

## **FEDERAL -- MINING**

Daniel A. Jensen, Reporter

### **Court Rules on Validity of Hardrock Mine Permitting Regulations**

In a decision that left both sides claiming at least partial victory, a federal district court has upheld nearly all of the hardrock mine permitting regulations implemented by the Bush administration. In *Mineral Policy Center v. Norton*, No. 01-00073 (D.D.C. Nov. 18, 2003), the court analyzed facial validity challenges to the revised "3809" mine permitting regulations. 66 Fed. Reg. 54,834 (Oct. 30, 2001); 43 C.F.R. pt. 3809 (2003). The challenges were brought by several environmental groups and were defended by the Interior Department and a mining industry group.

The 3809 regulations were originally established in 1980, following passage in 1976 of the Federal Land Policy and Management Act (FLPMA), 43 U.S.C. §§ 1701-1782. The initial regulations contained standards meant to implement, with respect to mining operations, FLPMA's requirement that the Interior Department "take any action necessary to prevent unnecessary or undue degradation of the [public] lands." *Id.* § 1732(b). The original definition of "unnecessary or undue degradation" centered on (1) disturbance greater than that which would normally result from an ordinarily prudent operator, (2) failure to comply with applicable environmental protection laws, and (3) failure to complete reasonable mitigation measures, including proper reclamation of disturbed areas. 45 Fed. Reg. 78,902, 78,910 (Nov. 26, 1980).

In the final days of the Clinton administration, the 3809 regulations were amended. 65 Fed. Reg. 69,998 (Nov. 21, 2000). Relative to "unnecessary or undue degradation," the 2000 regulations replaced the 1980 "prudent operator" standard with a new "mine veto" (as dubbed by the industry) standard, in which the Bureau of Land Management (BLM) could deny a plan of operations (i.e., a mining permit) if the plan failed to comply with certain performance standards or would result in "substantial irreparable harm" to a "significant" scientific, cultural, or environmental resource value of the public lands that could not be "effectively mitigated." *Id.* at 70,116. Environmentalists saw this as a wise change that would allow BLM to deny a mining permit if it involved an area that was simply unsuitable for mining. Industry saw this as a violation of fundamental mining law that would allow BLM to subjectively veto a mining permit after expensive efforts to discover and develop a mineral deposit.

The new Bush administration quickly took steps to further revise the 3809 regulations and abolish the "mine veto" standard for unnecessary or undue degradation. 66 Fed. Reg. 54,834, 54,837-38 (Oct. 30, 2001). The 2001 regulations have a definition for unnecessary or undue degradation that is a cross between the 1980 definition and the 2000 definition. The 2001 definition prohibits activities that (1) fail to comply with certain operational performance standards, the terms of an approved plan of operations, operations described in a proper notice of intent, or other federal and state environmental and cultural resource protection laws; (2) are not reasonably incident to exploration, mining, or processing operations; or (3) fail to comply with specific laws applicable to special lands such as wilderness and national monuments. *Id.* at 54,860; 43 C.F.R. § 3809.5 (2003). The 2001 regulations retained other provisions of the 2000 regulations, including (1) mandatory financial guarantees for all mining disturbances, including notice-level activities; (2) an approved plan of operations for all mining activities other than casual use and exploration, even where the disturbed area is less than five acres; and (3) operational performance standards.

The court's analysis was based on cross motions for summary judgment. On the most critical issue, "unnecessary or undue degradation," the court gave a partial victory to the environmental groups by holding that "unnecessary" degradation and "undue" degradation are not the same thing, a holding that is contrary to a 2001 Solicitor's Opinion (M-37007, Oct. 23, 2001). Slip Op. at 18-20. In so holding, the court rejected the argument that as long as a proposed mining activity is truly "necessary" to mining, the BLM has no authority to prevent it. *Id.* at 19. The court agreed with the argument that BLM must prevent "undue" degradation, even though the cause of the degradation may be "necessary" for mining. *Id.* at 20-22.

However, that holding was irrelevant because the court went on to hold that the challenged regulations adequately prohibit both unnecessary degradation and undue degradation. *Id.* at 22-26. The court found that the regulations reasonably interpret and implement FLPMA's "unnecessary or undue degradation" mandate by providing for the exercise of case-by-case discretion to protect the environment through the process of (1) plan of operations approval; (2) notice of intent requirements; (3) financial guarantees; (4) operational performance standards;

(5) compliance with other environmental laws such as the Endangered Species Act, the Archeological Resources and Protection Act, the Clean Water Act, and the Comprehensive Environmental Response, Compensation and Liability Act; and (6) Interior's ability under FLPMA to withdraw public lands from mineral entry or place lands in protective designations such as areas of critical environmental concern. Finding that the phrase "unnecessary and undue degradation" (a phrase that is undefined in FLPMA) was ambiguous, the court applied the reasonable agency interpretation standard set forth in *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), holding the BLM's interpretation, as set forth in the 2001 regulations, reasonable and therefore valid. Slip Op. at 24-25. The court concluded that the 2001 regulations "are neither 'procedurally defective' nor 'arbitrary or capricious in substance,' nor 'manifestly contrary' to the FLPMA." *Id.* at 25-26.

The court then addressed the environmentalists' argument that BLM must apply the "full panoply" of land management laws to any lands not covered by mining claims or covered by invalid mining claims. *Id.* at 27. Specifically, the environmentalists argued that BLM must (1) manage such lands on the basis of multiple use and sustained yield, rather than the various mining laws; (2) prevent permanent impairment of such lands; and (3) ensure the receipt of fair market value for a miner's use of such lands. *Id.* Arguments (1) and (2) were rejected. The court found that BLM's existing regulations meet the statutory requirements of FLPMA, most significantly through the creation of and adherence to applicable land use plans. *Id.* at 31-33.

However, the court agreed with argument (3). FLPMA states that it is the "policy" of the United States to receive fair market value for the use of public lands unless otherwise provided by statute. 43 U.S.C. § 1701(a)(9). The court held that initial exploration activities, ingress to mining claims, and the use of valid mining and mill site claims are exempt from the general fair market value payment requirement because they are explicitly allowed by FLPMA or the General Mining Law, but a miner must pay fair market value for the use of unclaimed land or invalidly claimed land. Slip Op. at 33-36. On this one issue, the court remanded the matter to the Interior Department to address through administrative action.

This holding seems to be of limited practical significance, since few miners would invest in significant operations on unclaimed land, and the government generally does not require a claim validity determination before approving mineral operations on the claim (see following article).

Finally, the court rejected the environmentalists' challenge to the categorical exemption of exploration projects of less than five acres (notice-level projects) from plans of operation and from review under the National Environmental Policy Act (NEPA). *Id.* at 36-45. The court held the challengers failed to show that Interior's decision not to require a plan of operations for notice-level activities violates FLPMA or is otherwise arbitrary and capricious. The court refused to "second guess Interior's judgment." *Id.* at 37. The court also held that notice-level projects do not constitute "major Federal action" and thus do not trigger the requirement of NEPA review. *Id.* at 40-45.

Overall, the existing 2001 hardrock mine permitting regulations were upheld with the sole exception of the failure to require fair market value payment for operations on unclaimed or invalidly claimed federal lands.

The judge concluded his opinion with what seems to be an autonomous and subjective parting shot at the mining industry and the BLM, writing:

In sum, it is clear that mining operations often have highly significant -- and sometimes devastating -- environmental consequences. It is also clear that the 2001 Regulations, in many cases, prioritize the interests of miners, who seek to conduct these mining operations, over the interests of persons such as plaintiffs, who seek to conserve and protect the public lands. While such prioritization may well constitute unwise and unsustainable policy, with one exception, the court cannot find that the 2001 Regulations unreasonably implement the FLPMA, in violation of the Administrative Procedures Act, nor can the court conclude that the Secretary acted arbitrarily or capriciously in promulgating the 2001 Regulations, such that this court may intervene. Accordingly, with one exception, plaintiffs' facial challenge must fail.

*Id.* at 45.

### **Proof of Claim Validity Not Required for Plan of Operations Approval**

The Interior Board of Land Appeals (IBLA) has rejected a legal argument sometimes advanced by groups opposed to mine development -- that before operating approval can be given, the government must verify the validity of unpatented mining claims on which the operations will occur. In *Western Shoshone Defense Project*, 160 IBLA 32, GFS(MIN) 26(2003), opponents of the Pipeline open pit gold mine in Nevada appealed the Bureau of Land Management's (BLM) approval of an amended plan of operations. The approval dealt with the operator's plans to

dispose of water through surface infiltration ponds. In addition to raising various environmental compliance arguments, the Western Shoshone Defense Project (WSDP) argued that the mine plan approval was illegal because BLM had not determined the validity of the underlying mining claims. WSDP argued that no right to mine can exist without a BLM determination that the claimant has complied with the laws of the United States and that, therefore, an investigation of claim validity must be an integral part of BLM's analysis of a proposed plan of operations. *Id.* at 55.

The claim owner countered that BLM does routinely check to see that the land was open to mineral entry when the claims were located, but that claim validity determinations are not mandatory and are made discretionarily only in special circumstances, such as location within a designated wilderness area, location on lands withdrawn after claim location, or where there is evidence that the claims are not part of a bona fide mining operation. *Id.* at 55-56.

The IBLA agreed with the claimant. Observing that "BLM generally does not determine the validity of the affected mining claims before approving a plan of operations," the IBLA explained that BLM does have the discretionary right to examine the validity of unpatented mining claims at any time. *Id.* at 57. This is because vested rights as against the United States are obtained only upon a showing that the claim is supported by the discovery of a valuable mineral deposit. But BLM has no absolute duty to examine the validity of claims underlying a proposed plan of operations. *Id.* at 56-57. "[W]hile BLM always possesses the authority to investigate the validity of unpatented mining claims, it is not required to do so, nor should it suspend consideration of a plan of operations even when it decides to conduct a validity examination of the affected claims to determine whether to initiate a [validity] contest." *Id.* at 57.

The IBLA further held that WSDP, as the party alleging invalidity, "had an obligation to present evidence which, at a minimum, would establish a reasonable basis for questioning the validity of the claims." *Id.* WSDP submitted no such information, and its "fanciful speculation will not suffice." *Id.* The IBLA also noted that ancillary use of lode mining claims for mining-related purposes (in this case, temporary water infiltration facilities) "does not in and of itself support the inference that those claims are not supported by a discovery absent evidence that this ancillary use precludes future mineral extraction from those claims." *Id.* at 57, n.8.

On the same subject, both the BLM and the Forest Service recently issued policy directives that are consistent with the *Western Shoshone Defense Project* decision. The BLM document states: "The BLM policy is that validity examinations are not automatically performed when a mining plan of operation is filed, unless the mining operation is within an area that is withdrawn or segregated; or a mineral examination report is required to determine if the minerals are uncommon varieties. A plan of operation may be processed for lands open to mineral entry and containing minerals subject to the mining laws without requiring proof of validity." Instruction Memorandum No. 2003-242 (Aug. 1, 2003) (citations omitted). The Forest Service document states: "On National Forest system lands reserved from public domain and open to entry under the mining law, the Forest Service is not required to inquire into claim validity before processing and approving proposed plans of operations." Informational Memorandum from Undersecretary Mark Rey (Sept. 22, 2003).

## **FEDERAL -- OIL & GAS**

Gregory R. Danielson, Reporter

### **Assistant Secretary Issues Decision Regarding Deduction of Post-production Costs from Royalty for Coalbed Methane Produced in the Powder River Basin**

Devon Energy Corporation (Devon) requested the Minerals Management Service (MMS) to make a valuation determination for its coalbed methane (CBM) produced from federal oil and gas leases in the Powder River Basin in Wyoming. Based upon the facts submitted by Devon, the Assistant Secretary of the Department of the Interior, in a Decision Letter dated October 9, 2003, held that in determining the value of CBM for royalty purposes, Devon could not deduct that portion of the costs of compression, transportation, and dehydration required to put the gas in a marketable condition. Since the determination was issued by the Assistant Secretary of the Interior, it is a final action of the Department of the Interior and is not appealable to the Interior Board of Land Appeals.

Devon produced its CBM at a pressure between 2 and 10 pounds per square inch gauge (psig), but sold the gas off the leased premises and delivered it to a market pipeline over 126 miles away at a pressure of 1100 psig. Prior to the sales point, Devon's gas was gathered to one of several central delivery points and then moved through various lines and several phases of compression and dehydration before being delivered to Devon's gas booster plant at 800 pounds per square inch (psi). The gas booster plant compressed the gas to 1200 psi, a pressure sufficient to enter the market pipeline. The Assistant Secretary determined that the compression and dehydration costs incurred to this point were not deductible as they were necessary to put the gas in a marketable condition. The Assistant Secretary

further held that the required pressure for gas to be in a marketable condition is the pressure necessary for the gas to pass through the line that delivers the gas to the purchaser.

After leaving the booster plant, Devon transported the gas 26 miles to a plant and sales point for the market pipeline. During the transmission to the sales point, the gas lost one-third of its pressure. Devon therefore recompressed the gas to reach the pipeline requirement of 1200 psi. The Assistant Secretary held that Devon was "not required to condition the production to marketable condition more than once at its own expense." Thus, if compression is performed to move gas to the plant because the plant is distant from the lease and is not otherwise a necessary component of bringing the gas to the relevant pipeline pressure, the cost of that compression will be allowed as a deduction.

The Assistant Secretary also considered what movement of gas under the instant facts constituted gas gathering, for which costs were not deductible, and what movement constituted transportation, for which an allowance was calculated. Relying on the definition of gathering set forth in 30 C.F.R. § 206.151, the Assistant Secretary determined that the movement to a central accumulation point off the lease approved by the MMS constitutes gathering, even if that point is not the first point at which commingling or accumulation occurs. In the present case, BLM approved the central delivery points as the measuring point. Under the applicable definition, movement of the gas to the central delivery points and the custody transfer meter constitutes gas gathering. Movement beyond the custody transfer meter at the central delivery points constitutes transportation. The Assistant Secretary noted that BLM could have approved a different point as the approved measurement point, such as the field boosters, but the lessee did not so request and BLM accepted the central delivery points as the approved measurement point "and the consequence described above follows from that decision."

## **MINING -- OIL & GAS, ENVIRONMENTAL ISSUES**

Steven Marlin, Reporter

### **U.S. District Court Issues Ruling Concerning CERCLA Liability for Coeur d'Alene River Basin Mining Legacy**

On September 3, 2003, the U.S. District Court for the District of Idaho issued an opinion addressing liability for conditions resulting from over 100 years of mining in the Coeur d'Alene River Basin in the Silver Valley region of Northern Idaho, including the Bunker Hill Superfund Site. *Coeur d'Alene Tribe v. Asarco Inc.*, 280 F. Supp. 2d 1094 (D. Idaho 2003). The case is of interest to the mining industry, as the court resolved numerous undecided issues under the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) that are relevant to the impacts of contamination caused by historical mining activities.

Widespread mining activities conducted in Silver Valley since the late 1880s resulted in past and ongoing releases of tailings containing lead, cadmium, and/or zinc from exposed surface piles, underground mine workings, and surface impoundments into the soil, groundwater, the Coeur d'Alene River and its tributaries, and Lake Coeur d'Alene. The United States and the Coeur d'Alene Tribe (collectively, plaintiffs), brought actions against Asarco Inc. and Hecla Mining Co. (collectively, defendants), to recover response costs and natural resources damages under CERCLA § 107(a), 42 U.S.C. § 9607(a).

The defendants disputed the liability allocation percentages sought by the plaintiffs, and whether natural resources continue to be injured as a result of mining-related contamination. The defendants also filed counterclaims seeking to hold the United States itself liable for contributing to hazardous substance releases. The court bifurcated the trial and held the defendants liable as owners and operators for over half of the total tailings released in the Coeur d'Alene River Basin, and allocated liability based on each defendant's contribution to releases of tailings containing hazardous substances. The court also found the United States government liable as an arranger for contributing to hazardous substance releases in the Basin. The case now heads to trial to quantify damages.

One of the more important issues the district court resolved, in terms of CERCLA liability for mining-related activities, was whether the plaintiffs were barred from recovering natural resources damages that occurred prior to December 11, 1980, the date CERCLA was enacted. Unlike response costs, which can be recovered even if incurred for hazardous substance releases that occurred prior to CERCLA, CERCLA § 107(f)(1) bars recovery of natural resources damages where the damages and the release of hazardous substances that caused the damages occurred wholly before December 11, 1980. The defendants argued that no releases and injuries to natural resources have occurred post-enactment because companies have impounded tailings in Silver Valley since 1968, 12 years before CERCLA was enacted.

The court concluded that the plaintiffs could recover natural resources damages in this case on two bases. First, the court found that while tailings have indeed been impounded since 1968, hazardous substances have continued to

be released since 1980, flowing downstream in the Basin. The court concluded that this passive water migration of contamination, unaided by human conduct, constitutes post-enactment "continuing re-releases" of hazardous substances under CERCLA, and resulting damages are therefore recoverable. Second, the court concluded that for purposes of the section 107(f)(1) bar against recovery of pre-enactment natural resources damages, the date when the resulting injury to natural resources is quantified is the critical factor. In other words, the damages do not necessarily occur when the injury (i.e., the release of hazardous substances) occurs. Thus, in this case, according to the court, even if the release occurred pre-enactment, the resulting damages -- the monetary quantification of the injury to natural resources -- occurred post-enactment. Notably, this conclusion sits in direct contrast with the Montana U.S. District Court's decision in *Montana v. Atlantic Richfield Co.*, 266 F. Supp. 2d 1238 (D. Mont. 2003), in which that court rejected the injury quantification argument and concluded that section 107(f)(1) bars recovery of natural resources damages where the release and resulting injury wholly occur prior to December 11, 1980.

The court in *Coeur d'Alene Tribe* was also concerned with double recovery of natural resources damages by a natural resources trustee, where multiple natural resources trustees are involved. In this case, the United States, the Coeur d'Alene Tribe, and the State of Idaho all held natural resources trusteeships in the Coeur d'Alene Basin. The court established the principle that to avoid double recovery of natural resources damages, the court should allocate such damages among the trustees by percentage, based on the extent each trustee exercises "actual management and control" over each natural resource (e.g., land, fish, wildlife, biota, air, water). *Coeur d'Alene Tribe*, 280 F. Supp. 2d at 1116.

Questions also arose in this case as to the proper method of divisibility pertaining to liability between the defendants, and the applicable causation standard for natural resources damages claims. The court rejected the plaintiffs' suggestion that each mill's hazardous waste, generated over multiple decades, must be fingerprinted to sustain the defendants' assertion that liability is divisible. Deeming such a divisibility method "grossly unfair and unjust," the court ruled that divisibility based on volume of tailings produced was reasonable. *Id.* at 1120-21. As to the appropriate causation standard, the court applied the "contributing factor" test adopted by the Ninth Circuit; i.e., more than a de minimis amount, to an extent that at least some injury to natural resources would have resulted had each defendant's release occurred alone. *Id.* at 1124. The court found that each defendant's release was a contributing factor to contamination in the Coeur d'Alene River Basin.

Finally, the court addressed several issues pertaining to the United States government's liability as an operator and arranger. The defendants asserted that the United States was liable based on its involvement in Silver Valley mining operations during World War II, its use of tailings to construct Interstate 90 (I-90), its involvement in dredging activities, and its ownership of unpatented mining claims containing abandoned mines operated by defunct companies.

The court rejected the government's sovereign immunity claims, but concluded that while the government exercised some degree of involvement in mining operations during the war, including contracting for mine production and setting prices, the government did not manage, direct, or conduct operations specific to the release or disposal of hazardous substances to a sufficient extent to constitute operator or arranger status under CERCLA. While the court found the government liable as an arranger for use of tailings to construct the roadbed and embankments of I-90, and for BLM's dredging operations, the court rejected government liability for conditions caused by mining activities on unpatented claims.

One additional holding of interest to mining companies was the court's ruling that exploration activities raise arranger liability where such exploration generates mine tailings. This issue is likely more important in the allocation phase, particularly if such mine tailings are insignificant compared to tailings generated by another party's ore production activities.

The *Coeur d'Alene Tribe* case is important to the mining industry in that it addresses several issues the mining industry potentially faces pertaining to the impact under CERCLA of contamination caused by past mining practices that were standard at the time. However, while the district court resolved important issues of controversy and first impression in the Ninth Circuit, mining companies should be mindful that the Ninth Circuit will likely review these issues on appeal, following the damage quantification portion of the trial.

## **CONGRESS / FEDERAL AGENCIES -- GENERAL**

Laura Lindley, Reporter

### **BLM Implements *Utah v. Norton* Settlement Nationwide**

As described in an earlier issue of this *Newsletter*, Vol. XX, No. 2 (2003), the Department of the Interior and the State of Utah entered into an agreement in settlement of the litigation brought by the state against the Bureau of Land

Management's (BLM) re-inventory of roadless areas for possible wilderness study area (WSA) designation. On September 29, 2003, the BLM issued two instruction memoranda that extend the terms of that settlement agreement to all public lands except lands in Alaska and except lands that are already being managed as wilderness study areas.

Instruction Memorandum No. 2003-274 informs all BLM offices that the authority to conduct wilderness review under section 603(a) of the Federal Land Policy and Management Act, 43 U.S.C. § 1782(a), expired on October 21, 1993. Subsequent to that date, there is "no general legal authority for the BLM to designate lands as WSAs for management pursuant to the non-impairment standard" set forth in section 603. However, lands that may have been designated as a WSA after October 21, 1993, through the land management planning process will continue to be managed as a WSA until that management direction is changed in a new land use plan. The instruction memo provides that during the planning process, the BLM will still consider all available information to determine whether areas should be managed to protect "wilderness-like" resource values.

Instruction Memorandum No. 2003-275 describes how BLM may consider wilderness characteristics (defined as "features associated with the concept of wilderness") during the land use planning process. For example, wilderness characteristics of an area could be protected by establishing visual resource management objectives to preserve the natural appearance of the area, off-highway vehicle use could be limited or prohibited, or an area of critical environmental concern (ACEC) might be designated if the area having wilderness characteristics also satisfies the statutory requirements for ACEC designation. However, the non-impairment standard would not apply to any area managed for protection of its wilderness-like values.

## **CONGRESS / FEDERAL AGENCIES -- MINING**

Randall E. Hubbard, Reporter

### **Patent Moratorium and Claim and Maintenance Fees Extended**

On November 10, 2003, in Department of the Interior and Related Agencies Appropriations Act, 2004 (the Act), Congress extended existing requirements for paying mining claim location and maintenance fees through 2008. Pub. L. No. 108-108, 117 Stat. 1241, 1245. The fees payable to the BLM remain the same: \$25 per claim or site when locating a mining claim, millsite, or tunnel site; and \$100 per year claim maintenance fee (which also applies to millsites and tunnel sites). Small miners who meet certain qualifications (including the performance of assessment work) remain eligible for an exemption from payment of the claim maintenance fees. 30 U.S.C. § 28f. In sections 307(a) and (b) of the Act, Congress extended through September 30, 2004, the moratorium on processing patent applications, other than those originally grandfathered in 1994.

### **Deputy Solicitor Issues New Millsite Opinion**

On October 7, 2003, Roderick Watson, the Deputy Solicitor of the Department of Interior, issued a Memorandum Opinion, M-37010, "Mill Site Location and Patenting under the 1872 Mining Law." That Opinion (the 2003 Opinion) overturns a 1997 Solicitor's Opinion, M-36988, "Limitations on Patenting Millsites under the Mining Law of 1872," issued by former Solicitor John Leshy (the 1997 Opinion). The 1997 Opinion concluded that the 1872 Mining Law limited to five acres the amount of land that could be claimed for millsites associated with a particular mining claim. According to the 1997 Opinion, the Department of the Interior should reject patent applications that exceeded five acres of millsites per associated mining claim, and should disapprove plans of operations that employed more millsite acreage than five acres per associated claim, unless the use of additional lands was obtained through other means. The 2003 Opinion concludes that

the mill site provision [of the 1872 Mining Law] does not categorically limit the number of mill sites that may be located and patented to one for each mining claim, and that the Department's traditional practice of not applying such a numerical limitation is in conformity with the requirements of the Mining Law. Accordingly, we conclude that the 1997 Opinion in reaching the opposite conclusion does not properly interpret the mill site provision and improperly departs from the Department's traditional practice and interpretation.

2003 Opinion, at 23. Deputy Solicitor Watson reached his conclusion based upon an analysis of the express language of the 1872 Mining Law, administrative and judicial decisions interpreting the Mining Law, the congressional purpose in enacting the Mining Law, and the Department's "prevalent administrative practice and interpretation [that] has been in accordance with the view that the five-acre mill site provision does not impose a numerical limitation on mill sites." *Id.* at 3. The 2003 Opinion concluded that "the Department should continue with

its traditional practice [with respect to patent applications and plans of operation including millsites] as described in this opinion and as reflected in BLM's written guidance prior to the 1997 Opinion." *Id.* at 41. Secretary of the Interior Gale Norton concurred in the 2003 Opinion.

### **Final Rules Issued on Mining Claim Location, Recordation, and Maintenance**

On October 24, 2003, the Bureau of Land Management (BLM) issued final rules for mining claim location, recordation, and maintenance. 68 Fed. Reg. 61,046 (2003). The new rules become effective on November 24, 2003. The rules were first proposed on August 27, 1999. 64 Fed. Reg. 47,023 (1999). Among the significant provisions of the final rules are the following:

- (1) The proposed rules would have incorporated the 1997 Opinion limitations on millsites. The final rules do not include those limitations on millsites, relying extensively on the conclusions set forth in the 2003 Opinion. The final rules require, however, that mining claimants limit their millsite acreage to that which is necessary for "efficient and reasonably compact mining or milling operations." 68 Fed. Reg. at 61,070-71 (to be codified at 43 C.F.R. § 3832.32).
- (2) The proposed rules would have required that a mining claimant discover a valuable mineral deposit before locating a mining claim or millsite. In line with existing case law, the final rules have removed discovery as an element of locating mining claims. 68 Fed. Reg. at 61,069 (to be codified at 43 C.F.R. § 3832.1).
- (3) The final rules require that the description of a lode claim in a certificate of location be given in metes and bounds. 68 Fed. Reg. at 61,069 (to be codified at 43 C.F.R. § 3832.12).
- (4) The proposed rules would have provided that a mining claimant who located a claim whose size was more than 10% above the maximum allowed by law would forfeit the entire claim. The final rule removes this provision. Instead, if a claim is oversized, the BLM will issue a decision allowing the claimant 30 days to file an amended location certificate. 68 Fed. Reg. at 61,071 (to be codified at 43 C.F.R. § 3832.91).
- (5) The final rules preclude the use of an amendment to enlarge an existing mining claim or site. 68 Fed. Reg. at 61,072 (to be codified at 43 C.F.R. § 3832.21).
- (6) The proposed rules would have authorized the BLM to void an amended mining claim if the claimant failed to file the amendment with the BLM within 90 days after recording the amendment in the local recording office. The final rules remove this provision and restore the old regulations, which provide simply that the BLM will not recognize changes in a claim until they are properly filed with the BLM. 68 Fed. Reg. at 61,072 (to be codified at 43 C.F.R. § 3833.22).
- (7) The new regulations attempt to clarify existing regulatory provisions concerning when defects in location or annual maintenance requirements will result in a forfeiture of a mining claim and when such defects can be corrected. 68 Fed. Reg. at 61,067 (to be codified at 43 C.F.R. §§ 3830.90-.97).

### **ALASKA --MINING**

J.P. Tangen, Reporter

### **State Eliminates Statute of Limitations in Actions to Recover Real Property**

Without significant fanfare the Alaska state legislature eliminated the state's statute of limitations regarding actions to recover real property. Previously, the statute barred actions to recover real property unless the plaintiff, an ancestor, a predecessor, or the grantor of the plaintiff was seized or possessed of the premises in question within 10 years before the commencement of the action. Alaska Stat. § 09.10.030. As amended, an action may be brought *at any time* by a person who was seized or possessed of the real property in question at some time before the commencement of the action or whose grantor or predecessor was seized or possessed of the real property in question at some time before commencement of the action, and whose ownership interest in the real property is properly recorded, in order to (1) quiet title to that real property, or (2) eject a person from that real property.

This modification of the statute was inspired by a 1990 Alaska Supreme Court decision that held that the use of a portion of a rural parcel for subsistence and recreational activities was sufficient to establish continuous, notorious,

and exclusive possession. *Nome 2000 v. Fagerstrom*, 799 P.2d 304 (Alaska 1990). In that case, the defendants had used the land on weekends during the summer beginning in about 1974. In 1978, they had built a cabin on the disputed parcel, which was in place when the lawsuit was filed in 1987. The court found that the use of the property by the defendants prior to 1977 was sufficient to justify a jury finding that the exclusivity element of adverse possession was satisfied.

### **Alaska Enters into Memorandum of Understanding with Bureau of Land Management Concerning Access to State Bond Pool**

On August 8, 2003, the Director of the Alaska State Office of the Bureau of Land Management and the Commissioner of the Alaska Department of Natural Resources executed a cooperative agreement intended to meet the financial guarantee requirements of 43 C.F.R. §§ 3809.570 and 3809.571 by taking advantage of the Alaska Statewide Bonding Pool when conducting mining operations on federal land.

Under the Alaska Statewide Bonding Pool, qualified applicants are required to post \$150 per acre of ground to be disturbed pursuant to an approved plan of operations. Of that sum, \$112.50 is refundable upon the successful completion of the operator's reclamation obligation. The balance of the fee is retained by the fund. The restrictions on access to the fund include a prohibition on the use of cyanide or other chemical leachate and a restriction on the size of the operation. For operations disturbing in excess of 40 acres, the operator must establish to the satisfaction of the Alaska Division of Mining, Land and Water that the reclamation liability will not exceed one-third of the unrestricted assets of the bonding pool at the time of the application. The bonding pool will be administered by the State of Alaska, and BLM reserves the discretion to decline operators access to the pool on a case-by-case basis.

### **CALIFORNIA -- MINING**

M. William Tilden & Penelope Alexander-Kelley, Reporters

### **State Mining and Geology Board Adopts Revised Language Concerning Release of Financial Assurances at Completion of Mine Reclamation**

On October 30, 2003, the State Mining and Geology Board approved revised regulatory language adding a new section to the agency's regulations: "Affecting the Modification or Release of Financial Assurance Instruments at the Completion of Mine Site Reclamation." The changes considered at the October meeting were previously introduced at the Board's September meeting. The approval of the revised language triggers a 15-day comment period.

According to the report of the Executive Director to the Board, the revised language "clarified" provisions of existing regulations concerning the establishment and approval of financial assurances required under the State's Surface Mining and Reclamation Act of 1975 (SMARA), Cal. Pub. Res. Code §§ 2170-2797. Under existing law and regulations, the amount of a financial assurance is set based on the requirements of an approved reclamation plan for a particular surface mine, and is subject to annual revision. The financial assurance is submitted by the miner to the local lead agency, (city or county, usually) and then the lead agency is required to forward it on to the Director of the Department of Conservation (DOC). The DOC has 45 days to review and provide comments to the lead agency. The financial assurance is issued for the benefit of the lead agency and the DOC, both of whom are named beneficiaries. Further, the existing regulations provide that the financial assurance is released after reclamation is completed in accordance with the approved plan.

The Board determined that such a release is actually a modification of the financial assurance, subject to review and comment by the DOC. The Board reasoned that this review authority must allow the DOC to review the final mine inspection report upon which a finding of complete reclamation is made by the lead agency, and that the 45-day review period includes the ability of the DOC to inspect the mine and make a separate determination whether the reclamation plan requirements have been fulfilled. Finally, the Board determined that under this existing authority, it "may" notify the miner and the lead agency of its findings and any deficiencies it has identified. In this case, where deficiencies exist, the lead agency could not release the financial assurance "since the mine site was not fully reclaimed in compliance with SMARA." Thus, to clarify the existing regulations and authority of the DOC, the Board approved language to amend Cal. Pub. Res. Code § 3805.5 to delete a provision stating that upon a finding of such deficiencies, "the financial assurance shall not be released until the violation is corrected." In place of this provision allowing for a cure of the deficiencies, the Board added a new provision that in such case the DOC can commence with the process to forfeit the financial assurance mechanism for the mine operation, under Cal. Pub. Res. Code § 2773.1(d). Further hearing after the 15-day comment period is required.

## **"Disorganized" Administrative Record Justifies Reversal of Land Use Decision Approving Conditional Use Permit for a Mine**

In *Protect Our Water v. County of Merced*, 110 Cal. App. 4th 362 (2003), opponents of a mining project: Protect Our Water, San Joaquin Raptor Rescue Center, and the Merced River Valley Association (collectively POW), filed a petition for writ of mandate to challenge the approval by the County of Merced of a "massive project involving the mining of 15 million tons of aggregate reserves on 456 acres near the Merced River" by Calaveras Materials Incorporated (CMI). POW claimed a number of violations of the California Environmental Quality Act (CEQA). The trial court denied the petition, but the Court of Appeal, Fifth District, reversed. The court found that the county's approval must be reversed because the administrative record was so poorly organized that the court could not determine whether the county had complied with the law.

The administrative record included 14 binder-sized volumes. The court described the record as reading as if "its preparers randomly pulled out documents and threw them into binders, failing to organize them either chronologically or by subject matter. Key findings required under CEQA are impossible to find -- let alone sufficient to enable us to determine whether they are supported by substantial evidence." 110 Cal. App. 4th at 365. The court admonished future parties not to ignore procedural requirements or they would risk reversal, and be "forced to start over at great public and personal expense." *Id.*

It bears noting that the court of appeal reversed the trial court even though POW prepared the administrative record filed with the court in the case. And while POW was faulted for the poor organization and indexing of the record this did not excuse the county's failure to prepare an adequate record. The court found, for example, that the documents generated by the county were inadequate for review because it was "impossible to identify many of the documents as the County has failed to properly label them, and some documents appear incomplete." *Id.* at 373. It was also impossible to determine from the record what findings the county had made and whether the county had finally resolved project-related decisions and certified the CEQA document. Ultimately, the county bears the responsibility for preparing adequate CEQA documents and disclosing to the public the reasons for a project's approval if the project has significant environmental effects, and having failed to meet that responsibility, the decision approving the mine had to be reversed.

## **Update on State Limits on Surface Mining Operations**

In Vol. XX, No.2 (2003) of this *Newsletter*, we reported on two pending bills that would have impacted surface mining operations in the state. Senate Bill 218 (Sher) would have terminated the mineral classification authority of the State Mining and Geology Board, thereby effectively ending the state's long-time program of identifying mineralized areas in the state to assist with long-term local urban planning and prevent land use designations that lead to the loss of valuable minerals. Senate Bill 649 (Kuehl) was proposed to raise mining fees to fund a new abandoned mine program with a fee of \$5.00 per ounce of gold produced and \$0.10 per ounce of silver. Both bills are now inactive.

## **COLORADO -- OIL & GAS**

Sheryl L. Howe, Reporter

### **Part of COGCC Rule 303(a) Set Aside**

*Board of County Commissioners v. Colorado Oil & Gas Conservation Commission*, No. 02CA1879, 2003 WL 22208407 (Colo. Ct. App. Sept. 25, 2003), *petition for reh'g filed* Oct. 24, 2003, involves an amendment to Rule 303(a) promulgated by the Colorado Oil and Gas Conservation Commission (COGCC). The amended rule states regarding permits to drill for oil and gas: "The permit-to-drill shall be binding with respect to any conflicting local governmental permit or land use approval process." Plaintiffs argued the amended rule was invalid on its face. The trial court dismissed the plaintiffs' action for declaratory judgment, finding that the plaintiffs did not have standing. The court of appeals found that the plaintiffs did have standing and went on to address the substantive issue.

The court cited *Board of County Commissioners v. Bowen/Edwards Associates, Inc.*, 830 P.2d 1045 (Colo. 1992) and other Colorado cases on the preemption issue. Under these cases, local regulation is preempted if the operational effect of the local regulation conflicts with the state law or regulation. The court notes that *Bowen/Edwards* found that operational conflict arises when the effectuation of a local interest would materially impede or destroy the state interest. The court of appeals in the current case found that the words "any conflicting" in the COGCC rule have much broader meaning than "operationally conflicting" as discussed in *Bowen/Edwards* and other Colorado authority. 2003 WL 22208407, at \*5. The court found the word "any" means "all" and that, on its face, amended Rule 303(a) would preempt local government actions beyond those that materially impede or destroy

the state interest. The court stated that the COGCC rule could result in eroding the delicate balance between local interests and state interests set forth by *Bowen/Edwards*. *Id.* Therefore, the court set aside the amended portion of the rule.

### **Covenant of Reasonable Development Was Not Breached When It Was Not Economically Prudent to Develop the Oil and Gas Reserves**

In *Whitham Farms, LLC v. City of Longmont*, No. 02CA1160, 2003 WL 21939945 (Colo. Ct. App. Aug. 14, 2003), *petition for cert. filed*, Oct. 6, 2003, the Colorado Court of Appeals affirmed the Weld County District Court's decision that the covenant of reasonable development had not been breached by the oil and gas lessee. The case related to three oil and gas leases covering 310 acres of land. One well had been drilled in 1982 and the well had been recompleted as a producing well in 1997.

The parties stipulated as to the facts, apparently including that it was not economically prudent for the oil and gas lessee to develop the oil and gas reserves. The plaintiff argued the lessee had breached the covenant of reasonable development and that the leases should be terminated. The oil and gas lessee relied on the law providing that the covenant of reasonable development requires a lessee to develop known resources when it is profitable to do so.

The plaintiff argued that even if drilling additional wells was not economically viable, the leases should be cancelled because the lessee was holding the leases for speculation. The trial court found that the lessee acted reasonably in developing the lands as recently as 1997 and the lessee had not ruled out the possibility of further development should such development become profitable. The court of appeals stated that because the plaintiff had not presented any evidence that additional development of oil and gas could not be profitable within a reasonable time, the plaintiff did not prove that the lessee was speculating or that the lease should be cancelled on that basis. The portion of the case relating to the argument about speculation relied on a prior Colorado Court of Appeals case, *North York Land Associates v. Byron Oil Industries, Inc.*, 695 P.2d 1188 (Colo. Ct. App. 1984), where a division of the court of appeals had found that if there is very poor potential for profitable wells, the lessee must surrender the lease rather than hold it on the mere speculative and remote hope that economics might change in favor of profitable drilling.

The plaintiff in *Whitham Farms* asked the court to shift the burden of proof to the defendant when additional development had been shown not to be profitable. The court of appeals found that the plaintiff retained the burden of proof.

The plaintiff also argued that the court should apply the accommodation doctrine from *Gerrity Oil & Gas Corp. v. Magness*, 946 P.2d 913 (Colo. 1997) to require the oil and gas lessee to accommodate the surface owner's rights to the fullest extent possible. The court of appeals noted that the *Gerrity* case applied a "due regard" concept relating to surface owners. The court in *Whitham Farms* found that here the surface owner was suing as a mineral owner and lessor, which distinguished the accommodation doctrine and *Gerrity* from the current case involving the covenant of reasonable development.

### **Surface Owners' Complaint Dismissed Because Lessee Had Not Yet Filed an APD**

In *Burkett v. Amoco Production Co.*, No. 02CA1104, 2003 WL 21939832 (Colo. Ct. App. Aug. 14, 2003), *petition for cert. filed*, Oct. 6, 2003, the court of appeals upheld the trial court's dismissal of plaintiffs' complaint for declaratory judgment. The plaintiffs were seeking to have the court declare the parties' rights concerning additional wells Amoco might drill on the plaintiffs' lands. There had been preliminary discussions and some agreement between the parties concerning the locations for additional wells. Amoco had not submitted an application for permit to drill (APD) with the Colorado Oil and Gas Conservation Commission. Therefore, the specific site for the proposed wells and other facts related to the proposed wells were not yet known. The court referred to the "due regard" concept in *Gerrity Oil & Gas Corp. v. Magness*, 946 P.2d 913 (Colo. 1997), which requires the lessee to accommodate the surface owner to the fullest extent possible consistent with the lessee's right to use the surface for the reasonable development of the mineral estate. The court, however, found that the question of what is reasonable and necessary could not be resolved here because the site selection had not yet been made. There were extrinsic facts that were not yet determinable and therefore declaratory judgment was not appropriate.

### **State Tax on Producing Leaseholds is Based on Valuation at the Wellhead, Not the Tank Battery, and Deductions are Allowed**

*Petron Development Co. v. Washington County Board of Equalization*, No. 02CA1476, 2003 WL 22305635 (Colo. Ct. App. Oct. 9, 2003), relates to the real property tax on oil-producing leaseholds and lands, which are

assessed by county assessors. The Colorado Constitution, art. X, § 3(1)(b), includes a provision that "the valuation for assessment for ... lands or leaseholds producing oil or gas, as defined by law, shall be a portion of the actual annual or actual average annual production therefrom, based upon the value of the unprocessed material, according to procedures prescribed by law for different types of minerals." The county assessor, the Washington County Board of Equalization, and the Board of Assessment Appeals had all found that the selling price at the tank battery was the value to use to determine this tax. The court of appeals reversed these decisions and found the Colorado Constitution and the applicable Colorado statutes require valuation of "unprocessed material" and that meant the taxpayer could use the sale price at the tank battery, less gathering, transportation, manufacturing, and processing costs, to determine value for purposes of this tax.

The court described the wells as extracting an emulsion of oil, gas, water, and other impurities, which emulsion is then pumped through various pieces of equipment that inject chemicals to break down the emulsion, remove water, and separate or settle the contents; the court held that "injection of chemicals, breakdown of the emulsion, and removal of impurities and water subject the oil to a particular method, system, or technique of preparation, handling, or other treatment designed to prepare it for market, and enhance the oil's marketability by changing its physical characteristics. That activity constitutes 'processing.'" 2003 WL 22305635, at \*4. The county's assertion that the wellhead is at the tank battery was rejected by the court, because it ignores the constitutional provision requiring the value of the oil to be based on the value of unprocessed material.

### **La Plata District Court Rules Gathering, Treating, and Compression Costs Are Not Deductible for Royalty Calculations**

The District Court, La Plata County, Colorado, in *Parry v. Amoco Production Co.*, No. 94CV105 (D. Ct., La Plata Co., Colo., Oct. 6, 2003), issued an order on marketability and reasonableness of costs. This case is still pending and the question of damages was bifurcated for subsequent determination. The issues of marketability and reasonable costs were tried to the court and the court's order is a 41-page decision that reviews the history of the San Juan Basin, Amoco's development in the basin, changes in the regulation of gas prices and transmission pipelines, and the market for Amoco's gas in the basin. The court discusses the rules in *Garman v. Conoco, Inc.*, 886 P.2d 652 (Colo. 1994) and *Rogers v. Westerman Farm Co.*, 29 P.3d 887 (Colo. 2001). The case involved both conventional gas and coal seam gas. The court found that Amoco's gathering, treating and compression costs, up to the sale of the gas at an interstate pipeline, could not be deducted in royalty calculations where the leases were silent, including leases containing "at the well" or "at the mouth of the well" language but containing no other language allocating post-production costs.

The court quoted extensively from *Rogers*. The order emphasizes that marketability is a question of fact. Therefore, the court's decision regarding gathering, treating, and compression costs in this case does not mean that such costs are always nondeductible. The court notes that similar costs may be deductible in some circumstances and not in others. In applying the law to the facts, the court found that the 90% of the gas that Amoco sold to its marketing affiliate was not sold in arm's-length sales and further found that the other 10% of gas sold to others did not show there was a market at the wellhead for various reasons, including that the gas was not sold or because the sales were minimal and most gas was delivered to transmission pipelines.

The court addressed the reasonableness of certain costs and found it was reasonable to use a uniform charge per unit of gas on a certain system, rather than looking at the costs associated with a particular well depending on its location or the quality of gas produced from that well. The court also entered an order on the effect of division orders, in which the court found that provisions in a division order could not change the lease and could not be used to supply specific cost allocations as to those leases which were silent as to allocation of costs. As noted above, this is a district court decision and the case is still pending, so the decision is not legal precedent.

## **MISSISSIPPI -- OIL & GAS**

W. Eric West, Reporter

### **Old Real Estate Law Applied to Modern Joint Operating Agreements and Gas Marketing**

*Wilkinson v. Transco Exploration, Inc.*, No. 3:99-CV-204WS and *Stack v. AmSouth Bank*, No. 3:99-CV-836WS (Sept. 30, 2003) combined for trial in the U.S. District Court for the Southern District of Mississippi, Jackson Division, involved split stream gas sales, gas balancing, joint operating agreements, gas balancing agreements, gas purchase agreements, "over-produced" parties, "under-produced" parties, cessation of production so there could be no balancing in-kind, and an insolvent operator so there could be no cash balancing. Although the litigation began

with more than 100 parties in 1984, at its conclusion in 2003 the only parties remaining were J.E. Stack, Jr., who claimed to be under-produced, and Albert and Burgess Thomasson, who Stack claimed were over-produced.

This reporter was advised that this decision will eventually appear in the West Reporter System (Federal Supplement). The decision is mentioned now in order to alert the reader to its existence and to the application by the court of basic real estate law to modern joint operating agreements and gas marketing techniques.

The court held the Thomassons were not liable on the theory of conversion because Stack had executed gas balancing agreements, as an exhibit to the joint operating agreements, under which he agreed that any gas sold in excess of a party's proportional interest would belong to the selling party so that the title of the purchaser would be secure. As a result the Thomassons did nothing wrong by the sale. The court held the fact that the Thomassons' authorized sales representative, Tomlinson Interests, Inc., failed to properly account for over production did not constitute conversion as the over-produced gas "belonged" to the Thomassons under the gas balancing agreements. The court held the Thomassons liable on the theory of agency because Tomlinson Interests, Inc., as their designated sales representative, was their agent and they were liable for the agent's failure to properly account for over production.

In a footnote, the court said the owners in the wells were co-tenants and subject to a joint operating agreement so that under the law of co-tenancy, a producing co-tenant is liable to a non-producing co-tenant for its share of proceeds. In another footnote, the court said the gas balancing agreement, by providing that gas sold by an operator for a producing party "belonged" to the over-produced party, allowed for a partition of the hydrocarbons.

## **NEW MEXICO -- OIL & GAS**

John S. Nelson, Reporter

### **Cessation of Production; Shut in Royalty Provision; Force Majeure Provision**

In *Maralex Resources, Inc. v. Gilbreath*, 76 P.3d 626 (N.M. 2003), the New Mexico Supreme Court considered the interplay between the habendum, cessation of production, shut-in royalty, and force majeure provisions in an oil and gas lease. The lease had been held in effect beyond its primary term by production from a gas well. The well ceased producing because the pressure in the well decreased to the point that it was insufficient to flow into the pipeline of the gas purchaser. Steps were taken to restore production, and production was in fact eventually restored. Unfortunately for the lessee, however, its efforts turned out to be too late, and the court held that the lease terminated.

In the earlier case of *Greer v. Salmon*, 82 N.M. 245, 479 P.2d 294 (1970), the court held that a temporary cessation of production is defined by a provision in an oil and gas lease that allows the lessee a prescribed period of time within which to take steps to restore production if production ceases after the expiration of the primary term. Any cessation which continues for longer than the prescribed period without the commencement of steps to restore production is not temporary, and results in termination of the lease under its habendum clause. In *Maralex*, the lease contained such a provision, and the lessee did not take steps to restore production within the prescribed period (although more will be said on this point below). As a result, the lease terminated unless it was saved by another of its savings provisions.

One of such provisions relied on by the lessee was the shut-in royalty provision. The court held that the terms of the shut-in royalty provision required that the shut-in well be capable of producing gas. Because the well was unable to produce into the purchaser's pipeline, however, it was not capable of producing. Therefore, the requirements of the shut-in royalty provision were not satisfied, and the lessee did not have the option of saving the lease by paying shut-in royalty.

The lessee also relied on the force majeure provision in the lease, arguing that the decrease in pressure in the well was beyond the lessee's control, and was therefore an event of force majeure that prevented the lease from terminating. The court held that because this was a problem with the well itself, and was not the result of some external event beyond the lessee's control (such as a sudden pressure increase in the purchaser's pipeline), this was not an event of force majeure.

One final point relates to the holding of the court that the lessee did not commence steps to restore production from the well within the time allowed by the cessation of production provision. The first thing the lessee did after discovering that the pressure in the well had dropped was to turn the well off to see if the pressure would build up to a point that gas would once again flow into the purchaser's pipeline. Although this step was unsuccessful in restoring production, it was taken within the time limit allowed by the cessation of production provision. In addition, under the wording of the provision, it was not entirely clear that there was in fact a time limit on the commencement of steps to restore production. The lessee attempted to argue these points on appeal. Unfortunately for the lessee, however, they

had not been argued to the trial court. Therefore, they were not preserved for appeal, and the supreme court refused to consider them. It is certainly not clear that these arguments would have prevailed in the trial court or on appeal. This is another reminder, however, that great care must be taken in presenting the case to the trial court, as one never knows what might end up saving the day.

## **TEXAS -- OIL & GAS**

William B. Burford, Reporter

### **Adverse Possession Saves Lease after Cessation of Production**

In a long-awaited decision, the Texas Supreme Court held in *Natural Gas Pipeline Co. v. Pool*, 46 Tex. Sup. Ct. J. 1077, Nos. 01-0057 & 01-0058, 2003 WL 22038662 (Aug. 28, 2003), that an oil and gas lessee may, by continuous production for the statutory period, acquire title to the leasehold estate in the producing tract while claiming under a lease that has in fact previously expired on cessation of production.

The decision arose from the appeals of two cases from the Amarillo court of appeals that share a common fact pattern with numerous others still pending in Texas Panhandle trial courts. The two cases decided here involved an oil and gas lease executed in 1926 and natural gas leases executed in 1936 and 1937. Each lease would, by its terms, extend for a specified period and then so long as oil or gas, or natural gas in the case of the gas-only leases, was produced. The owners of the lessors' interests sued to quiet title and for damages, contending the leases had terminated due to cessation of production. On the lessors' presentation of Texas Railroad Commission records showing no production for various periods ranging from one to five months, the last such period occurring in 1984, the trial court granted partial summary judgments in both cases declaring that the leases had terminated. Following trial it awarded large damages against the defendant lessees.

The lessees had defended on the basis of, among other things, the temporary cessation doctrine. When a lease has no savings clause, as most modern leases do, to prevent its termination during a temporary cessation of production, this doctrine holds that the lease will nevertheless remain in effect if the cessation is due to a sudden stoppage of the well or some mechanical breakdown of equipment, or the like, and if production is restored within a reasonable time. Unable after the passage of many years to produce evidence, the defendants could not meet their burden to show reasons for the production gaps or efforts to restore production within a reasonable time.

The supreme court did not reach the applicability of the temporary cessation doctrine, seizing instead on the defendants' argument that adverse possession barred the suits. On the uncontroverted evidence that the lessees had continued to produce and sell all the oil and gas produced from the land, paying the lessors only a relatively small royalty, for a period of more than 10 years after the leases had allegedly terminated, and had drilled new wells during that time as well, the court held that the lessees acquired by adverse possession fee simple determinable mineral estates identical to the oil and gas leasehold estates defined by the original leases.

The court began its somewhat confusing exposition by noting that adverse possession is an actual and visible appropriation of real property, commenced and continued under a claim of right that is inconsistent with and hostile to the claim of another person. Moreover, a lessee's position after a lease expires is analogous to that of one holding over after the execution of a deed or after a judgment vesting title in another is entered. Such a person, as a general rule, is a permissive tenant whose possession cannot be considered adverse until the tenancy has been repudiated and notice of the repudiation has been brought home to the titleholder. Actual notice of repudiation is not required, however. Notice can be inferred from a showing that the adverse occupancy has been long continued, open, notorious, exclusive, and inconsistent with the existence of title in others.

In the case of an oil and gas lessee's holding over, it appears from the opinion, such constructive notice of the adverse possessor's claim does not depend on the "long-continued" character of possession prior to the beginning of the statutory period, as possession by a surface occupant might. A tenant of the surface who holds over and does nothing more than continue to occupy the premises as before, paying rent as before, is not in the same position as an oil and gas lessee who holds over. An oil and gas lessee who holds over continues to physically remove and dispose of valuable, non-renewable minerals for its own account. Such actions are by their nature hostile to the lessor's ownership of all the minerals in place once the lease expires.

Once the leases terminated, if they did so, the character of the lessors' and lessees' respective real property interests reversed dramatically and instantaneously, so that the lessees had no right to produce any minerals. As a matter of law the lessors were put on notice that the lessees' claims were hostile to the claim that the leases had terminated when the lessees continued to operate the leases, produce oil or gas, sell it, and pay only a royalty to the lessors. The lessees were not required to give actual or constructive notice that they were no longer claiming an

interest under the leases but only that they were claiming an interest that was inconsistent with the lessors' title to all the minerals after the leases expired.

The court's opinion, it emphasized, should not be read as awarding fee simple absolute interests to the lessees. They acquired the same interests that they adversely possessed, the oil and gas leasehold estates defined by the original leases. Those interests, the court said, are fee simple determinable interests in the respective properties on the same terms and conditions as the original leases, and the terms that made the original leases determinable continue to apply to the interests acquired by adverse possession.

The court did not say, and appears to have been careful not to, that the original leases were revived, although that may be the practical effect. If the leases were not revived, have all of the leases' contractual terms survived as part of the lessees' new leasehold? Does the adverse possession inure to all areas and depths covered by the original lease, whether or not owned by the adversely possessing lease owners? These and other issues may be expected to receive the courts' attention after *Pool*.

### **Nonconsent Penalty Not Triggered Unless 30 Days Elapse Between Proposal and Commencement**

The court in *Dorsett v. Valence Operating Co.*, 111 S.W.3d 224 (Tex. App.--Texarkana 2003, pet. filed), reached a surprising conclusion in construing the provisions of a 1977 AAPL Form 610 operating agreement for drilling proposals and non-consent elections. A party who fails to respond to a proposal for the drilling of a well will not become subject to the agreement's nonconsent penalty, the court held, where the operator commenced the proposed operation before the end of the 30-day period allowed for response.

Dorsett owned 4.05391% of the working interest and Valence, the operator, 94.28446% under the operating agreement for the Mobley No. 1 Gas Unit. Valence sequentially proposed the drilling of some eight wells by notice to Dorsett under Article VI.B.(1) of the agreement, which provided as follows:

The parties receiving such a notice shall have thirty (30) days after receipt of the notice within which to notify the parties wishing to do the work whether they elect to participate in the cost of the proposed operation.... Failure of a party receiving such notice to reply within the period above fixed shall constitute an election by the party not to participate in the cost of the proposed operation....

111 S.W.3d at 227. Under Article VI.B.(2), a party thus electing not to participate in drilling a well would relinquish its interest in the well until those participating in the well recouped, out of proceeds of production from the well, 300% of the cost of drilling the well and of any newly acquired equipment in the well, as well as 100% of the cost of newly acquired surface equipment and of operating the well during the recoupment period. In order for a party giving notice of a drilling proposal to be entitled to the benefits of the article, it provided, "the party or parties giving the notice and such other parties as shall elect to participate ... shall, within sixty (60) days after the expiration of the notice period of thirty (30) days ... , actually commence work on the proposed operation and complete it with due diligence...." *Id.* If less than all parties approved any proposed operation, Article VI.B.(2) further provided that the proposing party, immediately after the expiration of the applicable notice period, was to advise the parties consenting to the operation of the total interest of the participating parties, whereupon each consenting party would have the right either to limit its participation to its own share of the cost or elect to carry a portion of the nonparticipants' costs and receive a proportionate share of their interests in the well until recoupment of the nonconsent "penalty."

In no case did Valence allow 30 days to pass after its notice to Dorsett before commencing work. In all cases but one, in fact, Valence had already commenced the operation before proposing the well. After holding that "commencement" of drilling did not require that the well be spud and that preliminary work such as site preparation was sufficient, the court addressed the effect of the operator's commencement prior to the end of the 30-day response period.

The election period serves as an "accounting device," the court observed, lending certainty and providing information to the operator and the parties who choose to bear the costs. The arrangement ensures that the parties will have current geographical and financial information regarding the proposed operation and allows them to reconsider their positions and make their decisions and financial arrangements accordingly. In order to fully develop this relationship, the court declared, the consenting parties must know who is participating and to what extent before the project begins. If the court were to adopt Valence's position that it merely was required to allow 30 days before considering Dorsett to have elected not to participate but was not prohibited from commencing operations in the meantime, it said, the consenting parties' second election would be meaningless, and their obligations would be uncertain. Further, Valence's construction could allow a party to assess an operation's progress before making a participation election. Surely, the court asserted, Valence did not intend to place itself at such a disadvantage by

giving nonoperators that power. Doing so would make poor business sense and undermine the very purpose behind a nonconsent penalty.

An operation, the court pointed out, would not be a "proposed" operation, according to the quoted wording of the operating agreement, if already commenced before the end of the notice period. Additionally, according to the court, Valence's interpretation of the agreement ignored its language providing that the operator must commence operations within 60 days of the *expiration* of the 30-day notice period. Clearly, the court declared, the parties intended work to begin within that time period, not before it. In order for the provisions concerning subsequent operations to be meaningful and cohesive, the parties must have intended that operations not commence before the expiration of the 30-day notice period.

Thus, the court found Valence's construction to be unreasonable as it would render meaningless other portions of the agreement, would allow one subsection to control, and would operate contrary to both the parties' objective intent and basic business principles. Therefore, it held, the nonconsent penalty was never triggered and was not enforceable against Dorsett.

The court's analysis of the purpose of these standard operating agreement provisions seems shallow and mechanistic, to say the least. It is difficult to see any disadvantage to a party receiving a drilling proposal in premature commencement of operations. Just the opposite is true, as there is likely to be more information about the cost of the operation, and perhaps its result, after it has begun. It is far from obvious as well that the consenting parties' election whether to proceed or to carry a portion of any nonconsenting interests is rendered meaningless, as the court asserts. On the contrary, no party would appear to be adversely affected by commencement prior to such election except those who have begun the drilling and are already committed to paying for it. The court's assertion that Valence surely did not intend to place itself at a disadvantage by allowing nonoperators to assess an operation's progress before making their election lends little support to its conclusion. Possibly that disadvantage is outweighed by the desire to proceed without delay or other exigencies, particularly when only a small interest is involved or the work being done while the notice is pending is not extensive. Does it make better business sense to suppose that Valence instead intended to carry Dorsett's interest without obtaining any benefit in the form of Dorsett's nonconsent penalty? If this decision stands, parties proposing wells under standard operating agreement forms will be faced with unnecessary delays and massive uncertainty.

### **Nonoperator's Release of Surface Rights Held Not a Repudiation of Operating Agreement**

The court in *El Paso Production Co. v. Valence Operating Co.*, 112 S.W.3d 616 (Tex. App.--Houston [1st Dist.] 2003, no pet. h.), was faced with an unusual dispute between Valence, the operator of a gas well under what appears to have been a typical 1977 AAPL Form 610 operating agreement, and Sonat Exploration Company, a nonoperating owner of a 17.58407% working interest.

Houston Lighting & Power Company (HL&P), the surface owner of the well location, desired to use the land for ash disposal and sought to acquire the mineral rights, presumably so that its use would not be interfered with by oil and gas development. In 1994 Sonat accepted an offer from HL&P and executed a release in which it quitclaimed to HL&P any right to use the surface for mineral exploration, development, and production and, "to the extent possible" under the operating agreement, assigned HL&P the right to cause or authorize the producing gas well to be plugged and abandoned at any time on or after December 31, 1995. The instrument did not convey any interest in the minerals, however, and specifically reserved the right to develop by pooling, unitization, or directional drilling.

By letter dated August 12, 1996, Valence notified Sonat that it planned to conduct a workover of the well but that it considered Sonat, as a result of its execution of the HL&P release, no longer to own an interest in the well. Valence thereafter treated Sonat as having relinquished its interest in production from the well, and Sonat sued Valence for breach of contract and conversion, among other causes. Sonat appealed a judgment based on jury findings that Valence had breached the operating agreement but that Sonat had repudiated the agreement and thereby waived its right to enforce it. The court of appeals reversed.

To have repudiated a contract, the court noted, a party must have absolutely and unconditionally refused to perform without just excuse. It did not agree with Valence that Sonat's release had given up all the right Sonat had to authorize Valence to rework the well and had made it impossible for Sonat to legally discharge its obligations to contribute to development and production. Sonat's assignment of the right to plug and abandon the well, the court observed, was only made to the extent possible under the operating agreement, and Sonat had not conveyed any interest in the minerals. The release did not in any way interfere with Valence's activities as operator and was no evidence that Sonat had positively and unconditionally refused to perform its obligations. The release likewise was not a waiver of Sonat's right to demand Valence's compliance with the agreement. It quitclaimed rights to the surface but did not give up any right to oil and gas production.

Valence contended that Sonat was subject to the operating agreement's 400% nonconsent penalty, even though it had not been given notice of the proposed operation, because Sonat was contractually precluded from giving effective consent. Even if Valence were correct that Sonat could not effectively consent, said the court, its failure to consent could not result in imposition of the contractual penalties because the obligation to timely elect whether to consent is triggered only by the required notice of the proposed operation. Because Valence did not give the notice, Sonat could not be subjected to the penalty. Valence finally argued that it should not be held liable in damages because Sonat's remedy was to recoup its lost gas production under the provisions of the operating agreement's gas balancing agreement. The court disagreed, holding that the gas balancing agreement did not purport to provide a remedy for breach of contract but only to provide a method of balancing the gas account where a party failed to take its share. Here Sonat had not failed to take its share but had instead been prevented from doing so.

### **Sale of Gathering System Did Not Excuse Commitment to Deliver Gas**

*Natural Gas Clearinghouse v. Midgard Energy Co.*, 113 S.W.3d 400 (Tex. App.--Amarillo 2003, pet. filed), decided the appeal of a trial court judgment awarding damages for the seller's breach of a gas purchase contract between Natural Gas Clearinghouse (NGC), the owner of a gas gathering system, and Midgard, formerly Maxus Exploration Co., the owner of a gas processing plant. In the contract NGC agreed to deliver and sell to Maxus, at a minimum, all volumes of gas produced into two particular laterals for a term of five years. NGC sold its gathering system and stopped all deliveries well before the end of the term.

NGC argued on appeal that the proper construction of the contract was that it was obligated to deliver its gas transported through the two laterals only so long as it owned or controlled the gas. The court disagreed. NGC, the court said, represented that it owned the gathering system, controlled a certain quantity of gas transported through it that was available for processing, and promised to provide it to Maxus for five years. Nothing in the contract, it went on, expressly conditioned NGC's performance on its continued ownership of the gathering system, and the court refused to read such a condition into it. The situation was no different, in the court's view, from that in which Farmer X agrees to deliver Buyer Y 1000 bushels of wheat. Farmer X cannot deliver the bushels to Z and then profess immunity from Y's suit because he no longer had the wheat to deliver.

The court distinguished *Northern Natural Gas Co. v. Conoco, Inc.*, 986 S.W.2d 603 (Tex. 1998), on which NGC sought to rely, on the basis of the specific language of the gas contract at issue there. In *Northern* the seller had agreed to deliver all gas available under its gas purchase contracts *in effect from time to time*. The seller had bought out of its obligations under the gas purchase contracts so that there were no longer any in effect. The duty to provide gas was thus in *Northern* expressly contingent on there being gas contracts in effect from time to time and imposed no duty on the seller to deliver nonexistent gas under nonexistent contracts nor to contract to buy gas from the producers.

### **Fear and Apprehension of Injury Will Not Support Nuisance Claim Against Operator**

*Union Pacific Resources Co. v. Cooper*, 109 S.W.3d 557 (Tex. App.--Tyler 2003, pet. denied), decided the appeal of an \$85,000 judgment for the Coopers, oil and gas lessors and homeowners whose house was some 700 feet from the drillsite of Union Pacific Resources Company's (UPRC) Whitetip Well No. 1. Because poisonous hydrogen sulphide gas (sour gas) was common in the area, UPRC developed an evacuation plan for an area that included the Coopers' house. A contractor engaged by UPRC visited the Coopers to explain the possible need for evacuation and how it would be effected, and a UPRC landman followed up with additional meetings with them. It became apparent to the landman that the Coopers were anxious to leave their home while the well was being drilled. Their fears were apparently based on remarks by Mrs. Cooper's brother, a retired Dallas fireman, that if they smelled rotten eggs, it was sour gas and they would be sure to die. UPRC paid some expenses for the Coopers to move temporarily and agreed to pay others. When the UPRC landman attempted to pay, however, he was refused and told that the Coopers had filed suit. The suit resulted in the trial court's award of damages on the Coopers' nuisance claim after a jury trial.

UPRC argued that the Coopers' nuisance claim was unsupportable because it was based solely on fear and apprehension, and the court of appeals agreed. A nuisance can occur, the court noted, by emotional harm to a person from the deprivation of the enjoyment of his or her property, such as fear, apprehension, offense, or loss of peace of mind. Following *Maranatha Temple, Inc. v. Enterprise Products Co.*, 893 S.W.2d 92 (Tex. App.--Houston [1st Dist.] 1994, writ denied), however, the court held that where there is no physical injury, issues of public policy dictate that a nuisance cause of action cannot be based on fear, apprehension, or other emotional reactions that result from the lawful operation of industries. Allowing a cause of action to persons who have not been harmed in their land or body by the lawful operation of an industry, but who are afraid they one day will be, could open the courts to a potential torrent of litigation. Fear of the unknown, the court observed, is not a nuisance. Since no sour gas was

ever encountered in the well, much less at the Coopers' house, they had shown no physical harm and thus had presented no evidence to establish a viable nuisance claim.

### **Receivership Lessee Not Entitled to Past Proceeds**

Tex. Civ. Prac. & Rem. Code Ann. § 64.091 provides a procedure under which the interests of "lost" mineral owners may be leased by a court-appointed receiver. In *Amoco Production Co. v. Wood*, 113 S.W.3d 462 (Tex. App.--Texarkana 2003, no pet. h.), the court construed the statute in somewhat unusual circumstances.

In 1954 La Gloria Company and Stanolind Oil & Gas Company formed the Neal C. Richardson 640-acre gas unit and drilled a gas well. A 23.145-acre mineral interest in the unit area, not under the drillsite tract, was owned by John Dewese. The Dewese interest was not committed to the Richardson unit. The operating agreement for the unit contained an unusual provision that if there were uncommitted interests in the unit, La Gloria and Stanolind would each pay half the costs attributable to them and maintain a "carried interest account." The carried interest account would be held for the uncommitted owner if he or she ever joined the unit until the operating agreement terminated. The unit well had produced continuously until the time of suit, and the operating agreement remained in effect.

In 1999 Wood, the owner of a mineral interest in the unit, procured the appointment of the Harrison County Clerk as receiver for the Dewese mineral interest and acquired an oil and gas lease from the receiver. The lease, as amended, was purportedly effective March 1, 1955, apparently the date of first production from the Richardson well, and it included pooling authority. Wood then ratified the unit declaration, retroactively to March 9, 1954, the date it was filed for record, and demanded the unit operator pay him the funds in the carried interest account, claiming his receivership lease entitled him to past production proceeds attributable to the Dewese interest. Vernon E. Faulconer, Inc., the operator, refused and, when Wood filed suit, joined Amoco Production Company and Exxon Mobil Corporation, previous owners who had maintained the account in the past. Faulconer settled with Wood, but Amoco and Exxon Mobil appealed the trial court's summary judgment ordering them to pay the Dewese carried interest account to Wood.

The court of appeals reversed. The statute authorizing receivership leases, it pointed out, does not authorize the receiver to convey any rights to personal property. Produced minerals become personal property once severed from the real estate at the wellhead. The earliest date Wood could have contributed the Dewese interest to the unit was the date of his lease in 1999, and he was not entitled to retroactive proceeds.

The court's decision seems manifestly correct, but its explanation is confusing in that it several times refers to "royalties" accruing to Wood, whereas it appears he claimed not royalties but working interest production under his lease. It also refers to his purported ratification of a prior "lease," although the ratification was presumably that of the 1954 pooling or of the unit operating agreement. Are these minor oversights or yet another example of a court's fundamental misunderstanding of basic oil and gas law?

### **Venue Held Mandatory in County Where Leases Alleged to Be Clouded Are Located**

In *re Stroud Oil Properties, Inc.*, 110 S.W.3d 18 (Tex. App.--Waco 2002, pet. filed), decided Stroud's appeal of an order transferring venue of its dispute with Predator Development Company, L.L.C. from Brazos County to Tarrant County. At issue was a joint development contract under which Predator would generate prospects in Brazos and surrounding counties for Stroud to drill. Stroud filed a breach of contract suit in Brazos County, alleging Predator had retained interests subject to the agreement greater than those to which it was entitled and that venue was mandatory there under Tex. Civ. Prac. & Rem. Code Ann. § 15.011, requiring actions to remove encumbrances from the title to real property or to quiet title to real property to be brought in the county in which all or part of the property is located. Predator responded with a motion to transfer venue, denying that Stroud's suit was to recover an interest in real property or to remove an encumbrance. Stroud amended its petition to request removal of the joint development contract as an encumbrance on its leases in Brazos and other counties, specifically including certain recently acquired Brazos County leases. Predator countered that Stroud had not owned the specific interests in Brazos County when it had filed suit, that Predator had asserted no claim to the interests and filed a disclaimer of any interest in them, and that the agreement in controversy did not apply to the interests in any event.

The court of appeals points out that, at a venue hearing, the court makes its determination from the live pleadings on file at the time of the hearing and that if one of multiple claims is subject to a mandatory venue provision, the mandatory venue provision controls. Moreover, the court determines the nature of the suit by looking to the rights asserted in the plaintiff's petition and the relief sought therein. The merits of the case need not be proven.

The joint development agreement required, upon termination of the agreement following a party's breach, that the defaulting party assign the non-defaulting party all of its interests in leases within any undrilled "Prospects,"

defining a prospect as "a location of sufficient size to accommodate a horizontal well in the Austin Chalk Formation." 110 S.W.3d at 27. The trial court must hear evidence, the court said, to determine whether Stroud's Brazos County leases were within an "undrilled prospect" and which party had breached the agreement. If Stroud were the defaulting party, it might be obligated to make an assignment to Predator. Thus, the agreement on its face was a cloud on Stroud's title to its leases, susceptible to Stroud's mandatory-venue action for removal of encumbrances. That Predator had filed a disclaimer made no difference. Venue is determined when the cause of action accrues. Stroud's cause of action accrued when it was assigned the Brazos County leases, and Predator's subsequent disclaimer was not pertinent. Likewise, Predator's failure to affirmatively assert a claim to Stroud's Brazos County leases would not defeat mandatory venue, as the agreement was a cloud on title whether or not recorded or asserted.

### **Grantee's Successors Estopped From Disputing Mineral Reservation in Earlier Deed**

*Earwood v. Smart*, 107 S.W.3d 1 (Tex. App.--San Antonio 2002, pet. denied), involved a dispute over a strip of land included in gas-producing pooled units. Patents had been issued by the State of Texas that allegedly were in conflict in that they purported to cover the same tract, and the dispute was between the successors to the interests of the conflicting patentees. One group of mineral owners claimed under R.C. Walker, the 1911 patentee of the specifically described strip of land, alleged to have been a vacancy between two earlier blocks of surveys. The Earwood family, on the other hand, claimed under patents issued on the basis of surveys made in 1880 and 1881, alleging that there was no vacancy and that their own patents instead covered the strip.

In 1911 Walker executed a deed to Earwood, predecessor to the interests of the present Earwood family, conveying the strip of land alleged to have been a vacancy and reserving all of the minerals. Regardless of whether or not a vacancy existed, the court held, the Earwood family was thus estopped from denying the Walker mineral ownership pursuant to the reservation in the 1911 deed. Thus, even if Walker owned no interest in the minerals, because there was no vacancy, prior to the deed, his mineral reservation in effect divested Earwood of any mineral ownership and vested it in Walker. This was true even with respect to a portion of the disputed strip in which Earwood apparently had not acquired any interest until after the 1911 deed.

This case holds, in effect, that mineral title, and even after-acquired title, can pass from a grantee to a grantor by virtue of a mineral reservation, at least if it can be shown that title to the tract was in dispute between the parties. One must be alert to situations in which a grantee who owns (or subsequently acquires) minerals in a tract is the grantee in a deed that contains a mineral reservation.

### **Pooling Held Valid under Lease Provisions**

In *HS Resources, Inc. v. Wingate*, 327 F.3d 432 (5th Cir. 2003), the court affirmed a summary judgment that pooling of an oil and gas lease by the lessee, HS, was authorized by its terms and that payment of royalty on a pooled basis was proper. The lease by Wingate, covering 728.02 acres, included a typical pooling provision except that it prohibited pooling for a gas well unless all of the leased premises were included in the pooled unit either for that well or for another well producing from the same formation. The lease further limited the size of gas pooled units for wells drilled to 10,000 feet or less to 160 acres plus a tolerance of 10%, or 176 acres, and included a provision specifically requiring the lessee during the primary term to either drill additional wells at no more than 180-day intervals, to release acreage not within a producing unit, or to pay delay rentals as to acreage outside such units.

A 9,925-foot gas well was completed, and HS and the other working interest owners filed a unit declaration creating a pooled unit of 176 acres, consisting mostly of tracts covered by the Wingate lease. The well began producing on April 24, 2000. On May 2, 2000, within the lease's primary term, after Wingate complained that the pooling violated the lease because it failed to incorporate all of the leased premises, the working interest owners released the lease as to all of the land that was not included in the pooled unit and filed a supplemental unit designation confirming the pooling. When Wingate continued to assert that the pooling was invalid and that his royalty should be paid on an unpooled basis, HS sued for and was granted a declaratory judgment to the contrary.

Wingate argued that the lease prohibited pooling unless the entire 728 acres were included in the pooled unit. This contradicted the provision limiting units for gas wells drilled to depths less than 10,000 feet to 176 acres, however. The two provisions could be harmonized only by reading the pooling provisions together with the provision allowing the lessee to release portions of the leased premises not within a pooled unit. Wingate's proposed reading of the lease was internally inconsistent, the court declared, at once recognizing that the lease allowed pooling but requiring any pooled unit to include all 728 acres of the leased land -- something expressly disallowed by other provisions.

Wingate's further argument that HS's pooling was in bad faith also was meritless as a matter of law. The release provision, the court observed, clearly required HS, after the discovery and production of gas, either to develop the lease or to release those portions outside producing units. HS had released the unpooled lands promptly, within less than two weeks after production had begun. Under these facts, said the court, its actions simply did not constitute bad faith.

## **WEST VIRGINIA -- OIL & GAS**

Gregory R. Danielson, Guest Reporter

### **West Virginia Court Holds That Oil and Gas Lease Does Not Cover Coalbed Methane**

In *Energy Development Corp. v. Moss*, No. 31,238, 2003 WL 22762066 (W. Va. Nov. 20, 2003), the West Virginia Supreme Court of Appeals affirmed a circuit court decision holding that a particular oil and gas lease did not cover coalbed methane (CBM).

In the mid 1980s Energy Development Company (EDC) obtained an oil and gas lease covering two tracts of land in which the lessors owned all minerals, including the oil, gas, and coal. The oil and gas lease let and leased to the lessee "all of the oil and gas and all the constituents of either in and under the land hereinafter described in all possible productive formations therein...." EDC drilled seven conventional wells but did not test the coal formations for CBM. In 1998 a dispute arose over royalty payments and EDC filed a counterclaim for a declaratory judgment determining that the oil and gas lease covered CBM.

The supreme court framed the issue as follows: "whether a gas lease executed in 1986, before the widespread commercial production of coalbed methane in West Virginia, signed by a lessor who owned the land, coal, oil and gas, conveyed to the oil and gas lessee the right to develop coalbed methane, absent any specific language on the issue." The court held that the lease was ambiguous as to whether it covered CBM and allowed the introduction of extrinsic evidence to determine the parties' intent. The court further held that the lease should be interpreted as of the date of its execution, and that the lease should be construed in favor of the lessors and against the lessee. The court also examined evidence of custom and usage and in particular noted that if the lease covered coalbed methane, it would carry with it an implied right to invade the coal seams in a fashion that would make it dangerous to later produce the coal. The court stated that it was also guided by public policy goals, set forth by the legislature, to balance the safe mining of coal seams with the promotion of CBM development. Based upon these factors, the court held that "[i]n the absence of specific language to the contrary or other indicia of the parties' intent, an oil and gas lease does not give the oil and gas lessee the right to drill into the lessor's coal seams to produce coalbed methane.... We express no opinion as to what result may obtain in a different factual scenario, as such a question is not before the Court at this time."

## **WYOMING -- OIL & GAS**

William N. Heiss, Reporter

### **Wyoming Supreme Court Finds Overriding Royalty Reserved in Assignment of Federal Oil and Gas Lease Is Proportionately Reduced by Interest Assigned**

In *Double Eagle Petroleum & Mining Corp. v. Questar Exploration & Production Co.*, 2003 WY 139, 78 P.3d 679 (Wyo. 2003), the Wyoming Supreme Court reaffirmed its decision in *Wadi Petroleum, Inc. v. Ultra Resources, Inc.*, 2003 WY 41, 65 P.3d 703 (Wyo. 2003). The dispute concerned a reservation contained in a 1978 assignment from Hondo Oil and Gas Company to El Paso Natural Gas Company. In the 1978 assignment Hondo conveyed to El Paso all of its 20% carried working interest in the subject and other gas leases, reserving an overriding royalty of "3-1/8% of 8/8ths." The assignment was made on a federal assignment of record title form, filed with the BLM, and recorded in Sublette County, Wyoming, with no mention of proportionate reduction. Notwithstanding this lack of any reference to proportionate reduction, the district court found that the overriding royalty interest of the appellants, as successors to Hondo, was proportionately reduced to 0.625% by the 20% interest out of which it was created. In their appeal to the Wyoming Supreme Court the appellants argued that the district court erroneously concluded that the federal record title assignments were ambiguous and then improperly used extrinsic evidence to determine the intent of the parties in interpreting those assignments.

In relying on *Wadi*, the Wyoming Supreme Court found that the district court was correct as a matter of law in determining that the disputed assignments were ambiguous, and because they were ambiguous the district court properly examined extrinsic evidence to resolve the ambiguity. As in *Wadi*, the court quoted from Richard W. Hemingway's *Law of Oil and Gas* in which he discusses the necessity of precisely defining the interest reserved in

an assignment. Much of the quoted portions of the Hemingway treatise concerned proportionate reduction resulting when a lease covers less than the full mineral title. Relying on this authority, the court found that the reservation was ambiguous due to lack of clarity and incompleteness of expression and found ambiguity inherent in the assignment. The court found that the silence of the assignment as to proportionate reduction leaves open the question of proportionate reduction. Because the assignments were ambiguous, the court held that the district court properly examined extrinsic evidence, including expert testimony, in order to resolve this ambiguity. As in *Wadi*, the court concluded that the appellants' interest was proportionately reduced to 0.625%.

### **Deed's Reservation of "Oil Rights" Is Ambiguous and Creates Question of Fact**

In *Hickman v. Groves*, 2003 WY 76, 71 P.3d 256 (Wyo. 2003), the Wyoming Supreme Court was asked to review a district court decision holding that a reservation by the grantors in a warranty deed in which they reserved "one-half of all oil and commercial gravel rights" did not include a reservation of gas. The appellants were the successors in interest to Jerry Hickman and Effie F. Hickman, grantors in a 1944 warranty deed, while the appellees were the successors in interest to the grantee in that deed. In 2001, the appellees filed an action seeking to quiet title to all coalbed methane underlying the property. The appellants filed a counterclaim seeking judgment that they owned one-half of the gas, including coalbed methane, pursuant to the 1944 reservation. Both parties filed cross motions for summary judgment and the district court entered judgment in favor of the appellees, ruling that the warranty deed was unambiguous and the "reservation of oil rights" did not reserve any gas rights, including coalbed methane, as a matter of law.

The supreme court, in citing *Boley v. Greenough*, 2001 WY 47, 22 P.3d 854 (Wyo. 2001), stated that "in interpreting unambiguous contracts involving mineral interests, we have consistently looked to surrounding circumstances, facts showing the relations of the parties, the subject matter of the contract and the apparent purpose of making the contract." *Hickman*, 71 P.3d at 258. In this case although substantial disagreement existed over the meaning of the deed, neither party claimed the deed was ambiguous. The supreme court acknowledged the district court's ruling was based on the ultimate conclusion that in determining whether a deed is ambiguous an objective test must be applied in which the intent of the grantor is decided solely from the words used. However, the Wyoming Supreme Court stated that this objective test does not accurately reflect the status of law in Wyoming, particularly as it is applied to contracts involving mineral interests. The court quoted the Colorado case of *KN Energy, Inc. v. Great Western Sugar Co.*, 698 P.2d 769 (Colo. 1985), in which it was held that in determining whether an ambiguity exists the court may consider extrinsic evidence bearing upon the meaning of the written terms such as evidence of local usage and of the circumstances surrounding the making of the contract. However, the court may not consider the parties' own extrinsic expressions of intent. The court also relied on Samuel Williston's *A Treatise on the Law of Contracts* to find that custom and usage of particular words may be proved to show the intention of parties to a contract of phrases of a particular technical meaning which are susceptible to two or more plain or reasonable constructions and that such evidence of usage may be admissible to give meaning to apparently unambiguous terms where other parol evidence would be inadmissible. The appellants, in support of their motion for summary judgment, submitted affidavits of eight landmen providing testimony that in the early 1950s and prior it was common for rural residents to refer to "oil rights" when referring to both oil and gas rights without differentiating between the two substances. The appellants also submitted affidavits detailing the somewhat meager educational background of the grantors in the subject warranty deed. The Wyoming Supreme Court found these affidavits raised a material question of fact as to the actual meaning of the words "oil rights" as used in the warranty deed and whether those rights were intended to include both oil and gas rights, either including or excluding coalbed methane, or solely oil with no attendant "gas rights" of whatever nature.

The appellees argued that there is a difference between gas associated with oil and gas not associated with oil, such as coalbed methane gas. Further, the appellees contended that natural gas was well recognized as a valuable resource independent from oil at the time of the warranty deed and that grantors would certainly have specified whether gas was to have been reserved in the 1944 deed. By asserting these arguments, the Wyoming Supreme Court found that the appellees admitted that a question of material fact exists as to whether or not the grantors intended to entirely convey all gas or reserve a half interest in such gas. The court found that by admitting that natural gas was a well-recognized commodity separate from oil at the time of the deed the appellees invited review of the historical circumstances existing at the time. Accordingly, the Wyoming Supreme Court found that the record presented issues of material fact and reversed the summary judgment and remanded the case for further proceedings.

### **Sale Accomplished Through Merger of Second Level Subsidiary Triggers Preferential Right to Purchase in Agreement by Ultimate Parent**

In *Williams Gas Processing-Wamsutter Co. v. Union Pacific Resources Co.*, 2001 WY 57, 25 P.3d 1064 (2001), the Wyoming Supreme Court considered whether a sale by merger of a wholly-owned subsidiary of a subsidiary of a parent company violated or triggered a preferential right to purchase contained in an agreement entered into by the parent company and Williams Gas Processing. On August 27, 1993, Williams and Union Pacific Resources Co. (UPRC) entered into two agreements covering the Echo System gas plant and gathering system, with Williams owning 66% and UPRC owning 34% of the property. Both contracts are identical as to the preferential right to purchase. The provision triggering preferential rights became effective in the event any owner desired to sell all or part of its interest in the gas processing plant to a non-affiliate as either a separate transaction or as part of a package of assets. Although "non-affiliate" was not defined in the contract, affiliate was defined as "a corporation or other legal entity ... directly or indirectly through one or more intermediaries, controlling, controlled by or under common control with an Owner." 25 P.3d at 1068. The agreement also provided that there would be no preferential right to purchase in those cases where any party wished to mortgage its interest or dispose of its interest by merger, reorganization, consolidation, or a sale or transfer of its interest to a subsidiary or parent company or subsidiary of a parent company.

In 1998, UPRC entered into a Merger and Purchase Agreement with Duke Energy Field Services, to sell a processing plant. As part of this transaction, UPRC transferred its interest in the Echo System by deed to Fuels Acquisition Co. (FAC), an affiliate of UPRC and wholly-owned subsidiary of UP Fuels, which itself was wholly owned by UPRC. UPRC then created Holding Company, Inc. The stock of UP Fuels and other UPRC entities was transferred to Holding Company, Inc. Finally, Holding Company, Inc. merged with Duke Energy Field Services (DEFS). Williams filed its complaint to block the transfer, seeking specific performance of its preferential purchase rights.

The trial court found that the Echo System was not sold as a "package of assets." Nor did the district court find any material facts that supported the conclusion that FAC was a "non-affiliate" as defined by the agreements at the time the Echo System was transferred to it. Specifically, the district court found that the transfers that took place prior to the merger of Holding Company, Inc. and DEFS did not trigger the preferential right because they were transfers to a subsidiary of the parent company. FAC was a wholly-owned subsidiary of UP Fuels which in turn was a wholly-owned subsidiary of UPRC, thus the transfer did not trigger the preferential rights. The transfer of the Echo System into Holding Company, Inc., which was a wholly-owned subsidiary of UPRC, also did not trigger the preferential rights. Finally, the merger of Holding Company, Inc. into DEFS did not trigger the preferential right. On cross motions for summary judgment the trial court denied the motion of Williams and granted that of UPRC.

On appeal to the Wyoming Supreme Court, the court held that for purposes relevant to the resolution of this case the transaction between UPRC and Duke was a sale. The court quoted from its prior case in *Raymond v. Steen*, 882 P.2d 852 (Wyo. 1994) in which the court stated that "[a] sale is made for purposes of a right of first refusal when there is a transfer for value of a significant interest in the subject property to a stranger who thereby gains substantial control over the subject property." *Id.* at 857. While the court did not go so far as to characterize what UPRC did as a "sham transaction," it did agree with Williams that UPRC's position rests upon a highly tortured and technical reading of the contract terms which the court would not adopt in construction of the contract to permit UPRC to evade Williams' right of first refusal. The court found that UPRC's actions transparently were calculated to attempt to do indirectly that which the agreements would not allow UPRC to do directly. The supreme court reversed the trial court's order and remanded it to the district court with directions to enter summary judgment in favor of Williams against UPRC.

An interesting aspect of this case is that the Wyoming court expressly refuses to follow the reasoning of the Texas Supreme Court in *Tenneco Inc. v. Enterprise Products Co.*, 925 S.W.2d 640 (Tex. 1996), in which the Texas court permitted a structure similar to that put together by UPRC.