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COMPULSORY OIL AND GAS UNITIZATION: EFFECT ON OVERRIDING ROYALTY OBLIGATIONS

A HYPOTHETICAL JUDGMENT OF THE HIGH COURT OF JURISTIC REVIEW
IN

PETER FOX BREWING CO. V. SOHIO PETROLEUM CO.*

Maurice H. Merrill†

JUS, CHIEF JUSTICE. As should be well known, our practice is to sit in review of decisions presenting elements of difficulty, and concerning the propriety of which there seems reason for doubt. We have no jurisdiction to reverse, to modify, or to affirm. Our judgment must be confined to approval or to disapprobation, or to some position between these two extremes.

The principal case, as determined in the United States District Court for the Northern District of Illinois¹ and as affirmed by the Court of Appeals for the Seventh Circuit,² appears to be a matter peculiarly apt for our examination. It is not alone that the decision is on important questions of law which were hotly contested and closely debated. There is the further consideration that the points determined were of first impression, involving construction of the statutory law of a distant jurisdiction and application of that law in a context not familiar to those sitting in judgment. If these points were determined improperly, the effect of the precedent, if we allow it to go unexamined, may be most unfortunate. Of course, even should we come to the conclusion that the disposition was wrong, this misfortune may not be avoided. Courts with more mundane competence than ours may accept the authority of the decisions. But, at least, we shall have made available our views.

I. STATEMENT OF THE PROBLEM

In some respects, our statement of facts will be more in detail than that contained in the opinions filed by the courts under review. However, it does not alter the essential bases of the litigation. The additional detail serves merely to clarify the legal issues involved.

Fox and Schmitz, hereinafter designated for convenience as

* 296 F.2d 274 (7th Cir. 1961), *affirming* 189 F. Supp. 743 (N.D. Ill. 1960).

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¹ *Peter Fox Brewing Co. v. Sohio Petroleum Co.*, 189 F. Supp. 743 (N.D. Ill. 1960).

² 296 F.2d 274 (7th Cir. 1961).

F, owned certain oil leases on land in Oklahoma.³ By contract, hereinafter referred to as the Agreement, executed August 20, 1943, *F* contracted with the Standard Oil Company of Ohio, hereinafter referred to as *S*,⁴ to assign these leases to *S* in return for a cash consideration and other stipulations which, so far they are important, are specified hereinafter. By the terms of the Agreement and of the effectuating assignments, *F* reserved, as to all the leases "as a group,"

"... an overriding royalty (free and clear of all development and operating expense) . . . of one-half of the crude oil, gas, casinghead gas, and other hydro-carbons produced, saved and marketed from said leasehold premises or the proceeds thereof accruing to the working interests assigned and transferred hereunder to Standard or its nominee, subject, however, to a deduction from said one-half (1/2) of the following items:

"... (b) That quantity of crude oil, gas, casinghead gas, and other hydro-carbons, or the proceeds thereof, which at current well market prices at the time of sale thereof, shall be equal in value to \$200 per each producing well per month, except that in the event that any well producing oil in paying quantities shall at the same time produce water in excess of 10% of the total fluid produced from the well, then as to that well during such period while such condition shall exist the deduction shall be that quantity of crude oil, gas, casinghead gas, and other hydro-carbons, or the proceeds thereof which at current well market prices at the time of sale thereof shall be equal in value to \$250 per month."

If this subtraction, and other authorized deductions which now have become obsolete, produced a deficit for any month, *F* was to be under no duty to make up the deficit, but such deficits were to be carried forward and deducted from net amounts due *F* in the future "until such deficit or deficits shall have been liquidated." Obviously, under such an arrangement, some wells might decline in production to a point indicating permanent unprofitability to *F*. As a safeguard against such an outcome, *F* was permitted to

³ While we speak of Fox and Schmitz only in the role of plaintiffs, actually, as the result of various transfers of interest, many persons came to occupy the position of plaintiffs and some were divested of their interests during the progress of the litigation. Our concentration upon the individuals Fox and Schmitz is in the interest of simplicity.

⁴ Actually, Standard later transferred its interests to its wholly owned subsidiary, Sohio Oil Company. In the interest of simplicity, we shall ignore this transfer, which in no way altered the legal picture, and shall continue to use the letter *S* to designate Standard or Sohio, whichever at the moment was the owner of the leases.

tender to *S* an assignment of "all right, title or interest in and to the overriding royalty reserved herein in so far as the same related or pertains to" any well as to which the amounts payable did not exceed the amounts deductible for ninety days or more. Thereafter, computations of overriding royalties were to be made without reference to the production from wells so released.

S, in turn, assumed obligations to *F*. It agreed to shut in no paying well except for necessary repair or reconditioning work or for compliance with state or federal regulation.⁵ It agreed to develop and operate the properties "in a good and workmanlike manner at all times,"⁶ and agreed that producing wells should be kept "at the maximum rate of production" allowed by the state or federal authority having jurisdiction.⁷ It agreed to render to *F* monthly itemized statements of receipts and disbursements, to give *F* "pertinent information" concerning drilling and operations, and to permit *F* to examine relevant books and records.⁸ *S*, while retaining full discretion as to the development and operation of the premises, agreed to manage and develop the entire premises "to the mutual benefit of both parties and in compliance at all times with the 'prudent operator' rule."⁹ In case of failure to offset wells on adjoining land, *S* agreed that there should be reassigned to *F*, on demand, forty acres centered about the site where the offset should have been drilled.¹⁰ *S* was to give *F* thirty days notification of the intended abandonment of any well, whereupon *F* was to have the option, within twenty days, to request a reassignment of the forty acres surrounding that well upon paying *S* the fair value of the equipment connected with the well. Upon such reassignment the well, its production, and the reassigned area were to be excluded from the provisions of the agreement.¹¹

This contract became effective. The assignments were made. *S* took over the development and operation of the assigned leases. Thereafter, at its 1945 session, the Oklahoma Legislature enacted a statute authorizing the compulsory merging of oil and gas properties tapping a common source of supply for the purpose of unitized operation.¹² Under this statute, the West Edmond Hunton Lime

⁵ Agreement § 5.

⁶ *Id.* § 6.

⁷ *Id.* § 5.

⁸ *Id.* § 6.

⁹ *Id.* § 8.

¹⁰ *Ibid.*

¹¹ *Id.* § 13.

¹² Okla. Sess. Laws 1945, tit. 52, ch. 3b.

Unit was created, effective October 1, 1947. It embraced, along with other properties, all the leases then covered by the Agreement. The production from these leases was from the Hunton Lime. S became the Unit Operator, under the supervision of the Operating Committee of the Unit. In 1951 the original unitization statute was repealed.¹³ However, it was replaced by a substitute law¹⁴ which, insofar as the matters involved in this litigation are concerned, was practically identical with the prior law. For that reason, reference will be made to the present statute, under which the Unit now is operating.¹⁵ The details of the operation of these laws, as they affect the problem at hand, will be developed more fully in the appropriate portions of this opinion.

In the due course of the unitized operation, a number of the wells subject to the Agreement were abandoned as producing wells. The tracts on which these abandoned wells were located continued to share in the unit production according to the percentage assigned to them in connection with the unitization. Despite the discontinuance of these wells, S persisted in subtracting from the share of the return apportioned to each such tract the monthly decrement provided for in the Agreement.¹⁶ Likewise, it made that same deduction for the wells continued in operation. This was done in reliance upon those provisions of the unitization statute reading:

"Property rights, leases, contracts, and all other rights and obligations shall be regarded as amended and modified to the extent necessary to conform to the provisions and requirements of this Act and to any valid and applicable plan of unitization or order of the Commission made and adopted pursuant hereto, *but otherwise to remain in full force and effect*. . . . The amount of the unit production allocated to each separately-owned tract within the unit, and only that amount, regardless of the well or wells in the unit area from which it may be produced, and regardless of whether it be more or less than the amount of the production from the well or wells, if any, on any such separately-owned tract, shall for all intents, uses and purposes be regarded and considered as production from such separately-owned tract, and, except as may be other-

¹³ Okla. Sess. Laws 1951, tit. 52, ch. 3b, § 16.

¹⁴ Now OKLA. STAT. tit. 52, §§ 287.1-.15 (1961).

¹⁵ Cf. *Palmer Oil Corp. v. Amerada Petroleum Corp.*, 343 U.S. 390 (1952), upholding the unitization legislation in litigation commenced before the repeal and substituted enactment, the Supreme Court of the United States having been "advised by the Supreme Court of Oklahoma that this repeal had no effect on these causes."

¹⁶ Agreement § 4.

wise authorized in this Act, or in the plan of unitization approved by the Commission, shall be distributed among or the proceeds thereof paid to the several persons entitled to share in the production from such separately-owned tract in the same manner, *in the same proportions*, and upon the same conditions *that they would have participated and shared in the production or proceeds thereof from such separately owned tract had not said unit been organized and with the same legal force and effect.*"¹⁷

The deductions taken by *S* have produced a deficit, as to many of the tracts, in the share accruing to the overriding royalty. Further, the allocable proportion under the unitized operation has resulted in less monthly revenue to the tracts under the Agreement than was realized under individual operation.

In consequence, plaintiffs below, some original owners of and some successors to the *F* interests, filed this suit against *S* to reform the agreement by eliminating the provision for the per well deduction, as being in conflict with the Oklahoma unitization law and the actual unitization agreement, and as being frustrated in its contractual object by the operation of the unitization agreement. Plaintiffs asked an accounting covering the sums which would have been due to the *F* interests under the contract as reformed from the date of unitization. At law they sought a money judgment on the theory that, as the enactment of the unitization statute and the creation of the unit ipso facto invalidated the provision for the per-well deduction, no reformation was actually necessary; in any event, they contended, elimination of the deductions as to the abandoned wells did not require reformation. The trial court denied all relief, and the court of appeals affirmed this denial in all respects.

In reviewing these determinations, we shall enumerate, first, certain general elementary principles which seem to us basic for the proper solution of the problems presented by the litigation. Then we shall discuss, in greater detail, the specific issues requiring answer in order to provide the correct determination of these problems.

II. GENERAL PRINCIPLES

A. The Agreement, relating to an interest in Oklahoma land¹⁸ and necessitating performance in Oklahoma, is governed by Okla-

¹⁷ OKLA. STAT. tit. 52, § 287.9 (1961). (Emphasis added.)

¹⁸ Black v. Wickett, 146 Okla. 191, 293 Pac. 782 (1930).

homa law as to validity,¹⁹ and as to obligations of performance.²⁰

B. By the Oklahoma statutes, performance of the Agreement has become illegal to such extent as may be necessary to conform to the unitization law and to the Plan of Unitization of the West Edmond Hunton Lime Unit adopted in pursuance thereof. The Agreement and the rights and obligations thereunder must be regarded as amended and modified to that extent.²¹

C. By the Oklahoma statutes: "A contract must be so interpreted as to give effect to the mutual intention of the parties, as it existed at the time of contracting, so far as the same is ascertainable and lawful."²² "The whole of a contract is to be taken together, so as to give effect to every part, if reasonably practicable, each clause helping to interpret the others."²³ "A contract must receive such an interpretation as will make it lawful, operative, definite, reasonable and capable of being carried into effect, if it can be done without violating the intention of the parties."²⁴ "However broad may be the terms of a contract, it extends only to those things concerning which it appears that the parties intended to contract."²⁵

D. By the law of Oklahoma, "A contract may be explained by reference to the circumstances under which it was made, and the matter to which it relates."²⁶ Hence testimony may be received to establish these matters.²⁷

E. Under these principles, it is clear that, in determining the extent to which the Agreement is not in harmony with the provisions and requirements of the unitization law, a particular provision may not be read in isolation. A portion of the Agreement may not be sustained simply because there is no verbal inconsistency between it and the statute. It must be read in connection with related clauses, to determine the general intent of the parties, in the light of the circumstances surrounding the execution of the contract, as shown by the evidence and by circumstances of which the court may take judicial notice; that general intent must be

¹⁹ RESTATEMENT, CONFLICT OF LAWS § 360(1) (1934).

²⁰ OKLA. STAT. tit. 15, § 162 (1961); 2 BEALE, CONFLICT OF LAWS § 346.6 (1935); GOODRICH, CONFLICT OF LAWS 340 (3d ed. 1949); RESTATEMENT, *op. cit. supra* note 19, § 358.

²¹ OKLA. STAT. tit. 52, § 287.9 (1961).

²² OKLA. STAT. tit. 15, § 152 (1961).

²³ OKLA. STAT. tit. 15, § 157 (1961).

²⁴ OKLA. STAT. tit. 15, § 159 (1961).

²⁵ OKLA. STAT. tit. 15, § 164 (1961).

²⁶ OKLA. STAT. tit. 15, § 163 (1961).

²⁷ *Harjo v. Harjo*, 207 Okla. 73, 247 P.2d 522 (1952); *Tyer v. Caldwell*, 114 Okla. 13, 242 Pac. 760 (1926); *Withington v. Gypsy Oil Co.*, 68 Okla. 138, 172 Pac. 634 (1918); *cf. Union Sugar Co.*, 31 Cal. 2d 300, 188 P.2d 470 (1948).

effectuated, if this can be done lawfully. If the parties' intent cannot be lawfully effectuated, the provisions relative thereto must be regarded as "amended and modified to the extent necessary to conform to the provisions of this [unitization] Act" ²⁸

III. EFFECT OF UNITIZATION ON THE AGREEMENT

The argument for the plaintiffs below rested first upon the proposition that the provision for the deductions from the overriding royalty was based upon a method of operation which was forbidden by the Oklahoma unitization statute and was abandoned in response to the statutory command. Hence, they contended, the provision for that deduction must fall because of its inconsistency with the new legislative scheme. We think that this argument is sound for the following reasons.

By the terms of the Agreement, which, as we have seen, must be read as a whole, *S* was to develop and operate the assigned land on an individual basis as to each tract, utilizing its own judgment and discretion, but in competition with other tracts in the field. It was required to protect the assigned tracts against drainage from wells on adjacent land. It was required so to operate each tract as to secure the maximum production allowable by the state or federal authority having jurisdiction. It agreed to operate and develop the individual properties in a good and workmanlike manner at all times, and to manage and develop them in compliance with the "prudent operator" rule, which requires the exercise of reasonable diligence and care adequately to explore, develop, operate, and protect the property on an individual lease basis.²⁹ *S* was not to shut down any paying well producing oil or gas, except for repairs, for reconditioning, or in accordance with an order of a state or federal officer, board, or agency. *S* was required to tender to *F* a reassignment of tracts on which it determined to abandon wells, together with these wells.

All these provisions constitute an integrated scheme whereby the assigned units were to be developed to, and operated at, maximum productivity. Thereby the *F* interests were given the utmost possible assurance against the contingency that the per-well monthly deductions might create deficits which would reduce their income or which, perhaps, might reduce future royalties. These

²⁸ OKLA. STAT. tit. 52, § 287.9 (1961).

²⁹ See MERRILL, COVENANTS IMPLIED IN OIL AND GAS LEASES § 122 (2d ed. 1940) and authorities there cited.

provisions are so essential in reducing the risk of deficits that they must be taken to be "the basis on which" *F* "assented to the bargain" and to create "a major part—an essential part—of the value of one of the performances [the per-well deduction] that the parties" agreed "to exchange."³⁰ As such, their continued effectiveness is "necessarily inherent in the actual performance of the contract,"³¹ and cessation of the contract constitutes a fact which modifies the promise of *F* in respect to the per-well deduction. Therefore the express development and operation obligations undertaken by *S* are implied conditions on *F*'s liability for the per-well deduction.³² They are, in the language of the Oklahoma statute, the "object" of *F*'s assent to the deduction,³³ and the "consideration" therefor.³⁴

The Oklahoma statutory law and the plan of unitization adopted under its authority, however, wipe out all these stipulations in the following manner:

A. For the judgment and discretion of *S*, the unitization substitutes the direction of the Operating Committee of the Unit. By statute the unit plan is to provide for "an operating committee to have general over-all management and control of the unit and the conduct of its business and affairs and the operations carried on by it."³⁵ The West Edmond Hunton Lime Unit Plan of Unitization constitutes the Operating Committee with a membership of one representative from each lessee within the unit area.³⁶ In addition to giving the Committee general authority in the words of the statute,³⁷ the Plan specifically vests the Committee with power to determine the extent of drilling operations and development;³⁸ with designation of which wells shall produce and at what rate;³⁹ with the approval or disapproval of plans of development or operation to be submitted to regulatory bodies having jurisdiction over the subject matter;⁴⁰ and with the prerogative to "direct and consult with the Unit Operator in all matters pertaining to the duties and functions of the Unit Operator."⁴¹ The Unit Operator is expressly

³⁰ 6 CORBIN, CONTRACTS § 1355, at 465 (1962).

³¹ 5 WILLISTON, CONTRACTS § 668 (3d ed. 1961).

³² *Ibid.*

³³ OKLA. STAT. tit. 15, § 101 (1961).

³⁴ OKLA. STAT. tit. 15, § 106 (1961).

³⁵ OKLA. STAT. tit. 52, § 287.4(e) (1961).

³⁶ Plan of Unitization, West Edmond Hunton Lime Unit [hereinafter referred to as Plan], § VIII(1).

³⁷ *Id.* § VIII(2).

³⁸ *Id.* § VIII(2)(d).

³⁹ *Id.* § VIII(2)(f).

⁴⁰ *Id.* § VIII(2)(l).

⁴¹ *Id.* § VIII(2)(n).

required to carry on and conduct "operations in connection with the development and the operation of the Unit Area for Oil and Gas . . . in accordance with the instructions of the Operating Committee."⁴² This is in entire accord with the theory of unit operation, under which "the lessee surrenders to the discretion of the unit management the power to carry out" his obligations, express and implied, to other interests.⁴³ However, it is entirely inconsistent with the obligations assumed by *S* in the Agreement.

The extent to which these provisions require that the determinations of the Unit Operating Committee supplant the judgment and discretion of *S* is illustrated by *West Edmond Hunton Lime Unit v. Stanolind Oil & Gas Co.*⁴⁴ In that case, the Unit was granted specific performance of a directive of the Unit Operating Committee, requiring the defendant, a lessee of land embraced in the unitized area, to turn over to the control of the Operating Committee a well which had been completed to produce oil from both the Hunton Lime and the Bartlesville Sand overlying the Hunton Lime. The well was to be transferred in such condition as to be capable of production from the Hunton Lime only. The Unit was also granted an injunction forbidding the defendant from using the well bore and equipment for production from the Bartlesville formation. The Court of Appeals for the Tenth Circuit held that the Unit Operating Committee's orders could be reviewed only to determine whether they were "arbitrary, capricious and without any rational basis in fact."⁴⁵ It held that, in view of the evidence as to the possible adverse effect upon the activities of the Unit in the exploitation of the Hunton Lime, the prohibition against dual production from the two sands could not be held to be "arbitrary or capricious." Rather, it was "founded upon the technical knowledge and judgment of those charged with the duty and responsibility of managing and operating the unit."⁴⁶ Thus we see that, as to this matter, as the court of appeals said, "the decision is not committed to the owners of the dually completed wells. . . ."⁴⁷ As a result of this decision, we see that the freedom of *S* to exercise its best judgment and discretion in the operation of the assigned tracts, as required by the Agreement, has been subjected to the control of

⁴² *Id.* § X, at 12.

⁴³ See Jacobs, *Unit Operation of Oil and Gas Fields*, 57 YALE L.J. 1207, 1220 (1948).

⁴⁴ 193 F.2d 818 (10th Cir.), *cert. denied*, 343 U.S. 920 (1952).

⁴⁵ *Id.* at 824.

⁴⁶ *Id.* at 825.

⁴⁷ *Id.* at 823.

the Operating Committee of the Unit, not only with respect to the Hunton Lime production, but also, to an important extent, with respect to the ability to produce from any other sand in the field which is not taken into the unit for exploitation. For instance, if twin wells must be drilled on any of these properties to exploit the Bartlesville Sand, provisions of section 4(b) of the Agreement would inflict upon *F* a doubling of the deduction as to that tract, although, but for the directive in question, the production from the two sands could be secured from a single well, with a single deduction. Obviously, in such a matter, the judgment and discretion of *S* is superseded by that of the Unit Operating Committee, contrary to the provisions of the Agreement.

That this is no chimera is demonstrated by the Report of the Engineering Sub-Committee of the Unit, dated January 27, 1953, from which it appears that, as to wells embraced within the Agreement of August 20, 1943, *S* indicated a desire to produce from the Bartlesville Sand, as well as from the Hunton, on seven tracts of the unit. Its discretion in this respect, however, was subjected to the oversight of the Sub-Committee and the Operating Committee. The report listed, as to those wells, the future destiny recommended for each of them in the unit operation and the extent to which dual completion would be prejudicial to these plans. Five of them were listed as future pumping wells, as to which it was indicated that dual production was impracticable. The two others were listed for future gas lift operation. For them, it was stated that there should be installed additional specialized equipment, at the expense of the Bartlesville Sand production, before the dual production would be approved by the Unit. Obviously the performance of the duties of *S* to *F* under the Agreement was seriously and substantially altered by the unitization, in a manner directly affecting the propriety of the per-well deduction.

B. For the individual development and operation of the assigned tracts, the statute and the plan of unitization substituted unitized operation of the entire source of supply embraced in the Unit, without regard to lease boundaries or location of wells. Thus the statute requires the plan of unitization to include provision for the "efficient unitized management or control of the further development and operation of the unit area for the recovery of oil and gas from the common source of supply affected."⁴⁸ The order creating the unit is to provide "for the unitization and unitized opera-

⁴⁸ OKLA. STAT. tit. 52, § 287.4(a) (1961).

tion of the common source of supply or portion thereof described in the order. . . ."⁴⁹ "From and after the effective date" of the creation of a unit, "the operation of any well producing from the common source of supply or portion thereof within the unit area defined in the order . . . except in the manner and to the extent provided in such plan of unitization shall be unlawful and is hereby prohibited."⁵⁰ Further provision was made for unitization of obligations arising under individual leases:

"Unit production as that term is used in this Act shall mean and include all oil and gas produced from a unit area from and after the effective date of the order of the Commission creating the unit regardless of the well or tract within the unit area from which the same is produced."⁵¹

"Operations carried on under and in compliance with the plan of unitization shall be regarded and considered as a fulfillment of and compliance with all of the provisions, covenants, and conditions, express or implied, of the several oil and gas mining leases upon lands included within the unit area, or other contracts pertaining to the development thereof, insofar as said leases or other contracts may relate to the common source of supply or portion thereof included in the unit area."⁵²

The Plan of Unitization provides that its adoption and the creation of the Unit "shall have the effect from and after the Effective Date hereof of unitizing all further development and operations for the production of Oil and Gas from the Unit Area and of pooling and unitizing the production so obtained, all to the same extent as if the Unit Area had been included in a single lease and all rights thereunder owned by the Lessees in undivided interests."⁵³

C. For the obligation to drill wells on each tract in accordance with the prudent operator rule, there is substituted a restriction of drilling to such wells as the Unit Operating Committee may authorize.⁵⁴ The Plan of Unitization makes it the function of that Committee to "determine the extent of drilling operations and development to be carried on by the Unit Operator, including the

⁴⁹ OKLA. STAT. tit. 52, § 287.3 (1961).

⁵⁰ OKLA. STAT. tit. 52, § 287.7 (1961).

⁵¹ OKLA. STAT. tit. 52, § 287.4(b) (1961).

⁵² OKLA. STAT. tit. 52, § 287.9 (1961); see Plan § VI, at 4.

⁵³ Plan § VI, at 3.

⁵⁴ OKLA. STAT. tit. 52, § 287.7 (1961).

approval or disapproval of the contemplated drilling, deepening, plugging back, reconditioning, abandonment or the use to be made of any well or wells."⁵⁵ "Wells drilled or operated on any part of the unit area no matter where located shall for all purposes be regarded as wells drilled on each separately-owned tract within such unit area."⁵⁶ All this accords with the general principle of unit operation, whereby development within the unitized tract, though not on the leased premises, complies with the operator's obligation to develop the leased premises;⁵⁷ but it is in diametric opposition to the advantages secured to *F* by the provision of the Agreement for the development of each tract in accordance with the obligation of the prudent operator.

D. For the obligation to protect each tract against drainage by wells on neighboring lands, there is substituted the bringing of all production into hotchpot,⁵⁸ and the principle that offsetting obligations do not apply between tracts within the same unit.⁵⁹

E. For the obligation to operate each well to secure the maximum productivity allowable under the conservation laws, there is substituted production from such wells and at such a rate as the Unit Operating Committee shall determine.⁶⁰ As to wells "making water," operation shall be directed, not to achieve maximum productivity, but "to minimize water encroachment into the Unit Area," and to "retard, control or effectively utilize such water encroachment."⁶¹

F. For the obligation not to shut down any well producing oil or gas in paying quantities, and for the stipulation that "all producing wells will be operated at all times,"⁶² there is substituted a wholesale program of shutting in wells.⁶³ These restrictions on pro-

⁵⁵ Plan § VIII(2)(d).

⁵⁶ OKLA. STAT. tit. 52, § 287.9 (1961).

⁵⁷ *Hardy v. Union Producing Co.*, 207 La. 137, 20 So. 2d 734 (1945).

⁵⁸ OKLA. STAT. tit. 52, §§ 287.4(b), 287.9 (1961).

⁵⁹ *Hood v. Southern Prod. Co.*, 206 La. 642, 19 So. 2d 336 (1944).

⁶⁰ Plan § VIII(2)(f).

⁶¹ *Id.* § XV(b).

⁶² Agreement § 5.

⁶³ Thus section XV of the Plan of Unitization provides:

"(d) The oil produced from the Unit Area shall be produced from those wells . . . from which the same can be obtained with the smallest loss or dissipation of reservoir energy reasonably possible under practicable operating conditions as they may exist from time to time.

"(e) Gas wells and wells which produce oil with gas-oil ratios found to be excessive in relation to the gas-oil ratios of other wells producing oil from the Unit Area shall be shut in or the production therefrom restricted in such manner as to make the most effective utilization of the gas energy of the reservoir reasonably possible under practical operating conditions as they may exist from time to time.

duction were regarded as one of the most beneficial incidents of this unitization.⁶⁴

Moreover, the exception in the Agreement that wells are to be shut in only "pursuant to an order, rule, or regulation of any officer, board or agency, state or federal,"⁶⁵ is superseded by the authority granted to the Unit, as outlined above. This Unit clearly is not a state or federal officer, board or agency, within the meaning of the Agreement. By statutory definition, it functions "on behalf and for the account of all the owners of the oil and gas rights within the unit area . . . to supervise, manage and conduct the further development and operations for the production of oil and gas from the unit area"⁶⁶ It holds possession of the property which it uses in the course of its operations "as agent of the several lessees"⁶⁷ It does not wield the governmental authority of the state through the issuance of orders, rules or regulations. True, the Unit is described as a "body politic and corporate,"⁶⁸ and it does play an important role in implementing Oklahoma's public policy to promote the conservation of oil and gas. But its general features approximate much more closely those of a private institution than those of a public authority. It has been suggested that it is likely that the analogies of private law, rather than those of public law, will be applied to most of its dealings.⁶⁹ Indeed, the Unit engages in the essentially private enterprise of developing and operating an oil field under statutory authority. Yet its determinations may shut in wells, contrary to the terms of the Agreement. While, for the field as a whole, and in the long run, restrictions of this sort, and of the other varieties previously discussed, may work out advantageously, it is obvious that, in connection with the hotchpot distribution of proceeds, they seriously restrict the monthly income apportionable to particular tracts. Thus they reduce the ability of

"(f) Gas (other than gas produced in connection with production of oil) shall be produced from the Unit Area only at such time or times and in such manner as in the judgment of the Operating Committee such gas may be produced without materially decreasing the quantity of oil economically recoverable from the Unit Area."

⁶⁴ "Unitization will immediately permit the selective production of wells. This will result in a substantial reduction in the daily gas production and at the same time the daily oil production from the field will be maintained at its present level or increased." See Barnes, *West Edmond's Unitization and Gas Injection Project Would Be One of Largest*, Oil and Gas J., Dec. 14, 1946, pp. 70, 71.

⁶⁵ Agreement § 7.

⁶⁶ OKLA. STAT. tit. 52, § 287.8 (1961).

⁶⁷ OKLA. STAT. tit. 52, § 287.9 (1961).

⁶⁸ OKLA. STAT. tit. 52, § 287.8 (1961).

⁶⁹ See Merrill, *The Legal Status of a Statutory Oil and Gas Production Unit*, 10 OKLA. L. REV. 249, 254 (1957).

the overriding royalty share to sustain the per-well deduction as compared with its ability to do so under operation on an individual basis according to the standards set by the Agreement.

G. For the "one-half of the crude oil, gas, casinghead gas and other hydro-carbons produced, saved, and marketed from said leasehold premises or the proceeds thereof accruing to the working interests assigned or transferred hereunder" reserved to *F* by the Agreement, the Plan of Unitization substitutes a similar share of the "amount of the unit production allocated to each separately-owned tract within the unit, and only that amount, regardless of the well or wells within the unit area from which it may be produced, and regardless of whether it may be more or less than the amount of the production from the well or wells, if any, on any such separately owned tract."⁷⁰ This proportion is to be determined by a formula which "will reasonably permit persons otherwise entitled to share in or benefit by the production from such separately-owned tracts to produce or receive, in lieu thereof, their fair, equitable and reasonable share of the unit production or other benefits thereof." This "fair, equitable and reasonable share of the unit production shall be measured by the value of each such tract for oil and gas purposes and its contributing value to the unit in relation to like values of other tracts in the unit, taking into account acreage, the quantity of oil and gas recoverable therefrom, location on structure, its probable productivity of oil and gas in the absence of unit operations, the burden of operation to which the tract will or is likely to be subjected, or so many of said factors, or such other pertinent engineering, geological, or operating factors, as may be reasonably susceptible of determination."⁷¹ This allocation is set up in Exhibit B to the Plan of Unitization and is approved and adopted in section VII of the Plan.

In contrast to this scheme, by the law as it existed at the execution of the Agreement between *F* and *S*, the production realizable from each separate tract was determinable by the "Law of Capture," limited only to the extent prescribed by the Oklahoma conservation laws.⁷² Under that law, the actual production from the

⁷⁰ Plan § VI, at 4.

⁷¹ OKLA. STAT. tit. 52, § 287.4(b) (1961).

⁷² "The law of capture, under which oil and gas is owned by the one lawfully reducing it to possession, still obtains in Oklahoma, except as it has been or may be regulated or restricted under laws passed in the exercise of the police power, such as the proration and spacing statutes and city zoning ordinances. Those laws do not abrogate the rule of capture." *Gruger v. Phillips Petroleum Co.*, 192 Okla. 259, 262, 135 P.2d 485, 488 (1943). This opinion, filed Feb. 16, 1943, was the latest exposition of the law of Oklahoma when the Agreement of August 20, 1943, was executed.

various tracts, subject to conservation regulations, was limited only by the diligence and the efficiency of the operations. *S* might capture more than the fair share of the tracts he was operating, if by promptitude and skill he could do so.⁷³ Such diligence and efficiency *S* had contracted expressly to exercise, by the provisions heretofore set out. Had this not been provided, the law would have imposed the duty by implication.⁷⁴

How different is the situation of *F* under the Plan! As has been aptly said, "With unitization, every operator and royalty owner receives a fixed percentage of revenue from the entire field."⁷⁵ The elements specified for determining the allocation of the proceeds from this unitized operation differ entirely from, and are more limiting than, the conditions of operation for which *F* contracted. They materially and adversely affect the prospect of earning income sufficient to cover the specified per-well deductions plus a substantial remainder for credit to the reserved override. This change could not have been, by any stretch of the imagination, within the contemplation of the parties in 1943 when the Agreement was executed, since there was then no unitization law upon the books.

The trial court thought that the Agreement should not be regarded as calling for "competitive exploitation," but rather as contemplating the possibility of unitization and making no provision for the effect thereof on the provision for the per-well deduction.⁷⁶ This it deduced from the provision that paying wells should not be shut in, except for repairs or reconditioning, "unless pursuant to an order, rule or regulation of any officer, board or agency, state or federal."⁷⁷ The appellate court somewhat blunted the force of this argument by saying that this clause referred to "governmental regulation in general and not to unitization exclusively," capping this off by saying that, in any event, the finding was unnecessary.⁷⁸ Concerning this last, the only comment we have to make is that we are reminded of the lawyer whose argument was interrupted by the interjection from the bench, "That's not the law"; he responded, "It was until Your Honor just spoke." The statement

⁷³ *Indian Territory Illuminating Oil Co. v. Larkins*, 168 Okla. 69, 31 P.2d 608 (1934); *cf. Wood Oil Co. v. Corporation Comm'n*, 205 Okla. 537, 239 P.2d 1023 (1950).

⁷⁴ *Cosden v. Carter Wolf Drilling Co.*, 183 F.2d 761 (10th Cir. 1950); see MERRILL, *op. cit. supra* note 29, § 188.

⁷⁵ See Barnes, *supra* note 64, at 71.

⁷⁶ See *Peter Fox Brewing Co. v. Sohio Petroleum Co.*, 189 F. Supp. 743, 755 (N.D. Ill. 1960).

⁷⁷ Agreement § 5.

⁷⁸ See *Peter Fox Brewing Co. v. Sohio Petroleum Co.*, 296 F.2d 274, 280 (7th Cir. 1961).

of the appellate court amounts to an assertion that the contemplation of the parties has no relevance to the interpretation of contractual language or to its continued effect when confronted by a cataclysmic change in governmental policy. This position is unique, to say the least.⁷⁹

As to the notions that the contractual language referred either to a unitization program specifically or to any conceivable sort of governmental regulation that might be invented in the future, these cannot stand when we realize that there were in effect at the time the Agreement was formed numerous Oklahoma statutes relative to prorationing of production, well-spacing, the prevention of wasteful methods of production, and the like,⁸⁰ under which wells could be shut in. Leases and other contractual documents relating to oil interests had long contained clauses designed to relieve operators from the risks that orders of this kind might be held insufficient protection against liability for failure to perform their contractual responsibilities.⁸¹ Parties to these stipulations clearly would have in mind the effects of orders of this sort upon the competitive operations with which they were familiar. It requires an extreme effort of the imagination to assume that the provisions in question were intended to preserve the deduction stipulations unaltered under a regulatory regime diametrically opposed to the condition of exploitation under which these contracts were designed to operate.

H. The option of *F* to take over wells abandoned by *S*⁸² is in conflict with many provisions of the statute and the Plan of Unitization, which, therefore, supersede it. Under the statute the Plan is required to set up a basis "upon which wells, equipment and other properties of the several lessees within the unit area are to be taken over and used for unit operations,"⁸³ thereby disabling *S* from transferring abandoned wells and equipment to *F*. Moreover, *F* could not take over abandoned wells to operate on an individual basis, as contemplated by the Agreement, since "the operation of any well producing from the common source of supply or portion thereof within the unit area defined in the order by persons other

⁷⁹ See 6 CORBIN, *op. cit. supra* note 30, §§ 1353-61; 6 WILLISTON, *CONTRACTS* § 1954 (Rev. ed. 1938).

⁸⁰ OKLA. STAT. tit. 52, §§ 81-303 (1961).

⁸¹ See BROWN, *OIL AND GAS LEASES* § 13.03 (1958); Mettrill, *Lease Clauses Affecting Implied Covenants*, in SOUTHWESTERN LEGAL FOUNDATION, *SECOND ANNUAL INSTITUTE ON OIL AND GAS LAW AND TAXATION* 141, 189 (1951); Terry, *Miscellaneous Clauses in Oil and Gas Leases*, in *id.* at 237, 264 (1951).

⁸² Agreement § 14.

⁸³ OKLA. STAT. tit. 52, § 287.4(d) (1961).

than the unit or persons acting under its authority or except in the manner and to the extent provided in such plan of unitization shall be unlawful and is hereby prohibited.”⁸⁴ Wells to be abandoned are to be turned back only to the lessee, to be utilized only “for the purpose of completing the same in some other formation not a part of the Unit Area.”⁸⁵ The lessee must “agree to assume full responsibility for the proper plugging and abandonment thereof at such time as the well is ultimately abandoned.”⁸⁶ The incompatibility of these provisions with a surrender of such wells and their equipment to *F* by *S* is apparent. *F*’s option to take over wells abandoned by *S* is so important a protection to the former against the effects of the per-well deduction that it is impossible for us to conceive how the courts below could have held that the deduction provision survived its abrogation. Their opinions are regrettably silent upon this most significant point. The learned courts below make no reference to this destruction of the royalty owner’s privileges correlative to the benefits granted the lessee, or to the incongruity that the one should survive and not the other.

From the recitation of the above items, it is clear that the law and the plan of operation adopted under the law have abrogated so many of the provisions of the Agreement governing the conditions under which the per-well deduction was to be made as completely to change the circumstances surrounding the operation of the assigned properties and to alter to the detriment of *F* the obligations upon which he could rely to keep the production up to levels which would assure a return to him after the per-well deductions had been made. This calls into operation the principle that when a change in law forbids the performance of an essential condition of a contractual obligation, the obligation also ceases.⁸⁷

IV. THE SUPERSEDING CHARACTERISTICS OF UNITIZATION

The supersession, by unitization, of agreements touching the individual properties incorporated in the unit has been recognized repeatedly by other courts.

In *Griswold v. Public Serv. Co.*,⁸⁸ the Supreme Court of Okla-

⁸⁴ OKLA. STAT. tit. 52, § 287.7 (1961).

⁸⁵ Plan § XXIV.

⁸⁶ *Ibid.*

⁸⁷ *Davidson v. Gaskill*, 32 Okla. 40, 121 Pac. 649 (1913); *accord*, *American Mercantile Exch. v. Blunt*, 102 Me. 128, 66 Atl. 212 (1906); *Midwood Sanitarium v. Fireman’s Fund Ins. Co.*, 261 N.Y. 381, 185 N.E. 674 (1933); *Cole v. Addison*, 153 Ore. 688, 58 P.2d 1013 (1936).

⁸⁸ 205 Okla. 412, 415, 238 P.2d 322, 325-26 (1951).

homa held that royalty provisions of individual leases were superseded by unitization, saying, "Their lease was communitized . . . and thereafter royalties were payable under the communitized lease, and not under their lease."

In *Beene v. Midstates Oil Corp.*,⁸⁹ the plaintiff was lessor under a lease to the defendant which, in addition to the normal royalty, reserved to the plaintiff an overriding royalty of an additional one-eighth, calculated on the production from each well separately, which was to be reduced to one-sixteenth as to any well "for such period . . . as such well is not capable of producing 50 barrels of oil per day when operated by a competent operator utilizing efficient and practicable methods and equipment for producing oil and gas." Later, the lease was combined with other lands in a field-wide unit. The plaintiff, as lessor, as well as the defendant, as lessee, executed the unitization agreement. That agreement contained provisions for the operation of the area as a unit; provided a formula for the apportionment of the unitized production among the individual tracts; and specified that "payments to all Operators and Royalty Owners are to be made on the basis of an assumed production in the amount or value of the Unitized Substances allocated under the agreement to each Production Unit in lieu of the actual production from each Production Unit" and that "payments made upon the basis herein stipulated shall constitute full performance of all obligations to pay rentals, royalties and all other sums whatsoever which may become payable to Royalty Owners. . . ." It further provided, in language strikingly similar to that of the Oklahoma statute,⁹⁰ that "existing permits, leases, pooling agreements, drilling and operating contracts, overriding royalty agreements, or other instruments affecting the lands covered by this agreement owned or held by the parties subscribing or consenting hereto, shall continue in full force and effect to the extent that they or any one or more thereof, are not in conflict with the provisions of or are not modified by this agreement, but in case of conflict the provisions of this agreement during its effectiveness shall govern and control, and such other agreements shall be and the same are hereby modified and amended accordingly."⁹¹ Under the operations in accordance with that agreement some wells were shut down, some were used for water injection, and some were used for gas injection. The point at issue between the plaintiff and the defend-

⁸⁹ 169 F.2d 901 (8th Cir. 1948).

⁹⁰ OKLA. STAT. tit. 52, § 287.9 (1961).

⁹¹ *Beene v. Midstates Oil Corp.*, 169 F.2d 901, 906, 907 (8th Cir. 1948).

ant was whether, as to certain wells to which the proportion assigned from the total unit production turned out at certain periods to be less than fifty barrels per day, the override should be paid on the basis of one-eighth or one-sixteenth for those periods. These wells had produced better than fifty barrels per day prior to unitization, and it was the plaintiff's contention that they were still capable of such production if operated on the basis prescribed in the lease. The court, in denying their contention that payment should be on the basis of one-eighth of the allocated return, said:

"The plan of the Agreement for consummating payment to the royalty owner is complete and it is clear that all such payments shall be made on the basis of an assumed production calculated and arrived at according to prescribed formula. It precludes resort to other bases of calculation to arrive at payments due any interested party by its specific provisions and its whole scheme for production and calculation and distribution of benefits is inconsistent with and in contrast to the use of actual or natural flow production of any well as a basis of calculation of a royalty or overriding royalty interest. The only basis contemplated for determining such interests is the assumed basis produced by the technical method of reckoning set forth in minute detail in the Agreement. An allocation made on that basis is the only measure of individual interest contemplated by the Agreement.

"Such assumed basis is in conflict with the basis of calculation of payments provided in the royalty and overriding royalty provisions of the lease. Both the one-eighth royalty and the one-eighth override were according to the lease to be calculated on the basis of the saved product of each well and admittedly the Agreement supersedes and supplies a new basis for both those calculations, the new basis being the 'allocation' provided for by the Agreement. The substitution of the 'allocation' for the former basis of actual production does not result because of express words of substitution in the Agreement. It follows from the conflict between the old basis defined in the lease and the new basis defined in the Agreement and the declaration of the Agreement that the new shall control over the old."⁹²

The significance of the *Beene* decision, as applied to the problem here involved, is twofold. (1) The decision recognizes that the supersession of individual agreements by the unitization plan, al-

⁹² *Id.* at 908.

though stated, as in the Oklahoma statute, to be limited to instances of conflict with or modification by the unitization plan, extends to provisions which are not verbally in conflict with or modified by the plan, but are necessarily involved with a method of exploitation which has been superseded by the plan. The continued capability of the wells to produce under the competitive conditions contemplated by the lease *could* have been determined, just as, in the instant situation, the per-well deduction *can* be determined. But, in each case, the continued effectiveness of the stipulation is inconsistent with the conditions of operation brought into play by unitization. (2) The court expressly recognizes that unitization constitutes "a pooled operation aimed at getting the most out of the area by efficient methods, excluding the concept of competitive production from one well against another. . . ." ⁹³ Consequently, the provisions of a contract designed to operate under conditions of competitive production, as the provisions of the Agreement of August 20, 1943, have been shown to be intended, cannot survive unitization.

In *Waller v. Midstates Oil Corp.*,⁹⁴ the lessors had reserved an overriding royalty in addition to the customary one-eighth. It was provided that the override should cease, as to any drilling unit, "when the well or wells on any such particular unit ceases to flow oil without being pumped or produced by other artificial means." At the time of unitization, all the wells on the premises were flowing, or were capable of flowing, oil, without resort to pumping or to other artificial means. The unitization became effective, with the assent of the lessors. Some of the wells in question were killed and used for injection wells. The lessor contended "that the whole field is being produced by mechanical means and that ended the excess royalty due plaintiffs." The Supreme Court of Louisiana ruled to the contrary, adopting the expressed opinion of the trial judge:

"[W]e think that since the individual leases with respect to the production of oil therefrom have lost their identity, that of necessity the leases lost their identity as excess royalty based on the manner of production of oil from the leased premises, and that the excess royalties were transferred from '7/8 of the oil *produced* from the respective drilling units' to '7/8 of the oil *allocated* to this drilling unit' just the same as the 1/18th [*sic*] underlying royalty was handled. It would certainly be unfair and unjust to the land owner to say to him that we have

⁹³ *Id.* at 909.

⁹⁴ 218 La. 179, 48 So. 2d 648 (1950).

drilled your wells and used them for injection wells and since we are producing no oil from your lease, we will pay you no royalty—they didn't say this; they said we will pay you on the agreed percentage of production in the field just as if the oil was produced from your well. There can be no sound reason why the same procedure should not, and was not followed with respect to overriding royalties. We think the agreement gives the answer, it does."⁹⁵

The significant aspect of the case is that the court held that the provision relative to termination of the override, when wells cease "to flow without being pumped or produced by other artificial means," had no continued validity after the operation of the field was shifted, from the competitive basis in respect to which that provision was drafted, to a unitized basis. As the court said, "We think that if defendant had said to plaintiffs, if you will sign this instrument, we will put the field on a mechanical basis, and that will stop your overriding royalty, they would never have secured the signatures of these plaintiffs to the agreement."⁹⁶ So, here, had it been said to *F* that the per-well deduction⁹⁷ would survive the competitive operation of the assigned properties, the individual disposition of all produced hydro-carbons, and the effectiveness of the eight distinct features of the contract, all of which facets tended to assure to *F* a productiveness from individual tracts adequate to support the deduction (yet all of which were superseded by unitization), we think it clear that *F* never would have assented to that deduction.

We think that portion of section 4 of the Agreement which relates to the per-well deduction is so utterly inconsistent with the program of development and operation set up for the West Edmond Hunton Lime Unit by the statute and the Plan of Unitization adopted therefor as to fall within the terms of the provision that "Property rights, leases, contracts and all other rights and obligations shall be regarded as amended and modified to the extent necessary to conform to the provisions and requirements of this Act and to any valid and applicable plan of unitization or order of the Commission made and adopted pursuant hereto"⁹⁸

The courts below attempted to evade the force of this statutory language by saying that the unitization did not render impossible

⁹⁵ See *Waller v. Midstates Oil Corp.*, *supra* note 94, at 196, 48 So. 2d at 654.

⁹⁶ *Ibid.*

⁹⁷ Agreement § 4.

⁹⁸ OKLA. STAT. tit. 52, § 297.9 (1961).

the performance of the provision for the per-well deduction.⁹⁹ This is true enough, in the sense that, as a matter of arithmetic, the allowance *can* be ascertained, and *can* be deducted from the share of the unit production allotted to each tract. But the functions which this allowance was to fulfill no longer are realizable. The suppositions on which it was based are gone with the old law. What sort of justice is it which allows *S* to continue enjoyment of the allowance after its utility has vanished? That its sole objective was to compensate *S* for expenses in connection with operating under conditions now eliminated by the statutory unitization we think is manifest.

In the first place, this is made clear by the terms of the Agreement itself. Section 6 requires *S* to furnish *F*, monthly "a full, complete and itemized statement of all receipts and disbursements in connection with the development and operation of the aforesaid properties during the preceding calendar month and to permit *F* at any time upon request to examine the books and records of *S* or of its subsidiary operating said premises in so far as the same pertain to such operations." Since *F*'s override is a carried interest, "free and clear of all development and operating expense," the only need which *F* could have for such statements and for access to the books and records of *S* relating to the development and operation of the premises would be to determine the advisability of exercising the two options reserved to *F*: (1) to eliminate from the contract wells which run deficits for ninety days or more¹⁰⁰ and (2) to take over wells which *S* determines to abandon.¹⁰¹ In forecasting the probable future profitability of wells, the comparison of the operating expense with the gross income and the per-well deduction would be of vital significance, from the standpoint of both *S* and *F*. The existence of the deduction would be a factor inducing *S* to continue operation of a well beyond the time when otherwise it might desire to abandon or to turn it back; it would also be a factor in the determination by *F* as to whether continued operation, after the deduction was eliminated, would be profitable. Similarly, the comparison of operating expense with income would be of significance to *F* in appraising on the one hand whether deficits from a particular well likely would be permanent and, on the other hand, whether, even with the per-well deduction, there was

⁹⁹ See *Peter Fox Brewing Co. v. Sohio Petroleum Co.*, 189 F. Supp. 743, 760 (1960); *Peter Fox Brewing Co. v. Sohio Petroleum Co.*, 296 F.2d 274, 280 (1961).

¹⁰⁰ Agreement § 4(2).

¹⁰¹ Agreement § 13.

likely to be a continuing operating loss which would lead *S* to proffer a return of the well. These factors would have a potent bearing on the propriety of a determination to release a particular tract from the override. The courts below seem nowhere to have given cognizance to this aspect of the problem.

Again, the manner in which the deduction is established shows its character as a contribution to operating expenses. The override is set up first, "free and clear of all development and operating expense." When, therefore, something is taken from this "free and clear" one-half, the deduction must be, in some form, a contribution, out of the part reserved, to expense. If the subtraction were to be a mere cutting down of the original reservation, that could have been accomplished more easily and more appropriately by limiting the extent of the retention rather than by making the reservation subject to a deduction. Also, the first item of subtraction, the one-half of the amount of an oil payment payable to another oil company, clearly is a contribution to the expense of exploitation of the leases from which the oil payment is due. The principle "*noscitur a sociis*" is applicable to the interpretation of contracts.¹⁰² "The whole of a contract is to be taken together, . . . each clause helping to interpret the others."¹⁰³ Finally, the increase of the drawback by fifty dollars per month as to each well producing more than ten percent water shows clearly that the deduction is intended as a contribution to operating expense, since the presence of salt water in production necessitates additional expenditures for the separation and disposition of the water.¹⁰⁴

Moreover, the necessity of such a special provision for contribution to operating expense is obsolete under unitization. Unitization completely alters the conditions under which the field is operated. By substituting cooperation for competition in development and production, unitized operation reduces costs and capital outlays; at the same time, by increasing ultimate recovery, it adds to the net profit of the producers. This is the recognized objective of the Oklahoma unitization law. The Corporation Commission, in order to establish a unit, is required to find that unitized operation "will with reasonable probability result in the increased recovery of substantially more oil and gas from the common source of supply than would otherwise be recovered," and that the additional cost of such operation "will not exceed the value of the additional oil and

¹⁰² See 4 WILLISTON, CONTRACTS § 618(3) (3d ed. 1961).

¹⁰³ OKLA. STAT. tit. 15, § 157 (1961).

¹⁰⁴ See CLOUD, PETROLEUM PRODUCTION 469-82, 501-11 (1937).

gas so recovered."¹⁰⁵ The achievement of such results has been one of the prime arguments of the advocates of unitized production methods. It has been said that, because of the "economies . . . realized through unitization, the small operator usually finds money demands on him substantially smaller than under a system of individual lease operation."¹⁰⁶ "Large economies result through avoiding duplication of equipment, through centralized management, and in other ways."¹⁰⁷ Other writers lay stress upon the economies in development and operation costs realizable through unit operation.¹⁰⁸ Reports on established projects indicate that they achieve this objective.¹⁰⁹ Specifically, a similar consummation has been asserted for the West Edmond Hunton Lime Unit.¹¹⁰

The increased production accomplished by unitization was achieved through the shutting down of over 200 wells, with a resultant reduction of the cost of operation, yet with a higher return to the operators. According to a report made as of the close of 1952,

¹⁰⁵ OKLA. STAT. tit. 52, § 287.3 (1961).

¹⁰⁶ See Jacobs, *Unit Operation of Oil and Gas Fields*, 57 YALE L.J. 1207, 1223 (1948).

¹⁰⁷ See Myers, *Spacing, Pooling and Field-Wide Unitization*, 18 MISS. L.J. 267, 271-72 (1947).

¹⁰⁸ See CLOUD, *op. cit. supra* note 104, at 71; Caruthers, *Procedures—Benefits—Problems—of Unitization*, OIL AND GAS J., July 28, 1949, pp. 302, 304-05; German, *Compulsory Unit Operation of Oil Pools*, 17 A.B.A.J. 393, 399 (1931); Heath, *Unitization Desirable in Secondary Recovery*, WORLD OIL, Oct. 1949, p. 48.

¹⁰⁹ See Gray, *Five Years of Operating at Langlie Unitized Repressuring Project*, OIL AND GAS J., Nov. 16, 1946, pp. 295, 297; Landis & Brock, *Four Case Histories Showing Why It Pays To Unitize*, OIL AND GAS J., July 7, 1952, pp. 62, 63.

¹¹⁰ "For September, the last month prior to unitization, the field's allowable was 40,000 bbl. and production was 34,907 bbl. The unit asked the Corporation Commission to grant an increase of 5,000 bbl. of oil a day and this was granted as of October 1. It was planned to obtain this additional production by shutting in high-gas-oil ratio wells and thus conserve this reservoir energy for increasing the productivity of the other wells in the field. Thus 165 wells had been shut in by November 1, and by November 15 the total had reached 225. For the month of October, the field produced a daily average of 46,331 bbl. or slightly in excess of the increased allowable. The report prepared on the field by the West Edmond Engineering Committee stated that, through selective production alone, an additional 10 million barrels of oil will be recovered." McCaslin, *Nation's Largest Unit Operation Accomplishes Much in First Three Months*, OIL AND GAS J., Jan. 1, 1948, pp. 44, 46.

"It has been estimated that without unitization, approximately 24 per cent of the total wells in the pool would have been abandoned by 1952, and that by that time all producing wells would have been placed on the pump. By the end of 1957, all wells would have been abandoned. Under Unitization, selectivity in shutting in of high-gas-oil-ratio wells alone may extend the producing life to 1959 or later. With a gas-injection program added, the producing life of the field should extend to 1965 or later."

"The 32 operating interests, the state, and the estimated 7,000 land and royalty owners should all benefit from the unitization. During the hearings before the Corporation Commission, Don R. Knowlton, consulting engineer, stated that unit operation would mean an additional \$16,000,000 for royalty owners, and an additional \$6,800,000 in gross production taxes for the state." *Id.* at 62, 63.

the average daily production was 6,035 barrels.¹¹¹ This was produced through 506 wells, out of a total of 750 credited to the field. Adding 15 water input wells, there were a total of 521 wells in operation, with 229 not in operation. A total of 102 wells were shut in because of an uneconomically high gas-oil ratio; 19 were listed as dead, of which three were tagged as not economical to correct. Six wells were labeled as marginal artificial lift wells permanently shut down; 77 were plugged and abandoned, and three more had been approved for that purpose, while 22 more apparently were abandoned for Hunton Lime production, being marked "returned to former lessee." In brief, for the field as a whole, production was being achieved through less than 70 percent of the total wells, as against 76 percent to be expected in operation under competitive conditions. The engineering estimate as to results under competitive production was that, by 1952, all producing wells would have been placed on the pump, while actually, in December 1952, 337 wells, nearly two-thirds of the producing wells, were still flowing. Of the total production, over 56.07 percent came from these flowing wells. While under competitive conditions it was estimated that 24 percent of the wells would have been abandoned by this time, over 30 percent were not in operation under unitization. The saving in operating costs resulting from these features of unitized operation, as compared with competitive production, is obvious. For instance, 361 flowing wells cost only, on the average, 78 dollars each to operate in March 1953, whereas the average cost of operating 171 pumping wells in the same month was 328 dollars. The monthly operating cost of the unit declined from an average of 126,444 dollars during 1948 to 83,062 dollars for the first four months of 1953.¹¹² For future operations, with natural flow no longer available, the Unit Operator contemplated employing two forms of gas lift, much cheaper than pumping, that could be applied efficiently only through the unitized operation.¹¹³

These savings, of course, redound to those who actually bear the expense of operation. This situation renders utterly obsolete the contribution of a flat sum per well, calculated as a proper contribution to operating costs under competitive operation, to be made by the interests which, under unitization, are denied the right

¹¹¹ See Monthly Operations Report, West Edmond Hunton Lime Unit, December 1952.

¹¹² See Analysis of Reservoir Performance, Operating Costs, and Future Operating Program of West Edmond Hunton Lime Unit, June 1953, p. 145

¹¹³ *Id.* at 157-65.

to enforce the obligation of diligence and skill in competitive production, as well as the special competitive advantages which might inhere in their tracts' location, assured to them by the same Agreement which provided the per-well contribution to operating costs. All the more is this true when, under unitization, the percentage applicable to their tracts is determined by many factors which have no relation to the competitive position of particular tracts.

The inconsistency of the per-well deduction with the theory and practice of unitized operation is well expressed in the following statement by one of the leading experts on such operations:

"Ultimate recovery is substantially independent of the well spacing and of the number of wells drilled. It is time for the industry to waken up to this fact and realize that only pressure maintenance of reservoirs accomplishes maximum recovery. The amount of recovery from a pool is not to be determined in direct proportion to the number of wells drilled in proven pools."¹¹⁴

An instance which clearly shows the distinction between unitized and competitive operations so far as the position of the overriding royalty owner is concerned is that of the salt water injection program. This was undertaken in the hope that water flooding would materially increase the production of oil. It dated from 1949.¹¹⁵ The hope was disappointed.¹¹⁶ Experience indicated that, at the very most, the project broke even; and it may have resulted in substantial losses of oil. It certainly trapped off large quantities of gas.¹¹⁷ It impeded maximum recovery of oil in certain areas.¹¹⁸ As of 1953, it was proposed to abandon this program for other methods of salt water disposal.¹¹⁹ Without unitization, this venture into water-flooding could not have been made, and the owners of royalty interests would have been saved the resultant losses.

To continue the life of the provision for deductions is also in direct conflict with an Oklahoma statutory provision which (1) requires, as a prerequisite to an order establishing a unit, a finding by the Corporation Commission, "that such unitization and adoption of one or more of such unitized methods of operation is for the com-

¹¹⁴ See Kaveler, *Progress Report on Unit Operation*, Oil and Gas J., Nov. 8, 1951, p. 316.

¹¹⁵ See Analysis of Reservoir Performance, Operating Costs, and Future Operating Program of West Edmond Hunton Lime Unit, June 1953, pp. 13-16.

¹¹⁶ *Id.* at 40-52.

¹¹⁷ *Id.* at 52, 83, 122.

¹¹⁸ *Id.* at 82, 83.

¹¹⁹ *Id.* at 82-86.

*mon good and will result in the general advantage of the owners of the oil and gas rights within the common source of supply or portion thereof directly affected"; and (2) requires that the unit, the unitization, and unitized operation be "upon such terms and conditions as may be shown by the evidence to be fair, reasonable, equitable and which are necessary or proper to protect, safeguard and adjust the respective rights and obligations of the several persons affected, including royalty owners, owners of overriding royalties, oil and gas payments, carried interests, mortgagees, lien claimants and others, as well as the lessees."*¹²⁰

These quoted provisions specifically establish the legislative intent that the effect of the altered conditions of development and operation brought about by unitization and unitized operation be beneficial to all interests concerned, including among such interests, by specific reference, "owners of overriding royalties." The program is not intended to benefit the lessee interests alone. As we read the opinions below, the continuance of the per-well deduction redounds exclusively to the advantage of the owner of the lessee interest and to the disadvantage of the owner of the overriding royalty interest. Therefore, it is in inescapable conflict with the provisions quoted, and, by the express command of another section, the Agreement is "amended and modified to the extent necessary"¹²¹ to conform to the provisions and requirements that the unitization and the unitized operation be "for the common good and . . . result in the general advantage of the owners of the oil and gas rights within the common source of supply," and that the "rights and obligations of . . . owners of overriding royalties . . . as well as the lessees" be protected, safeguarded and adjusted.¹²²

Reduction in the earning capacity of the royalty interests is a common phenomenon of unitization.¹²³ A leading purpose of unified operation is to decrease immediate production through eliminating "the competitive race to produce."¹²⁴ This has been a chief cause of opposition to unitization on the part of the owners of royalty interests,¹²⁵ an opposition which doubtless was one of the

¹²⁰ OKLA. STAT. tit. 52, § 287.3 (1961). (Emphasis added.)

¹²¹ OKLA. STAT. tit. 52, § 287.9 (1961).

¹²² OKLA. STAT. tit. 52, § 287.3 (1961).

¹²³ See *Gregg v. Harper-Turner Oil Co.*, 199 F.2d 1, 5 (10th Cir. 1952) (reduction from \$35-50 per month to \$6-7); *Smith v. Carter Oil Co.*, 104 F. Supp. 463 (W.D. La. 1952); *Garvin, The Effect of Field Unit Operation Upon the Royalty Interest and the Royalty Under the Oklahoma Statute*, 21 OKLA. B.A.J. 1793, 1795, 1797 (1950).

¹²⁴ *Oliver, Methods of Determining Relative Oil and Gas Content of Individual Land Holdings in Common Pool*, 17 A.B.A.J. 541 (1931).

¹²⁵ See *Heath, supra* note 108, at 51; *King, Pooling and Unitization of Oil and Gas Leases*, 46 MICH. L. REV. 311, 327 (1948).

strongest reasons for denying to the owners of such interests participation in proceedings for unitization under the original Oklahoma statute.¹²⁶ On the other hand, to achieve the reduction of operating costs and the spreading of recovery over a long period, results repeatedly praised as objectives of unitization,¹²⁷ at the expense of reduced returns or of the continuance of provisions tailored for conditions of competitive operation, as in the instant case, bears unjustly upon the owners of royalty interests. The per-well deduction, for instance, when applied to a period of prolonged and gradually declining production at lowered operating cost, is capable of wiping out entirely, through the closing years, the return to the overriding royalty interest. Thus it destroys the advantage of extended productivity, which, it has been declared, is a feature which justifies imposing upon the royalty owner a reduction in his "immediate or current receipts."¹²⁸ It seems clear that this is one of the results the avoidance of which is intended by the Oklahoma statutory provision which we have quoted. It is noteworthy in this connection that the propaganda in favor of the formation of this unit stressed the element of advantage to the royalty owners.¹²⁹ There is a strange irony in the fact that two courts should now uphold the operating interest in combining pre-unitization contracts with unitized operation to the detriment of those owners who were given assurance of benefit. We think it clear that the continued deduction under the Agreement conflicts with the statutory provisions above quoted, under the circumstances here presented.

There is another statutory provision which collides with the continuance of the per-well deduction after unitization. This is the prescription that the "division of interest or formula for the apportionment and allocation of the unit production, among and to the several separately-owned tracts within the unit area" shall be "such as will reasonably permit persons otherwise entitled to share in or benefit by the production from such separately-owned tracts to produce or receive, in lieu thereof, their fair, equitable and reasonable share of the unit production or other benefits thereof. . . . [U]nit production . . . shall mean and include all oil and gas pro-

¹²⁶ See Myers, *supra* note 107, at 274.

¹²⁷ See Jacobs, *supra* note 106, at 1210, 1224; Kaveler, *The Engineering Basis for and the Results from the Unit Operation of Oil Pools*, 23 TUL. L. REV. 331 (1949); Moses, *The Effect of Louisiana's Conservation Statute on the Doctrine of Implied Covenants in Oil and Gas Leases*, 27 TUL. L. REV. 313, 315 (1953); Myers, *supra* note 107, at 271-73.

¹²⁸ *Patterson v. Stanolind Oil & Gas Co.*, 182 Okla. 155, 77 P.2d 83, 89 (1938).

¹²⁹ See Barnes, *West Edmond's Unitization and Gas Injection Project Would Be One of Largest*, Oil and Gas J., Dec. 14, 1946, pp. 70, 71.

duced from a unit area from and after the effective date of the order of the Commission creating the unit regardless of the well or tract within the unit area from which the same is produced.”¹³⁰

The Agreement provided that the per-well deduction should be made from “one-half of the crude oil, gas, casinghead gas, and other hydro-carbons produced, saved, and marketed from said leasehold premises or the proceeds thereof accruing to the working interests assigned and transferred hereunder.” This enumeration comprised the sum of production from individual leaseholds, developed and operated on a competitive basis, under the compulsions of the specific obligations heretofore quoted. That individual production now has been wiped out by the statute and by the Plan of Unitization. Instead, there is apportioned to each leasehold a share of total unit production, produced on a cooperative basis quite different from that envisaged by the Agreement and distributed among the tracts according to a formula based on elements entirely foreign to the competitive system of exploitation which was to be the source of each tract’s yield under the Agreement. Consequently, the statute and the Plan of Unitization have completely destroyed the source from which the deduction was to come. They have substituted for it something quite different, to which the flat per-well deduction has no relevance and to which it is not adapted. In this respect, also, the Agreement must “be regarded as amended and modified to the extent necessary to conform to the provisions and requirements” of the statute and the Plan of Unitization. In the words used in *Beene v. Midstates Oil Corp.*, these provisions “require the calculation of payments to be made . . . on a basis different from and in conflict with that contemplated by and provided in the Agreement.”¹³¹

It has been said that under unitization the royalty owner has “an interest in the entire field, whereas, before, his only interest was in his particular well or wells.”¹³² A share in such general ownership is in no way comparable with ownership of an interest in a particular tract under competitive production.

Another inconsistency between the Agreement and the scheme of unitized operation is afforded by that portion of the Oklahoma statute reading: “Wells drilled or operated on any part of the unit area no matter where located shall *for all purposes* be regarded as

¹³⁰ OKLA. STAT. tit. 52, § 287.4(b) (1961).

¹³¹ 169 F.2d 901, 909 (8th Cir. 1948).

¹³² See McCaslin, *Preplanned Program with Royalty Owners Followed in Newest Unit Project*, Oil and Gas J., April 8, 1948, pp. 64, 65.

wells drilled on each separately-owned tract within such unit area."¹³³ If this statement means anything, it is that for *all* purposes, including the computation of the per-well deduction, every one of the wells in production in the unit is to be regarded as located on each of the tracts embraced in the Agreement. This would boost the deduction to such astronomic proportions as obviously to be impractical. Clearly, the legislature would not intend this. Since the statute requires the application of the quoted concept "for all purposes," there is no way in which the per-well deduction may stand in harmony with it. Necessarily, then, it must be eliminated from the Agreement by the prescription that "contracts, and all other rights and obligations shall be regarded as amended and modified to the extent necessary to conform to the provisions and requirements of this Act."

Let us now look to another portion of the Oklahoma Compulsory Unitization Statute, which establishes a statutory scheme for the distribution and payment of the operating expenses of the unit.¹³⁴ First, the statute allots one-eighth of the unit production to be dis-

¹³³ OKLA. STAT. tit. 52, § 287.9 (1961). (Emphasis added.)

¹³⁴ "The obligation or liability of the lessee or other owners of the oil and gas rights in the several separately-owned tracts for the payment of unit expense shall at all times be several and not joint or collective and in no event shall a lessee or other owner of the oil and gas rights in the separately-owned tract be chargeable with, obligated or liable, directly or indirectly, for more than the amount apportioned, assessed or otherwise charged to his interests in such separately-owned tract pursuant to the plan of unitization and then only to the extent of the lien provided for in this Act.

"Subject to such reasonable limitations as may be set out in the plan of unitization, the unit shall have a first and prior lien upon the leasehold estate and other oil and gas rights (exclusive of a one-eighth (1/8) royalty interest) in and to each separately-owned tract, the interest of the owners thereof in and to the unit production and all equipment in the possession of the unit, to secure the payment of the amount of the unit expense charged to and assessed against such separately-owned tract. The interest of the lessee or other persons who by lease, contract or otherwise are obligated or responsible for the cost and expense of developing and operating a separately-owned tract for oil and gas in the absence of unitization, shall however, be primarily responsible for and charged with any assessment for unit expense made against such tract and resort may be had to overriding royalties, oil and gas payments, royalty interests in excess of one-eighth (1/8) of the production, or other interests which otherwise are not chargeable with such cost, only in the event the owner of the interest primarily responsible fails to pay such assessment or the production to the credit thereof is insufficient for that purpose. In the event the owner of any royalty interest, overriding royalty, oil and gas payment or other interest which under the plan of unitization is not primarily responsible therefor pays in whole or in part the amount of an assessment for unit expense for the purpose of protecting such interest, or the amount of the assessment in whole or in part is deducted from the unit production to the credit of such interest, the owner thereof shall to the extent of such payment or deduction be subrogated to all of the rights of the unit with respect to the interest or interests primarily responsible for such assessment. A one-eighth (1/8) part of the unit production allocated to each separately-owned tract shall in all events be regarded as royalty to be distributed to and among, or the proceeds thereof paid to, the royalty owners free and clear of all unit expense and free of any lien therefor." OKLA. STAT. tit. 52, § 287.8 (1961).

tributed to the royalty owners in each separately owned tract, proportionately to the tract's allocation of production, "free and clear of all unit expense and free of any lien therefor." Second, the cost of operation is to be apportioned to each tract. In the West Edmond Hunton Lime Plan of Unitization, such apportionment is in "proportion to the percentage of interest of such tracts in and to the Unit . . ."¹³⁵ Payment of this charge is secured by a lien in favor of the unit upon all the interests in the tract exceeding the amount allotted as royalty. Third, the primary responsibility for the assessed operating expenses is upon the lessee's or operator's interest, and "resort may be had to overriding royalties . . . only in the event the owner of the interest primarily responsible fails to pay such assessment or the production to the credit thereof is insufficient for that purpose." If the owner of an interest thus secondarily liable pays any part of a unit expense assessment in order to protect his property, he is subrogated to the rights of the unit against the interest "primarily responsible for such assessment."

In brief, the law establishes a pattern whereby the one-eighth royalty interest is clear of all liability for unit expenses, even if it is owned by the operator himself. The remaining seven-eighths interest is chargeable, proportionately, with the unit expense; but, as between the operator's interest and overriding royalties or other non-operating interests, a real suretyship¹³⁶ is created, whereby the holders of the non-operating interests are entitled to be reimbursed out of the operating interest for any payment made to discharge the assessment, and are subrogated, to that extent, to the lien of the unit against the operating interest.

The inconsistency of this statutory scheme with section 4(b) of the Agreement is manifest. The statute imposes full secondary liability upon the override for all expense chargeable to the tract. The Agreement provides for a flat deduction of a specific sum, beyond which no responsibility attaches. The statute limits responsibility to the proportionate share of the expenses chargeable against the tract. The Agreement provides for a fixed deduction, no matter how little the expenses. The statute creates a lien in favor of the unit against the override, which therefore may be foreclosed upon and sold to satisfy the expense. The Agreement creates no such liability against the override; it merely allows deficits to be carried over and to be taken out of future credits from production.

¹³⁵ Plan § XI.

¹³⁶ See STEARNS, SURETYSHIP § 1.3 (5th ed. 1951).

The statutory liability is limited to each separate tract; the Agreement deduction is combined as to all tracts and is subtracted from "the gross proceeds of production accruing to the working interests from all wells on all of the leases" subject to the Agreement. The statutory liability is secondary, as we have seen; the Agreement deduction is absolute and cannot be shifted.

The inconsistency of the statutory scheme and the Agreement is such that the latter cannot coexist practicably and justly with the former. In some respects the statute is more favorable to the overriding royalty interest than is the Agreement. In other respects it is more burdensome. Of course, in those respects in which the Agreement is more burdensome to the override than is the statute, the owner of the override is caught in a "heads I win, tails you lose" proposition wholly inconsistent with an express statutory policy that the unitization and unitized operation shall be "fair, reasonable and equitable" and shall be such as to "protect, safeguard and adjust the respective rights and obligations of . . . owners of overriding royalties . . . as well as the lessees."¹³⁷ The Agreement provision for deductions, therefore, must yield in its entirety to the statutory arrangement.

That the statutory scheme is intended to supersede special agreements and arrangements with regard to liability for operating expenses is stated by Mr. T. Murray Robinson, a leading proponent of the statute and long a member of the legal committee of the Interstate Oil Compact Commission:

"On the theory that all tracts should be treated alike, the Oklahoma Legislature made a realistic division [in the statute] of lessor and lessee interests in the production. It provides that a one-eighth of the unit production be free and clear of all unit expense and creates a lien against the remaining seven-eighths interest in the unit tract and the production attributable to that tract for the payment of development and operating costs."¹³⁸

Concerning the necessity for cutting across prior arrangements, Mr. Robinson said:

"Obviously, situations will arise in which some of the tracts' share of the production can be obtained only by requiring

¹³⁷ OKLA. STAT. tit. 52, § 287.3 (1961).

¹³⁸ See Robinson, *Compulsory Unit Operation: Procedure, Proof, Validity and Legal Effect*, in SOUTHWESTERN LEGAL FOUNDATION, THIRD ANNUAL INSTITUTE ON OIL AND GAS LAW AND TAXATION 201, 219 (1951).

other tracts to contribute a greater share of the unit costs than their share of the production. Ordinarily this out-balance may be of little consequence in the earlier years of unit operation, but it may become substantial and destructive to the unit as it approaches its economic limit of operation. The failure of the laws [in some states] to establish a yardstick by which the lessors' and the lessees' interests are to be measured opens the door for making of deals in anticipation of unitization which easily result in unconscionable advantages to the cunning."¹³⁹

It may be added to this statement that, as our prior discussion reveals, the same unconscionable advantages may result from attempts to apply to unitized operation, and the limitations it imposes, provisions which were drafted with a view to competitive conditions of exploitation. This is quite regardless of any degree of Machiavellianism in either of the contracting parties and illustrates the wisdom of holding prior arrangements of this sort to be superseded by a specific statutory plan.

As to the position of overrides, Mr. Robinson said: "The owner of such an override receives his share of the production without cost so long as his lessee pays, and until the unit forecloses its lien against the seven-eighths interest."¹⁴⁰

That the Supreme Court of Oklahoma agrees that the statutory policy with respect to the allocation of operating expense is intended to be all-embracing and to supersede private contractual arrangements is indicated by its opinion in *Palmer Oil Corp. v. Phillips Petroleum Co.*¹⁴¹ In this case the Supreme Court of Oklahoma upheld the constitutionality of the original Oklahoma Compulsory Unitization law, which, as to the provisions now under discussion, was identical with the statute now in force. The particular point of significance to us is the court's response to a contention that, in limiting the royalty interest which should be free of responsibility for operating expense to one-eighth, the statute cut down prior agreements for a greater royalty which existed in some instances. The court replied:

"Considering, as we must, that the one-eighth royalty prescribed is reasonable to accomplish the overall purpose, it follows that the right to the exceptional royalty as such must yield to the extent it militates against the plan but should be preserved to the extent it may be done consistently with such plan.

¹³⁹ *Id.* at 220.

¹⁴⁰ *Id.* at 221.

¹⁴¹ 204 Okla. 543, 231 P.2d 997 (1951).

We hold that the Act gives full recognition to such right and only varies the method prescribed in the lease for its enjoyment. Prior to unitization such a lessor would be entitled to receive the entire royalty share free from the cost of production. The enjoyment of this right, however, was based upon the obligation of the lessee to produce and so deliver. Under the unitization such obligation obtains upon the unit to the extent of a one-eighth royalty and the obligation of the lessee to account for the remainder is recognized and declared. The liability of any excess royalty is made possible because for the plan of operation it is accorded the status of a leasehold interest. But by reason of the lease contract treating it as royalty the liability is made secondary, and could only obtain where there was a breach of the obligation of the lessee to discharge the operation cost allowable thereto as part of the leasehold interest."¹⁴²

Because of the special nature of leasehold royalty interests, the specific application of this language is not in point. Its significance lies in the fact that the court recognized that the statute overcomes a prior contractual stipulation concerning the royalty interest, "varies the method prescribed in the lease for its enjoyment," and provides that the liability of the non-operating interest in the seven-eighths production "is made secondary." It seems clear that the Supreme Court of Oklahoma would likewise hold that the statute varied the method prescribed in the Agreement now under consideration for the overriding royalty's participation in liability for operating expense, rendering that liability secondary in character and to be measured by the share of unit expenses apportioned to each tract. To hold otherwise would stack the cards against the overriding interest.

The decision in *Waller v. Midstates Oil Corp.*¹⁴³ offers an apt analogy. There, a lease provision that an overriding royalty should cease when wells ceased to flow oil without being pumped or produced by other artificial means was held to be superseded by a subsequent unitization agreement containing a provision for dealing with "excess royalties" under certain circumstances. This was in spite of the fact that the effect of the unitization was to cause the entire field to be produced by "artificial means." The court felt that the provisions as to excess royalties must have been in-

¹⁴² *Palmer Oil Corp. v. Phillips Petroleum Co.*, *supra* note 141, at 551, 231 P.2d at 1006.

¹⁴³ 218 La. 179, 48 So. 2d 648 (1950).

tended to supersede completely the lease provisions as to termination of the override. There is a similar incongruity here between the statutory provisions for operating expenses and the conditions of unitized operation, on the one hand, and the Agreement provision for deductions and the conditions of competitive operation on the other. We feel that the latter cannot stand concurrently with the former, and so must be completely superseded, as the statute prescribes.

It may be suggested that the per-well deduction is continued in force by the provisions which (1) make "primarily responsible" for assessments any "interest . . . of other persons who by . . . contract or otherwise are obligated or responsible for the cost and expense of developing and operating a separately owned tract" and (2) restrict the ultimate exemption to those interests "which otherwise are not chargeable with such cost."¹⁴⁴ It will be argued that the 200 dollars per month per-well deduction makes the overriding royalty interest "by contract . . . obligated or responsible for the cost of developing and operating" the tracts, *pro tanto*, and makes it "otherwise . . . chargeable with such cost." This, however, is untenable. The key words, "obligated," "responsible," and "chargeable," are all applied to the cost of development and operation under competitive conditions. These words, in legal significance, always have the meaning of a direct and legally enforceable duty with respect to the subject—in this instance the payment of the operating costs to those who furnished the necessary service and materials.

Clearly, the Oklahoma legislature must have been cognizant of the legal meaning of the terms it used. It must have meant by persons or interests "responsible," "obligated," and "chargeable" with respect to costs of development and operation, the persons or interests to whom the laborers, materialmen, and supply houses furnishing the labor and the articles could look for the enforcement of their claims. This would not include the overriding royalty interest, with respect to this deduction. Had *S* failed to pay some part of the costs under competitive operation as to any one of these tracts, the creditor could not have secured judgment against the owner of the override for that amount, or for any part of his claim. He could not have subjected the override to his demands, even secondarily, as the Unit can now do. The deduction does not impose a liability upon the override interest for the cost of operation. *S* is under no

¹⁴⁴ OKLA. STAT. tit. 52, § 287.8 (1961).

obligation to devote that particular sum to defraying the operating costs. The motive for permitting it, as we have seen, is no doubt to reimburse *S* for part of the operating costs; but it does not impose on *F*, or his interest, a liability, a responsibility, an obligation, or a charge with respect to those costs, any more than an indemnity insurer is directly liable to those persons whom his insured may injure.¹⁴⁵ This interpretation accords with the practical construction of the act by the Unit and the Unit Operator, *S*. If the override were regarded as chargeable directly with operating costs, the owners would be billed therefor. They are not. The assessment is made against *S*.

The conclusion, it seems clear to us, is that the decisions below are erroneous. Let the judgment be that they stand condemned in the High Court of Juristic Review.

AIANLI, J.,¹⁴⁶ concurring. There are a few points to which I wish to call attention, in addition to the matters discussed by the Chief Justice. With his expressions I am in complete accord. But the learned judge who sat in the district court seemed to be troubled by the failure of the owners of the *F* interests to protest the conduct of the defendants at an earlier date,¹⁴⁷ although he absolved them expressly from any imputation of laches.¹⁴⁸ To this, I have only to say that the delay certainly brought about no change of position on the part of *S* and occasioned it no harm. On the contrary, if this court is right in its conclusion that the provision for deductions was nullified by the change to unitized operation, all the delay entailed was the benefit to *S* in using money which it should have paid to *F*. No estoppel or other bar can be charged against *F* for merely accepting what was due in any event.¹⁴⁹

The court of appeals unfortunately treated the problem posed by the case as requiring solution solely on principles of private contract law, as is shown by the statement: "We do not deem relevant the argument advanced concerning the relative profits of the parties. The rights of parties fixed by contract are not governed by comparing their subsequent relative gains or losses."¹⁵⁰ This

¹⁴⁵ See VANCE, *INSURANCE* § 135 (3d ed. 1951).

¹⁴⁶ Of Choctaw derivation, substantially meaning justice.

¹⁴⁷ See *Peter Fox Brewing Co. v. Sohio Petroleum Co.*, 189 F. Supp. 743, 762 (N.D. Ill. 1960).

¹⁴⁸ *Id.* at 754.

¹⁴⁹ *Elliott v. Pure Oil Co.*, 10 Ill. 2d 146, 139 N.E. 2d 295 (1957).

¹⁵⁰ See *Peter Fox Brewing Co. v. Sohio Petroleum Co.*, 296 F.2d 274, 281 (7th Cir. 1961).

hardly will do when there is superimposed upon the private bargain a plan of operation dictated by a statute so shot through, as is the Oklahoma Compulsory Unitization Law, with an intent to hold even the balance as between the several types of ownership into which the mineral interest in the oil country customarily is divided. The Supreme Court of Oklahoma has recognized this intent, and has undertaken to effectuate it in other situations which have come before it for determination.¹⁵¹ It is difficult for me to conclude that it would not have shown a similar alertness to legislative purpose in this instance. It is unfortunate that the occasion for passing upon the effect of the statute should have arisen before judges so distant from the scene alike as to geography, as to familiarity with the type of operations involved,¹⁵² and as to the concern of the Oklahoma legislators for maintaining a balance among varied interests.¹⁵³

In the light of the expressed legislative concern to preserve all interests in a fair adjustment, the assumption of the court of appeals, of dubious propriety at best, that the Agreement contemplated the application of regulatory limits, even under statutes then unenacted,¹⁵⁴ becomes irrelevant. The truly relevant proposition is that the lawmakers specifically provided that the various interest-holders should receive "their fair, equitable, and reasonable share of the unit production or other benefits thereof"¹⁵⁵ and that "property rights, leases, contracts, and all other rights and obligations shall be regarded as amended and modified to the extent necessary to conform to the provisions and requirements of this Act"¹⁵⁶

It is equally irrelevant, in the light of this language, that the commission-approved Plan of Unitization did not make specific

¹⁵¹ "The unit organization with its operator stands in a position similar to that of a trustee for all who are interested in the oil production either as lessees, or royalty owners." *Young v. West Edmond Hunton Lime Unit*, 275 P.2d 304, 309 (Okla. 1954). It is obvious that the conduct of the operator in this case toward the *F* interests cannot be reconciled with that of a trustee. "In our opinion, it is more important to secure to each lessor, lessee, and owner of mineral rights in a field, his ratable share of the production therefrom . . . than it is to secure to some, the maximum profits from drilling and producing operations." *Application of Peppers Refg. Co.*, 272 P.2d 416, 424 (Okla. 1954).

¹⁵² No state in the Seventh Circuit possesses a compulsory field-wide unitization law.

¹⁵³ Oklahoma has been from its inception an equalitarian commonwealth, and its laws and institutions should be interpreted in the light of this historic base. See Merrill, *The Administrative Law of Oklahoma*, 4 OKLA. L. REV. 286, 287 (1951). This background reinforces the manifest intent of the Oklahoma legislature.

¹⁵⁴ See *Peter Fox Brewing Co. v. Sohio Petroleum Co.*, 296 F.2d 274, 279 (7th Cir. 1961).

¹⁵⁵ Okla. Stat. tit. 52, § 287.4(b) (1961).

¹⁵⁶ Okla. Stat. tit. 52, § 287.9 (1961).

provision concerning the per-well deduction portions of the Agreement, although the court of appeals seems to regard this as most significant.¹⁵⁷ The statute strikes down any provision which does not preserve to the several interest holders their "fair, equitable and reasonable share" of the various "benefits" under unitized operation. What the unitization plan may provide or fail to provide is completely beside the point. This makes of decisive significance all those considerations of justice, fairness, and economic hardship which both courts below too lightly dismissed as unworthy of attention.

¹⁵⁷ See *Peter Fox Brewing Co. v. Sohio Petroleum Co.*, 296 F.2d 274, 280 (7th Cir. 1961).