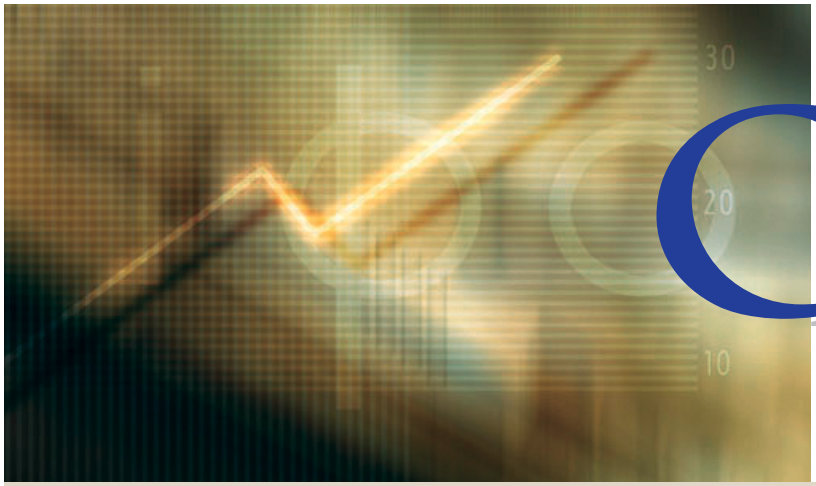

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Wellbore Assignments - Some Guidance At Last

By David Drumm

The practice of making "wellbore assignments" to consummate the sale of existing oil and gas production has become commonplace, but the legal interpretation of a wellbore assignment is problematic under the Texas theory of oil and gas ownership in place, whereby the mineral owner is considered as owning the oil and gas molecules located under specifically described lands in place.

In a wellbore assignment, the assignee's interest is limited to rights "in the wellbore" of a specifically defined well or wells.

The Amarillo Court of Civil Appeals was required to construe the legal effect of a wellbore assignment in the case of *Petro Pro, Ltd. v. Upland Resources, Inc.*, 279 S.W.3rd 743. There, Petro Pro was the successor to an assignee of a wellbore assignment in the King "F" No. 2 well, which was completed as a gas well in the Cleveland formation at the time of the wellbore assignment in 1998. Subsequently, Upland, as the owner of all leasehold rights in the 500 acre lease on which the King "F" No. 2 well was drilled, as well as in an adjoining 204 acre tract which was unitized with the 500 acre lease to form a 704 acre unit, drilled three Brown Dolomite wells (up hole from the Cleveland formation) in close proximity to the King "F" No. 2 well. Petro Pro claimed that its wellbore assignment gave it the right both to plug back to produce in the Brown Dolomite formation and to horizontally extend the wellbore to produce all oil and gas located anywhere within the 704 acre pooled unit, and claimed that the three Brown Dolomite wells drilled by Upland constituted a trespass and conversion of gas reserves it was entitled to produce under the wellbore assignment.

Although this opinion provides more guidance to drafters of wellbore assignments than previously available, wellbore assignments continue to be problematic.

The Court of Appeals interpreted the wellbore assignment consistently with the ownership in place theory to mean that the only oil and gas Petro Pro owned in place was that located within the wellbore of the King "F" No. 2 well, defined as the "orifice in the ground made by drilling." The court rejected Upland's argument that Petro Pro had no right to plug its well back to produce in the Brown Dolomite formation because the assignment did not specifically limit wellbore operations to a specific depth or formation.

Therefore, the court held that the vertical limit of the wellbore assignment was defined by the depth of the wellbore at the time of the assignment.

In addition to these rather limited rights of ownership of gas in place, the court also found that the wellbore assignee was conveyed all rights appurtenant to the assigned wellbore under the underlying oil and gas leases. One of these appurtenant rights was defined as the right to use surface area adjacent to the wellbore as reasonably necessary to operate the well. Another ancillary right was described as including the right to rework the well so as to produce from any formation that might possibly be reached from the existing wellbore, but the court resisted Petro Pro's urging to extend this right to the right to deepen or extend laterally the existing wellbore. Finally, an appurtenant right assigned was the right to produce gas not owned in place from the assigned wellbore. Consistent with the Texas "rule of capture," the right to produce from the wellbore includes the right not only to produce the minerals owned in place within the confines of the wellbore, but also the right to produce minerals migrating from adjacent property. Therefore, Petro Pro was allowed to produce minerals outside the confines of the wellbore which it did not own as gas in place.

Although this opinion provides more guidance to drafters of wellbore assignments than previously available, wellbore assignments continue to be problematic in resolving operational issues between the owners of various interests. In the instant case, the court rejected arguments of the royalty owner intervenors to interpret the wellbore assignment as creating exclusive rights in a 40 acre spacing unit around the assigned wellbore. If the royalty owners' argument had been accepted, there would have been greater clarity in defining the rights and obligations of the parties.

As it is, since Railroad Commission spacing rules are determined on a field specific basis, the priority of the competing theoretical rights of Petro Pro to recomplete its well to produce in the Brown Dolomite formation and the rights of Upland to drill Brown Dolomite wells depends on the ability of each party to obtain drilling permits under the Railroad Commission spacing rules, which require legally mandated setback distances from prior producing wells in the same field. This creates the anomaly that a "permit race" between Petro Pro and Upland would determine whether Upland receives a Brown Dolomite drilling permit close enough to the King "F" No. 2 Cleveland formation wellbore to block Petro Pro's subsequent permit application to recomplete in the Brown Dolomite formation or conversely, whether Petro Pro's recompletion permit application is granted first, restricting Upland's future locations for Brown Dolomite wells to the legally prescribed distance from that wellbore.

This is undoubtedly a result intended by neither party to the conveyance, so despite the helpful clarification provided by this opinion, wellbore assignments should continue to be used with extreme caution.

New Minerals Coverage Available in Texas Title Insurance Policies

By Bonnie Barksdale

Title insurance protects those who own or hold a mortgage on property against losses that occur when the owner or mortgagee discovers that someone else has a claim to the insured property. Title insurance is issued only after a title search, or a close examination, of all public records that impact the title of the property being purchased or mortgaged. Defects in title are corrected prior to the closing of the purchase of the property or the loan secured by the property. Title insurance is issued to the owner or mortgagee to protect against defects that might have been missed during the title examination and errors in the public record. Title insurance will explicitly exclude from coverage specific items having to do with easements, minerals, liens and other matters that may affect good title to the property.

A Texas title insurance policy does not currently include a standard exception or exclusion from coverage for mineral interests. If a title policy insures the fee simple ownership of property with no exception for mineral interests, the policy insures the minerals. In parts of Texas where oil and gas ownership impacts many properties (for example, East Texas), title companies have often included in their policies a blanket exception from coverage for any mineral interests. With the upsurge of mineral activity and the new finds of producing gas fields in the counties of Texas that are part of the Barnett Shale, this practice has become more common place.

During 2008, the Texas Commissioner of Insurance explored the use of exceptions for minerals by the title insurance industry. The Commissioner determined that, dependent upon the type of transaction, location of transaction, historical custom, and the abstract services used by title agents, title insurance companies handled the coverage and exclusion from coverage for minerals in different ways, but that the use of the blanket minerals exception was becoming more predominant. Many suggested that a general minerals exception was not permissible under Texas title insurance policy regulations and it was expected that the Commissioner would explicitly prohibit the use of the blanket minerals exception on Texas title policies. Instead, effective November 1, 2009, the Commissioner will adopt amendments to the Basic Manual for Rules, Rates and Forms for writing title insurance policies in the state of Texas that will allow the use of a general exception for minerals. These new amendments will also clarify and standardize rules and forms that regulate the writing of title insurance for mineral interests and ensure consistency throughout the state and across all types of Texas real estate transactions.

The amended Texas Title Insurance Information page that accompanies any title policy written in Texas will clarify that the title policy is not an abstract of title and that the title

insurance company is not obligated to determine the ownership of minerals. Policyholders will be told through this information page that mineral interests may not be covered by the Policy and that while the title insurance companies may refuse to issue a policy unless it includes an exclusion or exception as to mineral rights, endorsements may be available for purchase that will provide coverage related to certain risks involving minerals. The information page will clearly state that if the insurer issues the policy with an exclusion or exception to the minerals, "neither the policy nor the optional endorsements, will ensure that the purchaser has title to the mineral rights related to the surface estate."

The new amendments will authorize a title insurer to include in a policy or other title insuring form a prescribed exception or exclusion of minerals from the coverage of the policy. Pursuant to a new procedural rule P-5.1, the title company may include in the description of the insured property an exception that makes clear the policy does not insure title to minerals. Likewise, the company may include on schedule B of the policy an exception from coverage for leases, grants, exceptions, or reservations of minerals. When the title company includes either of these prescribed exceptions from coverage on either an owner or mortgagee policy, the insurer must then issue one of two new Minerals and Surface Damage Endorsements upon the request of the policyholder and payment of the requisite premium. The new Minerals and Surface Damage Endorsement issued on form T-19.2 is applicable to real property of one acre or less that is improved or intended to be improved for one to four family residential use or to real property that is improved or intended to be improved for office, industrial, retail, mixed use retail/residential, or multi-family purposes. This endorsement insures against loss sustained by reason of damage to improvements located on the land on or after the date of the policy resulting from the future exercise of any right to use the surface of the land for the extraction or development of minerals. Loss occasioned by subsistence is excluded, as is loss to lawns, shrubbery, or trees.

As to real property that does not qualify for the form T-19.2 endorsement described above, the new form T-19.3 Minerals and Surface Damage Endorsement must be issued when either of the above described P-5.1 exceptions or exclusions is included on the policy and an owner or mortgagee requests the endorsement and pays the necessary premium. This endorsement insures against loss (again excluding loss occasioned by subsistence) sustained by reason of damage to permanent buildings located on the land on or after the date of the policy that results from the future exercise of any right to use the surface of the land for the extraction or development of minerals.

A new rate rule, R-29, establishes a $50 premium for the issuance of the new Minerals and Surface Damage endorsement, whether using form T-19.2 or T-19.3.

A title insurer may also sell a Restrictions, Encroachments, Minerals Endorsement. This endorsement is available to an owner policy on a T-19.1 form and to a mortgagee policy on a T-19 form. Currently, the coverage under this endorsement is broader on the mortgagee policy as it applies to minerals. Effective November 1, 2009, the coverage as to minerals on both the T-19 and the T-19.1 form is the same. This endorsement insures against loss occurring to improvements, including lawns, shrubbery, or trees, that results from the future right of a party to use the surface of the insured land for the extraction or development of minerals excepted from the description of the property on Schedule A of the policy or excepted to in Schedule B of the policy. The new rate rule will raise the minimum premium for the issuance of this endorsement from $25 to $50. On a residential policy, the premium for the form T-19.1 endorsement will be 10% of the basic rate for a single issue policy or 5% of such basic rate if another endorsement, the survey amendment, is purchased. For non-residential property, the premium for a Form T-19 endorsement will be 15% of the basic rate for a single issue policy or 10% of the basic rate if the survey amendment is purchased.

Endorsements may be available for purchase that will provide coverage related to certain risks involving minerals.

There is some controversy over the November 1, 2009 amendments. The title insurance industry welcomes the changes as they make available a uniform approach to insuring minerals. Some property owners object to the changes because they feel the coverage should be provided at no additional cost to the consumer. In some instances, these property owners also advocate for a decrease in all title policy costs. Overall, it appears that the changes will offer clarity to title insurance coverage for minerals in the state of Texas and the amendments will allow, in at least some instances, broader coverage at a minimal cost.

Protecting Yourself Against Mechanic's Liens

By Christopher Norris

Whether you are remodeling your kitchen at home, you are a developer looking to install roads and utility lines for future development, or you are a landlord constructing improvements for a new tenant, there is a good chance you will hire a general contractor to do the work and the general contractor may hire subcontractors to do much, or all, of the labor on the project. Your contract with the general contractor will lay out the parties' rights and obligations, essentially that the contractor will complete the work within the timeframe you request, at the quality level you expect, and for the agreed price. But you should also be aware that, in addition to

contractual rights, Texas law provides the contractor and subcontractors with certain rights if they are not paid on time, specifically, the right to put a "mechanic's lien" on your property.

A mechanic's lien is a lien the Texas Property Code permits a contractor or subcontractor to place against your property to protect them against non-payment for the work they perform. Unfortunately, you may be at risk even if you are not at fault. If the owner (e.g., you) has properly paid the general contractor, a subcontractor can file a lien against your property if the general contractor fails to pay the subcontractor on time. Types of workers who may be eligible to receive a mechanic's lien include general contractors, electricians, architects, lumber yards, and plumbers. Mechanic's liens are also known as construction liens, materialman's liens, laborer's liens, supplier's liens, or artisan's liens, depending on the state you are in and the type of service being provided. Although the rules for mechanic's liens vary in each state, they usually, as in Texas, allow the protected individuals to jump to the front of the line should creditors have to go to court to get paid.

Let's take a kitchen remodel as a simple example (which can be extrapolated to larger projects) to demonstrate how mechanic's liens usually work in Texas. For the remodel you hire Carl the contractor who, in turn, hires a Sam the subcontractor to construct and install your new cabinets. If you refuse to pay Carl for some reason, Carl has certain remedies granted to him by your contract with him, including the accrual of fees or penalties and the right to sue you for payment. But, the Texas Property Code also provides that Carl can file a mechanic's lien against your house by giving you notice of and filing an affidavit with the county clerk's office which states, among other things, your name, the work performed, and the amount owed. Carl is required to file this affidavit not later than the 15th day of the third calendar month (fourth calendar month for non-residential projects) after the day the debt accrued. In fact, Carl's lien would not apply to any amount you owe which accrued prior to that three-month (or four month for non-residential projects) period. This lien will then encumber your house and likely prevent you from selling it until you have paid Carl and he has filed a release of the mechanic's lien in the county records. In an extreme case, Carl could ask a court to foreclose his lien and order a forced sale of your home in order to satisfy the debt you owe him.

Sam may not be getting paid as a result of your non-payment to Carl or, just as likely, you may have made the required payments to Carl and Carl may not have paid Sam as he should. If Sam properly gives you and Carl notice of and files an affidavit in the county records where the property is located, Sam will have a mechanic's lien against your property. As opposed to the three or four months given to general contractors, subcontractor's have only two months to file their affidavit and give notice. You will then be required to do one of the following: (1) pay Sam what he is owed out of the 10% retainage you should have retained from each payment to Carl or (2) if you have not yet paid Carl all that he is owed, withhold the amount owed to Sam from your payments to Carl. If you have not retained any funds from Carl, you will be personally liable for Sam's bill and your property is at risk. Just like Carl, Sam can sue you to foreclose the lien and ask a court to order a sale of your property to recover what he is owed. If you believe Sam (or Carl) have not followed the statutory filing and notice requirements or you post a bond with the court in the amount of the lien, you can have the lien removed by the court. Of course, if you have satisfied one of the two requirements above, Sam must clear the title on your home by filing a release of lien.

When you start a construction project, you have every intention of paying your contractors, but, in these tough financial times, it is important to realize that everything might not go as planned. It is important that you understand the contractual and statutory rights of contractors and subcontractors and the impact they can have on the marketability of your property by virtue of a mechanic's lien. It is in your best interest to pay attention to who your general contractor subcontracts the work. Be sure to be clear with the general contractor about how you will be making payments and how and when the general contractor will make payments to any subcontractors. Last, but not least, when signing a contract with a general contractor, like any other contract, make sure you understand each clause; when in doubt, ask for clarification or talk to your lawyer.