



MINERAL LAW NEWSLETTER

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FEDERAL — MINING

DANIEL A. JENSEN
— REPORTER —

UNITED STATES DOES NOT OWN SAND AND GRAVEL UNDER PITTMAN ACT PATENTS, BUT *WESTERN NUCLEAR* SURVIVES

Persistence has paid off for a Nevada company that was accused by the Bureau of Land Management of trespass for removing sand and gravel from the company's land. The Supreme Court, reversing a string of lower decisions, held that sand and gravel are *not* within the scope of "valuable minerals" reserved by the United States in land patents issued under the now-repealed Pittman Act. *BedRoc Ltd., LLC v. United States*, 124 S. Ct. 1587 (2004).

The Pittman Underground Water Act of 1919, 43 U.S.C. §§ 351-359, applied only to lands in Nevada. Intended to encourage settlement of Nevada's arid lands, the Pittman Act authorized a patent to those who found and properly developed underground sources of water. Lands appropriated under the Pittman Act were to be nonmineral in character. Pittman Act patents, therefore, reserved to the United States "all the coal and other valuable minerals."

Bedroc Limited, LLC owns land patented in 1940 under the Pittman Act. The land was subsequently mined for sand and gravel, which led to a dispute over whether the sand and gravel belong to the patentee's successor (Bedroc) or to the United States. The Interior Board of Land Appeals held that sand and gravel were reserved to the United States in the patenting process. *Earl Williams*, 140 IBLA 295, GFS(MIN) 99(1997). The federal district court agreed, *Bedroc Ltd., L.L.C. v. United States*, 50 F. Supp. 2d 1001 (D. Nev. 1999), as did the Ninth Circuit Court of Appeals. *Bedroc Ltd., L.L.C. v. United States*, 314 F.3d 1080 (9th Cir. 2002).

The Ninth Circuit based its decision on the purpose of the Act as shown by its legislative history and on the principle that mineral reservations in public lands are to be broadly construed in favor of the government. The Ninth Circuit also noted that its result was consistent with decisions, most notably *Watt v. Western Nuclear, Inc.*, 462 U.S. 36 (1983), confirming the United States' ownership of sand and gravel on lands patented under the Stock-Raising Homestead Act (SRHA), enacted only three years prior to the Pittman Act. See Vol. XX, No. 1, at 3 (2003) of this *Newsletter*.

continued on page 2

FEDERAL — OIL & GAS

GREGORY R. DANIELSON
— REPORTER —

D.C. DISTRICT COURT DENIES DEDUCTION OF COSTS FOR REMOVAL OF CO₂ FROM COALBED METHANE WHEN CALCULATING ROYALTY

Amoco Production Company (Amoco), Atlantic Richfield Company, and Vastar Resources, Inc. (Vastar) filed complaints seeking declaratory judgment and appealing the decisions of the Assistant Secretary of the Department of the Interior (DOI) which disallowed certain costs related to removal of carbon dioxide (CO₂) in the calculation of royalties due on the sale of coalbed methane gas produced from federal leases. In *Amoco Production Co. v. Baca*, 300 F. Supp. 2d 1 (D.D.C. 2003), upon consideration of cross motions for summary judgment, the district court affirmed the decisions of the Assistant Secretary.

Amoco and Vastar produced coalbed methane gas as lessees under federal oil and gas leases located in the San Juan Basin of northwestern New Mexico. The coalbed methane produced by these parties contained significantly higher levels of carbon dioxide than conventional natural gas. In calculating their royalty payments, Vastar and Amoco deducted certain costs related to the transportation and removal of CO₂. Vastar also applied for an extraordinary processing cost allowance for removal of CO₂.

In denying these deductions related to the transportation and removal of CO₂ and the processing allowance, the Minerals Management Service relied on a letter dated April 22, 1996, to producers of coalbed methane gas containing guidelines for calculating the proper payment of royalties and correct reporting of production. The guidelines applied specifically to circumstances in which CO₂ was removed from coalbed methane gas and vented into the air rather than being processed and sold as a separate product. Vastar and Amoco (Plaintiffs) argued that the DOI applied the "Dear Operator Letter" of April 22, 1996, as an agency rule in violation of the Administrative Procedure Act. The district court held that the "Dear Operator Letter" was an interpretive letter issued by the MMS and did not constitute a rule and therefore was not subject to notice and comment.

The district court affirmed the Assistant Secretary's findings that the gas in this case was not in a marketable condition in its natural state. The district court drew a distinction between marketing and merely selling the product. The court noted that the

continued on page 3

FEDERAL — MINING

continued from page 1

Reversing, a four-Justice plurality of the Supreme Court began by distinguishing the SRHA and *Western Nuclear*, which dealt with reservations of “all the coal and other minerals,” from the Pittman Act, which reserved “all the coal and other valuable minerals.” 124 S. Ct. at 1592. The Court held that, because the Pittman Act was unambiguous in its reservation of only “valuable” minerals, there was no need to resort to legislative history, and the only question was whether sand and gravel were commonly regarded as “valuable minerals” at the time of the Pittman Act in 1919. *Id.* at 1594-95.

The answer to that question, said the Court, was clearly no. Sand and gravel were, and are, abundant throughout Nevada. They were commercially worthless in 1919 due to Nevada’s sparse population (less than 80,000) and lack of development. Nevada is the driest state in the Union and, as the Court noted, “even the most enterprising settler could not have sold sand in the desert.” *Id.* at 1594 n. 6. Because the most natural interpretation of the mineral reservation does not encompass sand and gravel, the Court refused to consider the canon that ambiguities in land grants are construed in favor of the sovereign. *Id.* at 1594.

The Court went on to conclude that the class of valuable minerals reserved under the Pittman Act is the same class of minerals that could be located under the General Mining Law of 1872 (which opens to location “all valuable mineral deposits” within the public lands). In 1919, when the Pittman Act became law, common sand and gravel were not locatable. *Id.*

As for *Western Nuclear*, the Court noted that it had been a close decision, with four Justices vigorously dissenting (including Chief Justice Rehnquist, who is the author of this decision). The lead opinion hints that *Western Nuclear* was wrongly decided, but expressly declines to overrule it (apparently based on the recentness of the precedent). The Court did state, however, that it will not extend *Western Nuclear’s* holding to conclude that sand and gravel are *valuable* minerals. *Id.* at 1595. Two other Justices concurred in the decision, writing separately to say that *Western Nuclear* was wrongly decided, but should not be overturned because of significant reliance interests that would be upset by doing so, and heightened *stare decisis* concerns in cases involving property rights. *Id.* at 1597.

Three Justices dissented, arguing that Congress intended the mineral reservations in the SRHA and the Pittman Act to be the same, such that *Western Nuclear* should control to vest ownership in the United States. The dissent found it “highly unlikely that Congress would reserve its ownership of sand and gravel in the millions of acres of land in the West that were covered by the SRHA and not do so for the land in Nevada covered by the Pittman Act.” *Id.*

Because the Pittman Act only affects certain lands in Nevada, the bigger interest in this case was the Court’s treatment of *Western Nuclear*, which took a beating but remained intact.

MINERAL LAW NEWSLETTER

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FEDERAL — OIL & GAS

continued from page 1

Assistant Secretary found that there were limited sales of the gas in its natural condition at the well head, but the typical sales contract in the area was for a market that was distant from the production area and therefore required reduced levels of CO₂ to be sold. The court held that Plaintiffs must pay royalties on the cost of conditioning the gas to reduce CO₂ levels.

Plaintiffs asserted they were entitled to a transportation allowance for the cost of transporting CO₂ levels in excess of the pipeline quality standards of 2%. The court held that the Assistant Secretary properly denied the transportation allowance in this case because CO₂ removal was essential to place gas in a marketable condition and was not for the sole purpose of facilitating transportation.

The district court also rejected Vastar's request for approval of an extraordinary cost allowance for the cost of removing CO₂ from its gas stream. The court held that although the high level of CO₂ content may be unusual, the process used to remove the CO₂ was not so unique as to permit an extraordinary processing cost allowance.

Plaintiffs also argued that the agency is barred from collecting royalties accrued more than six years prior to May 27, 1997, pursuant to 28 U.S.C. § 2415(a). The district court recognized the split in the circuits on the interpretation of 28 U.S.C. § 2415(a) as it applies to MMS orders to collect additional royalties. Although the court discussed the Tenth Circuit's decision *en banc* in *OXY USA, Inc. v. Babbitt*, 268 F.3d 1001 (10th Cir. 2001), the court ultimately held that the statute of limitations was not applicable based upon a decision by the U.S. District Court for the District of Columbia in *Samedan Oil Corp. v. Deer*, No. 94-2123, 1995 WL 431307 (D.D.C. June 14, 1995), *rev'd on other grounds*, *Independent Petroleum Association of America v. Babbitt*, 92 F.3d 1248, 1260 (D.C.Cir. 1996).

DISTRICT COURT AFFIRMS BLM ISSUANCE OF LEASES AND APPROVAL OF APDs IN MONTANA CBM PROJECT

Northern Plains Resource Council (NPRC) brought an action under the Administrative Procedure Act in the U.S. District Court seeking to enjoin the issuance of oil and gas leases and applications for permits to drill coalbed methane (CBM) in the Tongue River Coalbed Methane Project without first preparing a supplemental environmental impact statement (EIS) and amending the existing resource management plan (RMP). In *Northern Plains Resource Council, Inc. v. U.S. Bureau of Land Management*, 298 F. Supp. 2d 1017 (D. Mont. 2003), the district court denied NPRC's request for injunction.

In 1984 and 1985, the Bureau of Land Management (BLM) prepared RMPs and EISs for the Billings and Powder River Resource Areas. In the early 1990s, BLM amended these RMPs

through the preparation of an EIS devoted entirely to the impacts of oil and gas leasing in these areas. The amended RMPs and EIS were approved in 1994 (1994 RMP/EIS). The 1994 RMP/EIS considered the impacts of limited CBM development and provided that in order for full-field development of CBM to occur on federal lands, an additional environmental document would be required. Between 1997 and 2001, the BLM held 23 competitive lease sales. BLM also approved 40 applications for permits to drill (APDs) for CBM including 11 APDs in the Tongue River CBM Project. Prior to the approval of each of these 11 APDs, the BLM performed an environmental analysis and concluded that with appropriate mitigation measures the proposed drilling would have no significant impact and an EIS would not be required.

The district court considered whether BLM should have prepared a new EIS and amended its RMPs prior to issuing oil and gas leases and approving APDs. The court held that it was not necessary to prepare a new EIS because the 1994 RMP/EIS authorized the level of CBM activity permitted by BLM. The court noted that the APDs were for limited exploratory drilling for CBM and recognized that further environmental studies would be needed before large-scale CBM production could be allowed.

The court also considered whether the BLM could restrict full leasehold development after the issuance of leases that did not contain stipulations that restricted CBM development. The court held that the leases could not convey development rights any greater than those authorized by the 1994 RMP/EIS. The court relied upon the language in the leases stating that the rights of the lessee are subject to applicable laws and the Secretary of the Interior's regulations and formal orders. Therefore, the leases are subject to 43 U.S.C. § 1732, which mandates BLM to manage public lands in accordance with land use plans, and 43 C.F.R. § 1610.5-3, which requires all resource management actions such as leasing to conform to approved land use plans. Since the land use plan would not allow full-field development without further NEPA documentation, the court held that the lessees were granted only the right to undertake exploratory drilling and small-scale development of CBM resources.

IBLA DISMISSES PROTEST TO FEDERAL OIL AND GAS LEASE SALE

Wyoming Outdoor Council (WOC) appealed the July 17, 2000, decision of the Wyoming State Office of the Bureau of Land Management (BLM) dismissing its protest to the offering of 132 parcels located in various Wyoming counties at a competitive oil and gas lease sale on June 6, 2000. The Interior Board of Land Appeals (IBLA) dismissed WOC's appeal as to all but five parcels based on lack of standing and an additional three parcels were dismissed voluntarily. In *Wyoming Outdoor Council*, 160 IBLA 387, GFS(O&G) 2(2004), the IBLA affirmed the BLM decision and dismissed the WOC protest of the remaining two parcels (Subject Parcels) from the June 6, 2000, competitive oil and gas lease sale.

EDITOR'S NOTE ON UNPUBLISHED OPINIONS: This *Newsletter* sometimes contains reports on unpublished court opinions that we think may be of interest to our readers. Readers are cautioned that many jurisdictions prohibit the citation of unpublished opinions. Readers are advised to consult the rules of all pertinent jurisdictions regarding this matter.

The Subject Parcels are within the jurisdiction of the BLM's Rawlins Field Office. After the Subject Parcels were nominated for the sale, the Rawlins Field Manager prepared an Interim Document of Land Use Conformance and NEPA Adequacy (DNA) which concluded that the inclusion of the Subject Parcels in the June 2000 lease sale conformed to the applicable land use plan and the existing documentation under the National Environmental Policy Act (NEPA). In its appeal, WOC argued that the environmental assessment was inadequate since the environmental impact statement (EIS) and the applicable resource management plans addressed the environmental effects of oil and gas leasing in general, but failed to mention coalbed methane development. This case is very similar to two previous WOC appeals discussed in previous newsletters. See *Pennaco Energy, Inc. v. U.S. Department of the Interior*, 266 F. Supp. 2d 1323 (D. Wyo. 2003) and *Wyoming Outdoor Council*, 158 IBLA 384, GFS(O&G) 5(2003) (involving parcels from the same Rawlins Field Office and the same underlying environmental documentation). IBLA rendered its decisions in the previous cases while the appeal in this case was pending. BLM therefore supplemented the administrative record before the IBLA by submitting a revised DNA based upon a supplemental examination of the existing environmental documentation. In its supplemental examination, the BLM examined the impacts from various coalbed methane projects being conducted in the Rawlins Field Office's management area and compared them to the existing EIS and concluded that the impacts from the development of methane gas from coal reservoirs was in conformance with the existing EIS and resource management plan.

The IBLA held that the record could be supplemented by the BLM's subsequent environmental review in response to the previous IBLA decisions. The IBLA also held that the record as supplemented supports the sale and leasing of the parcels in question for oil and gas exploration, including coalbed methane development. The IBLA stated that the original record did not adequately support leasing but the supplemental examination, which specifically looked at the impacts of coalbed methane exploration and development, satisfied the requisite hard look. The supplementary information showed that the impacts from coalbed methane exploration and development would generally not be different from the impacts from conventional gas exploration and development of the same parcels.

CONGRESS / FEDERAL AGENCIES GENERAL

LAURA LINDLEY AND ROBERT C. MATHES
— REPORTERS —

FISH AND WILDLIFE SERVICE FINDS LISTING GREATER SAGE GROUSE "MAY BE WARRANTED"

The Fish and Wildlife Service published its "90-day finding" on petitions to list the greater sage grouse as threatened or endangered. 69 Fed. Reg. 21,484 (Apr. 21, 2004). The Service found that substantial information had been submitted that listing

the sage grouse under the Endangered Species Act, 16 U.S.C. §§ 1531-1544, "may be warranted." The 90-day "warranted" finding triggers a more detailed review of the species' condition by the Fish and Wildlife Service but does not automatically mean that the species will be listed. The Fish and Wildlife Service expects that the review will take approximately nine months. 69 Fed. Reg. at 21,485.

The greater sage grouse depends on sagebrush for habitat and its declining numbers are attributed largely to loss of sagebrush habitat by conversion to agriculture, range treatments to increase livestock forage, mining and oil and gas development, and rural subdivision development. Although the sage grouse has declined in numbers, its habitat across the West is widespread. For that reason, ranchers, oil and gas and mineral developers, and other user groups are concerned that, if the sage grouse is listed, their activities will be significantly impacted.

One of the factors that the Fish and Wildlife Service is required to consider in making a listing determination is the efforts being made by a state or any political subdivision of a state to protect the species in the area under its jurisdiction. 16 U.S.C. § 1533(b)(1)(A). The Bureau of Land Management and most of the affected states are developing strategies to protect the sage grouse in the hopes of avoiding formal listing under the Endangered Species Act and the Fish and Wildlife Service must factor those efforts into its listing decision. Ironically, even though sage grouse are hunted in 10 of the 11 states where they currently exist, the Fish and Wildlife Service found that properly managed hunting does not threaten the continued existence of the species. 69 Fed. Reg. at 21,491.

FISH AND WILDLIFE SERVICE IDENTIFIES CANDIDATE SPECIES

On May 4, 2004, the Fish and Wildlife Service published a comprehensive list and review of species that are candidates or proposed for listing as endangered or threatened under the Endangered Species Act (ESA). 69 Fed. Reg. 24,876 (May 4, 2004). The Candidate Notice of Review (CNOR) presents the complete list of plant and animal species native to the United States that the Fish and Wildlife Service regards as candidates or has proposed for protection under the ESA. The list currently includes 279 candidate species. Since the list was last published in 2002, the Fish and Wildlife Service has added 29 species to the candidate species list, and removed 19 other species. Inclusion on the CNOR list does not provide any additional protection to a species, but does provide public land managers and the public notice of which species are in line for possible designation.

CONGRESS / FEDERAL AGENCIES OIL & GAS

LAURA LINDLEY AND ROBERT C. MATHES
— REPORTERS —

NEW OIL VALUATION RULE PUBLISHED

On May 5, 2004, the Minerals Management Service (MMS) published amendments to the rules governing the valuation of crude oil produced from onshore and offshore federal leases. 69 Fed. Reg. 24, 959 (May 5, 2004). The final rules take effect on July 6, 2004. The amendments revise the method for valuing crude oil for royalty purposes when the oil is not sold under an arm's-length contract and is produced from leases outside of California and Alaska. For production from the Rocky Mountain Region, value will no longer be based on published spot or index prices, but rather the NYMEX price adjusted for location and quality differentials and transportation costs. 69 Fed. Reg. at 24,976 (to be codified at 30 C.F.R. § 206.103(b)(3)). Outside of California, Alaska, and the Rocky Mountain Region, the value of crude oil not sold under an arm's-length contract is also the NYMEX price adjusted for location and quality differentials, but adding the "roll." 69 Fed. Reg. at 24,976 (to be codified at 30 C.F.R. § 206.103(c)(1)). The "roll" is a calculated amount designed to measure the trend of NYMEX prices for future deliveries and is either added to or subtracted from the NYMEX price depending on whether prices for the out months are higher or lower than the future price. *Id.* In California and Alaska, the Alaska North Slope spot price, adjusted for location and quality differentials, will continue to be used.

The amended rule details how the NYMEX or Alaska North Slope price is to be adjusted for the difference in value between the lease and the market center and (for NYMEX valued production) between the market center and Cushing, Oklahoma (where the NYMEX prices are based.) 69 Fed. Reg. at 24,978 (to be codified at 30 C.F.R. § 206.112). It also specifies allowable costs that may be deducted in determining the transportation allowance if there is no arm's-length transportation contract and increases the allowable rate of return in calculating the transportation allowance to 1.3 times the Standard and Poor's BBB industrial bond yield. 69 Fed. Reg. at 24,977 (to be codified at 30 C.F.R. § 206.111).

The MMS expects that these changes to the regulations will increase royalty payments slightly and will promote certainty and thereby reduce litigation.

ROYALTY INCENTIVES FOR DEEP OFFSHORE GAS PRODUCTION

The MMS published a rule on January 26, 2004, designed to encourage the drilling of deep gas wells in the Gulf of Mexico. 69 Fed. Reg. 3492 (Jan. 26, 2004). The rule establishes specified volumes of production that will be royalty free, provided the gas is produced from a well drilled or deepened after March 26, 2003, to a depth of at least 15,000 feet subsea. The volume of production that is royalty free varies depending on the depth

drilled and whether it is an original wellbore or a sidetrack. For example, a new well drilled to a total vertical depth subsea of 18,000 feet or more may produce up to 25 Bcf of gas royalty-free. The rule contains detailed procedures for determining what constitutes a qualifying well and for calculating the volume of royalty-free production to which the lessee is entitled.

Although the January rule provided for an effective date of March 1, 2004, the MMS published an amendment to the rule on April 30, 2004, making the rule effective as of May 3, 2004. 69 Fed. Reg. 24,052 (Apr. 30, 2004). In publishing the final rule in January the MMS had overlooked the requirement of 5 U.S.C. § 801(a)(3) which provides that a rule which has an annual effect on the economy of \$100 million or more cannot take effect earlier than 60 days after Congress receives a report on the rule. The MMS estimated that although the royalty relief rule would reduce net federal royalty collections, it would have an economic effect of \$100 million or more by reducing consumer expenditures on natural gas by about \$500 million each year. 69 Fed. Reg. 3492, 3505 (Jan. 26, 2004). The April 30 technical amendment to the royalty relief rule explained that Congress did not receive the rule until March 4, 2004, and, therefore, the rule could not take effect before May 3, 2004. 69 Fed. Reg. 24,052 (Apr. 30, 2004). This amendment changed the effective date of the rule to May 3, 2004. At the same time, the MMS also published notice that, because operators had commenced deep gas wells after March 26, 2003, in reliance on the royalty relief, it was exercising its discretion under the Deep Water Royalty Relief Act of 1995, 43 U.S.C. § 1337(a)(3)(B), to eliminate the royalty on gas produced between March 1, 2004 and May 2, 2004, from wells drilled on or after March 26, 2003, having a perforated interval the top of which is at least 15,000 feet total vertical depth subsea. 69 Fed. Reg. 24,055 (Apr. 30, 2004).

ALABAMA — OIL & GAS

EDWARD G. HAWKINS
— REPORTER —

REVERSAL OF \$20 MILLION PUNITIVE DAMAGE JURY AWARD IN *HUNT PETROLEUM CORP. v. STATE OF ALABAMA*

On April 30, 2004, the Alabama Supreme Court reversed and remanded a \$20 million punitive damage jury verdict in favor of the State of Alabama and against Hunt Petroleum Corporation. *Hunt Petroleum Corp. v. State*, No. 1011762, 2004 WL 924138 (Ala. 2004). The case involved royalty payments to the State of Alabama on a state lease form covering submerged gas producing lands in Mobile Bay. The *Hunt* case shares some common facts with the case between ExxonMobil and the State of Alabama, where most recently an Alabama jury awarded the State \$11.8 billion in punitive damages. See Vol. XXI, No. 1 (2004) of this *Newsletter*. Although many facts in the two cases are different, the *Hunt* decision could be a harbinger of what is to come in the *ExxonMobil* case, which is now proceeding through its second post-judgment review.

The underlying contract issue in the *Hunt* case was whether Hunt Petroleum could deduct gathering costs, treating costs, and

transportation costs to a pipeline from its gas royalty due the State of Alabama. By pre-trial partial summary judgment the trial court ruled in favor of the State and against Hunt Petroleum on that issue. Hunt did not appeal that ruling, so the issue at trial involved whether Hunt defrauded the State by concealing its deductions of those costs from its royalty payments to the State.

The State contended that it relied on over 100 monthly royalty payment reports and its acceptance of monthly royalty payment checks from Hunt Petroleum where Hunt did not disclose to the State its deductions of the disputed costs. The Alabama Supreme Court rejected the State's argument by holding that the State failed to present substantial evidence that it relied on the royalty payment reports and the checks. The evidence showed that the State reserved the right in its lease to audit Hunt Petroleum and that the State intended to conduct an audit at some time. The majority held that, if the State reserved the right to verify the royalty payments by audit, it could not have "reasonably relied" upon the royalty checks and monthly reports as would have been necessary to prove fraud under Alabama law. The majority also wrote that there was no evidence that anyone employed by the State looked at the monthly reports. The dissent, however, points out that State employees used the monthly report figures to prepare budget forecasts, so State employees must have looked at the reports. In any event, the majority opinion is based upon a lack of substantial evidence of reliance by the State upon the Hunt Petroleum concealments.

In a concurring opinion, Justice Houston argues that Hunt Petroleum could not have committed fraud in its royalty payments because its underpayment was a breach of contract and not a separate tort. If Justice Houston persuades a majority of the Alabama Supreme Court to his view, his concurring opinion may be a preview of the court's ruling in the pending *ExxonMobil* appeal.

Editor's Note: John S. Lowe, Oil and Gas Editor of this Newsletter, testified in this case on matters other than the issues addressed in the above decision.

ALASKA — OIL & GAS

RANDAL G. BUCKENDORF
VIKRAM N. CHAOBAL
— REPORTERS —

NORTHWEST NPR-A LEASING GIVEN GREEN LIGHT; ENVIRONMENTALISTS FILE SUIT TO ENJOIN

On January 22, 2004, the Secretary of the Interior signed the Record of Decision (ROD) for the Final Northwest National Petroleum Reserve—Alaska Integrated Activity Plan/ Environmental Impact Statement (Final IAP/EIS) that was issued on November 20, 2003. This action was significant for oil and gas companies doing business on Alaska's North Slope because the ROD adopted, with a few minor modifications, the preferred alternatives set out in the Final IAP/EIS, making all 8.8 million acres of the BLM-administered lands within the Northwest NPR-A available for leasing. See <http://www.doi.gov/news/rod.pdf>.

The ROD did defer leasing for 10 years on approximately 1,570,000 acres (17%) of the westernmost portion of the planning area. Within the lease deferral area, the ROD established a new 102,000-acre Kasegaluk Lagoon Special Area that is subject to a no-surface-occupancy (NSO) stipulation. Outside the deferral area, additional NSO stipulations are imposed along coastal areas, key rivers, and deep-water lakes. In total, the NSO restrictions apply to nearly 16% of the planning area. Stipulations and required operating procedures provide clearly defined setbacks, restrictions, and guidance for all aspects of oil and gas and related operations.

President Harding established the NPR-A, then called the Naval Petroleum Reserve, in 1923 to be administered by the Navy as an assured future oil supply for national defense purposes. Although exploration occurred over the next 50 years, there were no significant discoveries. In 1976, President Ford signed the Naval Petroleum Reserves Production Act (NPRPA), which among other things transferred jurisdiction of this area from the Navy to the Secretary of the Interior. Interest waned in the NPR-A through the 1980s and into the 1990s. However, in 1997 with the increased availability of three-dimensional seismic and the discovery by ARCO Alaska and Anadarko of the Alpine field near the eastern edge of the NPR-A, the Bureau of Land Management (BLM) undertook another detailed review of NPR-A leasing. The result was that BLM divided the 23.5 million acre NPR-A into three distinct management areas: Northeast, Northwest, and Southern Planning Areas.

After conducting a detailed environmental review and after preparing an IAP/EIS for the Northeast Planning Area, BLM opened portions of it to leasing in 1998 and has since conducted two lease sales. Half a dozen discoveries have been announced and ConocoPhillips (through the acquisition of ARCO Alaska in 2001) and Anadarko recently initiated a site-specific development EIS with the BLM seeking authorization to develop several of those discoveries.

The decisions to open the Petroleum Reserve to leasing and potential development are not without controversy. On February 16, 2004, a coalition of national and state environmental groups comprised of the Northern Alaska Environmental Center, the National Audubon Society, the Wilderness Society, the Natural Resources Defense Council, the Sierra Club, the Alaska Wilderness League, and the Center for Biological Diversity filed a complaint in the U.S. District Court for the District of Alaska challenging the Northwest ROD and seeking declaratory and injunctive relief under a variety of environmental statutes. *Northern Alaska Environmental Center v. Norton*, No. J04-006 CV (JKS). The complaint asserts that the Secretary of the Interior, the BLM, and the U.S. Fish and Wildlife Service violated the National Environmental Policy Act (NEPA), the Endangered Species Act (ESA), the NPRPA, and the Administrative Procedure Act (APA) when they decided to open the Northwest Planning Area to oil and gas leasing. On April 29, 2004, the plaintiffs requested the court to enter a preliminary injunction halting the upcoming June 2, 2004, lease sale. ConocoPhillips, Anadarko, Arctic Slope Regional Corporation, and the State of Alaska have each requested intervention. Five of the same seven environmental plaintiffs similarly challenged the 1998 ROD opening the Northeast Planning Area

to leasing. The case, which includes the same four interveners, is still pending in the U.S. District Court for the District of Columbia. *The Wilderness Society v. Norton*, No. 98-2395 (D.D.C. filed Oct. 5, 1998).

ENVIRONMENTAL GROUPS FILE PETITION TO LIST YELLOW-BILLED LOON UNDER ENDANGERED SPECIES ACT

In a separate legal challenge to the oil and gas industry's North Slope activities, a coalition of United States and Russian-based environmental organizations filed a petition on March 30, 2004, with the U.S. Fish and Wildlife Service (Alaska Region, the Service) to list the yellow-billed loon, *Gavia adamsii*, as an endangered or threatened species under the Endangered Species Act (ESA). The petition is *available at* www.biologicaldiversity.org/swcbd/PRESS/YBLpetitionfinal.pdf. The petitioners include the Center for Biological Diversity, the Natural Resources Defense Council, Pacific Environment, Trustees for Alaska, and seven Russian environmental organizations.

According to the filed petition, “[a]pproximately 22% of the worldwide breeding population of yellow-billed loons are thought to breed in Alaska.” Petition at 22. The petition further states that “[a]pproximately 80% of the Alaska population, and 18% of the speculated world population, of yellow-billed loons are found within the National Petroleum Reserve-Alaska.” *Id.* at 38. The petitioners cite the January 2004 decision of the Bureau of Land Management regarding the Northwest NPR-A and state that projects advanced because of this decision will cause “important habitat for the yellow billed loon [to] be further fragmented and the risk of disturbance to nesting activities increased.” *Id.* at 39. The petitioners allege that “[c]umulative impacts to wildlife have occurred from various industrial activities associated with oil and gas exploration and development on Alaska’s North Slope.” *Id.* at 36. Furthermore, the petitioners request that critical habitat be designated if the species is listed as threatened or endangered as required by the ESA. 16 U.S.C. § 1533(a)(3)(A).

Under the petition process, the Service has 90 days from the receipt of the petition to make a finding as to whether there is “substantial information” indicating that the petitioned listing *may* be warranted. If this preliminary finding is positive, a status review is conducted and within one year of receipt of the petition the Service must make a further finding that the listing either *is* or *is not* warranted. If the listing is found to be warranted, the Service publishes a proposed rule to list in the Federal Register. Alternatively, there can be a finding that it is “not warranted” to list or that it is “warranted but precluded” (other species of higher importance preclude listing at this time). Once a 60-day comment period is concluded, and the final rule to list the species is published in the Federal Register, the species is added to the endangered species list.

The listing of the yellow-billed loon could have a large impact upon North Slope oil and gas development activities and will be watched closely by industry and state entities alike. The petition is consistent with two failed attempts in recent years to block or impose additional stipulations on oil and gas development in Alaska’s Cook Inlet, through a petition for listing of the Cook Inlet Beluga Whale as threatened or endangered, *see*

55 Fed. Reg. 38,778 (June 22, 2000), and on the North Slope, through a petition for critical habitat designation for the Spectacled Eider, *see* 66 Fed. Reg. 9146 (Feb. 6, 2001).

WILLIAMS COMPLETES SALE OF ALASKA HOLDINGS

On March 31, 2004, Williams completed the sale of its Alaska business interests for about \$290 million, subject to certain closing adjustments. The sale allowed Williams to complete the exit of its petroleum refining and marketing sector nationwide. Williams divested its Alaska operations through three separate but linked transactions, selling its 220,000 barrel-a-day refinery and two petroleum terminals to Flint Hills Resources, LLC, its 3.0845% interest in the Trans-Alaska Pipeline System to Koch Alaska Pipeline Company, LLC, and its 26 convenience stores to Holiday Stationstores of Minneapolis. Flint Hills Resources also entered into a 10-year 77,000 barrel-per-day crude oil supply royalty-in-kind contract with the State of Alaska. Press Release, Williams (Apr. 1, 2004), *available at* www.williams.com.

ARKANSAS — OIL & GAS

THOMAS A. DAILY
— REPORTER —

ARKANSAS SUPREME COURT DISSOLVES INJUNCTION BARRING REMEDIATION OF WELL SITE PENDING LITIGATION

In *AJ&K Operating Co. v. Smith*, No. 03-232, 2004 WL 36242 (Ark. Jan. 8, 2004), Landowners sued Oil Companies for money damages resulting from alleged contamination and damage to land from drilling and production operations. The trial court entered a temporary restraining order barring Oil Companies from entering upon the site “under the guise of performing cleanup operations” in order to prevent “valuable evidence . . . [from being] . . . destroyed by the proposed remediation.” As the case slowly progressed, the Oil Companies made several requests for modification of the temporary restraining order, all of which were substantially denied. Oil Companies then took an interlocutory appeal to the Arkansas Supreme Court, which directed the trial court to permit cleanup and remediation of the site.

The court’s opinion is mostly a detailed recitation of the procedural history of the case. Its apparent holding, however, is that an operator’s implied duty to restore the lease premises (held to be an implied lease covenant in Arkansas in *Bonds v. Sanchez-O’Brien Oil & Gas Co.*, 289 Ark. 582, 715 S.W.2d 444 (1986)) is coupled with an implied right to enter and restore. The court emphasized that Landowners’ primary entitlement was to have their land restored, rather than to maximize the value of their lawsuit for money damages.

CALIFORNIA — OIL & GAS

KEVIN L. SHAW
— REPORTER —

ACCOUNTING CLAIMS UNDER JOA ARISE EACH MONTH

In *Armstrong Petroleum Corp. v. Tri-Valley Oil & Gas Co.*, 116 Cal. App. 4th 1375, 11 Cal. Rptr. 3d 412 (Cal. Ct. App. 5th Dist. 2004), in a lengthy opinion discussing the 1989 form of the AAPL Form 610 operating agreement as well as the COPAS accounting procedure and a gas balancing agreement attached as exhibits to the operating agreement, the court's holding focuses on whether a claim for underpayment or under-crediting of production and production revenue was a continuing cause of action, with a new claim arising each month when payments or credits were made or recorded by the operator. The court finds that the operator's obligations are divisible and that a "new, distinct wrong" arose each month. Thus, the four-year statute of limitations applicable to this sort of dispute would operate to allow the plaintiff to assert claims for each month within the four-year window, but all claims for prior months would be time-barred.

The underlying dispute appears to be over which party should bear an overriding royalty interest owed to a geologist. The resolution of that dispute would affect the respective net revenue interests of the parties, and their respective rights and obligations with respect to production and production revenue. Tri-Valley, the operator, sent a division of interests letter crediting Armstrong, a non-operator, with a net revenue interest (NRI) lower than the amount that Armstrong believed it was entitled to receive. At trial, the court found in favor of Armstrong as to the question of the calculation of the NRI. On appeal, Tri-Valley apparently argued that the breach of contract claim under the joint operating agreement arose in March 1997, when the initial division of interest letter was sent by Tri-Valley to Armstrong. Since the complaint was not filed until May of 2001, Tri-Valley argued that the four-year statute of limitations barred the entire claim. The court held otherwise, and allowed the action for the time periods within the four-year period. The appellate court did not find a California oil and gas case directly on point, but found persuasive the reasoning of the Fifth Circuit in a case under Texas law. *Hondo Oil & Gas Co. v. Texas Crude Operator, Inc.*, 970 F.2d 1433 (5th Cir. 1992).

COURT FINDS NO IMPLIED COVENANT OF FURTHER EXPLORATION

The issue in *The Lundin/Weber Co. LLC v. Brea Oil Co.*, 117 Cal. App. 4th 427, 11 Cal. Rptr. 3d 768 (Cal. Ct. App. 5th Dist. 2004), was whether California law recognized an implied covenant for further exploration in two oil and gas leases. The appellate court concludes, based on the language of the two leases, that the parties had "set out the lessee's exploration and development responsibilities in such a way as to leave no room for the implication of a duty to do more than that which is specified in their agreement." 11 Cal. Rptr. 3d at 775.

In this case, a 1926 lease and a 1995 lease burdened certain lands. Several oil and gas wells had been drilled and were producing on those lands. Lundin/Weber, the current lessor, demanded that Brea, the current lessee, drill additional deeper wells. Apparently, Brea had not "prospected, explored or drilled" below a certain depth in the period since it acquired the working interest under the 1926 lease and entered into the 1995 lease.

The court finds that the leases contained provisions requiring the drilling of certain wells to certain depths. The 1926 lease required the drilling of a minimum of 10 wells each year and further provided that, after 20 years, the lease would terminate except with respect to 10-acre squares around each well then producing. The 1995 lease contained similar, but more detailed, provisions concerning drilling and the retention of acreage. The appellate court found that to impose an additional implied covenant of further exploration could "upset the allocation of risk and reward achieved by the parties in their negotiations." *Id.*

In concluding, however, the court said that it would "leave for another day the more fundamental question whether, and to what extent, California courts will imply a covenant of further exploration when such a covenant would not conflict with the express terms of the oil and gas lease." *Id.*

RIGHT OF FIRST REFUSAL NOT TRIGGERED BY TRANSFER BETWEEN COTENANTS

While not an oil and gas case, the dispute in *Pellandini v. Valadao*, 113 Cal. App. 4th 1315, 7 Cal. Rptr. 3d 413 (Cal. Ct. App. 3d Dist. 2003), involved the question of whether a particular transaction triggered a right of first refusal. Inasmuch as rights of first refusal and similar preferential rights are commonly used in the oil and gas business, the principles may be relevant.

Valadao was a cotenant, with Wooldridge, of an undivided interest in a property. Valadao and Wooldridge granted Pellandini a "right of first refusal to meet any bona fide offer for purchase of the property." 7 Cal. Rptr. 3d at 414. Valadao loaned money to Wooldridge, secured by a deed of trust on Wooldridge's interest in the property.

Wooldridge conveyed her interest in the property to Valadao, her cotenant, in lieu of foreclosure of the deed of trust lien. Pellandini argued that he should have been offered the right to buy Wooldridge's interest in the property pursuant to his right of first refusal. The court held that the right of first refusal was not triggered by the transfer between two cotenants, noting that the right was still in effect in the event of a sale of an undivided interest to a third party or the sale of the entire property. The court also noted that the precise wording of the contract provision suggested that only a sale by both cotenants to a third party would trigger the right.

COLORADO — MINING

HOWARD R. HERTZBERG
— REPORTER —

REFORMATION OF TREASURER'S DEED TO PATENTED MINING CLAIM

Board of Commissioners v. Timroth, 87 P.3d 102 (Colo. 2004), involved an action for reformation of a treasurer's deed to a patented mining claim. The Colorado Supreme Court held that treasurer's deeds can be reformed and reversed the lower court. *Timroth v. Oken*, 62 P.3d 1042 (Colo. App. 2002), reported in Vol. XIX, No. 4 (2002) of this *Newsletter*.

The court of appeals held that the tax deed, which was issued in 1964 and based on a tax sale in 1908, was void on its face due to apparent irregularities in the 1908 tax sale, and held that evidence that could have proved the propriety of the tax sale could not be admitted in order to validate and reform the deed. In reversing the court of appeals, the supreme court held that evidence could be admitted for the purpose of determining whether a treasurer's deed void on its face could be reformed in a manner to validate it (in this case by showing there were no irregularities in the underlying tax sale), and that the reformation would relate back to the date of the original treasurer's deed.

In holding that a tax deed could be reformed, the supreme court referenced Colorado cases that appeared to support the lower court finding that such deeds could not be reformed. The supreme court held, however, that those cases either did not directly address the issue or failed to provide clear guidance. Based on decisions from other jurisdictions, the court found that "a treasurer's deed otherwise void on its face may be reformed—through the use of extrinsic evidence—under limited circumstances." 87 P.3d at 107. In this case, the error in the deed was "little more than a scrivener's error." *Id.* The court also indicated that there is a "general trend toward affirming tax titles." *Id.* at 108. Earlier in the opinion, the court had noted that authorities "for the rule against reformation of treasurer's deeds are over sixty years old and from other jurisdictions." *Id.* at 106.

Based on a footnote in the court's opinion, it appears that Timroth argued on appeal that the deed was void because of an alleged failure to offer the property for sale, as required by statute, but that issue was not raised at trial and the supreme court therefore refused to consider it.

IDAHO — MINING

JEFFREY C. FEREDAY
JOHN M. MARSHALL
— REPORTERS —

LEGISLATURE PASSES TWO BILLS PROVIDING FOR SALE OF STATE OWNED MINERALS

The Idaho legislature passed two bills during the 2004 session that significantly increase the state's flexibility in disposing of state owned lands and mineral deposits. The first, House Bill 510, amends current Idaho law to allow the sale of the mineral estate

to a purchaser of the surface estate in situations where the Idaho State Land Board identifies the surface estate "as having the potential highest and best use for development purposes, such as residential, commercial or industrial purposes." Prior to HB 510, state law required the reservation of the mineral estate to the state in all cases. This made it difficult for the state to capture full market value for prime development properties because the land came with the risk that a third party later would threaten to mine the reserved minerals. HB 510 removes this risk, and thus allows the state to receive full market value on prime development properties, by allowing the state to sell the full fee estate on these lands.

The second bill, House Bill 755, is a companion bill to HB 510 and provides for the sale of previously reserved mineral estates, again where the highest and best use of the surface estate is for development purposes. This bill allows the owner of a surface estate to purchase a reserved mineral estate to clear title prior to developing the property. However, because the sale of the reserved mineral estate must be through public auction, it is possible for a third party to purchase the mineral estate. In such a circumstance, the bill clarifies that the owner of the mineral estate must compensate the surface owner for any damage to improvements caused by mining. Both bills become effective July 1, 2004.

MONTANA — OIL & GAS

COLBY BRANCH AND STEVEN RUFFATTO
— REPORTERS —

DISCOVERY RULE CONFIRMED

The Montana Supreme Court in *Sandtana, Inc. v. Wallin Ranch Co.*, 2003 MT 329, 80 P.3d 1224 (Mont. 2003), has reaffirmed its adherence to the age-old "Discovery Rule." This doctrine, followed only in a minority of states, holds that the *discovery* of natural gas prior to expiration of the primary term of an oil and gas lease constitutes "production" for purposes of satisfying the habendum clause, thereby extending the lease into its secondary term. Thereafter, the lease continues for so long as the lessee uses reasonable diligence in marketing the gas. In effect, the Discovery Rule affords a diligent lessee time to market the fruits of its discovery. Once a market has been obtained and actual production established, the lease continues for so long as production in paying quantities is maintained.

At issue in *Sandtana* was the interpretation of a hand-drafted continuous development clause that had been attached to three oil and gas leases covering undivided interests in the same tract of land. The continuous development clause provided in relevant part:

[P]roduction from any well drilled hereunder shall not serve to extend the primary term of this lease, except as to the leased premise[] contained within the governmental Section in which a producing well is located. Lessee shall be entitled to extend this lease beyond the primary term as to leased premises located outside a governmental Section containing a producing well by paying or tendering to

lessor on or before the expiration of the primary term an annual rental

80 P.3d at 1226.

The leases also contained a standard operations clause. In the belief that conducting drilling operations over expiration of the primary term would continue the leases under the operations clause notwithstanding the continuous development clause (which was silent as to the operations clause), the lessee waited to commence drilling until the day before the leases were to expire.

As sometimes happens, the plan began to go awry. The driller made good time, and was drilling the shallow pay by the very next morning. The record does not reflect whether his mud was light or the pay was overpressured, but in any event, the well blew out. All of the mud was thrown to the pit, and as the natural gas followed, the local farmer reported a sound like a jet aircraft.

The driller quickly regained control of the well and was logging by midnight, when the primary term of all three leases expired. Casing was run the next morning. Rentals were tendered by the lessee two days after the primary term of the leases expired. This tender was refused by the lessors. Though they did not contest the validity of the leases with regard to the section of land containing the completed well, the lessors maintained that the leases had expired with regard to all other lands for failure to timely tender rentals under the continuous development clause. Thereafter, the lessee filed a declaratory action to confirm leasehold title to the disputed tracts.

The Montana Supreme Court cited the blowout as evidence that a discovery had been made. Invoking the Discovery Rule, it held that "production" had been established by discovery. Thus, the lease would normally have been extended into its secondary term in its entirety. Under the continuous development clause, however, rentals were required to be tendered *on or before the expiration of the primary term* to maintain all leased lands not within a section containing a producing well. Invoking its longstanding rule that time is of the essence in oil and gas leases, and that failure to pay rentals on time results in immediate and automatic termination of the lease, the court held that the lease had expired as to all lands outside the section in which the producing well was located.

In its holding, the court made a critical distinction between oil and gas production. Unlike oil, gas cannot be stored above ground. Its production is dependent on the existence of a pipeline. If a well is a discovery, it is likely that no pipeline will be available until sufficient wells have been drilled to prove up the necessary reserves and economics. Considerable time may pass between discovery of the gas reserves and production. It is for this primary reason that the court continued to adhere to the Discovery Rule—but the court also continued to limit that rule to natural gas discoveries. Oil must be actually produced and extracted to satisfy the habendum clause in Montana.

Though the Montana court has always followed the Discovery Rule, the continued vitality of that rule was heretofore questionable, given the advent of modern savings clauses in oil and gas leases. The court's welcome holding is also somewhat surprising in view of its continuing adherence to the rule favoring forfeiture of oil and gas leases (which requires a strict construction against the lessee in matters pertaining to the termination of leases), and

in view of its recent adoption of a strict view regarding temporary cessation of production. See "Doctrine of Temporary Cessation Adopted," Vol. XX, No. 1, at 14 (2002) of this *Newsletter*.

The court's holding leaves several questions. The court did not clearly explain what constitutes a "discovery." Must the well be completed and capable of production prior to expiration of the primary term, or is the simple "discovery" of gas-bearing strata enough? At one point in its opinion, the court states that "discovery" requires completion and capability of extraction. This statement implies that the well must be fully completed and capable of production prior to expiration of the primary term. Sandtana's well had not even been cased prior to expiration of the primary term, however, much less completed and capable of production.

Later in its opinion, the court states that Sandtana's well "produced gas to the surface" on the last day of the primary term, and was therefore "a producing well." 80 P.3d at 1231. This implies that actual production to the surface prior to expiration of the primary term may be sufficient to constitute a "discovery." Such actual production might occur in a well drilled with air or under-balanced fluids (as in the *Sandtana* case) or during a drill stem test. What happens, however, if upon expiration of the primary term the "discovery" has been evidenced only by geophysical logs, sample analysis, and/or gas detection—but later confirmed through subsequent completion or testing?

It is not clear how the Discovery Rule "fits in" with modern savings clauses. The writers presume that the written agreement of the parties will control, and so the precise effect of the Rule in any particular case will depend on the language of the oil and gas lease at issue. Nor is it clear how the Discovery Rule comports with the strict rules of interpretation favoring oil and gas lessors otherwise followed by the Montana court. It may be an open question, for instance, whether the Discovery Rule may be invoked by the lessee in the event of loss of market following first production.

OKLAHOMA — OIL & GAS

JAMES C. T. HARDWICK
— REPORTER —

FLUCTUATING PRICES DO NOT JUSTIFY FAILURE TO PRODUCE IN PAYING QUANTITIES

Smith v. Marshall Oil Corp., 2004 OK 10, 85 P.3d 830 (Okla. 2004) was a dispute between a lessee, Smith, and a top lessee, Marshall Oil, as to whether Smith's lease, in its secondary term, had been maintained by production in paying quantities. In response to the top lessee's claim that the lease had terminated because it had ceased to produce in paying quantities, Smith attempted to defend that the action was one for breach of the implied covenant to market, that the lessor never made a verbal or written demand to comply with the implied covenant to market, did not give Smith reasonable time to comply with any such demand, and never brought an action to declare forfeiture of the lease. The supreme court rejected Smith's implied covenant argument, reasoning that under the habendum clause, the lease would terminate of its own terms if it had ceased to produce in

paying quantities unless Smith could present compelling equitable considerations to justify its failure to produce in paying quantities.

The court found no compelling equitable considerations. The court noted that for the years 1996 through 1998, gross revenues were just over \$12,000, while lifting costs were in excess of \$52,000. Further, there was a period following this intermittent production when there was no production at all. Smith's asserted justification was that he deliberately ceased production hoping oil and gas prices would rise. The court labeled this as "mere hope." As for Smith's testimony that he did not want to produce wells when oil dropped to \$8.00 a barrel and that he would wait until oil rose to \$30.00 a barrel, the court noted that during the period in question he had sold oil for various prices: \$16.25 per barrel, later for \$22.50 a barrel, and then later for \$18.50 a barrel. The court commented that "[f]luctuating market prices do not rise to the level of an equitable consideration." 85 P.3d at 836.

DAUBERT APPLIED RETROACTIVELY TO CLAIM THAT OILFIELD OPERATIONS CAUSED TOXIC CONTAMINATION

In *Twyman v. GHK Corp.*, Okla. Civ. App. No. 98426, Jan. 23, 2004 (opinion released for publication), Plaintiffs claimed that oilfield operations conducted by Defendants GHK and Mobil on and adjacent to Twyman's dairy farm resulted in pollutants migrating from their oilfield reserve pits that contaminated Twyman's water well. As a consequence, a number of Twyman's cows experienced health problems, some died, and Twyman claimed this contamination caused him to lose his entire herd, rendering his farm worthless. He sued for negligence, nuisance, and deceit. From a jury award of \$7,250,000, the trial judge ordered remittitur, resulting in a reduction to \$500,000. On appeal, the issue was the reliability of expert scientific testimony on causation under the standards of *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993). In 2003, Oklahoma adopted *Daubert* in *Christian v. Gray*, 2003 OK 10, 65 P.3d 591 (Okla. 2003). To Defendants' appeal challenge that Plaintiffs' expert testimony failed to meet the reliability standards of *Daubert*, Plaintiffs asserted *Daubert* should not be applied since trial was before the Oklahoma Supreme Court adopted *Daubert* in 2003. The court of civil appeals, however, found *Daubert* to be applicable, noting that Defendants had argued for the applicability of *Daubert* at all appropriate stages in the trial court, that retroactive application of a newly announced rule is "the traditional common law approach rather than the exception" and a matter of judicial policy, that *Daubert* was not novel and could not be considered a bolt out of the blue since *Daubert* had been decided by the U.S. Supreme Court some 10 years before its official adoption by the Oklahoma Supreme Court. Further, there had been no showing that the controverted evidence here had previously been accepted as valid.

Applying a clear abuse of discretion standard of review, the court then reviewed whether *Daubert* had been satisfied. The court noted that Plaintiffs utilized a number of scientific witnesses in attempting to support their assertion that heavy metals, hydrocarbons, and radioactive material migrated from a well site on adjoining property through geological, subsurface fractures and polluted their wells, and further, that the polluted water caused the health problems of their dairy cows and eventual loss of their

dairy business. Although not conceding Plaintiffs' claim, Defendants' primary defense was that the Plaintiffs' scientific evidence as to proximate causation was fatally unreliable. Although Defendants contested the entire evidentiary trail from well site to cow demise, the court of civil appeals said it needed to look only to the evidence relied on to prove the water well was the cause of the cows' illness. The court found that it was scientifically unreliable, and thus, inadmissible under *Daubert* for which reason Plaintiffs failed to prove the requisite proximate cause. The court found that there was no scientific literature to support Plaintiffs' witnesses' theory that the levels of heavy metals were toxic to the bacteria in the cows' digestive system leading to the cows' loss of weight and other problems when the heavy metals levels were within safe drinking water range. Further, the theory had not been tested in any manner, there was no peer review other than Plaintiffs' own experts, and as a entirely new theory, it did not have general or widespread acceptance in the relevant scientific community. The court felt that the witnesses had not ruled out other causes of the cows' illness, had provided no evidence as to the heavy metals levels that would be required to cause the illnesses that Plaintiffs' cows suffered, and characterized the witnesses' testimony as nothing more than *ipse dixit*.

Another Plaintiffs' expert's theory was that Plaintiffs' cows had a bovine leukemia virus that was subclinical, and not a medical problem until immune system suppression occurred, and that radiation present in the water was the possible suppressing agent. However, since there was no testing of the radiation levels of the wells during the period in question, the court labeled this witness's testimony as "the uncertainty of possible causation based on the uncertainty of an unproven assumption," and determined it fell short of the *Daubert* standard.

Following reversal by the Oklahoma Court of Civil Appeals, Plaintiff Appellees have sought certiorari to the Oklahoma Supreme Court, which has not acted at the time of this writing.

AMENDMENTS TO THE OKLAHOMA GATHERING ACT

Volume XVI, No. 3, at 15 (1999) of this *Newsletter* noted the 1999 enactment of new legislation regulating gathering in Oklahoma. See Okla. Stat. tit. 52, §§ 24.4 – 24.5. On April 12, 2004, the Governor signed House Bill No. 2550, effective immediately, which made substantial amendments to the 1999 Act. The 1999 Act had given the Corporation Commission broad authority to order access to gathering, and set fees and terms and conditions of service. Among other changes, the amendment defines gathering (not defined in prior legislation) as the transportation, measurement, conditioning, compression, pressure, regulation, recompression, cleaning, treating, and associated fuel and gas loss occurring between the delivery point to a gatherer and the gatherer's redelivery point. These activities constitute gathering, whether for hire, compensation, or otherwise, or for a person's own account, or whether in connection with the purchase and resale of gas. Gathering does not include processing for the extraction of natural gas liquids (NGL), but processors are nevertheless subject to the Act insofar as they perform gathering activities. Only the acts of processing and NGL and product extraction are excluded. When a shipper utilizes a processor for gathering transportation, the amendment requires that the shipper pay the gatherer/processor a "spread fee" determined under the Act which is an

amount to keep the processor whole for any economic loss across the plant incident to redelivering equivalent BTUs to the shipper downstream of the plant. A spread fee results only if the value of the gas converted to NGLs is greater than the value of the recovered NGLs attributed to that particular gas volume.

A provision of the amendments that generated considerable controversy was one that permits a complaining shipper to seek to have applied to it the same fee or terms and conditions of service provided by a prior Corporation Commission order where the fee in dispute relates to the same wells as the prior Commission order. The Commission is required to grant the application unless the gatherer can demonstrate that the complaining shipper is not a similarly situated shipper or there has been a material change in conditions or circumstances since the prior fee or terms and conditions of service were determined.

In connection with disputed hearings, the Commission and the applicant have been given expanded information gathering authority. Under the amendments, gathering contracts covering the 25 wells most recently connected to the gatherer's system are deemed to be discoverable and will not be denied on a relevance objection. The Commission's authority to issue process to enforce the attendance of witnesses and to obtain relevant documents has been expanded and reinforced by \$5,000 per day civil penalty provisions for noncompliance. Further, the Commission has authority to compel the production of documents of any other gatherer the Commission finds, after notice and hearing, are relevant. In such case, the Commission may also enforce the attendance of witnesses and punish by contempt for noncompliance.

Amendments also were made that expand the definition of terms and conditions of service, narrow the excuses justifying a gatherer's refusal to provide gathering service, and modify the standards the Commission is to use for setting fees and terms and conditions of service. Provisions of the 1999 act requiring the gatherer to give notice of increasing its gathering fee, changing terms and conditions of service, continuing service, or not renewing an existing contract have been modified in a number of respects. All contracts now require notice of change. The notice period was extended for contracts of certain duration and the parties' authority to stipulate a different notice in their gathering agreement was limited. The existing provisions prohibiting undue discrimination in favor of a gatherer's affiliates have been amended to require that the gatherers maintain documents sufficient to permit the identification and segregation of affiliate gathering services.

SOUTH DAKOTA — OIL & GAS

MAX MAIN
— REPORTER —

ADMINISTRATIVE RULES ON RISK COMPENSATION

On April 15, 2004, the South Dakota Board of Minerals and Environment adopted new rules regarding risk compensation in compulsory pooling and compulsory unitization. If the nonparticipating owner's interest in the spacing unit is derived from

a lease or other contract for development, the risk compensation is 200% of the nonparticipating owner's share of the reasonable actual downhole costs, exclusive of a 1/8th royalty. S.D. Admin. R. 74:10:18:02. If the nonparticipating owner's interest in the spacing unit is not leased, the risk compensation is 100% of the nonparticipating owner's share of the reasonable actual downhole costs, exclusive of a 1/8th royalty. S.D. Admin. R. 74:10:18:03. The risk compensation factors are identical for compulsory unitization. S.D. Admin. R. 74:10:18:05 & :06. The new rules become effective July 1, 2004.

HOUSE BILL 1014

As an update, House Bill No. 1014, a proposal to reduce the percentage of working interest owners and royalty owners necessary to ratify a proposed oil and gas unit from 75% to 60%, passed the legislature and was signed by the governor on February 12, 2004. The law will become effective July 1, 2004, and will be codified at S.D. Codified Laws § 45-9-40.

TEXAS — MINING

WILLIAM B. BURFORD
— REPORTER —

CAPACITY TO PRODUCE "IN COMMERCIAL QUANTITIES" MAINTAINS URANIUM LEASES

Everest Exploration, Inc. v. URI, Inc., 131 S.W.3d 138 (Tex. App.—San Antonio 2004, no pet. h.), involved the viability of four uranium mining leases granted by the Vasquez family to URI. Everest held competing leases that would have become effective if the URI leases had expired.

The Vasquez-URI leases provided that they would remain in effect until February 12, 2000, "and so long thereafter as uranium . . . is produced in paying quantities" from the leased premises. 131 S.W.3d at 141. URI had ceased producing uranium in 1999 but, annually beginning in 2000, tendered annual shut-in royalty to the Vasquez family pursuant to the following lease provision:

If Lessee . . . has discovered uranium . . . on said Leased Land . . . , which in Lessees' opinion is capable of being produced in commercial quantities, but is not being produced . . . , then this lease shall not terminate . . . , and it shall nevertheless be considered that uranium . . . is being produced in paying quantities from said Leased Land provided such a shut-in Royalty is paid. . . . When the above Shut-in payment is made, it shall serve to extend the term of said lease for one (1) year from the date said payment is made. . . .

Id. On the Vasquez family's rejection of its shut-in payments, URI sued for a declaratory judgment that its leases were still effective. Everest intervened, seeking a declaratory judgment that the leases had terminated. The trial court granted summary judgment to URI.

It was undisputed that uranium had been discovered, so the dispositive issue on appeal was whether it was capable, in URI's opinion, of being produced in commercial quantities. The parties

agreed for purposes of the appeal, on the basis of definitions developed in oil and gas cases, that commercial quantities meant quantities sufficient to pay a profit, even small, over operating expenses, though the lessee may never repay its costs and the enterprise as a whole may prove unprofitable.

URI submitted summary judgment evidence that it could produce uranium in "commercial quantities" under the agreed definition at approximately \$8.00 per pound. Everest countered with a Securities and Exchange Commission filing by URI in which it stated that the market price of uranium was below its cost of production, noting published prices between a low of \$7.10 and a high of \$10.20 per pound. The filing further stated that URI must be able to sell uranium for at least \$12 per pound to achieve a positive cash flow. The SEC filing clearly dealt with its enterprise profitability and the price at which URI must be able to sell in order to make a profit, considering all its costs of production, the court of appeals said. Therefore, it held, the undisputed evidence of the sale price above which URI could produce in paying quantities was approximately \$8.00 per pound.

Everest contended that the market value had to be high enough to produce a profit on the dates it tendered the shut-in payments. (The opinion is not explicit, but presumably market uranium prices were below \$8.00 per pound on one or more of the dates URI tendered payment.) Relying on oil and gas cases, the court of appeals rejected the argument that production in paying or commercial quantities is determined at a static point in time or over some arbitrary period. Instead, a lease is capable of producing in commercial quantities if under all the relevant circumstances a reasonably prudent operator would maintain the lease for the purpose of making a profit and not merely for speculation. In light of this standard and of URI's summary judgment evidence, uncontroverted by anything submitted by Everest, that in URI's opinion the Vasquez uranium could be produced in commercial quantities and at a profit, the trial court did not err in granting summary judgment to URI.

TEXAS — OIL & GAS

WILLIAM B. BURFORD
— REPORTER —

FRANCHISE TAX BASED ON PERCENTAGE OF GAS SALES DID NOT REQUIRE PAYMENT FOR GAS TRANSPORTED FOR OTHERS, INCLUDING AFFILIATES

Southern Union Co. v. City of Edinburg, 129 S.W.3d 74 (Tex. 2003), involved a franchise granted by the City of Edinburg to Rio Grande Valley Gas Company (RGVG), a predecessor by merger to Southern Union Company, authorizing the gas company to install and operate pipelines under public rights-of-way and public lands within the city. The franchise agreement, embodied in the city's Ordinance No. 1129, required the gas company to pay a franchise tax of 4% of its gross income from all sales of gas within the city.

At the time of the franchise agreement in 1985, RGVG was selling gas to consumers in Edinburg. As the natural gas industry changed over the next few years, its business shifted to the transportation of gas for other suppliers, including companies

affiliated with RGVG by common ownership. The city sued Southern Union for unpaid franchise taxes, taking the position that all gas sold by any seller to consumers within the city was subject to the 4% franchise tax if delivered by means of Southern Union facilities. The trial court rendered judgments against Valero Energy Corporation, RGVG's parent company until 1993 when RGVG was sold to Southern Union, and against Southern Union. Valero and Southern Union appealed.

The supreme court reversed a judgment of the court of appeals which had largely affirmed the trial court's award of damages to the city and rendered judgment that the city take nothing. Read in context, the franchise ordinance's intent was that the gas company's "gross income" from sales within the city meant gross income from its own sales, not sales by other parties. This was particularly apparent given that the city had enacted ordinances expressly permitting RGVG to transport gas for large customers in the city and assessing fees for that transportation.

Moreover, the courts were not entitled to disregard RGVG's separate existence and treat sales by Valero affiliates, before the 1993 sale of RGVG to Southern Union, and by other Southern Union subsidiaries thereafter, as being sales by RGVG. The court of appeals had upheld the trial court's awards of damages against the parent companies and subsidiaries on the theory that the affiliated entities were all operated as a single business enterprise so that sales by any entity related to the same parent company should be subject to the franchise tax. The supreme court declined to decide whether the "single business enterprise" theory of alter ego for disregarding corporate structure is viable in Texas. It instead held that regardless of whatever label might be given to the city's attempt to treat the affiliated entities as a single one, article 2.21 of the Texas Business Corporation Act controlled. That statute provides that the shareholder or affiliate of a corporation has no obligation to the corporation or its obligees on the basis that the shareholder or affiliate is the alter ego of the corporation, or on the basis of actual or constructive fraud or sham to perpetuate a fraud, unless the obligee demonstrates that the shareholder or affiliate actually did perpetuate a fraud. There was no evidence to support a finding that the corporate entities involved here perpetuated an actual fraud. The mere fact that the various entities had common directors, shared employees and central accounting and payroll systems could not justify disregarding the affiliated companies' corporate structures. More importantly, proof of those facts would not establish liability under article 2.21.

This case has obvious implications beyond compensation under franchise arrangements between local governments and utilities. The court has made it clear, at least in the context of affiliated corporations, that affiliates cannot be regarded as a single entity merely upon a showing of their affiliation.

LANDOWNERS LACK STANDING TO SUE FOR INJURY TO LAND THAT OCCURRED BEFORE ACQUISITION

Denman v. Citgo Pipeline Co., 123 S.W.3d 728 (Tex. App.—Texarkana 2003, no pet.), decided the plaintiff landowners' appeal of a summary judgment in favor of Citgo, formerly the owner of a pipeline crossing the plaintiffs' land. Citgo had owned and operated the pipeline from 1975 until it sold the line in 1997. The plaintiffs acquired the land in 1998 and subsequently dis-

covered contamination of their soil, asbestos-covered pipelines, and other items related to the pipeline that they alleged had injured their land. The trial court granted summary judgment for Citgo on the basis that the plaintiffs lacked standing to bring the suit for injuries that occurred before their purchase of the land.

The court of appeals affirmed, following *Exxon Corp. v. Pluff*, 94 S.W.3d 22 (Tex. App.—Tyler 2002, pet. denied), and *Senn v. Texaco Inc.*, 55 S.W.3d 222 (Tex. App.—Eastland 2001, pet. denied). The right to sue for injury to land, whether permanent or temporary, is a personal right belonging to the person owning the property at the time of the injury and does not pass to a subsequent purchaser without express provision in the deed. A mere subsequent purchaser cannot recover for an injury committed before his or her purchase. Citgo presented summary judgment evidence that it had not conducted any operations on the land since selling the pipeline in 1997. Although the plaintiffs asserted that Citgo still owned the right-of-way and another pipeline within it, their evidence, consisting of a picture of a pipeline and some Citgo signs that had apparently not been removed, did not raise an inference of any ongoing operations or continued ownership on the part of Citgo.

FORMER OPERATORS NOT LIABLE TO LANDOWNERS FOR ABANDONED PRODUCTION FACILITIES

A pair of decisions of the Tyler court of appeals turned back trial court judgments holding operators liable for having created a nuisance by failing to remove structures no longer being used in their oil and gas operations.

The plaintiff landowner in *OXY USA, Inc. v. Cook*, 127 S.W.3d 16 (Tex. App.—Tyler 2003, pet. denied), had been awarded \$25,000.00 on his theory that OXY's having left the structures once used in its oil production operations after plugging eight wells constituted a nuisance that injured his land. OXY was only on the land by virtue of rights conferred on it by its oil and gas lease, the court of appeals observed, so that the landowner's cause of action depended entirely on the lease contract to establish a duty to remove the structures. His action was therefore one for breach of contract only, not for the tort of nuisance, and the jury's finding that OXY had created a nuisance failed as a matter of law. The jury had not been submitted the question of whether OXY's failure to remove oilfield materials and clean up the property constituted excessive use of the surface estate, nor had the plaintiff requested such a jury question, possibly because, as the court pointed out in a footnote, the same court of appeals determined in *Exxon Corp. v. Pluff*, 94 S.W.3d 22 (Tex. App.—Tyler 2002, pet. denied), that a similar lease imposed no duty on the operator to remove oilfield material after operations ceased.

Likewise, in *Exxon Corp. v. Tyra*, 127 S.W.3d 12 (Tex. App.—Tyler 2003, pet. denied), the court overturned a \$30,000 judgment based on a jury finding of nuisance damages. Between 1951 and 1968 Exxon had plugged and abandoned 16 wells on a tract of land acquired by Tyra in 1973, continuing to operate a 17th well until it was plugged in 1990. Tyra's suit claimed that Exxon's leaving concrete slabs, pumping unit foundations, derrick corners, and pipelines on the land and its failure to clean up pits constituted a nuisance, trespass, and failure to adhere to

reasonable and prudent operation by using more of the surface than was reasonably necessary. The court first concluded that Tyra lacked standing to assert a cause of action for injury to the property resulting from the 16 wells plugged before he had acquired the land. Only the person whose primary right has been breached may seek redress for an injury, the court explained. The injury to the property arising from the first 16 wells occurred before Tyra bought the land; Tyra knew of the injury; and the previous owner did not assign Tyra any claim for surface damages. With respect to the well that was plugged in 1990, after Tyra acquired the land, the court agreed with Exxon that there could be no tort liability for nuisance because this was a contract case and that it had no contractual duty under the lease requiring it to restore the property. Moreover, although the jury had found that Exxon had created a nuisance, it had also found that Exxon had not used more of the surface than it was entitled to use while exploring for and producing oil and/or gas and had not failed in its obligation to remove equipment and property after it had stopped its operations on the land.

APPEAL OF AFFIRMANCE OF RAILROAD COMMISSION ORDER DENIED ON PROCEDURAL GROUNDS

Helton v. Railroad Commission, 126 S.W.3d 111 (Tex. App.—Houston [1st Dist.] 2003, pet. denied), upheld the trial court's affirmance of the Texas Railroad Commission's order not to dissolve a pooled unit formed under the Mineral Interest Pooling Act. The 244-acre gas unit had been forcibly pooled in 1980 on the application of J. Wylie Harris. The gas-to-oil ratio of the unit well subsequently declined, and it was reclassified as an oil well in 1999. Helton thereupon applied to the Railroad Commission for dissolution of the unit. After a hearing in which Helton and Tri-Union Development Corporation, the unit operator, participated through counsel, and at which Harris appeared, testified, and argued as a third-party intervenor, the Railroad Commission adopted the opinion of its hearing examiner that the unit remained in effect and ordered that it not be dissolved. Helton appealed the Railroad Commission order to the trial court but did not serve Harris with a copy of his petition seeking judicial review.

The commission and Tri-Union successfully argued on appeal that the Texas Administrative Procedure Act (APA), Tex. Gov't Code Ann. § 2001.176(b)(2) (Vernon 2000), requiring a party seeking judicial review of a state agency order to serve a copy on the agency and each party of record in the agency proceeding, compelled the trial court to dismiss or deny Helton's petition for review because of his failure to serve Harris with a copy. Helton defended his failure to serve Harris by pointing out that Harris had not requested party status and had identified himself at the hearing as no more than an intervenor. Commission rules, however, defined parties as including an intervenor, and the court emphasized Harris's active participation at the hearing. Although Helton's failure to serve Harris did not deprive the reviewing trial court of jurisdiction, service was a necessary condition on which Helton's right to seek judicial review depended. Accordingly, Helton failed to prove his right to relief from the trial court, which had no choice but to affirm the commission's order.

TEXAS PROBATE COURT IS NOT THE PLACE TO LITIGATE COLORADO ROYALTY PAYMENT DISPUTE

Presumably because they had found a sympathetic jury, overriding royalty owners in the McElmo Dome Unit, a carbon dioxide unit in Colorado, sued the unit producers in the statutory probate court of Denton County, Texas. They alleged that the defendants, affiliates of Shell Oil Company and Mobil Oil Corporation, had improperly deducted transportation charges from their royalty payments since 1982. Among the plaintiffs were the trustees of certain inter vivos and charitable trusts. During the course of the litigation the court certified a class of plaintiffs consisting of all overriding royalty owners under Shell and Mobil leases committed to the unit.

In *Shell Cortez Pipeline Co. v. Shores*, 127 S.W.3d 286 (Tex. App.—Fort Worth 2004, no pet. h.), the court of appeals held the probate court's class certification void on the basis that the court lacked jurisdiction. A statutory probate court may exercise only that jurisdiction accorded it by statute, the court of appeals began. The plaintiffs contended that because the trustees of an inter vivos trust were parties, the probate court had jurisdiction under a statute conferring it in actions "involving an inter vivos trust." The court of appeals disagreed. The mere fact that an inter vivos trust has the same or similar claims as the members of the class does not, it held, transform the class claims into actions that involve the trust. To hold that the probate statutes vest a statutory probate court with jurisdiction over class claims simply because an inter vivos trust is a member of the class would circumvent and impermissibly broaden the legislature's narrow grant of jurisdiction.

In *Mobil Oil Corp. v. Shores*, 128 S.W.3d 718 (Tex. App.—Fort Worth 2004, no pet. h.), the court of appeals held that the plaintiffs' remaining claims for damages relating to the royalty payments were likewise not within the statutory probate court's jurisdiction. Again, a statutory probate court may exercise only that jurisdiction accorded to it by statute, the court explained. The plaintiffs contended that the probate court had jurisdiction under statutes conferring it in actions "appertaining to estates" or "incident to an estate" or conferring it, concurrently with the district court's jurisdiction in actions concerning trusts, in actions "involving" an inter vivos trust or a charitable trust. The plaintiffs' claims did not fall within any statutory examples of actions appertaining or incident to estates, such as the probate and construction of wills or the interpretation and administration of testamentary trusts, nor was the controlling issue the settlement, partition, and distribution of decedents' estates as also specifically mentioned in the jurisdictional statute. The question, therefore, was whether the plaintiffs' suit was an action involving an inter vivos or charitable trust. The plaintiffs argued that it was, because Texas trustees have the power to enter into mineral leases and to contest claims of and against a trust. Their contention was, in essence, that every suit to which a trustee is a party raises questions affecting or arising in the administration or distribution of a trust and thus can be heard in the probate court. To thus transform every case in which a plaintiff happens to be a trustee unto one "concerning trusts," the court held, would ignore or undo the legislature's care in limiting jurisdiction over matters concerning trusts.

OPERATIONS WITHIN POOLED UNIT MAINTAIN LEASE IN EFFECT

In *Pioneer Natural Resources USA, Inc. v. W.L. Ranch, Inc.*, 127 S.W.3d 900 (Tex. App.—Corpus Christi 2004, pet. denied), the court of appeals reversed a trial court judgment of damages for trespass, holding that the defendant's oil and gas lease had not terminated as the lower court had found.

The plaintiff executed a lease to Pioneer, the defendant, on August 20, 1993, covering its 103.75-acre tract for a primary term of one year and so long thereafter as operations were conducted on the leased land. The lease authorized pooling, with the usual provision that operations on any part of the unitized land would be considered, for all purposes except payment of royalty, operations conducted on the land under lease. The lease also included an addendum, whose Paragraph 17 provided that if oil or gas were not being produced from the leased premises, or if the lessee were not engaged in actual drilling operations, at the end of the primary term or any time thereafter, the lease would terminate.

Before the primary term expired, Pioneer pooled the plaintiff's tract into a 378.72-acre unit and commenced the drilling of a horizontal drainhole well. The wellbore did not penetrate the plaintiff's tract until after August 20, 1994, the end of the primary term. It was eventually drilled a length of some 2,300 feet under the tract and produced oil from its completion on October 18, 1994, until it was plugged in 1999. The plaintiff alleged that the lease had terminated on August 20, 1994, when there was no production nor operations on the leased premises and was granted a summary judgment and, after a jury trial, damages for trespass.

The lessor argued that Paragraph 17, calling for termination at the end of the primary term in the absence of production or operations on the leased premises, conflicted with the pooling provision and that Paragraph 17 prevailed because of another provision that the addendum would control in the event of any conflict. The court of appeals disagreed, noting that no language in the lease expressly prohibited or limited pooling. Another sentence in the same Paragraph 17, it pointed out, specifically referred to wells pooled with the plaintiff's tract, demonstrating that the parties did not intend to eliminate the lessee's pooling authority. The lessee's operations on land within the pooled unit at the end of the primary term were therefore sufficient to extend the lease.

The remainder of the court's opinion dealt with the trial court's further award of damages based on jury findings of Pioneer's negligence in drilling the well and fraud in inducing the plaintiff to execute a lease amendment increasing the authorized size of a pooled unit from 320 acres to 380 acres. With respect to negligence, the court held that there was no evidence to support the jury's finding, because the plaintiff's only expert witness testified he had no experience in the drilling of horizontal wells and because testimony of Pioneer's experts could not form the basis for a negligence finding contrary to the facts to which they testified. Besides, there could have been no damages for lost royalties based on Pioneer's negligence, since the evidence established that all available reserves had been recovered.

Finally, the court held that there was no evidence that the lessor was damaged by the amendment to the pooling provision. A Pioneer employee had made statements that Pioneer intended to drill three 4500-foot laterals and needed 380 acres to do so. The plaintiff's witnesses admitted, however, that the statements were not promises to drill the three 4500-foot laterals. Moreover, the injury suffered in a fraud case must be directly traceable to, and must have resulted from, the false representation upon which the injured party relied. The plaintiff advanced no concise argument that its lost royalties were traceable to the alleged misrepresentations. The plaintiff's damage awards for negligence and fraud, the court summed up, were based on incorrect and irrelevant calculations of an unqualified expert and amounted to no evidence.

POOLING NOT EFFECTIVE BEFORE FILING OF UNIT DESIGNATION

Oil and gas title lawyers often warn clients against taking and selling production before any necessary pooling has been accomplished. *Union Gas Corp. v. Gisler*, 129 S.W.3d 145 (Tex. App.—Corpus Christi 2003, no pet.), perfectly illustrates the reason.

Union completed its Watts-Gisler No. 1 Well in March, 2000, on a drillsite tract covered by an oil and gas lease from the Gislens. The Gisler lease authorized the lessee to pool their tract with other land, requiring that an instrument designating the unit be filed for record in the appropriate county records and providing that "upon such recordation the unit shall be effective as to all parties hereto." On August 7, 2000, Union filed for record a designation of a pooled unit consisting of the Gisler tract and several other tracts, which stated that it was to be effective as of first production. The Gislens asserted in their suit against Union the right to their full 3/16 royalty, not merely 3/16 of the ratio that the acreage of their tract bore to the total acreage of the pooled unit, on some \$1.3 million of royalty proceeds on gas production between the March completion of the well and the August 7 filing of the pooling designation. Union appealed from a summary judgment in favor of the Gislens.

The court of appeals agreed with the Gislens that it should enforce the plain terms of the oil and gas lease. Absent express authority, it noted, a lessee has no power to pool the lessor's interest with those of others. Under the express terms of the lease, pooling was to be effective upon recordation of a pooling designation; yet the designation Union filed stated that pooling was retroactive to first production. Union's pooling was not in accordance with its lease, insofar as the effective date of the pooling was concerned, and Union could not escape its contractual obligation to pay the Gislens their full 3/16 royalty as provided in the lease for production before the actual August 7 effective date of the pooling. It could not, said the court, modify existing contract rights by a subsequent, unilateral unit designation.

The other, non-drillsite, leases included in Union's pooling designation contained pooling provisions functionally identical to those of the Gisler lease, providing that pooling would be effected upon the lessee's filing its pooling designation for record. The royalty owners under the other leases claimed that Union was bound by its unit designation and that they should be paid royalties on production from the unit well beginning with

first production. The trial court had severed the claims of the non-drillsite royalty owners and had then granted them summary judgment as well, exposing Union to seemingly contradictory liability to the Gislens for royalty calculated on an unpooled basis and to the others for royalty based on the unit designation. In six practically identical unpublished opinions issued after its *Gisler* decision, e.g., *Union Gas Corp. v. Tittizer*, 2003 WL 22479980 (Tex. App.—Corpus Christi 2003, pet. filed), the court held against each of the non-drillsite royalty claimants. Because the unit was not effectively pooled until the August 7 recordation date, regardless of the lessee's unauthorized attempt to specify an earlier date, there was no unit production until that time.

SOLE REMEDY OF SUBCONTRACTOR'S INJURED EMPLOYEE DEPENDS ON TORT-REFORM LEGISLATION

Francis v. Coastal Oil & Gas Corp., 130 S.W.3d 76 (Tex. App.—Houston [1st Dist.] 2003, no pet.), upheld the trial court's take-nothing judgment in favor of the owner-operator of a gas well against a claim by a subcontractor's employee injured in an oilfield accident.

Coastal operated the M. Salinas No. 6 Well and held oil and gas leases on the property. It contracted with Acock, a consultant, to supervise the reworking of the well, and with Reeled Tubing to perform a "coiled tubing wash out," part of the reworking operation. Francis, an employee of Reeled Tubing, was injured in an explosion of gas that had collected over temporary tanks placed too close to the well site. The jury found, in response to a question framed under traditional common-law liability standards and submitted over Coastal's objection, that Coastal knew or should have known of the danger posed by the tank and failed to exercise ordinary care to protect Francis. It also found, however, that Coastal had not been negligent in response to another question conforming to Chapter 95 of the Texas Civil Practice and Remedies Code, enacted by the 1996 legislature as part of a sweeping tort-reform package. The trial court rendered a take-nothing judgment for Coastal on the basis that Chapter 95 provided Francis's sole remedy. The court of appeals affirmed.

Chapter 95, the court began, applies to claims for "damages caused by negligence" against a "property owner," defined as a "person or entity that owns real property primarily used for commercial or business purposes." Tex. Civ. Prac. & Rem. Code Ann. § 95.001(1)-(3) (Vernon 1997). It further applies only to a claim against a property owner, contractor, or subcontractor for personal injury, death, or property damage to an owner, contractor, or subcontractor or to an employee of a contractor or subcontractor that arises from the condition or use of an improvement to real property where the contractor or subcontractor constructs, repairs, renovates, or modifies the improvement. Tex. Civ. Prac. & Rem. Code Ann. § 95.002(1)-(2) (Vernon 1997). The heart of the statute relieves a property owner from liability for negligence claims arising from the failure to provide a safe workplace unless (1) the property owner exercises or retains some control over the manner in which the work is performed, other than the right to order the work to start or stop or to inspect progress and receive reports; and (2) the property owner had actual knowledge of the danger or condition resulting in the injury or damage and failed to adequately warn. Tex. Civ. Prac. & Rem. Code Ann.

§ 95.003(1)-(2) (Vernon 1997). The court had little trouble in holding that Coastal was an “owner” of real property as the holder of leases on the well location, discerning nothing in the statutory language supporting an interpretation that an owner of a premises who also operates it is removed from its provisions; that settled law recognizes that a mineral well constitutes an improvement to the property; and that the cleaning of the well by means of the “coiled tubing washout” was a repair or renovation of the well, so as to bring Coastal and its well location within the statute.

Turning to the jury’s negative finding of liability against Coastal, the court observed that the question that had elicited the finding defined negligence essentially in conformity with Chapter 95, instructing the jury that Coastal must have had actual knowledge of the risk and failed to adequately warn of it. In contrast, the question that had resulted in a jury finding of negligence defined it in terms of common-law “business invitee” liability, instructing that Coastal was negligent if it “knew or should have known” of the danger and failed to exercise ordinary care by failing to warn against it and to make the condition reasonably safe. The plain language of the statute, the court concluded, requires a plaintiff to meet its specific evidentiary burdens to prevail, so that it constituted Francis’s sole remedy. The trial court had been correct to disregard the jury’s negligence finding in response to the common-law-based question that the trial court admitted it had likely erred in submitting.

DRILLING CONTRACT PROVISIONS FOR ALLOCATION OF RISK UPHELD

Cleere Drilling Co. v. Dominion Exploration & Production, Inc., 351 F.3d 642 (5th Cir. 2003), concerned the allocation of losses and damage responsibility resulting from the blowout of the Kenaf Industries Unit No. 1 Well, which Cleere had contracted to drill for Dominion under a standard IADC form footage drilling contract. It was undisputed on appeal that the blowout was caused by Cleere, the drilling contractor, and the case was one of contractual allocation of risk. Although Cleere claimed that circumstances specified by the contract had occurred that would have converted it to a daywork contract and allowed Cleere to be compensated for its services and for loss of Cleere’s in-hole equipment, the court of appeals found no fault with the trial court’s findings of fact against Cleere in this regard. The court also affirmed the award of damages to Dominion for the cost incurred in controlling the well, presumably in keeping with the contract’s allocation of liability to the contractor. It nevertheless reversed the trial court’s allocation of liability for surface restoration and damage to Cleere.

The drilling contract, in Subparagraph 18.12, provided that the operator, Dominion, would be responsible for the control or removal of all pollution or contamination, other than that originating above the surface, specifically including that resulting from blowout, and that it would release and indemnify the contractor, Cleere, from and against any such liability. Under Subparagraph 18.15 of the contract, its provisions for release and indemnity were to apply without regard to cause, including the negligence of any party. The district court had held that Subparagraph 18.15 failed as a matter of law to meet the Texas public policy requirement of “fair notice” for release and indemnity agreements to be binding and that, in any event, the materials

deposited on the drillsite by the blowout did not constitute “pollution or contamination” for which the contract provided that Dominion would be liable.

The Texas “fair notice requirement” is that a contractual provision allocating liability for a party’s own negligence to another must specifically express that intent and that it must be conspicuous. Dominion conceded on appeal that Subparagraph 18.15 met the “express negligence” requirement that the provision clearly express the intent to indemnify a party against its own negligence. Assuming without deciding that the provision lacked sufficient conspicuousness, the court of appeals held the fair notice requirement irrelevant under the circumstances. The fair notice requirement does not apply, the court explained, when the indemnitor possessed actual notice or knowledge of the agreement. The record showed that Dominion representatives actively negotiated the contract’s provisions and that the parties made many changes to it, including additions to and deletions from Subparagraphs 18.12 and 18.15. The court characterized as feeble and specious Dominion’s argument that it did not have knowledge of the contract’s indemnity provisions because the person who had negotiated on its behalf was not a lawyer.

The court also rejected Dominion’s argument that although the salt water, gas, sand, and chemically treated drilling mud spewed on the surface by the blowout created a “mess,” it was not “pollution or contamination” for which the contract allocated liability solely to Dominion. The contract did not define pollution or contamination. Giving the words their ordinary meaning and quoting from a law dictionary and a general dictionary, the court emphasized that “contamination” may be said to result from contact with a “foreign substance” or the introduction of “undesirable elements” that render the surface soiled, stained, and unfit for its intended use. Asking rhetorically why Dominion would have spent hundreds of thousands of dollars on cleanup and on a surface damage settlement if the “mess” were not contamination and pointing out that Subparagraph 18.12 was the only contractual provision that could be applicable to surface restoration and cleanup costs, the court held Dominion liable for those costs (exclusive of those, such as surface fissures, that might not be attributable to foreign substances).

UTAH — MINING

DANIEL A. JENSEN
— REPORTER —

NEW REGULATIONS FOR HARDROCK MINING COMPLIANCE

In 2002, the Utah legislature established a comprehensive regulatory enforcement program for non-coal mining and exploration operations conducted within the state. Part of the Utah Mined Land Reclamation Act (Utah Code Ann. §§ 40-8-1 to -23), the relatively new hardrock mining enforcement procedures were similar to existing procedures for coal mining. The hardrock enforcement procedures include notices of violation, cessation orders, civil and criminal penalties for noncompliance, informal conferences with the enforcement agency (the Utah Division of Oil, Gas and Mining), administrative hearings (before the Utah

Board of Oil, Gas and Mining) for resolving violations, and judicial review of the agency action.

The Utah Division of Oil, Gas and Mining has now established administrative regulations to supplement the statutory hardrock mining enforcement provisions. The new regulations are found at Utah Admin. Code R. 647-6 to -8. They became effective on May 18, 2004.

WYOMING — MINING

WILLIAM N. HEISS
— REPORTER —

COLLATERAL AGREEMENT INSUFFICIENT TO REBUT PRESUMPTION OF EQUAL SHARES OF COTENANTS ACQUIRED IN WARRANTY DEED

In *Bixler v. Oro Management, L.L.C.*, 2004 WY 29, 86 P.3d 843 (Wyo. 2004), the Wyoming Supreme Court construed the effects of a collateral agreement on a subsequently executed warranty deed. Bixler and Oro Management entered into an agreement in 1999 to purchase from a third party 1,700 acres that included mining claims that the parties intended to develop for gold. The agreement was written on a napkin (napkin agreement), signed by both parties and provided:

Bixler's part of this agreement in monies is the price of \$365,000 thousand will consist of 50% of property which will be held in [tenants] in [common] and he is to receive (40) forty percent of the gravel and 25 percent of the net mineral rights. Mineral rights are to include load claims, placer material, stock piles and any other [pertinent] material from under or above ground.

86 P.3d at 846.

Within a month following the napkin agreement, the parties accepted and recorded a warranty deed drafted by seller's attorney conveying "the following described real estate" to Bixler and Oro as tenants in common. The property description was a list of placer and lode claims. *Id.*

Oro was to obtain mining permits, provide machinery, and pay all costs of mining. After two years Bixler became dissatisfied with the progress and filed suit for partition of the property, and claimed breach of their contract along with other counts. After discovery was concluded, Oro filed a motion for summary judgment, contending that the parties' interests were governed by the napkin agreement which, by its interpretation, gave Bixler no possessory rights in the mineral estate and therefore no right to partition the mineral estate. Bixler also filed a motion for summary judgment claiming that the warranty deed conveyed to him 50% interest in the surface and minerals and he was entitled to partition.

The district court denied Bixler's motion for summary judgment and held that the parties' interests in the property were governed by the napkin agreement and not by the warranty deed. The napkin agreement clearly gave Bixler a 50% interest in the surface and a 40% interest in the gravel. Following two days of additional testimony as to the meaning of "25 percent of the net

mineral rights," the court concluded that Bixler had the right to 25% of the net revenues of mineral production from the property. The district court found that the warranty deed on its face vested the parties, as cotenants, with interests presumed to be equal in the property, and that presumption was successfully rebutted by the prior agreement. Consequently, the district court found that Bixler had no possessory ownership of the mineral estate and was thus not entitled to partition of that estate. The court did find Bixler was entitled to partition of 50% of the surface and 40% of the gravel.

On appeal to the Wyoming Supreme Court Bixler argued that the terms of the napkin agreement were merged into the warranty deed which made Bixler an equal cotenant in both the surface and minerals. Oro conceded that the terms of the napkin agreement were merged into the deed but that the presumption that the grantees of the deed shared equally can be rebutted by extrinsic evidence showing that the parties intended a different result.

The Wyoming Supreme Court discussed general principles of the doctrine of merger, including the exception that contractual obligations collateral to the transaction may survive closing and be enforced under the contract. The collateral obligation exception clearly did not apply since the terms of the napkin agreement were "deed related" in that they related to issues of "title, possession [and] quantities or emblems of the land." 86 P.3d at 849. Thus the court held that the terms of the napkin agreement were merged into the deed.

The court went on, however, to determine the interests owned by the parties as a result of the deed. The court found the deed to unambiguously convey to the grantees, as tenants in common, an interest in both the surface and subsurface of the property described. As to the interest of each cotenant the court stated the general rule that if the instrument does not specify the shares to be owned by each cotenant, it is presumed that they are equal. However, this presumption can be rebutted by proof that the cotenants contributed unequal portions of the purchase price and there is neither a family relationship among the cotenants or evidence of a donative intent on the part of those contributing more of the purchase price. The court expressed some doubt as to whether the napkin agreement was even the type of evidence that other courts have used to rebut the presumption of equal shares. Generally, that evidence consists of unequal contributions to the purchase price and, in this case, Bixler contributed more than half of the \$700,000 purchase price.

In a bit of strained logic, the court found that the napkin agreement was offered by Oro not to "disprove equal shares owned by the tenants in common, but to prove Mr. Bixler owned *no possessory interest* in the mineral estate at all." 86 P.3d at 850. [Query: If the parol evidence proves ownership of 99% and 1% between cotenants, is this any different from evidence that shows ownership to be 100% and 0?]. The court stated that while parol evidence can be used to rebut the presumption of equal shares, it cannot be relied upon to contradict the deed itself. Thus, the court reversed the district court's holding that Bixler had no possessory interest in the mineral estate and remanded the case with instructions to enter summary judgment for Bixler on the issue of partition of his mineral interest.

WYOMING — OIL & GAS

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GRANT OF COAL HELD TO INCLUDE COALBED METHANE

In *Caballo Coal Co. v. Fidelity Exploration & Production Co.*, 2004 WY 6, 84 P.3d 311 (Wyo. 2004), the Wyoming Supreme Court considered whether the grant in two 1970 warranty deeds to Carter Oil Company included the coalbed methane (CBM). Both deeds granted all of grantors' undivided interest in the coal

TOGETHER WITH all of GRANTOR'S UNDIVIDED interest in and to all other minerals, metallic or non-metallic, contained in or associated with the deposits of coal conveyed hereby or which may be mined or produced with said coal, subject to the reserved royalty hereinafter provided.

84 P.3d at 313.

Both deeds provided for a royalty on coal to be paid to the grantors. Fidelity Exploration acquired oil and gas leases from Caballo Coal Company (CCC), the successor to Carter Oil Company, and from the appellees, successors to the grantors under the deeds. After drilling CBM wells on the property covered by the deeds, Fidelity filed an interpleader action in district court seeking a determination of who was entitled to the royalties on CBM production. Upon cross motions, the court entered summary judgment in favor of appellees and against Caballo Coal Company.

On appeal the Wyoming Supreme Court relied heavily on its holdings in *Newman v. RAG Wyoming Land Co.*, 2002 WY 132, 53 P.3d 540 (Wyo. 2002) and on *McGee v. Caballo Coal Co.*, 2003 WY 68, 69 P.3d 908 (Wyo. 2003). In both prior cases the court considered whether CBM had been conveyed in deeds granting the surface and "coal and minerals commingled with [the] coal" and reserving "all 'oil, gas and other minerals' not otherwise conveyed." *Newman*, 53 P.3d at 540.

As in *Newman* and *McGee* the court applied normal rules of deed construction in an attempt to determine whether the parties intended for the CBM to be conveyed with the coal. The court emphasized that the deeds in question here granted *all* minerals, including nonmetallic minerals. Since the two prior cases established that CBM is a mineral in Wyoming, the granting language of the deeds at issue would include CBM.

The appellees argued that the reservation in the deeds of a royalty on "all coal mined and sold, or removed" from the property, with no mention of gas, indicated an intent by the parties to convey only coal and not gas. *Caballo*, 84 P.3d at 318. The appellees also argued that the deeds were coal conveyances, as evidenced by the title provision stating "This is a deed conveying fee simple title to the coal in place, and is not a lease." *Id.* at 317. The court did not find these arguments convincing since they would render useless the plain language of the granting clause.

The court also looked at the historical context and concluded that the parties would have given words the meaning prevailing during the 1970s when separate production of CBM did not occur and when CBM was a useless and sometimes dangerous by-product of coal production. Contrary to *McGee* and *Newman*, where the grantors reserved "all oil, gas and other minerals," there was no mineral reservation by the grantors in the deeds at issue. The court found the deeds unambiguous and the parties' intent clear to convey all minerals, including CBM. Consequently, the district court's judgment was reversed.

CANADA — MINING

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WESTRAY AMENDMENTS TARGET CRIMINAL LIABILITY OF ORGANIZATIONS

On March 31, 2004, amendments to the Criminal Code of Canada, R.S.C. 1985, c. 46 (the Code), came into force that significantly affect the potential criminal liability of mining companies. Under the new Code provisions anyone operating in Canada without adequate environmental and occupational health and safety regimes could now face criminal charges. These sanctions are in addition to any civil and regulatory penalties that may be authorized under other federal and provincial statutes. Bill C-45, An Act to Amend the Criminal Code of Canada, S.C. 2003, c. 21, was developed as a legislative response to the 1992 Westray coal mine explosion in Plymouth, Nova Scotia. Twenty-six miners died. No charges were laid even though the public inquiry into the disaster was highly critical of the mine's owners and managers.

The changes will make organizations liable: (1) for the actions of employees including lower level supervisors, who oversee day-to-day operations, even if those employees are not senior managers; (2) when directors or executives with executive or operational authority intentionally commit, or direct employees to commit, offences to benefit the corporation; (3) when officers with executive or operational authority become aware of offences committed by other employees but do not take action to stop them; and (4) when the actions of those with authority and other employees, taken as a whole, demonstrate a lack of care that constitutes criminal negligence.

Section 217.1 creates a new legal duty: "everyone who undertakes, or has the authority to direct, how another person does work or performs a task is under a *legal duty to take reasonable steps to prevent bodily harm* to that person, or any other person, arising from that work or task" (emphasis added). If a person is or has the potential to be injured or killed in a workplace accident or as a result of an environmental incident (for example, a chlorine gas leak), a corporation or employee who fails to live up to this duty may be charged with criminal negligence.

Section 219 sets out the generally applicable criminal negligence test and was not amended by Bill C-45. Section 22.2 establishes a two-step process to convict an organization of

criminal negligence. First, the Crown must prove that a single representative or a group of representatives either carried out an act or omitted to carry out an act, in a situation where they are under an obligation to comply with the legal duty set out above. The Crown must also prove that the representative was acting within the scope of the authority granted by the organization at the time of the offence. Under Section 22.1, a "representative" could be a director, partner, employee, member, agent, or contractor of the organization. Second, the Crown must prove that the conduct of the accused party (or in the case of an organization, a senior officer) represented a marked departure from the standard that could reasonably be expected in the circumstances. Section 22.1 defines a "senior officer" as any representative who "plays an important role in the establishment of an organization's policies or is responsible for managing an important aspect of the organization's activities."

For example, if an employee supervised another employee carrying out a task and failed to put into place required safety measures, the supervising employee could face criminal negligence charges. If in addition the employer failed to give the negligent employee basic training necessary to carry out the job safely, or if appropriate resources were not allocated to health and safety on a company-wide basis, the organization could also face criminal negligence charges.

The Crown must prove Code offences "beyond a reasonable doubt," the highest standard. Therefore, Code offences may be more difficult to prove than regulatory contraventions, where the Crown must prove the contravention on a "balance of probabilities." Unlike regulatory prosecutions under occupational and environmental health and safety law, due diligence will not be a defence to a criminal charge. However, evidence of due diligence efforts will be helpful in preventing criminal charges and con-

victions, since this will make it more difficult for the Crown to prove its case.

In addition to the social stigma associated with a Code conviction, the liabilities for a criminal conviction could be substantial. Persons convicted of any criminal offence receive a criminal record. Individuals are subject to a range of penalties under the Code depending on the offence, including a maximum penalty of life imprisonment for criminal negligence causing death. Individuals convicted of less serious summary offences could face up to six months in jail and/or a \$2,000 fine. Under Section 735, an organization convicted of a summary offence may be fined up to \$100,000. The Code provides no limit on the fines that can be imposed on an organization convicted of a more serious indictable offence. According to Section 732.1 corporations could also face a variety of probation orders including such conditions as providing restitution to victims of the offence.

In serious cases the combined penalties imposed on a corporation could conceivably reach into the millions of dollars. Section 718.21 sets out various factors to consider, such as any measures that the organization has taken to reduce the likelihood of its committing a subsequent offence, in assessing a penalty.

To avoid liability, companies should develop comprehensive internal systems to ensure compliance with applicable laws, particularly in the areas of environmental regulation and occupational health and safety. Such regimes should include clear delineations of responsibility and communication of key issues from front line workers to upper level executives. Insurance would not typically protect corporations and executives from criminal liability, but companies should check with their insurers to determine whether their insurance coverage extends to criminal liability or whether such insurance is available.