

# Oil and Gas Operator Liability Addressed in Recent Texas Supreme Court Rulings<sup>1</sup>

(as of April 2009)

The Texas Supreme Court has issued two important and related opinions affecting mineral owners and their lessees. In *Exxon Corporation v. Emerald Oil & Gas Co., L.C.*,<sup>2</sup> the Court held that a private cause of action may be maintained under Section 85.321 of the Texas Natural Resources Code for damages resulting from a violation of conservation statutes or Texas Railroad Commission rules, but limited the class of parties with standing to sue under the statute. In *Exxon Corporation v. Emerald Oil & Gas Co., L.C. and Laurie T. Miesch, et al.*,<sup>3</sup> the Court interpreted the meaning of a continuous development clause, clarified the intent-to-induce element of fraud when the alleged misrepresentations are in reports filed with the Railroad Commission, and addressed the discovery rule on the accrual of a tort cause of action.

## BACKGROUND

The suits were brought by royalty interest owners of properties in South Texas and their present lessee against Exxon, as a former lessee. Under the Exxon leases, stringent disclosure, development and surrender clauses favored the royalty owners. After negotiations to reduce certain obligations under the leases failed, beginning in 1989 Exxon commenced plugging and abandoning 34 active wells. In response, the royalty owners hired a potential operator to evaluate the field, and based on that analysis, determined that six of the 34 wells could be economical to a small operator. The royalty owners demanded that Exxon desist the plugging of those six wells. In August and September 1990, the royalty owners sent letters to Exxon threatening suit if the wells were abandoned, demanding information and documents for the properties, and asserting that to plug and abandon the wells would commit waste.

Exxon continued its field abandonment plans and in 1991, notified the royalty owners that its plugging operations had been completed. The lands were later leased to Emerald. Emerald acquired Exxon's W-3 plugging reports and when it attempted to re-enter the wells found cut casing and other "junk" in the hole and other variances from the W-3s. Emerald sent a status report to the royalty owners, met with them, and obtained Exxon's internal plugging records from one of its partners.

## THE LAWSUITS

In July 1996, Emerald sued Exxon and alleged wrongful conduct in the development and abandonment of the field. Specifically, Emerald alleged causes of action for breach of statutory duty to properly plug a well, breach of statutory duty not to commit waste, negligence per se (violation of Natural Resources Code and Railroad Commission rules), tortious interference with economic opportunity, negligent misrepresentation, and fraud. In August and September 1996, the royalty owners intervened and alleged the same claims. They later amended their petition to allege breach of contract by failure to comply with the development clause in the leases.

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## Emerald's Statutory Claims

The trial court granted Exxon's motion for summary judgment on Emerald's statutory claims, holding that Exxon had no statutory duty to potential future lessees, including Emerald. The appellate court reversed, holding that Section 85.321 imposes a duty on current lessees to future lessees, and that this statute creates a private cause of action for damages caused by statutory violations. Exxon appealed to the Texas Supreme Court.

### Private Cause of Action

The Court first addressed whether Section 85.321 creates a private cause of action to allow Emerald to maintain a suit against Exxon for allegedly violating statutes concerning well plugging and waste. Section 85.321, entitled "Suit for Damages," reads:

*A party who owns an interest in property or production that may be damaged by another party violating the provisions of this chapter...or another law of this state prohibiting waste or a valid rule or order of the commission may sue for and recover damages and have any other relief to which he may be entitled at law or in equity. Provided, however, that in any action brought under this section or otherwise, alleging waste to have been caused by an act or omission of a lease owner or operator, it shall be a defense that the lease owner or operator was acting as a reasonably prudent operator would act under the same or similar facts and circumstances. (Emphasis added.)*

The Court looked at the plain language of the statute and determined that it clearly allows a person whose property interest is damaged by another party who violates the state's conservation laws or a Railroad Commission rule or order to sue to recover damages. The Court pointed to the statute's affirmative defense for owners and operators as further support that Section 85.321 creates a private cause of action.

### Scope of Private Cause of Action and Standing

Exxon also attempted to limit the scope of a private cause of action under Section 85.321 to only those allegations pertaining to committing waste, and not to Emerald's cause of action for improper plugging. In responding to this argument, the Court pointed again to the plain language of Section 85.321 and held that Emerald's allegations fell within the scope of the third clause of Section 85.321, which encompasses violation of Railroad Commission rules.

The Court then addressed the issue of standing to sue under Section 85.321 and looked to the legislative intent expressed in the language of the statute. Under this statute, the Legislature gave the right to a private cause of action to a person who "owns an interest ... that may be damaged by another party violating the provisions of this chapter..." The Court cited the longstanding recognition by Texas courts that a cause of action for injury to real property accrues when the injury is committed, that the right to sue is a personal right belonging to the person owning the property at the time of the injury, and that this right to sue does not pass to a subsequent purchaser of the property unless there is an express assignment of the cause of action. The Court held that Emerald, as a subsequent lessee without an ownership interest at the time of the alleged wrongful actions, did not have standing under Section 85.321.

### Negligence Per Se

Emerald's final statutory claims were moot, given the Court's decision that Emerald, as a subsequent lessee, lacked standing to bring a claim under Section 85.321.

Based on these decisions, the Court reversed the court of appeal's judgment in favor of Emerald and rendered a judgment that Emerald take nothing on the statutory claims.

## The Plaintiffs' Other Claims

Emerald's non-statutory claims and all claims from the royalty owners went to a jury trial. After trial, the court entered a directed verdict against Emerald and the royalty owners on the claims for tortious interference with economic opportunity, negligent misrepresentation and fraud, and the royalty owners' negligence per se claim.

The trial court entered judgment on the jury's verdict for the royalty owners and awarded \$5 million in actual damages and \$10 million in punitive damages on the waste causes of action and \$3.6 million for breach of contract. All parties appealed. The appellate court affirmed the judgment in favor of the royalty owners, reversed the directed verdict against Emerald, and remanded Emerald's claim for a new trial. Exxon appealed to the Supreme Court.

## Waste, Negligence Per Se, Negligent Misrepresentation, and Tortious Interference

The Court decided these causes of action based on the timeliness of the plaintiffs' respective lawsuits. These causes of action are subject to the two-year statute of limitations.

The Court recognized fraudulent concealment and the discovery rule as exceptions to the two-year statute. The plaintiffs argued that Exxon's filing of false or misleading well plugging reports in 1991 and/or the delay in discovering the injuries until 1994 when Emerald began its redevelopment efforts, tolled the two-year statute. The plaintiffs said that they did not discover the damage until January 1995, when Emerald explained to the royalty owners the extent of Exxon's alleged misconduct. The Court disagreed, pointing out that neither exception is applicable when a plaintiff has actual knowledge of the injury done to his interests. In the September 1990 letter, the royalty owners advised Exxon that plugging the wells would commit waste in violation of the law and the lease. In a June 1994 letter, Emerald advised the royalty owners that it discovered Exxon placed cut casing and junk in certain of the wells. The Court discounted the royalty owners' argument that they did not appreciate the significance of the statements in their 1990 letter to Exxon and the 1994 Emerald letter. In the opinion of the Court, the "letters unequivocally and conclusively establish that the royalty owners and Emerald knew or suspected there was damage to their interests ... in 1990 and 1994." Thus, the respective dates the plaintiffs acquired actual knowledge of their injuries triggered the accrual of the causes of action and the running of the two-year statute. The Court held that Emerald's claims brought in July 1996 and the royalty owners' claims brought in September 1996 were time-barred.

The Court reversed the \$15 million judgment in favor of the royalty owners on the waste claims, as well as the court of appeals order for a new trial for Emerald on similar claims. The Court rendered judgment in Exxon's favor with respect to the claims for waste, negligence per se, negligent misrepresentation, and tortious interference.

## Breach of Contract

The royalty owners alleged that Exxon breached the development clauses of the leases, which required Exxon to "prosecute diligently a continuous drilling and development program until [the tracts are] fully developed for oil and gas." Specifically, the royalty owners claimed Exxon failed to develop two productive zones. The court of appeals upheld the jury's verdict, holding that the testimony of the royalty owners' expert was some evidence that the leases were capable of producing in paying quantities until 1999 and that Exxon did not drill and complete wells in those productive zones. Exxon challenged the legal sufficiency of the evidence.

The Court first examined the scope of Exxon's development obligations under the leases, which defined the term "fully developed," as being when "at least one (1) well has been drilled and completed in each horizon or stratum capable of producing [oil or gas] in paying quantities" for a specified number of acres. The parties' disputed the meaning of "drill" and "complete."

Relying on previously recognized definitions of "drill" and "completed", the Court said that for a well to be considered "drilled and completed" under the development clauses, a hole must be dug in the ground, and if oil or gas is encountered the casing must be perforated or otherwise prepared for production.<sup>4</sup> A well does not need be producing to be considered completed; instead, it only needs to be capable of producing oil or gas.<sup>5</sup> The Court noted that the royalty owners conflated Exxon's obligation to fully develop the tract (i.e., drill and complete one well), with an obligation to fully exploit the tract. In the Court's view, the royalty owners wanted Exxon to produce and extract all the reserves in each zone capable of production in paying quantities, but this was not an obligation written into the leases. Instead, Exxon was only obligated to drill a requisite number of wells per acre, and if it encountered oil or gas, Exxon had to prepare the well for production in paying quantities.

Turning to the legal sufficiency of the evidence to determine whether Exxon satisfied this obligation, the Court evaluated the royalty owners' expert opinion testimony. That testimony indicated that the expert believed "fully developed" means that there are a "sufficient number of wells in it to get the reserves." His testimony revealed that he misconstrued the requirement that Exxon fully develop the tracts, as required by the leases, with his own understanding that Exxon needed to fully exhaust the production from those zones. The Court reversed the court of appeals' judgment on the breach of contract claim, which had affirmed the \$3.6 million award to the royalty owners, and rendered judgment in favor of Exxon.

## Fraud

The plaintiffs alleged that Exxon committed fraud by misrepresenting material information in its W-3 plugging reports with the intent that known mineral interest owners and lessees would rely on the information. The court of appeals held that evidence Exxon knew that unidentified, subsequent lessees and operators might rely on Railroad Commission filings to make business decisions was sufficient to satisfy the intent-to-induce reliance element of a fraud claim.

Exxon argued that there was no evidence that future operators would rely on the W-3 reports since the only purpose of the reports is to allow the state to protect against pollution, and that the court of appeals decision reduced the intent-to-induce reliance element to a much lower threshold requirement of mere foreseeability.

The Court held that one purpose established by the Railroad Commission for the W-3 reports and other rules concerning plugging of wells “is to prevent plugging of wells that hinder or prevent reentering wells, which could be desired by the same or subsequent owners or operators.”<sup>6</sup> Thus, the W-3 reports ensure that operators follow a plugging procedure that not only prevents pollution but also allows reentry into the wells for commercial purposes.

However, the Court did not agree that the mere fact that royalty owners and subsequent lessees might or should rely on statements in a former lessee’s plugging reports was sufficient to establish the intent-to-induce reliance element. The Court rejected the argument that the reason-to-expect standard reduces the intent-to-induce element of a fraud claim to a foreseeability standard. Instead, the Court reiterated that the reason-to-expect standard requires more than mere foreseeability. In fact, the claimant’s reliance must be ‘especially likely’ and justifiable, and the transaction sued upon must be the type the defendant contemplated.

The Court held that the letters and other communications among the parties was legally sufficient evidence to support the claim that Exxon had information that would lead a reasonable person to conclude there was an especial likelihood these plaintiffs would rely on Exxon’s inaccurate filings with the Railroad Commission at the time it filed them. Therefore, the Court remanded the fraud cause of action to the trial court for further proceedings.

## CONCLUSION

The Court confirmed that under Section 85.321, a party may be sued for violations of statutes concerning waste as well as Railroad Commission orders and rules. However, such a suit may only be brought by one who owned an interest in the property at the time of the alleged wrongful action.

The Court also reiterated its view expressed in earlier cases that mineral owners will be held to a high standard of vigilance when seeking to protect their interests. Letters and other communications suggesting enough knowledge to threaten a suit could start the running of the statute of limitations. This is true even if the sender does not have a full appreciation or understanding of the alleged wrongful action by the recipient.

The lesson for operators is to be careful what one files with the Railroad Commission, as another party may rely on it to its detriment (and potentially the operator’s) if those reports contain incorrect information.

The Court also provided important clarification as to the meaning of key terms commonly used in development clauses. Specifically, the terms of these lease agreements, requiring an operator to fully develop the minerals by drilling and completing a specified number of wells in specified production zones in paying quantities, do not impose a requirement that the operator fully deplete the reservoir. As to these leases the Court determined the development clause to be satisfied by the lessee doing what the unambiguous terms of lease obligated it to do, even if that obligation is different than its duty under common law.

For more information, please read our expanded review of this recent ruling at <http://www.lrmlaw.com/pdf/exxon-v-emerald.pdf>

<sup>1</sup> Or, “Why Exxon Came Out Whole Despite its Junk in the Hole”.

<sup>2</sup> No. 05-0729, March 27, 2009

<sup>3</sup> No 05-1076, March 27, 2009

<sup>4</sup> Op. at p. 7, citing Barrett v. Ferrell, 550 S.W.2d 138, 142 (Tex. Civ. App.—Tyler 1977, writ ref’d n.r.e.).

<sup>5</sup> Id.

<sup>6</sup> Op. at p. 11, citing 7 Tex. Reg. at 3989.

Looper Reed & McGraw would like to recognize attorneys  
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