Extending the Oil & Gas Lease into the Secondary Term on Outside Acreage by Production Within the Unit

Phillip E. Norvell

Follow this and additional works at: http://scholarworks.uark.edu/anrlaw

Part of the Natural Resources Law Commons, and the Oil, Gas, and Mineral Law Commons

Recommended Citation
Norvell, Phillip E., "Extending the Oil & Gas Lease into the Secondary Term on Outside Acreage by Production Within the Unit" (1981). Annual of the Arkansas Natural Resources Law Institute. 12.
http://scholarworks.uark.edu/anrlaw/12
"EXTENDING THE OIL & GAS LEASE INTO THE SECONDARY TERM ON OUTSIDE ACREAGE BY PRODUCTION WITHIN THE UNIT"

PHILLIP E. NORVEL, Professor of Law University of Arkansas School of Law (Property, Oil & Gas Law), Trial attorney, Federal Trade Commission, 1973-75. Speaker, 17th Annual Arkansas Natural Resources Law Institute on "The Coal and Lignite Lease Compared to the Oil and Gas Lease", and 19th Institute on "Possible Solutions to the Problems Presented by Missing Owners of Fee Simple Title or Non-Consenting Owners With a Coal or Lignite Prospect".
Unit Well Located on Unit Acreage
Other than the Leased Premises

Voluntary Pooling

The effect on outside acreage of production during the secondary term from a voluntarily pooled unit, when the unit well is not located on the leased premises is resolved by ascertaining the intent of the parties to the lease. Scott v. Pure Oil Co., a Fifth Circuit case arising out of Texas, and the most frequently cited case dealing with this fact situation, illustrates this principle. There the lessor granted an oil and gas lease on 317.93 acres, dated May 8, 1936, for a term of "10 years and so long thereafter as oil and gas was produced from the land." The lease did not contain a pooling or unitization clause. Thereafter, on May 23, 1945, an amendment was executed by plaintiffs, assignees of the lessor, which granted the lessee the right to pool or unitize, with certain specified restrictions, the leased acreage, or any part thereof, with other lands for gas production. The amendment provided, _inter alia_, the following:

The entire acreage so pooled into a tract or unit shall be treated for all purposes except for the payment of royalties as if it were included in this lease, and production of gas shall be considered for all purposes (except the payment of royalties) as if such operation were on and such production were from the land covered by this lease, whether or not the wells be located on the premises covered by the lease.

Lessees then pooled a portion of the tract with additional lands to create a 675.24 acre drilling unit. A producing gas well was drilled during the last year of the primary term on the unit but not on the 140 acre tract. After the end of the primary term, the lessee pooled
the remaining 177.93 acres into a drilling unit and completed a pro-
ducing well on that unit.

Plaintiffs then brought suit alleging that the lease had expired as to the outside acreage. They argued that production from a well located in the unit area but not on the 140 acres granted by the orig-
ginal lease was not such production as would perpetuate the lease into the secondary term as to the outside acreage.

In affirming the trial court's judgment, the court construed the language in the amendment as expressly providing that production anywhere in the unit was to be equivalent to production on the leased premises. The court observed.

The original lease provided that its terms would continue so long as oil or gas is produced from "said land". It is elementary that if gas or oil had been produced on any portion of the land covered by this lease during the primary term thereof, for as long as such gas or oil was being produced in profitable quantities the lease on the entire acreage would have been perpetuated. The amendment did not limit this provision, but enlarged upon it by providing that if gas were produced upon any acreage with which any portion of the land covered by the lease should be unitized, production would be considered for all purposes, except the payment of royalties, 'as if such operations were on and such productions were from the land covered by this lease, whether or not the well or wells be located on the premises by this lease: --

.......... it is clear that production on the unitized tract fulfilled the requirement for production in the original lease and that its terms were perpetuated upon the entire acreage herein described.10

The Court cited an earlier Arkansas case, Gray v. Cameron,11 which reached the same result.12 There the parties executed in 1944 an oil and gas lease covering 35 acres in the Haynesville field in Columbia County. Eighty acre spacing had been established for the field by the Oil and Gas commission. The lease contained a clause which allowed the lessee to pool or unitize adjoining tracts
to constitute a drilling unit. Another clause also provided:

Drilling or production shall be taken and accepted as drilling, producing, and lease operations under the terms of each and all of the oil and gas leases referred to above, and such operations . . . on any part of the unitized area shall have the same effect as if such operations . . . had been done on, or such production obtained from, each and all of the tracts in said communitized area, to the end that such operations* * * shall continue all of said oil and gas leases above mentioned in full force * * * as to all of the lands covered by this communitization agreement, and as to all of the lands covered by any and all of said leases so long as there may be production on the unitized area.13

Pursuant thereto, the parties entered into a unitization agreement in which only 8.81 acres of lessor's tract was included in the unit. Production was secured on the tract. The facts do not indicate, however, whether the well was located off the lessor's tract. In 1950, lessor brought suit to cancel the lease as to the acreage located outside the unit and for damages for breach of the implied covenant to reasonably develop that acreage. The trial court held that the unitization agreement supplemented the 1944 lease and according to the terms thereof, the lessee expressly retained control of the disputed acreage.

On appeal, the Supreme Court of Arkansas, affirmed, with Justice George Rose Smith dissenting. The Court construed the effect of the unitization agreement as being two-fold: drilling and producing on the unitized area would continue the leases on the acreage within the unit; and, such production would also continue the leases "as to all other lands". Although the court did not expressly so state, some ambiguity as to the outside acreage may have existed in the unitization agreement.14 However, as the purpose of the agreement was to guarantee a well for the benefit of all the affected parties, the court
noted that, in the absence of fraud, undue influence, or overreaching, it would not ignore the language "all of the other lands covered by any and all of said leases."15

Compulsory Pooling

The courts are split as to whether the entire lease will be perpetuated into the secondary term by production from the unit, where the well is located off the leased premises. The majority rule is that such production will suffice to extend the lease into the secondary term as to the outside acreage.16 This result is based either from a broad construction of the express language of the compulsory pooling order or statute,17 which typically provides that production from the unit well shall be treated as production from every leasehold that is encompassed within the unit, or from a general inference that the compulsory pooling scheme was not intended to affect the inherent indivisibility of the habendum or other clauses of the lease.

Hunter Oil Co. v. Shell,18 a Louisiana case, is a most obvious example. There, the lessee granted an oil and gas lease with a primary term of 10 years with the customary "thereafter" habendum clause. Toward the end of the primary term, a portion of the leased premises was forced pooled, and a producing gas well was drilled on the unit but off the leased premises. The pooling order provided, inter alia, as follows:

production . . ., shall be treated, developed, and operated as one lease, one unit, one property, one tract; and drilling operations, drilling and production on any of the tracts included within said unit shall constitute drilling operations, drilling and production under the terms of each and every one of said leases. . . affecting the property included within said unit.19

-5-
The lessor brought suit to cancel the lease as to the excluded acreage on the ground that the primary term had expired as to such lands. The trial court entered judgment for the plaintiff. In reversing the judgement, the Supreme Court reasoned:

The pooling order specifically provides that drilling operations, drilling production on any tracts within the unit shall constitute drilling operations, drilling and production under the terms of each and every one of said leases. . . affecting the property included within the unit, and applies to leases in their entirety, and the drilling of a producing well in the unit . . . within the primary term of the lease complies with the obligation to drill assumed by the lessee under the terms and provisions of the lease, and production in paying quantities from such a well constitutes production from all the property described in the lease and maintains the lease in full force and effect.20

Also, the court noted that contrary to the lessor's argument, the pooling order had not segregated the obligation of the lessee as to the unit acreage or the excluded acreage. In effect, the indivisibility of the habendum clause and the lessee's obligations thereunder were not affected by the conservation statutes.21

The minority view22 is represented by the Mississippi case of Texaco Gulf Producing Co. v. Griffith.23 The lessor in 1939 executed a lease with a primary term of 10 years and containing the usual habendum clause. The Gwinville gas field came into production as a proven gas field in 1944. Thereafter, the Oil and Gas board adopted 320 acre spacing regulations. Such a unit was established for an area which included lessor's 40 acre tract but not a non-contiguous eight-acre tract which had also been included within the lease. Voluntary pooling was affected as to the leasehold unit but the lessor refused to pool her royalty interests. A producing gas well was drilled on the unit but not on the lessor's lands. After the expiration of the
primary term, forced pooling occurred. Lessor then executed an oil
and gas lease to the plaintiff who later sought cancellation of the
lease on the theory that it had terminated. The trial court rendered
judgment for the plaintiff. As to that portion of the lease included
within the unit, the court, applied the doctrine of equitable pooling,
and held that the lease was perpetuated into the secondary term. As
to the excluded acreage, however, the court held that inclusion of
only a portion of leased land into a unit did not extend the lease as
to the outside acreage beyond the primary terms. The court reasoned
that, despite the obligation of a prudent operator to reasonably deve-
lop, permitting the lessee to hold the lease as to the eight acres
without the payment of royalties or rentals resulting from the com-
pulsory pooling would result in an unconstitutional deprivation of
property without due process and such a result was not contemplated by
the conservation or compulsory pooling statute.24

Unit Well Located on that portion of the
Lease Premises Included within the Unit:
Voluntary and Compulsory Pooling or Unitiza-
tion.

Regardless of whether the unit is formed by compulsory pooling25
or unitization, it is generally held or assumed that production on
that portion of the leased premises included within the unit keeps the
lease alive as to all of the leased premises, including the acreage
located outside of the unit, absent any provision in the lease to the
contrary.26 As to voluntary pooling, this conclusion rests on a
construction of the lease, typically focusing on both the "so long
thereafter as oil and gas is produced on said land" language of the

-7-
habendum clause, and the wording of the pooling clause which typically provides "production on any tract within the unit perpetuates each separate lease after expiration of the primary term as if such production were on each separate tract". Such language is construed to preclude the "divisibility" of the habendum clause, i.e., application to the leased premises within the unit but not to the acreage situated outside the unit. As to compulsory pooling, the conclusion also rests on a construction of the lease, and additionally, on the presumption that compulsory pooling, resulting in only a portion of the leased premises being included in the unit, was not intended to affect a division of the leasehold estate.

THE PUGH CLAUSE

Lessors, who receive royalty only on that part of the leased premises located within the unit, will be dissatisfied with the effect of unit production on the excluded acreage under the habendum clause. Their argument is that unit production will hold the excluded acreage under the lease indefinitely, during which time it will yield no royalties, and the lessor will be precluded from leasing to another operator for subsequent development. Responding to this argument, the courts have reasoned that the implied covenant of protection against drainage, reasonable development and further exploration require the lessee to develop the excluded acreage as an ordinary prudent operator.

However, the implied covenants rationale has its drawbacks as a method to prevent the lessee from holding the outside acreage for mere speculation. To establish a breach of an implied covenant for failure to drill on the excluded acreage, the lessee will have to sue, bear the
burden of proof and, typically, show that such a well, if drilled, would produce in paying quantities, i.e. quantities sufficient to recover the drilling, completing and operating costs, including a reasonable rate of return on the investment. Enforcing the prudent operator standard by litigation is not only cumbersome, but expensive and uncertain of success.

Thus, the Pugh Clause evolved as a method to sever the excluded acreage from the unit acreage for purposes of the habendum clause. Only the acreage within the unit that yields royalties to the lessor is to be perpetuated beyond the primary term of the lease. Eradication of the traditional indivisibility of the habendum clause, and alteration of the effect of the pooling clause or other provision which typically makes unit production equivalent to production coextensive with the leased premises, is the intent and effect of the Pugh Clause.

A simplified form of a Pugh clause appears as follows:

If operations can be conducted on or production be secured from the lands in such pooled unit other than that land covered by this lease, it shall have the same effect as to maintaining lessee's rights in force hereunder as if such operation were on or such production from the land covered hereby, except that its effect shall be limited to the land covered hereby which is included in such pooled unit.

Obviously, variations in the language of the Pugh Clause are legion and difficult problems of construction may arise. Worthy of note for the prudent draftsman is the holding that a Pugh Clause which did not contain language descriptive of non-productive subsurface horizons was inapplicable to effect a "vertical" severance of such non-productive areas of the leasehold estate. Likewise, Louisiana cases hold that a clause drafted in reference to voluntary pooling was inapplicable
to outside acreage held by production from a unit established by forced pooling.36

THE STATUTORY PUGH CLAUSE

In 1977, the Oklahoma legislature amended the compulsory pooling statute to provide:

In case of a spacing unit of one hundred sixty (160) acres or more, no oil and/or gas leasehold interest outside the spacing unit involved may be held by production from the spacing unit more than ninety (90) days beyond expiration of the primary term of the lease.37

By its terms, the statute operates as a limited Pugh clause in that it precludes production from satisfying the habendum clause as to the outside acreage for more than 90 days.38

In the initial challenge to the legislation, Wickham v. Gulf Oil Corp.,39 the Oklahoma Supreme Court held that the amendment operated prospectively and was inapplicable to leases in issue which were in existence at the date of the enactment. Thus, the constitutional objections of deprivation of property without due process and impairment of the obligation of contract were deferred.40 Further constitutional objections may be forthcoming.41 For example, since the act exempts from its operation units containing less than 160 acres, an equal protection objection may be made as to the prospective applicability of the act.42

If the present statute is held unconstitutional, it will likely reappear in a form free of such objections. In the meantime, mineral practitioners in Oklahoma who represent lessees face the task of drafting a clause which is valid under the rule against perpetuities43 and which will allow the lessee to reacquire the lease-
hold estate as in the excluded acreage upon its being "released" by the statutory "Pugh Clause". The Mineral Bar in other jurisdictions, in the meantime, must wait to see if the statutory Pugh Clause, will become an integral part of the oil and gas regulatory scheme.
FOOTNOTES


2. Although the discussion centers on the perpetuation of the lease into the secondary term of the habendum clause, and its maintenance thereunder, the analysis is also applicable to drilling operations on the unit. See, Williams and Meyers, Oil and Gas Law, § 669.14 (1980). References to such operations have been omitted merely to facilitate the discussion.

3. See, generally, Franks, The Rights of Consenting and Nonconsenting Owners under Secondary Recovery and Pressure Maintenance Operations 16th Ann. Inst. on Oil and Gas Law and Taxation 343 (1962); Rebman, Continuation of the Oil and Gas Lease on Outside Acreage by Production within the Unit, 35 Tex.L.Rev. 833 (1957).

4. Williams and Meyers, supra Note 2, also discusses the following related fact situations: inclusion of all of the leased premises into the unit with the well located on the lease premises; the same facts as before with the unit well located on the other unit acreage; and, inclusion of a portion of the leased premises into the unit with the producing well located on that portion of the leased premises excluded from the unit.


7. 194 F.2d 393 (5th Cir. 1952).

8. Id. at 395.

9. Id. at 395.

10. Id. at 395.

11. 218 Ark. 142, 234 S.W.2d 769 (1950).
12. Brixey v. Union Oil Co., 283 F.Supp. 353 (W.D.Ark. 1968), is the only other relevant Arkansas case in point. There, the court held, inter alia, based on the explicit language of the pooling clause, that the drilling of a producing well on the unit, though not located on the lessor's land, secures the lease into the secondary term as to the outside acreage. In that case the habendum clause of the oil and gas lease provided:

"10 years and as long thereafter as oil, gas, . . . or either of them is produced from said land, or from lands with which said lands is pooled* * *Id. at 354.

The pooling clause also provided:

"The entire acreage so pooled into attract or unit shall be treated, for all purposes except the payment of royalties on production from the pooled unit, as if it were included in this lease. If production is found on the pooled acreage it shall be treated or if production is had from this lease, whether the well or wells be located on the premises covered by this lease or not." Id at 355.

13. 218 Ark. at 143, 234 S.W.2d at 770.

14. Id.

15. Id.


17. See, 53 Ark. Stat. Ann. 115 (A-3) which provides as follows: All operations, including but not limited to the commencement, drilling or operations of a well upon any portion of a drilling unit for which an integration order has been entered, shall be deemed for all purposes the conduct of such operations upon each separately owned tract and interest in the drilling unit by the several owners thereof. The portion of the production allocated to the owner of each tract or interest included in a drilling unit formed by an integration order shall, when produced, be considered for all purposes as if it had been produced from such tract or interest by a well produced thereon.
18. 211 La. 893, 31 So.2d 10 (1947).

19. 211 La. at 894, 31 So.2d at 12.

20. Id., 211 La. at 895, 31 So.2d at 13.

21. Mr. Justice Hammiter dissented on the following grounds: A literal reading of the pooling order restricted the effect of compulsory pooling to property included within the unit; unconstitutional deprivation of property without due process and adequate compensation; and, the doctrine of indivisibility as to the lease obligations is only applicable as between the contracting parties, their heirs and assigns, and is inapplicable to circumstances caused by the intervention of the state. Id, 211 La. at 898, 31 So.2d at 15.

22. Diversity cases in federal courts in Oklahoma, predicting state law, have followed the majority view, but not without some reluctance. The principal case is Whittaker v. Texaco, Inc., 283 F.2d 169 (10th Cir. 1958). There, the lessee granted an oil and gas lease to a tract of land covering 303 acres. Prior to the end of the primary term, the corporation commission established 40 acre drilling and spacing units for an area which encompassed the leased lands. One such unit included only a portion of the leased premises. Thereafter, a well was completed on that unit but off the leased premises and a spacing order was entered which had the effect of forced pooling the mineral owners interest. At the conclusion of the primary term, the lessor sued to cancel the lease as to the excluded acreage. The trial court held that the lease as to the excluded acreage had been extended by a well drilled off the leased land but within a spacing unit established by the corporation commission. In affirming the trial court's decision, the court relied primarily on Panhandle Eastern Pipeline Co. v. Isaacson, 255 F.2d 699 (10th Cir. 1958) which had held that a defeasible term mineral interest is preserved as to the excluded acreage by the completion of a shut-in gas well on the unit, but, not on the leased premises included therein. Obviously, as pointed out by Williams and Meyers, supra note 2 at 669.14, "there may be ground for holding that a defeasible term mineral or royalty interest is extended by unit production in this situation as to excluded acreage, even though a lease might not be extended as to the excluded acreage under the same circumstances." Supra note 2 at 669.14.

Circuit Judge Murray, in his concurring opinion in Whittaker, indicated that he felt bound by Isaacson and Kunc., but opined:

"If I were free, however, to forecast Oklahoma law, I should not hesitate to hold that the drilling of the well in question operated to extend the lease beyond the
primary term, only as to that portion which was included in the established spacing unit in which the well was drilled." 293 F.2d at 177.

Two subsequent cases have followed Whittaker, Crews Oil Co. v. Superior Oil Co., 319 F.2d 532 (10th Cir. 1963) and Tyler v. Superior Oil Co., 223 F.2d 479 (10th Cir. 1963).


24. Wells v. Continental Oil Co., 142 So.2d 215 (Miss. 1962), a subsequent Mississippi Supreme Court case, casts doubt on the precedential value of Griffith. Wells also involved the issue of whether the lease was perpetuated into the secondary term as to outside acreage by production on the unit. Wells did, however, involve voluntary pooling and the location of the unit well on that portion of the lease premises included within the unit. In Wells, the Court held, emphasizing the language of the habendum clause and the pooling clause, held that the unit production perpetuated the lease into the secondary term. In so doing, the court distinguished Griffith, inter alia, as follows: in that case the well was not located in that portion of the leased premises included in the unit; compulsory pooling was involved; and the drilling unit and integration in Griffith was established under implied legislative authority, as opposed to the statutory scheme in existence at the time of Wells.

Thereafter, in promulgating the compulsory fieldwide unitization statute, the Mississippi legislature included the following provision, §53-3-1111 (1964), forerunner of the Oklahoma statutory Pugh clause:

However, when an oil, gas and mineral lease contains land partially within and partially without said unit area, the unit agreement and production from the unit shall have no force and effect on lands lying outside said unit area within one (1) year or during the term of the lease, whichever is a longer period of time, from the date of determination of the unit area by the state oil and gas board shall render such lease or leases on lands lying outside said unit area void and of no force and effect, unless otherwise held by production other than from unit production.

For a discussion of the statute and its constitutionality, see, Custy and Knowlton, Compulsory Fieldwide Unitization Comes to Mississippi, 36 Miss. L. Rev. 123 at 138-140 (1965); Brunini, Important Elements in the Development of Oil and Gas Conservation in Mississippi, 6 Interstate Oil Compact Commission Committee Bull., No. 2, p. 1 at 6 (1964); and, Williams & Meyers, supra note 2 at §953.


28. See, Kunc v. Harper-Turner Oil Co., 297 p.2d at 374 in which the court stated: "We think that pooling by the Corporation Commission does not have the effect of creating two leasehold estates and that unitization of a portion of a lease with other lands does not affect the terms of the lease."


31. In Gregg v. Harper-Turner Oil Co., 199 F.2d 1 (10th Cir. 1952), involving, inter alia, partial cancellation of the lease for non-development of acreage excluded from the unit, the suggestion was made that the lessee would be held to a higher standard of development as to such acreage. The court stated:

Lessees caused the unitization agreement excluding this 120 acre tract therefrom to be affected. This resulted in a division of the acreage of the Gregg tract, covered by the original lease. As the owner 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 lessor and lessee under these circumstances. Their responsibilities as lessees become correspondingly greater toward the excluded acreage than it was before severing by unitization. 192 F.2d 6.

Also, the theory of abandonment may also be a viable remedy for the lessor. See, Buchanan v. Sinclair Oil and Gas Co., 218 F.2d 436 (5th Cir. 1955).

32. For breach of implied covenant to protect against drainage, reasonable development, see, respectively, Williams & Meyers, supra note 2 at 8821 et seq.

34. Bennett v. Sinclair Oil & Gas Company, 405 F.2d 1005, fn.6 at 1010 (5th Cir. 1968).

35. Rist v. Westhoma Oil Co., 385 P.2d 791 (1963), contra, Rogers v. Westhoma Oil Co., 291 F.2d 726 (10th Cir. 1961). See, also, Williams & Meyers, supra note at §669.14, citing, Brumby, "Lease Negotiations from the Viewpoint of the lessor", L.S.U. Seventh Annual Institute on Mineral Law, 45 at 63 (1960), the following clause applicable to nonproductive subsurface formations:

Notwithstanding anything to the contrary herein contained drilling operations on a pololed unit or units established as provided herein or by governmental authority shall maintain this lease in force only as to that portion of the leased premises included within such unit or units, and production from a pooled unit or units shall maintain this lease in force only as to the reservoir or reservoirs from which production is obtained by the unit well or wells.


38. For a more detailed discussion of the statute, see, KUNTZ, Statutory Well Spacing and Drilling Units, 31 Okla.L.Rev. 344, 348 (1978).


40. KUNTZ, supra note 38 at 355.

41. The amendment may also violate the prohibition in the Oklahoma Constitution, Art. 5, Sec. 54, which restricts each legislative act to one subject that must be sufficiently identified in the statute. See, KUNTZ, supra note 38 at 353.

42. U.S. Const. amend. XIV, §1.