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Arkansas Oil and Gas Update

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ARKANSAS OIL AND GAS UPDATE

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I. INTRODUCTION

Arkansas is without new legislation to note in this installment of the Survey. The Arkansas General Assembly meets bi-annually, in odd numbered years. Interim fiscal sessions were authorized and special sessions are possible, but the fiscal sessions resulted in no developments that need discussion.

However, the courts were active, requiring comment upon two decisions of the Arkansas Supreme Court and seven decisions of the Arkansas courts of appeals. Federal courts in Arkansas were busy as well. The Author will complete this discussion with four cases decided by the Eighth Circuit Court of Appeals, along with two United States District Court opinions.

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II. ARKANSAS SUPREME COURT DECISIONS

In Arkansas, whether or not one or more specific substances are included within a grant or reservation, the meaning of "minerals" or "mineral deposits" is determined by whether, at the time of the deed or reservation and in the place where the lands are located, those substances were generally regarded as minerals in legal and commercial usage. That is a statement of the so-called *Strohacker* Doctrine, first announced in the Arkansas Supreme Court's 1941 decision in *Missouri Pacific Railroad Co. v. Strohacker.*[2]

Most Arkansas litigation over the *Strohacker* Doctrine has involved oil and gas, though it is applicable to other minerals as well.[3] The *Strohacker* case, itself, involved 1892 and 1893 reservations of "all coal and mineral deposits" in deeds conveying lands in Miller County, Arkansas, from the predecessor of the appellant railroad. The Court affirmed the trial court's ruling that oil and gas were not reserved in those deeds because they were not within the contemplation of the parties. Then, over several subsequent decisions, the Court made it clear that the test was not the subjective intent of the parties to the instrument. Rather, the required determination was of the "legal and commercial usage" at the time and place of the deed.[4]

Most subsequent *Strohacker* oil and gas cases involved deeds executed between 1895 and 1910. However, with the discovery and development of the Fayetteville Shale Play in Central Arkansas, several cases were brought by landowners challenging the effectiveness of unspecific reservations of "minerals" within deeds executed in the 1930s. The first three with reported opinions were filed in federal courts. In all three, the decisions were to the effect that, by some time earlier than 1930, oil and gas became recognized as minerals throughout the entire state of Arkansas.[5]

In an opinion released in April 2012, the Arkansas Supreme Court adopted the reasoning of those federal decisions.[6] The Court stated that its prior decisions had removed any question that "at some point between 1905 and 1937, it became common knowledge in Arkansas that a reservation of mineral rights in Arkansas included oil and gas."[7]

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2. Mo. Pac. R.R. Co. v. Strohacker, 152 S.W.2d 557, 563 (1941).

3. For a recent and thorough history of the *Strohacker* Doctrine, see Jaimie G. Moss, *The Strohacker Doctrine: Its Application in Arkansas Courts and the Need for an Updated Rule*, 64 ARK. L. REV. 1095 (2011).

4. *Id.* at 1107.

5. Griffis v. Anadarko, E & P Co., 606 F.3d 973 (8th Cir. 2010); Froud v. Anadarko, E & P Co., No. 4:09-CV-00936-WRW, 2010 WL 3516906 (E.D. Ark. Sept. 1, 2010); Robertson v. Union Pac. R.R., No. 1:09CV00020 JLH, 2010 WL 3363400 (E.D. Ark. Aug. 24, 2010).

6. Staggs v. Union Pac. R.R. Co., No. 11-902, 2012 WL 1222225, at *5 (Ark. Apr. 12, 2012).

7. *Id.*

In an unrelated case, the Arkansas Supreme Court upheld the dismissal of a challenge to Arkansas' method of valuing producing mineral interests for tax purposes.[8] The Court's denial of most of the taxpayers' claims was based upon its ruling that they lacked substance. However, that decision left open possible future litigation over the valuation of the mineral interests when it dismissed the valuation claim for procedural reasons, saying that the taxpayers are first required to pursue administrative remedies before the counties' equalization boards.

III. ARKANSAS COURT OF APPEALS DECISIONS

Recording statutes vary widely from state to state. In a "pure race" jurisdiction, a buyer is not charged with notice of an unrecorded instrument, even if she knows all about it. In a "notice" jurisdiction, anyone with actual knowledge of an unrecorded instrument is estopped from being a bona fide purchaser for value, innocent of the instrument. Arkansas has long been among the notice states. Then, in its 1990 decision, *Killam v. Texas Oil & Gas Corp.*, the Arkansas Supreme Court announced an extremely liberal view of what constitutes notice.[9]

A deed conveyed a mineral interest to Killam and McMillan, who were partners at the time, but that deed was not recorded. Later, there was a second deed from McMillan to Killam, which was recorded. Additionally, Killam was assessed for taxes as the owner of a one-half mineral interest beneath the tract. Texas Oil and Gas's title examiner relied upon the record title. He concluded that the tract's surface owner, not Killam, owned 100% of the minerals. Texas Oil and Gas leased from the surface owner, drilled wells, produced gas, and got sued by the heirs of Killam.

Both the trial court and Arkansas Supreme Court ruled for the Killams, expanding the meaning of "notice." If there is record notice of a possible unrecorded claim, however incomplete, a buyer has an affirmative duty to search for any unrecorded deeds needed to complete the title chain.

In *Walls v. Humphries,* the Arkansas court of appeals declined to further extend the *Killam* ruling.[10] Humphries sold 100 acres to Hernandez, who sold to Walls. Both sales were made pursuant to unrecorded contracts. Indeed, nothing was recorded that would lead one to suspect the land was owned by anyone but Humphries. In spite of having sold to Hernandez, Humphries executed an oil and gas lease and then deeded the minerals to a third party.

8. May v. Akers-Lang, No. 11-652, 2012 WL 90015, at *3–5 (Ark. Jan. 12, 2012).
9. Killam v. Tex. Oil & Gas Corp., 798 S.W.2d 419, 422–23 (Ark. 1990).
10. Walls v. Humphries, No. CA11-242, 2012 WL 11458, at *1, *3 (Ark. Ct. App. Jan. 4, 2012).

Walls and Hernandez sued Humphries for fraud. They also sued the mineral lessee and third party mineral purchaser to void the lease and recover the minerals. According to Walls and Hernandez, their mere possession of the 100 acres was notice to all. Those defendants were granted summary judgment based upon the recording statute. The court of appeals affirmed. The distinction between this case and *Killam* is apparent, though it was not well-explained in the Court's opinion. In *Killam*, the clues to the unrecorded deed lay within a subsequent recorded deed and the tax records, both public records. The discovery of unrecorded Hernandez and Walls contracts would have required on-the-ground inspection of the land, which the court of appeals held was an idea repugnant to the recording statute.

Arkansas law recognizes that an oil and gas lease is a contract. All oil and gas leases are not identically written, so each will be interpreted according to its own unique language. Two recent Arkansas courts of appeals decisions, each involving different versions of essentially the same lease clauses, illustrate the point.

In *Garner v. XTO Energy Inc.*, the appellants contended that an oil and gas lease expired when its primary term expired.[11] The lease provision at issue reads as follows:

> If prior to the discovery of oil or gas on the leased premises, Lessee should drill a dry hole or holes thereon, or if after discovery of oil or gas the production thereof shall cease for any cause, this Lease shall not terminate if Lessee commences additional operations as provided herein within ninety (90) days thereafter, or, if it be within the primary term, then not until the expiration thereof. If at, or after, the expiration of the primary term oil or gas is not being produced on the leased premises, but Lessee is then engaged in operations thereon as provided herein, this Lease shall remain in force so long as operations are prosecuted (whether on the same or successive wells) with no cessation of more than ninety (90) days, and, if production results therefrom, then as long as production is maintained pursuant to the terms hereof.[12]

Drilling began before the primary term's expiration, but the well was not completed until two months after it expired. Appellants argued that the lease had expired as well. Their suggested interpretation of the above-quoted lease language was that it applied only in situations where a dry hole had been drilled or a productive well had ceased to produce.

The court of appeals was unconvinced, terming appellants' argument, "a monolithic set of conditions, all of which must be satisfied, in order for the primary lease term to be extended."[13] Rather, the court

11. Garner v. XTO Energy, Inc., No. CA11-139, 2011 WL 4824319, at *1 (Ark. Ct. App. Oct. 12, 2011).
12. *Id.* at *3.
13. *Id.*

found the language to clearly extend the lease when operations were ongoing at the primary term's expiration.

In stark contrast is the same court's decision in *Petrohawk Properties, LP v. Heigle*.[14] There, the "equivalent" lease provision was differently written:

> It is agreed that this lease shall remain in force for a term of Five (5) years from the date (herein called the primary term) **and** so long thereafter as oil and gas, or either of them, is produced from said land by the Lessee, and as long thereafter as operations, as hereinafter defined, are conducted upon said land with no cessation for more than ninety (90) consecutive days.[15]

Just as in *Garner*, the lessee sought to perpetuate the lease by commencing operations just before the end of the primary term, and the lessors sued. According to those lessors, the word "and" was not ambiguous. Under the language of the above lease clause, operations alone would not extend the lease term. Rather, both operations and production were required. The trial court agreed with the lessors, as did the Arkansas court of appeals.

It appears that the form of the *Heigle* lease has an unfortunate, but obvious, scrivener's error. "And" is supposed to be "or." If one makes that simple change, suddenly the lease makes sense. However, the Arkansas court of appeals was unwilling to reform the clause.

Two recent cases decided by the Arkansas court of appeals involved Arkansas' after-acquired title statute, which provides:

> If any person shall convey any real estate by deed purporting to convey it in fee simple absolute, or any less estate, and shall not at the time of the conveyance have the legal estate in the lands, but shall afterwards acquire it, then the legal or equitable estate afterwards acquired shall immediately pass to the grantee and the conveyance shall be as valid as if the legal or equitable estate had been in the grantor at the time of the conveyance.[16]

The first case is *Mauldin v. Snowden*.[17] Mr. and Mrs. Snowden owned the surface of two tracts. Cenark, a corporation owned entirely by the Snowdens, owned all of the minerals beneath one tract and one-half of the minerals beneath the other. The Snowdens conveyed both tracts to Mr. and Mrs. Flory by warranty deed, and the Florys conveyed them to the appellants, again by warranty deed. Then the Snowdens caused Cenark to convey its mineral interests to the Snowdens. The appellants sued, seeking to quiet title to those mineral interests pursuant to the after-acquired title statute.

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14. Petrohawk Props., LP v. Heigle, No. CA11-419, 2011 WL 5562654, at *1 (Ark. Ct. App. Nov. 16, 2011).

15. *Id.* at *2 (emphasis added).

16. ARK. CODE. ANN. § 18-12-601 (2009).

17. Mauldin v. Snowden, No. CA11-204, 2011 WL 5080663, at *2 (Ark. Ct. App. Oct. 26, 2011).

At trial, the Snowdens persuaded the court that all parties, including the appellants, understood that minerals were not being conveyed by the Snowdens, notwithstanding the general warranty within their deed. Thus, the Snowdens were granted a decree of equitable reformation of the deed to except minerals therefrom.

The Arkansas court of appeals affirmed the reformation of the deed, thus preempting the application of after-acquired title.

The other after-acquired-title case was *Evans v. SEECO, Inc.*[18] The trial court determined that Mrs. Evans's late husband had reserved, to himself, a fee mineral interest when he otherwise conveyed the property to his daughters, who were predecessors in interest to the surface owners of various tracts at issue. The daughters conceded that their conveyances to the surface owners conveyed whatever mineral interests that the daughters owned, so the dispute was between the surface owners and Mrs. Evans, who claimed to own at least a dower interest in the mineral interest reserved by her husband.

The court of appeals held that when Mrs. Evans joined in the general warranty deed within which her husband, alone, reserved the mineral interest, her warranty triggered the application of the after-acquired-title statute, and thus, any dower interest that she received upon her husband's death passed to the grantee daughters.

Deltic Timber Corp. v. Newland was the second appeal to the Arkansas court of appeals of a case that applied rather common deed exception language to unusual facts.[19] The deed in question, a warranty deed from the Batsons, who were the parents of the Appellees, to Deltic contained the following exception: "[e]xcepting all prior, valid reservations and/or conveyances of record of oil, gas, and other minerals in and under the subject land."[20]

The facts are unusual. At the time the Batsons conveyed to Deltic, an undivided 3/8 twenty-year term mineral interest was outstanding in a prior grantor. Thus, the Batsons owned the surface, a 5/8 fee mineral interest and the remainder in the 3/8 mineral interest that was subject to the twenty-year term interest. The appellees contended that the effect of the deed's language of exception was to except and reserve to the Batsons the entire outstanding 3/8 mineral interest, including the remainder, which they owned. Deltic argued that the exception only excepted interests, which the Batsons did not own. Thus, according to Deltic, the remainder interest passed to Deltic under the warranty deed.[21] Both sides contended, in competing summary judg-

18. Evans v. SEECO, Inc., No. CA11-465, 2011 WL 5974368, at *1 (Ark. Ct. App. Nov. 30, 2011).

19. Deltic Timber Corp. v. Newland, No. CA11-1042, 2012 WL 1327823, at *1 (Ark. Ct. App. Apr. 18, 2012); *see also* Deltic Timber Corp. v. Newland, No. CA09-810, 2010 WL 1233471 (Ark. Ct. App. Mar. 31, 2010).

20. 2012 WL 1327823, at *1–2.

21. *Id.* at *2.

ments, that their position was correct as a matter of law. The trial court granted the appellees' summary judgment request.

On the first appeal, the Arkansas court of appeals reversed, but it declined to accept Deltic's argument that it owned the remainder as a matter of law. Instead, upon its own motion, the court of appeals held the exception language to be ambiguous, as far as the remainder was concerned, and remanded the case for trial to determine the parties' subjective intent.

That resulted in the trial court ruling, again, for the appellees. This time it found, on disputed evidence, that the Batsons had intended to reserve the remainder to themselves and that Deltic was aware that it was conveyed less than 100% of the minerals.

Deltic appealed again, citing proof presented at the trial that the quoted exception language is commonly used merely to protect a grantor from an inadvertent breach of the warranty of title. The court of appeals again affirmed. The court made no effort to defend its somewhat questionable prior holding that the exception language was ambiguous, holding instead, that it had become the law of the case, binding upon the court on the second appeal.

The final Arkansas court of appeals case within the scope of this survey is *Capstone Oilfield Disposal of Arkansas v. Pope County,* which was an appeal of a matter that arose in the Arkansas Oil and Gas Commission (the "Commission").[22] The Commission had granted Capstone's application to operate a commercial disposal well, over the opposition of a county government and certain landowners. Capstone failed to post a financial assurance bond covering its proposed operations, as required by a Commission rule that such financial assurance be posted within sixty days of the filing of an application. Thus its application was first denied by the Commission.

Capstone then petitioned for a rehearing before the Commission and, that time, posted the required bond. Over objection, the Commission granted Capstone's application. However, on appeal, both the circuit court[23] and Arkansas court of appeals agreed that the Commission was powerless to grant Capstone's application because the Commission's rules, which the Commission had no authority to waive, required that the bond be posted within sixty days of the filing of the application. Thus acceptance by the Commission of the untimely bond was unlawful.

22. Capstone Oilfield Disposal of Ark. v. Pope Cnty., No. CA11-1087, 2012 WL 1110075 (Ark. Ct. App. Apr. 4, 2012).

23. The circuit court is the court with initial jurisdiction of petitions for judicial review under the Arkansas Administrative Procedures Act. ARK. CODE. ANN. § 25-15-201 to -219 (2009).

IV. Eighth Circuit Court of Appeals Decisions

In three consolidated appeals, the Eighth Circuit Court of Appeals affirmed summary judgments against Arrington Oil & Gas, Inc. in suits brought by mineral owners whose lease drafts had been dishonored when Arrington apparently decided it had leased lands in an unproductive area.[24]

Arrington had argued that it was not obligated to honor the drafts because of lack of mutuality of obligation, since the lessors were not required to execute the leases and present the drafts. Arrington had cited a Texas court of appeals decision for that proposition, but the federal appeals court distinguished that decision as being limited to liability based solely upon the bank draft, as opposed to the underlying contract.[25] Here, the underlying contract was the offer to lease, which became binding upon Arrington when the lessors accepted its offer by executing the lease forms and returning them with the drafts.

In another decision, the Eighth Circuit Court of Appeals affirmed a district court's ruling that a farm loan bank chartered and operated under the former Federal Farm Loan Act of 1916 ("Act")[26] had the right to retain a perpetual mineral interest in lands upon which it had foreclosed pursuant to the act when it resold the lands. The Act prohibited a land bank from perpetually retaining land that it purchased at foreclosure sales after its borrowers defaulted. In *Nixon v. Agribank, FCB*, the owners of the surface and remaining one-half mineral interest argued that the Land Bank's retention of a perpetual mineral interest violated the Act and was therefore invalid.[27] The United States District Court granted a motion to dismiss the action, agreeing with AgriBank that the practice of reserving perpetual mineral interests fell into an exception from the Act's prohibition because the Farm Credit Administration's interpretation of the prohibition to exclude mineral estates, in 6 C.F.R. 10.64, was sufficient "special permission," as contemplated by that Act.[28] As an alternative reason for dismissing the action, the court noted that repealed statutes cannot be further enforced unless "competent authority" has kept the statute alive for that purpose. The district court found that there was no such "competent authority" with respect to the repealed Act.

In its opinion affirming the district court, the appeals court agreed with the district court's "special permission" analysis and found no need to review the district court's alternative reason for dismissal.[29]

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24. Smith v. Arrington Oil & Gas, Inc., 664 F.3d 1208, 1218 (8th Cir. 2012).

25. *See* Spellman v. Lyons Petroleum, Inc., 709 S.W.2d 295, 297 (Tex. App.—Houston [14th Dist.] 1986, writ ref'd n.r.e.).

26. 12 U.S.C. § 781 Fourth (b) (repealed 1971).

27. Nixon v. Agribank, FCB, 686 F.3d 912, 914 (8th Cir. 2012).

28. Nixon v. Agribank, FCB, No. 4:11CV00125, 2011 WL 4529894, at *2 (E.D. Ark. Sept. 2011).

29. *Nixon*, 686 F.3d 912.

The Eighth Circuit Court of Appeals also affirmed the United States District Court decision in *Enervest Operating, LLC v. Anadarko Petroleum Corp.*,[30] a case discussed in the Arkansas portion of the 2012 Texas Wesleyan Survey on Oil and Gas.[31] That decision, a first for Arkansas, held that coalbed methane gas was owned by the gas owner, rather than the coal owner, when the gas and coal had been severed from one another by separated deeds. The appeals court did not foreclose the possibility that different deed language might compel a different result. However, that different language is hard to imagine.

In 2006, the United States Supreme Court, in *Jones v. Flowers*, a case that involved a surface interest, held that the Arkansas ad valorem tax sale statute, which required only that notice be sent to the delinquent taxpayer by certified mail, was constitutionally deficient, at least as applied to the facts of that case.[32] Because *Jones's* ruling was somewhat dependent upon its particular facts, and because the Supreme Court declined to prescribe a constitutional-in-every-case notice method, practitioners were left to determine, case-by-case, whether notice of a pending tax sale was constitutionally compliant.

Linn Farms & Timber Limited Partnership v. Union Pacific Railroad Company, involved mineral rights owned, of record, by Missouri Pacific Railroad Company.[33] Missouri Pacific, formerly headquartered in Fort Worth, Texas, had merged into Union Pacific, with headquarters in Omaha. Oblivious to that, both the county tax collector and the Commissioner of State Lands sent certified notices addressed to Missouri Pacific at its former Fort Worth post office box. These notices, sent two years apart, were each returned with the notation "NOT DELIVERABLE AS ADDRESSED–UNABLE TO FORWARD." No further notice to Missouri Pacific was attempted.

The record established that the Commissioner actually had used the railroad's correct Omaha address in connection with tax matters in other counties but, through lack of internal communication, continued to use the old Fort Worth address for lands in Van Buren County, where the lands at issue were located.

The federal court of appeals voided the sale to Linn Farms, holding that the notice was constitutionally deficient. The court faulted the Commissioner for not discovering the correct address within his own records and also noted that a simple internet search for a business as prominent as the railroad would have enabled it to be located.

30. Enervest Operating, LLC v. Anadarko Petroleum Corp., 676 F.3d 1144, 1145–46 (8th Cir. 2012).

31. Thomas A. Daily, *Arkansas*, 18 TEX. WESLEYAN L. REV. 467, 471 (2012).

32. Jones v. Flowers, 547 U.S. 220, 223, 239 (2006).

33. Linn Farms & Timber Ltd. P'ship v. Union Pacific R.R. Co., 661 F.3d 354 (8th Cir. 2011).

V. UNITED STATES DISTRICT COURT DECISIONS

Early during the Fayetteville Shale Play, some lease brokers were leasing off the county tax records. The leases taken often described the entire section in which the lessor was thought to own something and contained a statement that the lessor intended to lease all he owned, whether or not correctly described.

Barber v. Chesapeake Exploration, LLC, was brought by a lessor who was originally paid a bonus based upon the mineral acres that he was known to own.[34] When Chesapeake later discovered that Barber owned additional mineral interests within the section, it tendered additional bonus, which Barber refused. Among other things, Barber challenged the lease's legal description as invalid. Citing decisions of the Arkansas Supreme Court, the United States District Judge agreed with Chesapeake that the lease's description was adequate.

In *Walls v. Petrohawk Properties, LP*, oil and gas lessors sought cancellation of assignments of an oil and gas lease that they had executed.[35] The lease contained a provision requiring its owner to obtain the lessors' consent for any assignment. Notwithstanding that provision, the lease was assigned three times. Each time, requests for consent sent to the lessors were ignored. Production resulted, and the lessors were paid royalties exceeding $200,000. Finally, when they were requested consent to the last assignment, the lessors claimed that all assignments were void and that they were entitled to damages for the breach. The United States District Court ruled, summarily, against them. When the lessors accepted the benefits of the lease, they waived their right to complain of the assignments made without their consent. Their refusal to consent to the final assignment, which was to Exxon Mobil Corporation, was just plain unreasonable. Arkansas law requires a duty of reasonableness in the exercise of a power to refuse consent to assignment.[36]

34. Barber v. Chesapeake Exploration, LLC, No. 4:11CV00234 JLH, 2012 WL 113280, at *7 (E.D. Ark. Jan. 13, 2012).

35. Walls v. Petrohawk Props., LP, No. 4:11CV00199 JMM, 2012 WL 113266, at *5 (E.D. Ark. Jan. 13, 2012).

36. Warmack v. Merchants Nat'l Bank of Fort Smith, 612 S.W.2d 733, 735 (Ark. 1981).