SEPTEMBER 2018
VOL. 18-8

PRATT'S

ENERGY LAW REPORT

LexisNexis®

Pratt's Energy Law Report

VOLUME 18 NUMBER 8 SEPTEMBER 2018

LexisNexis®

QUESTIONS ABOUT THIS PUBLICATION?

For questions about the **Editorial Content** appearing in these volumes or reprint permission, please email:
Jacqueline M. Morris at ..... (908) 673-1528
Email: ..... jacqueline.m.morris@lexisnexis.com
Outside the United States and Canada, please call . . . . . (973) 820-2000

For assistance with replacement pages, shipments, billing or other customer service matters, please call:
Customer Services Department at . . . . . (800) 833-9844
Outside the United States and Canada, please call . . . . . (518) 487-3385
Fax Number . . . . . (800) 828-8341
Customer Service Website . . . . . http://www.lexisnexis.com/custserv/

For information on other Matthew Bender publications, please call
Your account manager or . . . . . (800) 223-1940
Outside the United States and Canada, please call . . . . . (937) 247-0293

ISBN: 978-1-6328-0836-3 (print)
ISBN: 978-1-6328-0837-0 (ebook)
ISSN: 2374-3395 (print)
ISSN: 2374-3409 (online)

Cite this publication as:

[author name], [*article title*], [vol. no.] PRATT'S ENERGY LAW REPORT [page number] (LexisNexis A.S. Pratt);
Ian Coles, *Rare Earth Elements: Deep Sea Mining and the Law of the Sea*, 14 PRATT'S ENERGY LAW REPORT 4 (LexisNexis A.S. Pratt)

Editorial Office
230 Park Ave., 7th Floor, New York, NY 10169 (800) 543-6862
www.lexisnexis.com

MATTHEW BENDER

(2018–Pub.1898)

Editor-in-Chief, Editor & Board of Editors

Hydraulic Fracturing Developments
Eric Rothenberg
Partner, O'Melveny & Myers LLP

Pratt's Energy Law Report is published 10 times a year by Matthew Bender & Company, Inc. Periodicals Postage Paid at Washington, D.C., and at additional mailing offices. For customer support, please contact LexisNexis Matthew Bender, 1275 Broadway, Albany, NY 12204 or e-mail Customer.Support@lexisnexis.com. Direct any editorial inquires and send any material for publication to Steven A. Meyerowitz, Editor-in-Chief, Meyerowitz Communications Inc., 26910 Grand Central Parkway Suite 18R, Floral Park, New York 11005, smeyerowitz@meyerowitzcommunications.com, 646.539.8300. Material for publication is welcomed—articles, decisions, or other items of interest to lawyers and law firms, in-house energy counsel, government lawyers, senior business executives, and anyone interested in energy-related environmental preservation, the laws governing cutting-edge alternative energy technologies, and legal developments affecting traditional and new energy providers. This publication is designed to be accurate and authoritative, but neither the publisher nor the authors are rendering legal, accounting, or other professional services in this publication. If legal or other expert advice is desired, retain the services of an appropriate professional. The articles and columns reflect only the present considerations and views of the authors and do not necessarily reflect those of the firms or organizations with which they are affiliated, any of the former or present clients of the authors or their firms or organizations, or the editors or publisher.

POSTMASTER: Send address changes to Pratt's Energy Law Report, LexisNexis Matthew Bender, 121 Chanlon Road, North Building, New Providence, NJ 07974.

Texas Supreme Court Provides Guidance on Retained-Acreage Clauses

By Amy Pharr Hefley, Dan L. Mark, Tina Q. Nguyen, and Craig S. Vogelsang*

The authors of this article explain two unanimous Supreme Court of Texas' opinions on retained-acreage clauses in oil and gas instruments with divergent results and offer litigation and transactional takeaways.

The Supreme Court of Texas has issued two unanimous opinions on retained-acreage clauses in oil and gas instruments with divergent results. The clauses at issue in each opinion set the size of the retained acreage by reference to a Texas Railroad Commission ("Railroad Commission") rule or regulation, which is very common in Texas oil and gas leases. As these decisions demonstrate, the particular words used in retained-acreage clauses, and the Railroad Commission rules or regulations they incorporate, make all the difference when it comes to preserving rights in a mineral lease.

THE QUESTION PRESENTED

Both cases presented the same question: to what extent does a lessee-operator retain acreage upon the termination of the primary term of the lease after drilling on some parts of the leased acreage but not others? In *Endeavor Energy Resources, L.P. v. Discovery Operating, Inc.*,[1] the court construed a retained-acreage clause to preserve only the roughly 81 acres per well that the lessee-operator (Endeavor) had designated as proration units in its plat filings with the Railroad Commission, even though the applicable field rules permitted operators in that field to assign up to 160 acres per well, and Endeavor claimed it mistakenly assigned less than 160 acres for each well. In *XOG Operating, LLC v. Chesapeake Exploration Limited Partnership*,[2] the court held that the

---

* Amy Pharr Hefley (amy.hefley@bakerbotts.com) is a partner at Baker Botts L.L.P. and deputy department chair of the firm's litigation department, representing plaintiffs and defendants in both state and federal courts. Dan L. Mark (dan.mark@bakerbotts.com) is a partner at the firm focusing on downstream and midstream transactions and projects. Tina Q. Nguyen (tina.nguyen@bakerbotts.com) is a senior trial associate at the firm practicing in the areas of energy litigation, pension and ERISA matters, real-estate defense, as well as other commercial disputes. Craig S. Vogelsang (craig.vogelsang@bakerbotts.com) is a partner at the firm advising clients on the acquisition, disposition, and development of oil and gas exploration and producing properties, natural gas, crude oil, natural gas liquids and other hydrocarbon product pipelines, and gas processing plants.

[1] — S.W.3d —, No. 15-0155 (Tex. Apr. 13, 2018).

[2] — S.W.3d —, No. 15-0935 (Tex. Apr. 13, 2018).

retained-acreage clause was not limited to the operator's (Chesapeake) designation but rather was controlled by the applicable field rules, which resulted in Chesapeake retaining more acreage than what it designated in the proration plats that it filed with the Railroad Commission.

THE COURT'S DECISIONS

The two cases involved different oil and gas instruments with differently worded retained-acreage clauses, but presented the same core issue—the amount of acreage preserved by a retained-acreage clause. A retained-acreage clause typically works in conjunction with other lease-preservation measures: "While a habendum clause generally extends the entire lease so long as some production is occurring on the lease, and a continuous-development clause further extends the entire lease so long as the operator remains engaged in the required development efforts, a retained-acreage clause typically divides the leased acreage such that production or development will preserve the lease only as to a specified portion of the leased acreage."[3] To distinguish between the acreage that is kept by the lessee-operator upon termination and the acreage that is returned to the lessor, retained-acreage clauses are often drafted to refer to a Railroad Commission designation, such as a proration unit, to identify the acreage that is retained by the lessee-operator. The Railroad Commission's field rules may affect how a proration unit is designated. For example, some field rules refer to operators "assigning" acreage in a proration unit, while others "prescribe" proration units—a distinction that affected the two cases before the court.

Retained-acreage clauses are "contractual and vary widely because parties are free to contract in any way they choose not prohibited by law.[4]" "Each retained-acreage clause must be construed on its own, under governing principles of contract interpretation."[5] "[A]s with any contract, the parties to a retained-acreage provision are presumed to know the law and to have stated their agreement in light of it."[6] According to the court, what distinguished the *Endeavor* and *XOG* cases were the terms of the retained-acreage clauses and the Railroad Commission's applicable field rules. The retained-acreage clause in *Endeavor* stated that, at the end of the lease's primary term or

> upon the cessation of the continuous development . . . whichever is later, the lease shall automatically terminate as to all lands and depths

---

[3] *Endeavor*, No. 15-0155.

[4] *XOG*, No. 15-0935.

[5] *Endeavor*, No. 15-0155.

[6] *XOG*, No. 15-0935.

> covered herein, *save and except* those lands and depths located within a *governmental proration unit assigned to a well* producing oil or gas in paying quantities and the depths down to and including one hundred feet (100') below the deepest productive perforation(s), with each such governmental proration unit to contain the number of acres required to comply with the applicable rules and regulations of the Railroad Commission of Texas for *obtaining the maximum producing allowable* for the particular well.[7]

Focusing on the phrase "governmental proration unit *assigned* to a well," the court held that the only reasonable construction was that it referred to an "*operator's* assignment of a proration unit through its filing of a proration plat with the Railroad Commission," because "operators, and only operators, 'assign' acreage to proration units."[8] Although the Railroad Commission's field rules for the area permitted proration units of up to 160 acres, Endeavor did not designate or assign 160 acres to the proration units for its wells. Instead, Endeavor designated roughly 81-acre proration units, which was sufficient to obtain the maximum producing allowable for those wells. As a result, the court affirmed the lower court's summary judgment ruling that Endeavor had lost any interest in acreage outside the 81-acre proration units under the retained-acreage clause.

By contrast, in *XOG*, the court deemed significant the references to a "prescribed" proration unit in the retained-acreage clause and field rules.[9] The retained-acreage clause in *XOG* provided that the acreage assigned to Chesapeake would revert to XOG after the primary term,

> *save and except that portion* of [the leased acreage] *included within the proration* or pooled *unit of each well* drilled under this Assignment and producing or capable of producing oil and/or gas in paying quantities. *The term "proration unit"* as used herein, *shall mean the area within the surface boundaries of the proration unit then* established or *prescribed by field rules* or special order of the appropriate regulatory authority for the reservoir in which each well is completed. *In the absence of such field rules* or special order, *each proration unit shall be deemed to be 320 acres* of land in the form of a square as near as practicable surrounding[ ] a well completed as a gas well producing or capable of production in

---

[7] *Id.* (emphases in original).

[8] *Id.* (first emphasis added, second emphasis in original).

[9] *See XOG*, No. 15-0935 ("In *Endeavor*, neither the retained-acreage provision nor the field rules refer to a "prescribed" proration unit.").

paying quantities . . . .[10]

Chesapeake had drilled six wells during the primary term of the lease. Five of the wells were in the Allison-Britt Field, and one was in the Stiles Ranch Field. Based on the retained-acreage clause, the court concluded that the proration unit for each of the six wells was 320 acres (for a total of 1,920 acres), even though Chesapeake had designated much less acreage in the proration plats it filed with the Railroad Commission. Because the Railroad Commission's field rules for the Allison-Britt Field stated that, "[f]or allowable assignment purposes, the *prescribed* proration unit shall be a [320] acre unit," the court concluded that the proration unit for each of five wells in the Allison-Britt Field rules was 320 acres.[11] Because no field rules applied to the sixth well in the Stiles Ranch Field, the court concluded that the "deemed" proration unit for that well was 320 acres under the retained-acreage clause.[12] The court affirmed the lower court's summary judgment ruing that Chesapeake retained all of the acres under the retained-acreage clause, and none reverted to XOG.

LITIGATION TAKEAWAYS

Endeavor and *XOG* make clear that retained acreage clauses are unique contractual provisions, and courts will not take a one-size-fits-all approach when interpreting them. The specific language used in the lease will be examined to determine the parties' intent. And while parties often focus on the text within their lease, consideration should also be given to the statutes and regulations that may affect how that text is interpreted due to being incorporated by reference in the lease. For example, knowing the field rules that may apply when drilling in different formations is important, given how common disputes have become over whether retained acreage determined by reference to proration units is "fixed," i.e., set at the time the well is originally completed, or "floating," i.e., capable of increasing or decreasing when a well is re-completed in another formation with different field rules. As the Texas Supreme Court emphasized, parties to a contract "are presumed to know the law and to have stated their agreement in light of it."[13] That is true even if "the contracting parties may not fully understand the ramifications of including a regulatory term in the typical mineral lease."[14]

---

[10] *Id.* (emphases in original).

[11] *Id.* (emphasis added).

[12] *Id.*

[13] *XOG*, No. 15-0935.

[14] *Endeavor*, No. 15-0155.

Also significant is the court's discussion of special limitations. "A special limitation in an oil and gas lease provides that the lease will automatically terminate upon the happening of a stipulated event."[15] Examples of special limitations include "the cessation of production in contravention of the lease's terms, failure to commence drilling or reworking operations within the time the lease required, or an operator's failure to timely pay a shut-in royalty the lease required"—terms that commonly come into dispute, given their potential to end a lease.[16] The court reaffirmed that courts "will not find a special limitation 'unless the language is so clear, precise, and unequivocal that [courts] can reasonably give it no other meaning.' "[17]

In *Endeavor*, the court determined that the lease language clearly and unequivocally imposed a special limitation: "The plain, grammatical language of Endeavor's leases shows that the parties intended the leases to continue only as to acreage that had been assigned to a well as reflected in the certified plats Endeavor filed with the Railroad Commission, and that the leases 'shall automatically terminate' as to all acreage not assigned to those proration units."[18] But in *XOG*, the court held that the contract language was not sufficient to revert acreage back to XOG: "we cannot read it to do so unless it is so 'clear, precise, and unequivocal that we can reasonably give it no other meaning.' "[19]

Thus, we expect that special limitations will continue to be an issue ripe for disputes. A lessor would likely argue that the special limitation is sufficiently clear, precise, and unequivocal to cause a lease termination, while a lessee would argue the opposite to avoid lease termination. But in a toss-up situation, this rule should favor the lessee.

TRANSACTIONAL TAKEAWAYS

The cases also highlight the need to devote special attention to retained-acreage clauses, especially where significant valuations are placed on the expectation for long-term production from large amounts of acreage under lease. In the context of an acquisition, the due diligence activities of a prospective buyer or assignee should include an analysis of the wording of the retained-acreage clause contained in any oil and gas instrument affecting any oil and gas lease with significant value.

---

[15] *Id.*

[16] *Id.*

[17] *Id.*

[18] *Id.*

[19] *XOG*, No. 15-0935.

It should be noted that many instruments beyond oil and gas leases include retained-acreage clauses. For example, in *XOG*, the agreement that contained the disputed retained-acreage clause was a farmout agreement between XOG and Chesapeake. Thus, the importance of properly assessing and drafting retained acreage clauses arises in the context of any number of oil and gas instruments, including joint development agreements, drillcos, conveyances, and joint operating agreements—not just oil and gas leases and farmouts.

The courts permit parties to have significant leeway in drafting provisions in oil and gas instruments. *Endeavor* and *XOG* once again provide evidence that "words matter" in drafting or interpreting these types of agreements.