Aggressive Top Leasing in Texas: *Who Let the Dogs Out?*

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Other presentations relating to oil and gas made by Mark include:

Just Because They Call it "Royalty", Doesn't Mean You Always Get Treated that Way, Presentation to the Panola County Royalty Owners Association, October 1998;

Royalty and Related Pricing Mechanism Disputes: Learning the Three "E's", South Texas College of Law, Oil & Gas Law Institute, August 6-7, 1998;

Making and Responding to Failure to Develop Claims: Addressing the Three "E's", 29th Annual Ernest E. Smith Oil, Gas & Mineral Law Institute, March 21, 2003.

Five Common Misconceptions About Producer "Control" of ANS Gas and Its Relation to the Pipeline, Testimony Before the Alaska Legislative Budget and Audit Committee, April 20, 2005.

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There has been an extraordinary resurgence in top leasing in Texas over the last two years. Much of this top leasing is taking place in the "hottest" areas, including the Eagle Ford shale in South Texas and the Wolfberry play in West Texas. This reflects a general trend nationwide where top leasing is increasingly being used to acquire acreage in a number of the resource plays. Because there is every reason to think that top leasing will grow as a tool for acquiring acreage, it is worthwhile to consider the overall process. This article does that.

Introduction

The term "top lease" is used in the oil and gas industry to describe "a lease granted by a landowner during the existence of a recorded mineral lease which will become effective if and when the existing lease expires or is terminated." *Shown v. Getty Oil Co.*, 645 S.W.2d 555, 561 (Tex. App. – San Antonio 1983, writ ref'd n.r.e.) citing WILLIAMS & MEYER OIL AND GAS LAW MANUAL OF TERMS, p. 606 (1981). The phrase is also frequently used as a verb, as in "Texaco top leased the XYZ ranch."

Taking top leases was at one time viewed very negatively by courts and some parts of the industry. *Frankfort Oil Company v. Snakard*, 279 F.2d 436, 445, n. 23 (10th Cir. 1960), *cert. denied*, 364 U.S. 920 (1960) ("Topleasing has the same invidious characteristics as claim jumping."). The truth is, however, that top leasing is legal and it frequently promotes competition for oil and gas property that would otherwise be neglected. Professor David E. Pierce, for example, has described top leasing as "an accepted business practice in the oil and gas industry which the courts have sanctioned in various ways for almost a century." See, *"Effective Top Leasing and Mysteries of the Habendum Clause,"* Oklahoma Bar Association Newsletter, p. 2 (April 2005) (available online).

The purpose of this article is to address five issues of general interest with respect to top-leasing. These are: (1) How does top leasing generally work?; (2) What are some things to be concerned about when top leasing?; (3) What are the ways to more effectively "top lease" so as to maximize your chances to secure the right to drill the underlying acreage?; (4) How to protect against top leasing of acreage owned by your company; and (5) a few miscellaneous propositions about top leasing.

1. HOW DOES TOP LEASING GENERALLY WORK?

Top leases are taken on "top" of other preexisting or "bottom" leases, with the top lease becoming effective only after the termination of the preexisting lease. While top leases *can* be taken by the preexisting lessee (as, for instance, in a defensive move to prevent a lease expiration resulting in lost acreage), this article focuses primarily on the circumstances where a non-party to the original lease takes the top lease.

A. Primary Term Top Leasing Strategies.

There are two fundamentally different types of top leasing, that are worth distinguishing. First, there is top leasing associated with an anticipated primary term expiration. In other words, Barnes, knowing that Ewing has a lease with a two year primary term that is up in 45 days, takes a top lease to insure that if Ewing does nothing to perpetuate the lease, then Barnes' top lease will take effect. For reference purposes, let's call this "Primary Term Top Leasing."

Primary Term Top Leasing is normally a straight forward bet that the original lessee has either lost interest in the property or for some other reason is not able to act and is not going to drill on or unitize the property. By its nature, this kind of top leasing does not tend to involve a number of the complications that are often found in Secondary Term Top Leasing.

There are in turn two basic different paths that Primary Term Top Leasing can take, assuming that the bottom lease either terminates or arguably terminates, that are worth discussing.

(1) The top lease becomes effective without any effort by the preexisting lessee to preserve the original lease.

Sometimes a bottom lessee will make no effort or pretext about the lease continuing beyond the primary term. Normally, this will, from the lessor and top lessee's perspective, involve a straight forward request for a release of acreage from the lessee and upon receipt and recordation of that release there should be no question that the top lease is effective.

Many leases have a specific clause that requires a lessee to execute a release upon termination of an oil and gas lease. See WILLIAMS & MEYERS, 4 OIL AND GAS LAW § 679, p. 265 (1992). Regardless, Texas courts have held that such a duty exists under the common law. *Holman v. Meridian Oil*, 988 S.W.2d 802, 805 (Tex. App. – San Antonio 1999, pet. denied). Furthermore, a lessee's failure to execute such a release may be actionable and include a right to significant damages in the event that a loss of an opportunity to re-lease can be established. *Holman,* 988 S.W.2d at 808 (recognizing requirement of "evidence of a specific loss" for recovery). Obviously, in a top lease situation where a bottom lessee refuses a release a landowner could assert loss of the further consideration to be received from the top lessee upon termination of the preexisting lease and inception of the top lease.

(2) The top lease becomes effective because "operations" were not undertaken on a timely basis.

Frequently, lessees will wait until the very end of the primary term before undertaking any action to preserve a lease. The cycle of leasing with respect to shale plays such as the Haynesville and parts of the Eagle Ford, where gas prices have had companies repeatedly explaining that their gas drilling is driven by "lease capture" concerns, suggests that we may soon see a new wave of such "last minute" activity. The fact that so much activity occurs at the very end of the primary term, means that such activity can (and from a lessor's perspective definitely "should") be very carefully scrutinized. See, *Kramer,* "Keeping Leases Alive in the Era of Horizontal Drilling and Hydraulic Fracturing: Are the Old Workhorses (Shut-in, Continuous Operations and Pooling Provisions) Up to the Task?," 49 WASHBURN LAW JOURNAL 283 (2010).

Many leases provide that "commencement" of "operations" before the expiration of the primary term, assuming that production is obtained in due course, is sufficient to continue the lease until production "in paying quantities" ceases. The meaning of "commencement of operations" has been a heavily litigated issue. See e.g., Smith & Weaver, 1 *Texas Law of Oil and Gas*, 2 ed. § 4.5 (Mitchie 1997).

Specific language or definitions in the lease will of course govern when applicable. For example, in *Veritas Energy v. Brayton Operating Corp.*, No. 13-06-061-CV, 2008 WL 384169, at *2 (Tex. App.—Corpus Christi Feb. 14, 2008, pet. denied), where the lease used the phrase "commencement of *drilling* operations" as the condition for extending the lease, the Corpus Court of Appeals found that clearing land for a road near the end of the lease's primary term did not constitute "drilling operations" and thus was not sufficient to prevent the lease from terminating. *Id.*

Texas decisions about what is required by way of "operations" or "drilling operations" at the end of the primary term are not entirely consistent and thus make reliance by a producer upon anything short of actual spudding problematic. *Compare, Ridge Oil Co., Inc. v. Guinn Invests., Inc.*, 148 S.W.3d 143, 158, 160 (Tex. 2004) (holding that the lessee did not conduct activities calculated to obtain production and its minimal activities, staking, obtaining a drilling permit, and paying surface damages, failed to perpetuate the lease); *Bargsley v. Pryor Petroleum Corp.*, 196 S.W.3d 823, 826 (Tex. App.--Eastland 2006, pet. denied) (explaining that while various activities preliminary to actual spudding of a well have been held to constitute "drilling operations," such as selection of a drill site, placing timbers on the ground to be used in drilling operations, leveling the well location, and moving bulldozers to well sites and the digging of pits and reservoirs, the lessee's activities, including long-stroking the existing oil well, laying a pipeline, doing electrical work, installing, checking, and repairing flow lines, replacing a tank, keeping the electricity on, and keeping the equipment on the lease, while under certain circumstances might be considered "operations," are not "drilling operations" as a matter of law); and *Whelan v. Lacey,* 251 S.W.2d 175, 176-77 (Tex. Civ. App.-Texarkana 1952, writ ref'd n.r.e.) (stating that actual drilling was unnecessary and concluding that the lease clause "engaged in drilling for oil or gas" was satisfied by preparations including clearing the location,

digging working pits and reservoirs, moving in a completed drilling rig, delivering a new draw works to the location and starting rigging-up).

Regardless of any specific lease language regarding operations, "good faith" and "reasonable diligence" "in pursuing a producing well," are also required. *Hydrocarbon Management v. Tracker Exploration,* 861 S.W.2d 427, 438 (Tex. App. – Amarillo 1993, no writ).

B. Secondary Term Top Leasing.

Secondary Term Top Leasing is exactly what it says--top leasing designed to take advantage of lease expiration during the secondary term. In other words, the preexisting lease is indisputably past the primary term, and whether the top lease becomes effective depends on whether the lease is or is not being perpetuated according to its terms.

The two most common circumstances that lead to a lease terminating are: (1) a complete cessation of production; and (2) production continuing, but being in less than "paying quantities." Both of these circumstances are worth examining in greater detail.

(1) The top lease becomes effective due to a complete cessation of production.

There is a distinction between a "total cessation of production" that occurs "when a well that has been producing gas [or oil] ceases to produce any quantity of gas [or oil], and a failure to produce in paying quantities." *Cannon v. Sun-Key Oil Co.,* 117 S.W.3d 416, 421 (Tex. App. – Eastland 2003, pet. denied). "When there has been a total cessation of production, the two-prong cessation of production in paying quantities analysis [hereafter reviewed] does not apply." *Id.* (citations omitted).

Wells that are merely *capable* of producing in paying quantities, but that are not actually producing, do not constitute "production" sufficient to keep the lease in force after its primary term. *Anadarko Petroleum Corp. v. Thompson*, 94 S.W.3d 550, 557 (Tex. 2002) citing *Peveto v. Starkey*, 645 S.W.2d 770, 771 (Tex. 1982). These wells can only perpetuate the lease if they qualify as "shut-in" under the relevant lease provisions, *and* the contractually required shut-in payments are made. *See Peveto*, 645 S.W.2d at 771. To qualify as shut-in, the well must normally be "capable" of producing in "paying quantities" at a specific time.

Whether a well is "capable" of production is determined by whether it is capable of producing in paying quantities without additional equipment or repairs. *See Anadarko*, 94 S.W.3d at 558. In this connection, Texas has adopted the standard that a well is capable of producing only if the well would begin flowing by simply turning it "on." *Id. See also EOG Resources, Inc. v. Killam Oil Co., Ltd.*, 239 S.W.3d 293, 302–03 (Tex. App.—San Antonio 2007, pet. denied) (applying *Anadarko* test of whether the well will flow when turned "on").

Note that the commonly applied test for capability – being able to flow by merely turning the well "on" – can involve a very important and not altogether appreciated, in the authors' experience, application in a shale context, where wells often will not flow unless and until they

are fraced. Because these wells need to be fraced and cannot simply be "turned on", the Fort Worth Court of Appeals held that an un-fraced Barnett shale well cannot be considered "capable of producing" and so will not qualify as shut-in to preserve a lease beyond the primary term. *AFE Oil & Gas, L.L.C. v. Armentrout*, No. 2-07-100-CV, 2008 WL 623980, at *3–5 (Tex. App.—Fort Worth, Mar. 6, 2008, pet. denied).

Texas courts have permitted leases to be preserved beyond the primary term on grounds that the lease is still deemed to be "producing" if the cessation in production is only "temporary." This doctrine, sometimes referred to as the "temporary cessation of production doctrine," recognizes the reality that due to a variety of circumstances wells simply cannot flow every single day without at least occasional interruption for things like mechanical repairs. *See Ridge Oil Co.*, 148 S.W.3d at 151 (temporary cessation doctrine applies even if not mentioned in a lease, as long as there are no contrary lease provisions). Furthermore, the doctrine is not limited to only sudden stoppage or mechanical breakdowns, but is a fact-specific analysis concerning whether the cessation is permanent or is something that is subject to being fixed and the remedy is in fact being pursued. *See Id*. at 152 (noting with approval cases finding that stoppage was "temporary" in circumstances including lawsuits, obstructions in gas lines, collapsed casing that required the well to be plugged and a new one drilled and the expiration of a purchase agreement).

Illustrative of the temporary cessation doctrine is the a recent case, *Wickford, Inc. v. Energytec, Inc. (In re Energytec, Inc.)*, Bankr. No. 09-41477, Adv. No. 09-4202, 2009 WL 5101765 (Bankr. E.D. Tex. Dec. 17, 2009) wherein the Bankruptcy Court for the Eastern District of Texas held that a cessation of production caused by internal Railroad Commission confusion did not operate to terminate a lease because it was beyond the lessee's control. However, a subsequent unexplained delay in responding to a second Railroad Commission suspension was held to result in a lease termination because it was considered within the lessee's control.

(2) The top lease becomes effective due to a lack of production in paying quantities.

The vast majority of oil and gas leases in Texas are silent as to the quantity of production required. Texas law has long been that it is implied that production must be "in paying quantities" to perpetuate a lease calling for "production." *Garcia v. King*, 139 Tex. 578, 164 S.W.2d 509, 511 (1942) (where a lease term was for ten years and "as long thereafter as oil, gas, and other minerals is produced from said land hereunder," the word "produced" meant "produced in paying quantities"); *Grinnell v. Munson*, 137 S.W.3d 706 (Tex. App. – San Antonio 2004, no writ) (same).

This said, some leases define the production required or spell out that the lease will remain in existence for so long as there is production, "commercial or otherwise," and the courts have found that these clauses are enforceable. *McLean v. Kishi*, 173 S.W. 502 (Tex. Civ. App – Galveston 1915, no writ).

A lessor trying to show that an oil and gas lease terminated because of a lack of production in paying quantities must meet a two-prong test. First, the lessor must show that the lease failed to yield a profit over a reasonable period of time. *Grinnell*, 137 S.W.3d at 715; *Cannon v. Sun-Key Oil Co., Inc.*, 117 S.W.3d 416 (Tex. App. – Eastland 2003, pet. denied). Second, the lessor must show that a reasonably prudent operator would not have continued to operate the well in the manner in which it was being operated for the purpose of making a profit and not merely for speculation. *Id*.

A well produces in "paying quantities" for purposes of continuing the lease if the value of the oil and gas produced creates a profit, however small, after deducting the costs of lease operation and marketing. *Clifton v. Koontz*, 160 Tex. 82, 325 S.W.2d 684, 691 (1959); *Evans v. Gulf Oil Corp.*, 840 S.W.2d 500, 503 (Tex. App. – Corpus Christi 1992, writ den.); *Pshigoda v. Texaco, Inc.*, 703 S.W.2d 416, 418 (Tex. App. – Amarillo 1986, writ ref'd n.r.e.). However, whether the cost of drilling, testing, completing and equipping the well are ever recovered as well as whether the undertaking as a whole will ultimately result in a loss is irrelevant to "paying quantities" analysis. *Id.*

The second prong involves balancing an operator's interests in its investment versus the stated policy against speculation. Because Texas recognizes that the essential goal of an oil and gas lease is to generate profit for both the lessor and the lessee, a lessee is not allowed to hold a lease after the primary term solely for the purpose of speculation; in other words, holding it only in the hope that conditions will change. *Clifton*, 325 S.W.2d at 691.

Clifton identified the following factors that should be considered by a reasonable and prudent operator:

- the depletion of the reservoir;
- the price for which the lessee is able to sell his production;
- the relative "profitableness" of other wells in the area;
- the operating and marketing costs of the lease;
- the lease provisions;
- a reasonable period of time under the circumstances; and
- whether or not the lessee is holding the lease merely for speculative purposes.

325 S.W.2d at 691.

Sometimes, in the authors' experience, producers confuse the fact that the second prong is directed not at whether the producer can do something economic with the property (for instance, a producer *could* drill a deeper well), but at whether the operator would continue to "operate the well in the manner in which it was being operated." These are fundamentally different questions. Frequently, the extremely lackluster way in which old marginal wells have been produced will make this a very challenging point for a lessee to win.

2. WHAT ARE SOME THINGS TO BE CONCERNED ABOUT WHEN TOP LEASING?

A few bottom leaseholders react very poorly to efforts to top lease their acreage. They view top leasing as tantamount to "taking something that is theirs." A professional approach to top leasing should not normally expose a top lessee to any legitimate liability *vis-à-vis* the preexisting lessee. Still, there are a few areas to be concerned with and corresponding steps that can be taken to minimize exposure to potential claims and otherwise avoid problems.

A. Circumstances when Top Leasing can be a Bad Idea.

There are a few circumstances that should serve as red flags when you are considering taking a top lease. These include: (1) is the would-be top lessor subject to any right of first refusal?; (2) is the prospective lessee subject to any restrictions on its ability to lease in the area?; and (3) are there circumstances that mean the top lease is unlikely to become effective?

(1) Where the lessor is bound by a right of first refusal.

In a fair number of modern leases, lessees have inserted a clause that seeks to preserve a right of first refusal. Typically, these clauses give the original lessee the right to renew a lease before any third party has a chance to top lease. So, for example, a typical oil and gas lease may provide:

> **15. Right of First Refusal.** If, at any time within the primary term of this lease or any continuation thereof, or within six (6) months thereafter, Lessor receives any bona fide offer, acceptable to Lessor, to grant an additional lease (top lease) covering all or part of the afore described lands, Lessee shall have the continuing option, by meeting any such offer, to acquire such a lease. Any offer must be in writing and must set forth the proposed Lessee's name, bonus consideration and royalty consideration to be paid for such lease, and include a copy of the lease form to be utilized reflecting all pertinent and relevant terms and conditions of the top lease. Lessee shall have fifteen (15) days after receipt from Lessor of a complete copy of any such offer to advise Lessor in writing of its election to enter into an oil and gas lease with Lessor on equivalent terms and conditions. If Lessee fails to notify Lessor within the aforesaid fifteen (15) day period of its election to meet any such bona fide offer, Lessor shall have the right to accept said offer. Any top lease granted by Lessor in violation of this provision shall be null and void.

If a top lessee is going to proceed at all when such rights of first refusal exist, they should do so with the firm understanding that such rights may very well defeat their objectives. This will, of course, also mean that top lessees will want to carefully condition all but a nominal consideration for signing on the right of first refusal not being exercised.

(2) Where the prospective top lessee is bound by restrictions on its ability to lease.

There are also a number of circumstances in which a would-be top lessee is not itself free without restrictions to enter into top leases. These include, for example, prior contractual restrictions such as areas of mutual interest and similar provisions in development agreements as well as less formal confidential relationships. In *MacDonald v. Follett,* 142 Tex. 616, 180 S.W.3d 334, 337 (1944), for example, the Texas Supreme Court found that a relation of trust and confidence existed between Follett and MacDonald prior to the execution of top leases and a constructive trust was held to exist in certain top leases, to preserve an override for the benefit of Follett.

It is also possible that less formal joint venture arrangements can impede a would-be top lessee's ability to take a lease for itself. For example, the Supreme Court of North Dakota in *Sandvick v. LaCrosse,* 747 N.W.2d 519 (N.D. 2008) addressed a situation where two members of a group who had jointly taken numerous leases top leased acreage previously leased by other members of the group. On the facts, the court found that the top lessees had been members of a joint venture and that they acquired the top leases in breach of their fiduciary duties as joint venturers and remanded the case for a determination of damages. 747 N.W.2d at 524.

The Texas Statute of Frauds, see e.g. TEX. BUS. & COM. CODE § 26.01(b)(4), (5), (6) and (7), makes the enforcement of unwritten partnerships dealing with oil and gas leases extremely problematic. Nevertheless, the time and expense associated in disposing of such claims emphasizes the importance of always having a clean and documented understanding of the relationship between parties doing business in the context of oil and gas leasing.

Many of these restrictions will not constitute an absolute barrier to making a top lease, but they may very well involve offering part of the opportunity to others. Obviously, the procedures surrounding notice associated with such contractual arrangements are important to follow because no one wants to take the entire risk associated with bonus money, etc. for a top lease only to then find out, if and when the venture proves successful, that such benefits must now be shared on a "risk-free" basis with others, who if previously notified would likely never have participated.

(3) Circumstances where top leasing is not the "slam dunk" it might otherwise seem to be.

There are a series of circumstances that can take what appears to be a "slam dunk" circumstance for a top lease becoming effective and turn that into a very doubtful proposition.

On occasion, for example, what was a perfect example of a "dead as a doornail" lease will have been revived. Texas courts have, for example, held that the doctrine of reviver applies when a subsequent execution of mineral deeds refers to an otherwise lifeless oil and gas lease and recognizes its validity. See e.g., *Loeffler v. King,* 149 Tex. 626, 236 S.W.2d 772, 774 (1951) (Deed providing that the land was "under an Oil and Gas lease" revived the lease that had terminated for lack of production in paying quantities); *Humble Oil & Refining Co. v. Clark,* 126 Tex. 262, 87 S.W.2d 471, 473 (1935) (Deed providing that it covered property held by a lease and that "this sale is made subject to the terms of said lease" revived the lease that had terminated for the nonpayment of rentals). But see, *Westbrook v. Atlantic Richfield Company,* 502 S.W.2d 551 (Tex. 1973) (holding that ratification of a field-wide unit agreement did not ratify or revive a terminated lease.)

Likewise, even if a lease does not "produce in paying quantities" the lease may still be perpetuated under any number of different "savings clauses" often found in oil and gas leases. See generally, Elmore, "Lease Saving Clauses and Equitable Doctrines: Production in Paying Quantities, Cessation of Production, Shut-In Royalties, Ratification and Revivor", 36th Annual Ernest E. Smith Oil, Gas & Mineral Law Seminar, April 8-9, 2010. Savings clauses' ability to perpetuate the lease, or not, remains a frequent source of litigation. *Id.*

Finally, more than one "great" top lease project has proven unsuccessful because leases have, upon further review, been unitized in small part and lack any Pugh clause. Such circumstances may or may not raise good faith pooling issues, but regardless they are rarely the "slam dunk" top lease candidates that they might otherwise appear to be at first glance.

B. Avoiding the Rule Against Perpetuities in Top Leases.

The Texas Constitution provides that "[p]erpetuities ... are contrary to the genius of free government, and shall never be allowed." TEX. CONST. ART. I, § 26. Courts have enforced this provision by applying the rule against perpetuities (herein "the Rule"). *Trustees of Casa View Assem. of God Ch. v. Williams,* 414 S.W.2d 697, 702 (Tex. Civ. App. - Austin 1967, no writ). Under the Rule, no interest is valid unless it must vest, if at all, within twenty-one years after the death of some life or lives in being at the time of the creation of the interest. *Peveto v. Starkey,* 645 S.W.2d 770, 772 (Tex. 1982); *Foshee v. Republic Nat'l Bank of Dallas,* 617 S.W.2d 675, 677 (Tex. 1981).

The Rule relates only to the vesting of estates or interests, not to the vesting of possession, and is not applicable to present interests, or future interests which vest at their creation. *Kelly v. Womack,* 153 Tex. 371, 268 S.W.2d 903 (1954). Upon creation of an oil and gas lease, the grantee receives a fee simple determinable estate in the minerals, and the grantor is left with a possibility of reverter. *Jupiter Oil Co. v. Snow,* 819 S.W.2d at 468. This possibility of reverter is the right to the mineral estate upon termination of the lease, and is itself a freely assignable vested right. *Id.*

Top leases have an often "built-in" Rule issue because it is entirely possible (and "possibility" is all that is required, not likelihood) that any preexisting lease that continues for so long as production continues, will continue for longer than 21 years. The Court of Appeals in *Hamman v. Bright & Co.,* 924 S.W.2d 168 (Tex. App. – Amarillo 1996) *vacated pursuant to*

settlement, 924 S.W.2d 168, for example, held that oil and gas top leases, that were to become effective if and when existing oil and gas leases expired or were terminated, violated the Rule.

There are two recognized solutions to prevent the Rule from voiding a top lease. First, and the simplest, is to put a term of years on the top lease. For example, if the bottom lease does not terminate in 20 years, then the top lease terminates. See Note, "The Rule Against Perpetuities: The Validity of Oil and Gas Top Leases and Top Deeds in Texas After *Peveto v. Starkey*," 35 BAYLOR L. REV. 399, 410 (1983) (suggesting a clause reading as follows be added: This lease is to become effective immediately upon termination of the present lease, but no longer than 21 years from this date, otherwise this lease shall then be null and void.").

The second solution involves obtaining an assignment of the interest that the lessor holds in the minerals—that being reversionary rights. Obviously, the reversionary rights constitute a presently vested interest. *Bagby v. Bredthauer,* 627 S.W.2d 190, 197 (Tex. App. - Austin 1981, no writ). As a practical matter, however, finding a landowner with the sophistication and patience to understand and then negotiate language regarding a conveyance of reversionary rights, with some carve-out to restore the rights that the mineral owner will certainly want to keep, makes the first solution imminently more practical.

If, notwithstanding your best efforts, you find yourself faced with a Rule problem, it is worth considering whether the *cy pres* doctrine may be used to reform and thereby save the would-be top lease. See e.g., *Stoltz, Wagner & Brown, et al v. J. Walter Duncan, Jr., et al,* 417 F.Supp. 552, 557 (W.D. Okla. 1976) ("under the reformation power provided by 60 Oklahoma Statutes §§ 75, 76 and 77, the top leases should be reformed to give effect to the 'general intent' of the creators (lessors). That is to say, the top leases should be reformed by the separation and elimination of the second proviso which offends the Rule."); Note, "The Rule Against Perpetuities: The Validity of Oil and Gas Top Leases and Top Deeds in Texas After *Peveto v. Starkey*," 35 BAYLOR L. REV. 399, 410 (1983), citing *Stolz Wagner & Brown v. Duncan*. See also, TEX. PROP. CODE § 5.043 "Reformation of Interests Violating Rule Against Perpetuities."

C. Avoiding Claims by not Attacking (in the Top Lease) the Validity of the Preexisting Lease.

It can and should be anticipated that a few companies will regard a top lease as an "act of war" notwithstanding the fact that they may not even know they own a property or be able to locate it on a map. With a small number of simple precautions, however, the chances that such bottom lessees will do any harm to a top lessee can be seriously minimized and these same precautions will in turn significantly lessen the chances that a preexisting lessee will even try to make any kind of claim.

(1) The kind of claims that perturbed bottom lessees tend to bring.

The *Voiles* case in Oklahoma is an illustration of a lessee who evidently decided they would try to strike back on every conceivable grounds against their top lessee. *Voiles v. Santa Fe Minerals,* 911 P.2d 1205 (Okla. 1996). This case involved the top lessee being sued for

tortious interference with contractual relations, champerty and maintenance, and slander of title. 911 P.2d at 1209-1212. All of these counterclaims were resolved in favor of the top lessee. While Oklahoma law was applicable, the basic common law principles that were cited in *Voiles* would appear to be applicable under Texas law.

The tortious interference with contract claim was rejected because the top lessee "cannot be liable for wrongfully interfering with a contract if [as was determined in *Voiles*] it was acting in a representative capacity for a party to that contract." 911 P.2d at 1210. See also, *Macquarie Bank Limited, et al v. Bradley D. Knickel, et al*, 2010 WL 2649863 (D.N.D. 2010) ("top leasing is not an independent tortious act in North Dakota, and there is no evidence that top leasing is a tortious act in Texas. The Court finds that the Defendants have failed to state a claim of tortious interference for MBL's and Macquarie Barnett's conduct of top leasing Lexar's acreage.").

"Champerty" is defined as "[a]n agreement between a stranger to a lawsuit and a litigant by which the stranger pursues the litigant's claim as consideration for receiving part of any judgment proceeds." *Anglo-Dutch Petroleum Intern., Inc. v. Haskell*, 193 S.W.3d 87, 103 footnote 14 (Tex. App. – Houston [1st Dist.] 2006, pet. denied); BLACK'S LAW DICTIONARY 224 (7th Ed. 1999).

The champerty and maintenance claims in *Voiles* were rejected based on the fact that the lessee "had served an important interest of the mineral owners in having their first impression case heard," and the court also suggested that the doctrines of champerty and maintenance had largely outlived their usefulness. 911 P.2d at 1211-12. In this connection, the court cited with approval the Alabama Supreme Court's decision in *Lott v. Kees*, 276 Ala. 556, 125 So.2d 106 (1964) where the court explained that where the leases were "characteristic of the industry," and the lessors were without funds to maintain litigation "we do not think that the advancement of financial help violated any principle of law or public policy," quoting *Lott*, 165 So.2d at 111. See also, *Mitchell v. Amerada Hess*, 638 P.2d 441, 442-3 (Okla. 1981) (rejecting a champerty claim in a top lease context based on the interest that the top lessee had in the litigation by virtue of his top lease and rejecting the preexisting lessee's standing to raise champerty.).

The slander of title claim was rejected in *Voiles* based on the fact that the "evidence fails to show malice", which under Oklahoma law amounted not to "ill will or hatred, but a lack of good faith and want of probable cause." 911 P.2d at 1209-10.

Prospective top lessees will take comfort in the *Voiles* court's rejection of these claims. However, commentators have pointed out that such claims could be disposed of on much more fundamental grounds which a prospective top lessee should be aware of and work through.

(2) Why these claims shouldn't succeed if the top lease presents no attack on the validity of the existing lease.

In ordinary circumstances, there is no good reason for the top lease document itself to call into question the validity of the preexisting lease. The granting clause can instead make very clear that the top lease is "subject to" the preexisting lease. Of course, there is nothing inconsistent in taking such a top lease and then mounting a full-scale attack on whether the preexisting lease is still good by virtue of a lawsuit. (The procedure behind this will be discussed

in section 3). The point here is that a top lessee can seriously minimize exposure to claims for slander of title and/or tortious interference by the top lease itself avoiding any direct challenge to the preexisting lease.

This approach was described by Professor Pierce in his previously cited article, at p. 10, where he explained:

> Many of the problems associated with top leasing can be avoided if the top lease makes it clear it is not an assertion regarding the validity of the existing lease. Although the top lease may be the prelude to a law suit concerning the validity of the existing lease, the top lease document should be drafted as a title document, not a litigation document. As a title document it should clearly indicate its focus is on whatever residuary mineral interest may exist in property during the life of the top lease. This is the essence of a top lease: "[A]n oil and gas lease to take effect only if the pre-existing lease should expire or be terminated." [citing *Voiles*, 911 P.2d at 1207.] Contrast this situation with a second lease covering the same property that is not contingent on the invalidity of the existing lease. Although this is sometimes referred to as a "top lease" [citation omitted] it does not fit the *Voiles* definition of a lease to take effect "only if the pre-existing lease should expire or be terminated." The mere existence of a top lease that takes effect only when an existing lease terminates, will not trigger liability for obstruction, slander of title, tortious interference, or champerty and maintenance.

In formulating "subject to" language (or alternatively in trying to defend a bottom lease against a top lease) it is worth considering whether "subject to" language may involve a ratification or reviver of an otherwise dead lease. See Jackson & Weissbrod, "Top Leasing in the Appalachian Basin," 6 E. Min. L. Inst. Found p. 12-17 (1985) citing *Morgan v. Fox*, 536 S.W.2d 644-649-50 (Tex. Civ. App. – Corpus Christi 1976, writ ref'd n.r.e.); Michael L. Brown, "Effect of Top Leases: Obstruction of Title and Related Considerations," 30 Baylor L. Review 213, 227, n. 121 (1978) ("Making a top lease merely 'subject to' the bottom lease could have the effect of reviving an expired or defective bottom lease."). These authors have suggested that "the better practice is to condition the top lease upon the rights 'if any' of the bottom lease." Jackson & Weissbrod at 12-17; Brown at 227.

D. The Impact of a New Lease on Existing Overriding Royalties.

The termination of a bottom lease in favor of a top lease can have life and death implications for an overriding royalty interest. In the absence of a fiduciary duty or contractual obligation, a bottom lease holder in Texas is generally under no duty to "renew" or otherwise recognize overrides arising out of old leases. *Sunac Petroleum Corp. v. Parkes*, 416 S.W.2d 798, 804 (Tex. 1967); *Medallion Oil Co. v. TransAmerican Natural Gas Corp. (In re: GHR Energy Corp.)*, 972 F.2d 96, 99-100 (5th Cir. 1992), *cert. denied*, 507 U.S. 1042 (1993) (explaining that a

former override owner's interest was "washed out" by termination of a lease, notwithstanding that production never ceased on the leasehold).

Circumstances have frequently arisen in East Texas, for example, where overrides have risen to forty percent or more of the net revenue interest, effectively preventing any further development in the absence of extremely robust circumstances. In the face of these circumstances, parties such as royalty owners, potential farmees and even the original bottom lease holder will undoubtedly be interested in seeing whether or not a new lease, to which the burdensome overrides would *not* attach, can be undertaken. For this reason, parties taking overrides are especially well-advised to consider making clear that their overrides will attach to renewals and modifications of the original lease.

This is another area in which the law of other states differs from Texas. Kansas, for example, recognizes that a "duty of fair dealing" exists between the assignee of the lessee's interests in an oil and gas lease and the holder of an overriding royalty interest created by the assignment giving rise to the assignee's interests and that this duty can be breached by taking a top lease and "washing out" an overriding royalty. *Reynolds-Rexwinkle Oil v. Petex*, 268 Kan. 840, 847-53, 1 P.3d 909, 915-19 (Kansas 2000).

The authors have been involved in an East Texas case where a significant implied covenant to develop/lease termination claim was settled by a top lessor conveying a part of its new leases in a unit to the bottom lease holder, the bottom leases being released and extraordinarily burdensome overrides disappearing. This meant that the net revenue interests were much more supportive of drilling additional wells that have paid significant royalties and a small (some would say far *too* small) part of the enhanced net revenue served as a basis on which to pay counsel an override as a fee.

3. WAYS TO MORE EFFECTIVELY "TOP LEASE" SO AS TO MAXIMIZE YOUR CHANCES OF SECURING THE RIGHT TO DRILL THE UNDERLYING ACREAGE.

Taking top leases and then realizing value from their becoming effective obviously involves a series of steps. This section deals with suggestions regarding how top leases should be taken (including particular provisions), suggestions on working with bottom lessees and finally, procedural issues and suggestions with respect to the prosecution of cases to establish the invalidity of bottom leases.

A. Suggestions in "Taking Top Leases."

Beyond those suggestions already made, there are three other suggestions regarding how to most effectively top lease that are worth mentioning.

(1) The top lessee will want to secure rights to assert the invalidity of the preexisting lease.

Many a top lessee, after securing a top lease, has come to realize that their top lessor is not well-equipped to effectively prosecute a claim that will adjudicate the invalidity of the preexisting lease and thereby establish the viability of the top lease. The problems can include a lack of experience, an aversion to conflict, an inability or unwillingness to front costs, or even an inability to locate competent counsel. Because a top lessee's entire interest may hinge on successfully asserting the invalidity of a preexisting lease, this is a matter that should be dealt with up-front.

One method for dealing with this is by securing an agreement with the top lessor that will give the top lessee the right to prosecute such claims. An example of the kind of language that parties have used to address these circumstances is found in the *Voiles* case where the top leasing party in its offer letter explained:

> 1. *A legal action will be filed on the mineral owners' behalf seeking a judgment that the existing lease has terminated.* Our client will pay 100% of all legal, brokerage and engineering costs associated with the action.

And then, that offer language was followed up by specific lease language that read:

> *Lessor hereby appoints Lessee [Hugoton] as their special agent* with full and complete power to take all necessary steps to obtain a release or *judicial termination* of the above described Oil and Gas Lease….*Said power of agency shall include...the power to hire and retain legal counsel to file the litigation in the name of the Lessor;* and the power to pursue such legal action in the courts of the state of Oklahoma in the name of and on behalf of the Lessor.

Voiles, 911 P.2d at 1211 (emphasis supplied in original).

As a practical matter, a great deal of the problem may also be solved by introducing the top lessor to counsel who are skilled and motivated (paid by the result, not by the hour) to vigorously prosecute a claim against the preexisting lease. The nature of such suits is that the top lessor should not be required to play much, if any, role in the prosecution of the suit. Accordingly, after obtaining authorization to file the suit, counsel should be able to proceed to obtain a relatively efficient determination of the validity of a preexisting lease, win or lose.

(2) Avoiding backsliding by a lessor.

In taking a top lease it is advisable to obtain an express agreement by the lessor: (1) not to extend or take any other action to perpetuate the existing lease; and (2) that no such extension has been previously undertaken. One commentator has suggested language such as:

> Lessor represents and warrants that lessor has not entered into any renewal or agreement to renew said prior lease so as to extend the primary term as set forth or recorded therein.
>
> ***
>
> [L]essor covenants and agrees not to further extend, amend or modify" the bottom lease.

Max H. Ernest, "Top Leasing – Legality v. Morality," 26 Rocky Mt. Min. L. Inst. 957, 975-76 (1980).

Extensions by forgetful or worse lessors of the bottom lease, in the face of top leases, raise knotty issues. *Rorex v. Karcher,* 101 Okla. 195, 224 P. 696 (1924) is an Oklahoma Supreme Court decision where the bottom lessee's rights under an extension agreement made after a top lease where held to be "subject to" the rights of the top lessee. The Nebraska Supreme Court in *Willan v. Farrar,* 124 N.W.2d 699, 704 (1963) held that a lessor who gives a top lease "owed a duty not to render their provisions ineffective. The purpose of [the top] leases should not be permitted to be defeated by the actions of the lessors at will." 124 N.W.2d at 704. For what it is worth, the authors seriously doubt that either of these cases would be decided the same way under Texas law.

(3) Being clear which of <u>your</u> leases is effective.

If you are taking a top lease on one of your own leases, you should also take special care to document the effect of that top lease; *i.e.,* when will *it* versus the bottom lease be effective. This will avoid a dispute such as which royalty (you will likely have to increase royalty as part of your top lease) is due when a well is commenced before expiration of the primary term of the bottom lease. Ernest at 978.

B. Trying to Work Out an Accommodation Between the Top and Bottom Leases.

For obvious reasons, the preferred course is to reach an agreement with the preexisting lessee. Sometimes, this will be as simple as calling the preexisting lessee, explaining the top lessee's interest is in drilling to a different formation and explaining a willingness to accommodate the existing well's operations. In such circumstances, an accommodation can be documented by the bottom lessee formally recognizing the old lease is extinguished or released (in whole or in part) and the top lessee making an assignment of the existing well bore to the preexisting lessee.

Alternatively, and particularly when the perpetuation or lack thereof of the bottom lease is subject to greater doubt, there is the standard range of "horse trading" alternatives including carried interests, farmouts, joint operations, etc. that can be explored.

C. Procedural Issues in Attacking the Ongoing Validity of the Bottom Lease.

If an amicable resolution is not possible, there are four specific procedural issues that a top lessee will want to make sure are appropriately addressed in order to most effectively assert their rights pursuant to a top lease.

(1) The proper parties will need to be joined.

Careful consideration of the correct parties is in order simply to avoid future delays and/or to avoid providing the preexisting lessee grounds for objection. A general rule of thumb is that any party to the preexisting lease (lessors and lessees) or their successors must be made parties to the suit. *JLM Investments v. Acer Petroleum Corp.*, 2001 U.S. Dist. LEXIS 4611 (N.D. Tex. 2001) (cases cited therein).

Additionally, consideration must be given to whether it is necessary to join overriding royalty owners whose interests, upon termination of the preexisting lease, may cease to exist. *Id*.

(2) The proper type of action must be brought.

The proper lawsuit vehicle will, in almost all cases, be a trespass to try title action. Peter A. Vermillion, "Lease Termination: Determining the Correct Cause of Action," 25th Annual Advance Oil, Gas and Energy Resources Law Course, October 4-5, 2007, Chapter 17; *See also, Ramsey v. Grizzle*, 313 S.W.3d 498 (Tex. App. – Texarkana 2010, no pet.) (a lease termination claim based upon the continuous operations clause must be tried as a trespass to try title action.).

In such a suit, the Texas Supreme Court has made clear that neither party can normally collect their attorneys' fees. See, *Martin v. Amerman*, 133 S.W.3d 262, 264 (Tex. 2004); *Natural Gas Pipeline Co. of America v. Pool*, 30 S.W.3d 618, 636 (Tex. App. – Amarillo 2000) *rev'd on other grounds,* 124 S.W3d 188 (Tex. 2003) (in case essentially an action to recover possession or for trespass-to-try-title attorney's fees should not have been awarded under declaratory judgment act); *McRae Exploration & Production, Inc. v. Reserve Petroleum Co.*, 962 S.W.2d 676, 684 (Tex. App. – Waco 1998, no pet.) (plaintiff cannot artfully plead a title dispute as a declaratory judgment suit to obtain an award of attorneys' fees not otherwise available.).

(3) Satisfying notice requirements.

As a procedural matter, it is worth noting that many of the common notice requirements as a prerequisite to filing suit may not apply to suits by lessors to terminate preexisting leases. *See e.g., Gibson Drilling Co. v. B&N Petroleum,* 703 S.W.2d 822, 827 (Tex. App. – Tyler 1986, writ ref'd n.r.e.) (notice requirement that lessor "give sixty days' previous notice" for lessee's "failure to comply with the lessee's obligations under the lease before…suit could be prosecuted" did not apply to suit seeking "a declaratory judgment that the 1978 lease had terminated."); *Waggoner and Zeller Oil Co. v. Deike,* 508 S.W.2d 163, 165-166 (Tex. Civ. App. – Austin 1974, writ ref'd n.r.e.) (termination is not a breach and therefore notice requirements for a breach are inapplicable).

(4) The possible impact of making a demand.

It is also worth considering the impact, if any, of a demand for a release combined with a top lease upon a bottom lessee's continuing obligations. For example, there is Texas authority that supports the proposition that demanding a release and executing a top lease excused operations until title was settled.

> It is our opinion that the acts and conduct of appellees in executing the top lease to Pewitt on June 2, 1945, together with the letter of appellees' attorney to the Shell Oil Company dated June 12, 1945, repudiating said lease and demanding the execution of a release of same while said lease was in effect per force of payment of the shut-in royalty, on October 16, 1944, relieved appellants of the duty of operating the gas well located on said lease until the controversy between them and appellees respecting the title to the lease was settled.

Shell Oil Co., Inc., et al v. Goodroe, et al, 197 S.W. 395, 400 (Tex. Civ. App. – Texarkana 1946).

Courts in other states have likewise held that the execution of top leases equaled a challenge to title thereby excusing shut-in payments. *Clifford Robinson v. Continental Oil Company,* 255 F.Supp. 61 (D. Kan. 1966) ("Execution of top leases after oil and gas lessee, acting as prudent operator, had finally determined during primary term of lease that lessee had commercial gas well from which gas could be produced in marketable quantities constituted a challenge to lessee's title, for purpose of determining whether lessee was required to tender shut-in payments").

There is also apparently contrary Texas authority that requests for releases of leases do not constitute the kind of repudiation that will excuse a lessee's obligations. *Atlantic Richfield Company, et al v. W.O. Hilton, et al,* 437 S.W.2d 347, 354 (Tex. Civ. App. – Tyler 1969, writ ref'd n.r.e.) ("We do not believe the tender of such letters are such as to 'wrongfully repudiate the lessee's title by unqualified notice that the leases are forfeited or have terminated.'") (citing cases).

D. Proving that a Preexisting Lease has Terminated: the Two Most Common Cases.

The prototypical grounds for terminating a preexisting lease are that there has been either a lapse in production, or alternatively, that the production which has occurred is not commercial.

(1) Proving a cessation of production case.

In the context of a trial, this question, or something similar, will very likely be submitted to the jury:

> At the end of the primary term of the lease in question, did Defendant fail to engage in drilling or reworking operations that were continued with no cessation of more than _ days and that resulted in the production of oil, gas, or other mineral in paying quantities?
>
> You are instructed that "reworking operations" means any and all actual acts, work, or operations in which an ordinarily competent operator, under the same or similar circumstances, would engage in a good-faith effort to cause a well or wells to produce oil or gas in paying quantities.
>
> Answer "Yes" or "No."
>
> Answer:_____

Oil, Gas & Energy Resource Law Section, Oil and Gas Pattern Jury Questions and Instructions, September 14, 2005, updated July 7, 2009, Question 4.e.6. Lease Termination Question – Drilling or Reworking Operations at End of Primary Terms, p. 34 (available online).

Normally, the real fight in these cases will be over whether the cessation of production is excusable and, in this context, it is important to give juries some context. A lessor/top lessee will want to make clear that the overall pattern is one of neglect and trying to string the royalty owner along while the producer isn't doing their job. The top lessee will want to emphasize that they are ready, willing and able to do what the bottom lessee has neglected to do for years. The bottom lessee will want to characterize the size of its investment and how it is prudently stewarding the overall property. Again, all of this will help place the time periods in context.

(2) Proving a "paying quantities" case.

Paying quantities cases are fact-intensive and will require a claimant to come forward with evidence of:

(1) that actual production from the well over a reasonable period of time did not yield a profit after deducting operating and marketing costs; and

(2) that a prudent operator would not continue, for profit and not for speculation, to operate the well as it has been operated.

Clifton, 325 S.W.2d at 691; *Cannon*, 117 S.W.3d at 421; and *Bales v. Delhi-Taylor Oil Corp.*, 362 S.W.2d 388, 391 (Tex. Civ. App. – San Antonio 1962, writ ref'd n.r.e.).

Obviously, an intelligent top leasing approach will begin with a precise understanding of the history and amount of production and its relation to the costs associated with that production. In most cases, reports to the Railroad Commission and the Texas Comptroller's office will give precise historical information (subject to a couple of months lag) about the production/income

side of the equation. Accordingly, it will be the cost side of the equation that will require the most analysis or outside expertise.

The basic calculation is:

> Oil and Gas Revenues
> Less Costs
> Must equal a Profit

The formula has been held to include a large number of expenses that must be subtracted from the revenues. See, Gross, D.H., *Meaning of Paying Quantities,* 43 A.L.R. 3d 8 (2008); and Shaw, Kevin L., *California "Paying Quantities" Law and Current Statutory Law Affecting Idle Oil or Gas Wells,* 1992 (available online) (collects case law from around the country). If the resulting figure is negative, the well is not producing in paying quantities.

The expenses that should be subtracted from revenue include:

> royalty payments, *Clifton,* 325 S.W.2d at 693;
>
> administrative and overhead charges traceable to producing and marketing of the production, *Ladd Petroleum Corp. v. Eagle Oil & Gas Co.,* 695 S.W.2d 99, 108-9 (Tex. App. – Fort Worth 1985, writ ref'd n.r.e.) (but not if the elimination of the well in question would not materially reduce the overhead expenses);
>
> treating and transportation charges, *Fick v. Wilson*, 349 S.W.2d 622, 624 (Tex. Civ. App. – Texarkana 1961, writ ref'd n.r.e.); *Hanks v. Magnolia Petroleum Company,* 24 S.W.2d 5 (Tex. 1930);
>
> charges for labor and repairs, *Skelly Oil Co. v. Archer,* 163 Tex. 336, 34-6, 356 S.W.2d 774, 781-2 (1962); and *Fick,* 349 S.W.2d at 624-5;
>
> depreciation of salvageable production equipment, *Skelly Oil Co.,* 356 S.W.2d at 781-2; and *Bales,* 362 S.W.2d at 391. Compare, *Evans v. Gulf Oil Corp.,* 840 S.W.2d 500, 504-5 (Tex. App. – Corpus Christi 1992, writ denied) (book depreciation, as opposed to actual depreciation is not included); and
>
> taxes, *Persky v. First State Bank of Vernon,* 117 S.W.2d 861, 863 (Tex. Civ. App. – Amarillo 1938, no writ) (ad valorem taxes); and *Skelly Oil Co.*, 356 S.W.2d at 781 (severance taxes).

By contrast, Texas courts have determined that none of the original costs of drilling, completing or equipping the well should be subtracted in determining paying quantities. See *Skelly Oil Co. v. Archer; Pshigoda v. Texaco, Inc.,* 703 S.W.2d 416 (Tex. App. – Amarillo 1986,

writ ref'd n.r.e.). Likewise, reworking expenses and depreciation of original investment are not to be subtracted. *Id.* Finally, for purposes of revenue determination, only lease royalty is subtracted; overriding royalties remain as a credit. See *Clifton,* 325 S.W.2d at 693.

In the context of a trial, this question (or something similar) will very likely be submitted to the jury:

> Did the well in question cease to produce oil and gas in paying quantities?
>
> You are instructed that to find that a well has ceased to produce oil and gas in paying quantities, you must find both: (1) that production from the well over a reasonable period of time does not yield a profit after deducting operating and marketing costs; and (2) that a prudent operator would not continue, for profit and not for speculation, to operate the well as it has been operated. You are further instructed that where production is sufficient to yield a return in excess of operating and marketing costs, the well is producing in paying quantities even though drilling and equipment costs may never be repaid and the undertaking considered as a whole may ultimately result in a loss. You are further instructed that operating expenses include expenses such as taxes, overhead charges, labor, repair, depreciation of salvable equipment, and periodic expenditures incurred in the operation of the well. You shall not consider any costs or expenses incurred in connection with the original drilling or the reworking of the well.
>
> Answer "Yes" or "No."
> Answer: _____

Oil, Gas and Energy Resource Law Section, Oil and Gas Pattern Jury Questions and Instructions, Question 4.e.8. Cessation of Production in Paying Quantities Question, pp. 35-6 (available online).

The courts have been less than consistent in establishing the length of time over which the paying-quantities test applies. Obviously, the length of time depends on the circumstances in each case. So far, the courts have examined anywhere from four months to a maximum of nineteen months in determining "paying quantities." *Compare, Evans v. Gulf Oil Corporation,* 840 S.W.2d 500, 503 (Tex. App. – Corpus Christi 1992, writ denied) (16-19 months); *Bell v. Mitchell Energy Corp.,* 553 S.W.2d (Tex. Civ. App. – Houston [1st Dist.] 1977, no writ) (calendar year); *Morgan v. Fox,* 536 S.W.2d 644 (Tex. Civ. App. – Corpus Christi 1976, writ ref'd n.r.e.) (7-18 months); *Ballafonte v. Kimbell,* 373 S.W.2d 119 (Tex. Civ. App. – Fort Worth 1963, writ ref'd n.r.e.) (18 months); *Bales v. Delhi-Taylor,* 362 S.W.2d 388 (Tex. Civ. App. – San Antonio 1962, writ ref'd n.r.e.) (four months prior to shut in for workover); and *Fick v. Wilson,* 349 S.W.2d 622 (Tex. Civ. App. – Texarkana 1961, writ ref'd n.r.e.) (9 months prior to shut in). However, if the lease defines the period for which production-in-paying-quantities is to

be measured, a reasonable period of time is not implied. *Ridenour v. Herrington*, 47 S.W.3d 117, 121-122 (Tex. App. – Waco 2001, pet. denied).

E. The Synergy between Development Claims and Lease Termination Claims.

The vast majority of leases are subject to an implied duty to reasonably develop. See Cotham, "Making and Responding to Failure to Develop Claims: Addressing the Three 'E's'", 29th Annual Ernest E. Smith Oil, Gas & Mineral Law Institute, Houston, Texas (March 21, 2003), pp. 2-3. This duty is, in the author's experience, quite often arguably breached. Often, the same circumstances that lead to top leasing and original lease termination, are also present in failure to develop cases. See Cotham at pp. 19-22.

When a lease termination case is properly combined with a failure to develop case, an original lessee is faced with extraordinary potential exposure. The lessee must pay damages equal to the amount of royalty that *would* have been paid had the lease been properly developed, Cotham at pp. 10-14, and also loses the lease (from which it might have been able to recoup such royalties).

Top lessees may also have claims against bottom lessees for trespass to the extent that the bottom lease expires, the top lease becomes effective and yet the bottom (former) lessee continues to produce. In *Lone Star Producing Co. v. Walker*, 257 So.2d 496 (Miss. 1971), the Mississippi Supreme Court granted the top lessee damages in the amount of the value of production from the date of the bottom lessee's completion of reworking operations, less the bottom lessee's reasonable costs of production. Of course, in a clear cut or egregious case, Texas law would not allow a trespasser to recover its costs, but instead would require an accounting based on gross production proceeds. *Whelan v. Killingsworth*, 537 S.W.2d 785 (Tex. Civ. App. – Texarkana 1976, no writ).

4. AVOIDING TOP LEASING OF YOUR COMPANY'S ACREAGE.

If you represent companies trying to avoid top leasing, there are five practices to consider. These are:

(1) attempt to include a right of first refusal on top leases and/or an option to renew (not always easy matters to negotiate);

(2) extend your company's leases earlier than normal;

(3) production below a threshold (exceeding a "paying quantity" *plus* a generous allowance) should trigger an action plan on any core acreage a company holds;

(4) activity that shows up in permits by your company will publicly suggest the sort of interest that will discourage would-be top lessees; and

(5) talk to your lessors and explain your future plans for the property.

Obviously, landmen have a number of skills that can greatly contribute to avoiding top leasing. Foremost among these is the ability to communicate directly with landowners in ways they understand and appreciate and to thereby evidence a producer's ongoing interest in a property.

5. MISCELLANEOUS EXECUTION/OPERATION ISSUES ASSOCIATED WITH TOP LEASES.

This last section addresses a series of miscellaneous issues that courts have dealt with concerning top leases.

A. Avoiding the Second Installment of Top Lease Bonus Money.

In *Sohio Petroleum Co., et al v. Jack J. Grynberg,* 757 P.2d 1125, 1126 (Colo. Ct. App. [Div. 1] 1988), the Court addressed whether a top lessee could avoid the second installment (money due when the bottom lease expired) by invoking the surrender clause in the top lease. The question was whether the top lessee "could validly exercise a surrender clause in a top lease prior to the effective date of the lease, and thereby avoid paying the full amount of an installment of a deferred bonus contracted for in a separate letter agreement." The Colorado Court agreed "with the trial court that he could not do so."

B. Quasi-estoppel Against a Top Lessee.

In *Cambridge Production, Inc. v. Geodyne Nominee Corporation, et al,* 292 S.W.3d 725, 732 (Tex. Civ. App. – Amarillo 2009, pet. denied), the Court found that a top lessee was subject to the same quasi-estoppel defense that his lessors were based on the lessor's long acceptance of royalties from unit wells located off of their property. In this regard, the Court noted:

> Because Cambridge has no rights in Section 33 as a top lessee except such rights as it might have acquired under the new Section 33 leases, it cannot terminate the Prater Unit if the necessary defendants (the Section 33 mineral interest owners) have no such right. The summary judgment evidence is undisputed that the Section 33 mineral interest owners have accepted the benefit of revenues of production from the Prater No. 1 well. It is also undisputed that the Prater No. 1 well is not located on Section 33. Thus, the Section 33 mineral interest owners would not have received the royalties they have received over the years but for the Unit Designation of Prater No. 1. Cambridge's claim to title under the new Section 33 leases must rest upon repudiation by the top lessors of Geodyne's Section 33 leases. In doing so, they would, of necessity, be asserting a right inconsistent with the benefits that were previously accepted by them. Thus, appellees met their summary judgment burden of proof and established quasi-estoppel as a matter of law.

C. Termination Occurs when Production Ceases, Not When the Court decides.

An interesting timing issue regarding when a lease termination took effect was addressed very recently in *Baytide Petroleum, Inc. v. Continental Resources, Inc., et al,* 231 P.3d 1144, 1145 (Okla. 2010):

> We granted certiorari to consider an issue of first impression: whether an oil and gas lease sought to be terminated for failure to produce in paying quantities during the secondary term remains effective until the lease has been judicially cancelled? We hold that it is not the court order which terminates the lease. Rather, it is the failure to produce in paying quantities under the habendum clause during the lease's secondary term.

In *Baytide*, the issue was whether or not a bottom lessee's lease was effective at the time a unit was formed, thus making the bottom lessee subject to an equipment purchase arrangement that it wanted to avoid. However, the same timing issue could be relevant to a variety of other circumstances contexts.

D. Warranties in a Top Lease.

Oklahoma courts have addressed the extent of warranties of title in a top lease context and surprisingly, at least to the authors, have found warranties in the absence of direct disclaimer language. The Oklahoma Court of Appeals explained:

> Appellants argue that the proper construction to be placed on a general warranty of title clause in a top lease is that the lessor warrants he owns the minerals and has the authority to convey right of entry, exploration, production, and possession subject only to the right, if any, of a prior unreleased lease of record. We believe that if Appellants desired this result they could have easily inserted in the top lease the above stated language or could have stricken the warranty clause in said top lease in the same manner they struck the clause concerning crop damages… The covenant of warranty contained in the top lease must be given its plain effect and intent since the warranty clause and the oil and gas lease do not contain any limitations, exceptions or qualifications.

Siniard v. Davis, 678 P.2d 1197, 1200 (Okla. Ct. App. 1984).

Conclusion

The trend toward more aggressive top leasing in Texas and nationwide is undeniable. The nature of today's resource plays all but guarantees that top leasing will be an increasingly common undertaking. There are steps that a would-be top lessee can take to avoid problems and also to enhance their opportunity for the top lease to become effective and profitable. Hopefully, this article will prove helpful in relating these steps and familiarizing readers with the top lease process.