LEXSTAT 1-15 THE LAW OF POOLING AND UNITIZATION, 3RD EDITION § 15.04

The Law of Pooling and Unitization, 3rd Edition

CHAPTER 15 Termination of Units

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§ 15.04 Termination Through Lease Termination

Does the pooling of a unit terminate when a lease within the unit terminates? In the case of a compulsory unit, the answer is clearly no. This is because the pooling or establishment of the drilling/spacing unit operates on the right to produce throughout the tract, not simply upon a particular lease. A unit order is in the nature of an *in rem* order. Thus, it does not matter who happens to own the right to produce.

In the case of a declared unit or voluntary pooling the question is more difficult. The starting point should be basic principles of property law. For a declared unit in which the lessee pools the leased tract through authority granted it by the lessor, the power of the lessee to bind the property should extend no longer than the lease itself. Thus, if the lease terminates, then the pooling of the lease rights accomplished under it also terminate. However, another way of viewing the pooling clause is in terms of agent and principal. If the lessor gives the lessee authority to pool, is this not binding on the lessor and the property regardless of whether the lease itself continues? While this view can certainly be taken, the more correct view is that the lessor grants a power to pool the leasehold rights, and thus this pooling can extend no longer than the lease itself. The pooling clause is limited to the lease itself; it is not an additional power granted to the lessee that can extend beyond the lease.

This is not to say, however, that merely because a lease can be said to terminate that the pooling accomplished under it has necessarily terminated. It is necessary to look at all the circumstances of the pooling in order to determine whether there is a continuation of the pooling once a lease that has been pooled may be said to have terminated. Thus, for example, if a lessor has received substantial benefits, particularly production from other tracts in the pooled unit, the lessor ought to be subject to a continuation of the pooling even though the lease may have terminated for some reason. One might put this in terms of estoppel of the lessor to assert the termination of the pooling or on the basis that the acceptance of the benefits of the pooling has made the pooling irrevocable so long as there is production from the pooled unit. Two cases from the Texas courts illustrate this point well.

Pooling terminated when other leases in unit terminated--In the case of *Texaco, Inc. v. Lettermann* n21 a Texas court of appeals held that a lessee could again pool the lease under the pooling clause after the prior unit had terminated. In this case, the lessee (Texaco), acting under a pooling clause, included the lease acreage in a unit with two other lessees of adjoining land in 1953. A dry hole was drilled. The two other leases that had been consolidated terminated later in 1953. In November 1957 the lessees executed an instrument that terminated and rescinded the consolidated gas leasehold unit. That same day the lessee again pooled a portion of the lease, 80 acres out of the 322.2 in the lease, to

form a 241-acre unit. Production was then obtained on the lessor's tract, which continued to trial. In 1959 the lessee pooled the remaining 242.2 acres of the lease, and a unit well produced in paying quantities. The lessor took the position that the lessee could not take the lease out of the unit in the first instance, and thus the lessor had to be paid on a lease basis, not a unit basis, for the well drilled on his acreage. The lessor claimed that the lessee had exhausted the power to pool after pooling once, and further that if the pooling was valid, then only the 80 acres in the second, or 1957, unit was held because the primary term ended before the 1959 unit well was drilled. The Texas court held the unit could be revoked, or rather, that it had terminated. The first declared unit, established in 1953, went out of existence when the other leases with which it had been pooled were terminated. The court did not tie the termination to the rescinding instrument. The court stated:

> For a consolidated or unitized unit to exist, it must be made up of two or more leases which are in full force and effect. We think it is clear that the lessors of the SE1/4 and SW1/4 of Sec. 22 could not be bound by the terms of the lease pooling clause in their lease after the leases had expired. ... With two of the three leases making up the 1953 Unit terminating by their own terms, we fail to see how the unit could survive. A unitized unit is wholly dependent upon existing mineral leases. No case has been cited which supports a rule of law that holds that once a unitized leasehold unit has been designated, the consolidated unit remains in full force and effect so long as any one leasehold estate therein remains in full force and effect. We are unwilling to so hold here.n22

Some doubt may be cast upon the continued validity of this portion of *Lettermann* by *Ladd Petroleum Corp. v. Eagle Oil and Gas Co.* n23 although the *Ladd* court was careful to distinguish *Lettermann.* In *Ladd* two pooled tracts were held by a common lessee with a producing well on one of the tracts. The lessee mistakenly filed a release of the producing lease but subsequently acquired a new lease. The lessors of the tract not released claimed their lease terminated following the principle of *Lettermann* that termination of a pooled lease terminates the pooled unit. The appellate court rejected this contention, saying that the tract on which the producing well existed remained pooled even though the lease may have terminated. Does this mean the lessee, under a pooling clause, has power to bind the property beyond the term of the lease? If so, it appears an unsound principle. The court likened the release to an assignment of a lease under which pooling clearly would continue, but this is not a proper analogy because an assignee accepts the benefits and burdens of a lease. The alternative theory was, in effect, that a lessee lacks the power to terminate a pooling while production continues from pooled acreage. Indeed, the court distinguished *Lettermann* on the ground that production had ceased in that case. When limited in this fashion, *Ladd* is not inconsistent with *Lettermann.* The lessors of the tract on which the lease had been released did not challenge, apparently, the continued validity of the unit and their obligation to share with the adjacent acreage. In any event, these lessors gave a new lease to the same lessee who promptly again pooled the same acreage.

Although lease terminated the effectiveness of the pooling by lessee as to that lessor's interest continued--In *Wagner & Brown, Ltd. v. Sheppard* n23.1 a lessor's mineral interest in a 63 acre tract was pooled under a pooling clause by the lessee to form a 122 acre unit. When she was not timely paid her royalty after the first sales from the unit, her lease terminated. Two unit wells were located on the tract burdened by her interest. After termination of the lease, the operator paid her as an unleased owner but on a unitized basis rather than on the basis of the tract where the wells were located. That is to say, the operator paid as though the unit continued as to her now unleased interest. The Texas Supreme Court reversed an appeals court ruling that when the lease terminated, fee-simple absolute in the fractional mineral estate reverted to claimant and the pooling agreement also terminated as to her interest. Instead, her reversionary interest remained subject to the unit, and production from the wells was allocated to the entire unit. Looking to both the pooling clause and the unit declaration, the court said these referred to the pooling of "premises" and "lands" rather than the leasehold estate and thus they evidenced an intent to bind all interests in the lands, including the lessor's reversionary interest. The court cited but rejected the position of this section of this Treatise and Pat Martin & Bruce Kramer, *Williams & Meyers Oil and Gas Law* § 931.2 (2007), stating that both "rely almost entirely on *Texaco, Inc. v. Lettermann*, in which ... the polling [sic] clause unitized leases rather than lands."n23.2

As to pre- and post- termination of lease costs, the lower court held that the operator could recoup the unleased owner's proportionate share of expenses and costs incurred after termination, but that it could not obtain repayment for expenses and costs incurred before termination of the lease. On this point, the supreme court also reversed, reasoning as follows:n23.3

> While the defendants lost forever their legal claim to Sheppard's minerals, that does not necessarily mean that they also lost their equitable claim for the improvements they had built on her tract. Again, equity might deny such a claim had the lease expired long after production had begun and the operators had recovered most of their drilling costs. But the lease here terminated at the very outset of production, so denying reimbursement would work a substantial forfeiture. Under the facts in the record here, the trial court abused its discretion by allowing Sheppard to reap all the proceeds of production without bearing any of the costs.

The court remanded for determination of (1) the reasonable and necessary costs of production to be deducted from amounts due lessor/mineral owner for costs incurred after termination of her lease, (2) whether the defendants are entitled to equitable recovery of their pre-termination costs, and if so (3) the reasonable and necessary amount of those costs.

The authors believe the Texas Supreme Court has misapplied common law contract and property principles. The court's premise was that the lessor had expressly authorized the pooling of her possibility of reverter: "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."n23.4 The flaw in the court's construction of the language is self-evident. First, the lessor's possibility of reverter could not be part of the "leased premises" because she did not lease her possibility of reverter. Rather "leased premises" in a lease refers to what has been leased: the leased interests (e.g. oil and gas, coal, sulphur, helium etc.) and to the geographic and/or depth area. Second, an "interest therein" can only refer back to "leased premises" ; because Sheppard's possibility of reverter was not leased, it cannot be an interest in the "leased premises." A second obvious flaw in the court's reasoning is its use of the lessee's "Designation of Unit signed by the lessees" ("both Sheppard's lease and the unit agreement pooled certain 'premises' and 'lands,' not just their leased interests") to interpret the intent of the lessor who was not a party to the unit agreement.

Careful drafters can avoid in the future the problems associated with the *Sheppard* court's decision. But we wonder whether the opinion will lead to a series of claims that units that many have thought terminated are actually still in existence, binding upon lessors many years after the leases in an area have terminated? For state-created units there may be an administrative remedy to terminate old, defunct units. But how can a mineral owner do this if the lessee is long gone or unwilling?

We also suspect that the *Sheppard* decision invites mischief and strategic behavior. As to recoupment of well-costs the decision blurs together cotenancy and leases, allowing lessees to recoup costs on a equitable basis after the lease has terminated as though they were cotenants with the lessor from the start. Will a lessee that sees a well will be unlikely to reach payout be able to terminate the lease to avoid paying royalty but nevertheless be able to recoup well costs out of the former lessor's interest?

FOOTNOTES:

(n1)Footnote 21. Texaco, Inc. v. Lettermann, 343 S.W.2d 726, 14 O.&G.R. 427 (Tex. Civ. App., 1961) , *writ ref'd n.r.e.* A similar point was taken up but not decided in Trawick v. Castleberry, 1953 OK 142, 275 P.2d 292, 4 O.&G.R. 63, 17 O.&G.R. 50 (Okla. 1954) .

(n2)Footnote 22. 343 S.W.2d at 730-731 . *See also* Duffy v. Callaway, 309 S.W.2d 853, 8 O.&G.R. 1274 (Tex. Civ. App., 1958) , *writ ref'd,* which involved the apportionment arising from a community lease where the lessee released the lease as to part of the land. The court stated: "The life of the lease and the presumed pooling agreement

could have been terminated by the unilateral act of the lessee in merely failing to drill or pay rent. The effects of such a pooling continued only so long as the lease remained in force." 309 S.W.2d at 856 . For a ruling similar to *Lettermann* but involving the sale of land by certain lessors who had entered into a royalty pool, see Hover v. Cleveland Oil Co., 150 Kan. 531, 95 P.2d 264 (1939) ; the Kansas court ruled that the pooling arrangement ended when one of the pooling lessors conveyed his land to another by warranty deed. This case is further discussed in § 19.02 *below*.

(n3)Footnote 23. Ladd Petroleum Corp. v. Eagle Oil and Gas Co., 695 S.W.2d 99, 87 O.&G.R. 116 (Tex. App., 1985) , *writ ref'd n.r.e.*

(n4)Footnote 23.1. Wagner & Brown, Ltd. v. Sheppard, 282 S.W.3d 419 (Tex. 2008) , *rev'g* 198 S.W.3d 369 (Tx. App.--Texarkana, 2006) .

(n5)Footnote 23.2. 282 S.W.3d at 424.

(n6)Footnote 23.3. 282 S.W.3d at 429.

(n7)Footnote 23.4. 282 S.W.3d at 423.