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97-0403
HECI V. NEEL

BARON: This is an oil and gas case in which the Neel family is the lessor, and HECI, the lessee under a standard oil and gas lease. There is one other important player, that's AOP Operating Company. They are not a party to this litigation, but they operated wells on land immediately adjacent to the Neel lease in Fayette County.

It's undisputed that AOP engaged in illegal production that caused waste, and violated Railroad Commission rules and regulations.

HECI brought three separate actions to stop AOP. HECI initiated proceedings at the Railroad Commission of Texas in 1985, and in 1988.

GONZALEZ: You were successful in those efforts to stop the drilling?

BARON: Yes, they were. In 1989, HECI obtained a permanent injunctive relief in Fayette County from a DC there. In addition, HECI recovered a judgment for damages to HECI's reserves caused by AOP.

There's no question but that the Neels' have their own direct cause of action against AOP.

ABBOTT: Can you point to any evidence in the record that makes it clear that the damages that HECI recovered from AOP were basically 5/6?

BARON: Yes, but I think we can look at a couple of things. First, HECI couldn't sue on the Neels' behalf. They didn't have an assignment and the CA correctly held they had no right to sue. But also, if you look at page 307-308 of the record, there they are using a $6.50 a barrel price for oil, which is testified to be the price in the ground to the working interest owner. And elsewhere in the record it shows that the actual sale price of oil on the barrel would be $17.00. So it's a reduced price. It's a working owner's price. And that testimony applies directly to plaintiff's exhibit 21, which again ties exactly to the number that the jury put into the verdict, which asked about HECI's damages.

The Neels had their own suit against AOP under this court's decision in *Eliff v. Texan Drilling* and also a statutory right of action under the Natural Resources Code. But as you know, they sued HECI, not AOP claiming entitlement to a 1/6 royalty share in the AOP judgment.

This court has granted review on two issues. The first question is whether HECI had an implied duty to tell the Neels about the AOP judgment, and to tell the Neels that they

needed to go out and file their own lawsuit. The second question is, whether information that's publically available to the Railroad Commission of Texas and it's publically disseminated in the local and trade presses, somehow inherently undiscoverable saving the Neels' claims here from the bar of the statute of limitations?

I would like to talk about the discovery rule issue. First, I know the court's heard a lot about it. I think the Neels in their amici have pretty well substantially confused this issue. I think we need to start with *Altai* where the court recognized there are two separate questions. And the first question is, "as a matter of law does the discovery rule apply to this case?" And that's the question here. Only if the discovery rule applies this court gets to the second question, which you've just heard a lot about and, that is, "is the discovery rule satisfied when or whether should this plaintiff known or should have known of the injury?"

The Neels want to skip the first question. Here's what they are arguing. They are arguing the discovery rule always applies unless the individual plaintiff knows of the injury either by actual notice or through constructive knowledge, which is the legal equivalent of actual notice, or the individual plaintiff should have known of the injury, because something suspicious was brought to the plaintiff's attention. That's exactly the argument that *Computer Associates* made, and this court rejected in *Altai* and for a good reason, because it makes the discovery rule applicable in every case, and it makes it a jury question in every case. But the Neels are confusing this issue is pretty evident if you look at the cases they are relying on. The Neels cite a single case, which is *Andretta v. West*, which involved breach of fiduciary duty by the owner, the holder of the executive mineral right.

This court recognized in *Espi(?)* that fiduciary transactions are generally subject to application of the discovery rule. The Neels have an amicus brief filed on their behalf by the Scanlin Group. It cites a whole lot more cases, that's the one with the 3-page chart, if the court has seen it.

HANKINSON: As to both issues that you are going be arguing before us, isn't the underlying question as you just were starting to allude to, the nature of the relationship between the lessor and the lessee? Is it a fiduciary relationship? Is it agency? Is it a purely contractual relationship between two parties dealing at arms-length?

BARON: It's the latter. Certainly, I think the courts are in agreement generally. The CA held there was no fiduciary duty here. The Neels have not come up on that issue. So there is not a fiduciary relationship, and there is testimony in the record that the only relationship between the parties is this contract, is this lease.

Going back to the Scanlin brief. They have 3 pages of cases. Those also involve breach of fiduciary duty, which we don't have, or they involve claims of fraud or fraudulent concealment, which also we don't have. So those aren't this case. Those are seeing whether the

discovery rule is satisfied, not whether the discovery rule applies as a matter of law. So we're back to question 1 under *Altai* in that case. And the Neels' claims will be barred here unless they meet the *Altai* test. And that is, they must be inherently undiscoverable and objectively verifiable.

The Neels' claims don't meet that standard for four reasons: 1), they are participants in an on-going regulated activity...

ABBOTT: What is it that should have been discovered here? I don't think it's the lawsuit against AOP. Is it that the third party was draining?

BARON: That's what the Neels' pleaded at page 4 of the transcript. They plead the discovery rule and say they could not have discovered basically AOP's conduct. So, yes, that's correct.

ABBOTT: You don't disagree with that?

BARON: No. And they could have found that. They know that information at the Railroad Commission affects their interest. They had access to this information. This type of information was publically disseminated in the local and trade press. And 4th, when they did make some effort, they found it.

OWEN: Let's assume for the moment, that HECI did nothing, that they didn't go to the RR Commission and try to get restrictions on production, they didn't drill offsetting wells and the drainage continued for more than 4 years. Would that be inherently undiscoverable?

BARON: Are you saying that they only filed the suit?

OWEN: They didn't file a suit. They didn't do anything. They just allowed the drainage to continue and took no action.

BARON: Well HECI didn't have anything it could do on the lease to prevent the drainage. It's illegal drainage. They couldn't drill an offset well or pump more in response.

OWEN: And, I'm saying, they took no action whatsoever. Would that be inherently undiscoverable that they were not performing their lease obligations to protect the lease hold? Would that be inherently undiscoverable?

BARON: If there was no visible physical evidence or accessible documentary evidence that would have allowed the Neels to discover that claim, yes, I think the discovery rule would apply there.

OWEN: What do you mean by documentary evidence? What if there is evidence in

HECI's possession, but it's just not publically available, does that make a difference on whether it's inherently undiscoverable or not?

BARON: Yes, I think it does. I think the Neels have to be able to have access to this information. And I don't think that we disagree with some of the...

OWEN: What if they asked HECI for it?

BARON: And they failed to provide it?

OWEN: I mean does the fact they have the ability to ask for it bear on the analysis of whether it's inherently undiscoverable or not?

BARON: There is testimony in this record that it was HECI's policy, the president testified, that if they were asked for information they provided it.

OWEN: I'm trying to get at what makes it either discoverable or not discoverable?

BARON: Well I think there has to be something that the plaintiff has access to that can give them some notice of compliance.

OWEN: You see that there is a well on the other side of your lease line. And do you have some obligation to ask your operator, "Are they draining from us or not?"

BARON: The question would be: "Are they illegally draining us?", which is a different question. And I think if there is no well on your lot and you can see that right across the fence there's a well over there, then you should ask your operator: "Are we being drained? Can you do something that would legally protect us against this drainage?" Our case is problematic - it's illegal drainage and there's nothing that HECI could do short of going to the commission and complain to stop it.

OWEN: Well why is that different? Even if you see a well on your property, you're the royalty owner and you see a well across the lease line, and you say: "Are we doing everything we can at the RR commission to keep our property from being drained?" Why is that any different?

BARON: There are certain obligations you have under the lease, and there are certain obligations you don't. And the obligation under this lease would be to go and complain to the RR commission.

OWEN: And why is that different from if you have no well, drilling a well...these are what the royalty owner can ask the operator?

BARON: Well the royalty owner can always ask the operator. In fact, the royalty owner has a statutory ability to ask the operator for particular information under the Texas Natural Resources code, under the 915.01 through 506 series of statutes. So, I think that they did have the ability to ask. If they had asked they would have been given the information in this case. I think if the royalty owner asks, and the information isn't given, the information is in some private confidential file of the potential defendant, and the only way they can get it is for them to sue, then that may be a good case to apply the discovery rule to. That's not this case. We've got information everywhere.

Particulary here, oil and gas is a regulated industry in Texas. Landowners and royalty owners _____ with profit from oil and gas activities know that action by or at the RR commission is affecting their interest everyday. So it's no surprise to them if there's a lot of information about their wells at the RR Commission and in fact all the wells in the field.

And, here, I think we need to make this point: the RR Commission's records were very straightforward. If they had gone to the '85 proceeding, there is this single page order, signed by all three commissioners that says: "AOP is causing waste in the Jenny Well Cox field." In the 1988 proceeding, the Neels had to look no farther than the title of the proceeding: Application of HECI To Determine Whether Waste Is Occurring In The Field. And there the commission found in its final order that AOP's excessive production was adversely affecting wells on the Neel lease. So they had this information, and they had access to it.

ABBOTT: Did the RR Commission files also show that that problem had been corrected?

BARON: It had been corrected for the future, but it did not correct past occurrences, past waste, past damage, past drainage.

ABBOTT: So if you went in and looked at everything that was on file with the RR Commission, if I understand what you're saying, what it showed is that there had been past inappropriate drainage by AOP?

BARON: Right.

ABBOTT: That had gone uncorrected, but as far as the future drainage was concerned, that was all resolved?

BARON: Right.

ABBOTT: And so by looking at that on its face it kind of shows that it looks like there was some damages?

ABBOTT: Exactly.

OWEN: Could you tell from the face of the record? I mean it could be, that other operators would be allowed to over-produce, vis-a-vis by AOP and even it out. Did the record show that?

BARON: The record didn't show an adjustment in production is my recollection. It also showed that there was water being produced by wells on the Neel lease, which is a sign of fairly significant damage to the geological structure under the lease. So that was also in the RR Commission final order.

What the Neels are really arguing is not that they couldn't find this information. They are just arguing that they didn't have to go look for it, and that this would just be as a public policy matter too great a burden to place on them.

OWEN: You don't contest that your operator has an obligation to protect the leasehold from drainage, that's an implied obligation; is that correct?

BARON: That's correct. That's a recognized obligation.

OWEN: What is so erroneous about as part of that implied obligation requiring the operator to notify royalty owners that they have a cause of action for damages for the waste or damage to the reservoir? Why is that not just a parcel of the obligation to protect the leasehold?

BARON: Because it's not protecting the leasehold. What it's protecting are there tort claims against neighboring operators. And it's not part of the lease. And if you look at implied covenants in Texas, there are some commonalties when they have been implied, and usually it's when they will result in fulfilling the central purpose of the lease, and that's to obtain production. And here, the tort claim is not going to change the amount of production on the Neel lease. And it also doesn't require the lessee here to perform something that only the lessee can perform, like drilling a well to prevent drainage by an offsetting well. Here, the Neels always had control over their own tort claim.

OWEN: Did the Neels have the ability to go to the RR Commission and complain about illegal production?

BARON: That's an operator's duty...

OWEN: Did the Neels have the right to do that?

BARON: I don't think they do. Actually, I'm not certain, but I think that the operators appear before the RR commission, and that is part of the duty to manage and administer the lease is to go to the RR Commission and take administrative action that will protect future production from the lease. But this activity here bringing a lawsuit is something that the Neels had control of.

They never assigned it to HECI, and HECI couldn't sue on their behalf.

And I think the other problem with this duty is that it's unclear where this implied covenant starts, and where it finishes. The CA thought it was drafting something narrow just saying: "You only have to tell us once you decide to go sue." But you can imagine just different little steps like: what if HECI had just gone over to AOP and talked to them and reached some kind of settlement without resorting to litigation? Would HECI then need to notify the Neels? Or what if HECI knew about AOP's illegal waste, but then negligently or recklessly decided not to sue? What we're requiring HECI to do is basically police everybody in the field, and then go report to the Neels anytime the smallest problem might be arising just to protect itself against being a guarantor for somebody else's illegal conduct in the field. And that's so far from what the purpose of this lease is, that it really does suggest that it's best left to express agreement of the parties. And there are notice and information provisions in lots of different leases that in the summary judgment record.

ABBOTT: I presume you read the amicus brief filed by the _____?

BARON: Yes.

ABBOTT: And in there, they discussed at length about the difficulties that lessors or royal interest holders have in determining whether or not they are being properly paid, whether or not there is drainage, different things like that. Are you saying in this case that the problems discussed in the amicus brief _____ here because it was obvious from the RR Commission filings, that you wouldn't have to bring in all sorts of fields of experts to calculate all sorts of different things, that you could tell clearly from the RR Commission filings that there was drainage taking place, that would put these folks on notice that they had a claim against the AOP?

BARON: That's certainly true.

ABBOTT: The only reason why you claim that there was notice in this case it made the situation not inherently undiscoverable is because of a publication in a petroleum...what was the name of the publication?

BARON: I think it's Petroleum Information or something like that.

ABBOTT: What was published in there and how accessible is that? In other words, how realistic is this particular publication is something that all royalty interest holders are going to be consulting?

BARON: I think what we need to look at is at page 655 of the record. The president of HECI testifies that he contacted the local paper so that they could write about the judgment. And then apparently was picked up by Petroleum Information and discussed in there. The record doesn't have copies of the articles or information about the circulation of these publications. The point of

these publications though it's not whether they should have subscribed to them or should have known of them, but the fact that this information was publically disseminated, both in the industry and in the community, don't make it impossible or very difficult for the Neels to get wind of it. It's not that they have to read it, but that it would be generally open public information and the industry that could be likely to be discussing get back to them.

ABBOTT: Because it was discussed in this particular case doesn't mean that in all situations whenever drainage may occur, that it will be inherently discoverable like that, because not all situations of drainage are going to be discussed openly like that are they?

BARON: Absolutely not. There will be situations where it's completely under the ground and there is no way to find out about it through documentary evidence or through some kind of visible evidence on the property. That's correct.

ABBOTT: Why would it be reasonable or a reasonable expectation to place upon of a royalty interest holder, that they would have to scour through the records on file at the courthouse to see whether or not there a lawsuit had been filed for them to know that maybe they have a claim also?

BARON: Well there are two parts to that. One, that is public information that's in the courthouse where the land is located. So, it's public information that's in an area that's connected to where the injury allegedly is occurring. We don't have just that here. We've got big sign posts that are pointing to the courthouse both in the media publication and then in the RR Commission records. If the information that's public is in a place where you know to go look for it and you have access to it, then it seems to me that we can expect people to pursue and protect their own economic interest in a contract and in real property by taking those actions.

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RESPONDENT

COHEN: Counsel for HECI and, I, disagree about a lot of stuff, but the first thing I disagree about is who's trying to confuse who. There are two questions in this case and I think the first one is: Whether due diligence requires a royalty owner to routinely search RR Commission and DC records when there is no reason for them to look there?

ENOCH: Do we get to due diligence until we've determined that the event is inherently undiscoverable?

COHEN: No. I think the *Altai* test applies. We have another fundamental disagreement about...

ENOCH: So how do you get past the...forgetting about due diligence, how do you get

past the statement that this activity was not inherently undiscoverable because the activity was publically disseminated, the information about this was publically disseminated?

COHEN: We look at the precedent and the legislation in this state about whether people are charged with constructive notice of public records. There are two categories of records that the legislature and this court have singled out as being constructive notice in all cases: probate; and that's the *Mooney v. Killion*, and there's also _____ records. And that's not even a filing in the DC office. That's a lawsuit getting put in property records.

ENOCH: The constructive notice is not the issue. The inherently undiscoverable...let me start over. The illegal pumping might be something that's inherently undiscoverable. Thus, HECI's effort at stopping the illegal pumping is not inherently undiscoverable because that effort is done in a regulatory environment where filings are done with the RR Commission and these are public records. We're not talking about constructive notice to the lessors, we're just saying: Is HECI's effort at stopping this a conduct that is inherently undiscoverable?

COHEN: And our answer is, "under the current precedent in this state, there is no requirement that a royalty owner would have to go to the RR Commission, which is the only place that they would find out about HECI's activities."

HANKINSON: So your position is, that RR Commission records are inherently undiscoverable?

COHEN: No, they are not inherently undiscoverable.

HANKINSON: Why are public records inherently undiscoverable?

COHEN: They are not inherently undiscoverable. The test has always been you have to have something that puts you on inquiry notice. Something has to set the bell off.

HANKINSON: But that's when the discovery rule has already been determined to apply, correct?

COHEN: And you determine whether or not to apply the discovery rule by applying the *Altai* test.

HANKINSON: And the first element of the *Altai* test is whether or not the matter is inherently undiscoverable?

COHEN: Correct.

OWEN: How is this different from an underpayment of royalty cases? Setting aside

what may or may not be in the RR Commission records for the moment, let's assume that the operator has underpaid the royalty owners, they have made certain deductions that they weren't entitled to make under the lease. Do we apply the discovery rule in a case like that?

COHEN: Your factual distinction is in those cases every month the royalty owner is going to get a statement...

OWEN: Let's assume it doesn't show what was deducted, it just shows a net amount to you?

COHEN: Then I think _____ and apply in the concealment area when we get down to litigate that case. But if at some point the royalty owner says: I believe I'm being underpaid, and there was nothing on the check detail every month, and there was no way for them to know what the price that was being paid...is that part of your hypothetical?

OWEN: Let's assume you get a royalty check every month and it says: BTUs at the price, and then you get your check, and it doesn't explain how that all was calculated. But there have been certain deductions that the lease doesn't allow you to take that were made before that amount was paid to the royalty owner, and that goes on for years. Do we say that that breach of the lease is inherently undiscoverable?

COHEN: That situation is going to be inherently undiscoverable and it's also going to implicate the fraudulent concealment issues. Because when it's the deductions, there is going to be no way of knowing other than the operator's records, or the payor's records. If it was just a posted price case, where they were paying you something less than a posted price, then you _____ the argument, "Could I have found out what the true price should have been from underpayment of royalty?"

HECHT: In *Altai* we held that a undocumented theft of trade secrets is not inherently undiscoverable. How can a documented theft of oil be inherently undiscoverable given that holding in *Altai*?

COHEN: In *Altai*, you had factors that were cited in the court's opinion, which are not available here. Number 1) you've looked at the employer's policy regarding document control, and found that that employer did not use a document control policy for trade secrets, that was common in the industry. Number 2) you said that the employer should know the market flex, and if you see a competing product come out that you had been working on and the employee who had been working on it had now gone to the competitor, that should setoff the bell. The inquiry notice should start. And that happened in the *Altai* case some three years before they filed suit. Those factors are just not present.

ENOCH: If your read *Altai* isn't what happened in *Altai* is because if you looked, you

could find it, the activity was not inherently undiscoverable? And isn't that exactly what we have in this case? If they looked, the activity would not be undiscoverable. You're trying to say, "unless they are required to look, then the activity is not inherently undiscoverable? But in *Altai* it was the reverse of that. In *Altai* it said: "it doesn't matter about when you look, it only matters if you look would you find it." And in *Altai* we said, "It's not inherently undiscoverable because if they looked they would have found it." In this case, if they looked, they would have found it. So why isn't it discoverable?

COHEN: Under that scenario and under that reasoning nothing is undiscoverable. I don't believe that *Altai* stands for that proposition. *Altai* tries to take years and years of looking at discovery rule cases category by category. It will apply to legal malpractice, but it won't apply to this type of case. *Altai* and *S. V. & R.V.* distill a test for when you apply the discovery rule. And if you look at what the CA's have done since 1995, I think everybody out there believes that you are looking not at a specific category or case anymore, but you are looking at a two-part test that can be applied across the board. *Altai* works. It has worked fine. And it will work in this case and the CA applied it correctly.

The difference in *Altai* is actual notice, or something that the employer did that could have protected himself. There is nothing the Neels did in this case, or could have done that a reasonable royalty owner should have done.

ABBOTT: They did find out about it though?

COHEN: They found out about the settlement of the judgment.

ABBOTT: How did they find out about that?

COHEN: The record reflects that they received a phone call from a lease broker in the area, who just called up Mr. Neel one day in May, 1993, and that's in the summary judgment response affidavit.

GONZALEZ: Mrs. Baron argues that your remedy, you have your own cause of action against AOP, do you disagree with that?

COHEN: We did have our own cause of action against AOP. It would probably have been time-barred by the time we learned about it. However, there are other points on that. First of all, that doesn't abrogate their duty to protect us under the implied covenant to protect the lease. There is the *Texas Oil & Gas v. Alstrom* cited in one of the amicus briefs and the CA's opinion that suggests that they had the right because they are the owner of a 100% of the oil and gas in place, that we conveyed that to them in assignment. And finally, if you look at the proof that was presented, the CA said, "whether they sued for the Neels' damages was inconclusive," and they didn't want to rule on that one way or the other. And they've come up with some after the fact explanations that

really aren't as explicit as the testimony...

OWEN: But even if they have, let's assume that you still had time to sue AOP, and they recovered 100% for the preserves, that's no bar against you going in and getting what you want. It's AOP's problem. If they didn't object to the jury issue they may have overpaid these people, but isn't that AOP's problem, not yours or HECIs?

COHEN: In that case, the implied covenant would be meaningless. We have an election. We have two ways to go on it. Suppose we determine that their $3.7 million judgment against AOP was all the money in the world that AOP had, and they settled it for something less than because it wiped AOP out, then a suit against AOP would have been a complete waste of time. Does that mean we don't have the right under the implied covenant to pursue these _____.

OWEN: I'm just saying the fact that sued AOP and recovered, may not have gotten the dollars, but got a judgment doesn't wipe out your right to sue AOP, does it?

COHEN: No, it doesn't. But it doesn't abrogate our rights to sue them, because they have the duty to us. They have a more direct duty to us than AOP does.

ABBOTT: In the oil and gas industry in Texas what would be wrong with a rule that put everyone who has an interest in oil and gas, whether it be a royalty holder or whatever, for right now let's apply it to royalty holders, what would be wrong with having a requirement that royalty owners are put on constructive notice of all information that is on file with the RR Commission? I am just talking about information that a person can pick up and look at and comprehend without having to go out and hire multimillion dollar experts. What's wrong with a requirement that all royalty lease holders are put on constructive notice that information at the RR Commission?

COHEN: Nothing would be wrong if the legislature passed that statute and held everybody to that standard like they do with people who claim interest on a probate case. But this court has never usurped the legislative function to make a class of records constructive notice like probate _____.

OWEN: You said a moment ago, that your cause of action against AOP was probably time barred, why is that?

COHEN: I guess implicit in that it is the assumption that we didn't learn about it until May, 1993.

OWEN: Why isn't that inherently undiscoverable? I'm having trouble seeing why you say your cause of action against AOP was time-barred, but your cause of action against HECI isn't. What's the difference?

COHEN: No, they would have raised the same defense, but they would have other defenses like collateral estoppel and things that we would have had to address. It is no more...

OWEN: But you said time-barred. I'm just focusing on time-barred. Is it time-barred or not?

COHEN: It would not necessarily be time-bar. We would invoke the discovery rule under that same set of facts.

OWEN: If HECI had done nothing, if they knew about the illegal production and could not drill an offset well, did not take any action at the RR Commission and just let you be drained for 4-5 years, is that an inherently undiscoverable situation? Is that drainage?

COHEN: Yes it is.

OWEN: And why is that?

COHEN: There would be no way for the royalty owner to know that unless...in this case when there was over-production there would be no way for them to know that because they don't have engineers. Royalty owners typically do not have engineers to do annual reserve studies and tell that there is some damage to the formation. The record is not clear how HECI determined that AOP was lying to the RR Commission, which is essentially what they did. They were filing false P1s and P2s every month and misstating what they were taking out of the ground.

There is no way for the royalty owners to learn that. They could go to the RR Commission and see what AOP is reporting on their P1s and P2s, what the allowable is. The record is not clear how HECI discovered it. A logical guess would be when they had annual reserve studies done they would notice problems or notice increased water production, which would be indicative of problems, and that perhaps put them on notice that they needed to look further at what AOP was doing. But the record doesn't tell us how that happened.

Going back to your question, Judge Abbott, there is no case that's ever been decided in this state that says that the RR Commission records put a person on constructive notice.

HANKINSON: Aren't typically though property owners put on constructive notice of all public records regarding their property?

COHEN: No. That is not correct. A purchaser of property is on notice of things in the chain of title. But things happening after you already own it, you are not on constructive notice. This court has decided that in the *Wise v.* _____. There's a case out of San Antonio called _____ *v. Lightfoot*, in which they said, "the first purchaser is on notice, but at that point the purchaser doesn't have an obligation to go check every morning to see if something has impacted

his or her title." It goes back to an old Amarillo case called *Clay v. Cox* .

HECHT: If it's important that there is no case that helps them on the discovery rule, there's no case that helps you on the implied covenant is there?

COHEN: *Amoco v. Alexander* does. Because that case stands for the proposition that the lessee's obligations are based upon and measured by the reasonable prudent operator standard. At page 568 of that...

HECHT: But we've never said that meant giving notice?

COHEN: No. But *Amoco* came into this court in 1981 and made the exact same argument and said, "You've never required anybody to go to the RR Commission and seek an exception." And the court said at page 568 of that opinion that, "We're not looking at a specific list item-by-item on implied covenants. *Amoco* stands for the proposition that their obligations are based upon and measured by reasonable prudent operator. And here they set the standard. They decided that RR Commission relief was inadequate to protect that leasehold estate.

HECHT: If they hadn't and had decided not to give you notice, you could have quarreled with that _____.

COHEN: Yes, we could have quarreled about that as well. That would be a different case.

HECHT: So just because they decided doesn't in your view end it? I mean whether they have to give notice may depend on, in your view, suspicions, actual knowledge, negotiations, all sorts of things?

COHEN: If once they make that decision that that's what a reasonable prudent operator would have to do to protect the leasehold estate, they can't just do it to protect the 5/6. That's the flaw in their argument.

HANKINSON: But didn't they act as the reasonably prudent operator to protect the leasehold by going to the RR Commission, by getting the injunction once they determined that the waste was occurring?

COHEN: Yes.

HANKINSON: And at that point in time it stopped, and they protected the leasehold from further waste, correct?

COHEN: Correct. Well that's not quite accurate because if you look at the record, the second RR Commission filing was filed simultaneous with the lawsuit. The RR Commission didn't

reach their conclusion until 6 months after they settled this judgment.

HANKINSON: But you didn't make a claim that they didn't act as the reasonably prudent operator to stop the waste?

COHEN: No, we did not.

HANKINSON: So the claim really has to do with we have HECI pursuing its claims over against AOP? That's what the litigation was about.

COHEN: The litigation was to enjoin them from over-producing and to get back the lost production _____ damage or drainage.

HANKINSON: And by enjoining further waste, they did protect their leasehold by getting that injunction?

COHEN: That was part of it, yes.

HANKINSON: So then we have them pursuing their own claim for damages based on their ownership interest in that property?

COHEN: I disagree that they just pursued their own claim.

HANKINSON: I understand that. But that's what they were doing?

COHEN: They pursued a claim for a damage or drainage. The record reflects that they went on alternative theories.

HANKINSON: And what is the nature of the relationship then between HECI and your client? Is it contractual?

COHEN: It's purely contractual. The fiduciary has nothing to do with it.

HANKINSON: Why can't two parties to a contract each on their own just decide to pursue their own tort claims?

COHEN: They can, but the implied covenant is broad enough to require them that when they made the decision that the lawsuit for damages and injunctive relief was necessary to protect the leasehold, they had to protect it all. They are arguing back and forth past themselves on this. Either they did sue on the Neels' behalf, and they kept the money, which is unjust enrichment, and I think the evidence is pretty good on that that they proved up 100% of the loss, or they didn't sue to protect the entire leasehold estate, and they should have.

HANKINSON: The injunctive relief that they sought to get further waste benefitted the whole leasehold didn't it?

COHEN: Absolutely. Everything they did up to that last step was for the mutual benefit.

HANKINSON: And then at that point in time sued for their damages that had occurred in the past that had already occurred?

COHEN: Not necessarily, because they proved up two measures of damages. One was the amount that AOP illegally took out of the ground and that came to $1.6 million; and then they proved also as a measure of damages how much the total reserves in each well had been diminished. That's plaintiff's ex. 21.

HANKINSON: And that had all already occurred?

COHEN: No, that was the alternative theory as to what they might not be able to get out in the future. When they talk about the damage issue, it's what you would have got out in the future, but for the increased water saturation.

ABBOTT: If the Neels had an independent ability to sue AOP, how is it that HECI had the authority to sue AOP on behalf to the Neels?

COHEN: Well the CA did not hold that they had that authority. But I think if you read the *Ostrom* case, that's cited by the CA, and look at the very first paragraph of the lease, it talks about the lessee getting 100% of the rights to all the minerals at that point under the lease, And if they own 100% of it, they had the right to sue on the _____ for the 100% interest. But that's not what the CA held. I think it's arguably that they could have and probably did sue on behalf of _____.

OWEN: Let's suppose this had been a blowout situation, and you have a royalty owner that lives in New York and says: "I don't read the local newspapers, and I don't have occasion to go to the RR Commission." Would a blowout situation be a discovery rule type case where the operator filed the lawsuit to recover for the lost hydrocarbons?

COHEN: I would think you would apply the same test to that person. It was the sort of thing that was published over the wire service and on the 6 o'clock news media. This court has held in defamation cases that when things have such dissemination in the national they can become discoverable.

OWEN: The whole county knows the well blew out. It's not inherently undiscoverable it's just that you don't happen to live in the area. How did we square that with inherently undiscoverable?

COHEN: Well we have hundreds of thousands of royalty interest owners that don't necessarily live in the county where their property is. Do we want to require them to subscribe to the local paper and which of the more than 100 trade journals do we want to require them to subscribe to? Suppose they put it in an oil and gas journal rather than petroleum and information. I think that the *Altai* would work just fine. And you start out using inherently undiscoverable. If there is actual notice as most of these cases are, that solves it. If there is such national or widespread dissemination that a reasonable person knew or would have known, that solves it. And when you get to public records you say, "is that person required by statute to go look, did they have any reason to go look, and what would they have found out had they gone?" You've got to get to that. That's the kind of test you have to apply that. And that keeps you consistent with what I thought the court was going in *Altai* to get away from this category-by-category jurisprudence and try to come up with some unifying requiring principles in this area.

GONZALEZ: Other than *Amoco v. Alexander* is there any other case that you cite as authority to the proposition that HECI as a reasonable operator had a duty to inform the Neels of this illegal drainage?

COHEN: No, it is truly and application of the implied covenant to protect the leasehold as stated there.

GONZALEZ: Stated in *Amoco*?

COHEN: Stated in *Amoco*.

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REBUTTAL

BARON: Starting with *Amoco*. *Amoco* imposed on the lessee a duty to take action to protect future production, drainage in the future not recovering damages for drainage in the past.

GONZALEZ: I am trying to understand the equities here. HECI knew of the illegal drainage?

BARON: Yes.

GONZALEZ: Made efforts to stop it before the RR Commission, that was unsuccessful; got an injunction and then sued for damages to the whole leasehold estate, and now you don't want to share those proceeds with the royalty owner?

BARON: As I explained in response to Justice Abbott's question, no, we couldn't get their damages; and 2) we didn't. And I think Justice Owen was right when she said, "even if we did, it's AOP's fault for not objecting to the submission in the damages that were awarded in that case."

But the duty under *Amoco* is to protect the leasehold estate. It has to be part of the leasehold estate to require you to protect it. Future production is part of the leasehold estate. It will eventually be produced from the leasehold.

GONZALEZ: But you want to be compensated for the oil that has already been taken?

BARON: We dispute whether it's been taken or not, whether this is damage or drainage suit against AOP. But basically what the damages number reflects was damage to the geological structure under the lease because of the purely water production by a well on the lease.

GONZALEZ: It was not for compensation for the product that was illegally syphoned off?

BARON: Even if it were, that's not part of the leasehold because there is not HECI could do on the leasehold to produce that oil that was taken.

GONZALEZ: If it was for compensation for damages to that leasehold estate for the oil that was illegally syphoned off, don't you have a duty to share it?

BARON: It can't be damages for part of the leasehold estate. The leasehold estate is looking to the future, the duties of the lessee are prospective. We are looking at what is the main purpose of this contract? The main purpose of this contract is to produce oil from our lease and to pay royalty under the express royalty provision of the lease. And the express purpose of the contract is not to go out and dig up litigation claims for your lessor. And that's what is common about implied covenants. What they say is, "they are only applied, they are disfavored, they are applied only if they are absolutely essential to accomplish the main purpose of the lease," which is production. And they also only apply it when it's something only the lessee can do.

The Neels' admitted, they have their own claim against AOP. I don't think that claim would have been time-barred because of the false filings by AOP at the RR Commission. There would be claims of fraudulent concealment in that case against AOP that would probably permit the Neels' claims to go forward.

They hypothesize that we could have discovered possibly the damage based on an annual reserve report. It's not in the record how HECI discovered it, but there are plenty of examples of express lease provisions: all of the GLO leases that the state uses require the lessee to provide to the lessor an annual reserve estimate. So if the Neels wanted that information they could have contracted for it, and it would have shown them the problem if that's how we discovered it.

Let me say one word about constructive notice. That's not the issue in this case. Constructive notice is a legal doctrine that charges you with actual notice. It's as if you really knew it. That's part 2 of *Altai*: Did these plaintiffs know or did they have constructive knowledge? The first question under *Altai* is whether you could go and find it if you went and looked for it?

ABBOTT: If that were really the test, what would be inherently undiscoverable because we all have access to all information that exist and if we can't discern what it means ourselves, we can go hire an expert.

BARON: We don't all have access to all information. I think we have the example of the trade secret information, that's in a private pile that you can't have access to.

ABBOTT: And that's not inherently undiscoverable. You're saying that because it is information that exist, it is not inherently undiscoverable?

BARON: No, I'm really not going that far. I think it's information that exist to which you have access. I think you have to be able to get a hold of it in order for that to work.

ABBOTT: So does that mean that a landowner somewhere, if a lawsuit is filed that may affect that property without the landowner being served and he has a claim against someone else and as a result of it he's put on notice because that lawsuit was filed somewhere?

BARON: Well I think certainly that's public information to which the landowner has access. I think this court can make some kind of determination on how connected that information is to the activity that's occurring, that would put you on some kind of obligation to go look. Clearly the RR Commission records here are absolutely directly connected to activities on the Neel lease. There's no question about that relationship. If this information had been in the motor vehicle records or something, and that may have been inherently undiscoverable, because it's not in a place that is connected enough to your transaction that you could be expected to go look for it.

ABBOTT: If we write the opinion your way, would it not necessarily be a requirement but not an implication that all royalty owners in the future are going to have to keep up with all RR Commission filings?

BARON: Well I think they are required to do that now, because that's what the statute of limitations imposed on everybody, which is you have to monitor potential claims and you have to assert them in a timely way. And the Neels have over 1 million barrels of oil under their lease. They can make an economic decision on how closely they want to monitor those claims. But I think the legislature has imposed that duty on them. And what they're saying is they are exempted from that duty and they are exempted from exercising any due diligence under the *Altai* test.

ABBOTT: How does the legislature impose that duty on them?

BARON: Well it's imposed it on everybody by adopting the statute of limitations that says if you don't bring your claims within two years or four years they are barred.