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OIL AND GAS

by

William J. Flittie*

IN THIS summary, Texas Supreme Court cases are first presented, with the exception of one case of overriding importance destined for ultimate disposition by the supreme court. That case is *Texas Oil & Gas Corp. v. Vela*.¹

In 1964 the United States Court of Appeals for the Fifth Circuit, dealing with a Texas lease, held that an unusual royalty clause requiring cash payment for oil and gas "at the market value prevailing for the field when run" required payment at current gas prices, not the prices set in a twenty-year gas sales contract entered into in 1950, though those prices were advantageous when made.² Though distinguishable by that peculiar phrasing, the precedent was followed in the *Vela* case, where the royalty clause for gas is in the standard phrasing of "one-eighth of the market price at the wells." The facts of *Vela* show a 1934 life-of-the-lease gas sales contract at 2.3 cents per MCF, probably advantageous, and at least reasonable, when made, but about 11 cents per MCF out of line with the post-1960 prices in terms of which the deficiency is claimed. The difficulties of proving market value of gas also are a substantial part of the *Vela* litigation, but the primary issue is the meaning of "market value" or "current market value." When the problem is expanded to recognize the implied covenant obligation of the lessee to market as soon as practical and the realities of the gas business in which long term contracting is mandatory if a sale is to be made, it is by no means certain these words should not relate to values as of the time of contracting. Four corners and latent ambiguity rules of construction might well cause the supreme court to arrive at an opposite result when it reaches the case. But now, even further complicating the matter, the Fifth Circuit has remanded two comparable cases under the primary jurisdiction doctrine for a determination by the Federal Power Commission of whether it will claim the right to control, as rates, gas royalty prices and increases of prices where jurisdictional interstate gas is involved.³ Because there probably are many more leases with interstates sales commitments than purely intrastate commitments there now is a problem as to whether there is state jurisdiction in a majority of these cases.

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¹ 405 S.W.2d 68 (Tex. Civ. App. 1966) error granted, 20 Sw. L.J. 940.

² *Foster v. Atlantic Ref. Co.*, 329 F.2d 485 (5th Cir. 1964).

³ *J. M. Huber Corp. v. Denman*, 367 F.2d 104 (5th Cir. 1966); *Weymouth v. Colorado Interstate Co.*, 367 F.2d 84 (5th Cir. 1966).

In another important case the supreme court held that the estimated market demand to be distributed to wells in a pool cannot be restricted below that figure if the production can be obtained without physical waste, even though correlative rights are derogated in the process.⁴ Involved were pools containing small tract rule 37 exception wells, still under the now discredited one-third well-two-thirds acreage distribution formula because not timely attacked when the special field rules were adopted. Market demand was estimated as the usual summation of producer forecasts under the statewide rule. Mathematically there resulted an estimated market demand so great that regular tract wells, produced at maximum permitted capacity, could not produce the well allowables assigned. Hence they were classified as limited capacity wells, permitted to produce that maximum, and the balance of the pool demand became available to the small tract wells under the well distribution formula. This permitted them to produce far in excess of their "fair share" on a relative-reserves-represented basis, with consequent drainage of the large tracts. A dissenter would have permitted the Railroad Commission to use a special alternative formula designed further to restrict below market demand to improve correlative rights balance on the theory that this element properly is considered in ascertaining "lawful" market demand. With "rule of capture" the basic law, however, it is not possible to pronounce the effects of a well distribution formula illegal so long as wells do not exceed maximum permitted rates of production. The majority suggested that summing producer forecasts need not be the sole means of estimating market demand to be distributed to wells. This may be a partial solution. Beyond that, however, to fully protect correlative rights it would seem the Railroad Commission would have to adopt new well distribution formulas in the older pools. Though the courts will not compel this done, there can be little doubt but that an administrative body has the power so to do. Whether the Commission will wish so to do is another matter, particularly when it be considered it could not stop at the halfway house of ameliorating the situation, but would have to go all the way in terms of the now enforced "fair share" concept. The old unfair formulas are not protected from assault by substantive law; only by the procedural quirk that in the great majority of pools now producing appeals were not timely taken.

In *Railroad Comm'n v. Rio Grande Valley Gas Co.*,⁵ construing the Common Purchaser Act in a natural gas situation, the supreme court upheld the Commission in its order to make a 3,610-foot gathering line extension and to take gas from pools, without discrimination, where no com-

⁴ *Railroad Comm'n v. Woods Exploration Co.*, 405 S.W.2d 313 (Tex. 1966). See generally Note, *Oil and Gas—Proration—The Railroad Commission's Authority To Protect Correlative Rights*, in this issue.

⁵ 405 S.W.2d 304 (Tex. 1966). See generally Note, *supra* note 4.

petitive take was occurring, but which geographically were in a "field" area from which other production was being purchased. Contract terms, including price, were ordered negotiated under compulsion of the order. The opinion does not consider that the gathering line extension ordered was over one leasehold surface to serve minerals underlying another. Also unremarked is the fact that this case involved a purely intrastate situation—a rarity when one considers that most gas fields either have interstate purchasers or are near enough to fields that do to bring into play the Common Purchaser Act's further command against unjust and unreasonable discrimination among separate fields. But since 1963 it has been crystal clear that no state ratable takes can be imposed on these purchasers because of federal Natural Gas Act exclusive regulation.⁶ What is the correct solution when federal pre-emption strips from state regulation most of the jurisdictional base on which that regulation was predicated? Is a rational program of state regulation, consistent with the state legislative purpose, then possible? Questions like these remain to be answered.

The issue of whether the Railroad Commission can order makeup of illegal excess production was decided in favor of such power in *Railroad Comm'n v. Sample*⁷ against the contention that the exercise of such a power amounted to the infliction of an unauthorized penalty. Involved was illegal excess production from able wells of a lease, falsely attributed to dummy wells incapable of production, but reported to the Commission and scheduled by it as marginal wells. The makeup was accomplished by reducing the normal allowables of the able wells by one-half until excess past production was made up.

A fairly standard type of lease pooling clause provided for forty-acre oil units unless governmental authority should "prescribe or permit" larger units, in which case the lessee could pool to the extent of the units "prescribed." The supreme court held special field rules setting eighty-acre proration units, with eighty-acre tolerances permitted, would not support pooling in 160-acre units.⁸ The effect is to render the "or permit" portion of the first phrase entirely meaningless surplusage, which scarcely comports with modern rules of contract construction.

Another construction case involved an unusual lease requiring commencement of a well in 120 days, completion within 120 days after commencement, and if a successful well was so commenced and completed, the lease was to remain in effect so long as production continued. A well was commenced and completed as a commercial gas well within the required intervals, but then there ensued a five-month gap before actual production

⁶ Northern Nat'l Gas Co. v. Corporation Comm'n, 372 U.S. 84 (1966).

⁷ 405 S.W.2d 338 (Tex. 1966), 20 Sw. L.J. 690.

⁸ Jones v. Killingsworth, 403 S.W.2d 325 (Tex. 1965).

could be commenced. No shut-in royalty was involved, so there was neither actual nor constructive production in this interval. Avoiding an automatic termination habendum clause consequence, the supreme court construed the lease as having no primary term. Hence commencement and completion were full compliance with the lease terms, and production was not required to hold it at this point.⁹ Presumably once actual production did commence, the usual habendum clause necessity of maintaining it thereafter would arise.

*Continental Oil Co. v. Doornbos*¹⁰ showed this fact situation: There were outstanding in a prior chain of title a 1/32 royalty, another 1/32 royalty and an open end 1/4 of the royalty (which is a 1/32 royalty if a usual 1/8 royalty reserved lease is what is made). The grantor reserved another 1/32 royalty. Thereafter the grantor leased, reserving a royalty in excess of 1/8. He then sought a reformation, effective between grantor and grantee (but obviously not against the prior 1/4 of the royalty owner) that 1/4 of the royalty meant 1/32. This would have given the grantee all royalty in excess of 1/8. Moreover, because the open end 1/4 of the royalty increased as lease royalty increased, the grantee sought a *Dubig* warranty construction charging the grantor's 1/32 royalty to the extent necessary to cover the increase. Reformation was rejected, there being no evidence the parties had agreed as to how the potential excess burden consequences should be borne even though they may have dealt with the open end royalty as if it were a 1/32 royalty. All that then remained was a straightforward chain of title sequence problem with each prior reserved royalty first satisfied and the grantee entitled to any balance.

Where an undivided mineral interest was leased in terms purporting to cover the whole tract, then placed in a unit with the unit well off the lease lands, it was held that the unleased tenant in common of another undivided fractional mineral interest in the tract had no basis for sharing in the unit production allocated to the tract even though, among the owners in the unit, the tract had been treated as a full mineral interest tract.¹¹ The unleased tenant in common had not ratified. Had he done so, the result might have been different.

In other supreme court cases during the period under review it was held that an oral promise to convey an overriding royalty to a lease finder was barred by the Texas Trust Act and Statute of Frauds. The court reasoned that there was an insufficient showing of fiduciary relationship to make available the constructive trust remedy, whereby the necessity of a writing sometimes is avoided.¹²

⁹ *Fox v. Thoreson*, 398 S.W.2d 88 (Tex. 1966).

¹⁰ 402 S.W.2d 879 (Tex. 1966).

¹¹ *Superior Oil Co. v. Roberts*, 398 S.W.2d 276 (Tex. 1966), 20 Sw. L.J. 907.

¹² *Consolidated Gas & Equip. Co. v. Thompson*, 405 S.W.2d 333 (Tex. 1966).

The compensated retention for six months of a former officer of a merged company, as consultant, to smooth the merger transition did not place a fiduciary duty upon the consultant as would prevent his writing a letter in behalf of his father, mineral owner in one of the leases transferred in the merger, demanding further leasehold development.¹³

A separately acquired surface lease to support enlarged oil and gas operations, to run concurrently for the duration of the oil and gas lease on the same lands, but with rentals payable in advance, did not terminate for failure timely to pay rentals.¹⁴ The result was reached by construing the rental obligation as a covenant rather than a condition or limitation, but it was suggested that equitable relief against forfeiture for violation of a condition also supported the result.

A drilling cotenant was held not entitled to interest upon sums expended in the proportionate accounting recovery out of production to which a drilling cotenant is entitled from the non-drilling cotenant.¹⁵

A note of warning to oilfield suppliers was given in an instance where a supplier of tubing and casing attempted to establish its statutory mechanics' and materialmen's liens on the equipment as superior to that of claimants with mechanics' and materialmen's liens for services and labor. The court held the liens were of equal dignity, neither enjoying priority.¹⁶

The employee of a non-profit producers association with by-laws forbidding disclosure, nevertheless, in the proper discretion of the trial court, could be compelled to give evidence on deposition involving geological information and including secret maps and charts.¹⁷ The deposition was concerned with developing salt water injection effects in the East Texas Field.

The last Texas Supreme Court case here considered involved liquids sharing in a gas processing arrangement. The processor of the gas inadvertently inserted the wrong formula in the written contract, but accounted for years on the basis of the formula intended. Because the supplier of the raw gas was not shown to have agreed to any but the formula appearing in the contract, reformation was denied and the gas supplier held entitled to recover under the written contract formula—provided an estoppel did not exist.¹⁸ The case was remanded to determine the last issue. There were dissents stating the basis of estoppel is affirmative deception and that none had been shown.

¹³ *Tennessee-Louisiana Oil Co. v. Cain*, 400 S.W.2d 318 (Tex. 1966), 20 Sw. L.J. 418. For further discussion see Pelletier, *Corporations*, at footnote 16.

¹⁴ *Sirtex Oil Indus., Inc. v. Erigan*, 403 S.W.2d 784 (Tex. 1966).

¹⁵ *Cox v. Davison*, 397 S.W.2d 200 (Tex. 1965), 19 Sw. L.J. 861.

¹⁶ *Lane-Wells Co. v. Continental-Emsco Co.*, 397 S.W.2d 217 (Tex. 1965).

¹⁷ *Lehnhard v. Moore*, 401 S.W.2d 232 (Tex. 1966), 20 Sw. L.J. 222.

¹⁸ *Champlin Oil & Ref. Co. v. Chastain*, 403 S.W.2d 376 (Tex. 1965).

Presently before the supreme court for review is *Andretta v. West*¹⁹ where the appeals court held the owners of "an undivided one-fourth interest in and to all of the . . . royalty . . . that may be produced" were royalty owners only, not entitled to share in lease rentals or, under an extension of the lease, payments described as "lien royalty" if a well was not drilled. Despite the nomenclature used, the latter payment, since it performed the delay rental function, was classified as such and royalty owners were not entitled to share.

In another case where writ of error has been granted the original lessee assigned, reserving an overriding royalty, which also attached to renewals and extensions of the lease. The assignee pooled for gas only and drilled an off-lease pooled unit well before the end of the primary term, all as provided in the lease. An oil well was obtained. Thirteen days later another well was commenced on lease lands under a usual sixty-day dry hole clause. This well was a lease well, and resulted in lease oil production. Doubting the efficacy of his lease, the lessee took a new lease about one year after completion of the second well. The appeals court held the first well the legal equivalent of a dry hole, implementing the sixty-day clause. Hence, when the second lease was obtained the first lease was held by its own production. Thus the second lease was an extension or renewal of the first lease, and the overriding royalty attached to it.²⁰

Two civil appeals decisions involved the *Dubig* rule. In the first the plaintiff conveyed to the defendant, reserving one-half of the minerals. Then, by warranty deed, the defendant conveyed back to the plaintiff excepting one-half of the minerals. The effect was held to vest all minerals back in the plaintiff, the *Dubig* warranty construction rule not being varied because the outstanding minerals in the prior chain happened to be owned by the grantee.²¹ Also involved in this case is the usual rule a tenant in common cannot adversely possess against another tenant in common without unmistakably communicating his purpose to the other cotenant. In the second case there was a 1/64 royalty outstanding in the prior chain. Conveyance was by warranty deed, reserving a 1/4 mineral interest. The issue was where the burden of this 1/64 royalty should be charged. Since a 3/4 interest had been warranted without reservation, it was held properly chargeable against the 1/4 mineral interest reserved.²²

In the period under review there were of course many civil appeal cases turning on interpretation and construction of clauses. Neat categorization of these cases is virtually impossible because of the multiplicity of rights

¹⁹ 402 S.W.2d 543 (Tex. Civ. App. 1966) error granted.

²⁰ Sunac Petroleum Corp. v. Parkes, 399 S.W.2d 840 (Tex. Civ. App. 1966) error granted.

²¹ Coyne v. Butler, 396 S.W.2d 474 (Tex. Civ. App. 1965).

²² Selman v. Bristow, 402 S.W.2d 520 (Tex. Civ. App. 1966) error ref. n.r.e.

affected. In *Guaranty Nat'l Bank & Trust v. May*²³ the holder of the power to lease five tracts of land with varying severed royalty interests leased all five tracts in one instrument containing an unauthorized pooling clause. The lessee pooled and completed a productive well in one of the five tracts where the royalty was equally divided between the lessor and a non-ratifying royalty owner. A ratifying royalty owner in some of the other four tracts sought the benefits of pooling against the lessor's half interest. Without citing authority the court held the royalties involved could not be communitized without the joinder of all royalty owners. The refusal of the supreme court to review can be explained on the alternative ground of estoppel, arising because the ratifying party seeking participation had for years taken the benefits of the same apportionment of royalty he here sought to defeat in the production from another well by virtue of his ownership in another of the five tracts.

*Hall v. McWilliams*²⁴ is a case almost impossible to square with the supposed new Texas rule that a lease does not expire so long as a reasonable operator would be expected to hold it in the expectation of resuming profitable production, and not for mere speculative purposes.²⁵ Here production ceased because the Railroad Commission suspended a salt water well injection permit on which producing operations depended. Without going into details, a new injection had been arranged and full profitable operations again were in full swing ten months thereafter. The court held that the lease terminated by operation of law as of the end of the third month because not maintained by production in paying quantities. Apparently the sixty-day clause providing that if production "should cease from any cause this lease shall not terminate if Lessee commences additional drilling or reworking operations" was read as the only means of continuing the lease more than sixty days after physical cessation of production. In fact the clause is permissive, serves another purpose entirely, and is not a sound basis for setting aside the ultimate habendum duration rule of Texas.

A lessee attempted to avoid liability for failure to drill an offset well by attempting to release back to the lessors only the affected productive formation. The court held this was no effective release because the clause contemplated release of all lease lands under a surface description, and the lessee accordingly continued liable.²⁶ The lessee also sought to limit the offset obligation to the minimum well and lease line distances under the statewide rule, but this was rejected for the obvious reason it would require drilling in forbidden locations. It would appear that a special offset clause

²³ 395 S.W.2d 80 (Tex. Civ. App. 1965) *error ref. n.r.e.*

²⁴ 404 S.W.2d 606 (Tex. Civ. App. 1966) *error ref. n.r.e.*

²⁵ *Clifton v. Koontz*, 160 Tex. 82, 325 S.W.2d 684 (1959).

²⁶ *Shell Oil Co. v. Stansbury*, 401 S.W.2d 623 (Tex. Civ. App. 1966).

limiting the obligation in terms of governmental drilling units can be implemented only after special field rules set proration units. And, though a narrow fee strip in another ownership intervened between the draining well and the demanded offset, the strip was held no bar to actionable drainage. Again, in an effort to avoid the minimum royalty of \$2.00 an acre in a 6,978-acre lease perpetuated by production, the lessee released all but 640 acres two days before the end of the first year after the end of the primary term and denied obligation on the released acreage for that year. The court's opinion is to the effect that a usual option to release must be implemented before the inception of a current year, not during it, if it is to be effective in that year.²⁷

Two other civil appeals decisions furnish interesting examples of construction of delay rental clauses. Where assignees of the original lessor had circulated to them a title curative stipulation and struck from it the payee bank designated in the lease, inserting the name of another bank, but in an unexplained manner a delay rental check payable to the new bank was sent the old, there cleared and deposit made to the assignee-lessor's credit, the payment was held to be a sufficient compliance with the delay rental obligation.²⁸ One wonders if the result would obtain if the mailing had been shown to be the lessee's mistake, as it probably was. Or perhaps the circumstances of changing the designated bank were so irregular as to justify the result anyway. In another delay rental case involving a usual form "unless" lease, timely mailing of a check, not actual time of bank receipt, was held to be the extent of the lessee's obligation if he would keep the lease in force.²⁹

In a case involving basic contract construction two wells had been drilled under prior arrangements including formal contracts requiring driller indemnity in all circumstances. These contracts never were signed by the operator. The instant well was drilled under a letter agreement specifically referencing these contracts for terms and conditions. Through the driller's negligence the pipe became stuck. It is difficult to understand, but the court held the reference not specific enough to adopt the terms of the prior instruments into the letter agreement and that the driller was not entitled to indemnity.³⁰

Two cases, one involving negligent leakage of salt water from an unlined disposal pit³¹ and the other salt water damage from waterflooding operations,³² chiefly stand for the proposition that limitations begin to run not

²⁷ *Pan Am. Petroleum Corp. v. Robinson*, 405 S.W.2d 698 (Tex. Civ. App. 1966) *error ref. n.r.e.*

²⁸ *Carroll v. Roger Lacy, Inc.*, 402 S.W.2d 307 (Tex. Civ. App. 1966) *error ref. n.r.e.*

²⁹ *Corley v. Olympic Petroleum Corp.*, 403 S.W.2d 537 (Tex. Civ. App. 1966) *error ref. n.r.e.*

³⁰ *M. V. Delaney Co. v. Murchison*, 395 S.W.2d 705 (Tex. Civ. App. 1965).

³¹ *Crawford v. Yeatts*, 395 S.W.2d 413 (Tex. Civ. App. 1965) *error ref. n.r.e.*

³² *Tenneco Oil Co. v. Rollans*, 399 S.W.2d 217 (Tex. Civ. App. 1965).

from the inception of the operations, but when damage was or should have been apparent even though not yet fully developed and still spreading. This presents a fact question for court or jury. In a somewhat more complicated case salt water damage was caused by leakage through seismic shot holes made by a prior owner of the lease and not sealed off. The current lessee, who was injecting salt water, was aware of the condition and could have foreseen the consequences of not properly cementing his injection string, though unable to locate all the old shot holes. Accordingly he was liable, and to a surface tenant as well for crop and livestock damage.³³ The surface lease antedated the oil and gas lease, but no reason is apparent for a distinction as to tenants because of this.

*Amerada Petroleum Corp. v. Railroad Comm'n*³⁴ supports the Railroad Commission in its view that it is compelled to permit illegally directed wells to be redrilled to proper bottom hole locations, at least absent evidence that production beyond that which would have been possible with a correctly bottomed well has been obtained. In reaching this result it was held the Commission properly refused to consider private agreements with adjacent owners that the illegal wells would not be redrilled, this presumably being for the courts to determine.

A production payment was deferred to commence after a prior \$2,600,-000 net payout. It was held that failure to list compression and lift gas expenses in the schedule of expense items to be deducted in arriving at the net payment meant these items should not be deducted, thereby advancing the time the production payment began.³⁵

An option to purchase land providing that "not less than one fourth (1/4) of the mineral rights and full leasing rights shall go with the place" was sufficiently definite for specific performance to be ordered.³⁶

When, in consideration of installation of a waterflood project an operator joined a secondary recovery unit and assigned a production payment to the unit operator, even though the waterflood was not installed, the further conveyance of the production payment in a deed of trust transaction with a bank could not be defeated.³⁷ Contentions that the failure to install the waterflood resulted in an automatic defeasance of the assigned production payment were met by a determination that only a contractual covenant was involved.

Affiliated producing and purchasing companies entered into a gas sales contract. For purposes of the severance tax the state contended the price was too low and market price should be determined by means other than

³³ *Currey v. Ingram*, 397 S.W.2d 484 (Tex. Civ. App. 1965) *error ref. n.r.e.*

³⁴ 395 S.W.2d 403 (Tex. Civ. App. 1965) *error ref. n.r.e.*

³⁵ *Slavik v. Southern Minerals Corp.*, 395 S.W.2d 92 (Tex. Civ. App. 1965) *error ref. n.r.e.*

³⁶ *Brevard v. King*, 400 S.W.2d 576 (Tex. Civ. App. 1966) *error ref. n.r.e.*

³⁷ *Valor Oil Co. v. Eisner*, 396 S.W.2d 235 (Tex. Civ. App. 1965) *error ref. n.r.e.*

the contract price. Absent fraud, collusion or bad faith, which had not been shown, the court held that article 301³⁸ required a construction that the contract price was the basis for calculating the tax.³⁹

The usual rule that the life tenant is entitled only to income from corpus when the lease was made after the life tenancy commenced resulted in the personal representative of the deceased life tenant having to turn over bonus and royalty payments the life tenant had received.⁴⁰

Unsubmerged state lands in bays, lakes and islands of the Gulf of Mexico classify as submerged lands, not vacant and unsurveyed school lands, for mineral leasing purposes.⁴¹

Where a dry hole contribution letter specifically required testing of a designated zone, which was adequately tested, but the obligation was sought to be avoided because an unmentioned zone was not adequately tested, reliance being placed on general language to furnish accurate information in the course of drilling, the court held that the drilling party had complied and was entitled to the contribution.⁴²

Lastly, no vested right in maintaining a sole well in tracts force pooled by municipal ordinance arose where the ordinance was invalid because, while it made provision for mineral owner interests, it made none for those of mineral lessees. Accordingly, when a subsequent ordinance was adopted permitting another operator a second well in the original force pooled area, the second well was a legal well.⁴³

³⁸ TEX. REV. CIV. STAT. ANN. art. 301 (1959).

³⁹ Calvert v. Union Prod. Co., 402 S.W.2d 221 (Tex. Civ. App. 1966) *error ref. n.r.e.*

⁴⁰ Hamilton v. Clyde, 405 S.W.2d 850 (Tex. Civ. App. 1966). For further discussion see Galvin, *Wills and Trusts*, this Survey at footnote 25.

⁴¹ Butler v. Sadler, 399 S.W.2d 411 (Tex. Civ. App. 1966) *error ref. n.r.e.*

⁴² Arkansas-Louisiana Gas Co. v. Sears, 400 S.W.2d 595 (Tex. Civ. App. 1966).

⁴³ Phillips Petroleum Co. v. Meacom, 395 S.W.2d 828 (Tex. Civ. App. 1965) *error ref. n.r.e.*