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Oil and Gas - Damages - Voluntary Unitization - Liability of Operator of Waterflood Project to Non-Joiner - Baumgartner v. Gulf Oil Corporation

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OIL AND GAS—Damages—Voluntary Unitization—Liability of Operator of Waterflood Project to Non-Joiner. Baumgartner v. Gulf Oil Corporation 184 Neb. 384, 168 N.W.2d 510 (1969).

Defendant was the operator of a state approved[1] unitization project formed to increase the ultimate recovery of oil and to prevent waste. The unit agreement, which provided for secondary recovery of oil by waterflooding was signed by all of the working interest owners in the field except the plaintiff who was offered a fair and equitable opportunity to join. Upon plaintiff's refusal to participate, his section was excluded from the unit and waterflooding was initiated. Plaintiff's action was in trespass and conversion for value of oil swept from under plaintiff's lease by defendants waterflooding project.

The evidence clearly indicated that the plaintiff could not have profitably developed his lease to recover the small amount of primarily recoverable oil that underlay his lease and that in the absence of waterflooding by defendant, no secondary oil could have been recovered by plaintiff. Had plaintiff joined the project and borne his share of the costs, his profit would have been $27,455.00. Had he drilled independently (a drilling permit was denied by the commission because plaintiff was able but refused to join the unit)[2] and taken advantage of the waterflooding, the highest estimate of his profit would be $12,224. The trial court applied the common law of willful trespass and entered judgment against defendant for the value of the oil drained from under plaintiff's lease without deduction of any development or operating costs ($89,933.00).

In reversing, the Supreme Court of Nebraska held that where a secondary recovery project has been authorized by the commission, the operator is not liable for willful trespass to

1. The Nebraska Oil and Gas Commission approved the project under a superceded voluntary unitization statute (Session Laws of Nebraska, § 57-910, repealed) which has since been revised to provide for compulsory unitization (REV. STAT. OF NEB. § 57-910).
2. The decision was later reversed but not until the recoverable oil was swept from beneath plaintiff's lease. This raises the question, outside the scope of this note, of whether plaintiff would have a cause of action against the commission for denying his drilling permit because he chose not to participate in the unitization. The statute in effect was a voluntary unitization statute and seemingly would not warrant denial of a drilling permit for failure to participate in a unitization project. See generally 6 WILLIAMS & MEYERS, OIL AND GAS LAW § 933 (1964).

owners who refused to join the propect when the injected recovery substance moves across lease lines, but rather is liable only for the profit the non-joiner could have realized "had he drilled, developed and operated his property outside the unitization project; that is, as if no unitization had occurred."[3] Though this rule generates an acceptable result based on the particular facts in this case, as a general measure of damages for cases having the same dominant features,[4] it is inadequate. This inadequacy stems from its failure to always promote the public policy it was designed to support and the inequitable awards that could arise from it. A better measure, consonant both with equity and public policy, is the common law measure for unintentional trespass and conversion.

The context out of which this case arises is one in which public policy favoring maximum ultimate recovery of oil competes with the traditional concept of private ownership and use of property. Historically, under the rule of capture, surface interest holders were entitled to whatever oil they could produce by primary recovery operations conducted on their own land. But primary recovery operations were able to recover only a small part of the oil actually in place, so secondary recovery methods evolved by which controlled injection of water or gas into an oil pool created sufficient pressure to permit recovery of additional oil. Unfortunately, the forces generated by secondary recovery methods didn't respect lease lines, and oil could be swept from under the property of one not participating in the secondary recovery effort. As a result, the owners of separate interests in a common reservoir voluntarily joined together to share the costs and proceeds from secondary recovery projects. The effect was substantially increased recovery at a lesser cost. The problem arises, as in *Baumgartner,* when one of the persons holding an in-

3. Baumgartner v. Gulf Oil Corp. 184 Neb. 384, 168 N.W.2d 510, 519 (1969).

4. The dominant features are:
   (a) a voluntary unitization project
   (b) approved by the appropriate commission
   (c) for secondary recovery using some method requiring injection of foreign substance, e.g. water or gas
   (d) which the plaintiff non-joiner had a fair opportunity to join
   (e) that was operated without negligence
   (f) and which resulted in a reduction in the amount of oil in place beneath plaintiff's lease.

terest in the common reservoir refuses to join the project but will be affected by the forces it sets in motion. Though seemingly a private conflict, this problem is in fact a conflict between public policy and private rights.

Were the question merely a conflict of private interests, the courts would undoubtedly have settled the question of liability under the traditional common law rule of intentional trespass and conversion and the measure of damages would have followed automatically. That there was a physical trespass set in motion by the waterflood operator and that the invasion was intentional is beyond dispute. In the absence of some contrary public policy, the result is apparent: liability for intentional trespass and damages measured by the value of the mineral converted with no deduction of production costs. The introduction of the policy factor by oil and gas conservation legislation favoring maximum ultimate recovery made this result unacceptable; the courts were obliged to re-examine the question of liability in light of this policy. The re-examination led some courts to completely deny liability by: restricting the effective definition of trespass;[5] holding that approval by the appropriate state agency precludes liability;[6] holding that having refused a fair opportunity to join, any damage would be "damnum absque injuria."[7] Another court, though still finding liability, based it on a theory with a less severe impact than that of willful trespass.[8] But the questions of liability is beyond the scope of this note[9] which is directed toward evaluating the impact of the measure of damages on the policy goals to be effected.

Due to the ever-increasing demand for petroleum products, public policy dictates that maximum efficient recovery of oil be promoted and, therefore, that secondary recovery projects be encouraged. State legislatures have generally en-

5. California Co. v. Britt, 147 Miss. 718, 154 So.2d 144 (1963).
6. Railroad Comm. of Tex. v. Manziel, 361 S.W.2d 560 (Tex. 1962).
7. Tide Water Assoc. Oil Co. v. Stott, 159 F.2d 174 (5th Cir. 1946).
8. Tidewater Oil Co. v. Jackson, 320 F.2d 157 (10th Cir. 1963).
9. *See generally: Tort liability in Waterflood Operations*, 5 ALBERTA L. R. 52 (1966); Keeton & Jones *Tort liability and the Oil and Gas Industry II*, 39 TEX. L.R. 253; Methvin *Secondary Recovery Operations: Rights of the Non Joiner* 42 TEX. L.R. 364; Driscoll *Secondary Recovery of Oil & Gas: Significance of Agency Approval*, 13 KAN. L.R. 481; *Oil & Gas: Rights & Liabilities Incident to Water Flood Operations*, 17 OKLA. L.R. 457; Kelly *Trespass in Secondary Recovery*, 17 S.W.L.J. 591.

dorsed this policy and indicated through the various oil and gas conservation acts that this public need will prevail over conflicting private rights—but only to the extent necessary to provide for this public need. Many states have expressly recognized this balancing of interest by adopting the policy statement of the Model Oil and Gas Conservation Act: "It is hereby declared to be in the public interest to foster . . . the greatest ultimate recovery of oil . . . and that correlative rights of all owners be fully protected,"[10] whereas other states have only impliedly recognized it in other provisions within their statutes. For example, the Wyoming statute[11] which provides for the establishment of drilling units (to prevent waste in accordance with public policy) recognizes the need for protection of correlative rights (to minimize the infringement on private rights). Since the legislative intent is clear that public policy will prevail, the problem is not one of balancing public and private interests to see which will prevail, but rather one of discovering the rule that will provide for this public need with the least infringement on competing private rights. Some states have solved this problem by passing compulsory unitization statutes.[12] The *Baumgartner* case arose in a state that left the problem to the courts. It is suggested that the court failed to select from the alternatives available to and discussed by it, the measure of damages best meeting the standard of promoting maximum recovery with the least infringement on private rights.

The trial court decision and the dissenting opinion of the Supreme Court decision represent the two extreme alternatives available to the court. Considering first the trial court holding of liability based on common law willful trespass, it obviously overcompensates in favor of private interests and would substantially inhibit increased secondary recovery through unitization. As to any particular owner who had a minor interest in a pool, it would be to his advantage to re-

10. FLA. STAT. ANNOT. § 377.06 (1968).
S. D. COMP. LAWS § 45-9-1 (1967).
REV. STAT. OF NEB. § 57-901 (1959).
OKLA. STAT. ANNOT. § 286.1 (1951).
TEX. REV. CIV. STAT. § 6008, Sec. 1 (1969).

11. WYO. STAT. § 30-221 (1957).

12. The following states have adopted some form of compulsory unitization: Ala., Alas., Ark., Cal., Colo., Fla., Ga., Kan., La., Mich., Miss., Neb., Nev., N.Y., N.D., Ohio, Okla., Ore., Wash.

fuse to join a unitization project proposed by the major operators. Were he to join, he would have to pay his share of the costs, whereas under the trial court rule, he could sue for the value of the oil displaced or drained without deduction of any costs. *Baumgartner* exemplifies the inequity of such a rule. Though plaintiff's fair share was admittedly only $27,-455.00, his recovery under this rule was $89,333.00. Facing this type of liability, the major operators would be reluctant indeed to initiate any waterflooding without the consent of all the interested parties.

Conversely, the Supreme Court dissent would dismiss the complaint disallowing any recovery for plaintiff's loss of oil. As viewed by the dissent, the private right to be protected was merely the plaintiff's correlative right to a fair and equitable opportunity to recover the oil beneath his lease. This the dissent considered was satisfied by a reasonable offer to participate in the unitization project. Having thus met their duty to the plaintiff, the defendants could proceed with impunity, because in the absence of a breach of duty, there is no liability. The logic of this view is appealing, particularly when colored by the suspicion that plaintiff's motive for not joining was less than commendable.[13] He apparently was holding out in an attempt to coerce the other operators into allowing him to participate in the project without sharing in the costs.[14] However appealing, this approach not only shortchanges the doctrine of correlative rights, but is substantially more severe than is necessary to promote unitization. It is sufficient that the operators realize a fair return on their investment, not an unwarranted bonus at the expense of an adjacent non-joiner. Neither of the extremes—no liability or maximum liability—stacks up well against the standard of effective promotion of secondary recovery with the least possible infringement on private property interests.

The majority opinion fares better under this standard as applied to the specific facts of *Baumgartner*. It compensates

13. The plaintiff's motive for not joining the unitization project is not relevant to the rule of damages arrived at by the court. The objective is not to punish the non-joiner for legitimately exercising his right to refrain from participating, but rather to compensate him for a loss of property to the extent that such compensation does not have a deleterious effect on the promotion of unitization projects.
14. Baumgartner v. Gulf Oil Corp., 184 Neb. 384, 168 N.W.2d 510, 513 (1969).

to a degree the non-joiner for his loss of oil and also gives the unit operators a fair return on their project. However, it does not fare so well when treated as a general rule to be applied to other fact situations. In the language of the court, the measure is "the amount he could have recovered had he drilled, developed, and operated his property outside the unitization project."[15] Though somewhat ambiguous, the fact that the court put a ceiling on the amount recoverable ($12,224.00) equal to the amount of profit plaintiff could have made had he drilled independently and taken advantage of the waterflooding seems to mean that the amount of plaintiff's damage under this rule might well be a function of how effectively he could exploit the waterflooding of the defendants. Though in this case, the result is fairly reasonable, the situation is easily imagined in which the amount of recovery could substantially exceed the value of the oil actually beneath the non-joiner's land, or conversely, the recovery could be nothing, though the non-joiner actually had oil drained from beneath his land (a possibility in this case). The problem with the majority rule is that the amount of recovery is not proportionate to the property converted and consequently can vary independently of the loss to plaintiff or gain by the defendant. At one extreme under this rule, the prospect of liability to a non-joiner could virtually prohibit a waterflood operation and have an effect directly opposite to that dictated by public policy. At the other extreme, a non-joiner could be deprived of a substantial quantity of oil yet recover nothing, an unnecessary infringement on private rights. This rule, then, though producing a fairly equitable result in the instant case, fails in its broad application.

The fourth alternative was dismissed by the court in a single sentence,[16] even though upon careful examination it seems to best meet the criterion of promoting secondary recovery with a minimum infringement on private rights. The alternative dismissed is essentially the common law rule for unintentional trespass and conversion: the value of the mineral converted less the applicable production and development

15. *Id.*, 519.
16. *Id.*, 512.

costs. It is also the equivalent of the non-joiner's share had he joined the unit.

As to infringement on private property rights under this rule, it is minimal. The land owner gets no bonus at the expense of the unit operators, but is fully compensated for the loss of oil beneath his land. Only to the extent that the non-joiner is deprived of the opportunity to decide when (or if) to convert his mineral asset to a cash asset is he actually injured. He suffers no economic loss and is likely, due to the economies of unitization, to realize an economic gain. Such a gain would have been realized by the plaintiff in *Baumgartner* had this measure been used. The evidence showed that his profit, had he joined, would have been $27,455.00, whereas the maximum he could have recovered through his own efforts was $12,224.00.

The effect on unitization and secondary recovery is also entirely satisfactory; it promotes such projects to the extent that it doesn't discourage them. This should be sufficient if the project is in fact economically sound. The initial incentive for proposing the secondary recovery project, substantially increased recovery and the resultant profit, is unimpaired by the prospect of liability to a non-joiner. Whether or not he decides to participate, the expected return on the project and the resultant inducement to proceed is the same; the measure of damages is the equivalent of the non-joiner's share had he participated. If this inducement is not sufficient, then the project is probably not economically sound and better discouraged than encouraged. It is hardly sound public policy to encourage marginal endeavors. The court explicitly rejected this rule on the basis that the non-joiner should not share equally in the profits of the waterflood project, since he chose not to share also in the risks. Through a valid criticism, it is not significant enough to justify scrapping the rule in favor of of one of those previously discussed. In fact, the non-joiner does share to a degree in the risk, in that if the common pool itself is damaged by the waterflood operation, he shares in this damage to the extent of his interest in the pool. As to the risk of a net loss, considering that the actual risk of a substantial net loss is low and, that in the event of a net loss, the

non-joiner's share would be quite small, it is unlikely that the inequity of allowing the non-joiner to avoid this risk would seriously discourage the promoters of a promising unitization project.[17]

In addition to its independent merits, the rule of value less production costs finds substantial implicit support in the state oil and gas conservation acts. In those states that do not have a compulsory unitization statute, support for this rule is found by analogy to the compulsory pooling provisions. (Though pooling relates to a cooperative effort within a drilling unit, rather than a reservoir, the dominant characteristics —a cooperative effort, in the interest of economy, to develop a commonly held reservoir—are sufficient to support the analogy.) The Nebraska pooling statute[18] which was in effect when *Baumgartner* was decided and which is currently in effect in Wyoming[19] provides that each owner who does not agree to the pooling is entitled to receive from the operators his share of the production applicable to his interest less his share of the cost, the equivalent of the rule under consideration. The rule finds even greater legislative support in the current Nebraska statute[20] (taken from the model code) which provides for compulsory unitization; the statute calls for a "just and equitable distribution of production and costs."

The quantum liability of the operators of a voluntary unitization project to a non-joiner should not be measured by the profit the non-joiner could have made independently, but rather by the common law rule of damages for unintentional trespasses: the value of oil converted less production costs. Such a rule will adequately promote secondary recovery projects while minimizing infringement on private property rights.

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17. Viewed prospectively, suppose the total additional investment is $250,000.00, the risk of total loss is 10%, and the non-joiner's interest is 4%. The risk that the non-joiner is avoiding could be valued at 10% of $250,000.00 times 4% or $1,000.00—hardly sufficient to discourage a promising enterprize.
18. REV. STAT. OF NEB. § 57-909 (1959).
19. WYO. STAT. § 30-221(g) (1957).
20. REV. STAT. OF NEB. § 57-910 (1959).