ROUND 1

Written by Chuck Brownman[1]

GENERAL FACTS

1. Introduction: A "Black Gold Rush" and the Permian Basin

The Permian Basin is an oil-and-gas-producing area located in West Texas and the adjoining area of southeastern New Mexico. Covering an area approximately 250 miles wide and 300 miles long, the Permian is composed of more than 7,000 fields producing from multiple geologic formations, with production depths ranging from a few hundred feet to five miles below the surface. Recent increased use of enhanced-recovery practices in the Permian has resulted in a substantial increase in production, with 2018 oil production surpassing just over 2.5 million barrels of oil per day, and 2018 gas production yielding almost 9 billion cubic feet of gas per day.[2]

When an area significantly increases its hydrocarbon production (or, at least, its production capability), a "boom" mentality takes over as many competitor companies, large and small, established and new, race in to try and obtain (or control) the mineral rights to as much acreage as they can. In this "boom" environment, with increased competition comes higher land prices. This competition is fierce and can catapult a company to massive profitability or massive debt leading to bankruptcy. Not surprisingly, when there is a high competition for land and mineral rights, there is also a high rate of "top leasing," an old (but not always respected) business practice.[3]

2. The Parties

A. *Kander Energy Company* ("Kander") is a large, established, publicly-traded and well-known oil and gas company that concentrates on the "upstream" or exploration and

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[2] Texas Railroad Commission website, last visited on December 12, 2019. Production figures found at https://www.rrc.state.tx.us/media/55036/permian-basin-oil.pdf (for oil) and https://www.rrc.state.tx.us/media/55037/permian-basin-gas.pdf (for natural gas).
[3] More information on top leases is in Section 4.B. on pages 5-6 below.

production ("E&P") phase of the business.[4] Accordingly, it either owns mineral rights in its own name and/or leases those mineral rights from third parties under a variety of typical agreements, including oil and gas leases.[5] Whether owned or leased, those mineral rights give Kander the ability to explore for oil and gas (and potentially other minerals, although in this problem we are focusing on oil and natural gas) through drilling. If oil and/or gas are discovered in commercial quantities, those mineral rights also give Kander the ability and the obligation to produce the hydrocarbons by operating the wells that produce the hydrocarbons.

Like many of its competitors, Kander does business in most of the shale basins located throughout the United States, including the Permian Basin (located in west Texas and eastern New Mexico), the Eagle Ford (Southern Texas), the Marcellus (in the Appalachian Basin in the eastern U.S.), the Bakken (North Dakota) and the Niobrara (Colorado, Wyoming and South Dakota. The geographical boundaries and productivity of those shale basins (or "plays") are constantly undergoing expansion, refinement and re-assessment, as producers drill in new extension areas previously un- (or under-) explored.

B. ***Steel Leases LLC*** ("Steel") is also an E&P company, although its history is much shorter than that of Kander. It is a small, privately-owned and private equity-backed company that has only been in existence for a few years.

Steel's business strategy is to identify exploration opportunities in existing plays by either (a) taking oil & gas leases on the outskirts of existing plays, to see if the mineral formation trends in that direction, and (b) taking "top leases" – oil & gas leases that cover a mineral estate that is still covered by another valid, existing oil & gas lease.[6]

3. Transaction History

Competition among the various E&P companies that are exploring in the Permian Basin is fierce, as each company attempts to obtain and control as much acreage as possible for as long as possible, and under the best terms it can get. As a result of that competition, some companies have taken to leasing land that is already leased, hoping to benefit if the underlying lease terminates or expires.

On April 18, 2018, Kander signed an Oil & Gas Lease with Larry Lesser (the "Lessor"). The Lease covered the Lessor's 160 acres of land in Reeves County, Texas, and contained "standard terms", as follows:

(a) 3-year primary term, ending on April 18, 2021, with the term continuing for as long as oil or gas are produced from the leased lands

[4] The "midstream phase" in the oil and gas industry involves the gathering, transportation, processing / refining and storing of oil and gas. The "downstream phase" in the oil and gas industry involves the distribution and sale to industrial, commercial and residential end-users.
[5] More information on oil and gas leases is in Section 4.A. on pages 4-5 below.
[6] More information on top leases is in Section 4.B. on pages 5-6 below.

(b) If Lessee "commences operations for drilling" a first well before the end of the primary term, Lessee is given a reasonable time to finish
(c) Bonus of $100 / acre, which was paid upon execution
(d) Annual rental of $100 / acre, payable at the beginning of each lease year
(e) A royalty of 1/8 of all oil and gas produced and sold from the property
(f) Typical other clauses, such as a delay rental and shut-in royalty

On October 31, 2020, Steel signed an Oil & Gas Lease with the Lessor covering the same 160 acres of land in Reeves County, Texas that were already leased to Kander. The Oil & Gas Lease between the Lessor and Steel contained the following terms:

(a) 3-year primary term, ending on October 31, 2023, with the term continuing for as long as oil or gas are produced from the leased lands
(b) Bonus of $20 / acre, paid on execution [**note:** the amount is low, because this Lease may never fully vest]
(c) Annual rental of $250 / acre, starting if / when the Lease comes into being
(d) A royalty of 1/6 of all oil and gas produced and sold from the property
(e) Typical other clauses, such as a delay rental and shut-in royalty

As more fully explained below,[7] lessees in oil & gas leases must commence operations before the end of the primary term in order to enter the secondary term (or habendum) of the oil & gas lease. Up to this point, Kander has only cleared some land on the leased premises, put up a sign that says, "future home of the Lesser No. 1 Well," and ordered some standard equipment that could be used on a variety of wells, but it has not begun permitting.

Upon learning that Steel had signed a top lease with the Lessor, Kander took the same tactics used by Santa Fe Minerals in a 1996 Oklahoma "quiet title" lawsuit – filing suit against Steel in state court, alleging every possible legal theory it could reasonably allege, including:

(a) slander of title;
(b) tortious interference with contract;
(c) maintenance and champerty (a lesser-known pairing of old-fashioned claims, alleging that a disinterested party is meddling to encourage litigation, and that the disinterested party is supporting the person in a lawsuit on the condition that the subject matter of the action is to be shared with the disinterested party, respectively);
(d) obstruction; and
(e) conspiracy.

As possible remedies for its multitude of legal theories and claims, Kander has asked for damages; a permanent injunction against Steel top leasing Kander's lease; a declaration that the

[7] See Section 4.A. on pages 4-5 below.

primary term of its lease with the Lessor be tolled until the litigation is completed; and a declaration that the top lease be held void under the Rule Against Perpetuities.

Steel filed a general denial to Kander's claims. In addition, it has raised a counterclaim, seeking a declaratory judgment that Kander has not commenced operations for drilling, and therefore the Oil & Gas Lease between Mr. Lesser and Kander should be determined to have expired as of the end of the primary term.

The parties are meeting in Houston to attempt to resolve the litigation before the discovery phase begins in earnest, which would require each party to invest significant amounts of time, money and effort.

4. General Information About Oil & Gas Leases and Top Leases

A. Oil & Gas Leases[8]

The oil and gas lease is a unique form of contract. It is the foundation of the oil and gas industry in the U.S. Because most minerals in the U.S. are privately owned, some way had to be found for those willing to risk capital to exploit oil and gas to obtain rights to those resources. The oil and gas lease was the result. In its basic form, the oil and gas lease has remained unchanged since the early days of the energy industry.

The concept is simple: the mineral owner (called the "Lessor") conveys the mineral estate in her land to the company that wants to exploit the minerals, for a term — a "primary term" for a fixed number of years (usually anywhere between two and ten), during which the lessee must "commence operations" or lease ends; and a "secondary term," which lasts for as long thereafter as oil or gas is produced in paying quantities. In that conveyance, the mineral owner reserves a cost-free interest in production – a royalty interest. The landowner / lessor thus transfers the risk and cost of development to the grantee / lessee, and retains a risk-free royalty interest in production.

The oil and gas lease is both a conveyance and a contract, and the law that has developed around the lease reflects both concepts. Its character as a conveyance has important consequences, and it is important for the landowner to understand those consequences, especially if the landowner owns both the surface and mineral estates. (As you may recall from your basic Property courses, the two estates can either be owned by one party, or one may be severed from the other, and owned separately).

If the two estates are severed from each other, the mineral estate is the "dominant" estate, meaning that the owner of the mineral estate has the right, without compensation, to use so much of the surface estate as is reasonably necessary to explore for and produce oil and gas from the property. This basic idea is subsumed within the lease. The lessee in the lease acquires not only the mineral estate, but also the right to use the surface estate for mineral development. This

[8] Adapted from the "Oil and Gas Lawyer" blog of John B. McFarland, Shareholder in the law firm of Graves Dougherty Hearon & Moody: entry dated July 16, 2013 (site last visited on December 8, 2019); found at https://www.oilandgaslawyerblog.com/thoughts-on-the-oil-and-gas-le/

includes the right to build roads, lay pipelines, install production facilities, conduct seismic surveys, etc. And it includes the right to use groundwater for oil and gas exploration and production and the right to dispose of produced water and associated waste by drilling and operating injection wells on the property. All of these rights are implied in the grant of the mineral estate, and need not be specifically mentioned in the lease. If the landowner wants to restrict the lessee's right of surface use in any way, those restrictions must be explicitly provided for in the lease. Absent such express contractual restrictions, the right of surface use is part of the bundle of rights granted to the lessee as part of the mineral estate.

Courts (at least the ones in Texas) generally favor the lessee, pursuing a policy that development of mineral resources is often the land's highest and best use. So when construing the primary term, courts give the lessee some leeway in what the lessee must do to have "commenced operations" within the primary term; and if the lessee *has* satisfied that minimum level of activity before the primary term ends, the lessee is then given a reasonable amount of time to complete the drilling and other preparatory activities even after the primary term has ended. However, Texas decisions about what is required by way of "operations" or "drilling operations" at the end of the primary term, to qualify for the additional time, are not entirely consistent.

An oil and gas lease is also a contract and enforceable as such. As the case law interpreting oil and gas leases began to develop, courts began to imply certain provisions into the lease, as a matter of contract interpretation. Courts considered that the lease imposed certain obligations on the lessee that were not expressed in the contract but were necessary in order for the parties to have the benefit of their bargain. These "implied covenants" are now well-recognized, and include the obligation to reasonably develop the lease and the obligation to protect the lease against drainage by wells on adjacent lands.

Courts also created rules for construction of certain lease provisions. For example, leases remain in effect for a term of years and "as long thereafter as oil or gas is produced." But what if there is a temporary cessation of production? Does the lease terminate? Faced with this question, courts developed the rule of "temporary cessation." A lease will not terminate because of temporary lapses in production if the lessee acts diligently to restore production.

B. Top Leases

The term "top lease" describes a lease "granted by a landowner during the existence of a recorded mineral lease which will become effective if and when the existing lease expires or is terminated."[9] When such a lease is granted, the existing lease becomes known as the "bottom lease."

[9] Shown v. Getty Oil Co., 645 S.W.2d 555, 561 (Tex. App. – San Ant. 1983, writ ref'd n.r.e), citing Williams & Meyer Oil and Gas Law Manual of Terms, p. 606 (1981).

Taking top leases was, at one time, viewed negatively by courts and by some parts of the oil and gas industry.[10] But despite the negative views held by some, top leasing is legal, even if not embraced by all, and it can promote competition for oil and gas property that would otherwise be neglected. Professor David Pierce, for example, has described top leasing as "an accepted business practice in the oil and gas industry which the courts have sanctioned in various ways for almost a century.[11]

Sometimes a top lease is granted by the same lessor to the same lessee – in those cases, the top lease is, effectively, an extension of the original lease. More often, however, the top lease is what is referred to as a "three-party top lease," where there is one lessor, but two different lessees. Most litigation over top leasing occurs in this latter situation.

Confidential Information for Kander Energy Company

Kander has two contradictory objectives for Mr. Lesser's land that it has leased – first, it is very interested and excited to explore the property, because it feels like the land has a better than average chance of being productive, and because there have been rumors that some nearby producers have drilled productive wells; but second, due to the current low(ish) prices for oil, gas and other hydrocarbon products, and due to other budgetary restrictions and deadlines, it wants to defer for as long as possible the drilling of a well.

All of that being said, if the property is developed by Kander (either alone, or in conjunction with another party), Kander wants to control the timing and operational aspects of the exploration. Kander especially doesn't believe that Steel has the experience, manpower or knowledge to safely and efficiently drill and operate a well.

a. The Existing Oil & Gas Lease (a/k/a the "bottom lease"): Kander knows that its activities on the bottom lease are at the low end of what it should have done in the primary term to keep the lease going, and going to trial and having Steel raise that issue would be problematic for Kander. Therefore, Kander's preference would be to make a deal with Steel, but not on just any terms.

   Kander also knows that it could approach the Lessor of its Oil & Gas Lease, and negotiate an amendment of that Lease, to keep the top lease from going into effect. But Mr. Lesser has been difficult to deal with (at best), and he's pretty perturbed that the well hasn't been drilled yet and his anticipated and hoped-for "massive royalties" have yet to start rolling in. His attitude could be an obstacle to amending and extending the bottom lease.

[10] Frankfort Oil Co. v. Snakard, 279 F.2d 436, 445 n. 23 (10th Cir. 1960), cert. denied, 364 U.S. 920 (1960), saying that "Topleasing has the same invidious characteristics as claim jumping."
[11] See "Effective Top Leasing and Mysteries of the Habendum Clause," Oklahoma Bar Journal Newsletter, April 2005, p. 2 (available online).

b. The New Oil & Gas Lease (a/k/a the "top lease"): Based on a series of cases from Oklahoma and Texas[12], Kander feels pretty good about some of the claims it has raised against Steel in the litigation, although it knows that nothing about a trial is certain. But it feels as though it can use those claims to squeeze a better deal out of Steel.

Also, from the small amount of discovery that has already been conducted, Kander knows that the top lease contains terms that aren't as good as its own lease. In a perfect resolution, Kander would keep the bottom lease in existence, be able to defer drilling a first well for between 1-3 years, and then, if and when the first well *is* drilled, Kander would be the operator of the well. Unfortunately, Kander knows that it cannot achieve such a result – it *must* deal with Steel.

Therefore, in no particular order, an ideal result for Kander would be:

(1) Kander and Steel would agree to let the bottom lease expire and proceed jointly and cooperatively under the terms of the top lease;

(2) Because Kander has already paid a bonus and three years of annual rentals (a total of $64,000) under the bottom lease, it would prefer to have Steel solely pay those same kinds of payments under the top lease to "balance" out each party's commitment; however, management has given approval to have Kander pay up to half of the top lease payments (the total of the bonus and first annual rental Steel already paid was $43,200, and the total of the remaining two annual payments is another $80,000; so half of the amount Steel already paid would be $21,600, and half of the amount to be paid annually for the next two years would be $40,000), but only *IF* the timing of the drilling of the well is as Kander prefers (item (5) below); otherwise, if the first well is drilled in 2022, management would only want to pay one-fourth of these amounts;

(3) Kander knows that because Steel is privately owned and backed by private equity (which requires a fairly quick return on investment[13]), the data developed from the parties' joint exploration and production activities on the top lease could be disclosed in a data room set up as part of a sale[14]; therefore, Kander wants the data to be kept confidential so that other

[12] Voiles v. Santa Fe Minerals, Inc., 911 P.2d 1205 (Okla. 1996); Peveto v. Starkey, 645 S.W.2d 770 (Tex. 1972); and Hamman v. Bright & Co., 924 S.W.2d 168 (Tex. 1996).

[13] What private equity funded E&P companies (such as Steel) typically do is acquire the mineral interests and drill as few wells as possible (to avoid spending more money than needed, to increase their return) in an effort to "prove up" the reserves (i.e., to demonstrate that the acreage should have sufficient oil and gas to be produced profitable). Accordingly, unlike long-term producers who are interested in producing as much oil and gas as possible for as long as production is feasible, Steel's interest is likely more short-term.

[14] A "data room" is what the term implies – a "room" (nowadays often a "virtual" room, or limited access website) where the prospective seller puts data about the assets being sold, and prospective buyers can then review the data to help them decide if they want to bid on the assets being sold, and if so, at what price.

parties that are exploring on nearby or adjacent tracts (or are considering doing so) would not be given a competitive advantage.[15] Kander wants this data kept confidential for as long as possible, with 24 months being best, but 12 months being the minimum that Kander could accept;

(4) Kander is suspicious of Steel and its potential relationship with the Lessor; therefore, Kander would require that Steel commit not to work with the landowner to keep Kander off the property (a claim of obstruction);

(5) If Kander and Steel can reach an agreement to jointly participate in the drilling of the first well under the terms of the top lease, for budgetary reasons, Kander wants Steel to agree that the well will not be drilled until at least the first quarter of 2023; however, Kander management has begrudgingly said that it could live (if necessary) with the well being drilled sometime in 2022 (but in no event in 2021); and

(6) Kander suspects that Steel has other leases in the area. If the first well is as successful as Kander hopes, Kander would certainly want the right to acquire some of Steel's other leases. A common way for parties to approach this is by establishing an "area of mutual interest" ("AMI"), where a party would have a right to participate in another party's leases. AMIs are popular because in many cases when parties enter into an exploration agreement, they will not have yet leased all of the area in question. Parties may be more willing to expend funds for exploration if they know they will later have the option of sharing in any acquisitions of oil and gas interests in the area.

While AMI negotiations can get quite detailed, one primary issue to be negotiated is the size of the AMI (typically expressed as a distance from the outer boundaries of the current lease). AMIs could range from a very small buffer zone around the edge of the contract area to hundreds of square miles. The best result for Kander would be to have the AMI be as big as possible, which would give it the largest number of additional leases to participate in; therefore, the absolute minimum distance it will consider is ¼-mile from the outer boundary of the lease (with anything larger than that considered a successful result).

Another issue that must be discussed is the period of time the AMI would be binding and in force. Kander prefers an AMI term of five to eight years. Although in most instances, AMIs generally serve their purpose within a five year term, Kander sees no harm in requesting additional time.

Confidential Information for Steel Leases LLC

[15] In new or competitive fields, geologic and production data are considered very sensitive and proprietary.

Steel is very interested and eager to settle the lawsuit and finalize a deal with Kander. First, Steel is a small company, and it doesn't have the time or manpower to engage in a lengthy and document-intensive lawsuit. Second, as a relatively new company (and a newcomer to the oil and gas E&P segment of the energy industry), it doesn't want to develop a negative reputation. But those reasons alone aren't sufficient for Steel to cave to Kander's pressure.

Also, Steel is anxious that this land be drilled. First, it feels like the land has a better than average chance of being productive, and there have been rumors that some nearby producers have drilled productive wells. If that is true, then other leases nearby that Steel has taken could be wildly profitable (either due to production from them, or because other parties will want to acquire those leases and will pay Steel for that right). And second, despite the current low(ish) prices for oil, gas and other hydrocarbon products, because it must report positive earnings and cash flows to its private equity investors sooner rather than later, it doesn't want to defer the drilling of the first well.

a. The Existing Oil & Gas Lease (a/k/a the "bottom lease"): Steel believes that Kander's activities on the bottom lease are at the low end of what it should have done in the primary term to keep the lease going. Therefore, Steel feels fairly confident if it has to go to trial; however, winning the trial would be like "winning the battle, but losing the war," since then Steel would (1) have to actually drill a well and operate it, which is beyond its staff's capabilities and numbers, and (2) get the kind of reputation that would make future deals more difficult and expensive. Therefore, Steel's preference would be to make a deal with Kander, but it is not desperate to do so on just any terms.

b. The New Oil & Gas Lease (a/k/a the "top lease"): Steel is worried about Kander's claims about the top lease, especially the one that the top lease is void because it violates the Rule Against Perpetuities. In its haste, Steel signed a top lease that becomes effective when the bottom lease expires, and Steel's attorneys have advised them that under a series of cases in Oklahoma and Texas,[16] that language could be a problem under the Rule Against Perpetuities. So rather than risk the validity of the top lease, Steel would prefer to work jointly and cooperatively with Kander.

Therefore, in no particular order, an ideal result for Steel would be:

(1) Kander and Steel would agree to let the bottom lease expire and proceed jointly under the terms of the top lease;

[16] Voiles v. Santa Fe Minerals, Inc., 911 P.2d 1205 (Okla. 1996); Peveto v. Starkey, 645 S.W.2d 770 (Tex. 1972); and Hamman v. Bright & Co., 924 S.W.2d 168 (Tex. 1996).

(2) If Kander and Steel can reach agreement to jointly participate in the drilling of the first well under the terms of the top lease, Steel wants the well will be drilled as soon as possible, preferably in the third or fourth quarter of 2021; however, Steel management has begrudgingly agreed that it could wait to have the well drilled sometime in 2022, but in no event would it wait until 2023;

(3) Because Steel is privately owned and backed by private equity (which requires a fairly quick return on investment), Steel's interest is drilling a well quickly, having that producing well (it hopes!) prove the land's capability of producing oil and gas profitably, then quickly selling all of the mineral interests it owns, leases, or otherwise controls.[17] Accordingly, unlike long-term producers who are interested in producing as much oil and gas as possible for as long as production is feasible, Steel's interest is more short-term. Therefore, while other parties that are exploring on nearby or adjacent tracts (or are considering doing so) might get a competitive advantage from seeing the data developed from exploration and production activities on the lease,[18] Steel sees the data merely as an aid to selling the oil and gas leases (and the corresponding mineral interests they own and control through those leases), and doesn't care much about how the data would be used once Steel sells its interest in the land. Therefore, Steel wants the data to be accessible in a data room[19], even though making the data available could compromise its confidentiality. Steel would like to set up a data room as soon as possible – 6 months would be ideal, but definitely within 18 months.

(4) If Kander and Steel are going to work jointly under the top lease, Steel would want Kander to (a) reimburse Steel for up to half of the bonus and annual rentals that Steel already paid to the Lessor under the top lease (the bonus was paid on signing, and the first year's annual rental was paid at the same time – these two items totaled $43,200, so half of that would be $21,600), and (b) agree that the remaining two future annual rental payments ($40,000 / year) would be shared equally; however, Steel would be willing to pay up to three-quarters of these amounts, but *only* *IF* the timing of the drilling of the well is as Steel prefers (end of 2021 or early 2022).

(5) Steel is suspicious of Kander and its existing relationship with the Lessor; therefore, Steel would require that Kander commit not to amend or extend the bottom lease, or otherwise work with the landowner to keep Steel off the property; and

[17]What private equity funded E&P companies (such as Steel) typically do is acquire the mineral interests and drill as few wells as possible (to avoid spending more money than needed, to increase their return) in an effort to "prove up" the reserves (i.e., to demonstrate that the acreage should have sufficient oil and gas to be produced profitable).
[18] In new or competitive fields, geologic and production data are considered very sensitive and proprietary.
[19] A "data room" is what the term implies – a "room" (nowadays often a "virtual" room, or limited access website) where the prospective seller puts data about the assets being sold, and prospective buyers can then review the data to help them decide if they want to bid on the assets being sold, and if so, at what price.

(6) Steel has other leases in the area. If the first well is as successful as Steel hopes, it would want to seek other joint venture partners to share the burdens and obligations of those other leases, and to operate those wells. If this deal goes well with Kander, Steel would consider giving Kander the right to acquire some of Steel's other leases. A common way for parties to approach this is by establishing an "area of mutual interest" ("AMI"), where a party would have a right to participate in another party's leases. AMIs are popular because in many cases when parties enter into an exploration agreement, they will not have yet leased all of the area in question. Parties may be more willing to expend funds for exploration if they know they will later have the option of sharing in any acquisitions of oil and gas interests in the area.

While AMI negotiations can get quite detailed, one primary issue to be negotiated is the size of the AMI (typically expressed as a distance from the outer boundaries of the current lease). AMIs could range from a very small buffer zone around the edge of the contract area to many miles. The best result for Steel would be to have the AMI be as small as possible, since a large AMI could discourage other potential buyers. Therefore, the absolute maximum distance it will consider is ½-mile from the outer boundary of the lease (with anything smaller than that considered a successful result).

Another issue that must be discussed is the period of time the AMI would be binding and in force. Steel prefers not to be bound by an AMI term of more than five years. This is a standard term and in most instances, AMIs generally serve their purpose within the five years.