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Dixon v. Anadarko Production Co.

DIXON V. ANADARKO PRODUCTION CO.:

Oklahoma Prima Facie Case of the Breach of an Implied Covenant in an Oil and Gas Lease Without Proving Profitability When Lessee is Allegedly Draining his Lessor's Land.

In *Dixon v. Anadarko Production Co.*,[1] the Supreme Court of Oklahoma added another factor to their determination of whether the *plaintiff-lessor* had established a prima facie case of breach of an impled covenant in an oil and gas lease. The additional factor was that the *defendant - lessee* was allegedly draining his lessor's land by a well drilled on adjacent land also leased to the lessee.

In *Dixon* the lessors had requested cancellation of the deeper horizons of an oil and gas lease for breach of the covenant to fully develop. The Oklahoma Supreme Court placed the burden of excusing a five year and ten month delay in drilling on a lessee who was allegedly draining his lessor's land.[2] The shift in burden of proof was founded on the assumption that a lessee draining his lessor's land should have superior knowledge of the probability of finding oil in paying quantities and should also make studies to determine when further drilling would be prudent.

Before discussing the factors considered by the courts in determining whether the *defndant - lessee* had to excuse its lack of drilling, or whether the *plaintiff - lessor* had to show an expectation of profit from drilling, a review of the purposes underlying the implied covenants is required.

Oil and gas leases are generally silent concerning operations after oil or gas is found.[3] This protects lessors from

[1] 505 P.2d 1394 (Okla. 1972).
[2] *Id.* at 1395, the lessee, one year and two months after plaintiff demanded drilling of a deep test well, drilled an offset well 660 feet east of plaintiff's land.
[3] 5 H. WILLIAMS & C. MEYERS, OIL AND GAS LAW §801 (1972).

asking for too little and lessees from promising too much since neither can anticipate the various technical and legal difficulties which may later arise. To prevent confusion in this void and to eliminate unenforceable vague contracts the courts have recognized the implied covenants of oil and gas leases. These covenants are oil and gas lease requirements which fulfill the general contract principle that the contracting parties must show good faith and cooperate to fulfill the purpose of the contract.[4] These covenants allow the courts to enforce the leases and the parties to expect fair dealing.[5]

The jurisdictions vary in naming the implied covenants but most have some form of these three:

1. The covenant to protect the leasehold from drainage.
2. The covenant to reasonably develop the leasehold.
3. The covenant to further explore.[6]

If the lessee has breached one or more of the implied covenants the lessor may sue for damages or cancellation of the undeveloped unprotected, or unexplored portions of the lease. Cancellation of the lease is the remedy in a majority of jurisdictions when damages are inadequate or impossible to determine.[7] In Oklahoma cancellation is conditional on the lessee's failure to drill within a fixed period of time in all but exceptional cases.[8]

To establish a breach of an implied covenant is similar to any action founded on contract, the burden of proving the ele-

[4] For a discussion of the implied covenants' derivation from the requirement that the parties to a contract must cooperate to achieve the purposes of the agreement, see *Id.* §802.1.

[5] *See* M. MERRILL, COVENANTS IMPLIED IN OIL AND GAS LEASES §§222-23 (2d ed. 1940).

[6] 5 H. WILLIAMS & C. MEYERS, *supra* note 3, at §815.

[7] R. HEMINGWAY, THE LAW OF OIL AND GAS §§8.10-.11 (1971).

[8] Gregg v. Harper-Turner Oil Co., 199 F.2d 1 (10th Cir. 1952).

ments is on the party bringing the action.[9] The *plaintiff - lessor* must show that the *defendant - lessee* failed to exercise the standard of performance necessary. In oil and gas leases this standard of performance is that conduct expected of an operator of ordinary prudence, bearing in mind whether further drilling or operation will be profitable to both the lessee and the lessor.[10] The burden of proving that the lessee breached an implied covenant requires that the lessor show the profitability of the further drilling or operation demanded by him.[11] Therefore to obtain cancellation for the breach of an implied covenant the burden of proof is on the *plaintiff - lessor* to show that a prudent operator would have drilled the well demanded.[12]

In Oklahoma the prudent operator rule has been modified

[9] In addition to showing a breach by the *defendant - lessee,* the *plaintiff - lessor* must show that a demand has been made on the lessee to comply with the implied covenant and such demand disregarded before a court of equity will cancel a portion of the lease. Pohlemann v. Stephens Petroleum Co., 99 F. Supp. 875 (W.D. Okla, 1951), *aff'd,* 197 F.2d 134 (10th Cir. 1952) (concerning the covenant to develop); Sunray Mid-Continent Oil Company v. McDaniel, 361 P.2d 683 (Okla. 1961) (concerning the covenant to protect from drainage).

[10] Spiller v. Massey & Moore, 406 P.2d 467 (Okla. 1965). This discussion of cancellation of the lease does not include the issue raised by M. Merrill in 4 OKLA. L. REV. 58 (1951) that if the lessor seeks only damages for the breach of the covenant to protect against drainage, the profitability of drilling is irrelevant to recovery.

[11] Often the requirement of "substantial drainage" is used with the breach of the protective covenant but this is merely an element of showing profitability. The burden is stated as first showing that substantial drainage has occurred, and second, that a protection well would recover the costs and make a profit. 5 H. WILLIAMS & C. MEYERS, *supra* note 3, at §823, *citing* Sunray Mid-Continent Oil Co. v. McDaniel, 361 P.2d 683 (Okla. 1961).

[12] Pohlemann v Stephens Petroleum Co., 197 F.2d 134 (Okla. 1951); Brewster v Lanyon Zinc. Co., 140 F. 801 (8th Cir. 1905); Spiller v. Massey & Moore, 406 P.2d 467 (Okla. 1965).

to include an examination of several factors in addition to profitability.[13] In *Doss Oil Royalty Co. v. Texas Co.*[14] the Supreme Court of Oklahoma held than an unreasonable delay in drilling would justify shifting the burden to the *defendant-lessee* to excuse the delay.[15] The Oklahoma supreme court in following *Doss* has clearly indicated that factors other than profitability of future drilling are important. In *McKenna v. Nichols,* the Oklahoma supreme court stated, while . . . we would consider the . . . likelihood of profit from further drilling, we would *also give weight to other considerations* . . . ." (Emphasis added).[16]

Oklahoma's modified prudent operator rule is similar to the general prudent operator test supplemented with a consideration of other factors as unreasonable delay in drilling. In *Dixon* the Supreme Court of Oklahoma considered another factor, *i.e.* drainage by a lessee from adjacent land. Since the *defendant-lessee* in *Dixon* had drilled a productive offset well 660 feet east of the *plaintiff-lessor's* tract a duty was imposed to "make studies and keep abreast of the available information to determine when, or if, further drilling would be profitable and prudent."[17] Moreover, the drilling on adjacent land was held to have given the lessee "superior knowledge of the cost of drilling to the deeper sand and the probability . . . of finding production in paying quantities."[18] After

[13] Blake v. Texas Co., 123 F. Supp. 73 (E.D. Okla. 1954); Colpitt v. Tull, 204 Okla. 1289, 228 P.2d 1000 (1950); Doss Oil Royalty Co. v. Texas Co., 192 Okla. 359, 137 P. 2d 934 (1943); 5 H. WILLIAMS & C. MYERS, *supra* note 3, at §806.3; Kuntz, *The Prudent Operator and Further Development,* 9 OKLA. L. REV. 255 (1956); Merrill, *The Prudent Operator and Further Development-Oklahoma Rule,* 5 OKLA. L. REV. 453 (1952).

[14] 192 Okla. 359, 137 P. 2d 934 (1943).

[15] Love, *The Doss Oil Royalty Company Case and Subsequent Decisions,* 16 OKLA. B.A.J. 1838 (1945); Merrill, *supra* note 13.

[16] 193 Okla. 526, 145 P. 2d 957, 960 (1944).

[17] 505 P. 2d at 1396 (Okla. 1972).

[18] *Id.*

recognizing a duty to make studies concerning profit and a superior knowledge of the chances of profit the Court then quoted an established rule of pleading which justified shifting the burden of proof:

> It is the general rule that where the party who has not the general burden of proof possesses positive and complete knowledge concerning the existence of facts which the party having the burden is called upon to negative, or where for any reason the evidence to prove a fact is chiefly, if not entirely, within his control, the burden rests on him to produce the evidence.[19]

Previous Oklahoma cases in which the lessee was allegedly, or in fact, draining his lessor's land have given no significance to the common-lessee aspect.[20] Possibly it was unnecessary to do so. In *Spiller v. Massey & Moore*,[21] the *plaintiff-lessor's* evidence was held to have sufficiently supported a claim of substantial drainage and that a prudent operator would have drilled. Likewise in *Deep Rock Oil Corp. v. Bilby*,[22] the supreme court upheld plaintiff's damages for the lessee's delay in completing a well to prevent drainage. There was no issue of profitability in that the well was completed and productive.

The Supreme Court of Oklahoma in *Coal Oil & Gas Co. v. Styron*,[23] upheld cancellation because the lessee held the lease only to find a reservoir separate from the one which he was already draining through adjacent land. The court stated that the lessee's intent not to drill at anytime near was not in accord with duties to develop but did not directly place a special duty on the lessee who was draining his lessor's land. However, the lessee's drainage was determinative in the court's conclusion. Since the lessee was already draining the

[19] *Id.*
[20] 5 H. WILLIAMS & C. MEYERS, *supra* note 3, at §824.
[21] 406 P. 2d 467 (Okla. 1965).
[22] 199 Okla. 430, 186 P. 2d 823 (1947).
[23] 303 P. 2d 965 (Okla. 1956).

leased premises with wells on adjacent land his intent was inferred as holding the tract for the possibility of finding a separate reservoir and not to drill into the one he was presently draining. In *Gregg v. Harper - Turner Oil Co.*, the United States Court of Appeals for the Tenth Circuit, interpreting Oklaohma law, held that a higher responsibility to develop was due the lessor when the lessee was draining his own lessor's land.[24] The *defendant - lessee* had a producing well on each forty acre tract of the 1,040 acre adjacent tract while only one such well on 160 acres of the *plaintiff - lessor's* tract.[25] The court held that a special duty was owed the lessor since the lessee would ultimately recover all the oil under plaintiff's tract through its other wells.[26] Unlike *Spiller* or *Deep Rock Oil Corp.*, both *Coal Oil & Gas Co.* and *Harper-Turner Oil Co.* at least indirectly considered the factor of drainage by a common lessee from adjacent land. The last two cases have been utilized to establish that:

> [a] lessee who has leases on property adjacent to that of the lessor . . . [owes] a special duty of complete development to the lessor . . . and has been required to drill additional wells under penalty of cancellation even though the lessor has not shown that such wells would be profitable.[27]

The Supreme Court of Oklahoma has now held in *Dixon v. Anadarko Production Co.* that a factor in the lessor's establishment of a prima facie case for cancellation of an oil and gas lease, with the burden on the *defendant - lessee* to excuse his failure to drill, is whether the lessee is draining his lessor's land. Past cases as *Doss* and *McKenna* have considered a showing of unreasonable delay sufficient to shift the burden of

[24] 199 F. 2d 1 (1952).
[25] *Id.* at 4.
[26] For a discussion of the lessor's right to cancel oil and gas leases for breach in absence of showing reasonable expectation of profit to lessee from further drilling when the lessee operates on surrounding land see Annot., 79 A.L.R.2d 792, 808 (1961).
[27] *Id.* at 808.

establishing profitability from the *plaintiff-lessor. Dixon* couples the delay wth the draining of the lessor's land and the imputed superior knowledge of profitability resulting from that drainage to justify shifting the burden of proof. This is a reasonable method of balancing the interests underlying the implied covenants. Both the lessor's concern for reasonable development and protection from drainage and the lessee's right to avoid the cost of undue exploration have been respected. The result is a solution between either placing strict liability on the lessee or ignoring the fact that the lessee is the operator of the offending well.

CONCLUSION

Another factor has been considered for establishing breach of the implied covenants to develop and protect from drainage, *i.e.* whether the alleged drainage is due to the lessee operating on adjacent land.

The court does not simply ask whether the plaintiff-lessor has shown a lack of prudence in the failure to drill. Rather the court has examined factors in light of the essential purposes of the implied covenants allegedly breached for protection of the parties in a circumstance not specifically covered by the lease. Whether there is a likelihood of profit to the lessee if forced to drill as demanded by the lessor is, of course, one factor, unreasonable delay in drilling another.[28] Now *Dixon* has clearly added the factor of whether the lessee is draining his lessor's land and thus unwilling to drill from the lessor's land into a reservoir already reached by the lessee through adjacent land.

[28] Colpitt v. Tull, 204 Okla. 1289, 228 P.2d 1000 (1950); Doss Oil Royalty Co. v. Texas Co., 192 Okla. 359, 137 P.2d 934 (1943).