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GONE, GONE, GONE—DETERMINING HOW MUCH ACREAGE IS TRULY "RETAINED" UNDER RETAINED ACREAGE CLAUSES IN LIGHT OF ENDEAVOR ENERGY RESOURCES AND XOG OPERATING

by Philip B. Jordan, Ethan M. Wood and Brittany Blakey
Gray Reed & McGraw LLP
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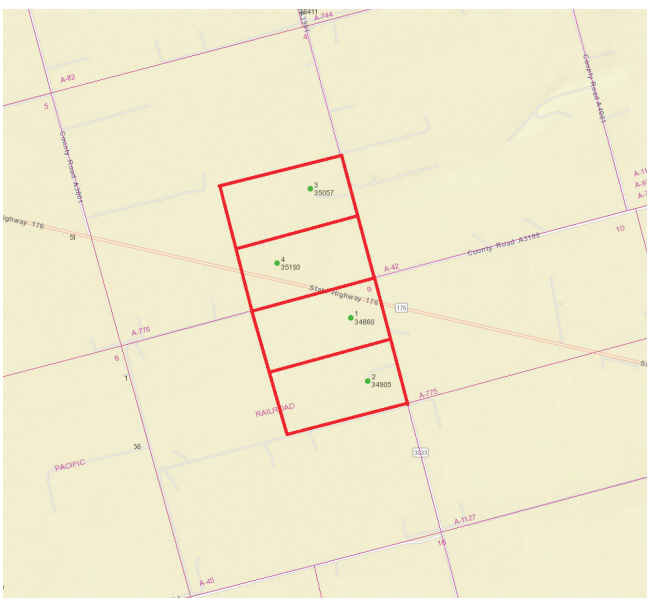
With its recent holdings in *Endeavor Energy Resources v. Discovery Operating* and *XOG Operating v. Chesapeake Exploration*, the Texas Supreme Court has again stressed the importance of closely reading the terms of oil and gas leases and assignments—especially when it comes to retained acreage clauses. But, the court also set a trap for the unsuspecting operator relying on production allowables for pooling authority or for retaining as much acreage as possible under a retained acreage clause. What can operators do to keep their acreage safe from landowners and their lawyers?

***Endeavor Energy Resources, L.P. v. Discovery Operating, Inc.*, No. 15-0155, 2018 WL 1770290 (Tex. Apr. 13, 2018).**

Endeavor acquired oil and gas leases covering a 640-acre section and the north half of an adjoining section to the south. The leases contained retained acreage clauses and Endeavor drilled four wells as follows:



After completing the wells, Endeavor filed certified proration plats with the Texas Railroad Commission ("RRC"). The plats designated approximately 81 acres for each well as depicted above. After Endeavor's leases' primary terms expired, Patriot reviewed the leases and certified proration plats Endeavor filed with the RRC and concluded that Endeavor's leases terminated as to the northwest quarter of Section 9 and the southwest quarter of Section 4. Patriot then obtained leases on that acreage and later assigned them to Discovery. Discovery drilled wells on that acreage, which subsequently led to the central dispute.

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Relying on the retained acreage clauses, Discovery asserted that Endeavor's leases had expired as to the lands outside the 81-acre proration units Endeavor formed at the RRC. Endeavor argued that it retained 160 acres around each well because the leases' references to "maximum producing allowable" meant that each proration unit automatically consists of the greatest amount of acreage permitted per RRC rules.

At the time, the RRC's rules for the Spraberry (Trend) Area allotted 80 acres to a proration unit with an additional 80 acres of "tolerance acreage" at the operator's election. The Spraberry field rules required operators to file certified plats describing their proration units.

The leases' retained acreage clauses stated: "[this] lease shall automatically terminate . . . save and except those lands and depths located within a governmental proration unit *assigned* to a well . . . [containing] the number of acres required to comply with the applicable rules and regulations of the Railroad Commission of Texas for obtaining the maximum producing allowable for the particular well." The Texas Supreme Court concluded that the leases' use of "assigned" referred to the lessee's assignment of acreage through its regulatory filings.

Focusing on the specific lease language, the court agreed with Discovery's argument that the retained acreage clauses required the operator to file a plat assigning only the amount of acreage necessary to obtain the maximum producing allowable as determined by the applicable field rules, which in this case was 80 acres. To retain 160 acres, Endeavor needed to actually assign 160 acres to each well. Having met the threshold requirement for compliance with the field rules, Endeavor retained "exactly what it bargained for: approximately 81 acres per well." But, The court further noted that "[a]lthough such an assignment would hypothetically raise each well's maximum producing allowable, when productive acreage is a component of the maximum producing allowable—as it is here—the operator must verify that additional acreage is actually necessary or required to achieve the maximum allowable…" or it may "open itself up to claims that it is not acting in good faith in purporting to retain a substantially greater amount of acreage."

***XOG Operating, LLC v. Chesapeake Expl., Ltd. P'Ship*, No. 15-0935, 2018 WL 1770506 (Tex. Apr. 13, 2018).**

Like Endeavor, the court wrestled with how much acreage was retained pursuant to a retained acreage clause. Here, the provision in a term assignment by XOG Operating to Chesapeake stated that Chesapeake would keep the leased acreage within the proration or pooled unit of each drilled well. However, the assignment contractually defined "proration unit" to include the boundaries of a proration unit "then established or *prescribed* by field rules." Here, the Commission's field rules for the Allison–Britt Field applied. A "prescribed" proration unit under the applicable rules was 320 acres per well.

Chesapeake filed its Form P-15 for each well and assigned proration units totaling 800 acres for its wells. XOG Operating sued Chesapeake after Chesapeake refused to release or reassign any acreage to XOG. Each side moved for summary judgment. XOG argued that the disputed acreage was not retained by Chesapeake pursuant to the term assignment's retained acreage provision because Chesapeake failed to "assign" that acreage to a proration unit in its P-15 filings. Chesapeake argued that it retained 320 acre units as "prescribed by field rules."

The same principles applied in *Endeavor* were applied here as well. The court acknowledged that although retained acreage provisions are based on regulatory filings and rules, they are fundamentally contractual in nature and parties to said clauses are presumed to know the law and to have stated their agreement in light of it.

The court held that acreage "included within the proration unit for each well … prescribed by filed rules" referred to acreage set by the field rules, not acreage "assigned" by the operator. At the time, the field rules defined a "prescribed"

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proration unit as 320 acres for the Allison–Britt Field[1]. Therefore, under the retained acreage provision's language, Chesapeake retained 1,920 acres for its 5 wells drilled, and not only 800 acres. The court distinguished Endeavor from this case in that the field rules in Endeavor referred to assignments by operators claiming acreage. The field rules in this case referred to "assigned" acreage as well, but unlike the rules in Endeavor, the rules here also "prescribed" proration units.

Takeaways from Both Cases

The fact that the Texas Supreme Court applied the same principles to two cases that resulted in two different outcomes signifies four key conclusions about retained acreage clauses in Texas.

- First, operators should be meticulous in reading the express language within their leases' retained acreage clauses. Texas courts have long recognized and preserved parties' ability to negotiate contractual provisions and memorialize those understandings within leasehold provisions.

- Second, operators should abstain from relying on field rules to ensure that maximum acreage is retained. Rules vary by field and are not always uniform across the state.

- Third, operators should pause before perfunctorily filing a P-15 Statement of Productivity of Acreage Assigned to Proration Units and certified plat. Doing so may result in a situation similar to that of *Endeavor* in that the filing of a plat effectively excludes acreage from being retained.

- And finally, because of the Texas Supreme Court's dicta in *Endeavor* that operators designating proration units with additional tolerance acreage must do so in good faith, there is an argument that assigning more acreage to a proration unit than is required for maximum production from that well (as opposed to obtaining a maximum production allowable), means that the proration unit could have been formed in bad faith. Such a result would be a boon for landowners and their attorneys and a significant risk to the vast majority of operators that have historically taken different approaches.

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[1] *One single well was drilled in the Stiles Ranch Field, which was deemed 320 acres per the retained acreage clause because there were no applicable field rules.*