THE POOLING CLAUSE AND THE EFFECTS OF UNITIZATION ON THE OIL AND GAS LEASE*

GENERAL

The purpose of this paper is to present a general discussion of the problems confronting a lessee in respect of the pooling clause and the effects of unitization on the provisions of the oil and gas lease in Canada.

In the United States entire texts[1] have been devoted to the subject of pooling and unitization. The material herein merely highlights the subject matter. It will, however, be endeavoured to state the present position of Canadian law with respect to what was more recently the standard pooling provision in use in Canada.[2]

Litigation in Canada respecting the oil and gas lease has been minimal and that sector of Canadian oil and gas law respecting pooling and unitization is confined to a few decisions. It is of some interest to note that in 1954, Leo Hoffman, speaking of the state of American law on the subject, said:

> The problems in voluntary pooling and unitization represent a fertile field both for further litigation and for further beneficial development in the law of oil and gas. This phase of oil and gas law remains relatively new and largely untried.[3]

The state of Canadian law on pooling and unitization has certainly not progressed beyond this point. Indeed, there are no Canadian cases dealing directly with the problems arising out of the effects of unitization on the oil and gas lease. Our knowledge of the effects of unitization on the oil and gas lease, of necessity, has been derived from American authorities.

The terms "pooling" and "unitization" are used throughout this paper. The term "pooling" as used herein means the bringing together of small tracts sufficient for the granting of a well permit under applicable spacing rules, while the term "unitization" refers to units covering large field-wide or pool-wide unit areas or portions thereof. The majority of oil and gas industry personnel in Canada today ascribe such meanings to these terms.

The incorporation in the pooling clause of the power of a lessee to unitize the lands held under his oil and gas lease is rare in Canada.. One instance has come to our attention where such a power is purportedly

* C. T. Mullane and A. P. G. Walker, both of the Exploration and Production Legal Department of Shell Canada Limited, Calgary, Alberta.

1 Myers, The Law of Pooling and Unitization (1957); Hoffman, Voluntary Pooling and Unitization.

2 "The Lessee is hereby given the right and power at any time and from time to time to pool or combine the said lands, or any portion thereof, with other lands adjoining the said lands, but so that any one such pool or unit (herein referred to as a 'unit') shall not exceed one drilling unit as hereinbefore defined, when such pooling or combining is necessary in order to conform with any regulations or orders of the Government of the Province of Alberta or any other authoritative body, which are now or may hereafter be in force in relation thereto. In the event of such pooling or combining, the Lessor shall, in lieu of the royalties elsewhere herein specified, receive on production of leased substances from the said unit, only such portion of the royalties stipulated as the area of the said lands placed in the unit bears to the total area of lands in such unit. Drilling operations on, or production of leased substances from, any land included in such unit shall have the same effect in continuing this Lease in force and effect during the term hereby granted, or any extension thereof, as to all the said lands, as if such operation or production were upon or from the said lands, or some portion thereof."

3 Hoffman, *ante* n 1 at p. 295.

given to a lessee.[4] To our knowledge the lessee has never attempted to rely on this power to unitize the leased land.

Reliance on the power to unitize pursuant to a pooling and unitization clause under oil and gas leases in the United States has been negligible due mainly to the complexity of situations involved in forming field-wide units.[5] Because of the limited efforts by lessees both in the United States and Canada to unitize their leased lands pursuant to the provisions of their leases without further consent by the lessor, our considerations are restricted to the lessees' use of the power to pool only.

Another means of pooling oil and gas properties prevalent in the early days of the development of the oil and gas industry in the United States, was the use of the community lease. This type of pooling is brought about where two or more landowners, each owning separate tracts of land, join in a single oil and gas lease describing and granting for oil and gas purposes the entire area owned by them.[6] To our knowledge this type of pooling has not been used in Canada.

I. THE POOLING CLAUSE

Evolution of the Pooling Clause

In the United States the need for a pooling clause was first brought about by the Japhet doctrine.[7] *Japhet* v. *McRae*[8] established the rule that where a portion of the land covered by an oil and gas lease has been sold, the entire royalty from a producing well on the lease belongs to the owner of that portion of the land on which the well is drilled. The harsh injustice of this rule was first avoided by the inclusion of entirety clauses[9] and finally by the insertion of the pooling clause.

Another step in establishing the necessity of a pooling clause, especially in Canada, was the establishment by conservation authorities of spacing units on which only one well could be drilled.[10] This step was the prime mover for the necessity of pooling clauses in oil and gas leases in Canada. The rule of capture[11] and the economic waste of drilling un-

4 California Standard 1954 Manitoba Lease Form: "13. The Lessee shall have the right to abandon any well before completion thereof or at any time thereafter should it prove in the sole discretion of the Lessee unlikely that such well will prove productive of petroleum and/or natural gas or that is unprofitable or uncommercial to continue producing such well. The Lessee shall have full and complete power and authority inits own discretion either itself or by agreement with othe producers or owners of petroleum and/or natural gas in the vicinity of the said lands to evolve, enter into and carry into effect any arrangements or agreements for the conservation of petroleum and/or natural gas, proration of production therefor or unitization or restrictions of development therefor or any other similar arrangements and may withhold production or withhold the leased substances from the market as conditions and/or the price of such leased substances may in the Lessee's sole discretion warrant, and in so far as the terms of this lease and grant are in conflict with, or inconsistent with, the terms of such arrangement or agreement, the provisions of such agreement or arrangement shall prevail."

5 See Myers *ante* n. 1 at p. 58.

6 See Hoffman, *ante* n. 1 at p. 9.

7 See Hoffman, *id* at 186.

8 (1925), 276 S.W. 669 (Tex. Comm. App.)

9 "If the leased premises shall hereafter be owned severally or in separate tracts, the premises nevertheless shall be developed and operated as one lease and all royalties accruing hereunder shall be treated as an entirety and shall be divided among and paid to such separate owners in the proportion that the acreage owned by each such separate owner bears to the entire leased acreage."
See Hoffman, *ante* 1 at p. 186. An identical entirety clause was dealt with in the recent case of *Prudential Trust Co. Ltd.* v. *National Trust Co. Ltd.* (1965), 50 W.W.R. (N.S.) 29.

10 See The Oil and Gas Conservation Act 1957 (Alta.), c. 63, s. 22 and the regulations made under s. 34, clauses (a) and (c).

11 "That rule simply is that the owner of a tract of land acquires title to the oil or gas which he produces from wells on his land, though part of the oil or gas may have migrated from adjoining lands. He may thus appropriate the oil and gas that has flowed from adjacent lands without the consent of the owner of those lands, and without incurring liability to him for drainage. The non-liability is based upon the theory that after the drainage the title or property interest of the former owner is gone." See *Elliff* v. *Texon Drilling Co.* 146 Tex 575.

necessary wells so as to comply with the covenant to protect against drainage[12] of course also played their roles in making pooling clauses a practical necessity.

Up until 1959, and to a lesser extent through to 1961, the pooling clause referred to earlier[13] was prevalent in the industry.

From 1960 until this year there have been three decisions of the Supreme Court of Canada which have had a marked effect on the acceptability of the earlier pooling clause from a lessee's point of view.[14] Current oil and gas leases in Canada contain the following pooling clause which is designed to avoid the difficulties encountered in the earlier pooling clause:

> The Lessee is hereby given the right and power at any time and from time to time to pool or combine the said lands, or any portion thereof, or any zone or formation underlying the said lands or any portion thereof, with any other lands or any zone or formation underlying the same, but so that the lands so pooled and combined (herein referred to as a 'unit') shall not exceed one (1) spacing unit as hereinbefore defined. In the event of such pooling or combining, the Lessor shall, in lieu of the royalties elsewhere herein specified, receive on production of the leased sustances from the said unit, only such portion of the royalties stiplated herein as the surface area of the said lands placed in the unit bears to the total surface area of lands in such unit. Drilling operations on, or production o fthe leased substances from "or the presence of a shut-in or suspended well on," any land included in such unit shall have the same effect in continuing this Lease in force and effect as to all the said lands as if such operations or production were upon or from the said lands, or some portion thereof, or as if said shut-in or suspended well were located on the said lands, or some portion thereof.

It may be well to point out that nearly all of the problems respecting the pooling of leased lands with other lands arise in respect of the drilling of a gas well. Unfortunately for the lessee, every freehold lease envisages the drilling of a well on the leased land whether the leased land in question is a quarter section or several sections. In most jurisdictions, conservation authorities permit only one gas well to be drilled per section.[15] Where a well drilled on a quarter section under lease turns out to be a gas well, the lessee must pool his quarter section with three other quarter sections before he may produce gas from his well. Normally, in the case of a well to be drilled in a gas field or a potential gas producing area, the lessees make appropriate arrangements before the well is drilled.

Supreme Court Decisions

The three decisions from the Supreme Court of Canada have provoked lessees to take a long hard look at the provisions of the pooling clauses in their oil and gas leases. The pooling clause subject to litigation under

12 "In the event of commercial production being obtained from any well drilled on any drilling unit laterally adjoining the said lands and not owned by the Lessor, or, if owned by the Lessor, not under lease to the Lessee, the Lessee shall commence or cause to be commenced within six (6) months from the date of such well being placed on production, the drilling of an offset well on the drilling unit of the said lands laterally adjoining the said drilling unit on which production is being so obtained, and thereafter shall drill the same to the horizon in the formation from which production is being obtained from the said adjoining drilling unit; PROVIDED that if such well drilled on lands adjoining the said lands has been proved to be productive primarily or only of natural gas, the Lessee shall not be obligated to drill an offset well unless an adequate and commercially profitable market for natural gas which might be produced from the offset well can be previously arranged and provided."

13 *Ante*, n. 2, hereinafter referred to as the "earlier pooling clause".

14 *Shell Oil Company* v. *Gunderson* [1960] S.C.R. 424,
Shell Oil Company v. *Gibbard* (1961-62), 36 W.W.R. (N.S) 529.
Canadian Superior Oil of California Ltd. v. *Kanstrup and Scurry-Rainbow Oil Ltd.* (1965), 47 D.L.R. 1.

15 See The Oil and Gas Conservation Act, Alberta, *ante* n. 10—nder the regulations a special spacing unit may be obtained which is less than a section. Saskatchewan, British Columbia and Manitoba also require one section spacing for each gas well.

the three leases involved in these decisions were identical in substance and almost identical in form to the earlier pooling clause.

The *Gunderson* case[16] involved a lease of the SE¼ of a section. The *Gibbard* case,[17] which followed, involved the SW¼ of the same section. Both cases centered around a gas well drilled by Shell on the NE¼ of that section. The more recent *Kanstrup*[18] case involved a lease of the NW¼ of a section in Alberta. A pooling clause almost identical to the Gibbard and Gunderson pooling clauses was inserted in the Kanstrup lease as an amendment. Again, as in the Gunderson and Gibbard situations, a gas well was completed on the section in which the leased land was located but was located on one of the other quarter sections.

The Gunderson Case

As mentioned above, the Gunderson lease covered the SE¼ of a section in Alberta. The lease was dated July 19, 1950 and was granted for a primary term of five years. No well was drilled on the quarter section during the primary term. Delay rentals, however, maintained the lease. In 1952 a well was drilled by Shell, the lessee, on the NE¼ of the section. The well was capable of production. However, as there was no market available, it was not connected to a gathering system and was capped. One month before the end of the primary term, Shell served notice on the lessor of the SE¼ purporting to pool that quarter section with the remainder of the section pursuant to clause 9 of the lease.[19]

The shut-in royalty clause in the lease reads as follows:

> 3. Provided no royalties are otherwise paid hereunder, the Lessee shall pay to the Lessor each year as royalty the sum of Fifty Dollars ($50.00) for all wells on the said lands where gas only or primarily is found and the same is not used or sold, and while the said royalty is so paid each such well shall be deemed to be a producing well hereunder.

The lessee tendered a $50.00 payment with the pooling notice which the lessor's representative refused to accept. He also refused to accept similar payments in each succeeding year. The lessee brought an action for a declaration that the lease was in force. Shell argued that when one reads clause 3 in conjunction with clause 9, i.e. the pooling clause, the effect is to change the meaning of "said lands" in clause 3 to mean the entire section so as to include the well in the NE¼ of said section. The Supreme Court of Canada, however, found that the pooling clause in itself did not serve to extend the primary term beyond the five year period. The Court was quick to point out that the capped gas well on the NE¼ of the section did not by itself extend the primary term. In answer to Shell's submission that clause 9 read with clause 3 covered the situation, the Court held that clause 3 was restricted in its operation solely to wells "on the said lands" and "said lands" were clearly defined to mean only the leased lands, that is, the SE¼ of the said section. In so doing the Court rejected Shell's argument that the notice of pooling served on the lessee changed the meaning of "said lands" in clause 3 to include the whole section. It is important to point out that the validity of the pooling itself was not questioned in the Supreme Court of Canada's decision. This should be borne in mind when reviewing the *Gibbard* and *Kanstrup* cases.

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16 *Ante* n. 14.
17 *Ibid.*
18 *Ibid.*
19 *Ante.* n. 2.

Clause 1 of the lease commenced by stating that the defined meaning shall prevail "unless there is something in the subject or context inconsistent therewith". The Court found there was nothing in the subject or context of clause 3 inconsistent with giving to the "said lands" its defined meaning, i.e. the SE¼ of the said section. In interpreting this lease there were two possible interpretations. The court, relying on the contra preferentum rule, construed the lease against the draftsman, the lessee.[20]

The Gibbard Case

As pointed out earlier, the validity of the pooling in the *Gunderson* case was not in issue. However, this question did come to the forefront in the *Gibbard* decision.

The Gibbard lease was a lease to Shell Oil Company of the SW¼ of the section in issue in the Gunderson case. The lease was granted in September of 1949 for a primary term of 10 years. The action was brought for a declaration that the lease had been terminated at the end of its primary term.

The pooling clause (clause 9) was identical to that in the Gunderson lease. At the time the Gibbard action was commenced the Gunderson lease as to the SE¼ had terminated. The well on the NE¼, drilled in 1952, was shut-in at the time of the attempted pooling. On August 2, 1955 Shell sent notice to the lessor, Gibbard, that the lease was being pooled with the other quarter sections to form a "drilling unit" as defined and prescribed by government regulations. In 1959 a market became available for the production from the shut-in well on the NE¼ section. It was necessary under the regulations to obtain a permit to produce the well and to establish a spacing unit. An application was made to the Conservation Board for a special spacing unit, that is, for a three-quarter section spacing unit, and this was granted, effective July 1, 1959. In July 1959, following the granting of the special spacing order, Devon-Palmer, an assignee of Shell, sent to Gibbard a copy of the Board Order and also royalty cheques for July and August. The royalty statements maintained that the royalty was payable pursuant to the August 2nd, 1955 pooling notice. These royalty cheques were returned by Gibbard.

The Supreme Court of Canada held that the pooling order given on August 2, 1955 could not be effective since Shell at that time had no interest in the SE¼ (Gunderson lease) and that when notice was given the pooling or combining was not necessary in order to conform with the regulations or orders of the Government of the Province of Alberta, or any other authoritative body which were then in force and relating thereto as required by the wording of clause 9.

Shell had argued that the pooling notice was necessary in order to conform with government regulations and, in the alternative, claimed that if the pooling notice of 1955 was ineffective, then the pooling accomplished by the special spacing unit prescribed by the Board and effective July 1, 1959, was valid.

The real issue in this case was whether pooling or combining was necessary at the time notice was given. The Court found that there were no regulations in existence which affirmatively required any such pooling

20 See Angus, *Voluntary Pooling in Canadian Oil and Gas Law*, (1961), 1 Alta. L. Rev. 485.

and it seemed to the Court inconceivable that the Conservation Board would of its own initiative, or on application of either party, direct such pooling when the parties had themselves agreed upon the terms upon which such pooling should be brought about. The Court also mentioned that it seemed that the lessee had intended to include in this lease a provision for pooling to cover the situation where it was necessary to include the leased lands with other lands in order to obtain approval of the Board to a spacing unit and to obtain a permit, if required, to produce oil or gas discovered on any part of the proposed unit. In the opinion of the Court, the language employed by the lessee was insufficient for such purpose.[21]

The Kanstrup Decision

The Kanstrup situation was similar to the *Gunderson* and *Gibbard* cases in that it involved a quarter section of land on which a well was not drilled. A well was drilled on one of the other quarter sections of the same section by Kanstrup's lessee.

The pooling clause was identical in substance to those in the Gunderson and Gibbard leases and the shut-in royalty clause, 3 (b), provided that where gas from a well producing gas only was not sold or used, the lessee might pay a royalty, $100.00 per well per year and if such payment was made it would be considered that gas was being produced within the meaning of clause 2.[22]

The habendum clause read as follows:

> 2. Subpect to the other provisions herein contained, this lease shall be for a term of 10 Years from this date (called 'primary term') and as long thereafter as oil, gas, or other mineral is produced from the said land hereunder, or as long thereafter as Lessee shall conduct drilling, mining or re-working operations thereon as hereinafter provided and during the production of oil, gas or other mineral resulting therefrom.

The lease was an "unless" type lease. The lessor, in 1952, entered into a royalty trust agreement under which he assigned his 12½ percent royalty to Prudential Trust. In 1957 Canadian Superior negotiated an amendment to Kanstrup's lease (clause 14(A)), wherein the pooling clause, almost identical to the Gunderson and Gibbard pooling clauses, was inserted.

In 1958 a well was drilled in the SW¼ of the section in which Kanstrup's quarter section was located. Canadian Superior capped the well as there was no market available. Also in 1958, Kanstrup granted to Scurry-Rainbow a "top lease" under which Scurry-Rainbow acquired an option to obtain a new lease for a period of 10 years on the expiration of the Canadian Superior lease.

In July 1958, Canadian Superior tendered to Prudential Trust the $100.00 shut-in royalty payment. Following this, also in July, the lessor wrote to Canadian Superior stating that the lease had expired. Scurry-

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21 See Mr. Justice Locke's decision, (1961-62), 36 W.W.R. (N.S.) at pp. 534-535.

22 Clause 3(b) reads as follows:
"3. The royalties reserved by Lessor are:
(b) On gas, including casinghead gas or other gaseous substances, produced from said land and sold or used off the premises or in the manufacture or gasoline or other product therefrom, the market value at the well of one-eighth of the gas so sold or used, provided that on gas sold at the wells the royalty shall be one-eighth of the amount realized from such sale; where gas from a well producing gas only is not sold or used, Lessee may pay as royalty $100.00 per well per year, and if such payment is made it will be considered that gas is being produced within the meaning of Paragraph 2 hereof;".

Rainbow, holders of the top lease, served a notice on Canadian Superior pursuant to The Land Titles Act, to remove its caveat or to commence proceedings in respect thereof. Canadian Superior commenced an action.

The issue in the case was whether the lease of the NW¼ held by Canadian Superior expired at the end of the primary term or whether it was continued either as a result of the operation of other clauses of the lease or by Kanstrup's election to waive the operation of clause 2. Canadian Superior argued that the payment of the $100.00 shut-in royalty payment in respect of the capped well placed Canadian Superior in the same position as if gas were produced within the meaning of clause 2 of the lease and that the lease was therefore extended beyond its primary term. Kanstrup countered this argument by maintaining that clause 14 (A) had no application since at no time was pooling necessary in order to comply with a government order or regulation. The *Gibbard* case was relied on in support of this submission.

The Supreme Court of Canada held that prior to the amendment of the lease by addition of clause 14 (A) the primary term could only have been extended as long as oil, gas or other mineral were produced from the said land. As in the *Gibbard* case, the Court found that the shut-in royalty clause applied to a non-producing gas well on the leased lands, but that clause 14 (A) did not say that a non-producing gas well not on the leased lands was equivalent to a non-producing gas well on the leased lands, so as to entitle Canadian Superior to rely upon the latter portion of clause 3 (b). It was held, in addition, that no such provision could be applied under clause 14 (A) as clause 14 (A) limited the right to pool to a situation in which pooling was necessary in order to comply with government orders or regulations. Even if clause 14 (A) did have the effect of enabling Canadian Superior to rely on a capped gas well anywhere on the unit, there was no gas which could be considered as being produced from the leased quarter section.

The Supreme Court of Canada agreed with the trial judge that the payment of the $100.00 shut-in royalty payment after the primary term had expired, was not effective to continue the term of the lease thereafter. It is submitted that even if the shut-in royalty had been tendered before the expiration of the primary term, the lease would have terminated.

One of Canadian Superior's arguments was that the acceptance by Kanstrup of a portion of the $200.00 total shut-in royalty payment which was tendered after the primary term had expired, constituted a waiver by Kanstrup. The Court found that prior to receiving any payment, Kanstrup had already written Canadian Superior contending that the lease had expired. Therefore there was no election, waiver or forfeiture by Kanstrup. The court looked to the provision in the lease which automatically terminated the lease at the expiration of the primary term and, relying on the *East Crest* case,[23] it was held that Kanstrup's legal position could not be affected by his acceptance of the shut-in royalty payment or portion thereof after the lease had automatically terminated following the expiration of the primary term.

23 *East Crest Oil Co. v. Strohschein* [1952] 2 D.L.R. 432, (1952), 4 W.W.R. (N.S.) 553.

The Potapchuk Case

A fourth case, *Pan American* v. *Potapchuk*,[24] involved a pooling clause identical to the earlier pooling clause. The trial judge followed the *Gunderson* decision. In addition, this case points out the further difficulties a lessee may encounter in attempting to amend his lease to provide a pooling provision after a top lease has been granted by the lessor. For in addition to finding that the pooling as in the Gunderson situation was ineffective, the trial judge held that the holder of the top lease had acquired an equitable interest in the leased lands which had been protected by the filing of a caveat, and that the lessor could not, by agreeing to an amendment to his lease, derogate from the interest granted in the top lease. It therefore appears that the pooling clause amendment would have been ineffective to extend the lease even without reliance on the *Gunderson* decision. The Alberta Appellate Division affirmed the trial judge's decision and on appeal to the Supreme Court of Canada the lower court decisions were upheld.

The Lessee's Position

It is apparent from the foregoing review of the leading cases dealing with the earlier pooling clause, that it is virtually impossible for lessees operating under similar pooling clauses with respect to gas fields to effect a pooling of their leased lands under the terms of their leases when a well is not located thereon. The question therefor arises as to what a lessee, finding himself in this situation, can do to avoid the possibility of losing his lease on the expiration of the primary term.

One possible method of alleviating this situation is that upon realizing his lands are in a gas field and that there is a possibility of a well being drilled on the section in which he has a lease, the lessee should have his lease amended to incorporate a pooling clause containing the provisions of the current clause set out above.[25] However, a top lease may prevent him from following this procedure.

Alternatively, he could apply to the Conservation authorities for a compulsory pooling order[26] stating that (1) pooling is necessary and that (2) a voluntary pooling cannot be effected pursuant to the pooling clause or through negotiation with the lessor. There is some doubt as to the effectiveness of this alternative, especially in Alberta since the compulsory pooling provisions in the Oil and Gas Conservation Act were not intended to settle issues between the lessor and lessee, nor indeed to extend the primary term of leases, but were enacted to cover situations arising where *lessees* could not agree to the pooling of their lands to form a spacing unit.

It remains to be seen whether the pooling clauses drafted since the *Gunderson* decision will have resolved all the difficulties that lessees may encounter in effectively pooling acreage to form a spacing unit.

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24 *Pan American Petroleum Corporation et al* v. *Potapchuk and Scurry-Rainbow Oil Limited* (1964), 46 W.W.R. (N.S.) 237.

25 *Ante*, at p. 252.

26 The Oil and Gas Conservation Act 1957, (Alta.), c. 63, s. 71 et seq.

II. THE EFFECTS OF UNITIZATION ON THE PROVISIONS OF THE OIL AND GAS LEASE

Under this heading, an attempt will be made to outline generally the effect of unit operations upon some of the express and implied covenants normally found in the petroleum and natural gas lease. Stated another way, the problem becomes one of determining what changes, if any, are created in the lessor-lessee relationship as a result of the initiation of unit operations. It is well established that in the absence of compulsory unitization legislation, a royalty owner or a working interest owner has complete freedom of choice in deciding whether or not to enter into a unit.[27] As R. M. Myers states:

> in the case of voluntary agreements it is strictly up to the interest holders themselves as to whether or not they wish to execute the unit agreements. A lessee is without authority to unitize the royalty interest under the lease with other interests, and in the absence of statutory authority unitization cannot be compelled.[28]

We shall assume for the purpose of discussion that both the lessor and the lessee have elected to enter the unit and have executed the unit agreement. We shall therefore consider the unit agreement particularly in relation to the clauses which have a direct bearing on the lease. In this respect, the relevant clauses in the Model Form of Unit Agreement issued by the American Petroleum Institute are included under Article 3, entitled "Creation and Effect of Unit".

Clause 3.1 states:

> *Oil and Gas Rights Unitized.* Subject to the provisions of this agreement, all Oil and Gas Rights of Royalty Owners in and to the lands described in Exhibit A, and all Oil and Gas Rights of Working Interest Owners in and to said lands, are hereby unitized insofar as the respective Oil and Gas Rights pertain to the Unitized Formation, so that operations may be conducted as if the Unitized Formation had been included in a single lease executed by all Royalty Owners, as lessors, in favour of all Working Interest Owners, as lessees, and as if the lease had been subject to all of the provisions of this agreement.

Clause 3.3 states:

> *Amendment of Leases and Other Agreements.* The provisions of the various leases, agreements, division and transfer orders, or other instruments covering the respective Tracts or the production therefrom are amended to the extent necessary to make them conform to the provisions of this agreement, but otherwise shall remain in effect.

Clause 3.4 states:

> *Continuation of Leases and Term Royalties.* Operations, including drilling operations, conducted with respect to the Unitized Formation on any part of the Unit Area, or production from any part of the Unitized Formation, except for the purpose of determining payments to Royalty Owners, shall be considered as operations upon or production from each Tract, and such operations or production shall continue in effect each lease or term royalty interest as to all lands covered thereby just as if such operations had been conducted and a well had been drilled on and was producing from each Tract.

Once the lessor and the lessee have executed the unit agreement, there is little doubt that clauses such as those quoted above have the effect of amending the lease to obviate any conflict with the unit agreement. As one authority comments:

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27 See Williams and Meyers, Oil and Gas Law, Vol. 6 at p. 687, for the proposition that under certain circumstances, the doctrine of estoppel may apply to a non-signing royalty owner. Also see W. J. Doggett, *Practical Legal Problems Encountered in the Formation, Operation and Dissolution of Fieldwide Oil and Gas Units*, 16 Okla. L. Rev. at p. 145 et seq. for the suggestion that ratification, rather than estoppel may apply.

28 Myers, *id*, at p. 378.

Such provisions of unit agreements are unquestionably effective to alter or modify the leases involved so as to bring them into conformity with the unit agreement if all persons having an interest in the leased premises are parties to the unit agreement of if pooling or unitization is required by a valid compulsory order. Obviously, one party to the lease, e.g., the lessee, may not modify the lease by joinder in a voluntary agreement, however, without the joinder of the lessor.[29]

In those parts of Canada where voluntary unitization is employed, the unit agreements entered into invariably contain clauses virtually identical to those set out above.[30]

In Saskatchewan, the effect of the compulsory unit operation order is set out in Section 43 of The Oil and Gas Conservation Act and amendments thereto:[31]

43. The portion of unit production allocated to a separately owned tract shall for all purposes be deemed to have been actually produced from such tract, and operations conducted pursuant to a unit operation order shall for all purposes be deemed to be operations carried on or conducted for the production of oil and gas from each separately owned tract in the unit area in the fulfilment of all the express or implied obligations of the owner of such tract or of a producer under each lease and any contract applicable thereto in so far as the same relates to the field, or pool or portion thereof covered by such order.

In addition to section 43, the usual plan of unit operation in Saskatchewan contains a clause covering the effect of unit operations on the leases in the unit.[32]

A broad statement concerning the effect of unit operations generally upon the express and implied covenants of an oil and gas lease which has been included in a unit, is set out in the Texas decision of *Southland Royalty Company* v. *Humble Oil & Refining Company*.[33] A frequently quoted portion of the judgment states:

Some of the legal consequences of a unitized lease as between the lessors on the one hand and the lessees on the other, in the absence of express agreement to the contrary, are as follows: the life of the lease is extended as to all included tracts beyond the primary term and for as long as oil, gas or other minerals are produced from any one of the tracts included in the lease; the commencement of a well on any one of the tracts operates to excuse the payment of delay rentals on all included tracts for the period stated in the lease; production from a well on any one of the tracts relieves the obligation to pay delay rentals, during production, on all the included tracts; the lessee is relieved of the usual obligation of an implied covenant of reasonable development of each tract separately; wells may be located without reference to property lines; the lessee is relieved of the obligation to drill offset wells on other included tracts to prevent drainage by a well on one or more of such tracts. As between the lessors themselves, each relinquishes his right to have his own tract separately developed, his right to receive all of the royalties from production from wells on his own tract, and his right to have wells drilled on his tract offsetting other wells on the leased premises, and each gains the right to share proportionately in royalties from wells on the other included tracts. In short, the parties by the execution of a unitized lease agree that production of oil or gas from wells located on any tract included in the lease will be regarded during the life of the lease as production from each and all other tracts included therein.

Many of the problems that develop from unit operations are due to the failure of royalty owners to execute the unit agreements. As Myers says:[34]

It is seldom that all interest holders in a field have signed these agreements when they become effective. They are, of course, effective and enforceable as to those

29 Williams and Meyers, *Oil and Gas Law*, Vol. 6 at p. 748.
30 For example, see clauses 301, 302 and 303 of Article III of the Model Oil and Gas Unit Agreement approved by the Petroleum and Natural Gas Committee of Mines Ministers' Conference.
31 R.S.S., 1953, c. 27.
32 For example, see clause 203 of the Plan of Unit Operation governing The Midale Unit, The Saskatchewan Gazette, July 20, 1962.
33 249 S.W. 2d 914.
34 See Myers, *ante*, n. 27 at p. 378.

who sign them, and pre-existing oil and gas leases and other contracts are modified to the extent that the unit agreements are in conflict with them. But it is when the signers begin the operation of the unit, thus created, that they run into the problems caused by the existence of the unsigned interests, because the pre-existing oil and gas leases and other contracts of the non-signers remain in effect and unmodified by the unit agreements.

Throughout this paper we shall consider some of the problems created by the failure of royalty owners to execute the unit agreements.

The Effect of Unitization Upon the Royalty Clause

Under the typical lease royalty provision, the lessee covenants to pay the lessor a certain royalty based on production of oil and gas from the leased lands. Usually the royalty amounts to one-eighth of the current market value of production from the lands. On unitization, production from the unit as a whole is allocated to each individual tract on the basis of each tract's percentage participation in the unit. The production so allocated to a tract is deemed for all purposes to have been produced from such tract. Clause 6.1 of the Model Form of Unit Agreement issued by the American Petroleum Institute states:

Allocation to Tracts. All Unitized Substances produced and saved shall be allocated to the several Tracts in accordance with the respective Tract Participations effective during the period that the Unitized Substances were produced. The amount of Unitized Substances allocated to each Tract, regardless of whether it is more or less than the actual production of Unitized Substances from the well or wells, if any, on such Tract, shall be deemed for all purposes to have been produced from such Tract.

Each working interest owner remains liable for payment of royalties to the royalty owner in accordance with the terms of the lease. In the Model Unit Agreement this is provided for in clause 6.5 upon the following terms:

Responsibility for Royalty Settlements. Any party receiving in kind or separately disposing of all or part of the Unitized Substances allocated to any Tract or receiving the proceeds therefrom shall be responsible for the payment thereof to the persons entitled thereto, and shall indemnify all parties hereto, including Unit Operators, against any liabliity for all royalties, overriding royalties, production payments, and all other payments chargeable against or payable out of such Unitized Substances or the proceeds therefrom.

This, in effect, is a change in the method of computing the royalty. One of the American cases frequently referred to in support of this view is *Beene* v. *Midstates Oil Corp.*[35] The lease involved in that case provided for the payment of a one-eighth royalty on all oil produced, and in addition reserved an override, calculated on each well separately, which was fixed at one-eighth when a well produced 50 or more barrels per day and one-sixteenth when a well produced less than 50 barrels per day. After unitization, the allocation of production under the unit formula resulted in an allocation of less than 50 barrels per well per day. The lessor contended that the override should be based on the individual well's capability of producing rather than the production allocated under the unit formula. The Arkansas Court held that the method of computing the override was amended by the unit agreement and that all royalty payments were to be paid on the basis of allocated production under the terms of the unit agreement.

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35 169 F. 2d 901.

What is the situation respecting payment of royalties if a lessor does not execute the unit documents? In discussing the payment of royalties under these circumstances, Myers states:

> They (the royalties) must be accounted for in the manner provided for in the oil and gas lease and on the basis of actual production from the tract, rather than on the basis of the production allocated to the tract under the terms of the unit agreements.[36]

Conversely, according to Myers:

> If there is no production from the tract in question, the unsigned royalty interest in the absence of equitable considerations receives nothing though there is production elsewhere in the unit.[37]

In support of the first proposition the case of *Bruce* v. *Ohio Oil Co.*,[38] an Oklahoma decision, held, *inter alia,* that while lessees could unitize without consent of the royalty owners, they would nevertheless be liable to each non-consenting royalty owner for the full royalty for production obtained from his land. *Boggess* v. *Milam*,[39] a West Virginia case, appears to be the leading case in support of the second situation, namely, that if there is no production from a non-signing royalty owner's tract, that royalty owner will receive no royalty.

A notable departure from the rule in the *Bruce* case appeared in the case of *Dobson* v. *Arkansas Oil and Gas Comm.*[40] In this case, prior to unitization, the well on the non-signing royalty owner's land had an allocation of 250 barrels per day. After unitization, a pressure maintenance scheme was implemented and Dobson's well was selected as a producer. The result was an increase in production from the well of approximately 60 barrels a day. The court rejected Dobson's contention that the payment of royalty should be based on the actual production from his lands. In the result, the lessee paid royalty on the well allowable as it existed prior to unitization. The decision was based on the equitable ground that the lessor should not share in the benefits of unitization when he would not accept the burdens that might result from the unit operations.

There appear to be no Canadian decisions on the question of the payment of royalties to a non-signing royalty owner after unitization. Nevertheless, it is submitted that the courts in this country would reject the *Dobson* case and hold that the payment of royalties to a non-signing royalty owner should be made in accordance with the terms of the lease.

The Effect of Unitization Upon
Certain of the Implied Covenants

Any discussion of the United States law pertaining to oil and gas leases necessarily requires some reference to the implied covenants to be performed by the lessee. It follows that in discussing the effect of unitization upon the oil and gas lease in the United States, it is important to attempt to ascertain the effect of unitization on the implied covenants themselves.

It is not within the scope of this paper to consider the effect of imlied covenants on the oil and gas lease in Canada. However, a Canadian case where the court was prepared to hold that there was an implied

36 See Myers, *ante,* at p. 384.
37 *Ibid.*
38 169 F. 2d 709.
39 34 S.E. 2d 267 (1945).
40 235 S.W. 2d 33 (1950).

covenant on the part of the lessee to drill a well should be mentioned.[41] However, doubt has been expressed as to whether or not "Canadian Courts will prove as fertile ground for the growth of such covenants as were the courts of the United States where the policy of development dominated judicial thought."[42]

In view of the fact that there is no established Canadian law relating to implied covenants, some reference to the effect of unitization on the implied covenants in the oil and gas lease in the United States may be of interest.

W. J. Doggett, prior to embarking on a detailed examination of the effect of unitization upon the implied covenants, has warned: "In this as in other fields of law, it is difficult, if not futile to generalize."[43] Keeping in mind Mr. Doggett's caveat, an attempt will be made to see what effect unit operations have upon certain of the main covenants implied in the lease. Three of the main implied covenants are:

(a) To develop the land after discovery of oil and gas in paying quantities;
(b) To protect against drainage;
(c) To market the production.

In discussing the implied covenant to further develop, Doggett states:

> The standard principally used by the courts is the standard of the reasonably prudent operator, who must have regard for both the interests of lessor and lessee alike.[44]

In *Phillips Petroleum Co.* v. *Peterson*,[45] a Utah decision, Chief Judge Phillips stated at page 754:

> A lessee is bound by implied covenants in the lease to diligently explore and develop the lease, and to do so under a fair unitization plan, if unitization is effected; to market the production if the oil and gas is found in paying quantities; to do that which an operator of ordinary prudence, having due regard for the interests of both the lessor and the lessee, would do; and, in the case of unitization, to act fairly and in good faith, with due regard for the lessor's interests, and to provide for a fair apportionment of the oil produced.

Thus, in the United States, the implied covenant to further develop applies in the case of unitization, although, as stated in the *Southland*[46] case, the lessee is no longer bound to reasonably develop each tract separately. It should be noted that the obligation to develop the unitized lands is specifically provided for in the American Petroleum Institute's Model Unit Agreement. Clause 3.7 states:

> *Development Obligation.* Nothing herein shall relieve Working Interest Owners from the obligation to develop reasonably as a whole the lands and leases committed thereto.

Turning to the effect of unitization on the implied covenant to protect against drainage, a review of the authorities, it is suggested, leads to the conclusion that where there are a group of leases in a unit, the lessee is relieved of the duty to prevent drainage among the leases so included. The lease considered in the Louisiana case of *Everett* v. *Phillips Petroleum Co.*[47] provided for the payment of offset royalty if the lessee drilled

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41 *Reynolds* v. *Ackerman*, 32 W.W.R. 289, see the comment of McBride, J. at p. 298.
42 Lewis and Thompson, *Canadian Oil and Gas*, Vol. 1, para. 121.
43 See Doggett, *ante*, n. 27 at p. 292.
44 *Id* at 293.
45 4 O&GR 746.
46 *Ante* n. 29.
47 218 La. 835. Discussed by Doggett, *ante* n. 27 at p. 297.

a producer on its other leases within a certain distance of the lessor's land. Under a compulsory pooling order, part of the leased land was pooled with a part of another lease operated by the lessee, and a producer was drilled within the prescribed distance on the lessee's other land. The court held that the lessor was not entitled to any offset royalty because the effect of the pooling order was to prohibit the drilling of the offset well. Thus, while the decision in the *Everett* case evolved around the express prohibition against drilling an offset well and only involved small drilling units, it does not appear unreasonable to conclude that if all interest owners in a field-wide unit execute the uiit documents, the rule stated above would apply in the case of voluntary unitization. Merrill puts it succinctly:[48]

> The unitized operation project contemplates that the tracts in the unit will be operated together, with fewer wells than are necessary under individual exploitation, and hence that deposits under some tracts will be brought to the surface through wells on other tracts. The individual owners get their returns through the formula apportioning to them a share of the income from the entire unit. There is no occasion to apply the rule requiring protection against drainage to the individual leases.

The implied covenant to market production from the lessor's lands includes the duty to use reasonable diligence in disposing of the production and at the same time to obtain a reasonable market price therefor. One effect of unitzation upon this implied covenant is that the lessee will thereafter market allocated production rather than the actual production from his lessor's lands. With this variation, it is submitted that this implied covenant remains unaffected by unit operations. The Oklahoma decision in *Young* v. *West Edmond Hunton Lime Unit*[49] held that the unit as a whole owed the royalty owners collectively the duty of selling production at the highest market price. This decision was soundly criticized by Doggett who observed:[50]

> It is hoped that this case will not be followed in other jurisdictions nor, in fact, even in Oklahoma. Nevertheless, it should be a red flag to all unit lessees that they may have the onerous duty of maintaining a fiduciary relationship with the royalty owner and of marketing royalty owner's share of the unitized substances at the highest market price.

Drainage by the Unit from Lands Owned by a Lessor Who Has Refused to Join the Unit

A leading case dealing with these circumstances is *Tide Water Associated Oil Co.* v. *Stott.*.[51] The facts are as follows:

> The lessee of more than 2,000 acres of land in a wet gas field succeeded in effectuating an agreement between itself and the lessors and other royalty owners, except the plaintiffs, for unit operation of its block of leases. Under the plan the wet gas was processed in a reduction plant and the liquid hydrocarbons removed and the dry residue gas returned to the producing formation to maintain reservoir pressure. The plaintiffs repeatedly refused to join the co-operative development plan, although the terms offered them were the same as were offered other lessors and the court found that the terms and conditions were fair and reasonable and in conformity with the practices in other unit operation plans. Other operators in the same reservoir had unitized their acreage. Eventually the recycling operations would replace all of the wet gas in the field with dry gas. The plaintiffs brought suit against the defendant lessee to recover damages for drainage of wet gas from their lands and replacing it with dry gas.[52]

48 Merrill, *Implied Covenants and Secondary Recovery*, 4 Okla. L. Rev. at p. 195.

49 9 O&GR 1286.

50 See Doggett, *ante*, n. 27, p. 302.

51 (1946) 159 F. 2d 174, 5th Cir.

52 Summers, Oil and Gas, Vol. 1A, sec 104, n. 21.5 at p. 154.

The court refused to award damages to the plaintiffs. As mentioned in the facts set out above, the court found that the unit plan was fair and reasonable and held that if there was a duty of fair dealing imposed upon the lessee, the fact that the plan was fair and reasonable satisfied this duty. While holding that the plaintiffs were perfectly entitled to refuse to unitize, the court stated that this fact did not prevent the lessee from operating the balance of its leases to the best advantage of all the interest owners. It should be noted that there were producing gas wells on the plaintiffs' lands and the court stated that under the circumstances the lessee could not be expected to drill additional wells, with the result that the lessee had not breached the implied covenant to protect against drainage.

In commenting upon the ramifications of the *Stott case,* Hoffman states:[53]

> The *Stott* case is of far-reaching significance with respect to field-wide unitization. However, it should be noted and emphasized that the court did not deny or impair the continuing obligation of the unitized lessee to protect the land of the non-unitized lessor against drainage in the traditional sense by maintaining offset wells and producing them at a prudent rate. This has application to any of the ordinary field-wide units. Moreover, this view that the non-unitized lessor is entitled to continuing protection of his separate tract against drainage by offsetting wells is extended by the court, by implication, to the implied covenants to reasonably develop the separate tract, as such, and to use reasonable diligence in marketing the production. Hence, the lessee must not let the larger aspect of the *Stott* case obscure the necessity for satisfying the usual requirements of the implied covenants in the basic lease contract, this still being his sole contract with the non-unitized lessor. In the usual field-wide unit formed by voluntary agreement this is as it should be.

The author continues:

> But what the court seemed to say was that with the usual implied covenants to protect against drainage, reasonably develop, and market the production satisfied, the lessees were left to face only the overall duty to operate the premises in a reasonable and prudent manner. This did not forbid operations on adjoining properties to the mutual benefit of the lessor and lessees there, but it did impose on the defendants the duty to use 'reasonable care in good faith' to protect the leases in question from damage caused by such operations on adjoining properties. The duty was satisfied by the defendants' offer to the plaintiffs of a fair and reasonable unitization arrangement. Having refused to participate in the unitization, the plaintiffs were in no position to recover their damages from their lessees.

The *Stott* case illustrates the importance of the concept of fairness and reasonableness of the unit plan. This raises the obvious question of what criterion is to be applied in determining whether a particular unit plan is fair and reasonable? It should be kept in mind that the *Stott* case involved one of several different units operating in a single field. Under these circumstances, Hoffman suggests that the court considered whether the unit plan offered to the plaintiff was the usual type of plan in existence in the overall field.[54] However, this consideration cannot pertain to a situation where a single unit covers an entire field. Under these circumstances, it appears that the test would be to ascertain whether the complaining royalty owner was given the opportunity to participate on the same basis as those royalty owners who had agreed to unitize their interests.

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53 Hoffman, *ante,* n. 1 at p. 224.

54 *Id* at 228.

Hoffman summarizes his own views concerning this problem when he states:[55]

> It is submitted that in the Stott type of case the court, in determining whether the unitization plan offered the complaining lessor was fair and reasonable, should be guided principally by a consideration of the comparative proportion of the royalty interests within the unit area which have been voluntarily committed to that plan if the plan is such as to operate on all interests within the unit area in a uniform manner. The mere fact that the participation formula affects one interest differently from its effect upon another interest should not be controlling so long as the basic formula is of uniform application to all interests. The same comment can fairly be made with respect to most other features of the usual unitization plan. The primary consideration is that the unitization agreement constitutes a private contract incorporating many items ordinarily considered matters of trade and negotiation, and the court in the usual case should not substitute its (or the jury's) independent opinion concerning the fairness and reasonableness of the unitization agreement for that of the majority royalty owners whose interests are at stake and who have accepted it after considering its actual effect upon their interests.

It is submitted that in Canada, the fairness and reasonableness of the unit plan should be the main factor to be considered by the courts in dealing with circumstances similar to those in the *Stott* case. The fact that the majority of royalty owners voluntarily join the unit should be a guiding factor in the courts' determinations. However, since the burden of establishing that the unit plan was not fair and reasonable would be on the non-consenting party, it would, it is suggested, be necessary for the court to examine the overall feasibility of the unit plan.

The Effect of Unit Operations on a Lease Where Only a Part Thereof is Included in the Unit

Many of the United States decisions on this point arose as a result of pooling operations rather than unit operations conducted on a field-wide basis. While a review of some of the leading cases results in certain conclusions, it is important to note that the wording of the pooling clause in each case was usually a determining factor in the respective decisions.

In the Texas case of *Buchanan* v. *Sinclair Oil & Gas Co.*,[56] part of the plaintiff's lease was pooled with other lands. A gas well was drilled on a portion of the pooled acreage not forming part of the plaintiff's acreage. The plaintiff attempted to obtain a declaration that the lease had terminated because rentals had not been paid. The court stated at page 404:

> We come, then, to the crucial question in the case, whether, as contended by the appellee and found by the district judge under the decisions of this court in *Scott* v. *Pure Oil Co.*, 194 F. 2d 393, and of the Supreme Court of Texas in *Southland Royalties Co.* v. *Humble Oil Co.*, 249 S.W. 2d 914, the drilling on, and production from, the Buchanan unit has preserved the lease in its entirety so that no delay rentals were due in 1951, or have since become due.

The court followed the earlier Texas decisions and held that the lease was kept in force as a result of the drilling on and production from the pooled lands. The court's decision gave effect to the wording of the pooling clause which provided the production from the pooled acreage as a whole should be considered for all purposes, except payment of royalties, as if such production were from the leased lands. This case should not, however, be construed as a basis for the proposition that the lessee can ig-

[55] *Id.* at p. 229.
[56] 4 O&GR 400.

nore that part of the lease excluded from the pooled acreage. At the conclusion of its judgment, the court stated at page 406:

> Nothing in the district judge's holding or judgment, nothing in our affirmance of it, justifies, authorizes, or will permit appellee to hold the ununitized portion of the lease against well founded legal claims, of abandonment or for damages for breach of the implied covenants, or, where there is no other adequate relief, against well-founded claims, for relief in equity.

Almost all of the U.S. jurisdictions which have considered this question are in accord with the Texas decisions.[57]

The authorities examined are in general agreement that the cases dealing with small pooled areas are applicable to field-wide unitization.[58] The writers have searched in vain for a Canadian decision on this point. However, bearing in mind the importance of the wording of the pooling clause or the unit agreement, as the case may be, there seems to be no good reason why a Canadian court, when confronted with a factual situation similar to the *Buchanan* case, would arrive at a different conclusion than the Texas tribunal.

CONCLUSION

Anyone familiar with the law relating to the effect of unit operations upon the oil and gas lease will appreciate that the foregoing is far from being an exhaustive dissertation on the subject. However, it is hoped that some of the more important efects of unitization on the lease have been considered.

In Canada, for the present, the effect of unit operations on the individual leases must be obtained from the construction of the leases themselves and the unit documents in the case of voluntary unitization, and in the case of compulsory unitization, from the legislation and the unit operation order. It is submitted however, that because the unit documents and the compulsory unitization legislation in Canada have been developed along lines similar to their United States counterparts, there is good reason for anticipating that most of the general rules which have evolved in the American courts will in due course be applied in Canada.

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57 But see *Texas Gulf Producing Co.* v. *Griffith*, 2 O&GR 1103, a Mississippi decision which does not accord with the majority view.

58 W. J. Doggett, *ante*, n. 27. Myers, *Legal Problems Incident to Operation of a Unit*, Institute on Oil and Gas Law and Taxation, Southwesthern Legal Foundation, 8th Annual, 302.