



THE EVOLVING LANDSCAPE OF CO-TENANCY IN THE TEXAS OIL PATCH

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In Texas, along with a majority of other jurisdictions, a co-tenant may develop the mineral estate without the consent of his other co-tenants, subject to the rule of accounting. Texas courts have delivered a pair of decisions that may significantly impact oil and gas development among co-tenants.

Last year, the Texas Eleventh Court of Appeals considered an operator's obligation to pay royalties to lessors who had leased to a different party. *Devon Energy Prod. Co., L.P. v. Apache Corp.*, 50 S.W.3d 259 (Tex. App.—Eastland 2018, pet. denied).

In *Devon*, Apache and Devon were co-tenants but were unable to agree to the terms of a joint operating agreement. After Apache drilled several wells on the subject tract, Devon's lessors sued seeking payment of royalty. The court concluded that Apache did not meet the definition of "payor" in the Natural Resources Code as it had never undertaken to pay Devon's lessors. Consequently, the court held that Apache, as the drilling co-tenant, did not owe a statutory duty to pay royalties to the lessors of Devon, the non-participating co-tenant. The questions as to when Devon's lessors were entitled to payment of royalty and the effect of any royalty payments by a non-operating co-tenant were not before the court and remained unanswered.

Until now.

On March 13, 2019, the Texas Eighth District Court of Appeals issued its decision in *Cimarex Energy Co. v. Anadarko Petroleum Corp.*, 2019 Tex. App. LEXIS 1992 (Tex. App.—El Paso Mar. 3, 2019, no pet. h.).

In *Cimarex*, Anadarko and Cimarex were co-tenant working interest owners in a 440-acre tract. Anadarko operated several wells on the property and did not seek Cimarex's participation. After Cimarex unsuccessfully sought to participate in the wells, it filed suit against Anadarko seeking an accounting. The parties ultimately entered into a Settlement Agreement whereby Anadarko agreed to account to Cimarex monthly for its share of production and Cimarex obtained contractual audit rights. Both parties agreed to be responsible for paying their respective lessors, and Cimarex fully paid royalties to its lessors for their share of production from the date of first production.

Upon the expiration of the primary term of Cimarex's lease, Anadarko ceased making payments to Cimarex claiming that Cimarex's lease had terminated because such lease required production by Cimarex to extend the lease beyond the primary term. Anadarko also held top leases with Cimarex's lessors covering the subject tract.

Cimarex claimed that its lease was extended into its secondary term by production from the leased premises. Alternatively, Cimarex claimed "that it paid royalties to the lessors during the primary term based on Anadarko's production and the land, and . . . that it would be inherently inconsistent to interpret the lease to require it to pay royalties on Anadarko's production during the primary term, while not allowing Cimarex to rely on Anadarko's production to keep the lease alive into the secondary term."

The Court of Appeals rejected Cimarex's first claim relying on its holding in *Hughes v. Cantwell* that "where a mineral lease states that its primary intent is for the exploration, drilling and production of *oil and gas*, it naturally follows that the lessors' intent is to require the *lessee* [emphasis added] to, at some point in time, take action to cause production on the land" 540 S.W.2d 742, 743 (Tex. App.—El Paso 1976, writ ref'd n.r.e.). The court concluded that Cimarex was required to take steps to obtain production on the leased premises and could not rely on a co-tenant's production to extend the lease beyond its primary term.

The court also rejected Cimarex's second argument, finding nothing contradictory with interpreting the lease as requiring a lessee to make royalty payments on a co-tenant's production during the primary term of a lease while at the same time requiring the lessee to obtain its own production on the property in order to extend the lease beyond its primary term. Consequently, the court held that Anadarko was not estopped from claiming the subject lease terminated based on the lessors' acceptance of royalties during the primary term.

The potential implications of the two cases are significant. The leverage of a drilling co-tenant to negotiate joint operating agreements on terms it finds *most* favorable may have increased substantially. In addition, depending on the terms of a specific lease, a non-participating co-tenant may owe royalties to its lessors upon production obtained by a third party during its primary term but, absent a joint operating agreement, lose such lease upon the expiration of its primary term.

As a result, lessees may want to consider amending their lease forms to ensure that any production from the subject tract, irrespective of the party obtaining such production, is sufficient to extend the lease beyond its primary term and also ensure that their leases include a surrender clause.

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