

Texas Oil and Gas Law Journal



LexisNexis®

BRUCE M. KRAMER, EDITOR IN CHIEF

Volume 19, Number 5

October 2005

Joint Operating Agreements—Part 1

by
Stuart C. Hollimon*

I. INTRODUCTION

In recent years, several excellent papers have been presented at this program and at other CLE institutes addressing issues arising under the AAPL Model Form Operating Agreement. Some of these are listed below.¹ This paper supplements these other resources with a discussion of operating agreement cases decided in Texas within the past five years. Cases dealing with the same section of the operating agreement are grouped together, and a few cases that address several issues may be discussed in more than one section of the paper.

II. SUBSEQUENT OPERATIONS

A. *Valence Operating Company v. Dorsett*, 164 S.W.3d 656 (Tex. 2005)

Holdings: (i) The thirty-day notice period for proposed subsequent operations under Article VI.B. of the AAPL Form 610-1977 Model Form Operating Agreement sets a deadline for the non-operator to decide whether to participate in the proposed operation, but does not forbid the operator from commencing work before the

CONTENTS

Joint Operating Agreements—Part 1

By Stuart C. Hollimon 49

CASE NOTES

Royalty Payments

Anadarko E&P Co., L.P. v. Clear Lake Pines, Inc. 57

Cessation of Production

Brown v. Reeter 58

Apex Depositions

In re CenterPoint Energy, Inc. 59

Texas Oil and Gas Law Journal (USPS 021-326, ISSN 1544-7049) is published bi-monthly by LexisNexis Matthew Bender, 1275 Broadway, Albany, NY 12204-2694. Periodical Postage paid at Albany, NY and additional mailing offices.

Postmaster: Send address changes to Texas Oil and Gas Law Journal, LexisNexis Matthew Bender, Attn: Customer Service, 1275 Broadway, Albany, NY 12204-2694.

*Stuart C. Hollimon practices law with the firm of Andrews, Kurth in Dallas, Texas. This paper is a revised version of a paper presented to the Dallas Bar Association's Review of Oil and Gas Law XX on August 25-26, 2005.

¹Robert Cole Grable, "Operator Liability, Marketing Obligations, Tension Points, and Royalty Calculations Under Joint Operating Agreements," ANNUAL REVIEW OF OIL AND GAS LAW XVIII, Dallas Bar Association Energy Law Section, August 21-22, 2003; John R. Cooney, "Recent Developments Concerning Joint Operating Agreements—Preferential Rights and Exculpatory Clauses," 55 INST. ON OIL & GAS L. & TAX'N, Ch. 11 (2004); James C. T. Hardwick, "Something Old, Something New—Current Issues Under the Joint Operating Agreement," 51 INST. ON OIL & GAS L. & TAX'N, Ch. 6 (2000); John R. Reeves, "Significant Cases Governing the Onshore Operating Agreement," 49 INST. ON OIL & GAS L. & TAX'N, Ch. 2 (1998).

ISSN 1544-7049

© 2005 Matthew Bender & Company, Inc., a member of LexisNexis Group. All rights reserved.

The *Texas Oil and Gas Law Journal* is published by LEXISNEXIS™, telephone 1-800-833-9844.

EDITOR IN CHIEF

Bruce M. Kramer

CASE NOTES EDITOR

Katrina Rose

PRACTICE AREA EDITOR

John R. Prince

rand.prince@lexisnexis.com

1-800-252-9257, ext. 2168

EDITOR

Patricia Valentine

patricia.a.valentine@lexisnexis.com

1-800-252-9257, ext. 2286

Bruce M. Kramer is a Maddox Professor of Law at Texas Tech University School of Law in Lubbock, Texas. He is the co-author of the multi-volume treatises entitled *The Law of Pooling & Unitization* and *Williams & Meyers, Oil & Gas Law*. Katrina Rose, B.E.D., J.D.

The editors welcome suggestions for making this *Journal* more useful to Texas lawyers.

This *Journal* may be cited as 19 TEX. OIL & GAS L.J. xx (2005). The following citation form is used for court of appeals cases not yet appearing in the *South Western Reporter*: *Smith v. Jones*, No. 40,000, Op. Serv.—Civil, T6-89-23-146 (Austin [3d Dist.] Oct. 1, 1961). This form does not include a writ history because in many instances the time for filing an application may not have expired.

LEXISNEXIS™ publications are intended to help attorneys and others maintain professional competence by providing accurate, current information on selected topics, but no express or implied warranties with regard to the use of accuracy of this publication are made by LEXISNEXIS™, the editors, or the contributors. Publications are sold with the understanding that LEXISNEXIS™ is not engaged in rendering legal, accounting, or other professional advice. When dealing with specific legal matters, attorneys should consult original sources and rely on their own expertise. Other readers should engage the appropriate professional services to provide legal or other expert advice.

end of the notice period; and (ii) the non-consent penalty is enforceable and is not a liquidated damages provision.

Elmagene Dorsett and Valence Operating Company were parties to an operating agreement under which Valence was the operator. The original operator, TXO, drilled the initial test well in 1981. Valence acquired ownership and became the operator in 1994, and drilled eight more gas wells on the contract area from 1996 to 2001. These eight wells were drilled under the “Subsequent Operations” provisions of Article VI.B.

The notice provision for Subsequent Operations provides in relevant part as follows:

Should any party hereto desire to drill any well on the Contract Area other than the well provided for in Article VI.A., or to rework, deepen or plug back a dry hole drilled at the joint expense of all parties or a well jointly owned by all the parties and not then producing in paying quantities, the party desiring to drill, rework, deepen or plug back such well shall give the other parties written notice of the proposed operation, specifying the work to be performed, the location, proposed depth, objective formation and the estimated cost of the operation. The parties receiving such a notice shall have thirty (30) days after receipt of the notice within which to notify the parties wishing to do the work whether they elect to participate in the cost of the proposed operation. . . . Failure of a party receiving such notice to reply within the period above fixed shall constitute an election by that party not to participate in the cost of the proposed operation. . . .

AAPL Form 610-1977, Art. VI.B. 1. The provisions governing operations by less than all parties in Article VI.B.2. allowed the consenting parties to recoup up to 100 percent of the non-consenting party’s share of the costs of any new surface equipment, up to 100 percent of the non-consenting party’s share of the cost of operation of the well, and up to 300 percent of the non-consenting party’s share of the costs and expenses of drilling and of newly acquired equipment in the well.

Valence gave Dorsett written notice of its intent to drill each of the eight wells drilled from 1996 to 2001, but in each case Valence began preparatory work—and in some cases actual drilling operations—before thirty days had elapsed after Dorsett’s receipt of the notice. Dorsett received the notices but did not consent and did not contribute to the cost of the wells. Valence therefore imposed the non-consent penalty described in Article VI.B.2.

In 2000, Dorsett sued Valence disputing the imposition of the non-consent penalty. Dorsett contended that Valence was required to allow the thirty-day notice period to elapse before commencing work on proposed operations. She contended that Valence’s

failure to do so was a breach of contract that prevented enforcement of the non-consent penalty. She also contended that the non-consent penalty was an unenforceable liquidated damages provision. In addition to the causes of action related to the non-consent penalty, Dorsett also asserted causes of action alleging that Valence had damaged the surface of her land through negligence and failure to accommodate an existing surface use.

The parties filed cross-motions for partial summary judgment on the claims related to the non-consent penalty. The trial court granted Valence's motion, finding that Dorsett failed to elect to participate in the eight proposed wells, and that the non-consent penalty was enforceable against her. The summary judgment became final when the trial court severed the contract claims from the surface damage claims.

The court of appeals reversed the trial court judgment and rendered judgment for Dorsett. Citing *Hamilton v. Tex. Oil & Gas Corp.*, 648 S.W.2d 316 (Tex. App.—El Paso 1982, writ ref'd n.r.e.), the court of appeals noted that even though withholding consent to subsequent operations is within the rights of a non-operating party under the operating agreement and, therefore, is not a breach of the agreement, the non-consent penalty is nevertheless analyzed under the two-pronged test that is applied to liquidated damages provisions. 111 S.W.3d at 229 n.2. Before a court will enforce a liquidated damages provision under that test, the court must find that the harm caused by the breach is of a nature that makes estimation of damages very difficult, and that the amount of liquidated damages that the provision calls for is a reasonable forecast of just compensation. Following *Hamilton*, the court concluded that the nonconsent penalty is a mechanism through which consenting parties are compensated for assuming the financial risks associated with exploration and development, and that the uncertainty and substantial risks in such activities are such that the provision should be enforced. 111 S.W.3d at 229.

Despite its finding that the non-consent penalty was enforceable under the two-pronged test for liquidated damages provisions, the court held that the penalty could not be recovered by Valence from Dorsett under the circumstances presented by this case because Valence failed to give proper notice of the proposed operations, and as a result, the non-consent penalty was not triggered. The court of appeals held that the operator must allow the 30-day notice period to expire before commencing the proposed operations, and because Valence commenced operations before the notice period expired, it failed to comply with the notice period and thus was not entitled to recover the nonconsent penalty from Dorsett.

In support of that holding, the court of appeals reasoned that the ordinary meaning of "proposed" is "planned for the future,"

and that the term "proposed operations" in the notice provision therefore does not mean previous or current operations. 111 S.W.3d at 234. Under that interpretation of the notice provision, the court of appeals concluded that Valence failed to give proper notice, and thus could not recover the nonconsent penalty from Dorsett, because its notices for the eight wells were notices of current operations rather than proposed operations.

The supreme court reversed the judgment of the court of appeals and rendered judgment for Valence. On the issue of whether the nonconsent penalty is an unenforceable liquidated damages provision, the supreme court agreed with the lower court's conclusion that the provision is enforceable, but disagreed with the court's reasoning. The supreme court held that the non-consent penalty is not a liquidated damages provision, and it expressly disapproved its treatment as such in *Hamilton* and in the court of appeals. The supreme court explained its reasoning as follows:

Dorsett contends that the non-consent penalty is an unenforceable liquidated damages provision. We disagree. This clause is different from a liquidated damages clause. Liquidated damages clauses fix in advance the compensation to a party accruing from the failure to perform specified contractual obligations, whereas non-consent penalties reward consenting parties for undertaking a defined risk. See *Nearburg*, 943 P.2d at 567 ("[T]he non-consent penalty is the agreed-upon reward to [a consenting party] for taking the risk. . . . As a contractual arrangement, the carried interest is subject to negotiation and modification, and the parties' rights and obligations depend upon their contract."); RESTATEMENT (SECOND) OF CONTRACTS § 356 (1981) ("Damages for breach by either party may be liquidated in the agreement but only at an amount that is reasonable in the light of the anticipated or actual loss caused by the breach and the difficulties of proof of loss."). The non-consent penalty provision in this oil and gas operating agreement is the mechanism utilized to allow the consenting parties the opportunity to recover their investments and receive defined returns from future operations. For such operations, they undertake a financial risk that the non-consenting parties do not. Here, the non-consenting party is not being punished for breaching a contract; she simply agreed not to participate in a return on an investment she did not make. Indeed, after the provision's requirements are met, she receives additional revenues from new wells for which she paid nothing. One Texas court of appeals, in its consideration of whether a non-consent penalty was enforceable, characterized the penalty as a liquidated damages clause and decided that it was enforceable against the non-consenting working interest owner. *Hamilton v. Tex. Oil & Gas Corp.*, 648 S.W.2d 316, 321 (Tex. App.—El Paso 1982, writ ref'd n.r.e.). While *Hamilton* reached the correct result, we disapprove of its treatment of the non-consent penalty as a liquidated damages provision.

164 S.W.3d at 664.

On a practical note, the court reasoned that interpreting the nonconsent provision as an unenforceable liquidated damages provision would eliminate any incentive for parties to consent and incur the costs and liabilities for new projects. The court pointed out that under that interpretation the incentives would strongly favor not consenting because a non-consenting party would be entitled to the rewards of new operations without incurring any expense. 164 S.W.3d at 665.

In a separate concurring opinion, Justice Brister reasoned that liquidated damages are a measure of damages to be imposed on a party in the event of a breach, and that the non-consent penalty is thus not a liquidated damages provision because a party who elects to opt out of a proposed operation is not in breach of the agreement, but instead is exercising a contractual right. Justice Brister suggested that the amount that the consenting parties are allowed to recoup is more properly viewed as a bonus to those parties rather than a penalty to be imposed on the non-consenting parties. 164 S.W.3d at 665–666.

Regarding the timing of the notice relative to the commencement of operations, the supreme court held that the notice provision in the operating agreement does not place any restrictions on when the operator can commence operations. The court explained its reasoning as follows:

We agree with Valence that this provision places no temporal limitation on Valence’s ability to commence work on the proposed projects. The Agreement clearly states that “[t]he parties receiving such a notice shall have thirty (30) days after receipt of the notice within which to notify the parties wishing to do the work whether they elect to participate in the cost of the proposed operation.” *Id.* Art. VI.1. This plain language in the Agreement describes Dorsett’s right to receive notice of proposed operations and to elect to participate in those operations. It places no restrictions on when Valence may commence drilling or preparations for drilling. . . .

In short, the thirty-day notice period sets a deadline for Dorsett to decide whether to participate in proposed operations. Nothing in the language of the Agreement forbids the operator from commencing work before the end of the notice period. However, there is a temporal limit in the Agreement on Valence that sets a deadline, not a required start date, on Valence’s commencement of work. The Agreement requires the operator to commence work no later than sixty days after the expiration of the thirty-day notice period. A.A.P.L. Form 610-1977, art. VI.B.2 (1977). This distinction between the two notice periods in the Agreement retains the working interest owner’s right to thirty days notice before being required to make a decision, while also requiring the operator to commence work no later than ninety days after formally proposing the operation to the interest owners.

664 S.W.3d at 662–663.

The supreme court noted in this connection that “early” commencement of operations may actually benefit the non-operators by avoiding detrimental occurrences such as drainage by a neighboring operator. 664 S.W.3d at 663. Early commencement of the operation also gives the non-operators an opportunity to observe at least the early stages of the operation before making their elections.

B. *El Paso Production Co. v. Valence Operating Co.*, 112 S.W.3d 616 (Tex. App.—Houston [1st Dist.] 2003, pet. denied)

Holding: Non-consent penalties cannot be recovered out of the interest of a party that was not given proper notice of the proposed operation.

Texas Oil & Gas Co., as operator under a joint operating agreement, drilled a producing well on a 680-acre contract area in Freestone County. The operating agreement provided that if any party to the agreement desired to rework, deepen, or plug a well drilled at the parties’ joint expense,

[That party] shall give the other parties written notice of the proposed operation, specifying the work to be performed, the location, proposed depth, objective formation and the estimated cost of the operation. The parties receiving such a notice shall have thirty (30) days after receipt of the notice within which to notify the parties wishing to do the work whether they elect to participate in the cost of the proposed operation.

As a non-consent penalty, the operating agreement allowed the consenting parties to take the share of production attributable to the interests of the non-consenting parties until such share was equal to “400% of that portion of the costs and expenses of drilling, reworking, deepening, or plugging back . . . which would have been chargeable to such non-consenting party if it had participated therein.”

Valence acquired the interest of Texas Oil & Gas and succeeded Texas Oil & Gas as operator. Sonat Exploration Co., predecessor in interest to El Paso, acquired a non-operating working interest in the well. Houston Lighting & Power, needing to enlarge its ash disposal area, negotiated with Valence to acquire access rights to a tract of land in the contract area. When those negotiations fell through, HL&P offered Sonat \$204,000 for the release of Sonat’s surface rights to a 91-acre tract at the well site. Sonat accepted the offer and entered into an agreement releasing HL&P from surface damages to the tract and quitclaiming to HL&P its right to use the surface for exploration, production and

development. The agreement further provided that, to the extent possible under the operating agreement, Sonat assigned to HL&P its right to cause the well to be plugged and abandoned. The agreement expressly provided, however, that Sonat did not transfer any interest in the oil and gas in the tract, and it expressly excepted Sonat's right to develop and produce the minerals.

As a result of this agreement between Sonat and HL&P, Valence took the position that Sonat no longer had an interest in the well. Valence informed Sonat of this position by letter. The letter, as a "courtesy," also informed Sonat that Valence planned to workover the well, but it did not offer Sonat the opportunity to participate in the workover. Valence treated Sonat as a non-consenting party to that operation.

The ensuing lawsuit included numerous JOA-related claims and counterclaims. One of the principal issues concerned the effect of the Sonat-HL&P agreement on Sonat's status as a party to the operating agreement and on Valence's right to impose the non-consent penalty. The court rejected Valence's arguments that by quitclaiming its interest to HL&P, Sonat had repudiated or waived its rights under the operating agreement. The court concluded that because Sonat had retained its interest in the well, it was entitled to receive its proportionate share of the production. With specific reference to the non-consent issue, the court held that Sonat could not be a non-consenting party because it had never received proper notice of the proposed operation. The court explained its reasoning on that issue as follows:

By the terms of the JOA, a party who wanted to rework the well at the joint expense of all parties was required to give written notice of the proposed operation to the other parties. This notice was required to specify the work to be performed, the location, the proposed depth, the objective formation, and the estimated cost. A party who received such notice had 30 days in which to give notice of its election to participate. A party who did not give such notice of participation became a non-consenting party and was subject to a 400% penalty if the reworked well produced in paying quantities. There was no provision in the JOA for the imposition of the penalty if the initial required notice was not given.

112 S.W.3d at 623. Based on evidence conclusively establishing that Valence did not give Sonat proper notice, the court held that "Sonat's failure to consent to the rework operation cannot result in the imposition of any of the contractual penalties because the obligation to give timely notice of consent is triggered *only* by the required notice of proposed operations." *Id.* (Emphasis by the court).

C. ExxonMobil Corp. v. Valence Operating Co., 174 S.W.3d 303, 2005 Tex. App. LEXIS 4716 (Tex. App.—Houston [1st Dist.] 2005) (Opinion on Rehearing)

Holding: Non-consent penalties cannot be recovered out of the interest of a party that was not given proper notice of the proposed operation.

ExxonMobil and Valence are parties to a joint operating agreement governing operations on the Gladewater Gas Unit 16 in Gregg and Upshur Counties. Three wells on the unit produced gas from the Cotton Valley Lime formation, and it was determined that there were proven behind the pipe reserves in the shallower Cotton Valley Sand.

In 1996, ExxonMobil, which had succeeded to the interest of the original operator, entered into a farmout agreement with Wagner & Brown, Ltd. ("WB") and C.W. Resources ("CW"), giving them the right to earn the conveyance of ExxonMobil's interest in the Cotton Valley Sand portion of Unit 16 upon the successful completion of a test well. WB and CW proposed two new wells to Valence, but Valence never responded to the proposals because it was not aware of the farmout agreement and thus did not know that WB and CW had any relationship with Unit 16. Because Valence did not respond to the proposals, it was deemed non-consenting on those wells, both of which were completed as producers.

Valence sued ExxonMobil for breach of the maintenance of uniform interest provision of the operating agreement. That issue is discussed in a later section of this paper. Valence contended that by farming out its interest in the Cotton Valley Sand, ExxonMobil had breached the operating agreement and caused Valence to incur non-consent penalties and the additional expense associated with the drilling of new wells that it would not have incurred but for the breach.

In affirming a trial court judgment awarding Valence recovery of the non-consent penalties, the court of appeals cited *El Paso Production Co. v. Valence Operating Co.*, *supra*, for the proposition that "Valence's failure to consent to the drilling operation 'cannot result in the imposition of any of the contractual penalties because the obligation to give timely notice of consent is triggered *only* by the required notice of proposed operations.'" 174 S.W.3d 303, 317-318, 2005 Tex. App. LEXIS 4716 at *35 (quoting from *El Paso v. Valence*). The court explained this further as follows:

It is not enough that WB and CW—non-parties to the JOA— notified Valence of *their* proposal to drill new wells in the Cotton Valley Sand formation to capture the same reserves that could have been accessed from the existing wellbores. Such "no-

“tice” from strangers to the JOA, coming after the farmout agreement had already been executed, entirely failed to satisfy the purpose of the notice requirement, namely, that Valence be given the opportunity to consent, or not, to a proposal made by a party to the JOA who had agreed to all its terms and conditions—not by strangers to the JOA with different interests. We hold, therefore, that the trial court correctly concluded that ExxonMobil’s breach of the notice provision of the JOA relieved Valence of the burden of paying non-consent penalties.

174 S.W.3d 303, 317-318, 2005 Tex. App. LEXIS 4716, at *35–36.

D. Mobil Producing Texas & New Mexico, Inc. v. Cantor, 93 S.W.3d 916 (Tex. App.—Corpus Christi 2003, no pet.)

Holding: The operating agreement does not place an affirmative obligation on non-consenting parties to suspend their receipt of payments.

Procedurally, this is an unusual case because Mobil was appealing from an order granting its own motion for summary judgment.

Mobil was the operator under an operating agreement that covered a contract area in Gonzales County. Mobil proposed a reworking operation on Well No. 1. Certain non-operators elected not to participate, but proceeds of production were nevertheless paid to them by mistake, without withholding for costs and penalties on the non-consent operation. When Mobil discovered the mistake, it sued to recover the overpayments under theories of breach of contract and unjust enrichment. Mobil moved for summary judgment on both theories of recovery. The trial court granted the summary judgment on the ground of unjust enrichment. Applying the two year statute of limitations that is applicable to actions for unjust enrichment, the court limited Mobil’s recovery to the \$6,348.85 in revenues received by the defendants during the two years preceding the suit. The judgment did not award prejudgment interest or attorneys’ fees to Mobil. Mobil appealed the judgment, contending that summary judgment should have been granted on the ground of breach of contract, that it should have been awarded an amount totaling \$197,062.03 for the four-year period before suit, and that the judgment should have included prejudgment interest and attorneys’ fees.

The court of appeals affirmed the trial court judgment. The court held that the operating agreement did not place an obligation on the non-consenting parties to suspend their receipt of payments, so there could be no recovery for breach of contract. Any recovery must therefore be under a quasi-contract theory such as unjust

enrichment, subject to the two-year statute of limitations. A separate concurring opinion explained this result more fully as follows:

The agreement spelled out how the parties’ interests in production would be affected should some not consent to the reworking of the well. There is no dispute that the Cantor Appellees elected not to participate in the reworking, so their revenue interest diminished in accordance with the agreement until Mobil and the consenting parties recovered the reworking costs from production. However, the operating agreement did not place an obligation on the non-consenting parties, the Cantors, to take any action in order to suspend their payments. That being so, it is difficult to see how they could breach the contract. Rather, they received moneys they were not entitled to under the agreement, a classic case for application of the doctrine of unjust enrichment.

Mobil’s rights to an increased share of revenue of the well, and appellants’ decreased share, are determined by the contract, but no duty was imposed on appellants to take any action to implement those terms of the operating agreement. The mere receipt of money they were not entitled to does not constitute a breach. There is no evidence that appellants’ breached the contract. The summary judgment could not be properly granted on a breach of contract theory with its accompanying four year statute of limitations.

93 S.W.3d at 922.

Because Mobil could not recover for breach of contract, it was not entitled to recover prejudgment interest or attorneys’ fees.

E. Stable Energy, L.P. v. Kachina Oil & Gas, Inc., 52 S.W.3d 327 (Tex. App.—Austin 2001, no pet.)

Holdings: (i) forfeiture of interest by a non-consenting party is effective when the proposed operation is commenced, and not when the participating party tenders the costs attributable to the non-consent interest that the participating party has agreed to acquire; and (ii) there will be no forfeiture of interest by the non-consenting party unless the operation that is commenced is the same as the operation that was proposed, and such operation is conducted by a duly elected operator.

This case involves a dispute over the ownership and operation of a well in Fayette County. The original owners of the well entered into a joint operating agreement under which CRB Oil & Gas was designated as the operator. The designated operator changed from time to time over the ensuing years until Kachina became operator in 1991. The original operator, CRB, owned a working interest in the well, but the succeeding operators, including Kachina, had no working interest.

In 1989, Pampell Interests purchased a minority interest in the well and became a party to the operating agreement. Pampell

Interests was subsequently merged into Stable Energy. Stable and Anchor Operating Co. are affiliates.

In September 1992, the operator, Kachina, sent the working interest owners notification of a proposed workover operation on the well, which had ceased production. Stable consented to the project and tendered its share of the costs. Later, Stable agreed to assume the costs attributable to the parties who had elected not to participate, and it tendered the costs attributable to those interests. Stable already owned a 33% interest in the well, and the non-consenting parties owned a 28% interest, so the combination of those interests would give Stable a controlling interest in the well.

Although Stable had consented to the proposed workover operation and had sent checks to cover its own share of the costs plus the costs attributable to the interests of the non-consenting parties, Stable and Kachina were in dispute regarding the proposed project and other issues. During the course of that dispute, Stable contended that it was entitled to take over as operator of the well. That contention was based on a JOA requirement that the operator must have an ownership interest. Under the JOA, an operator such as Kachina, which owned no interest in the well, could be replaced upon the election of a successor operator by parties owning a majority interest. Stable contended that its original interest plus the interests of the non-consenting parties gave it the majority interest needed to replace Kachina as operator.

Stable's affiliate, Anchor, took possession of the well and conducted an acid workover on the well. With Anchor in possession of the well, Kachina withdrew its own proposal for a workover of the well. The cost and method of the workover conducted by Anchor differed materially from the workover proposed by Kachina.

Stable filed suit seeking an accounting and a declaration that Anchor was the operator of the well. The district court found in favor of Kachina because Stable failed to establish that it had acquired the non-consent interests needed for the removal of Kachina and for the election of Anchor as successor operator. The court of appeals affirmed the judgment for Kachina.

The result in this case turned on the court's interpretation of the provisions that determine when a consenting party's acquisition of the interests of non-consenting parties becomes effective. Stable contended that the non-consenting parties' relinquishment of their interests to Stable became effective when Stable consented to the proposed operation and tendered the costs attributable to such interests to Kachina. The court rejected that position and held that relinquishment of the non-consent interests could only be triggered by commencement of the proposed operation. The court explained this as follows:

Relinquishment of non-consenting interests is governed by article VI.B.2 of the JOA: "*Upon commencement of operations for the . . . reworking . . . of any such well by Consenting Parties . . . each Non-Consenting Party shall be deemed to have relinquished to Consenting Parties . . . all of such Non-Consenting Party's interest in the well and share of production therefrom.*"

Thus, the JOA does indeed provide that the parties who choose not to participate in the project forfeit their interests in the well. However, this provision specifies that relinquishment occurs upon commencement of operations. Contrary to Stable's contention that tender triggered relinquishment, the JOA mandates that ownership of non-consent interests could not have transferred to Stable until – at the earliest – the date when the workover began. *See Abraxas Petroleum Corp. v. Hornburg*, 20 S.W.3d 741, 754–55 (Tex. App.—El Paso 2000, no pet.).

For this reason, only actual commencement of Kachina's proposed project could have triggered relinquishment of the non-consent interests. . . .

52 S.W.3d at 332.

Stable argued that the project proposed by Kachina commenced when Anchor seized the well and performed an acid workover, and that this triggered the relinquishment of the non-consent interests. The court concluded, however, that Anchor's activities would constitute legitimate commencement of the proposed operation only if (i) the operations performed by Anchor were the same as those proposed by Kachina, and (2) the operations were performed by a duly elected operator.

For the proposition that the operations performed must be the same as those that were proposed, the court cited the Article VI.B requirement that the proposal must inform the owners of the location, proposed depth, objective formation and the estimates cost so that they can decide whether to participate. The court concluded that "if non-consenting parties are going to forfeit their interests, it is essential that the operation triggering that forfeiture is the same one the parties rejected." 52 S.W.3d at 333. The court concluded that this condition was not satisfied, and relinquishment of the non-consent interests was not triggered, because the evidence showed that Anchor's project differed substantially from Kachina's proposal.

For the proposition that legitimate commencement of the proposed operation must be executed by the duly elected operator, the court cited Article V.A., which provides that the operator shall have full control of all operations, and Article VI.B., which provides that the "operator shall perform all work for the account of the Consenting Parties." 52 S.W.3d at 333. The court acknowl-

edged that Kachina was vulnerable to removal as operator because it did not own an interest in the well, but it concluded that such vulnerability was immaterial because Stable and Anchor did not have the majority interest required to elect a successor operator.

F. *Abraxas Petroleum Corp. v. Hornburg*, 20 S.W.3d 741 (Tex. App.—El Paso 2000, no pet.)

Holding: Issuing an AFE for an operation for which an AFE is not required can be a breach of the joint operating agreement.

Abraxas Petroleum Corp. v. Hornburg addressed several issues under the joint operating agreement, so it is discussed in this section as well as in other sections of this paper. Insofar as subsequent operations are concerned, the principal holding is that issuance of an AFE for activities that do not require one can be a breach of the operating agreement.

Pearson-Sibert Oil Co. was the operator of the Cleo Smith lease in Stonewall County. The lease had been in continuous production from four wells since 1952. Abraxas purchased Pearson-Sibert's interest in 1992, and took over operations on the lease. Within months, operating expenses escalated and production dwindled. In November 1993, Abraxas wrote to the non-operators and informed them that all four wells had ceased to produce because the number one well had parted rods, the numbers three and four wells had holes in the tubing, and the number two well had holes in the casing. The letter described proposed workover procedures to restore the wells to production, together with a cost estimate for each well.

Article VII.D.3. of the operating agreement prohibited the operator from undertaking any single project reasonably estimated to require an expenditure in excess of \$30,000 except in connection with the drilling, reworking, deepening, completing, recompleting, or plugging back of a well which had been previously authorized. Although none of the jobs proposed for the individual wells exceeded \$30,000, the estimated total cost for the restoration of production from all four wells was \$44,250. The letter informed the non-operators that they had 30 days in which to elect whether to participate in the proposed activities, and that if they declined to consent, then their income from the lease would be paid over to Abraxas until Abraxas had recovered 300% of their proportionate shares of the expenses.

When none of the working interest owners consented to the proposed operations within the 30-day window, Abraxas deemed their status to be "non-consent," and it began appropriating their future runs. Of the proposed workover operations, Abraxas performed only one small project at a cost of approximately \$7,500,

but it never informed the working interest owners that it had decided not to proceed with the other operations.

Several of the working interest owners filed suit against Abraxas alleging negligence, gross negligence, willful misconduct, breach of contract, and waste. The breach of contract claim alleged, among other things, that Abraxas breached the operating agreement by sending the AFE letter because no single project proposed in the letter had an estimated cost in excess of \$30,000, and because the proposed activities were not reworking operations but instead were routine operating activities which are not subject to the consent/non-consent election under the operating agreement. The jury found that Abraxas did breach the operating agreement by sending the AFE letter.

On appeal, Abraxas contended that merely sending an AFE letter could never be a violation of the operating agreement. The court rejected that argument. The court said:

We first reject Abraxas' contention that the sending of the AFE could never violate the JOA. Abraxas is correct that an AFE is an estimate or budget of proposed expenses, but that is not its sole or even its primary function. The sending of an AFE triggers the consent/non-consent provisions of the JOA and puts the receiving parties to an election of participating in the proposal or suffering a substantial penalty in the event the proposed work results in a producing well. Therefore, if an AFE is unjustified under the facts, then it may constitute a breach of the JOA to send the AFE and put the parties to that election.

20 S.W.3d at 755. The court also rejected Abraxas' contention that merely sending the AFE letter did not result in any damages. On that issue the court said:

Abraxas argues that the mere sending of the AFE letter did not result in any damages to Appellees. However, the sending of the AFE letter triggered Appellees' contractual obligation to elect whether to participate in the cost of the proposed operations or suffer the 300 percent penalty specified in the JOA. When Appellees did not respond to the AFE, Abraxas immediately seized Appellees' interests in the Cleo Smith lease and began appropriating their earnings. Abraxas continued to withhold the earnings even though it did not complete the operations specified in the AFE. Still further, Abraxas retained their interests until the lease had no value. Consequently, the evidence is both legally and factually sufficient to establish that sending the AFE resulted in damages to Appellees.

20 S.W.3d at 758.

CASE NOTES

ROYALTY PAYMENTS

Section 91.403 of the Natural Resources Code does not envision subsequent purchasers to be liable for statutory interest on royalties paid late by a previous owner.

Anadarko E&P Co., L.P. v. Clear Lake Pines, Inc., No. 03-04-00600-CV, 2005 Tex. App. LEXIS 5267 (Tex. App.—Austin July 7, 2005).

FACTS

Clear Lake owned and was the lessor of various oil and gas wells; Anadarko was the leaseholder. The previous leaseholder was Edco Energy, and the purchaser of condensate was Mesa Pipeline Company. Clear Lake was the owner of the royalty interest in the mineral production from the wells, and Mesa failed to pay royalties for the production from a well from December 1993 to April 1995. Eventually, Mesa paid the late royalties to Clear Lake at the end of September 1997, long after Anadarko had acquired the leasehold from Edco on March 10, 1995.

The 1995 Asset Purchase Agreement transferring the interest in the leasehold from Edco to Anadarko stated that Anadarko acquired the lease free from defect, except for designated “permitted encumbrances.” By agreement, these encumbrances included “lessors’ royalties, overriding royalties, revisionary interests, and similar burdens . . . in any of the Properties as such interests are set forth on Exhibit ‘B.’ “They further include “all other contracts, agreements, instruments and obligations affecting the oil and gas leasehold estate.” Exhibit “B” of the agreement described a number of mineral wells. There also was a lease between Anadarko and Clear Lake providing that Anadarko would pay royalties on the oil and gas of the described properties after the closing date.

Clear Lake believed it was owed statutory interest for the late royalties under the Natural Resources Code, and filed suit against Anadarko for those interest payments, alleging that Anadarko was liable for statutory breach by failing to pay interest on the late royalties, but it did not file suit against Mesa or Edco. Anadarko filed summary judgment motions, which were denied. Clear Lake filed its own summary judgment motion, which was granted. Clear Lake was awarded the statutory interest on the well for which royalties were late, as well as attorneys’ fees.

DISCUSSION

Anadarko appealed. The Austin Court of Appeals reversed. Justice Patterson, writing for a unanimous panel, began by summarizing the competing theories. Clear Lake’s argument was that Anadarko is the statutory “payor” as defined in section 91.401 of the Natural Resources Code and that Anadarko assumed the obligations of the “payor” through its lease with Clear Lake and through the “Permitted Encumbrances” section of its Asset Purchase Agreement with Edco. Anadarko’s view is that it does not fit the definition of “payor” and that none of its agreements provided for its assumption of the disputed obligation.

First, the court was faced with determining whether Anadarko was a “payor” under the code. According to Justice Patterson, “The Agreement and the lease reflect that Anadarko was the ‘owner of the right to produce.’ There is nothing in the record to show that Anadarko was the ‘first purchaser’ of the production of oil or gas.” However, Anadarko describes Mesa as the “first purchaser,” and Clear Lake does not argue that Mesa was *not* the “first purchaser,” and its pleadings describe Mesa as the “purchaser of condensate” of the well for which royalty payments were late. “Thus,” noted Justice Patterson, “absent an ‘arrangement’ between Mesa and Anadarko providing that Mesa pay Anadarko the proceeds, or absent a prior arrangement between Mesa and Edco providing that Mesa pay Edco the proceeds, Mesa was the ‘payor.’ “ As the “first purchaser,” according to the court, Mesa was the “payor,” and so was statutorily obligated to pay royalties by the expiration time set out in section 91.402 and, in the event of a late payment, the statutory interest required by section 91.403.

The court went on to observe that under Texas law, an encumbrance is an interest in realty that diminishes its value and is a burden on its transfer, with examples of encumbrances including liens, claims, easements, and servitudes. “In Texas,” Justice Patterson interjected, “we find no case law extending the concept beyond its traditional scope, and Clear Lake cites none,” with it following that royalties accrue and become, in turn, interests in personal property at the time the minerals are severed from the land. Citing *Phillips Petroleum Co. v. Adams*, 513 F.2d 355 (5th Cir. 1975); *Texas Oil & Gas Corp. v. Moore*, 630 S.W.2d 450 (Tex. App.—Corpus Christi 1982, writ dismissed w.o.j.); and *Sabine Prod. Co. v. Frost Nat. Bank*, 596 S.W.2d 271 (Tex. App.—Corpus Christi 1980, writ dismissed), the court observed that it follows then that royalties become interests in personalty at the time the minerals for which they are owed become personalty.

“The question, then,” wrote Justice Patterson, “is whether Anadarko assumed any obligation to pay the statutory interest through the Asset Purchase Agreement with Edco.” The answer

was that Anadarko could not assume such an obligation from Edco *unless* Edco had that obligation—unless Edco was the “payor.” Because the Agreement was between Anadarko and Edco (as opposed to Anadarko and Mesa), and because Edco had no obligation to pay the statutory interest that Anadarko could assume, Anadarko assumed no such obligation. Moreover, the court went on to add that even “if we accept for the sake of argument that there was an ‘arrangement’ between Edco and Mesa making Edco the ‘payor,’ nothing in the Agreement required Anadarko to assume the statutory interest obligation.” Ultimately, the appellate court’s conclusion was that because the natural resources code did not obligate Anadarko to pay statutory interest, and because Anadarko did not agree to assume any such obligation from whomever was obligated under the statute, Anadarko was not liable for any of the statutory interest on the late-paid royalties.

CESSATION OF PRODUCTION

The two-pronged ‘cessation of production in paying quantities’ test is inapplicable at summary judgment involving an allegation of total cessation of production.

Brown v. Reeter, No. 11-04-00009-CV, 2005 Tex. App. LEXIS 4794 (Tex. App.—Eastland June 23, 2005).

FACTS

Mary Reeter owned a portion of the surface estate where the leases—referred to by the parties as the “Martin Lease,” the “Day Lease,” and the “Day A Lease”—are located. She acquired the surface on April 26, 1999, and filed suit against Wayne Brown, Roxie C. Brown, Mondaile Energy, Inc., and Ron Dority d/b/a Shady Oil Company in 2002, claiming that the leases had expired prior to her acquisition of the property due to lack of production. These defendants were operators of the leases at various times. Reeter also alleged claims for damages with respect to the manner in which the Browns and the entities operated the leases, additionally asserting a breach of contract claim against Wayne Brown arising from letters exchanged between the parties’ attorneys prior to suit being filed.

Reeter filed a motion for partial summary judgment on her claims seeking to terminate the three leases and her breach of contract claim against Wayne Brown. No response to the motion was filed. The trial court granted the motion, subsequently entering an order severing out a portion of her causes of action.

DISCUSSION

The Browns and the entities appealed, attacking the summary judgment. In affirming, Justice Arnot, writing for a unanimous

panel of the Eastland Court of Appeals, began by addressing the contention that the trial court had erred in granting summary judgment on the breach of contract claim that Reeter asserted against Wayne Brown. The court agreed with Reeter’s assertion that the issue was not appealable under the terms of the order of severance which the trial court entered.

“Under the express terms of the severance order,” Justice Arnot wrote, “only appellee’s claims seeking the termination of the three leases were placed into a separate lawsuit and assigned the cause number of 3,586.” The other claims, including the breach of contract claim against Wayne Brown, remained in the original lawsuit bearing the cause number of 2,747. “Thus,” the court held, “appellee’s breach of contract claim against Wayne Brown is not a matter addressed in the judgment from which appellants appeal,” adding that “the summary judgment granted by the trial court on the breach of contract claim remains an interlocutory, unappealable order because it has not been severed from appellee’s other causes of action and because it is not before us.” Consequently, the appellate court could not address the merits of that issue.

The second issue on appeal addressed the trial court’s determination that the Day Lease expired for lack of production. Reeter had sought to terminate the Martin Lease and the Day A Lease in addition to the Day Lease, and the Browns and the entities announced at the hearing on the motion for summary judgment that they did not dispute Reeter’s claim that the Martin Lease and the Day A Lease had expired for lack of production. Consequently, their issue on appeal dealt solely with the Day Lease.

Justice Arnot observed that in her traditional motion for summary judgment, Reeter had alleged that the Day Lease terminated prior to April 26, 1999, with the summary judgment evidence in support of this consisting of certified copies of the five written leases which comprise the Day Lease, the appellants’ answers to interrogatories, and certified copies of the records from the Railroad Commission. The five written leases at issue provided that they “shall remain in force for a term of three (3) years from this date (called ‘primary term’), and as long thereafter as oil, gas, or other mineral is produced from said land.”

Reeter had alleged in the motion that there was no production on the Day lease from February 1998 through December 1998, supporting this allegation with appellants’ discovery responses and records from the Railroad Commission. As to the former, appellants had responded to an interrogatory asking for information about production occurring on the Day Lease after February 1998 as follows: “You may obtain the information from the Texas Railroad Commission,” and “That information is contained in public records at the Texas Railroad Commission Office in Abi-

lene, Texas.” The pertinent records indicated that no production had occurred on the Day Lease from February 1998 through December 1998, with the Commission’s records further indicating that no production had occurred on the Day Lease in the months of February, March, and April of 1999.

Citing *Clifton v. Koontz*, 160 Tex. 82, 325 S.W.2d 684 (Tex.1959); and *Cannon v. Sun-Key Oil Co., Inc.*, 117 S.W.3d 416 (Tex. App.—Eastland 2003, pet. denied), the appellate court noted that, “A lessor seeking to establish that a lease terminated because of a ‘cessation of production in paying quantities’ must meet a two-prong test: (1) that the lease failed to yield a profit over a reasonable period of time and (2) that a reasonably prudent operator would not have continued to operate the well in the manner in which it was being operated for the purpose of making a profit and not merely for speculation.” The Browns and the entities asserted that the appellee’s summary judgment evidence is deficient as a matter of law because she did not address any of the economic elements regarding the profitability of producing oil and gas from the Day Lease at any time.

The court rejected this contention, citing *Ridenour v. Herrington*, 47 S.W.3d 117 (Tex. App.—Waco 2001, pet. denied); *Bachler v. Rosenthal*, 798 S.W.2d 646 (Tex. App.—Austin 1990, writ denied); and *Wainwright v. Wainwright*, 359 S.W.2d 6280 (Tex. Civ. App.—Fort Worth 1962, writ ref’d n.r.e.), for the proposition that when there has been a “total cessation of production,” the two-prong “cessation of production in paying quantities” analysis does not apply. Consequently, Justice Arnot wrote, “appellee did not need to address the profitability of obtaining production from the Day Lease because she alleged a complete cessation of production for several months.”

The court also rejected the contention that matters contained within appellee’s summary judgment evidence raised fact questions regarding the accuracy of the Railroad Commission’s own data, specifically, Wayne Brown’s indication in a deposition that the Railroad Commission had erroneously credited production from the Day Lease to either the Martin Lease or the Day A Lease in the past. Noting that the ability to raise these matters at this point was “tenuous” in light of the lack of a written response to the motion for summary judgment. Beyond this, even assuming that these deposition responses could be relied upon at all, Justice Arnot observed that “he did not identify any specific periods of time wherein production from the Day Lease was erroneously credited to the other two leases,” adding further that “the records from the Railroad Commission indicate that no production occurred on any of the three leases in the months of July, August, September, and October of 1998.”

APEX DEPOSITIONS

When an executive seeks to avoid a protective order to submit to a deposition, an affidavit in which he states that he has never been involved in the day-to-day operations of the subject matter of a dispute and has no personal knowledge of its operations is sufficient to force the party seeking the deposition to show otherwise, and a single deposition notice does not constitute a reasonable effort to obtain information via less intrusive means.

In re CenterPoint Energy, Inc., No. 10-05-00244-CV, 2005 Tex. App. LEXIS 505 (Tex. App.—Waco June 29, 2005) (orig. proceeding).

FACTS

A former CenterPoint subsidiary, Texas Genco Holdings, Inc., operated a power plant located on property in Limestone and Freestone Counties and known as the Limestone Electric Generating Station. CenterPoint sold the Limestone Plant and several other power plants to Texas Genco, LLC in December 2004. The sale of the Limestone Plant included a neighboring 392-acre tract of land which is designated as a solid waste facility for the disposal of waste by-products generated by the plant. Valence owns significant mineral interests in the disposal site property. Before the sale, Valence obtained a permit from the Railroad Commission to drill a gas well on the property, entered the land, and prepared a site for the well.

Texas Genco filed suit seeking a temporary restraining order and seeking to enjoin Valence from drilling the well. Texas Genco’s suit contends that Valence’s drilling activities breach Valence’s duty to accommodate Texas Genco’s rights as the owner of the surface estate because drilling at the contemplated location “would permanently and irreversibly damage [Texas Genco’s] long-planned, TCEQ-approved use of the land as a Disposal Site.” Valence’s contention is that its operations will not interfere with Texas Genco’s current use of the property because Texas Genco is not presently disposing (and has never disposed) of waste by-products from the Limestone Plant at the property, thus arguing that discovery regarding profitability, revenues, and costs for the Limestone Plant and regarding Texas Genco’s future plans for the Limestone Plant are “critical” to determine whether the proposed drilling will substantially impair Texas Genco’s use of the land.

When Valence sought to depose CenterPoint CEO David McClanahan, CenterPoint responded with a motion for protective order. CenterPoint supported its motion with McClanahan’s affidavit, which states in pertinent part that he currently serves as President and Chief Executive Officer of CenterPoint Energy, Inc.,

and that “I have no unique or superior knowledge regarding any aspect of this case. I have no personal knowledge of any aspect of the dispute between Texas Genco, LP and Valence made the basis of this lawsuit. I have never been involved in the day-to-day operations of the Limestone Station and have no personal knowledge of its operations. Prior to CenterPoint Energy’s sale of Texas Genco Holdings, Inc., the Limestone Station’s day to day operations were managed by Texas Genco personnel, and decisions pertaining to the operation of the Limestone Station were delegated to the management and staff of Texas Genco. As a result of the sale, the executive responsible for power plant operations is now employed by Texas Genco, LLC. The president and chief executive officer of Texas Genco Holdings, Inc. during the time it was owned by CenterPoint Energy retired in connection with the sale.”

At a hearing on CenterPoint’s motion for protective order, Valence argued that McClanahan should be deposed because: (1) Centerpoint Energy owned Texas Genco Holdings, Inc. when Texas Genco filed the underlying suit; (2) McClanahan has been with the organization “for a while” and “knows about the operations, the value, [and] the way the Limestone Plant is run from an operations point of view;” and (3) the contemplated deposition is “not overburdensome” or “undue.” CenterPoint’s reply was that McClanahan should not be ordered to submit to a deposition because Valence failed to show that he possesses unique or superior personal knowledge of discoverable information. Judge H. D. Black, Jr., of the 77th District Court of Freestone County, denied the protective order.

DISCUSSION

CenterPoint sought a writ of mandamus, contending that the trial court had abused its discretion by permitting Valence to depose McClanahan because Valence did not show that McClanahan has “any unique or superior personal knowledge of discoverable information” or that less intrusive means of discovery have proven insufficient. In conditionally granting the writ, Justice Reyna, writing for a unanimous panel of the Waco Court of Appeals, began by citing *In re Alcatel USA, Inc.*, 11 S.W.3d

173 (Tex. 2000) (orig. proceeding), for the crux of the apex deposition doctrine: that when a party seeks to depose a high level corporate official, a corporation may seek to shield the official from the deposition by filing a motion for protection supported by the official’s affidavit denying knowledge of any relevant facts.

Valence contended that McClanahan’s affidavit did not adequately deny knowledge of relevant facts, citing *In re Columbia Rio Grande Healthcare, L.P.* 977 S.W.2d 433 (Tex. App.—Corpus Christi 1998) (orig. proceeding), but CenterPoint relied on a more recent decision of a different appellate court, namely *In re Burlington N. & Santa Fe Ry.*, 99 S.W.3d 323 (Tex. App.—Fort Worth 2003) (orig. proceeding), to support its contention that the affidavit is indeed sufficient.

Noting that McClanahan stated in his affidavit that he has “no unique or specialized knowledge regarding any aspect of this case” and that he has “never been involved in the day-to-day operations of the Limestone Station and [has] no personal knowledge of its operations,” and in light of the issue in the underlying lawsuit being whether Valence’s proposed well will preclude or impair “an existing use by the surface owner,” Justice Reyna concluded that McClanahan had sufficiently denied knowledge of any relevant facts regarding any existing usage of the disposal site so as to shift the burden to Valence to show otherwise. However, according to the appellate court, Valence presented no evidence to support their counter-argument. Consequently, the court held that Valence failed to arguably show that McClanahan “has any unique or superior personal knowledge of discoverable information.”

Also rejecting Valence’s contention that it had been unable to obtain the discovery it seeks by less intrusive means, the court held that Valence’s single deposition notice—served on CenterPoint requiring it to designate a representative to testify on its behalf and contemplating a deposition date two weeks after the hearing on the protective order—does not satisfy Valence’s burden to show that it had “made a *reasonable* effort” to obtain the information sought through less intrusive means of discovery. “Thus,” Justice Reyna wrote, Judge Black had “abused his discretion by denying CenterPoint’s motion for protective order.”