2-1998

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DRAINAGE, DRILLING UNITS & CONSERVATION AGENCY ORDERS

REFLECTION ON SUNBELT EXPLORATION CO. V. STEPHENS PRODUCTION CO.

Phillip E. Norvell
I. Sunbelt Exploration Co. v. Stephens Production Co., 896 S.W.2d 867 (Ark. 1995)

In the 1950's, Stephens Production Co. and Chevron USA, Inc. (hereinafter collectively referred to as Stephens) acquired oil and gas leases to land in the Arkoma Basin. The leases were subsequently pooled by the Arkansas Oil and Gas Commission to create the Gregory Unit. The Gregory Unit adjoins the Blakely Unit, the Gooch No. 1 Unit, and the Gooch No. 2 Unit. Various natural gas reservoirs, including the Dunn reservoir, lie under these units. The established field rules of the Arkansas Oil and Gas Commission permit each 640 acre unit only one well for the Dunn reservoir. In addition to owning leases in the Gregory Unit, Stephens also owns all the leasehold working interest in the Blakely and Gooch Units. In 1959, Stephens established production on the Gregory Unit by completing the Gregory No. 1 well. That well did not produce from the Dunn reservoir.

In 1961, Stephens completed a well on the Blakely Unit that was the first well in the immediate area to produce from the Dunn reservoir. In 1971, Stephens recompleted the Gregory No. 1 well to produce the Dunn reservoir from the Gregory Unit. The Dunn reservoir underlying the Gregory Unit is “fault separated,” the reservoir is physically divided by a fault. Consequently, the Gregory No. 1 well did not drain that part of the Dunn reservoir of the Gregory Unit that is located on the south side of the fault. Stephens did not then know that the Dunn reservoir under the Gregory Unit was fault separated. Between 1961 and 1985, Stephens completed offset wells on the Gooch Units that produced gas from that part of the Dunn reservoir situated to the south of the Gregory Unit fault.

In the late 1980's, Sunbelt Exploration Co., (Sunbelt), acquired “top leases” from all of the Gregory Unit lessors. In 1990, Sunbelt then demanded that Stephens release the non-productive portion of the Gregory Unit. Stephens, whose geologist had by then discovered the existence of the fault, refused to release its leases and began drilling the Gregory No. 2 well that conclusively confirmed that the Gregory Unit was fault separated. Subsequently, Stephens drilled the Gregory No. 3 and 4 wells to produce that part of the Dunn reservoir located on the south side of the fault.

Sunbelt, along with its lessors, sued Stephens in Circuit Court to “try title” to the Gregory Unit leases, eject Stephens as a trespasser, and for damages and cancellation of the leases for breach of the implied covenant to develop and protect against drainage. Also, Sunbelt sought

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a judicial declaration that its top leases were valid and effective from the date of their execution and that Stephens’ leases were, at that time, “ineffective.” The Circuit Court, upon Motion by Stephens, determined that Sunbelt’s cause of action was for cancellation of Stephens’ oil and gas leases, as opposed to “trying title,” and transferred the suit to Chancery Court. At trial, the Chancellor entered judgment on the merits for Stephens, and also, awarded Stephens attorneys’ fees.

The Arkansas Supreme affirmed the Chancellor’s Decree on appeal. The Circuit Court properly transferred the action to the Chancery Court. Cancellation of an oil and gas lease is an equitable remedy and is the appropriate remedy for breach of the implied covenant of reasonable development. Although Sunbelt mentioned ejectment in its pleadings, Sunbelt’s request for cancellation of Stephens’ leases is appropriate and controlling and the cause of action is equitable. Likewise, Sunbelt’s top leases only become possessory when Stephens either concedes abandonment and voluntarily relinquishes possession of the leases or they are judicially canceled.

Absent the existence of fault separation in a unit, the Oil and Gas Commission only allows one well per unit for the Dunn reservoir which precludes the implied obligation to drill an additional well to the Dunn reservoir. However, Stephens did not breach its duty to discover the Dunn fault in the Gregory Unit prior to 1990. The fault’s existence was only conclusively demonstrated by the drilling of the Gregory No. 2 well in 1990. Prior to that time, other geologists, including Sunbelt’s geologist, also missed the fault when mapping the Unit. Moreover, over the years the shut-in pressures for the Blakely well, the Gregory No. 1 and the Gooch wells were almost identical, indicating that they were all producing from the same reservoir.

Nor did Stephens breach the implied covenant to protect against drainage. First, unlike some other jurisdictions, Arkansas law does not shift the burden of proof on the issue of drainage to the lessee when the lessee owns the wells that are allegedly draining the lease premises. More importantly, the evidence indicates that Stephens has produced or will produce more gas from the Gregory Unit than was originally in place under the Gregory Unit.²

II. The Background of Sunbelt

A. The Oil and Gas Lessee’s Liability for Breach of the Implied Obligation to Protect Against Drainage.

1. The Prudent Operator Standard

The lessee has an implied obligation to drill an offset well to protect against drainage when

² The Court further held that the Chancellor did not err in awarding attorneys’ fees to Stephens pursuant to Ark. Code Ann. § 16-22-308 (Repl. 1991), which permits the trial court to award attorneys’ fees in breach of contract actions.
“substantial drainage” is occurring and the offset protection well, if drilled, would likely produce oil or gas in “paying quantities.” Production in paying quantities for purposes of the implied drainage covenant demands that the cost of drilling, completing and operating the offset protection well, as well as a reasonable profit for the lessee, will likely be recovered. Gerson v. Anderson Prichard Co., 149 F.2d 444 (10th Cir. 1945) (applying Oklahoma law.); Blair v. Clear Creek Oil & Gas Co., 230 S.W. 286 (Ark. 1921). Damages for breach of the offset protection covenant is the “lost royalty,” the royalty on the oil and gas unlawfully drained from the land. Cancellation of the lease or cancellation on condition that the lessee fails to drill an offset protection well may also be an appropriate remedy for breach of the drainage obligation.

2. The Common Lessee and Fraudulent Drainage

Some courts hold that the production in paying quantities standard of the prudent operator rule does not apply to drainage occasioned by the lessee’s operations on adjacent lands. Therefore, the lessor does not have to prove that the offset protection well if drilled would likely be profitable. The lessor must only prove that substantial drainage is occurring. This is contrary to the maxim that a prudent operator only drills wells when it is profitable. However, it is best explained by the famous passage from Geary v. Adams Oil & Gas Co., 31 F. Supp. 830, 834 (E.D. Ill. 1949):

“But here the mind is haunted by the fact that the defendant is the beneficiary of the oil drained from the plaintiffs’ land by the wells on the north and south which belong to the defendant. It has not only been saved the cost of drilling, equipping and operating a protecting well but it gets the oil anyway without plaintiffs being paid for it.”

3 For a citation to other cases, see Daniel F. Sullivan, Annotation, Implied Duty of Oil and Gas Lessee to Protect against Drainage, 18 A.L.R. 4th § 5 (1981).

4 230 S.W. at 289.

5 Sullivan, supra N. 3 at § 35.

6 Professor Maurice H. Merrill, another colossal oil and gas scholar of the past, also made an equally worthy comment about fraudulent drainage:

“... no doubt if the lessee owns the fee, or royalty interest, in the adjoining land and operates thereon to draw oil or gas from beneath the leased premises because he will get a larger share, at the same time blocking development on part of others by keeping the lease alive, there is both harsh dealing and sharp practice properly deserving to be called by the hard name of fraud. Similar comment may be made if his purpose is to favor one lessor at the expense of another.” Maurice H. Merrill, Covenants Implied in Oil and Gas Leases, § 111 (2nd ed. 1940).
The rationale behind the fraudulent drainage rule has long been discredited. Omitting the paying quantities standard in the common lessee drainage situation may subject the lessee for liability for failure to drill an unprofitable well. The mineral owner, in the absence of having the lands leased, would not be expected to drill an unprofitable well to avoid off tract drainage occasioned by the rule of capture. Therefore, why should such a burden be placed on the lessee merely because he owns the offsetting producing lease?7

Even though the possibility of unfair dealing does not merit changing the profitability standard, inherent in the prudent operator standard. Williams et al. argue that the lessee should bear the burden of going forward with the evidence and the burden of persuasion on the issue of profitability when his adjacent operations or leasehold interests are the source of the drainage claim.8 Some courts have followed this view. Seacat v. Mesa Petroleum Co., 561 F. Supp. 98 (D. Kan. 1983); Elliott v. Pure Oil Co., 139 N.E. 295 (Ill. 1956).

B. The Drilling Unit (Well Spacing Regulations)

The Oil and Gas Production Act, hereinafter referred to as the Conservation Act, requires the Arkansas Oil and Gas Commission (AOGC) to establish “drilling units.” Ark. Code Ann. § 15-72-302(b)(1) (Michie 1987)

1. Drilling units are established for separate common sources of supply to prevent waste associated with excess drilling of wells. Id.

2. Drilling units must be configured to comprise the “maximum area which may be efficiently and economically drained by one (1) well. Id. at § 302(b)(2).

3. Net drainage must be avoided so that each producer will have the opportunity to produce his just and equitable share of the common source of supply. Id. at § 302(d).

   a. Net drainage is drainage that is not equalized by counter drainage. Id. (Net drainage is typically referred to as net uncompensated drainage).

   b. the quantity of recoverable oil or gas in the developed area of the (his)

7 For the traditional criticism of the rule, see 5 Howard R. Williams, Patrick H. Martin & Bruce M. Kramer, Oil and Gas Law § 824.3 (1996). For a more modern criticism of the rule, see Judge Posner’s caustic and perceptive, yet gratuitous criticism of Geary in Finley v. Marathon Oil Co., 34 F.3d 1225 (7th Cir. 1996). For a discussion of major cases that follow the fraudulent drainage rule, see Seacat v. Mesa Petroleum, 561 F. Supp. 98 (D. Kan. 1983).

8 Williams, Martin & Kramer, supra N. 7 at § 824.4.
tract in the common source of supply bears to the recoverable oil and gas in the total developed area of the common source of supply. Insofar as the amounts can be practically ascertained. *Id.* (Just and equitable share is typically referred to as "fair share.")

4. The Act requires the unit well to be "drilled approximately in the center" of the unit to permit the tract to recover its "fair share" of the oil and gas. "Exception well locations" are permitted so that the producer may avoid dry holes and seek geological advantage in the well location. If necessary, reductions in well allowable may be required to prevent the exception location well from draining other units. *Id.* At § 302(c).

C. The Effect of Drilling Units (Well Spacing Regulations).

1. Enactment of an Oil and Gas Conservation Act that permits the agency to conduct evidentiary hearings, establish well spacing units, force integrate non-consenting interests, issue drilling permits, and formulate rules and orders to prevent waste do not preclude the oil and gas lessor from seeking damages in a civil suit for breach of lessee's implied obligation to prevent drainage. *U.V. Industries, Inc. v. Danielson*, 602 P.2d 571 (Mont. 1979). In effect, a lessor harmed by drainage is not relegated to an administrative remedy by the Conservation Act. *See also Elliff v. Texon Drilling Co.*, 210 S.W.2d 558 (Tex. 1948).

2. The implied obligation to drill an offset protection well to prevent drainage does not exist if the spacing regulations precluded the drilling of the well. *Monsanto Chemical Co. v. Sykes*, 147 So.2d 290 (Miss. 1990). *See also cases discussed infra.* 4(C)(2).

3. A lessee, or mineral owner, is entitled to an additional well from the conservation agency to prevent net uncompensated drainage. *French v. Champlin Exploration, Inc.*, 534 P.2d 1302 (Okla. 1975). The denial of such an additional well would constitute "confiscation," a noncompensable taking of property in violation of state and federal constitutional due process clauses.
III. The Overlooked Fault and Drainage

A. The Overlooked Fault

Stephens' failure to find the fault that separated the Dunn reservoir in the Gregory Unit was judged by the prudent operator standard under the guise of the lessee’s implied obligation to "prudently manage" the lease. An evaluation of the relevant evidence as to whether the fault separation should have been discovered by the objective reasonable prudent operator lead both the Chancellor and the Court to conclude that Stephens was not imprudent in failing to find the fault. The fact that both Sunbelt’s and Stephens' geologists, at one time or another, both missed the fault when mapping the geology of the Gregory Unit, and the existence of the similarity in the shut-in pressures of all of the local wells, falsely signifying that they were all producing from the same reservoir, compelled the Court to conclude that an objective prudent operator would not have been remiss in failing to detect the fault separation.

A clear inference from Sunbelt is that the prudent management standard that was applied to determine if Stephens was liable for overlooking the fault is a negligence standard. The prudent management of the lease standard masks the elements of duty, breach of duty, causation, and foreseeability of the “reasonable man” standard of negligence.

That is not the only, nor the more liberal, standard that has been applied to the lessee’s activities relating to lease management. In Sinclair Oil & Gas Co. v. Bishop, 441 P.2d 436 (Okla. 1967), the lessee was attempting to complete a well in an oil and gas pool with an associated gas cap. Both the well and the lease were higher on the gas cap than the other wells in the field. In completing the well, the lessee, relying on his expert, perforated the bottom two feet of the zone, tested it for 7 hours, and then moved up the hole and perforated another section of the zone where, after sandfracing, the well was ultimately completed. The well failed as an oil producer. The lessors, sued to cancel the lease for the lessee’s failure to complete, test and operate the well as a prudent operator. Lessors’ expert testified that the lessee should have completed the well in the lowest possible portion of the Skinner zone to enhance the ratio of oil to gas production from

9 The opinion is murky as to the relevance of the “overlooked fault.” Pursuant to the AOGC’s field rules, the fault separation of the Dunn formation would mean that the Gregory Unit had two separate Dunn reservoirs, each being distinct common sources of supply, entitling the Unit for a Dunn well for each reservoir. The failure to drill only one Dunn well because of the overlooked fault would raise the issue of failing to comply with the implied development covenant. Conversely, any additional well drilled on the Unit to the South of the fault would have been an offset protection well that would have protected the Unit from drainage. Also, absent the discovery of the fault separation, would the drainage claim ever have materialized? Therefore, the missed fault may also be relevant to the drainage claim. To facilitate the discussion, the drainage issue and the issue of the overlooked fault will be treated separately even though they may be related.

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the well. The lessor argued that the lessee did not properly test the lower perforations, the test time being insufficient, and that the lower perforations should have been sandfraced. The lessee’s expert, who managed the well completion job, testified that the perforation of the well at the higher elevation was an attempt to complete the well at the proper location based on the data derived from the well logs and core analysis. The Court was unsympathetic to the lessor’s claim. The Court noted that the lessors’ testimony “at most showed there might have been a better method of completion.” The lessee, however, attempted to complete the well according to the judgment of its expert. The Court held that the lessee could rely on its own experts which foreclosed the lessor’s claim as to the improper completion of well. The lessee’s negligence in completing the well did not appear to be an issue in the case.

May the difference between Sunbelt and Bishop over the standard to be applied to determine if the lessee has complied with the obligation to prudently manage the lease be explained on the basis that Sunbelt involved a geologist engaged in geological interpretation while Bishop involved a petroleum engineer engaged in completing a well? Clearly, one can speculate as to the differences, if any, between petroleum engineering and geology that may result in an operator’s misplaced reliance on a petroleum engineer being a defense to an imprudent lease management claim while his misplaced reliance on the geologist subjects him to negligence scrutiny.

B. Sunbelt’s Drainage Claim

1. Dismissing the Fraudulent Drainage Syndrome

The Court affirmed the Chancellor’s refusal to shift the burden of going forward with the evidence and the burden of persuasion from the plaintiffs to the defendants on the prudent operator issue because of Stephens’ role as a common lessee whose adjacent unit wells were allegedly draining the Gregory Unit.

2. Liability only for Net Uncompensated Drainage

Plaintiffs’ drainage action failed for lack of any losses incurred due to drainage. The evidence indicated that the Gregory Unit, after the completion of the No. 2, 3 and 4 unit wells in the South fault block, will produce 30% to 40% more gas than was originally in place under that portion of the Unit. In effect, as opposed to suffering net uncompensated drainage, plaintiffs appear to be the beneficiaries of drainage coming from the off setting units.

3. The Compensable Drainage Issue

Defendants expert witness admitted that if the Gregory No. 2 well, which confirmed the fault separation, had been drilled earlier, then the Gregory Unit would have produced even more gas from the south fault block. This raises the issue, that was not decided in Sunbelt, of the applicability of the theory of “compensable drainage.” Compensable drainage is the right of the
lesser to be free from drainage from his unit even if such drainage is counterbalanced by drainage to his unit. The theory was popularized by the venerable and gifted scholars of oil and gas law, Howard Williams, Charlie Myers\textsuperscript{10} and Eugene Kuntz,\textsuperscript{11} who opined that a landowner, under the rule of capture, has a right to recover all of the oil and gas underlying his tract. The migration of his minerals to neighboring tracts is injurious to the landowner regardless of the extent of the migration of oil and gas to his leasehold. A prudent operator would protect against such drainage even if he were suffering no net loss. The theory of “compensable” drainage has historically endured only as theory. No case has sustained the proposition. In a recent case to be discussed in detail later, \textit{Fransen v. Conoco Inc.}, 64 F.3d 1481 (10th Cir. 1995) \textit{cert. denied}, 116 S. Ct. 1060 (1996), the plaintiff mineral owners, argued, \textit{inter alia}, that the implied obligation to protect against drainage encompasses liability for “compensated drainage” if the prudent operator “paying quantities” standard is met. The 10th Circuit in \textit{Fransen} rejected the “compensated drainage” theory, holding that the establishment of spacing and drilling units for a common source of supply by the conservation agency limits the lessee or operator to no more than its “fair share” of the oil and gas. As the Court in \textit{Fransen} observed, “none may take an unproportioned amount.”

IV. Implications of Sunbelt

What if Stephens had discovered the fault and not drilled the offset wells to protect against drainage?

A. The implied obligation to seek an additional well in a drilling unit to protect against drainage

1. The origin of the obligation: Merrill the Prophet

“\text{The past three decades have witnessed an ever-increasing subjection of the petroleum industry to regulation by administrative agencies. Particularly has this been true with respect to the adjustment of the interests of producers from a common source of supply and to the preservation of the industry against what is regarded as wasteful and uneconomic production. The methods adopted included proration, suspension of production, limitations on drilling, well-spacing, compulsory pooling, preferred use regulation, and the prohibition of wasteful practices. Generally, these restrictions have been upheld as constitutional exercises of regulatory power. The lessor surely may not be heard to assert that his lessee ought to violate such a regulation in order to fulfill the obligation which the law would have implied in the absence of the exercise of the government’s power.}"

It does not follow, however, that a lessee, confronted with an assertion that he has failed to perform duties imposed upon him by the law of implied covenants, may set up an impregnable

\textsuperscript{10} 5 Williams, Martin & Kramer, \textit{supra} N. 7 at §§ 822.3-4.

\textsuperscript{11} 5 Eugene Kuntz, \textit{A Treatise on the Law of Oil and Gas} § 61.3 (1991).
defense merely by pointing to an administrative regulation which, on its face, forbids compliance with the obligation put forward. The legal problems involved are far too complex to be resolved so easily.” Maurice H. Merrill, Current Problems in the Law of Implied Covenants in Oil and Gas Leases, 23 Tex. L. Rev. 137, 141 (1945).

2. The Leading Cases


Plaintiffs, lessors, sued Amoco Production Co. (Amoco) for damages caused by fieldwide drainage. The field, the Hastings West field, is a water drive oil reservoir that “dips” downward from the southeast to the northwest. Amoco has 80% of the field production. Plaintiffs’ leases with Amoco are “downdip,” on the lower part of the reservoir. Amoco also operates leases that are “updip,” on the higher part of the reservoir. Due to the natural reservoir conditions, production from the updip leases causes the oil water contact line to rise, “watering out” the downdip leases, and, also, drives the oil from the downdip leases to the updip leases, resulting in fieldwide drainage. Production anywhere in the field, however, causes the oil-water contact to rise and move from the downdip leases to the updip leases. Plaintiffs’ downdip leases yield a 1/6th royalty while Amoco’s updip leases bear a 1/8th royalty. Plaintiffs alleged that Amoco slowed its production on the downdip leases and accelerated its production on the updip leases so that it would ultimately recover the oil underlying the plaintiffs’ leases from the updip leases at the lower royalty. Plaintiffs also alleged that Amoco had a duty to obtain additional oil production from their leases by drilling additional wells. The Supreme Court of Texas affirmed the trial court’s judgment for the plaintiffs. The Court held that the implied covenant to protect against drainage encompasses fieldwide drainage. In so doing, the Court rejected Amoco’s argument that it owed obligations to all of its lessors in the field and that increasing production from the downdip leases, depriving the updip leases of their natural advantage due to location on the reservoir, would expose Amoco to liability to their updip leases. The Court responded by emphasizing that Amoco had no economic incentive, due to the fieldwide drainage and the greater royalty burden on the downdip leases, to increase production on the plaintiffs’ leases. The conflict between Amoco and its downdip and updip leases is a consequence of its being a “common lessee.” If plaintiffs were Amoco’s only lessors, Amoco’s interest would be to capture the most possible oil from the plaintiffs leases. In sum, the reasonable prudent operator standard that Amoco owes to the plaintiffs is not to be reduced because Amoco has other lessors in the field. The Court also held that Amoco had the duty, inhering in the reasonable prudent operator standard, to seek additional wells (Rule 37 exceptions) from the Texas Railroad Commission (TRC) to protect against fieldwide drainage.

Alexander indicated that the duties of a reasonably prudent operator to protect from field wide drainage may include 1) drilling replacement wells 2) re-working existing wells 3) drilling additional wells, seeking fieldwide regulatory action, seek rule 37 exceptions from the TRC, seeking voluntary unitization and seeking other favorable relief. There is no duty unless such an
amount of oil can be recovered to equal the cost of administrative expenses, drilling or reworking and equipping a protection well, producing and marketing oil, and yield to the lessee a reasonable expectation of profit.

Amoco should have applied for additional well to protect against drainage and having failed to do so, plaintiffs were entitled to show the exceptions would most likely would have been granted and they suffered damages because of the failure.

b. *Spaeth v. Union Oil Co.*, 710 F.2d 1455 (10th Cir. 1983)

Plaintiff lessor leased lands situated in an established 640 acre well spacing unit, encompassing section 4, to Union Oil Co. (Union) who thereafter drilled a producing well on the unit. Union also owns working interests in 3 off-setting 640 acre spacing units that also produce from the same common source of supply. Plaintiff and the other mineral interest owners in section 4 filed an application with the Oklahoma Corporation Commission (OCC or Commission) for authorization to drill another well in the spacing unit. Union appeared before the Commission and resisted the application. The Commission denied the application and plaintiff appealed to the Oklahoma Supreme court. Union opposed the plaintiff's appeal before the Supreme Court. Pending the appeal, plaintiff sued Union in federal court seeking damages and partial lease cancellation for drainage. While the action in federal court was pending, the Oklahoma Supreme Court reversed the Commission's denial of plaintiff's request for an additional well to protect against drainage. *Spaeth v. Corporation Commission*, 597 P2d 320 (Ok. 1979). Union’s petition for rehearing was denied by the Oklahoma Supreme Court.

Plaintiff then recovered judgment in the federal court drainage case in the amount of $22,807 actual damages and $3 million punitive damages. The 10th Circuit affirmed the judgment as to liability. Union breached its obligation, under the implied obligation to protect against drainage, to seek an additional well in the spacing unit. Union's purported defense to opposing the plaintiff's application before the Commission and appeal to the Supreme Court was that it had relied on the advice of its experts. The argument was found to be without merit because plaintiff had presented before the Commission proceeding the evidence of an expert supported by

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12 Merrill articulated the cause of action for breach of the obligation to seek administrative relief as follows:

As part of his case, he must produce testimony of the lessee's inaction, the physical conditions of the field, the existence of draining from beneath his tract to the existing well, the probable productivity of a well upon his tract, and the facts which justify granting an exception to the confiscation rule (additional unit well).

technical data while Union had offered no expert testimony. The punitive damage award was sustained on the theory of “tortious drainage” based on Union’s reckless and wanton disregard of the plaintiff’s rights. However, finding that the award of punitive damages shocked the court’s conscience, the case was remanded to federal district court with instructions to reduce the amount of punitive damages.

B. If You Go to the Agency to Get the Additional Well and Lose, is it Over and Done with?

1. Amoco Production Co. v. Alexander, supra, contains the following dicta:

   If the TRC denies the Rule 37 permits, after a reasonably prudent application, the operator has no liability for not drilling the wells.

2. Merrill’s Tenacious view

   The lessee’s obligation is to exhaust administrative remedies, seek judicial review, perhaps to appellate courts or the even the highest tribunal, in order that the lessee may be adjudged free to carry out his duties as an operator ordinarily prudent. A lessee who has failed to exhaust his remedies to secure freedom so to act must be adjudged to have fallen short of his obligation to his lessor, unless he can show by clear and convincing evidence that the effort would have been fruitless. Maurice H. Merrill, Current Problems in the Law of Implied Covenants in Oil and Gas Leases, 23 Tex. L. Rev. 137, 145-146 (1945).

3. Amoco Production Co. v. Ware, 602 S.W.2d 620 (Ark. 1980). Reh’g denied.

   Amoco Production Co. v. Ware, supra, indicates, if not holds, that the lessee has no per se obligation to seek judicial review of an AOGC decision on behalf of a royalty owner. In Ware, the plaintiff was a royalty owner whose 80 acre tract was situated on the edge of the Chalybeat Springs oil and gas field. Plaintiff’s tract was under lease to Amoco who was the majority working interest owner in the field and was in the process of forming a fieldwide gas reinjection unitization project. Before Amoco finalized its unitization project, Murphy Oil Co (Murphy) petitioned the AOGC for a drilling permit for a 160 acre unit that included plaintiff’s tract. Amoco opposed Murphy’s drilling permit on the basis that there was no oil and gas underlying Murphy’s part of the proposed drilling unit. Plaintiff showed up at the hearing and testified for Amoco. In part, plaintiff testified that he did not want a well drilled on the 160 acre unit because it might be a dry hole and exclude his tract from participation in the unitization project. The AOGC granted the drilling permit for the 160 acre unit. Amoco filed a notice of appeal from the Commission’s decision. However, instead of pursuing the appeal, Amoco entered into a unitization agreement with Murphy that included the 160 acre tract unit into the fieldwide unit. Amoco included the 160 acre tract in the unit because Murphy, having been granted the contested drilling permit, had been effectively found by the Commission to be entitled to share in the oil and gas produced throughout the 160 acre tract. As a consequence of the inclusion of the 160 acre tract...
unit in the project, plaintiff's participation interest in the fieldwide unitization project was diluted.

Plaintiff sued Amoco in circuit court for damages for, *inter alia*, failing to appeal the AOGC's Order. The Chancellor found for the plaintiff on the basis that Amoco breached the implied covenant to "protect the interest" of the lessor which included the duty to appeal the AOGC's decision to a court of last resort. The Supreme Court reversed, finding no implied obligation on behalf of Amoco to appeal the AOGC's decision. In so doing, the Court noted that there was no evidence that the Commission's decision would be readily reversed by a reviewing court. Amoco, the Court opined, simply used its best judgment and proceeded to include the entire 160 acre tract in accordance with the Commission's decision on the drilling unit. The Court further noted that the plaintiff could himself have appealed the decision of the AOGC.

C. Binding the royalty owners to the Agency's determination that No Additional Well is required to protect Correlative Rights.

1. Issue Preclusion (Collateral Estoppel) and Collateral Attack

a. Collateral Attack

The order or determination of an administrative body, acting within its jurisdiction and under authority of law is not subject to collateral attack. This is so in absence of fraud or bad faith. In this connection, it has been considered that the only method of attack available is by appeal as provided by statute. *Bryant v. Public Service Commission*, 924 W. 472, 482 (Ark. App. 1996).

b. Issue Preclusion

When an administrative agency is acting in a judicial capacity and resolves disputed issues of fact properly before it which the parties have had an adequate opportunity to litigate, the courts have not hesitated to apply res judicata to enforce repose. *Rainbolt v. Everett*, 639 S.W.2d 532, 534 (Ark. App. 1982), citing *United States v. Utah Construction and Mining Co.*, 384 U.S. 394 (1966), the leading United States Supreme Court case applying the doctrine of issue preclusion to an administrative agency.

13 *Katter v. Arkansas Louisiana Gas Co.*, 765 F.2d 730 (8th Cir. 1985) held that a facially valid forced integration order of the AOGC could not be collaterally attacked in an action for money damages that was premised on the invalidity of the order due to a deficiency in the notice of the integration hearing.
adjudication. 14

2. A Trilogy of Oklahoma Cases


An Order of the Oklahoma Corporation Commission (OCC) denying an application to drill an additional well in a well spacing unit to prevent net uncompensated drainage was held to collaterally estop the lessors, from recovering damages against the lessee in a drainage action in federal court. In Ruyle, Plaintiffs15 own mineral interests in section 14 that are leased to Conoco. The OCC originally established section 14, and the

14 Richardson v. Phillips Petroleum Co, 791 F.2d 641 (8th Cir. 1985), reh’g denied, 799 F.2d 426 (8th Cir. 1986), cert. denied, 107 S. Ct. 929 (1987), involved the applicability of the doctrine of issue preclusion to a factual finding of the AOGC in a civil tort trespass action for damages occasioned to a well’s productivity by an adjacent secondary recovery unitization project. In that case, the AOGC authorized the creation of a secondary recovery unitization project. The defendant was the project’s operator. Plaintiffs, owners of leases situated adjacent to the project, petitioned the AOGC to revoke the unitization project due to the diminished productivity of their wells caused by the subsurface invasion of the injected substances from the unitized operations. The commission determined that plaintiffs’ lease operations were not “irreparably harmed” for purposes of granting injunctive relief. Plaintiffs then filed a civil tort action in trespass in state court, wherein the action was removed to federal court, seeking compensatory damages. The 8th Circuit reversed the trial court’s summary judgment in favor of the defendant on the basis of the issue preclusion. The court found that more than a de minimus difference existed between the facts necessary to enjoin a secondary recovery operation and those appropriate to award compensatory damages for trespass. Also, the scope of the Commission’s jurisdiction indicated that its proceedings are determinative only for purposes of the controversy before the agency. Since the Commission lacked the jurisdiction to award money damages, the lack of identity between the issues litigated and decided in the commission hearings and the issues raised in the civil tort action preclude application of the collateral estoppel doctrine.

15 Some of the plaintiffs in Ruyle owned mineral interests that were not leased to Conoco. The unleased mineral owners claim that Conoco as the unit operator owed a fiduciary duty that it violated by failing to protect the unit against net uncompensated drainage.
adjacent sections, as 640 acre well spacing units for the underlying Des Moines formation. The well spacing order permitted only one well for each unit. Conoco owns 37% of the unit production and operates the unit well, the Meacham #1-14, on section 14. Conoco also owns 29% of the well located on the adjacent spacing unit, the Downing #1-15, that is located on section 15. In October of 1990, Great Bear Exploration, Inc., (GBE), who owned an interest in section 14, filed an application before the OCC seeking an additional well in the unit to protect the Des Moines formation from net uncompensated drainage by offset wells on adjacent units. Plaintiffs appeared before the Commission proceedings and supported the application of GBE. Conoco contested GBE’s application. The ALJ denied the application for an additional well on the basis that the existing unit well in section 14 would drain all the hydrocarbons underlying the unit and that permitting an additional well in the unit would harm the correlative rights of the adjacent sections owners. Through all stages of review, including the Oklahoma Supreme Court, the ALJ’s Order was affirmed.

While the application for the additional well was pending before the OCC, plaintiffs sued Conoco in state court for, inter alia, damages for net uncompensated drainage. Conoco moved the action to federal court and subsequently moved for summary judgment due to the preclusive effect of the Commission’s Order. The federal district court rejected Conoco’s collateral estoppel argument and the jury returned a verdict for $55,000 actual damages and $1.14 million punitive damages. Conoco was further ordered to drill an additional well or release it leases within 120 days. The 10th Circuit reversed the trial court’s decision on appeal, holding, inter alia, that the doctrine of issue preclusion as well as the Oklahoma statute prohibiting the collateral attack of an OCC Order barred the plaintiffs common law drainage claim.16

In reaching this result, the federal appellate court observed that under Oklahoma law, applying the doctrine of issue preclusion, once a tribunal has decided an issue of fact or law necessary to its judgment, that issue may not be relitigated between the same parties or their privies in a suit on a different cause of action.18 Issue preclusion only applies when the issue sought to be barred has been “fairly and fully” litigated in the prior proceeding.

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16 See Leek v. Continental Oil Co., 971 F.2d 604 (10th Cir. 1992).

17 The Court observed that it “must give the same preclusive effect to state court judgments that those judgments would be given in the courts of the state in which judgments were rendered.” 444 F.3d at 842.

The Court then examined the status of the plaintiffs as parties to the Commission's proceedings and their privity with GBE, either of which is required to invoke issue preclusion. Plaintiffs initially executed agreements authorizing GBE to act on their behalf in the OCC proceeding. Plaintiffs then filed motions with the Administrative Law Judge (ALJ) seeking to intervene in the matter and appear at the hearing to present arguments or evidence. Apparently the ALJ never acted on the motions. The ALJ's initial report, however, indicated that plaintiffs appeared at the hearings through their attorney in support of GBE's application. The federal district judge held that plaintiffs were not subject to issue preclusion because Conoco failed to establish that plaintiffs were parties to the proceeding. Likewise, finding that plaintiffs did not sufficiently control GBE's course of conduct in the proceedings, the trial judge concluded that no privity existed. Further, the trial court held that the Commission's proceedings did not afford the plaintiffs an effective opportunity to litigate the issues. The 10th circuit, looking at the totality of the circumstances, reversed the trial court and held that plaintiffs were "parties" to the OCC's proceedings for purposes of issue preclusion. The court reasoned that the failure of the ALJ to formally rule on the plaintiffs motion to intervene did not prevent the plaintiffs from participating in the hearing. The Oklahoma Conservation Act, 52 Okla. Stat. Ann. § 87.2(a), designated mineral owners as "proper parties" to the proceedings for an additional well. The Plaintiffs entered an appearance at the hearing through their attorney which in accordance with the Commission's Rules of Practice designates them as a "party of record." In addition to finding that the plaintiffs were parties to the proceeding for purposes of the doctrine of issue preclusion, the Court also concluded that plaintiffs had been presented with the requisite opportunity to fully and fairly litigate the issues before the Commission.

Plaintiffs also argued on appeal that issue preclusion should not be applied because the issues before the court, involving damages for drainage, only appertained to private rights, and were different than the issues resolved in the Commission proceedings, involving protection of correlative rights, that appertained only to matters of public interest. The 10th Circuit rejected the plaintiffs argument. Even though the Commission's jurisdiction to "protect correlative rights" is limited to instances affecting the "public interest," and only courts can award damages for breach of contract, there is a direct relationship between correlative rights and drainage. The Commission determined

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19 The binding of courts by factual determinations made by Oil and Gas Conservation Agencies on the basis of issue preclusion has been changed by the United States Supreme Court case of United States v. Utah Construction and Mining Co., 384 U.S. 394 (1966). The change is not yet widely understood. For example, Conoco's lawyer before the federal district court in Ruyle "voiced his belief (to the trial judge) that the court was not bound on the issue of drainage because the Commission cannot assess money damages." 44 F.3d at 841.

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through its administrative process, pursuant to its jurisdiction to protect correlative rights, that net uncompensated drainage was not occurring to section 14.\(^{20}\) When the judicial relief depends entirely upon the adjustment and protection of correlative rights that has already been ruled on by the Commission, the court is not at liberty to award such relief if the Commission has concluded that correlative rights have not been violated.\(^{21}\)


Involved the same wells and spacing units and administrative proceeding involved in *Ruyle*. In *Fransen*, the plaintiffs were lessors who, though given notice of the GBE application for the additional well, did not participate in the administrative proceedings. Plaintiffs sued Conoco\(^{22}\) in federal district court alleging, *inter alia*, the failure to protect the premises against drainage. The trial court granted summary judgment to Conoco on the basis that they could not be liable for failing to drill an additional well when the OCC had prohibited the drilling of an additional well on the unit. The 10th Circuit affirmed the trial court’s holding on appeal.

Because the plaintiffs did not participate in the OCC’s proceedings, the Court refused to bar the plaintiffs action on the basis of issue preclusion. The statutory prohibition on collateral attacks against the OCC’s orders barred all of the mineral owners’ claims. One need not be a party to the proceeding to be barred from collaterally attacking a conservation agency order. Because the plaintiffs must prove that a reasonable prudent operator would drill an additional well on section 14 to protect against drainage, their drainage claims constitute an impermissible collateral attack that would

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\(^{20}\) The Commission held, based on the ALJ’s finding, that Conoco “acted prudently” in section 14 by recovering the unit’s fair share of gas and resisting GBE’s application to drill an additional well to recover more than the unit’s fair share. On appeal, plaintiffs argued that the Commission’s determination as to Conoco’s “prudence” was not entitled to preclusive effect because it was unnecessary to determine the issues before the Commission. The Court rejected that argument on the basis that such a finding by the OCC was a necessary and inevitable element to its determination that no improper drainage was occurring.

\(^{21}\) Finally, the Court further held that OCC order was subject to issue preclusion and the statutory prohibition against collateral attack even though the Order was not a final, appealable Order at the time of trial.

\(^{22}\) In addition to Conoco, C.I.G. Exploration, Inc. (CIGE) held leases in section 14 from some of the plaintiffs and was a defendant in this action.
avoid, defeat, evade or deny the effect of the OCC order that denied an additional well to section 14. The Court also noted that a prudent operator would not drill a well that is prohibited by law.

In rejecting plaintiffs' civil tort drainage claim solely on the basis of collateral attack, the 10th Circuit avoided having to consider additional arguments, not raised in Ruyle, concerning the inappropriateness of barring the mineral owners' claim by issue preclusion. Plaintiffs argued that issue preclusion should not apply because the notice of the OCC proceedings was deficient in that it did not indicate that drainage was an issue before the Commission, and, the mineral owners could not have foreseen that the Commission's factual findings could have preclusive effect. Likewise, plaintiffs argued that the differences between the administrative proceedings and the judicial proceedings, over the right to a jury trial, the availability of money damages, and the more extensive trial proceedings, that distinguish the judicial action, but are missing from the administrative proceeding, makes unfair the application of the doctrine of collateral estoppel to the drainage action.

The mineral owners also argued that even if the OCC order prevented the drilling of an additional protection well on section 14, the defendants had the implied obligation to seek other administrative remedies to protect the lessors interest from net uncompensated drainage. The defendants could have requested the OCC to adjust the well allowables, either reducing section 15's well allowable or increasing section 14's well allowable, or require payment of compensatory royalty by the offset well operators. However, because the OCC had determined in the GBE proceeding that section 14 was not suffering net uncompensated drainage but recovering its fair share of the common source of supply, the defendants could not have obtained the suggested administrative relief without collaterally attacking the order the OCC order. Therefore, the court concluded that Conoco cannot be liable for seeking such relief.


Sprowls is factually identical to Ruyle and Fransen in that a previous order of the OCC that determined that the spacing unit was not suffering substantial net uncompensated drainage barred, on the basis of an impermissible collateral attack and issue preclusion, the mineral owners’ subsequent judicial action for drainage against the unit operator.\(^\text{23}\) The 10th Circuit in Sprowls emphasized that the Commission order

\(^{23}\)The Commission proceeding involved a “desspacing proceeding,” a hearing to despace the previously established 640 acre spacing unit and “respace,” recreate four (4) 160 acre spacing units. The desspacing order, if granted by the Commission, would have
prevented the drilling of an additional well in the unit and that no breach of a duty, express or implied, can be based on the operator's failure to drill a well that it cannot lawfully drill.

permitted additional wells to be drilled within the confines of the "despaced" unit. The Commission order determined that despacing was not necessary to protect correlative rights since the existing unit well would drain 182% of the amount of gas that underlays the unit. The Court noted that this finding necessarily includes a determination that the 640 acre unit is not suffering substantial uncompensated drainage.