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# TULSA LAW JOURNAL

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## POOLING AND UNITIZATION: LEGAL AND ETHICAL CONSIDERATIONS

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and  
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*In this Article, Messrs. Handlan and Sykes attempt to discern developing trends relative to the primarily ethical issues of the duty of fair dealing in pooling and unitization and the implied duty to pool or to unitize. In examining the power to pool or unitize, the authors examine voluntary pooling and unitization by either implied right or express provision, as contrasted to compulsory pooling and unitization. The authors then address the implied duty to pool or unitize as suggested by commentators and the limited case law dealing with the implied covenant to protect against drainage. The focus then shifts to the duty of fair dealing and an examination of two common situations leading to the issue of fair dealing—irregular geometries of unit areas and holding expiring acreage. The problem of nonjoining interest owners that result in “holes” in the unit area is also analyzed. Antitrust considerations and the nature of a unitized title*

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*are also examined in relation to the consequences of pooling and unitization.*

## I. INTRODUCTION

Pooling refers to the consolidation of tracts of land into a single drilling unit of the size prescribed by applicable spacing rules. This consolidation can prevent the physical and economic waste that results from drilling unnecessary wells. Equally important, pooling serves to protect the correlative mineral ownership rights of landowners whose holdings overlie a common reservoir.<sup>1</sup>

Unitization refers to the aggregation of all, or at least most, of the tracts overlying a reservoir so that the reservoir may be operated without regard to individual surface property rights. Thus a unitized field can be operated as a single entity; this integration is the key to conducting such operations as gas cycling, pressure maintenance, and secondary recovery.<sup>2</sup>

Because of the increasing importance of pooling and unitization throughout the United States, the legal ramifications of these practical devices have become a matter of increasing concern to oil and gas practitioners, operators, and landmen. This Article focuses upon certain legal and ethical issues that the authors think significant to attorneys, operators, and landmen. It is trusted that those concerned with other aspects of this critical area of oil and gas law will be able to satisfy their needs, as well as their native curiosity, through reference to the substantial body of jurisprudence and scholarly commentary that has grown up over the past few years.

The distinction between law and ethics is not easily drawn. Law is substantially concrete, something that is defined either by enacted statute or by judicial precedent. Ethics, on the other hand, is largely abstract. There is a tendency to believe that ethics, like art or pornography, is something that is immediately recognizable when seen. The problem, of course, is that everyone has a slightly different outlook on what is ethical. Nevertheless, it is quite obvious that society can tolerate only a limited degree of variation from some acceptable but generally unarticulated norm.

Simply stated, the victim of unethical conduct may take his case,

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1. 6 H. WILLIAMS & C. MEYERS, OIL AND GAS LAW § 901, at 2-4 (1981) (footnotes omitted).

2. *Id.*

however novel from a purely legal standpoint, to court. There the breach of ethics may be discussed in terms of equity, but it will nevertheless reach a judicial forum where the issue will be subject to resolution by a judge or jury. There is, of course, a considerable body of judicial precedent that deals with equitable issues, but ethical matters are always in a state of flux and are often considered on a case-by-case basis. This Article will attempt to discern certain developing trends relative to the primarily ethical issues of the duty of fair dealing in pooling and unitization and the implied duty to pool or to unitize. In addition, the more traditional legal issues relative to voluntary pooling, such as the effect of pooling provisions in leases, the utilization of separate pooling agreements, and the significance of the distinction between the contract theory and the cross-conveyance theory, will be examined.

## II. POWER TO POOL OR UNITIZE

### A. *Voluntary Pooling and Unitization*

#### 1. Implied Right

Voluntary poolings and unitizations derive from agreements among the interested parties. In general, there is no inherent, implied right to pool interests under oil and gas leases. It has been argued, however, that there are two basic instances in which voluntary pooling will be implied: community leases and equitable pooling.<sup>3</sup>

The community lease is a single lease executed by the owners of two or more tracts of land, as if they were joint owners, to a single lessee.<sup>4</sup> There is a division of authority on the question of whether the execution of a community lease creates a pooled or communitized lease as a matter of law. The Texas courts appear to hold that it does and therefore require that royalties from wells drilled on the leased premises be apportioned among the various lessors in the proportion that the area of the tract owned by each bears to the total area covered by the community lease.<sup>5</sup> West Virginia seems to have accepted the viewpoint

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3. See, e.g., Whittington, *Voluntary Communitization—When Will It Be Implied in Oil and Gas Leases?*, 22 ROCKY MT. MIN. L. INST. 653 (1976).

4. See generally Ashworth, *Selected Problems in Voluntary Pooling: A Suggested Rationale*, 26 OHIO ST. L.J. 420, 421-28 (1965) (analysis of the community lease); Hardwicke & Hardwicke, *Apportionment of Royalty to Separate Tracts: The Entirety Clause and the Community Lease*, 32 TEX. L. REV. 660, 676-81 (1954) (discussing the community lease).

5. *Parker v. Parker*, 144 S.W.2d 303 (Tex. Civ. App.—Galveston 1940, writ ref'd); (where a joint lease directed the lessee to pay royalties to the "lessor" (the joint owners) in proportion that the property belonging to each bore to the entire tract, no matter in what part of the tract production had occurred, the lease was an "unitized lease" as a matter of law, and the owners of the

that the execution of a community lease gives rise to an irrebuttable presumption, or rule of property law, that apportionment necessarily results from the execution of a community lease.<sup>6</sup> It has, however, been suggested that the rule of apportionment may not be a rule of property in West Virginia and that the rule in that state is that there is a rebuttable presumption of intent on the part of joint lessors to apportion the royalty.<sup>7</sup> If that is true, then West Virginia follows the Oklahoma rule and not the Texas rule.<sup>8</sup> In Oklahoma, community leases give rise to a presumption that apportionment is intended, but this presumption may be rebutted by parol evidence.<sup>9</sup> It should also be noted that one Texas court has not followed the general Texas rule and held that the presumption in favor of apportionment may be rebutted by evidence of contrary intent.<sup>10</sup> Finally, the courts of some states, most notably Louisiana, have held that there is no presumption for or against apportionment and that the intent of the parties will control.<sup>11</sup>

Although equitable pooling is discussed here as exemplary of the implied right to pool, it is really a type of judicially imposed pooling that is neither voluntary nor compulsory by specific statutory provi-

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individual tracts were entitled to share pro rate in royalties); *see also* *Howell v. Union Producing Co.*, 392 F.2d 95 (5th Cir. 1968) (the community nature of a jointly executed oil and gas lease is destroyed by an express contract term denying community status); *Ward v. Gohlke*, 279 S.W.2d 422 (Tex. Civ. App.—San Antonio 1955, writ ref'd), (the holding of *Parker* has become a rule of property in Texas); *Landgrebe v. Rock Hill Oil Co.*, 273 S.W.2d 636 (Tex. Civ. App.—San Antonio 1954, writ ref'd n.r.e.); *French v. George*, 159 S.W.2d 566 (Tex. Civ. App.—Amarillo 1942, writ ref'd) (a unitized lease is implied in the absence of any contrary agreement); *cf.* *Southland Royalty Co. v. Humble Oil and Ref. Co.*, 151 Tex. 324, 249 S.W.2d 914, 916 (1952) (court refused to reexamine the *Parker* holding stating it was now a rule of property).

6. *See* *Hamilton v. McCall Drilling Co.*, 131 W. Va. 750, 50 S.E.2d 482 (1948); *Lynch v. Davis*, 79 W. Va. 437, 92 S.E. 427 (1917).

7. *Whittington*, *supra* note 3, at 662.

8. *Id.* It would also appear that in West Virginia, an intent to pool will not be implied from a community lease unless the separate tracts are described as a single tract. Since it would seem impossible to describe tracts that are not contiguous as a single tract, contiguity of tracts would appear to be a requirement in West Virginia. *Id.* at 663.

9. *Irick v. Hubbell*, 280 P.2d 733 (Okla. 1955); *Peerless Oil & Gas Co. v. Tipken*, 190 Okla. 396, 124 P.2d 418 (1942); *Brazell v. Brown*, 169 Okla. 623, 38 P.2d 17 (1934).

10. *Phillips Petroleum Co. v. McIlroy*, 178 F. Supp. 107 (N.D. Tex. 1959).

11. *Louisiana Canal Co. v. Heyd*, 189 La. 903, 181 So. 439 (1938); *Fontenot v. Humble Oil & Ref. Co.*, 210 So. 2d 340 (La. Ct. App. 1968) (where several lessors, owning different interests in non-contiguous tracts join, in a single lease which describes all of their property and gives a total acreage for all of the different tracts, the lease is considered a joint lease as between lessor and lessee, and the court will not admit "parol evidence to establish the severability of a lease as between lessee and lessor, where the language of the contract clearly indicates that the lease is a joint or community lease as between lessor and lessee." *Id.* 341, 344); *Hall v. LeMay*, 191 So. 2d 720 (La. Ct. App. 1966).

sion.<sup>12</sup> The doctrine of equitable pooling has evolved as a consequence of a series of Mississippi cases holding that spacing regulations based on general conservation statutes but lacking compulsory pooling provisions have the legal effect of pooling the land included into the drilling unit.<sup>13</sup> Since statutory procedures will ordinarily be followed in Mississippi to establish a compulsory unit, the doctrine of equitable pooling appears to be without further major significance in that state. Louisiana is the only other state east of the Mississippi River that has shown any support for the doctrine of equitable pooling.<sup>14</sup> Further discussion of this anomaly is left to the numerous commentators who have addressed equitable pooling.<sup>15</sup>

## 2. Express Provisions

Voluntary pooling is customarily accomplished by one of two methods: (1) lease clauses authorizing the lessee to pool or to unitize in the future and normally implemented by a written agreement; or (2) separate formal agreements between royalty owners and working interest owners to allow pooling and unitization. The second method can, of course, be utilized in the absence of an express pooling provision in the lease, so long as the agreement is executed by all the requisite parties.

The question has occasionally been raised as to whether a pooling provision violates the rule against perpetuities. This legal principle states that no interest in property is good unless it must vest, if at all, no

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12. Custy & Knowlton, *Compulsory Field-Wide Unitization Comes to Mississippi*, 36 Miss. L.J. 123, 124 (1965).

13. *Humble Oil and Ref. Co. v. Hutchins*, 217 Miss. 636, 64 So. 2d 733 (1953); *Superior Oil Co. v. Berry*, 216 Miss. 664, 64 So. 2d 357 (1953); *Hassie Hunt Trust v. Proctor*, 215 Miss. 84, 60 So. 2d 551 (1952); *Griffith v. Gulf Ref. Co.*, 215 Miss. 15, 60 So. 2d 518 (1952).

14. See *Dillon v. Holcomb*, 110 F.2d 610 (5th Cir. 1940); *Placid Oil Co. v. North Central Texas Oil Co.*, 206 La. 693, 19 So. 2d 616 (1944); see also *Williams v. Arkansas Louisiana Gas Co.*, 193 So. 2d 78 (La. Ct. App. 1966) (plaintiff who held one-eighth interest in mineral right to land under lease was entitled to an accounting of amounts due him from production on unitized property by holder of the rights to the other seven-eighths); cf. *Leonard Crude Oil Co. v. Walton*, 39 Mich. App. 293, 197 N.W.2d 503 (1972) (farm-out oil lessee commenced operations for drilling by entering into an agreement with pipeline company to drill well, attempting to go forward with well while litigation in case was commenced, requesting that tract be pooled and, after date set for expiration of lease, receiving order pooling lands). See generally Hardy, *Ruminations on the Effect of Conservation Laws and Practices on the Louisiana Mineral Servitude and Mineral Royalty*, 25 LA. L. REV. 824, 833 (1965) (analyzing the possible existence of equitable pooling in Louisiana in light of *Dillon* and *Placid*).

15. See, e.g., 1 R. MYERS, *THE LAW OF POOLING AND UNITIZATION*, § 3.03 (2d ed. 1967 & Supp. 1983); 5 W. SUMMERS, *THE LAW OF OIL AND GAS* § 972 (1966); 6 H. WILLIAMS & C. MEYERS, *supra* note 1, § 906; Gillis, *Involuntary Equitable Pooling in Mississippi*, 27 Miss. L.J. 10 (1955).

later than twenty-one years, plus the period of gestation, after some life or lives in being at the time of creation of the interest.<sup>16</sup> Arguably, a pooling provision in an oil and gas lease creates a future estate that may not vest, or come into existence, for a considerable length of time. The Kansas Supreme Court addressed this question in *Kenoyer v. Magnolia Petroleum Co.*<sup>17</sup> and held that the pooling provision was valid. A similar result was also reached in *Phillips Petroleum Co. v. Peterson*.<sup>18</sup> The Oklahoma Supreme Court, in granting a new trial on other grounds, declined to consider a trial court judgment holding that a pooling agreement was void and ineffective under the rule against perpetuities.<sup>19</sup> Nevertheless, there is sufficient doubt on the matter in many states to cause some draftsmen to impose a twenty-one year limit on the power of the lessee to pool the premises.

Absent an express limitation contained in the pooling clause as to the purposes for which the premises may be pooled or unitized, the lessee may communitize the premises for the purpose of maximizing production through any reasonable method, regardless of whether this method was known to the parties at the time of the execution of the lease. The problem, however, is that many operators utilize lease forms that contain restrictive pooling and unitization clauses. Some provisions limit the purposes or restrict the circumstances under which the power to pool or unitize may be exercised. For example, a provision that authorizes pooling or unitization "when it is necessary to do so in order to conform with any regulations or orders of the Government or any other authoritative body relating thereto"<sup>20</sup> is unnecessarily narrow. Other provisions may be silent on the critical matters of whether partial pooling is authorized or may contain restrictions with respect to the location or proximity of the land with which the leased premises may be pooled or unitized. Virtually all pooling provisions limit the maximum size of any unit that may be created, but in many instances that maximum is unnecessarily small. It is critical that the landman understand the pooling provision in his oil and gas lease and its ramifications; drillers are strongly advised to use a lease form containing a pooling provision drafted in the broadest possible language, since

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16. See generally L. SIMES, HANDBOOK OF THE LAW OF FUTURE INTERESTS 253-97 (2d ed. 1966) (discussing the rule against perpetuities).

17. 173 Kan. 183, 245 P.2d 176 (1952).

18. 218 F.2d 926 (10th Cir. 1954), cert. denied, 349 U.S. 947 (1955).

19. *Garvin v. Pettigrew*, 350 P.2d 970 (Okla. 1958), cert. denied, 364 U.S. 823 (1960).

20. 4 H. WILLIAMS & C. MEYERS, *supra* note 1, § 669.2, at 9 (example from an Alberta lease form).

courts tend to construe such language very strictly. Landmen and drillers should also use a single pooling form, since problems may arise when leases with incompatible provisions are pooled.

The authority granted a lessee to pool or to unitize does not, of course, authorize him to modify the basic provisions of the lease by inconsistent provisions in the unitization agreement.<sup>21</sup> Consequently, the pooling or unitization agreement must be consistent with the authority granted by the provision in the lease, unless the lessor becomes a party to the pooling or unitization agreement by executing or ratifying the same. In such a case the provisions of the agreement would prevail over inconsistent provisions of the lease.<sup>22</sup>

Another issue to be considered is whether the holder of the executive right to a property can agree to voluntarily pool or unitize the non-executive rights. The courts of Texas and Louisiana have addressed this issue with contradictory results. In Texas, the courts have held that the power to lease does not carry with it the power to pool. Therefore, the owner of the executive right cannot, by incorporating a pooling provision in an oil and gas lease, authorize the lessee therein to pool nonparticipating royalty interests without their consent.<sup>23</sup> This holding means that the owner of the participating rights in an oil and gas lease cannot bind the nonparticipating royalty interests by executing a pooling or unitization agreement unless the signatures of the nonparticipating royalty owners are obtained on the pooling and unitization agreement.<sup>24</sup> In contrast, the courts in Louisiana have held that the owner of a mineral servitude subject to an outstanding royalty has the power to pool the land.<sup>25</sup> The commentators are equally at odds on this issue.<sup>26</sup>

### B. *Compulsory Pooling and Unitization*

The purpose of pooling and unitization is to conserve oil and gas, prevent waste, and protect correlative rights. Because it may some-

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21. *Id.* at 93.

22. *See, e.g.*, *Waller v. Midstates Oil Corp.*, 218 La. 179, 48 So. 2d 648, 654 (1950); *Merrill Eng'g Co. v. Capital Nat'l Bank*, 192 Miss. 378, 5 So. 2d 666, 672 (1942).

23. *See Minchen v. Fields*, 162 Tex. 73, 345 S.W.2d 282, 285 (1961).

24. *See Brown v. Smith*, 141 Tex. 425, 174 S.W.2d 43 (1943); *Brown v. Getty Reserve Oil, Inc.*, 626 S.W.2d 810 (Tex. Ct. App.—Amarillo 1981 writ *dism'd w.o.j.*); *Guaranty Nat'l Bank & Trust of Corpus Christi v. May*, 395 S.W.2d 80 (Tex. Ct. App.—Waco 1965, writ *ref'd n.r.e.*).

25. *See LeBlanc v. Haynesville Mercantile Co.*, 230 La. 299, 88 So. 2d 377 (1956).

26. *Compare* 6 H. WILLIAMS & C. MEYERS, *supra* note 1, § 925.1, at 513-14 (advocating the Louisiana position), *with* 1 R. MYERS, *supra* note 15, § 4.07, at 129-32 (supporting the Texas position).



times be impossible to achieve these goals through voluntary, contractual methods, most states, through the exercise of their police power, have enacted statutes that provide for compulsory pooling or unitization. The constitutionality of such statutes has been upheld in numerous cases.<sup>27</sup>

It has been suggested that under certain circumstances a lessee may be under a duty to pool or to unitize the leased premises with other premises in order to maximize the lessor's receipts.<sup>28</sup> Commentators who have addressed the limited case authority on this issue have suggested that this implied duty arises out of the implied covenant to protect against drainage.<sup>29</sup> Traditionally, an oil and gas lessee must comply with this implied obligation by drilling an offset well, provided it is economically feasible.<sup>30</sup> To recover in an action for breach of the implied covenant to protect against drainage, a lessor must show the existence of substantial drainage from the leasehold and the profitability of an offset well.<sup>31</sup> The element of profitability requires that the production be in quantities sufficient to cover the drilling and completion costs and operating expenses, along with a reasonable return on the investment.<sup>32</sup>

Several Louisiana cases have amplified this implied covenant and have suggested that under certain circumstances a lessee may be under an implied duty to pool the leased premises being drained with adjoining property on which the draining well is located. Under this ration-

27. See generally 1 R. MYERS, *supra* note 15, §§ 8.01-.02; 1 W. SUMMERS, *supra* note 15, § 974; 6 H. WILLIAMS & C. MEYERS, *supra* note 1, §§ 902, 912-913, 940-948; Custy & Knowlton, *supra* note 12, at 123-41; Emens & Lowe, *Ohio Oil and Gas Conservation Law—The First Ten Years (1965-1975)*, 37 OHIO ST. L.J. 31 (1976); Gray & Schaefer, *Conflict Between Voluntary Pooling Agreements and State Spacing and Pooling Orders*, 27B ROCKY MT. MIN. L. INST. 1517 (1982); Hardy, *Pooling and Unitization in the Eastern United States: Part I*, 2 E. MIN. L. INST. 16-1, 16-19 (1981); Martin, *Pooling & Unitization in Mississippi & Louisiana*, THE LANDMAN 43 (July 1983); Meyers & Williams, *Petroleum Conservation in Ohio*, 26 OHIO ST. L.J. 591 (1965); Rogers & Gault, *Mississippi Compulsory Field-Wide Unitization*, 44 MISS. L.J. 185 (1973); Swan & Hallock, *The Comparisons, Contracts, and Effects of Compulsory Pooling Statutes*, 28 ROCKY MT. MIN. L. INST. 911 (1982); Williams, *Compulsory Pooling and Unitization (of Oil and Gas Rights)*, 15 OIL & GAS INST. 223 (1964); Comment, *Compulsory Unitization in Florida: A New Emphasis in the Energy Crisis?*, 27 U. FLA. L. REV. 196 (1974).

28. See Merrill, *Unitization Problem: The Position of the Lessor*, 1 OKLA. L. REV. 119, 132 (1948); Merrill, *The Modern Image of the Prudent Operator*, 10 ROCKY MT. MIN. L. INST. 107, 120 (1965).

29. 6 H. WILLIAMS & C. MEYERS, *supra* note 1, § 935, at 619; Hoffman, *Pooling and Unitization: Current Status and Developments*, 33 OIL & GAS INST. 245, 256-59 (1982).

30. See 5 H. WILLIAMS & C. MEYERS, *supra* note 1, § 822, at 79; Hoffman, *supra* note 29, at 257.

31. *Id.*

32. *Id.* §§ 822.1-.5, at 82-104; Hoffman, *supra* note 29, at 257.

ale the breach of the covenant lies not in the failure to drill an offset well but in the failure to pool the property suffering drainage with the property causing the drainage. In *Breaux v. Pan American Petroleum Corp.*<sup>33</sup> the court stated:

The implied obligation of the lessee to prevent drainage may also include an attempt to have a pooling unit formed. . . .

. . . It is conceivable, although it is not necessary for a determination to that effect to be made in this case, that the lessor would be entitled to recover damages by alleging and proving that the lessee could have created a pooling unit, thus enabling the landowner to participate in the production from the draining well, but that he failed to do so. But, even on that ground the lessor must establish the value of the minerals which he would have received if such a unit had been timely formed.<sup>34</sup>

In *Williams v. Humble Oil & Refining Co.*<sup>35</sup> the district court stated in its fifth conclusion of law:

A mineral lessee has a duty to the mineral lessor to act as a prudent administrator of the leased premises. If the lessee is draining oil or gas from beneath the leased premises by a well drilled by the lessee on other property, its duty to act as a prudent administrator may include an implied obligation to unitize the leased premises with those from which production is being obtained, or to drill an offset well, or to effect an offset completion of a well already drilled on the leased premises, if these acts are economically feasible . . . .<sup>36</sup>

The court further observed:

The implied obligation of the lessee to protect the leased premises from drainage is coupled with his obligation to use them as a prudent administrator; hence there may be an obligation on the part of the lessee who is producing from adjacent property to take some action once it learns, as it alone best knows, that it is draining oil or gas from premises that it has a duty to protect. The lessee might conceivably discharge its duty to act as a prudent administrator in various ways. It might drill an offset well or effect an additional completion of an existing well. If it thinks either that this is inadvisable

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33. 163 So. 2d 406 (La. Ct. App.), *writ denied*, 246 La. 581, 165 So. 2d 481 (1964).

34. 163 So. 2d at 415-16.

35. 290 F. Supp. 408 (E.D. La. 1968), *aff'd*, 432 F.2d 165 (5th Cir.), *reh'g denied*, 435 F.2d 772 (5th Cir. 1970), *cert. denied*, 402 U.S. 934 (1971).

36. 290 F. Supp. at 411.

under the circumstances or that it cannot be done profitably, it might have a duty to seek unitization.<sup>37</sup>

In affirming, the Fifth Circuit Court of Appeals stated:

*Breaux* makes it clear that a cause of action for damages can be predicated as much upon the lessee's failure to seek unitization as upon the more commonplace failure to drill offset wells or completions. . . .

To require the lessee in certain circumstances to seek unitization will not place an unfair burden upon him. Indeed, the concept of a duty to unitize is thoroughly compatible with the "prudent administrator" standard governing his conduct with respect to other implied covenants. . . .

. . . When the lessee himself is doing the draining on adjacent land, the argument for unitization is even more compelling.<sup>38</sup>

In *Amoco Production Co. v. Alexander*<sup>39</sup> the Texas Supreme Court held that the implied covenant to protect against drainage extends to field-wide drainage, as well as to drainage by wells on an adjoining tract. The court further stated that the duty to protect against field-wide drainage may require seeking voluntary unitization.<sup>40</sup>

Dicta in several Oklahoma cases have supported the existence of an implied duty to pool or to unitize. In *Gillham v. Jenkins*,<sup>41</sup> the Oklahoma Supreme Court stated that:

We hold that the trial court was correct in its decision that, under all the circumstances of this case, it was the duty of lessee to pool or combine the involved acreage with other acreage in order to comply with the necessary Federal rules and regulations and thus secure a market for the production.<sup>42</sup>

Although *Tidewater Oil Co. v. Penix*<sup>43</sup> involved secondary recovery, the

37. *Id.* at 422.

38. 432 F.2d at 173-74. *See also* *Baker v. Chevron Oil Co.*, 245 So. 2d 457 (La. Ct. App. 1971) (oil company employees diligently pursued unitization and there was no dereliction of duty) *aff'd*, 260 La. 1143, 258 So. 2d 531 (1972); *cf.* *Massey v. Gulf Oil Corp.*, 508 F.2d 92 (5th Cir. 1975) (recovery factor percentage did not accurately represent percentage of recovery by prudent operator in this field upon which to award damages); *Continental Oil Co. v. Blair*, 397 So. 2d 538 (Miss. 1981) (oil company had in all good faith prudently developed lease); *Waseco Chem. & Supply Co. v. Bayou State Oil Corp.*, 371 So. 2d 305 (La. Ct. App.) (failure of lessee to employ "fire flood" method of recovery constituted failure by lessee to diligently develop lease), *writ denied*, 374 So. 2d 656 (La. 1979).

39. 622 S.W.2d 563 (Tex. 1981).

40. *Id.* at 568.

41. 206 Okla. 440, 244 P.2d 291 (1952).

42. *Id.* at 443, 244 P.2d at 294.

43. 223 F. Supp. 215 (E.D. Okla. 1963).

reasoning underlying the following declaration of the district court would appear to be applicable in the pooling or unitization context: "[T]he Lessee not only had a right, but had a *duty*, to waterflood the premises for the recovery of oil for the benefit of the mineral owners should it be determined by a prudent operator to be profitable."<sup>44</sup>

### III. DUTY OF FAIR DEALING

Because the typical oil and gas lease pooling clause grants very broad authority to the lessee, the courts of some jurisdictions have tended to limit this authority by holding that there is an implied requirement that it be exercised by the lessee in good faith.<sup>45</sup> The Mississippi Supreme Court found a breach of the duty of fair dealing in the exercise of the power to pool in *Southwest Gas Producing Co. v. Seale*.<sup>46</sup> The operator, Hayes, had drilled a unit well on land owned by the plaintiff, Seale, including in the 40-acre unit 13.36 acres of Seale's land, 6.35 acres of a second party's land, and 20.29 acres of land owned by a third party, Johnson. It was alleged that part of Johnson's land had been proved nonproductive and that the operator had included this acreage in the unit in order to obtain a new lease from Johnson. The Mississippi Supreme Court found that the lessee had breached his implied covenant of good faith and stated:

Moreover, the inclusion of 20.29 acres of the Johnson land in Seale Unit No. 1, although Hayes knew that a considerable portion of the Johnson land was dry, (Johnson No. 1, recently drilled, had demonstrated that), was not in accord with the standards of a reasonably prudent operator having in mind the interests of both lessor and lessee. We do not seek here to define the nature of the restrictions on the lessee's authority under a pooling clause, but we hold that under the stated circumstances, the lessee, Hayes, did not comply with the implied requirement in the lease that he act fairly and in good faith toward his lessor, Seale. Hayes' actions in this particular pooled unit (Seale No. 1) are not such as could be reasonably expected of an operator having regard for both his and his lessor's interest. They do not comport with the duty of good faith and fair dealing under the pooling clause in the Seale lease and under the implied requirements of the lease.<sup>47</sup>

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44. *Id.* at 217 (emphasis added).

45. See cases cited *infra* notes 46 and 49.

46. 191 So. 2d 115 (Miss. 1966).

47. *Id.* at 121-22.

Even though the court found a breach of good faith, it held that the lessor was not entitled to forfeiture of the lease and remanded the cause for determination of damages.<sup>48</sup>

The broad parameters of the duty of fair dealing are also set forth in *McDonald v. Grande Corporation*.<sup>49</sup>

[T]he jurisprudence in Louisiana and in other states interprets the powers granted the lessee by a voluntary pooling clause as subject to such restrictions as will prevent arbitrary and unfair dealings and as will therefore enforce a "standard of good faith" on the part of the mineral lessee. . . .

Thus, in exercising the broad powers granted to a mineral lessee by a lease, the mineral lessee is under the duty to exercise them in accordance with the fundamental purpose for which they were granted to him by the lessor-landowner, which is to secure the greatest possible ultimate return to the landowner from the mineral development of his land. The mineral lessee must therefore act in connection with the voluntary pooling power with the good faith intention of serving the lessor-landowner's interest or, at the very least, the mineral lessee must not act in connection with such pooling power to the detriment of the lessor-landowner's interest, since in pooling the lessor-landowner's land, the lessee is acting virtually as the former's agent as well as for itself.<sup>50</sup>

The duty of fair dealing is a somewhat amorphous legal concept that arguably could be breached by any number of relatively innocent acts. Fortunately, however, the courts have tended to apply the doctrine almost exclusively in the context of pooling or unitization for the purpose of perpetuating leases whose primary terms are about to expire. In many instances such an attempt will involve the creation of a peculiarly shaped unit.

#### A. *Irregular Geometries*

*Elliott v. Davis*<sup>51</sup> was a lessor's action to cancel certain oil and gas leases on the ground that the lessees had exercised the pooling authority in bad faith.<sup>52</sup> Near the end of the primary terms of the respective

48. *Id.* at 122-23.

49. 148 So. 2d 441 (La. Ct. App. 1962), *writ denied*, 244 La. 128, 150 So. 2d 588 (1963).

50. 148 So. 2d at 449.

51. 553 S.W.2d 223 (Tex. Civ. App.—Amarillo 1977, *writ ref'd*). *See generally* Hoffman, *supra* note 29, at 250-52.

52. 553 S.W.2d at 224.

leases, the lessee had created an irregularly shaped 352-acre unit that included portions of each of the subject leases.<sup>53</sup> A gas well was completed on one of the tracts in the unit. The trial court entered a summary judgment in favor of the lessors, but the Texas Court of Civil Appeals reversed and remanded, concluding that the proof offered on the motion for summary judgment, which included evidence of the configuration of the unit, the fact that the expiration of the primary terms of the leases was imminent at the time of the pooling designation, and the operator's testimony that he did not consider a geological basis in the formation of the unit, failed to conclusively establish bad faith but instead left a fact question to be determined by the trier of fact.<sup>54</sup> Consequently, the court did not resolve the substantive issue of whether the pooling authority had been exercised in bad faith.

The good faith issue was also dealt with in *Amoco Production Co. v. Underwood*.<sup>55</sup> In *Amoco*, the lessor had created a gas unit under the pooling provisions of eight oil and gas leases that covered 2,252.03 acres. Of this total, 688.02 acres were included in the unit, which had allegedly been gerrymandered so that the lessee could continue to hold the majority of these leases, which were about to terminate for nonproduction.<sup>56</sup> The unit was designated two days before the end of the primary terms of the leases and included certain nonproductive acreage. Finding that the lessor had exercised bad faith, the trial court cancelled the unit designation and declared certain of the leases terminated for lack of production.<sup>57</sup> The Texas Court of Civil Appeals affirmed, expressing the view that the use of pooling to hold leases that would otherwise expire when the lessee has no future plans to develop constitutes bad faith.<sup>58</sup>

In a similar situation, the plaintiff in *Gorenflo v. Texaco, Inc.*,<sup>59</sup> relied on *Amoco* to contend that the 160-acre declared unit in question had been gerrymandered to include expiring leases in the vicinity of the well.<sup>60</sup> Although the personnel of one defendant admitted that the unit was formed to protect that defendant's equity position by holding

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53. *Id.* at 225.

54. *Id.* at 227.

55. 558 S.W.2d 509 (Tex. Civ. App.—Eastland 1977, writ ref'd). See generally Hoffman, *supra* note 29, at 250-52.

56. 558 S.W.2d at 511.

57. *Id.*

58. *Id.* at 512-13.

59. 566 F. Supp. 722 (M.D. La. 1983).

60. *Id.* at 727-28.

leases that were soon to expire,<sup>61</sup> other testimony indicated that the well was at the optimum location for drainage according to available seismic data.<sup>62</sup> Moreover, the evidence demonstrated that, even though the unit was not precisely centered about the well, the unit boundaries were necessarily located as they were to avoid a suspected fault that otherwise would have prevented unit acreage from being properly drained.<sup>63</sup> Consequently, the court found that the defendant lessees had acted in good faith when exercising their rights under the pooling clause.<sup>64</sup>

### B. *Holding Expiring Acreage*

The foregoing cases, while dealing with the issue of irregular geometry, also address the more typical situation that gives rise to a controversy over the duty of fair dealing: the inclusion of all or a portion of a lease within a unit, either shortly before the primary term expires or shortly before an anniversary date. Such "timing" of the unit's creation may give rise to a belief that the motivation was not conservation but rather perpetuation of the lessee's interest. There are five general situations in which this controversy may occur:

(1) All of the leased premises are included in the unit, and a well is drilled on the lease;

(2) All of the lease is included in the unit, but the well is drilled on another tract in the unit;

(3) A portion of the lease is included in the unit, and a well is drilled on that portion;

(4) A portion of the lease is included in the unit, but the well is drilled on another tract in the unit;

(5) A portion of the lease is included in the unit, and a well is drilled on the portion of the lease not included in the unit.<sup>65</sup> In each case the issue is whether the drilling of the well, whether by virtue of production in paying quantities or the mere prosecution of operations, satisfies the "thereafter" clause in the lease and extends the term of that

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61. *Id.* at 727.

62. *Id.* at 727-28. This fact situation is similar to those in *Boone v. Kerr-McGee Oil Indus.*, 217 F.2d 63 (10th Cir. 1954), where the court found the unit was valid and rejected the bad faith argument.

63. *Id.*

64. *Id.*

65. See 6 H. WILLIAMS & C. MEYERS, *supra* note 1, §§ 950-953, at 694.3-715.

lease.<sup>66</sup> There is no authority with respect to the fifth scenario, but the other four have been addressed in numerous cases.

Where the entire lease is included in the unit and production is thereafter obtained or drilling operations are prosecuted, whether on the lease or on some other tract within the unit, the general rule is that there has been no breach of the duty of fair dealing and that the lease remains in full force and effect.<sup>67</sup> In the second situation, where part of the lease is included in the unit and production is thereafter obtained, or drilling operations are thereafter prosecuted, on that portion of that lease, it is generally held that production on the portion of the lease included within the unit is sufficient to keep the lease alive in its entirety after the expiration of the primary term under the language of the typical "thereafter" clause, unless the lease or unitization agreement contains a specific provision to the contrary.<sup>68</sup>

More problematic is the situation in which a portion of the lease is included in the unit and either production is obtained or drilling operations are thereafter prosecuted on a portion of the unitized or pooled area other than the portion of the lease that is included within the unit. When the pooling or unitization has been the result of compulsory processes, the entire lease has customarily been continued in force by production on the unit, even though production occurs off the lease in question.<sup>69</sup> This result appears to have turned upon the construction of the statute or pooling order; the critical question being whether the

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66. The habendum clause of a modern oil and gas lease typically provides for a short primary term of from one to five years, subject to extension for "so long thereafter" as oil, gas, or other specified minerals are produced in paying quantities or operations for oil and gas are being conducted on the premises. 3 H. WILLIAMS & C. MEYERS, *supra* note 1, §§ 601.4, 603.3(f). In construing the phrase "paying quantities," the critical question is whether the lessee will receive a financial benefit from production. *Id.* § 604.6. Drilling operations for the purpose of extending a lease beyond its primary term may be described as any work or operations undertaken *in good faith* for the purpose of satisfying the lessee's obligations under the lease, followed diligently and in due course by the actual drilling of a well. *Id.* § 618.1.

67. *See, e.g.*, Gorenflo v. Texaco, Inc., 566 F. Supp. 722 (M.D. La. 1983); Crichton v. Lee, 209 La. 561, 25 So. 2d 229 (1946); Hardy v. Union Producing Co., 207 La. 137, 20 So. 2d 734 (1944); Rebstock v. Birthright Oil & Gas Co., 406 So. 2d 636 (La. Ct. App.), *cert. denied*, 407 So. 2d 742 (La. 1981); Superior Oil Co. v. Beery, 216 Miss. 664, 63 So. 2d 115, 64 So. 2d 357 (1953); Merrill Eng'g Co. v. Capital Nat'l Bank, 192 Miss. 378, 5 So. 2d 666 (1942); *cf.* Morris v. Mayden, 35 Ill. App. 3d 338, 341 N.E.2d 428 (1976) (executory interest did not ripen into possessory interest because production from term acreage extended term lease).

68. *See, e.g.*, Wells v. Continental Oil Co., 244 Miss. 509, 142 So. 2d 215 (1962). *See also* Custy & Knowlton, *supra* note 12, at 138-40 (discussing the effect of the Mississippi compulsory unitization statute upon the "thereafter" clause).

69. *See, e.g.*, Broussard v. Amerada Petroleum Corp., 350 F. Supp. 104 (W.D. La. 1972); Dubois v. Midwest Oil Corp., 219 F. Supp. 593 (W.D. La. 1963); LeBlanc v. Danciger Oil & Ref. Co., 218 La. 463, 49 So. 2d 855 (1950); Kimbrough v. Atlantic Ref. Co., 152 So. 2d 412 (La. Ct. App.), *writ denied*, 244 La. 666, 153 So. 2d 882 (1963).



statute or order expressly or implicitly provided that production from the unit would be treated as production from every leasehold, any part of which is included in the unit.<sup>70</sup> The Mississippi Supreme Court, in *Texas Gulf Producing Co. v. Griffith*,<sup>71</sup> focused on the issue of whether a lease expired at the end of the primary term as to acreage excluded from the unit and concluded that the Mississippi compulsory pooling statute did not contemplate that production from a well on the unitized area would extend to leased land outside of the unit.<sup>72</sup> An illustrative example of typical compulsory pooling legislation is the state of Ohio's pooling statute, which provides:

From and after the date of a pooling order, all operation, including the commencement of drilling or the operating of or production from a well upon any tract or portion of the drilling unit, shall be deemed for all purposes the conduct of such operations upon and production from any lease or contract for lands any portion of which is included in the drilling unit.<sup>73</sup>

Needless to say, such language does not clearly address the question of whether unit production holds the outside acreage.

In the voluntary pooling or unitization situation, the courts customarily have focused on the construction of the express provision in

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70. *Delatte v. Woods*, 232 La. 341, \_\_\_, 94 So.2d 281, 287-89 (1957); *cf.* *Odom v. Union Producing Co.*, 243 La. 48, 141 So. 2d 649 (1962) (a portion of the lease was held by production in a forced pooled unit with the producing well and shut-in, the lessee voluntarily pooled the remainder of the lease which voluntary unit had a pre-existing gas well off the lease and the remainder was held by payment of shut-in royalties); *Texas Gulf Producing Co. v. Griffith*, 218 Miss. 109, \_\_\_, 65 So. 2d 447, 451-53 (1953) (leased land outside the unit, segregated from leased land which was pooled, was not held by production on the unit on land). *See generally* 6 H. WILLIAMS & C. MEYERS, *supra* note 1, § 953, at 718-26.5; Comment, *Production from Compulsory Pooled Unit Extends Lease on Outside Acreage?*, 33 ROCKY MTN. L. REV. 184 (1961).

71. 218 Miss. 109, 65 So. 2d 447 (1953).

72. *Id.* at \_\_\_, 65 So. 2d at 452 (the acreage excluded was non-contiguous with the acreage included in the unit). For a commentary on the Mississippi statute, see 6 H. WILLIAMS & C. MEYERS, *supra* note 1, § 953, at 721-26.1. *See generally* Custy & Knowlton, *supra* note 12, at 130. MISS. CODE ANN. § 53-3-111 (Supp. 1983) currently provides that, when an oil and gas lease covers land that is partially within and partially without a unit, production from the unit will have no force and effect on lands outside the unit and that failure to drill and develop such lands outside the unit within one year of the date of determination of the unit area by the state oil and gas board or during the term of the lease, whichever is the longer period of time, will render the lease void as to the land outside the unit, unless it is held by production other than the unit production.

73. OHIO REV. CODE ANN. § 1509.27 (Baldwin 1983); *see also* ALA. CODE § 9-17-87 (1980); ILL. ANN. STAT. ch. 96½, §§ 5436(c), 5452(4) (Smith-Hurd 1979); KY. REV. STAT. § 353.630(4) (1983); MICH. COMP. LAWS ANN. § 319.363 (West 1967); MISS. CODE ANN. § 53-3-7(a) (1972); N.Y. ENVTL. CONSERV. LAW § 23-0901(3) (McKinney 1973); OHIO REV. CODE ANN. § 1509.28 (B) (Baldwin 1982); 58 PA. CONS. STAT. ANN. § 408(b) (Purdon 1964); S.C. CODE ANN. § 48-43-340(B) (Law. Co-op. Supp. 1983); W. VA. CODE § 22-4A-7(b)(2) (1981).

the lease or agreement dealing with the effect of production on the unit. Several Louisiana cases have addressed the duty of fair dealing in the voluntary context. *Wilcox v. Shell Oil Co.*<sup>74</sup> involved a lease that covered 550 acres and contained a pooling provision. A forced pooling order creating a 160 acre unit, composed of 80 acres from the 550 acre Wilson lease and 80 acres from adjoining land, was issued as to two sands, but did not apply to a third sand encountered in the drilling of a test well and which gave promise of production.<sup>75</sup> The well was commenced on property adjoining to the Wilson lease and was completed as a producer in the third sand, however, production in the third sand did not extend the Wilson leases under the pooling order. Thereafter, the lessee recorded a declaration of a unit area as to the third sand pursuant to the pooling clause of the lease, one day before the due date for delay rentals. The new 40 acre unit included 20 acres of the 550 acre Wilson lease and 20 acres of the adjoining lease on which the producing well had been drilled. No delay rentals were paid and the lessee contended that production from the well had kept the lease alive. The court, in an action to cancel the lease in its entirety, held that the lease did not survive the lessee's failure to timely pay delay rentals.<sup>76</sup> Two potential explanations for the court's decision exist. First, it could be argued that the court's holding flowed from a strict construction of the language of the pooling clause in favor of the lessor and against the lessee, with the determinative fact being that the well was drilled before the unit was established.<sup>77</sup> Second, the case may stand for the proposition that under the duty of fair dealing the lessee may not utilize a pooling clause to keep the lease alive by a last-minute pooling order.<sup>78</sup>

*Mize v. Exxon Corp.*<sup>79</sup> involved an Alabama Oil and Gas Board order that unitized operations for an extensive pool within three fields. The unit included the plaintiff lessors' 39 acres, but only one acre was within the revenue sharing "productive limits." The lessors claimed

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74. 226 La. 417, 76 So. 2d 416 (1954).

75. *Id.* at \_\_\_, 76 So. 2d at 418.

76. *Id.* at \_\_\_, 76 So. 2d at 422.

77. *Id.* at \_\_\_, 76 So. 2d at 420-21. This interpretation of *Wilcox* has been forwarded by different courts. See *Harper v. Hudson Gas & Oil Corp.*, 299 F.2d 238, 242 (5th Cir. 1962); *Miller v. Kellerman*, 228 F. Supp. 446, 460-61 (W.D. La. 1964), *aff'd*, 354 F.2d 46 (5th Cir. 1965), *cert. denied*, 384 U.S. 951 (1966); *Odom v. Union Producing Co.*, 243 La. 48, \_\_\_, 141 So. 2d 649, 664 (1966) (pooling clause in question authorized pooling after production and did not require the production to be from a well completed prior to production on the unit).

78. *Cf.* 226 La. at \_\_\_, 76 So.2d at 421-22 (plaintiffs signed a division order as to the 40 acre unit but knew nothing about the different sands and the significance of the different formations).

79. 640 F.2d 637 (5th Cir. 1981).

damages for drainage by the unit from the 38 acres not included in the unit and sought cancellation under the terms of the lease and for lack of development.<sup>80</sup> The trial court granted summary judgment for the lessee, dismissing the plaintiffs' claim for cancellation. On appeal, the court of appeals reversed the summary judgment and held that the lessee's implied duty to reasonably develop the premises existed whether or not there was a pooling or unitization order.<sup>81</sup>

Notice also should be taken of two recent cases involving the issue of whether production from the unit extends the primary term of the leases included therein as to horizons not included in the unit. *Ego Oil Co. v. Garner*<sup>82</sup> was an action by the plaintiff oil company for a declaratory judgment that its leases were valid and in full force and effect as to all of defendants' real property, including all geological formations covered by the leases.<sup>83</sup> The unitization agreement at issue had created a unit that was defined as being all formations from the surface down to the base of the Sainte Genevieve geological formation.<sup>84</sup> Moreover, the sixth paragraph of the unitization agreement stated that:

[C]ontinued operation of a well under the terms of each lease, mineral deed, royalty conveyance or other instrument covering any portion of the unit area, and the production of oil from any separate tract in the unit . . . shall continue each of said leases . . . in full force and effect as to all lands and formations covered thereby in the same manner and to the same extent as though produced from the land described in and covered by it.<sup>85</sup>

Although it was stipulated that there was production from the unit, there was no actual production from the Luttrell lease included therein; and the Luttrells granted a new lease subsequent to the expiration of the original lease's primary term.<sup>86</sup>

The trial court concluded that production from the unit perpetuated the original lease as to all formations down to the base of the Sainte Genevieve formation, but the court declared the lease terminated as to all lower formations.<sup>87</sup> The court of appeals affirmed the

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80. *Id.* at 638.

81. *Id.* at 641.

82. 115 Ill. App. 3d 82, 450 N.E.2d 375 (1983) (Luttrells were the lessors and Garner was a subsequent lessee of the Luttrells).

83. *Id.* at \_\_\_, 450 N.E.2d at 375.

84. *Id.* at \_\_\_, 450 N.E.2d at 376.

85. *Id.*

86. *Id.*

87. *Id.* at 376-77.

trial court as to formations from the surface down to the base of the Sainte Genevieve formation, but reversed the trial court's finding that the leases in question had terminated as to formations below the base of the Sainte Genevieve formation, stating that:

[A] majority of courts which have had occasion to consider the question here presented have held that production of oil within a unit extends the lease beyond its primary term as to the lands covered by the lease but not included in the unitized area. The rationale behind the majority rule is that since unitization provides an efficient and less expensive method of oil and gas recovery, allowing lease termination as to outside acreage would discourage unitization and this would be contrary to public policy. We conclude that the majority rule is a sound one and should be followed in Illinois.

Defendants urge that we should not follow the majority rule and suggest that we distinguish between vertical and horizontal divisions of land. That is, defendants maintain that most of the cases applying the majority rule concern vertical divisions of the land based upon surface boundaries and not horizontal divisions based upon geographical formations below the surface. However, we fail to perceive the importance of the distinction which defendants attempt to draw. The public policy favoring economical use of our limited resources of oil and gas remains the same whether the lands are divided vertically or horizontally. Therefore, we conclude that production in the unitized area extended the term of the entire lease regardless of the fact that the division may be described as being horizontal.<sup>88</sup>

In *Morgan v. Mobil Oil Corp.*,<sup>89</sup> the plaintiff lessors sought a legal determination as to whether their leases with the defendant had terminated, particularly as to production from all geological formations below the Panoma-Council Grove formation.<sup>90</sup> The plaintiffs argued that the defendant had "no rights to formations below the Panoma-Council Grove horizon, since the 1938 unit operating agreement and the 1974 amendment thereto did not perpetuate its rights to geological horizons below the Panoma-Council Grove formation."<sup>91</sup> The court focused on

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88. *Id.* at 378-79 (citations omitted).

89. 556 F. Supp. 108 (D. Kan. 1983).

90. *Id.* at 108.

91. *Id.* at 112 (emphasis deleted).

two provisions of the 1938 unit operating agreement. The first provided:

The production of oil and/or gas from said unitized area in paying quantities, shall perpetuate the oil and gas rights of Lessee under all of said leases in said entire unitized area and relieve Lessee from all further obligation to drill and/or to pay delay rentals under any and all leases covering lands within said area. . . .<sup>92</sup>

The second provided:

This agreement and the rights of Lessee under all leases covering parcels within the unitized area, shall be and remain in full force and effect so long as oil or gas is produced in paying quantities anywhere in said area, and shall not be affected by the expiration of the primary term of said leases, or any of them.<sup>93</sup>

The court noted the above-quoted provisions of the unitization agreement and stated that:

[P]roduction from the unitized "area" perpetuates the lessee's rights. The terms "tract" . . . and "part" . . . are synonymous with "area", and thus can apply to both horizontal and vertical divisions. In the case at bar nothing in the instruments would abrogate the application of the above general principles to perpetuate plaintiffs' leases beyond their primary term.<sup>94</sup>

As the cases above suggest, the question of holding expiring acreage through pooling or unitization is one that depends not only upon the application of the standards of good faith and fair dealing, but also upon strict construction of the pertinent pooling and unitization lease provisions. It is critical to remember that if the provision in question does not authorize partial pooling, then the issue of whether partial pooling of the lease would extend the term of the entire lease cannot arise, since partial pooling would not be authorized by the terms of the lease. Moreover, other lease provisions may affect the above-described results. Some leases, for instance, include the so-called "Pugh clause," which customarily effects a severance of the lease where less than all of the leasehold is included in a single unit.

The typical Pugh clause provides that the formation of a unit that includes less than all of the leased premises will cause the pooled and

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92. *Id.* at 111 (emphasis deleted).

93. *Id.* at 111-12.

94. *Id.* at 113 (footnote and citations omitted).

unpooled portions of the lease to be treated as if subject to separate leases. For example:

If any part of the mineral lands covered hereby are pooled or unitized by voluntary or compulsory process and this lease is not then otherwise perpetuated by its own production not pooled or unitized, its acreage not pooled or unitized shall be segregated from that pooled or unitized and the acreage so segregated shall continue under the primary term hereof with an annual payment of delay rentals proportionately related to that acreage calculated as in the assignment clause hereof, or such acreage may be held by any other means permitted by this lease to keep it in force and effect.<sup>95</sup>

Where a lease containing such a provision is pooled or unitized, operations on, or production from, the unit will keep the lease alive only as to the portion of the lease included in the unit. The actual result in any case will depend upon an analysis of the Pugh clause in question. It should be noted, however, that the courts of Louisiana have held in a series of cases that when a compulsory unit is formed under the provisions of an applicable statute, the provisions of that statute and the unit plan, rather than the provisions of the lease, will govern.<sup>96</sup>

#### IV. HOLES IN THE UNIT

The efficiency of pooled or unitized operations decreases in inverse proportion to the number of holes or windows that appear in the unit.<sup>97</sup> Consequently, the refusal of the lessor to become a party to a voluntary pooling or unitization agreement may frustrate establishment of the unit in the absence of some compulsory process. The problem of non-joining interest owners is rare in compulsory poolings, but may arise when there is a failure to include productive acreage in a pool. However, this problem can be resolved by supplemental compulsory inclusion of the additional acreage.<sup>98</sup> With respect to voluntary poolings and unitizations, however, it is clearly impractical to proceed without a high percentage of commitment from royalty owners and an even

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95. 6 W. SUMMERS, *supra* note 15, § 1127, at 16.

96. *Bennett v. Sinclair Oil & Gas Co.*, 275 F. Supp. 886 (W.D. La. 1967), *aff'd*, 405 F.2d 1005 (5th Cir. 1968); *Smith v. Carter Oil Co.*, 104 F. Supp. 463 (W.D. La. 1952); *Odom v. Union Producing Co.*, 129 So. 2d 530 (La. Ct. App.), *rev'd*, 243 La. 48, 141 So. 2d 649 (1961).

97. The terms "hole" and "window" are colloquialisms used to describe unsigned interests affecting a pooled or unitized area. See 1 R. MYERS, *supra* note 15, § 14.03, at 499.

98. 5 W. SUMMERS, *supra* note 15, § 976, at 129.

higher percentage of commitment from working interest owners.<sup>99</sup> Nevertheless, there may be, and usually are, some nonconsenting parties in unitizations. The typical holdout is a royalty interest owner where the corresponding working interest is committed, but the reverse can occur.<sup>100</sup>

Pooling and unitization agreements are "effective and enforceable as to those who sign them, and preexisting oil and gas leases and other contracts will be modified to the extent that the unit agreements are in conflict with them."<sup>101</sup> Once unit operations commence, however, problems will be encountered with respect to unsigned interests since preexisting oil and gas leases and other contracts of those refusing to join remain in effect and unmodified by the unit agreements.<sup>102</sup> Normally, a lessee who unitizes the working interest will continue to be liable to account to his lessor for a royalty on all oil and gas produced from a well or wells located on the leased premises.<sup>103</sup> If, however, the lessor has not joined in the pooling or unitization agreement, the lessee's express and implied covenant obligations will probably not be affected by the pooling or unitization, and production on the unit but off the lease in question will not suffice to extend the lease beyond the primary term.<sup>104</sup> The properties of the non-signers cannot, of course, be used for the benefit of the unit and operations on a non-signer's tract must usually be confined to the benefit of that tract alone. Consequently, significant problems can be created where sound conservation practices require that pressure maintenance, recycling, and secondary recovery operations be pursued.

The lessor's control over such operations upon his own land has been the subject of litigation in two cases in Illinois. In *Ramsey v. Carter Oil Co.*,<sup>105</sup> the defendant lessee was enjoined from converting a producing well into a gas injection well as part of secondary recovery operations on a large tract that included the plaintiffs' premises on the theory that the injection well would drive some oil from beneath the plaintiffs' premises.<sup>106</sup> The court held that the oil was a part of the

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99. *Id.*

100. *Id.*

101. 1 R. MYERS, *supra* note 15, § 14.03, at 499.

102. *Id.*

103. *See, e.g.*, *Smith Petroleum Co. v. Van Mourik*, 302 Mich. 131, 4 N.W.2d 495 (1942).

104. *See, e.g.*, *Belden v. Tri-Star Producing Co.*, 106 Ill. App. 3d 192, 435 N.E.2d 927 (1982); *Knight v. Chicago Corp.*, 144 Tex. 98, 188 S.W.2d 564 (1945).

105. 74 F. Supp. 481 (E.D. Ill. 1947), *aff'd*, 172 F.2d 622 (7th Cir.), *cert. denied*, 337 U.S. 958, *reh'g denied*, 338 U.S. 842 (1949).

106. 74 F. Supp. at 483.

underground land and that the removal of any oil from under the plaintiffs' land was an interference with the plaintiffs' property rights, even though the plaintiffs would have received more oil from the remaining portion of their land by virtue of the gas injection program.<sup>107</sup>

In the subsequent case of *Carter Oil Co. v. Dees*,<sup>108</sup> the same field, the same lessee, and the same repressuring operation were involved as in *Ramsey*. The lessee sought a declaratory judgment that it could convert one of four producing wells on a 40-acre tract into a gas injection well. It was contended that this was in accord with approved operating practices and would be the plan adopted by the prudent operator having in mind the best interest of the lessors as well as the lessee.<sup>109</sup> The court refused to follow *Ramsey* and distinguished it on the basis that the court therein did not find that the proof met the test of what a reasonably prudent operator having in mind the interests of both lessor and lessee would do.<sup>110</sup>

Such problems as these, along with the rather considerable confusion in accounting that would be created by the failure of interest owners to sign the unit agreements, serve to emphasize the importance of compulsory pooling and unitization. When a voluntary pooling or unitization agreement among all the interest owners cannot be reached, compulsory pooling or unitization should certainly be considered.<sup>111</sup>

Alternatively, although not a recommended course of action, an operator who is confronted with interest owners who refuse to execute the pooling or unitization agreement might attempt to bind them to the agreement under principles of ratification or estoppel by inducing them to accept royalties.<sup>112</sup> The mere acceptance of production royalties, however, may not have the effect of binding the lessors to unitization agreements that they have refused to sign. An Illinois appellate court held in *Beldon v. Tri-Star Producing Co.*<sup>113</sup> that the lessors would not

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107. *Id.* at 482.

108. 340 Ill. App. 449, 92 N.E.2d 519 (1950).

109. *Id.* \_\_\_, 92 N.E.2d at 520.

110. *Id.* at \_\_\_, 92 N.E.2d at 523-24. See also Campbell, *Oil and Gas Conservation in Illinois*, 1959 U. ILL. L.F. 570, 581-83; Myers, *Problems of Pooling, Unitization, and Secondary Recovery*, 1959 U. ILL. L.F. 543, 566-67.

111. See, e.g., *Sylvania Corp. v. Kilborne*, 28 N.Y.2d 427, 271 N.E.2d 524, 322 N.Y.S.2d 678 (1971).

112. See *Mize v. Exxon Corp.*, 640 F.2d 637 (5th Cir. 1981); *Ego Oil Co. v. Garner*, 115 Ill. App. 3d 82, 450 N.E.2d 375 (1983); *Bi-County Properties v. Wampler*, 61 Ill. App. 3d 799, 378 N.E.2d 311 (1978); *Dobbins v. Hodges*, 208 La. 143, 23 So. 2d 26 (1945). See generally Brunini, *Estoppel, Adoption, and Ratification Affecting Oil, Gas and Mineral Leases, Pooling and Unitization Agreements*, 9 OIL & GAS INST. 165, 206-08 (1958).

113. 106 Ill. App. 3d 192, 435 N.E.2d 927 (1982).



be bound by a unitization agreement unless the benefit accepted consisted of royalty payments computed according to the figures established in the unitization agreement.<sup>114</sup>

It is critical to remember that even though a lease contains a pooling and unitization provision, voluntary pooling or unitization cannot be effected unless the lease itself is valid. For instance, in the absence of statutes expressly addressing this issue, "there are serious questions concerning the authority of a fiduciary or a person in a quasi-fiduciary role to enter into a pooling or unitization agreement or to execute a lease containing a pooling clause."<sup>115</sup> Several states have enacted statutes that expressly authorize fiduciaries to do this.<sup>116</sup> In Ohio, for instance, the law provides that a guardian may lease the possession and use of any lands belonging to the ward containing coal, oil, natural gas, or any other mineral substances for the purpose of mining or removing such substance "for such time as the probate court approves."<sup>117</sup>

Many parcels of real estate have been deeded for specific purposes such as for educational, religious, or cemetery use; or for streets, parks, or rights of way. If the grant is in fee simple, such property may probably be leased for oil and gas purposes, but the deed must be examined to determine whether any restrictive covenants exist that would limit the right of the grantee to grant an oil and gas lease. If the municipality owns strips dedicated or granted for street or highway purposes, it normally will have the right to grant an oil and gas lease, subject to any constraints imposed by applicable state or local law.<sup>118</sup> The ability to lease lands needed for parks or playgrounds will follow the same principle.<sup>119</sup> Similarly, when state or federal lands are to be included in the area to be pooled or unitized, appropriate state and federal law governing pooling and unitization should be strictly followed.<sup>120</sup>

One must carefully consider the language of the deed if churches and cemeteries are found in the middle of an oil field. If there is any

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114. *Id.* at \_\_\_, 435 N.E.2d at 938.

115. 6 H. WILLIAMS & C. MEYERS, *supra* note 1, § 925.6, at 523.

116. *See, e.g.*, FLA. STAT. ANN. § 744.441(6) (West Supp. 1983) (requires court approval); ILL. ANN. STAT. ch. 110½, § 20-20 (Smith-Hurd Supp. 1983-84) (subject to court approval); KY. REV. STAT. § 353.240 (1983) (subject to circuit judge approval).

117. OHIO REV. CODE ANN. § 2111.26 (Baldwin 1982).

118. *See* 2 W. SUMMERS, *supra* note 15, § 221, at 42.

119. *Id.* at 44 n.48.6.

120. *See generally* R. MYERS, *supra* note 15, §§ 11.01-09 (discussion of unitization on public lands).

special wording,<sup>121</sup> it must be construed as placing a restriction upon the use of the land, and the validity of an oil and gas lease would be doubtful. If, after careful consideration, it is determined that a church or a cemetery association has the full right and power to lease the land, a lease may be taken from either by following the proper procedure. The majority viewpoint, however, seems to be that a church may not lease a cemetery site for geophysical exploration purposes or production activity and that any burial lot owner or any relative of a person buried in a cemetery can enjoin the drilling for oil on dedicated cemetery land.<sup>122</sup> Consequently, a non-drilling lease would always seem to be advisable in this type of situation.

## V. CONSEQUENCES OF POOLING AND UNITIZATION

### A. Antitrust Considerations

One commonly stated obstacle to voluntary unitization is the fear of violating antitrust laws.<sup>123</sup> Only one case directly relating to a unitization program, *United States v. Cotton Valley Operators Committee*,<sup>124</sup> has thus far been reported. *Cotton Valley*, which originated in the District Court for the Western District of Louisiana, was dismissed by the trial court on grounds not related to the merits of the issue.<sup>125</sup> The dismissal was affirmed by a divided United States Supreme Court without opinion.<sup>126</sup> In many states voluntary units are expressly au-

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121. For example, a reversionary clause may state that once the land has ceased to be used for the purposes granted, it will revert to the grantor or his heirs.

122. See, e.g., *Humphreys v. Bennett Oil Corp.*, 195 La. 531, 197 So. 222 (1940); *Briggs v. Bloomingdale Cemetery Ass'n*, 113 Misc. 685, 185 N.Y.S. 348 (N.Y. Sup. Ct. 1920), *aff'd mem.*, 11 A.D.2d 821, 202 N.Y.S. 918 (N.Y. App. Div. 1924) (mining of gypsum denied); *Boggs v. McCasland*, 117 Okla. 54, 244 P. 768 (1926); *Eternal Cemetery Corp. v. Tammen*, 324 S.W.2d 562 (Tex. Civ. App.—Ft. Worth 1959, writ ref'd n.r.e.); *Houston Oil Co. v. Williams*, 57 S.W.2d 380 (Tex. Civ. App.—Texarkana 1933, writ ref'd); *White v. Williams*, 57 S.W.2d 385 (Tex. Civ. App.—Texarkana 1933, no writ); *Cochran v. Hill*, 255 S.W. 768 (Tex. Civ. App.—Ft. Worth 1923, no writ); See generally *Ritter v. Couch*, 71 W. Va. 221, 76 S.E. 428 (1912); 2 W. SUMMERS, *supra* note 15, § 221, at 45-51; *Smith, Oil and Gas Leases*, 26 OHIO ST. L.J. 370, 378 (1965); Comment, *Oil and Gas: Developing Cemeteries in Oklahoma for Oil and Gas Purposes*, 8 OKLA. L. REV. 474 (1955).

123. See, e.g., *Custy & Knowlton*, *supra* note 12, at 132-34; King, *Pooling and Unitization of Oil and Gas Leases*, 46 MICH. L. REV. 311, 326-27 (1948); Searls, *Antitrust and Other Statutory Restrictions of Unit Agreements*, 3 OIL & GAS INST. 63 (1952).

124. 75 F. Supp. 1 (W.D. La. 1948), 77 F. Supp. 409 (W.D. La. 1948), *aff'd per curiam*, 339 U.S. 940, *reh'g denied*, 339 U.S. 972 (1950).

125. Three motions were filed by defendants. The trial court denied the motion to dismiss and the motion for production of certain documents. The court, however, partially granted a motion for a more definite statement of the facts. This appears to be why the United States appealed. See 77 F. Supp. at 413-14.

126. *Cotton Valley*, 339 U.S. 940.

thorized and frequently are exempted from state antitrust laws.<sup>127</sup> Nevertheless, to lessen the possibility of an antitrust action, it is advisable to avoid any semblance of price fixing, to welcome outsiders who want to participate in the pooling or unitization agreement, to set out the conservation purposes in the agreement, and to assure that each operator who owns a share of the processing plant of the unit also owns an identical share in the gas that goes into the plant and the products of such gas.<sup>128</sup>

### B. *Nature of Unitized Title*

One of the abiding questions concerning pooling and unitization agreements is whether they are mere contracts or instead create cross-conveyances of interests in land.<sup>129</sup> In other words, the issue posed is whether the agreement merely gives each owner a contract right to share in the production from premises other than those that he has contributed, or whether it conveys some of his interest to the owners of other leases in the unit while conveying part of their interest to him. Numerous consequences may flow from the determination of this issue, including the following:

(1) If a pooling or unitization agreement effects cross-conveyances, all persons having interests in the pooled or unitized premises are necessary parties to an action involving any one parcel included in the agreement;

(2) If a cross-conveyance is effected, one should obtain the consent of all persons having operating or nonoperating interests in the premises affected by a pooling or unitization agreement;

(3) If the cross-conveyance theory is followed, a voluntary pooling or unitization agreement involves the conveyance of interests in

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127. ALA. CODE § 9-17-13(e) (1980); FLA. STAT. ANN. § 377.29 (West 1974); GA. CODE ANN. § 43-706(b) (Supp. 1982); IND. CODE ANN. § 13-4-7-14(e) (Burns 1981); KY. REV. STAT. § 353.565(9) (1983); MICH. COMP. LAWS ANN. § 319.374 (West 1967); MISS. CODE ANN. § 53-3-7(e) (1973); N.Y. ENVTL. CONSERV. LAW § 23-0701 (McKinney Supp. 1983-84); OHIO REV. CODE ANN. § 1509.41 (Baldwin 1982); PA. STAT. ANN. tit. 58, § 409 (Purdon 1964); S.C. CODE ANN. § 48-43-360 (Law. Co-op. Supp. 1983); W. VA. CODE § 22-4A-9 (1981).

128. See 1 R. MYERS, *supra* note 15, at § 12.05. See generally *id.* §§ 12.01-.04 (discussing federal and state antitrust laws and the *Cotton Valley* decision); 6 WILLIAMS & MEYERS, *supra* note 1, at § 911 (discussing voluntary unitization and application of antitrust laws); Burke & Oliver, *Current Antitrust Developments in Oil and Gas Exploration and Production*, 30 OIL & GAS INST. 271 (1979); Whitaker and King, *Antitrust Considerations for the Oil Industry—From the Producing Fields to the Service Station*, 24 OIL & GAS INST. 25 (1973) (discussing application of antitrust statutes to various aspects of the petroleum industry).

129. See generally, 1 R. MYERS, *supra* note 15, § 13.02; 5 W. SUMMERS, *supra* note 15, § 956; 6 H. WILLIAMS & C. MEYERS, *supra* note 1, §§ 929-929.2.

land, and the requirements of the statute of frauds and of conveyancing statutes must be satisfied;

(4) If the cross-conveyance or contract theory is adopted, a pooling or unitization agreement may affect the application of venue statutes to various controversies;

(5) If a pooling or unitization agreement is viewed as a cross-conveyance, it is arguable that execution of such an agreement brings into play doctrines relating to the operation of recordation statutes and the bona fide purchaser doctrine.<sup>130</sup>

Texas has adopted the cross-conveyance theory.<sup>131</sup> There is no clear holding on this question in Louisiana despite language in several Louisiana cases suggesting the acceptance of the cross-conveyance theory,<sup>132</sup> Williams and Meyers have concluded that the Louisiana courts are inclined to reject the cross-conveyance theory.<sup>133</sup> A federal court in Mississippi has also concluded that cross-conveyances are effected by a unitization agreement.<sup>134</sup> Although there is no clear authority in Pennsylvania on this question, an early case involving a coal lease suggests that a unitization agreement would not amount to a conveyance.<sup>135</sup> Similarly, there is language in several West Virginia cases that suggests a rejection of the cross-conveyance theory.<sup>136</sup> At one time, Illinois apparently adopted the cross-conveyance theory,<sup>137</sup> but it has since adopted a statute that provides that plans of unitization, including unit

130. See 6 H. WILLIAMS & C. MEYERS, *supra* note 1, § 929.1.

131. See, e.g., *Minchen v. Fields*, 162 Tex. 73, \_\_\_, 345 S.W.2d 282, 285 (1961); *Renwar Oil Corp. v. Lancaster*, 154 Tex. 311, 276 S.W.2d 774 (1955); *Brown v. Smith*, 141 Tex. 425, 174 S.W.2d 43 (1943); *Veal v. Thomason*, 138 Tex. 341, 159 S.W.2d 472 (1942); *Kelln v. Brownlee*, 517 S.W.2d 568 (Tex. Civ. App. \_\_\_, Amarillo 1974, writ ref'd n.re.). *But see* *Sohio Petroleum Co. v. Jurek*, 248 S.W.2d 294 (Tex. Civ. App. \_\_\_, Ft. Worth 1952, no writ) (court stated that cross-conveyance point was not well taken).

132. See, e.g., *Monsanto Chem. Co. v. Southern Natural Gas Co.*, 234 La. 939, \_\_\_, 102 So. 2d 223, 226 (1958); *Coyle v. North American Oil Consol.*, 201 La. 99, 9 So. 2d 473 (1942); *Martel v. A. Veeder Co.*, 199 La. 423, 6 So. 2d 335 (1942).

133. 6 H. WILLIAMS & C. MEYERS, *supra* note 1, § 930.3 and cases cited therein.

134. *Hudson v. Newell*, 172 F.2d 848, 852-53 (5th Cir.), *modified on reh'g*, 174 F.2d 546 (5th Cir. 1949) (*en banc*) (paragraph six of the original opinion, concerned with the cross-conveyance theory, was withdrawn); see also *Custy & Knowlton*, *supra* note 12, at 134-35 (suggesting that Mississippi will probably follow the cross-conveyance theory).

135. *Coolbaugh v. Lehigh & Wilkes-Barre Coal Co.*, 218 Pa. 320, 67 A. 615 (1907) (owners of two adjoining tracts executed a joint coal lease under which royalties were placed in a "hotch pot" and when one lot was sold at a judicial sale, it divested the owner of any claim to the hotch pot).

136. *Bogges v. Milam*, 127 W. Va. 654, \_\_\_, 34 S.E.2d 267, 270 (1945); *Lynch v. Davis*, 79 W. Va. 437, \_\_\_, 92 S.E. 427, 430 (1917).

137. *Ragsdale v. Superior Oil Co.*, 40 Ill. 2d 68, \_\_\_, 237 N.E.2d 492, 494 (1968), *rev'g* 85 Ill. App. 2d 467, 229 N.E.2d 299 (1967). See generally 1 R. MYERS, *supra* note 15, § 13.01 (Supp. Oct. 1983); 5 W. SUMMERS, *supra* note 15, § 956 (Supp. 1983); 6 H. WILLIAMS & C. MEYERS, *supra* note 1, § 930.11.

operating agreements, do not effect cross-conveyances.<sup>138</sup>

## VI. CONCLUSION

It is difficult to summarize the numerous issues relative to the ethics and legality of pooling and unitization without greatly oversimplifying what can be a complex area of the law. Nevertheless, there may be some merit to stating the proposition to landmen and operators in simple terms. (1) Adhere strictly to the terms of the pooling provisions in your leases and abide by the terms of your pooling and unitization agreements. If you do so, you are probably acting legally. (2) In pooling or unitizing acreage, deal fairly and in good faith. If you do so, you are probably acting ethically.

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138. ILL. ANN. STAT. ch. 96½, § 5452(1) (Smith-Hurd 1979); *see also* MICH. COMP. LAWS ANN. § 319.365 (West 1967).