ABA SECTION OF NATURAL RESOURCES, ENERGY, AND ENVIRONMENTAL LAW

TACTICAL AND LEGAL CONSIDERATIONS IN THE USE OF EXPERTS IN ENERGY AND ENVIRONMENTAL LITIGATION

POOLING AND UNITIZATION LITIGATION

E. R. NORWOOD
TAYLOR & NORWOOD
LIBERTY, TEXAS

MAY 10, 1991
WESTIN GALLERIA HOTEL
HOUSTON, TEXAS

TABLE OF CONTENTS

TABLE OF CONTENTS

I. SCOPE OF THE ARTICLE

This article will examine the legal standards for judging whether, or not, a lessee has complied with its implied duty to properly form a pooled unit under the pooling clause of an oil and gas lease, the remedies available to the lessor for the breach of that duty, and the evidence that has been found persuasive in suits to cancel pooled units.

This article will not address the lessee's express duties under the pooling clause; such as, whether the unit's size exceeds the unit size specified in the pooling clause or the lessee has properly filed the unit designation.

II. INTRODUCTION

Many oil and gas leases contain pooling clauses. The purpose of the pooling clause is to allow the lessee to pool two, or more, leases for the drilling of a unit well. A pooled unit is often necessary for the lessee to comply with the spacing and density rules of the conservation agency having jurisdiction. Under the common type pooling clause, the lessee may pool (1) to comply with the spacing and density requirement of the appropriate conservation agency or (2) to promote the conservation of the oil and gas in and under and that may be produced from the leased premises.

A common form of pooling clause reads as follows:

> Lessee is hereby granted the right, at its option, to pool or unitize any land covered by this lease with any other land covered by this lease, and/or with any other land, lease, or leases, as to any or all minerals or horizons, so as to establish

units containing not more than 80 surface acres, plus 10% acreage tolerance; provided, however, units may be established as to any one or more horizons, or existing units maybe enlarged as to any one or more horizons, so as to contain not more than 640 surface acres plus 10% acreage tolerance, if limited to one or more of the following: (1) gas, other than casinghead gas, (2) liquid hydrocarbons (condensate) which are not liquids in the subsurface reservoir, (3) minerals produced from wells classified as gas wells by the conservation agency having jurisdiction. If larger units than any of those herein permitted, either at the time established, or after enlargement, are required under any governmental rule or order, for the drilling or operation of a well at a regular location, or for obtaining maximum allowable from any well to be drilled, drilling, or already drilled, any such unit maybe established or enlarged to conform to the size required by such governmental order or rule. Lessee shall exercise said option as to each desired unit by executing an instrument identifying such unit and filing it for record in the public office in which this lease is recorded. Each of said options may be exercised by lessee at any time and from time to time while this lease is in force,

and whether before or after production has been established either on said land, or on the portion of said land included in the unit, or on other land unitized therewith. A unit established hereunder shall be valid and effective for all purposes of this lease even through there may be mineral, royalty, or leasehold interests in lands within the unit which are not effectively pooled or unitized. Any operations conducted on any part of such unitized land shall be considered, for all purposes, except the payment of royalty, operations conducted upon said land under this lease. There shall be allocated to the land covered by this lease within each such unit (or to each separate tract within the unit if this lease covers separate tracts within the unit) that proportion of the total production of unitized minerals from the unit, after deducting any used in lease or unit operations, which the number of surface acres in such land (or in each such separate tract) covered by this lease within the unit bears to the total number of surface acres in the unit, and the production so allocated shall be considered for all purposes, including payment or delivery of royalty, overriding royalty and any other payments out of production, to be the entire production of unitized minerals from the land

to which allocated in the same manner as though produced therefrom under the terms of this lease. The owner of the revisionary estate of any term royalty or mineral estate agrees that the accrual of royalties pursuant to this paragraph or of shut-in royalties from a well on the unit shall satisfy any limitation of term requiring production of oil or gas. The formation of any unit hereunder which includes land not covered by this lease shall not have the effect of exchanging or transferring any interest under this lease (including, without limitation, any delay rental and shut-in royalty which may become payable under this lease) between parties owning interests in land covered by this lease and parties owning interests in land not covered by this lease. Neither shall it impair the right of lessee to release as provided in paragraph 5 hereof, except that lessee may not so release as to lands within a unit while there are operations thereon for unitized minerals unless all pooled leases are released as to lands within the unit. At any time while this lease is in force lessee may dissolve any unit established hereunder by filing for record in the public office where this lease is recorded a declaration to that effect, if at that time no operations are being

conducted thereon for unitized minerals. Subject to the provisions of this paragraph 4, a unit once established hereunder shall remain in force so long as any lease subject thereto shall remain in force. If this lease now or hereafter covers separate tracts, no pooling or unitization of royalty interest as between any such separate tracts is intended or shall be implied or result merely from the inclusion of such separate tracts within this lease but lessee shall nevertheless have the right to pool or unitize as provided in this paragraph 4 with consequent allocation of production as herein provided. As used in this paragraph 4, the words "separate tract" mean any tract with royalty ownership differing, now or hereafter, either as to parties or amounts, from that as to any other part of the leased premises.

A lessee has very broad powers in creating, and amending, a pooled unit under the common pooling clause. Those broad powers have been limited by court decisions implying certain duties to the lessee's exercise of those powers. Early cases interpreting the nature of the pooling clause characterized it as an "anticipatory" provision which, must of necessity, be drafted in general terms. At the time of execution of the lease, neither the lessee nor the lessor has any way of knowing the geologic facts necessary for the lessee to apply the pooling power, and it is not practical for the lessee to await the

ascertainment of such facts prior to executing the lease. *E.g., Tiller v. Fields, 301 S.W.2d 185 (Tex. Civ. App. - Texarkana 1957, no writ).*

Courts have compared the lessee's broad anticipatory powers under the pooling clause to the broad powers of an agent acting for his principle, the lessor, in forming pooled units. Largely as the result of that agency analogy, the courts' have articulated the lessee's implied duty as one of "good faith" in forming pooled units. E.g. *Tiller v. Field, supra*. The courts' use of the agency analogy does not comport with the modern authority as to the nature of a lessee's implied obligations under an oil and gas lease; consequently, that analogy and its correlative "good faith" standard should be rejected. This article examines the nature of the lessee's implied duty to properly form a pooled unit and advances the premise that the proper standard for measuring a lessee's conduct in forming pooled units is the objective "reasonably prudent operator" standard and is not the subjective "good faith" standard.

III. THE LEGAL STANDARDS FOR DETERMINING WHETHER POOLED UNITS ARE VALIDLY FORMED

Although the lessee, of necessity, has broad powers in forming pooling units pursuant to the pooling clause of the lease, those powers are limited by the implication of certain duties in respect of the lessee's exercise of such powers. The exact nature of the lessee's implied duty has not been well defined by the courts. That is, the duty has been variously defined as the subjective standard of "good faith" and as the higher objective standard of the "reasonably prudent operator", and a few early cases even raised the lessee's duty to that of a fiduciary. Since the lessee's duty is an implied duty, that

duty should be defined by the same objective standard of the "reasonably prudent operator" as are the other implied obligations of a lessee.

A. Standard of "Good Faith"

The lessee's duty in forming pooled units has most often been stated to be that of "good faith." E.g., *Amoco Production Co. v. Underwood, 558 S.W.2d 509 (Tex. Civ. App. - Eastland 1977, writ ref'd n.r.e.); Elliott v. Davis, 553 S.W.2d 223 (Tex. Civ. App. - Amarillo 1977, writ ref'd n.r.e.)* and *Imes v. Globe Oil & Refining Co., 184 Okl. 79, 84 P.2d 1106 (1938).*

The good faith standard as applied by the Courts has, however, been something more than merely the subjective standard of the lessee's lack of any dishonesty, or ill motive, in forming a pooled unit. Kramer & Martin, *The Law of Pooling and Unitization Sec. 8.06.* There has been, unfortunately, some rather murky reasoning by the Courts in articulating the proper standard of measuring the lessee's conduct in forming pooled units. Typical of this problem is the Mississippi Supreme Court's reasoning in *Southwest Gas Producing Co. v. Seale, 191 So.2d 115 (Miss. 1966).* In *Seale*, the Court stated that:

> Moreover, the inclusion of 20.29 acres of the Johnson land in Seale Unit No. 1, although Hayes knew that a considerable portion of the Johnson land was dry, (Johnson No. 1, recently drilled, had demonstrated that), was not in accord with the standards of a reasonably prudent operator having in mind the interests of both lessor and lessee. We do not seek here to define the nature of the restrictions on the lessee's authority under a pooling clause, but we hold that under the stated circumstances, the lessee, Hayes, did not comply with the implied requirement in the lease that he act fairly and in good faith toward his lessor, Seale. Hayes' actions in this particular pooled unit (Seale No. 1) are not such as could be reasonably expected of an operator having regard for both his and his lessor's interest. They do not comport with the duty of good faith and fair dealing under the pooling

clause in the Seale lease and under the implied requirements of the lease. Likewise, the United States Court of Appeals for the Fifth Circuit, interpreting Louisiana law, has stated the standard as "a prudent operator" acting "in good faith." *Debetaz v. Chevron, 891 F.2d 562 (5th Cir. 1990).* Clearly, the standard cannot be both the subjective good faith standard and the objective reasonably prudent operator standard.

Although the lessee, of necessity, must be granted broad powers in forming pooled units, the exercise of that broad power should be limited by something more than the lessee's subjective good faith in forming the pooled unit. It would be a rare case, indeed, when the lessee could not present some geologic evidence to justify a pooled unit. The lessee is held to the objective standard of the reasonably prudent operator as to the lessee's other implied obligations under the lease. The lessee should, likewise, be held to the same objective standard of the reasonably prudent operator in forming pooled units.

B. Reasonably Prudent Operator Standard

As noted by the commentators Kramer & Martin in their work, *The Law of Pooling and Unitization,* while most cases vaguely articulate lessee's standard as that of "good faith", the standard is something more than the subjective standard of the absence of any dishonesty, or ill motive, in lessee's forming of the pooled unit. The authors state that:

> While all would agree that the pooling power must be exercised by the lessee in "good faith" as opposed to "bad faith" a precise definition of the standard of conduct to be followed by the lessee is difficult to articulate and apply. Reading the cases one encounters the terms "good faith" (which may be further divided into "subjective good faith" and "objective good faith") or "utmost good faith"; "reasonable prudent operator"; and "fiduciary". When one is distinguishing the "good faith" standard from the "reasonable prudent operator" standard, the good faith standard means that the lessee may do those acts beneficial to itself so long as the lessee is not acting in a way

> intentionally to harm the lessor, while the reasonable prudent operator standard is a higher standard of conduct that requires the lessee to do those acts that are mutually beneficial to lessor and lessee and perhaps, to refrain from those acts that are not mutually beneficial to lessor and lessee. Yet it must be admitted that the courts do not use the terms with any great precision in reference to the pooling clause, and a court may well use the term "good faith" in application to facts that clearly would meet the "reasonable prudent operator" standard. The fiduciary standard is yet a higher standard, requiring the lessee to take action favorable to the lessor even if not beneficial to the lessee. Most courts would reject the notion that the lessee owes a fiduciary duty to the lessor.

Since the limitation on lessee's power to pool under the express pooling clause of the lease is implied, that duty should be governed by the same objective reasonably prudent operator standard as the lessee's other implied obligations under the lease. *See, Amoco v. Alexander, 622 S.W.2d 563 (Tex. 1981).*

By way of analogy, a lessee's implied duty to market the hydrocarbons produced from the lease has been defined as that of "good faith." *Le Cuno Oil Co. v. Smith, 306 S.W.2d 190 (Tex. Civ. App. - Texarkana 1957, writ ref'd n.r.e.), cert. denied, 356 U.S. 974; Amoco Production Co. v. First Baptist Church of Pyote, 579 S.W.2d 280 (Tex. Civ. App. - El Paso 1979), writ ref'd n.r.e., per curiam, 611 S.W.2d 610 (Tex. 1980).* Nonetheless, the Texas Supreme Court has recently approved a jury instruction which defined the lessee's implied duty to market as that of a reasonably prudent operator having due regard both for the interest of the lessee and the lessor. *Cabot Corp. v. Brown, 754 S.W.2d 104 (Tex. 1987).* The lessee's implied duty to the lessor in forming pooled units should also be that of the reasonably prudent operator having due regard both for the interest of the lessee and the lessor. There is no logical basis for setting the standard for lessee's conduct as

to the implied covenants of protection, development, and marketing as the objective reasonably prudent operator standard and setting the standard for the lessee's implied duty in pooling as the subjective standard of good faith. *See generally*, Williams & Meyers, *Oil & Gas Law, Sec. 806.2*, wherein the authors make a most eloquent and forceful argument that the subjective good faith standard should be rejected as the standard for lessee's performance of its implied covenants under the lease, to wit:

> Just as the absolute standard does too much, the good faith standard does too little. A test of good faith performance, being subjective, has two practical defects: (1) it is difficult to apply (how does the fact finder determine *bona fides*?); and (2) its meaning is vague (what does good faith mean in respect to oil and gas operations?). But more important, the good faith test fails to meet the requirements of the principle of cooperation upon which implied covenants ultimately rest. The cooperation principle requires that the parties act in such a manner as to carry out the purpose of the contract. The purpose of an oil and gas lease is the exploitation of the minerals under the leasehold. That purpose is not satisfied by mere good faith action by the lessee; that is, the lessee's refraining from fraudulent conduct will not by itself promote the exploitation of the leasehold. For the leasehold to be operated properly, the lessee must conduct those operations customary in the industry under the circumstances. In short, realization of the purposes of the lease requires *reasonable* efforts toward that end, not merely the avoidance of dishonest conduct contrary thereto. For this reason the overwhelming majority of jurisdictions apply a standard of performance intermediate between absolute duty and good faith action. This test of compliance with the implied duties is the prudent-operator standard, discussed in the following subsection (§806.3).

The Texas Supreme Court's holdings' in *Amoco Production Co. v. Alexander, supra,* and in *Cabot Corp. v. Brown, supra,* indicate that the proper test for a lessee's conduct as to all of its implied obligations under an oil and gas lease is the objective reasonably prudent operator standard. That test should also be applied to lessee's implied obligations under the pooling clause of the lease - to do otherwise fails to properly advance the

purposes of the lease and fails to adequately protect the lessor. The subjective "good faith" standard is not enough; a lessee's mere avoidance of dishonest conduct under that subjective standard is not enough. There is no logical basis for the imposition of a different standard as to the lessee's traditional implied covenants under the lease and the lessee's implied duty in forming pooled units. Most of the cited cases are applying more than a subjective "good faith " standard although they use the term "good faith" in defining the standard. E.g., *Debetaz v. Chevron, supra;* and *Southwest Gas Producing Co. v. Seale, supra*. The time has come for the clear articulation of the appropriate standard as that of the reasonably prudent operator; it is the standard being applied, and it should be properly defined by the Courts.

C. Fiduciary Standard

Several cases have, in dicta, stated that the lessee owes its lessor a fiduciary duty of the utmost good faith toward the lessor in exercising the power granted under a lease pooling provision. E.g., *Expando Production Co. v. Marshall, 407 S.W.2d 254 (Tex. Civ. App.- Fort Worth 1966, writ ref'd n.r.e.)*. The fiduciary standard is inappropriate and has recently been rejected by a Texas court in *Vela v. Pennzoil Producing Co., 723 S.W.2d 199 (Tex. Civ. App. - San Antonio 1986, writ ref'd n.r.e)*. In *Vela*, in rejecting the fiduciary standard, the Court stated that:

> Although it has been said that the lessee has a fiduciary obligation in the exercise of the pooling power, it is submitted that the lessee is not a fiduciary and that such a standard is entirely too strict. This is so because the lessee has not undertaken to manage and develope the property for the sole benefit of the lessor. The lessee has a substantial interest that must be taken into account, and it would not be required to subordinate its own interest to the interest of the lessor. Since its interests are frequently in

> conflict with those of its lessor, it must exercise its power in good faith, taking into account the interest of both the lessor and lessee.

723 S.W.2d at 206.

Moreover, the Texas Supreme Court in *Texas Oil & Gas Corp. v. Hagen* issued an opinion that held that the oil and gas lease created no fiduciary relationship between the lessee and lessor. *31 Tex. Sup. Ct. J. 140 (Tex. 1987).* That opinion was later withdrawn, and the judgment of the intermediate court of appeals set aside, pursuant to a settlement agreement reached by the parties and approved by the trial court. *Texas Oil & Gas Corp. v. Hagen, 760 S.W.2d 960 (Tex. 1988).* In view of *Vela,* and the Supreme Court's reasoning in the *Hagen* opinion, it is highly unlikely that a Texas court would hold the lessee to a fiduciary standard in forming pooled units. The fiduciary standard is inappropriate and should be rejected by the courts in favor of the reasonably prudent operator standard.

D. Whether the Lessee has Breached its Implied Duty to Properly Form a Pooled Unit is a Fact Question to be Determined by the Finder of Fact

The question of whether the lessee has breached its implied duty to properly form a pooled unit is a fact question and summary judgment on that fact issue is not appropriate. *Elliot v. Davis, supra*; and *Vela v. Pennzoil Producing Co., supra.*

The following is a proposed form of a jury question applying the reasonably prudent operator standard.

PROPOSED JURY QUESTION:

Do you find, from a preponderance of the evidence, that the lessee failed to pool the leased premises as a reasonably prudent operator would have pooled the leased

premises, under the same or similar circumstances, having due regard for the interest of the lessee and the lessor.

E. The Date of Creation of Unit as the Proper Time to Judge Lessee's Conduct in Creating Unit

The lessee's conduct in forming the pooled unit should be judged as of the date of the creation of the pooled unit taking into account the facts and circumstances known, or that should have been known, by the lessee at that time. *Southwest Gas Producing Co. v. Seale, supra.*

IV. REMEDIES FOR BREACH OF THE LESSEE'S IMPLIED DUTY IN FORMING POOLED UNITS

The most obvious remedy for the breach of the lessee's implied duty to properly form the pooled unit is a declaration of the court that the unit was improperly formed and a declaration cancelling the unit. Those remedies can be obtained in a declaratory judgment action against the lessee and the other interest owners in the unit. An accounting and damages are also a proper remedies for the lessor of the well site tract since cancelling the unit will only prospectively protect the lessor; the cancellation will not make the lessor whole as to the production obtained prior to the cancellation of the unit.

Attached as Appendix 1 is a form of petition wherein a lessor, as plaintiff, seeks a cancellation of a pooled unit and damages.

A. Declaration Cancelling the Unit

The remedy in Texas for the breach of the lessee's implied duty to properly form the pooled unit is a declaration of the court cancelling the unit and holding the unit for naught and removing the cloud on lessor's title cast by such improperly formed unit.

Amoco Production Co. v. Underwood, supra.

B. Lessor Whose Lease is Not the Well Site Tract

The lessor whose lease is not the well site tract, in addition to a declaration cancelling the unit and holding it for naught, and removing the cloud from lessor's title cast by such unit designation, may be entitled to the cancellation of his lease if that lease is beyond it primary term and the lease was being held only by production from the cancelled unit. *Amoco Production Co. v. Underwood, supra.*

C. Lessor Whose Lease is the Well Site Tract

The remedy for the lessor whose lease is the well site tract, in addition to a declaration cancelling the unit and holding it for naught, and removing the cloud from lessor's title cast by such unit designation, should also be entitled to recover damages from the lessee in an amount equal to the royalties the lessor would have received had the unit been properly formed less the royalties actually paid to the lessor plus prejudgment interest and attorney's fees. *Southwest Gas Producing Co. v. Seale, supra.*

In *Seale*, the trial court had cancelled the challenged 40 acres Seale No. 1 oil unit, because it included a 20.29 acres Johnson tract although most, if not all, of that 20.29 acres tract had been conclusively shown to be nonproductive by the drilling of a dry hole on that tract. In addition to cancelling the unit, the trial court cancelled the lease on the well site tract. The Mississippi Supreme Court reversed the trial court's cancellation of the well site lease, and remanded the case to the trial court with instructions that the trial court determine how much, if any, of the 20.29 acres Johnson tract would have been

included in a unit by a reasonably prudent operator exercising the duty of fair dealing and good faith with his lessor, Seale. On remand, the trial court was further instructed to award the lessor, Seale, damages in an amount calculated on all production from the Seale No. 1 well, from the date of first production, based upon Seale's new unit participation factor, after the trial court has redrawn the 40 acre unit, less the royalties previously paid to Seale in respect of production from the Seale No. 1 well.

Under Texas law, and the law of most other jurisdictions, the lessee's breach of its implied obligations under the lease will not support the equitable remedy of cancellation of the lease unless the lessor's damages are impossible to ascertain. *Texas Pacific Coal & Oil Co. v. Barker, 6 S.W.2d 1031 (Tex. 1928);* and *Christie, Mitchell & Mitchell Co. v. Howell, 359 S.W.2d 658 (Tex. Civ. App. - Fort Worth 1962, writ ref'd n.r.e.).* Although the cases reserve to the courts the equitable remedy of an "outright" cancellation of the lease, there are no reported Texas cases in which a court has decreed an outright cancellation for a lessee's breach of its implied obligations under the lease. Cancellation of the well site lease for lessee's breach of its implied duty to properly form a pooled unit is inappropriate, and it is highly unlikely a Texas court would grant such relief. Cancelling the improperly formed unit, redrawing the unit, and awarding the lessor damages in respect of past production based upon the increased royalties the lessor would have received had the original unit been properly formed is the proper remedy for the lessor of the well site tract. There are no reported Texas cases which have dealt with the remedies available to the lessor of the well site tract when that tract has been included

in an improperly formed pooled unit; however, it is submitted that Texas should adopt the remedy fashioned by the Mississippi Supreme Court in *Southwest Gas Producing Co. v. Seale, supra.*

D. Attorney's Fees and Pre-Judgment Interest

1. Attorney's fees

In Texas, and most other jurisdictions, the prevailing lessor may recover its attorney's fees, if properly plead and proved, as a matter of right, but the lessor in Texas must make a proper presentment of the claim for breach to the lessee thirty (30) days before trial. *Tex. Civ. Prac. & Rem. Code sec. 38.001 et seq.;* and *U. S. Steel Corp. v. Whitley, 636 S.W.2d 465 (Tex. Civ. App. - Corpus Christi 1982, writ ref'd n.r.e.)*

2. Pre-Judgment Interest

In Texas, the prevailing lessor should recover prejudgment interest at the rate of ten (10) percent per annum on any damages awarded for the breach of the lease contract including the implied obligation of the lessee to properly form a pooled unit. *Perry Roofing Co. v. Olcott, 744 S.W.2d 929 (Tex. 1988);* and *Tex. Rev. Civ. Stat. Ann. art. 5069-1.05.* In Texas state practice, statutory or contractual, interest may be recovered with only a prayer for general relief, but prejudgment interest sought at common law as an element of damages must be plead specifically. *Vidor Walgreen Pharmacy v. Fisher, 728 S.W.2d 353 (Tex. 1987)*; and *Benavidez v. Isles Construction Co., 726 S.W.2d 23 (Tex. 1987).* In federal court, prejudgment interest need not be pleaded specifically; a general prayer for relief will support the recovery of prejudgment interest. *Consolidated Cigar v. Texas Commerce*

Bank, 749 F.2d 1169 (5th Cir. 1985).

E. Joinder of Parties

Under Texas practice, it is necessary to join as parties all interest owners in the challenged unit, i.e., all working interest owners, overriding royalty owners, royalty owners and the owners of production payments, or other interests of any nature, since each of those interests would be effected by the dissolution of the unit. E.g., *Veal v. Thomason, 159 S.W.2d 472 (Tex. 1942).*

F. Factors Giving Rise to Claims that the Lessee has Improperly Formed a Pooled Unit

There are only three reported cases in which the lessor has prevailed and shown that the lessee breached its implied obligation to properly form the pooled unit! *Amoco Production Co. v. Underwood, supra; Southwest Gas Producing Co. v. Seale, supra* and *Imes v. Globe Oil & Refining Co., supra*. The facts of those three cases should be studied carefully by the practitioner. The remainder of the reported unit cancellation cases have found that the lessees did not breach their implied duty to properly form the pooled units. Those cases are compiled and discussed in Williams & Meyers, *Oil and Gas Law, Sec. 607, et seq.,* and Kramer & Martin, *Law of Pooling and Unitization, Sec. 8.06.* The following are facts that have given rise to pooling clause disputes:

1. Leases near end of primary term when unit formed;

2. Irregular shape of the unit, i.e., gerrymandered to include maximum number of leases;

3. The unit included nonproductive acreage which was known as probably

nonproductive at the time of the formation of the unit;

4. The lessee has a smaller royalty burden as to certain of the pooled acreage;

5. Productive acreage on the well site lease was excluded from the unit to make room for possibly unproductive acreage from adjacent leases;

6. The well site lease contained enough productive acreage to obtain a full proration unit without the necessity of pooling additional acreage;

7. The pooling of non productive acreage to create a buffer area to prevent the drilling of "fringe" wells; and

8. The lease pooling provision as to the leases pooled with the well site lease contain a provision that a minimum number of acres be included in any pooled unit, i.e., that at least 1/2 of the leased acreage be included in any pooled unit.

G. Marshalling the Evidence

Every case in which the lessor claims that the lessee breached its implied duty to form the pooled unit will require expert testimony. The respective experts for the parties will base their testimony upon such evidence as is listed below:

1. Seismic data and seismic maps;

2. Geologic structure and isopaches maps;

3. Production history of the wells in the field;

4. The interoffice correspondence and correspondence between the working interest owners as to the need for forming the unit.

5. The volumes of oil and gas production from the unit in issue and the value of the production; and

6. All filings and orders of the conservation agency in respect of the unit and adjacent wells.

This evidence will need to be requested as early in discovery as possible and, as in all cases, the sooner the attorney selects and begins working with an expert in gathering and analyzing the aforesaid evidence the better.

The cases will turn upon expert testimony as to whether, under the facts and circumstances known at the date of the formation of the unit, the lessee formed the unit as a reasonably prudent operator would have formed the unit under the same circumstances having due regard for the interest of the lessor and lessee.

In essence, the lessor's expert will testify that, based upon his review of the facts and circumstances surrounding the formation of the pooled unit, the lessee failed to form the pooled unit as a reasonably prudent operator having due regard to the interests of the lessee and lessor. The lessee's expert will, conversely, testify that, under the circumstances, the lessee formed the pooled unit as would a reasonably prudent operator having due regard for the interests of the lessee and lessor. A fact issue is thereby raised and must be decided by the fact finder. The reported cases show rather clearly that the lessor has a substantial burden, and long odds, in attacking a pooled unit. The burden and the odds are prohibitive if the lessee is held only to the subjective good faith standard rather than the appropriate reasonably prudent operator standard.

NO. 1

JOHN DOE	§	IN THE DISTRICT COURT OF
	§	
VS.	§	HARRIS COUNTY, TEXAS
	§	
BIG OIL COMPANY	§	_____ JUDICIAL DISTRICT

PLAINTIFF'S ORIGINAL PETITION

TO THE HONORABLE JUDGE OF SAID COURT:

COMES NOW, JOHN DOE ("Doe"), plaintiff herein, complaining of BIG OIL COMPANY ("Big Oil"), defendant herein, and for cause of action against such defendant would show the Court the following:

1. Plaintiff, JOHN DOE is a citizen and resident of the State of Texas.

Defendant, BIG OIL COMPANY, is a Texas corporation, whose registered agent for the service of process is Richard Smith, which registered agent may be served with process at 123 A Street, Suite 1, Houston, Harris County, Texas 77002.

2. This is an oil and gas case brought by plaintiff seeking judgment of this Court declaring that two (2) pooled gas units comprised of oil, gas and mineral leases covering property located in Harris County, Texas were wrongfully formed and are void, *ab initio*, as to the plaintiff. Plaintiff also seeks judgment of this Court for damages in an amount equal to the difference in the royalties that plaintiff should have been paid, had the two pooled units not been formed and the amount of the royalties that defendant has paid to plaintiff. Plaintiff would further show that the amounts in dispute in this suit are greatly in excess of the minimum jurisdictional limits of this Court, and that this Court has jurisdiction and venue to determine the rights of the parties herein.

3. Plaintiff is, and at all times relevant to this petition was, the owner of an undivided mineral interest in that certain tract of land located in Harris County, Texas, described as follows:

> 640 acres of land, more or less, being all of the Daniel Boone Survey, A-1 in Harris County, Texas.

4. On September 18, 1986, with an effective date of November 30, 1986, plaintiff, John Doe, leased to Big Oil's predecessor in title, the above captioned tract of land, by executing an oil and gas lease ("Doe Lease"), for the purpose, and with the explicit right, of operating and drilling for oil and gas. The lease was for a primary term of three (3) years from the stated effective date, November 30, 1986, and for as long thereafter as oil and gas were produced in paying quantities. The Doe Lease was recorded in Vol. 714, Page 191, of the Deed Records, Harris County, Texas.

5. Paragraph 4 of the Doe Lease provides that the lessee, or his assigns, may pool, or unitize, the land described in the Doe Lease with other lands covered by the Doe lease and/or with any land, lease or leases as to any or all minerals or horizons. Specifically, paragraph four (4) of the Doe Lease provides that:

> Lessee is hereby granted the right, at its option, to pool or unitize any land covered by this lease with any other land covered by this lease, and/or with any other land, lease, or leases, as to any or all minerals or horizons, so as to establish units containing not more than 80 surface acres, plus 10% acreage tolerance; provided, however, units may be established as to any one or more horizons, or existing units may be enlarged as to any one or more horizons, so as to contain not more than 640 surface acres plus 10% acreage tolerance, if limited to one or more of the following: (1) gas, other than casinghead gas. (2) liquid hydrocarbons (condensate) which are not liquids in the subsurface reservoir, (3) minerals produced from wells classified as gas wells by the conservation agency having jurisdiction. If larger units than any of those herein permitted, either at the time established, or after enlargement, are required under any governmental rule or order, for the

drilling or operation of a well at regular location, or for obtaining maximum allowable from any well to be drilled, drilling, or already drilled, any such unit may be established or enlarged to conform to the size required by such governmental order or rule. Lessee shall exercise said option as to each desired unit by executing an instrument identifying such unit and filing it for record in the public office in which this lease is recorded. Each of said options may be exercised by lessee at any time and from time to time while this lease is in force, and whether before or after production has been established either on said land, or on the portion of said land included in the unit, or on other land unitized therewith. A unit established hereunder shall be valid and effective for all purposes of this lease even though there may be mineral, royalty, or leasehold interests in lands within the unit which are not effectively pooled or unitized. Any operations conducted on any part of such unitized land shall be considered, for all purposes, except the payment of royalty operations conducted upon said land under this lease. There shall be allocated to the land covered by this lease within each such unit (or to each separate tract within the unit if this lease covers separate tracts within the unit) that proportion of the total production of unitized minerals from the unit, after deducting any used in lease or unit operations which the number of surface acres in such land (or in each such separate tract) covered by this lease within the unit bears to the total number of surface acres in the unit, and the production so allocated shall be considered for all purposes, including payment or delivery of royalty, overriding royalty and any other payments out of production to be the entire production of unitized minerals from the land to which allocated in the same manner as though produced therefrom under the terms of this lease. The owner of the reversionary estate of any term royalty or mineral estate agrees that the accrual of royalties pursuant to this paragraph or of shut-in royalties from a well on the unit shall satisfy any limitation of term requiring production of oil or gas. The formation of any unit hereunder which includes land not covered by this lease shall not have the effect of exchanging or transferring any interest under this lease (including, without limitation, any delay rental and shut-in royalty which may become payable under this lease) between parties owning interests in land covered by this lease and parties owning interests in land not covered by this lease. Neither shall it impair the right of lessee to release as provided in paragraph 5 hereof, except that lessee may not so release as to lands within a unit while there are operations thereon for unitized minerals unless all pooled leases are released as to lands within the unit. At any time while this

> lease is in force, lessee may dissolve any unit established hereunder by filing for record in the public office where this lease is recorded a declaration to that effect, if at that time no operations are being conducted thereon for unitized minerals. Subject to the provisions of this paragraph 4, a unit once established hereunder shall remain in force so long as any lease subject thereto shall remain in force. If this lease now or hereafter covers separate tracts, no pooling or unitization of royalty interests as between any such separate tracts is intended or shall be implied or result merely from the inclusion of such separate tracts within this lease but lessee shall nevertheless have the right to pool or unitize as provided in this paragraph 4 with consequent allocation of production as herein provided. As used in this paragraph 4, the words "separate tract" mean any tract with royalty ownership differing, now or hereafter, either as to parties or amounts, from that as to any other part of the leased premises.

6. Big Oil subsequently acquired the Doe Lease from the original lessee and, in December, 1987, drilled and completed two wells on the Doe Lease, the Big Oil Company, Doe Well No. 1 and the Big Oil Company, Doe Well No. 2. Each well has produced, and continues to produce, large quantities of oil and gas.

7. On December 14, 1987, with a stated effective date of December 9, 1987, and purportedly pursuant to the pooling and unitization authority of paragraph 4 of the Doe Lease, Big Oil formed the Doe No. 1 Gas Unit by filing a designation of unit with the county clerk of Harris County, Texas, which unit designation is recorded in Vol. 754, Page 504 of the Deed Records of Harris County, Texas. The Doe Gas Unit No. 1 was comprised of 320 acres, but only 160 acres of the unit was comprised of acreage covered by the Doe Lease. The Doe No. 1 well was drilled on the Doe Lease, and it was not necessary to bring in additional acreage to that covered by the Doe Lease in order to have a full spacing unit and to receive a full allowable under the density and spacing rules of the Texas Railroad Commission. Indeed, the applicable density and spacing rules only require

a 40 acre proration unit and not the 320 acres unit designated in the Doe Gas Unit No. 1.

8. On December 21, 1987, with a stated effective date of December 14, 1987, Big Oil purportedly amended the designation of the Doe No. 1 Gas Unit to change the unit configuration. The amended unit designation also contained 320 acres, but only 160 acres of the unit was comprised of acreage covered by the Doe Lease even though there was adequate acreage covered by the Doe Lease to comply with the density and spacing rules of the Texas Railroad Commission.

9. Also on December 21, 1987, and immediately after the drilling and the completing of the Doe No. 2 well, with a stated effective date of December 21, 1987, Big Oil formed the Doe Gas Unit No. 2 by designating that certain unit by instrument recorded in Vol. 754 Page 655 of the Deed Records of Harris, County, Texas. The Doe Well No. 2 is located on the Doe Lease, and it was not necessary to bring in additional acreage to that covered by the Doe Lease to have a full spacing unit and to receive a full allowable under the density and spacing rules of the Texas Railroad Commission. Indeed, the applicable density and spacing rules only require a 40 acres proration unit, and not the 320 acres unit designated in the Doe Gas Unit No. 2.

10. Subsequently, on or about, September 14, 1988, the Doe No. 3 well was drilled and completed on the Doe Lease and was included in the Doe Gas Unit No. 1, which Doe Gas Unit No. 1 contained 320 acres but with only 160 acres of the Doe Lease included in such unit.

11. Under the Doe Lease, the defendant was under an implied covenant to form both the Doe Gas Unit No. 1 and the Doe Gas Unit No. 2 and as a reasonably prudent operator would have formed each of those units under the same or similar circumstances

that existed at the time of the formation of the aforesaid two units having due regard for the interests of the lessee and the lessor. This implied obligation is implied in fact in the Doe Lease just as if it had been expressly written into the Doe Lease. In view of the geologic and engineering data available at the time of their formation, no reasonably prudent operator would have formed the Doe Gas Unit No. 1, or the Doe Gas Unit No. 2; therefore, each of such units was formed in breach of Big Oil's aforesaid implied obligations under the aforesaid pooling clause. Plaintiff has performed all conditions precedent to defendant's obligations under the Doe Lease. As a result of such breaches of the aforesaid implied covenant, the plaintiff has been damaged in an amount in excess of the minimum jurisdictional limits of this Court. To remedy the improper formation of the two aforesaid units, this Court should enter judgment declaring that each of such units was wrongfully formed in breach of the Doe Lease and declaring that each of such units is void, *ab initio*, and declaring that such units are cancelled and of no force or effect.

12. Pleading further, plaintiff would show that, as a result of the aforesaid breaches of the Doe Lease, the plaintiff has suffered damages in an amount equal to the difference between the amount of the royalties that plaintiff would have been paid had the units not been improperly formed and the amount of royalties that the plaintiff has been paid by defendant, plus all prejudgment interest on such amounts allowed by law, which damages greatly exceed the minimum jurisdictional limits of this Court.

13. As a result of the aforesaid breaches of the Doe Lease, the plaintiff has been required to retain the undersigned attorneys to prosecute this suit. Plaintiff is, therefore, entitled to recover his reasonable attorneys' fees incurred in prosecuting this suit - all as

provided in *Tex. Civ. Prac. & Rem. Code Ann. art. 38.001* and, alternatively, *Tex. Civ. Prac. & Rem. Code Ann. art. 37.009.*

WHEREFORE PREMISES, CONSIDERED, plaintiff prays that the defendant be cited to appear and answer herein, and that on final hearing hereof, this Court enter its judgment as follows:

1. Declaring that the Doe Gas Unit No. 1 and the Doe Gas Unit No. 2 were designated in breach of the Doe Lease and are each void, *ab initio*, and are cancelled and of no force or effect;

2. Awarding plaintiff damages against defendant, jointly and severally, in an amount in excess of the minimum jurisdictional limits of this Court, as specified in paragraph 12, above;

3. Awarding plaintiff his attorneys fees, court costs, and all interest, both prejudgment and post judgment, allowed by law; and

4. Granting plaintiff such other and further relief, whether at law or in equity to which plaintiff may show himself justly entitled to receive.

Respectfully submitted,

TAYLOR & NORWOOD
340 Main Street
Liberty, Texas 77575
Tel. 409/336-6408
Fax. 409/336-8167

By_____
E. R. Norwood
Bar No. 15113500

ATTORNEYS FOR PLAINTIFF

TABLE OF AUTHORITIES

CASES

APPENDIX 2

RULES OF PROCEDURE

TEXTS