

9. Does the Discovery Rule Apply to Royalty Payment Claims?

TEXAS

The short answer in Texas is - NO. The long answer in Texas is - NO, NO, NO, NO!

The Discovery Rule is one of at least two exceptions to the general rule of statute of limitations. The statute of limitations is the time period, commencing with the specific date when a cause of action “accrues”, and ending on the specific date a lawsuit is filed. For example, the Texas Statute of Limitations for breach of a contract, the most frequent claim in oil and gas litigation, is four years. If lessee records its designation of unit on January 1, 2006 and lessor’s suit for bad faith pooling is filed on January 2, 2010, the suit will be dismissed for being “time barred”. The discovery rule defense defers the accrual of the cause of action until the claimant knows, or should have known in the exercise of reasonable diligence, the facts giving rise to his claim.

There are at least two exceptions to the strict application of the statute of limitations, the discovery rule and its companion, fraudulent concealment. The difference between the two is that fraudulent concealment requires the active intention by the defendant to prevent the plaintiff from discovering the defendant’s wrong or the plaintiff’s damage. The two prongs (the court’s word not mine) a plaintiff must prove to apply the discovery rule are that the injury to him was:

- a. Inherently undiscoverable; and
- b. Objectively verifiable.

HECI Exploration Co. v. Neel, 982 S.W.2d 881, 886 (Tex. 1998), citing *Computer Associates International, Inc. v. Altai, Inc.*, 918 S.W.2d 453, 457 (Tex. 1996).

The saga of *Rogers v. Ricane* (5 appellate opinions) provided at least a hint of how the Texas Supreme Court would not apply the discovery rule in an oil and gas context as highlighted in its subsequent *HECI* opinion. The 1937 base lease in *Rogers* covers 7,893 acres in Cochran County, located West of Lubbock, Texas and abutting New Mexico. Hundreds of Sprayberry oil wells maintained the base lease in its entirety. Superior Oil Company owned a 329.3 acre portion of the base lease which it farmed out/assigned to Western Drilling Company in 1949. Western drilled the well it was required to drill and it produced until 1961 when the well became a salt water disposal well. In 1965 Western’s charter to do business in the State of Texas was forfeited by the Secretary of State. In 1961, prior to the cessation of Western’s well, E. P. Campbell, President of Western, in his individual capacity, conveyed the 329.3 acre portion of the base lease to Dakota Company, Inc. In 1979, Torreyana Oil Corp., successor to Dakota, as part of the Ricane Group, drilled an oil well which commenced production in October of 1979. In 1984, the Rogers Group, being the shareholders of the defunct Western Company, brought a trespass to try title suit, which had a 3 year statute of limitations, against the Ricane Group seeking to recover possession of the 329.3 acre portion of the base lease, since Western was still the record title owner of the tract in question. Ultimately, the Courts sustained the defendant’s statute of limitations defense by concluding that the shareholders of the defunct corporation had the duty to maintain awareness of all activities on their formally producing and non-producing properties. *Rogers v. Ricane*

Enterprises, Inc., 775 S.W.2d 931 (Tex. App. - Amarillo 1987) reversed at 772 S.W.2d 76 (Tex. 1989); *Rogers v. Ricane Enterprises, Inc.*, 852 S.W.2d 751 (Tex. App. - Amarillo 1993), 130 O&GR 392, reversed at 884 S.W.2d 763 (Tex. 1994), 130 O&GR 415; *Rogers v. Ricane Enterprises, Inc.*, 930 S.W.2d 157 (Tex. App. - Amarillo 1996, pet. denied), 135 O&GR 178.

The following cases rendered in the last twelve years reflect why the discovery rule is difficult to apply in an oil and gas context:

- a. In *HECI*, the damage was caused by an adjacent lessee violating TRC Orders and over producing, thus draining the plaintiff's tract. The plaintiff's lessee obtained a large judgment from the adjacent lessee for the overproduction/drainage, but paid no royalty. The lessees settled the suit and filed a release of judgment in September 1989. The plaintiffs, some of whom were old people in nursing homes, sued HECI, their lessee, in December, 1993. In holding that the discovery rule was not applicable, the Supreme Court held that all of the plaintiff's claims accrued at the time the overproduction occurred, the latest date being December, 1988 when the overproduction ceased. The Court held that the injury was not "inherently undiscoverable" pointing out that the plaintiffs could have obtained information about the adjacent lessee's overproduction from the Texas Railroad Commission (TRC), by reading local newspapers and examining the records in the county courts. One of the important consequences of the HECI Opinion was that the discovery rule will apply to any royalty claim categorized as based upon "damage to a common reservoir".
- b. In *Hay v. Shell*, 986 S.W.2d 772 (Tex. App. - Corpus Christi 1999, pet. denied) the royalty owners claimed their lessee improperly pooled their acreage with unproductive acreage. On January 20, 1977 Shell filed the designation of unit in question which covered 704 acres, 640 acres plus a 10% tolerance. The plaintiffs learned of the formation of the unit in March, 1977 when they reviewed their division orders. In 1989 a subsequent lessee obtained approval from the TRC to reduce the unit from 704 to 160 acres by swearing that only 160 acres were reasonably productive of hydrocarbons. The Hays learned for the first time that the unit was reduced in May, 1992. On February 21, 1995 the royalty owners sued the subsequent lessee and on 9/15/96 joined Shell as a defendant. The Court's primary holding in the case was its decision that conflicting expert testimony created a type of swearing match which prevented the discovery rule facts from being "objectively verifiable".
- c. In *Wagner & Brown v. Horwood*, 58 S.W.3d 732 (Tex. 2001), the lessors claimed that the lessee had underpaid royalties by deducting excessive fees for gathering and compressing the gas produced. In 1983 one of the royalty owners hired a consultant who concluded that a compression fee of 25¢ - 30¢ per Mcf was excessive. In 1985 the royalty statements showed a reduced fee of 12¢ per Mcf, which prompted a contact with W & B, who confirmed that the charge was in fact 12¢. While the royalty owner remained suspicious that he was being charged

more than 12¢, the royalty owners did not file suit until April 9, 1996. The Trial Court granted the payors a summary judgment concluding that all claims prior to April 9, 1992 were time barred. The El Paso Court of Appeals reversed the Trial Court and concluded that the discovery rule applied because:

1. The royalty owners' injury was inherently undiscoverable; and
2. The injury was objectively verifiable since the injury could be proven by expert testimony and by financial records showing standard charges made by other similarly situated producers and gatherers in the area; and
3. HECI was not applicable because it only analyzed the discovery rule in the context a claim of damage to a common reservoir.

The Supreme Court reversed the Court of Appeals and held that the discovery rule did not apply to the classic cases for injuries caused by the lessee's excessive or improper charges, which would result in the underpayment of oil and gas royalties payable under oil and gas leases. The Court held that such claims as a class were not "inherently undiscoverable" because royalty owners could:

- a. Contact their lessees and gas purchasers for information; and
 - b. Investigate on their own the accuracy of the fees identified in the statements included with the royalty checks.
- d. In *Funk v. Devon Louisiana Corp*, 2005 WL 2560107 (Tex. App. - Corpus Christi 2005 pet. denied) (Mem.Op.) the Corpus Christi Court of Appeals, six years after its *Hay v. Shell* decision, again decides another bad faith pooling case. In *Hay*, the Court determined that the injury was not objectively verifiable. In *Funk*, the Court identified the category of injury as the improper pooling of unproductive acreage with productive acreage and included that it was not inherently undiscoverable. This conclusion was based on the fact that TRC records were available to the plaintiffs more than four years from the date they filed suit. *Funk* holds that the royalty owner must exercise diligence to discover the non-existence of a common reservoir through requests for information from the lessee and a review of TRC records.
- e. In *Exxon Corp. v. Emerald Oil & Gas Co.*, 52 Tex. Supp. J. 467, 2009 WL 795668 (Tex. March 27, 2009) Exxon was charged with sabotaging productive wells by plugging them in a way that would not permit reopening. Exxon's leases in the Mary Ellen O'Connor Field in South Texas required the payment of a 50% royalty to the royalty owners. In the 1970s, Exxon tried to amend the leases and reduce the royalty requirement because Exxon complained the leases, burdened with a 50% royalty, were no longer economic for Exxon to operate. Exxon negotiated with royalty owners over a period of time but ultimately plugged and abandoned the wells by August 16, 1991. Emerald leased a portion of the field previously operated by Exxon and attempted to reenter the wells Exxon had plugged, discovering junk, cut casing and plugs in the wellbores, items that were

not identified by Exxon in its W-3 Plugging Reports filed with the TRC. Emerald determined that 80-90% of Exxon's W-3s inaccurately described the status of the wells plugged. After Emerald brought suit against Exxon, the royalty owner intervened in August and September of 1996, asserting claims for waste, negligence per se, tortious interference and breach of the implied covenant to develop. The jury found that the royalty owners discovered, or should have discovered in the exercise of reasonable diligence, the waste committed by Exxon on January 24, 1995, the date Emerald informed the royalty owners of the full extent of Exxon's damages to the wells and of Exxon's discrepancies in filing the well plugging reports with the TRC. The Trial Court overruled Exxon's limitations defense and, based upon the jury verdict, awarded the royalty owners in excess of 20 Million dollars. The Corpus Christi Court of Appeals sustained the Trial Court by concluding that plaintiff's injury was inherently undiscoverable because the damage to subsurface wellbores could not be confirmed either by visual inspection or review of public available records. The damages were objectively verifiable because there was substantial objective evidence of the injury to the wellbores. The Supreme Court confirmed the appellate court's conclusion that the injury at issue was "waste of hydrocarbons" (a tort) which carried a two year statute of limitations, but reversed and rendered in favor of Exxon concluding, as a matter of law, that both Emerald and the royalty owners had actual knowledge of the claims more than two years before Emerald and the royalty owners filed suit. While the jury determined that the royalty owners discovered Exxon's waste on January 24, 1995, the Supreme Court based its decision on two uncontested letters dated September 12, 1990 and June 8, 1994. The September 12, 1990 letter from the royalty owners to Exxon was a generic demand that bad things would happen to Exxon if it plugged producing wells. In Emerald's June 8, 1994 letter to the royalty owners, Emerald advised that Exxon had cut the casing and dumped junk in the wells that Exxon had plugged. The Supreme Court held that, as a matter of law, the letters "unequivocally and conclusively" established that the royalty owners and Emerald "knew or suspected there was damage to their interest ... in 1990 and 1994."

- f. *DDD Exploration, Inc. v. Key Production Co., Inc.*, 2009 WL 1159154 (N.D. Tex. - Amarillo Div. 2009) was a dispute between an oil operator and the adjacent salt water disposal operator. Key drilled its Nichols wells in 1998 into the Chappel formation in Hardeman County, Texas. The Nichols well was a dry hole so in 2000 Key decided to convert the Nichols well into a commercial salt water well. The TRC on March 23, 2000 granted Key a permit to dispose of up to 15,000 barrels per day of salt water into the well. In its permit application, Key represented to the TRC that the Chappel formation into which Key would inject the salt water was not productive of oil or gas. In May, 2006 DDD completed the Evans well, which was located 300' from the Nichols well because DDD had obtained a special exception, in the Chappell formation. The Evans well was unsuccessful because it produced almost entirely salt water. On November 8, 2006 a TRC hearing examiner ordered that Key shut-in the Nichols well because it was

injecting water into a productive formation rather than into a non-productive formation. At the time of trial, DDD's Evans well was producing 18-20 barrels of oil per month, the same rate of production it achieved after Key ceased injecting salt water into its Nichols well.

DDD filed its action against Key on January 2, 2008 claiming that the Nichols well and Evans well were in pressure communication and that the salt water injected into the Nichols well drowned the reservoir underlying the Evans well.

The Court granted Key's motion for summary judgment based upon its statute of limitations defense. The Court held that DDD's claims were not inherently undiscoverable because DDD should have known, prior to drilling its well, that the adjacent Nichols well was receiving salt water in the Chappel formation. The Court held that DDD failed to act with reasonable diligence. Further, the Court held that the plaintiff's claims were not objectively verifiable. The Court was unimpressed with plaintiff's expert witness because the expert admitted that he could not determine in advance where the oil was located. In this regard, the Court stated that:

Ultimately, drilling for oil is an inherently speculative enterprise. By its very nature, injuries to a subterranean reservoir are not objectively verifiable for the purposes of the discovery rule.

Thus, the DDD exploration opinion seems to preclude the applicability of the discovery rule in most of the lessor/lessee implied covenant cases of drainage, development, marketing and administrative duties since all such cases depend upon expert testimony as to causation, standard of conduct and damages. Also, in virtually all of such cases, the party's expert witnesses will offer greatly diverse testimony. Thus, it would be a rare oil and gas case in which the expert testimony would be so near consensus, and supported by other undisputed evidence, as would meet the objectively verifiable standard to support the application of the discovery rule.

Conclusion - Only an exceptionally diligent Texas mineral/royalty owner can obtain all the facts necessary to support his claim and avoid the limitations defense.

LAWYERS BEWARE - The statute of limitations for legal malpractice claims is two years, the standard limitation for all torts. However, the Texas Supreme Court has already concluded that the discovery rule applies to all attorney malpractice suits. *Willis v. Maverick*, 760 S.W.2d 462 (Tex. 1988).