

Scrutinizing the Scope of Oklahoma’s Statutory Pugh Clause [Stephens Production Co. v. Tripco, Inc., 389 P.3d 365 (Okla. Civ. App. 2016)]

Ethan D. Thompson

Summary: The Oklahoma Court of Civil Appeals held that the Oklahoma statutory Pugh Clause does not apply to a statutorily created unit because the Unitization Act addresses producing wells, while the Pugh Clause addresses pre-production leases. The court erred by failing to recognize that the purposes of both statutes are to prevent waste, and the court’s interpretation created opportunities for more waste.

I. INTRODUCTION

Oil and gas continues to be a major economic force, but the law struggles to keep up with the demand to produce. Regulatory agencies ensure the oil reserves produce efficiently and effectively. These agencies must balance the interests of lessors and lessees while demanding that the resources be exploited in a manner that encourages development and successful recovery of the greatest portion of resources technologically feasible.

In balancing these interests, the agencies have the authority to determine who can drill where and which methods they can use. These decisions cause tension between lessors who want to ensure that their interest is being fervently developed and lessees who want to control the field, prevent competition, and reduce cost. In *Stephens Production Co. v. Tripco, Inc.*,¹ the Oklahoma Court of Civil Appeals decided against enforcement of a statutory lease provision terminating a lease on land that was not independently producing.

II. BACKGROUND

A. Case Description

In 1996, Tripco, Inc., Defendant, recorded an oil and gas lease for the SE/4 of Section 31, Township 18N, Range 2W from the Indian Meridian comprising 160 acres.² Plaintiff, Stephens Production Co., held two separate leases executed in 2013.³ One lease consisted of the eighty acres in the E/2 of the SE/4 of Section 31, Township 18N, Range 2W from the Indian Meridian (“Stephens 1”).⁴ The other lease was forty acres located on the SW/4 of the SE/4 of Section 31, Township 18N, Range 2W from the Indian Meridian (“Stephens 2”).⁵ Co-plaintiff, Eagle Oil & Gas Co., held a lease that included

1. 389 P.3d 365 (Okla. Civ. App. 2016).

2. *Id.* at 366. The use of an accurate legal description for the land in question is a crucial part of any property dispute; a graphic representation of this information is attached at the end of this Comment. *See infra* Figure 1, p. 15.

3. *Stephens Prod. Co.*, 389 P.3d at 366.

4. *Id.*

5. *Id.*

all formations except the Oswego formation in the NW/4 of the SE/4, all formations in the NE/4 of the SE/4, and all formations in the S/2 of the SE/4 in Section 31 (“Eagle 1”).⁶

On January 31, 2014, Plaintiffs filed a quiet title action seeking cancellation of the 1996 Tripco lease on the grounds that there was no production from the leased lands.⁷ The leased lands were part of the Northwest Lawrie Oswego Unit (“NLOU”), which was created through the Unitization Act “by a July 19, 1996 order of the Oklahoma Corporation Commission.”⁸ The Oklahoma Corporation Commission (the “OCC” or the “Commission”) stated that creation of the unit was “necessary because enhanced recovery operations will prevent waste, increase ultimate recovery, and protect correlative rights.”⁹ The order also superseded drilling and spacing unit orders of the Commission issued prior to the adoption of the NLOU.¹⁰

Plaintiffs moved for summary judgment, which the trial court denied.¹¹ The court held that Tripco’s lease was valid and productions from unit operations in the NW/4 of the SE/4 of Section 31 held and maintained Tripco’s lease.¹² Pursuant to Oklahoma statute, the trial court entered a final judgment on less than all claims in the action to “protect the parties’ interests and allow appellate review,” and Plaintiffs appealed.¹³

B. Legal Background

The OCC has exclusive authority to regulate oil and gas in the state of Oklahoma and has statutory authority to issue rules, orders, and regulations for “common sources of supply.”¹⁴ The pertinent statutory definition of “common sources of supply” is an “area which is underlaid or which, from geological or other scientific data, or from drilling operations, or other evidence, appears to be underlaid, by a common accumulation of oil or gas or both.”¹⁵ The OCC also has authority to make rules and regulations to prevent waste, which includes not only its ordinary meaning, but also “economic waste, underground waste, surface waste, and waste incident to the production

6. *Id.*

7. *Id.*

8. *Id.*

9. *In re* Approving Unitized Mgmt. in the Nw. Lawrie Oswego Unit, Order No. 403591, Cause CD No. 960002048, at 2 (Okla. Corp. Comm’n July 19, 1996), <http://imaging.occeweb.com/imaging/OAP.aspx>. [<https://perma.cc/X8RZ-2UXY>].

10. *Id.* at 4. In issuing the unitization order, the Commission chose to replace the existing drilling and spacing requirements with the drilling requirements of the NLOU. *Id.* Drilling and spacing units are a common way to control well density. 5 EUGENE KUNTZ, A TREATISE ON THE LAW OF OIL AND GAS § 77.3 (Matthew Bender rev. ed. 2017).

11. *Stephens Prod. Co.*, 389 P.3d at 368.

12. *Id.*

13. *Id.* The Oklahoma statute allows for a final judgment to be entered on “one or more but fewer than all of the claims” when there is “no just reason for delay and upon an express direction.” OKLA. STAT. tit. 12, § 994 (2017).

14. OKLA. STAT. tit. 17, § 52(A)(1) (2017); OKLA. STAT. tit. 52, § 86.4 (2017).

15. tit. 52, § 86.1(3).

of crude oil.”¹⁶

In 1951, the legislature passed the Oklahoma Unitization Act (“the Act”), which was meant to achieve “greater ultimate recovery of oil and gas,” prevent waste, and protect the correlative rights of interest owners.¹⁷ The Act vested authority in the OCC to issue orders consistent with the intent of the Act.¹⁸ Prior to issuing an order to unitize however, the Commission must find that (1) the unitized management is “reasonably necessary” to recover “substantially more oil and gas from the common source of supply,” (2) that the methods are feasible, (3) that the “estimated additional cost . . . will not exceed the value of the additional oil and gas so recovered,” and that (4) the unitization is for the common good.¹⁹ Further, “[w]ells drilled or operated on any part of the unit area no matter where located shall for all purposes be regarded as wells drilled on each separately-owned tract within such unit area.”²⁰

Because production from any part of the leased premises constitutes production from the whole premises, a well on a five-acre tract can secure an entire 160-acre lease in perpetuity so long as the well is producing.²¹ The same holds true when multiple leases are lumped together into a larger area of land, called a unit.²² Thus, many landowners choose to include clauses preventing portions of their land not in the unit from being secured by a lease that does not have independent production.²³ A Pugh Clause terminates the lease as to the portions of the land that are not included in a unit if the lessee does not conduct independent operations.²⁴ Therefore, the Pugh Clause requires the lessee to develop areas of the lease that are not included in a unit.²⁵ Without the Pugh Clause, the lessee could satisfy the production requirements of the entire lease even if only a sliver of it is included in a much larger unit.²⁶

Oklahoma’s statutory Pugh Clause provides that no oil or gas leasehold interest outside of a spacing unit “may be held by production from the spacing unit more than ninety (90) days beyond expiration of the primary term of the lease.”²⁷ Some scholars suggest that the Clause was created to address the inequity to the landowner that occurs when leased land outside a unit is held by production only by virtue of unitized constructive production.²⁸

16. *Id.* § 273.

17. *Id.* § 287.1.

18. *Id.* § 287.2.

19. *Id.* § 287.3.

20. *Id.* § 287.9.

21. KUNTZ, *supra* note 10, § 26.10.

22. *Id.* § 26.13.

23. *Id.*

24. *Id.* § 48.4.

25. Patrick H. Martin, *Implied Covenants in Oil and Gas Leases – Past, Present & Future*, 33 WASHBURN L.J. 639, 647 (1994).

26. KUNTZ, *supra* note 10, § 48.4.

27. OKLA. STAT. tit. 52, § 87.1(b) (2017).

28. Paula C. Murray & Frank B. Cross, *The Case for a Texas Compulsory Unitization Statute*, 23 ST.

III. COURT'S DECISION

Plaintiffs argued that Tripco's lease terminated after the expiration of the primary term because there was no production from the S/2 or the NE/4 of the SE/4 of Section 31.²⁹ In addition, the only production from the NW/4 of the SE/4 of Section 31 was limited to the NLOU.³⁰ Because production comes only from the unit, the statutory Pugh Clause prevents the perpetuation of the lease interests on the NE/4 of the SE/4 and the S/2 of the SE/4 of Section 31.³¹ Leasehold owners within a secondary recovery unit enjoy the same rights, remedies, and obligations of those within a traditional drilling and spacing unit.³² Further, the unit order supplanted and superseded existing drilling and spacing units; thus, the NLOU constitutes a spacing unit.³³

Tripco argued that its lease contains no depth or Pugh Clause limiting the sources of production.³⁴ The NLOU is not a spacing unit because a unit created under the Act includes fiduciary duties not applicable to a spacing unit.³⁵ Finally, the language in title 52, section 87.1 of the Oklahoma Statutes clearly limits application of the Pugh Clause to spacing units.³⁶

The court applied *de novo* review and held that the statutory Pugh Clause does not apply to the NLOU because the statutes address "separate issues regarding oil and gas development."³⁷ The court explained that the issues addressed by the Pugh Clause were issues of "pre production of oil and gas wells during the primary term of a lease."³⁸ In contrast, the Act addresses "enhanced recovery operations after wells in a field have produced under primary operations for a length of time."³⁹ In determining that the statutes were intended to address different underlying issues, the court ultimately held the legislative intent behind the Pugh Clause was not meant to apply to the facts of this case.⁴⁰

Moreover, the court concluded that application of the statutory Pugh Clause in this situation would "contravene provisions in [the Act]."⁴¹ The

MARY'S L.J. 1099, 1133-34 (1992). The most common reason for a lessee to wish to hold on to a non-producing lease is economic speculation. Gary B. Conine, *Speculation, Prudent Operation, and the Economics of Oil and Gas Law*, 33 WASHBURN L.J. 670, 714 (1994).

29. *Stephens Production Co. v. Tripco, Inc.*, 389 P.3d 365, 367 (Okla. Civ. App. 2016). Tripco sought to enjoin Plaintiffs from participating in Section 31's wells and production. *Id.* As seen here, a neighboring leaseholder may wish to freeze out other leaseholders in order to enjoy a larger share of production. *See id.*

30. *Id.* at 366.

31. tit. 52, § 87.1(b). Subsection (b) provides that no oil leasehold interest outside of the spacing unit may be held by production from the spacing unit beyond ninety days of the primary term expiration date. *Id.*; *Stephens Prod. Co.*, 389 P.3d at 367.

32. *Stephens Prod. Co.*, 389 P.3d at 368.

33. *Id.*

34. *Id.* at 367. A depth clause is a form of limited Pugh Clause that terminates the lease in all formations below the deepest level of production. KUNTZ, *supra* note 10, § 26.13.

35. *Stephens Prod. Co.*, 389 P.3d at 368.

36. *Id.*

37. *Id.* at 369.

38. *Id.* at 370 (quotation omitted).

39. *Id.* (quotation omitted).

40. *Id.*

41. *Id.*

Act provides that operations under the unit shall be considered fulfillment of provisions of the leases comprising the unit.⁴² In addition, the Act provides that wells drilled anywhere on the unit are considered wells drilled on each separately owned tract.⁴³ Thus, the entire Tripco lease was held by production past the primary term.⁴⁴

IV. COMMENTARY

A. The Court Incorrectly Concluded the Statutory Pugh Clause does not Apply to the NLOU Because the Statutes Focus on Conservation and Prevention of Waste.

The court concentrated on the legislative intent behind both the Act and the statutory Pugh Clause.⁴⁵ As the court noted, legislative intent is “ascertained *from the whole act in light of its general purpose.*”⁴⁶ However, after laying out the purposes of each statutory creation, the court seemingly ignored the overarching purpose of conservation through prevention of waste.⁴⁷ Both the court and Defendants went to great lengths to distinguish the Act from the Pugh Clause legislation.⁴⁸ In one attempt to distinguish the two statutes, Tripco argued that a unit under the Act invokes fiduciary duties that are not present in the units described in the statutory Pugh Clause.⁴⁹ In *Hitch Enters., Inc. v. Cimarex Energy Co.*,⁵⁰ however, the United States District Court for the Western District of Oklahoma included both the Act and the statutory Pugh Clause in its discussion of fiduciary obligations that arise from the existence of a unit.⁵¹

In addition, although both the court and Tripco attempt to distinguish the underlying purposes, the Tenth Circuit Court of Appeals recognized Oklahoma Supreme Court precedent that the Commission’s “rules and regulations present a comprehensive regulatory plan.”⁵² The Tenth Circuit’s opinion is particularly telling because the two Oklahoma Supreme Court cases it applied analyzed both the Pugh Clause statute and the Act.⁵³

As the court stated, the purpose of the statutory Pugh Clause is to

42. *Id.*

43. *Id.*

44. *Id.*

45. *See id.* at 369–70.

46. *Id.* at 369 (emphasis added).

47. *See id.* at 369–70.

48. *See id.* at 368–70.

49. *Id.* at 368.

50. 859 F.Supp.2d 1249 (W.D. Okla. 2012).

51. *Id.* at 1262.

52. *Greyhound Leasing & Fin. Corp. v. Joiner City Unit*, 444 F.2d 439, 444 (10th Cir. 1971) (citing *Harper Oil Co. v. Hays*, 431 P.2d 387 (Okla. 1967) (addressing OKLA. STAT. tit. 52, § 87.1 (1963)), and *Woody v. State Corp. Comm’n*, 265 P.2d 1102 (Okla. 1954) (addressing OKLA. STAT. tit. 52, § 287.1 (1951))).

53. *Id.* at 444.

prevent waste and address correlative rights of interest holders.⁵⁴ The legislative finding section of the Act, which the court cites to establish the OCC's authority for unitization, states explicitly that the purpose is to achieve "greater ultimate recovery of oil and gas," prevention of waste, and protection of "the correlative rights of the owners in a fuller and more beneficial enjoyment of the oil and gas rights."⁵⁵

V. CONCLUSION

In conclusion, the court attempted to show that the statutory Pugh Clause could not apply to the NLOU because the legislative intent behind the statutory Pugh Clause and the Oklahoma Unitization Act were aimed at different purposes.⁵⁶ However, the court's analysis of legislative intent was flawed because both statutes clearly state that their purposes were to prevent waste.⁵⁷ Additionally, the Tenth Circuit has ruled that all regulations promulgated by the Oklahoma Corporation Commission comprise a comprehensive regulatory plan, which, although not conclusive, shows that regulations aimed at similar general purposes should work in conjunction with one another.⁵⁸ Therefore, the statutory Pugh Clause should have applied in this case and Tripco's lease should have terminated as to all portions not included in the unit.

54. *Stephens Prod. Co.*, 389 P.3d at 369.

55. OKLA. STAT. tit. 52, § 287.1 (1951).

56. *Stephens Prod. Co.*, 389 P.3d at 370.

57. See OKLA. STAT. tit. 52, § 87.1 (2017); OKLA. STAT. tit. 52, § 287.1 (1951).

58. *Greyhound Leasing & Fin. Corp.*, 444 F.2d at 444.