unitization laws are not, as previously noted, involved in this case, we do believe that the underlying rationale for the adoption of such laws, i.e., to avoid waste and provide for maximizing recovery of natural resources may be interpreted as expressing a public policy of this state which is pertinent to the rule of law in this case. Inherent in such laws is the realization that transient minerals such as oil, gas and brine will be wasted if a single landowner is able to afford secondary recovery processes while conversely acknowledging a need to protect each landowners rights to some equitable portion of pools of such minerals.\textsuperscript{46}

Lindquist and Moore also argue on appeal that the trial judge erred in refusing to disqualify William Wynne from representing the Oil and Gas Commission. They argue that Ark. Code Ann.

\textsuperscript{42} Osborne v. Arkansas Territorial Oil and Gas Company, 103 Ark. 175, 179-80, 146 S.W.2d 122 (1912).

\textsuperscript{43} 20 S.Ct. 576, 177 U.S. 190, 44 L.Ed. 729 (1900).

\textsuperscript{44} \textit{Williams v. Arkansas Oil and Gas Commission}, 307 Ark. 99, 817 S.W.2d 863 (1991).

\textsuperscript{45} 271 Ark. 621, 609 S.W.2d 346 (1980).

\textsuperscript{46} \textit{Jameson}, 271 Ark. at 628.
§ 15-71-104(a), which states that the Attorney General shall be the attorney for the Commission, is exclusive so as to preclude the Commission from contracting with private counsel. That seems to be an issue of first impression.

*Hales, Sunbelt, and Lindquist* will all be decided in the year 2000. Come back next year for the rest of the story.