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The Effect of Pooling and Unitization Upon Oil and Gas Leases

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When all or part of a given leasehold is included in a unit by the terms of a pooling or unitization agreement, the relationship of the lessor and lessee with regard to the express and implied terms of the lease may be affected in important respects. In this paper the effect of pooling and unitization of the leasehold upon the express and implied terms of oil and gas leases will be considered.¹

By way of background, we recall that the lessee has no power to affect his contractual duties to the lessor under the lease by pooling or unitization absent consent by the lessor, estoppel, or compulsory process under a valid state statute. In fact, pooling or unitization of a leasehold not binding on the lessor may increase the lessee's duties. Consent to pooling or unitization may be expressed in a pooling clause in the lease instrument, or in a separate agreement or by ratification. Estoppel may arise from the lessor's acceptance of benefits from pooling or unitization.

The lessee may pool his working interest without a pooling of the landowner interest.² It is unsettled whether an express prohibition against pooling or unitization in a lease would be effective. Such prohibition might be invalid as a violation of the Rule against Restraints upon Alienation. No

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¹ On the problems considered herein see HOFFMAN, VOLUNTARY POOLING AND UNITIZATION (1954); Barth Walker, *Recent Developments in Pooling and Unitization*, SOUTHWESTERN LEGAL FOUNDATION SIXTH ANNUAL INSTITUTE ON OIL AND GAS LAW AND TAXATION 47 (1955); Shank, *Pooling Problems*, 28 TEXAS L. REV. 662 (1950); A. W. Walker, Jr., *Developments in the Law of Oil and Gas in Texas During the War Years—A Résumé*, 25 TEXAS L. REV. 1 (1946); Shank, *Some Legal Problems Presented by the Pooling Provisions of the Modern Oil and Gas Leases*, 23 TEXAS L. REV. 150 (1945).

² See HOFFMAN, *supra* note 1, at 194. The following cases are cited therein: Bruce v. Ohio Oil Co., 169 F.2d 709 (10th Cir. 1948), *cert. denied*, 336 U.S. 913 (1949); Smith Petroleum Co. v. Van Mourik, 302 Mich. 131, 4 N.W.2d 495 (1942); Knight v. Chicago Corp., 144 Tex. 98, 188 S.W.2d 564 (1945); Pinchback v. Gulf Oil Corp., 242 S.W.2d 242 (Tex. Civ. App. 1951, error *ref'd n.r.e.*).

cases have been discovered in which the question was squarely raised; in one case³ which might have presented the problem, its consideration was rendered unnecessary by a construction of the restraint clause as not applicable to unitization.

Pooling or unitization of only the working interest by the lessee will not modify the lease terms in important respects. The lessee will continue to be subject to the covenants in the lease; he will be compelled to account to the lessor for a royalty on production from the leased premises; and production from the leased premises will be required to continue the lease in effect during the secondary term of the lease.⁴ The difficult question which arises in this context concerns conduct of the lessee on portions of the unit other than the leased premises in question. May he engage in operations on the unit—for example, secondary recovery operations which may cause some replacement of wet gas beneath Blackacre by dry gas—for the purpose of maximizing total recovery of hydrocarbons? As indicated herein-after, pooling or unitization by the lessee without the joinder of the lessor may remove interior boundary lines as between lessees, but they will remain as to lessors, and each lease must be protected against drainage and be given reasonable development.⁵

In many instances, of course—those with which this paper is concerned—the lessor will have consented to the pooling or unitization⁶ or compulsory process for pooling or unitization will have bound his interest to the pool or unit. The problems may be analyzed by reference to four generic types of fact situations. Each involves the leasing of a tract of land—Blackacre—followed by the creation of a unit under a pooling or unitization agreement. These four fact situations may be summarized as follows:

Case I: All of the leased premises—Blackacre—is included in the unit and production is obtained from a well drilled on Blackacre, or drilling operations are prosecuted on Blackacre.

Case II: All of Blackacre is included in the unit and production is obtained from a well drilled on the unit or drilling operations are prosecuted

³ Knight v. Chicago Corp., *supra* note 2.

⁴ See HOFFMAN, VOLUNTARY POOLING AND UNITIZATION 197 (1954).

⁵ See, e.g., Tide Water Associated Oil Co. v. Stott, 159 F.2d 174 (5th Cir. 1946), *cert. denied*, 331 U.S. 817 (1947). See discussion following topic heading VI *infra*.

⁶ The execution of a joint or community lease by the owners of separate parcels may give rise to the types of problems considered herein. On such leases, see HOFFMAN, VOLUNTARY POOLING AND UNITIZATION c. 2 (1954); Williams, *The Effect of Various Conditions of Ownership on Oil and Gas Transactions*, 5 UTAH L. REV. 1, 21 (1956).

A lessor may under some circumstances be found to have consented to the agreement by ratification or estoppel. Dobbins v. Hodges, 208 La. 143, 23 So.2d 26 (1945) (ratification by accepting royalty payments); Leopard v. Stanolind Oil and Gas Co., 220 S.W.2d 259 (Tex. Civ. App. 1949, error *ref'd n.r.e.*) (ratification by acceptance of royalty payments and by execution of royalty deed referring to the lease). The signing of a division order and acceptance of royalties may not, however, ratify a pooling agreement entered into by a lessee if the lessor has no notice thereof. Wilcox v. Shell Oil Co., 226 La. 417, 76 So.2d 416, 3 O.&G.R. 1903 (1954).

thereon, but the producing well is not drilled or the drilling operations are not prosecuted on Blackacre itself but on some other tract included within the unit.

Case III: A *part* only of Blackacre is included in the unit and production is obtained from or the drilling operations are prosecuted on the portion of Blackacre included in the unit.

Case IV: A *part* only of Blackacre is included in the unit and production is obtained from or the drilling operations are prosecuted on a portion of the unitized or pooled area other than the portion of Blackacre which is included therein.

One additional case may be mentioned: part only of Blackacre is included within a unit and production is obtained from or drilling operations are prosecuted on the part of Blackacre excluded from the unit. This case is not discussed herein. The writers know of no cases dealing with this situation. The absence of cases is probably explained by the fact that exploration and development of a unit typically occurs before exploration and development of other acreage excluded from a unit by action of a lessee with an interest in the unit. If exploration or development first occurs off the unit, exploration and development of the unit will almost certainly promptly follow without the necessity of action by owners of interests in the unit.

We shall consider as to each of these four cases the impact of pooling or unitization upon: the royalty provisions of the lease (I); the delay rental provisions of the lease (II); the "thereafter" clause of the lease (III); savings clauses in the lease (IV); and the express or implied covenants of the lease (V). We then turn to the effect of refusal of a lessor or lessee to pool or unitize (VI).

By way of caveat, the reader is reminded that a lessee under some circumstances owes a "duty of fair dealing" to the lessor. To the extent that a lessee's conduct may be found to violate that duty, the discussion under the above-mentioned headings must be modified. Specific treatment of this duty follows the discussion under these headings (VII). We shall then consider the effect of inconsistency of provisions in a lease and in a pooling or unitization agreement (VIII), certain construction problems (IX), and some policy considerations (X).

I

THE ROYALTY CLAUSE

The effect of the royalty clause of the lease is modified by pooling or unitization in each of the above four cases. By the terms of the typical lease, the lessor is entitled to a royalty on production from Blackacre but is not entitled to royalties on production from other tracts. By virtue of the pool-

ing or unitization, the lessor becomes entitled to a royalty on a pro rata share of the production attributable to Blackacre under the terms of the participation formula of the agreement, whether the production is from Blackacre itself or from other tracts included within the agreement. Prior to the agreement, the lessor was entitled to a royalty measured by the full production from Blackacre; after the agreement he is entitled to a royalty measured only by a pro rata share of the production from Blackacre. Prior to the agreement, the lessor was not entitled to a royalty on production other than from Blackacre; now he is entitled to a royalty measured by a pro rata share of production from other tracts included in the unit with Blackacre.⁷

If Blackacre is a 20-acre tract and all of Blackacre is included within a 40-acre unit upon which one well is drilled (Cases I and II), the lessor of Blackacre who was entitled under the terms of the lease to a $\frac{1}{8}$ th royalty on production from Blackacre will be entitled to a $\frac{1}{8}$ th royalty on an apportioned share of the production under the unit. Similarly, if Blackacre is a 200-acre tract, 20 acres of which are included in a 40-acre unit on which a producing well is drilled (Cases III and IV), the lessor of Blackacre, who under the terms of the lease was entitled to a $\frac{1}{8}$ th royalty on production from Blackacre, will thereafter be entitled to a $\frac{1}{8}$ th royalty on an apportioned share of the production under the unit. Assuming the participation formula in both instances is on a straight acreage basis, the lessor will be entitled under the agreement to a $\frac{1}{8}$ th royalty on $\frac{1}{2}$ of the oil produced by the well, whether the well is located on Blackacre or on a portion of the unit other than Blackacre. In effect, then, the lessor under the agreement will have a $\frac{1}{16}$ th royalty on production from the unit.⁸

⁷ *Dillon v. Holcomb*, 110 F.2d 610 (5th Cir. 1940) (Case II); *Hunter Co. v. Shell Oil Co.*, 211 La. 893, 31 So.2d 10 (1947) (Case IV); *Griswold v. Public Service Co.*, 205 Okla. 412, 238 P.2d 322, 1 O.&G.R. 108 (1951) (Case I); *Patterson v. Stanolind Oil & Gas Co.*, 182 Okla. 155, 77 P.2d 83 (1938), *appeal dismissed*, 305 U.S. 376 (1939) (Case I); *French v. George*, 159 S.W.2d 566 (Tex. Civ. App. 1942, error ref'd) (Case I); *Parker v. Parker*, 144 S.W.2d 303 (Tex. Civ. App. 1940, error ref'd) (Case II); see *Brown v. Smith*, 141 Tex. 425, 174 S.W.2d 43 (1943).

The parties to the agreement may, of course, provide expressly for non-apportionment of production among the several parcels included within the lease. See *Petroleum Midway Co. v. Moynier*, 205 Cal. 733, 272 Pac. 740 (1928); *HOFFMAN, VOLUNTARY POOLING AND UNITIZATION* 32, 50-52 (1954). However, such express provision is rare except in community leases as it is contrary to the usual purpose of unitization to obtain efficient development of the producing formation without regard to surface boundaries. Partition by lessors having interests under a community lease may result in non-apportionment of royalties on the basis of express or implied intent. *Garza v. De Montalvo*, 147 Tex. 525, 217 S.W.2d 988 (1949); see *HOFFMAN, VOLUNTARY POOLING AND UTILIZATION* 75-81 (1954).

⁸ In some states, e.g., Mississippi, the lessor's royalty interest in the production from a well located on the unit but off Blackacre is appurtenant to his interest in Blackacre. *Merrill Engineering Co. v. Capital National Bank*, 192 Miss. 378, 5 So.2d 666 (1942). In other states, e.g., California, the interest is in gross. *Tanner v. Title Insurance & Trust Co.*, 20 Cal.2d 814, 129 P.2d 383 (1942).

Absent a contrary provision in the unit agreement, royalty is paid to the lessor of Blackacre in accordance with the terms of his lease and not according to the terms of other leases in the unit, although production may be wholly derived from such other leaseholds. Thus, in a federal case arising in Louisiana, a 4-acre tract and a 6-acre tract were pooled, and a well was drilled on the latter tract. The lease of the 6-acre tract provided for a $\frac{1}{8}$ th royalty; the lease of the 4-acre tract provided for an overriding royalty and an oil payment in addition to a $\frac{1}{8}$ th royalty. It was held that the lessor of the 4-acre tract was entitled to recover the royalty, the overriding royalty and the oil payment provided for by his lease on the 4/10ths of the production under the unit attributable to the 4 acres and was not limited to recovery of 4/10ths of $\frac{1}{8}$ th of production from the unit.⁹ In the case of sliding scale royalties provided for in leases or deeds the unitization agreement governs the production allocable to the well or tract involved and the royalty appropriate to the allocated production will be due and payable.¹⁰ The lease governs as to the fraction or percentage of the royalty, but the amount of production on which royalty is paid is calculated under the unit agreement.

For purposes of offset or substitute royalty payments, production under the unit is considered as production from the leased premises included therein. Thus in a Louisiana case,¹¹ a lease provided that if no well were drilled thereon, the lessee would pay offset royalty or substitute royalty in the event the lessee obtained commercial production within 1320 feet of the leased premises or a draining well was drilled within 670 feet of the premises. Payment of such royalty was held to be excused by the inclusion of the tracts in a compulsory unit and payment of royalty was made on the basis of the production attributable to the leasehold under the unit plan.

In summary, then, in each of cases I through IV: (a) the particular fraction or percentage of production payable as royalty under the terms of the lease is not altered, but (b) the production on the basis of which the royalty is paid is the share of the total production from the unit apportioned in accordance with the agreement to the particular leasehold whether or not such production was from a well on the particular leasehold.

Thus far the treatment of Cases I through IV appears identical. But Cases III and IV differ from Cases I and II in that not all of Blackacre is

⁹ *Dillon v. Holcomb*, 110 F.2d 610 (5th Cir. 1940); see also *Arkansas Louisiana Gas Co. v. Southwest Natural Production Co.*, 221 La. 608, 60 So. 2d 9, 1 O.&G.R. 1186 (1952) (royalty owners in a unit are entitled to be paid on the basis of the amounts received by their own lessees from the sale of the proportion of the production allocated to the tract in which they have an interest rather than on the basis of the return from the sale of all gas and distillate produced from the unit).

¹⁰ *Beene v. Midstates Oil Corp.*, 169 F.2d 901 (8th Cir. 1948).

¹¹ *Everett v. Phillips Petroleum Co.*, 218 La. 835, 51 So. 2d 87 (1950).

included within the unit and hence the participation formula does not give consideration to all of Blackacre but only to that portion included within the unit. This would appear entirely equitable and fair only if the jural relationship of the lessor and lessee as to the portion of Blackacre excluded from the unit remains unaffected by the agreement. To the extent that such jural relationship is affected by the agreement, an element of apparent inequity or unfairness may enter the picture. We turn then to the other effects of the agreement upon this relationship.

II

THE DELAY RENTAL CLAUSE

Under the typical lease, in Cases I and II, if there is no production and no drilling anywhere on the unit on the first anniversary of the Blackacre lease, the lease will terminate unless the delay rentals therein provided for are paid. It will be necessary to continue annual rental payments until drilling is commenced or production obtained on the unit. In the typical "unless" lease, commencement of drilling or production keeps the lease alive without tender of rentals. If such is the case, then drilling operations or production on the unit, though not on Blackacre, will keep the Blackacre lease alive.¹² Occasionally a lease will provide for a minimum royalty equal at least to the amount of delay rental payments. Absent such a provision, it is, of course, irrelevant whether the payments, if any, made to the lessor as royalty are less than the delay rental payments to which he would otherwise have been entitled.

In summary, whatever keeps the lease in force if done on Blackacre will keep the lease in force if done anywhere on the unit, where Blackacre has been pooled or unitized. A difficulty will be presented by unitized leases containing different drilling provisions. Suppose the Blackacre lease requires either payment of rental or *completion* of a well. The adjoining lease in the unit requires payment of rentals or *commencement* of a well. It would seem that commencement of a well on the adjoining land will not satisfy the terms of the Blackacre lease, and the lease will terminate if the well is not completed before the anniversary date of the Blackacre lease.

The above statements are equally applicable to Cases III and IV, as to the portion of Blackacre included within the unit.¹³ Some difficulty is presented as to the portion of Blackacre excluded from the unit.

It may first be noted that the practice of including a clause specifically covering Cases III and IV is becoming increasingly common when such

¹² *Sohio Petroleum Co. v. V.S.&P.R.R.*, 222 La. 383, 62 So.2d 615, 2 O.&G.R. 178 (1952).

¹³ This statement assumes the pooling or unitization is binding on the lessor. If not binding on the lessor, the lease will terminate on the anniversary date for non-payment of rentals in Cases II and IV. *Wilcox v. Shell Oil Co.*, 226 La. 417, 76 So.2d 416, 3 O.&G.R. 1903 (1954).

leases authorize the lessee to pool or unitize. A typical clause will provide that if a portion but not all of the leased acreage shall be included within a pooling or unitization agreement, production on the unit shall not excuse the payment of rentals on that portion of the leasehold excluded from the unit.¹⁴ This provision makes the lease divisible so far as the provisions of the delay rental clause are concerned if a portion only of the leasehold is included within a unit. A similar provision may preclude the possibility of the lease being kept alive during the secondary term as to acreage excluded from the unit merely by virtue of production on the unitized tract.

More frequently, perhaps, the unitization or pooling agreement will provide the contrary: that operations on or production from any tract included within a unit shall be taken and accepted as such drilling and production under the terms of each of the leases as to all of the acreage under such lease whether included within the unit or not.¹⁵ (Obviously a lessee will prefer this type of clause just as a lessor will prefer the type previously mentioned. Variations in the language of such clauses are legion, and each variation may give rise to different problems.) Under the latter type of clause, whenever the payment of rentals on the portion of Blackacre included within the unit would be excused, the payment of rentals on the balance of Blackacre excluded from the unit appears also to be excused.¹⁶ Logically, it would seem that if the lease of the excluded acreage is continued in effect by production on the unit after the expiration of the primary term in Case IV, then it should not be necessary to pay rentals on such acreage during the primary term in order to keep it alive. This relationship between the thereafter and the delay rental clauses of the lease in the event of production in Case IV was recognized both in the *Buchanan* case,¹⁷ in

¹⁴ See HOFFMAN, VOLUNTARY POOLING AND UNITIZATION 122-23 (1954).

¹⁵ See *Phillips Petroleum Co. v. Peterson*, 218 F.2d 926, 928, 4 O.&G.R. 746, 747 (10th Cir. 1954): "Lessee shall have the right to unitize, pool, or combine all or any part of the above described lands with other lands in the same general area . . . and, in such event, the terms, conditions, and provisions of this lease shall be deemed modified to conform to the terms, conditions, and provisions of such approved cooperative or unit plan of development or operation and particularly, all drilling and development requirements of this lease, express or implied, shall be satisfied by compliance with the drilling and development requirements of such plan or agreement, and this lease shall not terminate or expire during the life of such plan or agreement."

¹⁶ *Delatte v. Woods*, 232 La. 341, 94 So. 2d 281, 7 O.&G.R. 813 (1957); *Jackson v. Hunt Oil Co.*, 208 La. 156, 23 So. 2d 31 (1945).

In *Wilcox v. Shell Oil Co.*, 226 La. 417, 76 So. 2d 416, 3 O.&G.R. 1903 (1954), the court held in a Case IV situation that the lease in its entirety failed by reason of non-payment of rentals on the anniversary date. As is indicated *infra* at note 101, this result followed either from a strict construction in favor of the lessor of the language of the particular pooling clause or from a duty of fair dealing.

¹⁷ *Buchanan v. Sinclair Oil & Gas Co.*, 218 F.2d 436, 4 O.&G.R. 400 (5th Cir. 1955). To the same effect, *Smith v. Carter Oil Co.*, 104 F. Supp. 463, 1 O.&G.R. 698 (W.D. La. 1952).

which it was held that production from the unit excused the payment of rentals on the portion of Blackacre not included within the unit, and in the *Griffith* case,¹⁸ involving a compulsory unit, in which the contrary position was suggested.

In a number of states the law is uncertain on the matter here considered,¹⁹ particularly in view of the infinite variety of the pooling or unitization clauses used and the possibility that minor variations in the language of such clauses may lead to apparently inconsistent results. Under such circumstances many lessees wisely continue to pay rentals in Cases III and IV during the primary term upon the portion of Blackacre excluded from the unit rather than run the risk of an adverse decision.²⁰

In summary, many modern leases contain express provisions concerning the effect of pooling or unitization upon the delay rental clause of a lease. Absent such express provisions, production on the unit—or, in appropriate cases, drilling operations or the completion of a well—(1) will excuse the payment of rentals on an anniversary date during the primary term as to that portion of the leased premises included within the unit, (2) some states, but not all, will excuse the payment of rentals as to that portion of the leased premises excluded from the unit, and (3) it is more probable that the latter result will be reached in Case III than in Case IV.

III

THE "THEREAFTER" CLAUSE

In Cases I and II, production in paying quantities from a well or wells drilled on the unit serves to keep the leasehold alive after the expiration of the primary term of the lease under the provisions of its "thereafter" clause,

¹⁸ *Texas Gulf Producing Co. v. Griffith*, 218 Miss. 109, 65 So.2d 447, 834, 2 O.&G.R. 1103, 1278 (1953). The court observed therein that "if the production from the unit well is to be held to continue in force the lease as to the 8 acres which are outside the unit and located about three-fourths of a mile from the other 40 acres, then the lessee may hold the lease in force indefinitely as to said 8 acres without any obligation to drill thereon, except such as may be required of a prudent operator in the development and protection of the land from drainage, and without any obligation to pay delay rentals thereon during the remainder of the primary term of the lease, and without any obligation to pay royalties or other compensation or benefits to the lessors, or royalty or mineral holders." *Id.* at 137, 65 So.2d at 451, 2 O.&G.R. at 1109.

¹⁹ Dictum in a leading Texas case, *Southland Royalty Co. v. Humble Oil & Refining Co.*, 151 Tex. 324, 328, 249 S.W.2d 914, 916, 1 O.&G.R. 1431, 1434 (1952), may be broad enough to indicate that in Cases I through IV, commencement of drilling operations during the primary term on the unit operates to excuse the payment of delay rentals and that production from the unit relieves the obligation to pay rentals during the primary term. But the facts involved Case II and the broad language should be limited to that case.

²⁰ See, e.g., *Smith v. Carter Oil Co.*, 104 F. Supp. 463, 1 O.&G.R. 698 (W.D.La. 1952); *Trawick v. Castleberry*, 275 P.2d 292, 4 O.&G.R. 63 (Okla. 1953) (in a Case IV situation the lessee paid rentals during the primary term, thereby avoiding litigation; litigation later developed on the question of whether the leasehold on the land excluded from the unit survived the expiration of the primary term).

whether the production is from a well located on or off Blackacre.²¹ It appears generally to be held²² or assumed²³ that in Case III, production on the portion of Blackacre included within the unit is sufficient to keep the lease alive as to all of Blackacre after the expiration of the primary term under the language of the typical "thereafter" clause unless the lease or unitization agreement contains a specific provision to the contrary.

Greater difficulty is found in Case IV. In the Case IV situations involving compulsory pooling or unitization, the entire lease has been continued in force by production on the unit but off Blackacre.²⁴ Cases so holding frequently have appeared to turn upon construction of the statute or pooling order, *viz.*, did the statute or order expressly or by implication provide that production from the unit would be treated as production from every leasehold, any part of which is included within the unit.²⁵ When voluntary pooling or unitization has been involved, the courts have generally been concerned with the construction of the express clause in the lease or agreement dealing with the effect of production on the unit.²⁶ The implication to be derived from this inquiry by the courts is that production in Case IV

²¹ *Boone v. Kerr-McGee Oil Industries Inc.*, 217 F.2d 63, 4 O.&G.R. 370 (10th Cir. 1954) (Case II; pooling by lessee under pooling clause in lease); *Crichton v. Lee*, 209 La. 561, 25 So.2d 229 (1946) (Case II; compulsory unitization); *Hardy v. Union Producing Co.*, 207 La. 137, 20 So.2d 734 (1944) (Case II; compulsory pooling); *Superior Oil Co. v. Berry*, 216 Miss. 664, 63 So.2d 115, 64 So.2d 357, 2 O.&G.R. 193, 1094 (1953) (Case II; compulsory pooling); *Merrill Engineering Co. v. Capital National Bank*, 192 Miss. 378, 5 So.2d 666 (1942) (Case II; voluntary unitization); *Whelan v. Placid Oil Co.*, 274 S.W.2d 125, 4 O.&G.R. 442 (Tex. Civ. App. 1954, error ref'd n.r.e.) (Case II; pooling by lessee acting under pooling clause executed by concurrent owners of one-half undivided interest; lease perpetuated as to the interest of those concurrent owners but not as to the interest of concurrent owners who did not authorize pooling).

²² *McCammon v. The Texas Co.*, 137 F. Supp. 256, 5 O.&G.R. 1160 (D. Kans. 1955) (voluntary pooling); *Kunc v. Harper-Turner Oil Co.*, 297 P.2d 371, 5 O.&G.R. 1028 (Okla. 1956) (compulsory drilling unit); *Godfrey v. McArthur*, 186 Okla. 144, 96 P.2d 322 (1939) (opinion not clear as to whether this was Case III or IV and does not indicate any difference in legal effect in this regard between Cases III and IV).

²³ *Scott v. Pure Oil Co.*, 194 F.2d 393, 1 O.&G.R. 546 (5th Cir. 1952); *Gregg v. Harper-Turner Oil Co.*, 199 F.2d 1, 1 O.&G.R. 1685 (10th Cir. 1952); see discussion of *Texas Gulf Producing Co. v. Griffith*, 218 Miss. 109, 65 So.2d 447, 834, 2 O.&G.R. 1103, 1278 (1953), at note 28 *infra*.

²⁴ *LeBlanc v. Danciger Oil & Refining Co.*, 218 La. 463, 49 So.2d 855 (1950); *Hunter Co. v. Shell Oil Co.*, 211 La. 893, 31 So.2d 10 (1947); see *Godfrey v. McArthur*, 186 Okla. 144, 96 P.2d 322 (1939); *Kunc v. Harper-Turner Oil Co.*, 297 P.2d 371, 5 O.&G.R. 1028 (Okla. 1956) (dictum).

²⁵ *Hunter Co. v. Shell Oil Co.*, *supra* note 24.

²⁶ *Scott v. Pure Oil Co.*, 194 F.2d 393, 1 O.&G.R. 546 (5th Cir. 1952); *Gray v. Cameron*, 218 Ark. 142, 234 S.W.2d 769 (1950); *Wilcox v. Shell Oil Co.*, 226 La. 417, 76 So.2d 416, 3 O.&G.R. 1903 (1954); *Jackson v. Hunt Oil Co.*, 208 La. 156, 23 So.2d 31 (1945); *Trawick v. Castleberry*, 275 P.2d 292, 4 O.&G.R. 63 (Okla. 1953). In *Diggs v. Cities Service Oil Co.*, 241 F.2d 425, 7 O.&G.R. 827 (10th Cir. 1957), the court did not discuss the question but the broadly phrased pooling clause clearly covered Case IV.

might not have the effect of keeping a lease alive as to that portion of Black-acre excluded from the unit after the expiration of the primary term unless the statute, pooling order, lease or agreement so provided, expressly or by implication.²⁷

In *Texas Gulf Producing Co. v. Griffith*²⁸ it was held that upon the expiration of the primary term the lease terminated as to an 8-acre portion of the leased acreage excluded from the unit in Case IV, but not as to a 40-acre portion included within the unit. It should be noted that the 40-acre and the 8-acre tracts here involved were non-contiguous. This fact does not appear to have any weight in the decision, but the possibility that it was seen as having weight cannot be ruled out completely.²⁹

Caution must be observed in reasoning from this opinion for another reason. Throughout its discussion the court clearly is referring to Case IV and not to Case III.³⁰ It is possible, therefore, to limit this holding severely to Case IV and to the situation in which the portion of the leased premises excluded from the unit is not contiguous to the portion of the leased premises included within the unit.

In many states, the effect in Case IV of production or drilling operations as extending *vel non* the lease on the excluded acreage under the thereafter clause of the lease remains in doubt.³¹ Under such circumstances,

²⁷ Cf. *Scott v. Pure Oil Co.*, *supra* note 26; *Beck v. Norbeck Co.*, 116 Mont. 345, 151 P.2d 1014 (1944).

²⁸ 218 Miss. 109, 65 So.2d 447, 834, 2 O.&G.R. 1103, 1278 (1953).

²⁹ In stating the contrary proposition in the form of *reductio ad absurdum* the court used the example of segregated tracts as follows: "[I]f the production from such unit were to be held to keep the lease in force indefinitely as to the leased land without the unit, the lessor would be deprived of the right to drill on the leased land without the unit, and deprived of any royalties, rentals, or benefits therefrom. Under such interpretation, if a lease covered *segregated* tracts aggregating 1000 acres and 40 acres thereof were placed in a drilling unit, and production should be had on land within the unit but not on the 40 acres, the lease might be continued in force indefinitely beyond the primary term as to the entire 1000 acres, without any royalties, rentals, or other benefits to the lessor, or royalty and mineral owners, as to the 960 acres without the unit." *Id.* at 139, 65 So.2d at 452, 2 O.&G.R. at 1110 (1953) (emphasis added).

³⁰ Note the emphasis in the quotation from the opinion, note 29 *supra*, to the fact that production was on land "within the unit but not on the 40 acres." Ethridge, J., specially concurring on Suggestion of Error, notes specifically that the decision does not "consider whether a producing well on the leased lands in the unit continues the lease on lands outside of it." *Id.* at 147, 65 So.2d at 838, 2 O.&G.R. at 1283. This language was quoted in *McCammon v. The Texas Co.*, 137 F. Supp. 256, 5 O.&G.R. 1160 (D. Kans. 1955), to establish that *Griffith* was not authority in a Case III situation.

³¹ The question has never been decided in Texas, for example. Dicta in *Southland Royalty Co. v. Humble Oil & Refining Co.*, 151 Tex. 324, 249 S.W.2d 914, 1 O.&G.R. 1431 (1952), could be broadly read to suggest that production from the unit keeps the lease alive in each of Cases I through IV. However, the case actually involved Case II and a term mineral deed with a thereafter clause. Pooling resulted from a community lease including *all* the acreage covered by the term mineral deed. Moreover it is several times stated that production off the land extends the lease as to "all included tracts." Thus, on the basis of both the facts before the court and the language it used, the dicta should be strictly limited to Cases I and II.

it is obviously of great importance to consider carefully the language to be included within a pooling or unitization clause of a lease or a later executed agreement. By appropriate language it may be made abundantly clear what the parties intend in this respect.

By way of summary, (1) The express provisions of the lease or unit agreement will govern the effect of production from the unit at the expiration of the primary term of the lease of a tract, all or part of which is included in the unit; (2) If the lease or agreement is silent on the matter, such production (a) clearly suffices to extend the term of the lease in Cases I and II, (b) clearly suffices to extend the term of the lease as to that portion of the premises included within the unit in Cases III and IV, (c) apparently suffices to extend the term of the lease in Case III as to that portion of the premises excluded from the unit, but (d) may not have such effect as to the excluded acreage in all states in Case IV; and (3) The uncertainty just mentioned as to Case IV suggests the desirability of the inclusion of a specific clause in the lease or agreement dealing with this matter.

IV

SAVINGS CLAUSES IN THE LEASE

In Cases I and II, if the lease of Blackacre contains a drilling operations clause or a continuous drilling operations clause, operations on or off Blackacre of the type specified in the clause will suffice to keep the lease alive.³² By the same token, if the lease contains a shut-in gas well clause and the unit well, whether on or off Blackacre, is shut-in, payment of the shut-in royalty will suffice to keep the lease alive in Cases I and II both during the primary term and after its expiration,³³ subject to the usual requirements under this clause—for example, that the well is capable of producing in paying quantities. Obviously the apportioned share of this shut-in royalty payable to the lessor of Blackacre may be nominal.

Authority is limited as to the operation of these savings clauses in Cases

Scott v. Pure Oil Co., 194 F.2d 393, 1 O.&G.R. 546 (5th Cir. 1952), was an action to declare a lease expired at the end of the primary term as to the portion of the leased acreage excluded from a unit on which production had been obtained (Case IV). The court appears to accept unquestionably the proposition that in Case III, the entire lease would be perpetuated by production on that part of Blackacre included within the lease. In the instant case, however, it examined carefully the language of a lease amendment relating to pooling before concluding that under the lease amendment production from the unit was equivalent to production from that portion of Blackacre included within the unit *for all purposes* except the payment of royalties, and hence the lease on the excluded portion of Blackacre was kept alive in Case IV by production on the unit. See Note on this case, 31 TEXAS L. REV. 75 (1952).

³² McClain v. Harper, 206 Okla. 437, 244 P.2d 301, 1 O.&G.R. 872 (1952) (Case II; drilling operations clause in lease).

³³ Cf. LeBlanc v. Haynesville Mercantile Co., 230 La. 299, 88 So.2d 377, 6 O.&G.R. 443 (1956).

III and IV. There would appear to be little doubt but that as to the portion of Blackacre included within the unit, drilling operations of the type specified by the lease clause or payment of shut-in royalty under a shut-in gas well clause will suffice to perpetuate the lease. In a state which follows the *Hunter* case,³⁴ the lease is probably perpetuated as to the portion of Blackacre excluded from the unit. Under the language of the typical shut-in royalty clause, for example, so long as the shut-in royalty is paid, the well for which it is paid "shall be held to be a producing well." If a "producing well" on the unit will be held to keep the lease alive during the secondary term as to the acreage excluded from a unit, timely payment of the shut-in royalty would appear to have the same consequences.³⁵

V

THE COVENANTS OF THE LEASE, EXPRESS AND IMPLIED³⁶

As we have seen, at least some states hold that production on a unit will excuse the payment of rentals on excluded acreage during the primary term and will keep the lease alive as to excluded acreage after the expiration of the primary term in both Cases III and IV.³⁷ If this position expressed the full measure of the rights and duties between lessor and lessee, the lessee could retain and the lessor would be deprived indefinitely of the value of the mineral estate in the excluded acreage, the lessee paying no royalty for the excluded acreage and the lessor receiving no benefit from it. At no cost at all to himself the lessee could retain the acreage for speculative purposes, depriving the lessor and the public of the benefit of its exploration and development. However, the relationship of lessor and lessee are also affected

³⁴ *Hunter Co. v. Shell Oil Co.*, 211 La. 893, 31 So. 2d 10 (1947).

³⁵ Authority on the matter is lacking. In *Buchanan v. Sinclair Oil & Gas Co.*, 218 F.2d 436, 4 O.&G.R. 400 (5th Cir. 1955), the court suggests that payment of shut-in gas well royalties in Case IV will excuse payment of rentals on that portion of Blackacre excluded from the unit. It was able to decide the case on another ground and hence reached no holding on this proposition, but the suggestion as to the effect of payment of the royalty is as relevant to extension of the lease after the expiration of the primary term as to excusing the payment of rentals during the primary term.

A related problem was raised in *LeBlanc v. Haynesville Mercantile Co.*, 230 La. 209, 88 So. 2d 377, 6 O.&G.R. 443 (1956), in which the question was raised, but left unanswered, whether payment of shut-in royalty interrupted prescription *liberandi causa* of a royalty interest as to the excluded portion of Blackacre when only part of Blackacre was included within the unit upon which the shut-in well was located. Prescription was held to have been interrupted or suspended as to all of Blackacre; the pleadings did not require a decision on separate treatment of the included and excluded acreage.

³⁶ Some of the problems discussed herein are treated in Merril, *Implied Covenants, Conservation and Unitization*, 2 OKLA. L. REV. 469 (1949).

³⁷ See text at notes 13-20 *supra*; text following topic heading III *supra*.

by the express and implied covenants of the lease.³⁸ We turn then to the impact of unitization or pooling upon the express and implied drilling covenants of an oil and gas lease. Thereafter we shall briefly consider one further implicit lease provision, the implied special limitation requiring devotion of the premises to exploration, development and production.³⁹

The effect of a unitization agreement upon covenants was summarized in a leading Texas case, *Southland Royalty Co. v. Humble Oil and Refining Co.*:⁴⁰

Some of the legal consequences of a unitized lease as between the lessors on the one hand and the lessees on the other, in the absence of express agreement to the contrary, are as follows: . . . the lessee is relieved of the usual obligation of an implied covenant for reasonable development of each tract separately; wells may be located without reference to property lines; the lessee is relieved of the obligation to drill off-set wells on other included tracts to prevent drainage by a well on one or more of such tracts. As between the lessors themselves, each relinquishes his right to have his own tract separately developed, . . . and his right to have wells drilled on his tract off-setting other wells on the leased premises, . . .

The case in which this broad dictum was uttered had nothing to do with the relationship of a lessor and lessee as concerns the covenants of a lease; it concerned the effect of the unitization agreement upon the extended life of a term mineral interest under a "thereafter" clause. The somewhat carelessly phrased generality of the dictum leaves a number of questions unanswered. Did the court mean to speak of Cases III and IV as well as Cases I and II? Are distinctions to be drawn among these four cases and among the various covenants? Let us examine these four cases with respect to certain express and implied covenants.

A. Express Drilling Obligations

In Cases I and II, the express drilling obligations of the lessee of Blackacre remain unaffected by the unit agreement unless expressly negated thereby, except that performance may be on the unit but off Blackacre (Case II).⁴¹ For example, if the lessee has covenanted to drill a test well within six months, the unit agreement does not afford an excuse for failing

³⁸ This point is mentioned in several cases, e.g., *Texas Gulf Producing Co. v. Griffith*, 218 Miss. 109, 65 So. 2d 447, 834, 2 O.&G.R. 1103, 1278 (1953); *Buchanan v. Sinclair Oil & Gas Co.*, 218 F.2d 436, 4 O.&G.R. 400 (5th Cir. 1955).

³⁹ *Buchanan v. Sinclair Oil & Gas Co.*, *supra* note 38; text beginning at note 70 *infra*.

⁴⁰ 151 Tex. 324, 328, 249 S.W. 2d 914, 916, 1 O.&G.R. 1431, 1434 (1952) (dictum).

⁴¹ *Hardy v. Union Producing Co.*, 207 La. 137, 20 So. 2d 734 (1944); *York v. Harper*, 91 So. 2d 423, 7 O.&G.R. 30 (La. App. 1956). *Cf. Superior Oil Co. v. Dabney*, 147 Tex. 51, 211 S.W. 2d 563 (1948) (lessee released acreage excluded from the unit; a well was drilled on the unit but off Blackacre; held that lessee was under no obligation to drill a well as provided for by an express covenant in the lease of Blackacre).

to perform this obligation; the lessee may, however, drill the required test well on a portion of the unit other than Blackacre.

While the writers are not aware of authority on Cases III and IV,⁴² in both cases it would appear that drilling operations on the unit would qualify as satisfying in whole or in part any express obligations of the lessee if additional drilling is prevented by applicable spacing regulations or a compulsory pooling or unitization order. When additional drilling is not barred, the court should not lightly construe the instrument involved to permit performance of the covenant obligations on the unit but off Blackacre (Case IV). In Case III, performance of the covenant obligations is on Blackacre itself but the lessor will not gain the full benefit of performance inasmuch as he will be entitled only to an apportioned share of the royalties from production. Perhaps it will be held in Case III that the duty imposed by the express drilling obligations may be satisfied by performance on the portion of Blackacre included within the unit, but as indicated hereinafter,⁴³ it is the writers' contention that Cases III and IV should be treated identically in this and other respects involving pooling and unitization.

The pooling or unitization agreement will frequently provide expressly for a suspension of drilling obligations imposed by a lease, substituting therefor the obligations imposed by the pooling agreement.⁴⁴ As indicated hereinafter, even without this express clause, the provisions of the agreement, when inconsistent with the lease provisions, will prevail.⁴⁵ However, if a particular lease is surrendered by the unit operator, the obligations imposed by that lease are revived, and for failure to comply therewith the lease may be forfeited.⁴⁶

B. Obligation to Protect Against Drainage

In analyzing the impact of pooling or unitization upon the express or implied covenants to protect against drainage, three variants in the drainage pattern should be distinguished: (1) drainage from Blackacre to non-unit premises or from the unit to non-unit premises; (2) drainage from the portion of Blackacre included within the unit to another portion of the same unit; (3) drainage from the portion of Blackacre excluded from the unit to the unit in which another portion of Blackacre is included.

In Cases I through IV there may be liability for breach of the offset covenant if there is drainage from Blackacre to non-unit premises or from

⁴² *Superior Oil Co. v. Dabney*, *supra* note 41, does not appear to be relevant inasmuch as the lessee released the acreage excluded from the unit, thereby converting a Case IV into a Case II situation.

⁴³ Text following topic heading X *infra*.

⁴⁴ *Duff v. Du Bose*, 27 S.W. 2d 122 (Tex. Com. App. 1930).

⁴⁵ See Discussion following VIII *infra*.

⁴⁶ *Duff v. Du Bose*, 27 S.W. 2d 122 (Tex. Com. App. 1930).

the unit to non-unit premises.⁴⁷ In these, as in other instances of drainage, the other requirements usually incident to relief for breach of this covenant must be met. For example, it must be shown that an offset well would be profitable.⁴⁸ There may be the further issue whether an offset well can be drilled under applicable spacing requirements.⁴⁹

In the second variant, drainage from the portion of Blackacre included within the unit to another portion of the same unit, there would appear to be no liability.⁵⁰ There is no obligation to protect against drainage across interior boundary lines of the unit. Since the lessor of Blackacre will receive a royalty based on the pro rata share of the production attributable to Blackacre under the terms of the agreement whether the producing wells are on or off Blackacre, he clearly suffers no damage in Case II by reason of drainage from Blackacre to another part of the unit of which Blackacre is a part. By the same token, in Case IV, in so far as the alleged drainage is from the portion of Blackacre within the unit to another portion of the same unit, there is no breach of duty under this covenant. In Cases I and III, when the only unit well or wells are on the portion of Blackacre included within the unit, there is no drainage from Blackacre and hence there is no problem raised under this covenant as respects drainage across interior boundary lines of the unit; if there are also wells on other parts of the unit which cause drainage from the portion of Blackacre included within the

⁴⁷ See *Toomey v. State Board of Land Comm'rs*, 106 Mont. 547, 81 P.2d 407 (1938); *Merrill, Implied Covenants and Secondary Recovery*, 4 OKLA. L. REV. 177, 195 (1951), citing *Geary v. Adams Oil & Gas Co.*, 31 F. Supp. 830 (E. D. Ill. 1940), and *Indian Territory Illuminating Oil Co. v. Haynes Drilling Co.*, 180 Okla. 419, 69 P.2d 624 (1937).

⁴⁸ *Gerson v. Anderson-Pritchard Production Corp.*, 149 F.2d 444 (10th Cir. 1945) (drainage from unit to non-unit premises as a result of wells drilled by the common lessee; held, no liability for drainage without proof that if an offset well had been drilled, it probably would produce sufficient oil to repay the expenses of drilling, equipping, and operating the well, and also a reasonable return on the outlay). *Cf. Gray v. Cameron*, 218 Ark. 142, 234 S.W.2d 769 (1950), *infra* at note 51. The requirements may be modified by a duty of fair dealing. See text following topic heading VII *infra*.

⁴⁹ *Everett v. Phillips Petroleum Co.*, 218 La. 835, 51 So. 2d 87 (1950). The lease of certain squares and strips of land of various dimensions including an irregular canal 100 feet wide provided for the payment of a substitute royalty if the lessee did not drill on the leased premises but (1) brought in a commercial producer within 1320 feet of said premises or (2) another person brought in a producing well within 670 feet of the nearest boundary line. The leased premises were included in a 40-acre unit upon which one well was drilled (but not on the leased premises). The court held that the lessee was not required to pay the substituted royalty. The contractual provision was held to yield to the conflicting valid orders of the Commissioner of Conservation which rendered impossible the drilling of an offset well on the leased premises. The court observed that plaintiff would share in production from the unit well on the same basis as if the well had been drilled on the leased premises rather than on another part of the unit in which the leased premises were included.

⁵⁰ See *Brown v. Smith*, 141 Tex. 425, 174 S.W. 2d 43 (1943); *Merrill, Implied Covenants and Secondary Recovery*, 4 OKLA. L. REV. 177, 195 (1951), citing *Hood v. Southern Production Co.*, 206 La. 642, 19 So. 2d 336 (1944).

unit to another portion of the unit, the situation is the same as in Cases II and IV.

Difficulty is presented by the third variant, that is, where the drainage is from the portion of Blackacre excluded from the unit to the unit in which another portion of Blackacre is included. True, in this case, the lessor of Blackacre will continue to receive a royalty on this oil, but he will not be entitled to the full royalty provided for by the lease (e.g., $\frac{1}{8}$ th); he will be entitled only to a royalty on the proportionate part of the production attributable under the unit formula to the part of Blackacre included within the unit, whether the unit well be on or off Blackacre. The lessor of Blackacre is, therefore, unquestionably damaged by the drainage. Authority on the matter is extremely limited. If the unit well is on Blackacre (Case III) it may be difficult for the lessor of Blackacre to obtain any relief for drainage inasmuch as there is no drainage across the lease lines of Blackacre. If the unit well is not on Blackacre (Case IV), relief may be more readily available. Thus in *Gray v. Cameron*,⁵¹ although relief was denied the lessor in Case IV, denial apparently was on the basis of failure to prove that an offset well would have been profitable, a necessary element of the cause of action for breach of the protection covenant; the case may perhaps be said to support the proposition that there may be liability for drainage in Case IV under the third variant.

To the writers there appear strong equitable arguments for allowing relief to the lessor of Blackacre in either Case III or IV under this third variant.⁵² When a unit is formed by a separate agreement to which the lessor is a party, perhaps he may be said to have had adequate opportunity at the time of negotiation and execution to protect his interests as regards drainage from the excluded portion of Blackacre to the unit. But when the unit has been formed by a lessee acting under statutory authority or the authority of a broadly phrased pooling clause in the original lease, the arguments for relief for the lessor appear particularly appealing. There do not appear to be compelling arguments against such relief, particularly since the lessor would still have to satisfy the usual requirements of proof

⁵¹ 218 Ark. 142, 234 S.W. 2d 769 (1950).

⁵² Hoffman, VOLUNTARY POOLING AND UNITIZATION 251-52 (1954), suggests, however, that "since the portions of the lease within the unit and outside the unit will, absent an express covenant agreement, continue to constitute a single lease even after the creation of the unit, the lessee is under no obligation to protect the portion of the same lease within the unit [Case III]. The pooling or unitization agreement does not create a new property line for that purpose. In view of the provision of the pooling or unitization agreement that production at any point on the unit shall be considered as production from each tract within the unit, it is likewise probably true that the lessee is under no obligation to drill a well on the portion of the lease outside the unit merely to offset a unit well on some part of the unit other than the portion of the same lease within the unit [Case IV]."

of (a) drainage in fact, and (b) that an offset well would be profitable. In the present state of authority, there is little basis for asserting dogmatically that the lessor will be granted relief. Certainly, however, the possibility of relief under the covenant to protect against drainage has not been ruled out, and even if relief is denied under this covenant, the lessor may yet be entitled to some protection under the duty of fair dealing.⁵³

C. Development Obligations

In Cases I and II, the performance by a lessee of the development obligations imposed by the implied covenants of the lease will be measured by the development of the unit in which Blackacre is included.⁵⁴ The dearth of discussion of this problem in reported cases seems to indicate either that development problems have not been serious or that such problems as have arisen can normally be resolved by negotiation among interested parties. The great majority of units, whether voluntary or compulsory, have been one-well units in which there can be no development problem. When the unit agreement covers a larger area it will normally make specific provision concerning development. The unit provisions concerning development then displace the lease express or implied provisions on the subject when the lessors are parties to the unit agreement or are bound by it under compulsory process.

In so far as we are concerned in Cases III and IV with the development obligations of a lessee under the implied terms of a lease, the lessor may properly seek an appropriate remedy for breach if the operations on the unit are not sufficient to meet the obligations of reasonable development of Blackacre. This has been recognized since the early cases dealing with the effect of unitization or pooling upon the provisions of oil and gas leases.⁵⁵ Our question here involves a comparison of the development obligation owed to excluded acreage in Cases III and IV with the development obligation owed to a leasehold unaffected by pooling or unitization. To what extent do the rights and remedies differ in these two situations?

It will be recalled that in the ordinary reasonable development case, the lessor is required to prove that (1) the lessee has not developed the premises as rapidly or as completely as would a reasonably prudent operator, and (2) the development well or wells would have been profitable in the

⁵³ Discussed in text following topic heading VII *infra*.

⁵⁴ See Merrill, *Implied Covenants, Conservation and Unitization*, 2 OKLA. L. REV. 469, 477 (1949).

⁵⁵ Thus in *Hunter Co. v. Shell Oil Co.*, 211 La. 893, 31 So. 2d 10, (1947), which held that in Case IV production on the unit sufficed to keep a lease alive as to the excluded acreage under the "thereafter" clause, the court declared that "[I]f the producing well in the unit is not sufficient to meet the obligation of adequate development of the property covered by the lease the law gives plaintiff [lessor] a remedy." *Id.* at 905, 31 So. 2d at 14.

sense of realizing a net return over the cost of drilling the well or wells and current operating costs. On proof of the above, the lessor is usually entitled to recover such damages as he can prove, typically measured by the royalty which would have been paid if the development well or wells had been drilled with reasonable diligence. In some instances, in lieu of or in addition to damages, he has been held entitled to an absolute or a conditional decree of cancellation of the lease as to the undeveloped acreage.⁵⁶

There has been some suggestion of an increased duty resting on the lessee in Cases III and IV. In *Gregg v. Harper-Turner Oil Co.*,⁵⁷ a lease covered 160 acres on which two wells had been drilled, the first in 1943, a producer, and the last in 1947, a dry hole. In 1948, forty acres around the producing well were included in a 1,040-acre unit. Repeated demands for further drilling were made in 1948 and 1949. Although there was no proof that additional wells would be profitable, the court ordered conditional cancellation of the lease as to the 120 acres excluded from the unit. The court declared:⁵⁸

Harper and Turner caused the unitization agreement excluding this 120 acre tract therefrom to be effected. This resulted in a division of the acreage of the Gregg tract, covered by the original lease. As the owners of the lease, they now stand in a different relationship to the excluded acreage than they do to the 40 acres included in the producing unit. Equity will consider the rights of both the lessor and the lessee under these circumstances. *Their responsibilities as lessees become correspondingly greater toward the excluded acreage than it was before severing by unitization.*

It should be noted that only an estimated two years expired between the completion of the last well and the demand for further drilling.

While relief was granted as an incident to the enforcement of the implied covenant of further exploration⁵⁹ under the authority of the *Doss*⁶⁰ and *Colpitt*⁶¹ cases, the case nevertheless is some authority for placing a greater duty on the lessee with regard to acreage excluded from the unit. In

⁵⁶ The picture presented in this paragraph is painted in bold, broad strokes, inasmuch as the details of the development covenant are not within the scope of this paper. For a careful examination of the covenant see the discussion in Professor Merrill's outstanding treatise, *COVENANTS IMPLIED IN OIL AND GAS LEASES* (2d ed. 1940); Kuntz, *The Prudent Operator and Further Development*, 9 OKLA. L. REV. 255 (1956); L.S.U. FOURTH ANNUAL INSTITUTE ON MINERAL LAW (1956); and the two papers by Professor Meyers on covenants, *Two Drilling Covenants Implied in Oil and Gas Leases*, 38 MINN. L. REV. 127 (1954); *The Implied Covenant of Further Exploration*, 34 TEXAS L. REV. 553 (1956).

⁵⁷ 199 F.2d 1, 1 O.&G.R. 1685 (10th Cir. 1952) (Case III).

⁵⁸ *Id.* at 5, 1 O.&G.R. at 1690-91 (Emphasis added).

⁵⁹ See *Willingham v. Bryson*, 294 S.W. 2d 421, 6 O.&G.R. 1094 (Tex. Civ. App. 1956); Meyers, *The Implied Covenant of Further Exploration*, 34 TEXAS L. REV. 553 (1956).

⁶⁰ *Doss Oil Royalty Co. v. Texas Co.*, 192 Okla. 359, 137 P.2d 934 (1943).

⁶¹ *Colpitt v. Tull*, 204 Okla. 289, 228 P.2d 1000 (1950).

other further exploration cases arising in Oklahoma, cancellation for failure to explore has been denied where only a short time has elapsed since the last drilling.⁶² In most cases granting relief, failure to drill persisted at least as long as ten years.⁶³ Thus, the *Gregg* case may increase the obligation of the lessee by shortening the period of time deemed to be an unreasonable delay in drilling, for which cancellation may be granted under the further exploration covenant. Other cases, however, fail to indicate that any unusual weight will be given to the exclusion of acreage from a unit and treat Cases III and IV like any other further exploration case.⁶⁴ Because of the well-developed protection of lessors against failure to explore in Oklahoma, it may not be important to single out Cases III and IV for special treatment there. But in states reluctant to apply the further exploration covenant to ordinary lease situations, Cases III and IV should be distinguished therefrom and the exploration covenant more readily applied.

In Louisiana, in a Case IV situation, an absolute decree of cancellation issued as to the excluded acreage on the ground of failure of further exploration.⁶⁵ Nothing in the opinion indicates, however, that this case involving unitization of a part of the leased premises differs in the slightest from a case not involving unitization where a part only of the leased premises has

⁶² *Pohlemann v. Stephens Petroleum Co.*, 197 F.2d 134, 1 O.&G.R. 1274 (10th Cir. 1952) (4 months from the completion of a dry hole on the land had elapsed before demand and eighteen months had expired when the suit was tried); *Trust Co. v. Samedan Oil Corp.*, 192 F.2d 282, 1 O.&G.R. 33 (10th Cir. 1951) (four years); *Shell Oil Co. v. Howell*, 208 Okla. 598, 258 P.2d 661, 2 O.&G.R. 1306 (1953) (15 months).

⁶³ *Sauder v. Mid-Continent Petroleum Corp.*, 292 U.S. 272 (1934) (17 years); *Magnolia Petroleum Co. v. Wilson*, 215 F.2d 317, 3 O.&G.R. 2065 (10th Cir. 1954) (26 years); *Smith v. Moody*, 192 Ark. 704, 94 S.W.2d 357 (1936) (11 years); *Carter v. Arkansas Louisiana Gas Co.*, 213 La. 1028, 36 So.2d 26 (1948) (10 years); *Sand Springs Home v. Clemens*, 276 P.2d 262, 4 O.&G.R. 60, 272 (Okla. 1954) (12 years); *Colpitt v. Tull*, 204 Okla. 289, 228 P.2d 1000 (1950) (20 years); *Morrison v. Johnson*, 199 Okla. 264, 185 P.2d 208 (1947) (10 years); *McKenna v. Nichlos*, 193 Okla. 526, 145 P.2d 957 (1944) (13 years); *Doss Oil Royalty Co. v. Texas Co.*, 192 Okla. 359, 137 P.2d 934 (1943) (14 years).

⁶⁴ *Pohlemann v. Stephens Petroleum Co.*, 197 F.2d 134, 1 O.&G.R. 1274 (10th Cir. 1952) (Case III; the court in denying cancellation of the lease as to the excluded acreage discussed the problem in terms of the usual Oklahoma rules arising under the *Doss* and related cases without special reference to the unitization problem); *Kunc v. Harper-Turner Oil Co.*, 297 P.2d 371, 5 O.&G.R. 1028 (Okla. 1956) (Case III; the court denied cancellation of the lease as to the excluded acreage for reason of non-development on the ground of failure to give the required notice and demand. The opinion in no wise appears to treat this situation differently from one which does not involve pooling or unitization); *Trawick v. Castleberry*, 275 P.2d 292, 4 O.&G.R. 63 (Okla. 1953) (Case IV; seven acres of 80-acre leasehold were included in a producing unit in 1945. There was no further development of the lease prior to suit in 1951. Cancellation of the lease as to the 73 excluded acres was denied. The court declared that there was no evidence of drainage. Assuming that an unreasonable time had elapsed without the drilling of additional wells, the court found that the lessee had fully discharged the "burden of the evidence" by establishing that an additional well, if drilled, would not be profitable.).

⁶⁵ *Nunley v. Shell Oil Co.*, 76 So.2d 111, 4 O.&G.R. 236 (La. App. 1954).

been developed. Where unitization is not involved, upon a proper showing of breach of covenant a decree of cancellation as to the undeveloped acreage may issue, whether absolute⁶⁶ or conditional in form.⁶⁷ By the same token, such a decree may issue as to excluded acreage in Cases III and IV.

To summarize the effect of pooling or unitization upon the development obligations of a lessee: (1) in Cases I and II, performance by a lessee of the obligations will be measured by the development of the unit in which Blackacre is included; and (2) while a clear holding on the matter is lacking, language in some opinions indicates the existence of a greater duty on the lessee in Cases III and IV than in the ordinary lease situation with respect to the implied drilling covenants. The nature and effect of the increased obligation, where it is recognized, has not yet crystallized.

D. Duty to Represent Interests of Lessor

It has been suggested by one eminent authority that increasing governmental regulation of drilling practices—for example, by compulsory pooling and unitization—has given rise to a new duty of the lessee adequately to represent the interests of his lessor before administrative bodies.⁶⁸ Certainly as of this moment the extent of this duty has not been clearly defined. For purposes of this paper this concept is included within the so-called “duty of fair dealing” which is discussed hereafter.⁶⁹

E. The “Devotional Special Limitation”

Thus far this discussion of the relationship of the lessor and lessee as concerns exploration and development has been couched in the standard language of “covenants.” We have touched upon the nature of the obligation of the lessee under the covenants of the lease, express or implied, and the remedies of the lessor for breach. It has been noted that the remedy of the lessor for failure of the lessee to develop excluded acreage in Cases III and IV may be inadequate. In a recent case in the Fifth Circuit Court of Appeals arising from Texas, the court refers to this problem of adequacy of remedy and alludes to the so-called “devotional special limitation” as a

⁶⁶ *Eota Realty Co. v. Carter Oil Co.*, 225 La. 790, 74 So.2d 30, 3 O.&G.R. 1876 (1954); see also *Carter v. Arkansas Louisiana Gas Co.*, 213 La. 1028, 36 So.2d 26 (1948) (Case III; working interest but not the royalty interest unitized).

⁶⁷ *Humble Oil and Refining Co. v. Romero*, 194 F.2d 383, 1 O.&G.R. 358 (5th Cir. 1952).

⁶⁸ Merrill, *Fulfilling Implied Covenant Obligations Administratively*, 9 OKLA. L. REV. 125 (1956); Merrill, *Current Problems in the Law of Implied Covenants in Oil and Gas Leases*, 23 TEXAS L. REV. 137, 140-46 (1945). *Contra*, Eberhardt, *Effect of Conservation Laws, Rules and Regulations on Rights of Lessors, Lessees, and Owners of Unleased Mineral Interests*, SOUTHWESTERN LEGAL FOUNDATION FIFTH ANNUAL INSTITUTE ON OIL AND GAS LAW AND TAXATION 125, 151 (1954).

⁶⁹ Text following topic heading VII *infra*.

possible solution to the problem.⁷⁰ Brief mention must be made of this "devotional special limitation."

The genesis of this limitation is in the early case of *Texas Co. v. Davis*,⁷¹ which involved a long-term lease. The lessee obtained production but it quickly terminated and the lessee ceased all operations, doing nothing further on the premises for many years. By the terms of the delay rental clause, no further payment of rentals was required to keep the lease alive during the primary term. Some years later a second lessee of the same premises obtained major production. At this time dispute arose between the two lessees. In deciding the dispute the Supreme Court of Texas held that there was an implied special limitation in the first lease that the premises would be devoted to exploration, development and production; the first lessee had not so devoted the premises to these purposes after the initial production terminated; and therefore, under this special limitation, the first lease had terminated and the second lease was valid.

Although initially it was feared that the doctrine of this case might have tremendous impact upon the relationship of the lessor and lessee, in fact, it has been of little importance. Evolutionary changes in the terms of leases have substantially nullified the doctrine. Thus, during the primary term, modern leases may be continued in force by payment of rental or drilling operations. If drilling operations are unsuccessful, there is usually present a clause providing for resumption of rentals. If drilling operations are successful, but production ceases during the primary term, the lease ordinarily contains an express provision under which rentals may be resumed or drilling operations commenced, having the effect of continuing the lease in force. Absent a savings clause, at the end of the relatively short primary term, and anytime thereafter, the lease terminates upon the cessation of production. While modern leases may terminate during the primary term, this is due to express provisions in the lease not to an implied devotional limitation. Thus, with the modern lease instrument providing expressly for a variety of contingencies upon which the lease terminates, there is little if any occasion for the implied devotional limitation to be applied in the ordinary lease situation apart from the effect of pooling or unitization. It may, however, become applicable to pooling and unitization in Cases III and IV.

In the *Buchanan* case,⁷² the court was faced with determining whether

⁷⁰ *Buchanan v. Sinclair Oil & Gas Co.*, 218 F.2d 436, 4 O.&G.R. 400 (5th Cir. 1955); see 31 TEXAS L. REV. 75, 77 (1952), which also suggests the employment of the devotional special limitation in Cases III and IV to prevent the lessee from holding the unpooled portion of a lease without developing it or paying delay rentals on that portion.

⁷¹ 113 Tex. 321, 254 S.W. 304, 255 S.W. 601 (1923).

⁷² *Buchanan v. Sinclair Oil & Gas Co.*, 218 F.2d 436, 4 O.&G.R. 400 (5th Cir. 1955).

production from the unit but off Blackacre in a Case IV situation excused the payment of rentals. In deciding that production had that effect, the court felt called upon to face the charge that the holding deprived the lessor "of the right to drill on the leased land without the unit and . . . of any royalties, rentals, or benefits therefrom."⁷³ It declared that:⁷⁴

The exact contrary of this has been held in *Texas Company v. Davis*, 113 Tex. 321, 331, . . . and the companion case reported in that volume, and in *W. T. Waggoner Estate v. Sigler Oil Co.*, 118 Tex. 500, 509, . . . and the host of cases following in their train, where it has been pointed out (1) that the estate acquired by the so-called lessee and his assigns is a determinable fee which will be lost on cessation of the use of the land for purposes of oil and gas exploration development and production; (2) the estate of the lessee or his assigns will not survive abandonment or disuse; (3) the lessee, when the lease was taken was, and at all times afterwards remained, subject to the implied obligation to continue the development and production of oil or gas with reasonable diligence; and (4) and (5) while breach of the implied covenant will not authorize forfeiture and the usual remedy for its breach is an action for damages, in accordance with the equitable procedure established in state and federal courts, a court will, under extraordinary circumstances, entertain an action to cancel the lease in whole or in part.

In the light of these accepted, indeed imperative principles, it should be, we think it is, clear that, in urging upon us in this case the claimed inequity which would result if appellee is permitted to hold the entire lease without development by the device of including a part of it in a unit and citing the *Mississippi* case in support, the appellants have misconstrued in nature and effect the judgment appealed from.

. . . Nothing in the district judge's holding or judgment, nothing in our affirmance of it, justifies, authorizes or will permit appellee to hold the ununitized portion of the lease against well founded legal claims, of abandonment or for damages for breach of the implied covenants, or, where there is no other adequate relief, against well founded claims, for relief in equity.

The reference by the court to the case of *Texas Co. v. Davis*⁷⁵ must refer to the implied special limitation doctrine presented therein; this reference could open a Pandora's box of litigation. The difficulties posed by that decision when it issued were met by a change in lease forms. Its shadow arises once again with the suggestion that whenever rentals are not being paid the implied special limitation of the *Davis* case may attach to that portion of a leasehold not being developed in a Case III or IV situation.

One should not read too much into dicta, but this language does pose a problem for draftsmen of pooling clauses in leases or of unitization agreements. Should the language of such clauses and instruments be redrafted

⁷³ 218 F.2d at 441, 4 O.&G.R. at 405.

⁷⁴ *Id.* at 441-42, 4 O.&G.R. at 405.

⁷⁵ 113 Tex. 321, 254 S.W. 304, 255 S.W. 601 (1923).

so as to negate by contrary express provision an implied devotional limitation? As a result of this language, a lessee must think of the consequences of attempting to hold acreage excluded from a unit in Cases III and IV after the expiration of the primary term; perhaps his interest has terminated automatically and he will be a trespasser if he thereafter drills on the excluded acreage. The inadequacy of the covenant remedies of the lessor in the event of non-development of excluded acreage is persuasive that some more satisfactory remedy is required. To go to the extreme of the "devotional special limitation" doctrine because of the inadequacy of the lessor's remedy may be undesirable because of the litigation-breeding character of the doctrine and the impediments to proper development which uncertainty as to rights of parties always introduces. The alternative is rigorous enforcement of the exploration and development duties of the lessee, particularly as to the acreage excluded from a unit.

VI

REFUSAL TO POOL OR UNITIZE

Voluntary pooling or unitization is frequently difficult of accomplishment because of the recalcitrance of some of the numerous persons who have interests in the premises intended to be included within a unit. Two questions may arise under these circumstances: (1) Does a lessee who objects to the establishment of the unit or the inclusion of the leasehold therein have a duty to the lessor under some circumstances to join in the agreement? (2) What is the effect upon the relationships of the lessor and lessee of the refusal of the lessor to join in the agreement?

On the former question, Professor Merrill has suggested that if a lessee refuses to communitize a lease in a recycling operation to guard against the ultimate loss of wet gas through the operation of other recycling plants in the field, the willing lessors might have a basis for contending that there had been a violation of the implied covenant for protection.⁷⁶ There are some dicta and other secondary authorities in support of this position.⁷⁷

⁷⁶ Merrill, *Unitization Problems: The Position of the Lessor*, 1 OKLA. L. REV. 119, 132 (1948). In discussing *Western Gulf Oil Co. v. Superior Oil Co.*, 92 Cal. App. 2d 299, 206 P.2d 944 (1949), he observed that "The lessor conceivably might compel the lessee to join in a reasonable plan for unitized operations, designed to enhance total recovery," and that the decision in the *Western Gulf Oil Co.* case does not affect this suggestion as the lessors apparently were content with the lessees' refusal to unitize. MERRILL, COVENANTS IMPLIED IN OIL AND GAS LEASES, § 78, n. 54a (Supp. 1955).

⁷⁷ *Gillham v. Jenkins*, 206 Okla. 440, 443, 244 P.2d 291, 294, 1 O.&G.R. 842, 847 (1952): "We hold that the trial court was correct in its decision that, under all the circumstances of this case, it was the duty of lessee to pool or combine the involved acreage with other acreage in order to comply with the necessary Federal rules and regulations and thus secure a market for the production."

Griffith v. Gulf Refining Co., 215 Miss. 15, 27-28, 60 So.2d 518, 521-22, 61 So.2d 306,

Case authority on the latter question is rather limited.⁷⁸ Refusal of the lessor to participate in the unit may, of course, cause the frustration of the attempt to establish the unit, absent some compulsory process. If the lessee owns other leases in the area, he may elect to surrender the leasehold of the objecting lessor. If he does so he will not be liable for drainage from the leasehold if the surrender is made before drainage begins.⁷⁹

The right of the lessee to join in a unit agreement over the objection of a lessor has been established in so far as the lessor's interests remain unaffected.⁸⁰ Normally a lessee who unitizes the working interest will continue liable to account to his lessor for a royalty on all oil produced from a well or wells located on the leased premises.⁸¹ His covenant obligations, express

1 O.&G.R. 1627, 1630-31 (1952); "It is unthinkable that the 90 acres can be utilized as alleged by the complainants in this case, and its royalty owners receive nothing while the owners of the 160 acres receive all of the benefits. . . . Since Gulf and Magnolia pooled their leasehold interests without the consent of these royalty holders, they were, therefore, under the duty to preserve the property rights of such royalty owners." See HOFFMAN, VOLUNTARY POOLING AND UNITIZATION 109-12 (1954).

⁷⁸ The question is discussed in Williams, *Problems in the Conservation of Gas*, ROCKY MOUNTAIN MINERAL LAW FOUNDATION SECOND ANNUAL MINERAL LAW INSTITUTE 295, 343-47 (1956), from which this discussion is largely taken.

⁷⁹ The limited case authority is discussed in Shank, *Pooling Problems*, 28 TEXAS L. REV. 662, 681 (1950).

⁸⁰ See *Bruce v. Ohio Oil Co.*, 169 F.2d 709, 712 (10th Cir. 1948), *cert. denied*, 336 U.S. 913 (1949).

⁸¹ In *Smith Petroleum Co. v. Van Mourik*, 302 Mich. 131, 4 N.W. 2d 495 (1942), the lessee drilled a producing well on Blackacre (a 2-acre tract) but he was entitled to only a two-acre allowable of 20 barrels a day, which was insufficient to permit profitable production. Without the consent of the lessor of Blackacre, the lessee pooled the two acres with an adjoining 8-acre tract, and thereafter he was given a 10-acre allowable of 100 barrels per day. It was held that he must account to the lessor of Blackacre for a one-eighth royalty (as provided for in the lease) on the full production from the well; other parties to the pooling agreement were entitled to an accounting on the basis of the terms of the agreement. *But cf. Dobson v. Arkansas Oil & Gas Comm'n*, 218 Ark. 160, 235 S.W. 2d 33 (1950). Plaintiff, the owner of a royalty interest in a well located on a 160-acre drilling unit, refused to join in a voluntary agreement unitizing the field (comprising some 5,000 acres) in which the 160-acre drilling unit was located. The state Oil and Gas Commission then issued a compulsory unitization order for the field. Under the terms of this order plaintiff was entitled to .00304% of the total production from the field, which netted him a sum considerably smaller than his royalty on the production from the well on the 160-acre unit. Before the unitization order, the well in which plaintiff had a royalty interest had an allowable of 250 barrels per day. Under the order, a blanket allowable for the field was granted and the operator was permitted to use certain wells for output wells and others for reinjection of gas. The well on the 160-acre unit was selected as an output well and produced about 312 barrels a day during the unitized operations. The court held that (1) the unitization order was invalid for lack of authority in the Commission, but (2) plaintiff was entitled to a royalty only on 250 barrels a day rather than on the 312 barrels per day actually produced under the invalid unitization order.

In *Bruce v. Ohio Oil Co.*, *supra* note 80, the court suggested that if a lessee unitized two leaseholds without the consent of the lessors and drilled a single well on the unit, he would be liable to the lessor of the tract on which the well was drilled for a full royalty in the entire production and to the lessor of the other tract for an additional amount.

and implied, probably will be unaffected by the pooling or unitization.⁸² Production on the unit but off Blackacre will not suffice to extend the lease beyond its primary term.⁸³

Difficulty arises when the lessee seeks to pool or unitize leased premises over the objection of the lessor if the lessor's interests will be materially affected by the establishment of the unit and operations thereunder.

Sound conservation practices may require that pressure maintenance, recycling and secondary recovery operations be pursued. These operations usually require that a substantial acreage be treated more or less as a unit even though separate tracts owned by different lessors are involved. Does the lessor have a power to prevent such operations? This question has two facets: (1) what use may the lessee make of Blackacre itself in conducting such operations and (2) may he engage in such operations on adjoining leaseholds?

The lessor's control over such operations upon his own land has been the subject of litigation in two cases arising in Illinois. In the first case, *Ramsey v. Carter Oil Co.*,⁸⁴ an action by the lessors, the lessee was enjoined from converting a protection well into a gas repressuring well as part of a secondary recovery operation upon a large tract including plaintiffs' leased premises. The court declared that "it would seem that a reasonably prudent operator bound to produce oil by approved methods has the right implied in an oil lease to adopt proper gas repressuring systems for secondary recovery of oil. Indeed, it would seem that he is under the same duty to do so as he is to drill off-set wells."⁸⁵ Nonetheless the conversion was enjoined on the theory that the injection well would drive some oil from beneath plaintiffs' premises, the court declaring that for the lessee to drive oil from plaintiffs' land was a trespass upon and a violation of plaintiffs' right and title to the oil in place. The court apparently conceded *arguendo* defendant's contention that plaintiffs would receive more oil from the remaining portion of their land and that plaintiffs would be reimbursed by migration of oil to their land from other tracts as a result of conversion of wells on those lands to repressuring wells; nevertheless it held that plaintiffs might enjoin the course of conduct since they "own the oil and they have a right to have it left in place and to be removed only by methods which will not deprive them of it."⁸⁶

⁸² A leading writer has suggested that the lessor "cannot complain of lessee's entering into pooling and unitization projects involving other leases if by such operations the lessee breaches none of the covenants of his lessor's lease." Shank, *Pooling Problems*, 28 TEXAS L. REV. 662, 681 (1950).

⁸³ See *Knight v. Chicago Corp.*, 144 Tex. 98, 188 S.W. 2d 564 (1945).

⁸⁴ 74 F. Supp. 481 (E.D. Ill. 1947), *aff'd*, 172 F.2d 622 (7th Cir. 1949), *cert. denied*, 337 U.S. 958 (1949).

⁸⁵ *Id.* at 482.

⁸⁶ *Ibid.*

If we can assume that the court was not satisfied with the proof of defendant's contentions, then, of course, the result is justifiable. However, the opinion appears peculiarly short-sighted in light of the court's assumptions that plaintiffs would ultimately recover more royalty oil as a result of defendant's proposed operations. The lease gave exclusive operating rights to the lessee. Obviously the lessor was not interested in having recoverable oil left in place in the ground; he sought by the lease to gain maximum ultimate recovery of royalty oil. The result of this opinion is to give an obstinate lessor a veto power upon proper conservation practices unless his demands for excessive consideration are met.

A more enlightened position was taken by an appellate court in Illinois in a later case.⁸⁷ This case involved the same field, the same lessee, and the same repressuring operation. The lessee sought a declaratory judgment that he might convert one of the four producing wells on a 40-acre tract into a gas reinjection well, alleging that this was in accord with approved operating practices and would be the plan adopted by a prudent operator having in mind the best interests of the lessors as well as the lessee. Oil production has steadily declined by reason of exhaustion of gas pressure, and the proposed repressure plant would result in ultimate recovery of a considerably greater quantity of oil from the remaining three wells than could be obtained from all four under primary production operations. Just as in the *Ramsey* case, the conversion of a well on this leasehold into an injection well would drive some oil from the land, but other conversions on other lands would drive a substantially equal amount of oil onto the land. The increase in the defendant's royalty oil as a result of the proposed operations would amount to some \$5,000 to \$12,000. The court refused to follow the *Ramsey* case, distinguishing it on the basis that the court therein did not find that the proof met the test of what a reasonably prudent operator would do, having in mind the interests of both lessor and lessee.

The related question of a lessor's veto power over acts of his lessee upon adjacent premises as part of a reasonable conservation program, the effect of which is to injure the lessor, was raised in *Tide Water Associated Oil Co. v. Stott*.⁸⁸ The defendants herein held leases covering 2,215 acres, underlaid with wet gas in a common reservoir of some 7,355 acres. About 88 acres of plaintiffs' land were included in defendants' 2,215-acre leasehold interests. In 1939 defendants began to recycle gas. Prior thereto they offered to plaintiffs an opportunity to join in a unitization program for recycling, with the right to participate on the same basis as royalty owners under other

⁸⁷ *Carter Oil Co. v. Dees*, 340 Ill. App. 449, 92 N.E. 2d 519 (1950). For a discussion of the *Ramsey* and *Dees* cases see Meyers, *Two Drilling Covenants Implied in Oil and Gas Leases*, 38 MINN. L. REV. 127 (1954).

⁸⁸ 159 F.2d 174 (5th Cir. 1946), *cert. denied*, 331 U.S. 817 (1947).

tracts subject to defendants' leases, but plaintiffs refused to participate in the plan. Recycling was not practicable economically on plaintiffs' tracts alone, so defendants continued to operate the three wells thereon, extracting condensate in separators at the well, and selling the remaining semi-dry gas to the only purchaser in the field. Flaring being prohibited, production of condensate from the wells on the tracts was limited to the market available for residue gas. Under the recycling operations conducted on all other leases held by the lessees, the wet gas produced was processed through a gasoline plant which removed a higher proportion of liquid hydrocarbons than was possible by the use of simple separating devices at the well, and the remaining dry gas was returned to the reservoir through injection wells. Since residue gas was not wasted, a much higher production of gas was permitted. The effect of the operations was gradually to replace wet gas in the field with dry gas.

The trial court gave a judgment to plaintiffs for damages based on the finding that wet gas had been replaced with dry gas under plaintiffs' tracts by reason of defendants' operations. Judgment was reversed, however, by the appellate court.

Plaintiffs contended that there was an implied covenant of an oil and gas lessee not to injure his lessor's lease by operations on other premises. This court found inadequate support in the treatises and cases for the asserted existence of this implied duty, and concluded that "the duty of an oil and gas lessee to operate the leased premises in a reasonable and prudent manner cannot prevent his operating the adjoining properties to the mutual advantage of the lessee and lessor there concerned." Moreover the plaintiffs had been afforded an opportunity to participate in the recycling program "in the same manner and on the same basis as other landowners and royalty owners in the field,"⁸⁹ and the court found no evidence to show that the plan was unfair to the royalty owners in general or to the plaintiffs in particular. In short, the court found that the plan offered by defendants to the plaintiffs for unitization of their tracts and participation in the recycling operations "was reasonable and fair in all respects," and that defendants "amply fulfilled any duty of fair dealing which may have been imposed upon them by the lessor-lessee relationship." Moreover, since other operators in the field were recycling gas, plaintiffs and defendants alike were threatened with loss of a common property right; plaintiffs "may not refuse to cooperate with their lessees for their mutual protection in the adoption of the practicable customary method or plan universal in the Long Lake Field offered them by appellants and at the same time assert and demand damages."⁹⁰

⁸⁹ *Id.* at 178.

⁹⁰ *Id.* at 179.

The foregoing discussion indicates the necessity of caution in making any generalization concerning this case for several reasons:

(1) In so far as the result of the case turns upon the failure of the court to find that there is an implied duty of the lessee not to injure his lessor's lease by operations on other premises, a different result might be reached in a state which recognizes the existence of that duty.⁹¹

(2) The result of the case clearly turns in large part upon the court's conclusion that plaintiffs had been offered a fair chance to join in a fair plan of unitization. On the question of fairness of a particular plan it is easy for reasonable men to reach contrary conclusions.⁹² The possibility that in later litigation the fact finder may conclude that the offered plan was not "fair" to the objecting lessor imposes a serious impediment to the introduction of such conservation measures by a lessee who has been unable to secure consent from all interested parties. If his conclusion as to the fairness of the plan is not accepted by the trier of facts, the lessee could, under the reasoning of the principal case, be liable in damages for the effect of his operations.⁹³

A number of states authorize voluntary pooling and unitization agreements under some circumstances and provide a method for obtaining approval of the plan by the state regulatory commission.⁹⁴ Probably approval of a plan by the regulatory commission would be strongly persuasive of the fairness of the plan, but almost certainly this would not be conclusive on the issue.

(3) The third of the legs upon which this opinion appears to rest is that other lessees were recycling and that the defendants and plaintiffs would have suffered non-compensable loss by reason of such activities of third parties if the defendants were precluded by failure to obtain plaintiffs' consent from engaging in like activities. If this element were absent from the case, would defendants have been freed of liability to plaintiffs? If a

⁹¹ For a collection of authorities on this implied duty see Merrill, *Unitization Problems: The Position of the Lessor*, 1 OKLA. L. REV. 119, 131-32 (1948); Seed, *The Implied Covenant in Oil and Gas Leases to Refrain from Depletory Acts*, 3 U.C.L.A.L. REV. 508 (1956); 25 TEXAS L. REV. 690-91 (1947).

⁹² Merrill, *Unitization Problems: The Position of the Lessor*, 1 OKLA. L. REV. 119, 132-35 (1948), expresses doubt as to the court's conclusions re the fairness of the plan involved in the *Stott* case.

⁹³ Professor Merrill has suggested that "the lessor who declines to accept unreasonable terms is in the same position as one who is excluded arbitrarily from inclusion in the unit and . . . such a one may maintain successfully that his lessee's conduct is a violation of implied obligations." Merrill, *Implied Covenants, Conservation and Unitization*, 2 OKLA. L. REV. 469, 479 (1949).

⁹⁴ See, e.g., TEX. REV. CIV. STAT. art. 6008b (Vernon Supp. 1950). Other statutes of this kind are listed in Murphy, *The Unit Operation of Oil and Gas Fields*, 27 NOTRE DAME LAW. 405, 408 (1952).

negative answer is given to this question, and the language of the opinion suggests such an answer, it means that a lessee may not engage in such conservation practices as recycling without the consent of all interested parties unless and until some other operator commences such practices.

Clearly the state of authority is far too meager to permit of bald declarations concerning the present state of the law. It would appear, however, that good conservation practice dictates that, whatever the theory adopted in the jurisdiction concerning the effect on the right-duty relationship of lessor and lessee of operations by the lessee on adjacent premises, whenever the lessee makes a fair offer to a lessor to participate in a unitized plan of recycling, pressure maintenance or secondary recovery and the offer is refused, the lessee may proceed with such a plan on other premises without liability to the non-consenting lessor so long as he conducts operations on the premises of the non-consenting lessor in accordance with the rules usually applicable to the lessor-lessee relationship.

Professor Merrill's analysis of the problem is as follows:⁹⁵

The lessor's refusal to join in a voluntary plan for unitized operation upon reasonable and non-discriminatory terms justifies the lessee's proceeding in the unitization, excluding the lease in question, despite the fact that the operation may be detrimental to the lessor's interest. On the other hand, the lessee certainly remains under a duty to his lessor to include the latter's land in the unit on proper terms. Hence the availability of the lessor's refusal to join in the unitization as an excuse depends upon the reasonableness of the terms offered. Courts should scrutinize carefully this issue in all cases involving the lessee's participation in a unitized operation from which the tract affected has been excluded, provided the evidence shows it to be part of the geologic unit.

VII

DUTY OF FAIR DEALING

In a number of contexts the economic interests of one person in oil and gas properties may be affected by the conduct of another person. In situations of this character the self interest of both parties will frequently coincide, in which event self interest of one will adequately protect the other against improper conduct.⁹⁶ But when this is not true, what protection is there against improper conduct? For example, the interest of an owner of a term royalty interest in Blackacre may be affected by the conduct of the owner of executive rights; unless the latter leases or develops Blackacre during the term of the royalty interest, the former's economic interest may expire with the primary term for failure of production. Likewise, when a

⁹⁵ MERRILL, COVENANTS IMPLIED IN OIL AND GAS LEASES § 92 (Supp. 1955).

⁹⁶ See Schlittler v. Smith, 101 S.W.2d 543 (Tex. Com. App. 1937).

lease contains a clause authorizing the lessee to pool Blackacre with other parcels, the interest of the lessor may be affected by the conduct of the lessee in including only a portion of Blackacre within a unit or in including within the unit other lands in which the lessee has an interest.

It is not within the scope of this paper to discuss all of the relationships in which this problem may arise but it may be suggested that there appears to be developing in each a duty which may be described as a "duty of fair dealing."⁸⁷ The character and scope of the duty remains ill defined at present, and it may not be the same in every context. In this paper we shall endeavor to indicate certain of the aspects of this duty in the context of the lessee-lessor relationships after pooling. The cases in which a breach of the duty of fair dealing has been found are few in number and hence the character and extent of the duty are difficult to discern. Some suggestion thereof may be found in the cases which indicate, if only by way of dictum, the existence of such a duty.

In *Boone v. Kerr-McGee Oil Industries, Inc.*,⁸⁸ for example, shortly before the expiration of the primary term of Blackacre, the lessee, acting under a pooling clause in the lease of Blackacre, pooled the lease with an adjoining leasehold on which a producing well had previously been drilled (Case II). The lessor sought a cancellation of the lease, alleging that the pooling of the leases was in bad faith for the purpose of extending the term of the lease of Blackacre without operations thereon.⁸⁹ The court appears

⁸⁷ The so-called "fraudulent drainage" cases appear to involve an application of the duty of fair dealing. See Williams, *Problems in the Conservation of Gas*, ROCKY MOUNTAIN MINERAL LAW FOUNDATION SECOND ANNUAL MINERAL LAW INSTITUTE 295, 339-41 (1956). Professor Merrill has suggested that the lessee has a duty to represent the interests of his lessor before administrative bodies. See note 68 *supra*. This may also be encompassed within the concept of a duty of fair dealing. See Jones, *Problems Presented by the Separation of the Exclusive Leasing Power from the Ownership of Land, Minerals or Royalty*, SOUTHWESTERN LEGAL FOUNDATION SECOND ANNUAL INSTITUTE ON OIL AND GAS LAW AND TAXATION 271 (1951); Jones, *Non-Participating Royalty*, 26 TEXAS L. REV. 569 (1948); Seed, *The Implied Covenant in Oil and Gas Leases to Refrain from Depletory Acts*, 3 U.C.L.A.L. REV. 508 (1956).

⁸⁸ 217 F.2d 63, 4 O.&G.R. 370 (10th Cir. 1954).

⁸⁹ Some of the difficulty which may arise from a last minute effort to include leased premises within an existing unit is illustrated by *Application of Little Nick Oil Co.*, 208 Okla. 695, 258 P.2d 1184, 2 O.&G.R. 1297 (1953). The lease of a 40-acre tract contained a pooling clause. Within the last month of the primary term, lessee obtained an agreement with adjoining lessees to include the tract in an existing producing unit and obtained an order from the Corporation Commission to increase the allowable of the unit on the basis of the additional "productive acreage." Immediately upon the expiration of the primary term of the 40-acre tract, applicant obtained a new lease of the tract from the lessor and sought vacation of the allowable order; the lessor filed suit to quiet his title against the first lease. The Commission vacated the allowable order and directed that the 40-acre tract be taken out or subtracted from the "productive acreage" included within the producing unit. The opinion does not make clear what effect this action has upon the validity of the prior lease or the new lease. Did the first lease terminate by reason of failure of production at the expiration of the primary term? Or was it saved from termination by reason of interference by the lessor? See *e.g.*, *Eastern Oil Co. v. Coulchan*, 65 W. Va. 531, 64 S.E. 836 (1909).

to assume (arguendo, at all events) that if the pooling was not in good faith for the purpose of conservation, it was ineffective to keep the lease of Blackacre in effect after the expiration of the primary term. It found, however, that the lessee¹⁰⁰

exercised not only a sound discretion but a wise one. Had this pooling arrangement been effected when two or three years of the primary term of appellants' [lessors'] leases remained, there would be no question with respect to the correctness of the decision of Kerr-McGee [lessee] to produce the entire acreage from this one well and to pay to each royalty holder his proportionate share of the production. The mere fact that only a few months of the primary term remained does not change the basic problem with which Kerr-McGee was faced and does not make arbitrary a decision which, based upon a consideration of relevant factors, was proper. Neither does the pooling arrangement, reached upon a consideration of relevant factors, become arbitrary merely because it relieves appellees from ruinous, wasteful drilling operations which would be necessary if it wanted to retain its leases, even if that was one of the factors it had in mind at the time it reached its decision.

That the result of such tardy pooling may be entirely different in Case IV is suggested by the Louisiana case of *Wilcox v. Shell Oil Co.*¹⁰¹ The lease here involved covered 550 acres and included a pooling clause. A forced pooling order was issued as to two sands, a 160-acre drilling unit was established which included 80 of the 550 acres of Blackacre, and a well was drilled on the unit but off Blackacre to test the two sands. This well was completed as a dry hole in these sands. However, a third sand encountered in the drilling gave promise of production. This third sand was not subject to the forced pooling order. The well was completed as a producer in this third sand. Thereafter, one day before the due date of delay rentals on Blackacre, the lessee, acting under the pooling clause contained in the lease

¹⁰⁰ 217 F.2d at 65-66, 4 O.&G.R. at 373. Another good faith question was raised in *Diggs v. Cities Service Oil Co.*, 241 F.2d 425, 7 O.&G.R. 827 (10th Cir. 1957). The pooling clause of the lease involved authorized 40-acre units for oil wells and 640-acre units for gas wells. Shortly before the end of the primary term the lessee formed a unit for a gas well and drilled a producing well on the unit (Case IV). It was contended that the lessee did not act in good faith in forming a gas well unit; the court found good faith on the part of the lessee and that the well in question was a gas well. Under a pooling clause which provides that in Cases II and IV, production on the unit will have no effect on excluded acreage and which provides for larger gas units than oil units, this particular good faith question can be of great importance.

¹⁰¹ 226 La. 417, 76 So. 2d 416, 3 O.&G.R. 1903 (1954). While application for rehearing was pending, the case was settled and dismissed on joint motion, leaving the authority of the decision in some doubt. See Davidson, 1954 *Louisiana Supreme Court Decisions*, L.S.U. THIRD ANNUAL INSTITUTE ON MINERAL LAW 158, 164 (1955). The doubt has since been substantially dispelled by *Mallett v. Union Oil & Gas Corp.* 94 So. 2d 16, 7 O.&G.R. 434 (La. 1957) (Case IV), which affirmed a judgment based on the authority of the *Wilcox* case in a substantially similar fact situation.

See Comment, *The Right of the Lessee to Pool the Mineral Interest Before and After the Expiration of the Primary Term*, 10 Sw. L.J. 165 (1956).

of Blackacre, executed and recorded a declaration of a unit area including 20 acres of Blackacre and the 20 acres of an adjoining lease on which the producing well had been drilled. Delay rentals were not paid on the anniversary date of the lease, the lessee relying on the production from the Case IV well to keep the lease alive. In an action brought to cancel the lease in its entirety, the court held for the plaintiff that the lease did not survive the failure of the lessee to pay rentals on the anniversary date. The case can be explained as illustrating merely a meticulous construction of the language of a pooling clause in favor of the lessor and against the lessee. The court certainly places much weight on the fact that the well was drilled before the 40-acre unit was established and that the pooling agreement required that a well be drilled after the establishment of the unit.¹⁰² If this is all the case means, it is of importance in the drafting of pooling clauses; lessees may change the clause so as to avoid this possible difficulty. Arguably, however, the case may be said to stand for a broader and more significant proposition, namely: under a duty of fair dealing between the lessee and the lessor, the lessee may not, by virtue of a pooling clause in the lease, keep the lease alive in Case IV by a last-minute pooling order. Or, in other words, pooling was ineffective to keep the lease alive since not in good faith for the purpose of conservation.

A leading case on the existence of the duty of fair dealing is *Imes v. Globe Oil & Refining Co.*¹⁰³ A community lease executed by owners of 21 lots contained a clause authorizing the inclusion of certain other lots within the terms of the lease "at any time." After producing wells were drilled by the lessee on the premises covered by the community lease, the lessee sought to permit the owners of six other lots to join in the unit and share in the royalty from the two wells. Apparently the lessee owned the royalty interest in the six lots which he sought to bring within the unit and the court was satisfied that the evidence sustained the trial court finding that the six lots had been condemned as valueless for oil and gas purposes. In denying the inclusion of these additional six lots in the unit, the court observed that the lessee "was virtually the agent of the lessors, and for this reason he was bound to use good faith."¹⁰⁴ In essence the case suggests that when the interests of lessee and lessor cease to be mutual, the lessee who is given certain authority by terms of a pooling or unitization clause in the lease to

¹⁰² 226 La. at 427, 76 So. 2d at 420, 3 O.&G.R. at 1907.

¹⁰³ 184 Okla. 79, 84 P.2d 1106 (1938), discussed in Shank, *Pooling Provisions of Oil and Gas Leases*, 23 TEXAS L. REV. 150, 156-59 (1945). Cf. *Thomas v. Ley*, 177 Okla. 150, 57 P.2d 1186 (1936), in which it was found that the inclusion of additional lots within a unit was binding upon the lessors of the lots upon which a well was being drilled (but not completed) at the time of such action.

¹⁰⁴ 184 Okla. at 81, 84 P.2d at 1109.

affect the interests of the lessor must act in "good faith"; he must deal fairly with the interests of the lessor.

Another Oklahoma case¹⁰⁵ involved pooling by the lessee in Case I after production was obtained from Blackacre, under the authority of a pooling clause in the lease of Blackacre. In this instance, however, by reason of federal regulation, production from the well on Blackacre would have been impossible unless Blackacre had been pooled to form a larger unit. Under these circumstances the court found that the *Imes* case was distinguishable. It declared that in the *Imes* case, the lessee did not act in good faith but was attempting to enrich himself at the expense of the lessor; in the instant case a "real necessity and purpose existed at the time of the pooling, which was done in good faith to obtain the marketing of the gas from the well on plaintiff's land"¹⁰⁶ The court explicitly declares that the "lessees were bound to act in good faith. Otherwise they would have come within the doctrine of the *Imes* case."¹⁰⁷

A federal case arising in Oklahoma, *Oklahoma Natural Gas Co. v. Texola Drilling Co.*,¹⁰⁸ also dealt with the power of a lessee to include within a producing unit additional acreage when the effect is to reduce the share of production payable to owners of interests in the original unit. An 80-acre area had previously been unitized and a producing well drilled thereon. Plaintiff, the owner of certain operating interests in the 80-acre area, joined in the original unit agreement whereunder it was entitled to 38% of the net proceeds from the sale of oil and gas produced. Thereafter the operator of the unit, without the knowledge of plaintiff, arranged for an increased allowable by attributing to the well a portion of a contiguous lease which it owned, thereafter making payments to plaintiff according to a formula which reduced the percentage of the total production proportionately with the increased allowable (the percentage interest being reduced from 38% to 27% plus). It was held that the attribution of the additional acreage to the jointly-owned well was "unauthorized and illegal and did not change the terms of the contract involved,"¹⁰⁹ and that plaintiff was entitled to receive the full contract percentage (38%) for the total production. Although the Commission had power and authority to define and fix the boundaries of any common source of supply of gas in the state and provide for ratable taking of gas to protect correlative rights, such power must be exercised in strict conformity with the grant of power from the legislature, and the ex parte action here involved was invalid.

¹⁰⁵ *Gillham v. Jenkins*, 206 Okla. 440, 244 P.2d 291, 1 O.&G.R. 842 (1952).

¹⁰⁶ *Id.* at 442, 244 P.2d at 293, 1 O.&G.R. at 846.

¹⁰⁷ *Id.* at 442, 244 P.2d at 294, 1 O.&G.R. at 846.

¹⁰⁸ 214 F.2d 529, 3 O.&G.R. 1933 (10th Cir. 1954).

¹⁰⁹ *Id.* at 531, 3 O.&G.R. at 1935.

These cases illustrate what are perhaps the typical situations which give rise to controversy over a "duty of fair dealing" between lessor and lessee where the lease contains a pooling clause: (1) Inclusion of all or a portion of Blackacre within a unit shortly before the expiration of the primary term or shortly before an anniversary date when the timing of the act may give rise to belief that the motivation was not conservation but perpetuation of the lessee's interest; (2) Inclusion within a unit of Blackacre together with lands in which the lessee has an economic interest greater than that which he owns in Blackacre, when such act may give rise to belief that the motivation was not conservation but an increased financial return to the lessee.

It is not certain whether the so-called "duty of fair dealing" is merely an application of the equitable doctrines of unjust enrichment or is more extensive in scope. It is too early to define the nature of the restrictions on the lessee's authority in such terms as "good faith," "fiduciary duty," "standard of a reasonably prudent operator having in mind the interest of both lessor and lessee," or the rules governing "waste" by a concurrent owner.¹¹⁰ In any event, it is certain that the authority given a lessee by a pooling clause is somewhat circumscribed despite the broad, unequivocal language of the clause.

A duty of fair dealing may also arise from a surrender clause in the lease or agreement. In *Clark v. Elsinore Oil Co.*,¹¹¹ land under a lease containing a clause authorizing the lessee to surrender a part of the undrilled leasehold was included in a unitization agreement. After production was obtained on the unit (Case III), all of the lease except 10 acres surrounding the oil well

¹¹⁰ Hoffman, *Some Problems in Pooling and Unitization*, SOUTHWESTERN LEGAL FOUNDATION SEVENTH ANNUAL INSTITUTE ON OIL AND GAS LAW AND TAXATION 219, 237 (1956), suggests that there is an implied requirement under the lease pooling clause "that in exercising the authority the clause grants to him, the lessee must act in the utmost good faith."

In upholding the validity of a unitization clause against the claim that it violated the Rule against Perpetuities, the court in *Phillips Petroleum Co. v. Peterson*, 218 F.2d 926, 4 O.&G.R. 746 (10th Cir. 1954), *cert. denied*, 349 U.S. 947, 4 O.&G.R. 1178 (1955), observed that "Anticipatory provisions in leases for the commitment by the lessee of such leases to unitization, of necessity must be in general terms The practice of unitization by a power granted the lessee in advance, if faithfully carried out, will be fair and profitable both to the lessor and lessee, and is vital to the oil and gas industry in the interests of the conservation of both natural and material resources. It should be upheld, although the grant of power is in general terms, because it is subject to implied terms that will prevent arbitrary and unfair dealing, will require compliance with the implied covenants in the lease for the benefit of the lessor and will impose a rigid standard of good faith on the part of the lessee." *Id.* at 933, 4 O.&G.R. at 752-53. Again the court observed that the lease clause gave the lessee authority to effectuate the unit plan of development and operation so long as the lessee "acted in good faith, fairly, and with a due regard for the interests of the lessors, as well as its own interests, . . ." *Id.* at 935, 4 O.&G.R. at 755.

¹¹¹ 138 Cal. App. 6, 31 P.2d 476 (1934). For a discussion of the surrender cases, see HOFFMAN, VOLUNTARY POOLING AND UNITIZATION 65-75 (1954).

was surrendered. The court held that the lessor continued entitled to a share of the royalties from the unit based on the original acreage included within the unit. It may be noted that community leases sometimes contain express provisions to the same effect, providing that parties having an interest in premises surrendered by a unit operator shall continue to have an interest in unit production.¹¹²

In *Superior Oil Co. v. Dabney*¹¹³ the lease and contemporaneous agreements contained an express drilling covenant, a surrender clause, and a pooling clause. The lessee included 17 acres of the 796-acre leasehold in a producing unit (Case IV) and then surrendered the balance of the leasehold, without having engaged in any drilling operations. The court held that he was excused from such drilling operations and that his leasehold interest in the 17 acres included in the unit was kept in effect by production on the unit. This is a context in which the court might well have, but did not, find a breach of the duty of fair dealing.

VIII

INCONSISTENCY OF PROVISIONS IN A LEASE AND IN A POOLING OR UNITIZATION AGREEMENT

The authority given a lessee by a lease of Blackacre to pool or unitize the premises does not, of course, give him the power to modify the basic provisions of the lease by inconsistent provisions in the unitization agreement. It appears, therefore, that the provisions of a pooling or unitization agreement executed by a lessee under the authority of such a lease clause cannot prevail against inconsistent provision of the lease.

In two instances, however, problems may arise as to the effect of inconsistency of the provisions of a lease of Blackacre and a unitization agreement. The first occurs when the lessor becomes a party to the pooling or unitization agreement by executing or ratifying the agreement, the second when the agreement is imposed by compulsory process.

In the former instance, that is, where the lessor of Blackacre has executed or ratified the unit agreement, the provisions of the agreement will prevail over inconsistent provisions of the lease.¹¹⁴ Similarly, the lessor may be estopped to enforce the inconsistent provision of the lease under some

¹¹² See *Tanner v. Title Insurance & Trust Co.*, 20 Cal. 2d 814, 129 P.2d 383 (1942).

¹¹³ 147 Tex. 51, S.W. 2d 563 (1948).

¹¹⁴ *Beene v. Midstates Oil Corp.*, 169 F.2d 901 (8th Cir. 1948) (inconsistency herein related to the royalty provisions of the lease and the unitization agreement); *Merrill Engineering Co. v. Capital National Bank*, 192 Miss. 378, 5 So. 2d 666 (1942) (inconsistency between express drilling covenants of the lease and the unitization agreement); *cf. Phillips Petroleum Co. v. Ham*, 228 F.2d 217, 5 O.&G.R. 268 (5th Cir. 1955) (royalty in money clause of agreement supercedes royalty in kind clause of the lease; the result of this case may turn in part upon estoppel and in part on the fact that the well was not on the leasehold—Case II rather than Case I).

circumstances.¹¹⁵ A constructional preference in favor of the lessor may yet operate, of course, as to the provision of the unitization agreement just as it does in the case of the lease proper.¹¹⁶ When the pooling or unitization agreement is imposed by compulsory process, the provisions of the agreement must be found to prevail over any inconsistent lease provisions,¹¹⁷ at least in cases in which the statute antedates the lease.

IX

CONSTRUCTION PROBLEMS

The construction problems which may arise from pooling clauses in leases or from pooling or unitization agreements are as numerous and various as the clauses and agreements themselves. Typical construction problems concern: (1) the power of the lessee to include less than all of Black-acre within a unit;¹¹⁸ (2) the power of the lessee to change unit boundaries by increasing or decreasing the size of the unit;¹¹⁹ (3) the effect of production from or operations on the unit upon the various lease clauses;¹²⁰ (4) the effect of surrender to the lessor of part or all of the leasehold or part of the premises included within the unit;¹²¹ (5) the effect on the unit and on the interests included therein of the invalidity of the inclusion of one tract or interest within the unit;¹²² (6) alleged inconsistency between the provisions of a lease and of a pooling or unitization agreement.¹²³

¹¹⁵ Cf. *Phillips Petroleum Co. v. Ham*, *supra* note 114.

¹¹⁶ *Waller v. Midstates Oil Corp.* 218 La. 179, 48 So.2d 648 (1950); see *Midstates Oil Corp. v. Waller*, 207 F.2d 127, 2 O.&G.R. 1081 (5th Cir. 1953). In the first of these cases, the Louisiana court held that the royalty provisions of the agreement must prevail over inconsistent royalty provisions of the lease. In later litigation, the federal court gave the lessor the benefit of the constructional preference mentioned. The lease provided for an overriding royalty on flowing wells. Under the agreement certain wells were shut in. The court held the lessor was entitled to an overriding royalty on the amount of production allocable to the leasehold under the unit participation plan without regard to the "flowing well" qualification.

¹¹⁷ *Smith v. Carter Oil Co.*, 104 F.Supp. 463, 1 O.&G.R. 698 (W.D. La. 1952); *Everett v. Phillips Petroleum Co.*, 218 La. 835, 51 So.2d 87 (1950) (note 49 *supra*); *Alston v. Southern Production, Inc.*, 207 La. 370, 21 So.2d 383 (1945); *Superior Oil Co. v. Foote*, 214 Miss. 857, 59 So.2d 85, 844, 1 O.&G.R. 735, 1239 (1952); *Young v. West Edmond Hunton Lime Unit*, 275 P.2d 304, 3 O.&G.R. 1736, 4 *id.* 68 (Okla. 1954), *appeal dismissed*, 349 U.S. 909 (1955).

¹¹⁸ See *HOFFMAN, VOLUNTARY POOLING AND UNITIZATION* 113-18 (1954).

¹¹⁹ See *Imes v. Globe Oil & Refining Co.*, 184 Okla. 79, 84 P.2d 1106 (1938), discussed in text at note 103 *supra*; *HOFFMAN, supra* note 118, 124-27 (1954).

¹²⁰ See discussion under headings I-V *supra*.

¹²¹ *Superior Oil Co. v. Dabney*, 147 Tex. 51, 211 S.W.2d 563 (1948) (*supra* note 113); see *Clark v. Elsinore Oil Co.*, 138 Cal. App. 6, 31 P.2d 476 (1934) (*supra* note 111); *Grimes v. La Gloria Corp.*, 251 S.W.2d 755, 1 O.&G.R. 1784 (Tex. Civ. App. 1952) (lessee held to be without authority to exclude from a unit a parcel originally included therein); *HOFFMAN, VOLUNTARY POOLING AND UNITIZATION* 127-31 (1954).

¹²² See *Union Oil Co. v. Touchet*, 229 La. 316, 86 So.2d 50, 5 O.&G.R. 1177 (1956).

¹²³ See discussion following heading VIII *supra*.

The cases which have been concerned with these or other construction problems have been litigated because the parties to the instrument failed either to think through and reach agreement on future contingencies arising under the pooling clause or agreement, or, where the contingencies were anticipated, to express clearly their intention regarding them. Obviously, more careful draftsmanship including careful thought as to the contingencies which may arise is in order.

The decided cases on these construction matters are relatively few in number and permissible generalization at this time must be limited. However, in the light of such cases as *Wilcox*,¹²⁴ *Imes*,¹²⁵ and *Touchet*,¹²⁶ it is possible to suggest that the authority given a lessee to affect the interests of his lessor by pooling or unitization will be strictly construed. The burden is on the lessee to include in the lease or agreement rather specific language authorizing the conduct he wishes to pursue.

X

GENERAL POLICY CONSIDERATIONS

In the preceding portions of this paper an attempt has been made to set forth the present state of the law as to the impact of pooling or unitization upon the jural relationship of lessor and lessee. It has been indicated that in certain contexts a distinction may be drawn between four factual situations, Cases I through IV. It has become obvious, however, that Cases I and II in practical effect are identical with regard to such matters as a duty to protect against drainage or the continued validity of the lease during the secondary term. Cases III and IV are not in practical effect identical to Cases I and II; they can and have been in some instances distinguished from Cases I and II and from each other, expressly or by implication. It is to this matter that serious attention should be directed.

It is the writers' contention that Cases III and IV, in both of which some leasehold acreage is excluded from the unit, should be treated alike. The proper analysis is that given in the *Griffith* case,¹²⁷ not that in the *Hunter* case;¹²⁸ that is, when some acreage is excluded from the unit, the

¹²⁴ *Wilcox v. Shell Oil Co.*, 226 La. 417, 76 So. 2d 416, 3 O.&G.R. 1903 (1954) (*supra* note 101).

¹²⁵ *Imes v. Globe Oil & Refining Co.*, 184 Okla. 79, 84 P.2d 1106 (1938) (*supra* note 103).

¹²⁶ *Union Oil Co. v. Touchet*, 229 La. 316, 86 So. 2d 50, 5 O.&G.R. 1177 (1956).

¹²⁷ *Texas Gulf Producing Co. v. Griffith*, 218 Miss. 109, 65 So. 2d 447, 834, 2 O.&G.R. 1103, 1278 (1953). This case held that upon the expiration of the primary term, the lease terminated as to the 8-acre portion of the leased acreage excluded from the unit in Case IV, but not as to the 40-acre portion included within the unit.

¹²⁸ *Hunter Co. v. Shell Oil Co.*, 211 La. 893, 31 So. 2d 10 (1947). This case is the first and leading case standing for the proposition that the lease is indivisible and that production on the unit will extend the lease into the secondary term both as to acreage included and excluded from the unit.

lease should be treated as divisible.¹²⁹ As to the portion of the leasehold included within the unit, the treatment should be the same as in Cases I and II; as to the part of the leasehold excluded from the unit, the rights and duties of the lessee should be unaffected by what takes place on the unit. In other words, as to the excluded acreage, (1) the lessee should be subject to loss of the leasehold under the terms of the delay rental clause if he does not pursue drilling operations thereon or pay rentals on or before an appropriate anniversary date of the lease; (2) the lease on the excluded acreage should terminate on the expiration of the primary term of the lease if there is then no production from the excluded acreage; and (3) the covenants of the lessee as to the excluded acreage should be unaffected by drilling operations on, or production from, the included acreage.

Our position is based on the fact that in both Case III and Case IV the lessor realizes no benefit from the lease on the excluded acreage by virtue of production from the unit; his share of production is limited to a pro rata distribution based on the amount of the acreage included within the unit or upon some other participation formula which gives no weight to the excluded acreage. The lessee, on the other hand, is able to retain the excluded acreage for speculative purposes without operations thereon and without making any payment for retaining the excluded land.

It is further our position that in a jurisdiction which has treated the lease as non-divisible, the court should be willing to find that there is a duty of further exploration as to the excluded acreage. Failure of the courts to enforce a rigid duty of exploration will permit lessees to retain acreage indefinitely without any compensation to lessors for holding such land and without any obligation to search the land for new mineral deposits. Moreover, it precludes exploration by others who are thus unable to obtain a lease.

The decision in the *Hunter* case¹³⁰ has had and will continue to have a generally unfortunate effect. It has caused lessors to oppose the enactment of compulsory pooling and unitization statutes and to resist participation in voluntary agreements. It is fair to say that pooling and unitization serve

¹²⁹ In some instances it has been held that, upon the partial assignment of the working interest by a lessee, the lease may be made divisible as to certain of the obligations of the lessee to the lessor. See discussion of this matter in Brown, *Assignments of Interests in Oil and Gas Leases*, SOUTHWESTERN LEGAL FOUNDATION FIFTH ANNUAL INSTITUTE ON OIL AND GAS LAW AND TAXATION 25, 39-44 (1954); Merrill, *The Partial Assignee—Done in Oil*, 20 TEXAS L. REV. 298 (1942). In Cases III and IV, inclusion of part of Blackacre within a unit has the effect of giving persons other than the lessor and lessee certain interests in the portion of Blackacre included within the unit. In effect, then, this is a partial assignment. To the extent that partial assignments may make a lease divisible in any jurisdiction this is an additional argument that the inclusion of a portion only of Blackacre within a unit makes the lease divisible.

¹³⁰ *Hunter Co. v. Shell Oil Co.*, 211 La. 893, 31 So. 2d 10 (1947).

the public policy of preventing physical and economic waste and that rules which discourage lessors from consenting to pooling and unitization defeat that public policy; the rule of *Hunter* clearly has that effect. That this is recognized is perhaps evidenced by the recent pattern of decisions in Louisiana on prescription *liberandi causa*. Recent cases have treated a servitude as divisible between the included and excluded acreage where pooling or unitization is involved and have held that prescription *liberandi causa* is not interrupted or suspended in the case of excluded acreage by production from or operations on the unit in which a part of the leasehold is included.¹³¹

It is true that parties to a lease containing a pooling clause or to a pooling or unitization agreement may agree that the lease shall be indivisible and that production on a unit which includes a part of the leasehold shall suffice to extend the term of the lease as to the excluded acreage. Such an intent is not lightly to be inferred. It is important to examine carefully the language in the instrument alleged to have this effect and to apply to such language the normal constructional preference for the lessor. In drafting such instruments, the parties should carefully negotiate on this matter and include in the lease language sufficiently explicit to remove all uncertainty as to their intent in Cases III and IV.

It is dubious construction policy for a court to find a legislative intent to reach the result of *Hunter* as opposed to the result of *Griffith*. If the matter were squarely posed to the legislature by explicit statutory language, it is extremely doubtful that a statute providing for the *Hunter* result could be enacted.

In summary, a construction of an instrument or a statute in the manner suggested by *Hunter*, which construction is not made mandatory by explicit language, has the effect of impeding the negotiation of voluntary agreements and the securing of the requisite consent to pooling and unitization under compulsory statutes and hence has the effect of requiring unnecessary drilling with resultant waste. Moreover, it withdraws potentially producing land from exploration by others. Public policy of preventing physical and economic waste and encouraging exploration would be better served by finding leases divisible when a portion of the leasehold is excluded from a unit.

¹³¹ *Jumonville Pipe & Machinery Co. v. Federal Land Bank*, 230 La. 41, 87 So.2d 721, 6 O.&G.R. 61 (1956); *Childs v. Washington*, 229 La. 869, 87 So.2d 111, 6 O.&G.R. 44 (1956); *Elson v. Mathewes*, 224 La. 417, 69 So.2d 734, 3 O.&G.R. 384 (1953).