



**PLANO Legal Update  
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**Litigation Update: *Hayes Fund for the First United Methodist Church of Welsh, LLC v. Kerr-McGee Rocky Mountain, LLC***

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On December 8, 2015, the Supreme Court of Louisiana issued a much anticipated ruling in *Hayes Fund for the First United Methodist Church of Welsh, LLC v. Kerr-McGee Rocky Mountain, LLC* (“*Hayes Fund*”). The decision was a victory for mineral lessees operating in Louisiana because the Court unequivocally affirmed that the “manifest error” standard is alive and well. Even though the legal concept of “manifest error” does not typically register on the radar of landmen, we believe the community will appreciate this decision’s significance to the oil and gas industry.

A. Royalty Interest Owners Claim Loss of Future Income

The *Hayes Fund* case was, at its heart, a lost income case. Despite receiving more than \$19 million in mineral royalties from two wells, plaintiffs/royalty interest owners alleged that the imprudent operations by defendants/mineral lessees deprived plaintiffs of their full measure of mineral royalties—totaling an additional \$13 million. Plaintiffs claimed that defendants violated their obligation under the mineral lease and La Mineral Code Art. 122 to act as a reasonably prudent operator. The case was tried over a period of twenty five days before a judge, no jury. The trial level is important because the trial court decides which testimony by the parties’ expert witnesses is more credible when purported “facts” conflict. Once the trial court rules on the facts, the appellate court must accept the facts as true, except in particular circumstances as discussed below. In *Hayes Fund*, the expert witnesses testified to the conduct of defendants/mineral lessees’ operations downhole, among other factual disputes.

Plaintiffs own royalty interests in two wells in Jefferson Davis Parish—the Rice Acres No. 1 (“Rice Acres”) well and the Hayes Lumber No. 11-1 (“Hayes Lumber”) well. Defendants are the mineral lessees and working interest owners of those wells. The Rice Acres well produced from a single reservoir, while the Hayes Lumber produced from two reservoirs (an upper and a lower). The three producing zones are subject to unit orders issued by the Louisiana Commissioner of Conservation.

When the Rice Acres well was drilled, a drilling pipe became differentially stuck in the wellbore. That original wellbore was ultimately plugged and side tracked 132 feet away; the

replacement wellbore produced for almost five years before it “watered out.” Plaintiffs alleged that the original wellbore was not properly cemented and, as a result, the productive formation was inadequately isolated, thereby allowing extraneous water to enter and ruin the formation. Plaintiffs further alleged that, because the well prematurely watered out, any recoverable hydrocarbons were commercially lost. However, defendants responded that the cement job in the original wellbore was more than adequate; water was present in the wellbore because the reservoir was water-driven, not as a result of a poor isolation cement job. Moreover, despite the problems with the original wellbore, the well produced as defendants had expected.

As for the Hayes Lumber well, it was outfitted downhole with a three permanent packer design. The Hayes Lumber well produced for almost nine years and eventually sanded in. Plaintiffs alleged that this outfitting was imprudent because it made it impossible to install control hardware when the well later suffered sanding problems. Defendants responded that the packer design was entirely prudent under the circumstances, because it permitted them to isolate the various sands as they successively watered out. Moreover, defendants maintained that their actions could not have been imprudent because they had no reason to anticipate sanding issues when the well was originally drilled.

B. Trial Court Finds That Mineral Lessees Are Not Liable

The district court held a bench trial on these issues in 2012. The case was tried for 25 days over 11 months in non-consecutive sessions. After a full trial on the merits, consideration of the evidence and testimony of the expert witnesses, the district court issued a 13-page decision finding that plaintiffs failed to meet their burden of proof on causation and it dismissed plaintiffs’ entire case, awarding zero damages. Essentially, the trial court believed the testimony of defendants’ expert witnesses when it came time to decide whether defendants’ actions breached any duties owed under the lease and Art. 122.

The main import of the district court’s opinion was this: several actions by defendants were entirely prudent under the circumstances, and other actions, while imprudent (*e.g.*, the differentially stuck pipe), did not cause plaintiffs any damage. The trial largely consisted of a battle of the experts. The district court concluded that the triple packer design in the Hayes Lumber well was a prudent one, as the hardware afforded certain production advantages in light of the reservoir’s water-drive characteristics. As for the Rice Acres well, the district court agreed with plaintiffs that defendants acted imprudently by causing the drilling pipe to become irretrievably stuck. But it disagreed that plaintiffs suffered any damage as a result. It found that defendants put an adequate cement plug over and around the stuck drill pipe, which effectively prevented the migration of extraneous water into the producing reservoir. Whatever water was present in the wellbore occurred because the reservoir was water-driven.

C. Third Circuit Reverses the Trial Court’s Decision

Plaintiffs appealed the district court’s ruling to the Louisiana Court of Appeal, Third Circuit. The Third Circuit reversed the district court by making its own factual findings and credibility determinations. In agreeing with each and every assignment of error advanced by plaintiffs, the Third Circuit ordered defendants to pay plaintiffs more than \$13.4 million in

damages, representing what plaintiffs claimed were the royalties that they would have received but for defendants' allegedly imprudent operations.

A good portion of the Third Circuit's opinion focused on the district court's findings of fact—which were that defendants acted prudently, and that any imprudence did not damage plaintiffs. Appellate review of a district court's factual findings are entitled to a great deal of deference; reviewing courts are not to disturb a finding of fact unless there is “manifest error” or it is “clearly wrong”—that is, there is no reasonable basis in the record to support the district court's decision. The standard is *not* whether a reviewing court would have found the facts of the case differently. Despite the volumes of testimony presented to it, including the testimony of five defense experts, the Third Circuit reversed the district court, almost wholesale adopting the arguments asserted by plaintiffs.

Notably, the Third Circuit's opinion discussed a number of issues, two of which landmen should find important: (1) the application of the collateral attack doctrine; and (2) the imposition of absolute liability.

1. “Collateral Attack Doctrine”

Because the district court found that defendants were not liable, it did not address the issue of damages. The Third Circuit, however, reviewed the record, made its own factual determinations, and reversed the district court on the threshold question of liability. As a result, the Third Circuit then found it fit to discuss the appropriate measure of damages.

The major discussion regarding the measure of damages revolved around the applicability (or inapplicability) of the “Collateral Attack Doctrine.” Recall that the three reservoirs in *Hayes Fund* underlie unitized lands. These units were created by order of the Commissioner of Conservation with the Louisiana Department of Natural Resources. If an aggrieved party disagrees with an order of the Commissioner, the sole remedy is to file a lawsuit in Baton Rouge (19<sup>th</sup> JDC). Or if the aggrieved party comes across new relevant evidence, he or she may petition the Commissioner to modify or rescind the original unit order. In any event, the aggrieved party cannot challenge the decision (or any factual finding) of the Commissioner in a different case after the Commissioner rules. Such challenges are impermissible “collateral attacks” on the original orders.

Plaintiffs and defendants alike acknowledged that the appropriate way to measure damages is by calculating the additional amount in mineral royalties plaintiffs would have received from production had defendants not acted imprudently. But there was a clear disagreement in the parties' respective methodologies.

In their calculations, plaintiffs assumed that the total volume of hydrocarbons available for capture equaled the total volume of the unit areas. Plaintiffs consistently argued that this assumption was required by the orders of the Commissioner of Conservation creating the three unit areas, and that the introduction of any evidence to the contrary would constitute an impermissible collateral attack.

Defendants, on the other hand, argued that the unit orders did not determine the volume of hydrocarbons within the respective units. Rather, the unit orders merely defined the maximum area which could be efficiently drained by a single well, while ensuring that the surface owners could equitably partake in those hydrocarbons contained within the productive strata.

The real disagreement centered on the difference between “geographic” and “geologic” units. Defendants insisted that the unit size is an inadequate substitute for reservoir volume—the unit plats do not mimic the subsurface configuration of the reservoirs, and they certainly do not communicate the volume of reserves in those reservoirs. When faced with insufficient geological information, the Commissioner routinely establishes a geographic unit. In such cases, the unit lines are based on surface expressions—dry holes, section lines, etc. And in this specific case, the unit orders were clearly stated: “NOTE ALL BOUNDARIES ARE GEOGRAPHIC.” Plaintiffs responded that the Conservation Act does not distinguish between geographic and geologic units; moreover, the unit orders themselves do not make this distinction either. Therefore, any discussion of whether the unit orders incorrectly identify the size of the underlying reservoirs is an impermissible collateral attack.

Ultimately, the Third Circuit sided with plaintiffs and completely disregarded defendants’ rebuttal damages model, ruling it a collateral attack. Therefore, the Third Circuit was left with only the evidence on damages introduced by plaintiffs, and this evidence formed the sole basis for the Third Circuit’s discussion of damages.

## 2. Absolute Liability for Surface and Subsurface Damages

The mineral lease at issue was a standard Bath form lease that included a surface damages provision: “The Lessee shall be responsible for all damages to timber and growing crops of Lessor caused by Lessee’s operations.” But the restrictive words “timber and growing crops of Lessor” were manually stricken from the model form during negotiations. As an addendum to the surface damages provision, the parties appended an exhibit (“Exhibit A”) which spelled out specific instances where plaintiffs could recover damages from defendants without having to prove fault for certain surface and subsurface activities. These no-fault scenarios encompassed much more than damages to “timber and growing crops.” For example, one provision addressed site restoration, another addressed salt water disposal, and a third addressed the measure of damages.

The Third Circuit held that the district court committed legal error in requiring plaintiffs to prove fault. Rather, it found that defendants were absolutely liable regardless of whether their conduct was imprudent because of the open-ended damages provision in the mineral lease, which the Third Circuit interpreted to include surface and subsurface damages. In other words, plaintiffs were entitled to all the damages they sustained regardless of whether defendants acted imprudently because the modifier “timber and growing crops” had been deleted.

Defendants protested that the Third Circuit’s decision ignored settled rules on the interpretation of contracts—more specifically, mineral leases. Defendants’ strongest argument, in a nutshell, was that all provisions to a contract must be read as a whole and given effect to the extent possible. The Third Circuit’s decision rendered the entirety of Exhibit A redundant, as the

modified form language necessarily encompasses all of the more specific damages provisions included in Exhibit A.

D. Louisiana Supreme Court Reverses the Third Circuit

On the heels of the Third Circuit’s decision, defendants filed an application for a writ of certiorari to the Louisiana Supreme Court in December 2014, asking the Court to reverse the decision of the Third Circuit.<sup>1</sup>

Impressively, the Court issued a unanimous decision reversing the Third Circuit. The entire focus of the Court’s 67-page decision is the manifest error standard of appellate review. The Court did not discuss the arguments relating to the collateral attack doctrine and absolute liability because resolution of those issues was unnecessary to decide the case. The Court instead focused on the threshold issue of “manifest error.” Here, the Court found that the Third Circuit did not properly apply the manifest error standard. The Third Circuit incorrectly substituted its own findings of fact for those made by the trial court. As a result, the Court reversed the Third Circuit’s decision and reinstated the ruling of the district court.

As the Court aptly noted, this case was a battle of experts. The Court’s decision is replete with excerpts from the trial testimony of plaintiffs’ and defendants’ experts discussing the Rice Acres well and the Hayes Lumber well. As to the Rice Acres well, the Court held that the district court’s conclusion that the reservoir was water driven and not subject to extraneous water from other zones was not unreasonable in light of the evidence presented at trial. As to the Hayes Lumber well (lower zones), the Court found that the lower zones were not unattainable based on the testimony of defendants’ expert, Calvin Barnhill, who posited a number of alternative ways a reasonable operator could successfully produce the remaining reserves. And as to the upper zone, the Court found that the trial record supported the conclusion that the reservoir was water-driven; therefore, it was always expected to produce water.

The significance of all of this, of course, is that the Louisiana Supreme Court—as the Third Circuit should have done—looked for a reasonable basis for the trial court’s decision, found that basis in the record of the trial court, and determined that the trial court was not clearly wrong when it believed one side’s experts over the other’s.

For a copy of the Supreme Court’s decision in *Hayes Fund*, please visit:  
<http://www.lasc.org/opinions/2015/14C2592.opn.pdf>.

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<sup>1</sup> In full disclosure, our firm filed an amicus brief on behalf of the Louisiana Oil & Gas Association (“LOGA”) in support of defendants’ application for writs and a follow-up amicus brief in support of defendants’ position on the merits.