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Oil and Gas

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OIL AND GAS

INTERRUPTION OF PRESCRIPTION OF MINERAL SERVITUDE —
DRILLING ON ONE HALF OF LEASED TRACT

Louisiana. The case of *Smith v. Holt*¹ presents the problem of whether the drilling of a well on the west half of a tract will interrupt prescription of the mineral servitude as to the east half of the tract, both halves being covered by one mineral lease.

Defendant, owner of a forty-acre tract, sold the east half and west half, reserving to himself in each sale all the minerals in both tracts. Plaintiff acquired the east half. Defendant executed an oil, gas and mineral lease covering the full forty acres.

The Louisiana Department of Conservation, after notice and hearing, established a spacing pattern allowing only one well per forty-acre unit. The lessee obtained a permit and drilled a producer on the west half. No drilling was done on the east half of the tract.

Plaintiff contended that drilling and production on the west half did not interrupt prescription of the mineral servitude on the east half; therefore, the ten-year liberative prescription had extinguished the servitude on the east half. He also claimed that the order of the Conservation Commission was nothing more than a general spacing order for the whole area and was not intended to operate as a pooling order, which requires a separate order.

Defendant contended that the lessees from the mineral owner of the entire tract under a single lease embracing the two servitudes, were the sole "owner" as defined in Section 2(h) of Act 157 of 1940;² that a permit to drill having been obtained by them, it had the effect of an agreement to pool their interests and to develop the land as a pooling unit, thus requiring no separate order

¹La....., 67 So. 2d 93 (1953).

² 17 LA. REV. STAT. (West, 1951) § 30:3 (8).

of pooling, which is required only in cases of forced pooling. Therefore, the well on the west half, but in the forty-acre unit, interrupted prescription of the east half of the tract.

The Louisiana Supreme Court, holding for defendant, said that contractual relations and property rights of persons must yield to a proper exercise of the police power. Only in the case of forced pooling is an order "requiring such pooling" necessary. The same equitable distribution may be accomplished by convention; and obviously, where there is a sole owner of a unit, a pooling order could serve no useful purpose. Also, the plaintiff, having only a reversionary right to the mineral interest he claimed, would have been without interest to oppose a pooling order if one had been sought.

This case involved the problem of which right, plaintiff's or defendant's, must yield to the other. Plaintiff, owner of the reversion on the east half, had the right to the property if a well was not drilled on the east half within the ten-year prescriptive period. On the other hand, defendant, owner of the mineral servitude, had the right to drill only one well on the forty-acre tract in obedience to the order of the Conservation Department. And here the court held that as a matter of public policy the prescription statutes must yield to the regulatory order under the state conservation statutes.

A question raised by the case is whether the doctrine pronounced is applicable to contiguous lands outside the production unit. A recent discussion in the *Oil and Gas Reporter*³ says that the answer will depend upon whether the rationale of the decision is that the exercise of the servitude has the effect of interrupting the prescription or is that the reserved mineral rights were continued in effect because of the "obstacle" theory, *i.e.*, the conservation order prohibited drilling of more than one well.

³ Note, 2 OIL & GAS REP. 1401 (1953).

If the former explanation be true, then the mineral servitude would continue under the rule that exercise of a servitude upon a tract of land interrupts the prescription as to all contiguous lands covered by the same servitude.⁴ If the latter explanation be true, the servitude would be extinguished as to the contiguous lands since there is no "obstacle," *i.e.*, the order did not prohibit the drilling on a tract outside the forty-acre unit.

Another answer to the same question will depend upon whether in the future the Louisiana Supreme Court will apply the doctrine of *Hunter Co. v. Shell Oil Co.*⁵ and *Smith v. Carter Oil Co.*⁶ Those cases held that production on any lands within the compulsorily pooled unit, even though from a well not covered by the lease, maintains the servitude in effect even on lands covered by the lease but not within the pooled unit.

Therefore, under the theory that mineral servitudes are indivisible, the rule of the principal case may be applied to contiguous lands outside the production unit.

CONSTRUCTION OF OIL PAYMENT PROVISION — SEPARATE LEASES — PAYMENTS DUE OUT OF EITHER OR BOTH?

Oklahoma. The case of *Tilley v. Allied Materials Corporation*⁷ involves the construction of an oil payment provision. Under a drilling contract, the driller agreed to drill two wells on two separate leases, receiving in return cash and a \$30,000 oil payment to be paid out of $\frac{1}{4}$ of $\frac{7}{8}$ of the first oil produced from the leases. Both wells were producers, the first producing oil and the second producing gas.

Tilley, the driller, contended that as the first lease produced oil, this lease was obligated to pay the full \$30,000 oil payment out

⁴ *Lenard v. Shell Oil Co.*, 211 La. 265, 29 So. 2d 844 (1947).

⁵ 211 La. 893, 31 So. 2d 10 (1947).

⁶ 104 F. Supp. 463 (W. D. La. 1952).

⁷Okla....., 256 P. 2d 1110 (1953).

of the $\frac{1}{4}$ of $\frac{7}{8}$ of the first oil produced after he had completed his contract by drilling both wells.

Allied contended that under the reformed contract Tilley was only entitled to receive \$15,000 out of $\frac{1}{4}$ of $\frac{7}{8}$ working interest from the first well drilled. In a previous case Tilley had sued to reform the contract, and the court had ordered that the contract should be reformed to provide for the payment of \$15,000 to be paid out of $\frac{1}{4}$ of the production of gas as well as oil accruing to the two leases. The purpose of the suit was to include gas as a source from which payments should be made. Allied claimed that by this suit Tilley was entitled only to \$15,000 oil payment out of the first lease.

The Oklahoma Supreme Court held for Tilley. It said that the earlier suit was not *res judicata* since issues were not drawn as to whether Tilley was entitled to the \$30,000 oil payment out of the first well or out of both wells, or whether the first well was solely liable to an oil payment of \$15,000.

This case illustrates the important difference between an oil payment and a production payment. An oil payment is limited to production of oil while a production payment covers oil, gas and other subsurface minerals.

CONSTRUCTION OF WELL COMPLETION CLAUSES — WHAT IS A DRY HOLE?

Oklahoma, Texas. Two of the most controversial cases decided in 1953 were *Rogers v. Osborn*⁸ and *Skelly Oil Co. v. Wickham*,⁹ These cases dealt with the problem of whether a lease was extended after the primary term by drilling operations on a well commenced during the primary term and continued after the primary term until it was completed as a non-producer, plus the drilling of a second well, which was a producer, after the end of

⁸Tex. 261 S. W. 2d 311 (1953).

⁹ 202 F. 2d 442 (10th Cir. 1953).

the primary term but before the completion of the first well. In both cases the lessors sued to have the lease terminated, and the lessees claimed that the lease had been extended by drilling operations carried on at the end of the primary term. Hence, said the lessees, a second well commenced before completion of the first well within the extended period resulting in a producer maintained the lease in force under the "thereafter" clause.

In the *Rogers* case the clause in question was as follows:

If prior to discovery of oil or gas on said land Lessee should drill a *dry hole* or *holes* thereon, or if after discovery of oil or gas the production thereof should cease from any cause, this lease shall not terminate if lessee commences additional drilling or re-working operations within sixty (60) days thereafter or (if it be within the primary term) commences or resumes the payments or tender of rentals. . . . If at the expiration of the primary term oil, gas or other mineral is not being produced on said land but lessee is then engaged in drilling or re-working operations thereon, this lease shall remain in force so long as *operations* are prosecuted with no cessation of more than thirty (30) consecutive days, and if they result in the production of oil, gas or other mineral so long thereafter as oil, gas or other mineral is produced from said land. . . . (Emphasis added.)

The Texas Supreme Court held that the first well did not result in a dry hole, or at least the dry-hole clause had no application, since the lessees sought and obtained a jury finding that Well No. 1 was not dry. Nor was there cessation of production, since there never was any production. The court in giving the 30-day clause a strict construction said that the clause did not refer to drilling operations on new wells but applied instead only to particular drilling or re-working operations being carried on at the end of the primary term.

The 60-day clause presented the first problem. Was Well No. 1 in fact a dry hole? Were lessees estopped from asserting otherwise by their seeking and obtaining a jury finding that it was not a dry hole? What effect would the court's holding have on a lessee's desire to drill and develop a lease?

It is submitted that Well No. 1 was a dry hole, as that term was used in the lease, and that the lease should have been extended for 60 days under the *St. Louis Royalty Co.*¹⁰ holding. The intention of the parties surely was not to express or imply a strict limitation on the term "dry hole." The parties wanted a producer, and undoubtedly the lessors wanted the lessees to drill and develop the lease until they discovered a producer. If not, why was the provision inserted in the lease to encourage additional drilling after a well failed to produce? If a well, after completion with due diligence, cannot be made to produce, is it not a dry well in the parlance of the oil industry?

The supreme court held that "since lessees sought and obtained a finding that Well No. 1 was not dry, the dry hole clause has no application." So if the question is purely one of fact, the jury's finding would bind lessees. It is suggested that future lease forms should provide for cases where a well is not a dry hole but yet cannot produce in paying quantities.

A second problem is presented by the 30-day clause. The trial court and the court of appeals¹¹ construed the word "operations" in this sentence in its broader meaning. Under this interpretation the lease would remain in force so long as operations of any kind were being prosecuted on the land. The supreme court, giving a more limited interpretation, stated that the sentence applied only to the particular operations on Well No. 1 which were in progress at the end of the term.

It is submitted that the word "operations" is susceptible to either interpretation. The dissenting justices¹² preferred the broader interpretation, since the parties could have inserted the adjective "such" or word of like import had they intended the more limited meaning. At any rate, future lease forms should carry some adjective limiting the word "operations." In this case

¹⁰ *St. Louis Royalty Co. v. Continental Oil Co.*, 193 F. 2d 778 (5th Cir. 1952).

¹¹ *Rogers v. Osborn*, 250 S. W. 2d 296 (Tex. Civ. App. 1952).

¹² Justices Culver and Garwood.

the parties probably intended the meaning to be as construed by the supreme court. The 30-day clause is usually intended to cover situations where, at the end of the primary term, there is no production but lessee is engaged in drilling operations. The phrase, "thirty (30) consecutive days," relates only to the cessation of drilling or re-working operations in a particular well and not to the time interval between completion of such operations in one well and commencement of additional operations in another well. The time interval between wells is provided in the 60-day clause.¹³

The *Skelly Oil* case contained a special drilling clause as follows:

If the lessee shall commence to drill a well within the term of this lease or any extension thereof, the lessee shall have the right to drill such well to completion with reasonable diligence and dispatch, and if oil or gas, or either of them, be found in paying quantities, this lease shall continue and be in force with like effect as if such well had been completed within the term of years herein first mentioned. (Emphasis added.)

The lessee contended that the drilling of the first well at the end of the primary term was sufficient to cause an extension of the lease and that any well commenced within the term of the extension gave the lessee the right to complete the second well after the expiration of the extended term.

The district court¹⁴ held as follows:

... the lease terminates at the end of the definite term as set out in the habendum clause with the provision that upon a condition subsequent being met, i.e., the completion of a well commenced within the term for which delay rentals are paid and resulting in a producer, then the lease will be reinstated and will relate back to the original term of the lease, enabling the "thereafter" clause of the habendum to become operative.

¹³ Kerr, *Maintaining the Lease in Effect Other Than by Payment of Delay Rentals and Shut-in Royalties*, FIFTH ANNUAL INSTITUTE ON OIL AND GAS LAW AND TAXATION (Southwestern Legal Foundation, 1953) 337, 372-376.

¹⁴ Wickham v. Skelly Oil Co., 106 F. Supp. 61, 69 (E. D. Okla. 1952).

The court of appeals affirmed, saying, "To hold otherwise would give to a simple conditional well completion clause the meaning and effect of a continuous drilling or development clause. . . ."¹⁵

The lessee relied strongly upon the case of *Simons v. McDaniel*,¹⁶ which held that the grant to a lessee of the right to commence a well at any time within the term fixed by the lease contract, by necessary legal implication, carried with it the right to complete the well after the period fixed for commencement had expired. The *Simons* case differs from the *Skelly* case in that the deed had no express provision for the completion of a well after the primary term (well completion clause). However, the court used words implying that the lease continued in effect until completion of the well. The court said, ". . . where a well has been commenced under a drilling clause, the lease by its terms is continued in force pending completion in good faith of the well"¹⁷

The court of appeals held the *Simons* case to be inapplicable since it involved implied provisions of a lease whereas the *Skelly* case involved an express provision. The express provision was held controlling, and the correct interpretation of the provision was said to be that the lease terminated at the end of the primary term subject to the right in the lessee to complete a well already being drilled. If the well resulted in a producer in paying quantities, the lease would be reinstated.

Mr. Hawley C. Kerr,¹⁸ one of the attorneys for the lessees in the *Skelly* case, contends, "This statement . . . [in the well completion clause] that the lease 'shall continue' necessarily presupposes that the lease had remained in force 'pending completion' of the well—otherwise there would be nothing to continue. A separate and distinct continuation of the lease was thus provided for in addition to the extension 'pending completion'"

¹⁵ 202 F. 2d at 446.

¹⁶ 154 Okla. 168, 7 P. 2d 419 (1932).

¹⁷ 7 P. 2d at 421.

¹⁸ *Supra* note 13, at 375.

PRIMARY TERM OF ROYALTY DEED — CONSTRUCTION —
PRODUCTION WITHIN SIX-MONTH PERIOD

Texas. The case of *Clark v. Holchak*¹⁹ presents the question of the interpretation of a term royalty deed reading as follows:

. . . in case there is no paying production on said land on December 10, 1945, and for six months thereafter, . . . this grant shall become null and void, . . . but should there be such production, then and in that event, this grant shall remain in full force and effect until such production ceases, after which this instrument shall become null and void.

Plaintiff, grantee under the deed, was unable to get production before December 10, 1945, but he did obtain paying production before the expiration of the six-month period thereafter. He brought suit for a declaratory judgment establishing his right to the royalty interest under the deed. The trial court sustained a special exception to his petition for failure to allege "that there was paying production on said land on December 10, 1945, which continued for six months thereafter." The court of civil appeals²⁰ affirmed stating, "We think the contract is capable of no interpretation except that the property interest reverted in the absence of paying production on December 10, 1945."

The Supreme Court of Texas reversed and remanded. It held that beginning production within the six months' period after December 10, 1945, was sufficient under the habendum clause in question to keep the grant in force until production ceased. The court said that a wrong approach had been made to the problem. The subject matter of the provision under review was "no production" and not "production." Under the clause in question, two elements must concur in order to bring about a reverter, namely, "no paying production" on December 10 and "no paying production" for six months thereafter. "If there was paying production on any day of the six months' period, then the absence of

¹⁹Tex....., 254 S. W. 2d 101, 2 OIL & GAS REP. 273 (1953).

²⁰ *Clark v. Holchak*, 247 S. W. 2d 463, 464 (Tex. Civ. App. 1952).

production on December 10 did not continue to exist for six months," said the court.²¹

It is submitted that the construction of the provision by the court was correct. The effect of adding the six months provision was simply to define the primary term of the grant as the designated number of years, or other designated time period, plus six months. Although no reason for its use is known to the writer, this type of form has been in use for some time.²² Most term royalty forms have been subject to criticism because of their failure to keep abreast with the modern lease forms.

The court stated that, should there be paying production after the date of the deed which ceased prior to December 10, the grant would not terminate under the clause in question unless for the six months' period following that date there should be no paying production. From this statement the question arises as to whether production started but ceasing within the six months' period would terminate the lease at the date of cessation of operations even though that date be before the end of the six months' period. Under the holding in this case it would seem that once the primary term is defined, the interest will continue for at least that long, regardless of whether production starts and then ceases during the term. However, there are some dicta to the effect that the primary term loses significance when a well is drilled. The case of *Tennant v. Matthews*²³ states that when a lessee elects to commence operations in lieu of continued payment of delay rentals, he loses his right to keep the lease in force by the payment of rentals. "... [H]aving elected to begin operations, the lease could be kept in force thereafter in only one of two ways, viz.: (1) By discovering oil or gas in paying quantities; or (2) by continuing such operations."²⁴

²¹ 254 S. W. 2d at 103.

²² See *Bain v. Strance*, 256 S. W. 2d 208 (Tex. Civ. App. 1953) *er. ref. n.r.e.*, for a recent case involving the same type of deed. The court in its interpretation of the deed followed the principal case.

²³ *Tennant v. Matthews*, 19 S. W. 2d 1115 (Tex. Civ. App. 1929) *er. ref.*

²⁴ *Id.* at 1117.

It is doubtful whether this dictum is logically applicable to modern lease forms. Such forms usually contain a clause allowing additional drilling or reworking operations to be commenced within a specified time after cessation of production or allowing the resumption of payment of delay rentals if the cessation occurs within the primary term. The dictum is clearly not applicable to a term mineral or royalty grant.

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