A LIFE BEYOND THE LEASE: THE POOLING POWER SURVIVES THE TERMINATION OF THE OIL AND GAS LEASE IN TEXAS

Comment

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I. THE TEXAS SUPREME COURT LEVELS THE PLAYING FIELD

On November 21, 2008, the Texas Supreme Court shocked the oil and gas industry in a case of first impression, *Wagner & Brown v. Sheppard*.[1] For the first time, the court addressed the effect a lease has on a pool of producing properties if a lease in that pool expires.[2] In *Sheppard*, the court held that a lessor's participation in a pooled unit did not end with the termination of the lease.[3] Thus, the pooling clause, which grants the lessee the power to pool, may survive beyond the termination of the lease if the clause includes the pooling of "lands" and not just the pooling of the "leases."[4]

The Texas Supreme Court's decision greatly impacted the oil and gas industry because it expanded the lessee's power to pool.[5] By expanding the lessee's power to bind lessors to pooling agreements beyond the termination of the lease, the Texas Supreme Court caused a shift in power between leasing oil and gas companies and mineral owners.[6] Before *Sheppard*, in an attempt to level the playing field, courts generally offered leasing mineral owners protection against powerful and wealthy oil and gas companies.[7] But, after years of holdings favorable to mineral owners, limiting the power of oil and gas companies as lessees, the Texas Supreme Court finally loosened its tight noose on lessees by increasing the lessee's power through the pooling clause.[8] This expansion of power is advantageous to leasing oil and gas companies because after a lessor's lease has terminated, the lessor's tract may still be bound to the conditions of the pooling agreement.[9] Therefore, although the lease has terminated, lessees

1. *See* Wagner & Brown v. Sheppard, 282 S.W.3d 419, 424 (Tex. 2008).
2. *See id.*
3. *Id.*
4. *See id.* at 423. Pooling is the combining of multiple tracts of minerals to create a sufficient acreage to drill a well. *See* discussion *infra* Part III.A.
5. *See Sheppard*, 282 S.W.3d at 423-24; *see also* discussion *infra* Parts III.A & V.A (discussing the power to pool and the implications of *Sheppard*).
6. *See Sheppard*, 282 S.W.3d at 424-25.
7. *See infra* Part III.
8. *See Sheppard*, 282 S.W.3d at 424-25.
9. *See id.*

will continue to maintain control of unleased minerals and receive profits from any wells drilled on the unleased tract.

This decision is relevant to the industry because the majority of oil and gas leases contain a pooling clause, which allows lessees to enter into pooling agreements on behalf of the lessor.[10] A pooling agreement binds multiple neighboring tracts together to form a drilling space large enough to comply with state spacing requirements.[11] Many mineral owners hold a fractional interest in the minerals or own a small tract of land that alone would not meet such requirements; thus, a pooling agreement is necessary to combine multiple interests in order to drill.[12]

This Comment examines the implications of the Texas Supreme Court's recent decision in *Sheppard* on the oil and gas industry in Texas; more specifically, this Comment addresses how the decision impacts the power to pool leases.[13] But, before jumping into the case, it is essential to first understand the basic concepts and terminology used in the oil and gas industry. Accordingly, Part II describes the varying interests in minerals, concurrent ownership of minerals, operating agreements, and state regulation. Part III focuses on the pooling of leases and the power lessees possess through the pooling clause within a lease. Part III also addresses the duty lessees owe lessors, specifically in relation to pooling. Part IV analyzes the court's decision in *Wagner & Brown v. Sheppard.* And, Part V answers the following questions raised by the court's decision: What power do lessees now possess under the pooling clause? Are lessors bound by operating agreements after their lease has terminated? Did *Sheppard* change the duty of care lessees owe lessors? Did the Texas Supreme Court get it right? Finally, Part VI looks at the future implications of the court's decision. Ultimately, this Comment will offer insight as to the impact of *Sheppard* in the legal community and provide solutions to issues regarding the interpretation of the pooling clause and the drafting of oil and gas leases.

II. THE DEVELOPMENT OF AN OIL AND GAS LEASE

A. Mineral Interests and Leasehold Interests

In order to grasp the complex problems that may arise in an oil and gas lease contract, it is important to first understand the different interests in minerals and the development of the lease itself.[14] Surface property and the

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10. *See* discussion *infra* Part III.A.
11. *See* discussion *infra* Part III.A.
12. *See* discussion *infra* Part III.A.
13. *See Sheppard*, 282 S.W.3d at 430.
14. *See infra* notes 22-33.

property beneath the surface, the minerals, may have separate owners.[15] While it is possible for the surface owner to also own the minerals beneath the surface, it is common to sever ownership of the surface and minerals to create two entirely separate estates.[16] The owners of the minerals below the surface are the mineral interest owners.[17]

In all states, surface owners commonly possess a present interest in fee simple, but depending on the state, the present interest in the minerals may or may not be held in fee simple.[18] The majority of states, including Texas, New Mexico, Colorado, and Kansas, recognize the concept of ownership in place, which permits mineral owners to own the land in fee simple; however, the mineral owner's right to each individual mineral is a determinable interest that automatically terminates once someone else captures the minerals.[19] Other states, such as Louisiana, California, Oklahoma, and Wyoming, subscribe to the principle of non-ownership, whereby the mineral owner or lessee only has the right to explore, develop, and produce oil and gas, but does not actually own the minerals until the moment they are captured.[20]

A mineral interest owner possesses the exclusive right to participate in oil and gas leases and to incur profits from production.[21] The mineral owner may lease his mineral interest to a lessee, whose leasehold interest is often referred to as the working interest or operating interest, and the lessee will then possess the exclusive right to produce the minerals.[22] While the lease is in existence, the lessee possesses a fee simple determinable in the

15. 1 ERNEST E. SMITH & JACQUELINE LANG WEAVER, TEXAS LAW OF OIL AND GAS § 2.1(A) (2d ed. 1999).

16. 1 SMITH & WEAVER, *supra* note 15, § 2.1(A) (citing Tex. Co. v. Daugherty, 176 S.W. 717 (1915)); JOHN S. LOWE, OIL AND GAS LAW IN A NUTSHELL 86 (3d ed. 1995) (explaining that under Louisiana's civil law regime, landowners cannot own fugacious minerals; thus, the mineral rights cannot be severed and instead, only a mineral servitude may exist). Severance may be total or partial, and ownership in the minerals may be fractional. *See* 1 SMITH & WEAVER, *supra* note 15, § 2.1(A) (citing Tex. Co. v. Daugherty, 176 S.W. 717 (1915)).

17. PATRICK H. MARTIN & BRUCE M. KRAMER, WILLIAMS & MEYERS OIL AND GAS LAW § 202.2 (Abridged 3d ed. 2007) [hereinafter WILLIAMS & MEYERS OIL AND GAS LAW Abridged].

18. *Id.* A fee simple, also known as a fee simple absolute, is "[a]n interest in land that, being the broadest property interest allowed by law, endures until the current holder dies without heirs." BLACK'S LAW DICTIONARY 648 (8th ed. 2004).

19. LOWE, *supra* note 16, at 29. A determinable interest, also known as a fee simple determinable, is an interest in an estate that automatically ends upon the occurrence of a specified event; upon termination of a determinable interest, the mineral ownership reverts to the grantor. BLACK'S LAW DICTIONARY 649 (8th ed. 2004). Ownership in place is a corporeal fee simple and afforded the same rights as a surface estate; therefore, mineral owners cannot lose their rights to the minerals by abandonment. 1 SMITH & WEAVER, *supra* note 22, § 2.1(A)(1).

20. LOWE, *supra* note 23, at 28-29. This Comment focuses on ownership in place mineral rights.

21. 1 SMITH & WEAVER, *supra* note 15, at § 2.1(A)(2) (stating that the surface owner has no right to partake in the exploration and production of oil and gas or participate in the execution of an oil and gas lease). Although the mineral owners are under no obligation to share any profits with the surface owners, most oil and gas leases contain provisions that allow the surface owners to receive some benefit from exploration and production on the property. *See id.*

22. *See id.*; LOWE, *supra* note 16, at 41.

oil and gas, and the original mineral owner, the lessor, retains a possibility of reverter (assuming ownership in place).[23] Generally, the lessee is an oil and gas company that has leased the right to drill and produce the property, but the lessee may also transfer the operating rights to an operator (an oil and gas company), who will then be in charge of exploring, drilling, and producing on the property.[24]

A typical oil and gas lease is a conveyance that allows the lessee to receive an interest in the minerals for a particular amount of time, referred to as the primary term; once the primary term has expired, the lessee may continue to maintain ownership as long as the lessee is able to produce oil or gas.[25] When multiple owners each own a fractional interest in the minerals, the lessee may choose to execute a community lease, which joins all of the mineral owners of a particular tract in one single lease.[26]

B. Royalty Interests

In consideration of the lessor's mineral interest to the lessee, the lessor typically reserves a royalty interest in the lessee's production of oil and gas.[27] Once the lease is created, the mineral owner may convey all or part of his royalty reserved under the lease to another person.[28] But, the mineral owner also has the power to convey a royalty interest before the execution of a lease or to create a royalty interest in another outside of the lease agreement.[29]

Although there are many different types of royalties, the royalty created upon the execution of an oil and gas lease, often referred to as a

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23. *See* 1 SMITH & WEAVER, *supra* note 15, § 2.2. A fee simple determinable is a present possessory interest in the minerals for a set or limited period of time (some leases may function as a fee simple on a condition subsequent; however, for purposes of this Comment that is irrelevant). *See id.* (citing Stephens Cnty. v. Mid-Kansas Oil & Gas Co., 113 Tex. 160, 254 S.W. 290 (1923)). Once the lease expires or terminates, the mineral interest automatically reverts back to the lessor because the lessor maintains a future possessory interest in the minerals—a possibility of reverter. *See* WILLIAMS & MEYERS OIL AND GAS LAW Abridged, *supra* note 17, § 301.

24. LOWE, *supra* note 16, at 339; *see also infra* Part II.D (defining an operating agreement and the role of an operator).

25. 1 SMITH & WEAVER, *supra* note 15, at § 2.2 (citing A.W. Walker, Jr., *The Nature of the Property Interests Created by an Oil and Gas Lease in Texas*, 7 TEX. L. REV. 1, 20 (1928)).

26. LOWE, *supra* note 16, at 234. Although community leases are a common practice in Texas, other states have viewed it as a mere "inference that the parties intended to pool their interests." *Id.*; *see* discussion *infra* Part III. This Comment discusses concurrent ownership in more detail. *See infra* Part II.C.

27. *See* WILLIAMS & MEYERS OIL AND GAS LAW Abridged, *supra* note 17, § 202.3. Consideration, however, is not required to create a valid lease because the lease conveys a present interest in land. *See* 1 SMITH & WEAVER, *supra* note 15, § 2.2 (citing Jones v. Bevier, 59 S.W.2d 945 (Tex. Civ. App.—Beaumont 1933, writ ref'd).

28. WILLIAMS & MEYERS OIL AND GAS LAW Abridged, *supra* note 17, § 202.3.

29. *Id.*

"landowner's royalty," is the most common.[30] The original landowner (or mineral owner), who is also a lessor, leases the mineral interest to the lessee in exchange for the royalty interest.[31] The royalty owner is then entitled to a fraction of the oil or gas produced, free of drilling and operating expenses.[32] Upon executing an oil and gas lease, the lessor thus possesses both a royalty interest and a reversionary interest.[33]

Unlike the mineral interest owner, the royalty interest owner does not have the right to explore, drill, or produce oil and gas on the premises unless the lease expressly states otherwise.[34] In addition, the royalty interest owner does not have the ability to execute a lease.[35]

C. Concurrent Ownership/Joint Ownership of Mineral Rights

Multiple persons may own a tract of minerals concurrently.[36] Each concurrent mineral owner, no matter how small or large her fractional interest in the minerals may be, may enter into a lease with different lessees.[37] A majority of states agree that each co-owner (also referred to as a cotenant) has the right to excavate the minerals without the other co-owners' consent.[38] Ideally, in a oil and gas lease, all the co-owners have agreed to lease their interest to the same lessee under a single binding lease; once the lease terminates, it will terminate as to all the owners.[39] This,

30. *See* 1 SMITH & WEAVER, *supra* note 15, § 2.4(B)(1). This Comment discusses the impact of *Sheppard* on the landowner's royalty when a lease agreement permits the pooling of lands. *See infra* Part V.B.

31. *See id.*

32. *See id.* § 2.4(A).

33. *See id.*; *see also* discussion *supra* Part II.A (discussing the lessor's future interest in the mineral estate). The grantor's reversionary, future interest in the minerals is called a "possibility of reverter." BLACK'S LAW DICTIONARY 1204 (8th ed. 2004).

34. WILLIAMS & MEYERS OIL AND GAS LAW Abridged, *supra* note 17, § 301; 1 SMITH & WEAVER, *supra* note 15, § 2.2. In addition, the royalty interest owner does not have the ability to execute a lease. 1 SMITH & WEAVER, *supra* note 22, § 2.4(A). The executive interest owner possesses the right to execute oil and gas leases. *See* discussion *supra* Part I.A.

35. 1 SMITH & WEAVER, *supra* note 15, § 2.4(A).

36. *See* 1 SMITH & WEAVER, *supra* note 15, § 2.3(A). Accordingly,

> [B]y severing the two estates, however, it is possible to have a wide variety of differing ownership interests in the surface and the minerals. One person may own the surface in severalty, while the mineral estate is owned in common by several other persons, who may or may not include the surface owner.

Id.

37. *See id.*

38. *See id.* § 2.3(A)(1) (citing Burnham v. Hardy Oil Co., 147 S.W. 330 (Tex. Civ. App.—San Antonio 1912), *aff'd*, 108 Tex. 555 (1917); Tynes v. Mauro, 860 S.W.2d 168, 176 (Tex. App.—El Paso 1993, writ denied)); *see also* LOWE, *supra* note 16, at 86 (explaining that this majority rule is based on the Court's decision in *Prairie Oil & Gas Co. v. Allen*, 2 F.2d 566 (8th Cir. 1924)). Under the minority view, a cotenant cannot drill for oil or gas without the other co-owner's permission and to do so would be wasteful. LOWE, *supra* note 16, at 86.

39. *See* 1 SMITH & WEAVER, *supra* note 15, § 2.3(A)(2). States may provide exceptions to this general rule through statutory enactment. *See* TEX. CIV. PRAC. & REM. CODE ANN. § 64.091 (Vernon

however, is not always the case.[40] Therefore, if a lessee only executes a lease with one co-owner and that co-owner conveys his or her undivided interest to the lessee to explore, drill, and produce, then the lessee steps into the shoes of that lessor as cotenant with the other co-owners of the mineral estate.[41]

Although the majority rule, including Texas, allows one co-owner to develop minerals without the consent of the additional co-owners, the non-joining or non-leasing co-owners are entitled to production proceeds in proportion to their fractional ownership in the minerals less their share of reasonable and necessary costs of production.[42] The developing co-owner, or if there is a lease, the lessee, bears the burden of unsuccessful operations and cannot recover from the non-participating co-owners.[43]

Often times concurrent mineral interest owners will enter into different leases with different lessees, creating concurrent ownership.[44] The existence of multiple lessees, typically oil and gas companies, creates a concurrent ownership of the leasehold.[45] Concurrent ownership in the leasehold (a term meaning an interest in a lease) leads to the execution of an operating agreement in order to maintain control over the drilling operations.[46]

D. Operating Agreements

Once an oil and gas company, or lessee, has leased a tract of minerals from a mineral owner, it possesses the working interest in the lease.[47] The working interest includes the right to develop the minerals.[48] In many instances, multiple lessees may each possess a working interest in a particular tract or pooled unit.[49] A pooled unit is a combination of multiple adjacent leases, pulled together to drill a well.[50] A single tract within the pooled unit may also contain multiple lessees from different fractional co-

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2008) (Under the Texas statute, if a co-owner's location is unknown, the remaining co-owners may still execute the lease if they can show that they made a diligent search for the missing cotenants and that they will suffer substantial injury unless the land is developed). *See* 1 SMITH & WEAVER, *supra* note 15, § 2.3(A)(2).

40. *See* 1 SMITH & WEAVER, *supra* note 15, § 2.3(A)(2).

41. *Id.*

42. WILLIAMS & MEYERS OIL AND GAS LAW Abridged, *supra* note 17, § 202.3.

43. *Id.* Non-participating co-owners may be liable for unsuccessful production costs if the co-owner consented to the drilling operations and agreed to cover partial costs. *Id.*

44. 3 SMITH & WEAVER, *supra* note 15, § 17.1(A).

45. *See* WILLIAMS & MEYERS OIL AND GAS LAW Abridged, *supra* note 24, § 503.1.

46. *See id.* § 503.2.

47. *See id.*

48. *Id.*

49. *Id.*

50. *See* discussion *infra* Part III.A.

owners of a tract.[51] Therefore, to avoid waste and inefficient drilling, working interest owners commonly agree to enter into an operating agreement.[52]

Parties that agree to combine their efforts to form a pool usually enter into an operating agreement.[53] The purpose of the operating agreement is to name one of the working interest owners as the operator; such agreements are necessary because a pooled unit consists of multiple interest owners.[54] In addition, the operating agreement indicates the operator's scope of authority and the allocation of the proceeds and costs among the working interest owners.[55] The operator is usually a working interest owner or a company that the working interest owner contracted to work on the premises.[56] The operator is responsible for the management and everyday operation of the oil or gas wells.[57] The overall goal of electing a single operator in control of drilling and production is to prevent waste and promote efficient drilling in accordance with state regulations.[58]

E. Rules and Regulations

The primary role of state regulation of oil and gas is to prevent waste and protect mineral ownership rights.[59] The Texas Railroad Commission regulates oil and gas production in Texas.[60] The Texas Railroad Commission and the Texas judiciary both have the power to regulate and impact the oil and gas industry.[61] The Texas Railroad Commission provides concrete rules that lessees and lessors must abide by, whereas Texas courts offer common law rulings.[62] It follows that lessees and lessors

51. 3 SMITH & WEAVER, *supra* note 15, § 17.1(A). Additional working interest owners may exist if a lessee sells his working interest to investors or to other oil and gas companies. *Id.*

52. *Id.*

53. *Id.* In addition to an operating agreement, lessees may also enter into a joint operations agreement; the terms of this agreement typically overlap with the terms of an operating agreement. *Id.*

54. *Id.* at § 17.3(A)(1).

55. *Id.*

56. *Id.*

57. *See id.* § 17.3(A)(2).

58. *See id.* § 17.3(A).

59. RICHARD C. MAXWELL ET. AL., OIL AND GAS CASES AND MATERIALS 781 (8th ed. 2007). In the early 20th century, Texas experienced excessive and unnecessary drilling, which caused Texas to lose both money and precious natural recourses. *See* Wagner & Brown v. Sheppard, 282 S.W.3d 419, 420 (Tex. 2008) (citing Howard R. Williams, *Conversation of Oil and Gas*, 65 HARV. L. REV. 1155, 1166 (1952)). To prevent further waste, the Texas Legislature introduced voluntary pooling in 1949 and compulsory pooling in 1965. *Id.* at 421 (citing Act approved May 24, 1949, 51st Leg., R.S., ch 259, § 1, 1949 Tex. Gen. Laws 477-83 (current version at TEX. NAT. RES. CODE § 101.011)); Act approved March 4, 1965, 59th Leg., R.S., ch. 11, § 2, 1965 Tex. Gen. Laws 24-6 (current version at TEX. NAT. RES. CODE § 102.011); *see* R.R. Comm'n v. Miller, 434 S.W.2d 670, 671 (Tex. 1968)).

60. *See* RAILROAD COMMISSION OF TEXAS, http://www.rrc.state.tx.us/ (last visited Sept. 16, 2010).

61. *See id.*

62. *See id.*

must take into account the state regulations and courts' decisions when drafting the many different clauses included in an oil and gas lease.

State conservation agencies, such as the Texas Railroad Commission, regulate production by setting allowable production rates or volumes, which limit the amount of oil and gas each well is permitted to produce.[63] Four factors an agency may consider when setting an allowable rate—although not an exhaustive list—are as follows: the individual well, the reservoir or field, the pipeline system within the state, and the state as a whole.[64] Each well's allowable production rate is subject to change monthly, bi-monthly, quarterly, or semi-annually.[65]

In addition to allowables (permitted production rates), state agencies regulate well spacing; well spacing regulations control the location of wells and the amount of drilling permitted into a single underground reservoir.[66] Spacing requirements come in two forms.[67] First, spacing rules or orders from a state agency may require a well to be located a certain distance from property lines or other wells; these types of rules are lineal spacing rules.[68] Second, lineal limitations, or density spacing rules, regulate the specific area or acreage in which a single well is permitted.[69] In 1962, the Texas Railroad Commission (the Commission) adopted the 40-acre spacing rule, Rule 37.[70] The rule states that no well shall be drilled within less than 1,200 feet of any other well completed on the same tract, and no well shall be drilled within less than 467 feet to any property line, lease line, or subdivision line.[71] The Commission, however, reserves the power to make case-by-case changes to the minimum spacing dimensions that Rule 37 requires.[72]

Mineral owners may own an interest in a tract too small to comply with state spacing requirements. Therefore, state agencies permit small tract mineral owners to enter into pooling agreements with neighboring tract to meet spacing requirements in order to drill.[73]

63. MAXWELL ET. AL., *supra* note 59, at 781.

64. *Id.* at 782.

65. *Id.*

66. *Id.* at 784-85.

67. *Id.* at 784. States may possess both forms at the same time. *Id.*

68. *Id.*

69. *Id.*

70. *Id.* at 818.

71. *Id.* (citing 16 TEX. ADMIN. CODE § 3.37 (Vernon 2010)). The Railroad Commission sets spacing requirements, which indicate the number of acres required to form a pooled unit. *See id.* (citing 16 TEX. ADMIN. CODE § 3.37 (Vernon 2010)).

72. 2 SMITH & WEAVER, *supra* note 15, § 9.3(C).

73. *See* discussion *infra* Part III.A.

III. THE POOLING POWER: PRE *SHEPPARD*

A. Pooling vs. Unitization

Although many people use the terms "pooling" and "unitization" interchangeably, each term has a distinct meaning.[74] Pooling occurs when an operating company, seeking to drill a well, combines multiple smaller tracts of separately owned minerals to form a pool that complies with the state's spacing requirements.[75] Once the separate mineral owners, or the lessees of the minerals, become part of the pool, they each share the costs and proceeds of exploration and production in proportion to their share of interest in the tract.[76] Unitization, on the other hand, refers to the combination of several producing leases over a large underground formation of oil or gas to form one large unit, which allows all the wells within the unit to work together and produce more efficiently.[77] While pooling typically occurs during the primary stage of production or recovery, unitization generally comes into play during secondary recovery to produce oil and gas that would otherwise be unrecoverable.[78]

It is important to understand the difference between pooling and unitization because in a pooled unit, an owner shares the profits (and perhaps the costs) of one or more wells with the mineral owners within the pooled unit.[79] On the other hand, in a unitized unit, a mineral owner shares profits with multiple mineral owners from multiple pools—this results in the mineral owner, or lessee, owning a smaller share of production.[80] A mineral owner (or the relative lessee) can justify participation in a unit, however, because the wells within the unit are working together toward secondary recovery, and therefore, the mineral owner receives royalties on oil and gas that would have remained in the ground if unitization had not occurred.[81]

There are also similarities between pooling and unitization, which is why they are often used interchangeably.[82] In Texas, both pooling and unitization may be voluntary or compulsory.[83] Compulsory pooling or unitization occurs when a state agency forces one or more mineral interest

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74. 2 SMITH & WEAVER, *supra* note 15, § 11.1(B).
75. *See, e.g., id.*
76. *See, e.g., id.*
77. *See, e.g., id.* § 11.1(B).
78. *See, e.g., id.*
79. *See* WILLIAMS & MEYERS OIL AND GAS LAW Abridged, *supra* note 17, § 902.
80. 1 MARTIN & KRAMER, WILLIAMS & MEYERS OIL AND GAS LAW § 901 (2009) [hereinafter WILLIAMS & MEYERS OIL AND GAS LAW].
81. *See* 2 SMITH & WEAVER, *supra* note 15, § 11.1(B).
82. *See id.*
83. 6 HOWARD R. WILLIAMS ET AL., OIL AND GAS LAW §§ 924, 940 (3d ed. 1989).

owners to enter into a unit to avoid waste.[84] Voluntary pooling or unitization occurs when the lessors and lessees agree to a pooling or unitization provision within the lease and then the various lessees enter into a unit or pooling agreement.[85] Because of the similarities between the two, issues that arise in pooling often lead to issues in unitization, and vice versa.[86]

Leases often contain pooling clauses, which grant the lessee the power to combine multiple mineral interests to form a pooled unit before drilling the well.[87] These voluntary pooling agreements, as they are called, are beneficial to the owners of the mineral interests under small tracts because without them, the owner's tract would be too small to satisfy the state spacing requirements.[88] Pooling allows neighboring mineral owners of small tracts to combine their interests to form a sufficient pool to drill.[89]

B. The Effect of Pooling on the Distribution of Production Proceeds

Pooling and unitization agreements are typically advantageous to lessors.[90] Generally, lessors can only receive royalties from producing wells located on their own tract.[91] But, when lessors agree to a pooling clause, they are then entitled to a royalty from wells located within the pool or unit on separately owned tracts.[92] The lessor's royalty from production is measured by his or her royalty stated in the lease in proportion to the size of the lessor's tract in the pool or unit.[93] Thus, pooling provides an advantage to mineral owners whose tract is unable to produce profitable minerals because, as part of the pool, the mineral owner will recover profits from production even though the well was not drilled on his specific tract.[94]

Sharing profits with neighboring landowners may appear disadvantageous to the mineral owner whose tract the well is drilled on; however, pooling may have been necessary for production.[95] For instance, a pooling agreement may be the only option a small tract mineral owner has to produce the minerals within his tract because, without the pooling of neighboring properties, the tract alone would not meet the spacing requirements.[96] Furthermore, if an operator drills additional wells on any of

84. *See id.* §§ 905, 912.
85. *Id.*
86. *Id.* §§ 923, 940.
87. 1 WILLIAMS & MEYERS OIL AND GAS LAW, *supra* note 87, § 961.2.
88. *See id.* § 901.
89. *See* 6 WILLIAMS ET AL., *supra* note 83, § 902.
90. *See id.* § 951.
91. *See id.*
92. *See id.*
93. *See id.*
94. *See id.*
95. *See id.*
96. *See id.*

the tracts included in the pool, then the profits are shared, thus increasing the mineral owner's ability to share in future wells.[97]

Pooling also affects whether a non-leasing mineral cotenant can recover profits from production based on the location of a well.[98] Although the leasing parties share royalties in the pooled unit regardless of the location of the well, a non-leasing cotenant only receives his or her fractional share of the net production if the well is located on the non-leasing cotenant's tract of minerals; otherwise, the non-leasing cotenant is not entitled profits.[99]

C. The Pooling Power and Implied Good Faith Obligation

In addition to benefiting lessors, the pooling clause is also advantageous to lessees because it bestows the power to pool upon the lessee.[100] This power affects the rights of mineral owners and the drilling process.[101] The power to pool means that lessees do not need to go back later and ask each lessor for permission to drill additional wells; doing so would be cost-prohibitive.[102] Without the power to pool, a lessor's primary term cannot be extended without drilling a well on the lessor's property, whereas with pooling power, the lessee can extend the primary term by drilling anywhere on the pooled premises.[103] Because the pooling clause provides the lessee with such power, courts have set limits to ensure the lessee does not abuse this power.[104]

Even though pooling agreements within a lease are typically interpreted broadly to achieve the results the leasing parties intended, a

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97. *See id.*

98. 1 SMITH & WEAVER, *supra* note 22, § 2.3(A)(2).

99. *Id.* (citing MCZ, Inc. v. Triolo, 708 S.W.2d 49 (Tex. App.—Houston [1st Dist.] 1986, writ ref'd n.r.e.)).

100. RICHARD W. HEMINGWAY, LAW OF OIL AND GAS 453 (3d ed. West Publishing Co. 1991).

101. 1 BRUCE M. KRAMER & PATRICK H. MARTIN, THE LAW OF POOLING AND UNITIZATION, § 8.01 (3d ed. 1989) [hereinafter THE LAW OF POOLING AND UNITIZATION].

102. *Id.*

103. *See id.* The lessee may also use a community lease to pool together multiple interests to form a unit because a community lease has the same effect as a voluntary pooling agreement. *See* 6 WILLIAMS ET AL., *supra* note 90, § 904 (citing Hardwicke & Hardwicke, *Apportionment of Royalty to Separate Tracts: The Entirety Clause and the Community Lease*, 32 TEXAS L. REV. 660, 676 (1954)) ("[A community lease] is a single lease covering two or more tracts executed by the separate owners as if they were joint owners.").

104. *See* HEMINGWAY, *supra* note 100, at 455; *see also* Elliot v. Davis, 553 S.W.2d 223 (Tex. Civ. App.—Amarillo 1977, writ ref'd n.r.e.), Pritchett v. Forest Oil Corp., 535 S.W.2d 708 (Tex. Civ. App. —El Paso 1976, writ ref'd n. r. e.), Texaco, Inc. v. Lettermann, 343 S.W.2d 726 (Tex. Civ. App. — Amarillo 1961, writ ref'd n. r. e.), Banks v. Mecom, 410 S.W.2d 300 (Tex. Civ. App.—Eastland 1966, writ ref'd n. r. e.), Tiller v. Fields, 301 S.W.2d 185 (Tex. Civ. App.—Texarkana 1957, no writ), Expando Prod. Comp. v. Marshall, 407 S.W.2d 254 (Tex. Civ. App.—Fort Worth 1966, writ ref'd n. r. e.), Imes v. Globe Oil & Ref. Co., 84 P.2d 1106 (Okla. 1938) (discussing the lessee's good faith obligation to the lessor).

104. HEMINGWAY, *supra* note 107, at 455 (citing *Elliott*, 553 S.W.2d at 226-27).

lessee cannot exercise his pooling power outside that which the agreement permits.[105] In addition, lessees must exercise their pooling power in good faith toward the lessor and royalty owners.[106] Texas common law indicates that lessees must take into account the surrounding circumstances, the reasonable development of the property, and the interests of both the lessor and lessee to make decisions in good faith.[107] Therefore, although the lessee must comply with the express terms of the pooling agreement, any action taken must be done in good faith.[108]

Texas courts directly addressed the lessee's implied good faith obligation concerning the power to pool in *Amoco Production Co. v. Underwood.*[109] In *Amoco*, the lessee pooled together eight tracts based on the pooling power within each lease.[110] Each lease contained the following pooling clause:

> Lessee, at its option, is hereby given the right and power to pool or combine the land covered by this lease, or any portion thereof, as to oil and gas, or either of them, with any other land, lease or leases when in Lessee's judgment it is necessary or advisable to do so in order to properly develop and operate said premises, such pooling to be into a well unit or units not exceeding forty (40) acres, plus an acreage tolerance of ten percent (10%) of forty (40) acres, for oil, and not exceeding six hundred and forty (640) acres, plus an acreage tolerance of ten percent (10%) of six hundred and forty (640) acres, for gas . . . .[111]

The lessors of the eight tracts contended that the lessee had "gerrymandered" the tracts to form a pooled unit for the sole purpose of advancing the lessee's own pecuniary interest, disregarding the interests of the lessors.[112] Evidence showed that the lessee formed the pooled unit approximately two days before several of the leases' primary terms ended

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105. *E.g.*, HEMINGWAY, *supra* note 107, at 455 (citing Edwin M. Jones Oil Co. v. Pend Oreille Oil & Gas Co., 794 S.W.2d 442, 442 (Tex. App.—Corpus Christi, 1990, writ denied) (holding that according to the express terms of the pooling agreement, the lease only authorized the pooling of the lessor's royalty interest and not the lessor's converted working interest.).

106. *E.g.*, *Elliot*, 553 S.W.2d at 226-27; HEMINGWAY, *supra* note 100, at 455; 1 THE LAW OF POOLING AND UNITIZATION, *supra* note 108, § 8.01. A lessee should not be able to pool two tracts of leased property for the sole purpose of maintaining two leases by drilling one well. LOWE, *supra* note 16, at 239. A lessee acts in bad faith if he pools to bring in land condemned by previous drilling and found worthless. HEMINGWAY, *supra* note 107, at 455 (citing Sw. Gas Producing Co. v. Seale, 191 So.2d 115 (Miss. 1966)).

107. HEMINGWAY, *supra* note 100, at 455 (citing *Elliott*, 553 S.W.2d at 226-27).

108. *Id.* Pooling in bad faith includes the pooling of worthless land or land condemned by prior drilling. *Id.*

109. Amoco Prod. Co. v. Underwood, 558 S.W.2d 509, 512 (Tex. Civ. App.—Eastland 1977, writ ref'd n.r.e.).

110. *Id.* at 510.

111. *Id.* at 511.

112. *Id.*

and deliberately excluded property that was productive.[113] Based on this evidence, the timing of the pooled formation, and its configuration, the court affirmed the trial court's decision and held that the lessee established the unit in bad faith in order to extend the eight leases beyond their primary terms.[114] The court then cancelled the unit and terminated some of the leases.[115]

Under certain circumstances, the lessee has an affirmative duty to pool.[116] The lessee owes a duty of fair dealings to the lessor.[117] This duty includes the duty to prevent drainage and to develop as a reasonably prudent operator would.[118] Although the pooling clause may not expressly require the lessee to exercise his pooling power, under the implied duty of fair dealing, the lessee may be required to exercise the power to pool in order to avoid liability for breaching an implied covenant of the lease.[119] Therefore, although the pooling clause grants the lessee the power to pool, this power is limited by the implied good faith obligation the lessee owes to the lessor and royalty interest owners.[120] On the other hand, however, additional duties implied in all oil and gas leases, such as the duty to prevent drainage and the duty to develop as a reasonably prudent operator, may push the lessee in the opposite direction and force him to take action by forming a pool or unit.[121]

IV. THE RISE OF THE POOLING POWER: *WAGNER & BROWN V. SHEPPARD*

A. A Case of First Impression

In *Wagner & Brown v. Sheppard*, the Texas Supreme Court addressed an issue of first impression concerning the effect of the expiration of a lease on a pooled unit when the expired lease was one of many subject to the pooling agreement.[122] In *Sheppard*, the Texas Supreme Court made three crucial findings: (1) the pooling agreement controlled the lessor's interest even after the lease authorizing the pooling terminated, (2) the lessor was liable for reasonable expenses regarding the unit incurred after the lease

113. *Id.* at 512.
114. *Id.* at 513.
115. *Id.*
116. 1 THE LAW OF POOLING AND UNITIZATION, *supra* note 101, § 8.06.
117. *Id.*
118. *Id.*
119. *Id.* (citing Salyer v. Cal. Co., 164 F. Supp. 287 (E.D. La. 1958), aff'd, 262 F.2d 589 (5th Cir. 1959) (holding that the cancellation of a lease was improper based on the lessor's claim that the lessee breached an implied covenant of the lease by failing to timely exercise the pooling power)).
120. *See* Elliot v. Davis, 553 S.W.2d 223, 226-27 (Tex. Civ. App.—Amarillo 1977, writ ref'd n.r.e.); Amoco Prod. Co. v. Underwood, 558 S.W.2d 509, 513 (Tex. Civ. App.—Eastland 1977, writ ref'd n.r.e.).
121. *See* 1 THE LAW OF POOLING AND UNITIZATION, *supra* note 101, § 8.06.
122. Wagner & Brown v. Sheppard, 282 S.W.3d 419, 421 (Tex. 2008).

terminated, and (3) the lessor may be liable for drilling costs incurred prior to the expiration of the lease.[123]

In *Sheppard*, the plaintiff, Jane Sheppard owned one-eighth of the minerals beneath a 62.72-acre tract that was part of a 112.16-acre unit; thus, her percentage of ownership in the unit equaled one-eighth of 51.3%.[124] Sheppard leased her one-eighth interest to C.W. Resources, Inc., and the owners of the remaining seven-eighths of the minerals leased their rights to Wagner & Brown, Ltd.[125] The lease between Sheppard and C.W. Resources permitted the pooling of neighboring tracts.[126] On September 1, 1996, Wagner & Brown, C.W. Resources, and other mineral lessees on neighboring tracts entered into a pooling agreement, which pooled Sheppard's tract as well as eight others to form the W.M. Landers Gas Unit.[127] The pooling agreement named C.W. Resources as the unit operator.[128] C.W. Resources drilled and produced the first gas well in October 1996 and the second gas well in September 1997; both wells were located on the tract containing Sheppard's minerals.[129] In September 2000, Wagner & Brown replaced C.W. Resources as the new operators of the W.M. Landers Gas Unit.[130]

After taking over as operator of the unit, Wagner & Brown discovered that C.W. Resources had not fulfilled Sheppard's lease requirements.[131] Sheppard's lease contained a provision stating that if the lessee did not pay Sheppard her royalties "within 120 days after first gas sales," the lease would terminate the following month.[132] C.W. Resources had failed to pay Sheppard's royalties within 120 days of the first gas sale.[133] This oversight caused Sheppard's lease to terminate on March 1, 1997, making Sheppard an unleased cotenant (or co-owner).[134] Both parties agreed that, as an unleased cotenant, Sheppard was to receive a share of the proceeds less her proportionate share of production and marketing costs.[135] But, they disagreed as to the amount of proceeds Sheppard was entitled to and the costs she was responsible for.[136]

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123. *Id.* at 424.
124. *Id.* at 422.
125. *Id.* at 421.
126. *Id.*
127. *Id.* The court used the terms pool and unit interchangeably and referred to the pooling agreement as a unit agreement. *Id.* Although the pooling agreement formed the W.M. Landers Gas Unit, it was not a unitization agreement; therefore, for simplicity purposes, this Comment will refer to the agreement as a pooling agreement to avoid confusion. *See id.*
128. *Id.*
129. *Id.*
130. *Id.*
131. *Id.*
132. *Id.*
133. *Id.*
134. *Id.* at 421-22.
135. *Id.* at 422.
136. *Id.*

Sheppard brought a declaratory judgment action against Wagner & Brown, claiming that the termination of her lease terminated the pooling agreement and she was entitled to the proceeds of one-eighth of all the production, less any production expenses after the lease expired, rather than one-eighth of only 51.3% of production.[137]

The first issue in the case was whether the termination of Sheppard's lease also terminated her participation in the unit.[138] If the termination of Sheppard's lease did terminate her participation in the pooled unit, then she was entitled to one-eighth of 100% of the production because both gas wells were located on her tract of minerals.[139] If, however, the termination of her lease did not terminate her participation in the pooled unit, then Sheppard was only entitled to one-eighth of 51.3% of the production, which was the amount of property she owned in proportion to the pooled unit.[140] The second issue the court addressed concerned how Sheppard, an unleased mineral estate owner, would share in the costs of the well, including the expenses incurred before and after the lapse of the lease.[141]

The trial court granted summary judgment in favor of Sheppard, holding that the termination of her lease also ended her participation in the pooled unit.[142] The court also held that Sheppard was only responsible for costs pertaining to her individual lease that were incurred after the termination.[143] The court of appeals affirmed the trial court's decision.[144]

B. Lease Termination Does Not Terminate Participation in Pooled Unit

The Texas Supreme Court reversed the lower courts' decisions, holding that the termination of Sheppard's lease did not terminate the unit or Sheppard's participation within the unit.[145] The court reasoned that a lease is not a prerequisite for pooling and that mineral owners can become part of a pooled unit without a lease.[146] The court considered the language used in the pooling provision in Sheppard's lease as well as the pooling agreement the lessees entered into to form the pooled unit.[147] The court first focused on the express language of the lease to determine whether the pool terminated.[148] Sheppard's 1994 lease stated:

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137. *Id.*
138. *Id.*
139. *Id.*
140. *Id.* Sheppard owned one-eighth of the minerals beneath a 62.72-acre tract that was part of a 112.16-acre unit; thus, her percentage of ownership in the unit equaled one-eighth of 51.3%. *Id.*
141. *Id.*
142. *Id.*
143. *Id.*
144. *Id.*
145. *Id.* at 423.
146. *Id.* at 422 (citing Westbrook v. Atl. Richfield Co., 502 S.W.2d 551, 554 (Tex. 1973)).
147. *Id.*
148. *See id.*

> 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 interest. . . . Production, 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, except that the 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 . . . . In the absence of production in paying quantities from a unit, or upon permanent cessation thereof, Lessee *may terminate* the unit by filing of record a written declaration describing the unit and stating the date of termination. Pooling hereunder shall not constitute a cross-conveyance of interests.[149]

This provision gave the lessee the express power to pool, which authorized C.W. Resources, the lessee, to enter into a pooling agreement with additional adjacent mineral owners or lessees.[150] The pooling agreement the lessees signed stated that the agreement "hereby pool[s] and combine[s] said leases and the lands . . . into a single pooled unit or unitized area for the development of and production of gas and associated hydrocarbons."[151] The court determined that the lease's pooling clause and the pooling agreement pooled the lands, rather than the leaseholds.[152] Therefore, because both pooling provisions pooled the land rather than the lease itself, the termination of Sheppard's lease did not terminate her participation in the pooled unit because her land was still bound even though her lease no longer existed.[153] The termination of Sheppard's lease only affected the present ownership of the minerals; once the lease terminated, the ownership of the minerals reverted to Sheppard.[154]

The Texas Supreme Court disagreed with the appellate court's decision to terminate Sheppard's participation in the pool, as well as its application of two Texas cases—*Ladd Petroleum Corp. v. Eagle Oil & Gas Co.* and *Texaco, Inc. v. Lettermann*—as a basis for its holding.[155] The appellate court first distinguished *Ladd Petroleum Corp. v. Eagle Oil & Gas Co.*, a case out of the Second Court of Appeals, from *Sheppard*.[156] In *Ladd*, the court held that the termination of a lease did not also terminate

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149. *Id.* (emphasis added).

150. *Id.* The pooling clause within the lease was between Sheppard, the lessor, and C.W. Resources, the lessee; the lease differs from the pooling agreement, which is an agreement between the lessees to pool the leases and lands together to form a unit. *See id.*

151. *Id.*

152. *Id.* at 423.

153. *See id.*

154. *Id.*

155. *Id.* (citing Wagner & Brown, Ltd. v. Sheppard, 198 S.W.3d 369, 375 (Tex. App.—Texarkana 2006).

156. *Id.* (citing Ladd Petroleum Corp. v. Eagle Oil & Gas Co., 695 S.W.2d 99, 106 (Tex. App.—Fort Worth 1985, writ re'd n.r.e.).

the unit because the lease expressly permitted the pooling of "other lands" and leases; thus, the pooling agreement was not dependant solely on the leases.[157] The appellate court determined that the rule in *Ladd* was not applicable in Sheppard's case because the issue in *Ladd* concerned the termination of an entire pool, while *Sheppard* only involved the termination of a lessor's participation in the pool.[158] In *Ladd*, the lessor owned the majority mineral interest in a tract that the lessee pooled with adjacent tracts to form a pooled unit.[159] Therefore, if the termination of the lessor's lease also terminated his participation in the unit, then the unit would cease to exist.[160] The appellate court concluded that *Ladd* was inapplicable because Sheppard only owned one-eighth interest in the minerals beneath the pooled tract; thus, the termination of her lease would not terminate the entire unit because the remaining lessors with a seven-eighths mineral interest in the same tract were still part of the unit agreement.[161] The court of appeals also relied on *Texaco, Inc. v. Lettermann* by drawing similarities between the two cases.[162] In *Lettermann*, the court held that the termination of a lease also terminated the pooling agreement, and when three leases in a pool terminated, so did the entire pool.[163]

The Texas Supreme Court disagreed with the appellate court's application of both *Ladd* and *Lettermann*.[164] With respect to the *Ladd* case, the court concluded that the pooling agreements in both *Sheppard* and *Ladd* were similar because each permitted pooling with other lands and leases.[165] The court stated that because the lands and leases were pooled in *Ladd*, the tracts remained part of the unit even when the lease did not.[166] Second, the Texas Supreme Court stated that the rules of contract interpretation should not change based on the size of the mineral interest at stake.[167] The court explained that the termination of a mineral interest in a pool should not depend on the lessor's percentage of interest in the tract's minerals.[168] Just as in *Ladd*, if Sheppard's original mineral interest had been eight-eighths rather than one-eighth, allowing her to terminate participation in the unit would have terminated the unit all together, cutting off all production for

157. *Id.* (citing *Ladd Petroleum Corp.*, 695 S.W.2d at 106).
158. *Id.* (citing *Sheppard*, 198 S.W.3d at 375).
159. *Ladd Petroleum Corp.*, 695 S.W.2d at 101.
160. *Id.* at 106.
161. *Sheppard*, 282 S.W.3d at 423.
162. *Id.*
163. Texaco, Inc. v. Lettermann, 343 S.W.2d 726, 730 (Tex. App.—Fort Worth 1985, writ ref'd n.r.e.).
164. *Sheppard*, 282 S.W.3d at 423-24.
165. *Id.* at 423 (citing *Ladd Petroleum Corp.*, 695 S.W.2d at 106).
166. *Id.* (citing *Ladd Petroleum Corp.*, 695 S.W.2d at 106).
167. *Id.*
168. *Id.*

the other members in the pool.[169] Therefore, the court concluded that the appellate court erred by not applying the rule in *Ladd* to *Sheppard*.[170]

The Texas Supreme Court also disapproved of the appellate court's application of *Lettermann* because the lease terms at issue in that case expressly provided for the pooling of "the gas leasehold estate" instead of the pooling of lands as in the Sheppard lease.[171] The court stated that a pooling of lands should not terminate the pool on the same grounds as a pool formed by leases.[172] The Texas Supreme Court held that the pooling agreement, rather than Sheppard's lease pooling clause, bound the operator's interest as well as the mineral owner's royalty interest and possibility of reverter.[173] The pooling agreement affected Sheppard's possibility of reverter because the lease permitted the pooling of "all or any part of the leased premises or interest therein," and Sheppard's possibility of reverter is an interest in the leased premises.[174]

The *Sheppard* court based its decision on principles of contract law, stating that owners and operators have the power to create a pool and with that power comes the ability to determine when the pool terminates.[175] The court further explained that interest owners and operators must bargain for the terms of the pooling agreement and specify within the agreement under what terms they want the pool to terminate.[176] Therefore, because Sheppard's pooling agreement pooled the tract (rather than just the lease), the termination of the lease did not affect Sheppard's participation in the pool.[177] The court concluded that although Sheppard was a cotenant, she was still bound by the pooling agreement and entitled to one-eighth of 51.3% of production proceeds—the proportion her tract bears in relation to the total acreage in the unit.[178]

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169. *Id.*

170. *Id.*

171. *Id.* (quoting Texaco, Inc. v. Lettermann, 343 S.W.2d 726, 727 (Tex. Civ. App.—Amarillo 1961, writ ref'd n.r.e.)).

172. *Id.*

173. *Id.* at 423-24 (citing Southland Royalty Co. v. Humble Oil & Ref. Co., 249 S.W.2d 914, 916 (Tex. 1952)); Brown v. Smith, 174 S.W.2d 43, 46 (Tex. 1943)).

174. *Id.* at 423. "When a unit is properly pooled, the owners of the minerals or reversionary interests in a separate tract within the unit surrender their right to receive their interest in all production from wells located on their own tract . . . ." *Id.* at 423 (quoting Mengden v. Peninsula Prod. Co., 544 S.W.2d 643, 648 (Tex. 1976); citing Southland Royalty Co. v. Humble Oil & Ref. Co., 249 S.W.2d 914, 916 (Tex. 1952)).

175. *Id.* at 424 (citing Tittizer v. Union Gas Corp., 171 S.W.3d 857, 860 (Tex. 2005)).

176. *Id.* (citing *Southland Royalty Co.*, 249 S.W.2d at 916).

177. *Id.* Sheppard agreed to the pooling agreement and its terms; based on principles of contract law, Sheppard could have bargained for the pooling of the leasehold interest instead of the land, but she failed to do so. *Id.* at 423-24.

178. *Id.* at 424. The court left open the possibility for pooling agreements to end upon cancelation of a lease if such termination is explicitly included in the pooling agreement. *Id.*

C. Lessor Required to Pay Reasonable Unit Expenses After Lease Termination

After determining that the termination of Sheppard's lease did not terminate her participation in the pooled unit, the Texas Supreme Court held that Sheppard was liable to pay her share of reasonable expenses the pooled unit incurred after the termination of her lease.[179] Sheppard argued, and the appellate court agreed, that she was only responsible for expenses related to her individual tract because she no longer possessed an interest in the unit, but the Texas Supreme Court disagreed and remanded the case to determine whether the expenses Wagner & Brown incurred were reasonable.[180]

Based on the court's holding that Sheppard remained part of the pooled unit, the court stated that Sheppard was responsible to pay her proportionate share of production costs for the entire unit and not just her specific tract.[181] Although Sheppard argued that she should only have to pay for the expenses related to her tract because the two wells were located on her tract, the court was not convinced by her reasoning because Sheppard's tract alone would not have satisfied spacing requirements had the tracts not been pooled.[182] In addition, the court also stated that Sheppard had an interest in the expenses related to other tracts within the unit because future wells may be located off her tract.[183]

The court, however, remanded the issue of unit expenses to the trial court.[184] The court stated that no evidence supported the trial court's failure to award Wagner & Brown compensation for expenses.[185] The case was remanded on this issue to reassess the amount of damages Wagner & Brown asked for and determine if such an amount was reasonable and necessary based on the evidence.[186]

D. Lessor May Be Liable for Drilling Costs Prior to the Lease Expiration

In addition to unit expenses, the court also discussed the issue of Sheppard paying drilling costs prior to the expiration of her lease.[187]

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179. *Id.* at 424-25.

180. *Id.* at 425. The court of appeals held that Sheppard was not liable for unit expenses because she no longer possessed an interest in the pool. *Id.* at 424 (citing Wagner & Brown, Ltd. v. Sheppard, 198 S.W.3d at 369, 375 (Tex. App.—Texarkana 2006)).

181. *Id.* at 425.

182. *Id.*

183. *Id.* As previously stated, a non-leasing cotenant cannot recover from production not on his property. *See* discussion *supra* Part II.B.

184. *Id.* at 425.

185. *See id.*

186. *See id.*

187. *See id.*

Sheppard agreed that she must pay production and marketing expenses after her lease expired, but claimed that she was not liable for drilling costs incurred prior to the expiration of her lease.[188] The court held that even though C.W. Resources breached Sheppard's lease, the current operator, Wagner & Brown, may still be entitled to compensation for the improvements made on the property, such as drilling costs, before the lease expired.[189]

The court relied on principles in equity, stating that as a general rule "a person who in good faith makes improvements upon property owned by another is entitled to compensation."[190] The gas wells that the operators drilled on Sheppard's property were improvements to the property because they increased her property's value.[191] The court stated that the general rule was applicable even if no lease existed; however, in this case, a lease did exist.[192] Therefore, the issue was whether the lessee could receive relief based on principles of equity when the party relying on a claim in equity mistakenly allowed the valid lease to expire.[193]

The court held that the trial court abused its discretion by granting summary judgment in favor of Sheppard and failing to address the equitable issues in the case.[194] As a matter of equity, the court found it unfair that Sheppard received benefits from the production of the two gas wells on her

188. *See id.* (citing White v. Smyth, 214 S.W.2d 967, 979 (Tex. 1948) ("upholding operating cotenant right to assess 'payrolls, salaries, depreciation, repairs, insurance, commissions,' as well as reasonable compensation for the operator's personal services").

189. *Id.* at 427. The court refused to interpret Texas law as establishing that drilling costs were either "*always* or *never* recoverable when a lease expire[d]." *Id.* at 428 (stating that it was rare to find a case where the operator allowed the lease to expire before collecting drilling costs).

190. *Id.* at 425 (citing Sharp v. Stacy, 535 S.W.2d 345, 351 (Tex. 1976)); *see also* Resolution Trust Corp. v. Kemp, 951 F.2d 657, 665 (5th Cir. 1992) ("Under Texas law, a purchaser who makes improvements upon property in the good faith belief that it has good title to the property is entitled to compensation for the improvements."), RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 10 (Tentative Draft No. 1, 2001) ("A person who improves the real or personal property of another, acting by mistake, has a claim in restitution as necessary to prevent unjust enrichment.").

191. *See Sheppard*, 282 S.W.3d at 426.

192. *Id.* (stating that this concept is similar to the rule that a cotenant who drills without another cotenant's consent is entitled to reimbursement) (citing Byrom v. Pendley, 717 S.W.2d 602, 605 (Tex. 1986)); *see also* Cox. v. Davison, 397 S.W.2d 200, 201 (Tex. 1965) ("holding interest not recoverable even if operator borrowed money to drill.")). "The Texas rule is that a cotenant who produces minerals from common property without having secured the consent of his cotenants is accountable to them on the basis of the value of the minerals taken less the necessary and reasonable cost of producing and marketing the same." *Cox*, 397 S.W.3d at 201.

193. *See Sheppard*, 282 S.W.3d at 427. The court stated that although equity does not protect those who sleep on their rights, it appeared incorrect to offer less equity to one who obtained a valid lease and then lost it by mistake than one who by mistake never possessed a valid lease to begin with. *Id. (*citing Atl. Ref. Co. v. Noel, 443 S.W.2d 35, 41 (Tex. 1968) (Walker, J., dissenting); Hanks v. Rosser, 378 S.W.2d 31, 40 (Tex. 1964)).

194. *See id.* at 429-30. Although the court refused to establish that drilling costs were always recoverable and remanded the case, it emphasized that such equitable claims are dependent upon the particular facts of the case. *Id.* at 428, 430.

tract at the defendant's expense.[195] Furthermore, after discovering the expiration of Sheppard's lease, Wagner & Brown offered Sheppard the option of continued royalties, free of drilling costs, in exchange for the reinstatement of her lease; however, Sheppard refused this option.[196] The court stated that it would be inequitable to allow Sheppard to act as a cotenant and receive full benefits from production but escape the burdens that come with the role of a cotenant (such as paying for drilling costs).[197]

The court also relied on the concept that "equity abhors forfeiture."[198] The court concluded that, although C.W. Resources forfeited the lease when it failed to pay the first royalty, the lease said nothing as to whether the operator also forfeited their right to the drilling costs.[199] Therefore, although the defendants lost their claim to Sheppard's minerals, that did not require them to lose their equitable claim for the improvements made to Sheppard's tract.[200] The court ultimately reversed the trial court's decision and remanded the case on this issue for further proceedings.[201]

The court's decision in *Sheppard*, overall, favors the lessee.[202] After years of limiting the lessee's power in oil and gas leases, the Texas Supreme Court granted the lessee additional power through the pooling clause.[203] *Sheppard's* expansion of the pooling power may affect past, present, and future leases in the oil and gas industry.[204] In order to understand the far-reaching implications of *Sheppard*, an analysis of the court's holding and reasoning is necessary.[205]

V. THE BIG PICTURE: POST *SHEPPARD*

A. Questions Raised by Sheppard

In *Sheppard*, the Texas Supreme Court broadened the lessee's power to pool.[206] As a result, pooling provisions and agreements may now authorize a lessee to pool not only the lessor's royalty interest, but also the

195. *Id.* at 429.
196. *Id.* at 421.
197. *Id.*
198. *Id.*
199. *Id.*
200. *See id.*
201. *See id.* at 430. The court recognized that other facts not appearing in the record could justify denying Wagner & Brown equitable claim to recover drilling costs prior to the termination of Sheppard's lease. *See id.* at 427.
202. *See id.* at 430.
203. *See id.* at 424.
204. *See* discussion *infra* Part VI.A.
205. *See* discussion *infra* Part V.A-E.
206. *See id.* at 424.

lessor's possibility of reverter.[207] Additionally, the pooling clause may continue to remain effective even after the lessor's possibility of reverter becomes a fee simple absolute.[208] This decision was largely unexpected by the oil and gas industry because, prior to *Sheppard*, courts only authorized pooling of the lessee's present interest in the minerals and the lessor's royalty interest.[209]

Sheppard raises numerous questions concerning pooling and the extent of the lessee's power to use the terms of an oil and gas lease to bind owners to pooling agreements and operating agreements.[210] The lessee's increased power to bind former lessors to pooled units may also impact the standard of care lessees owe lessors.[211] By increasing the lessee's pooling power, *Sheppard* may have inadvertently lowered the good faith standard lessees are required to abide by.[212] Thus, lessors may now have less control over the power bestowed upon lessees and operators.[213] The implications of *Sheppard* are especially important because pooling clauses are so ubiquitous in oil and gas leases.[214] Without pooling clauses and pooling agreements, operators would not be able to satisfy well spacing requirements to drill a well, and many mineral owners would not be able to profit from their mineral ownership.[215]

B. What Power Do Lessees Now Possess Under the Pooling Clause?

The court's decision in *Sheppard* appears to have expanded the pooling power by allowing lessees to pool not only the present leasehold interests, but also the future interests of the minerals.[216] As previously stated, when a lessee and lessor execute a lease, the lessee acquires an interest in the minerals so long as the lease continues to exist; this present interest is known as a fee simple determinable.[217] While the lease conveys a fee simple determinable interest to the lessee, it also conveys a present

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207. *See id.*; Interview with Bruce Kramer, Scholar and Retired Oil and Gas Professor of Law, Texas Tech School of Law (Aug. 27, 2009) [hereinafter Interview with Bruce Kramer].

208. *See Sheppard*, 282 S.W.3d at 424; Interview with Bruce Kramer, *supra* note 207.

209. Interview with Bruce Kramer, *supra* note 207.

210. *See Sheppard*, 282 S.W.3d at 424.

211. *See* discussion *infra* Part V.D.

212. *See* Bruce M. Kramer, *The Nuts and Bolts of Pooling: A Primer for the Uninitiated in* STATE BAR OF TEXAS PDP, 24TH ANNUAL ADVANCED OIL, GAS & ENERGY RESOURCES LAW COURSE Ch. 16, 5 (2006) [hereinafter *The Nuts and Bolts of Pooling: A Primer For the Uninitiated*].

213. *See* discussion *infra* Part V.B-C.

214. *See* LOWE, *supra* note 16, at 234.

215. *See Sheppard*, 282 S.W.3d at 424.

216. *See id.* The term leasehold interest refers to the present interests an oil and gas lease creates. *See* 1 SMITH & WEAVER, *supra* note 15, § 2.1(A).

217. 1 SMITH & WEAVER, *supra* note 15, § 2.2 (citing Stephens Cnty. v. Mid-Kansas Oil & Gas Co., 113 Tex. 160, 254 S.W. 290 (1923)). *See also supra* Part II.A (explaining the general concept of interests the lease creates).

interest to the lessor—the lessor's royalty interest.[218] In addition to present interests, the lease also creates future interests, which are interests that vest once the present interest has expired.[219] The lessor possesses a reversionary future interest in the mineral estate called a possibility of reverter.[220] The lessor's possibility of reverter vests automatically once the lessee's fee simple determinable interest in the minerals ends.[221] Thus, once the lease terminates or expires, the lessee's present interest in the minerals ends and the ownership of the minerals automatically reverts back to the lessor.[222] Once the lessor repossesses ownership of the minerals, the lessor's interest in the minerals becomes a fee simple absolute.[223]

Prior to *Sheppard*, it was commonly believed that the lessee's pooling power only authorized the pooling of the leasehold interests, i.e. the present interests created by the lease.[224] This meant that the lessee's pooling power could not extend beyond the life of the present interests created by the lease, which include both the lessee's fee simple determinable interest and the lessor's royalty interest.[225] Therefore, when a lease terminated, so did the lessee's pooling power because the expiration or termination of a lease also terminated the present interests created under that lease—the lessee no longer possessed an interest in the minerals and the lessor was no longer entitled to royalties from the lessee because full ownership of the minerals reverted back to the lessor.[226]

In *Sheppard*, however, the court held that the lessee's pooling power can extend beyond the life of the lease when the pooling agreement expressly provides for the pooling of the lands rather than just the leases.[227] The court's decision is shocking because it allows lessees to pool not only the present leasehold interest in the minerals, but also the lessor's future reversionary interest in the minerals.[228] The fact that the lessee now has the power to pool the lessor's future interest means that even after the lease terminates, and the lessor automatically assumes ownership of the minerals based on her possibility of reverter, the conditions of the pooled unit still bind the lessor.[229] Moreover, if the former lessee is also the operator of the

218. *See* 58 C.J.S. Mines and Minerals § 288 (2009) (citing Jupiter Oil Co. v. Snow, 819 S.W.2d 466 (Tex. 1999).

219. *Id.*

220. *Id.*

221. 53A Am. Jur. 2d Gas and Oil § 198 (2006) (citing *Jupiter Oil*, 819 S.W.2d at 466).

222. *Id.*

223. *Id.* A fee simple, also known as a fee simple absolute, is "[a]n interest in land that, being the broadest property interest allowed by law, endures until the current holder dies without heirs." BLACK'S LAW DICTIONARY 648 (8th ed. 2004).

224. *See The Nuts and Bolts of Pooling: A Primer for the Uninitiated*, *supra* note 212, at 3-4.

225. *See id.*

226. *See id.*

227. *See Sheppard*, 282 S.W.3d at 424.

228. *See id.*; Interview with Bruce Kramer, *supra* note 207.

229. *See Sheppard*, 282 S.W.3d at 424; Interview with Bruce Kramer, *supra* note 207.

unit, she will be able to maintain control over the former lessor even though the underlying lease has ended.[230]

Generally, once a lease expires, lessors have been able to regain full possession and control of the minerals and to renegotiate the terms of a new lease with another leasing oil and gas company. The decision in *Sheppard* impacts lessors because even after their leases have expired, they may be unable to enter into new leases.[231] Lessors will continue to be bound by the pooling clause in their lease, thereby decreasing the marketability of their minerals and making it more difficult to enter into new oil and gas leases.[232] What's more, after the lease has expired, the former lessor becomes an expense bearing mineral interest owner because the lessor must pay the unit expense herself.[233] As an expense bearing mineral interest owner, the former lessor not only continues to be bound by the pooled unit, but she is also required to pay unit expenses without reaping the benefits under the lease (benefits such as royalty payments and bonuses from a lease agreement).[234] Therefore, based on the survival of the pooling clause and pooling agreement beyond the termination of a lease, former lessors may be left with a less marketable tract of minerals as well as the expenses incurred from the pooled unit off of their own tracts.

C. Are Lessors Bound by Operating Agreements After the Termination of the Lease?

The increased pooling power *Sheppard* confers on lessees may be as far-reaching as to bind lessors to operating agreements beyond the life of the lease.[235] Operating agreements generally go hand in hand with pooling and unit agreements.[236] As discussed above, the operating agreement is a contract that governs production, management, and operations.[237] The operators of unitized and pooled leases typically require operating agreements to maintain control and order on the production site.[238] The operating agreement holds all the leases within the pool or unit agreement liable for the expenses relating to drilling operations in the unit or pool.[239]

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230. *See Sheppard*, 282 S.W.3d at 424; Interview with Bruce Kramer, *supra* note 207.

231. *See Sheppard*, 282 S.W.3d at 424.

232. *See id.*

233. *See* discussion *supra* Part III.B. If a lease exists, the lessee would pay the unit expenses, but in this case, the former lessor must pay the expenses because he is no longer a royalty owner under the lease. *See* discussion *supra* Part III.B.

234. *See* discussion *supra* Part III.B.

235. *See Sheppard*, 282 S.W.3d at 424.

236. *See* discussion *supra* Part II.D.

237. *See* discussion *supra* Part II.D.

238. *See* discussion *supra* Part II.D.

239. *See* discussion *supra* Part II.D.

The court in *Sheppard* determined that Sheppard, an unleased mineral interest owner, was liable for expenses incurred off of her tract, but within the unit, because she was still bound by the pooling agreement.[240] Although Sheppard argued that she was not bound by the operating agreement because her lease had terminated, the court disagreed.[241] The court has, therefore, not only expanded the lessee's pooling power, but has also allowed the lessee's power from the pooling clause to bind the original lessor to an operating agreement beyond the termination of the lease.[242] Even more unsettling, is the fact that Sheppard was not even a party to the operating agreement that was entered into by the lessee.[243] The Texas Supreme Court's decision ignores the reality of oil and gas transactions and the likelihood that Sheppard would not have signed the lease if she could have foreseen that the pooling clause would bind her to the operating agreement after expiration of her lease.[244] This expansion of power appears inconsistent with the duty of care lessees owe lessors.[245]

D. *Did* Sheppard *Change the Standard of Care Lessees Owe Lessors?*

As a general rule, lessees owe lessors and royalty interest owners a duty to act in good faith.[246] Legal experts in the oil and gas industry question whether the holding in *Sheppard* affects or violates the duty lessees owe to lessors.[247] The lessee's ability to exercise its pooling power beyond the termination of the lease to bind the lessor to the pooling agreement and operating agreement probably violates the lessee's implied duty to act in good faith.[248] Because the standard of care lessees owe lessors is subjective, the court's decision in *Sheppard* is likely to lower the standard.[249] Lessees may now rely on *Sheppard* to justify binding the lessor to agreements the lessee has entered into on the lessor's behalf, based on the lessee's pooling power, even after the lease has terminated.[250]

The lessee in *Sheppard* probably did not intend to, nor expect to, bind Sheppard's tract beyond the existence of the lease.[251] Prior to *Sheppard*, a court had never held that the lessee's pooling power, granted in the pooling clause of the lease, outlived the life of the lease; thus, it appears that the

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240. *See Sheppard*, 282 S.W.3d at 424-25.
241. *Id.*
242. *See id.*
243. *See id.* at 422.
244. *See id.* at 424-25.
245. *See* discussion *supra* Part III.C.
246. *See* HEMINGWAY, *supra* note 100, at 455.
247. Interview with Bruce Kramer, *supra* note 207.
248. *See Sheppard*, 282 S.W.3d at 424.
249. *See id.*
250. *See id.*
251. *See id.*

lessees may have acted in bad faith by trying to bind Sheppard to the pooled unit beyond the terms they negotiated in the lease.[252] Leases created prior to *Sheppard* may include similar language, permitting the pooling of lands, without the intention to bind the lease beyond the existence of the lease.[253] Lessors will be unable to rely on their subjective intent when drafting and agreeing to the terms of the lease because the court in *Sheppard* did not take the parties intent into consideration and focused primarily on the express language used.[254]

In addition to permitting the lessee to bind the lessor to the pooled unit, the court also stated that the lessee—whose actions caused the lease to expire—may recover drilling costs from the lessor before the lease terminated.[255] Prior to *Sheppard*, a lessee was better off if he mistakenly drilled a well on a random tract that he did not have a lease on, than if he had drilled on a leased tract but accidently allowed the lease to expire.[256] This seemingly backwards concept is rooted in the fact that a lessee who trespasses in good faith, meaning he reasonably and honestly believed he had superiority of title in the minerals, is entitled to recover drilling and operating costs from the mineral owner; whereas, a lessee who drills upon a tract on which he had a lease but caused the lease to terminate is a bad faith trespasser.[257] A bad faith trespasser is liable to the lessor for the value of the oil and gas produced and cannot deduct drilling costs.[258]

In *Sheppard*, Ms. Sheppard claimed that the operators, C.W. Resources and Wagner & Brown, were bad faith trespassers because they were on her property while her lease had technically terminated.[259] Thus, Ms. Sheppard argued that she was entitled to the value of the oil and gas produced on her property and was not liable for drilling and operating costs incurred before the termination of her lease.[260] The Texas Supreme Court disagreed with Sheppard based on principles of equity and relied on the common law rule that a person is entitled to compensation when he in good faith makes improvements upon another's property; the court concluded that this rule should apply to a lessee who obtains an oil and gas lease, but mistakenly allows the lease to expire.[261] The court stated that "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

252. *See id.*
253. *See id.* at 423-24.
254. *See id.*
255. *See id.* at 424-25.
256. *See* HEMINGWAY, *supra* note 100, at 196-207.
257. *See id.* at 196.
258. *See id.*
259. *See Sheppard*, 282 S.W.3d at 425.
260. *Id.*
261. *Id.* at 425-27.

place."[262] The court held that although the lessee breached the lease, the default should not be to automatically bar the lessee from reimbursement for the improvements made on the property.[263]

The court's holding appears to reduce the standard of care lessees owe lessors.[264] Lessees may now try to get away with drilling on a lessor's tracts, after breaching the lease or drilling additional wells without renewing the lease, and still be entitled to recover drilling and operating costs from the lessor.[265] Before *Sheppard*, to receive the value of production, the lessor just had to show that the lessee breached the lease, drilled on the lessor's property, and was therefore a bad faith trespasser.[266] The court's decision in *Sheppard*, however, places the ball in the lessee's court by providing the lessee the opportunity to present the court with a set of facts favorable to the lessee's position, facts that require the application of equity.[267] Based on the court's reasoning in the case, this threshold does not appear high; the lessee may just have to show that he acted with competence and treated the lessor fairly.[268] Although this decision is highly favorable to lessees, it is probably unlikely that lessees will be able to get away with blatant acts of bad faith because courts will most likely apply the rule on a case-by-case basis.[269]

Overall, it appears that *Sheppard* lowers the standard of care lessees owe lessors when operating under an oil and gas lease.[270] This outcome is not surprising because, as previously stated, the court's decisions in the case favor the lessee and increase the lessee's overall power.[271] Therefore, similar to a mathematic equation, as the lessee's power increases, the subjective standard of care the lessee owes the lessor is likely to decrease.

E. Did the Texas Supreme Court Get it Right?

As previously stated, the court made two major holdings in Sheppard: (1) the termination of Sheppard's lease did not terminate her participation in the pooled unit, and (2) Sheppard must bear the costs of production (drilling and operating costs) incurred before her lease terminated, in addition to the costs incurred by the unit (but not her specific tract) after her lease

262. *Id.* at 427.
263. *Id.* at 425.
264. *See id.* at 430.
265. *See* Charlie Sartain & Josh Weaver, *Wagner & Brown v. Sheppard—The Rest of the Story: Who Pays for the Well After the Lease Terminates*, LOOPER REED & MCGRAW, NEWS & RECOURSES (Dec. 11 2009), http://www.lrmlaw.com/news_resources_details.php?id=176.
266. *See id.*
267. *See id.*
268. *See Sheppard*, 282 S.W.3d at 425-30; Sartain & Weaver, *supra* note 265.
269. *See* Sartain & Weaver, *supra* note 265.
270. *See Sheppard*, 282 S.W.3d at 430.
271. *See id.* at 425-30.

terminated.[272] Although it is debatable whether the court got it right, it appears the court made the correct decision.

The court's conclusion that the termination of a lease does not necessarily terminate the lessor's participation in a pooled unit is probably correct.[273] Prior to the case, however, pooling and unitization experts had argued that, "[f]or 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."[274] This statement reflects the general belief that a pooling clause in a lease regarding the lessee's power to pool terminates through lease termination.[275] In addition, since the Texas Supreme Court's decision in *Sheppard*, multiple parties have filed amicus briefs opposing the court's decision.[276] Those opposing the court's decision argue that once a lease terminates, the pooled unit should not continue to bind any present or future interests created in the lease.[277]

Although the court's decision in *Sheppard* contradicts the industry's general perception of the pooling clause, it provides a consistent, applicable rule for future leases.[278] For example, consider if the facts of the case were different and the location of the two producing wells were not located on Sheppard's tract. If the court had agreed with Sheppard and held that her participation in the unit also terminated with the termination of her lease, then Sheppard would not have been entitled to proceeds from wells drilled on tracts other than her own.[279] Therefore, whether it would be favorable to Sheppard to remain part of the pool depends on the location of the wells.[280] Under the actual facts of the case, Sheppard sought to end her participation in the pooled unit because the wells were located on her tract, and without the pool, she had a larger interest in production.[281] But, under a different set of facts, Sheppard may have argued that her interests were in the pooled unit to keep an interest in the wells.[282] The inconsistency between these two fact patterns based on an opposite ruling of the court would cause a problem for mineral owners negotiating a lease because it would be impossible to predict the location of the wells.[283] Similarly, those

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272. *See id.*

273. *See id.* at 424-25.

274. 1 THE LAW OF POOLING AND UNITIZATION, *supra* note 101, at § 15.04.

275. *See id.* § 8.01.

276. John McFarland, *What Happens to a Pooled Lease When the Lease Terminates?*, OIL AND GAS LAWYER BLOG (Mar. 13, 2009), http://www.oilandgaslawyerblog.com/2009/03/what-happens-to-a-pooled-lease.html.

277. *Id.*

278. *See Sheppard*, 282 S.W.3d at 430.

279. *See* discussion *supra* Part III.B.

280. *See* discussion *supra* Part III.B.

281. McFarland, *supra* note 276.

282. Wagner & Brown v. Sheppard, 282 S.W.3d 419, 422 (Tex. 2008).

283. McFarland, *supra* note 276.

advocating on behalf of the oil and gas companies, while under the actual facts of the case must agree with Wagner & Brown's arguments, might switch sides under a different set of circumstances.[284]

In regard to the court's holding that Sheppard was liable for drilling costs incurred before her lease terminated and costs incurred by the unit (but not her lease) after her lease terminated, the court most likely got it right.[285] The court's decision in *Sheppard* is consistent with the general rule that when a lessee drills a well on a tract co-owned by an unleased mineral interest owner, the lessee must pay the unleased cotenant her share of production less her proportionate share of drilling and operating costs.[286] Under the general rule, the unleased cotenant cannot recover from production until production proceeds outweigh the cost of drilling.[287] Sheppard, however, argued that she should be paid the proceeds of her share of production without the reduction of drilling costs because when the lessee drilled the wells, her lease had not terminated; for that reason, she was entitled to payment as a royalty owner up until the time her lease terminated.[288] If the court had agreed with Sheppard, it would have been inconsistent with the general rule of payment to unleasing cotenants and Sheppard would have received more money than she was fairly entitled to as an unleased cotenant.[289]

Although the court probably made the best decision, its rationale is slightly conflicting.[290] First, the court relied on principles of equity in order to reach the conclusion that Sheppard may be required to pay drilling costs before her lease terminated, but did not mention principles of equity or fairness when discussing the survival of the pooling clause beyond the lease.[291] This is interesting because the court could have avoided opening Pandora's box of past pooling agreements and future ramifications of the case by terminating the lessee's pooling power as a matter of equity. Secondly, the court first determined that Sheppard was bound by the pool even after her lease terminated because the lease existed when the pool was formed, which granted the lessee the power to pool.[292] The court, however, later stated that Sheppard was required to pay drilling costs as if the lease was not in existence at the time the well was drilled.[293] So, in one instance

284. *Id.*
285. *See Sheppard*, 282 S.W.3d at 425-30.
286. *See* discussion *supra* Part III.B.
287. McFarland, *supra* note 276.
288. *Sheppard*, 282 S.W.3d at 425.
289. *See* McFarland, *supra* note 276.
290. *See Sheppard*, 282 S.W.3d at 425-30.
291. *Id.* at 425.
292. *See id.* at 424.
293. *Id.* at 427.

the court relied on the existence of the lease, whereas it later acted as though the lease never existed.[294]

Right or wrong, there is no easy answer, and based on the court's unanimous decision, it is unlikely that it will be overturned.[295] While allowing Sheppard's participation in the pool to terminate based on principles of equity would cause less controversy, the court's decision provides a consistent applicable rule, and lessors can probably easily limit the lessee's pooling power through the terms of the lease.[296] Therefore, those part of the oil and gas industry should now consider the future implications of the case and the possible solutions to deal with the problems seen in *Sheppard*.

VI. FUTURE IMPLICATIONS AND SOLUTIONS

The decision in *Sheppard* significantly impacts practicing oil and gas attorneys for two reasons. First, pools that were once considered terminated may still exist, which may affect the unleasing mineral interest owner's production proceeds and expense rates. And second, the interpretation of the pooling power and pooling clause has changed, impacting past, present, and future leases.

A. Pooling Agreements May Come Back to Life

Pooling and unitization agreements that were once thought "dead" based on the termination of a lease may still be alive.[297] The pooling or unitization agreement may outlive the lease in the sense that it binds the lessor's interest beyond her interest described in the lease.[298] Once the lease terminates, the lessor's royalty interest reverts back to an interest in fee simple; that is, the royalty interest owner reverts back to being a mineral interest owner upon the expiration of the lease term.[299] Therefore, the agreement binds not only the lessor's royalty interest, but also the reversionary interest of the lessor.[300]

If pooled units are still alive, then mineral owners, whose participation in a pool or unit ended because their leases terminated, are now non-leasing

294. *See id.* at 424-27.

295. *Id.* at 419.

296. *See id.* at 430.

297. Matthew McGowen & Martin Gibson, *The Texas Supreme Court's Decision in* Wagner & Brown, Ltd. et al v. Sheppard, at 2 (2009), http://www.pattonboggs.com/files/News/d9ad8643-3e62-4701-a4e6-0100126fa968/Presentation/NewsAttachment/d522e8e9-8552-46ef-9b14-02a9d5a3c887/Oil%20and%20Gas%20Alert_Gibson%20McGowenclean%20_2_.pdf.

298. *Id.*

299. 38A AM. JUR. 2d *Gas and Oil* § 72 (2006) (citing Jupiter Oil Co. v. Snow, 819 S.W.2d 466 (Tex. 1991)).

300. *See* Matthew McGowen & Martin Gibson, *supra* note 297, at 2.

cotenants, which means that many may seek legal advice to determine whether their share of production will decline. Currently, these non-leasing cotenants receive a percentage of all production based on their fractional mineral interest in one tract; however, if their participation in the unit never expires, then their share of production should decrease to the proportion their tract bears to the unit's total acreage.[301] Oil and gas companies may also seek legal advice as to the proper accounting of production proceeds in relation to current non-leasing cotenants who may still be bound by their pooling agreements. Although their leases have terminated, non-leasing cotenants may still be bound by their pooling agreements because the court in *Sheppard* concluded that the termination of a lease does not automatically terminate the agreement to pool or unitize.[302]

Mineral owners may now be worried that they have an obligation to reimburse lessees for expenses incurred in production even after the lease has expired. In *Sheppard,* the court held that Sheppard was responsible for expenses in the lease, even after the lease had terminated, because she was still considered part of the unit.[303] This raises the question of where the line is drawn. To what extent is the lessee able to recover drilling and operating costs? The court stated that based on equity principles, the lessee should be able to recover costs when he has made improvements to the property; however, the court does not define what constitutes an improvement or which improvements qualify as production costs.[304] Furthermore, when is a lessee's power to pool ever terminated? Although now more oil and gas leases may include provisions expressly indicating termination, past leases may not include such language.

The next step is to determine whether the expansion of the pooling power has actually impacted a lessee or lessor. Attorneys should start by interpreting the pooling clause and determining the scope of the pooling power.

B. Interpreting the Pooling Clause

Some courts believe that lease clauses should be interpreted strictly against the lessee, thus limiting the lessee's power to pool.[305] The majority of courts and legal scholars, however, agree that that pooling or unitization

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301. *See id.*

302. *See* Wagner & Brown v. Sheppard, 282 S.W.3d 419, 424-25 (Tex. 2008).

303. *Id.* at 424.

304. *Id.* at 425-26.

305. 1 THE LAW OF POOLING AND UNITIZATION, *supra* note 101, § 8.03 (citing *e.g.*, Mallett v. Union Oil & Gas Corp., 232 La. 157 (1957); Wilcox v. Shell Oil Co., 226 La. 417 (1954)). These courts will typically look at the express authorization of the pooling clause and determine if the clause specifically authorizes the acts of the lessee. *Id.*

clauses should be interpreted broadly.[306] These courts focus on whether the lease expressly limits the lessee's power to pool as to deny the lessee the power to pool based on the facts of the case.[307]

Sheppard has changed the approach to interpreting the pooling clause within previously created leases.[308] According to the Texas Supreme Court, to determine whether a pooling agreement has actually terminated, attorneys and courts should look within the four corners of the pooling agreement and ascertain the intent of the parties based on the language the lessee and lessor agreed upon.[309] If the agreement pools the lands or premises, then its existence is independent of the lease and may outlive the lease because the agreement is based on the actual land and not the leasehold interest.[310] On the other hand, if the agreement expressly provides for the pooling of leaseholds or lease interests, then participation in the pool automatically expires the moment the lease terminates.[311]

Until *Sheppard*, courts did not construe the pooling of lands within a lease's pooling clause to bind the minerals beyond the existence of the lease. The court in *Sheppard* did not take into account the subjective intent of the parties (Sheppard most likely did not intend to bind her tract to the pooled unit beyond the termination of her lease based on the previously stated repercussions); therefore, looking forward, lessors and oil and gas attorneys must carefully consider the terms of the lease, especially the provision providing lessees the power to pool.[312]

C. Drafting Oil and Gas Leases

Sheppard has increased the importance of negotiation between lessors, lessees, and their representing lawyers.[313] Courts agree that the specific language of the lease and the language of the pooling agreement control.[314] Therefore, because owners and operators must agree to the terms to create a pool or lease agreement, the parties are free to determine when and on what

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306. *Id.* (citing Texaco, Inc. v. Letterman, 343 S.W.2d 726 (Tex. Civ. App. 1961, writ ref'd n.r.e.); Owens v. Superior Oil Co., 105 N.M. 155 (1986)). This view is also in accordance with the general principles of contract interpretation. LOWE, *supra* note 16, at 240.

307. 1 THE LAW OF POOLING AND UNITIZATION, *supra* note 101, § 8.03 (citing *Letterman*, 343 S.W.2d at 726; *Owens*, 105 N.M. at 155).

308. *See Sheppard*, 282 S.W.3d at 423-24.

309. *See id.* The agreement may be a separate document from the lease or it may exist as a clause within the lease.

310. *See id.*

311. *See id.*

312. *See id.*

313. *See id.*

314. *See, e.g., id.* In addition, the court in *Sheppard* found it necessary to consider all the circumstances of the pooling to determine whether there is a continuation of the pooling once a pooled lease terminates. *See, e.g., id.*

terms the pool shall terminate.[315] For example, if Sheppard wanted the pooling agreement to expire upon the termination of her lease, then she should have indicated such expiration through the express language of the lease to reflect her intention.[316]

Unfavorable termination and pooling terms in many leases have led oil and gas attorneys to advise their clients, both lessees and lessors, to avoid standardized lease forms and agreements.[317] As a practical matter, some oil and gas attorneys have advised lessees to avoid "automatic termination" clauses within a lease.[318] The use of an automatic termination provision in a lease provides no room for error; thus, if an unintentional error occurs, the lessee may suffer negative economic ramifications.[319] Attorneys argue that a clause, commonly added to a lease by a lessor, stating that the lessor's remedy if royalty payments go unpaid (such as the clause terminating the lease in *Sheppard*) is unnecessary because § 91.401 and § 91.402 of the Texas Natural Resources Code already provide that the operator must pay royalties within 120 days of first production and an interest penalty is added to late paid royalties instead of termination.[320]

Another less drastic alternative to avoid automatic termination upon the failure to make royalty payments is to include a notification clause in the lease.[321] A notice provision would require the lessor to first notify the lessee that he failed to pay royalties on time, and if payment is not made within a specific amount of time after notification, the lease is canceled.[322] This option, at the very least, offers the lessee notice.[323]

Avoidance of standardized lease agreements also benefits the lessor.[324] Based on the outcome in *Sheppard*, the "standard form" language used in many oil and gas leases appears to permit pooling clauses and agreements to outlive the oil and gas leases through the pooling of lands.[325] Providing additional, customized language in a lease that indicates the lessor's intent is crucial to avoid the problems seen in *Sheppard* and to protect the

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315. *See* Presentation by Jack M. Wilhelm, The End of General Principles—The Lease Language Prevails, 5 (Oct. 24, 2009) [hereinafter The End of General Principles]. The parties must expressly state in the lease the terms on which the right to pool shall terminate. *See id.*

316. *See Sheppard*, 282 S.W.3d at 423-24; *see also* The End of General Principles, *supra* note 322, at 2 (stating that the use of "standard" lease forms may be over due to the impact of *Wagner & Brown v. Sheppard* on the oil and gas legal industry).

317. *See* The End of General Principles, *supra* note 315.

318. *See id.* at 2, 6.

319. *See id.* If such clauses cannot be avoided, attorneys encourage lessees to enable a system to monitor timely payment to avoid termination. *See id.* at 3.

320. *See id.* at 2 (citing TEX. NAT. RES. CODE §§ 91.401-.402). The code also states that if litigation is necessary, the lessor is entitled to recover his or her legal fees. *See id.* (citing TEX. NAT. RES. CODE § 91.406).

321. *See id.* at 3.

322. *See id.*

323. *See id.*

324. *See id.*

325. *See id.*

lessor.[326] As a result of *Sheppard*, it is now essential for lessors to ensure that the pooling clause is expressly binding on the termination clause, thereby terminating the lessee's pooling power upon the lease's termination.[327] Although both lessees and lessors may be opposed to standardized forms, tension may exist between the lessee's attempt to avoid automatic termination clauses and the lessor's attempt to terminate the lessee's pooling power upon the termination of the lease.[328] This tension highlights the importance of communication and negotiation when drafting a customized lease.[329]

VII. CONCLUSION

Over the years, courts have felt the tension between lessors and lessees, each fighting for more power and control. Prior to *Sheppard*, courts appeared to generally side with lessors and set limitations on lessees, such as the implied standard of care lessees owe lessors.[330] In addition, courts have previously held that the termination of a lease also terminated the lessor's participation in a pool, another favorable outcome to the lessor.[331] But, the tide has changed. The Texas Supreme Court withdrew its limitations and expanded the lessee's power in the landmark case *Wagner & Brown v. Sheppard*.[332]

According to *Sheppard*, lessees now have the power to pool mineral interests beyond the life of the lease.[333] In *Sheppard*, the court permitted the lessee to pool the lessor's reversionary interest because the pooling clause and the pooling agreement authorized the pooling of the lands rather than the pooling of the leases.[334] This case raises concerns regarding the overall power lessees now possess under the pooling clause and the lessee's ability to bind the lessor to additional agreements, such as operating agreements entered into prior to the lease's termination.

The court's decision in *Sheppard* impacts past, present, and future leases.[335] *Sheppard* may cause former lessors who once participated in a pooled unit to become rebound to the unit by the terms of the pooling agreement.[336] Present lessors and lessees may also be affected by the

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

327. *See id.* at 422-23; The End of General Principles, *supra* note 315, at 4-5.

328. *See* The End of General Principles, *supra* note 315, at 5.

329. *See id.*

330. *See* HEMINGWAY, *supra* note 100, at 455.

331. *See id.* (citing Texaco, Inc. v. Lettermann, 343 S.W.2d 726 (Tex. Civ. App.—Amarillo 1961, writ ref. n. r. e.).

332. *See Sheppard*, 282 S.W.3d at 424.

333. *See id.*

334. *Id.*

335. *See* discussion *supra* Part VI.

336. *See* discussion *supra* Part VI.A.

decision based on the express language in their leases.[337] If a current lease's pooling clause contains language similar to the lease in *Sheppard*, then the lessee's pooling power will likely extend beyond the life of the lease.[338] When parties enter into future leases, they should consider the repercussions of the language used in the lease and customize the terms of the contract in order to avoid the unlimited pooling power.[339]

While the court's decision was largely unexpected by the oil and gas industry, it offers a consistent applicable rule.[340] By broadening the lessee's pooling power, the Texas Supreme Court leveled the playing field in the constant battle between mineral owners and oil and gas companies.

337. *See* discussion *supra* Part VI.B.
338. *See* discussion *supra* Part VI.B.
339. *See* discussion *supra* Part VI.C.
340. *See* discussion *supra* Part V.E.

ERRATA

Due to an oversight, the *Texas Tech Law Review* did not catch an error in the following paragraph, which was was included in the article "*The Majestic and the Mundane: The Two Creation Stories of the Exclusionary Rule*," authored by Scott E. Sundby and Lucy B. Ricca and published in Volume 43, Book 1. The paragraph was not full justified and Justice Ginsburg's name was misspelled.

The *Texas Tech Law Review* apologizes to Scott Sundby, Lucy Ricca, and Justice Ginsburg for the error. The corrected paragraph should read:

I. INTRODUCTION

The Supreme Court's decision in *Herring v. United States* resurrected the debate over the future of the exclusionary rule in American criminal procedure.[1] In many ways, however, the decision is as fascinating for how it views the history of the exclusionary rule as for what it portends about the rule's future. In *Herring*, Chief Justice Roberts and Justice Ginsburg articulated remarkably different visions of the exclusionary rule and its judicial heritage.

1. *See id.* at 704-05 (2009); Sean D. Doherty, *The End of an Era: The Exclusionary Debate Under* Herring v. United States, 37 HOFSTRA L. REV. 839, 839-40 (2009); Jeffrey L. Fisher, *Reclaiming Criminal Procedure*, 38 GEO. L.J. ANN. REV. CRIM. PROC. xv (2009); Wayne R. LaFave, *Recent Development: The Smell of* Herring*: A Critique of the Supreme Court's Latest Assault on the Exclusionary Rule*, 99 J. CRIM. L. & CRIMINOLOGY 757, 758 (2009).