

### Question 10 – July 2015 – Selected Answer 1

1. No, Big Oil is not entitled to form a pooled unit that includes the south part of Whiteacre. Per, the leases' terms, both the Whiteacre and Blackacre leases could be maintained past the primary term by pooling the units and placing a well on a portion of the pooled acreage that would produce in paying quantities. A pooling clause allows different leased tracts to be pooled together or united to be considered as "one" tract and a well can be placed anywhere on the pooled portion, regardless if it is just located on one of the parcels, With a pooling clause, both leases will be maintained. A pooling clause will permit the lessee to pool just portions of the leased tract and still be able to maintain the lease. Pooling clauses, however, may be limited by what is known as a Pugh clause. The pugh clause will serve to sever the "unpooled" or not joined portions of the lease tract and those portions will no longer be considered part of the lease unless there is the payment of delay rentals or there is production of paying quantities in those areas.

Here, the Big Oil leases of Blackacre and Whiteacre included language that permitted the parties to pool certain portions of the leased tract. For that reason, on Oct. 2, 2013 Big Oil validly formed a pooled unit by pooling the north half of Whiteacre and north half of Blackacre. However, the terms of the lease also include a Pugh clause which is enforceable as to Betty's Whiteacre lease which states that the lease would remain only in force as to those lands within the pooled units upon which production was already occurring at the end of the primary term.

At issue here is that Big Oil formed a unit by pooling the south halves of both tracts on July 15th, 2014, at which point the primary term had already ended and both units need to be producing in paying quantities by that time. The primary term, which is a term during which the lessee may delay producing in paying quantities until a certain time specified in the lease, was only for one year following June 1, 2013 when the parties entered in the lease. Which means that by June 1, 2014, the tracts needed to be producing in paying quantities. According to the lease terms, Blackacre is safe and the entire tract remains under the lease because a portion of the tract was pooled therefore the entire tract remains part of the lease according to pooling clause. However, the lease specifically mentions that as to Whiteacre, the Pugh provision applies, and the only portion that would remain part of the lease is the part that is producing in paying quantities which is the portion that was pooled (north part of Whiteacre). The remainder portion, south of Whiteacre, is severed by the Pugh clause and is no longer part of the lease because there was no production in paying quantities in that portion after the primary term ended.

On July 1, 2013, when Big Oil attempts to pool both southern portions of the tracts, south of Whiteacre has been severed so Big Oil cannot pool this portion of the tract.

2. Rights in Blackacre's water are owned by Cary in May 2014. At issue is whether the water belongs to surface and also who owns the surface. On April 2009, Ann conveyed Blackacre to Cary and reserved to herself the mineral interest by indicating that she reserved to herself "all the oil, gas and other minerals in and under that may be produced in Blackacre". For this reason, Ann only conveyed to Cary the surface of Blackacre.

In determining who owns certain "substances" of the tract, the code provides there are certain types of substances that belong to surface by operation of law. Water is one of the substances that as a matter of law belongs to the surface. Since the surface was conveyed to Cary in April 2009, he owns the water that is part of his surface.

### Question 10 – July 2015 – Selected Answer 2

1. Is BigOil entitled to form a pooled unit that includes the south part of Whiteacre? Explain fully.

BigOil is not entitled to form a pooled unit that includes the south part of Whiteacre. Crucial to this question is how to read the lease provisions as they are spelled out.

First of all, the primary term of the lease only lasted until June 1, 2014. The secondary term was as long as production in paying quantities, or PPQ, existed "on the leased tract." So, the lease could only continue if there was PPQ in Whiteacre at the time.

There were also pooling clauses that BigOil took advantage of. BigOil properly pooled the north half of Whiteacre and the north half of Blackacre. There was PPQ on the north half of Whiteacre starting in November 2013, which was within the primary term of the lease. Under the pooling clauses, production on "pooled acreage" would be treated as if it were from "the leased acreage," whether or not the well was located on the leased acreage. This meant that, because the north half of Whiteacre was PPQ at the time, the

production on the pooled acreage of the north half of both properties could be treated as PPQ for all of Whiteacre and all of Blackacre. So, ordinarily, under this interpretation, the PPQ for the north half of Whiteacre, if it continued past June 1, 2014, would entitle BigOil to continue producing under the secondary term of the lease on both Blackacre and Whiteacre.

However, Betty's lease of Whiteacre had a specific provision where her lease would only remain in force as to "those lands within the pooled units upon which production was already occurring at the end of the primary term." To break this down, in this case, that means that the lease will only remain in force as to the north half of Whiteacre--"those lands within the pooled units"--because it was the "pooled unit" of Whiteacre that had achieved PPQ--"upon which production was already occurring"--by June 1, 2014--"at the end of the primary term." To consolidate, Betty's lease only remained in force as to the north half of Whiteacre, because that was where production in the pooled units was taking place when the primary term switched over to the secondary term.

This means that the lease as to the southern half of Whiteacre actually expired upon the expiration of the primary term, because of the special clause in Betty's Whiteacre lease severing the non-pooled units from the pooled units where there was already PPQ. Therefore, on July 15, 2014, when BigOil attempted to pool the southern half of Whiteacre as "part of the leased acreage" with the southern half of Blackacre, it could not do so--because the southern half of Whiteacre was no longer part of BigOil's "leased acreage" under the severing clause in Betty's Whiteacre lease. Therefore, Betty's objection is valid, and BigOil is not entitled to form a pooled unit that includes the south part of Whiteacre.

Note that BigOil is still entitled to pool the southern half of Blackacre because Blackacre's lease does not have such a special clause in it. Under the "as if it were from" language, the production on the pooled acreage--of the northern halves of Blackacre and Whiteacre--is treated "as if it were from" the leased acreage--all of Blackacre--even though the well is not located on Blackacre itself. So, BigOil can pool the southern half of Blackacre with whatever land in the immediate vicinity it likes, even though Blackacre's PPQ is coming from the northern half of Whiteacre. However, since Blackacre no longer has a valid lease on the southern half of Whiteacre, it may not pool that land unless it gets a separate lease agreement from Betty.

2. Who owned the water rights attributable to Blackacre in May 2014? Explain fully.

Cary owned the water rights attributable to Blackacre in May 2014.

When a conveyance reserves all mineral rights in a property, that conveyance in effect severs the surface estate from the mineral estate. In this case, when Ann conveyed Blackacre to Cary, she reserved for herself "all oil, gas, and other minerals in and under and that may be produced from Blackacre." So, Blackacre's surface estate went to Cary, but Ann retained the mineral estate, which severed the surface from the minerals.

The mineral estate, severed in 2009, is subject to the plain meaning rule, in effect in Texas since the 1980s. If a material is not one of the nine that belongs to the surface as a matter of law, courts will use the plain meaning test to determine whether the material belongs to the surface estate or the mineral estate. Water, as a material, is one of the nine that belongs to the surface estate as a matter of law. In 2009, when Blackacre's estates were severed into the surface and mineral estates, Cary held the surface estate. Water, as a material, belongs to Cary's estate. So, Cary owned the water rights attributable to Blackacre in May 2014. Only Cary had the right to enter into the lease with Deb. Ann had no authority to do so.

### **Question 10 – July 2015 – Selected Answer 3**

1) No, BigOil is not entitled to form a pooled unit that included the south part of Whiteacre. The issue is whether a lessee is able to pool land under one term of the lease while another term of the lease provides that no such pooling is permitted.

In Texas, when a mineral lease contains terms that seem to contradict, the lease is interpreted in favor of the

lessor because most oil companies, as lessees, are the parties that draft the mineral lease. Here, the facts state that both mineral leases contained a clause that provided that production on pooled acreage would be treated as if it were from the leased acreage, regardless of whether the well was located on the leased acreage. However, the facts also state that Betty's Whiteacre lease contained a "Pugh" clause, which provides that if part of the leased premises is pooled, any part of the leased acreage that is not covered in the pooled unit will terminate unless drilling operations begin on the non-pooled land or delay rental has been timely paid. Thus, these two terms in Betty's Whiteacre lease seem to contradict each other because the drill on the pooled acreage is located on Whiteacre, which under the terms of the clause mentioned above in both mineral leases, the production of that drill will keep the entire Whiteacre property under the lease while the Betty's "Pugh" clause provides that only the northern part of Whiteacre is still under the terms of the lease.

As mentioned earlier, when a mineral lease contains terms that contradict, Texas courts will interpret the lease in favor of the lessor. Interpreting the Whiteacre lease in Betty's favor, the "Pugh" clause will trump the other clause and will terminate the lease as to the southern portion of Whiteacre. Because BigOil failed to begin drilling operations by the end of the primary term (May 31, 2013), the lease will terminate as to the southern portion of Whiteacre.

2) Cary owned the water rights attributable to Blackacre in May 2014. The issue is whether a reservation of the mineral estate by a grantor includes the right to water located on the property.

Texas courts are required to use two different tests to determine whether certain items are considered a "mineral" covered by a mineral lease. For leases executed before September 1, 1983, the court will apply the "surface destruction" test, which looks at whether extraction of the minerals will destroy part of the surface estate. If destruction does occur, the item retrieved is considered part of the surface estate. For leases executed on or after September 1, 1983, the courts will apply the "ordinary and natural meaning" test, which looks to whether the item, used in its ordinary and natural meaning, would constitute a "mineral". Texas courts have also provided landowners a list of items that are not part of the mineral estate as a matter of law, including water, building stone, shale, gravel and sand. Here, the water on Blackacre belong to the owner of the surface estate. When Ann conveyed Blackacre to Cary in April 2009, she conveyed only the surface estate while retaining the mineral estate. Because the water rights belong to the surface owner of Blackacre i.e. Cary, Ann had no right to enter into a lease with Deb for the water rights attributable to Blackacre.

Therefore, Deb should have entered into a lease agreement with Cary for the water rights, since Cary was the owner of the surface estate.