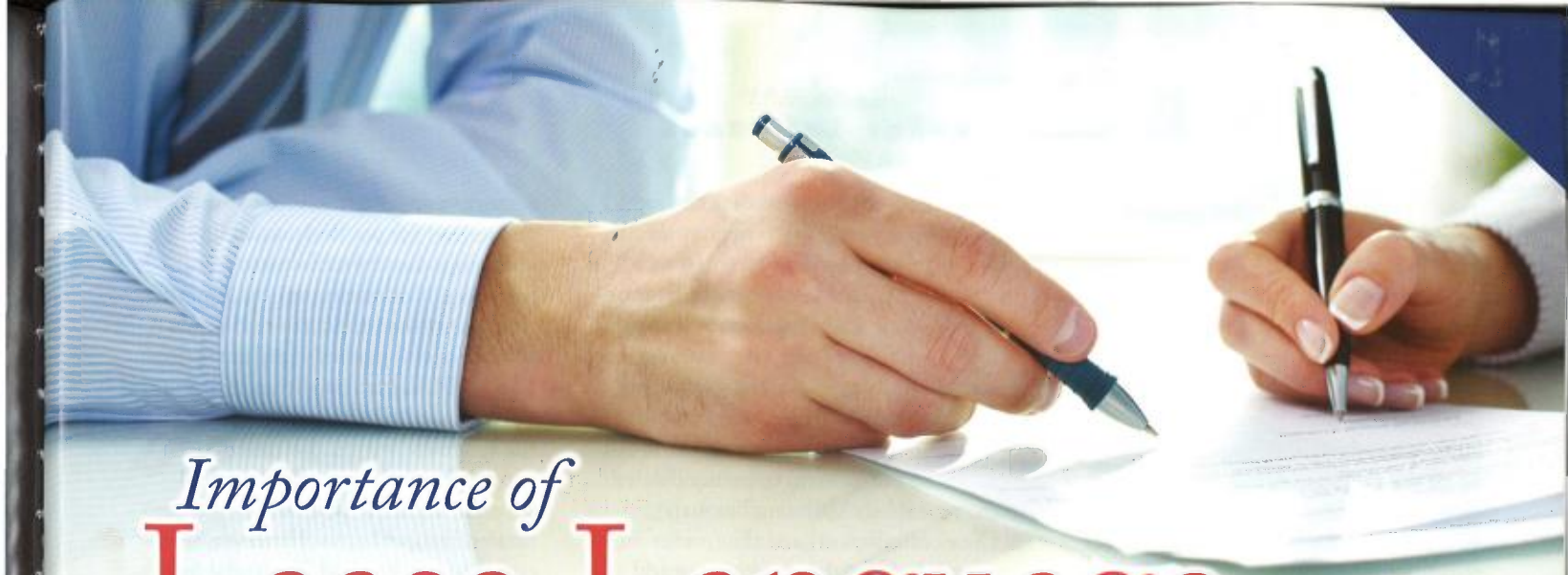

Importance of Lease Language *that references regulatory rules*

By Austin Brister

On Aug. 5 the San Antonio Court of Appeals released its opinion in *ConocoPhillips Co v. Vaquillas Unproven Minerals Ltd.*, No. 04-15-00066-CV (San Antonio — Aug. 5, 2015), affirming the trial court's order declaring ConocoPhillips breached two oil and gas leases in Webb County by failing to release all acreage in excess of 40 acres for each producing and shut-in natural gas well capable of producing in paying quantities. As a result, ConocoPhillips was ordered to release an additional 15,351 acres. The issue on appeal was whether the retained acreage clauses allowed ConocoPhillips to retain 40 acres per gas well or 640 acres per gas well.

This case illustrates how appellate courts can interpret acreage perpetuation and release language in a lease in conjunction with regulatory rules. As such, this case underscores the importance of lease language that references regulatory rules, which may provide for spacing or proration units of a greater or smaller size than the default acreage provided within the lease.

The Facts

Vaquillas is the lessor under two oil and gas leases with ConocoPhillips, one covering 26,622.79 acres and the other covering 6,740 acres. Both leases contain identical retained acreage clauses providing that after ConocoPhillips' continuous drilling program ended, ConocoPhillips was required to release all acreage in excess of:

> … 40 acres for each producing oil well and 640 acres for each producing or shut-in gas well, except that in case any rule adopted by the Railroad Commission of Texas or other regulating authority for any field on this lease provides for a spacing or proration establishing different units of acreage per well, then such established different units shall be held under this lease by such production, in lieu of the 40 and 640-acre units above mentioned. (Emphasis supplied.)

ConocoPhillips completed the drilling program on June 21, 2012. A dispute arose as to the acreage ConocoPhillips was allowed to retain surrounding more than 200 gas wells. The Railroad Commission adopted a field rule covering the leased premises, providing for 467 feet spacing, but did not expressly set forth a number of acres per well. Vaquillas argued that this field rule caused statewide Rule 38 to be applicable, providing for 40 acres per well. As a result, Vaquillas argued that the exception in the retained acreage clause had been established, and therefore ConocoPhillips was only able to retain 40 acres surrounding each well rather than the default 640 acres. ConocoPhillips disagreed, arguing that the exception had not been established. The trial court granted summary judgment in favor of Vaquillas and ConocoPhillips appealed.

The Court's Analysis

The court noted that a retained acreage clause in an oil and gas lease authorizes the lessee to retain acreage around a producing well in the event of a forfeiture of the lease. Generally, a retained acreage clause states the specific number of acres that can be retained. However, the clause may provide for a change in this basic size, which can be greater or smaller if the Railroad Commission adopts field rules providing for spacing or proration units of a different size.

In this case, the retained acreage clause initially refers to a particular number of acres that ConocoPhillips was entitled to retain and then provides for an exception in the event field rules are adopted that "provide for a spacing or proration establishing different units of acreage per well."

ConocoPhillips argued that the 640-acre limit provided

in the leases should apply because the field rule contains a spacing requirement but does not specifically establish "different units of acreage per well."

The court disagreed with ConocoPhillips, noting that although the field rule does not expressly set forth a number of acres per well, Rule 38 of the statewide rules applies to "special" spacing rules and describes 40-acre units for gas fields. The court reasoned that the retained acreage clause provides initial acreage but also contains an exception where field rules adopt "different" units of acreage. Because the Rule 38 acreage is applicable and is "different" from the initial acreage set forth in the retained acreage clause, the 40-acre units in Rule 38 are controlling.

ConocoPhillips presented several arguments, each of which the court rejected. These arguments are summarized as follows:

1. ConocoPhillips argued that the field rule did not establish a maximum acreage that could be assigned to a well, and Rule 38 only establishes the minimum acreage required to drill a well. However, the court stated that the retained acreage clause did not reference field rules that established the acreage that could be retained but instead referenced rules that establish "different" acreage.
2. ConocoPhillips argued that under the court's holding the exception would swallow the general rule because if the minimum required acreage under Rule 38 is applied, the 640-acre general rule would never apply. However, the court noted that this ignores that there are fields with no special rules, under which Rule 38 would not apply.
3. ConocoPhillips argued that the holding would be adverse to the pooling clause. However, the court noted that a conflict between the number of acres authorized for retention and the number of acres authorized for pooling can lead to unintended and problematic results. However, in rejecting this argument, the court noted that it is not allowed to rewrite the parties' contract.
4. ConocoPhillips argued that if it was only allowed to retain 40 acres, then the language within the retained acreage clause that each unit shall contain "at least" one well would be rendered superfluous. However, the court noted that had no special field rules been adopted, the units would be 640 acres and more than one well could exist within each unit.
5. ConocoPhillips argued that the retained acreage clause provided a different number of acres to be retained for oil wells and gas wells, while there is no difference under the court's construction. The court stated that while this is true, ConocoPhillips agreed to the inclusion of the exception within the retained acreage clause.

6. ConocoPhillips argued that the court should not interpret the retained acreage clause to impose a limitation on the grant unless the language is clear. However, the court stated that the retained acreage clause is clear, precise and unequivocal.

The Holding

The court affirmed the trial court's order, construing the retained acreage clause as allowing ConocoPhillips to retain only 40 acres surrounding each well, thereby requiring the release of 15,351 acres. On Aug. 25 the San Antonio Court of Appeals granted ConocoPhillips' Motion for Extension of Time to File Motion for Rehearing. In a Motion for Rehearing, parties generally set forth an argument that the previous judgment of the court was in error. This would then provide the court an opportunity to correct any errors on issues already presented to the court.

The Takeaways

Of course, it is important to understand that this case represents one court's interpretation of these specific leases, and this holding could potentially be subject to modification, additional appeal or both. Nevertheless, I believe cases such as this underscore the critical importance of closely reading all portions of an oil and gas lease relating to acreage perpetuation and release, including the pooling clause, retained acreage clause, continuous development clause, offset clauses, drilling obligation clauses, savings clauses and any other clause relating to the perpetuation or termination of all or a part of the leased premises.

A careful understanding includes not only *when* a release is triggered, but also *how much* acreage is released. Caution should be used in drafting any retained acreage clause that provides a change in the basic unit sizes based on rules adopted by the Railroad Commission. For example, the Railroad Commission rules may be greater or smaller than the default acreage provided in the lease. How does your lease clause handle a scenario in which the Railroad Commission acreage is less than the default acreage described in the lease?

Cases like this also emphasize the importance of seeking advice when modifications to approved form provisions are proposed, particularly as to clauses relating to pooling, acreage retention or both. For existing oil and gas leases, cases like this emphasize the importance of a detailed understanding of all clauses relating to pooling and acreage retention. The consequences of failing to do so may be unforeseeable and may be contrary to the intent of the oil and gas company. As the Texas Supreme Court stated in *Luckel v. White*, 819 S.W.2d 459, 462 (Tex. 1991), "it is not the actual intent of the parties that governs, but the actual intent of the parties as expressed in the instrument as a whole."

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