<u>The Discovery Rule Ten Years After HECI v. Neel – Does It Apply to Oil and Gas Claims?</u>

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By Ben Elmore and E. R. Norwood

I. Introduction

It has been a little more than ten years since the Texas Supreme Court's opinion in *HECI v. Neel*, 982 S.W.2d 881 (Tex. 1998). The purpose of this article is to review the post *HECI* discovery rule cases involving oil and gas claims and, based upon *HECI* and its progeny, to venture opinions as to which, if any, oil and gas claims will be subject to the application of the discovery rule.

In *HECI,* the Supreme Court re-affirmed that the discovery rule was applicable only to certain categories of claims in which (1) the injury was inherently undiscoverable and (2) the injury was objectively verifiable. The Court held that the discovery rule is to be applied on a categorical basis rather than on a fact specific, case-by-case basis. In *HECI,* the Court held that the discovery rule did not apply to the category of claims involving damage to a common reservoir. Of course, that category of claims, damage to a common reservoir, includes many lessor/lessee contract claims.

In *Wagner & Brown v. Horwood*, 58 S.W.3d 732 (Tex. 2001), the Supreme Court held that the discovery rule did not apply to the lessors' breach of contract claims for the alleged underpayment of gas royalties as a result of the lessee's alleged overcharges for gas compression and gathering, finding that the alleged overcharges were not inherently undiscoverable. The Court expressly declined to hold that the discovery rule is inapplicable to the entire class of cases based upon the breach of the express and implied covenants in oil and gas leases. Significantly, the Court held that *HECI* governed only the class of claims arising from damage to an oil and gas reservoir.

Post *HECI*, the Texas Courts of Appeal have refused to state categorically that the discovery rule does not apply to oil and gas breach of contract claims, however, in each case discussed below, the Courts of Appeal recite the authorities requiring the application of the discovery rule by categories of claims, conduct a fact specific, case-by-case, analysis and then determine that the discovery rule does not apply to the contract claims at bar. Since *HECI*, only one Court of Appeals has applied the discovery rule in an oil and gas context. That case involved claims for the damage to reservoirs underlying leases based upon the lessee's alleged wrongful and malicious conduct in plugging wells located on the leases. The Supreme Court, however, recently reversed that case and held that, whether or not the discovery rule applied, as a matter of law, the claimants had actual knowledge of their claims more than two years before they filed suit. Thus, those claims were time barred under the applicable two year statute of limitations. *Exxon Corporation v. Miesch,* 2009 WL 795668, 52 Tex. Sup. J. 467 (March 27, 2009).

In short, the Texas Supreme Court's *HECI* opinion has resulted in fact specific, case-by-case analyses, the cumulative effect of which is to greatly reduce the likelihood that the discovery rule will ever be applied to any of the common lessor-lessee claims, including implied covenant claims.

II. The *HECI v. Neel* Decision

In *HECI v. Neel*, the royalty owners sued their lessee, HECI Exploration Company ("HECI") and its successor, seeking their proportionate royalty share of the settlement proceeds from a judgment that HECI recovered in a suit it filed against the operator on an adjoining lease, AOP Operating Corporation ("AOP"). The HECI and AOP leases produced from a common reservoir, and AOP had overproduced one of its wells from April 1987 until December 1988 in violation of Texas Railroad Commission ("RRC") rules.[1] HECI claimed that AOP's overproduction damaged the common reservoir, because it caused oil to migrate into the gas cap and thereby decreased the amount of oil and gas that could be recovered from the reservoir. HECI filed suit against AOP in 1988 and judgment was rendered in HECI's favor in May 1989. The parties subsequently settled the case, and a release of the judgment was ultimately filed in September 1989.

The Neels did not learn of the suit until four years later and sued HECI in December 1993. In their suit, the Neels asserted four causes of action: (1) breach of contract for which they sought damages in the amount of their 1/6th

[1] 982 S.W.2d 881, 884 (Tex. 1998).

royalty share of the settlement proceeds that HECI obtained against AOP; (2) negligent misrepresentation for HECI's failure to disclose the damage to the reservoir and the existence of its suit against AOP; (3) breach of the implied covenant to protect against drainage; and (4) unjust enrichment. Recognizing that they had a limitations problem, the Neels asserted that the discovery rule precluded limitations from barring their claims, arguing their claims did not accrue until the Neels discovered those claims in 1993.

The Court stated that the implied covenant the Court of Appeals found to exist embodied two notice requirements, *i.e.*, the lessee's (1) notice of the need for suit and (2) notice of the lessee's intent to sue. The Court held that there was no implied covenant for a lessee to give the lessor notice of the lessee's intent to sue. The Court further held that the discovery rule did not apply to the purported implied covenant to notify of the need to sue, and that the Neels' claims based upon that purported implied covenant was barred by limitations. The Court, therefore, did not decide, and left for another day, the question of first impression as to whether Texas recognizes an implied covenant to give notice of the need to sue.

In discussing the application of the discovery rule, the Supreme Court first determined that all of the Neels' claims accrued at the time the overproduction occurred, the latest date of which was December 1988 when the overproduction ceased.[2] Citing its prior holding in *Computer Associates Int'l, Inc. v. Altai, Inc.*, 918 S.W.2d 453 (Tex. 1996), the Court articulated two unifying principles that generally apply in discovery rule cases: (1) the nature of the injury is inherently undiscoverable; and (2) the injury is objectively verifiable. The Court then reconfirmed that "the applicability of the discovery rule is determined categorically," meaning that the type, or category, of injury at issue is the key in determining the application of the rule.[3] In other words, if the injury is of the class or type that is inherently undiscoverable and objectively verifiable, then the discovery rule applies. Based on the specific facts presented, the Court determined that the ***type of injury*** was damage to a common reservoir.

Having thus identified the type of injury, the Court analyzed whether the injury was "inherently undiscoverable." The Court states that royalty owners have an obligation to exercise reasonable diligence in protecting their interests, and that the existence of implied covenants does "not dispense with the need for royalty owners to exercise due diligence in enforcing their contractual rights, express or implied, within the statutory limitations period."[4] A diligent royalty owner must make inquiries to their lessee, recognize the existence of other operations in the area and wells visible on neighboring properties, and must inspect records on file with the RRC. With respect to the latter, the Court stated that although in certain circumstances RRC records may provide constructive notice, the records regarding AOP's illegal production did not constitute notice in the context of the Neels' claim against HECI. However, with respect to the type of injury claimed by the Neels – injury to a common reservoir - the filings and other materials publicly available from the RRC are a ready source of information and HECI's failure to provide such information did not make it inherently undiscoverable. Given these sources of information, the Court held that a royalty owner cannot be oblivious to the existence of a common reservoir, and knows or should know that wells drilled in a common reservoir can potentially cause drainage or damage to that reservoir.[5]

> The Neels' cause of action against AOP for damage to the reservoir from illegal production is not the type of injury that is inherently undiscoverable. Accordingly, HECI's failure to notify the Neels of the existence of such a cause of action is not within a category of claims to which the discovery rule should be applied.[6]

HECI, and its progeny, place a high burden upon royalty owners seeking the protection of the discovery rule. This is a burden that, arguably, ignores the realities of the oil and gas industry in general and lessor/lessee relationships in particular. For instance, requiring royalty owners to obtain information from their lessee assumes that the lessee will be responsive and

2 *Id.* at 885.

3 *Id.* at 886.

4 *Id.* at 887.

5 *Id.* at 887-88.

6 *Id.* at 886.

forthcoming with relevant and decipherable information. In reality, most lessees are very protective of their information, especially when that information relates to the particulars of the reservoir, the lessees' operations on adjoining leases, if any, and the basis of the lessees' decisions as to the common reservoir. In fact, many lessees will either ignore a lessor's request for such information or refuse to provide that information – unless the lease requires the lessee to provide such information. Most lessees only provide their lessors with the royalty payment information required under TEXAS NATURAL RESOURCES CODE § 91.500.

As a practical matter, the lessor is left with only such information as can be gleaned from public records, mainly RRC records. The average royalty owner, however, is not knowledgeable concerning the various types of records on file with the RRC, and, if they can find the relevant records, they will likely not be able to understand the information in such records. Nevertheless, royalty owners will likely be charged with knowledge of the content of such records, even if the royalty owner has no knowledge of the existence of such records and could not understand those records in any event. If the type of injury is damage to a common reservoir or some other injury, the existence of which is disclosed by RRC records, the Court will likely find it is not inherently undiscoverable and the discovery rule does not apply. Since *HECI*, only one case, *Advent Trust Co. v. Hyder*, 12 S.W.3d 534 (Tex. App.–San Antonio 1999, pet. denied), has expressed concerns about the heavy burdens placed on royalty owners in reviewing and understanding RRC records. The holding in that case will be discussed below.

It is clear from *HECI* that the discovery rule does not apply to claims arising from injuries to the common reservoir – irrespective of how difficult it would have been for the lessor to discover the existence of the injury. Although the Court did not hold that the category of claims at issue are breach of express and implied covenants, the impact of identifying the injury as damage to a common reservoir encompasses the common implied covenant claims of failure to develop and protect the leasehold from drainage. As will be discussed further below, it is also difficult to envision a reservoir damage case in which the causation issue and damage issue would not implicate contested expert testimony which would render the alleged injury not "objectively unverifiable" and unable to meet the second element necessary to invoke the application of the discovery rule.

III. In the Past 10 Years, Texas Courts Have Been Reluctant to Apply the Discovery Rule Except in Limited Circumstances of Waste and Damage to the Wellbore

(1) Hay v. Shell, 986 S.W.2d 772 (Tex. App.–Corpus Christi 1999, pet. denied)

Shortly after *HECI*, the Corpus Christi Court of Appeals decided *Hay v. Shell,* 986 S.W.2d 772 (Tex. App.–Corpus Christi 1999, pet. denied). In *Hay*, the royalty owners asserted that their lessee improperly pooled their acreage with unproductive acreage. On January 20, 1977, Shell Oil Company ("Shell") filed a Designation of Pooled Gas Unit for the E.D. Hay No. 1 gas well ("Unit"). That designation combined adjoining leases with the plaintiff's lease to form a 704 acre unit. The Unit produced gas in commercial quantities; the date of first production was in February 1977. The Hays learned of the formation of the Unit in March 1977 upon their review of division orders. Shell had previously filed its P-15 report with the RRC in which it was required to affirm, under penalty of perjury, that all of the acreage included in the Unit was reasonably productive of gas.

On November 1, 1984, Shell sold its interest in the Unit to Parker & Parsley Petroleum Company ("Parker") who became operator of the Unit. In 1989, Parker obtained approval from the RRC to reduce the Unit from 704 acres to 160 acres, and filed its P-15 report swearing that the 160 acres were reasonably productive of hydrocarbons. In May 1992, the Hays searched the RRC records, obtained Shell's and Parker's P-15 forms, and learned, for the first time, that the Unit acreage had been reduced. Suspecting their royalty share had been diminished by the inclusion of unproductive acreage in the original larger Unit, the Hays filed suit on February 21, 1995 against Parker. On August 15, 1996, the Hays joined Shell as a defendant. The Hays asserted causes of action for breach of contract, breach of the marketing covenant, failure to develop, fraud, and also sought an accounting for the full royalty share the plaintiffs should have received had the Unit been properly formed. The Hays pled the discovery rule to avoid the application of the statute of limitations. The trial court granted Shell's motion for summary judgment holding that the discovery rule did not apply.

Citing *HECI*, the Court of Appeals first determined that the injury complained of was pooling productive land with nonproductive land, and that such injury accrued in 1977 when the 704 acre unit was formed.[7] The Court briefly addressed the first prong of the test, agreeing with the Hays that Shell's P-15 form in which Shell swore that the 704 acres were reasonably productive was some evidence that the injury was inherently undiscoverable. However, the Court ended its analysis there and turned to the objectively verifiable prong.[8] The Court explained this prong as follows:

> An injury is objectively verifiable if the presence of injury and the producing wrongful act cannot be disputed, and the facts upon which liability is asserted are demonstrated by direct, physical evidence.[9]

While expert testimony alone will not satisfy this prong, especially if there is a swearing match between experts, the Court confirmed that ***near consensus*** expert testimony, coupled with objective evidence, may prove to be objectively verifiable.[10] The Court then analyzed the affidavits of the parties' respective experts.

Shell's expert opined that, in hindsight, the alleged unproductive acreage "could still reasonably be considered productive" for a number of reasons: petroleum engineering is not an exact science; petroleum engineers often differ in their opinions on the reserves and the drainage areas; the only way to determine the productivity of deep formations is by drilling a well; and the odds of a successful wildcat well have increased due to advancements in petroleum engineering science and technology, and the recent maps, seismic data and information obtained from other wells drilled and tested since the Unit was formed in 1977. Ultimately, Shell's expert opined that whether nonproductive acreage was, in fact, included in the Unit is not objectively verifiable. Hays' experts expressed opinions contrary to Shell's experts. The Court, therefore, held that such conflicting expert testimony created the type of "swearing match" that does not satisfy the objectively verifiable requirement. Accordingly, the discovery rule did not apply.[11]

Hay arguably limits application of the discovery rule to cases in which the parties' respective experts are in agreement that an injury has occurred. In fact, the experts retained by opposing parties rarely agree, which results in a swearing match between those experts. Naturally, every lessor/lessee case turns upon the resolution of factual disputes involving competing expert opinions as to damages. The holding in *Hay* would, therefore, preclude the application of the discovery rule in virtually every lessor/lessee claim, because the proof of those claims almost always involves disputed expert testimony as to causation, the lessee's conduct, and damages.

(2) *Advent Trust Co. v. Hyder,* 12 S.W.3d 534 (Tex. App.–San Antonio 1999, pet. denied)

In *Advent Trust Co. v. Hyder*, a group of working interest owners filed suit against their former operator, Noble Ginther ("Ginther"), for contribution arising out of a lawsuit filed by a farmee, CPX, Inc. ("CPX"). Two wells previously drilled by Ginther were dually completed in one formation at 4050 feet and a second at 4170-4180 feet. Based in part on its review of reports filed by Ginther with the RRC regarding these two wells, CPX drilled a well to a depth of 4050 feet, but found the formation was depleted. In July 1989, CPX sued the working interest owners and Ginther for failure to disclose that the formation was depleted and failing to make proper filings with the RRC. Shortly thereafter, Ginther died. Three years later in January 1992, CPX filed complaints with the RRC asserting that the working interest owners had violated RRC reporting requirements and had illegally commingled production. On August 12, 1992, the RRC ruled in CPX's favor after which the working interest owners settled the lawsuit with CPX and surrendered their interest in the field to CPX. On January 18, 1994, almost five years after

7 *Id.* at 776.
8 *Id.* at 777.
9 *Id.* at 777.
10 (Id.).

11 *Id.* at 777-78.

CPX initially filed its lawsuit, the working interest owners filed their suit for contribution against Ginther's estate asserting claims of negligence, negligent misrepresentation, fraud, breach of contract and indemnity, and sought the value of their surrendered interest as damages. The estate asserted limitations as a defense, and the working interest owners sought application of the discovery rule.

The jury determined that the working interest owners' claims arose on the date the RRC issued its findings, August 12, 1992. The Court of Appeals disagreed holding that their claims arose on the date when CPX filed its petition in July 1989, as at that point, the working interest owners were aware of their potential liability based on the factual allegations in the petition and could seek judicial remedies.[12] Having made this determination, the Court stated the issue of whether the discovery rule applied was moot, because even if it did, the working interest owners' claims were barred by limitations. Nevertheless, the Court took the opportunity to comment upon the *HECI* decision:

> Applying [the *HECI*] reasoning here, it seems unrealistic to expect the Hyder-Rowans to discover that wells have been dually completed simply by inspecting the property. There is nothing in the record to indicate that the dual completion of a well is as readily apparent as the existence of a well. Thus the source of damages in *HECI*, production at an adjoining lease, was arguably easier to notice. Moreover, until the Hyder-Rowans were made aware of the dual completion by CPX's suit, they had no reason to search the RRC's files to learn whether proper disclosures of the dual completion had been made.[13]

In a footnote, the Court stated further:

> We admit to being somewhat bewildered by this language. We have had limited exposure to oil and gas litigation. But it has been sufficient for us to comprehend that this is an area in which the smartest and most aggressive can make a great deal of money from a less-knowledgeable class of royalty interest owners. How are royalty owners, the trust officers for minors, lawyers, and judges, who are not knowledgeable about the state of the RRC records, able to distinguish between production records that provide constructive notice and those that do not? Rather than bringing predictability and consistency to this area of the law, we fear that placing the onus on royalty owners to hire the experts necessary to investigate whether the RRC records reveal they are being cheated is inherently unfair and unworkable in the oil and gas business environment we have come to know.[14]

Although this discussion may be relied upon by working interest owners and royalty owners in the future, it is dicta. In addition, the claimants in *Hyder* were working interest owners as opposed to royalty owners. Typically, working interest owners are much more sophisticated in oil and gas matters than royalty owners, and under most operating agreements, working interest owners are, upon request, entitled to review all of the operator's information on the jointly owned property. Accordingly, the burden of discovering an injury should be higher for working interest owners. Although *Hyder* addresses many of the issues facing royalty owners, it is not accurate to equate royalty owners and working interest owners with respect to their sophistication and knowledge of oil and gas matters.

***(3) Wagner & Brown v. Horwood*, 58 S.W.3d 732 (Tex. 2001)**

In *Horwood*, for the first time since *HECI,* the Supreme Court considered the application of the discovery rule in an oil and gas case, holding that it did not apply to a claim for underpayment of royalties.

The lessors under oil and gas leases claimed that the lessee had underpaid royalties by deducting excessive fees for gathering and for compressing the subject gas. Under the oil and gas lease at issue, royalties were due based upon the amount realized from the sale of the gas at the wells. Wagner & Brown ("W&B") was the successor

[12] 12 S.W.3d at 540.

[13] *Id.* at 539-40.

[14] *Id.* at n.1.

lessee under existing gas purchase contracts, entered in 1975, that sold the gas at the wellhead. As is typical in these situations, there were separate gas gathering contracts between the lessee and the gathering company, Canyon Pipe Line Corporation ("Canyon"), who compressed and delivered the gas to a central facility after which it was delivered to the ultimate pipeline purchaser. Under the gas purchase contracts, the compression charges were deducted from the sales price, which effectively decreased the royalty paid to the royalty owners under the leases.[15]

Prior to 1985, the royalty owners received statements that showed that the compression fee charged was 25¢-30¢ per Mcf. One of the royalty owners, David Glass, hired a consultant who in 1983 determined that the fee was excessive. Glass and the other royalty owners, however, did not pursue legal action at that time. In 1985, the royalty statements showed the fee had been reduced to 12¢ per Mcf, which prompted Glass to call W&B about the change. W&B confirmed that the charge was in fact 12¢, but Glass remained suspicious that the royalty interest was being charged more than 12¢. Glass did not pursue his suspicions any further until April 9, 1996 when he and another royalty owner, Lonnie Horwood, filed suit against W&B and Canyon alleging breach of the express and implied covenants in the lease, fraud, unjust enrichment and requested an accounting. In addition, they sought reimbursement for underpayment of royalties dating back to 1985. The trial court granted W&B and Canyon's summary judgment, holding that all of the claims prior to April 9, 1992 were time barred under the applicable statutes of limitation, *i.e.*, barring all claims accruing four years prior to filing of suit.[16]

In reversing the trial court's summary judgment, the El Paso Court of Appeals held that the discovery rule applied, because the royalty owners' injury was inherently undiscoverable and the injury was objectively verifiable, since the injury could be proven by expert testimony and financial records showing standard charges made by other similarly situated producers and gatherers in the area.[17]

W&B and Canyon contended that, under *HECI*, the discovery rule did not apply to claims of underpayment of royalties. The Court of Appeals, however, determined that *HECI* was not applicable, because it only analyzed the discovery rule in the context of a claim of damage to a common reservoir.[18]

In holding that the discovery rule applied to royalty underpayment claims, the Court of Appeals conducted a fact specific analysis, and reasoned that the information the royalty owners needed to discover their claim could only have come from W&B and Canyon, and that the two defendants failed to provide that information.[19] In fact, the monthly statements the royalty owners received from W&B showed a compression fee of 12¢-17¢, but the actual fees charged and received by Canyon were in excess of 30¢. In addition, the royalty owners offered an affidavit of an expert in the industry who opined that the actual compression fees charged by Canyon could not have been determined from the lessees' royalty statements. Also, the summary judgment proof showed that Canyon did not report its fees to any public agency. Thus, there were no public records from which the royalty owners could have determined the fees that were deducted from their royalties.[20] Based on these facts, the Court of Appeals held the injury was inherently undiscoverable, stating that:

> The characterization of the underpayment of royalties as inherently undiscoverable is sound in situations in which the royalty owner's only means to discover his or her injury is through information provided by the lessee. When the lessee provides information which reveals the nonexistence of an injury, thus giving the royalty owner no reason to investigate or discover his or her claim, the inherent

15 58 S.W.3d at 733.

16 *Id.* at 734.

17 *See Horwood v. Wagner & Brown, Ltd.*, 61 S.W.3d 1, 9 (Tex. App.–El Paso 1999), *rev'd*, 58 S.W.3d 732.

18 *Id.* at 7.

19 *Id.* at 6.

20 *Id.*

> undiscoverable nature of the injury is even more evident.[21]

The Supreme Court reversed the Court of Appeals and held that the discovery rule did not apply to the class of cases for injuries caused by the lessees' excessive or improper charges, which resulted in the underpayment of oil and gas royalties payable under oil and gas leases. The Court began its analysis with a restatement of its holding in *HECI* that the discovery rule must be applied on a categorical basis:

> Accordingly, the question here is not whether Horwood and Glass detected the alleged improper charges and resulting underpayment within the limitations period. Rather, we must decide whether theirs is "the type of injury that generally is discoverable by the exercise of reasonable diligence."[22]

The Court then rejected W&B and Canyon's contention that *HECI* precluded the application of the discovery rule in all claims for breach of oil and gas lease covenants, stating that:

> W&B and Canyon argue that *HECI* stands for the proposition that all claims for breach of oil and gas lease covenants are categorically exempt from the discovery rule's application. That reading, however, oversimplifies our analysis in *HECI*.
>
> * * *
>
> Because we concluded that damage to the common reservoir was not inherently undiscoverable, we held that neither was the lessee's failure to notify the Neels of their potential claims. Thus, the category of claims HECI governs ***is not*** all alleged breaches of implied or express oil and gas lease covenants, ***but claims arising from damage to an oil and gas reservoir***.[23]

Although the Court held that *HECI* did not preclude the application of the discovery rule to all lease covenant claims, the Court stated that *HECI* was informative in determining whether the discovery rule applied to Horwood's and Glass' type of royalty underpayment claim. The Court reasoned that, as in *HECI*, the royalty owners could look to their lessees for information. Namely, in this royalty underpayment claim, the royalty owners could have, pursuant to § 91.504 of the TEXAS NATURAL RESOURCES CODE, requested that the lessee explain any deductions or adjustments that were not explained on the royalty check attachments and that the lessee was required, pursuant to § 91.505, to respond to that request by certified mail within thirty days of the request.

The Court was not persuaded by Glass' summary judgment proof that Glass had asked the lessee for that information and had been assured that the charges were only 12¢ per Mcf, when in fact those fees were much higher. The Court held that while such alleged misrepresentation might toll limitations based upon fraudulent concealment, that doctrine was separate from the discovery rule. Moreover, even if there was fraudulent concealment, which the Court did not decide, that evidence is case specific to the case at bar and does not effect the categorical determination of whether the injury of underpayment of royalties based upon excessive or improper charges is a category of case in which the injury is inherently undiscoverable.

The Court also rejected the royalty owners' argument that, under *HECI*, unless the information about an injury is available from a public source, a claimant cannot, in the exercise of due diligence, be expected to discover the injury. That is, the royalty owners argued that if the information is not publicly available and if the lessee is the sole source of the information, then under *HECI*, the injury is inherently undiscoverable. In rejecting this argument, the Court stated that, "we did not imply that an injury is inherently undiscoverable if it cannot be detected by examining public records."[24] The reason being, the royalty owners could have sought information from their lessee or in this instance, the gas gatherer and the gas purchasers. Thus, the Court stated: "there were several sources of information available to Horwood and Glass from which they could have

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[21] *Id.*

[22] *Horwood*, 58 S.W.3d at 735.

[23] *Id.* at 736 (emphasis added).

[24] *Id.* at 736.

discovered the propriety of post-production charges."[25]

Further, the Court rejected the royalty owners' argument that they should not have to bear the burden of discovering their injuries. The Court reasoned that expecting royalty owners to discover improper charges is no more burdensome than expecting software companies to discover the theft of their trade secrets. *See*, *Computer Associates Int'l, Inc. v. Altai, Inc.*, 918 S.W.2d 453, 457 (Tex. 1996). Most tellingly, however, the Court held that: "those who receive statements listing fees charged should be alerted to the need to perform additional investigations to protect their interests."[26] The Court held that Glass did just that by hiring a consultant who, in 1982, using the royalty statements and other information available to him, determined that Glass had been overcharged.

The Court's holding places a heavy burden on royalty owners to investigate and to pursue claims against their lessees for underpayment of royalties based upon post-production charges and, by extension, all underpayment of royalty claims. The Court's reasoning is subject to criticism for suggesting that lessees will be forthcoming with information, in a form, understandable to the average royalty owner as to the deductions and charges levied against royalty owners – even the information that lessees are obligated to provide under NATURAL RESOURCES CODE § 91.500, *et seq.* Nevertheless, to protect his rights, the lessor must formally request an explanation of all post-production charges. If the lessee fails to respond, or to fully respond, the lessor must then decide whether to file suit or not. Otherwise, the lessor's claims will be barred by the statute of limitations and restricted to those claims that have accrued within four years of the date that suit was filed. On the other hand, if the lessee's explanations are direct and clear, the lessor must then check the reasonableness of those charges by learning what other operators are charging. If in doing so, the lessor determines the charges are reasonable, the lessor will forego filing suit. Based upon *Horwood*, however, if the lessee is later found to have misrepresented the nature of, or the amount of, those charges, the lessor can file suit but must plead and prove the more burdensome fraudulent concealment exception to toll the statute of limitations.

Further, the Court is unrealistic in contending that gas gatherers and gas purchasers are a source of information to royalty owners. First, royalty owners do not have a contract with the gas gatherers and purchasers. Second, there is no common law or statutory duty for the gas gatherer or purchaser to provide any information to royalty owners. Third, gas gatherers and purchasers would, almost certainly, refuse to provide any information to the royalty owners unless compelled to do so in response to a formal discovery request or a trial subpoena.

Irrespective of the burden on royalty owners, *Horwood* results in a broad limitation of the discovery rule to oil and gas contract claims. As it did in *HECI,* the Supreme Court refused to hold that the discovery rule does not apply to all breach of contract cases. Instead, the Court essentially achieved the same result by identifying a second category of injury, underpayment of royalties, to which the discovery rule does not apply. This type of injury is often the basis for a claim of breach of the implied covenant to market, or the breach of the express royalty calculation provisions. Between the two categories of injuries identified in *HECI* and *Horwood*, the Supreme Court has arguably determined that the discovery rule does not apply to the vast majority of lessors' contract claims that could be asserted against their lessees.

(4) *Horwood v. Wagner & Brown II,* 2001 WL 223282 (Tex. App.–Austin 2001, pet denied) (not designated for publication)

In *Horwood v. Wagner & Brown II,* the Austin Court of Appeals considered the discovery rule in the context of royalty owners' claims to recover a portion of the proceeds their lessee, Wagner & Brown ("W&B"), obtained in three lawsuits that W&B had prosecuted against its gas purchaser. The royalty owners relied on the applicable royalty clause in their leases that required W&B to pay royalties on the market value of gas sold or used off the premises or in the manufacture of gasoline, and for gas sold at the wells, the amount realized from the sale. For purposes of this article, the relevant lawsuit involved a claim of wrongful curtailment W&B

[25] *Id.* at 737.

[26] *Id.*

filed in March 1985 against Valero Transmission Company ("Valero").[27] W&B and Valero were parties to a gas purchase agreement containing a take-or-pay clause. W&B's gas was categorized as high priority under the RRC's priority system requiring that certain types of gas purchasers must take the volumes specified in their gas purchase contracts if the pipelines employed have limited capacity. When Valero's line reached capacity, it failed to follow RRC rules and continued taking lower priority gas. W&B prevailed and final judgment was entered against Valero who paid $7.1 million in damages. In November 1991, the royalty owners filed their lawsuit against W&B seeking a portion of this judgment under theories of breach of the express royalty provisions of their leases, breach of implied covenants and unjust enrichment.

Relying on *HECI,* the Court of Appeals examined the royalty owners' claims against W&B and determined their injury resulted from the wrongful curtailment by Valero, and thus the royalty owners' causes of action accrued concurrently with the accrual of W&B's cause of action against Valero.[28] The Court then misconstrued *HECI* as holding that injuries to royalty owners "resulting from a third party's failure to follow RRC rules, were not inherently undiscoverable and the discovery rule could not be used to overcome a limitations deficiency."[29] To the contrary, the Supreme Court stated in *HECI*, and again in *Wagner & Brown v. Horwood*, that its *HECI* opinion was limited solely to the category of injuries caused by damage to a common reservoir.[30] Manifestly, *HECI* does not hold that the discovery rule is inapplicable to all claims for injuries caused by a third party's failure to follow RRC rules that are not covered by the discovery rule.

Although it's an unpublished opinion, *Wagner & Brown II* will likely be cited by lessees to further restrict the application of the discovery rule by asserting that royalty owners are obligated to exercise reasonable diligence to protect their interests from third parties with whom their lessee contracts. Under such a broad interpretation of *HECI,* royalty owners would be required to request information from their lessees concerning the lessee's contractual arrangements with pipelines, processors and purchasers. As previously noted, those requests for information will, almost certainly, be refused or ignored. Royalty owners must then shoulder the onerous burden of determining how to protect their interests in view of a future argument by their lessee that ***any*** claim the royalty owner brings that can be traced to ***any*** failure by a ***third party*** to follow RRC rules is barred by limitations.

(5) Hutchison v. Union Pacific Resources Co., 2001 WL 1337888 (Tex. App.–Austin 2001, pet denied) (not designated for publication)

In *Hutchison v. Union Pacific Resources Co.,* Hutchison was the owner of a one-half mineral interest in an 80 acre tract that Union Pacific Resources Co. ("Union Pacific") claimed that it had under lease during the period relevant to this dispute. In August 1992, Union Pacific drilled a horizontal well that Hutchison claimed traversed a part of the Hutchison tract. The well produced until April 1994, and Union Pacific plugged the well in October 1994. Thereafter on April 10, 1996, a general partnership, Cer-Mor-Leb, who owned an interest in Union Pacific's lease, assigned its interest in the proceeds from the well to Hutchison. Hutchison filed suit against Union Pacific on July 26, 1996 claiming that the lease held by Union Pacific was void *ab initio*, because it violated the rule against perpetuities. Thereby, Hutchison claimed that her interest in the 80 acre tract was not leased, and as an "un-leased and un-pooled mineral owner," she sought one-half of the entire commingled production from the well, contending that Union Pacific could not establish the percentage of the total unit production attributable to Hutchison's 80 acre tract.

The trial court found that the lease was ambiguous as to when the parties intended the lease to take effect and submitted the ambiguity issue to the jury. The jury answered the lease ambiguity question in favor of Union Pacific and did not reach any of the damage questions. The trial court entered judgment that Hutchison take nothing – from which judgment Hutchison appealed, and Union Pacific filed cross points in support of the trial court's judgment.

[27] The other two lawsuits were filed at times such that the statute of limitations was not an issue.

[28] 2001 WL 223282 at *3.

[29] *Id.* at *4.

[30] *See HECI,* 982 S.W.2d at 887; *Wagner & Brown v. Horwood,* 58 S.W.3d at 736.

The Austin Court of Appeals affirmed the trial court's judgment – not based upon the jury's verdict – but on different grounds, *i.e.*, that Hutchison's claims were barred by limitations, because the discovery rule did not apply. The Court held that even if the lease was void *ab initio*, Hutchison's claim for half of the proceeds from the well was essentially a claim for trespass and conversion, each of which carry a two year statute of limitations. Relying on *HECI* and circular logic, the Court reasoned that since damage to a common reservoir is discoverable, so too is a trespass claim accompanied by an accusation of conversion as to the common reservoir.

> If in the exercise of reasonable diligence a party could generally discover an injury, or facts that could lead to an indication of an injury, the [discovery] rule should not apply. For example, damage or drainage to a common oil or gas reservoir is not an inherently undiscoverable injury. ***Often the act of conversion implies a necessary trespass to complete a taking. A trespass claim accompanying an accusation of conversion, then, would also not be inherently undiscoverable.***[31]

In support of its analysis, the Court stated, "reasonable diligence may include taking such actions as using the records of the RRC regarding production in a given field to ascertain whether ones interest might be in jeopardy."[32] It is unclear how a royalty owner would be able to determine if a well was improperly bottomed on his land from just reviewing the production records on file with the RRC. Unfortunately, the Court's opinion does not disclose whether or not the trial court record contained a directional survey of the well that was filed with the RRC that showed the well penetrated the Hutchison tract.

It appears the real reason for the Court's holding that the discovery rule was inapplicable is this statement:

> In the circumstances of this case, Hutchison was aware of operations that might affect her interests in this acreage, as this is the fourth in a series of suits against Union Pacific Resources, affecting various permutations and combinations of Hutchison's interests in this field.[33]

Unfortunately for royalty owners, the Court's holding may provide some authority for the proposition that the discovery rule does not apply to categories of injuries sustained from a combination of trespass to the mineral estate accompanied by the conversion of oil and gas produced from the mineral estate. Under the Court's reasoning, the discovery rule is inapplicable even if the trespass and conversion were accomplished by a surreptitiously drilled "slant hole" well that was intentionally deviated to trespass upon an adjoining tract. Such a result is, of course, absurd.

(6) *Taub v. Houston Pipeline Co.*, 75 S.W.3d 606 (Tex. App.–Texarkana 2002, pet denied)

In *Taub v. Houston Pipeline Co.*, the Taubs were surface owners of a tract of land covered by oil and gas leases owned by Houston Pipeline Co. ("HPL"). The Taubs were "sophisticated and active participants in oil and gas matters."[34] Because the field had been substantially depleted, HPL's predecessor wanted to use the reservoir underlying the Taubs surface for gas storage. This required a partial release of acreage by the lessee and a surface use agreement (the "Collateral Agreement"), that was executed on September 15, 1966, under which HPL was limited to the use of 2 acre surface sites around each well location and related surface easements. Pursuant to the Collateral Agreement, after September 1, 1972, to the extent that any site was not used by HPL for 365 consecutive calendar days, HPL's right to the site terminated, and HPL had 90 days to "plug and cement any well, remove all equipment and facilities, level and clean the surface, and file an instrument acknowledging termination."[35]

HPL did not use two of the sites, the 4M and 5M well sites, for 365 consecutive days from February 1, 1988 to January 31, 1990, but HPL did not plug and abandon the well on the 5M site until April 8, 1994. HPL also failed to give the

31 *Id.* at *3.
32 *Id.*

33 *Id.*
34 75 S.W.3d at 620.
35 *Id.* at 612-13.

Taubs notice as required under the Collateral Agreement. As a result, the Taubs claimed they were not aware of the termination of the 5M site as of January 31, 1990. In 1993, HPL assigned its nonstorage rights to Enron who intended to drill a new well near the 5M site. As a result of HPL's partial release of acreage, Enron had to enter negotiations with the Taubs for a surface use agreement for the new well site. In furtherance of the transaction, Enron offered to obtain a release from HPL of the 5M site. The Taubs agreed and executed a new surface use agreement with Enron on June 22, 1994. Thereafter, Enron drilled two wells on its site. Henry Taub testified that had he known that the 5M site had previously terminated, he would not have agreed to the surface agreement with Enron.

In addition, in July 1998, HPL removed a 12-inch pipeline located on two other sites, the 6M and 7M sites, replacing it with a 20-inch pipeline – an action the Taubs claimed was not authorized under the Collateral Agreement. For reasons not stated in the opinion, on May 8, 1996, the Taubs, HPL and Enron entered into an agreement tolling limitations for any litigation brought by the Taubs.

On December 4, 1998, the Taubs sued HPL for trespass, for breach of the Collateral Agreement, and for fraudulently inducing the Taubs to enter into the surface use agreement with Enron. The trial court granted HPL's summary judgment on all of the Taubs' claims, and on appeal, one of the primary issues was whether the discovery rule applied to toll limitations beyond the date contemplated by the parties' tolling agreement.

The Taubs asserted that the discovery rule applied to toll the four year statute of limitations applicable to their breach of contract claim beyond May 8, 1996.[36] The Court held that the alleged trespass was not inherently undiscoverable, because it involved oil and gas operations, or lack thereof, on the surface of the land. In affirming the trial court's summary judgment, the Court stated: "Diligence is required by the owner of the surface as to the operation of oil and gas leases, particularly where operation or lack thereof at the lease site is legally significant."[37] The Taubs argued that the surface activities were such that visual observations would not lead one to discover that HPL's surface rights had terminated. Relying on *HECI*, the Court held that the Taubs had a duty to go beyond just visual observation and were required to make inquiries to HPL regarding its activities on the disputed well sites. As a result, the fact that HPL's surface rights had terminated was not inherently undiscoverable. For the same reasons, the Court refused to apply the discovery rule to the Taubs' trespass claim.[38]

Taub is another example of a Court using *HECI* to make a fact specific, versus a categorical, determination that the discovery rule does not apply.

(7) *Funk v. Devon Louisiana Corp.*, 2005 WL 2560107 (Tex. App.–Corpus Christi 2005, pet denied) (mem. op.)

Six years after its *Hay v. Shell* decision, the Corpus Christi Court of Appeals decided another bad faith pooling case. In *Funk v. Devon Louisiana Corp.,* Texas Eastern Exploration Company ("TEE") was the lessee under an oil and gas lease covering the Funk land on which it began drilling a well on August 14, 1983. Nine days later, TEE entered an oil and gas lease with the Whittingtons covering 673.8 acres adjacent to the Funk lease. TEE pooled portions of both leaseholds – 179.9 acres of the Funk tract and 149 acres of the Whittington tract – and filed a Declaration of Unit in December 1984. From 1984 to 1997, the working interest transferred hands four times, and on two occasions in 1993 and 1997, the Funks executed ratifications of their lease. Thereafter, the working interest was transferred four more times ending up in the hands of Devon. On November 13, 2000, the Funks filed a lawsuit against TEE, and all subsequent lessees, asserting that the Unit was formed in bad faith resulting in a reduction of their royalty share of the oil and gas produced from the unit well. The trial court granted summary judgment for the defendants, and on appeal, the primary issue addressed by the Court of Appeals was whether the discovery rule applied to the Funks' claims.

Relying on its opinion in *Hay v. Shell*, discussed above, the Court determined that the Funks' injury occurred in 1983 at the time of the pooling of productive lands with nonproductive

[36] *Id.* at 618.

[37] *Id.* at 619.

[38] *Id.* at 620-21.

lands.[39] The Court then framed the issue for decision as follows:

> Accordingly, the question here is not whether the Funks detected the alleged improper pooling and resulting underpayment within the limitations period. Rather, the categorical question is whether theirs is "the type of injury that generally is discoverable by the exercise of reasonable diligence."[40]

In *Hay*, the Court determined that the injury was not objectively verifiable. In *Funk,* the Court addressed only the inherently undiscoverable prong of the test. The Court identified the category of injury, *i.e*., the improper pooling of unproductive acreage with productive acreage, and determined it was not inherently undiscoverable. The Court noted that in attempting to establish bad faith pooling, the Funks' expert relied upon and cited records on file with the RRC, including well logs and structure maps. The Court held that these records were available to the Funks "as early as January 1986 and perhaps before."[41] In addition, the Court stated that the Funks knew or should have known that their lands were pooled when they received their diminished royalty checks in 1984, or when they signed division orders in 1985.[42] Relying on the *HECI* decision, which stated that royalty owners cannot be oblivious to the existence of a common reservoir, the Court held that royalty owners likewise "cannot be oblivious to available public records and other available information indicating the ***non-existence*** of a common reservoir."[43]

Given the *HECI, Hay* and *Funk* decisions, it seems unlikely that a Court will apply the discovery rule to bad faith pooling cases. In a bad faith pooling case, such as *Hay* and *Funk,* the lessor/royalty owner must prove that some portion of the acreage pooled is unproductive. Under *Hay*, to meet the objectively verifiable prong of the test, the parties' experts must be "near consensus" that some of the acreage is unproductive. In almost all bad faith pooling cases of this type, the issue as to whether or not the lessee has knowingly included unproductive acreage in the unit will turn upon hotly contested and conflicting expert testimony.[44] Thus, under *Hay*, the discovery rule is inapplicable in virtually all bad faith pooling cases.

Funk focuses on the inherently undiscoverable prong and 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 RRC records. Although the Court of Appeals did not expressly hold in either *Hay* or *Funk* that the discovery rule is inapplicable to the entire category of bad faith pooling cases, as a practical matter, it appears unlikely that the rule will be applied in any bad faith pooling case.

(8) *Kerlin v. Sauceda,* 263 S.W.3d 920 (Tex. 2008)

Almost ten years after issuing its opinion in *HECI,* the Texas Supreme Court further explained its holding in *HECI*. In *Kerlin,* the heirs of Juan Jose Balli ("Balli") filed suit against their attorney and trustee, Gilbert Kerlin ("Kerlin"), alleging Kerlin defrauded them of oil and gas royalties in Padre Island. Balli was recognized in 1829 by the State of Tamaulipas, Mexico as part owner of Padre Island. In 1830, Balli conveyed his interest to Santiago Morales ("Morales"), but later the two men signed a rescission agreement, because Morales was concerned about Balli's title. Nevertheless, Morales later mortgaged part of the interest and conveyed the rest to another party. By 1900, through multiple conveyances and adverse judgments – one of which was *Havre v. Dunn* in Cameron County on June 29, 1928 – a federal court had ruled that Balli, and thus his heirs, no longer held title to any part of the island.

In 1937, Kerlin's uncle, Frederick Gilbert ("Gilbert"), was contacted by several individuals who informed him of the Balli/Morales rescission agreement. Gilbert formed a partnership to pursue a claim to recover title to

39 2005 WL 2560107 at *2.

40 *Id.* at *3.

41 *Id.*

42 *Id.*

43 *Id.* (emphasis added).

44 In other types of bad faith pooling cases, such as claims of gerrymandering the unit or pooling a lease for the sole purpose of extending the lease, it is unlikely the discovery rule would apply given that a lessor will be charged with knowledge of the terms of his lease, will typically receive ratifications of a unit and has access to public records, including the RRC form P-12 and unit declaration.

Balli's interest, and asked Kerlin to travel to South Texas and purchase the Balli heirs' interests. Kerlin was successful in obtaining warranty deeds from the Balli heirs; those deeds reserved a 1/64th of a 1/8th royalty interest in the heirs. Kerlin and Gilbert then had their attorney file a motion for new trial and cross action in the *Havre v. Dunn* suit naming as plaintiffs Kerlin and the Balli heirs, among others.

The Balli heirs were never informed of the lawsuit. A settlement was ultimately reached and a hearing was held to approve the settlement on November 9, 1942. A stipulation of settlement was filed which granted Kerlin mineral interests in 1,000 acres of Padre Island and fee simple title to 20,000 acres in the southern portion of the island. Kerlin executed reconveyance deeds to the Balli heirs, but the heirs were never informed of the settlement or deeds, and the deeds were never recorded or delivered to the heirs. When the heirs wrote to Kerlin in 1953 inquiring as to their reserved royalty interest, Kerlin responded that he had received no title under the Balli deeds, and that Kerlin had been unable to establish that Balli owned any interest in the island. In 1961, Kerlin sold the 20,000 acres for $3.4 million and conveyed the mineral interest that he and one of his partners had received in the settlement to Kerlin's wholly owned companies, PI Corp and Windward Oil & Gas Corp.

In 1985, another Balli heir, Connie Sauceda, contacted Kerlin about the royalty interest reserved in the Balli deeds, and Kerlin informed her that the deeds were invalid. Finally, in 1993, the Balli heirs filed suit against Kerlin and his two companies claiming breach of contract, breach of fiduciary duty, fraud, and conspiracy seeking, among other things, their reserved royalty interest under the deeds. The defendants raised the defense of limitations. In response, the Balli heirs argued the defendants fraudulently concealed information from them, thus tolling limitations. The trial court and jury found in favor of the heirs on their claims, and the Court of Appeals affirmed.

In analyzing whether the limitations periods on the heirs' claims were tolled by fraudulent concealment, the Supreme Court relied on its discussion in *HECI* concerning the discovery rule. After discussing its holdings in *HECI* regarding a royalty owner's duty to seek information from his lessee, from RRC records and from visible operations on adjoining property, the Court stated that fraudulent concealment and the discovery rule require a plaintiff to exercise reasonable diligence to discover the alleged wrong.[45] To that point the Court stated that:

> Like fraudulent concealment, the discovery rule does not apply to claims that could have been discovered through the exercise of reasonable diligence. While the discovery rule differs from fraudulent concealment in that its applicability is determined on a categorical basis, *HECI* is nevertheless instructive in this case.[46]

Turning to the facts of the case, the Court found that (i) the heirs were previously advised by Kerlin that their claims were worthless, (ii) that the *Havre v. Dunn* judgment and Kerlin's receipt of their interest was a matter of public record, and (iii) that the heirs knew they held a reserved royalty interest but never received any royalties.[47] The Court reasoned that had the Balli heirs exercised reasonable diligence, they could have discovered their claims before the limitations period ran. Accordingly, the Court held the Balli heirs could not rely upon fraudulent concealment to toll limitations on their claims.

The *Kerlin* Court made it clear that irrespective of whether the discovery rule applies or whether the statute is tolled by virtue of fraudulent concealment, the statute of limitations begins to run when the claimant learns, or by the exercise of reasonable diligence, should have learned of the injury. That is, neither the discovery rule nor the doctrine of fraudulent concealment precludes the running of the statute of limitations indefinitely. The determination of that date, in most instances, will present a fact question, and *HECI* lists the types of evidence that should be useful in determining that fact question. In other words, the analysis again becomes fact specific, rather than categorical.

The Supreme Court recently applied this analysis, under review of a no-evidence point, to

[45] 263 S.W.3d at 926.
[46] *Id.* at 926-27.
[47] *Id.* at 927.

set aside a jury's determination of the date that the claimants knew or should have known of their injury, and found that date was established by what the Court determined to be undisputed evidence (which had been considered by the jury), on a date earlier than that found by the jury. The Supreme Court, therefore, held that claims were time barred under the applicable statutes of limitation. *See, Exxon Corporation v. Miesch*, *infra*.

(9) Exxon Corporation v. Miesch, 2009 WL 795668, 52 Tex. Sup. J. 467 (March 27, 2009)

In *Exxon v. Miesch*, the Supreme Court reversed the Court of Appeals decision that the discovery rule applied and held that, as a matter of law, the Miesches had actual knowledge of their claims prior to two years before they filed suit. Their claims were, therefore, time barred under the two year statute of limitations.

Emerald Oil & Gas, Inc. ("Emerald"), as the subsequent lessee, brought suit against the Miesches' former lessee, Exxon Corp. and Exxon Texas, Inc. ("Exxon") for wrongful conduct in the development and abandonment of wells in the Mary Ellen O'Connor Field in South Texas. The Exxon leases included a 50% royalty obligation to the Miesches. Adjacent leases operated by Quintana, and in which Exxon owned an interest, had much lower royalty obligations. In the early 1970s, Exxon requested that the Miesches agree to amend the leases and lower the royalty obligation, because Exxon contended that the leases, burdened with a 50% royalty, were no longer economic for Exxon to operate. Negotiations ensued, information was provided by Exxon to the Miesches to review and various proposals were made, but ultimately an agreement could not be reached.

As a result, Exxon plugged and abandoned the Miesch wells by August 16, 1991. Thereafter, Emerald leased a portion of the field previously operated by Exxon. In its attempts to reenter some of the wells plugged by Exxon, Emerald discovered junk in the wellbores, cut casing and plugs in the wellbores in places different than those that were identified by Exxon in its W-3 Plugging Reports that it filed with the RRC. Emerald obtained well logs from Quintana on the subject wells and determined that the plugging procedures in the well logs also differed from those described in Exxon's W-3s. Emerald determined that 80-90% of Exxon's W-3s inaccurately described the status of the wells. Emerald also spoke to some of the individuals who were involved in Exxon's plugging procedures. Based on this investigation and its own experts' analyses, Emerald determined that Exxon had deliberately sabotaged the wells. After Emerald brought suit against Exxon, the Miesches intervened in August and September 1996, asserting claims for waste, negligence per se, tortious interference and breach of the implied covenant to develop.

At trial, Exxon asserted that all of the royalty owners' claims, except breach of contract and fraud, were barred by the two year statute of limitations. The royalty owners pled the discovery rule and fraudulent concealment. The trial court entered a directed verdict for Exxon on Emerald's remaining claims and all of the royalty owners' claims except common law and statutory waste and breach of the lease. 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, which was the date that Emerald informed the royalty owners of the full extent of Exxon's damages to the well and "numerous discrepancies" in Exxon's well plugging reports to the RRC.

Based upon the jury's verdict, the trial court overruled Exxon's limitations defense. The jury also found for the royalty owners on the other liability question and awarded $5 million in actual damages for waste, $10 million in punitive damages for waste, and $3.6 million in damages for breach of the lease. The trial court entered judgment for the royalty owners based upon that jury verdict.

On appeal, Exxon argued that limitations barred the Miesches' waste claim[48] arguing that the Miesches should have learned of their injury by August 16, 1991 when Exxon completed plugging the wells; that the Miesches' alleged injury was temporary as opposed to permanent, and therefore the discovery rule did not apply; that their injury was discoverable from public documents and an inspection of the premises, among other available sources; and that, because

[48] The Miesches relied on fraudulent concealment to toll their breach of the implied covenant to develop claim.

the amount of the alleged damages were the subject of conflicting expert testimony, the injury was not objectively verifiable.[49]

In addressing these arguments, the Corpus Christi Court of Appeals first determined that the injury at issue was waste of hydrocarbons which carries a two year statute of limitations.[50] The Court of Appeals held that the discovery rule "may apply" regardless of whether the injury is temporary or permanent and that, in any event, the distinction between temporary and permanent injury to land does not apply in the context of waste of hydrocarbons and breach of contract.[51]

Citing *HECI* for the proposition that the essential issue is whether waste is a category of injury to which the discovery rule applies, the Court of Appeals addressed the first prong of the test – whether the waste was inherently undiscoverable. The Court stated that the royalty owners "need not prove that the injury was impossible to discover, but only that it was difficult to learn of the injury."[52] The Court held that, although, typically, royalty owners can look to the lessee or records on file with the RRC to discover their injuries, in this case they could not have done so, as "[d]amage to subsurface wellbores cannot be determined by visual inspection or even a review of publicly available records."[53] Turning to the objectively verifiable prong of the test, the Court held that there was substantial objective evidence proving the injury: cut casing, junk in wellbores, plugs and other obstacles in the wellbores that should not have been there.[54] Based upon that objectively verifiable evidence, the Court rejected Exxon's arguments that the conflicting expert testimony precluded the application of the discovery rule.

Miesch exemplifies the difficulty that lessor-royalty owners face in obtaining information from its lessee as to operations on the lease. To that point the Court of Appeals stated that:

> Exxon initially refused to provide the royalty interest owners information on grounds that it was proprietary, then that the information would be too difficult to locate and retrieve, and finally, that the information would be made available only if a confidentiality agreement were signed.[55]

Although Exxon finally provided the Miesches with a reading room containing much of the requested information, as the Court of Appeals noted:

> The reading room, however, did not contain all information on the field: Exxon did not include any interpretive data and did not include all of the well logs for the field.[56]

The Miesches hired a consultant well-known to many oil and gas litigators, George Hite, to review the information in the reading room. Hite testified that the reading room did not contain information on certain productive zones. This data, as well as some other, was not provided by Exxon until formal discovery.[57]

The Miesches' problems in obtaining information from their lessee are representative of the problems that most lessor/royalty owners face in obtaining information from their lessees.

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[49] *See Exxon Corp. v. Miesch*, 180 S.W.3d 299, 313 (Tex.App.–Corpus Christi-Edinburg 2005), *aff'd in part, rev'd in part,* 2009 WL 795668.

[50] *Id.* at 314.

[51] *Id.* at 315.

[52] *Id.*

[53] *Id.* The Court later discussed when a royalty owner may be deemed to have knowledge of wellbore damage and waste. Exxon argued that even if the discovery rule applied, the Miesches knew or should have known of their injury more than two years before filing suit, focusing on a June 1994 letter from Emerald informing the Miesches that they were having problems reentering 14 of the 121 wells in the field. The Court determined that "the discovery rule tolls limitations until the [Miesches] knew of enough damage to know that the problems regarding wells were not isolated." ***Id.* at 317.** Accordingly, the Court was "not willing to say that finding a few isolated problems on a small number of the wells that had been reentered to date establishes field-wide knowledge regarding systemic damage to some numerous wells as a matter of law." *Id.*

[54] *Id.* at 316. The court also held for the same reasons that the discovery rule applied to toll Emerald's negligent misrepresentation claim against Exxon, finding that Emerald knew or should have known of its claim in January 1995 when it obtained information from Quintana that Exxon previously would not and did not provide. *Id.* at 338.

[55] *Id.* at 311.

[56] *Id.*

[57] *Id.*

Moreover, lessees will almost always refuse to provide interpretative information, including geologic and seismic maps, and engineering reports, unless and until required to do so in formal discovery. This interpretive information is often the most important information in determining a lessee's true opinions as to the matter in dispute.

The Supreme Court granted Exxon's petition for review and reversed the Court of Appeals holding that "irrespective of whether fraudulent concealment or the discovery rule tolls any portion of an applicable limitations period", as a matter of law, Emerald and the Miesches had actual knowledge of the claims, which were subject to a two year statute of limitations, more than two years before Emerald and the Miesches filed suit. Thus, those claims are time barred.[58] The Supreme Court, thereby, disregarded the jury's factual determination that January 24, 1995 was the date that the royalty owners discovered, or in the exercise of reasonable diligence, should have discovered, the waste committed by Exxon.

In setting aside the jury's verdict on the date of the accrual of the Miesches' causes of action, the Supreme Court relied upon two letters – one dated September 12, 1990 from the royalty owners to Exxon and the other dated June 8, 1994 from Emerald to the royalty owners. In their September 12, 1990 letter to Exxon, the royalty owners explained to Exxon that "plugging and abandonment of the referenced wells would commit waste and would be contrary to public policy and laws", that the letter "shall also be considered as formal demand not to plug the above referenced six wells", that the royalty owners have "located a group of oil and gas companies willing to accept the plugging obligation", and that Exxon would be sued for waste and violation of the law if it plugged the wells. In its June 8, 1994 letter, Emerald told the royalty owners that Exxon had cut casing and dumped junk in the wells that Exxon had plugged.[59]

The Supreme Court held that the legal significance of the undisputed evidence of the two letters could not be ignored by the Court of Appeals and jury.[60] The Supreme Court then, pursuant to its no-evidence review, 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 interests . . . in 1990 and 1994."[61]

The Supreme Court further held that there was no evidence to support the royalty owners' claim that the lease was not fully developed and rendered judgment that the royalty owners take nothing on its breach of lease – development claim.[62] The Supreme Court, on other grounds, affirmed the Court of Appeals' judgment reversing the trial court's directed verdict with respect to the fraud claim and remanded that claim to the trial court for further proceedings.[63]

***(10) DDD Exploration, Inc. v. Key Production Co, Inc.* 2009 WL 1159154 (N. D. Tex. – Amarillo Div. 2009) (interpreting Texas law)**

In *DDD Exploration*, an oil and gas operator, DDD Exploration, Inc. ("DDD"), sued Key Production Co., Inc. ("Key") who operated a commercial saltwater disposal well adjacent to DDD's 91.375 acre Evans Lease, for alleged damages to DDD's Evans No. 1 Well caused by Key's allegedly wrongful injection of large volumes of saltwater into the common reservoir. Specifically, DDD brought causes of action against Key for trespass, negligence, negligence per se, common law waste, statutory waste, statutory violation of TEX. ADMIN. CODE § 3.46, misrepresentations made to the RRC, and violation of the RRC's saltwater disposal permit.

58 The trial court granted Exxon's summary judgment against Emerald on its claims for breach of duty to plug the wells properly, breach of a duty to avoid committing waste, and negligence per se. In granting Exxon's motion, and severing those claims, the trial court reasoned that Exxon owed no duty to Emerald as a subsequent lessee. Emerald appealed the trial court's summary judgment and severance orders; the Corpus Christi Court of Appeals reversed and remanded Emerald's claims to the trial court. The Supreme Court granted Exxon's petition for review, and in a companion opinion, reversed the Court of Appeals and rendered judgment that Emerald take nothing on its claims against Exxon. *Exxon Corp. v. Emerald Oil & Gas Company, LLC*, 2009 WL 795760, 52 Tex. Sup. J. 462 (March 27, 2009).

59 2009 WL 795668 at *1-2.

60 *Id.* at *4.

61 *Id.*

62 *Id.* at *7.

63 *Id.* at *10.

In 1998, Key drilled its Nichols Unit No. 1 Well ("Nichols Well") in the Chappel formation in Hardeman County, Texas; the well was a dry hole. In 2000, Key decided to convert the Nichols Well to a commercial saltwater well and made an application to the RRC for a permit to convert the well. On March 23, 2000, the RRC granted Key a permit to dispose of up to 15,000 barrels per day of saltwater into the well. In its permit application, Key represented to the RRC that the Chappel formation into which Key would inject the saltwater was not productive of oil or gas.

In April 2004, DDD took the Evans Lease, which adjoined the Key saltwater disposal well. In May 2005, DDD drilled the Evans Unit No. 1 Well, which was a dry hole. In February 2006, DDD sought a Rule 37 spacing exception from the RRC to allow DDD to drill its Evans No. 1 Well ("Evans Well") nearer to its lease line than would otherwise have been allowed under the applicable spacing rules, hoping to gain 100 feet of structure to the highest well in the field in the Chappel formation. In May 2006, DDD completed the Evans Well, which was located only 300 feet from the Nichols Well.

The Evans Well came in approximately 89 feet higher on structure than the previous highest well in the field, but it was unsuccessful and produced almost entirely saltwater. On November 8, 2006, the RRC 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 as represented by Key on its permit application. At the time of trial, the Evans Well was producing about 18-20 barrels of oil per month, and its rate of production had not changed since Key ceased injecting water into the Nichols Well.

DDD filed its action against Key on January 2, 2008, amended that action on March 5, 2008 and had Key served with the amended complaint on March 13, 2008. DDD claimed that the Nichols Well and Evans Well were in pressure communication, and that the saltwater injected into the Nichols Well drowned the reservoir underlying the Evans Well.

The Court refused to apply the discovery rule and 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's claims were, at their core, claims for damage to a common reservoir, which *HECI* has held are not a category of claim to which the discovery rule applied. Further, the Court held that, although some claims for damages to the common reservoir might not be quickly discovered, "this isolated fact does not alter the reality that in most cases, reservoir damage is capable of detection within the time allocated for bringing suits."[64]

The Court further held that DDD did not act with reasonable diligence, as required by the discovery rule, which only defers the accrual of a cause of action until the claimant knows, or by exercising reasonable diligence, should know of facts giving rise to the claim. Specifically, the Court stated that:

> Before DDD started drilling the DDD-Evans Unit # I in May, 2005, it was aware that the RRC had granted Key a permit to use the Nichols No. 1 Well for saltwater disposal. The permit and permit application were a matter of public record.
>
> * * *
>
> Similarly to HECI, knowledge of saltwater pumping, along with RRC records, are sufficient for knowledge of an injury, or at least sufficient to give rise to a reasonable cause to investigate whether an injury has taken place. The failure to investigate such an injury in a timely manner shows a lack of diligence on the part of DDD and the mineral rights owners.[65]

Further, the Court held that the claims were not objectively verifiable. The Court reasoned that the discovery rule required that the injury be objectively verifiable so that the policy underpinnings of the statutes of limitations are met by balancing the possibility of stale or fraudulent claims against individual injustice. Citing *S.V. v. R.V.*, 933 S.W.2d 1 (Tex. 1996) and *Robinson v. Weaver*, 550 S.W.2d 18 (Tex. 1977), the Court stated:

64 2009 WL 1159154 at *5.
65 *Id.*

> While expert testimony alone does not suffice to establish that an injury is objectively verifiable for purposes of the discovery rule, recognized expert opinion on a particular subject could be so near consensus that, in conjunction with objective evidence, it could provide the verification required.[66]

The Court found that DDD's expert testimony fell well short of proving that the injury was objectively verifiable, because DDD's expert provided only hindsight evidence that the oil had migrated from underneath the Evans Well. DDD's expert did not know where it migrated, and did not know what volume of saltwater injection would be required to flush the oil from beneath the Evans No. 1. Further, he could not say how much of the alleged 210,000 barrels had been flushed from beneath the Evans Well or how much of that oil may remain under the well. Most significantly, in the Court's opinion, DDD's expert implicitly admitted that the injury was not objectively verifiable by stating in his affidavit that even though hydrocarbons are visible on a seismic map, "one cannot know in advance of drilling if any are there because 'you can't look underground and see.'"[67]

The Court also noted DDD's expert testimony as to the reserves attributable to the Evans Well were very speculative, because as of the date of the drilling of the Evans Well, there were no commercial producers located in the entire field. Further, DDD's president had estimated, before it was drilled, that the Evans Unit No. 1 would produce 500,000 barrels of oil, but it was a dry hole. The Court, therefore, held:

> 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.[68]

The *DDD Exploration* opinion seems to preclude the application 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. In virtually all of such cases the claimant's expert testimony on these issues is hotly contested by the lessee's expert 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.

IV. The Current State of the Discovery Rule in Oil and Gas Cases and Some Tentative Predictions as to its Future in Oil and Gas Cases

In the 10 years after *HECI*, there have been ten reported cases in which the Courts have addressed the application of the discovery rule to oil and gas cases – nine Texas State Court cases and one U.S. District Court case interpreting Texas law. Ultimately, not one applied the discovery rule.

The Supreme Court in *HECI*, and other discovery rule cases, teaches that the discovery rule has been applied in limited categories of cases to defer accrual of a cause of action until the plaintiff knew, or exercising reasonable diligence, should have known of the facts giving rise to a cause of action.

The discovery rule applies only in those exceptional cases when (i) the nature of the claimant's injury is inherently undiscoverable and (ii) objectively verifiable. "Inherently undiscoverable" does not mean that the particular claimant did not discover the particular injury within the limitations period. Rather, to bring particularity and uniformity to Texas jurisprudence, the *HECI* Court intended for subsequent courts to determine on a categorical, *i.e.*, as to a class of cases, rather than a fact specific, case-by-case basis, whether an injury is subject to the discovery rule. However, most courts since *HECI*, including the Texas Supreme Court, conduct a fact specific analysis in the context of each court's own interpretation of how the oil and gas industry works, leading to inconsistent analysis of the inherently undiscoverable prong.

Based upon the Supreme Court's recent holdings in *Kerlin* and *Miesch*, it is clear that before the Court even reaches its analysis of whether the case involves a category of claims that is inherently undiscoverable, it will determine whether, as a matter of law, the claimant either

[66] *Id.* at *6.
[67] *Id.*
[68] *Id.* at *7.

knew or should have known, by the exercise of reasonable diligence, of the existence of the claim at a time that bars the claim under the applicable statute of limitations. Moreover, the *Miesch* opinion shows that the Court will undertake its analysis even if a jury has found the date upon which the claimant knew or should have known of the claim. The Court seems perfectly willing to substitute its judgment for that of the jury and find, as a matter of law, the date that the claimant discovered or should have discovered their claim.

With respect to the objectively verifiable prong, virtually all oil and gas disputes involve issues of fact that require expert testimony to resolve, including lessor/lessee implied covenant cases for drainage, development, marketing and the proper administration of the lease. It is difficult to see how the discovery rule can apply in any case which turns on a fact issue that involves contested expert testimony. Under *Hay* and *DDD Exploration*, contested expert testimony does not meet the "objectively verifiable" prong of the test for the application of the discovery rule. The Supreme Court has not yet written on whether contested expert testimony can meet the objectively verifiable prong of the test, however, based on its prior decisions, it appears the Court will likely hold, as did the courts in *Hay* and *DDD Exploration*, that contested expert testimony does not meet the objectively verifiable prong of the test.

In view of the very restrictive application of the discovery rule in oil and gas cases and the knowledge and sophistication Courts are placing on royalty owners, following are some caveats that should be considered by royalty owners to protect their rights, *to wit*:

(1) Royalty owners cannot be oblivious to the existence of other operators in the area and must monitor their activities;

(2) Royalty owners cannot be oblivious to the existence of a common reservoir and must analyze whether their interests are being adversely affected by other parties' production from the common reservoir;

(3) Royalty owners are put on notice by wells visible on neighboring properties;

(4) Royalty owners know or should know that wells drilled in a common reservoir can potentially cause drainage or damage to that reservoir;

(5) Royalty owners must ask their lessee for information about the existence or non-existence of a common reservoir and the operations in that reservoir;

(6) Royalty owners are on notice of ***some, but not all,*** of the records on file at the RRC;

(7) With respect to an injury to a common reservoir, royalty owners are on notice of RRC records regarding fields in which there is competing production;

(8) With respect to bad faith pooling, royalty owners must request information from lessees regarding the productive nature of other acreage in a unit and review the lessee's filings with the RRC in that regard; and

(9) With respect to the payment of royalties, the royalty owner must carefully examine their royalty checks and insist that their lessee provide the royalty owners with the information required under TEX. NAT. RES. CODE § 91.408. Further, the royalty owners should request, in writing, such additional information from their lessees as is necessary to fully understand the entries on the royalty check stubs including the nature of, and amount of, all charges for post production costs. If appropriate, the royalty owners should also request, in writing, pertinent information from the gatherer, if any, and purchaser of the gas.

In view of *HECI* and its progeny, a royalty owner must investigate everything that concerns their royalty interests or run the very substantial risk that any claims the royalty owner may have against their lessee, or any other third party, will be time barred under the applicable statute of limitations. While this arguably advances the public policy of quieting disputes not filed within the period of limitations, it does so by placing a heavy burden upon the average royalty owner, which in Texas is a 65 year old widow.