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THE TEXAS SUPREME COURT AND OIL AND GAS JURISPRUDENCE: WHAT HATH *WAGNER & BROWN V. SHEPPARD* WROUGHT?

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I. INTRODUCTION

Soon after the drilling of the first oil well in Titusville, Pennsylvania in 1859, courts were pressed to develop a unique jurisprudence for oil and gas law.[1] Seeking solutions to disputes related to these newly valuable substances, judges inevitably turned to the familiar terrain of the common law.[2] For example, according to common law principles governing deeds of real property, the phrase "so long as" created a fee simple determinable estate in the grantee, leaving a separate non-possessory estate in the grantor, called a "possibility of reverter." Fee simple determinable estates end automatically upon the happening of some stated condition.[3] At that point, the grantor's "possibility of reverter" automatically becomes possessory.[4]

Since that "so long as" phrase appears in the typical oil and gas lease to limit its duration to as long as production continues, most states quickly classified the lease as creating a fee simple determinable in the lessee, leaving a possibility of reverter in the lessor.[5] For example, Texas courts have viewed the oil and gas lease as creating a fee simple determinable estate in the lessee since 1923.[6] In addition to this estates concept, oil and gas law evolved to include many other classic common law doctrines. An example includes rules governing cotenants: A producing cotenant must account to his cotenants on a net profits basis.[7] Basic rules affecting the

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1. DANIEL YERGIN, THE PRIZE: THE EPIC QUEST FOR OIL, MONEY & POWER 26–28 (1991) (describing the birth and history of the oil and gas industry). The week of August 26, 2009 marked the 150th anniversary of the Titusville well. Jad Mouawad, *After 150 Years, Whither Oil?*, N.Y. TIMES, Aug. 26, 2009, *available at* http://greeninc.blogs.nytimes.com/2009/08/26/after-150-years-whither-oil/.

2. Laura H. Burney, *A Pragmatic Approach to Decision Making in the Next Era of Oil and Gas Jurisprudence*, 16 J. ENERGY NAT. RESOURCES & ENVTL. L. 1, 9 (1996) [hereinafter Burney, *Pragmatic Approach*] (explaining that courts analogized to common law doctrines to solve early oil and gas disputes).

3. CORNELIUS J. MOYNIHAN, INTRODUCTION TO THE LAW OF REAL PROPERTY 32–33 (2d ed. 1988). A fee simple determinable:

> [E]xpire[s] automatically upon the happening or non-happening of an event stated in the conveyance or will creating the estate. Thus, A owning land in fee simple absolute, conveys it to B "to have and to hold to B and his heirs so long as the land is used for residential purposes . . . ."

Id. Had the grantor conveyed her entire fee simple absolute estate, she would have retained no interest in the property. Grantors who convey less than fee simple absolute retain an interest. When the conveyed estate is a fee simple determinable, the retained interest is called a "possibility of reverter." *Id.* at 105. To avoid confusion, a possibility of reverter should be distinguished from other "reversionary" interests, a distinction the Texas Supreme Court fails to make in its decision, as discussed in this article. *See infra* note 138 and accompanying text.

4. MOYNIHAN, *supra* note 3, at 105.

5. *See* A. W. Walker, *The Nature of the Property Interests Created by an Oil and Gas Lease in Texas*, 7 TEX. L. REV. 1, 9 (1928) ("After the execution of a lease we have two separate and distinct corporeal freehold estates where only one existed before, . . . a determinable fee estate in the oil and gas . . . [and] a possibility of reverter in the oil and gas estate.").

6. Stephens County v. Mid-Kansas Oil & Gas Co., 113 Tex. 160, 254 S.W. 290 (1923). Recent cases have affirmed this view. *See, e.g.*, Concord Oil Co. v. Pennzoil Exploration & Prod. Co., 966 S.W.2d 451 (Tex. 1998); Luckel v. White, 819 S.W.2d 459 (Tex. 1991).

7. Byrom v. Pendley, 717 S.W.2d 602, 605 (Tex. 1986) (discussed in this article, *infra* Part IV.E).

transfer of real property interests also apply, such as the notion that one cannot convey an interest greater than she owns.[8]

The dispute in a 2008 Texas Supreme Court case, *Wagner & Brown, Ltd. v. Sheppard*, involved these basic principles.[9] In that case, courts considered whether a standard lease pooling clause allows a lessee to pool the lessor's possibility of reverter in addition to its fee simple determinable estate. Stated differently: Does a lessor's interest remain pooled even after her lease terminates? According to the lessor, Sheppard, the answer is no. She claimed that when her lease terminated the lessee's fee simple determinable estate ended and her possibility of reverter became possessory. At that point, Sheppard argued she became a cotenant no longer subject to the pooling unit the lessee had committed her interest to while the lease was in effect. For that reason, she rejected the lessee's payments based on the diluted unit-based royalty she had been paid under the terms of the lease pooling clause. Instead, since the producing wells were on her property, she claimed that cotenancy accounting rules applied. Those rules require a lessee to account to unleased cotenants on a net profits basis (Sheppard's 1/8th share of profits from wells on her tract less 1/8th of the reasonable drilling and operating costs). And because express lease terms require lessees to incur all drilling expenses while the lease is in effect, that net profits accounting permits an offset for expenses incurred only after her lease terminated.[10]

Both the trial court and the court of appeals agreed with Sheppard. The Texas Supreme Court, however, disagreed with the lower courts in a November 21, 2008 opinion.[11] Viewed from a historical perspective, that opinion followed a trend: For more than 10 or even 20 years, the Texas Supreme Court consistently has favored producers' legal arguments in oil and gas lease disputes.[12]

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8. *See* W. T. Waggoner Estate v. Sigler Oil Co., 118 Tex. 509, 517, 19 S.W.2d 27, 28–29 (1929) (holding that when lessee's lease terminated its assignees also lost their rights to the property).

9. 282 S.W.3d 419 (Tex. 2008).

10. For descriptions of Sheppard's arguments, see Wagner & Brown, Ltd. v. Sheppard, 198 S.W.3d 369, 374, 378 (Tex. App.—Texarkana 2006), *rev'd*, 282 S.W.3d 419 (Tex. 2008).

11. *Sheppard*, 282 S.W.3d at 419. Sheppard filed a motion for rehearing and the court requested Wagner & Brown to reply; July 6, 2009 was the court's deadline for ruling on Sheppard's motion. However, the court overruled Sheppard's motion on June 5, 2009. *Id.*

12. *See, e.g.*, Exxon Corp. v. Emerald Oil & Gas Co., No. 05-1076, 2009 WL 795668, at *4, *10 (Tex. Mar. 27, 2009) (finding mineral/royalty owners' claims barred by statute of limitations and reversing multimillion dollar judgment against Exxon for intentionally sabotaging wells so they could not be re-entered); Bowden v. Phillips Petrol. Co., 247 S.W.3d 690, 709 (Tex. 2008) (decertifying subclasses of royalty owners seeking royalty underpayment damages); Kerr-McGee Corp. v. Helton, 133 S.W.3d 245, 258 (Tex. 2004) (reversing lower courts' ruling awarding damages for drainage concluding expert's testimony contained "too great an analytical gap" and rendering for producer); Natural Gas Pipeline Co. v. Pool, 124 S.W.3d 188, 202 (Tex. 2003) (holding that even though leases terminated lessee had reacquired leases by adverse possession); *In re* Bass, 113 S.W.3d 735, 745–46 (Tex. 2003) (stating that executive rights owner owed no duty to non-participating royalty owner to lease and develop mineral estate and indicating that a duty is not triggered in absence of a lease); Union Pac. Res. Group v. Hankins, 111 S.W.3d 69, 75

In light of this trend, the Texas Supreme Court's reversal was not unexpected. Yet the *Sheppard* opinion provoked strong reactions among oil and gas law practitioners, academics, and others involved in the industry.[13] In fact, the court received nearly a dozen amicus curiae briefs signed by more than 20 attorneys—many of whom typically represent producers—urging it to reconsider, citing these and other reasons.

1. The court contradicted the prevailing view among attorneys and others in the oil and gas industry that the standard lease pooling clause, such as the one in Sheppard's lease, does not permit a lessee to pool the lessor's possibility of reverter, and therefore lessors' interests are no longer pooled after lease termination.
2. The court injected uncertainty into land titles by rejecting settled principles and ignoring previous decisions, thereby raising myriad questions such as, What does a landowner own after her pooled lease terminates? Are deep rights still pooled despite prior termination of those rights according to express lease clauses? Have old pools been resurrected? If so, when do they end?

(Tex. 2003) (holding royalty underpayment cases could not be maintained as class action because of lease language differences); Wagner & Brown, Ltd. v. Horwood, 58 S.W.3d 732, 736–38 (Tex. 2001) (holding discovery rule barred royalty owner's claim and suggesting that contacting company to find information renders such information discoverable); Yzaguirre v. KCS Res., Inc., 53 S.W.3d 368, 372–75 (Tex. 2001) (applying plain meaning approach to lease royalty clause and declining to imply covenant to market to "market value at the well" royalty provision); HECI Exploration Co. v. Neel, 982 S.W.2d 881, 885–88 (Tex. 1998) (holding royalty owner's cause of action barred by discovery rule because publicly available information rendered facts inherently discoverable); Heritage Res. v. NationsBank, 939 S.W.2d 118, 130–31 (Tex. 1996) (charging lessor with post-production costs despite plain language that "no deductions" should be charged to lessor); *see also* John McFarland, *Texas Supreme Court Record on Royalty Owner Cases*, OIL AND GAS LAWYER BLOG, Apr. 6, 2009, http://www.oilandgas lawyerblog.com/2009/04/texas-supreme-court-record-on.html (concluding, "I was unable to find any Supreme Court case in the last ten years that ruled in favor of royalty owners."). It appears one has to go back to 1986 and 1981 to find solid victories for lessors. *See* Gavenda v. Strata Energy, Inc., 705 S.W.2d 690, 692–93 (Tex. 1986) (holding *Middleton*'s "binding until revoked" rule for division orders inapplicable when lessee is unjustly enriched); Amoco v. Alexander, 622 S.W.2d 563, 567–70 (Tex. 1981) (holding implied covenant of drainage included field-wide drainage and suggesting lessees must undertake broad affirmative duties to satisfy that covenant such as obtaining a Rule 37 exception). The *HECI* case, however, significantly retreated from *Amoco*'s broad view of implied covenants. *See* Laura H. Burney, HECI v. Neel *and Proposed Discovery Rule Legislation: Point/Counterpoint—The View of the Royalty Owner*, ADVANCED OIL, GAS & MIN. L. COURSE, § 4.1 (Sept. 21–22, 2000) [hereinafter Burney, HECI v. Neel] (transcript on file with the *St. Mary's Law Journal*).

13. The *Texas Lawyer* magazine included an article about the case immediately after it was released and quoted several attorneys who were critical of the decision. *See* John Council, *Pooling Lands, Not Just Leases*, TEX. LAWYER, Dec. 1, 2008, *available at* http://www.law.com/jsp/tx/PubArticleTX.jsp?id=1202426366561&hbxlogin=1 ("The Texas Supreme Court threw oil and gas lawyers a curve ball on November 21 in a decision that many believe will cause uncertainty in disputes between large energy companies and property owners who lease their land to the companies for drilling operations.").

3. The court departed from its plain meaning approach to lease interpretation and encouraged litigation by adopting an "equitable" view of lease terms, at least when it favors lessees.[14]

Not persuaded by these concerns, the court finalized its opinion on June 5, 2009. So now the question for players in the oil patch is: What hath *Wagner & Brown v. Sheppard* wrought? This article discusses that question, assesses the effects of the *Sheppard* decision on oil and gas jurisprudence, and provides suggestions for addressing the aftermath.

II. BACKGROUND: POOLING

Pooling is the combining of several tracts to form a single unit.[15] Although the terms are frequently used interchangeably, *pooling* must be distinguished from *unitization*:

> Pooling is the process of combining small tracts into an area of sufficient size to merit a well permit under the field's applicable spacing rule.... Pooling generally occurs while the field is in the primary stage of recovery. Unitization, on the other hand, is the process of combining all or a large part of the acreage of an entire field into a unit.... Unitization often occurs during secondary recovery after the natural pressure in the field has been dissipated in primary recovery.[16]

Pooling has two primary effects on the oil and gas lease: First, it erases lease lines, meaning that production from anywhere in the pooled unit constitutes production for a lease in the unit, even if the well is not on the leased tract. Pooling prevents a lease from terminating even when there is no production in paying quantities from that tract, as required by the lease's habendum (or term) clause. Stated differently, the lease pooling clause is also a lease savings clause for the lessee. Second, pooling affects the lessee's obligations to owners in the pooled unit. For example, a lease generally requires a lessee to pay its lessor a royalty based on a fractional

14. Pro-Sheppard Amicus Curiae briefs included briefs filed by oil and gas attorneys who represent landowners and producers, all with more than 20 and even 30 years of experience: the Texas Independent Producers and Royalty Owners Association; the Midland law firm of Cotton, Bledsoe, Tighe & Dawson, P.C.; four former Chairs of the Oil, Gas, and Energy Resources Law Section of the State Bar of Texas; several lawyers board-certified in oil and gas law; and those with extensive expertise in title opinions. The author was one of the attorneys who wrote in support of Sheppard's motion for rehearing. The following filed Amicus Curiae Briefs in support of the supreme court's opinion: (1) Chesapeake Energy Corp., Forest Oil Corp., and XTO Energy, Inc.; (2) Texas Civil Justice League, Inc.; (3) Marc L. Skeen; and (4) Lynch, Chappell & Alsup, P.C.

15. JACQUELINE LANG WEAVER, UNITIZATION OF OIL AND GAS FIELDS IN TEXAS: A STUDY OF LEGISLATIVE, ADMINISTRATIVE, AND JUDICIAL POLICIES 7–8 (1986) [hereinafter WEAVER, UNITIZATION]. Confusion also occurs between a reference to a *pooled unit* and units formed for secondary recovery through *unitization*.

16. *Id.*

amount of the production or the proceeds from the sale of that production from wells producing on the leased premises. Pooling changes that contractual obligation by requiring the lessor to accept a diluted royalty, one typically calculated on a surface-acreage basis (the number of acres of her tract compared to the total number of acres in the unit).[17] This diluted royalty formula applies even if the well is drilled on the pooled lessor's tract.

Forming pooled units is essential in the oil and gas industry. It prevents waste, insures efficient production of oil and gas, and protects correlative rights of mineral estate owners.[18] For that reason, most major producing states long ago passed compulsory pooling acts.[19] Notoriously slow to follow that path, Texas passed an act in 1965 known as the Mineral Interest Pooling Act ("MIPA").[20] Unlike acts in other states, however, authorities view the MIPA as limited in function, less a compulsory act than an act to encourage voluntary pooling.[21] In fact, in Texas pooled units formed pursuant to the MIPA are relatively rare.[22]

Therefore, in Texas the lease pooling clause serves as the most common method for creating pooled units.[23] Armed with that clause, the

17. For example, assume tract X, a 40-acre tract under a lease providing for a 1/8th royalty, is pooled with another 40-acre tract, and the lessee drills a producing well on tract X. Absent pooling the lessor in tract X would receive 1/8th of the production or proceeds, cost-free, from the well drilled on her tract. In light of the pooling, however, she has contracted to receive 40/80ths, or 1/2 of the 1/8th royalty set forth in her lease.

18. *See* WEAVER, UNITIZATION *supra* note 15, at 22–24.

19. *Id.* at 21–22. States began passing compulsory pooling laws in the 1940s and 1950s.

20. MIPA, TEX. NAT. RES. CODE ANN. § 102 (Vernon 2001). Professor Jacqueline Weaver has analyzed and criticized Texas's approach to pooling and unitization. *See, e.g.*, Jacqueline Lang Weaver, *The Politics of Oil and Gas Jurisprudence: The Eighty-Six Percent Factor*, 33 WASHBURN L.J. 492, 499 (1994) [hereinafter Weaver, *Politics*] ("Texas is unique. It is the largest oil and gas producing state in the United States, yet it has the weakest pooling and unitization laws.").

21. ERNEST E. SMITH & JACQUELINE LANG WEAVER, TEXAS LAW OF OIL AND GAS 12-7 (Lexis Nexis 2009) [hereinafter SMITH & WEAVER].

22. Carroll Martin & D. Davin McGinnis, *All for One and One For All: A Primer on Pooling in Texas*, 31 ERNEST E. SMITH OIL, GAS & MIN. L. INST. 2, at 1 (2005), *available at* http://www.utcle.org/eLibrary/preview.php?asset_file_id=553.

23. In addition to pooling acts and lease clauses, pooling occurs when a community lease is executed. A community lease is a single lease covering two or more separate tracts. "In Texas, execution of a community lease creates a strong presumption that the parties intended to pool their interests, with royalties being apportioned on the basis of the number of acres each lessor has contributed to the community lease." JOHN S. LOWE, OIL AND GAS LAW IN A NUTSHELL 242 (2009) [hereinafter LOWE, NUTSHELL].

Texas has rejected the concept of equitable or judicial pooling. *See* Ryan Consol. Petrol. Corp. v. Pickens, 266 S.W.2d 526 (Tex. Civ. App.—Texarkana 1954), *aff'd*, 155 Tex. 221, 285 S.W.2d 201 (1955) (discussed in LOWE ET AL., CASES AND MATERIALS ON OIL AND GAS LAW 189–90 (2008) [hereinafter LOWE ET AL., CASES AND MATERIALS] (noting Texas has rejected equitable pooling and explaining that "according to this doctrine, when a well is drilled on an established spacing unit, the land within the unit is automatically pooled as a matter of law")).

A note regarding the author's citations to casebooks and Lowe's *Nutshell*: In law review articles, authors generally refrain from citing such sources, at least as primary authority. For this lessee is free to commit the tract to a pooled unit and sign a separate unit agreement with other participating producers. Without a pooling clause, the lessee cannot pool the lease and affect the lessor's rights. Indeed, if a lessee pools without authority and a well is drilled on the leased premises, that lessee must account to its lessor for the full lease royalty on production from the well, even though the lessee receives only a diluted share of the production pursuant to the unit agreement it signed. This liability occurs because lessors do not sign the lessees' unit agreements or designations; therefore, lessors are not bound by contractual terms in those agreements, including terms allocating production and diluting royalty payments.[24] As described below, however, the Texas Supreme Court overlooked this fact, and many others, in the *Sheppard* opinion.

III. FACTS

Wagner & Brown, Ltd. v. Sheppard involves pooling accomplished under a lease pooling clause.[25] Jane Sheppard owns an undivided 1/8th mineral interest in 62.72 acres in Upshur County. In 1994 she leased her interest, as did the owners of the other 7/8ths interests, in the 62.72 acre tract.[26] Sheppard's lease provides for a 1/4th landowner's royalty.[27] Ironically, her lease is not a pro-producer form.[28] Instead, it contains several clauses landowners often desire but often cannot negotiate into their lease forms.[29] For example, although the royalty obligation typically is written as a covenant, that is, as a contractual promise to pay, rather than as a terminating condition, her lease specifically states in an addendum that if the lessee fails to pay timely, the lease automatically ends.[30]

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article, however, such authorities are particularly significant to show the extent to which the Texas Supreme Court's opinion literally departs from basic textbook oil and gas law principles.

24. LOWE, NUTSHELL, *supra* note 23, at 241.

25. 282 S.W.3d 419, 421–22 (Tex. 2008).

26. *Id.*

27. Wagner & Brown, Ltd. v. Sheppard, 198 S.W.3d 369, 371 (Tex. App.—Texarkana 2006), *rev'd*, 282 S.W.3d 419 (Tex. 2008). An unofficial copy of the Sheppard lease is available through the Upshur County Clerk Records at http://countyofupshur.com:8000/detail.aspx?doc=03945-1995&ms=0&n=03945-1995.

28. Practitioners often refer to a "Producers 88" to denote a classic pro-producer form. *See, e.g.*, JUDON FAMBROUGH, HINTS ON NEGOTIATING AN OIL AND GAS LEASE 1 (1997), *available at* http://recenter.tamu.edu/pdf/229.pdf. Commentators, however, note that there is no standard oil and gas lease. *See id.* ("No standard or universal lease form is used by the oil and gas industry.").

29. Examples of other pro-lessor clauses include: a no deductions from royalty provision, surface use restrictions, an indemnification clause, and notice requirements. *See id.*

30. The clause is in the addendum paragraph 15(k) and is set forth in the *Sheppard* opinion. 282 S.W.3d at 421.

A. The "Standard" Pooling Clause in Sheppard's Lease

Sheppard's pooling provision, however, is one the court labels a "standard industry pooling clause."[31] Indeed, the amicus briefs also view the clause as one commonly encountered in practice. As described above, the clause contains a savings provision clarifying that "[p]roduction, drilling or reworking operations anywhere on a unit which includes all or any part of the leased premises shall be treated as if it were production, drilling or reworking operations on the leased premises . . . ."[32] Because there was production from the unit—the wells on Sheppard's tract—this clause was not an issue in the case. In fact, because there was production from the unit, none of the other lessors claimed that their leases, or the unit, had terminated. Yet as discussed below, the Texas Supreme Court's opinion assumes that unit termination is the issue in the case.[33]

1. The Royalty Calculation for Pooling: A Covenant, Not a Conveyance of Royalty

Sheppard's pooling clause also contains standard language that changes the lessee's royalty obligation after pooling from a tract-based to a unit-based formula: "[After pooling] production on which Lessor's royalty is calculated shall be that proportion of the total unit production which the net acreage covered by this lease and included in the unit bears to the total gross acreage in the unit . . . ."[34] Wagner & Brown viewed this provision as granting the lessee the power to pool the lessor's interest beyond the life of the lease.[35]

31. *Id.* at 422.
32. *Id.*
33. *Id.*
34. *Id.*
35. *See* Petitioners' [Wagner & Brown's] Response to Motion for Rehearing at 7, Wagner & Brown, Ltd. v. Sheppard, 282 S.W.3d 419 (Tex. 2008) (No. 06-0845), 2009 WL 665157 ("More fundamentally, the argument that the lease only granted the lessee the power to pool its own interest is irreconcilable with the well-established principle that a pooling clause grants the lessee the power to pool the lessor's royalty interest."). In support of this statement, Wagner & Brown cites treatises that state, for example: "A pooling clause gives the lessee the power to pool or combine the royalty owner's interest without further approval of the royalty owner." *Id.* (citing 1 BRUCE M. KRAMER & PATRICK H. MARTIN, THE LAW OF POOLING AND UNITIZATION at 8-1 (3d ed. 2008)). But those authorities continue to clarify that the reference to the "royalty owner's interest" in the pooling context, refers to the lands subject to the lease, not the possibility of reverter. In fact, the Texas Supreme Court's opinion cites the same Kramer & Martin treatise, which opines that pooling does *not* last after a lease terminates; however, the court rejects that view. *See* discussion *infra* Part V.C & n.142. The pooling clause simply does not state that pooling pools the royalty and possibility of reverter in addition to the leased premises. Another pro-Sheppard amicus brief responded this way:

> [Wagner & Brown's] argument demonstrates a fundamental ignorance of an oil and gas lease, and ignores the simple explanation.
>
> The royalty obligation is a covenant that burdens the Leased Premises, and there can be no doubt that when the lessor authorizes the lessee to pool the Leased Premises, that authority includes the royalty. In fact, a substantial part of the pooling

That view of the royalty provision in a pooling clause, however, is incorrect. Pooling provisions do not *convey* lessors' royalty interests or their possibilities of reverter. No such language of conveyance appears in the pooling clause or in any part of the oil and gas lease. Instead, as the court of appeals in *Sheppard* recognizes, a pooling clause permits a lessee to pool not the lessor's royalty, but the lessee's estate—the fee simple determinable.[36] For that reason, the pooling power should not be viewed as creating a power of attorney in the lessee to pool the lessor's interest.[37] Instead, that clause creates contractual rights in the lessee that allow it: (1) to pool its fee simple determinable estate in the leased property with other tracts to create pooled units, without contacting the lessor; and (2) to change the lessee's royalty obligation after pooling from a well or tract-based calculation to a diluted, unit-based calculation.[38]

2. The First Sentence of the Pooling Clause: The Texas Supreme Court's Interpretative Focus

Rather than rely on the royalty-calculation provision, the Texas Supreme Court focuses primarily on the first sentence in the pooling clause: "Lessee shall have the right but not the obligation to pool all or any part of the leased premises or interest therein with any other lands or interests . . . ."[39] The court then turns immediately to language in the lessee's unit agreement, noting that it combined "leases and lands."[40] However, the court misinterprets the role and meaning of both the unit agreement language and the lead sentence in the pooling clause, and adopts, among others, these two mistaken premises: (1) lessors are bound

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> clause in the Sheppard lease is spent explaining how royalty is to be paid once the Leased Premises are pooled.
>
> However, the possibility of reverter is a separate estate vested in the lessor, . . . nowhere does the lease authorize the lessee to pool it. Petitioners' failure to grasp this fundamental concept is astonishing to any lawyer who regularly deals with oil and gas leases.

Reply Brief of Amicus Curiae of Dick Watt to Petitioners' Response to Motion for Rehearing at 5, *Sheppard*, 282 S.W.3d 419 (No. 06-0845), 2009 WL 908300 [hereinafter Reply Brief of Dick Watt]. (Mr. Watt is a former chair of the Oil, Gas, and Energy Resources Law Council of the State Bar of Texas).

36. *See* discussion of court of appeals opinion *infra* Part IV.

37. *But see* LOWE, NUTSHELL, *supra* note 23, at 243 ("A typical pooling clause grants the lessee a power of attorney to pool the lessor's interests."). But Professor Lowe continues to describe the pooling clause as changing "the result that would otherwise occur under the lease." *Id.* This statement is consistent with the view that the pooling clause simply contains contractual provisions that allow the lessee to pool without contacting the lessor and to change its royalty obligation after pooling. Viewing the pooling clause as creating contractual rights rather than as a power of attorney also avoids the argument that the clause imposes fiduciary duties on a lessee like those imposed on one granted a power of attorney.

38. *See* LOWE, NUTSHELL, *supra* note 23, at 246.

39. *Sheppard*, 282 S.W.3d at 422–23.

40. *Id.*

by lessees' unit agreements; and (2) a standard pooling clause allows a lessee to pool the lessor's possibility of reverter.[41]

B. The Dispute: Did Sheppard's Interest Remain Pooled After Her Lease Terminated?

The facts that placed that second premise into contention were these: In September 1996, over two years after Sheppard signed her lease, her lessee pooled her interest into the 122-acre W.M. Landers Gas Unit. This unit was composed of the Sheppard tract, including leases from the owners of the other undivided 7/8ths mineral interests in Sheppard's tract, and leases on eight other tracts. In October 1996 a gas well located on Sheppard's tract, called the Landers No. 1, was completed and began producing. Nearly a year later, in September 1997 a second well, the Landers No. 2, also located on Sheppard's tract, began producing.[42]

In September 2000 Wagner & Brown took over as operator of the Landers Unit and discovered that Sheppard had not been paid royalties by the prior lessee according to the timeline in her lease. Recognizing that her lease had terminated on March 1, 1997 according to its express terms, Wagner & Brown offered Sheppard a new lease, which she declined. Although Wagner & Brown recognized that Sheppard's status shifted from lessor to unleased cotenant, it contended that her interest remained subject to the pooled unit, including provisions diluting payments owed to her.[43]

Sheppard sued Wagner & Brown for the following: (1) failure to pay her based on her full undivided 1/8th mineral interest, undiluted by the pooling formula; (2) failure to properly account to her after lease termination as a cotenant by charging her with expenses incurred while her lease was in effect; and (3) failure to properly account by charging her with expenses on an aggregate basis (deducting costs from one well from revenues of another well), rather than on a well-by-well basis. This accounting question arose because Wagner & Brown sought to deduct costs of an expensive and unprofitable workover on the No. 1 well from revenues from the No. 2 well.[44]

C. The Trial Court: Sheppard Wins

The trial court agreed with Sheppard on all points. It noted that Sheppard automatically became a cotenant with the producers–owners in

41. *See id.* at 422–24.
42. *Id.* at 421.
43. *Id.* at 421-22.
44. Wagner & Brown, Ltd. v. Sheppard, 198 S.W.3d 369, 372 (Tex. App.—Texarkana 2006), *rev'd*, 282 S.W.3d 419 (Tex. 2008).

the unit on March 1, 1997, the date her lease terminated according to the royalty payment timeline. After that date, Sheppard was entitled to receive from the Landers No. 1 and No. 2 wells an undivided 1/8th of the net revenues attributable to her interest on a tract basis, not a pooled basis. In determining that net amount, Wagner & Brown could charge against the wells' revenues 1/8th of the necessary and reasonable costs of producing and marketing the minerals from those wells after lease termination, but not those incurred while the lease was in effect. Moreover, only costs figured on a well-by-well basis, not an aggregate basis, could be charged against Sheppard's interest.[45]

IV. THE COURT OF APPEALS DECISION: SHEPPARD WINS

The Texarkana Court of Appeals affirmed the trial court's rulings.[46] In its written opinion, the court describes the initial issue in the case as, "Is Sheppard's Interest Still Subject to the Pooled Unit?"[47] The court's answer: No.[48]

A. *"Is Sheppard's Interest Still Subject to the Pooled Unit?" No*

As the court began its analysis of this issue, it noted, "We have been unable to find anything in Texas caselaw directly on point to control our analysis."[49] However, an explanation exists for the lack of pinpoint authority on the question of whether pooling ends when the lease ends. That proposition has never been questioned—by attorneys, academics, title examiners, or courts—because the answer has never been in doubt.[50] Instead, in a statement echoed by all of Sheppard's amici and other attorneys, the brief filed by the Texas Independent Producers and Royalty Owners Association ("TIPRO") proclaimed:

> [N]o lessee, lessor or mineral owner in this state believes, understands, or intends the possibility of reverter owned by the original grantor (lessor) of a lease, or its heirs or assigns, to be pooled by standard form pooling language into a production unit by the lessee's unilateral declaration of pooling, or to remain or become pooled in the production unit after the underlying lease terminates

45. Wagner & Brown, Ltd. v. Sheppard, No. 486-97 (115th Dist. Ct., Upshur County, Tex. Feb. 23, 2005).
46. *Sheppard*, 198 S.W.3d at 371.
47. *Id.* at 374.
48. *Id.* at 377.
49. *Id.* at 374.
50. *See* SMITH & WEAVER, *supra* note 21, at 4-123 ("The widespread assumption prior to the decision was that a lessee has no authority to pool the lessor's possibility of reverter and the lessor's interest is no longer within a pooled unit after the lease expires.").

for whatever reason. This has never been the law in Texas, nor should it be.[51]

B. The Ladd *Case Does Not Control*

Seeking guidance, the court of appeals reviewed *Ladd Petroleum Corp. v. Eagle Oil and Gas Co.*,[52] an appellate case out of the Fort Worth Court of Appeals that the Texas Supreme Court ultimately considered controlling.[53] But as the court of appeals concluded, *Ladd* is:

> [F]ar different from the instant case in one important respect: in *Ladd*, the litigants were attempting to terminate the entire pool—or perhaps obtain a declaration that, when one pool participant is no longer in the pool, then the pool ceases to exist. Here, Sheppard merely insists that her participation in the pool has terminated, not that the entire pool has terminated.[54]

Although the court of appeals accurately assessed *Ladd* as "far different" than *Sheppard,* the court could have been more emphatic in rejecting *Ladd* as precedent. The controlling issue in *Ladd* was whether a lease, known as the Blair lease, had terminated according to its plain terms. In *Sheppard* the parties agreed that her lease had terminated according to its terms: Sheppard was not paid according to the timeline required for royalty payments. In *Ladd* the issue was whether the Blair lease had terminated according to the language of its habendum clause. The clause provided for a primary term of five years and "as long thereafter as 'oil, gas or other mineral is produced *from said land or land with which said land is pooled hereunder.*'"[55] The Blair lease was pooled with the Woody lease. A producing well was drilled on the Woody lease. As the court noted, "It was production from that unit well which kept the [Blair] leases alive after 1960."[56] Ladd eventually became lessee of both leases. In 1976 it inadvertently released the Woody lease. At that point,

51. Amicus Brief of Tex. Ind. Prod. and Royalty Owners Ass'n at 6, Wagner & Brown, Ltd. v. Sheppard, 282 S.W.3d 419 (Tex. 2008) (No. 06-0845), 2009 WL 357423; *accord* Amicus Curiae Brief of Herbert W. Henry at 14, *Sheppard*, 282 S.W.3d 419 (No. 06-0845) ("[P]rior to this case the overwhelming majority of persons engaged in the oil and gas business did not construe the standard industry pooling clause as authorizing a pool to survive lease termination. The Court's opinion in this case was a surprise to everyone I know."). (Mr. Henry has practiced oil and gas law for 37 years.). *See also* Patton Boggs LLP, Oil and Gas Alert: The Texas Supreme Court's Decision in *Wagner & Brown, Ltd. v. Sheppard*, Mar. 2009, http://www.pattonboggs.com/news/Detail.aspx?news=746 ("In no cases or instances has the pooling of lands under a lease been construed as a pooling of the underlying minerals free of the lease—until this case.").

52. 695 S.W.2d 99, 106 (Tex. App.—Fort Worth 1985, writ ref'd n.r.e.).

53. Wagner & Brown, Ltd. v. Sheppard, 282 S.W.3d 419, 423 (Tex. 2008).

54. *Sheppard*, 198 S.W.3d at 375.

55. *Ladd*, 695 S.W.2d at 101 (emphasis added).

56. *Id.*

the Blairs argued their lease also terminated, giving them the right to lease to a new producer. They also claimed the unit had terminated.[57]

Ladd argued that the unit had not terminated because one of the two leases had not terminated. According to Ladd, even if the Woody lease had terminated upon its release, the Blair lease never terminated. Therefore, in order to determine whether the unit had terminated, the court first had to examine whether the Blair lease had terminated according to the terms of its habendum clause.[58] The habendum clause specifically provided that production from other "land" with which the Blair lease had been pooled would maintain the Blair lease. Maintaining the lease was not limited to production from the Blair tract. Because the well on other pooled "land"—the Woody lease well—was producing, the court held that production maintained the Blair lease, even if the Woody lease had been released. Because one of the two leases in the unit continued, the unit continued.[59]

As the court of appeals in *Sheppard* concluded, *Ladd* never addressed the *Sheppard* issue: Whether a standard lease pooling clause pools the lessor's possibility of reverter in addition to the lessee's estate.[60] The Texas Supreme Court's opinion, however, fails to recognize that fact and considers *Ladd* support for its answer to an issue the *Sheppard* parties never raised: Whether the unit had terminated.[61] Seeking an answer to the actual issue in the case, the appellate court turned to applicable oil and gas law and other property principles.

C. *The Cross Conveyance Theory of Pooling: Instructive But Not Determinative*

To begin, the court noted that an "original explanation" for the effect of pooling was the *cross-conveyance of interests* theory.[62] According to that theory, pooling results in a conveyance of title among all participants in the pooled unit, and each acquires a proportionate property interest in

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57. *Id.* at 101–02.

58. *Id.* at 107. "As we read the leases, the power to unpool was not vested in the lessee. Therefore, an unpooling could only come about through an agreement of the lessors, or through a cessation of production as provided for in the habendum clauses." *Id.* The amicus briefs in the *Ladd* case note that title examiners generally view a pooled unit as terminated once all the leases in that unit have terminated.

59. *Id.* at 106. The court concluded that because the Blair lease was maintained by production from the Woody "lands" despite the release of the Woody lease, the unit did not terminate: "Despite this elimination of the leasehold interest through release, the unit did not terminate." *Id.*

60. *See* Wagner & Brown, Ltd. v. Sheppard, 198 S.W.3d 369, 375 (Tex. App.—Texarkana 2006), *rev'd*, 282 S.W.3d 419 (Tex. 2008).

61. *See* Wagner & Brown, Ltd. v. Sheppard, 282 S.W.3d 419, 422 (Tex. 2008) ("Does Termination of the Lease Also Terminate the Unit?").

62. *Sheppard*, 198 S.W.3d at 376.

the others' lands.[63] Many states have specifically rejected that theory, noting instead that pooling creates merely contract rights among the parties in a unit. In Texas most leases achieve that result by including the royalty-calculation formula that applies after pooling while also expressly stating that pooling does not affect a cross-conveyance of interests.[64] Because the Sheppard lease contains such a *no cross-conveyance* clause, the court of appeals (at least in part) discounted that theory as guidance for resolving the underlying issue in the case.[65] Instead, the court viewed the cross-conveyance theory as merely clarifying that pooling affects the parties' real property interests. Therefore, the court carefully analyzed the nature of those property interests.

D. A Property Law Analysis: A Lessee Owns a Fee Simple Determinable and Can Pool "No More Than It Owned"

The court of appeals began its property law analysis with a review of the estate created by an oil and gas lease:

> [T]he lessee in the usual oil and gas lease obtains a determinable fee in the oil and gas in place and, thus, obtains an interest in realty. As a determinable fee interest, it will last only for the primary term or so long as oil or gas is produced, or, as in this case, until some other event occurs that results in termination.[66]

Next, the court relies on the basic notion that one cannot convey more than he owns: "Even though the lessee had the right to pool the property, it could pool no more than it owned, and it only had an ownership interest in the mineral estate until that right was terminated."[67]

To restate that proposition, the court invoked the classic concept from first-year law school property courses, the bundle of sticks:

> It is uncontested that Wagner had the authority to agree on the unit designation and to commit Sheppard's interest to that unit. That authority, however, existed only because the lease existed, which transferred a "bundle of sticks" to Wagner for safekeeping. Wagner could not have transferred more than it had available—and . . . the

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63. *Id.* (citing Montgomery v. Rittersbacher, 424 S.W.2d 210, 213 (Tex. 1968)). The cross-conveyance theory originated in *Veal v. Thomason*, a case in which pooling occurred because of a community lease. 138 Tex. 341, 159 S.W.2d 472 (1942). A community lease is a single lease signed by several tract owners. That case raised a procedural issue: whether all owners were necessary parties in litigation against one owner regarding a title defect. *Id.* at 343, 159 S.W.2d at 473. For a criticism of the cross-conveyance theory, see Joseph J. French, Jr. & Frank W. Elliott, Jr., *The Legal Effect of Voluntary Pooling and Unitization: Theories and Party Practice*, 35 TEX. L. REV. 401 (1957).

64. LOWE, NUTSHELL, *supra* note 23, at 250.

65. *Sheppard*, 198 S.W.3d at 376 n.5.

66. *Id.* at 376.

67. *Id.* at 377.

termination automatically returned the "bundle" to the mineral owner free and clear of encumbrances.[68]

E. Cotenancy Accounting Analysis: Background

Once Sheppard's interest was "free and clear" of the lease, and the pooling allowed by that lease, she became an unleased cotenant. Therefore, cotenancy accounting rules applied from that point forward. The court described the transition: "The simple fact is that these parties were in one relationship [lessor–lessee] and that relationship ended. When it did, their respective responsibilities and duties necessarily changed to reflect the differences in the relationship."[69]

In assessing those duties, the court followed literally textbook cotenant accounting principles. In Texas and most states, an owner of an undivided interest in the mineral estate has the right to develop the minerals himself, or, in the usual case, lease his minerals to a third-party lessee, without joinder of his other mineral cotenants.[70] However, the developing owner or his lessee has a duty to account to the other cotenants.[71] One treatise sets forth those accounting rules as follows:

> Each non-joining co-tenant has the right to receive his proportionate share of the products produced, but must bear the reasonable costs of development, production and marketing. The producing co-tenant, however has a right of recoupment, and he may retain all of the production until he has recouped his costs. Where production is insufficient to cover the costs of development and production, the non-joined co-tenant is under no personal liability for his share of the excessive costs.[72]

The court of appeals relied upon often-cited Texas cases that followed these and other accounting principles, including *Byrom v. Pendley*,[73] *Hunt v. HNG Oil Co.*,[74] and *Broadway v. Stone*.[75] These cases merit

68. *Id.* The court continued with its property law analysis, concluding again that "[t]he property rights possessed by Wagner vanished, and when they did, so necessarily did the rights to that property that were dependent on Wagner's lease. The first point of error is overruled." In the process of reaching this conclusion, the court also rejected Wagner's claim that the pooling clause created an agency relationship between the lessor and lessee that allowed the pooling to extend beyond the life of the lease. *Id.* That conclusion is appropriate since, while in Texas and other states the oil and gas lease is not viewed as creating a fiduciary relationship between the parties, an agent does owe its beneficiaries a fiduciary duty. LOWE, NUTSHELL, *supra* note 23, at 102. Therefore, the court of appeals correctly views the lease pooling power as a contractual right that allows lessees to pool their fee simple determinable estates, but not the lessor's possibility of reverter.

69. *Sheppard*, 198 S.W.3d at 377.

70. LOWE ET AL., CASES AND MATERIALS, *supra* note 23, at 567.

71. *See, e.g.*, Byrom v. Pendley, 717 S.W.2d 602, 605 (Tex. 1986).

72. RICHARD W. HEMINGWAY, THE LAW OF OIL AND GAS 203 (3d ed. 1991).

73. 717 S.W.2d 602 (Tex. 1986).

74. 791 S.W.2d 191 (Tex. App.—Corpus Christi 1990, writ denied).

review because in reversing the court of appeals in *Sheppard*, the Texas Supreme Court also contradicts the appellate court's view of these cases.

In *Byrom v. Pendley*, Byrom had a lease from the owner of an undivided 11/24ths interest in property and took a second lease from the owners of an undivided 12/24ths interest in the same tract.[76] Pendley had previously leased the 12/24ths interest, but Byrom claimed the Pendley lease was invalid and sued him. While the lawsuit was pending, Byrom drilled a producing well. Pendley ultimately won that lawsuit, meaning he and Byrom were cotenants–lessees in the property. As the producing cotenant, Byrom agreed he owed Pendley a duty to account on a net profits basis.[77] Pendley, however, asserted that Byrom became a bad faith trespasser by disputing Pendley's title. In equity, good faith trespassers are entitled to recoup their reasonable and necessary costs to the extent they benefit a true owner.[78] Bad faith trespassers, however, are subject to a harsh rule and may not recover their costs.[79]

While the court of appeals agreed with Pendley, the Texas Supreme Court reversed.[80] In its opinion, the court clarified that because Byrom had one valid lease from another cotenant that never terminated, he was never a trespasser. Therefore, rules governing trespassing improvers did not apply. Rather, as Byrom had claimed, cotenancy accounting rules applied. These cotenancy accounting rules mirror those owed by good faith trespassers: He owed his non-producing cotenant an accounting on a net profits basis, which allowed him to deduct reasonable and necessary expenses from Pendley's proportionate share of production.[81]

While *Byrom* did not involve a trespassing driller, those facts did arise in *Hunt v. HNG Oil Co.*[82] In that case, the lessee entered under a valid lease, drilled a dry hole, then after the lease terminated, plugged back to a shallower formation and drilled a producing well. In light of the original lease, the lessee was considered a good faith trespasser entitled to deduct its reasonable costs of the producing well. However, the lessee was not allowed to recoup its initial drilling costs of the dry hole because those

75. 15 S.W.2d 230 (Tex. Comm'n App. 1929, holding approved).

76. *Byrom*, 717 S.W.2d at 604.

77. Byrom v. Pendley, 703 S.W.2d 405, 406 (Tex. App.—Eastland 1986), *rev'd*, 717 S.W.2d 602 (Tex. 1986).

78. LOWE ET AL., CASES AND MATERIALS, *supra* note 23, at 101.

79. *Id.* at 101–02 (describing "harsh" measure of damages applied to bad faith trespassers).

80. *Byrom*, 717 S.W.2d at 604.

81. *Id.* at 605. This opinion is also known for having distinguished *Humble Oil & Refining Co. v. Kishi*, 276 S.W. 190 (Tex. Comm'n App. 1925, judgm't adopted), *rehearing granted*, 291 S.W. 538 (Tex. Comm'n App. 1927, holding approved). *Kishi* addressed the measure of damages owed by Humble when it drilled a dry hole after its lease had terminated. There the court awarded market value of the right to lease. *Id.* at 191. The *Byrom* court noted *Kishi* involved a trespasser because the well was drilled after the lease had terminated. *Byrom*, 717 S.W.2d at 605; *see also* LOWE, NUTSHELL, *supra* note 23, at 52.

82. Hunt v. HNG Oil Co., 791 S.W. 2d 191 (Tex. App.—Corpus Christi 1990, writ denied).

costs were incurred under a valid lease before the lessee became a trespasser.[83]

As support for its conclusion, the court in *Hunt* relied on *Broadway v. Stone*.[84] In that case, a lessee drilled wells on a tract believing the lease covered all owners. In fact, the Broadways owned a 1/36th interest. The Broadways conveyed their land to Miller. At the time Miller acquired his interest there were four producing wells and one well under construction, which later produced. Miller became the sole plaintiff seeking an accounting from the lessee. The court concluded the lessee was allowed to recoup costs incurred after Miller acquired his interest, which excluded the initial costs of the four wells. In other words, the lessee was not a trespasser as to Miller until after the date Miller acquired his interest, so it could recoup only costs it incurred after that date. Since the lessee in *Hunt* did not become a trespasser until after its lease terminated, the *Hunt* court found *Broadway* "sufficiently analogous to our facts."[85]

Relying on these and other cases, and the accounting principles they embraced, the court of appeals addressed and answered the following accounting issues that the trial court had resolved in Sheppard's favor.

1. Can Wagner & Brown Recoup Expenses Incurred Before Termination? No

The court of appeals devoted relatively little analysis in its opinion to answering this "simple" question about whether Sheppard was liable for expenses incurred while her lease was in effect: "Wagner has directed us to no rule of law that would in some way make her retroactively liable for such expenses and costs, and has advanced no convincing argument to justify such an action."[86]

As described below, however, the Texas Supreme Court disagrees and determines that equitable rules for *good faith trespassers or improvers* supply a convincing argument to possibly charge Sheppard with pre-termination costs.[87] As revealed in the discussion above of *Byrom*, *Hunt*, and *Broadway*, when those rules apply, they trigger accounting rules similar to those owed by producing cotenants. For example, a builder who mistakenly builds a house on the wrong lot may recover certain costs on an equitable basis. Equitable rules apply precisely because the builder has no contract with the lot owner, yet that owner may be unjustly enriched by the structure.

83. *Id.* at 194.

84. Broadway v. Stone, 15 S.W.2d 230 (Tex. Comm'n App. 1929, holding approved).

85. *Hunt*, 791 S.W.2d at 194.

86. Wagner & Brown, Ltd. v. Sheppard, 198 S.W.3d 369, 378 (Tex. App.—Texarkana 2006), *rev'd*, 282 S.W.3d 419 (Tex. 2008).

87. *See* Wagner & Brown, Ltd. v. Sheppard, 282 S.W.3d 419, 429–30 (Tex. 2008).

In its *Byrom* decision discussed above, the Texas Supreme Court clarified the role of those rules. Because a cotenant is not a trespasser, good faith trespasser rules do not define the duty owed by a producing cotenant to non-joined cotenants.[88] Similarly, as the court in *Hunt* recognized, a lessee is not a trespasser or mistaken improver while the lease is in effect, so again equitable rules have no relevance. Instead, as the *Hunt* court concluded, while the lease remains in effect, those terms govern the parties' relationship.[89] To repeat the *Sheppard* appellate court's summary of the transition from lease terms to cotenancy accounting rules: "The simple fact is that these parties were in one relationship and that relationship ended."[90] As discussed below, the Texas Supreme Court ignores "this simple fact" and the lease relationship. Instead, it invokes equity to allow Wagner & Brown the opportunity to recoup costs it incurred while Sheppard's lease was in effect.

2. Can Wagner & Brown Deduct Leasehold, Land/Legal, and Overhead Expenses? No

As background for answering this question, the court reiterated these rules: "Expenditures involved in keeping the estate in production are reimbursable, though unsuccessful reworking operations are not—and reimbursement is to be pro-rata, out of the share in actual production."[91] The trial court had denied Wagner & Brown the right to deduct expenses it had labeled "leasehold," "land/legal," and "overhead."[92] In upholding that ruling, the appellate court concluded that Wagner & Brown had not presented evidence needed "to show that the trial court wrongly decided the issue" and pointed to Wagner's failure to segregate the types of expenses or to show how they benefited the cotenancy.[93] Under the Texas Supreme Court's view of the law and the evidence, however, Wagner & Brown escapes this ruling and earns a chance on remand to prove its right to deduct these expenses as reasonable and necessary costs.[94]

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88. Pendley v. Byrom, 717 S.W.2d 602, 605 (Tex. 1986).
89. *Hunt*, 791 S.W.2d at 194.
90. *Sheppard*, 198 S.W.3d at 377.
91. *Id.* at 378.
92. *Id.*
93. *Id.* at 380.
94. Wagner & Brown, Ltd. v. Sheppard, 282 S.W.3d 419, 430 (Tex. 2008). For a recent case distinguishing the Texas Supreme Court's ruling on these types of expenses, see BoMar Oil & Gas Inc. v. Loyd, No. 10-18-016-CV, 2009 WL 2136404, at *6 n.5 (Tex. App.—Waco Jul. 15, 2009) (mem. op.), *modified*, 298 S.W.3d 832 (Tex. App.—Waco 2009, no pet.) (appellate decision holding that *Sheppard* was not persuasive because Loyd, the non-joined cotenant protesting Bomar's accounting, "presented evidence that overhead fees were unreasonable and unnecessary"). This point raises another controversial issue in *Sheppard:* Which cotenant has the burden of proof regarding whether expenses are reasonable and necessary and, therefore, properly deductible?

3. Must Wagner & Brown Account To Sheppard on a Well-by-Well Basis? Yes

Wagner & Brown claimed its accounting duties allowed it to account to Sheppard on an aggregate or tract basis, instead of on a well-by-well basis. In particular, Wagner & Brown sought to deduct expenses from an expensive workover on the Landers No. 1 well from revenues emanating from the No. 2 well.[95] In support of that argument, Wagner & Brown cited as authority the *Hunt* and *Broadway* cases discussed above. The court of appeals disagreed: "Neither *Hunt* nor *Broadway* stand for any proposition that is in conflict with the trial court's ruling in this case."[96] Indeed, the review of those cases set forth above supports that conclusion. Yet in the end, Wagner & Brown prevails on this point under the Texas Supreme Court's initial determination that Sheppard's interest remained pooled and subject to accounting on a unit basis, even after her lease terminated.[97]

F. Summary of the Court of Appeals Opinion

The court of appeals framed the issue in the case as: "Is Sheppard's Interest Still Subject to the Pooled Unit?" Because it was undisputed that her lease had terminated, the answer to that question was no: The lessee could pool no more than it owned—which was its fee simple determinable estate, not the lessor's possibility of reverter.[98] After termination, the court noted that Sheppard's status changed from a lessor bound by lease terms to a non-joined cotenant.[99] In light of Sheppard's new status, Wagner & Brown, as producing cotenant, owed duties to account to Sheppard on a net profits basis. Under those duties, Wagner & Brown could recoup expenses incurred after Sheppard's lease terminated, but not those incurred while it was in effect. Instead, while the lease was in effect, the terms of that contract governed.[100] Even after termination, Wagner & Brown could recoup only reasonable and necessary expenses on a well-by-well basis, not on a tract or aggregate basis.[101]

V. THE TEXAS SUPREME COURT OPINION: WAGNER & BROWN WINS IN A UNANIMOUS OPINION

In support of its conclusions, the court of appeals recited textbook principles and honored the terms of the parties' lease and the holdings of

95. *Sheppard*, 198 S.W.3d at 380.
96. *Id.* at 381.
97. *Sheppard*, 282 S.W.3d at 430.
98. *Sheppard*, 198 S.W.3d at 374–77.
99. *Id.* at 377.
100. *Id.* at 377–80.
101. *Id.* at 380–81.

long-standing cases. Understandably, that court omitted from its analysis any application of the MIPA. In fact, the appellate court only mentions that act in a footnote in which it notes as background that when leases are pooled under the MIPA by order of the railroad commission, terminated leases remain pooled as an unleased mineral interest.[102] This minimal mention of the MIPA is appropriate for one simple reason: Sheppard's interest was pooled under a lease pooling clause, not the MIPA. Yet reflecting an approach that permeates the entire decision, the opening paragraphs of the Texas Supreme Court's opinion mischaracterize the MIPA and the Texas unitization act—and misstate the core issue in the case.

A. The Opening Paragraph: The Public Policy Goals of Pooling

The court's opening paragraph reads as follows:

> One observer has estimated that 85 percent of the 27,000 wells drilled in the East Texas oil field in the first half of the 20th century were unnecessary—resulting in a huge waste of money and natural resources. As one means of reducing excessive drilling, the Texas Legislature provided for voluntary pooling in 1949, and compulsory pooling in 1965.[103]

The court's choice to begin with this broad statement suggests that it relied at least in part on public policy to support its conclusions. Its reliance on public policy, however, is based on mistaken assumptions and fails to encourage an appropriate public policy solution through the legislature. First, regarding the MIPA—the 1965 act the court references—the legislature's reasons for finally passing that act were much narrower than the court suggests, and it is not truly "compulsory." As described by a respected treatise:

> The [MIPA] is not a carbon copy of any of the compulsory pooling acts that had long existed in other states. It is a unique act, forged by the legislature largely to protect small-tract owners and operators in the wake of the *Normanna* decision. Its legislative history has played a key role in the Texas Supreme Court's subsequent interpretation of the act. The courts have consistently construed MIPA as limited in function to protecting small-tract lessees rather than as a broad act designed to protect correlative rights generally, or as an act allowing large-tract lessees more flexibility in development.[104]

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102. *Id.* at 375 n.4.
103. Wagner & Brown, Ltd. v. Sheppard, 282 S.W.3d 419, 420-21 (Tex. 2008) (citations omitted).
104. SMITH & WEAVER, *supra* note 21, at 12-7.

In addition to its mistaken historical and substantive statements about Texas's pooling statutes, there are other problems with the court's reliance on public policy to resolve the dispute in *Sheppard*. By praising pooling acts, the supreme court appears to suggest that Texas would benefit from a more comprehensive statute, a proposition with strong support among many in the oil and gas industry.[105] That decision, however, rests with the legislature, not the courts.[106] Indeed, as Professor Jacqueline Weaver has argued, if Texas courts would decline "to bend the rules" to protect producers from lawsuits, the Texas legislature would be "forced to enact statutes which prevent the physical waste of oil and gas in Texas" by adopting compulsory rather than voluntary unitization and a more comprehensive pooling statute.[107]

One of the cases Professor Weaver has criticized is *Railroad Commission v. Manziel*, a 1962 Texas Supreme Court case.[108] In *Manziel* the Whelans had unitized all of their leased properties but had no unitization agreement with the Manziels. The Whelans planned a secondary recovery waterflooding project, designed to recover nearly 1 million barrels of oil. As part of this plan, the Railroad Commission had granted them a permit to inject water into a well that was closer to lease lines than permitted under field rules. The Manziels recognized that the injected water would spread radially and cross lease lines.[109] They sought to prevent this "trespass."[110] The Texas Supreme Court denied them relief. Instead, it held that "[t]he technical rules of trespass have no place in the consideration of the validity of the orders of the Commission."[111]

Professor Weaver assessed the effect of the court's ruling as follows:

> The court clearly believed that without a dispensation from trespass law, unit operators performing secondary recovery would be shut down by injunctions and billions of barrels of oil would remain unrecovered, locked in the reservoir rock forever.
>
> Really? Imagine for a minute that the court applied the orthodox rules of trespass law to this subsurface invasion of salt water. . . . Would the Texas legislature sit still for this sort of thing? Or might they then be forced to enact a compulsory unitization bill

105. *See, e.g.*, WEAVER, UNITIZATION, *supra* note 15, at 129–30 (discussing history that led to passage of the MIPA and its many limitations and concluding that those limitations "result in less pooling than would be desirable from an efficiency standpoint").

106. *Id.* at 128 (noting that the "[u]ltimate responsibility for compulsory pooling policy lay with the legislature").

107. Weaver, *Politics*, *supra* note 20, at 513 (criticizing the Texas Supreme Court's opinion in Railroad Comm'n v. Manziel, 361 S.W.2d 560 (Tex. 1962)).

108. 361 S.W.2d 560 (Tex. 1962).

109. *Id.* at 562–64.

110. *Id.* at 566.

111. *Id.* at 568-69.

that would put an end to the inefficient waterflooding patterns that persist in partially unitized fields.[112]

In *Sheppard* the supreme court's opening paragraph foreshadows the very approach Professor Weaver criticized.[113] While the *Manziel* opinion fails to rigidly apply common law rules of trespass to achieve a result that encouraged secondary recovery at least with a commission order in place, the *Sheppard* court goes further. It ignores the parties' contract and property law principles in an apparent attempt to promote pooling and protect existing pooled units, citing the MIPA as authority.[114]

Sheppard, however, does not involve a pooled unit created pursuant to the MIPA. Instead, the pooling occurred because of the parties' contract, and the terms of that contract—the oil and gas lease—should control rather than a broad policy goal of promoting pooling.[115] Despite the parties' lease terms, in the end the court effectively force-pooled Sheppard's interest by deeming it an unleased mineral owner still subject to the unit, the very fact, as described above, the court of appeals noted in its background footnote as one possible scenario, but only when pooling actually occurs under the MIPA.[116] Because the Texas Supreme Court bent the rules, as Professor Weaver criticized, it has discouraged a legislative response. Instead, as described below, the court created uncertainty and encouraged litigation by ignoring plain terms in the parties' lease, resorting to equity, and reframing the issue in order to reach its result.

B. The Court Reframes the Issue: "Does Termination of the Lease Also Terminate the Unit?"

In the paragraph immediately following its public policy pronouncements, the court turns to the issue in the case and states, "Since [the 1949 and 1965 acts were passed], this Court has never

112. Weaver, *Politics*, *supra* note 20, at 512; *see also* Burney, *Pragmatic Approach*, *supra* note 2, at 29 (noting the danger in leaving it to the legislature to pass needed statutes is that, as Professor Weaver recognized, politics between large producers and independents in Texas tend to "stalemate change").

113. *See* Wagner & Brown, Ltd. v. Sheppard, 282 S.W.3d 419, 420–21 (Tex. 2008).

114. *See id.*

115. The author and other writers have encouraged courts to consider public policy goals when appropriate in formulating oil and gas jurisprudence, but writers have not suggested that public policy should override private contracts. In a recent decision, the Texas Supreme Court relied in part on public policy in holding that fracing did not constitute an actionable subsurface trespass. Coastal Oil & Gas Corp. v. Garza Energy Trust, 268 S.W.3d 1 (Tex. 2008). That case, however, involved interpretation of a court-created rule, the rule of capture—a rule courts crafted with public policy considerations in mind. Burney, *Pragmatic Approach*, *supra* note 2, at 21 (reviewing cases and commentators approving of common law rule of capture as a principle that promotes public policy goals and balances interest of owners and producers).

116. *See* Wagner & Brown, Ltd. v. Sheppard, 198 S.W.3d 369, 375 n.4 (Tex. App.—Texarkana 2006), *rev'd*, 282 S.W.3d 419 (Tex. 2008)).

addressed how a pool of producing properties is affected if a lease in the pool expires."[117] This sentence creates concern for two reasons: First, it seems to assume, incorrectly, that passage of those acts would affect the analysis of pooling under a lease pooling clause. Second, it misstates the issue in the case. After providing factual background for the case, the court restates the misstated issue as, "Does Termination of the Lease Also Terminate the Unit?"[118]

However, unit termination is not the issue in *Sheppard.* Neither Sheppard nor any of the other owners in the Landers unit claimed that their leases or the unit had terminated. In fact, the leases from the owners of the other 7/8ths interests in the Sheppard tract were maintained by production from the wells on that tract. That production also maintained other leases in the unit; therefore, there was no concern that the unit had terminated. The only issue before the court—as both lower courts recognized—was whether Sheppard's undivided 1/8th mineral interest remained pooled after her lease terminated according to the express terms of the royalty-payment provisions in Sheppard's lease. Regardless of these facts, the Texas Supreme Court in its decision begins by citing the MIPA, which was not involved in the case, and then addresses an issue that no one had raised.

1. Has the Court Relied on Both the Lease and the Unit Agreement to Answer This Issue?

In addressing this reframed issue, the court recognizes that lease language should control and sets forth Sheppard's pooling clause. Next, however, the court turns to the "Designation of Unit." Although the court acknowledges that this document was signed by the lessees, it proceeds to interpret "the documents" together to determine their impact on Sheppard's interest:

> But we agree that a proper interpretation of *these documents* indicates the termination of Sheppard's lease did not terminate *her participation* in the unit. A lease is not necessarily required for pooling; mineral owners can join a pool even if no lease exists. Here, *both Sheppard's lease and the unit agreement* pooled certain "premises" and "lands," not just their leased interests. Although Sheppard's lease expired, the lands themselves obviously did not. Thus, while termination of Sheppard's lease changed who owned the

117. *Sheppard*, 282 S.W.3d at 421. The court's references to "a pool of producing properties" and to whether "the pool expires" are misstatements. Lessees have the power to pool the leased properties into pooled units, not "pools." A *pool* is an "underground reservoir containing or appearing to contain a common accumulation of oil and natural gas." WILLIAMS & MEYERS, MANUAL OF OIL AND GAS TERMS 802 (10th ed. 1997).
118. *Sheppard*, 282 S.W.3d at 422.

> mineral interests in the unit, it did not cause the unit to terminate because it was a pooling of lands, not just leases.[119]

In light of the court's references to "both documents," did it consider that although Sheppard had not signed the unit agreement she was bound by it?[120] This is just one of the myriad questions raised by this decision. The answer appears to be yes, a position at odds with previous decisions that recognize that lessors are not parties to unit agreements and are therefore not bound by their terms.[121] Regardless of that fact, the court examines "both documents" to answer its reframed issue concerning whether the unit had terminated. Curiously, the first sentence quoted above acknowledges the real issue by mentioning Sheppard's "participation" in the unit. That first sentence states that "a proper interpretation of *these documents* indicates the termination of Sheppard's lease did not terminate *her participation* in the unit."[122] Yet most of the opinion focuses on whether the unit had terminated.[123] In fact, the court does not directly address the relevant issue again until the final paragraph of the whole opinion, where it concludes: "[T]ermination of Sheppard's lease did not terminate her *participation* in the Landers unit."[124]

2. The *Ladd* Decision Controls

Before finally declaring that Sheppard's *participation* in the unit had not terminated, the court remained focused on whether the *unit* had terminated. As support for that conclusion, it relies on the *Ladd* decision,[125] the same case the court of appeals determined was "far different" from Sheppard's case.[126] The supreme court, however, failed to recognize that the *Ladd* court interpreted a lease habendum clause, not a pooling clause, and in the process determined that the Blair lease had *not* terminated. Missing that point, the supreme court in *Sheppard* concluded,

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119. *Id.* at 422–23 (emphasis added) (citations omitted).

120. Another odd sentence in this paragraph is the court's statement that a lease is not needed for pooling. *See id.* That may be true but there was a lease at issue in this case.

121. *See* SMITH & WEAVER, *supra* note 21, at 4-123 (discussing the Texas Supreme Court's opinion in *Sheppard* and noting that to the extent the opinion relied on language in the declaration of pooling it is at odds with Tittizer v. Union Gas Corp., 171 S.W.3d 857 (Tex. 2005)); *see also* Se. Pipeline Co. v. Tichacek, 997 S.W.2d 166, 170 (Tex. 1999) ("A Lessee has no power to pool without the Lessor's express authorization, which is usually contained in the pooling clause.").

122. *Sheppard*, 282 S.W.3d at 422 (emphasis added).

123. In the concluding section in which the court rejected the appellate court's conclusion that the pooling terminated when the lease terminated, the supreme court explained, "As termination of the lease changed none of the lands committed to the unit, we hold that it did not terminate the unit." *Id.* at 424.

124. *Id.* at 430 (emphasis added).

125. *See id.* at 422–23 ("On precisely this basis, the Second Court of Appeals held in [*Ladd*] that termination of a leas does not terminate a unit.").

126. Wagner & Brown, Ltd. v. Sheppard, 198 S.W.3d 369, 375 (Tex. App.—Texarkana 2006), *rev'd*, 282 S.W.3d 419 (Tex. 2008).

"In this case as in *Ladd*, lands as well as leases were pooled, so the tracts dedicated to the unit survived even if the related leases did not."[127]

Confident that *Ladd* controls, the supreme court dismissed the appellate court's treatment of that case, claiming these distinctions:

> The court of appeals here distinguished *Ladd* on the ground that it involved termination of an entire pool, while Sheppard seeks only termination of her participation in it. But there cannot be one rule on contract interpretation for small mineral interests and a different rule for large ones. If Sheppard's original interest had been 8/8ths rather than 1/8th, the ruling she seeks would have cut off all production for the other members in the pool just as occurred in *Ladd*.[128]

However, the distinctions the court notes are not correct. Regarding the court's conclusion that "there cannot be one rule on contract interpretation for small mineral interests and a different rule for large ones," nowhere does the size of the interest figure into the analysis for the *Ladd* court or the court of appeals in *Sheppard*. Instead, both courts focused on lease language in the habendum and pooling clauses, respectively.[129] Additionally, production was not "cut off" for the other members in the pooled unit in the *Ladd* case. Instead, production from the Woody lease maintained the Blair lease and the unit.[130] Similarly, even if Sheppard's original interest had been 8/8ths rather than 1/8th, as the court theorized, the ruling she sought would not "cut off" all production for the other members in the pool. Instead, the effect would be the same but the cotenancy accounting owed to her would change to reflect the larger size of her unleased interest.

Admittedly, that hypothetical would burden the lessee who signed the unit agreement.[131] However, those are not the facts in *Sheppard*. Moreover, lessees in general avoid such hypothetical situations by complying with the terms of their leases. Indeed, had Sheppard's lessee complied with the royalty payment timeline in the lease and avoided its termination, her case would not be in the courts. But Sheppard's lessee admittedly allowed the lease to terminate. That fact raised an issue not

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127. *Sheppard*, 282 S.W.2d at 423.

128. *Id.* (citations omitted).

129. *See Sheppard*, 198 S.W.3d at 374; Ladd Petrol. Corp. v. Eagle Oil & Gas Co., 695 S.W.2d 99, 101 (Tex. App.—Fort Worth 1985, writ ref'd n.r.e.).

130. *Ladd*, 695 S.W.2d at 101.

131. Under that hypothetical, since the wells are on Sheppard's tract, if she owned 100% of the tract, then her lessee would owe her a net profits accounting based on 100% of the production, even though that amount would exceed what that lessee had contracted to receive in the unit agreement. *See supra* Part IV.E (discussing lessees' accounting duties to interest owners in pooled units when lessees pool without authority from their lessors).

raised or analyzed in the *Ladd* decision. As one amicus accurately concluded, "[*Ladd*] is not applicable to the issue in this case."[132]

C. *"Just as pooling impinges on a mineral owner's royalty interest, it also may impinge on an owner's possibility of reverter."*

Addressing the actual issue in the case, the court of appeals concluded that because Sheppard's lessee had no power to pool her possibility of reverter, her interest was no longer subject to the pooled unit once her lease terminated. The Texas Supreme Court eventually addresses and rejects this conclusion:

> The court of appeals also reasoned from the premise that the pooling agreement transferred only the operator's interest, leaving Sheppard's possibility of reverter unimpinged. *But her lease allowed pooling of "all or any part of the leased premises or interest therein," and Sheppard's reverter was certainly an interest in the leased premises*. . . . Just as pooling impinges on a mineral owner's royalty interest, it also may impinge on an owner's possibility of reverter.[133]

This paragraph requires careful deconstruction. First, as some of the amicus writers wondered, Why did the court choose the word "impinged" for its analysis rather than a more traditional property-law concept?[134] *Impinged* means "to affect."[135] Under that definition, the court is correct that pooling impinges on the lessor's royalty interest. Specifically, as noted above, pooling affects the royalty-calculation formula by changing it from tract-based to unit-based. Pooling, however, does not convey the royalty interest; it merely changes the lessee's contractual obligation regarding royalty payments. The correct question—as the court of appeals framed it—is whether the lease pooling clause conveys the lessor's possibility of reverter.

The answer to that question is no. The supreme court misread the lease when it concluded the lessor's possibility of reverter is "an interest in the leased premises."[136] A plain reading of the lease dismantles that

132. Reply Brief of Dick Watt, *supra* note 35, at 6; *see also* Amicus Curiae Brief of Dick Watt at 12, *Sheppard*, 282 S.W.3d 419 (No. 06-0845), 2009 WL 301287. Amicus brief writers formulated their own hypotheticals to demonstrate the myriad problems with the supreme court's opinion. *See* discussion *infra* Part VI questioning the opinion's effect on depth severance provisions and whether the court has overruled Superior Oil Co. v. Roberts, 398 S.W.2d 276 (Tex. 1966).

133. *Sheppard*, 282 S.W.3d at 423–24 (emphasis added) (citations omitted).

134. One amicus brief writer was particularly perplexed by the court's use of "impinged" to analyze the issue. *See* Amicus Curiae Brief of George A. Snell, III at 6, *Sheppard*, 282 S.W.3d 419 (No. 06-0845), 2009 WL 761112 ("In a property law context, Amicus is familiar with the concepts of owning and managing property. Amicus is not familiar with the property concept of 'impinging.'").

135. MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY 624 (11th ed. 2003).

136. *Sheppard*, 282 S.W.3d at 423.

view. The granting clause of the lease conveys to the lessee "the following described land, hereinafter called *leased premises*." That phrase is defined by the property description of the land that follows (64.4 acres of the Hooper Survey) and the purpose clause, clarifying that only the mineral estate, not the surface, has been conveyed. Noting that the court ignored the proper definition of "leased premises" as it appears in the granting clause, amici described the interpretative conclusion required under the supreme court's view of the possibility of reverter as "*certainly* an interest in the leased premises." Under that view, because the granting clause conveys and includes "the leased premises," the lessor would have conveyed her entire estate to the lessee.[137]

However, Sheppard's lease clarifies the meaning of the phrase "leased premises." The second paragraph—the habendum clause—defines the term of the lease and the duration of the lessee's estate as enduring "for as long thereafter as oil or gas or other substances" are produced from the leased premises. As explained above, the "so long as" phrase creates not a fee simple absolute, but a fee simple determinable estate in the lessee. By operation of law, having conveyed less than her fee simple absolute estate in the property, the grantor–lessor retains a non-possessory estate—a possibility of reverter—that automatically becomes possessory when the lease terminates.[138] Contrary to the court's conclusion, the possibility of reverter is separate from, not an interest in, the "leased premises."[139]

Prior to lease termination, the lessee maintains its separate fee simple determinable estate but cannot convey or create by contract an interest greater than it owns. Similarly, although the lessee has the contractual right to pool the "leased premises" (all or part of the property described in the granting clause), the estate the lessee can pool is its fee simple determinable interest—nothing more.[140]

To analyze this point using language appearing in the supreme court's opinion, pooling cannot "impinge" on the lessor–owner's possibility of reverter unless that lessor–owner has agreed that pooling will endure after the lease has terminated. No such language appears in the Sheppard

137. *See, e.g.*, Amicus Curiae Brief of Dick Watt, *supra* note 132, at 6.

138. To avoid confusion, a possibility of reverter should be distinguished from other "reversionary" interests, a distinction that the Texas Supreme Court failed to make in its decision. Specifically, the Texas Supreme Court in *Sheppard* cited cases involving irrelevant reversionary interests, including *Mengden v. Peninsula Prod. Co.*, 544 S.W.2d 643 (1976) (involving reversionary interests created in farm-out agreements) and *Southland Royalty Co. v. Humble Oil & Refining Co.*, 151 Tex. 324, 249 S.W.2d 914 (1952) (construing term mineral deed that would revert at end of term unless term maintained by a community lease). *Sheppard*, 282 S.W.3d at 423–24; *see also* Amicus Curiae Brief of Dick Watt, *supra* note 132, at 8–11 (explaining that the reversionary interest cases "do not support the Opinion").

139. *See supra* note 5 and accompanying text.

140. *See* discussion *supra* Part IV.D.

lease or in any standard oil and gas lease. Because lessors do not sign lessees' pooling or unit agreements, they are not bound by those contracts. Instead, the pooling power merely grants the lessee authority to pool its fee simple determinable estate and change its royalty obligation without seeking the lessor's prior approval. Unlike the Texas Supreme Court, the court of appeals in *Sheppard* understood this purpose and the accepted principle that a standard lease pooling clause does not grant the lessee the power to pool the lessor's possibility of reverter. Therefore, when the lease ends, the lessor's interest is no longer subject to the pooled unit.[141]

In addition to contradicting the view of the court of appeals, amicus brief writers, and other attorneys on this point, the Texas Supreme Court discounted the view of oil and gas treatises. Specifically, the court noted that "Sheppard urges adoption of a treatise's view that 'pooling can extend no longer than the lease itself' because a lessor grants only 'a power to pool the leasehold rights.'"[142] In declining to adopt that view, the court ironically stressed that pooling clauses are "a matter of contract."[143] After that statement, the court returned to its reframed issue (whether the unit had terminated) and again suggested that both "documents" (the lease and the unit agreement) support its decision:

> If the parties want pooling to expire (or not) upon termination of one lease, they should be free to say so. The lease here allowed the Sheppard tract (rather than just the lease) to be pooled for purposes of production, and that is what the unit designation did. As termination of the lease changed none of the lands committed to the unit, we hold that it did not terminate the unit.[144]

After rejecting the prevailing view that a standard lease pooling clause does not allow a lessee to pool the lessor's possibility of reverter, the court turned to the cotenant accounting claims. In addressing these issues, the court again retreated from settled principles.

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141. Wagner & Brown, Ltd. v. Sheppard, 198 S.W.3d 369, 374–77 (Tex. App.—Texarkana 2006), *rev'd*, 282 S.W.3d 419 (Tex. 2008); *see also* discussion *supra* Part IV.A.

142. *Sheppard*, 282 S.W.3d at 424. The treatises cited to the court were 1 BRUCE M. KRAMER & PATRICK H. MARTIN, THE LAW OF POOLING & UNITIZATION § 15.04 (3d. ed. 2006) and 6–9 PATRICK H. MARTIN & BRUCE M. KRAMER, WILLIAMS & MEYERS, OIL AND GAS LAW, § 931.2 (2007).

143. *Sheppard*, 282 S.W.3d at 424.

144. *Id.* (citations omitted).

D. Cotenant Accounting: Wagner & Brown Wins

1. Equity Trumps Lease Terms: Sheppard May Be Liable for Drilling Costs Incurred Before Her Lease Terminated

As the supreme court notes, its determination that "the unit did not terminate" resolved most of the accounting issues in Wagner & Brown's favor.[145] Specifically, the court held that "Wagner & Brown properly accounted to Sheppard for both production and expenses on a unit basis."[146] As for the overhead, landman, and other expenses that both lower courts had ruled were improper, the supreme court instead reversed and remanded and instructed the trial court to consider whether those costs were reasonable and necessary.[147]

On another accounting issue, however, the court reached a conclusion that—in addition to its ruling that pooling extends beyond the life of the lease—provoked the flurry of amicus curiae briefs: its determination that equitable considerations allowed Wagner & Brown an opportunity to recover costs incurred even while Sheppard's lease was in effect.[148] Because the second well was drilled after her lease terminated, Sheppard recognized that her interest would be charged with her proportionate share of those reasonable and necessary drilling costs. The dispute therefore concerned the drilling costs of the first well, which was completed in October 1996, approximately five months before her lease terminated.[149]

To support its conclusion on this point—a point the court of appeals considered "simple,"[150]—the Texas Supreme Court undertook a broad search for authority but minimized oil and gas cases that have interpreted this exact question. At one point the court even discussed the doctrine of substantial performance, a doctrine applied to building contracts: "It is true that [Sheppard's lessee] breached Sheppard's lease, but a breaching party is not necessarily barred from reimbursement for improvements. For example, Texas law permits recovery to builders upon substantial performance, even if they have breached their building contract."[151]

145. *Id.*

146. *Id.* at 424–25.

147. *Id.* The court decided to remand having concluded: "At trial, Sheppard produced no evidence that any of these expenses were not reasonable and necessary; to the contrary, she stipulated that many of them were." *Id.* at 425. The parties did not appeal the court of appeals' conclusion that Wagner & Brown could not deduct expenses incurred from the first well from the revenues for the second well. *Id.* at 425 n.24.

148. *Id.* at 427.

149. *Id.* at 421–22.

150. *See* Wagner & Brown, Ltd. v. Sheppard, 198 S.W.3d 369, 377 (Tex. App.—Texarkana 2006), *rev'd*, 282 S.W.3d 419 (Tex. 2008).

151. *Sheppard*, 282 S.W.3d at 427.

Primarily, however, the court relied on "the general rule regarding improvements."[152] Rather than rely on *Byrom* or *Hunt*—cases involving oil and gas law—the court quoted from a case that determined purchasers of lots in a real estate development were not good faith improvers: "The principle is well established in equity that a person who in good faith makes improvements upon property owned by another is entitled to compensation therefore."[153] Continuing, the court stated, "As oil and gas wells are improvements to real property, the same rule applies to them: one who drills a well in good faith is entitled to reimbursement."[154]

Indeed, as noted in the discussion of *Byrom* above, the rules for good faith improvers or trespassers mirror those imposed on cotenants who produce from the co-owned property. That is, the producing cotenant, like the good faith trespasser, may recoup reasonable and necessary expenses before accounting to the other owners. Those rules, however, do not apply between lessors and lessees. Instead, their lease controls.

Rather than rely on the terms of Sheppard's valid lease, the court cites good faith improver cases that involve drillers who entered the property under invalid leases.[155] In *Sheppard*, however, the parties agreed Sheppard's lease was valid and terminated according to its own terms.[156] But these factual distinctions do not concern the court. Instead, the court reasons that since these improver rules would be available if "she signed no lease at all," they should be available when there is "a valid lease that was mistakenly allowed to expire" because "it is hard to see why one who obtains a lease and then loses it by mistake is entitled to less equity than one who by mistake never had a valid lease in the first place."[157]

Prior to this case, however, the rule that a lessee cannot recover for drilling costs while the lease was in effect was not "hard to see." In fact, that rule, like the pooling issue as resolved by the court of appeals, is textbook law. Lessors do not bear the burden of production costs while the lease is in effect; while the lease is in effect the lessee is not a trespasser or a good faith improver.[158] Rather, the lessee has a contractual

152. *Id.* at 425.

153. *Id.* at 425 & n.28 (citing Sharp v. Stacy, 535 S.W.2d 345, 351 (Tex. 1976)).

154. *Id.* at 426 (citations omitted).

155. *Id.* at 426 nn.35–36 (citing Brannon v. Gulf States Energy Corp., 562 S.W.2d 219, 224 (Tex. 1977) and Texas Co. v. State, 154 Tex. 494, 281 S.W.2d 83, 93 (1955), and noting both involved invalid leases).

156. *See Sheppard*, 282 S.W.3d at 421–22.

157. *Id.* at 427.

158. Although states consistently interpret standard oil and gas leases as relieving the lessor of the duty to pay production costs while a lease is in effect, jurisdictions have reached different conclusions regarding the allocation of post-production costs between lessees and lessors. Texas has determined that a lessor must bear his proportionate share of post-production costs when the royalty clause uses the "market value at the well" valuation standard. *Heritage Res., Inc. v. NationsBank*, 939 S.W.2d 118 (Tex. 1996) (holding that the literal language of the royalty clause required this interpretation); *accord* Owen L. Anderson, *Royalty Valuation: Should Royalty*

relationship with the lessor–owner, and the terms of that contract—the lease—control. Those terms guarantee the lessor a cost-free landowner's royalty, one free of the costs of production.[159] Therefore, even if the costs meet the reasonableness requirement imposed under the net profits accounting standard, "they cannot be deducted if not incurred during the trespass."[160]

Prior to the *Sheppard* decision, attorneys, casebook authors, and courts had well understood the effect of a valid oil and gas lease on good faith trespasser accounting rules. In *Hunt v. HNG Oil Co.*, discussed above, as in *Sheppard*, a lessee entered the land under a valid lease that later terminated. After termination the lessee plugged back a dry-hole well to a shallower formation and began producing.[161] Under those facts, the lessee was considered a good faith producer, a status that spared it from forfeiting all costs.[162] As a good faith trespasser, the lessee was entitled to recover only those costs incurred after the lease terminated. As the court explained, "HNG did not become a good faith trespasser until after the initial drilling of the well; therefore, it is not entitled to reimbursement for this improvement made prior to the expiration of the lease."[163]

The Texas Supreme Court acknowledges the *Hunt* decision but decides to dismiss it on a mistaken basis. According to the court, the *Hunt* opinion misread the *Broadway v. Stone* case, also discussed above, by failing to notice that *Broadway* permitted recovery of costs incurred before the owner purchased the property.[164] However, the expenses the court awarded in *Broadway* were incurred after the purchase, not before.[165] That determination supports the conclusion reached by the *Hunt* court. Therefore, the Texas Supreme Court in *Sheppard* misread *Broadway v. Stone*—the *Hunt* appellate court did not.[166]

Obligations Be Determined Intrinsically, Theoretically, or Realistically?, 37 NAT. RESOURCES J. 547 (1997).

159. LOWE, NUTSHELL, *supra* note 23, at 278.

160. LOWE ET AL., CASES AND MATERIALS, *supra* note 23, at 103 (citing Hunt v. HNG Oil Co., 791 S.W.2d 191 (Tex. App.—Corpus Christi 1990, writ denied)).

161. *Hunt*, 791 S.W.2d at 192.

162. *Id.* at 193–94. A bad faith trespasser has no right to seek reimbursement from the owner. *See* LOWE, ET AL., CASES AND MATERIALS, *supra* note 23, at 101.

163. *Hunt*, 791 S.W.2d at 193–94.

164. Wagner & Brown, Ltd. v. Sheppard, 282 S.W.3d 419, 428 n.51 (Tex. 2008).

165. Broadway v. Stone, 15 S.W.2d 230, 232 (Tex. Comm'n App. 1929, holding approved).

166. *See* discussion of Broadway *supra* Part IV.E; *see also* Amicus Brief of Tri-C Resources, Inc. at 11-12, *Sheppard*, 282 S.W.3d 419 (No. 06-0845) (describing how the supreme court in *Sheppard* improperly dismissed the *Hunt* opinion). In addition to dismissing *Hunt*, the supreme court cites a case the *Hunt* court found distinguishable, *Thoreson v. Fox*, 390 S.W.2d 308, 317 (Tex. Civ. App.—Amarillo 1965), *rev'd on other grounds*, 398 S.W.2d 88 (Tex. 1966). This case, unlike *Broadway*, involved a terminated oil and gas lease and, under limited facts, suggested that pre-termination costs can be recovered. *See Thoreson*, 390 S.W.2d at 308. In another example of the court's misuse of authority, in its preface to discussing that case, the supreme court in *Sheppard* concludes it is not "convincing." *Sheppard*, 282 S.W.3d at 427. In other words, both the *Hunt* court and the Texas Supreme Court in *Sheppard* found *Thoreson* unconvincing. However,

Having disposed of *Hunt* and cases it cited as binding precedent, the court in *Sheppard* concludes as follows:

> One cannot conclude much from this limited set of cases, except that operators apparently do not let many productive leases expire before recovering their drilling costs. Given the equitable nature of a reimbursement-for-improvements claim, we decline to read Texas law as establishing that drilling costs are *always or never* recoverable when a lease expires.
>
> Instead, we believe the equitable nature of such claims must turn on the equities in each case. Thus, for example, an operator who intentionally terminates a lease has a weaker claim to equity than one who does so by accident. . . . As with other equitable actions, a jury may have to settle disputed issues about what happened . . . .[167]

With that determination, the court reversed and remanded for a new trial and consideration of whether Wagner & Brown is entitled to "equitable recovery" for costs incurred before Sheppard's lease terminated.[168] Therefore, after *Sheppard*, lessees have reason to seek a jury determination that lease termination was "mistaken." Although that determination apparently will not prevent the lease from terminating, it could allow the lessee to recover costs incurred while the lease was in effect, despite the plain terms of the lease.

VI. WHAT HATH *WAGNER & BROWN V. SHEPPARD* WROUGHT?

Ironically, the Texas Supreme Court previously had championed certainty as a worthy public policy goal, particularly regarding issues affecting mineral titles.[169] Yet *Sheppard*'s disregard for the plain language

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the supreme court rejects the conclusion in *Hunt* that a producer cannot recoup costs incurred before the lease terminated, while at the same time agrees that *Thoreson*, which allowed pre-termination recoupment, was unconvincing. *Hunt*, 791 S.W.2d at 194 n.2. The *Hunt* court noted *Thoreson* in a footnote as one of two Amarillo court of appeals decisions addressing the issue, with *Thoreson* allowing costs and the other declining to do so. *Id.* For that reason, the *Hunt* court considered the *Broadway* case as better authority because it had "at least some approval of the Supreme Court." *Hunt*, 791 S.W.2d at 194.

167. *Sheppard*, 282 S.W.3d at 428.

168. *Id.* at 430. Texas cases have allowed lessees to rely on equity to prevent their leases from terminating due to late payment of delay rentals. *See, e.g.*, *Humble Oil & Refining Co. v. Harrison*, 146 Tex. 216, 205 S.W.2d 355 (1947) (holding lessor was estopped from claiming lease terminated when lessee made partial delay rental payment based on mistaken title information). For a discussion of these cases, see LOWE, NUTSHELL, *supra* note 23, at 218 (noting that despite determinable nature of delay rental clause, some cases invoke equity but "reach their pleasing but illogical results with little reasoning").

169. *See* Laura H. Burney, *The Regrettable Rebirth of the Two-Grant Doctrine in Texas Deed Construction*, 34 S. TEX. L. REV. 73, 81 (1993) (discussing Texas Supreme Court cases, such as Moser v. U.S. Steel Corp., 676 S.W.2d 99 (Tex. 1984) and Altman v. Blake, 712 S.W.2d 117 (Tex. 1986), as cases in which the court recognized the need for stability and certainty in the construction of mineral conveyances). Oil and gas law scholars have long championed the need for certainty to encourage production and ensure efficiency: "In matters of land titles, and most certainly in the field of oil and gas where heavy expenditures of capital are incident to

of the lease and for the opinions in treatises, amicus curiae briefs, and prior court decisions—plus its reliance on equity—inject unprecedented uncertainty into oil and gas jurisprudence. Some of the particular legal questions looming are considered below, as well as suggestions for dealing with the aftermath of the *Sheppard* decision.

A. *Title and Accounting Issues*

In asking the Texas Supreme Court to reconsider its opinion, amicus curiae briefs pointed to several questions raised by the opinion.

1. What Does Sheppard Own After Her Lease Terminates?

Since the court held that the lease terminated but remained subject to the pooled unit, does that mean Sheppard can only lease a pooled interest? Under the basic notion (one the court basically ignored)—that one can convey no more than she owns—the answer should be yes, Sheppard can only lease a pooled interest. The next question is, On what terms? Do the unit agreement's terms control since the court relied on it in its analysis, even though Sheppard never signed it? One question leads to another and only one fact is certain: After *Sheppard*, much is uncertain, and this lack of certainty will lead to more litigation over new questions raised by that case and over lease provisions and practices previously considered beyond question.

2. Would the *Sheppard* Rule Apply If the Wells Had Been Off Her Tract?

Several amici raised this question and noted tension with previous supreme court decisions, particularly *Superior Oil Co. v. Roberts*.[170] That case held that an unleased mineral owner whose interest was within the geographical boundaries of a pooled unit—but who had no contractual agreement with the parties—was not allowed to join the unit and obtain benefits of production from a well off his tract.[171] As amicus writers

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exploration, development and production, certainty is of the utmost importance." Eugene Kuntz, *The Law Relating to Oil and Gas in Wyoming*, 3 WYO. L.J. 107, 114 (1949).

170. 398 S.W.2d 276 (Tex. 1966).

171. *Id.* at 278. "A unitization agreement does not effect a merger of title of the tracts involved so as to give a cotenant of a separate tract, who refuses to sign the lease of his tract or the agreement, an interest as a cotenant in the other tracts of land." 3 SUMMERS OIL AND GAS (3d ed. 2009) 492 § 612. Such an owner does not automatically have the right to ratify the unit and benefit from production off his tract. *See* Fletcher v. Ricks, 905 F.2d 890, 892 (5th Cir. 1990) ("We decline to hold that the mere preparation and filing of a unit designation constitutes an offer to all persons who hold leases on land within the designated acreage to join in the unit."). Instead, whether the unpooled, non-drill site owner has the right to ratify may be based on whether he received an offer to ratify from the operator of the unit. *Roberts*, 398 S.W.2d at 278. Contrast the treatment of unpooled, non-drill site mineral owners with that of non-participating royalty interest owners ("NPRI"). *See* Montgomery v. Rittersbacher, 424 S.W.2d 210 (Tex. 1968)

questioned, If Sheppard's interest had been in a non-drill site tract in the unit, and the lessee failed to meet the requirements of the royalty-payment timeline, would the court allow Sheppard to recover her cotenancy share of production from that well?

Although the answer could be yes under the court's analysis, that conclusion contradicts *Roberts*. If the court intended that result, amici urged it to at least clarify that point on rehearing.[172] Since the court declined to do so, the viability of *Roberts* is unclear. *Roberts* could be distinguished on the ground that the mineral owner there never had a lease with the operator, unlike Sheppard. However, if *Roberts* has not been affected by the *Sheppard* opinion, and non-drill site mineral owners are barred from joining the unit, then as another writer noted, the court's ruling that "'a unit designation is not affected by the termination of a lease' applies only when it is to the advantage of the lessee to do so."[173]

3. How Does the Ruling Affect Depth Severance Clauses?

Several amici asked the court to address this issue on rehearing, giving detailed factual examples of the problems posed by the opinion.[174] This example illustrates the concerns: Most leases contain clauses that terminate automatically as to certain depths.[175] Assume that a lease in a pooled unit terminated as to certain depths and a new lessee takes a lease on these deeper formations and drills a producing well. Under *Sheppard*,

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(holding that pooling is not binding on NPRI without obtaining consent); *see generally* LOWE ET AL., CASES AND MATERIALS, *supra* note 23, at 710 (describing case holdings that executive cannot pool NPRI without consent and allowing NPRI to accept offer to pool when well is off his tract, or reject that offer when well is on his tract).

172. Amicus Curiae Brief of Ernest V. Bruchez at 6, *Sheppard*, 282 S.W.3d 419 (No. 06-0845). Mr. Bruchez—who is a former chair of the Oil, Gas, and Energy Resources Law Council of the State Bar of Texas—states:

> The Opinion is patently unfair to mineral owners whose leases have terminated (either partially or fully) on non-drill-site tracts unless the Court overrules *Superior v. Roberts*. If the Court does not withdraw the Opinion and does not overrule *Superior v. Roberts*, a lessee would have no incentive whatsoever to offer to purchase a new lease on the terminated rights because the lessee could produce, sell and keep 100% of the proceeds from production attributable to the previously leased and now unleased interest. If the Court intends to overrule *Superior v. Roberts* the Court should do so in clear terms in a revised opinion.

Id. (emphasis omitted) (citation omitted).

173. Amicus Curiae Brief of William M. Huffman, P.C. and Abney & Warwick in Support of Respondent's Motion for Rehearing at 21, *Sheppard*, 282 S.W.3d 419 (No. 06-0845) [hereinafter Amicus Curiae Brief of Huffman and Abney Warwick], *available at* http://www.supreme.courts.state.tx.us/ebriefs/06/06084507.pdf.

174. *See* Amicus Curiae Brief of Herbert W. Henry, *supra* note 51; Amicus Curiae Brief of Huffman and Abney & Warwick, *supra* note 173; Amicus Curiae Brief of George A, Snell, III, *supra* note 134.

175. A typical depth severance clause reads that "upon expiration of the primary term or cessation of continuous drilling or reworking operations, this lease terminates as to all depths more than 100 feet below the deepest depth drilled on the land described herein or other land pooled therewith."

are those depths still subject to the prior unit, meaning all interest owners in that unit now share in the well producing from depths expressly released under the first lease? Under the court's logic, the answer could be yes. Because the depths remained pooled under the *Sheppard* rule, the second lessee could only lease pooled acreage.

4. Have Old Units Previously Considered Terminated Been Resurrected?

As revealed by the depth-severance example, if termination as to depths does not terminate the lease as to those terminated horizons, then units previously thought to have partially terminated may be resurrected as to those depths. Indeed, under the court's strained analysis one could argue that units in which all leases had previously terminated have been entirely resurrected. The court consistently focused on "both documents" in determining whether Sheppard's interest remained pooled. Those documents are the lease and the unit agreement, which the court noted allowed for pooling "lands" not just leases. Seizing on the reference to "lands," the court justified its conclusion that Sheppard's interest remained pooled because even though her lease terminated, "the lands themselves obviously did not."[176] In light of that obvious but irrelevant conclusion, coupled with the court's apparent view that lessors are bound by unit agreements, it follows that unless a unit has terminated according to its express terms, it has not terminated—even if the leases have.

In its response to Sheppard's Motion for Rehearing, Wagner & Brown assured the court that its "opinion will not resuscitate units previously believed to have terminated."[177] In support of that conclusion, Wagner & Brown explained, "The only reasonable inference from the opinion, then, is that termination of a unit depends on the language that the parties chose to include in the unit agreement and lease pooling clause."[178] But that explanation provides little comfort. Instead, as explained in amicus curiae briefs, this "resurrection of units" concern is valid for at least two reasons. One is that unit agreements, like pooling clauses, often fail to expressly state when a unit will terminate, which was the case in the *Sheppard* unit agreement.[179] A second is the industry practice of rarely filing documents to formally terminate units, even when lease pooling clauses, like Sheppard's, provide that a lessee "may" do so.[180]

176. *See Sheppard*, 282 S.W.3d at 423.
177. Petitioners' Response to Motion for Rehearing, *supra* note 35, at 11.
178. *Id.* at 12.
179. Amicus Curiae Brief of Herbert W. Henry, *supra* note 51, at 5 (noting that he found no language in the Landers Unit agreement that "requires or assures the ultimate termination of the pooled unit").
180. *Id.* at 6–7.

After *Sheppard*, inserting express termination language in unit agreements and filing formal termination documents must become industry practice to counter the court's conclusion that—although the leases terminated—the "lands" and therefore the units have not.[181] Absent such determinative documents and language, however, the question remains whether under *Sheppard* units endure even after all leases have terminated.

According to Wagner & Brown, "Nowhere did the Court hold that a unit survives both cessation of production and termination of all of its constituent leases."[182] It is true that the court did not address the effect of cessation of production and termination of all the leases on the Landers unit. Those were not the facts in *Sheppard.* But the facts did not prevent the court from addressing an issue not raised: whether the unit had terminated. In addressing that reframed issue, as described above, the court chose to focus on language in the lease *and* unit agreement and concluded that since the lands had not terminated, the unit had not. And since, as the court accurately notes, "lands" do not terminate, it follows from this flawed analysis that the unit would not terminate, even if the leases have terminated. That result contradicts case law and industry custom and practice, but as an impressive number of amicus writers informed the court, so did its *Sheppard* opinion.[183]

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181. Amicus writer Herbert W. Henry suggests that pooled unit designations contain detailed provisions limiting the term of the pool, such as similar language found in joint operating agreements. Other suggestions are that "[a]ttorneys representing lessors should be educated as to the advisability of requesting such formal dissolutions of units when lease releases are requested." Email from Herbert W. Henry to Laura H. Burney (June 18, 2009) (on file with author).

182. Petitioners' Response to Motion for Rehearing, *supra* note 35, at 11.

183. In an effort to determine whether and when units terminate under *Sheppard*'s flawed reasoning, one amicus writer asked:

> If unit declarations do not terminate (become ineffective as to a lease) when the lease terminates, when does a unit declaration terminate? Is it logical or reasonable to conclude "pooling terminates as to all tracts in a unit when the last lease covering land in the unit terminates" but "termination of a lease does not terminate a pooling agreement as to the lessor's interest in a terminated lease unless it is the last lease to terminate?"

Amicus Curiae Brief of Huffman and Abney & Warwick, *supra* note 173, at 14.

Another amicus writer suggests that by analogizing to rules governing powers of attorney, and stressing the goals of pooling for efficient production of the land, units should terminate when production has ceased within the unit, which is the current assumption in the industry. Proposal submitted by Herbert W. Henry (available upon request from Mr. Henry). However, as the author describes in Part III.A., *supra*, in her opinion the pooling authority should be viewed as creating contractual rights, not as a power of attorney. Another point that could be persuasive with the court, since it cited the MIPA in its opening paragraph, is the provision in the MIPA that units terminate six months after cessation of production from a unit. *See* MIPA, TEX. NAT. RES. CODE ANN. § 102.082(3) (Vernon 2001 & Supp. 2009).

5. Is the *Sheppard* Opinion Limited to the *Sheppard* Facts?

Because none of the Texas Supreme Court justices dissented in *Sheppard*, odds are it will never be overruled.[184] Practitioners' primary hope, then, is that the decision is limited to its facts. Yet questions remain about the opinion's reach. For example, Does the *Sheppard* rule that a pooling clause allows the lessee to pool the lessor's possibility of reverter apply only to the language appearing in Sheppard's lease, the reference to "leased premises or interest therein?" That limitation would exempt from *Sheppard's* shadow common pooling clauses, such as those giving the lessee the "power to voluntarily pool or combine the *lands* covered by this Lease, or any portion thereof."[185] However, that limited view of *Sheppard's* effect is precarious. In one section, the opinion quotes and analyzes the particular phrase from Sheppard's lease. However, for the most part it sweeps broadly and loosely relying not just on its interpretation of the lease pooling language, but on the unit agreement, public policy, irrelevant or misconstrued cases, and equitable considerations.

Even if the opinion is limited to the language in Sheppard's lease, as one leading treatise suggests, that reading has far-reaching effects since similar language appears in thousands of leases. Therefore, as Professors Smith and Weaver describe:

> [T]he decision raises the possibility that tens of thousands of mineral acres that were pooled under leases executed over the last 70 years or more remain pooled even though the leases on those interests have long since terminated. If this is, indeed, the case, it raises the possibility that large numbers of title opinions are erroneous; landowners executing new leases on land subject to pooling have breached general warranties of title in their leases, and oil and gas companies that have taken such leases may have improperly purported to pool interests that are still within pooled units, may have incurred liability to owners of adjacent tracts, and may be subject to claims of slander of title.[186]

Another question about *Sheppard's* reach is whether the court's reliance on equity applies to a broad range of lease termination and accounting facts, or only to those presented in the case. One arguing for a broad application would point to the court's sweeping conclusion that

184. The author of the court's opinion, Justice Scott Brister, has announced he will resign and return to private practice. Another justice, Justice Harriet O'Neill, who joined in the opinion, has also announced she will leave the court. Justice Don Willett, who remains with the court, did not participate in the *Sheppard* decision.

185. This pooling clause appears in LOWE, NUTSHELL, *supra* note 23, at 242 (emphasis added).

186. SMITH & WEAVER, *supra* note 21, at 4-123.

"we decline to read Texas law as establishing that drilling costs are *always* or *never* recoverable when a lease expires."[187] Even if viewed as a narrow exception available only to lessees who "mistakenly" fail to comply with royalty payment timelines in their leases, that exception encourages litigation and stands as a stark departure from the Texas Supreme Court's previous approach to lease interpretation, the plain meaning doctrine.

B. Does Sheppard *Represent the Demise of the Plain Meaning Approach to Lease Interpretation?*

1. Background: Texas Courts and the Plain Meaning Approach to Interpreting Oil and Gas Lease Clauses

Writers refer to the *plain meaning* approach to describe a jurisdiction's interpretative view, particularly regarding the meaning of the gas royalty clause in an oil and gas lease. That clause created unique interpretative problems in the 1970s and 1980s when market forces caused prevailing "market values" of gas to exceed the values lessees were receiving under their long-term contracts for that gas. Lessors argued that since their leases required lessees to base royalties on the "market value at the well" of the gas produced from their lands, the lessees should base royalties on the higher values. Lessees responded that because they entered into their long-term contracts in good faith, the values they were receiving under those contracts should serve as the basis for calculating royalties. As courts from various jurisdictions began resolving these controversies, they adopted one of two general approaches. Courts following a *cooperative venture* approach favored lessees at the time by considering marketing realities extant at the time the lessees committed the gas to long-term contracts. Under the *plain meaning* approach, courts viewed the lease language as unambiguous and declined to consider outside factors.[188]

Texas adopted the plain meaning approach to the "market value royalty" interpretative issue in *Texas Oil & Gas Corp. v. Vela.*[189] In *Vela*, a 1968 decision, the Texas Supreme Court held that the "market value" royalty valuation requirement in a lease required the lessee to base royalties on the price of gas in the open market, even though the gas had actually been sold for less under the lessee's long-terms sales contracts.[190]

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187. Wagner & Brown, Ltd. v. Sheppard, 282 S.W.3d 419, 428 (Tex. 2008).

188. John S. Lowe, *Defining the Royalty Obligation*, 49 SMU L. REV., 223, 233–36 (1996). An impressive number of articles have addressed and analyzed the "market value royalty" cases. *See, e.g.*, Anderson, *supra* note 158, at 549; John Burritt McArthur, *The Precedent Trap and the Irrational Persistence of the Vela Rule*, 39 HOUS. L. REV. 982 (2002); David E. Pierce, *Exploring the Jurisprudential Underpinning of the Implied Covenant to Market*, 48 ROCKY MTN. MIN. L. INST. 10-1 (2002).

189. 429 S.W.2d 866 (Tex. 1968).

190. *Id.* at 871.

In other words, the *Vela* court enforced the plain terms of the lease, even though that interpretation burdened lessees by requiring them to base royalties on amounts higher than those they received from their gas purchasers.

The court reaffirmed *Vela* in a 1981 case, *Exxon Corp. v. Middleton.*[191] As in *Vela*, the increase in market values of gas placed a financial burden on the lessees. Yet the court refused "to disregard the plain and unambiguous terms of the royalty clause."[192]

In 2001 the Texas Supreme Court faced the reverse-*Vela* problem in *Yzaguirre v. KCS Resources, Inc.*[193] In that case, the lessors claimed lessees should base royalties on their contract prices, which were higher than the prevailing market value of gas. In ruling in favor of the lessees, the court again pledged its allegiance to the plain meaning approach:

> Because the *Vela* lease's *plain terms* specified a market price royalty, we rejected the lessee's argument that "the market price of gas within the meaning of the lease is the price contracted for in good faith by the lessee in pursuance of its duty to market gas from the premises." Instead, we held that the *plain terms* of the lease required the lessee to pay a market-value royalty even though the lessee received less than market value under its long-term sales contract. The same *plain terms* that fix the lessee's duty to pay royalty also define the benefit the lessor is entitled to receive. Thus, under the leases, Yzaguirre and the other Royalty Owners are entitled to a market-value royalty, not an amount-realized royalty.[194]

2. *Sheppard* Contradicts Plain Meaning Cases: *Hitzelberger* and *HECI*

Consistent with the Texas Supreme Court's resolution of the "market value royalty" issue, courts have resolved other oil and gas lease issues with the plain meaning approach. In a 1997 decision, *Hitzelberger v. Samedan Oil Corp.*, an appellate court construed a termination clause virtually identical to the one at issue in *Sheppard.*[195] That court characterized the language as unambiguous, rejected the notion that the canon of construction "the law abhors forfeiture" changed the effect of the clause, and found that as a matter of law the lessee's failure to abide by the royalty payment timeline terminated the lease: "We believe the forfeiture of a lease that is included in a pooled unit is especially distasteful to the law. However, we also believe that it is the lessee's

191. 613 S.W.2d 240 (Tex. 1981).
192. *Id.* at 245.
193. 53 S.W.3d 368, 369–70 (Tex. 2001).
194. *Id.* at 372–73 (emphasis added) (citations omitted).
195. Hitzelberger v. Samedan Oil Corp., 948 S.W.2d 497 (Tex. App.—Waco 1997, pet. denied).

responsibility to comply with lease and unit obligations to keep the lease in effect."[196]

Hitzelberger provides direct precedent for the Texas Supreme Court's analysis of the termination of Sheppard's lease. Because that clause, like Sheppard's, did not expressly excuse the lessee's failure to pay timely based on a mistake, the *Hitzelberger* court of appeals enforced it as written.[197] In *Sheppard*, however, the Texas Supreme Court never mentions that opinion. Instead, the court sympathizes with the lessee's failure to abide by the plain terms of the royalty payment timeline and grants it an opportunity to recover costs drilled while its lease was in effect.[198]

Unlike the *Sheppard* opinion, in *Hitzelberger* the court declined to ignore the express terms of the parties' lease or to rewrite them to achieve a result it deemed equitable. In addition to the "market value royalty" cases, the Texas Supreme Court had followed this approach in other oil and gas lease cases.[199] In fact, the court followed the *Hitzelberger* view in a controversial 1998 case, *HECI Exploration Co. v. Neel*.[200] In that case, a royalty owner sued its lessee after it recovered a large judgment against a neighboring operator and failed to share a portion of that settlement with the lessor. By the time the lessor learned about the settlement, it was too late for him to file his own suit against that

196. *Id.* at 508–09 & n.8.

197. *See id.* at 505–06.

198. Wagner & Brown, Ltd. v. Sheppard, 282 S.W.3d 419, 427–30 (Tex. 2008).

199. *See, e.g.*, Heritage Res., Inc. v. NationsBank, 939 S.W.2d 118 (Tex. 1996) (adhering to literal language of lease royalty clause using "market value at the well" royalty valuation and charging lessor with post-production costs despite language that "no deductions" should be charged to lessor); Sun Oil Co. v. Madeley, 626 S.W.2d 726 (Tex. 1982) (adhering to plain terms of lease provision granting additional royalty on "oil" not gas and rejecting equitable arguments that lessee must pay for oil and gas since it had done so for decades). For another recent case in which the court departed from a strict adherence to the plain meaning approach, see J. Hiram Moore, Ltd. v. Greer, 172 S.W.3d 609 (Tex. 2005). The case involved the interpretation of a deed, rather than a lease. Specifically, the court concluded the deed was ambiguous regarding whether the deed conveyed all of the grantor's royalty interests in a specific county. The justice who authored the *Neel* decision, discussed below, dissented and argued the deed was unambiguous and should have been enforced as written. *Id.* at 616–23 (Owen, J., dissenting).

200. HECI Exploration Co. v. Neel, 982 S.W.2d 881 (Tex. 1998). *See also* Burney, HECI v. Neel, *supra* note 12, (discussing criticisms of the *HECI* decision and describing failed legislative efforts to lessen the decision's burdensome effects on royalty owners). Criticism of *HECI v. Neel* and other Texas Supreme Court oil and gas cases has reached mainstream media: "In the oil-and-gas arena, the criticism of Owen [author of the HECI decision] comes from lawyers and law professors who have seen decades of precedents favoring landowners tossed aside to favor producers." Paul Burka, *Judging Priscilla*, TEX. MONTHLY, Nov. 2003, at 10. For a more recent article, see Mimi Swartz, *Below the Surface*, TEX. MONTHLY, Nov. 2009, at 108 (discussing the history behind and the ruling in the recent Texas Supreme Court case *Exxon Corp. v. Emerald Oil & Gas Co.*, No. 05-1076, 2009 WL 795668 (Tex. Mar. 27, 2009) (holding that mineral/royalty owners' claims were barred by the statute of limitations, reversing a multimillion dollar judgment against Exxon for intentionally sabotaging wells so they could not be re-entered)). The article states that in the Texas Supreme Court, "Royalty owners have not won a case against an oil company in at least ten years." Swartz, *supra*, at 187.

operator. The lessor sued his lessee for breach of implied covenants in the lease. According to the lessor, his lease included an implied covenant requiring his lessee to give him notice of its intent to sue. The lessor also claimed the lessee had been unjustly enriched since the settlement it received included damages to the lessor's interest. The court of appeals had ruled in favor of the lessor on these and other issues. The Texas Supreme Court, however, reversed in favor of the lessee.[201] In so doing, the court proclaimed: "This court has not lightly implied covenants in mineral leases. Our decisions have repeatedly emphasized that courts 'cannot make contracts for [the] parties.' . . . A Court cannot imply a covenant to achieve what it believes to be a fair contract or to remedy an unwise or improvident contract . . . ."[202] The court continued, "Contractual implications 'are justified only on the ground of necessity.' 'Necessity' does not include reformation of the contract through the use of an implied covenant in order to achieve what a court views as a more balanced agreement."[203]

In addition to restricting the doctrine of implied covenants by refusing to read terms into the lease, the court also held that the lessor's cause of action was barred by the statute of limitations. In reaching that conclusion, the court determined that the discovery rule did not apply to extend the statute's four-year limit because royalty owners have an obligation to protect their interests and discover facts necessary to do so—including searching a variety of outside sources, such as Railroad Commission records.[204] Similarly, in another case involving Sheppard's producer-defendant, *Wagner & Brown, Ltd. v. Horwood*, the supreme court again ruled that the lessor's lease claim was barred because they could have obtained relevant information from the lessee and gas purchasers.[205]

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201. *HECI*, 982 S.W.2d at 883–84.

202. *Id.* at 888–89 (citations omitted).

203. *Id.* at 889 (citations omitted).

204. *Id.* at 886–88.

205. 58 S.W.3d 732, 733 (Tex. 2001). The court held the discovery rule was not available because the facts were not "inherently undiscoverable." *Id.* at 735. At least one court has pointedly criticized the supreme court's approach to the discovery rule in the oil patch:

> We have had limited exposure to oil and gas litigation. But it has been sufficient for us to comprehend that this is an area in which the smartest and most aggressive can make a great deal of money from a less-knowledgeable class of royalty interest owners. How are royalty owners, the trust officers for minors, lawyers, and judges, who are not knowledgeable about the state of the Railroad Commission records, able to distinguish between production records that provide constructive notice and those that do not? Rather than bringing predictability and consistency to this area of the law, we fear that placing the onus on royalty owners to hire the experts necessary to investigate whether the Railroad Commission records reveal they are being cheated is inherently unfair and unworkable in the oil and gas business environment we have come to know.

If lessors bear these extensive responsibilities to protect their interests, it follows, as the *Hitzelberger* court concluded, that lessees should bear the burden of reading and abiding by the plain terms of leases in their possession. In *Sheppard*, however, the Texas Supreme Court reads a "mistake" excuse into the royalty-payment timeline provision in the lease, ignores provisions requiring the lessee to bear all production costs while the lease is in effect, and concludes that equity allows the lessee the opportunity to recover pre-termination costs on remand—all in direct contravention of the *HECI* mandate quoted above. With this approach, the court has drastically departed from settled rules of law and document interpretation, encouraged parties to litigate even plain terms in leases, and destabilized the rights and liabilities of owners and operators in oil and gas leases and pooled units.

VII. WHAT TO DO ABOUT *SHEPPARD*? CONCLUDING THOUGHTS

Despite having received an impressive number of amicus briefs from attorneys with decades of experience and extensive expertise in oil and gas law asking the Texas Supreme Court to if not withdraw then explain its opinion in *Sheppard*, the court declined to do so. Instead, it overruled Sheppard's motion for rehearing a month in advance of the deadline with no further comment on the case. Now the opinion stands as part of Texas oil and gas law. To avoid the opinion's effects in the future, practitioners should consider several steps:

1. **Include express termination language in unit agreements and file formal documents terminating units**. As discussed above, leases and unit agreements should expressly provide when units terminate and grant producers and interest owners the right to file documents terminating units. Filing such documents must become standard practice in the industry.
2. **Include anti-*Sheppard* clauses in leases.** Landowners should include anti-*Sheppard* clauses in leases. These clauses should clearly state, for example, in the pooling clause that the lessee has no power to pool the lessor's possibility of reverter beyond the life of the lease as to any depth or interest. Other clauses previously considered unnecessary should clarify that "in no event will lessor be required to bear costs of drilling or production either before or after the lease has terminated."[206]
3. **Delete the pooling clause from the lease**. As TIPRO notes in the amicus brief it filed, this could be an unintended

Advent Trust Co. v. Hyder, 12 S.W.3d 534, 539 n.1 (Tex. App.—San Antonio 1999, pet. denied) (citation omitted).

206. For examples of anti-*Sheppard* clauses, see the Appendix, *infra*.

consequence of the *Sheppard* opinion. Ironically, while the court begins its opinion stressing the public policy value of encouraging pooling, the opinion's interpretation of that clause discourages lessors from granting lessees that power in their leases:

> While amici recognize that pooling of leases does accomplish well-established public and conservation policy goals, the opinion of this Court nonetheless will actually have the opposite effect.... [C]ounsel for mineral owners may choose to prohibit pooling altogether to avoid any further opportunity for a lessee or this Court to reach a result contrary to established principles of oil and gas law.[207]

One amicus brief succinctly summarized the effects of the Texas Supreme Court's opinion in *Sheppard* as follows:

> The opinion's analytical flaw is that it purports to base its holding on the express terms of the contracts at issue, but it does not actually do so. It goes far beyond the terms of the lease, the only contract signed by Sheppard, in an apparent effort to achieve a result it considers equitable for the lessee. But in trying to achieve equity for the lessee to overcome what it perceived as a mistake, the opinion creates uncertainty for everyone else in the industry.[208]

Indeed, as the discussion in this article reveals, although *Sheppard* joins a long line of cases in which the Texas Supreme Court has adopted producers' legal arguments in oil and gas lease disputes, it injects unprecedented uncertainty into Texas oil and gas jurisprudence. Rather than discourage litigation, the opinion encourages parties to pursue disputes in courts since principles and practices previously considered settled now have been called into question. Therefore, for years to come attorneys, producers, title examiners, financial institutions, mineral owners, and other stakeholders in the oil and gas industry will grapple with the unfortunate legacy of *Wagner & Brown, Ltd. v. Sheppard.*

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207. Amicus Brief of Texas Independent Producers and Royalty Owners Ass'n at 10, Wagner & Brown, Ltd. v. Sheppard, 282 S.W.3d 419 (Tex. 2008) (No. 06-0845), 2009 WL 357423.

208. Amicus Brief of Tri-C Resources, Inc. at 12, *Sheppard*, 282 S.W.3d 419 (No. 06-0845). The attorneys for Tri-C Resources, Inc. are well-known experts in oil and gas law: Elizabeth N. Miller, John W. Camp, and Jane M. N. Webre, of Scott, Douglass & McConnico.

APPENDIX: SAMPLE ANTI-*SHEPPARD* CLAUSES

1. Sample clause that addresses and combats the *Sheppard* holding that a standard lease pooling clause allows a lessee to pool the lessor's possibility beyond the life of the lease:

   Notwithstanding the above provisions [of the pooling clause], any other provision in this lease, and any court decision (specifically, *Wagner & Brown Ltd. v. Sheppard*, 282 S.W.3d 419 (Tex. 2008)) or law, all rights to pool the leased premises and/or the land described herein with other land are expressly limited to allow Lessee to commit the leased premises to a pooled unit only so long as the premises described herein remain subject to this lease and may be exercised by the Lessee only in accordance with the following provisions:

   (a) Lessee may only exercise the rights to pool as to the depths leased hereby and only as to the lands and depths as to which this lease has not terminated as of the date such pooling document is filed in the office of the County Clerk of the county where the land leased hereby or any portion is located. Upon partial termination of this lease, as to any portion of the land and/or as to any depths, the rights of Lessee to pool the land and/or depths leased hereunder may be exercised by lessee only for that portion of the land and/or those depths as to which this lease has not terminated.
   (b) If the leased premises, or a portion thereof, is validly pooled with other land to form a unit prior to the partial or complete termination of this lease, upon partial termination of this lease as to area and depths or complete termination of this lease, Lessor may at any time thereafter terminate the pooling and unitization of the Lessor's interest in any portion of the interest leased herein that has terminated in any such unit by executing and filing for record in the office of the County Clerk of the county in which the land leased hereby or any portion thereof is located a document identifying or describing the area and/or depths as to which such pooling is terminated.

2. Sample addendum clause to be added as a Modification of Pooling Provisions:

   Notwithstanding any other provision in this lease, and any court decision or law, all rights to pool or combine lessor's interest in the leased premises and/or the land described herein with other land are expressly limited and may be exercised by the Lessee only in accordance with the following provisions:

(a) Lessee may only exercise the rights to pool the interest of lessor in the land and as to the depths leased hereby and only as to the lands and depths as to which this lease has not terminated as of the date such pooling document is filed in the office of the County Clerk of the county where the land leased hereby or any portion is located. Upon partial termination of this lease, as to any portion of the land and/or as to any depths, the rights of Lessee to pool the land and/or depths leased hereunder may be exercised by lessee only for that portion of the land and/or those depths as to which this lease has not terminated.
(b) If the leased premises, or a portion thereof, or the interest of the Lessor in part or all of the land described herein is validly pooled with other land to form a unit prior to the partial or complete termination of this lease, upon partial termination of this lease as to area and depths or complete termination of this lease, Lessor may at any time thereafter terminate the pooling and unitization of the Lessor's interest in any portion of the interest leased herein that has terminated in any such unit by executing and filing for record in the office of the County Clerk of the county in which the land leased hereby or any portion thereof is located a document identifying or describing the area and/or depths as to which such pooling is terminated.

3. Sample clause to avoid *Sheppard* ruling that lessees may be able to recover drilling costs incurred while a lease is in effect:

   In no event will lessor be required to bear costs of drilling *either before or after* this lease has terminated.