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## INTRODUCTION

In Wyoming's mature oil basins, where fee minerals exist, many leases are extended beyond their primary terms by production under the terms of the lease.[1] Because the fields are so old and because of the many acquisitions and consolidations within the oil and gas industry, an operator wanting to drill a new prospect sometimes has difficulty reaching agreements with the current leasehold owners to either purchase or reach other contractual arrangements to drill.

For secondary recovery units, Wyoming's compulsory unitization statute provides for segregation of post-1971 leases.[2] There is no uncertainty regarding the application of the statute to post-1971 leases. However, application of the statute to pre-1971 leases may provide some opportunity for operators drilling on acreage currently held only by production on unit operations which occupy less area than held by the original lease. Application of the implied covenant of further exploration may also create some opportunities on other portions of a lease not included in the unit for leases held by production that are not unitized.

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1. 8 HOWARD R. WILLIAMS & CHARLES J. MEYERS, OIL AND GAS LAW at 95 (1994).

2. WYO. STAT. § 30-5-110(k) (1977 & Supp. 1995) states:

> Whenever the commission enters an order providing for a unit operation, any lease, other than a state or federal lease, which covers lands that are in part within the unit area embraced in any such plan of unitization and that are in part outside of such unit area embraced in any such plan of unitization and that are in part outside of such unit area shall be vertically segregated into separate leases, one (1) covering all formations underlying the lands outside each unit area, such segregation to be effective as of the anniversary date of such lease next ensuing after the expiration of ninety (90) days from the effective date of unitization; provided, however, that any such segregated lease as to the outside lands shall continue in force and effect for the primary term thereof, but not for less than two (2) years from the date of such segregation and so long thereafter as operations are conducted under the provisions of the lease.

The purposes of this article are to explore the current status of the Wyoming's Compulsory Unitization Statute to pre-1971 leases in post-1971 units and the implied covenant of further exploration in Wyoming.

## COMPULSORY UNITIZATION

In 1971, the Wyoming Legislature passed the Compulsory Unitization Statute.[3] The original statute authorized the Wyoming Oil and Gas Conservation Commission to unitize fields for secondary or tertiary operations for the recovery of hydrocarbons if 80%[4] of the working interest ownership and 80% of the overriding royalty interest ownership approved the unitization formula for allocating the proceeds.[5] The policy considerations for such a statute are obvious. Secondary and tertiary recovery methods substantially increase the amount of oil and gas recovered from a reservoir and enables full extraction of available minerals.[6]

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3. WYO. STAT. § 30-5-110 (1977 & Supp. 1995). *See generally*, Dave B. Hooper, *Wyoming's New Unitization Statute*, 6 LAND & WATER L. REV. 537 (1971); Gray & Swan, *Fieldwide Unitization in Wyoming*, 7 LAND & WATER L. REV. 433 (1972); Mark W. Gifford, *The Law of Oil and Gas in Wyoming: An Overview*, 17 LAND & WATER L. REV. 401 (1982).

4. The 80% percent requirement may be reduced to 75% upon application to the commission if the circumstances of paragraph (f) of WYO. STAT. § 30-5-110 are met.

5. As one commentator states, compulsory unitization is:

> The bringing together, as required by law or a valid order or regulation, of separately owned tracts (or separate interests therein) into a unit constituting all or some portion of a producing reservoir and the joint operation of such unit. Unitization is important where there is separate ownership of portions of the rights in a common producing pool in order that it may be made economically feasible to engage in cycling, secondary recovery operations, pressure maintenance, reinjection, or explorations in depth.
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> Compulsory unitization of rather comprehensive scope is now available in many states. (citation omitted). In general, under these statutes, a state regulatory agency is given authority to impose unitization on a pool or part thereof as against the objection of a small minority interest if a proposed plan has been approved by a requisite majority (e.g., 75 percent) of the owners of operating interests and certain nonoperating interests. In some states compulsory process is available to accomplish unitization for purposes of cycling operations, but not for other purposes. In Washington, unitization may be ordered by the regulatory commission when in its judgment production in any pool or field shall have declined to a point where secondary recovery operations are necessary.
>
> To achieve the maximum objectives of a unitization program it is necessary that all persons having an interest in the program area become subject to the agreement. Without statutory compulsion, however, unanimity is frequently impossible to obtain. The principal obstacle to full, voluntary agreement is the problem of dividing the proceeds of production. Even under a compulsory unitization statute, the problem of dividing the proceeds of production creates considerable difficulty inasmuch as most compulsory unitization statutes require prior agreement of a substantial majority of the persons interested in the area to be unitized to a unitization plan, and agreement must be reached by such persons on such matters as division of the proceeds of development before the regulatory commission may act upon the plan.

8 WILLIAMS & MEYERS, *supra* note 1, at 195.

6. Paula C. Murray & Frank B. Cross, *The Case for a Texas Compulsory Unitization Statute*,

Paragraph (k)[7] of the compulsory unitization statute provides that fee leases partially included in a secondary recovery unit formed under the statute and partially excluded, are vertically segregated[8] at the unit boundary. Those lands included in the lease outside the unit, terminate two years after the anniversary date after formation of the unit and function as a separate lease.[9]

For leases and units formed after the effective date of the compulsory unitization statute, there is little question that lands in a fee oil and gas lease partially excluded from the unit, will terminate pursuant to Paragraph (k) in the absence of exploration.[10] However, it is unclear whether or not a pre-1971 lease may be vertically segregated by operation of Section 30-5-110(k). The question arises as to whether the compulsory unitization statute can affect the contractual entered in an arms-length transaction prior to 1971. This article analyzes whether the statute's application would violate the Due Process clause of the U. S. Constitution or whether application of the statute would result in an unjust takings under the U. S. Constitution.[11]

First, when a lessee refuses to release an oil and gas lease as to lands outside of a unit that were contained in the pre-1971 lease, there is uncertainty for subsequent companies who may want to drill on those lands. The subsequent operator does not know whether he will be committing trespass by drilling on an old lease under an agreement with the leasehold owner or whether the lease was in fact terminated under the statute and a new lease required. Failure to have the pre-1971 leases terminated increases the difficulty for operators not owning an interest but wanting to drill an exploratory well. The Powder River Basin is notoriously difficult to put together prospects[12] because of many old leases and fractional interests. It is not uncommon for the holder of a leasehold to attempt to extract an onerous deal from a potential driller or to just not respond to an operator who wants to buy, farmout, or make other contractual arrangement for drilling. Consequently, companies who may want to drill in the Powder River Basin and other mature Wyoming fields have chosen not to do so because of such problems.

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23 ST. MARY'S L.J. 1099, 1140 (1992); John C. La Master, *Consent Requirements in Compulsory Fieldwide Unitization*, 46 LA. L. REV. 843, 844 (1986).

7. WYO. STAT. § 30-5-110(k) (1977 & Supp. 1995).

8. *Id.* The lease is divided into two leases as to all horizons (vertically) at the unit boundary: one lease inside the unit for all horizons; and one lease outside the unit boundary for all horizons. *Id.*

9. *Id.*

10. *Id.*

11. U.S. CONST. amend. V.

12. Prospects are defined as a promotor's assessment of a drilling site based upon information from observation, testing and other sources. 8 WILLIAMS & MEYERS, *supra* note 1 at 855.

The application of the compulsory unitization statute to pre-1971 leases requires that the statute be applied retroactively and overcome any constitutional challenges which have been suggested by other commentators.

*Retroactive Application of WYO. STAT. § 30-5-110(k)*

In Wyoming the retrospective application of a statute is disfavored unless the legislature demonstrates clear intent for the statute's retrospective application.[13] The Wyoming Supreme Court has stated, however, that a statute relying on antecedent facts does not necessarily act retroactively.[14]

For example in *Belco*,[15] the Supreme Court of Wyoming held that a statute will be construed prospectively only if there is any doubt as to whether the statute was intended to apply retroactively. This is especially true when substantive rights of parties to the action are involved.[16] However, the court has also held that a statute does not operate retroactively solely because it draws on antecedent facts for its operation.[17]

The legislative intent to apply the compulsory unitization statute to pre-1971 leases is clear. First, it is clear that while pre-1971 leases were not entered into with notice of the compulsory unitization statute, the regulation of the oil and gas industry is within the state's power as carried out by the Oil and Gas Commission.[18]

Second, section 30-5-110(k) provides for a two-year grace period in which a lessee may begin exploration and production on portions of a pre-1971 lease which are outside the unitized tract. Thus, if the statute was not intended to apply to pre-1971 leases, the statute would not require a such a length grace period, because post-1971 lessees are on notice of the statute and are able to proceed with production based upon the knowledge that production on a lease should include those areas which are susceptible to unitization and those that are not. Finally, efficiency and judicial

13. Mustanen v. Diamond Coal & Coke Co., 62 P.2d 287 (Wyo. 1936).

14. Belco Petroleum Corp. v. State Bd. of Equalization, 587 P.2d 204 (Wyo. 1978).

15. *Id.* at 206.

16. Bemis v. Texaco, Inc., 400 P.2d 529, 530 *reh'g denied*, 401 P.2d 708 (Wyo. 1965).

17. *Belco*, 587 P.2d at 210. In fact, the court stated that with regard to an excise tax laid upon the present and continuing privilege of extracting minerals, the statute imposed a present tax which was measured only by an antecedent fact. *Id.* at 211.

18. Kerr-McGee Corp. v. Wyoming Oil & Gas Conservation Comm'n, 903 P.2d 537, 544 (Wyo. 1995); Big Piney Oil & Gas Co. v. Wyoming Oil & Gas Comm'n, 715 P.2d 557, 560 (Wyo. 1986). *See also*, Samson Resources Co. v. Oklahoma Corp., Com'n, 859 P.2d 1118 (Okla.App. 1993) (holding that oil and gas conservation statutes are an exercise of the police power which may validly affect vested rights); Atlantic Richfield Co. v. Tomlinson, 859 P.2d 1088 (Okla. 1993).

economy would not be served if the statute does not apply to pre-1971 leases. For example, if production and exploration on a pre-1971 lease remain unaffected by the statute, it would still be necessary for the court to determine whether production within a unitized portion of a lease was sufficient to hold the lease by production.[19]

If section 30-5-110(k) were not applied retroactively to include pre-1971 leases, the court would be faced with potentially conflicting policies. The statute through vertical segregation clearly advocates for increased production by forcing lessees to continue exploration within the boundaries of a given lease even where a producing unit occupies a portion of that lease. However, allowing a pre-1971 lessee the luxury of holding an entire leasehold tract by the production of a unit that does not occupy the entire leased tract would be contrary to the clear policy of further production as is evident in section 30-5-110. Thus, application of section 30-5-110(k) to pre-1971 leases best implements Wyoming's policies including the further development of oil and gas reserves while still allowing lessees to hold leases by production where production begins within two years following unitization.

*Takings*

The application of the compulsory unitization statute to pre-1971 leases is not a takings under the fifth amendment of the United States or Wyoming Constitutions.[20] First, the lessor has not lost any opportunity to

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19. This is an unanswered issue in Wyoming law and beyond the scope of this article. However, at least one commentator has suggested that in the presence of a statute similar to Wyoming's, production within a unit is insufficient to hold an entire leasehold by production. 6 WILLIAMS & MEYERS, *supra* note 1, § 953.

20. The Oklahoma legislature passed a segregation statute continuing a provision similar to Wyoming's statute. Oklahoma Statute 1981 § 87.1(b) provides:

> (b) In case of a spacing unit of one hundred and sixty (16) acres or more, no oil and/or gas leasehold interest outside the spacing unit involved may be held by production from the spacing unit more than ninety (90) days beyond expiration of the primary term of the lease.

52 OKLA. STAT. § 87.1(b) (1981). Wyoming's statute is more generous than Oklahoma's because there is at minimum a two-year grace period available to lessees in which they can begin production.

One commentator suggested that the application of Oklahoma's statute to leases entered into prior to the enactment of the statute would be unconstitutional based upon due process which prevents the taking of private property for private use with or without compensation. Eugene Kuntz, *Statutory Well Spacing and Drilling Unites*, 31 OKLA. L. REV. 344 (1978). However, this suggestion occurred prior to recent decisions by the United States Supreme Court regarding fifth amendment takings. *See infra* notes 22,23.

The Supreme Court of Oklahoma avoided the constitutional challenge to the statute by applying it only to leases entered into following the statute's enactment. The court stated that "[t]o apply Section 87.1(b) to the appellees' oil and gas lease would indeed impair the lease contract and prejudicially affect rights vested upon execution of the contract." Wickham v. Gulf Oil Corp., 623 P.2d

develop the segregated lease at the time of unitization.[21] Second, there is a legitimate governmental interest which is rationally related to the policy of increased mineral production.[22]

The only loss of property that would be suffered by a lessee, should vertical segregation of the lease occur, would be the result of the lessee's failure to take action to hold the portion of the lease which is outside the unit by production.[23]

*Contract Provisions*

By drafting specific contract provisions providing for whether or not production on unitized portions of a tract of land is sufficient to hold the entire leasehold by production, parties can avoid segregation of a lease under the compulsory unitization statute. Thus, lessees that wish to hold fee leases by production based upon unitization activities in the absence of exploration on the segregated portions of a lease should specifically include such provisions in the original lease.[24]

Finally, the court should hold that pre-1971 leases should be segregated into two leases where the lessor has not begun production outside of a unit which occupies less than all of a leased tract.[25] It is obvious that the

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613, 616 (Okl. 1981). The decision in *Wickham* was based upon statutory construction principles which in Oklahoma required that a statute not apply retroactively if it altered the rights and duties under an existing contract unless expressly intended by the legislature. *Id. See also*, David D. Hunt, II, *Oil & Gas: Retroactive Application of Oklahoma's Statutory Pugh Clause*, 53 O.B.A.J. 487, 490 (1982) (suggesting that a lessee's constitutional claims might be supplanted by a valid exercise of the police power).

21. WYO. STAT. § 30-5-110(k) (1977 & Supp. 1995) specifically provides for a period of at least two years to begin production on the portions of the lease situated outside the unit.

22. Texaco, Inc. v. Short, 454 U.S. 516 (1982). *See also* Jan G. Laitos & Richard A. Westfall, *Governmental interference with Private Interests in Public Resources*, 11 HARV. ENVT'L. L. REV. 1, 68 (1987).

23. This action would necessarily include new exploration and drilling sufficient to hold a lease by production.

In *Texaco v. Short*, the United States Supreme Court held that a takings cannot occur because of the complaining party's failure to act. The Court stated, "[T]his Court has never required to compensate the owner for the consequences of his own neglect." 454 U.S. at 530.

The Supreme Court has also stated that "[e]ven with respect to vested property rights, a legislature generally has the power to impose new regulatory constraints on the way in which those rights are used, or to condition their continued retention on performance of certain affirmative duties." United States v. Locke, 471 U.S. 84, 104 (1985).

24. *See generally* Wolff v. Belco Development Corp., 736 P.2d 730 (Wyo. 1987); Kuehne v. Samedan Oil Corp., 626 P.2d 1035 (Wyo. 1981).

25. Another method of obtaining vertical segregation is the Pugh Clause. A typical Pugh Clause provides "that if a portion but not all of the leased acreage shall be included within a pooling or unitization agreement, production on the unit shall not excuse the payment of rentals on that portion of the leasehold excluded from the unit." 6 WILLIAMS & MEYERS, *supra* note 1, at § 952.

legislature intended for fee leases to be segregated if a unit is formed. Such a result would permit the lessor to obtain additional bonus money as well as giving other companies the opportunity to acquire the leases in order to conduct exploration activities. Logic dictates that lessees who enjoy the benefits of units formed under the compulsory unitization statute should also bear the burdens, even if their leases pre-date the statute.

## COVENANT OF FURTHER EXPLORATION

In addition to vertical segregation following compulsory unitization, the covenant of further exploration is another method that would permit other operators and lessors the opportunity to develop oil and gas resources.[26] The implied covenant of further exploration requires a lessee to explore for hydrocarbons in unexplored portions of a leasehold.[27] The covenant of further development requires a lessee to continue development even when the leasehold is offset by producing wells. The implied covenant of further exploration also requires the lessee to "explore" for hydrocarbons which are unknown at the time of the lease.

In *Sonat Exploration Company v. Superior Oil Company, et al.*, the Wyoming Supreme Court held that the covenant of further exploration did not apply to the lessee under the facts of the case. However, the court left a window of opportunity for the application of the implied covenant.[28]

In *Sonat*, Eason Oil Company, purchased 6,006.85 mineral acres in Crook and Campbell Counties in 1978.[29] A portion of the acreage was subject to an oil and gas lease dated December 8, 1957, in which Superior Oil Company was the lessee and an owner of the lease.[30] In 1984, Eason sought to terminate the lease for breach of the implied covenant to develop.

The Supreme Court held that the lessor, in order to establish a breach of the implied covenant to develop, must prove a lack of reasonable diligence on the part of the lessee to develop the lease, which burden includes, showing of a reasonable expectation of profit for both lessor and lessee from further drilling.[31]

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26. Patrick H. Martin, *Implied Covenants in Oil and Gas Leases - Past, Present & Future*, 33 WASHBURN L. J. 639, 650 (1994).

27. *Id.*

28. 710 P.2d 221 (Wyo. 1985).

29. *Id.* at 223.

30. *Id.*

31. *Id.* The court stated:

One of the issues presented by this appeal is whether a lessor or one standing in the shoes of a lessor must prove a reasonable expectation of profit from further drilling in order to

*Significant Acts Discussed in Sonat*

In *Sonat*, Superior Oil Co. executed an oil and gas lease that was executed on December 8, 1957 for a term of 10 years.[32] The lease covered six separate tracts scattered throughout the Powder River Basin.[33] In May of 1960, production was obtained on the lease. The well was subsequently included in a unit in 1967. In 1960 and 1961, the lessee paid half of the cost of drilling two wells which offset a portion of the lease. Apparently these two wells were producers and subsequently included as part of the unit.

In 1964, Superior assigned a portion of the lease to Continental Oil Company, who drilled a dry hole and then subsequently reassigned the acreage to Superior. The acreage of the dry hole plus other acreage, totaling 320 acres, was released in 1978 after a demand for release of all acreage outside the Rozet Muddy Sand Unit. Eason mistakenly believed all acreage outside the unit was released.

In 1967, the Plaintiffs' predecessor in interest (lessors) committed all acreage from the producing well to the Rozet Muddy Sand Unit and have subsequently received proceeds from the unit. Superior Oil Company had contributed money toward the drilling of additional wells in the unit. In 1970, the Defendant, Superior Oil Company, contributed dry hole money pursuant to an agreement[34] to support a well drilled in the unit. In 1974, Superior entered into a Farmout Agreement for an offset of a portion of the lease. In 1983, Superior entered into a Farmout Option Agreement for lands on the lease. This last option agreement was not exercised because of a dry hole outside the subject acreage of the lease. In April 1984, Superior entered into a Farmout Agreement for a portion of the acreage.

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establish a breach of the implied covenant to develop. A second issue is whether the evidence supports the conclusion that Eason failed to prove a breach of the implied covenant. We hold that, even after a substantial delay between the last drilling and the commencement of the action to cancel the lease, a lessor in order to establish the breach in question must carry the burden of proving lack of reasonable diligence on the part of the lessee, which burden includes the showing of a reasonable expectation of profit for both the lessor and lessee from further drilling.

*Id.* (citations omitted).

32. *Id.*

33. *Id.*

34. A dry hole agreement is defined as the situation in which a person owning land or leases in the vicinity agrees,

to pay the driller an agreed sum of money if the driller will complete a well to a designated depth and if the well so drilled is a dry hole; usually the obligor will be entitled to receive certain information concerning the well drilled (e.g. the well log and electrical log).

8 WILLIAMS & MEYERS, *supra* note 1, at 325 (1994).

Subsequent to the filing of the suit, Superior entered into a Farmout Agreement on another portion of the lease.[35]

The lessors were under the impression that the entire acreage had been released in 1978 when in fact only 320 acres had been released. From 1978 until May 1984, when the lawsuit was commenced, Eason failed to drill on any of the tracts and entered into only one Farmout Agreement for drilling on the tracts.[36]

Eason attempted to prove that Superior breached the covenant of further development when it failed to test the Minnelusa Formation on one of the tracts. Eason's geologist, however, testified that he would want to do other work before recommending drilling.[37]

The Court in *Sonat* held that to show a breach of the implied covenant, the Plaintiffs must show that the lessee failed to exercise reasonable diligence to develop the acreage. In determining reasonable diligence, the following factors are taken into account:

1. Other activities in the area by other operators.
2. Whether further development could reasonably be expected to show a profit.
3. The length of delay in the exploration efforts.[38]

The Court concluded that the ultimate question was whether the lessees acted as prudent operators.[39]

The Court rejected the notion that an unreasonable time delay would shift the burden of proving profitability from the lessor to the lessee.[40] In other words, if a lease is to be broken, the Plaintiff (lessor) must prove that the lessee did not exercise reasonable diligence of a prudent operator to develop lands that are reasonably expected to be profitable.[41]

From the facts, it appears that the lessor, Eason attempted to show that the Minnelusa Formation was not being adequately explored. There is no reference made as to whether companies holding the lease had rejected

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35. *Sonat*, 710 P.2d at 226.

36. *Id.* at 227-28.

37. *Id.* at 230. A discussion of Eason's geological testimony is set forth in page 230 of the opinion. *Id.*

38. *Id.* at 225.

39. *Id.* at 230.

40. *Id.* at 228, 231.

41. *Id.* " . . . it is also imperative, when contemplating a reasonable-diligence issue, to consider whether further drilling would prove profitable, not only to the lessor but also to the lessee." *Id.* at 228.

offers to give a farmout. In fact, the court suggested that there was no evidence and stated that "although Superior may feel that it is not now prudent to drill upon these properties, this is not to say that it is engaged in the business of preventing or hindering the development of the properties in question. In fact, just the opposite conclusion must be drawn from a careful analysis of Superior's efforts."[42] The Court relied on the fact that no evidence was introduced to demonstrate that Superior was preventing other companies from drilling. The Court paid particular attention to the fact that Eason, the mineral owner, believed it owned the minerals and did nothing to develop it themselves. Eason's geologist testified that he would not recommend drilling without more work.

The Court held that the lessor must prove that development would be "reasonably profitable." The Court does not define what reasonably profitable would be, although there is a discussion of the economics of the Minnelusa Formation in the opinion.

The Court had difficulty finding a breach of an implied covenant for a sophisticated lessor that was an oil company engaged in oil and gas exploration but did not actively develop the acreage when it believed it did have the right to do so, and therefore, the lessor cannot complain that the acreage was not developed.

In order for a lessor to successfully assert a breach of the implied covenant of further exploration, the Court in *Sonat* indicates that the lessor must prove the following:

1. An extended length of time in which no activity is being conducted on the lease.
2. Enough activity in the area to merit exploration on the lease.
3. That the lessee is discouraging exploration by failing to grant Farmout Agreements to other operators (see statement on page 230 of the court's opinion, regarding hindering development).
4. That under the facts from the logs from the surrounding wells, that a prudent operator could be expected to drill the acreage and reasonably expect to make a profit from the activity.[43]

Thus far, the author is not aware of any case presented to a court in which evidence was offered by a lessor that the lessee actively resisted efforts to

42. *Id.* at 227.

43. These factors are ultimately part of the prudent-operator test, and a breach of the implied covenant further exploration may be proven only once the lessor proves that a lessee acted imprudently. *Id.* at 229.

explore on a lease held by production. Such a case will be necessary to fully develop the implied covenant of further exploration in Wyoming.

## CONCLUSION

Like many of the other areas of the law in Wyoming, there is no judicial determination of the effect of the segregation clause in Wyoming's compulsory unitization statute on pre-1971 leases and post-1971 units. A strong argument can be made that the segregation clause in section 30-5-110(k) applies to pre-1971 leases for post-1971 units. The Wyoming Supreme court has also not rejected the notion of the covenant of further exploration but has defined some specific limits on its application. Releasing some lands from some old leases will enhance the availability of acreage for further drilling.

The right fact situation needs to be presented for a final judicial resolution of the dilemma with the compulsory unitization statute and for a clearer definition of the applicability of the covenant of further exploration. If the price of oil stays high enough to justify the expenditure by a mineral owner or potential lessee, these issues will be resolved. Increased exploration and consequent increased production will certainly be to the economic benefit of the State of Wyoming. Hopefully, these issues will be resolved in the near future to provide certainty to the law and increased oil production for the state of Wyoming.