GRAY REED®
ATTORNEYS & COUNSELORS

MUST AN OFFSET WELL CLAUSE BE REASONABLY CALCULATED TO PREVENT DRAINAGE? NOT IN THE EAGLE FORD, ACCORDING TO THE TEXAS SUPREME COURT.

by Charles Sartain, Chance Decker and Ethan Wood
Gray Reed & McGraw LLP

On June 1, 2018, the Texas Supreme Court issued a sharply divided opinion in *Murphy Exploration & Production Co. — USA v. Adams*[1]. In *Murphy*, the Court held that an offset well clause did *not* require the lessee to drill wells reasonably calculated to protect against drainage from the neighboring tract. In a stinging dissent, four justices argued the majority disregarded the well-established meaning of the term "offset well" as used in the Texas oilfield for decades. This case may have far-reaching implications for years to come. Here's what you need to know.

THE FACTS

In 2009, Murphy entered into two oil and gas leases in Atascosa County with the plaintiffs the Herbsts, which contained identical offset well clauses:

> … [I]n the event a well is completed as a producer of oil and/or gas on land adjacent to and contiguous to the leased premises, and within 467 feet of the premises covered by this lease, that Lessee herein is obligated to . . . commence drilling operations on the leased acreage and thereafter continue the drilling of ***such off-set well or wells*** with due diligence to a depth adequate to test the same formation from which the well or wells are producing from the adjacent acreage.

When a well on a neighboring tract triggered the clause, Murphy drilled a well on the Herbts' tract 2,100 feet from the triggering well. It was undisputed this well would not prevent drainage from the Herbsts' tract. Thus, the Herbsts argued the well did not satisfy the offset well clause because it was not designed to protect against drainage. The Herbsts did not contend Murphy's offset well was required to "actually" protect against drainage and never stated how close to the triggering well the offset well was required to be. Rather, the Herbsts merely argued the offset well had to be "in close proximity to the lease line adjacent to the tract where the triggering well was drilled," and that Murphy's purported offset well was not close enough.

In response, Murphy argued the well satisfied the offset well clause because it was drilled on the leased premises to the same depth as the triggering well, which Murphy claimed is all the lease's explicit language required. Murphy argued that requiring an offset well to actually protect against or even be reasonably calculated to do so has no place in horizontal drilling in tight shale formations where drainage is minimal.

The trial court sided with Murphy. The appellate court sided with the Herbsts. The Texas Supreme Court granted review.

---

[1] Opinion; Briefs; Dissent

GRAY REED®
ATTORNEYS & COUNSELORS

MUST AN OFFSET WELL CLAUSE BE REASONABLY CALCULATED TO PREVENT DRAINAGE? NOT IN THE EAGLE FORD, ACCORDING TO THE TEXAS SUPREME COURT.

by Charles Sartain, Chance Decker and Ethan Wood
Gray Reed & McGraw LLP

THE RULES OF CONTRACT CONSTRUCTION

Courts interpret oil and gas leases just like any other contract. Thus, a court must read the lease, give its terms their plain and ordinary meaning, and enforce the lease as written. Courts may *not* modify a lease's explicit language absent extraordinary circumstances. However, a court *can* consider the context in which a lease was negotiated and executed to inform its interpretation of the words used in the lease. And, a court can interpret words and phrases in a contract in accordance with any special definitions those terms have in a particular industry.

THE RULING

In a 5-4 opinion, the Court held the offset well clause did *not* require Murphy to drill a well to protect against drainage from the neighboring tract, and that Murphy's well, some 2,100 feet from the triggering well, satisfied the offset well clause.

The Court's opinion was based on two important premises. First, the majority concluded that the court of appeals read a requirement into the leases that their unambiguous language does not support. Second, in interpreting the offset well clause the Court considered the "surrounding circumstances" under which the leases were executed.

As to the first point, the Court held that Murphy's leases provided their own definition of "offset well." That is, the leases stated that when the offset well clause was triggered, Murphy had to drill a well: (1) on the Herbsts' tract (2) with due diligence and (3) to the same depth as the triggering well and—here's the important part—the drilling of ***"such offset well"*** would satisfy the offset well clause. Because the leases used the term "such offset well" after setting forth three criteria for a satisfactory well, but did not include a proximity requirement or an express protection requirement, the Court would not add impose one.

As to the second point, the Court noted that the leases were executed in 2009 and were drafted with horizontal drilling in the Eagle Ford Shale in mind. The Court considered expert testimony presented by Murphy that drainage is almost non-existent from horizontal wells in tight-shale formations such as the Eagle Ford. Thus, the Court concluded it would be "illogical" for an offset well clause to require a well - even an "offset well" - to even attempt to protect against non-existent drainage. There is no need to require actual or potential drainage in an offset clause if, as in the case of tight shale formations, there are no shared reservoirs in the same sense as vertical drilling. The same strata of shale may underlie two separate tracts, but little or no drainage will occur between the two tracts.

THE DISSENT

Justice Phil Johnson authored a 31-page dissent, in which three justices joined. The dissent argued the definition of "offset well" commonly understood[2] at the time the leases were negotiated—2009—required Murphy to drill its well at a location where a reasonably prudent operator would drill to protect the leasehold from actual or potential drainage, regardless of whether drainage was actually occurring. The dissent claimed the majority opinion effectively read the term "offset" out of the leases (and in fact, demonstrated this by quoting the offset provision and striking the word "offset" to show that the clause read as Murphy insisted when the word was removed).

The only evidence outside of the leases themselves that addressed intent of the parties was the depositions of the Herbsts, who wanted the minerals protected from even the possibility of being poached by any type of well on adjacent

[2] Over 4 pages of the 31-page dissent were devoted to citations of the common industry definition of "offset wells" both before and after 2009.

MUST AN OFFSET WELL CLAUSE BE REASONABLY CALCULATED TO PREVENT DRAINAGE? NOT IN THE EAGLE FORD, ACCORDING TO THE TEXAS SUPREME COURT.

by Charles Sartain, Chance Decker and Ethan Wood
Gray Reed & McGraw LLP

property—vertical or horizontal. The dissent further argued the majority purposely avoided considering the Herbst's depositions by interpreting the leases as a matter of law. According to the dissent, the court's entire discussion of intent was neither linked to language of the leases nor any evidence in the record.

The dissent would have concluded that Murphy failed to prove conclusively that it had complied with the offset well provision, but at the very least the dissent argued that its interpretation of the leases was as reasonable as the majority's, which means the leases are ambiguous, requiring the Court to send the case back to the trial court for a trial to determine the intent of the parties.

WHERE DOES IT GO FROM HERE?

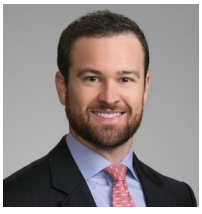
While the Court purported to limit its holding to the facts before it, the opinion may have far-reaching consequences for Texas oil and gas producers and their lessors. The vast majority of wells drilled in the most active Texas plays today are horizontal, tight-shale wells.

The majority considered the simple question: Why should an operator be obligated to protect against drainage that doesn't exist? At least five justices of the Texas Supreme Court appear to believe they aren't, and that they no longer have to even try.

This is another case where the commonly understood meaning of words used in widely-used contracts is rendered obsolete by advances in science and technology. The split decision is an example of a policy disagreement within the Court. The Court could have gone either way and five chose to go with the producer. Expect a motion for rehearing in which the lessors will attempt to convince at least one member of the majority of the merits of the lessors' position.

ABOUT THE AUTHORS

Charles Sartain, Partner - csartain@grayreed.com
An experienced trial lawyer with a unique background in the oil and gas industry, Charles Sartain primarily focuses on resolving complex energy disputes in Texas and Louisiana through litigation, arbitration and negotiation. His clients include oil and gas producers and investors, midstream transportation operators, and mineral and royalty owners involved all types of contractual, payment and operational disputes. Charles earned his B.S. and J.D. from Lousiana State University.



Chance Decker, Partner - cdecker@grayreed.com
An aggressive and results-driven litigator, Chance Decker focuses on resolving high-stakes disputes for businesses in the oil and gas industry. Chance's client list includes major players and growing businesses across the energy industry, including E&P companies, interstate pipeline companies, pipe and steel distributors, and oilfield services companies. Chance earned his B.S. from Texas A&M University and his J.D. from University of Houston Law Center.

Ethan Wood, Associate - ewood@grayreed.com
Ethan Wood has significant experience with natural resources law, lease and contract negotiations, title opinions, regulatory compliance, and environmental and surface use. He also has extensive knowledge and proficiency with oil and gas law in multiple jurisdictions, including Texas, New Mexico, Ohio, Pennsylvania, and Oklahoma. Before starting his law practice, Ethan was an independent petroleum landman. Ethan earned his B.A, *summa cum laude*, from Southern Methodist University and his J.D., *cum laude*, from Southern Methodist University Dedman School of Law.