

# Mineral Rights - Effect of Forced Unitization With Producing Acreage Subsequent to Primary Term Under Lease Containing Commence Drilling and Continuous Drilling Clauses

Gerald LeVan

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is to compensate the taxpayer for the cost of his asset, but for no more. As expressed by Mr. Justice Clark, "Congress intended by the depreciation allowance not to make taxpayers a profit thereby, but merely to protect them from a loss."<sup>38</sup> In light of this consideration the taxpayer could have prevailed only by showing that he was clearly entitled to the tax saving.

These decisions indicate that the Commissioner has succeeded in his attempt to have the law applied as it was probably intended. The depreciation of an asset which is normally held for its full economic life will not be affected, but only those which are sold while they have a substantial resale value. If any relief is to be forthcoming for the businesses which have lost these tax advantages, it apparently must come through congressional action.

*Peyton Moore*

MINERAL RIGHTS — EFFECT OF FORCED UNITIZATION WITH  
PRODUCING ACREAGE SUBSEQUENT TO PRIMARY TERM  
UNDER LEASE CONTAINING COMMENCE DRILLING  
AND CONTINUOUS DRILLING CLAUSES

Plaintiff, a Texas resident, sued, in an action removed to federal district court, to have his mineral lease on certain Louisiana lands declared superior to defendant's lease. Defendant's lease, executed on a standard printed form,<sup>1</sup> contained the customary sixty-day continuous drilling clause<sup>2</sup> and the customary thirty-day commence drilling clause.<sup>3</sup> Defendant was engaged in drilling operations at the expiration of the primary term but

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38. *Ibid.*

1. Bath Louisiana Special 14-BR 1, M. L. Bath Co., Shreveport, La.

2. *Ibid.*: "5. If prior to discovery of oil, gas, sulphur or other mineral on said land, lessee should drill a dry hole or holes, thereon, or if after discovery of oil, gas, sulphur or other mineral, the production thereof should cease from any cause, this lease shall not terminate if the lessee commences operations for additional drilling or reworking within sixty days thereafter or (if it be within the primary term) commences additional drilling operations or commences or resumes the payment or tender of rentals on or before the rental paying date next ensuing after the expiration of three months from date of completion of dry hole or cessation of production. . . ."

3. *Ibid.* "5. . . . If at the expiration of the primary term, oil, gas or other mineral is not being produced on said land but lessee is then engaged in drilling or reworking operations thereon, the lease shall remain in force so long as operations are prosecuted with no cessation of more than thirty (30) consecutive days, and if they result in the production of oil, gas or other mineral, so long thereafter as oil, gas or other mineral is produced from said land. . . ."

abandoned his efforts two days later, having completed a dry hole. Thirty-two days thereafter, defendant obtained an order from the Commissioner of Conservation unitizing a portion of the leased premises with adjacent land upon which there was a producing well. Subsequent to issuance of the order, plaintiff obtained a second lease on the land, and in the instant action demanded a share of production from the unit. On plaintiff's motion for summary judgment, *held*, denied. Since the lessee was engaged in drilling at the expiration of primary term, the lease was continued in force by terms of the commence drilling clause until completion of the dry hole. The continuous drilling clause then became operative, allowing the lessee sixty days from completion of the dry hole to commence additional drilling or reworking operations. As the court construed defendant's lease, production from the unit created by the Commissioner's order issued during that sixty-day period substituted for the lessee's obligation to drill and served to continue the lease, even though a portion of the land included was in production prior to creation of the unit. *Harper v. Hudson Gas & Oil Corp.*, 189 F. Supp. 781 (W.D. La. 1960).

The drilling paragraph of a typical oil and gas lease contains two clauses governing the legal relations of the parties in the event the lessee completes a dry hole. One of these clauses, known technically as the "continuous drilling clause" but referred to in the industry as the "sixty-day clause," provides that should the lessee complete a dry hole, he is given sixty days to commence *additional* drilling or reworking operations on the lease.<sup>4</sup> In the "commence drilling" or "thirty-day" clause, it is anticipated that the lessee might be engaged in drilling operations at the expiration of the primary term, subsequently completing a dry hole. In that event, the thirty-day clause allows him to continue working or reworking operations on that *particular* well so long as there is no cessation of operations for more than thirty continuous days. In short, the sixty-day clause allows the lessee sixty days to regroup and drill at a different location, while the thirty-day clause allows him to carry to completion the particular operation in which he is engaged at the expiration of the primary term. Both clauses afford the lessee an opportunity fully to develop the lease, but require him to do so without unreasonable delay.<sup>5</sup>

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4. Under a "drill or pay" lease, it is customary to suspend the requirement of delay rentals during this period. See note 2 *supra*.

5. See Discussion Notes, 7 OIL & GAS REP. 1512 (1957).

Courts in other jurisdictions have held that a lease containing typical thirty- and sixty-day clauses is continued by *production* from drilling operations begun within sixty days after completion of a dry hole in process at the expiration of primary term.<sup>6</sup> In these decisions it was necessary to give cumulative effect to the clauses — the thirty-day clause carrying the lease in force beyond primary term until completion of the dry hole, and the sixty-day clause constituting authority to engage in additional drilling operations within the ensuing sixty days. The cumulative effect of these clauses has not been tested before a Louisiana court.

The Louisiana Supreme Court has held uniformly that under leases permitting the lessee to unitize, production from the unit substitutes for the lessee's obligations to drill even though the producing well is not located upon that particular leasehold.<sup>7</sup> Recently the court has said:

"The rule is too well established in our jurisprudence to require citation that the drilling and production of oil from a unitized area constitutes an exercise and user of the mineral rights throughout the entire unit and operates as a substitute for performance of drilling obligations contained in a mineral lease covering any property or tract located within the unit."<sup>8</sup>

The reasons behind this policy are obvious. Lessor and lessee have a common objective, to obtain maximum production from the land. If such production can be realized without the expense, delay, and inconvenience of a drilling operation on the particular leasehold, neither party should be heard to complain. Accord-

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6. *Stanolind Oil & Gas Co. v. Newman Bros. Drilling Co.*, 157 Tex. 489, 305 S.W.2d 169 (1957), 56 MICH. L. REV. 823 (1958); *St. Louis Royalty Co. v. Continental Oil Co.*, 193 F.2d 778 (5th Cir. 1952). The latter case rested on an alternative holding of estoppel. Cf. *Skelly Oil Co. v. Wickham*, 202 F.2d 442 (10th Cir. 1953), where a lease did not contain a sixty-day clause or its equivalent. It was held that the thirty-day clause did not contain authority for the lessee to commence *additional* drilling operations subsequent to primary term, though the lease was held in force, by the *particular* drilling operations underway at the expiration of primary term, until the dry hole was completed. See also *Rogers v. Osborn*, 152 Tex. 540, 261 S.W.2d 311 (1953), where cumulation of the thirty- and sixty-day clauses was urged, but it was determined that a dry hole had not in fact been drilled. For a general discussion of these cases, see Spierling, *Habendum Clause as Affected by Shut-in, Commence Drilling, Continued Drilling and Other Clauses*, in 9 INSTITUTE ON OIL AND GAS LAW AND TAXATION 1, 21 (1958).

7. The leading case on this point is *Hardy v. Union Producing Co.*, 207 La. 137, 20 So.2d 734 (1944).

8. *Delatte v. Woods*, 232 La. 341, 385, 94 So.2d 281, 287 (1957).

ingly, most lease forms contain provisions authorizing the lessee to unitize at his option.<sup>9</sup> However, in the lease agreements construed in *Wilcox v. Shell Oil Co.*<sup>10</sup> and *Mallet v. Union Oil Co.*,<sup>11</sup> the Supreme Court refused to find authority for the lessees to continue their leases by unitizing with land already in production. In both instances, the lessees attempted to preserve their leases in the twilight hours by entering into *voluntary* unitization agreements attaching the leases to tracts, also leased by them, on which production had already been obtained. The *Wilcox* lease provided that:

“[T]he commencement of a well or the completion of a well to production, and production of oil or gas therefrom on any portion of an operating unit in which all or any part of the land described herein is embraced, shall have the same effect, under the terms of this lease, as if a well were commenced or completed on the land embraced by this lease.”<sup>12</sup>

The court interpreted this language as applicable only to production obtained subsequent to the creation of the unit. The court interpreted the pooling paragraph of the *Mallet* lease as permitting unitization solely for the purposes of “future development,” thus not empowering the lessee to unitize with land already developed.<sup>13</sup>

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9. See Discussion Notes, 7 OIL & GAS REP. 1512 (1957). In the instant lease, the pooling paragraph read in part: “6. If at any time while this lease is in force and effect lessee in its opinion deems it advisable and expedient, in order to form a drilling unit or units to conform to regular or special spacing rules issued by the Commissioner of Conservation of the State of Louisiana, or by any other State or Federal authority having control of such matters, or in order to conform to conditions imposed upon the issuance of drilling permits, lessee shall have the right, at its option, to pool or combine the lands covered by this lease or leases in the immediate vicinity thereof, whether such land, lease or leases are held by lessee or by others, such pooling to be into a unit or units not exceeding the number of acres, or the land subdivisions whichever may be the larger, allocated to one well by the above mentioned authority or authorities, and to be applicable only to such lands, horizons or strata as are covered by such regulations. . . . As between the parties hereto and except as herein otherwise specifically provided, the entire acreage so pooled into a tract or unit shall be treated for all purposes as if it were included in this lease. . . . Drilling operations on or production of oil, gas, sulphur or other minerals from any portion of the land covered hereby shall continue this lease in force and effect during or after the primary term as to all the lands covered hereby, irrespective of whether any portion thereof has been pooled. If operations be conducted or production be secured from land in such pooled unit other than land covered by this lease, it shall have the same effect as to maintaining lessee's rights in force hereunder as if such operations were on or such production from land covered hereby, except that its effect shall be limited to the land covered hereby which is included in such pooled unit. . . .”

10. 226 La. 417, 76 So.2d 416 (1954).

11. 232 La. 157, 94 So.2d 16 (1957).

12. 226 La. 417, 425, 76 So.2d 416, 420 (1954).

13. “It appears throughout the lease that it contemplates the development of

In the instant case, both parties conceded that the thirty- and sixty-day clauses cumulated to continue the lease for sixty days following completion of the dry hole. Nevertheless, the court felt constrained to treat the cumulation of these clauses at length, perhaps because the question of cumulation was *res nova* to Louisiana jurisprudence. The court adopted the reasoning of the Texas Supreme Court in *Stanolind Oil & Gas Co. v. Newman Bros. Drilling Co.*<sup>14</sup> wherein thirty- and sixty-day clauses identical to those in the instant lease were held to have cumulative effect.<sup>15</sup> The remaining question was whether the establishment by the Commissioner of Conservation of a drilling unit within the sixty-day period, including a portion of the leased premises with a producing well located on another section

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the property by drilling thereon and we find throughout the lease references made to the drilling or reworking operations; production of oil and gas; and commencing drilling operations. In paragraph 4 we find this language, after reference is made to the right to pool, viz.: 'when in Lessee's judgment it is necessary or advisable to do so in order properly to develop and operate said leased premises.' In the same paragraph of the lease it is to be noted that the phrase 'drilling or reworking operations thereon and production' are used.

"In paragraph 5 this language is used: 'If operations for drilling are not commenced on the land covered hereby or on land with which land covered hereby is pooled hereunder, as above provided.'

"In paragraph 6 we find this language, 'this lease shall not terminate if Lessee commences or resumes drilling operations or reworking operations.'

"In paragraph 9 we find this language: 'After the production of oil, gas, sulphur or other mineral has been secured from the land covered hereby or land pooled therewith.'

"In paragraph 11 we find, viz.: 'Should Lessee be prevented from complying with any express or implied covenant of this lease from conducting drilling or reworking operations,' etc.

"The language used in this lease unmistakably shows that the pooling agreement was authorized *only for the purpose of development* and the right to unitize with producing property was not granted. The whole tenor of the lease and the pooling agreement contemplates pooling before production." 232 La. 157, 164, 94 So.2d 16, 18 (1957).

Justice McCaleb's dissent rested on language also found in the pooling paragraph giving the lessee the option to unitize when " 'in the judgment of the lessee [unitization would] *promote the conservation of oil and gas* from said premises.'" (Emphasis added.) *Id.* at 165, 194 So.2d at 19.

14. 157 Tex. 489, 305 S.W.2d 169 (1957).

15. "The sixty-day clause deals only with two fact situations: (1) where a dry hole or holes are drilled prior to the discovery of oil or gas, and (2) where after discovery of oil or gas production ceases from any cause. The sentence provides that in either of the two fact situations, the lease may be kept in force by *additional* drilling or reworking operations begun within sixty days or (if it be within the primary term) by resumption of payment of delay rentals within a stipulated time. The lessee is specifically given the right to keep the lease alive by resuming payment of rentals in either situation provided it occurs before the end of the primary term. By necessary implication the lease may be kept in force by the additional drilling or reworking operations in either fact situation whether occurring within or after the end of the primary term.

"Although the clause stipulates that the lease will not terminate, it was not included simply to insure that the drilling of a dry hole or cessation of production would not be grounds for forfeiture of the lessee's estate. If this were its only purpose, it could be effective only at a time when the lease is, and would other-

of land, maintained the lease thereafter.<sup>16</sup> Plaintiff argued that only actual drilling or reworking on the leased premises could have continued the lease. In support of this position he cited several cases holding that the power to unitize is to be strictly construed. The court rejected these cases as inapplicable since the express language of the pooling paragraph authorized the lessee to unitize at his option "at any time the lease is in full force and effect." It reasoned that through cumulation of the thirty- and sixty-day clauses, the lease was in force and effect on the date the Commissioner's order was issued.<sup>17</sup> Alternatively, plaintiff contended that even if the power to unitize were operative on that date, the lessee was not authorized to unitize with land upon which there was already a producing well, citing as authority the *Wilcox* and *Mallet* cases, discussed above. The court distinguished these cases on the ground that they involved *voluntary* unitization agreements, while in the instant case, the unit was created by order of the Conservation Commissioner. However, if this distinction were not controlling, said the court, the intent of the lessor to authorize unitization with land in production was sufficiently clear from the language of the agreement. The pooling paragraph provided that the lease would be continued by "drilling operations *or* production" from any of

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wise remain, in full force and effect under its other provisions, i.e., during the primary term. The parenthetical expression shows beyond any question that the parties contemplated that the provision would be effective both during and after such term. Its primary purpose is to give a lessee who has incurred the expense of drilling a well an opportunity to save his lease in the event the well is a dry hole or production ceases after having been obtained. The effect of the provision then, once it becomes operative and lessee begins additional operations within the stipulated time, is to keep the lease alive as long as the additional drilling or reworking operations, and any production resulting therefrom continue.

"There is nothing in the lease to suggest that the sixty-day clause will not be effective if the particular operation begun during the primary term results in a dry hole. Even though the dry hole results from drilling which was going on at the end of the primary term or there is a cessation of production which kept the lease alive after the end of such term, the parties have agreed that the lease may be kept in force by *additional* drilling or reworking operations begun within sixty days, but *only* in the two fact situations mentioned." 157 Tex. 489, 496, 305 S.W.2d 169, 174 (1957).

16. As the court framed the issue, "[I]f additional drilling or reworking operations were not begun during that additional period of time, the lease would have expired, *unless it was maintained by some other provision of the agreement.*" 189 F. Supp. 781, 788 (W.D. La. 1960).

17. Plaintiff also contended that an agreement extending the lease "for a period of sixty (60) days from April 4, 1955, and so long thereafter as oil, gas or other minerals is produced therefrom," obtained by defendant before he commenced his sole drilling operation on the land, had the effect of superseding the original habendum clause and thus requiring that actual drilling on the lease was necessary to carry beyond primary term. The court rejected this argument on the basis of other language in the extension agreement to the effect that all provisions of the original lease were kept in force, save the length of the primary term.

the land in the unit.<sup>18</sup> Had the parties intended to limit the authority to unitize solely with land not yet producing at the time the unit was created, they would have used the conjunctive language, "drilling *and* production from any portion of the land in the unit will constitute production sufficient to continue the lease."<sup>19</sup>

From the phraseology of the drilling paragraph of the instant lease, it appears that possible cumulation of the thirty- and sixty-day clauses was not contemplated by the parties. Most probably, the thirty-day clause was inserted to protect the lessee's investment in a particular drilling operation at the expiration of primary term, from which particular well production might afterwards be obtained. The sixty-day clause, as it relates to dry holes, was probably inserted to allow a temporary abatement of delay rentals during the primary term while the lessee prepared to drill an additional well elsewhere on the leasehold.<sup>20</sup> It is equally unlikely that the parties anticipated that the lessee would have occasion to unitize a portion of the lease with land already in production. Though the instant decision may cause parties negotiating new leases to provide expressly for these eventualities, its major import rests upon the interpretation of lease provisions currently binding on parties who likewise may have failed to take these possibilities into account. From the standpoint of logic and fairness, the position taken by the court is entirely defensible. Defendant oil company had expended large sums of money in drilling on the lease only to discover data indicating that oil thereunder could be drained adequately by its well already producing on an adjacent tract. Defendant was instrumental in obtaining the unitization order and most probably bore the costs. By contrast, plaintiff's interest was not acquired until after the order was issued, and though he contributed nothing to the enterprise, he demanded the profit from defendant's expenditures.

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18. See note 9 *supra*.

19. Compare with the following from Justice McCaleb's dissent in *Mallet v. Union Oil Co.*, 232 La. 157, 167, 94 So.2d 16, 19 (1957): "Counsel point to the conjunction 'and' . . . and argues that drilling *and* production is essential in order for the unitization of the leased property to become effective. This is true but it does not restrict in any manner the time when the unit may be formed or warrant the conclusion that unitization must take place prior to drilling and production."

20. It will be noted that the sixty-day clause of the instant lease provided for sixty additional days to drill *after cessation of production*, as well as sixty additional days after completion of a dry hole. See note 2 *supra*. Perhaps reference in the drilling paragraph to the operation of the sixty-day clause *subsequent* to primary term contemplated only a cessation of production after primary term and not the completion of a dry hole.

The Louisiana Supreme Court, holding against the lessee in *Wilcox v. Shell Oil Co.*,<sup>21</sup> implied its disapproval of attempts to preserve the lease in its eleventh hour by unitizing voluntarily with land on which the lessee had already completed a producing well.<sup>22</sup> *Mallet v. Union Oil Co.*<sup>23</sup> was to the same effect. However, the court in the instant case did not consider those decisions to be controlling because the creation of the present unit was "forced" by an order of the Conservation Commissioner. The court observed approvingly that the lessee first drilled on the leased premises, and, having completed a dry hole, took prudent steps to protect what he could of his investment. Perhaps the courts in these three cases reacted to the demands of the various lessees in the same manner the lessors would have reacted at the time the leases were negotiated. It is unlikely that the *Wilcox* and *Mallet* lessors (or defendant's lessor) would have consented to a provision expressly authorizing the lessee to continue the lease indefinitely simply by unitizing at will with his own producing acreage. On the other hand, it is probable that defendant's lessor (and the *Mallet* and *Wilcox* lessors) would not have objected to a provision allowing the lease to be preserved by "forced" unitization with producing land, with the understanding that to obtain the unitization order, the lessee would be required to satisfy the Commissioner of Conservation that, on the basis of geological data, a unit should be created in the interests of conservation.

*Gerald LeVan*

#### MUNICIPAL CORPORATIONS — POWER OF THE LEGISLATURE TO ALTER MUNICIPAL BOUNDARIES

Petitioners, Negro residents of the City of Tuskegee, Alabama, sued in federal district court seeking a declaration that an act of the Alabama legislature, redefining the boundaries of the

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21. 226 La. 417, 76 So.2d 416 (1954).

22. "In order to keep the Wilcox lease alive . . . Shell was faced, as the rental date . . . approached, with the alternative of commencing drilling on the Wilcox land or paying the delay rental. To avoid both of these alternatives, Shell formed an operating unit in an attempt to cause production from the FT sand to be considered production under the Wilcox lease. This was very much to its interest because by it Shell could save a rental payment of \$2,750 and at the same time avoid the expense of drilling a well on the Wilcox lease within the 12 months remaining of the primary term in an effort to keep it alive beyond that term." *Id.* at 423, 76 So.2d at 418.

23. 232 La. 157, 94 So.2d 16 (1957).