

AN ANALYSIS OF *WAGNER & BROWN, LTD., v. SHEPPARD*

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Abstract

Oil and gas leases are one of the main granting instruments used in the oil industry. The “contract and conveyance” nature of these leases can make certain clauses challenging to interpret. In Wagner & Brown, Ltd. v. Sheppard, the main discussion focuses on a pooling clause, specifically the legal nature of that clause and the rights conveyed from lessor to lessee through such pooling. After providing a detailed analysis of Wagner and Brown with regard to the jurisdiction in which it was decided, this article applies that lens to the examination and comparison of the Turkish legislature’s treatment of pooling. This leads to the Texas Supreme Court’s decision being called into question based on its arbitrary interpretation of fundamental property law principals.

Öz

Petrol sözleşmeleri ve bunun Türk hukukundaki görünümü olan ruhsatlar, petrolün araştırılması, aranması, petrollü arazinin işletilmesi ve geliştirilmesi gibi hakların devrinde kullanılan başlıca araçlardır. Klasik anlamda petrol sözleşmeleri (oil and gas leases), sözleşme niteliğinin yanı sıra mülkiyetin devrini de sağlayan bir işlev görür. Tam da bu özelliği nedeniyle bu sözleşmelerin yorumlanması sıkıntılı olabilir. Bu yazıda, Teksas Yüksek Mahkemesi’ne ait Wagner & Brown, LTD. v. Sheppard, isimli davada, bu sözleşmelerin temelde bahsedilen söz konusu nitelikleri sonucunda, içerdikleri ameliyelerin birleştirilmesine (pooling) ilişkin hükümlerin uygulanması bakımından çıkan problemler irdelenmektedir. Teksas düzenleme ve uygulamaları uyarınca bu dava incelendikten sonra, ameliyelerin birleştirilmesine ilişkin düzenlemeler bakımından Türk Hukuku ve uygulamaları karşılatırmalı olarak işlenmektedir. Sonuç olarak ise, Teksas Yüksek Mahkemesince verilen karar, common law’a ait eşya hukuku ilkelerinin keyfiyete varan bir yorumla ele alınıyor olması bakımından sorgulanmaktadır.

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INTRODUCTION

In *Wagner & Brown v. Sheppard*,¹ the Supreme Court of Texas decided that the termination of an oil and gas lease did not terminate the related pooling unit. Furthermore, the Court ruled that the operator was not necessarily precluded from recovering in equity from plaintiff for reimbursement for plaintiff's share of costs incurred by the operator to drill a gas well on plaintiff's land before the lease expired. In reaching this result, the Court arguably misinterpreted some basic property law principles such as 'fee simple determinable' and 'possibility of reverter' with respect to oil and gas leases.² Several *amici* offered a variety of arguments with respect to this apparent contradiction.³ The decision is also inconsistent as to the reasoning the Court applied concerning the effect of a pooling clause to the unit and the decision regarding the costs are to be accounted to the lessor and the royalty amount is to be granted.⁴

This article is mainly divided into three parts. Part I discusses the *Wagner & Brown*; Part II discussed the possible consequences while Part III is the analysis of the pooling issues under the Turkish Law.

I. ANALYSIS OF THE DECISION

In connection with the misinterpretation of the long-established property law principles, the Court stated that:⁵

But her lease allowed pooling of "all or any part of the leased premises or interest therein," and Sheppard's reverter was certainly an interest in the leased

¹ *Wagner & Brown, Ltd. v. Sheppard*, 282 S.W.3d 419 (Tex. 2008).

² *Stephans County v. Mid Kansas Oil & Gas Co.*, 254 S.W. 290 (Tex. 1923); *Rogers v. Ricane Enterprises, Inc.*, 772 S.W.2d 76, 79 (Tex. 1999).

³ See Briefs for Dick Watt, George A. Snell, Herbert W. Henry, Amicus Curiae Brief of Texas Civil Justice League, Inc., Chesapeake Energy Corporation, Forest Oil Corporation, and XTO Energy Inc., all as Amicus Curiae, *Wagner & Brown, Ltd. v. Sheppard*, 282 S.W.3d 419 (Tex. 2008).

⁴ John McFarland, "What Happens to a Pooled lease When the Lease Terminates?," Oil and Gas Lawyers Blog, 13 March 2009, at <http://www.oilandgaslawyerblog.com/2009/03/what-happens-to-a-pooled-lease.html#more> (last visited 24 July 2011).

⁵ *Wagner & Brown, Ltd.*, 282 S.W.3d at 423-24 (quoting *Mengden v. Peninsula Prod. Co.*, 544 S.W.2d 643, 648 (Tex. 1976) (emphasis added); *Southland Royalty Co. v. Humble Oil & Ref. Co.*, 151 Tex. 324, 326, 249 S.W.2d 914, 916 (1952); *Brown v. Smith*, 141 Tex. 425, 428, 174 S.W.2d 43, 46 (1943).

premises. “When a unit is properly pooled, the owners of the minerals *or reversionary interests* in a separate tract within the unit surrender their right to receive their interest in all production from wells located on their own tract....” Just as pooling impinges on a mineral owner’s royalty interest, it also may impinge on an owner’s possibility of reverter.

Case law in Texas⁶ contradicts the Court’s decision and sees the possibility of reverter as a property interest in the lessor-grantor. From that perspective, pooling is not capable of impinging the grantor’s possibility of reverter.

The Court’s decision creates an inconsistency – although the parties accepted the termination of the lease, the court held that the lessor is bound by the pooling after the termination of her lease. On the other hand, regarding the drilling and completion costs, the lessor bears them as if the lease was not in existence at the time the well was drilled.⁷

From these standpoints, the decision rendered by the Supreme Court caused a great confusion among oil and gas lawyers. This article will explain the legal nature of the rights created and conveyed by oil and gas leases, the nature of the pooling clause and its effects on these rights. I am also going to cover the Court’s reasoning with respect to *Wagner & Brown* and try to explain the inconsistency of the decision. Last I am going to mention some possible problems caused by any application of the Supreme Court’s decision.

Lessor conveys a fee simple determinable interest in the mineral estate with an oil and gas lease and keeps the possibility of reverter.⁸ Property rights are pre-determined and tend to be specific and concrete. The Court, here, did not need to determine the content of the conveyed fee simple determinable, since it was already clear. Instead, contractual relations between the parties should have been analyzed. The other reasonable way of handling this case could be to base it upon only equitable grounds. This kind of approach would also help us to distinguish it on the basis of its distinctive features. However, what we see in the Supreme Court’s approach is trying to find reasons for the result that they had already reached rather than considering the facts in the first hand, then concluding the case.

⁶ *Caruthers v. Leonard*, 254 S.W. 779, 782 (Tex. Comm’n 1923); *York v. Kenilworth Oil Co.*, 614 S.W.2d 468, 471 (Tex. Civ. App.-Waco 1981, writ ref’d n.r.e.); *Jensen v. Wilkinson*, 133 S.W.2d 982, 984 (Tex. Civ. App.-Galveston 1939, writ dismiss’, judgment corrected); *Jupiter Oil Co. v. Snow*, 819 S.W.2d 466, 468 (Tex. 1991).

⁷ John McFarland, “What Happens to a Polled lease When the Lease Terminates?,” *Oil and Gas Lawyers Blog*, 13 March 2009, at <http://www.oilandgaslawyerblog.com/2009/03/what-happens-to-a-pooled-lease.html#more> (last visited 24 July 2011).

⁸ *Wagner & Brown, Ltd.*, 282 S.W.3d at 420.

This case raises three main issues regarding the nature of oil and gas leases from the aspect of property law, the nature of ‘pooling,’ and the nature of the agency relationship. Each will be discussed in part.

A. Nature of Oil and Gas Leases from the property law aspect

The first thing that we have to understand about the oil and gas leases is their legal nature. Despite the fact that the term ‘lease’ is used to define oil and gas instruments, it is not a lease in the traditional sense.⁹

An oil and gas lease is treated as both conveyance and contract.¹⁰ A lease is a conveyance because it is the instrument by which the mineral owner conveys a property right to an oil company to explore for and produce oil and gas, reserving a royalty interest in production. A lease is a contract because the oil company accepts the right to explore and produce, burdened by certain express and implied promises.

In states like Texas where the ownership-in-place theory is applied, the leasehold interest is considered to be a fee interest,¹¹ because the lease continues “as long as there is production;” it is determinable, because it can always terminate by the special limitations¹² in the lease such as a lack of production by the end of the primary term or the cessation of production during the secondary term.¹³ After conveying the determinable fee to the lessee, the only interest that

⁹ *BP America Production Co. v. Marshall*, 288 S.W.3d 430 (Tex. App. San Antonio, 2008). (“An oil and gas lease is not a “lease” in the traditional sense of a lease of the surface of a real property; rather, in a typical oil and gas lease, the lessor is a grantor and grants a fee simple determinable interest to the lessee, who is actually a grantee.”).

¹⁰ John S. Lowe, Owen L. Anderson, Ernest E. Smith, and David E. Pierce, *CASES AND MATERIALS ON OIL AND GAS LAW* 307 (Thompson West 2008). *See also* *Natural Gas Pipeline Co. of Am. v. Pool*, 124 S.W.3d 188, 192 (Tex. 2003) (“In Texas it has been long recognized that an oil and gas lease is not a ‘lease’ in the traditional sense of a lease of the surface of real property.”).

¹¹ *Bowers v. Taylor*, 263 S.W.3d 260 (Tex. App. Houston, 1st Dist. 2007).

¹² *See Wagner & Brown Ltd.*, 282 S.W.3d at 421 (Sheppard’s lease had a special addendum providing that if royalties were not paid within 120 days after first gas sales, her lease would terminate the following month, quoting the provision stated “[w]ithin 120 days following the first sale of oil or gas produced from the lease premises, or lands pooled therewith, settlement shall be made by the Lessee, or by Lessee’s agent, for royalties due hereunder with respect to such oil or gas, and such royalties shall be paid monthly thereafter without the necessity of Lessor executing a division or transfer order. If said initial royalty payment is not so made under the terms hereof, this lease shall terminate as of 7:00 A.M. the first day of the month following the expiration of said 120 day period”).

¹³ Lowe, *et al*, *supra* note 10, at 310; Joseph Shade, *PRIMER ON THE TEXAS LAW OF OIL AND GAS* 31, (Michie, 4th ed., 2008) (“The primary term (p/t) lasts for a fixed number of years...During the p/t the Lessee has the option but not the obligation to drill.” “...the secondary term (S/T) which lasts as long as oil and gas is produced from the lease. This period could last a short time or it could last for generations.”).

remains with the lessor is the possibility of reverter.¹⁴ “The lessee/grantee acquires ownership of all the minerals in place that the lessor/grantor owned and purported to lease, subject to the possibility of reverter in the lessor/grantor.”¹⁵

Energy companies, by virtue of leases granting them fee simple determinable interests in the minerals of the mineral estate with the lessors retaining only royalty interests, acquire title to all the minerals in place that the lessors own and purport to lease, subject to the possibility of reverter in the lessors; thus, the energy companies' interests are determinable because they may terminate on the occurrence of events specified in the leases, and, if the lease terminates, fee title to the minerals reverts entirely to the lessor.¹⁶

In *Wagner & Brown*, as stated above, the Supreme Court of Texas decided that once the pooling comes into an effect, it may also impinge on an owner's possibility of reverter.¹⁷ First of all, this conclusion is not logical and cannot have been the parties' intention.¹⁸ By signing an oil and gas lease, the lessor aims to convey a determinable interest to the lessee, which means that the lessor has an expectation to get her fee interest back in case the special limitations stipulated under the lease occurs. Why would the lessor ever want to convey her possibility of reverter to the same person that she conveyed the fee determinable? If she does so, she possibly has no available way to get her fee interest back. Second, this kind of conclusion is also legally impossible; the nature of property law tends to be certain.¹⁹ The characteristics of fee simple determinable and possibility of reverter as explained above has been the law in Texas.²⁰ There is also another point which was argued in the *amicus* brief by George A. Snell: the possibility of reverter cannot be an interest in the leased premises, because the lease defined what is conveyed instead of what is reserved in the lessor.²¹ Although some may claim that the lease may contain both the conveyed and the reserved interests, in case of ambiguity what is conveyed and what is reserved still needs interpretation. The possibility of

¹⁴ A. W. Walker, *The Nature of the Property Interest Created by an Oil and Gas Lease in Texas*, 7 TEX. L. REV. 539, 547 (1929); BLACK'S LAW DICTIONARY 548 (3d pocket. ed. 2006) (possibility of reverter is “[a] reversionary interest that is subject to a condition precedent; specif., a future interest retained by a grantor after conveying a fee simple determinable”).

¹⁵ *Natural Gas Pipeline Co. of Am.*, 124 S.W.3d at 192.

¹⁶ *Longoria v. Exxon Mobil Corp.*, 255 S.W.3d 174 (Tex. App. San Antonio, 2008).

¹⁷ *Wagner & Brown, Ltd.*, 282 S.W.3d at 423-24.

¹⁸ Brief for Dick Watt, as Amicus Curiae, *Wagner & Brown, Ltd. v. Sheppard*, 282 S.W.3d 419 (Tex. 2008) at 5.

¹⁹ Shade, *supra* note 13, at 3.

²⁰ *Natural Gas Pipeline Co. of Am.*, 124 S.W.3d at 192.

²¹ Brief for George A. Snell as Amicus Curiae, *Wagner & Brown, Ltd. v. Sheppard*, 282 S.W.3d 419 (Tex. 2008) at 3.

reverter can be conveyed separately,²² but it is not logical to convey it to the determinable interest owner in the same estate. This sort of transaction simply causes the conveyance of fee simple absolute.

B. The Nature of Pooling

Another discussion related with the presented issue is about the nature of the pooling clause.²³ A pooling clause “gives a lessee the right to combine small tracts or fractional interests for drilling and apports production to each interest”²⁴ by modifying the granting, *habendum* and royalty clauses in an oil and gas lease.²⁵ It modifies the granting clause, because under the pooling clause the lessee is given a power of attorney to pool the lessor’s interest.²⁶ It expands the *habendum* clause, because all the operations under the pooled unit have the effect to hold each pooled lease alive.²⁷ Last, the pooling clause modifies the lease by giving a royalty to each participating lessor according to their proportionate acreage contributed to the pooled unit.²⁸ Both the lessee and the lessor benefit from the pooling. Even though drilled wells are not located on their tract, participating lessors have a chance to get royalties from the pooled area. On the other hand, the lessee can develop and operate the field more effectively by drilling less wells and holding all the pooled leases in effect.²⁹

However, without an express authority to pool, the lessee does not have any contractual right to pool lessor’s interest.³⁰ In *Imes v. Globe Oil & Refining*, an Oklahoma court held that the relationship between the lessee and the lessor is analogous to the relationship between an agent and principal; the Oklahoma Supreme Court upheld that decision on appeal.³¹ In *Phillips Petroleum Co. v. Peterson*, a Utah court also decided that “[a] unitization provision in oil and gas

²² *Jensen v. Wilkinson*, 133 S.W.2d 982, 984 (Tex. Civ. App. 1939), *Bower v. Taylor*, 263 S.W.3d 260 (Tex. App. Houston 1.Dist., 2007).

²³ *Wagner & Brown, Ltd.*, 282 S.W.3d 419 at 423 (“Although Sheppard’s lease expired, the lands themselves obviously did not. Thus, while termination of Sheppard’s lease changed who owned the mineral interests in the unit, it did not cause the unit to terminate because it was pooling of lands, not just leases.”); *see also id.* at 424 (“If the parties want pooling to expire (or not) upon termination of one lease, they should be free to say so”).

²⁴ *Lowe, et al, supra* note 10, at 413.

²⁵ *Id.*

²⁶ *Id.* at 414

²⁷ *Id.*

²⁸ *Id.*

²⁹ *Id.*

³⁰ *Id.* (“...but the lessee may unilaterally seek and obtain a compulsory pooling order.”); *see also Brown v. Smith*, 141 Tex. 425, 174 S.W.2d 43 (1943); *Imes v. Globe Oil & Refining Co.*, 84 P.2d 1106 (Okla. 1938).

³¹ *Imes*, 84 P.2d at 1107.

leases is in the nature of a power coupled with an interest and is therefore irrevocable.”³²

At this point, Wagner & Brown argued that under the oil and gas lease, they had the authority to pool Sheppard’s lease and the power granted to Wagner & Brown is coupled with an interest, so that it is irrevocable. On the other hand, opposing argument asserted by Sheppard was that the lessee does not have any authority to pool once the lease terminates, and since the lease terminated as a result of the lessee’s misconduct, revocation of the granted power is not in question.

Both parties agreed on the fact that the lease terminated as a result of late royalty payments. The Texas courts have held that a lease can terminate by late royalty payment if the lease contains a clause providing that result:³³

Under Texas law, gas lessors were improperly treated as lessee’s unleased cotenants, rather than as lessors under lease agreements, after lessee had failed to pay royalties to lessors on gas production, for purposes of lessors’ action against lessee; leases did not contain clause providing for termination upon failure to pay royalty, all conditions necessary for lessee to retain fee had been satisfied, and, even assuming that lessee’s failure to pay royalties was intentional, that conduct could not result in lessee’s mineral estate terminating and reverting back to lessors.³⁴

From this perspective, under a lease which is no longer in effect, the lessee should not have a right to exercise its rights (or authorities) given with that lease.³⁵ However Wagner & Brown and supporting *amici* argued that (1) inside the pooling clause there is no language which cause the termination of an existing unit in case the lease itself terminates,³⁶ (2) the pooling clause in Sheppard’s lease gave the authority to pool the land, not just its leasehold interest,³⁷ and (3) a lessee normally does not need specific authority to pool its own interests.³⁸

³² Phillips Petroleum Co. v. Peterson, 218 F.2d 926, 934 (10th Cir. 1954).

³³ Mitchell Energy Corp. v. Samson Resources Co., 80 F.3d 976 (5th Cir. 1996). See also Hitzelberger v. Samedan Oil Corp., 948 S.W.2d 497 (Tex. App. Waco 1997).

³⁴ Mitchell, 80 F.3d. at 979.

³⁵ See Hawkins v. Texas Oil and Gas Corp., 724 S.W.2d 878 (Tex. App. Waco, 1987)(“Void oil and gas lease did not grant lessees legally binding consent for pooling of lessors’ royalty interest.”).

³⁶ Brief for XTO Energy Inc. and Louisiana Gas Development Corporation as Amicus Curiae Addressing the Effect of a Valid and Subsisting Pooled Unit on the Mineral Interest Owner’s Reversionary Interest, Wagner & Brown, Ltd. v. Sheppard, 282 S.W.3d 419 (Tex. 2008), at 11.

³⁷ *Id.*, at 5.

³⁸ PYR Energy Corp. v. Samson Res. Co., 456 F. Supp.2d 786 (E.D. Tex. 2006).

An oil and gas lease contains different provisions regarding the termination of the lease as a result of the modifier effect of the pooling clause.³⁹ After the pooling power is exercised, as long as there is production in one of the pooled tracts, the lease continues to be in effect.⁴⁰ From this point of view, one may argue that the amendment in Sheppard's lease (lease terminates if the royalties are not paid within 120 days following the first sale of oil and gas) should not affect the pooling clause, because the pooling clause had its own termination conditions. Simply put, the lease had its own terms, but pooling clause modified some of these terms,⁴¹ so the parties also modified the lease by the addendums. However, since the related addendum in Sheppard's lease only stipulated the conditions that could cause the termination of the lease, but not the termination of the pooled unit, the defendants argued that even if the lease itself terminates, it should not cause the termination of the pooled unit.⁴² As a matter of fact, in this case, the parties did not seek the termination of the pooled unit.⁴³

The second argument is about the difference between the pooling of lands or leases. The Supreme Court of Texas decided that Sheppard's lease allowed the lessee to pool lands, not only leases; therefore pooling occurred free from the lease itself.⁴⁴ Termination of the lease did not affect the pooled unit.⁴⁵ Here again, the problem is not about the termination of the pooled unit; nobody sought that result. On the other hand, even if the lessee pooled the interests granted by leases, at the end the interests in lands covered by those leases being pooled, as it is explained above, all rights and obligations created under the lease would terminate with the lease.

C. The Nature of Agency

The third argument is about the agency relationship. The defendant and supporting *amici* argued that normally, under a valid oil and gas lease, the lessee does not necessarily need to include a pooling clause; since the conveyed interest is a fee interest, the lessee naturally has the right to pool its own fee interest. Defendants continued their arguments by claiming that the pooling clause must serve for something else rather than pooling the lessee's own interest. They concluded that when the lease terminated, as a result of pooling clause, the lessee still had right to pool the lessor's interest, because under the

³⁹ Lowe, *et al*, *supra* note 10, at, at 413-14.

⁴⁰ *Id.* at 414.

⁴¹ It modifies the granting, habendum and royalty clauses.

⁴² Ladd Petroleum Corp. v. Eagle Oil & Gas Co., 695 S.W.2d 99 (Tex. App.-Fort Worth 1985, writ ref'd n.r.e.).

⁴³ *Wagner & Brown, Ltd. v. Sheppard*, , 198 S.W.3d 369, 375 (Tex.App.6th Dist.Texarkana 2006) ("Here, Sheppard merely insists that her participation in the pool has terminated, not that the entire pool has terminated.").

⁴⁴ *Wagner & Brown, Ltd.*, 282 S.W.3d at 423.

⁴⁵ *Id.*

pooling clause the lessee was given the authority to pool the lessor's possibility of reverter. Once the possibility of reverter was pooled, the lessor was not able to claim her mineral estate back as long as the pooling continued. This meant that both the lessor and the lessee had some kind of ownership over the mineral estate. Since the lease was terminated, the lessor had a fee simple interest in the mineral estate, but on the other side lessee could act as if it still had the fee simple determinable. Even though the lessor got her fee simple interest back, she could not exercise her rights over the mineral estate. Here pooling of the possibility of reverter acted as a means to extend the 'determinable' element, but results from both parties having a fee simple interest.

The plaintiff and supporting *amici* argued that a reversionary interest cannot be pooled. In Herbert W. Henry's *amicus* brief, it was explained as follows:

I submit that pooling the lessor's reversionary interest, which vests only when the lessee no longer has a lease, cannot relate to the lessee's efficient development and operation of the leased premises. It would logically follow that the lessee would not have any power to pool the lessor's reversionary interest.⁴⁶

The plaintiff also quoted from Professors Kramer and Martin:

While this view (that an agency grant should bind the lessor regardless of whether the lease itself continues) can certainly be taken, the more correct view is that the lessor grants a power to pool the leasehold rights, and thus this pooling can extend no longer than the lease itself. The pooling clause is limited by the lease itself; it is not an additional power granted to the lessee that can extend beyond the lease.⁴⁷

The *Imes*⁴⁸ case and others⁴⁹ state that the relationship between the lessor and the lessee is analogous to the relationship between a principal and an agent:

Authority granted lessee to effect a unitization of mineral interests included therein with other mineral interests in immediate vicinity constituted lessee the agent of the lessors with limited authority to convey royalty interests to owners of other mineral interests on terms stated in the lease.⁵⁰

Under an agency relationship, the principal has the power to end that relationship when he/she wants.⁵¹ However, here in the relationship between the

⁴⁶ Brief for Herbert W. Henry, as Amicus Curiae, Wagner & Brown, Ltd. v. Sheppard, 282 S.W.3d 419 (Tex. 2008) at 12-13.

⁴⁷ Bruce M. Kramer & Patrick H. Martin, THE LAW OF POOLING & UNITIZATION S. 15.04 (Bender 3d. ed. 2006).

⁴⁸ *Imes v. Globe Oil & Refining Co.*, 84 P.2d 1106 (Okla.1938).

⁴⁹ *Yelderman v. McCarthy*, 474 S.W.2d 781 (Tex. Civ. App., 1972).

⁵⁰ *Id.*

⁵¹ *Gaede v. SK Investments, Inc.*, 38 S.W.3d 753 (Tex.App.Houston.14.Dist. 2001).

lessor and the lessee, as construed by the Court, we cannot see the same characteristics, if an agency relationship does in fact exist. Therefore the defendant asserted that in their relationship it is “an agency coupled with an interest,” so the power was irrevocable. Does the relationship between the lessor and the lessee carries all the aspects of an agency coupled with an interest?⁵²

Although it is subject to the caveat that it does not express the only situation in which a power of an agent is beyond revocation by act of the principal (and perhaps by operation of law), the rule stated in the earlier annotation is supported by most of the later decisions. This rule is that in order for a power to be irrevocable because it is coupled with an interest, it is necessary that the interest shall be in the subject matter of the power, and not in the proceeds which will arise from the exercise of the power.

Does the lessee’s interest in the subject matter of the power or in the proceeds arise from the exercise of the power? The main interest here is the production obtained from the wells. The power granted by the pooling clause only serves as a tool to obtain production in an easy and efficient way. With a pooling clause, the lessee does not acquire an interest in the production more than he/she already had.

As a conclusion, interests conveyed by an oil and gas lease are clear enough not to leave any open doors to any kind of discussion. The lessee had the knowledge that the lessor was conveying a fee simple determinable interest in the mineral estate. As a result of this kind of conveyance, they also knew that the lessor kept the possibility of reverter. The specified conditions to cause the termination of the lease are also clear enough that both parties agreed that the lease terminated with the late royalty payment. However, the Court’s decision caused conflict as to who owned what and under which circumstances. The agency analogy is, on the other hand, convincing to some extent, but it is not capable of explaining the nature of the pooling in all its essence.

II. INCONSISTENCY IN THE SUPREME COURT’S DECISION

In *Wagner & Brown*, the Court of Appeals decided that Wagner could ask for one-eighth of expenses and costs incurred after termination, but it could not ask for expenses and costs that occurred before termination of the lease.⁵³

The simple fact is that these parties were in one relationship and that relationship ended. When it did, their respective responsibilities and duties

⁵² M. T. Brunner, Annotation, *What Constitutes Power Coupled With Interest Within Rule As To Termination Of Agency*, 28 A.L.R.2d 1243 (1953); see also Ralph B. Shank, *Some Legal Problems Presented By The Pooling Provisions of Modern Oil And Gas Leases*, 23 TEX. L. REV. 150, 156-58 (1945); *Superior Oil Co. v. Stanolind Oil & Gas Co.*, 230 S.W.2d 346 (Tex. Civ. App. 1950).

⁵³ *Wagner & Brown, Ltd.*, 198 S.W.3d at 377 (Court of Appeals decision).

necessarily changed to reflect the differences in the relationship. When Sheppard was the lessor of the property, she had no liability for what the lessee chose to do.

Regarding the leasehold, land/legal, and overhead expenses that Wagner could not deduct from Sheppard's one-eighth share of the production revenue, it must account to Sheppard on a well-by-well basis, since Sheppard became an unleased co-tenant after the termination of her lease.⁵⁴

On the contrary, the Supreme Court held the opposite: "But Sheppard ceased being a royalty owner shortly after production began. To the extent working interest owners paid drilling costs out of production over the following months, Sheppard too would be liable for those costs as she became a working interest owner after her lease terminated."⁵⁵

Concerning the deduction of expenses, the Supreme Court decided that Wagner could deduct those expenses because they held that the unit survived independent from the lease.⁵⁶

When it comes to drilling costs, the Supreme Court based its decision on co-tenancy as if the lease were not in effect at that time; regarding the deduction of expenses from royalties, it based its opinion on the survival of the unit. In this sense, the Supreme Court's decision involved inconsistency. While making this conclusion, the Court focused on two elements: (1) effects of the pooling clause⁵⁷ and (2) equity.⁵⁸

The unit survived, even though one of the leases in the unit terminated. Pooling simply created a situation which went beyond the leases themselves. The accounting method of the drilling costs and leasehold, land/legal, overhead expenses changed as a result of this new situation. When deciding the accounting issue, the Supreme Court preferred not to be bound by the existing relationship between the parties and justified this result mostly on equity.⁵⁹

"The principle is well established in equity that a person who in good faith makes improvements upon property owned by another is entitled to compensate therefore."

Even though the Court mentioned the fact that equity does not favor those who sleep on their rights, it concluded that "but it is hard to see why one who obtains a lease and then loses it by mistake is entitled to less equity than one

⁵⁴ *Id.* at 378-81.

⁵⁵ *Wagner & Brown, Ltd.*, at 429.

⁵⁶ *Id.* at 424-25.

⁵⁷ *Id.*

⁵⁸ *Id.* at 425.

⁵⁹ *Id.* (quoting *Sharp v. Stacy*, 535 S.W.2d 345, 351 (Tex. 1976).

who by mistake never had a valid lease in the first place.”⁶⁰ Other important factors mentioned by the Court is that the lease terminated by accident and that Wagner & Brown offered to reinstate an expired lease immediately. This fact also strengthens defendant’s position in the eyes of the court.⁶¹ On the other hand, refusing this offer, by knowing that both wells were located on her tract, made Sheppard’s position worse.

First of all, it is impossible to differ from the Supreme Court’s reasoning regarding the importance of the pooling. It is obvious that since pooling prevented waste of money and natural resources, as well as reduced excessive drilling, it should be encouraged.⁶² On the other hand, although the other equitable reasons mentioned above can be argued, there is one other fact of the concreteness of the lease and pre-determined nature of property rights. Now, the question remains as to which one prevails. As I tried to explain above, property rights are pre-determined in their nature. When one says that he conveys a fee simple determinable in his estate, everybody knows what he is conveying, and again everybody knows what he is reserving. From this point of view, all the discussion made regarding the pooling of the possibility of reverter is unnecessary, because this could not been the parties’ intention. The nature of the property rights cannot be changed or modified by contract. In contrast, pooling was a right created by the lease, so that the scope of this right is debatable. What should the parties’ intention regarding the pooling have been? Did they intend to create an agency relationship? Did they intend to be bound by the pooling after the termination of the lease, and if so does this contractual claim give rise to a cause of action? The Court, instead of focusing on the property rights, should have focused on those issues. Even though the agency analogy is the most suitable one for the pooling, it still does not fit exactly with the nature of the pooling clause under the reasons discussed above. Thus, the relationship created by the pooling clause is *sui generis*.

There is no statute regulating such a problem, and there is also no precedent covering the same issue. Therefore, the Court had to interpret the lease. In terms of interpretation, the first step should have been to declare the ambiguity of the lease in question.⁶³ In this case, was the lease really ambiguous? It is undisputable that the parties did not expressly say anything regarding the fate of the pooled unit upon the termination of the lease. Thus, the first thing to be done

⁶⁰ Brannon v. Gulf States Energy Corp., 562 S.W.2d 219, 224 (Tex. 1997) (holding driller under invalid lease was entitled to reimbursement of reasonable drilling expenditures if found to have drilled “in good faith belief in the superiority of its lease”).

⁶¹ Wagner & Brown, Ltd., 282 S.W.3d at 428.

⁶² See generally Railroad Com’n of Texas v. Pend Oreille Oil & Gas Co., Inc., 817 S.W.2d 36 (Tex. 1991).

⁶³ David E. Pierce, *Interpreting Oil and Gas Instruments*, 1 TEX. J. OIL GAS & ENERGY L. 1, 4 (2006).

should have been to determine the content of the pooling clause and interpret the lease in its entirety the same way.⁶⁴

To understand the pooling clause, all possible situations should be considered, because you cannot apply it in a different way in every different case as long as it has its distinctive features. Especially in a money- and risk-intensive field like the oil and gas industry, rules should be well-settled and concrete. In this context, let us assume that Wagner had five different leases from five different landowners, and five of them include the same provision regarding the termination of leases in case of late royalty payment. Wagner, somehow, failed to pay royalties by mistake which caused the termination of all of those five leases. In this case, according to the Court's decision, no matter what happens to the leases (as long as the lease allows the pooling of lands), the unit survives and their participation in the unit continues as co-tenants. However, regarding the drilling costs, accounting depends on how long ago the wells were drilled and other equitable grounds should also be considered.

This kind of settlement might balance the both sides' interests in a specific case, but to provide certainty it is obvious that rules should be more definite.

Since this case proved us that voluntary pooling is capable of causing a lot of problems and misunderstandings depending upon the specific conditions of each lease, regulatory agency should take steps to prevent these results. Even though the Texas Supreme Court's reasoning and decision are completely erroneous, the result that they reached has some importance when it is considered in the context of the risk and capital-intensive nature of the oil and gas industry. However, the Court is not allowed to reach such a result by turning the basic principles of law upside down.

There are some other possible results of this decision:

Deep Rights: The *amicus* brief by the Texas Civil Justice League, Inc. discusses some issues that might occur as a result of the Supreme Court's decision, and deep rights are one of those issues. The given example is that:

Two leases covering the W/2 (Lease 1) and the E/2 (Lease 2) of a section are pooled at all depths. Lease 1 has a partial termination clause providing that it terminates at the end of the primary term, in the absence of drilling operations, as to all depths below 100' below the base of the deepest producing formation. The unit well in the W/2 produces from a formation bottoming at 5,000', so Lease 1 terminates 100' below 5,000'. The owner of Lease 2 intends to drill an 8,000' test well in the E/2. Is the unleased mineral estate below 5,100' in the W/2 still subject to the original pooling?⁶⁵

⁶⁴ See *Moore v. Jet Stream Investments, Ltd.*, 261 S.W.3d 412 (Tex.App.Texarkana, 2008).

⁶⁵ Brief for Texas Civil Justice League, Inc., as Amicus Curiae in Opposition to Respondents' Motion for Rehearing, *Wagner & Brown, Ltd. v. Sheppard*, 282 S.W.3d 419 (Tex. 2008) at 4-5.

According to the Supreme Court's decision, the lessor of Lease 1 will continue to be bound by the pooling, because the lessor's possibility of reverter was also pooled. In a situation like this, the Court would probably interpret the lease in a different way based on equity. However, oil and gas industry needs more certainty, even though the result does not satisfy each party every time in equitable grounds.

Problems with Old Terminated Unit Problems:⁶⁶ Lessees generally do not release pooling agreements and the attendant leases. When we consider the result of pooling the possibility of reverter, those agreements and leases should be released in order to prevent any title problems.⁶⁷ On the other hand, the custom in the industry shows us that a pooling clause has never been construed in a way that the Supreme Court adopted.

The Other Side of The Coin: Termination of an oil and gas lease by late royalty payments might function as if it protects the lessor. However, in some cases, the opposite result may occur. Lessees who do not want to hold non-producing leases in effect may fail to pay royalties intentionally. The proper solution might be to require the termination of the lease upon notification. Instead of terminating the lease immediately, lessor should give a notice to the lessee and lessee should be given the opportunity to correct its failure. This type of provision would benefit both the lessor and the lessee. This is a long-term contract, and lessee takes a high risk to conduct this contract. Lessor should not be able to get the benefit in situations caused by the lessee's mistakes. Continuation of the relationship created under the lease would be for the benefit of the both parties.

Practical Necessities: As mentioned above, voluntary pooling provides some practical necessities such as preventing waste of money and natural resources, so it should be encouraged. However, despite the fact that the Court's argument encourages pooling, this might not be true. After this decision, lessors and their attorneys' have already started trying to draft clauses to prevent the result reached by the Court.⁶⁸ This shows that the concerns in this direction are worthy of attention. This ambiguity will continue to cause problems in the future.

⁶⁶ *Id.* at 5.

⁶⁷ Brief for Herbert W. Henry as Amicus Curiae, *Wagner & Brown, Ltd. v. Sheppard*, 282 S.W.3d 419 (Tex. 2008) at 3-4.

⁶⁸ See, e.g., William K. Abney, Continuing Legal Education Presentation "Wagner & Brown v. Sheppard: Practical Considerations," at the 36th Annual Ernest E. Smith, Oil, Gas and Mineral Law Institute (Apr. 9, 2010).

III. ANALYSIS OF POOLING UNDER TURKISH LAW

Oil and gas legislation in Turkey has different fundamental features from the practices in the Texas oil and gas industry. Similar to the vast majority of systems in countries other than the United States, the Turkish system is predicated on the fact that the nation itself bears all ownership rights pertaining to oil and natural gas in the country.

Before delving into the pooling issues in the Turkish legal system, it is perhaps best to provide a brief overview of the significant players typically involved. There is a governmental agency called the General Directorate of Petroleum Affairs (“GDPA”). This agency, in addition to a variety of other duties, is primarily responsible for processing license applications, granting licenses, and creating and maintaining records. Companies wishing to explore, develop or produce oil are required to apply for a license with the GDPA. Turkey’s national oil corporation (“TPAO”) is structured as a Public Economic Enterprise and the TPAO is involved with essentially every aspect of oil exploration, development and production within the country. It is worth noting, however, that TPAO also has to apply to the GDPA for licenses just like any other government or privately-owned company.

After this general summary of the structure of the Turkish Petroleum Legislation, I want to compare the pooling regulation with respect to *Wagner and Brown*. Despite the fact that no actual use of pooling has occurred in Turkey, a few articles in the Turkish Petroleum Law arguably provide the basis for pooling.

Articles 70 through 73 of the Turkish Petroleum Law ostensibly regulate pooling. Article 70 stipulates:

License owners whose license areas are situated in whole or in part in the same petroleum field, and pooling of whose operations is likely to prevent waste, to increase production and efficiency, or to lower production costs, may pool their operations with the approval of the General Directorate of Petroleum Affairs if the license owners accept reasonable conditions that may be set forth by the General Directorate of Petroleum Affairs. Such applications made by license owners shall be acted on promptly.⁶⁹

This Article requires more than one license area and license owner in addition to a proven and recognized petroleum field. Beyond these requirements, license owners must be able to prove that pooling would be more efficient than running similarly-situated individual operations which would unnecessarily double each other’s efforts and cause undue waste.

⁶⁹ Available at <http://www.pigm.gov.tr/english/index.php> (last visited Jun. 14, 2011).

According to the Petroleum Regulation, the GDPA requires a very specific project layout that proves the efficiency of pooling in the proposed area. Furthermore, it requires a detailed agreement between the parties including matters such as who will be the legally-recognized operator, how proceeds are to be assigned, *et cetera*.

According to Article 71 of the Petroleum Law, license owners are to work together on the development of the pooled area and collaborate to ensure overall efficiency. A significant positive result enjoyed by the parties involved in a pooling project is that a successful jointly-run pooling operation is obliged to pay only one royalty for the petroleum in the pooled area. It is worth noting, however, that the different parties maintain individual royalty responsibilities for any petroleum from their remaining independent fields not connected to the pooled area. There is also no “license” specifically issued for pooling; obtaining a right to pool basically involves applying for and receiving a type of permit from the GDPA.

Let us assume that three license owners apply to the GDPA to pool their production fields. They are granted the pooling right, but one of their individual licenses has expired – akin to the fact pattern in *Wagner and Brown*. What would happen next in this scenario? Is the GDPA obliged to extend that party’s license as long as the pooling continues? Or, if the GDPA grants the license to a new company, would that company be obliged to participate in the pooling? At this juncture, we see that Article 73 of the Petroleum Law gives us guidance about the fate of this hypothetical pooled area and the rights of the respective parties.

Except as to conditions set forth by the General Directorate of Petroleum Affairs and matters mentioned in the foregoing articles, unitization shall not involve changing the areas held by the license owners or their rights and obligations with respect thereto.

Although the wording does not offer much guidance on what would happen to the pooled area in a situation like *Wagner and Brown*, there is a subtle clue that the pooled area is subject to a different treatment after the creation of pooling: “...unitization shall not involve changing the areas held by the license owners or their rights and obligations with respect thereto.” This phrasing creates the impression that the pooled area is subject to different standards once the pooling occurs, because it explicitly says that pooling does not affect or change any rights and obligations related to un-pooled areas. However, pooling can change the rights and obligations concerning a pooled area; this results in different treatment to the pooled and un-pooled areas.⁷⁰

⁷⁰ Turkish Petroleum Law, art. 73.

The phrasing perhaps leads to another question: When will the rights pertaining to the pooled area expire? Here, a significant difference in Texan and Turkish policy exists: oil and gas leases in Texas prescribe an indefinite duration for the second term which constitutes the “production phase,” whereas Turkey grants production licenses for a period of no longer than 20 years.⁷¹ Under specific circumstances, however, licenses can be extended on a maximum of two occasions provided that the total extension time does not exceed 10 years.⁷² In connection with the question regarding the expiration date for the hypothetical pooled area, the GDPA would not be required to issue a new individual license to the company whose license was expiring regardless of whether or not production was still ongoing. In order to circumvent this type of scenario, however, the GDPA could potentially specify a different expiration date for the pooled area according to the aforementioned Article 73 of The Petroleum Law.

And, remember, this exercise is nothing more than legally researched conjecture at this point, as pooling has yet to occur in Turkey. Instead, companies typically engage in a patchwork of service agreements in order to achieve the same results of pooling, but the prevalence of this practice is not necessarily a consequence of the ambiguity of the pooling provision. A surprising potential reason for the lack of official pooling agreements might actually be due to unawareness of this provision in The Petroleum Law. Basic common law concepts and terminology, which Turkish practitioners were unfamiliar with, were nevertheless adopted and included in Turkey’s Petroleum Law. This reality is somewhat illustrated by the fact that many of those Turkish practitioners may never have really needed to apply the pooling provision and, therefore, often have little to no familiarity with it. This lack of guidance and precedent, not to mention the typically complex and varying interests of the parties involved, make it quite difficult to definitively predict how exactly the GDPA would rule if it was actually presented with such a scenario.

In the event that a different expiration date is not determined by the GDPA, Turkish judges, through methods of gap filling, would likely treat the pooled area differently and give it a different expiration date. They would most likely require all the license owners in the pooled area to be bound by the pooling. There is, unfortunately, no legal precedent and minimal legal research to support this conclusion based on the fact that the Turkish Petroleum Law is still relatively young. A potentially informing tidbit, however, is that the majority of the fundamentals guiding Turkish Petroleum Law are modeled after American Petroleum Law practices. Slight justification for this conclusion regarding the

⁷¹ *Id.* art. 65.

⁷² *Id.* art. 65/3.

hypothetical pooled area can arguably be found in Article 2 of the Turkish Petroleum Law:

The objective of this law is to enable the expedient, continuous and effective exploration, development and appraisal of the petroleum resources of the Republic of Turkey in accordance with the national interest.

Based on this article, if a proposed pooling arrangement is considered to be in Turkey's national interest, and then it is likely to be approved despite a current lack of any clear statement as such in Turkey's laws and regulations.⁷³

Turkish Courts would likely reach an inherently similar conclusion to that arrived at by the Supreme Court of Texas if the same pooling issue was ever litigated in Turkey. The Turkish Court's reasoning would likely differ from the Supreme Court of Texas, however – but their legal grounds for doing so and legal method for doing so would be arguably more justified, if not preferable. After all, Turkish Courts could accomplish the same outcome desired and achieved by the Supreme Court of Texas without destroying a very basic common law property principle in the process – something the Supreme Court of Texas somehow could not manage to do.

CONCLUSION

Since the Court's analysis regarding the pooling arrangement may impinge the lessor's possibility of reverter, it cannot be the law. This conclusion contradicts basic property law principles and if were to become settled law, there will be a huge misunderstanding of the legal concepts. Instead of trying to change property law concepts by interpreting the contract, the Court should have focused on the nature of contractual rights created by an oil and gas lease. Regarding the agency analogy, all related precedents in this area were contented with by saying that the pooling relationship is similar to agency relationship, but none of them made a satisfactory explanation to establish the similar ways and differing ways of those two concepts. Again, none of them clarified in which situations we should apply the agency analogy (we even do not have a concrete decision whether the pooling is just similar to agency relationship or it is an agency relationship).

Reasoning based on equity such as the lessee's good-faith, offering the renewal of the lease immediately, the fact that the wells were drilled just before the termination of the Sheppard's lease are to some extent convincing. The

⁷³ See also Turkish Petroleum Law, art. 12-13.

Court could have based its opinion on those facts and limited its decision narrowly based on this specific set of facts.

In the Texas legal system, we can see that contractual freedom has great value. In terms of oil and gas law, most states (such as Oklahoma) have less strict standards for compulsory pooling,⁷⁴ but in Texas, voluntary pooling is encouraged, and lessees are required to try to get permission for voluntary pooling from lessors in the first place.⁷⁵ Despite the fact that contractual freedom is valuable in terms of giving place to the parties' will, it carries risk on the other hand. If the parties fail to be specific enough, disputes arising from their relationship call for interpretation. No wonder that the courts apply some canons of contractual construction when they encounter such ambiguous terms, but when it comes to Supreme Court decisions, again it is no wonder that they frequently take public policy into consideration rather than purely applying the law. The discussion whether this kind of approach is right is not within the scope of this article. On the one hand, parties are not capable of foreseeing every possible consequence that may result from their contract, especially in long-term contracts like oil and gas leases. On the other hand, predictability is a cornerstone in the oil and gas industry. While oil companies conduct their relationships with undeveloped or developing countries, they look for predictability, legal stability and social stability. These are the facts of this industry. From oil companies' economic activities not only lessors and lessees benefit but also the country benefit with its entirety. Therefore, at some points the intervention of regulatory agencies is necessary to there are undesirable conflicts in the results.

⁷⁴ Shade, *supra* note 13, at 118 ("If parties in a situation where pooling would be desirable cannot work out a deal for themselves, the state will work out a deal for them by imposing compulsory pooling.).

⁷⁵ TEX. NAT. RES. CODE ANN. § 102.001-102.112 (Vernon 2006); *see also* Ernest E. Smith, *The Texas Compulsory Pooling Act*, 43 TEX. L. REV. 1003 (1965).

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