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OIL AND GAS CASE LAW UPDATE

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TABLE OF CONTENTS

I. TITLE AND CONVEYANCING PROBLEMS...................................... 1

A. FUTURE LEASE CLAUSE EFFECTIVE TO CONVEY ONE-FOURTH (1/4TH) INTEREST IN ALL ROYALTIES AS TO FUTURE LEASES EVEN THOUGH THE FUTURE LEASE CLAUSE WAS IN CONFLICT WITH THE GRANTING, HABENDUM AND WARRANTY CLAUSES OF THE ROYALTY DEED WHICH CLAUSES RECITE THAT A 1/32ND ROYALTY INTEREST WAS CONVEYED.. 1

B. WHETHER URANIUM IS A MINERAL UNDER THE TERMS OF A RESERVATION IN THE DEED IN ISSUE WAS A QUESTION OF FACT, I.E., WHETHER ANY REASONABLE METHOD OF EXTRACTION WILL CONSUME, OR DEPLETE OR DESTROY THE SURFACE ESTATE........... 3

C. NEW LEASES TAKEN AFTER OLD LEASES HAD TERMINATED WERE NOT RENEWALS OR EXTENSIONS OF THE OLD LEASES AND OVERRIDING ROYALTY OWNER'S INTEREST IN OLD LEASES TERMINATED WITH OLD LEASES - ROYALTY OWNER HAD NO INTEREST IN NEW LEASES.. 4

D. ROYALTY INTEREST CONVEYED WAS A FRACTIONAL ROYALTY AND NOT A FRACTION OF ROYALTY... 4

II. THE OIL GAS AND MINERAL LEASE... 5

A. LEASE TERMINATION.. 5

B. LESSOR'S GAS ROYALTY ON GAS USED IN THE MANUFACTURE OF LIQUID PRODUCTS WAS TO BE BASED UPON THE MARKET VALUE OF THE GAS AT THE WELL HEAD AND NOT ON THE SALES VALUE OF THE PROCESSED LIQUID PRODUCTS.. 8

C. LESSOR'S ROYALTY ON SULPHUR EXTRACTED FROM SOUR GAS 9

D. LESSOR IS NOT ENTITLED TO ROYALTY SHARE OF LESSEE'S TAKE OR PAY SETTLEMENT AND LEASE, STANDING ALONE, DOES NOT CREATE DUTY OF GOOD FAITH AND FAIR DEALING 10

III. MINERAL, ROYALTY AND EXECUTORY INTERESTS 10

A. THE OWNER OF EXECUTIVE RIGHTS OWES THE NON-EXECUTIVE OWNERS THE IMPLIED OBLIGATION OF "UTMOST GOOD FAITH" IN LEASING OR DEVELOPING THE MINERAL ESTATE 10

B. A ROYALTY OWNER WHO RESERVED AN OVERRIDING ROYALTY ON A FARMED-OUT LEASE, COULD NOT RECOVER TAKE OR PAY PAYMENTS FOR THE SALE OF THE GAS ATTRIBUTABLE TO HIS INTEREST BECAUSE THAT INTEREST WAS NOT DEDICATED TO THE CONTRACT 12

IV. CONTRACTS AND TRANSFERS BY THE OIL AND GAS LESSEE 12

A. OPERATOR MAY BE AGENT FOR NON-OPERATOR IN ASSERTING TAKE OR PAY CLAIMS 12

B. OPERATOR IS AGENT FOR OTHER WORKING INTEREST OWNERS FOR PURPOSES OF MECHANIC'S AND MATERIALMAN'S LIEN FILED BY DRILLING CONTRACTOR WHO ONLY CONTRACTED WITH OPERATOR 13

C. ASSIGNEE UNDER ASSIGNMENT OF LEASE IN ISSUE WAS CONVEYED ALL TAKE OR PAY CLAIMS EVEN THOSE THAT ACCRUED BEFORE THE EFFECTIVE DATE OF THE ASSIGNMENT 14

D. ASSIGNEE WAS NOT OBLIGATED TO REIMBURSE PURCHASER OF GAS FOR SEVERANCE TAXES PAID ON BEHALF OF IT'S ASSIGNOR.......... 15

E. GAS CONTRACT DID NOT AS A MATTER OF LAW RESTRICT THE GAS PURCHASER'S MINIMUM TAKE OBLIGATION FOR TAKE OR PAY PURPOSES TO A PERCENTAGE OF THE WELLS' DAILY ALLOWABLES AS SET BY THE RAILROAD COMMISSION.......... 15

V. STATE REGULATION OF OIL AND GAS.......... 16

A. THE COMMISSION'S GAS PRORATION RULES AS TO A PIPELINE'S SPECIAL MARKETING PROGRAMS ARE VALID AND ARE NOT PREEMPTED BY FEDERAL STATUTES.......... 16

B. RULE 37 SPACING BASED UPON THE PREVENTION OF WASTE MUST BE BASED UPON WASTE OF OIL OR GAS AND NOT MERELY THE PREVENTION OF ECONOMIC WASTE TO THE LESSEE.......... 17

I. TITLE AND CONVEYANCING PROBLEMS

A. FUTURE LEASE CLAUSE EFFECTIVE TO CONVEY ONE-FOURTH (1/4TH) INTEREST IN ALL ROYALTIES AS TO FUTURE LEASES EVEN THOUGH THE FUTURE LEASE CLAUSE WAS IN CONFLICT WITH THE GRANTING, HABENDUM AND WARRANTY CLAUSES OF THE ROYALTY DEED WHICH CLAUSES RECITE THAT A 1/32ND ROYALTY INTEREST WAS CONVEYED

Luckel v. White, 819 S.W.2d 459 (Tex. 1991)

In *Luckel*, the Supreme Court overruled *Alford v. Krum*, 671 S.W.2d 870 (Tex. 1984) and held that the future royalty clause in the royalty deed was effective to convey a one-fourth (1/4th) interest in all royalties as to future leases. The Court gave effect to this future royalty clause even though it was in conflict with the granting, habendum, and warranty clauses of the lease. Each of those clauses expressly stated that only a 1/32nd royalty interest was conveyed. The courts below had followed the recent case of *Alford v. Krum, supra*, which held that if the granting clause was in conflict with the future leasing clause, that conflict was resolved in favor of the granting clause, because the granting clause was the "controlling language" and the "key expression" of intent. The future leasing clause was, the courts below reasoned, nothing more than a restatement, or confirmation, of the quantum of interest specified in the granting clause.

In the name of divining the intention of the parties, the Supreme Court discarded the well established "repugnant to the grant" rule of construction and applied what it perceived as a more modern, less arbitrary, "four corners" rule of construction. In the Court's view, the court below, and the Supreme Court in *Alford*, "failed to harmonize the provisions under the four corners rule and then erred in applying the 'repugnant to the grant' rule in disregard of the future lease clause."

As pointed out in a well reasoned dissent by Justice Phillips, it is inconceivable that the parties to the royalty deed in issue intended to convey a different royalty in future leases than the royalty conveyed in the granting clause. The royalty deed was executed in 1935, and the grantor was illiterate and executed the deed with her mark, X. Courts, in 1935 and for years later, were taking judicial notice that the usual royalty on oil and gas leases was 1/8th. It seems elementary that, given the date of the deed and the lack of sophistication of the grantor, the parties intended to convey only a 1/32nd royalty interest in present and future leases, i.e., 1/4 of 1/8 = 1/32nd. The Supreme Court vaults this almost certain fact by stating that the primary duty of a court, when construing such a deed, is to ascertain the intent of the parties from all of the language in the deed by a fundamental rule of construction known as the "four corners" rule. In its effort to determine the intent of the parties by the "four corners" rule of construction, the Court surely misses the true intention of the parties and needlessly muddles decades of well settled property law.

The royalty deed clauses in issue:

> ["Granting" Clause]
>
> I, Mary Etta Mayes, . . . [convey to] L. C. Luckel, Jr. *an undivided one thirty-second (1/32nd) royalty interest in* and to the following described property, . . .
>
> ["Habendum" and "Warranty" clauses]
>
> TO HAVE AND TO HOLD *the above described 1/32nd royalty interest* . . . unto the said L. C. Luckel, Jr. his heirs and assigns forever . . . *to warrant and forever defend* . . . *the said 1/32nd royalty interest* . . .
>
> ["Subject-to" clause]

> It is understood that said premises are now under lease originally executed to one Coe and that the grantee herein shall receive no part of the rentals as provided for under said lease, but *shall receive one-fourth of any and all royalties paid under the terms of said lease.*
>
> ["Future lease" clause]
>
> It is expressly understood and agreed that the grantor herein reserved [sic] the right upon expiration of the present term of the lease on said premises to make other and additional leases . . . and the grantee shall be bound by the terms of any such leases . . . [and] *shall be entitled to one-fourth of any and all royalties reserved under said leases.*
>
> [Final clause]
>
> It is understood and agreed that Mary Etta Mayes is the owner of one-half of the royalties to be paid under the terms of the present existing lease, the other one-half having been transferred by her to her children and by the execution of this instrument, Mary Etta Mayes conveyed one-half of the one-sixteenth (1/16th) royalty *now reserved by her.*

B. WHETHER URANIUM IS A MINERAL UNDER THE TERMS OF A RESERVATION IN THE DEED IN ISSUE WAS A QUESTION OF FACT, I. E., WHETHER ANY REASONABLE METHOD OF EXTRACTION WILL CONSUME, DEPLETE OR DESTROY THE SURFACE ESTATE

Crews v. Plainsman Trading Co., 827 S.W.2d 455 (Tex. App. - San Antonio 1992, *writ denied*)

The deed in issue conveyed all of the surface and 1/2 of the minerals to the plaintiffs reserving 1/2 of the minerals to grantors. Plainsman was the mense assignee of the grantors of the deed. The surface owner claimed to own all of the uranium, because it was a part of the surface estate and was not a mineral. The Court of Appeals reversed the trial court's summary judgment for Plainsman that the uranium was a mineral. The Court of Appeals

held that the deed was dated March 14, 1963, i.e., before June 8, 1983, and under *Friedman v. Texaco, Inc.*, 691 S.W.2d 586 (Tex. 1985), the surface owner will prevail, and the uranium is not a mineral, if it is proven that the uranium is at the "near surface" (200 feet or less) and any reasonable method of extraction will consume, deplete or destroy the surface, including any methods in existence as of the date of trial.

C. NEW LEASES TAKEN AFTER OLD LEASES HAD TERMINATED WERE NOT RENEWALS OR EXTENSIONS OF THE OLD LEASES AND OVERRIDING ROYALTY OWNER'S INTEREST IN OLD LEASES TERMINATED WITH OLD LEASES - ROYALTY OWNER HAD NO INTEREST IN NEW LEASES

Exploration Co. v. Vega Oil & Gas Co., 843 S.W.2d 123 (Tex. App.- Houston [14th Dist.] 1992)

Old leases had terminated for want of production, and the overriding royalty interest owner's interest terminated with the old leases. Although the instrument creating the ORRI provided that the ORRI interest would continue as to any renewals and extensions of the old leases executed within 1 year of the termination of the old lease, the new leases were not taken until more than 1 year after the termination of the old lease. The ORRI, therefore, terminated with the old leases.

D. ROYALTY INTEREST CONVEYED WAS A FRACTIONAL ROYALTY AND NOT A FRACTION OF ROYALTY

White v. White, 830 S.W.2d 767 (Tex. App.- Houston [1st Dist.], 1992, *writ denied*)

A lessee paid royalty based upon its interpretation that the royalty instrument conveyed a fraction of the lease royalty, i.e., 3/8th of 1/7 of the lease royalty fraction. The Court of Appeals held that the grant conveyed 3/8th of 1/7th of all (8/8th) of the production. The Court held that the granting language was unambiguous and, under the four corners

rule of construction enunciated by the Supreme Court in *Luckel v. White, supra*, that language must be given its clear and unambiguous meaning.

II. THE OIL GAS AND MINERAL LEASE

A. LEASE TERMINATION

Evans v. Gulf Oil Corp., 840 S.W.2d 500 (Tex. App. - Corpus Christi 1992)

Lease did not terminate for failure to produce in paying quantities during the two periods in issue since the well produced a profit over and above operating expenses. The Court of Appeals affirmed the trial court's granting of summary judgment that the lease had not terminated and restated the test for determining whether a well is producing profitably. The test is (1) whether the income attributable to the original working interest yields a profit after deducting operating and marketing expenses and (2) whether a prudent operator would continue to operate the well - not merely for speculative purposes but in the reasonable expectation of a profit from the continued operation of the well. To terminate the lease the lessor must prove both (1) and (2). If a well is profitable under part (1) then part (2) is not applicable.

In affirming the trial court, the Court of Appeals held that depreciation of a compressor needed for marketing the gas was properly a deductible expense but that depreciation was to be actual depreciation of the compressor not some arbitrary bookkeeping entry. The lessors contended that the lessee could have, but failed to have, the well reclassified as a " stripper well" qualifying for a much higher gas price under federal gas regulations. The Court held that the royalties that were actually paid were relevant but not the theoretical royalties the lessee might have paid but did not. In fact, royalty payments

are not part of the calculus of profitability.

Gray v. Helmerich & Payne, Inc., 834 S.W.2d 579 (Tex. App. - Amarillo 1992, *writ denied*)

The lessee's obtaining a Railroad Commission form W-1 drilling permit, before the end of the primary term of the lease, was not a prerequisite to perpetuating the lease since preliminary drilling operations, i.e., building location and roads, were begun 1 day before the expiration of the primary term of the lease. In the absence of express language in the lease making the obtaining of the drilling permit a prerequisite to the beginning of drilling operations, such preliminary operations held the lease until the actual drilling of the well began. The Court of Appeals declined to follow a Michigan Supreme Court opinion that required a drilling permit be issued before the end of the primary term for drilling operations to hold the lease beyond the primary term.

The lease drilling clause in issue provided that:

> Notwithstanding any contrary provision, if lessee commences mining, drilling or reworking operations on said land or on a consolidated leasehold estate at any time while this lease is in force, <u>this lease shall remain in force as provided by any provision hereof and for any longer time during which said operations, or any additional operations, are prosecuted with no cessation of more than sixty consecutive days.</u> (Emphasis added)

Ice Bros., Inc. v. Bannowsky, 840 S.W.2d 57 (Tex. App. - El Paso 1992)

Lease terminated due to cessation of production for more than 90 days, which cessation was established as a matter of law, because the gas purchaser had not taken any gas for over one year and had sealed the gas meter. The lessor had top leased the tract to another lessee who prosecuted the suit on lease termination. Since the lease had

terminated, the top lessee could not, as a matter or law, tortiously interfere with the contractual relationship between the lessor and original lessee.

Parten v. Cannon, 829 S.W.2d 327 (Tex. App. - Waco 1992, *writ denied*)

Lease did not terminate, because the lessee did not file a written designation, as required by paragraph 18 of the lease, allocating the portions of the lease held by production at the end of the primary term of the lease. There were five producing wells on the 658 acre leased premises when the primary term expired. The lessee, however, failed to file with the county clerk the written designation as to the acreage allocated to each producing well. Under the aforesaid paragraph 18, all acreage not held by production at the end of the primary term reverted to the lessor. In reversing the trial court's judgment that the lease had terminated for the lessee's failure to file the written designation, the Court of Appeals held that the requirement of filing a written designation of the acreage held by production, at the end of the primary term, was a covenant and not a condition that would terminate the lease. The Court distinguished the covenant to designate and file from the production and allotment provision of paragraph 18, which provision was a condition. That is, the lessee could only maintain the lease as to a maximum number of acres for each producing well depending upon the depth of the well - irrespective of whether the lessee designates and files the allotted acreage with the county clerk. Further, the Court held that the lessors repudiation of the lease by a letter, in 1986, demanding the lessee cease further drilling operations, had excused the lessee from further operations until the title dispute was resolved.

B. LESSOR'S GAS ROYALTY ON GAS USED IN THE MANUFACTURING OF LIQUID PRODUCTS WAS TO BE BASED UPON THE MARKET VALUE OF THE GAS AT THE WELL HEAD AND NOT ON THE SALES VALUE OF THE PROCESSED LIQUID PRODUCTS

Carter v. Exxon Corp., 842 S.W.2d 393 (Tex. App. - Eastland 1992)

Lessors brought an action against its lessee for underpayment of gas royalty on gas used in the extraction of gas liquids and as to gas used off the lease in gas lift operations by the lessee. The gas was processed by a third party, which third party returned after processing, 1/3 of the liquids to the lessee. The residue gas was sold in the interstate market and, thus, subject to federal price regulation during the relevant time period. The lessors sought payment based upon their royalty fraction of the sales price of the finished liquid products after processing and upon the value of the gas consumed in the processing operation based upon the intrastate market price of the gas. The Court of Appeals affirmed the trial court's judgment that the lessors take nothing as to their claims. The lease royalty clause provided that the lessors were to be paid royalty based upon the market value, at the well, of one-eighth on gas sold or used off the leased premises or for the extraction of gasoline or other product therefrom.

The Court followed *Sowell v. Natural Gas Pipeline Co. of America*, 789 F.2d 1151, *reh. den'd, en banc*, 793 F.2d 1287 (5th Cir. 1986) and held that the leases did not allow the market value of the gas used in the manufacture of liquid products to be calculated on the sales value of the processed liquid products. The Court held that the language "at the well" established the point at which the market value of the gas was to be determined, and that market value was to be calculated at the instant the gas was produced from the reservoir. The Court rejected the "liquids products valuation" method claimed by the lessors by which

method the lessors attempted to calculate market value of the gas at a post production step after the processing procedure. Further, the Court held that the Lessors were entitled only to the market value, at the well, of the gas consumed in the liquids processing, and the gas used in gas lifting on other leases, based upon the federally controlled interstate price and not based upon the intrastate market price for such gas.

C. LESSOR'S ROYALTY ON SULPHUR EXTRACTED FROM SOUR GAS

Schwartz v. Prairie Producing Co., Inc., 833 S.W.2d 629 (Tex. App. - Houston [1st Dist.] 1992, *writ dismissed*)

The Court of Appeals reversed the trial court's granting of an instructed verdict for lessee that the sulphur royalty clause of the lease, i.e., $1.00 per long ton, applied as to sulphur extracted in processing sour gas. The lessors contended that they were owed royalties, on the extracted sulphur, of one-fourth (1/4th) of the net proceeds received by the lessee from the sale of the sulphur. The Court of Appeals held that the royalty clause of the lease was ambiguous, reversed the trial court, and remanded the case to the trial court to determine the fact issue of whether, or not, the parties to the lease intended for the sulphur royalty clause or for the gas royalty clause to apply as to sulphur extracted from sour gas.

The royalty clause in dispute is a very common clause and reads that:

> 3. As royalty, lessee covenants and agrees . . . (b) To pay lessor on gas and casinghead gas produced from said land (1) when sold by lessee, 1/4 of the amount realized by lessee, computed at the mouth of the well, or (2) when used by lessee off said land or in the manufacture of gasoline or other products, the market value, at the mouth of the well, of 1/4 of such gas and casinghead gas; (c) To pay lessor on all other minerals mined and marketed or utilized by lessee from said

> land, one-tenth either in kind or value at the well or mine at lessee's election, except that on sulphur mined and marketed the royalty shall be one dollar per long ton.

D. LESSOR IS NOT ENTITLED TO ROYALTY SHARE OF LESSEE'S TAKE OR PAY SETTLEMENT AND LEASE, STANDING ALONE, DOES NOT CREATE DUTY OF GOOD FAITH AND FAIR DEALING

Hurd Enterprises, Ltd. v. Bruni, 828 S.W.2d 101 (Tex. App. - San Antonio 1992, *writ denied*)

The Court of Appeals held that a lessor is not entitled to gas royalty on the lessee's settlement of take or pay claims, and that the common oil, gas and mineral lease, and the facts of the case, did not create a special relationship that raised the lessee's duties to that of "good faith and fair dealing." Rather, the lessee's duties as to the implied covenants in the lease, including the duty to reasonably market the gas, were to act as a reasonably prudent operator under the same or similar circumstances, having due regard for both its interests and those of its lessor. The Court rejected a fiduciary duty and the duty of utmost good faith in marketing the gas. The Court refused to find a confidential relationship and rejected the lessors' argument that the leasehold relationship was analogous to a contract of insurance in which courts have found a confidential relationship. The Court refused to follow the recent Louisiana Supreme Court, and U. S. Fifth Circuit, decisions that have held that a lessor is owed royalty on take or pay settlements.

III. MINERAL, ROYALTY AND EXECUTORY INTERESTS

A. THE OWNER OF EXECUTIVE RIGHTS OWES THE NON-EXECUTIVE OWNERS THE IMPLIED OBLIGATION OF "UTMOST GOOD FAITH" IN LEASING OR DEVELOPING THE MINERAL ESTATE

Dearing, Inc. v. Spiller, 824 S.W.2d 728 (Tex. App. - Fort Worth, 1992, *writ denied*)

The owner of a one-half (1/2) mineral interest and the executive rights in a 600-acre tract then under lease, purchased the only existing well on the lease without notice to the non-executive owners of the one-half (1/2) mineral interest. The executive owner then let the well cease production which "killed" the existing lease on the tract. The executive owner then leased the tract to an affiliated company for no bonus and a 1/8th royalty even though the executive owner had received a written offer to lease the tract for a $100 per acre bonus and a 1/4th royalty. The case was tried to a jury, and the jury returned a verdict that the executive owner breached its duty of utmost good faith. The trial court entered judgment canceling the "insider leases", canceling of the executive owner's executive rights over the non-executive owner's mineral interest, and establishing that the non-executive was a cotenant with respect to the production from the tract. The judgment also ordered an accounting with respect to all of the production, and expenses, incident to the development of the tract under the "insider leases." Based upon the jury's verdict, the court also entered judgment for punitive damages of $300,000 against each defendant. The Court of Appeals affirmed the trial court's judgment in all respects. The Court relied upon *Manges v. Guerra*, 673 S.W.2d 180 (Tex. 1984), in holding that the executive owner has an implied obligation to exercise the utmost good faith in leasing the tract or in developing the tract. The executive owner was obligated to obtain the highest royalty possible and was prohibited from self dealing. The executive owner must exact for the non-executive owner every benefit that it exacts for itself. If the executive owner could obtain an overriding royalty, or cash bonuses, for the non-executive and itself, it has a duty to do so. In executive rights cases the Court held that the duty of utmost good faith is, in effect, a fiduciary duty.

B. A ROYALTY OWNER WHO RESERVED AN OVERRIDING ROYALTY ON A FARMED-OUT LEASE, COULD NOT RECOVER TAKE OR PAY PAYMENTS FOR THE SALE OF THE GAS ATTRIBUTABLE TO HIS INTEREST BECAUSE THAT INTEREST WAS NOT DEDICATED TO THE CONTRACT

Dorney v. Henderson Clay Products, Inc., 838 S.W.2d 314 (Tex. App. - Texarkana 1992)

An overriding royalty owner had farmed his leases out, reserving an overriding royalty. He brought an action against his "farmee" for the recovery of a portion of the take or pay settlement between the "farmee" and the gas pipeline company. Although the overriding royalty owner had the right to take his gas in kind, he failed to enter a contract with the pipeline purchaser of the gas; therefore, he could not recover any portion of his "farmee's" take or pay settlement.

IV. CONTRACTS AND TRANSFERS BY THE OIL AND GAS LESSEE

A. OPERATOR MAY BE AGENT FOR NON-OPERATOR IN ASSERTING TAKE OR PAY CLAIMS

Johnson v. American Cometra, Inc., 837 S.W.2d 711 (Tex. App. - Austin 1992)

The operator under a Joint Operating Agreement ("JOA") may be the agent for the non-operators in asserting take or pay claims in respect of gas sold to the pipeline purchaser when the non-operators are not parties to the contract but all of the gas is, nonetheless, sold to the pipeline purchaser. The Court of Appeals reversed the trial court's granting of summary judgment to the operator that the non-operators take nothing on their claims. The Court held that the proportionate reduction clause in the gas purchase contract did not bar the non-operators' take or pay claims. The proportionate reduction clause provided that, to the extent that the seller did not own all of the interests dedicated to the contract, then

the buyer's minimum gas purchase obligation would be reduced to the "same proportion that Seller's interest bears to the entire interest in the gas reserves therein." The operator owned no interest in the gas reserves, in issue, but was merely operating the wells under the JOA. The Court held that, the issue of whether the operator was acting as agent for the sale of the gas for the non-operators, was a question of fact. Further, if the operator was the agent for the sale of all of the gas, then the proportionate reduction clause of the gas contract would not nullify the take or pay claims against the gas purchaser. Moreover, the Court held that the operator owes the non-operators the duty to perform its marketing duties as "a reasonably prudent operator" and, if the operator acted as the agent in selling the gas for the non-operators, it owes the non-operators all of the fiduciary duties of an agent to its principal. The Court held that the scope of the operator's duties is one of fact and precluded trial court's granting of summary judgment.

Further, the Court held that the operator's duty to act as a reasonably prudent operator included the obligation to share take or pay settlements with non-operators. The Court establishes new duties on the operator as to the non-operator that cannot be squared with the terms and intent of the JOA. The Court held that non-operators were not consumers under the Texas Deceptive Trade Practices Act and, therefore, could not maintain an action against the operator under that act.

B. OPERATOR IS AGENT FOR OTHER WORKING INTEREST OWNERS FOR PURPOSES OF MECHANIC'S AND MATERIALMAN'S LIEN FILED BY DRILLING CONTRACTOR WHO ONLY CONTRACTED WITH OPERATOR

Bandera Drilling Co., Inc. v. Lavino, 824 S.W.2d 782 (Tex. App. - Eastland 1992)

The operator contracted for the drilling of a well with the drilling contractor. The

other working interest owners were not parties to the contract. In fact, at the time of entering the drilling contract, the operator was the only owner of record. The Court of Appeals held that the operator was the agent for the other working interest owners; such that, the contractor's mechanic's and materialman's lien was effective as to the non-operating working interest owners. The drilling contractor was a "mineral contractor" under the lien statute and the non-operating working interest owners were "mineral property owners." The drilling contractor did not become a "mineral subcontractor" as to the non-operating owners, merely because there was an operator between the drilling contractor and the non-operating interest owners. The case is in conflict with *Youngstown Sheet and Tube Co. v. Penn*, 363 S.W.2d (Tex. 1962).

C. ASSIGNEE UNDER ASSIGNMENT OF LEASE IN ISSUE WAS CONVEYED ALL TAKE OR PAY CLAIMS EVEN THOSE THAT ACCRUED BEFORE THE EFFECTIVE DATE OF THE ASSIGNMENT

OTC Petroleum v. Brock Exploration, 835 S.W.2d 792 (Tex. App. - Amarillo 1992, *writ denied*)

The assignor of a lease had take or pay claims against its pipeline purchaser which claims accrued prior to the effective date of the assignment. The Court held that the assignment in issue had express language that assigned all of the assignor's rights in all contracts to the assignee including contracts of purchase of the oil and gas. The Court correctly stated the general rule that personal property does not pass in the assignment of an oil and gas lease unless it is expressly conveyed, but the Court held that the assignment in issue contained express language that assigned all of the assignor's rights under the gas purchase contract, including all take or pay claims - irrespective of when they accrued.

Note: Personal property that is not conveyed, unless it is expressly conveyed, include runs on oil or gas which have accrued but are not due for payment, or have been suspended by the purchaser, and claims against the purchaser in respect of past production.

D. ASSIGNEE WAS NOT OBLIGATED TO REIMBURSE PURCHASER OF GAS FOR SEVERANCE TAXES PAID ON BEHALF OT ITS ASSIGNOR

Lone Star Gas Co. v. Mexia Oil & Gas, Inc., 833 S.W.2d 199 (Tex. App. - Dallas,1992)

Pipeline purchaser paid state severance taxes for the first lessee-seller as to certain leases dedicated to the gas purchase contract. That lessee then assigned the lease to its assignee

Pipeline purchaser then sought to recover those payments from the assignee of the leases under the indemnity provision of the gas purchase contract. The Court held that, although the assignment was expressly made subject to the gas contract, the assignee was not liable for the reimbursement of taxes that were due from its assignor. The Court reasoned that an assignee is not liable for breaches of the gas contract that took place before the effective date of the assignment.

E. GAS CONTRACT DID NOT AS A MATTER OF LAW RESTRICT THE GAS PURCHASER 'S MINIMUM TAKE OBLIGATION FOR TAKE OR PAY PURPOSES TO A PERCENTAGE OF THE WELLS' DAILY ALLOWABLES AS SET BY THE RAILROAD COMMISSION

HECI Exploration Co. v. Clayjohn Gas Co., 843 S. W.2d 622 (Tex. App. - Austin, 1992)

The seller, lessee, under a gas contract brought a take or pay claim against the buyer. The trial court granted buyer's motion for summary judgment and entered judgment that seller take nothing as to its take or pay claims. The Court of Appeals reversed and remanded the case to the trial court for a trail on the merits. The Court held that the gas contract did not restrict the buyer's minimum purchase obligations to 80% of the wells daily allowable. The Court further held that the seller was not barred from asserting its take or

pay claims for having failed to invoice the seller for claimed deficiencies immediately after the annual period when such deficiencies allegedly occurred. Time was not of the essence in the contract, and the invoicing provision was not a condition precedent to the seller asserting its take or pay claim but was only a covenant. The Court further held that the buyer had failed to prove that it had purchased all of the legally deliverable gas under applicable Commission ratable take rules.

V. STATE REGULATION OF OIL AND GAS

A. THE COMMISSION'S GAS PRORATION RULES AS TO A PIPELINE'S SPECIAL MARKETING PROGRAMS ARE VALID AND ARE NOT PREEMPTED BY FEDERAL STATUTES

The Railroad Commission of Texas v. Lone Star, 36 Tex. Sup. Ct. J., 391 (December 31, 1992)

A pipeline purchaser challenged the Commission's proration rules and orders in respect to the special marketing programs ("SMPs") of the pipeline. The Court of Appeals had held that the regulations in issue were invalid, because they were in conflict with federal law, namely, the Natural Gas Policy Act of 1978.

The Supreme Court reversed the Court of Appeals and held that the Commission's gas proration rules as to SMPs were valid and not preempted by federal law. The Court discussed the United States Supreme Court's preemption holding in *Transcontinental Gas Pipe Line Corp. v. State Oil & Gas Board of Mississippi*, 474 U.S. 409 (1986), but found that the Commission's rules met the requirements of *Transcontinental* and its progeny.

B. RULE 37 EXCEPTION BASED UPON THE PREVENTION OF WASTE MUST BE BASED UPON WASTE OF OIL OR GAS AND NOT MERELY THE PREVENTION OF ECONOMIC WASTE OF THE LESSEE

Schlachter v. Railroad Commission of Texas, 825 S.W.2d 737 (Tex. App. - Austin, 1992)

Lessee sought a Rule 37 exception to re-complete a well in a shallower formation. The re-completion would have been only 173 feet from the lease line when Rule 37 required 467 feet spacing between the well and the property line. The Railroad Commission denied the Rule 37 exception. The lessee appealed. The Court of Appeals affirmed the denial of the permit, because the well was not necessary to prevent the ultimate loss of oil to the State of Texas. That is, a well drilled at a regular location by the lessee would have recovered all of the hydrocarbons that would have been recovered by the proposed re-completion. The lessee argued that the Supreme Court, in *Exxon Corp. v. Railroad Commission*, 571 S.W.2d 737 (Tex. 1978), had created a new category of waste other than the physical waste of oil that would justify a Rule 37 exception. This new waste is economic waste. The Court rejected this interpretation of Exxon and held that the waste necessary to support a Rule 37 exception is physical waste, i.e., that the exceptionally spaced well is necessary to recover oil that would otherwise be lost. If a substantial amount of oil will be saved by the drilling of an exceptionally spaced well and that oil otherwise would ultimately be lost, such waste will justify and exception. If the drilling of a regularly spaced well, and will not recover oil or gas that would otherwise be ultimately lost, then such waste is merely economic waste and will not justify a Rule 37 exception.