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Oil and Gas

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OIL AND GAS

THE more important litigation for the past year has concerned the construction and interpretation of lease provisions. Several important decisions were made construing common provisions of oil and gas leases.

COMMENCEMENT OF OPERATION AND PRODUCTION

Leases generally provide that the lease will expire at the end of the primary term unless there has been either production or commencement of operation. The question of what acts of the lessee are sufficient to comply with the provisions in the lease is often a difficult one. In an Arkansas case[1] the question arose as to what acts constituted a compliance with the provision that the lessee "shall commence drilling operations" before the expiration of the primary term, a provision found in a standard oil and gas "Commencement Form Lease." Drilling had begun a few days before the lease expired with a rig that was inadequate to reach the oil-bearing strata. The court held these actions sufficient, using the tests of good faith and diligence. Good faith was held to include an intention to drill to the production depth and the expenditure of $5,000 seemed to indicate this intent, and the lessee had the right to wait until the last day before expiration of the lease to commence drilling operations. The test of diligence was met by the operators up to the time when they were notified by the lessors of their attempted cancellation and operations were excused after that time. When a production clause was in litigation in Texas it was held to include production by means of swabbing;[2] and in Oklahoma production was held to mean produced in paying quantities to the lessee though the well might never repay its costs and might prove unprofitable.[3] In the latter case it was further held that while production created only a limited estate for the duration of production in paying quantities yet if at any time thereafter there was a close question of whether production was in paying

[1] Haddock v. McClendon, ...Ark....., 266 S.W. 2d 74 (1954), 3 Oil and Gas Rep. 1219.

[2] Upshaw v. Norsworthy, 267 S.W. 2d 566 (Tex. Civ. App. 1954) *error ref., n.r.e.*, 3 Oil and Gas Rep. 1558.

[3] Henry v. Clay, ...Okla....., 274 P. 2d 545 (1954), 3 Oil and Gas Rep. 1713.

quantities, the lessee would not suffer forfeiture of his lease on that account alone.

FORCE MAJEURE

In a case arising in Louisiana[4] the lease contained a provision which defined force majeure as including ". . . lack of labor or means of transportation of labor or material; Acts of God; insurrection; flood; strike." The question presented was whether the Louisiana seasonal rains were a force majeure within the meaning of the provision and it was held that they were not. The lease contained another provision excusing operations by the lessee for six months after the cessation of the force majeure and had the lease been construed as contended for by the lessee this period and the rainy seasons would overlap so that the lessee would have been able to hold the lease perpetually without any activity on his part.

FRACTION PROBLEMS

A frequently litigated question is whether an instrument entitles the conveyee to a fractional interest of gross production free of costs or whether he is entitled only to that fraction of the royalties, i.e., whether he has a royalty interest or a mineral interest. The question is often resolved in favor of the one interest or the other depending upon which express incidents of the one or the other are also stated to have passed with the fractional interest. The owner of an interest in the mineral estate may execute leases and share in bonuses, delay rentals, and other payments and rights besides his share of the royalty payments while the owner of a royalty interest is entitled only to his share of gross production, free of costs. Therefore when there was a reservation of a "Three Thirty seconds (3/32) interest in all crude oil that may hereafter be produced and saved . . ." it was held to be a reservation of a royalty interest because there were no other rights reserved besides an interest in oil produced and saved.[5] But when there was a conveyance of the right to share in all future "bonuses, rents and

[4] Logan v. Blaxton, ____La.____, 71 So. 2d 675 (1954), 3 Oil and Gas Rep. 791.
[5] Casteel v. Crigler, ____Okla.____, 266 P. 2d 643 (1954), 3 Oil and Gas Rep. 440.

royalties, and other benefits which may accrue" then a mineral interest was held to have been conveyed.[6]

Divisibility of Leases

The Louisiana cases, notably *Hunter v. Shell Oil Co.*,[7] have indicated that a lease contract is indivisible, but a recent case[8] reached a contrary result in a suit brought to cancel a particular portion of the original lease for failure to develop. The court distinguished prior cases and decided this case on the particular lease provisions involved, a provision that the lessee might release any portion of the premises held by him and have his rentals reduced proportionately and a provision that upon termination of the lease for any cause the lessee might retain a certain area around each well.

Entirety Provision

The Texas Supreme Court in *Thomas Gilrease Foundation v. Stanolind Oil and Gas Co.*[9] considered a case of first impression involving the construction of an entirety provision. Stanolind had taken a lease with an entirety provision included. The provision was that "[i]f the leased premises are now or shall hereafter be owned in separate tracts" then the premises should be developed and operated as one lease with each lessor receiving royalties in the proportion that the acreage which he owned bore to the entire leased acreage. This type provision is inserted for the benefit of the lessee so that there might be no controversy raised over whether the lessee should have to drill further wells on land under lease for the benefit of lessors who have no interest in the particular tract where the well is located. The Foundation in this case owned an interest in the tract from which production was being had in volume, but owned a greater interest in a tract from which production was being had in considerably less volume. Stanolind contended that the phrase "owned in severalty or in separate tracts"

[6] Surety Royalty Company v. Sullivan, ____Okla.____, 275 P. 2d 259 (1954), 3 Oil and Gas. Rep. 2073.

[7] 211 La. 893, 31 So. 2d 10 (1947).

[8] Eota Realty Company v. Carter Oil Co., ____La.____, 74 So. 2d 30 (1954), 3 Oil and Gas Rep. 1876.

[9] ____Tex.____, 266 S.W. 2d 850 (1954), 3 Oil and Gas Rep. 673.

referred only to the situation where the lessor owned an interest in one portion of the lease but not in another (the usual situation the provision is designed to cover is where there are conveyances by the lessor subsequent to the execution of the lease so that the leased premises are owned in separate tracts by different owners) and not the situation where the lessor owned interests, though of different quantum, in all portions of the lease. But the court decided that the provision was applicable to the situation presented and the Foundation was held entitled to receive royalties in proportion to their total interest in the land under lease.

SUBLEASE UNDER "WASHOUT" PROVISION

A lessee who assigns with an overriding royalty provision may wish to protect himself from an intentional termination of the lease on the part of the assignee who would like a new lease without the overriding interest. The lessee may protect himself by the means of a "washout" provision which provides that the overriding interest is to be a part of all future leases taken by the assignee on the lands covered by the original lease, which the assignee may take within a certain period of time from the expiration of the original lease. In *Berman v. Brown*[10] the conveyee of the lessee, under a conveyance containing a "washout" provision applicable to the conveyee's successors and assigns, made a further conveyance of the lease and retained a further overriding interest. The working interest was then burdened with 5/16 outstanding royalty interests. For this reason there was a failure to develop or pay delay rentals and the lessor was successful in a suit for cancellation of the lease. Less than two months after the judgment of cancellation the operator took out another lease and the insertors of the "washout" provision sued for their overriding royalty. The court held on rehearing that the retention of the second overriding royalty caused that conveyance to be a sublease and not an assignment, by reason of the reservation of the royalty, and that therefore there was no privity of contract between the operator and the insertors of the "washout" provision and consequently no liability to them.

[10] ____La.____, 70 So. 2d 433 (1954), 3 Oil and Gas Rep. 608.

ABSOLUTE LIABILITY

A case of possible far reaching importance was decided in Oklahoma, involving the question of absolute liability for the injection of salt water.[11] Plaintiff alleged as one of his causes of action that by reason of the injection of salt water by defendant, plaintiff was unable to recover a large footage of casing. Defendant appealed from a verdict and judgment thereon in favor of plaintiff. Defendant did not assign as error any question of negligence and the court upheld the decision below on the ground that there was sufficient evidence to support a finding of trespass, the injection being found to be the cause of plaintiff's inability to recover his casing; to meet the defendant's assignment of error that there was no sufficient showing of trespass to support an action for damages.

In an earlier Oklahoma case, not mentioned by the court, the theory of absolute liability for damage caused by water entering the oil stratum with consequent flooding of plaintiff's well was expressly rejected.[12] But in that case there was no injection, rather only a flooding from upper strata due to a collapsed casing in defendant's well. However, the flooding was aggravated by inaction on the part of the defendants due to their efforts to recover their casing. The court did not impose liability, saying, "[d]efendants only owed plaintiffs the duty to use every means a prudent operator would adopt to stop the flow of water . . ."

When salt water was injected into a salt water stratum on plaintiff's land, as a means of disposal, the Oklahoma court refused to impose liability.[13] But that opinion indicates that if damage had been caused, liability would have followed. The court stated that ". . . defendants admit and agree that in the event their injection of salt water into the well should in any way injure or damage plaintiffs they would be liable . . ."

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[11] West Edmond Hunton Lime Unit v. Lillard, ...Okla....., ...P. 2d..... (1954), 3 Oil and Gas Rep. 1426.

[12] Larkins-Warr Trust v. Watchorn Petroleum Co., 198 Okla. 12, 174 P. 2d 589 (1946).

[13] West Edmond Salt Water Disposal Assn. v. Rosecrans, 204 Okla. 9, 226 P. 2d 965 (1950).

PRUDENT OPERATOR RULE

The prudent operator rule in Oklahoma has been considerably confused since the decision in *Doss Oil Royalty v. Texas Co.*[14] The decision in that case was to the effect that the lapse of an unreasonable length of time without any further development after the expiration of the primary term would justify cancellation of the lease whether a reasonably prudent operator would drill or not.

Several cases arose in the past year which applied the prudent operator rule. The first was *Blake v. Texas Co.*[15] in which Judge Wallace makes an extensive survey of the development of the rule and sums up the present Oklahoma law. As presented in the *Blake* case there are three aspects of the rule as now constituted: (1) when the delay is irrebuttably unreasonable then the court may cancel the lease without a consideration of the profitability of further development, (2) when the delay is sufficient to be prima facie unreasonable then the lessee must rebut the prima facie showing with evidence of conduct as a prudent operator, and (3) when the time delay is not prima facie unreasonable then the lessor must establish that the lessee has failed to measure up to the standard of a prudent operator. In the *Blake* case a delay of seven years in drilling a second well was held to fall into category (2), but the operator met the burden placed upon him by showing little likelihood of profit and diligent efforts to obtain further information.

When only one well had been drilled in twenty years and further drilling was refused on the basis of a dry hole drilled by the operator and one drilled twenty years earlier by other parties the court decreed cancellation.[16] The court apparently thought that the facts of the case placed it in category (1), since the production from the one well was small and the dry holes would indicate an unlikelihood of further production, thus justifying a refusal to drill if the standard of the prudent operator alone were con-

[14] 192 Okla. 359, 137 P. 2d 934 (1943).
[15] 123 F. Supp. 73 (E.D. Okla. 1954), 3 Oil and Gas Rep. 2051.
[16] Sand Springs Home v. Clemens, ...Okla....., 276 P. 262 (1954), 4 Oil and Gas Rep. 60.

sidered. The other cases[17] were placed in category (2) although in the *Magnolia* case there was a delay of twenty-six years with only the drilling of a required offset well. In that case cancellation was decreed on the basis of evidence to the effect that further production could be obtained and Magnolia had expressly refused to further develop when the trial court offered to decree a conditional cancellation. In the *Castleberry* case a seven year delay was considered unreasonable by the court for the purposes of argument only, but cancellation was refused because the only evidence in the record was that of the operator to the effect that additional wells would not be profitable and the court considered that defendant had discharged the burden of the evidence placed upon him by the delay.

Necessary Parties

Since the decision in *Veal v. Thomason*[18] the Texas courts have ruled that whenever title is litigated to a tract of land in a pooled unit, all parties to the unit are necessary parties to the suit. In *Fussell v. Rinque*[19] an alternative is presented to making all of the parties to the pooling agreement parties to the suit. In that case the court overruled such an objection as to parties when both sides to the controversy recognized the validity of the unit.

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[17] Magnolia Petroleum Company v. Wilson, 215 F. 2d 317 (10th Cir. 1954), 3 Oil and Gas Rep. 2065; Trawick and Boddie v. Castleberry, ...Okla....., 275 P. 2d 292 (1954), 4 Oil and Gas Rep. 63.

[18] Veal v. Thomason, 138 Tex. 341, 159 S.W. 2d 472 (1942).

[19] 269 S.W. 2d 442 (Tex. Civ. App. 1954) *error ref., n.r.e.*, 3 Oil and Gas Rep. 1758.