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## NEW FACETS OF OLD ALTERNATIVES FOR UNLEASED MINERAL INTERESTS<sup>1</sup>

By Lisa Vaughn

This article explores why pooling is especially needed in urban areas such as the Barnett Shale, and what operators and mineral interest owners can do to solve the problems caused by unleased and un-pooled property interests.

The obvious starting place for our analysis is that an operator desires to minimize expenses for obtaining and developing the minerals he seeks to extract, and a mineral owner desires to obtain and maximize the value for his share of the minerals. In places other than the Barnett Shale, it can be easy: the landowner (who most likely owns both the minerals and the surface) and the operator enter into a lease for a big chunk of land; the operator drills a well on it, and the owner gets paid his share of the royalties.

In the Barnett Shale, however, the complications caused by the Railroad Commission's (RRC) spacing and allocation rules, municipality-dictated restrictions on drilling, severance of minerals, horizontal drilling techniques, and the tiny tracts of land typical in urban areas all combine to play havoc with what started out as a simple drill-and-pay scheme.

Because many homeowner tracts are only 1/3 acre or less, producers can be required to secure hundreds of leases for a single well. Securing those leases can be a costly proposition, both for the costs of the leases themselves and the transaction costs associated with negotiating and then keeping track of all those separate leases. And that is if things go smoothly. What if hold-outs in a neighborhood refuse to lease? What if the geographical features or building structures already present in the area require that the drill site be placed near the edge of a tract, which would drain minerals from non-leased land? What if geographical or other issues dictate that the well be sited on a

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1. Sources, ideas and perspectives for this article were inspired by not only the cases and authorities cited, but by many excellent seminars and articles, some of which are referenced below. There were certainly others over the years, and for those I forgot to include, I offer apologies.

- H. Philip Whitworth, *Horizontal Drilling in Urban Areas and Particularly the Barnett Shale*, 25th Annual Advanced Oil, Gas & Energy Resources Law Course (Oct. 4-5, 2007).
- Carroll Martin & D. Davin McGinnis, *All for One and One for All: A Primer on Pooling in Texas*, 31st Annual Ernest E. Smith Oil, Gas and Mineral Law Institute (April 1, 2005).
- Bruce M. Kramer, *The Nuts and Bolts of Pooling: A Primer for the Uninitiated*, 24th Annual Advanced Oil, Gas & Energy Resources Law Course (Oct. 5-6, 2006).
- JOSEPH SHADE, *PRIMER ON THE TEXAS LAW OF OIL AND GAS* (4th ed. 2008).
- Mark K. Leaverton, *MIPA . . . Schmipa: The Foibles of Texas Forced Pooling*, 25th Annual Advanced Oil, Gas & Energy Resources Law Course (Oct. 4-5, 2007).

separate parcel altogether, with horizontal drilling traversing unleased land? For all of these complications, an old, little-used statute called the Mineral Interests Pooling Act—MIPA—may be the “new” answer.<sup>2</sup>

### I. POOLING GENERALLY: WHY, HOW, WHEN, AND UNDER WHAT CIRCUMSTANCES?

At its simplest, pooling is nothing more than grouping together small tracts of land to form a drilling and production unit for a well. In the Barnett Shale, where there are no between-well spacing requirements, pooling allows enough land to be gathered to meet lease-line spacing requirements and increase production allowables if they are established by the RRC for this field.

In Texas, pooling has typically been created by an agreement between the parties who own separate tracts. Those agreements take several forms. One way for separate tract owners to pool their interests is by execution of a community lease, although this method is becoming more and more rare. In Texas, the execution of a community lease constitutes a pooling of the respective individual interests committed to the community lease so that production from anywhere in the community will be apportioned among all of the community lessors.<sup>3</sup> Another way to accomplish pooling is for the mineral owners to execute pooling agreements that are separate from the leasing agreements. This is also becoming more rare, since the vast majority of pooling agreements are now incorporated into the leases themselves.

When there is no agreement between the parties, however, pooling can still occur under MIPA.<sup>4</sup> In Texas, forced pooling under MIPA has been a rare procedure by both sides of the energy equation, but current developments may and should increase its importance, particularly in the Barnett Shale and other urban areas.

### II. ECONOMICALLY COMPELLING REASONS FOR POOLING

For operators, pooling allows them to extend the life of multiple leases with production from a single well. In urban areas such as the Barnett Shale, pooling is almost mandatory due to the multiplicity of small tracts of land, which are generally too small or oddly shaped to support a well because of rules such as those requiring placement at least a certain distance from any lease lines. And of course, pooling can allow a horizontal well’s bore site to be placed far from where the reservoir will actually be tapped, thus allowing operators to comply with municipal regulations and public policy issues by placing drilling

2. TEX. NAT. RES. CODE ANN. §§ 102.001–112 (Vernon 2001).

3. See, e.g., *Long v. Knox*, 291 S.W.2d 292, 298 (Tex. 1956).

4. See § 102.012.

activities further from homes. It also allows more production from fewer wells, thus serving the goals of conservation and minimizing waste. Beyond these reasons, however, are some lesser-known issues that can best be solved by pooling.

A. *Lessee may have a duty to pool.*

Texas operates under the “rule of capture,” which means that as long as the well has been properly permitted by the RRC, all minerals produced by that well “belong” to the well site property, no matter from where those minerals migrated prior to being extracted by the well.<sup>5</sup> The rule of capture generally protects an operator from being liable for draining neighboring lands in which he holds no interest.

As a result, older Texas cases indicate there is no duty to pool.<sup>6</sup> However, newer cases impose the duty to act as a reasonably prudent operator, and that may include pooling, especially if pooling would prevent drainage.<sup>7</sup> Thus, when lands in which the lessee has an interest are being drained, the lessee may be required to exercise pooling authority or seek it where it is not already given when a profitable well cannot be drilled to protect the non-drillsite tract. For example, in *Tide Water Associated Oil Company v. Stott*,<sup>8</sup> the court found in a gas-cycling project that the operator fulfilled its implied covenant to prevent drainage by offering to pool.<sup>9</sup> Notably, other jurisdictions facing this question *have* imposed this obligation.<sup>10</sup> Thus, an operator may be able to use pooling, and perhaps even an offer to pool regardless of whether the offer is accepted, to protect itself from a suit for breach of the implied covenant to prevent drainage.

B. *Lessee may expose itself to additional expenses or lawsuits if all interests touched by the well bore are not pooled.*

**1. Absence of pooling requires an RRC hearing to get a drilling permit.** To obtain a drilling permit for pooled lands, RRC Rule 40 requires that the operator file a Certificate of Pooling Authority, which must identify each tract pooled and whether any of the tracts have any unleased interests.<sup>11</sup> The operator is then required to pro-

5. See, e.g., *Coastal Oil & Gas Corp. v. Garza Energy Trust*, 268 S.W.3d 1, 13 (Tex. 2008).

6. See, e.g., *Waters v. Bruner*, 355 S.W.2d 230, 235 (Tex. Civ. App.—San Antonio 1962, writ ref'd n.r.e.).

7. See *Amoco Prod. Co. v. Alexander*, 622 S.W.2d 563, 568 (Tex. 1981) (stating that duties of reasonably prudent operator may include seeking voluntary unitization); see also *Se. Pipe Line Co. v. Tichacek*, 997 S.W.2d 166, 170 (Tex. 1999) (noting that pooling is an acceptable and common protective measure to prevent drainage).

8. *Tide Water Associated Oil Co. v. Stott*, 159 F.2d 174, 177 (5th Cir. 1946).

9. See *id.*

10. See, e.g., *Breaux v. Pan Am. Petroleum Corp.*, 163 So. 2d 406, 415–16 (La. Ct. App. 1964); *Gilham v. Jenkins*, 244 P.2d 291, 294 (Okla. 1952).

11. 16 TEX. ADMIN. CODE § 3.40 (2009).

vide notice to those unleased interests, and the owners are given an opportunity to protest at a RRC hearing; this mechanism is intended to help prevent a small-interest lessee or mineral-interest owner from being left out, but there are no absolutes. Similarly, if a proposed drill path would violate the lease spacing requirements, the operator is required to give notice to the owners and provide those landowners the opportunity to protest.<sup>12</sup> At these hearings, the only grounds sufficient to defeat a permit are that denial is necessary to prevent waste and to protect correlative rights of those property owners whose interests are actually crossed. Notably, the RRC has refused to deny permits based on complaints that the correlative rights of nearby mineral owners would be negatively impacted by drainage.<sup>13</sup> However, if all interests were pooled, objections and the expense of hearings could be avoided.

**2. Drillpipe placement may result in illegal wells.** The Rule 37 requirement of a certain number of feet between the well and the nearest property or pooling line can be tricky with horizontal drilling.<sup>14</sup> For horizontal wells in the Newark (East) Field, the distance to the “lease line” for Rule 37 purposes is measured by the distance from the lease or pooled unit’s boundary line to the nearest perforation in the well, as long as the well is cased and cemented back above the top of the correlative interval that is, the top of the producing formation. Similarly, if an external casing packer is placed in the well and cement is pumped above this packer to a depth above the correlative interval, the spacing distance is measured from the top of the casing packer or the closest open hole section in the interval to the nearest lease or pooled unit line. In the meantime, however, before the well is completed and the packers and cement are placed it would appear that the well would violate the spacing rules, which might render the well “non-permitted.”

Yet another lack-of-permit scenario may arise if the drillpipe ends up in locations not originally planned. Chesapeake recently encountered this issue when the horizontal portion of a well it was drilling in Fort Worth extended nearly twice as long as the initial permit allowed, leaving fifteen unleased and unpooled lots closer than the required distance of 330 feet from the well bore. As a result, Chesapeake may have to shut down the well altogether.<sup>15</sup> Again, these negative consequences could be avoided if all the interests are pooled.

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12. 16 TEX. ADMIN. CODE § 3.37 (2009).

13. See Tex. R.R. Comm’n, *Application of Andarko E & P Co. LP for an Exception to Statewide Rule 37*, Docket No. 0246122 (Dist. 3 Apr. 19, 2006) (proposal for decision) (acknowledging drainage problem faced by nearby small landowners, but refusing to permit that drainage to justify denying Rule 37 exception).

14. See § 3.37.

15. See Jim Fuquay, *Chesapeake, City, Homeowners, Spar Over Well Drilled Beneath Unleased Property*, FORT WORTH STAR-TELEGRAM, Feb. 24, 2009, <http://www.star-telegram.com/business/story/1224441.html>.

**3. *Unpooled severed surfaces can result in trespass.*** Yet another potential problem from lack of pooling arises if the well site is located on a surface that is severed from the mineral interests or the mineral interests below that surface are not being developed. Normally, the surface estate can be used to develop the minerals under that surface because the surface estate is considered subservient to its mineral estate.<sup>16</sup>

However, there is authority that if the minerals were severed prior to pooling, the surface owner may be able to enjoin or seek damages from development efforts that include minerals from other tracts.<sup>17</sup> This is even more certain if the unpooled surface is being used to site a horizontal drill that produces only from other tracts, in which case the operator will be subject to lawsuits seeking to enjoin operations or trespass damages.<sup>18</sup> Thus, if the surface is severed, the pooling of the mineral estate by itself will not necessarily expand the rights of the operator to use the surface to assist the pool. A separate surface lease or proper pooling that includes the surface can avoid these negative results.

**4. *Drillpipe crossing unpooled subsurfaces can result in trespass.*** A Rule 37 exception does not excuse or forgive trespass.<sup>19</sup> As a result, if the drillpipe actually traverses a piece of unpooled property, the operator may be liable for an expensive trespass or find itself defending against an injunction to stop drilling. There is at least some authority that mineral owners whose lands are not being produced, but whose property is crossed by horizontal well bores, may enjoin the trespass or seek damages regardless of whether the pipe is in the correlative zone.<sup>20</sup>

If the well bore traverses the correlative zone, the courts have held that damages can be 100% of all production unless the operator can prove to a reasonable certainty the proportion of production attributable to each unpooled tract, which can be a difficult and expensive

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16. See, e.g., *Getty Oil Co. v. Jones*, 470 S.W.2d 618, 621 (Tex. 1971); *Ball v. Dillard*, 602 S.W.2d 521, 523 (Tex. 1980) (holding that a surface owner may not unreasonably interfere with the mineral estate).

17. See, e.g., *Property Owners of Leisure Land, Inc. v. Woolf & Magee, Inc.*, 786 S.W.2d 757, 760 (Tex. App.—Tyler 1990, no writ) (stating that the surface may *not* be used to develop minerals from other tracts unless those mineral interests are pooled).

18. See *Robinson v. Robbins Petroleum Corp.*, 501 S.W.2d 865, 868 (Tex. 1973) (holding that the severed surface of one tract may not be used for oil and gas operations on adjacent tracts without the surface owner's permission).

19. See *Berkley v. R.R. Comm'n of Tex.*, 282 S.W.3d 240, 243 (Tex. App.—Amarillo 2009, no pet.).

20. See *Chevron Oil Co. v. Howell*, 407 S.W.2d 525, 528 (Tex. Civ. App.—Dallas 1966, writ ref'd n.r.e.) (upholding an injunction against drilling operations because of the "inevitable" damage to the subsurface formation whenever a well is drilled). *But see Humble Oil & Ref. Co. v. L. & G. Oil Co.*, 259 S.W.2d 933, 938 (Tex. Civ. App.—Austin 1953, writ ref'd n.r.e.) (holding that the mineral owner could not enjoin the drilling unless it could show that the drilling would interfere with its rights to develop minerals).

burden of proof.<sup>21</sup> For a potentially contrary view, see *Browning Oil Company v. Luecke*.<sup>22</sup> In the *Luecke* case, the court limited the lessor's recovery to only that production which was attributable to the portion of the horizontal drainhole actually under the lessor's acreage. Notably, however, the cause of action in *Luecke* was based on breach of a lease's pooling provision, not on trespass; as a result, the lessees had a lease governing production of the plaintiff's minerals, which no doubt significantly affected the damage calculation and should make this case inapplicable to apply to trespass cases.

If the 100%-of-production rule is found to apply to horizontal trespasses or the operator cannot prove what percentage of production comes from the trespassed tract, damages can be large. Damages become even higher if the well violates its RRC permit, because such a trespass is very likely to be found in "bad faith." Whether the trespassing operator can deduct drilling and operating costs is determined by whether the trespass was in good faith; that is, the operator had a reasonable but incorrect belief that his title permitted him to be on that land.<sup>23</sup> In short, there is a substantial risk that unpooled interests along the path of a horizontal drainhole will have to be paid as if it were a drill site.<sup>24</sup> Once again, valid pooling agreements will negate the potential for trespass actions.

*C. Lessee can use pooling to increase allowable production and minimize need for Rule 37 exceptions.*

As if avoiding trespass damage and potential injunctions were not enough incentive to pool, the proration or the amount of production permitted by the well is affected by the unpooled portions of the horizontal drainhole. Under Rule 86, all of the horizontal drainhole within the correlative interval must be included in the proration unit or no allowable will be granted.<sup>25</sup>

Horizontal drainholes must comply with applicable Rule 37 spacing exceptions as to each and every point of the well in the correlative interval between the penetration point (where the horizontal string begins) and the terminus (where the horizontal string ends), which means that all of those points must be a minimum of 330 feet from the lease or pooling boundary. Obviously, then, the larger the pool, the less likely the minimum distance requirements will be violated.

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21. See *Humble Oil & Ref. Co. v. West*, 508 S.W.2d 812, 818 (Tex. 1974).

22. See *Browning Oil Co. v. Luecke*, 38 S.W.3d 625, 640-41 (Tex. App.—Austin 2000, pet. denied).

23. See, e.g., *Bender v. Brooks*, 103 Tex. 329, 336, 127 S.W. 168, 171 (1910).

24. *Am. Trading & Prod. Corp. v. Phillips Petroleum Co.*, 449 S.W.2d 794, 798 (Tex. Civ. App.—El Paso 1969, writ ref'd n.r.e.).

25. 16 TEX. ADMIN. CODE § 3.86 (2009).

D. *Small or adjacent lessors' only mechanism to obtain value for drainage may be pooling.*

Probably most lawyers in Tarrant County have been approached by a left-out landowner with drilling going on somewhere nearby, asking whether they have any rights. If the drilling is only “nearby” and does not actually touch their property, these landowners have limited options because of Texas’ use of the rule of capture, even though everyone acknowledges that the drilling *is* draining mineral interests from which they would have been able to profit otherwise. Unfortunately, even objecting to an operator’s request for a Rule 37 exception does not provide these owners relief, because the RRC has denied such objections.<sup>26</sup> These owners’ only recourse has historically been to seek for voluntary pooling with the producing tracts.

To sum up, there are powerful financial reasons encouraging pooling. But what if the operator and mineral owner cannot agree?

### III. MINERAL INTERESTS POOLING ACT, OR MIPA FOR SHORT

MIPA was originally codified as Texas Revised Statutes Annotated, art. 6008c (1965) but was subsequently recodified into Chapter 102 of the Natural Resources Code.<sup>27</sup> MIPA was a legislative response to the Texas Supreme Court’s decision in *Atlantic Refining Company v. Railroad Commission of Texas*<sup>28</sup> (known as the *Normanna* case because the proration issues being litigated arose from production in the Normanna Field). In the *Normanna* case, the Texas Supreme Court struck down proration formulas that favored small tracts and allowed significant drainage of adjoining larger tracts in favor of formulas based largely on acreage. This decision made it uneconomical to drill wells on smaller tracts and created the political environment that led to the passage of MIPA.

Unlike other states’ forced-pooling statutes, MIPA is generally regarded as an act meant to encourage voluntary pooling rather than an act to provide compulsory state action.<sup>29</sup> According to legislative history, the real purpose of MIPA comes into play when pooling would be desirable to protect correlative rights and prevent waste, but the parties cannot work out a deal for themselves. In other words, MIPA

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26. See Tex. R.R. Comm’n, *Application of Andarko E & P Co. LP for an Exception to Statewide Rule 37*, Docket No. 0246122 (Dist. 3 Apr. 19, 2006) (proposal for decision) (acknowledging drainage problem faced by nearby small landowners, but refusing to permit that drainage to justify denying Rule 37 exception).

27. Act of 1965, 59th Leg., R.S., ch. 11, p. 24, Tex. Civ. Stat. Art. 3008c (recodified by the Mineral Interest Pooling Act, TEX. NAT. RES. CODE ANN. §§ 102.001–.112 (Vernon 2001)).

28. R.R. Comm’n of Tex. v. Pend Oreille Oil & Gas Co., Inc., 817 S.W.2d 36, 49–50 (Tex. 1991) (citing *Atl. Ref. Co. v. R.R. Comm’n of Tex.*, 162 Tex. 274, 346 S.W.2d 801 (1961)).

29. See Ernest E. Smith, *The Texas Compulsory Pooling Act*, 43 TEX. L. REV. 1003, 1009 (1965).



is a fall-back position meant to be used only after voluntary efforts have failed.<sup>30</sup> Regardless of its “voluntary encouragement goals,” however, MIPA can be used to force absent or unwilling parties to pool in the right circumstances.

Most articles that discuss MIPA note that it has not been used much, and although actual counts vary depending on the source, it cannot be disputed that MIPA is a little-used tool.<sup>31</sup> Although MIPA was in theory originally designed to protect the small-tract owner, in practice it has been an inefficient vehicle for that protection because of the relative cost. However, we may now discover that MIPA can morph into a powerful mechanism for operators, especially in urban areas such as the Barnett Shale where operators are facing checkerboard holdings due to the confluence of several circumstances including the sheer number of lots that must be leased to form a production unit and several years of intense leasing activities that increased mineral owners’ monetary demands and led to aggressive hold-out negotiations. This was compounded when the recent sinking market for gas prices caused widespread abandonment of leasing activities.

In this context, some 40 years after MIPA was enacted, MIPA almost seems tailor-made for the Shale. For example, MIPA does not apply to fields where the reservoir was discovered before March 8, 1961.<sup>32</sup> Since Newark (East) was discovered in 1981, however, the Barnett qualifies. Similarly, MIPA only applies if the RRC has adopted special field rules for the reservoir at issue (it has); all tracts sought to be pooled must be in the same reservoir (they almost certainly are); and all acreage sought to be pooled must be within the productive limits of the reservoir. All of these requirements are especially likely to be true for all Barnett Shale properties in the urban area.<sup>33</sup>

About the only aspect of MIPA that does not permit maximization of value in the urban horizontal drilling context is MIPA’s limitations on the size of proration units, which were established before the days of horizontal drilling. Under MIPA, the RRC can create a pool for a gas well of 640 acres plus 10% for a gas well, and the force-pooled unit must contain that approximate acreage.<sup>34</sup> However, if the pooling is

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30. See generally 56 TEX. JUR. 3d *Oil and Gas* § 576 (2004) (stating that the Texas Railroad Commission may prescribe forced pooling in certain situations); *Am. Operating Co. v. R.R. Comm’n of Tex.*, 744 S.W.2d 149, 154 (Tex. App.—Houston [14th Dist.] 1987, writ denied) (explaining that MIPA is intended to provide parties with encouragement and an incentive to voluntarily pool).

31. See COLIN K. LINEBERRY, *THE TEXAS RAILROAD COMMISSION’S ROLE IN THE OIL AND GAS BUSINESS INCLUDING POOLING AND DISPOSAL WELLS* 3 (2008) (stating that “in the last 10 years, of the 41 MIPA applications filed at the Commission, 14 were dismissed, 23 were withdrawn, and three were granted by Commission final order.”).

32. TEX. NAT. RES. CODE ANN. § 102.003 (Vernon 2001).

33. See §§ 102.011, 102.018.

34. *Id.* § 102.011.

voluntary, the RRC will permit horizontal gas wells in the Barnett to be considerably larger than 700 acres if the well is drilled minimum distances.<sup>35</sup>

**Who can apply for forced pooling?** As we have discussed, MIPA was originally enacted to create an avenue for the left-out small-tract owner to obtain value for the owner's minerals. Standing to bring a MIPA is not limited to owners of mineral estates, however, and there is no limitation on the size of the ownership for a MIPA applicant.

However, there is an argument that there are some limitations on the types of owners that can apply for forced pooling. As printed, the current statute appears to permit the owner of any interest at all to apply for forced pooling, as long as one is not trying to force pool government lands.<sup>36</sup>

In contrast, the original codification made distinctions on who could apply to force pool based on whether the unit to be created was "existing" or "proposed." An "existing" unit is one that geographically encompasses the applicant's property interest but in which the applicant's interest has not been pooled. A "proposed" unit occurs when the applicant seeks to pool a tract of land that is being or will be drained by an adjacent unit and its addition to the unit will change its geographic boundaries. As originally codified, the punctuation and structure of the language made it clear that if the applicant is attempting to join an "existing unit," an owner of any interest in that unit can apply for pooling, but if the unit is "proposed," only working interest owners and unleased owners could apply.

The recodification into the Natural Resources Code, however, did not maintain the prior structure of the statute even though the act that created the Natural Resources Code and recodified the old statutes stated that "it is the intent of the legislature that each provision of this code be interpreted to have the same meaning as the statutes from which it is derived."<sup>37</sup> In the original, the first part addressed existing units, and subparts a and b modified the portion relating to proposed units. Conversely, the recodified (current) statute combined parts 1 and 2 into a single point and made subparts a and b each their own independent grounds. As a result, if the section as currently written is read literally without knowledge of the prior structure, parts 2 and 3 are superfluous and contradictory to part 1, which grants standing to any interest owner regardless of whether the unit is existing or proposed. This conflict between the original codification and the current

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35. 16 TEX. ADMIN. CODE § 3.86 (2009); Tex. R.R. Comm'n, *Final Order Amending the Field Rules*, Docket No. 09-0253880 (July 29, 2008).

36. §§ 102.004, 102.012 (requiring lands to be pooled must be privately owned unless General Land office or other applicable agency consents).

37. Act of May 4, 1977, 65th Leg., R.S. ch. 871, Art. II, § 113.097, sec. 15, 1997 Tex. Gen. Laws 2692, 2697.

has not been decided, but in any event, will not preclude an operator from applying.

***What types of lands can be forced into the pool?*** In addition to the potential limitations on the types of owners that can seek forced pooling, MIPA contains several limitations on the types of lands that can be pooled. First, the lands being pooled must be privately owned unless the General Land Office or the applicable state agency consents.<sup>38</sup> Second, § 102.014(a), also known as the “muscle-in provision,” generally disallows forced pooling of lands that, on their own, have sufficient acreage to be as large as the standard proration unit for the reservoir.<sup>39</sup> Even in that situation, though, the RRC still has authority to force pool that large tract on behalf of an adjoining mineral interest owner whose lands are less than the standard proration unit if the owner has not been offered a reasonable opportunity to pool voluntarily.<sup>40</sup>

Third, the existing or proposed unit must have separately owned interests in two or more tracts.<sup>41</sup> Fourth, only those units where a well is already drilled or is proposed to be drilled are subject to forced pooling.<sup>42</sup> This latter requirement gives an operator additional control over the forced pooling options, because only an operator, not a royalty owner, has the right to drill.

In short, although MIPA was intended to assist the small left-out mineral interest owners, an operator is fully authorized and perhaps in the best position to use MIPA to join or expand a pool.

***When can an applicant seek forced pooling?*** Perhaps the most significant restriction of MIPA is that forced pooling can be granted only if the applicant has attempted voluntary pooling and failed. This requirement is more than procedural: it is jurisdictional. As a result, the applicant must prove much more than it made a simple attempt at voluntary pooling. Indeed, before the RRC can act on the application, the RRC *must* make a finding that the voluntary efforts ended with the applicant making a “fair and reasonable offer” that was rejected.<sup>43</sup>

The MIPA statute tells us that an offer to pool “on the same yardstick basis” as the interest owners already included within the unit is “fair and reasonable.”<sup>44</sup> Further guidance of “fair and reasonable” has been provided by the courts, which have held that whether an offer is fair and reasonable is to be considered from the standpoint of

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38. §§ 102.004, 102.012.

39. § 102.014(a).

40. *Id.*

41. § 102.011.

42. *Id.*

43. § 102.013(b).

44. § 102.013(c).

the offeree at the time the offer is made.<sup>45</sup> The Texas Supreme Court has also stated that a fair and reasonable offer must be “one which takes into consideration those relevant facts, existing at the time of the offer, which would be considered important by a reasonable person in entering into a voluntary agreement concerning oil and gas properties.”<sup>46</sup>

The offer must even take into account reasonable risk penalties. In the Barnett Shale, where the vast majority of wells produce with little more than the simple risk that the well suffers mechanical problems, it seems likely that the RRC will reject any offer that includes more than a nominal risk penalty.<sup>47</sup>

Finally, MIPA itself dictates that an offer to pool is not fair and reasonable if it gives the operator a preferential right to purchase mineral interests in the unit, an option to purchase production from the unit, imposes operating charges other than reasonable overhead charges, or precludes disputes over operation.<sup>48</sup>

**Potential end result of application for forced pooling.** If granted, the RRC has several options for ordering the pooling and apportioning ownership of production, distribution of royalties, and responsibility for drilling and completion costs. In all cases, however, the mandate is to reach a fair and reasonable result for all parties.<sup>49</sup>

For example, in ordering forced pooling, the RRC is permitted to impose risk penalties on the unleased mineral owner to compensate the risk takers for the fact that the force-pooled interests are not required to assume the risks of drilling the well. The risk penalty is statutorily limited to 100%,<sup>50</sup> which means that the force-pooled interests can be required to pay up to 200% of their pro rata share of the reasonable drilling and completion costs, plus their share of operating expenses for the well before getting paid. Thus, in a forced-pooled unit, an owner may elect to not pay his proportion share of drilling and completion costs in advance. If that occurs, the RRC’s forced-pooling order must provide for reimbursement out of production to the parties advancing the costs, including all actual and reasonable drilling, completion and operating costs, and a reasonable charge for the risk. However, the standard for assessing a fair and reasonable risk penalty is the actual chance of a successful completion at the time the well is drilled. In the Barnett Shale, there is little risk, and in the

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45. *Windsor Gas Corp. v. R.R. Comm’n of Tex.*, 529 S.W.2d 834, 837 (Tex. Civ. App.—Austin 1975, writ dismissed).

46. *Carson v. R.R. Comm’n of Tex.*, 669 S.W.2d 315, 318 (Tex. 1984).

47. *See Windsor Gas Corp.*, 529 S.W.2d at 836–37 (holding that an offer that included a risk-factor penalty of 2-1 not reasonable in light of testimony that there was little risk for the proposed wells).

48. § 102.015.

49. *Id.*

50. *See* § 102.052(a).

absence of evidence of risk, the RRC has concluded that nominal—and even zero—risk penalties are appropriate.<sup>51</sup>

***The flip side: difficulties and disadvantages in MIPA***

***Delay in obtaining decision.*** There are quite a few potential procedural delays in a MIPA proceeding. After waiting for the time necessary for reasonable offers to be formulated, distributed, and rejected, the applicant must prepare the application and provide notice to all interested parties. Then, the RRC schedules hearings, deliberates, and formulates responses. All of this can take between one and two years. To more accurately judge the delay factor, however, it must be compared with the time and delay that can occur in negotiating leases for large numbers of tiny tracts and then keeping track of all the individual leases.

***Public disclosure of information.*** Historically, operators kept lease payment terms secret so as to not impact other lease negotiations. In such circumstances, operators can be loathe to undertake the MIPA process, where it will have to prove the “fair and reasonableness” of its pooling offer by showing in a public forum what has been paid in the area. Recent times may have changed this attitude because in most of the urban Fort Worth areas, lease terms *were* being publicized at various public meetings and in news articles. Nevertheless, other information will also need to be disclosed in a MIPA proceeding, including various well, geographic, and engineering information, and such information will then be available not only to the unpooled mineral owner but to other offset operators who may be present at the hearing.

***Expense in preparing and arguing for the pooling.*** It seems unlikely that a small-tract owner would be able to prepare and prosecute a MIPA application without the assistance of a lawyer and at least some access to engineering and geological studies. Notably, however, all of that is easily within the grasp of operators and large owners, who will have access to the information required to prepare an application, i.e. which acres are productive, which acres will be drained, etc. Such an imbalance may increase the odds that small-tract owners will not effectively defend against an operator’s request to force pool. No one can dispute that the MIPA proceeding incurs costs. However, to more accurately judge the true costs of such a procedure, it needs to be compared to the additional expenses of hiring landmen in long-term efforts to completely lease large numbers of tracts; hiring engineers

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51. See Tex. R.R. Comm’n, *Application of Patricia C. Nowak for Formation of a Pooled Unit Pursuant to the Mineral Interest Pooling Act*, Docket No. 06-0245016 (Oct. 17, 2005) (proposal for decision) (risk penalty of 10%); Tex. R.R. Comm’n, *Application of Finley Resources, Inc., for the Formation of a Unit Pursuant to the Mineral Interest Pooling Act*, Docket No. 09-252373 (May 14, 2007) (proposal for decision) (risk penalty of zero).

and geologists to construct drillpipe paths that will simultaneously comply with all spacing requirements, not trespass and maximize recovery; and the potential expenses of trespass claims or other legal proceedings.

Despite these potential negatives, the recent MIPA application by Finley Resources, Inc. demonstrates that MIPA *can* be used to fill in the gaps of checkerboard holdings.

### III. ACTUAL USE OF MIPA BY OPERATOR

The reasonably recent application by Finley Resources, joined by Chesapeake and Dale Resources, illustrates the concepts discussed in this paper.

#### **Background**

- Prior to filing the MIPA application, Finley, Chesapeake, and Dale spent about two years entering into nearly 350 small-tract leases about a mile from downtown Fort Worth, which covered about 90 acres.
- Even after spending two years, during which time the amounts of bonuses increased eight-fold and royalties increased from 18.75% to 20%, Finley still lacked about 30 leases, which had an average size of about 2/10ths of an acre.
- The efforts to obtain leases for all the land had included letters, neighborhood meetings, and door to door canvassing.
- Finley's engineering showed that the "best path" for the drill bore went through or very close to many of the unleased lots, which raised the concern about unintentional trespass.

#### **Finley Resources' Information Provided to RRC:**

- Information on other wells in the area, including their production rates;
- Stratigraphic cross-section information that showed formation consistency around the proposed unit;
- Isopach map generated from available lots, scout tickets, and other data;
- A structure map;
- Reasons to believe that all of the acreage in the proposed unit is productive;
- Information to support the proposed drill paths;
- Information about the projected recovery if the proposed wells were drilled (about 16 bcf).

#### **RRC Found that the MIPA Requisites Were Met:**

- Two or more tracts;
- In a common reservoir;
- Separately owned interests in the proposed unit;
- No agreement to pool;
- One of the owners of the right to drill (Finley) had proposed a drill site;

- Finley had given proper mailed and published notice;
- That the pooling was required in order to permit those already in the pool to produce their minerals, and that forcing the rest to pool against their will would benefit them by preventing uncompensated drainage. This last finding, that essentially, “everybody wins,” was no doubt a powerfully persuasive argument to support the forced-pooling ruling.

***What the RRC Gave Finley and the Unleased Owners:***

- Force pooled all the interests and gave Finley the right to drill;
- Precluded Finley from the surface use of any of the unleased owners (on grounds that those voluntarily in the pool had obtained the same provision);
- Gave the unleased owners no bonus, 20% royalty interests, and a 4/5 working interest, out of which their share of expenses is to be paid with zero risk penalty. Interestingly, if productive drilling does result, the RRC’s order may arguably be more lucrative for those that were forced into the pool, than those that signed leases, particularly those that signed early;
- Took 18 months to get there—close to the same time that Finley spent trying to get the leases in the first place.

One must also wonder at the amount of money spent attempting to obtain the leases versus how much was spent for the RRC proceeding. Of course, as the RRC was coming out with that decision, the gas market was crashing. To my knowledge, no well has been drilled.

In conclusion, when mineral owners—hearing of high bonuses and royalty rates received in some location—get overly greedy and refuse to reasonably negotiate or simply cannot be found, or when abandonment of leasing activities leaves operators with checker-board holdings, MIPA may be an old, but now useful, solution to a new problem.