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LIBERAL LEASE INTERPRETATION BOOSTS LAGGING OKLAHOMA OIL PRODUCTION: *KUYKENDALL v. HELMERICH & PAYNE, INC.*

I. INTRODUCTION

In recent years, falling oil prices¹ have led to the decline of Oklahoma's oil industry² and the subsequent decline of the state's economy. With the decrease in exploratory drilling and the shut down of low production wells,³ unemployment and bankruptcies are increasing in Oklahoma and other oil producing states.⁴ As a result, workers migrating from Oklahoma left approximately 25,000 vacant homes in the state.⁵

To enhance oil and gas development in an uncertain economy, the traditional approach of interpreting leases against the lessee⁶ is giving way to more flexible lease interpretation.⁷ For example, in *Kuykendall v.*

1. The average price for Oklahoma crude oil in 1981 was \$35.22 dropping to \$28.46 in 1984. Kinzie & Dancy, *Protecting the Oil Field Creditor*, 56 OKLA. B.J. 1203, 1209 n.1 (1985). Amid some stabilization of falling oil prices in 1987, experts predict stabilization around the \$16-\$18 per barrel range in 1988. Pearson, *Tulsans to Remember '87 as Year of 'Slights'*, Tulsa World, Jan. 3, 1988, at A4, col. 6.

2. Falling 25 percent since mid-1986, Oklahoma oil production is expected to decline 15 percent annually. In the past few years, wildcatting has declined 85 to 90 percent. In addition, while drilling rigs in 1987 were slightly up from the 150 counted in 1986, the number is far from the June 1981 count of 882 drilling rigs. Tulsa World, *supra* note 1, at A4, col. 6. Oklahoma is fifth among oil producing states. West, *Good times and bad*, OIL & GAS J., Aug. 17, 1987, at 13.

3. In Oklahoma, approximately eight of ten oil wells are classed as "stripper wells" averaging production of 3.3 barrels of oil per day. Pearson, *Production In Paying Quantities: A Review of Oklahoma Law*, 56 OKLA. B.J. 1189, 1189, 1193 n.2 (1985). The 270,359 barrels of oil produced daily from 81,703 stripper wells in Oklahoma, represents approximately six of every ten barrels of oil produced in Oklahoma. *Id.*

4. True, *A year's tale*, OIL & GAS J., July 13, 1987, at 13. American Petroleum Institute statistics for 1986 show Louisiana led in unemployment with 13.1% of its population out of work followed by Alaska, 10.8%, and Texas, 8.9%. Oil industry business failures, mainly in Texas, Louisiana, Oklahoma, and Arkansas, exploded by 59.9% in 1986. Bankruptcies in Oklahoma increased by 55.9%. *Id.*

5. Oneok, Inc., Tulsa, serving most of Oklahoma, reports serving 6,400 fewer residential customers in 1987 than in 1986. West, *supra* note 2, at 13.

6. Courts traditionally construe contracts against the drafter who is usually the lessee. Beatty v. Baxter, 208 Okla. 686, 688, 258 P.2d 626, 628 (1953); Superior Oil & Gas Co. v. Mehlin, 25 Okla. 809, 817, 108 P. 545, 548 (1910).

7. Although there is some limited contrary authority, courts generally find commencement of drilling where only the "most modest preparations for drilling have been made." 3 H. WILLIAMS, OIL AND GAS LAW § 618.1 (1985).

Helmerich & Payne, Inc.,⁸ the Oklahoma Supreme Court upheld the lessee drilling company's rights although Helmerich & Payne (H&P) did not strictly comply with the "commencement of drilling" clause in the lease.

Flexible oil and gas lease interpretation evolved to the lessee's advantage through the addition of language varying the habendum clause⁹ and through modern spacing regulations.¹⁰ Addition of "commencement of drilling" language significantly affected the habendum clause by allowing commencement to suffice for production¹¹ thereby preventing lease termination. Pooling and unitization, spacing regulations which limited drilling to one well on a prescribed drilling unit, additionally changed the habendum clause thereby liberalizing lease interpretation.¹² The force majeure clause,¹³ another significant habendum clause modification, also prevents lease termination due to circumstances beyond the lessee's control.

Thus, modern lease interpretation involves a multiplicity of factors. Courts interpret lease language, including commencement of drilling,¹⁴ pooling and unitization,¹⁵ and a force majeure clause,¹⁶ in light of the overriding objective to promote oil and gas development.¹⁷ Flexible interpretation necessitates consideration of the good faith efforts of the lessee to comply with lease provisions¹⁸ and the equities affecting both

8. 741 P.2d 869 (Okla. 1987).

9. Early oil and gas lease habendum clauses provided for either a lengthy term of 40 to 99 years or a shorter definite primary term to be extended for an indefinite period of years by rental payments. Production was not required. Starting in the early 1900's, leases contained a short primary term and a simple habendum clause providing for continuation so long as oil or gas was produced. Meyers, *Continuation of the Oil and Gas Lease Beyond Its Primary Term--Long May It Waive*, 4 E. MIN. L. INST. § 17.02, at 17-2—17-3 (1983).

10. *Id.* at 17-3—17-4.

11. *Id.* The "commencement of drilling" language first added to leases was typically worded as follows:

This lease shall remain in force for a primary term of ten years, and *if lessee shall commence to drill within said primary term, lessee shall have the right to continue drilling to completion*, and said term shall continue as long thereafter as oil or gas is produced from the leased premises.

Id. (emphasis original).

12. *Id.* at 17-3. See *infra* notes 72-75 and accompanying text. Another significant change (irrelevant to this discussion) deals with the addition of "continuous operations" or "cessation of operations" language. 4 E. MIN. L. INST., *supra* note 9, at 17-3.

13. *Id.* at 17-4. See *infra* notes 76-81 and accompanying text.

14. See *infra* notes 84-102 and accompanying text.

15. See *infra* notes 103-22 and accompanying text.

16. See *infra* notes 123-27 and accompanying text.

17. See *infra* notes 82-83 and accompanying text.

18. See *infra* notes 90-99 and accompanying text.

parties.¹⁹ In fact, commentators find an evolving superstructure in current oil and gas law based on rules of fairness and reasonableness²⁰ rather than on straight contract law.²¹ Faced with the present oil industry problems, mild judicial intervention by liberally interpreting commencement of drilling language in an oil and gas lease could enhance development efforts. During the energy crisis of the 1970's, mild judicial coercion advanced Oklahoma's upsurge in oil and gas exploration.²² Therefore, when an oil producer, such as H&P, is making every effort to explore and produce, and the lessor's property rights would not be adversely affected,²³ pragmatism justifies flexible lease interpretation.

II. STATEMENT OF THE CASE

In *Kuykendall v. Helmerich & Payne, Inc.*,²⁴ the Oklahoma Supreme Court considered whether there was commencement of drilling which extended the primary lease term. The Kuykendall lease contained a five year primary term expiring December 20, 1976.²⁵ On November 12, 1976, prior to acquiring the lease, H&P filed an application with the Oklahoma Corporation Commission (the Commission) requesting enlargement of its well spacing unit in section 7 to include the Kuykendall lease.²⁶ H&P acquired the lease by transfer on November 17, 1976. On

19. See *infra* notes 100-02 and accompanying text.

20. Polston, *Recent Developments in Oil and Gas Law*, 6 E. MIN. L. INST. § 19.01, at 19-2 (1985). Although most relationships are formed by documents which are tailored to fit the parties' situations, the courts may disregard the document in favor of the relationship if the document operates unfairly against one party. *Id.*

21. Citing oil and gas law as an example of the trend toward the demise of contracts, Polston claims that oil and gas law is based on relationships where status is more important than contract. *Id.* at § 19.02[2], at 19-4.

22. Nesbitt, *A Primer on Forced Pooling of Oil and Gas Interests in Oklahoma*, 50 OKLA. B.J. 648 (1979) [hereinafter *Primer on Forced Pooling*]. Charles Nesbitt is a former Oklahoma Attorney General and Corporation Commission member. Judicial enforcement of statutory forced pooling contributed to the development of Oklahoma's implied covenant to explore. Pickerill, *Is There a New Implied Covenant of Exploration?*, 31 S.W. LEGAL FOUND. INST. ON OIL & GAS LAW & TAX'N, 245, 278 (1980) (citing 5 H. WILLIAMS & C. MEYERS, OIL AND GAS LAW § 845.5 (1985)). See J. LOWE, OIL AND GAS LAW 283 (1983). "The essential concept [of the implied covenant to develop] is that the economically motivated prudent operator will freely develop resources under his control within a reasonable time." *Id.*

23. *Hair v. Oklahoma Corp. Comm'n*, 740 P.2d 134, 140 (Okla. 1987) (claiming consistency with the court's pronouncement earlier the same day in *Kuykendall v. Helmerich & Payne, Inc.*, 741 P.2d 869 (Okla. 1987)).

24. 741 P.2d 869 (Okla. 1987).

25. *Kuykendall*, 741 P.2d at 870. The Kuykendalls leased their mineral interest in Grady County, Oklahoma (section 7) to Taft Milford. If drilling commenced prior to the expiration date, the lease could be extended indefinitely. *Kuykendall v. Helmerich & Payne, Inc.*, 54 OKLA. B.J. 26 (January 8, 1983).

26. *Kuykendall*, 741 P.2d at 870. The enlargement encompassed the entire 640 acres of section 7. *Id.*

December 3, 1976, H&P, as operator, commenced drilling the designated unit well, the McClure No. 1, in the northeast quarter of section 7—directly east of the Kuykendall quarter section.²⁷ The trial examiner, hearing the spacing application without contest on December 9, 1976, recommended that it be granted. On December 21, 1976, one day following the expiration date of the lease, the Commission established all of section 7 as a drilling and spacing unit for gas.²⁸

On March 30, 1977, H&P requested an order nunc pro tunc, transforming the effective date of the order to the date of the hearing on December 9, 1976.²⁹ The nunc pro tunc order was granted on May 4, 1977, but was subsequently declared void in 1979 by the Oklahoma Court of Appeals.³⁰ Meanwhile, in May of 1977, the unit well was completed as a producer of oil and gas.³¹

Kuykendall then demanded the lease be released because H&P had not drilled a well on the lease nor was the lease part of a drilling and spacing unit on the day of expiration.³² H&P countered by filing a quiet title action which it later dismissed.³³ Alleging that the lease held by H&P was a cloud on the title, Kuykendall filed to quiet his mineral interest.³⁴ H&P cross-petitioned for a judgment claiming that it held a valid lease as a result of the unit well's production.³⁵

According to the trial court, commencement and diligent completion of the proposed section unit well, combined with the pendency of a spacing application, constituted commencement of drilling under the lease.³⁶ The trial court further found that Oklahoma law prohibited H&P from drilling another well in the unit on the Kuykendall premises while diligently drilling the unit well.³⁷

Using a narrow construction of the commencement of drilling

27. *Id.*

28. *Id.*

29. *Id.* A nunc pro tunc entry is an entry presently made to allow acts to be done after the time when the acts should have been done. BLACKS LAW DICTIONARY 964 (5th ed. 1979). The spacing application hearing on December 9, 1976, was within the primary term of the lease.

30. *Kuykendall v. Corporation Comm'n*, 597 P.2d 1221 (Okla. Ct. App. 1979). Procedural Rules of the Commission claim orders may be effective on the filing date. Because the date was not appealed, it thereby became final and was not subject to collateral attack. *Id.* at 1223. The nunc pro tunc order was thereby declared invalid for lack of jurisdiction and lack of evidence. *Id.*

31. *Kuykendall*, 54 OKLA. B.J. at 26.

32. *Kuykendall*, 741 P.2d at 870.

33. *Kuykendall*, 54 OKLA. B.J. at 26.

34. *Kuykendall*, 741 P.2d at 870.

35. *Kuykendall*, 54 OKLA. B.J. at 26. H&P further claimed that Kuykendalls' interests should be limited to a 3/16 royalty interest.

36. *Kuykendall*, 741 P.2d at 870.

37. *Id.* (citing OKLA. STAT. tit. 52, § 87.1(e) (Supp. 1985)).

clause, the Oklahoma Court of Appeals reversed the decision, holding the primary term was not extended.³⁸ Noting H&P's diligence in obtaining a spacing order in the absence of opposition from Kuykendall, the dissent found a gross imbalance of equities in the majority's decision.³⁹ The Oklahoma Supreme Court reversed the Court of Appeals and held the lease valid.⁴⁰ The court's holding demonstrates that a lessee will not be held to a narrow interpretation of lease language when the lessee has demonstrated the intent to develop the unit.

III. BACKGROUND

Since the early 1900's when oil drilling boomed in Oklahoma, the industry has changed to meet growing demands. To keep pace with growth and new developments, lease drafters have had to modify lease language. The concepts of pooling and unitization, which were developed to maximize production and conserve natural resources, restricted operations. Consequently, lease language and interpretation were modified accordingly. In addition, protective language in force majeure clauses particularly affected judicial determination of compliance with "commencement of drilling" language.

A. *Commencement of Drilling*

For a lessee to preserve his rights under the lease, the majority of oil and gas leases require him to "commence drilling operations" or to "commence operations for drilling" before the lease term expires.⁴¹ If a lessee takes action associated with "actual drilling on the premises, in good faith, and diligently pursues them to completion," most courts find the lessee has complied with the commencement requirement for keeping the lease alive.⁴²

38. *Kuykendall*, 54 OKLA. B.J. at 29. See Note, *Narrow Construction of Commencement of Drilling Clause: Kuykendall v. Helmerich & Payne*, 19 TULSA L.J. 271 (1983).

39. *Kuykendall*, 54 OKLA. B.J. at 29 (Bacon, J., dissenting).

40. *Kuykendall*, 741 P.2d at 871. The court considered three averments of error:

(1) The lease expired for failure to drill on the premises or property spaced therein within the primary term; (2) H&P was not prohibited from drilling upon the leased premises so as to excuse its failure to commence; and (3) the Kuykendalls are not barred by laches or estopped from quieting their title to the premises.

Id. According to the court, it was unnecessary to consider the issues of bar and estoppel in a summary proceeding ruling.

41. J. LOWE, *supra* note 22, at 189.

42. *Id.* at 189-90.

The Oklahoma Supreme Court has liberally interpreted the commencement clause to include nearly any type of work at the well-site.⁴³ Activities which other state courts have liberally construed to constitute commencement include: staking the site, cutting rig timbers, and letting the drilling contract;⁴⁴ digging slush pits;⁴⁵ moving a drilling rig on site and starting "rigging up" to spud.⁴⁶

Arkansas' liberal approach held that a lease was not forfeited by failure to have a "drill bit pierce the earth"⁴⁷ by the lease deadline. Analogizing commencement of drilling with baking a cake, the court compared the arguments: "Does 'drilling' commence with the operations for a well, or does it commence only with the piercing of the ground with the drill bit? Does 'baking a cake' begin with the preparation of the dough, or only with the actual placing of the dough in the oven?"⁴⁸ By giving weight to *preparation*, Arkansas and other state courts encourage development and avoid unfairness to lessees who have committed substantial expenditures.⁴⁹

Although courts generally consider language in the lease to be controlling,⁵⁰ language is being construed more and more broadly. In 1925, the Montana Supreme Court distinguished "commencement of drilling operations" language in the lease from "commencement of operations for drilling."⁵¹ It thereby required actual "spudding in" or the first movement of the drill in penetrating the ground.⁵² Today, however, courts seldom distinguish between lease language requiring that the lessee "commence to drill," "commence drilling operations," or "commence operations for the drilling of a well."⁵³

43. Cases indicating types of activity adequate to constitute commencement include: *Burgess v. Oklahoma Gas Utils. Co.*, 171 Okla. 294, 295, 42 P.2d 240, 240 (1935) (moving materials onto site and erecting a derrick); *Smith v. Gypsy Oil Co.*, 130 Okla. 135, 136, 265 P. 647, 648 (1928) (drilling water well for oil well needs); *Cromwell v. Lewis*, 98 Okla. 53, 54, 223 P. 671, 672 (1923) (digging the cellar and transporting timbers to location).

44. *Fleming Oil & Gas Co. v. South Penn Oil Co.*, 37 W. Va. 645, ___, 17 S.E. 203, 205 (1893).

45. *Walton v. Zatkoff*, 372 Mich. 491, 127 N.W.2d 365 (1964).

46. *Whelan v. Lacy, Inc.*, 251 S.W.2d 175 (Tex. Civ. App. 1952).

47. *Vickers v. Peaker*, 227 Ark. 587, ___, 300 S.W.2d 29, 32 (1957).

48. *Id.*

49. See J. LOWE, *supra* note 22, at 190.

50. *Id.*

51. *Solberg v. Sunburst Oil & Gas Co.*, 73 Mont. 94, ___, 235 P. 761, 763 (1925).

52. *Id.* at ___, 235 P. at 763.

53. 3 H. WILLIAMS, OIL AND GAS LAW, § 606.1 (1985); *Walton v. Zatkoff*, 372 Mich. 491, 127 N.W.2d 365 (1964).

1. Good Faith Requirement

For a court to consider preliminary activity sufficient to constitute commencement, the activity must demonstrate good faith. For example, activity relating to drilling or preparation for drilling may demonstrate good faith and the intention to proceed diligently with drilling.⁵⁴ However, if courts find no intent for development or find a sham transaction, commencement will be denied.⁵⁵ Courts will not find commencement in the absence of sufficient evidence to show intent to drill and to produce oil. When the mere designation of a gas unit by the lessee tied up eight leases with no apparent intention for further development, a Texas court terminated the leases for lack of good faith commencement.⁵⁶ The Michigan Supreme Court also denied commencement status where the lessee did not acquire the necessary permit nor execute a drilling contract prior to the lease deadline.⁵⁷ In the absence of an enumerated good faith standard, courts consider the circumstances of the case to determine whether commencement has occurred.⁵⁸

2. Due Diligence

For commencement status to be accorded, the lessee must pursue operations with due diligence until completion.⁵⁹ Courts also evaluate due diligence depending on the circumstances; therefore, drilling preparations alone are insufficient to constitute commencement when further efforts are not made toward completion.⁶⁰ In making the due diligence determination, courts also consider activities toward completion undertaken after the lease deadline.⁶¹ As a result, if all equipment were removed from the site within weeks after the lease deadline, courts may infer a lack of due diligence or bad faith by the lessee.⁶² Thus, for a lease

54. *Fast v. Whitney*, 26 Wyo. 433, ___, 187 P. 192, 199 (1920).

55. *J. Lowe*, *supra* note 22, at 191. See *Butler v. Nepple*, 54 Cal. 2d 589, ___, 6 Cal. Rptr. 767, 771, 354 P.2d 239, 242 (1960) (when lessees staked the location, moved equipment and pipe onto the site then removed the equipment, the court found lack of a bona fide intention to commence drilling).

56. *Amoco Prod. Co. v. Underwood*, 558 S.W.2d 509, 512-13 (Tex. Civ. App. 1977).

57. *Goble v. Goff*, 327 Mich. 549, ___, 42 N.W.2d 845, 847 (1950).

58. Courts apply "gastronomic jurisprudence to give effect to the bargain the parties to the lease made" in deciding whether good faith exists. *J. Lowe*, *supra* note 22, at 191.

59. *Son-Lin Farms, Inc. v. Dyco Petroleum Corp.*, 589 F. Supp. 1, 2 (W.D. Okla. 1982).

60. *Herl v. Legleiter*, 9 Kan. App. 2d 15, ___, 668 P.2d 200, 203 (1983).

61. In *Legleiter*, drilling preparations did not constitute commencement when the lessee neither owned a drilling rig nor had one under contract. Yet the court indicated a different result if operations had continued with due diligence after the lease expired. *Id.*

62. "An oil and gas lease is governed by different rules of construction from those applicable to other contracts, being construed most strongly against the lessee and in favor of the lessor." Simon

to be extended because the commencement clause has been met, a lessee must begin preparation for drilling and continue operations after the lease deadline until the well is completed.

B. *Pooling and Unitization*

Pooling and unitization allow more flexible lease interpretation while at the same time creating complexities in lease extension interpretation. Although the terms are often used interchangeably, "pooling" means bringing together small tracts of land into a drilling unit or spacing unit of designated size,⁶³ whereas "unitization" is the joint operation of all or a portion of a producing reservoir.⁶⁴ Pooling prevents physical and economic waste and protects land owner's correlative rights in a formation by restricting the number of wells to be drilled on a unit.⁶⁵ Pooling also protects the rights of owners of land in a common reservoir from drainage losses.⁶⁶ Most significantly in lease analysis, if there is production or drilling on the unit, a pooling clause extends the lease beyond its primary term⁶⁷ even without actual production.⁶⁸

Unitization allows an entire field, or a substantial portion of a field,

v. Foster, 373 P.2d 28, 30 (Okla. 1962). Such construction was rationalized because the lessee generally prepares the lease and contracts are construed against the drafter. See *Prowant v. Sealy*, 77 Okla. 244, 252, 187 P. 235, 243 (1919); see, e.g., *Beatty v. Baxter*, 208 Okla. 686, 688, 258 P.2d 626, 628 (1953).

63. 6 H. WILLIAMS & C. MEYERS, *OIL AND GAS LAW* § 901 (1985). The size is designated in a spacing order granted by a state's Corporation Commission. *Id.*

64. *Id.*

65. Waste, as applied to the production of oil, is defined to include "economic waste, underground waste, including water encroachment in the oil or gas bearing strata; . . . methods that unreasonably interfere with obtaining from the common source of supply the largest ultimate recovery of oil; surface waste and waste incident to the production . . ." OKLA. STAT. tit. 52, § 86.2 (1971). Waste of gas includes the "production of gas in such quantities . . . as unreasonably to reduce reservoir pressure or . . . to diminish the quantity of oil or gas that might be recovered . . ." *Id.* § 86.3. See Harris, *Modification of Corporation Commission Orders Pertaining to a Common Source of Supply*, 11 OKLA. L. REV. 125, 127-28 (1958) for categorization of oil and gas waste. See also Harris, at 129-30 for a listing of specific rights constituting the concept of correlative rights. Harris broadly defines correlative rights as the "interdependent rights of each owner to share in the benefits of the common source of supply on a fair and equitable basis. . ." *Id.* at 129.

66. Drainage is the "migration of oil or gas in a reservoir due to a pressure reduction caused by production from wells bottomed in the reservoir." H. WILLIAMS & C. MEYERS, *OIL AND GAS TERMS* 265 (1987). According to the rule of capture established by early courts, the owner of a well was recognized as the owner of the oil and gas issuing through his well even though drained from lands of his neighbors. Reduction to possession constituted ownership. As a result, self-protection forced each owner of a tract of ground overlaying an oil pool to quickly drill as many wells as possible and produce to capacity. Accompanying gas was often flared or blown out. Resources and unnecessary development costs were wasted as drilling was denser than necessary. E. KUNTZ, J. LOWE, O. ANDERSON & E. SMITH, *OIL AND GAS LAW* 54-55 (1986).

67. Primary term currently refers to the period of time, usually five or ten years, during which a lease may be retained by a lessee even absent production in paying quantities via drilling operations or the payment of rentals. H. WILLIAMS & C. MEYERS, *supra* note 66, at 746.

to be operated as a single entity regardless of surface lines.⁶⁹ By strategically locating wells within a unit, reservoir energy use is maximized.⁷⁰ Unitization, therefore, results in greater recovery of oil at less cost. Unitization may be either voluntary or compulsory and may be formed either for exploration or for enhanced recovery.⁷¹

When a leasehold is included in a unit because of a pooling or unitization agreement, the agreement may significantly affect the express or implied terms of the lease.⁷² According to the Oklahoma Supreme Court, combining Oklahoma's oil and gas conservation statute with an Oklahoma Corporation Commission pooling order results in extending the primary term fixed in an oil and gas lease.⁷³ By allowing production in paying quantities to keep a leasehold alive after expiration of the primary term, pooling and unitization affect the "thereafter" lease clause.⁷⁴ The greatest difficulties arise regarding effects of usage of portions of the unit other than the specific leased premises,⁷⁵ because the leasehold is kept alive whether production is on the lease in question or on another portion of the unit.

C. Force Majeure Clause

A force majeure clause is utilized in a lease to prevent the lessee from losing the lease when circumstances beyond his control prevent fulfillment of all the lease conditions and covenants.⁷⁶ The force majeure

68. E. KUNTZ *et al.*, *supra* note 66, at 198. The following language is typical in a lease: "production, drilling or reworking operations anywhere on the unit which includes all or part of this lease shall be treated as if it were production, drilling, or reworking operations under this lease." *Id.*

69. H. WILLIAMS & C. MEYERS, *supra* note 63 § 901. Economic and property rights mandate unitization for operations including gas cycling, pressure maintenance, and secondary recovery. *Id.*

70. *Id.*

71. Anderson, *Mutiny: The Revolt Against Unsuccessful Unit Operations*, 30 ROCKY MTN. MIN. L. INST. § 13.02, at 13-3 (1984). To conserve the reservoir's natural energy and achieve the ultimate recovery, unitization at an early stage is ideal. *Id.* § 13.02, at 13-4. Under voluntary unitization, all of the interest owners in a field, or portion of a field, agree to joint operations to enhance recovery. However, because consent may not be achievable, there are compulsory unitization acts in many states to compel unitization. *Id.* See *id.* at n.5 for a listing of states with compulsory unitization acts. Texas is one of the few oil producing states without a compulsory unitization act. Oklahoma's act is codified at OKLA. STAT. tit. 52, §§ 287.1-15 (1969). See Kuntz, *Statutory Well Spacing and Drilling Units*, 31 OKLA. L. REV. 344 (1978) (effect of regulation of drilling under the statute on lessors and lessees).

72. H. WILLIAMS & C. MEYERS, *supra* note 63, § 950.

73. *State ex rel. Comm'r of Land Office v. Carter Oil Co.*, 336 P.2d 1086 (Okla. 1958) *quoted in* *Layton v. Pan Am. Petroleum Corp.*, 383 P.2d 624, 625 (Okla. 1963).

74. H. WILLIAMS & C. MEYERS, *supra* note 63, § 953.

75. *Id.* § 950, at 694.5. Pooling or unitization by a lessee may remove interior boundary lines between lessees, but the lines still apply to lessors. Therefore, each lease must be protected to create reasonable development and to prevent drainage.

76. Recent Development, *Oil and Gas: Effect of a Spacing Order Filed Before But Issued After*

concept provides a legal standard to implement the "doctrine of excuse" to allow risk allocation and management.⁷⁷ The concept of excuse results from the principle that the risk of a contingency affecting performance is presumed to rest on the promisor (lessee).⁷⁸ As a principle of equity, force majeure will prevent a court from preserving one party's rights when a supervening circumstance would place the total burden on the other party.⁷⁹

Force majeure encompasses concepts of impossibility, impracticability, and frustration of purpose.⁸⁰ In addition, force majeure includes judicial acknowledgement that certain types of governmental and judicial or administrative action constitute intervention by a superior force sufficient to excuse performance. For example, in a "government action" case, a Texas court held an oil and gas lease extended where drilling under the lease was prevented by bankruptcy court intervention.⁸¹

Therefore, a lease will be extended if the lessee demonstrates a good faith, diligent intent to commence drilling and to pursue operations until the well is completed. In granting the extension, the court will evaluate how pooling and unitization affect the leased premises as well as the rights of the parties. In addition, a force majeure clause will overcome adverse unavoidable circumstances to preserve the lease.

IV. DECISION

From 1932 forward, the Oklahoma Supreme Court's decisions have promoted oil and gas development.⁸² The court's decision in *Kuykendall* exemplifies liberal lease interpretation to foster development. The court similarly utilized strict construction favoring the lessor when the end

the Expiration of the Primary Term of a Lease Included in the Unit, 36 OKLA. L. REV. 469, 470 n.3 (1983).

77. Kirkham, *Force Majeure—Does It Really Work?*, 30 ROCKY MTN. MIN. L. INST. § 6.02, at 6-1, 6-4 (1984).

78. *Id.* at 6-5 (citing *In re Westinghouse Elec. Corp.*, 517 F. Supp. 440, 459 (E.D. Va. 1981)).

79. *Id.* at 6-7.

80. *Id.* § 6.03, at 6-10.

81. *Gilbert v. Smedley*, 612 S.W.2d 270 (Tex. Civ. App. 1981); *see also* *Gordon v. Crown Cent. Petroleum Co.*, 284 Ark. 94, 679 S.W.2d 192 (1984) (force majeure clause protected the lessee when his breach of the pooling clause resulted from compliance with government order). *But see* *Webb v. Hardage Corp.*, 471 So. 2d 889 (La. Ct. App. 1985) (voluntary bankruptcy filing by original lessee and sublessee was insufficient to extend the primary term of leases under the force majeure clause absent evidence that the delay or interruption of development was beyond the lessee's control).

82. *See* *Simons v. McDaniel*, 154 Okla. 168, 7 P.2d 419 (1932) (lessee evidenced a desire to develop). "[No] Court has been more favorable to the interests of a lessee, who seeks to perform his covenants." *Id.* at 421 (citing *Strange v. Hicks*, 78 Okla. 1, 188 P. 347 (1920)).

promoted development.⁸³ Recognizing the lessee's intent to develop in *Kuykendall*, the court considered the lessee's good faith diligent efforts which were construed by the effect of the unit spacing order. Finding further support for lease extension in the force majeure clause, the court found upholding the lease created an equitable result for both parties.

V. ANALYSIS

A. *The Commencement Clause and the Lessee's Equity*

To keep the lease in effect, the court in *Kuykendall* essentially expanded the lease's commencement clause to include the "pendency of a pooling application."⁸⁴ The drilling clause stated, "If the lessee shall commence to drill a well . . . within the items of this lease . . . on acreage pooled therewith, the lessee shall have the right to drill such well to completion . . ."⁸⁵ When a lease contains such commencement language, even if well completion is not accomplished until after the primary lease term, commencement within the primary term will cause an automatic extension of a lease.⁸⁶ The legal effect of the pooling order would therefore cause commencement of the unit well to constitute "commencement of drilling" for purposes of the *Kuykendall* lease⁸⁷ which was included in the unit.

When drilling has commenced on the sole designated well in a spacing unit, additional drilling is statutorily prohibited⁸⁸ even if the unit order is still pending. Therefore, in evaluating the circumstances, the court considered the spacing application's drilling prohibition, commencement of drilling in the unit's common source of supply, and completion of the well to production. The combined effect was sufficient to continue the lease.⁸⁹

83. *Id.* at 421 (citing *New State Oil and Gas Co. v. Dunn*, 75 Okla. 142, 182 P. 514 (1919); *Carder v. Blackwell Oil & Gas Co.*, 83 Okla. 243, 201 P. 252 (1921); *Mistletoe Oil & Gas Co. v. Revelle*, 117 Okla. 144, 245 P. 620 (1926)).

84. *Kuykendall*, 54 OKLA. B.J. at 27 (1982). According to the appellate court, this liberal construction favoring the lessee is condemned by a long line of cases. *Id.* (citing *Beatty v. Baxter*, 208 Okla. 686, 258 P.2d 626 (1953)).

85. *Kuykendall*, 54 OKLA. B.J. at 27 (emphasis original).

86. *Rein v. Humble Oil & Ref. Co.*, 400 P.2d 800 (Okla. 1965) (distinguishes lease term requiring commencement rather than completion).

87. *See State ex rel. Comm'r of Land Office v. Carter Oil Co.*, 336 P.2d 1086 (Okla. 1958) (lease is extended past primary term when production from any portion of the pooled acreage satisfies "thereafter" clause requirements); *see also Layton v. Pan Am. Petroleum Corp.*, 383 P.2d 624 (Okla. 1963) (legal effect of pooling order creates extension past primary lease term).

88. OKLA. STAT. tit. 52, § 87.1(e) (Supp. 1988).

89. *Kuykendall*, 741 P.2d at 874.

With the goal of promoting development, the Oklahoma Supreme Court will assess a lessee's intention to produce by considering the lessee's good faith efforts,⁹⁰ due diligence,⁹¹ and the equitable circumstances.⁹² In determining commencement, the equitable approach has extended to the areas of assessing discovery of production in paying quantities and the obligation to market products prudently.⁹³ Courts have historically taken a subjective approach, granting more leniency to an operator once he has made a discovery.⁹⁴

According to the court in *Kuykendall*, H&P was drilling into the unit and had made diligent efforts to secure the unit spacing application.⁹⁵ In addition, at the uncontested hearing, the trial examiner recommended that the spacing order be granted.⁹⁶ Although the effective date of the hearing can be given to spacing orders if the request is made in advance of the final order,⁹⁷ it is unclear why H&P failed to do so.⁹⁸ Hence, they could only wait for the official order.⁹⁹

Under the circumstances, H&P was effectively prevented from strict compliance with the commencement covenants of the lease.¹⁰⁰ Therefore, a contrary decision would have been inequitable to the lessee.¹⁰¹ Furthermore, within five months after commencement the well was completed as a producing well.¹⁰² Completion of the well on the unit was

90. *Son-Lin Farms, Inc. v. Dyco Petroleum Corp.*, 589 F. Supp. 1 (W.D. Okla. 1982).

91. *See supra* notes 42 & 45 and accompanying text.

92. "Oklahoma courts will consider equitable circumstances in determining whether the situation justifies continuation of the lease." R. HEMINGWAY, *THE LAW OF OIL AND GAS* § 6.4 (1983).

93. *Battle, Lease Maintenance in the Face of Curtailed/Depressed Markets*, 32 ROCKY MTN. MIN. L. INST. § 14.02 (1986).

94. *Id.* § 14.05(2).

95. *Kuykendall*, 741 P.2d at 870-71.

96. *Id.* at 870.

97. *Primer on Forced Pooling, supra* note 22, at 655.

98. After the official spacing order was filed, the Corporation Commission granted H&P a nunc pro tunc order stating that the hearing date on December 9, 1976, was the effective date of the order. The Oklahoma Court of Appeals reversed the order because of absence in the record of a request for an effective earlier date either at the hearing or prior to the filing of the unit spacing order on December 21, 1976. *Kuykendall v. Corporation Comm'n*, 597 P.2d 1221, 1223 (Okla. Ct. App. 1979). If H&P had requested that the filing date or hearing date be the effective date, the nunc pro tunc order specifying the filing date as the date of the unit order would have been declared valid. *Hair v. Oklahoma Corp. Comm'n*, 740 P.2d 134, 140-41 (Okla. 1987).

99. *Kuykendall*, 54 OKLA. B.J. at 29 (Bacon, J., dissenting).

100. *Kuykendall*, 741 P.2d at 873.

101. *Kuykendall*, 54 OKLA. B.J. at 29 (Bacon, J., dissenting).

102. *See supra* note 31. Under a strict approach, if the unit order had not been granted by the day the lease expired or if drilling in the *Kuykendall* lease had not commenced, the lease would be terminated.

sufficient to establish H&P's intent to produce. Therefore, equitable factors combined with diligent completion sufficiently justified lease extension even though the lease had technically expired.

B. *The Unit Spacing Order and the Lessor's Equity*

A state's power to further its interest in conserving its resources is exercised when a spacing order application is filed under the current section 87.1(e) of title 52 of the Oklahoma statutes.¹⁰³ Under section 87.1(e), the state's police power effectively suspends the right to drill during the pending period.¹⁰⁴ Recognizing the state's police power, the Oklahoma Supreme Court has continually acknowledged the validity of statutes granting authority to the Commission¹⁰⁵ to regulate oil and gas production for waste prevention.¹⁰⁶ Hence, at the time a lease, as a contract, is executed, current existing law governs its validity and effect.¹⁰⁷ Consequently, the court's interpretation of when "commencement" occurs will be determined in light of the statutory proscription.¹⁰⁸ Such a determination will not constitute a due process violation even if the lessor is thereby precluded from terminating the lease.

The Commission is authorized to assure equitable apportionment of beneficial oil and gas interests among leasehold owners¹⁰⁹ and to proportionally distribute costs of production.¹¹⁰ These apportionment powers do not violate due process.¹¹¹ The court in *Ward v. Corporation Commission*¹¹² found that withdrawal of an owner's right to drill without a

103. *Kuykendall*, 741 P.2d at 874. The pertinent portion of OKLA. STAT. tit. 52, § 87.1(e) (Supp. 1988) is as follows:

The drilling of any well or wells into any common source of supply for the purpose of producing oil or gas therefrom, after a spacing order has been entered by the Commission covering such common source of supply, at a location other than that fixed by said order is hereby prohibited. The drilling of any well or wells into a common source of supply, covered by a pending spacing application, at a location other than that approved by a special order of the Commission authorizing the drilling of such a well is hereby prohibited . . .

104. *Id.*

105. *Anderson v. Corporation Comm'n*, 327 P.2d 699 (Okla. 1957), *appeal dismissed*, 358 U.S. 642 (1959); *Wakefield v. Oklahoma*, 306 P.2d 305 (Okla. 1957); *Wood Oil Co. v. Corporation Comm'n*, 205 Okla. 537, 239 P.2d 1023 (Okla. 1950) (cited in *Layton v. Pan American Petroleum Corp.*, 383 P.2d 624 (Okla. 1963) and in *Oklahoma Natural Gas Co. v. Long*, 406 P.2d 499, 503-04 (Okla. 1965)); *Patterson v. Stanolind Oil & Gas Co.*, 183 Okla. 155, 77 P.2d 83 (1938), *appeal dismissed*, 305 U.S. 376 (1939).

106. *Anderson*, 327 P.2d at 703-04.

107. *Oklahoma Natural Gas*, 406 P.2d at 503; *Layton*, 383 P.2d at 627.

108. The law determinative of the right of the producer is subordinate to the police power of the state. *Champlin Refining Co. v. Corporation Comm'n*, 286 U.S. 210, 233-34 (1932).

109. *Anderson*, 327 P.2d at 700.

110. *Id.*

111. *Id.* at 703.

112. 501 P.2d 503 (Okla. 1972).

right to participate in the unit well's proceeds would comprise a taking without due process.¹¹³ Therefore, owners of an interest in the oil and gas of a spacing unit share in the production of the unit well at the time the unit is established.¹¹⁴

Under section 87.1(e), the right to participate in the unit well arises when the application is *filed* with the Commission.¹¹⁵ In the earlier *Wood Oil Co.* cases,¹¹⁶ the court did not require the lessee to account to the lessor for production before the spacing unit was finalized.¹¹⁷ The court in *Kuykendall* effectively distinguished its analysis by explaining that the court in *Wood Oil Co. II* reached its decision under the original section 87.1(d) which did not prohibit drilling into a pending unit, but only into a unit with a finalized spacing order.¹¹⁸ Therefore, because there was no interference with drilling rights during pendency, due process did not mandate participation in production until the spacing order was final.¹¹⁹ Because section 87.1(e), which replaced section 87.1(d), prohibits drilling during the pendency of a spacing application, due process requires participation in production of a unit well from the time the application is *filed*.¹²⁰

As the lessor, Kuykendall's due process rights were not violated because he had a right to participate in the proceeds of the designated unit well at the time the unit application was filed. Therefore, even though section 87.1(e) prohibited drilling an additional well into the Kuykendall lease, his rights were secured. In fact, the one day delay in obtaining the spacing order did not injure Kuykendall.¹²¹ H&P was obligated to recognize Kuykendall's interest in the well even though Kuykendall never

113. *Id.* at 507. "[O]il and gas lessees and others who own interests in the spacing (drilling) unit, share in the production of the unit well whether drilled before or after the spacing (drilling) unit is established as of the time the unit is established." *Id.*

114. *Kuykendall v. Helmerich & Payne, Inc.*, 741 P.2d 869, 873 (Okla. 1987). The right to participate is therefore operative during pendency of the application. *Id.*

115. *Id.*

116. *Wood Oil Co. v. Corporation Comm'n*, 268 P.2d 878 (Okla. 1954) (*Wood Oil III*) and *Wood Oil Co. v. Corporation Comm'n*, 205 Okla. 537, 239 P.2d 1023 (1950) (*Wood Oil II*) (*noted in Kuykendall*, 741 P.2d at 873-74).

117. *Wood Oil Co.*, 205 Okla. at 539, 239 P.2d at 1026.

118. *Kuykendall*, 741 P.2d at 873. The *Wood Oil II* case was decided under OKLA. STAT. tit. 52, § 87.1(d) (Supp. 1945). In 1947, § 87.1(d) was changed to prohibit drilling into a pending unit. In 1977, § 87.1(d) became § 87.1(e).

119. *Id.*

120. *Id.* at 872-73.

121. See Note, *supra* note 38, at 277-78, 282-83. The author maintains that at the time H&P filed the spacing order application, Kuykendall was probably delighted at the possibility of receiving an interest in McClure No. 1. *Id.* at 279.

shared any risk or expense.¹²² Therefore, liberal lease extension equitably benefitted both parties to the lease.

C. *Force Majeure Clause*

The drilling prohibition in section 87.1(e) triggered application of the force majeure clause in the Kuykendall lease and excused H&P from strict compliance with the lease terms.¹²³ The force majeure clause provided that the lessor could not terminate the lease if compliance was prevented by any rule or regulation.¹²⁴ Because the statute prohibits drilling any well into a pending unit other than the designated well, H&P could not possibly drill on the Kuykendall lease until the status of the unit was officially determined.

Justification for the statutory drilling prohibition flows from the original rationale for implementing unitization and pooling which was prevention of waste resulting from loss due to drainage.¹²⁵ When the Commission establishes that one well will effectively drain a unit, additional drilling would constitute waste.¹²⁶ The suspension of drilling rights during pending unit applications is essentially a conservation measure designed to ultimately further oil and gas development. Therefore, the court properly rejected the contention that H&P could have met the terms of the lease by requesting an emergency order to drill a second well on the Kuykendall lease.¹²⁷ An emergency order would probably have been denied as wasteful.

122. H&P argued that Kuykendall's failure to offer to pay any portion of McClure No. 1 drilling costs, in light of Kuykendall's extensive knowledge about the situation, constituted "lying behind the log" or "riding the well down" which are practices disfavored by the court. *Kuykendall*, 54 OKLA. B.J. at 28. As noted by H&P, had it been aware the lease would terminate, it could have procured a lease ratification to enter an agreement with Kuykendall for an equitable apportionment of the risks regarding McClure No. 1. *Id.*

123. *Kuykendall*, 741 P.2d at 871.

124. The lease held by H&P contained the following force majeure clause:

All express or implied covenants of this lease shall be subject to all Federal and State Laws, Executive Orders, Rules and Regulations, and this lease shall not be terminated in whole or in part, nor lessee held liable in damages, for failure to comply therewith, if compliance is prevented by, or such failure is the result of any such Law, Order, Rule or Regulation.

Id.

125. *See supra* notes 63-75 and accompanying text. The court had earlier rationalized lessor-oriented lease construction by alleging danger of loss of oil and gas through migration toward a producing well on adjoining land. *See Beatty v. Baxter*, 208 Okla. 686, 258 P.2d 626 (1953).

126. *Kuykendall*, 741 P.2d at 872.

127. An emergency order request would have required H&P to contradict its original spacing order application's contention that one well was sufficient. *Id.* Unless the case is extreme, the Commission will not make an exception to the rule allowing only one producing well on each spacing unit. *Ward v. Corporation Comm'n*, 501 P.2d 503, 507 (Okla. 1972).

The court's decision to extend the lease by finding drilling had commenced, therefore constitutes a valid interpretation of language in the lease. In summary, H&P demonstrated a good faith intention to produce and develop, which it pursued with due diligence. Terminating the lease would have inequitably affected H&P. Upon application for unitization, Kuykendall received the equitable right to participate in proceeds of the unit well; therefore, his rights were not adversely affected. Finally, the force majeure clause excused strict compliance with the lease terms because of the statutory drilling prohibition in 87.1(e).

D. *Future Implications*

The *Kuykendall* decision will reinforce the prevailing trend toward liberal interpretation of the commencement of drilling clauses.¹²⁸ It replaces the hardship and uncertainty for both lessees and lessors created by the narrow construction of the appellate decision.¹²⁹ If a lessee can demonstrate good faith, due diligence evidenced by substantial compliance, and the intent to produce evidenced by a completed unit well, the Oklahoma courts will be inclined to extend the lease.

As lease clauses increase in complexity and both parties become better informed, drafters should carefully structure lease clauses.¹³⁰ Defining exactly what will constitute drilling would simplify interpretation thereby reducing the potential for litigation. The lease should clearly indicate the expectation of the parties by using an objective standard.¹³¹ For example, if the lessee wants anything other than drilling to constitute commencement, he should specify those activities. In addition, the force majeure clause should be drafted to prevent lease termination due to unavoidable delays. Conversely, a lessor desiring to test the lessee's sincerity in developing the property may require a drilling rig on site with the drill bit actually turning in the ground.¹³²

Some possibilities exist for extending an existing lease: (1) negotiating an agreement with the lessor extending the primary term; (2) taking

128. See *supra* note 43 and accompanying text.

129. See Note, *supra* note 38, at 290.

130. *Kuykendall*, 54 OKLA. B.J. at 28. Certainly, modern lease forms suited to the problems confronting the oil and gas industry in the 1980's should replace old lease forms. See Meyers, *supra* note 9, § 17.11 at 17-26.

131. Interview with David E. Pierce, Visiting Associate Professor of Law, University of Tulsa College of Law, and Associate Director of the National Energy Law and Policy Institute (Jan. 29, 1988).

132. *Id.* A lessor may want the exact status of a lease determinable on the day of expiration if he wants to immediately sign an agreement with a new lessor or if he has a top lease agreement.

as many preparatory steps as feasible by the deadline to ensure lease extension in the event the spacing unit is denied,¹³³ and (3) continuing operations and diligently undertaking actual drilling in good faith.¹³⁴ In addition, a lessee applying for a spacing application within a limited time frame should request that the effective date of the final order be the date of filing. Some critics have labeled "relation back" to the filing date a legal fiction contrary to public policy.¹³⁵ However, recognized procedure allows changing the "effective date" if the request is made in advance of the final order.¹³⁶

In summary, the lessee has several options for achieving lease extension. The lessee can structure the lease to ensure a liberal commencement interpretation. The inclusion of a force majeure clause will protect against unavoidable delays. Lastly, lessees can proceed with due diligence in continuing operations as well as in procuring a spacing order within the confines of the lease term.

V. CONCLUSION

In granting a lease extension by finding the "commencement" clause was satisfied, the Oklahoma Supreme Court rectified an unnecessarily harsh appellate decision. Using a careful statutory analysis and considering the overall circumstances, the resulting flexible lease interpretation will enhance Oklahoma's goal of promoting production and development. In view of the depressed oil economy in Oklahoma, judicial decisions promoting development of oil are indeed prudent. The decision clearly reflects Justice Holmes' view of evolving law as an adaptation to the felt necessities of the time.

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133. Drilling preparations should include any of the alternatives mentioned *supra* notes 43-49 which were held sufficient to constitute drilling. See also Pearce, *Problems and Opportunities During Hard Times in the Minerals Industry*, ROCKY MTN. MIN. L. FDN. 8-1 (1986) (review of the mineral lessee's obligations and possible ways to keep oil and gas leases alive).

134. Pearce, *supra* note 133, at 8-13.

135. See Recent Development, *supra* note 76, at 470.

136. See *Primer on Forced Pooling*, *supra* note 22, at 655; see *supra* notes 97 & 98 and accompanying text.

