
Who Pays for the Well After the Lease Terminates? Wagner & Brown v. Sheppard – The Rest of the Story

December 11, 2009

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Wagner & Brown, Ltd. v. Sheppard* is well-known for its holding that termination of an oil and gas lease for land that was part of pooled unit doesn't always cause the unit to terminate. An overlooked aspect of the case asks the question: When, if at all, should the operator be entitled to recover drilling costs? The court, in a dramatic departure from prior law, held that equities must be balanced before deciding whether the lessee should lose the well before it has recovered well costs.

The oil and gas lease provided that if royalties were not paid within 120 days after first sales, the lease would terminate the following month. The lessor's tract was combined with other tracts to form a pooled unit. A gas well was successfully completed and began producing and a second well was completed. Both wells were located on the tract owned by the plaintiff-lessor Ms. Sheppard. She was not paid royalties within 120 days of first sales, and the lease terminated. Two issues were presented to the Court: First, whether termination of the lease also terminated the lessor's participation in the unit, and second, whether she should bear any costs incurred before her lease terminated, or any costs incurred after the lease terminated that relate to the unit but not her lease. This report focuses on the Court's opinion on the second issue.

Good and Bad-Faith Trespass Distinguished

Under the law before Wagner & Brown, a lessee was better off having mistakenly drilled a well on a tract on which he did not have a valid lease than drilling on a lease and accidentally allowing the lease to terminate.

The lessee would be a good faith trespasser if it entered the land with honest and reasonable belief in the superiority of its title. The trespasser would be entitled to recover the costs of drilling and operating the well before turning over all the value of the minerals produced to the owner on whom it trespassed. By contrast, the bad faith trespasser – a party who continues to enter a lease in the absence of a good faith belief in the existence of the lease – would be liable to the injured party for "the value of the things mined ... without deduction for the cost of labor and other expenses incurred in committing the wrongful act ... or for any value he may have added to the mineral by his labor." The trespasser would have to pay to the aggrieved owner the value of the oil and gas produced without any deduction for drilling and operating costs.

The Old Law – Expiration of the Lease

Terminated the Right to Recover Well Costs

Historically, when the lessee mistakenly allowed a lease to expire the lessee's right to recover drilling costs was terminated. The operator was entitled to the value of the minerals taken without deduction for the costs incurred or for any value he may have added to the minerals by his labor. No credit was given to the lessee whose well had not paid out at the time of termination.

With this law as background, the Supreme Court in *Wagner & Brown* answered the question: What should happen when a lease is mistakenly allowed to terminate after a well is drilled and before the operator has recovered its drilling costs?

The Law After *Wagner & Brown* – Equity Prevails

After Ms. Sheppard's lease terminated, she contended she was not responsible for any portion of drilling or other costs incurred before the lease expired because the operator was a trespasser. The trial court and the court of appeals agreed, but the Supreme Court disagreed. Citing the well-established rule that a person is entitled to compensation when he in good faith makes improvements upon property owned by another, the Court questioned why the law should be any different when there is a valid lease that is mistakenly allowed to expire. The Court reasoned, "...It is hard to see why one who obtains a lease and then loses it by mistake is entitled to less equity than one who by mistake never had a valid lease in the first place." The Court held that a breaching party is not necessarily barred from reimbursement for improvements, stating that "given the equitable nature of a reimbursement-for-improvements claim, we decline to read Texas law as establishing that drilling costs are always or never recoverable when a lease expires. Instead, we believe the equitable nature of such claims must turn on the equities in each case." The Court found that the trial court abused its discretion in refusing reimbursement of drilling costs.

As if this reasoning was not enough to justify its ruling, the Court also cited to a long-recognized maxim of Texas law that 'equity abhors a forfeiture' The Court referred to case law that in construing mineral leases, "doubts should be resolved in favor of a covenant instead of a condition so that forfeiture is avoided." There was no question that Ms. Sheppard's lease had expired when her first royalty payment was missed. But the Court noted that the provision terminating the lease if royalties were not paid timely said nothing about whether the operator forfeited drilling costs. The Court stated, "while [the lessees] lost forever their legal claim to Ms. Sheppard's minerals, [it did] not necessarily mean that [the lessees] also lost their equitable claim for the improvements they had built on [Ms. Sheppard's] tract." The Court noted that the lease terminated at that time, but denying the operator reimbursement for its drilling costs would work a substantial forfeiture.

Opportunities For the Lessee?

This decision is a welcome change in the law for lessees, and not so good for lessors. Prior to this ruling, the lessor had the upper hand. A lessee who mistakenly allowed a lease to expire for any reason, intentional or accidental, couldn't cite any meaningful case law in favor of reimbursement for drilling costs. Now, the equities of each case will be considered by the court when determining if the lessee should be entitled to reimbursement.

In almost every case the lessor's assertion will be that the sophisticated producer entered the lease voluntarily, and thus should be prepared to live with all of the ugly consequences. That is no longer the only factor to be considered in a lease termination suit. Given the opportunity created by this ruling, every operator should strive to treat the lessor fairly and equitably in every aspect of the parties' dealings. Texas law requires that "one who seeks equity must do equity and must come to court with clean hands." Equity, of course, is in the eye of the beholder. With that in mind, the goal, aside from being a good partner in an ongoing business relationship, should be to make sure that in the event of litigation the equities favor the lessee and not the lessor. The good news for the lessee is that the potential for presenting a favorable set of circumstances to the judge and jury is within its control, by being prepared to show that equity was done, the operator acted with competence, and the lessor was treated fairly during the events before the dispute.