



# Blood & Oil: Strategies for Mineral Cotenancy Disputes in Texas

Caleb A. Fielder, Esq.

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- ▶ Nothing herein is intended to constitute the furnishing of legal advice.

# Black Acre



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Abel



Bob



Cain



David



# Basics of Cotenancy

- ▶ Each cotenant has the absolute right to develop and use the land, and one cotenant may use Black Acre without fear of owing any rumination.
- ▶ As a general rule, one cotenant is not a trustee for the other, and no fiduciary duty is owed by one to the other.
- ▶ A cotenant in possession of the common estate who fails to adequately protect the property will be deemed to have committed waste, and will be liable to his cotenants for losses resulting therefrom.
- ▶ Where a cotenant has obtained rents or profits from the common estate, he must account to the other cotenants for their share of the proceeds minus the reasonable and necessary expenses.

# Basics of Cotenancy Accounting



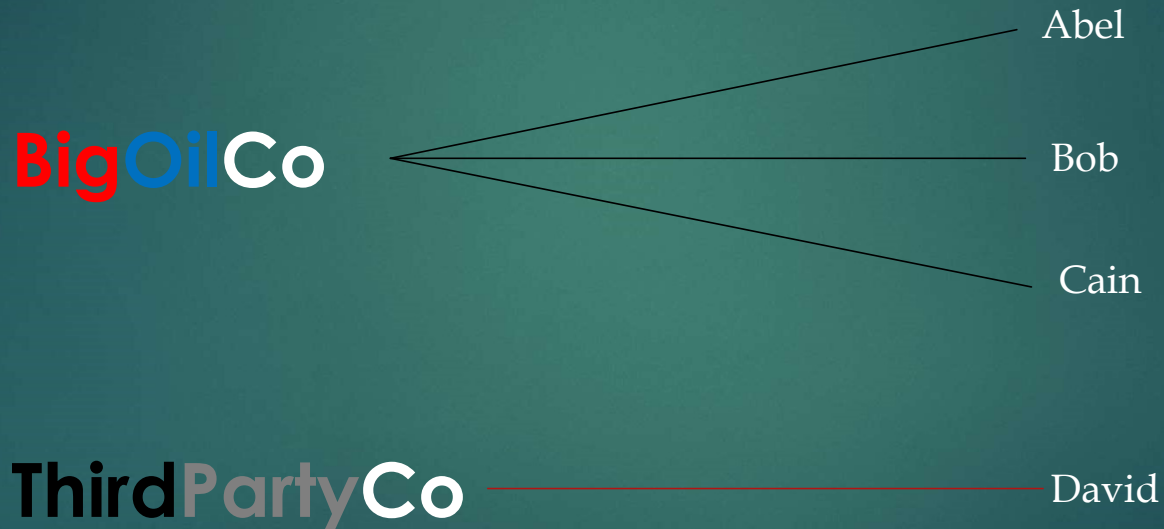
- ▶ Where a cotenant has obtained rents or profits from the common estate, he must account to the other cotenants for their share of the proceeds minus the reasonable and necessary expenses.
- ▶ Where a cotenant has expended funds to preserve the common estate, he may seek reimbursement from his cotenants
- ▶ But a cotenant who incurs speculative expenses is not entitled to reimbursement from his fellow cotenants.
  - ▶ Instead, he is entitled to recoup his reasonable and necessary expenses upon accounting to his cotenants for their proportionate share.

# Cotenancy of the Mineral Estate

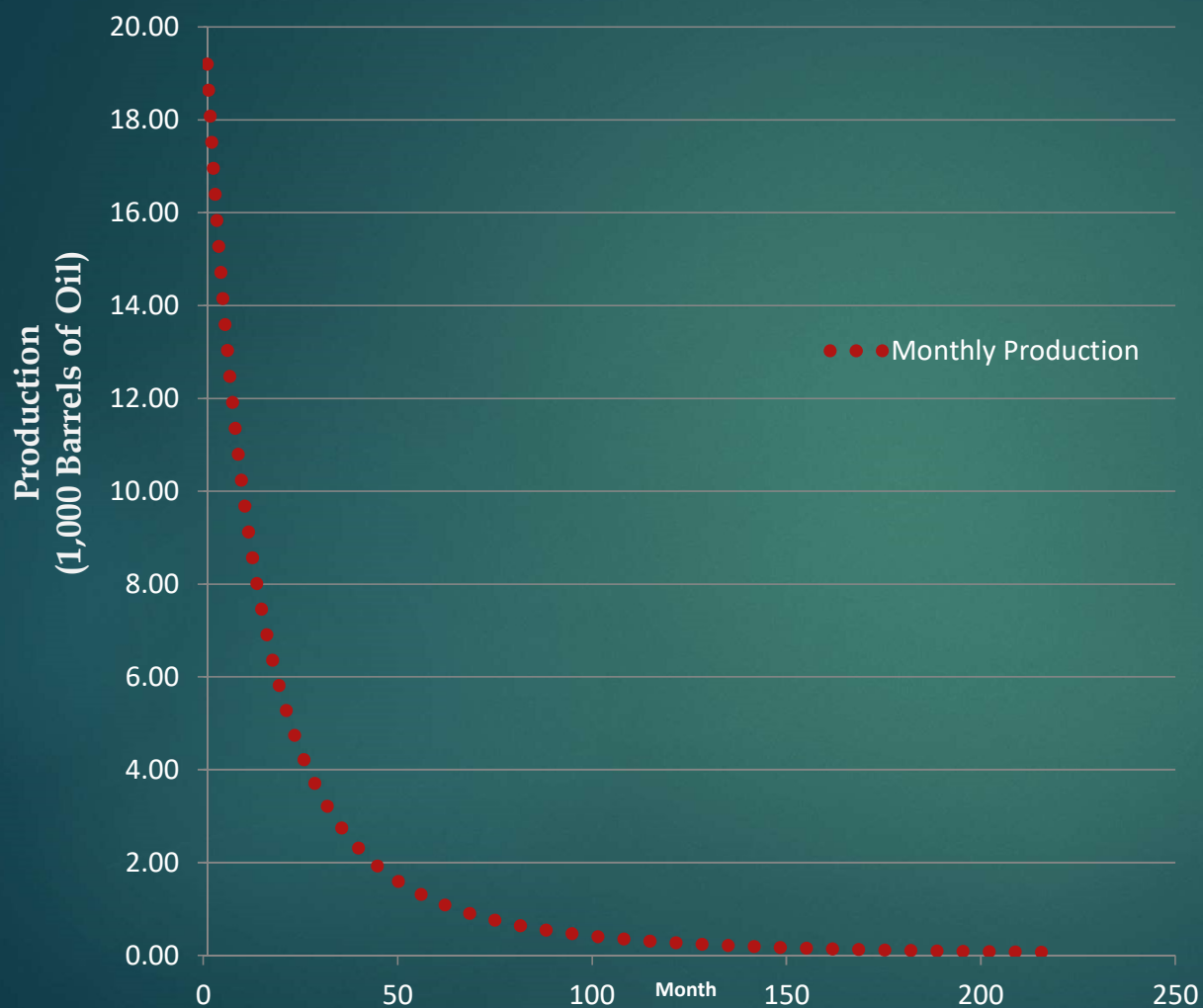


- ▶ Each cotenant (regardless of the amount of interest he/she owns) may explore, drill and develop oil and gas without the participation of the other cotenants.
- ▶ When an oil and gas lease has been executed, the lessee has acquired a fee simple determinable in the mineral estate.
- ▶ In the event a lease is acquired on an undivided interest, the lessee steps into the shoes of the lessor for cotenancy purposes.

# Black Acre – Oil and Gas Leases



# Black Acre No. 1 Well – Production Decline Curve



U.S. Energy Info. Admin., *Oil and Gas Supply Module of the National Modeling System: Model Documentation 2014*, U.S. DEPT ENERGY, 1, 174, Table 2.C-1 Hyperbolic decline curve parameters for select tight oil plays (July 2014),  
[https://www.eia.gov/outlooks/aeo/nems/documentation/ogsm/pdf/m063\(2014\).pdf](https://www.eia.gov/outlooks/aeo/nems/documentation/ogsm/pdf/m063(2014).pdf) (Eagle Ford-Oil Dewitt, TX.  $Q_i$  (b/d): 694,  $D_i$ : 0.082, "b" factor: 0.341,  $IP(b/d)$ : 640, EUR (Mbbbl/well): 365).

Formula for decline curve hyperbolic function:  $Q_t = Q_i / [1 + b * D_i * t^{(1/b)}]$ , where  $Q_t$  = Production in month  $t$ ,  $Q_i$  = Production rate at time 0,  $b$  = Hyperbolic parameter,  $D_i$  = Initial decline rate,  $t$  = Month in production). This has been reproduced via Excel spreadsheet with the following formula:  $Q_i * (1 + b * D_i * t)^{-1/b}$ . Production was calculated on a monthly basis with an assumed production life of 221 months.

# Black Acre No. 1 Well – Revenue



\$45/Barrel Oil

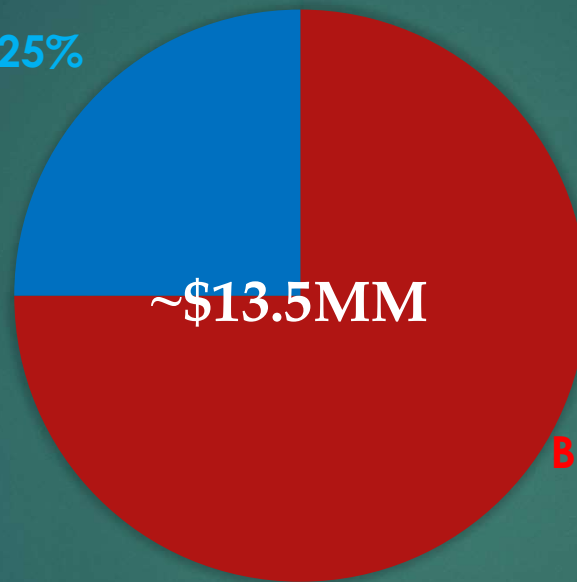
\*Discounted monthly at annual interest rate of 10%

# Black Acre No. 1 Well – Revenue

100% Leased at a 25% Royalty



Royalty, 25%



~\$13.5MM

BigOilCo, 75% Net Revenue Interest (NRI)



~\$10.2MM

- \$6.5MM (Cost)

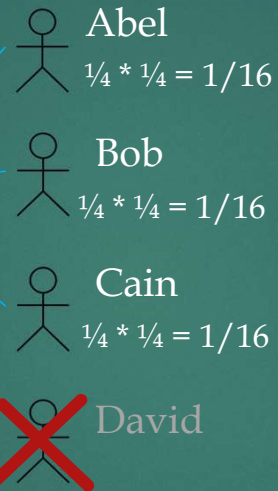
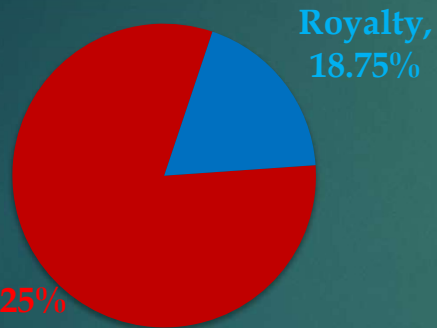
~3.7MM Profit

Net Present Value (NPV)

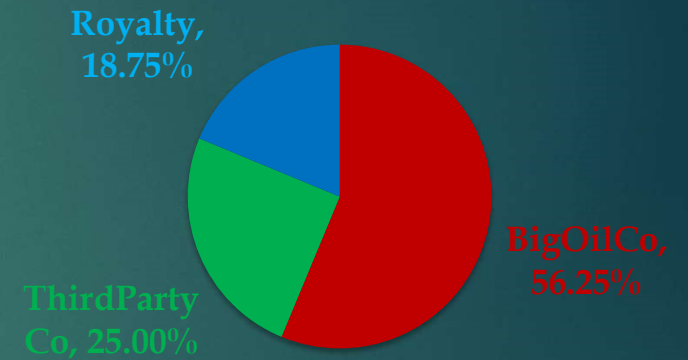
# Effects of a Carried Interest on NRI



Before Payout



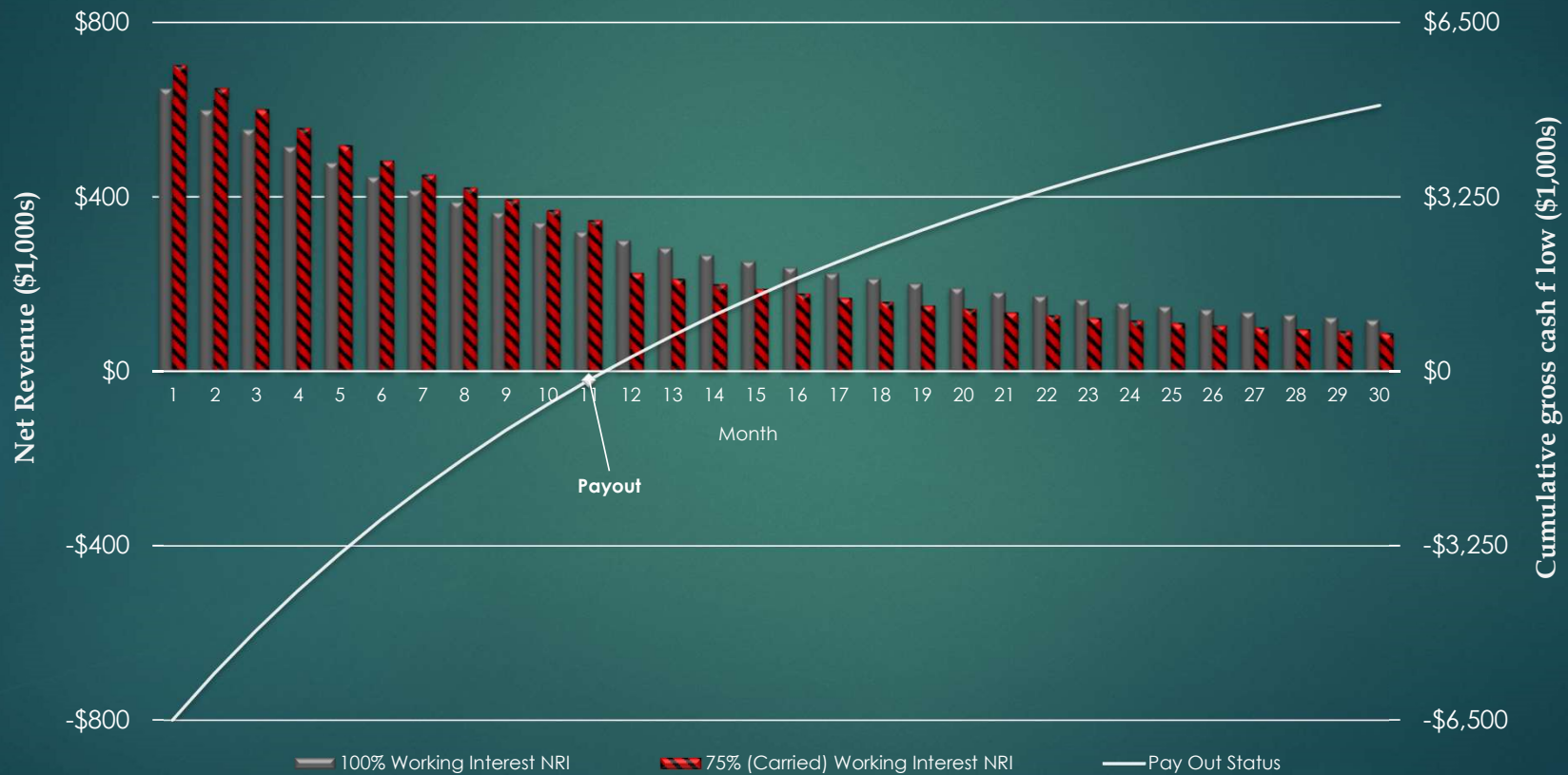
After Payout



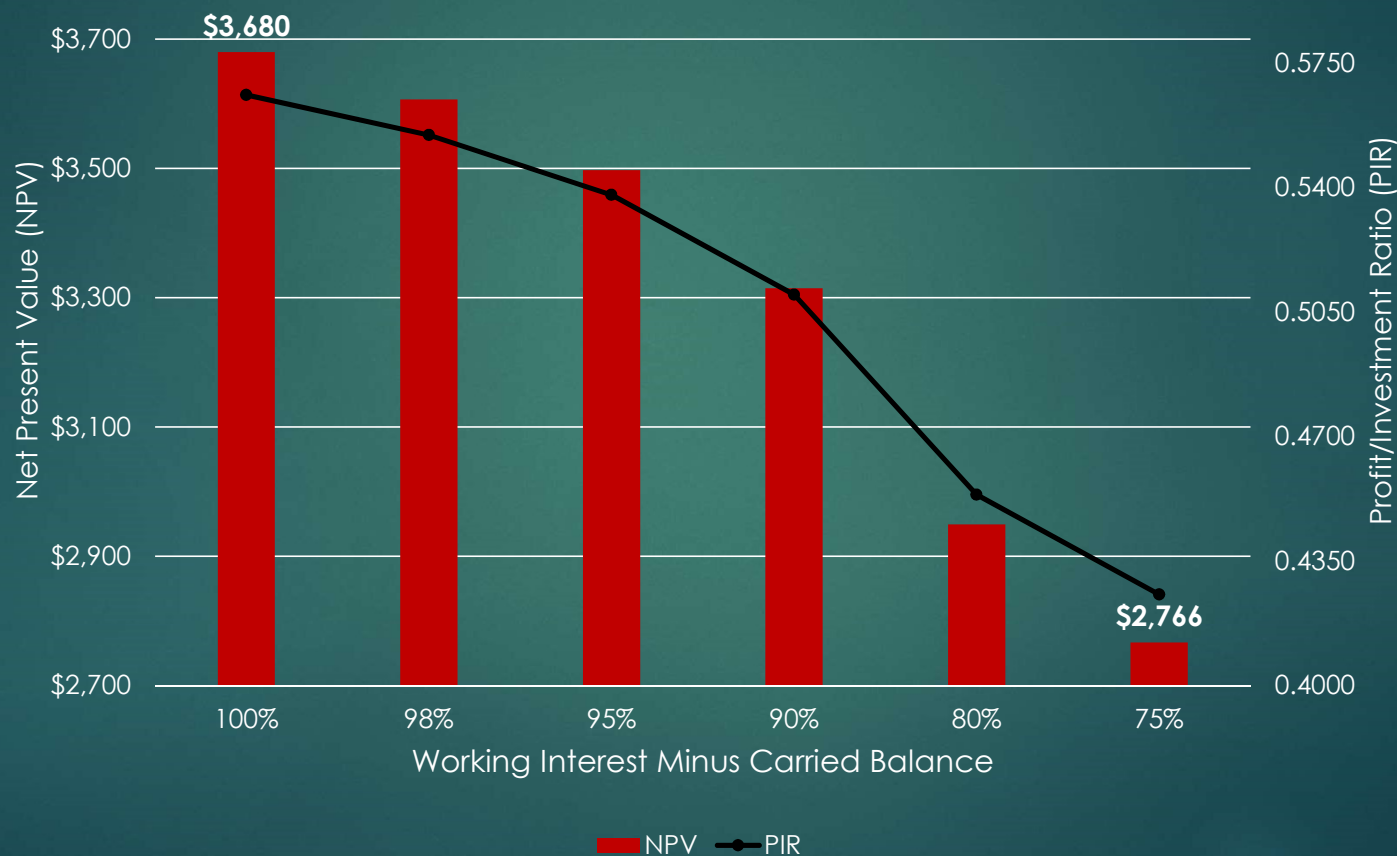
# Effects of a Carried Interest on Net Revenue



Back Acre No. 1 Well - Oil Revenue and Payout Status



# Effects of a Carried Interest on NPV



# Top-Leasing Strategy



- ▶ As a general proposition, a third party will be unable to rely on Big Oil's drilling activity to perpetuate its lease.
  - ▶ *See Hughes v. Cantwell*, 540 S.W.2d 742, 743-44 (Tex. Civ. App. — El Paso 1976, writ ref'd n.r.e.)
- ▶ A typical habendum clause in a “standard lease” will state that “this Lease shall be for a term of \_\_\_\_ years from this date (called ‘primary term’) and as long thereafter as oil and gas or other hydrocarbons are being produced from said land or land with which said land is pooled hereunder.”
  - ▶ *See, e.g.*, AM. ASS'N OF PROF'L LANDMEN, FORM 675 OIL AND GAS LEASE, *reprinted in* JOHN S. LOWE ET AL., FORMS MANUAL TO ACCOMPANY CASES AND MATERIALS ON OIL AND GAS LAW 101 (West Publishing eds., 6th ed. 2015) (hereinafter FORM 675 OIL AND GAS LEASE).
- ▶ Courts have held that where this kind of language is used that “The obligations which must be performed [in order to keep the lease alive] are specifically assigned to the Lessee.”
  - ▶ “acts of third parties or strangers to the contract [will] not suffice to meet his requirements of performance.”

# Top-Leasing Strategy

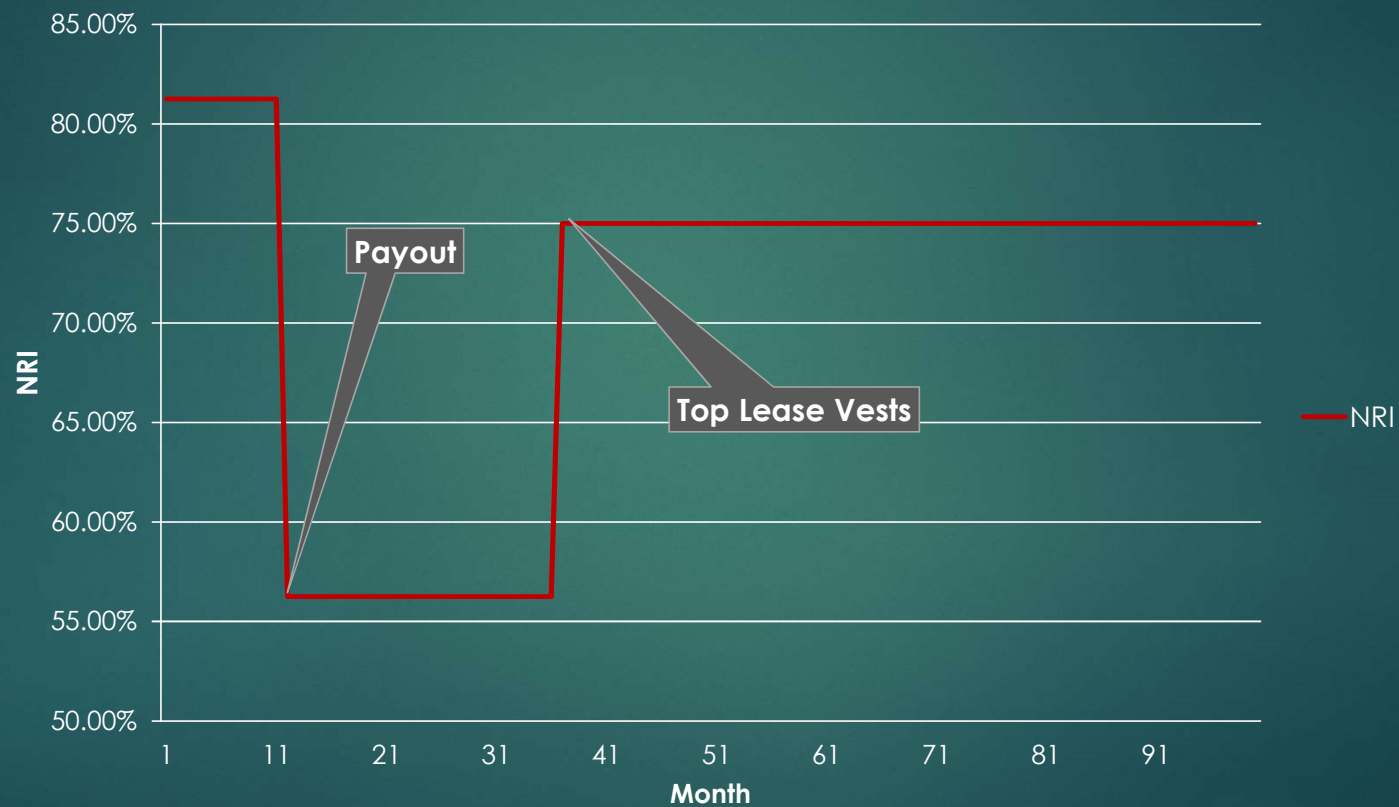


- ▶ Upon expiration, possession of the mineral estate, as to that undivided interest, reverts back to the mineral owner. Said mineral owner — now a cotenant in the mineral estate — would begin sharing in the proceeds of production.
  - ▶ Unless, of course, Big Oil has previously obtained a top lease from that mineral owner.
- ▶ A top lease is “[a] lease granted by a landowner during the existence of a recorded mineral lease which is to become effective if and when the existing lease expires or is terminated.”
- ▶ The basic function of the top lease is to put the top lessee “next-in-line” in the event the existing lease terminates, or is ultimately held to have terminated. The goal is to tie-up the mineral interest owner’s development rights before other competitors, including the existing lessee, have a chance to get a lease.
  - ▶ David E. Pierce, *Effective Top Leasing and Mysteries of the Habendum Clause*, 26 OKLA. BAR ASS’N MIN. LAW SEC. NEWSL. Vol. XXVI, No. 2, 2 (2005)

# Top-Leasing Strategy



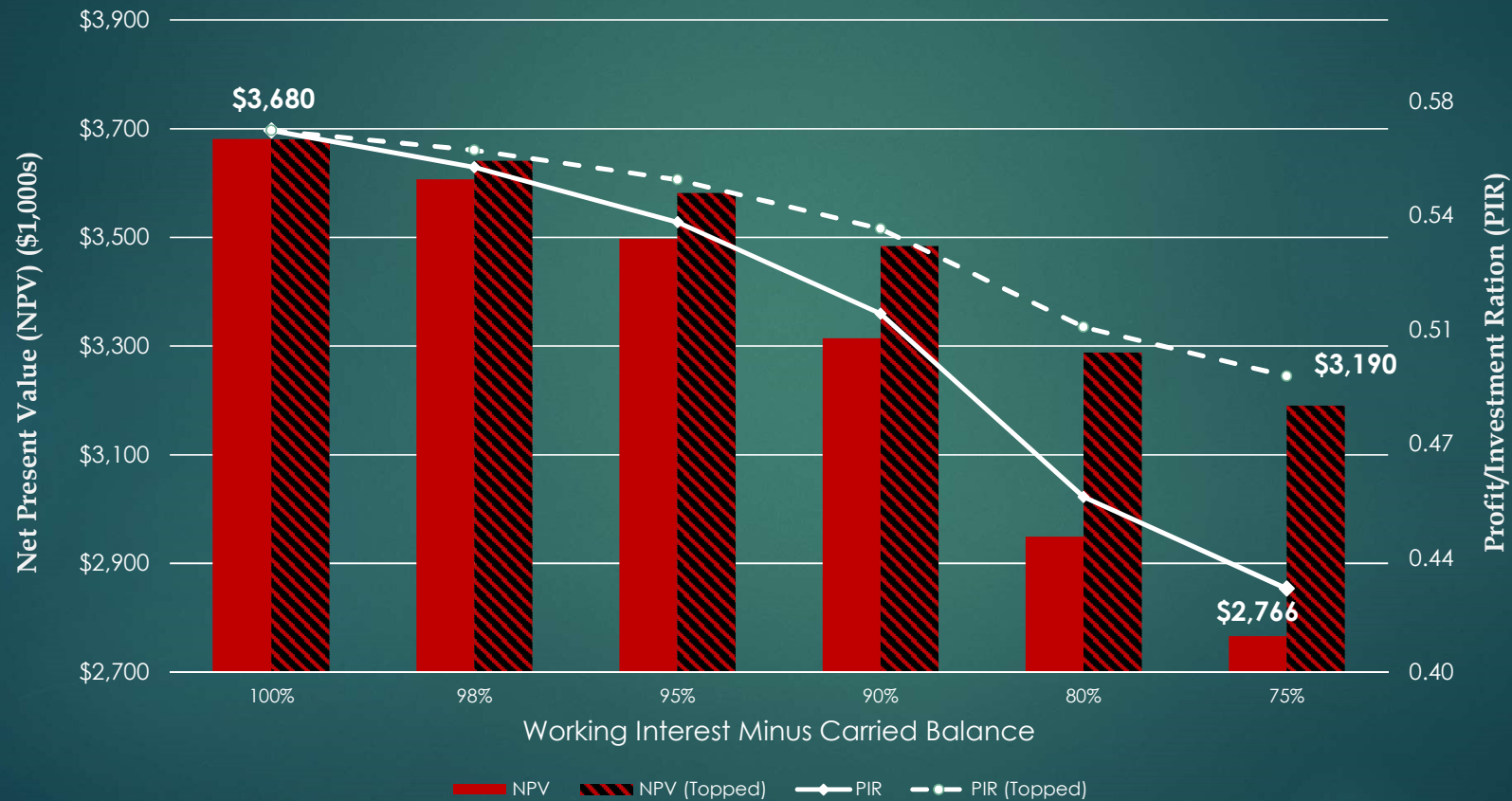
NRI Over the Life of the Well: 75% Working Interest, Cotenant Carried, Top Lease Vests at 3 Years



# Top-Leasing Strategy



Effects of a Carried Working Interest on NPV and PIR  
(Top Lease Scenario)





# Reasonable and Necessary Expenses

- ▶ “[A] cotenant has the right to extract minerals from the common property without first obtaining the consent of his cotenants; however, he must account to them on the basis of the value of any minerals taken, less the necessary and reasonable costs...”
  - ▶ *Wagner & Brown, Ltd. V. Sheppard*, 282 S.W.3d at 426
- ▶ “[W]hat is allowed the working cotenant, when called to account by another cotenant, is all expenses necessarily incurred by him in good faith in producing and rendering the product available.”
  - ▶ *Burnham v. Hardy Oil Co.*, 147 S.W. 330
- ▶ Categorical Exceptions:
  - ▶ Dry Holes
  - ▶ Interest

# Other Considerations



- ▶ Workovers, frac jobs and other operations
  - ▶ Cost of workovers which fail to reestablish production from non-producing wells are excluded. *Neely v. Intercity Management Corp.*, 752 S.W.2d 644
  - ▶ Cost of workovers which do not increase production or unsuccessful attempts to obtain production from a particular formation are likely to be excluded.  
*Bomar Oil & Gas Inc. v. Loyd*
- ▶ Well-by-Well Accounting or Tract-by-Tract?
  - ▶ Producing cotenant begins to account to his cotenants as the cost of each individual well are recouped or as the costs of all drilling on the common estate is recouped?
- ▶ Who Owes the Cotenant's Royalty?

# Recent Caselaw



- ▶ Devon Energy v. Apache Corporation
  - ▶ *Devon Energy Prod. Co. v. Apache Corp.*, 550 S.W.3d 259
  - ▶ Court of Appeals, 11th District, Eastland
  - ▶ April 30, 2018
  
- ▶ Cimarex Energy v. Anadarko Petroleum
  - ▶ *Cimarex Energy Co. v. Anadarko Petroleum Corp.*, No. 08-16-00353-CV
  - ▶ Court of Appeals, 8th District, El Paso
  - ▶ March 13, 2019

# Devon Energy v. Apache Corporation



- ▶ Texas Court of Appeals case focusing on whether Apache had statutory liability for paying royalties to the Lessor Plaintiffs pursuant to their leases with Devon.
- ▶ *Devon Energy Prod. Co. v. Apache Corp.*, 550 S.W.3d 259
- ▶ Tex. Supreme Court denied Petition for Review in October of 2018

Apache's liability for paying royalties to the Lessor Plaintiffs under their leases to Devon is by no means established. See Caleb A. Fielder, *Blood and Oil: Exploring Possible Remedies to Mineral Cotenancy Disputes in Texas*, 50 Tex. Tech L. Rev. 173, 199–202 (2017) (noting that this is a question that has not been expressly

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answered by case law and opining that the royalty, if any, owed to the third-party lessor (i.e., the Lessor Plaintiffs in this case) would be owed by the nonparticipating lessee (i.e., Devon)). As noted by Fielder:

Moreover, as between the driller and the nonparticipant, one would be hard-pressed to argue that the drilling party is responsible for the royalty payments of his cotenant's lessor. First, the drilling party in this scenario has no lease with the nonparticipant's lessor. He is a stranger to the nonparticipant's contract and has made no covenants, implied or otherwise. Moreover, because it is undisputed that the operator owes his non-drilling cotenant nothing until he has recouped his reasonable and necessary expenses, it would strain credulity to argue that the operator now owes him royalty merely by virtue of the fact that the cotenant has leased to a third party. Each owner in a cotenancy acts for himself and no one is the agent for the other nor has any authority to bind the other merely because of the relationship[.] Lastly, obligating the drilling party to pay his nonparticipating cotenant's royalty burden would create an opportunity for abuse. In an aggressive cotenancy scenario, the nonparticipating cotenant and his lessor could simply amend their lease to create an inordinately large royalty.

*Id.* at 202 (internal quotations and footnote omitted).

# Cimarex Energy v. Anadarko Petroleum



- ▶ Texas Court of Appeals case focusing on whether Cimarex's Lease was held by cotenant Anadarko's production.
  - ▶ *Cimarex Energy Co. v. Anadarko Petroleum Corp.*, No. 08-16-00353-CV
  - ▶ No Petition for Review currently filed.

# Questions?



Caleb A. Fielder, Esq.  
[caleb.fielder@gmail.com](mailto:caleb.fielder@gmail.com)