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RECENT DEVELOPMENTS IN OIL AND GAS IN ARKANSAS

Thomas A. Daily
RECENT DEVELOPMENTS IN NATURAL RESOURCES LAW CIRCA 2004

By Thomas A. Daily

TEXAS SUPREME COURT HOLDS THAT LOST LEASE RIGHTS MAY BE REACQUIRED BY ADVERSE POSSESSION

Three oil and gas leases, executed in 1926, 1936 and 1937 were claimed by the lessee to be held by production. That certainly appeared to be the case. Indeed, a successful well had been drilled as recently as 1996. However, in 1998 the lessors sued, seeking a declaratory judgment that the leases had expired because of cessations in production of up to 153 days during the 1950's and 1960's.

An investigation confirmed that the lessors were factually correct. In all probability the leases had expired, if technically construed. Texas Court of Appeals so held with the result that the wells were awarded to the lessors. The Texas Supreme Court reversed and reinstated the leases on a theory of adverse possession.²

The Court held that since an oil and gas lease is a determinable fee, if it expired the lessors would have acquired the right to drill and develop by reversion. Thus, when the lessees continued to operate the wells adverse to that right, the period of prescription ran against the lessors and the lessees reacquired the leasehold. It is notable that the court so held in spite of the fact that a portion of the production was paid to the lessors as royalty.

The Texas Court appears to be the second to hold that adverse possession can reinstate a lost lease. It cites an obscure 1952 Fifth Circuit Court of Appeals decision

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

²Natural Gas Pipeline Company of America v. Pool, 120 S.W. 3rd 317 (Tex. 2003).
which reached the same result. The more recent case is anything but obscure. We should expect its logic to be argued in Arkansas, Oklahoma and other oil and gas producing jurisdictions as lessors become increasingly litigious.

A LITERALIST OKLAHOMA SUPREME COURT REFUSES TO CONSIDER INDUSTRY CUSTOM—Holds There Can Be But One Operator for All Unit Wells

The Maintenance of Uniform Interest Clause of the model form operating agreement is almost routinely violated in this day and age. Nevertheless, its violation sometimes leads to problems as occurred in a recent Oklahoma case, Pitco Production Company v. Chaparral Energy, Inc. Pitco and Chaparral are working interest owners in a unit originally operated by Cheyenne Petroleum Company. The unit contains two wells. In the second of those a working interest owner had assigned is borehole rights to Samson Resources company. The operator, Cheyenne, then sold its entire unit rights to Chaparral, thus triggering an operator’s election. Samson, which owned an interest only in the second well, supported Pitco in the election. As a consequence, Chaparral received a majority vote in only the first well.

Chaparral insisted it was entitled to operate both wells. Pitco sued to obtain operations of the second well. The Oklahoma Supreme court sided with Chaparral. It blamed the problem upon the prior violation of the Maintenance of Uniform Interest Clause and, in effect, decided the case as though the assignment to Samson had never occurred.

The court refused to consider testimony that differently operated wells within drilling units are commonplace, holding that such evidence of industry custom is relevant only when the contract itself is ambiguous, which this contract was not. The court did not say

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3 St. Louis Royalty Co. v. Continental Oil Co., 41 193 F.2d 778 (5th Cir. 1952)

what it would do in a case where a party sought to specifically enforce Maintenance of Uniform Interest, but its tone suggests that it might well support such a remedy.

**LOUISIANA COURT HOLDS SURFACE DAMAGES ARE NOT LIMITED TO VALUE OF SURFACE**

In two separate decisions, Louisiana appellate courts have refused to limit contractually mandated surface damages to the total value of the land. The opinions distinguish between tort remedies, where such limits are regularly imposed and the duty to restore, which is contractual, and thus unlimited, at least in Louisiana.

The Louisiana cases involved express lease clauses requiring surface restoration. The Arkansas Supreme Court has held that, even absent such a provision, there is an implied covenant to restore “to the degree practicable.” It will be interesting whether the Arkansas Court will use the “practicable” modifier to reach the opposite result from that reached in Louisiana, should such a case arise.

**OKLAHOMA CONTORT CASE AFFIRMED BY COURT OF APPEALS—NEXT STOP IS OKLAHOMA SUPREME COURT**

This is our third year to report upon *Kaiser-Francis v. Bridenstine*. It involves a jury’s award of almost $55 million actual and $19 million punitive damages against Kaiser-Francis after the remaining defendants had wisely settled with the plaintiff class, leaving Kaiser-Francis and lots of empty chairs for defendants. We discussed the case at both the 2002 and 2003 Natural Resources Law Institutes.

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5 *Hazelwood Farm, Inc. v. Liberty Oil and Gas Corp.*, 844 So. 2d 380 (2003) and *Corbello v. Iowa Production*, ____ So. 2. ____ (2003).

6 Oklahoma Court of Civil Appeals, Division III, case No. 97,117.

The news has not been good for Kaiser-Francis. The Oklahoma Court of Appeals affirmed the lower court in an unpublished opinion. The Oklahoma Supreme Court has agreed to review the case. Tune in next year for the final report.

ARKANSAS' DEFINITION OF "UNIT" CHANGED BY STATUTE AS INCREASED DENSITY BECOMES COMMONPLACE IN MIDDLE ATOKA--QUESTIONS REMAIN

Act 964 of 2003 amends A.C.A. § 15-72-302 to change the definition of "unit". The previous definition required the unit to consist of the largest area capable of being effectively and efficiently drained by a single well. The new definition of "unit" is simply a governmental section (640 acres) unless a larger or smaller unit is established by order of the Arkansas Oil and Gas Commission. This change recognizes the reality that geologic knowledge is constantly evolving and thus permits the Oil and Gas Commission to authorize additional wells within existing units and the formation of new units without limiting the number of wells therein. This act also allows the Oil and Gas Commission to form exploratory drilling units which are larger or smaller than governmental sections. The prior statute effectively required exploratory units to contain 640 acres.

One of the major reasons behind the drafting of Act 964 was to insure the legality of a practice which had already begun, multiple Middle Atoka completions within drilling units along the south edge of the Arkoma basin. That evolutionary process continued throughout the past year. All of Gragg field is now subject to 160 acre Middle Atoka well spacing, while Waveland, Booneville and Chismville field rules provide for 80 acre subdivisions. An application to extend 160 acre subdivision spacing to the entire Hartford interval in Mansfield Field will be scheduled for hearing in March, 2004. Other similar fields are sure to follow.
All questions are not yet resolved, however. For example, with the statutory change, why do we need subdivisions at all? Would it not be simpler to merely provide for a minimum distance between well bores producing from the same common source of supply and leave the rest of the decisions about well spacing to the geologists? Also, if new units are added to these fields via establishment of offsetting production, why should they not become automatically entitled to the increased density rules of the remainder of the field? Time will tell.

**2003 Legislative Session Enacts a Few New Laws Affecting the Oil and Gas Business**

The 2003 Legislative Session was pretty uneventful for the natural resources industry but there were a few new laws of interest.

Act 276 amends A.C.A. § 15-72-305 to increase the minimum amount of royalty payment which must be remitted from $25 to $100. The statute still requires royalty to be paid at least annually, regardless of amount.

Act 1279 amends A.C.A. § 26-37-314 to allow the surface owners to purchase any tax forfeited severed mineral interests beneath their lands from the state by paying the delinquent taxes only. The act also attempts to retroactively cure procedural irregularities in prior purported tax forfeitures of severed mineral interests. For that reason it is constitutionally suspect.

Act No. 757 requires all documents affecting title to real property except surveys and plats, to be in a standardized format. In order to be recordable, such documents, including oil and gas leases and assignments must:

- be on 8½" by 11" paper; have a 2½" margin at the right top of the first page, a ½" margin on the sides and bottom of all pages, and a 2½" margin at the bottom of the last page; have an area reserved on the top right of the first
Those readers who are exposed to Arkansas media are well aware that the state's supreme court, left with no other choice, declared the state's entire public education system unconstitutional because it is neither "equal" nor "adequate" as required by the state's constitution. In that opinion the court gave the State until January 1, 2003 to fix the problem. The State did not meet that deadline but, in a marathon special session ending in February, 2004, which resulted in the largest tax increase in Arkansas history, the legislature did enact some educational reforms. Virtually every imaginable tax bill was introduced in the special session including the following, which is part of both House bill 1,166 and Senate Bill 61:

SECTION 7. Arkansas Code Title 26, Chapter 58, Subchapter 1 is amended to add a new section to read as follows:


(a) Except as provided in subsections (b)-(d) of this section, in addition to the tax levied by § 26-58-111(5), there is levied an additional severance tax on natural gas at the rate of fifteen cents (15¢) per one thousand (1,000) cubic feet.

(b)(1) The additional severance tax on natural gas shall be at the rate of three cents (3¢) per one thousand (1,000) cubic feet on gas:

(A) Produced from a well that has been designated as an oil well by the Director of the Arkansas Oil and Gas Commission and determined by the Commissioner of Revenues to have a wellhead pressure of fifty (50) pounds per square inch gauge or less under operating conditions; or

(B) That has risen in a vaporous state through the annular space between the casing and tubing of the oil well and has been released through lines connected with the casing head if the gas has been determined by the Commissioner of Revenues to have a casing head pressure of fifty (50) pounds per square inch gauge or less under operating conditions.

(2) For purposes of applying the reduced tax rate provided in this subsection (b), an oil well being produced by the method commonly known as gas lift shall be presumed, in the absence of a determination to the contrary by the Commissioner of Revenues, to have a wellhead pressure of fifty (50) pounds per square inch or less under operating conditions.

(3) To qualify for the reduced tax rate provided in this subsection (b), an oil well must have a casing head pressure of fifty (50) pounds or less per square inch for the entire taxable month.

(c)(1) The additional severance tax on natural gas shall be at the rate of one and three-tenths cents (1 3/10¢) per one thousand (1,000) cubic feet on gas produced from a well that has been designated as a gas well by the Director of the Arkansas Oil and Gas Commission and determined by the Commissioner of Revenues to be incapable of producing an average of five hundred thousand (500,000) cubic feet of gas per day.

(2) To qualify for the reduced tax rate provided in this subsection (c), a gas well must be incapable of producing five hundred thousand (500,000) cubic feet of gas per day during the entire taxable month.

(d) The additional severance tax on natural gas shall be at the rate of seven cents (7¢) per one thousand (1,000) cubic feet on gas that is produced from a natural gas well that has an approved contract price of less than fifty-two cents (52¢) per one thousand (1,000) cubic feet.

(e) The additional severance tax levied under this section shall begin on March 1, 2004.

The bill did not pass, in no small part because the severance tax is one of those taxes which the legislature can only increase with a three-fourths vote. However, the issue is far from dead. Arkansas' sales tax has reached the choke point. It is likely that the 2005 regular session will revisit the whole tax structure, especially since the money raised by the special session does not fully fund the school's needs.

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9 Arkansas Constitution, Article 5, § 38.

10 One of the rare taxes which may be increased by simple majority vote.

11 Six percent before adding on local sales taxes.
Now it is time for a word from our sponsor. The Arkansas Bar Association has recently amended its constitution to expand the class of Associate Members of the Association to make eligible licensed attorneys in good standing in another state who are full time employees of business organizations doing business in Arkansas. Our beloved Natural Resources Law Institute should be a primary beneficiary of that change. Sadly, deaths and retirements have depleted the ranks of Arkansas resident natural resources lawyers. Now our Natural Resources Law Section, the sponsor of this annual meeting, can expand its membership to include all Arkansas’ other oil and gas lawyers, the ones of you who work in corporate offices in other states. As soon as I have your signed membership application, you will be free to leave the room.