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BIG NEWS FROM THE COMMISSION, AND THE LEDGE IS ON THE LOOSE: RECENT DEVELOPMENTS IN NATURAL RESOURCES LAW

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THOMAS A. DAILY

INCREASED DENSITY FOR THE MIDDLE ATOKA—CAN YOU SAY "UNIT SUBDIVISIONS"?

For years we have observed that, contrary to our prior primitive understanding of geology, there are places in the Arkoma Basin where a single well will not effectively and efficiently drain a 640 acre drilling unit. That is particularly the case in fields along the south flank of the basin. Wells drilled in those units produce from Middle Atoka sands, which are both structurally and stratigraphically disconnected.

Units in those fields already contain numerous wells which are permitted to produce from the same correlative formations. Their operators have shown them to be physically separated from one another. Still, it is unreasonable to require an operator to drill and complete a well before learning whether he can produce its gas.

For years the Arkansas Oil and Gas Commission has moved haltingly toward a solution. This time last year it seemed that the answer lay in a stripper well rule. That proposal was to exempt stripper wells from the so-called "rule of one."

There was much to like about the proposed stripper well rule. It promised to permit additional development of important Middle Atoka reserves while allowing

1 Member, Daily & Woods, P.L.L.C., Fort Smith, Arkansas.
2 e.g., Mansfield, Gragg, Booneville, Chismville and Waveland Fields.
3 Wells incapable of producing 60 MCF per day.
4 Only one well may produce at any one time from each common source of supply within the unit.
complete economic depletion of marginal wells. Unfortunately, the devil was in the
details. The gas industry and the Commission failed to reach a consensus over such
issues as whether the stripper provision should be applied to each separate completion
within a well or whether those completions had to meet the stripper test when added
together. Ultimately the Commission tabled the stripper proposal while inviting
operators to apply for relief on a case-by-case basis.

In the meantime the Commission has favored another approach to the
problem—unit subdivisions. Field rules for portions of Mansfield, Booneville, Chismville
and Gragg Fields have been amended to permit multiple unit wells to be produced from
a common reservoir as long as they are located in separate 160 acre unit subdivisions.
Thus, a separate well can tap a common source from each 160 acre quarter section
within a 640 acre unit. Importantly, royalty payment and equitable ownership of the
wells continue to be on a 640 acre basis.\(^5\)

In late January, 2003, SEECO, Inc. filed an application for 80 acre unit
subdivisions in Waveland Field. Waveland reservoir permeability is even worse than
the rest of Middle Atoka. That application will be heard the day before this paper is
presented.

Beelzebub still haunts the details. The Commission's unit subdivision orders are
not identical. Industry has yet to reach consensus on minimum spacing between wells.
Ultimately these inconsistencies will be resolved, but we are not there yet.

\(^5\)Unfortunately, working interest owners can alter homogenous working interest
ownership by going no consent or dealing in bore hole farmouts.
The Arkansas General Assembly meets biannually in odd-numbered years. 2003 is such a year. The Legislature is in Little Rock as we speak.

It is a typical legislative session. Bills have been filed which would increase severance taxes, regulate gas well compressors and effectively banish standard form contracts. As of February 13, 2003, at least eight bills of interest to the natural resources industry are pending. A summary of the status of those bills, downloaded from the Legislature's website follows:

**House Bill 1078**
**Sponsor: Verkamp**

TO AUTHORIZE THE OIL AND GAS COMMISSION TO ADOPT NOISE STANDARDS, SOUND LEVEL LIMITS, AND NOISE CONTROL RULES FOR NOISE RESULTING FROM THE OPERATION AND MAINTENANCE OF NATURAL GAS WELLS, PIPELINE COMPRESSORS.

1/15/2003 - 1/15/2003 2:06:50 PM - Read the first time, rules suspended, read the second time and referred to the Committee on AGRICULTURE, FORESTRY & ECONOMIC DEVELOPMENT - HOUSE

**House Bill 1319**
**Sponsor: Lendall**

TO REVISE THE RATES FOR SEVERANCE TAX ON NATURAL GAS PRODUCED IN THIS STATE.

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6HB 1319.
7HB 1078.
8HB 1281.
9www.arkleg.state.ar.us
1/31/2003 - 1/31/2003 12:23:30 PM - Read the first time, rules suspended, read the second time and referred to the Committee on REVENUE & TAXATION- HOUSE

Senate Bill 45
Sponsor: B. Johnson

TO RESTRUCTURE VARIOUS STATE AGENCIES INTO TEN (10) DEPARTMENTS.

2/12/2003 - 2/12/2003 3:09:51 PM - Read the first time, rules suspended, read the second time and referred to the Committee on STATE AGENCIES & GOVT'L AFFAIRS- HOUSE
2/11/2003 - 2/11/2003 3:54:19 PM - The vote by which the Emergency Clause failed was expunged
2/11/2003 - 2/11/2003 3:53:30 PM - The Clincher was Expunged
2/6/2003 - 2/6/2003 11:44:40 AM - Returned by the Committee, with the recommendation that it Do Pass
2/5/2003 - 2/5/2003 1:40:49 PM - Re-referred to Senate Committee on State Agencies and Governmental Affairs
2/5/2003 - 2/5/2003 12:53:45 PM - Amendment # 3 read the first time, rules suspended, read the second time and adopted, ordered engrossed.
2/5/2003 - 2/5/2003 12:50:00 AM - Withdrawn from Committee for purpose of amendment # 3
2/3/2003 - 2/3/2003 1:44:09 PM - Amendment # 2 read the first time, rules suspended, read the second time and adopted, ordered engrossed.
purpose of amendment # 2
1/15/2003 - 1/15/2003 4:26:15 PM - Read first time, rules suspended, read second time, referred to Senate Committee on State Agencies and Governmental Affairs

House Bill 1281
Sponsor: Ledbetter

THE "FAIR BARGAIN ACT OF 2003"

1/29/2003 - 1/29/2003 3:05:08 PM - Read the first time, rules suspended, read the second time and referred to the Committee on JUDICIARY COMMITTEE- HOUSE

House Bill 1076
Sponsor: Verkamp

AN ACT TO AMEND ARKANSAS CODE § 18-28-403 TO REDUCE THE TIME REQUIRED FOR UNCLAIMED MINERAL PROCEEDS TO BE PRESUMED ABANDONED.

2/12/2003 - 2/12/2003 1:21:09 PM - Returned by the Committee Do Pass
1/15/2003 - 1/15/2003 2:05:59 PM - Read the first time, rules suspended, read the second time and referred to the Committee on AGRICULTURE, FORESTRY & ECONOMIC DEVELOPMENT- HOUSE

Senate Bill 75
Sponsor: G. Jeffress

AN ACT TO ALLOW THE SURFACE OWNER OF PROPERTY TO PURCHASE THE TAX DELINQUENT SEVERED MINERAL RIGHTS TO THEIR PROPERTY.

1/22/2003 - 1/22/2003 2:28:37 PM - Read first time, rules suspended, read second time, referred to Senate Committee on Revenue and Taxation

House Bill 1383
Sponsor: Gillespie

AN ACT TO RAISE THE THRESHOLD FOR ANNUAL AGGREGATE PAYMENTS
FOR OIL AND GAS PROCEEDS TO ONE HUNDRED DOLLARS ($100).

2/10/2003 - 2/10/2003 1:09:46 PM - Read the third time and passed and ordered transmitted to the Senate.
2/5/2003 - 2/5/2003 2:52:30 PM - Read the first time, rules suspended, read the second time and referred to the Committee on AGRICULTURE, FORESTRY & ECONOMIC DEVELOPMENT - HOUSE

Senate Bill 154
Sponsor: Wilkinson

TO PROVIDE ECONOMIC STIMULUS TO THE COAL MINING INDUSTRY BY PROVIDING A TAX CREDIT TO MINING ENTERPRISES THAT MINE ARKANSAS COAL.

1/29/2003 - 1/29/2003 2:17:45 PM - Read first time, rules suspended, read second time, referred to Senate Committee on Revenue and Taxation

It is probable that additional developments will occur during the week between February 13 and the presentation of this paper. This portion of the paper will be updated to reflect those developments.

OKLAHOMA CONTORTIONIST CASE REACHES COURT OF APPEALS

At the 2002 Natural Resources Law Institute we began our discussion of Kaiser-Frances Oil Company v. Bridenstine. The facts are set out in some detail in the 2002

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10 Texas County, Oklahoma, District Court Case No. CJ-2000-1.
A company named Funk owned the leases, the wells and the gathering system. Funk's gathering system charged Funk's wells 45¢ per MCF for gathering as well as a "marketing fee." Funk went broke. Funk filed bankruptcy. Kaiser-Frances Oil Company bought Funk out of the bankruptcy.

The class of royalty owners sued Kaiser-Frances and others claiming it had been defrauded. The essence of the fraud was that Kaiser-Frances' predecessor\textsuperscript{12} deducted illegally from the royalty and then failed to so inform the lessors. After all of the other defendants settled with the class, the jury awarded the class almost $55 million actual damages and almost $19 million punitive damages against Kaiser-Frances\textsuperscript{13}.

The case is now in the Oklahoma Court of Appeals. Kaiser-Frances' brief cites numerous asserted errors committed by the trial court. Two of those are obviously the most important.

The first asserted error involves a jury instruction.\textsuperscript{14} Instruction 26 told the jury that:

1. No costs incurred to create a marketable product can be deducted from the royalty share.
2. Actual post-production enhancement costs (i.e. costs incurred after a

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\textsuperscript{11} 41\textsuperscript{st} Natural Resources Law Institute (2002), pp. 1 through 4.

\textsuperscript{12} Funk

\textsuperscript{13} Kaiser-Frances was entitled to a credit of about $14 million attributable to the amounts paid to the class by the settling defendants.

\textsuperscript{14} Jury Instruction 26.
marketable product has been obtained), which are incurred off the lease or unit, may be
deducted from royalty only if the working interest owner proves all of the following three
conditions:

(a) That the costs are associated with transforming an already
marketable product into an enhanced product;
(b) That the costs deducted were reasonable; and
(c) That the actual royalty revenues increased in proportion to the costs
assessed against the royalty owner.
(3) The working interest owner is not entitled to profit at the expense of the
royalty owner; therefore, any permitted recovery of actual costs shall be without
allowance of any profit to the working interest owner.
(4) To be marketable, the gas must be transported by the working interest owner
at its sole cost to the place of sale unless the place of sale is “a distant market.” That
is, the working interest owner must pay all costs of transporting the gas unless the
place of sale is at a “distant market.”
The trial court based Jury Instruction 26 upon its interpretation of Mittelstaedt v.
Santa Fe Minerals, Inc.\(^\text{15}\) Actually, as Kaiser-Frances points out in its appellate brief, a
better statement of the Mittelstaedt doctrine is as follows:
(1) Royalty is valued at the well.
(2) When the lessee has made marketable gas available at the well and there is
no market on the lease premises, the royalty owner must share in the reasonable cost

\(^\text{15}\) 954.P.2d 1203 (Okla. 1998)
of moving the gas to market.

(3) If the gas is marketable and there is a market for gas at the well, but the lessee turns down the wellhead market and instead elects to construct a pipeline to move the gas off the lease premises, the lessor must share in the cost of transporting, blending, compression and dehydration off premises but only to the extent the lessee proves the costs are reasonable and enhance the value of the product.

The difference between Jury Instruction 26 and Kaiser-Frances’ version of the rule of *Mittelstaedt* is obvious. Under Kaiser-Frances’ interpretation, if, as it contends, there was no market at the well, Funk was entitled to charge royalty owners something for transporting the gas. Even if the 45¢ per MCF which Funk charged was excessive, the judgment should not have been for the entire amount but only for the excessive portion of the charges.

Second, Kaiser-Frances argues that, under Oklahoma law, it should not be held liable for punitive damages when the offense was committed by a corporate entity which it later acquired. If the purpose of punitive damages is to punish and deter, that makes sense.

Interestingly, the appeal contains no challenge of the contortionism that occurred in the case. In Texas, at least, no breach of contract can also be a tort. In that state, fraud may be relevant in contract cases, because fraudulent concealment of the cause of action can toll the Statute of Limitations. However, if the case sounds in contract,

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16 See, *DeWitt County Electric Coop. v. Parks*, 1 S.W.3d 96 (Tex. 1999); *Southwestern Bell v. FDP Corp.*, 811 S.W.2d 572 (Tex. 1991); *Southwestern Bell v. Delanney*, 809 S.W.2d 493 (Tex. 1991); *Amoco Production Co. v. Alexander*, 622 S.W.2d 563 (Tex. 1981).
rather than tort, punitive damages cannot be recovered.

This is a case to keep our eye on. Perhaps it will be resolved by this time next year.

**ARKANSAS COURT OF APPEALS AFFIRMS INJUNCTION AGAINST USE OF WELL ROAD UNDER “ACCOMMODATION DOCTRINE”**

McFarland and Pittman own oil and gas leases on land owned by Taylor. The leases are at least 20 years old. A successful well was drilled on lands west of Taylor’s property in the mid 1980’s. For many years, the operators of that well used a road across Taylor’s property, apparently with Taylor’s permission. McFarland and Pittman acquired the oil and gas leases by assignment in 1998. In 1997 or 1998, Taylor’s son, daughter-in-law and their small daughter moved into a mobile home adjacent to the road. The Taylors sought an injunction against further use of the road by McFarland and Pittman because of annoying traffic to and from the well and potential danger to their granddaughter. They offered evidence that an alternate road could be utilized at a cost of “no more than $1,500.00.”

The trial court\(^1\) granted the injunction and the Arkansas Court of Appeals affirmed.\(^2\) Citing the Arkansas Supreme Court’s 1929 opinion in *Martin v. Dale*,\(^3\) the Court of Appeals held that, while an oil and gas lessee has a reasonable right of ingress and egress, he must use it in the manner “least injurious” to the surface owner.\(^4\)

\(^1\) The Honorable Larry Chandler


\(^3\) 180 Ark. 321, 21 S.W.2d 428.
Moreover, the Court stated that “what is reasonable is a question of fact.” Thus, the standard of review is whether the lower court’s determination of reasonableness was clearly erroneous. The court held that the lower court’s injunction requiring the use of the alternate road, even at an additional cost, was not clearly erroneous and thus should be affirmed.

Arkansas Court of Appeals Holds That 1938 Mineral Reservation Did Not Include Brine Under Strohacker Doctrine

In 1938, appellant’s predecessors conveyed the Union County lands in question to Lyon Oil Refining Company by quitclaim deed. The quitclaim deed excepted all oil, gas and minerals. Appellants contended that that exception included timber rights and bromine enriched brine. The Court of Appeals did not agree.20 It affirmed that timber is not a mineral, relying upon Bonds v. Carter21 and Arnold v. Grigsby.22 It then held that brine is a mineral.23 However, the court affirmed the lower court’s ruling that brine was not generally regarded to be a mineral in 1938 when the quitclaim deed was executed and that, therefore, under the rule in Missouri Pacific R.R. Co. v. Strohacker24 the reservation in the quitclaim deed in question was ineffective as a reservation of


22 158 Ark. 232, 249 S.W. 548 (1923)

23 Relying upon A.C.A. § 15-56-301(b).

24 202 Ark. 645, 152 S.W.2d 557 (1941)
brine. Unfortunately, the Court of Appeals opinion in *Riche* is an unpublished opinion.

It is available for download from the Arkansas Court of Appeals website. A link to the website is one of the “law links” available on the Arkansas Bar Association’s home page.\(^{25}\) Members of the Arkansas Bar Association can also access unpublished Arkansas Court of Appeals and Supreme Court Opinions through Arkansas VersusLaw, beginning approximately March 1, 2003.

**TEXAS COURT OF APPEALS REJECTS BROAD INTERPRETATION OF THE "MOTHER HUBBARD CLAUSE"**

Mary Greer owned the surface, a one-fourth interest in the minerals, an additional one-fourth royalty interest and all executory rights in a 20-acre tract in Wharton County, Texas. She also owned a one-fourth non-participating royalty interest in three other 20-acre tracts. Two of those tracts were pooled into a unit named the "AB 801 SEC 14/W M Bernard #14 Survey," also known as the Medallion Oil-Sixs Frels Unit.

Ms. Greer then executed a royalty deed covering “all of that land out of the AB 801 SEC 14/W M Bernard #14 Survey, Wharton County, Texas, known as the Medallion Oil-Sixs Frels Unit.” The royalty deed contained the following language “in addition to the above-described lands, it is the intent of this instrument to convey, and this conveyance does so include, all of Grantor's royalty and overriding royalty interest in all oil, gas and other minerals in the above-named county or counties, whether actually or properly described herein or not, and all of said lands are covered and

\(^{25}\) www.arkbar.com
included herein as fully, and in all respects, as if the same had been actually and properly described herein."

Moore was the assignee of the Grantee in the royalty deed. Moore contended that the above-quoted "Mother Hubbard Clause" made him the owner of Greer's right to receive royalty in her other tracts which were not in the Medallion Oil-Sixs Frels Unit. The Texas Court of Appeals disagreed. In Greer v. Moore\textsuperscript{26} the Court held that such Mother Hubbard language conveys only small pieces or strips which may exist without the knowledge of one or both of the parties or which should have been described in the granting clause but were not described due to an incorrect legal description.

SAME WEST VIRGINIA DECISION DISALLOWS ROYALTY DEDUCTION FOR POST PRODUCTION COSTS AND VOIDS "JUDICIAL ASCERTAINMENT CLAUSES"

Welleman v. Energy Resources, Inc\textsuperscript{27} is a classic example of the adage "bad facts make bad law." Energy Resources, the lessee, did everything wrong. The leases provided that Energy Resources would commence operations on or before January 1, 1993 or, if it did not, would pay delay rental of $1.00 per acre per year. Energy Resources did neither of those things. Therefore, its leases expired on January 1, 1993.

Apparently oblivious to that reality, Energy Resources re-established production from an old gas well on the premises in October 1993 and produced that well until November 1998. Energy Resources received $2.22 per MCF for gas sold from the well.

\textsuperscript{26} 72 S.W.3d 436 (Tex. App. Dist. 1 2002)

\textsuperscript{27} 210 W.Va. 200, 557 S.E.2d 254 (2001).
Royalties, on the other hand, were paid at a rate of 1/8th of 87¢ per MCF.

According to Energy Resources, the difference between $2.22 and 87¢ was “post-production costs.” In other words, because of the deduction for post-production costs, royalty owners were being paid royalty on less than 30% of the gross proceeds of the gas all pursuant to an expired lease. Energy Resources was pocketing the difference.²⁸ In their lawsuit, the Wellemans sought cancellation of the leases or, alternatively, a judicial determination that the leases had expired. The Wellemans also sought the disallowance of the post-production charges. Energy Resources raised the leases’ “judicial ascertainment clauses” as a defense. Each of those clauses reads:

This lease shall never be forfeited or terminated for failure of lessee to perform in whole or in part any of its express or implied covenants, conditions or obligations until it shall have been first finally judicially determined that such failure exists, and lessee shall have been given a reasonable time after such final determination within which to comply with any such covenants, conditions or obligations.

The Wellemans court found two perfectly good reasons to declare the judicial ascertainment clauses void. First, the court held that such clauses are violative of public policy since they deprive the lessor of fundamental remedies and thus could enable the lessee to coerce acquiescence in unconscionable lessee behavior. Second, the clauses promote judicial waste²⁹ since they require every dispute where the lessor is successful to be litigated twice, first to accomplish the judicial ascertainment and then to terminate the lease.

²⁸ At this point, it should be observed that had this writer represented the Wellemans, he would have contended that they were entitled to 8/8ths of $2.20 per MCF without deduction for costs of any kind because of Energy Resources’ bad faith trespass.

²⁹ Judicial economy being the desired objective.
The Welleman court then went on to absolutely forbid the deduction of any kind of post-production cost from the royalty share. The court's scholarship on this issue is a little shaky. For example, in concluding that its result is likewise the law in Oklahoma, it cites *Wood v. TXO Production Corp.* but fails to cite *Mittelstaedt v. Santa Fe Minerals, Inc.*, a case which substantially clarifies and somewhat modifies *Wood*. Also cited is the Arkansas Supreme Court's decision in *Hanna Oil and Gas Co. v. Taylor*. As has often been observed, the true rule of *Hanna v. Taylor* may be that once a lessee has established a course of interpretation of its lease, it may not unilaterally change that interpretation. Even if *Hanna v. Taylor* really is about deductibility of post-production costs, it was decided well before *Mittelstaedt* and the Arkansas court may well re-examine it in the light of *Mittelstaedt*.

**GAS OWNERS OPEN SUBSTANTIAL LEAD**
**IN BATTLE WITH COAL OWNER OVER COAL BED METHANE**

A hot current issue is whether coal bed methane is owned by the gas owner or the coal owner when those two owners are not one and the same. The coal owner has won the first two heats, Pennsylvania and Alabama.

The coal owner's early lead was not to last. The gas owner has won the last

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30 854 P.2d 880 (Okla. 1992)

31 *Supra.*

32 297 Ark. 80, 579 S.W.2d 563 (1988).

33 *United States Steel Corp. v. Hoge*, 468 A.2d 1380 (P.A. 1983)

battles. Coal bed methane gas is gas in Montana,\textsuperscript{35} Federal and Indian Lands\textsuperscript{36} and, very recently, Wyoming. The Wyoming case is \textit{Newman v. RAG Wyoming Land Company}.\textsuperscript{37}

Neither Arkansas nor Oklahoma has a reported decision on this issue although both states are seeing coal bed methane development in areas where both coal and gas are severed. The only Oklahoma case was decided in the District Court of Haskell County and never appealed.\textsuperscript{38} In that case, the district judge's well-reasoned opinion was that coal bed methane belongs to the gas owner.

Arkansas has absolutely no case law on this issue. However, there is a pending interpleader case\textsuperscript{39} which may result in a decision, if it is not settled.

\begin{footnotesize}

\textsuperscript{36} \textit{Amoco Production Co. v. Southern Ute Indian Tribe}, 526 U.S. 465, 119 S. Ct. 1719, 144 L.Ed.2d 22 (1999)

\textsuperscript{37}\textsuperscript{2002} Wy. 132, _____ P.3d. _____ (2002)

\textsuperscript{38} \textit{Roberts v. Ambassador Oil Corp.}, Haskell County District Court Case No. C-94-43.

\textsuperscript{39} \textit{CDX Gas, LLC v. Upland Industries, et al.}, Sebastian County Circuit Case No. CIV-2001-144 G (I).
\end{footnotesize}