

YOURS, MINE, OR THEIRS?

THE RULE OF CAPTURE AND SUBTERRANEAN FLUIDS

by Judon Fambrough

In recent litigation, Texas courts focused on applying the rule of capture to oil, gas and groundwater production and injection of wastewater.

The rule of capture, simply put, legalizes the drainage of oil, gas and groundwater under certain conditions. Mineral owners and surface owners own these substances in the ground under their property, but not absolutely. If a neighbor (adjacent landowner) drains them from a legal location on his or her property and reduces them to possession on the surface, the substances then belong to the neighbor without liability for the drainage. This rule is sometimes referred to as the “big-pump theory.” The landowner with the biggest pump eventually owns all the oil, gas and groundwater in the area that it can drain and produce from a legal location.

The Railroad Commission of Texas (the commission) establishes the legal location for oil and gas production on a statewide basis. Generally speaking, this is a minimum of 467 feet from a property line. Each local groundwater district establishes the legal location for the production of groundwater in its district. No statewide rules exist. If there is no groundwater district, a legal location is anywhere across the property line.



Perhaps the leading case in groundwater production is *Day v. Edwards Aquifer Authority* decided by the Texas Supreme Court in 2012. The Edwards Aquifer Authority (EAA) denied Day a pumping permit for the amount of groundwater requested because he could not prove adequate usage (production) from the aquifer during the historical-use period from 1972 to 1993. Day sued for a taking of his groundwater under the Texas Constitution (Article I, Section 17[a]).

This section of the Texas Constitution provides, in part, that a person's property may not be taken, damaged, destroyed or applied to a public use without adequate compensation being tendered to the owner. The only exception is when the property owner consents. In this case, Day did not consent.

At the time, two principles of law applied to ownership and production of oil and gas: (1) landowners own the oil and gas beneath their property (in place) prior to capture and (2) with certain exceptions, the rule of capture permits drainage by an adjoining landowner without liability as long as the oil and gas are withdrawn from a legal location.

EAA raised the defense that no legal precedents exist in Texas recognizing landowners' ownership of groundwater prior to capture. EAA did not deprive or take Day's groundwater *after* it was captured (produced), but *before capture* by denying the pumping permit. No Texas cases supported Day's right to the groundwater in place prior to capture.

The high court responded by ruling, "Whether groundwater can be owned in place is an issue we have not decided. But, we held long ago that oil and gas are owned in place, and we find no reason to treat groundwater differently."

The rule of capture does not entail ownership of groundwater prior to capture, but neither does it preclude it. Furthermore, the court ruled that Day was entitled to a fair share of the groundwater for beneficial use based on a full development of the records.

The *Bragg v. EAA* decision, rendered a year later, also focused on the issue of a taking. EAA denied the Braggs permits to irrigate their two commercial pecan orchards. Again, based on historical usage, one permit was partially granted, the other denied entirely. The Braggs asserted that this amounted to a taking of their groundwater.

At the bench trial (trial without jury), the trial court found a taking occurred and awarded the Braggs roughly \$725,000. The EAA appealed both the issue of the taking and the amount of the damages.

The appellate court, citing the Day case, reiterated the landowner's absolute title to the water in place beneath the property subject only to the rule of capture and the state's right to regulate. The court then structured its decision after *Penn Central Transportation v. New York City*, decided by the U.S. Supreme Court, regarding the economic impact of an investment-backed expectation on a claim for taking.

The Braggs purchased the land in 1973 *before* the implementation of the Edwards Aquifer Act with the reasonable expectation of pumping as much groundwater as needed to irrigate their orchards. As the trees matured, which takes five to seven years, more water was needed. The Braggs would not have purchased the property had they known the future limitation on the use of the aquifer's groundwater.

Mr. Bragg was no amateur farmer. He held a master's degree in agricultural economics and served as a county extension agent, a position in which he advised other pecan growers. He was a licensed irrigator. The couple invested time, money (approximately \$2 million) and effort in planting, maintaining and operating the orchards. Despite their best efforts to lower the groundwater consumption by trimming and reducing the number of trees, the Braggs still lost money because of the inadequate or expensive supply of irrigation water.

"The purpose of the investment-backed expectation requirement," the San Antonio appellate court ruled, "is to assess whether the landowner has taken legitimate risks with the *reasonable* expectation of being able to use the property, which, in fairness and justice, would entitle him or her to compensation."

In this instance, the court found the expectations were both reasonable and, under the circumstances, compensable.

The court did not agree with the \$725,000 in damages, though. It remanded the case to trial to determine the difference between the value of the land as a commercial-grade pecan orchard *with unlimited access to water* and its value with limited or no access to groundwater under the EAA.



Litigation addressing trespassing subsurface fluids began in 1991 with *Geo Viking, Inc. v. Tex-Lee Operating Co.* The case involved the legality of subterranean trespassing frack fluids used to enhance (stimulate) the migration of hydrocarbons from underneath an adjoining, unleased tract. The operator hired Geo Viking (Geo) to frack beyond the boundaries of the 80-acre lease. Geo botched the attempt, and the operator sued for the revenue it would have received had the operation been successful.

The jury held that the rule of capture *permits* trespassing fluids to enhance the operator's production (drainage) from beneath the neighbor's property. The court of civil appeals reversed the jury's verdict by stating the rule of capture *does not* allow subterranean trespassing without liability. The Texas Supreme Court supported the appellate court's opinion by stating "... the rule of capture *would not permit* the operator to recover for a loss of oil and gas that might have been produced as the result of fracking beyond the boundaries of its tract."

Six months later, however, the high court withdrew its opinion, saying, "We should not be understood as approving or disapproving the opinions of the court of appeals analyzing the rule of capture or trespass as they apply to hydraulic fracturing." This left the issue unresolved.

In 2008, the Texas Supreme Court again addressed the issue in *Coastal Oil and Gas Corp. v. Garza Energy Trust*. In this case, Coastal successfully fracked beneath the plaintiffs' adjoining tract, depriving them of approximately \$1 million in lost royalties caused by the drainage. Unlike *Geo*, Coastal had both the tracts under lease, but they were not pooled.

The high court found no liability on the part of Coastal for two reasons. First, the rule of capture precludes any claim for injury caused by trespassing frack fluids. (This is a reversal of its initial opinion in *Geo Viking*.)

Second, when mineral owners sign an oil and gas lease (which is viewed as a *mineral deed* in Texas), they convey all possessory rights in the mineral property to the lessee (oil company) for the duration of the lease. This eliminates their right to sue for a subsequent mineral trespass. The only right they retain after signing a lease is the right to receive royalty payments. Because Coastal had both tracts under lease and thus owned the possessory rights in both, it could not be held for trespassing on its own property.

In another case six years later, the high court reflected on this decision. It ruled that because the plaintiffs no longer owned any possessory rights in the minerals, they must prove actual damages (other than drainage) for a recovery. Thus, the rule of capture negates the element of injury from a trespassing claim for fracturing.

The decision leaves open the question of liability when both tracts are *not* under lease by the same operator or when the tract being drained is not under lease to anyone. The opinion points out that an action for trespass requires the plaintiff to own the right of possession. But, if Coastal did not have both tracts under lease, would the court have ruled differently? Stay tuned.

According to the high court, the only recourse plaintiffs have in situations like this is to seek to pool their interests, drill an

offset well with their own funds or force their lessee to drill an offset well under the implied covenant. However, to successfully force a lessee to drill an offset well under the implied covenant, the mineral owner must prove the offset well would recover the lessee's drilling and completion costs; transportation, marketing and overhead expenses; and result in a reasonable profit. This is a difficult burden of proof.



FPL Farming (FPL) v. Environmental Processing Systems (EPS), 2011, is the most recent case involving trespassing subterranean fluids, specifically trespassing injected wastewater.

The defendant (EPS) began injecting wastewater 8,000 feet below the surface pursuant to a permit issued by the commission. The adjoining rice farmers (FPL) claimed the wastewater trespassed onto their property. They sued for an injunction to stop the project and for damages.

As a defense, EPS cited the 1962 Texas Supreme Court case of *Railroad Commission of Texas v. Manziel*. The case involved a secondary recovery operation approved by the commission. The project entailed the injection of massive amounts

of water into a depleted formation to enhance the recovery of the remaining oil. The injected water migrated beyond the boundaries of the project and polluted Manziel's domestic water supply.

As did FPL, Manziel sued for an injunction to stop the project and for damages. The court refused to issue an injunction because the project had been approved by

the commission, but it allowed recovery of damages. To avoid damages in this case, EPS relied on *Manziel*.

On appeal, the Beaumont Court of Appeals (citing *Manziel*) agreed and held that the approval of the project by the commission removed any liability (damages) for trespass when the wastewater migrated across property lines. However, when the Texas Supreme Court heard the case, it responded by stating that the lower court misinterpreted its ruling in *Manziel*.

The high court explained, "We did not decide whether the Railroad Commission's authorization of such operations throws a protective cloak around the injecting operator who might otherwise be subjected to the risks of liability (for damages). Instead, we held that the Railroad's Commission authorizations of secondary recovery operations are not subject to injunctive relief based on trespass claims."

When the rule of capture applies, landowners may seek to pool their interests, drill an offset well or force their lessee to do it for them.

The high court pointed out that the issues in *Manziel* and *Coastal* were factually similar. Both dealt with the subterranean injection of fluids that crossed property lines. Both were authorized by state agencies. Both dealt with the extraction of oil and gas, making the application of the rule of capture critical. The rule of capture is the cornerstone of the oil and gas industry.

The FPL case, however, did not involve the extraction of oil and gas but the injection of wastewater. For that reason, the *rule of capture does not apply* and EPS may be liable for the trespassing wastewater.

As mentioned earlier, when the rule of capture applies, landowners may seek to pool their interests, drill an offset well or force their lessee to do it for them. With wastewater, these protective measures are not available because the rule of capture does not apply.

"The mere fact that an administrative agency issues a permit to undertake an activity does not shield the permittee from third-party tort liability stemming from consequences of the permitted activity," ruled the court.

The issue of damages has not been settled. This case has been before the Beaumont Court of Appeals three times and the Texas Supreme Court once. Presently, there is a petition before the Texas Supreme Court to review the latest decision rendered by the appellate court in this matter.



An interesting development occurred during the 83rd Texas Legislative Session that may trigger another round of taking claims for groundwater under the Texas Constitution (Article I, Section 17[a]). The statute, effective Sept. 1, 2013, found in Chapter 122 of the Texas Natural Resources Code, attempts to encourage the treatment and recycling of oilfield wastewater. These fluids include salt or other mineralized substances, brine, hydraulic fracturing fluid, flowback water, produced water, or other fluids that arise out of or are incidental to the drilling for or production of oil or gas.

The new law lessens, to some degree, the liability for the possession and transfer of wastewater. The statute does so in two sections. The first section provides that with possession of the fluids (wastewater) comes ownership.

" . . . when fluid oil and gas waste is transferred to a person who takes possession of that waste for the purpose of treating the waste for a subsequent beneficial use, the transferred material is considered to be the property of the person who takes possession of it for the purpose of treating the waste for subsequent beneficial use until the person transfers the waste or treated waste to another person for disposal or use. . . ."

The second section allows the transfer of liability under certain circumstances. If the transfer is with the contractual understanding that the fluids will be treated to make them suitable for the subsequent drilling or production of oil or gas, the party making the transfer is no longer liable in tort for the subsequent use of the treated product.

The issue of a taking arises under the first section where ownership accompanies possession. An oil and gas operator may not always *own* the wastewater being transferred. Water for fracking may be obtained two ways: by purchase or under an implied right. Unless limited by the mineral lease, the lessee has the implied right *to use (not own)* as much of the physical surface and groundwater as is reasonably needed to explore

Unless limited by the mineral lease, the lessee has the implied right to use (not own) as much of the physical surface and groundwater as reasonably needed to explore and produce the minerals without asking permission and without having to pay.

and produce the minerals without asking permission and without having to pay. This right of *usage* is limited to the leased premises or lands pooled with it.

Consequently, if the frack water is initially acquired under this implied right, it still belongs to the landowner (surface owner) when it returns to the surface as wastewater. Any subsequent transfer of "ownership" by the lessee without the landowners' consent may constitute a taking even though authorized by the statute. ♣

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THE TAKEAWAY

Several recent cases in Texas have been key to oil, gas and groundwater production and wastewater injection in the state. Landowners will benefit from understanding the rule of capture, which governs who owns those substances before and after they are drained from property.



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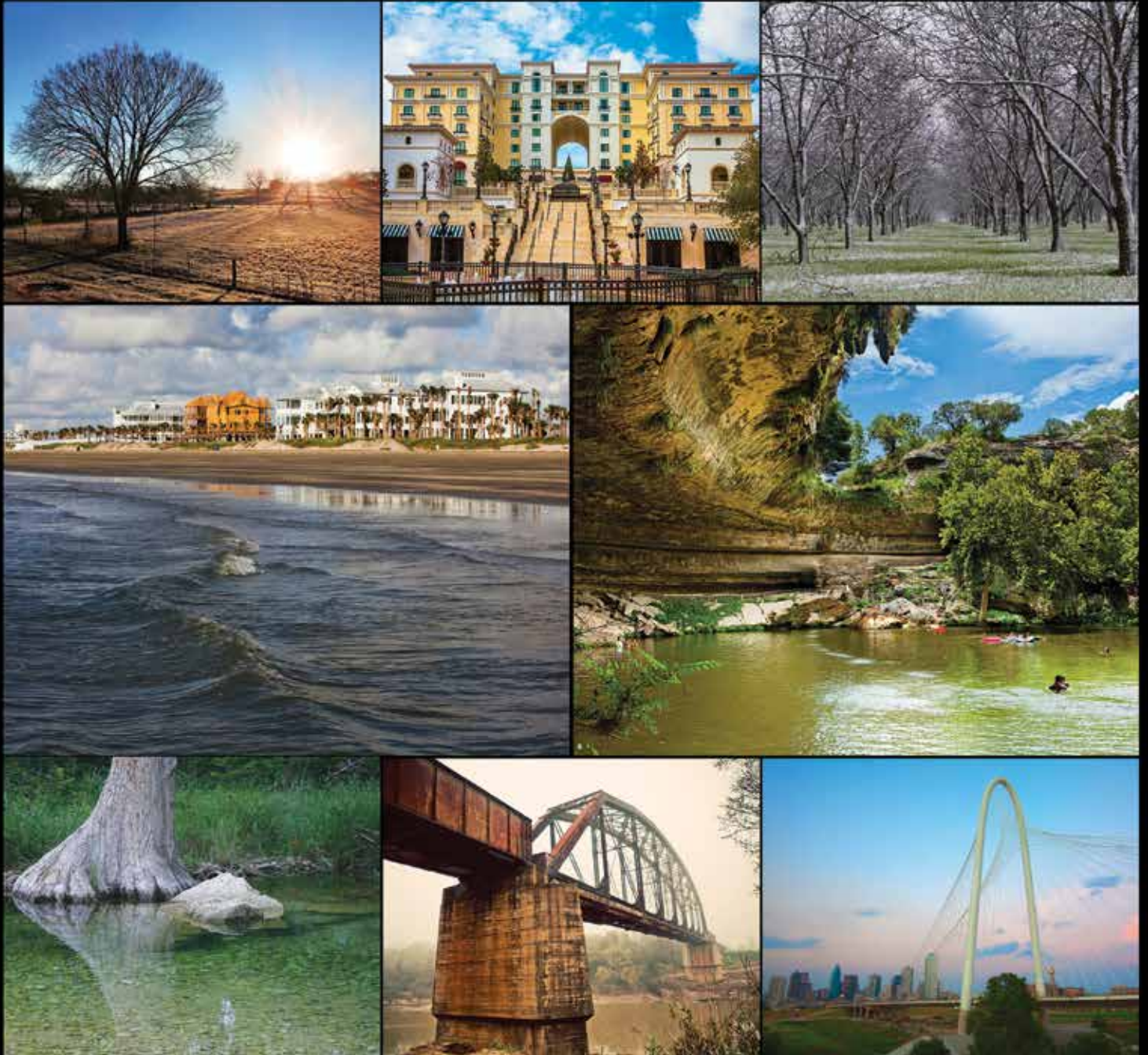
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It's All About the Big Bucks

Another deer season has come and gone. Lucky hunters have a buck in the freezer. For landowners, the bucks are in the bank. But not everyone is happy. More often than not, their problems have something to do with the deer lease. Make sure your lease doesn't have holes in it.

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