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**PROCEDURAL PROBLEMS IN LEASE CANCELLATION
CASES**

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PROCEDURAL PROBLEMS IN
LEASE CANCELLATION CASES

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INTRODUCTION

At the first meeting of the Institute in April, 1962, a very comprehensive and instructive talk on "Express and Implied Covenants in Oil and Gas Leases in Arkansas" was made by one of our members, J. A. O'Connor, Jr. of El Dorado. At the coming meeting of the Arkansas Bar in June, the Mineral Section will hear Professor Maurice Merrill of the University of Oklahoma Law School, the author of the standard treatise on implied covenants, speak on the subject of recent Arkansas decisions in the field. With such recent and imminent coverage, one may wonder what is left for me to discuss--and, frankly, that question has haunted me.

I would like to divide the discussion today into two sections. First, a discussion of necessary parties, and, secondly, the question of burden of proof as it has been discussed in lease cancellation cases.

I.

Since the question of "Parties" is essentially statutory, note should be taken at the outset of certain applicable sections of the Arkansas Statutes. Section 28-801 (Ark. Stats. 1947, Anno. being Section 25 of the Civil Code) provides that "Every action must be prosecuted in the name of the real party in interest" with certain exceptions not applicable to this type of litigation. Section 27-806 provides generally for the joinder of parties plaintiff and defendant, and Section 27-814 provides:

"The court may determine any controversy between parties before it, when it can be done without prejudice to the rights of others, or by saving their rights. But when a determination of the controversy between the parties before the court can not be made without the presence of other parties, the court must order them to be brought in."

In an early decision, Smith v. Moore, 49 Ark. 100, 4 S.W. 2d 282 (1886), the court said:

"The obvious intention of the statute is to require all persons to be made parties to an action who will be necessarily and materially affected by its result...."

With this statutory background, which is not essentially different from similar procedural laws of most jurisdictions, we turn to an examination of some of the problems which arise with respect to parties in lease cancellation cases. Before doing that, however, let me point out that in this discussion I am not attempting to define and distinguish between the terms "proper", "necessary" and "indispensable" parties as those terms are used in federal procedure and in some state procedural laws. This could be the subject of a whole Institute and then probably not be exhausted. When I speak of "parties", I am trying to use that term in the sense of "necessary" parties as mentioned in the section of the Civil Code of Arkansas quoted above and as defined by the Arkansas Supreme Court in construing that section.

In Alphin et al. v. Gulf Refining Co., 39 F. Supp. 570 (W.D. Ark. 1941), suit was brought to cancel a lease which originally covered 440 acres of land. After the lease was executed, the lessor conveyed 200 acres in fee to the plaintiffs, who also became owners of substantial interests in the minerals. Defendants were Gulf Refining Co., a partial assignee of the lease as to this 200 acres and the remaining owners of the oil, gas and mineral rights in the 200 acres. However, one of the named defendants had died prior to the filing of the suit and his heirs and devisees were not made parties. Apparently, they were the owners of an undivided 1/16 interest in the oil, gas and minerals in one 10-acre tract. Gulf contended that the implied covenants of the lease were indivisible and that the action "could only be instituted where there has been an election so to do by all of the owners of the reversion and where all of the owners of such reversion have joined in demand for performance."

Relying upon Standard Oil Company of Louisiana v. Giller, 183 Ark. 776, 38 S.W. 2d 766 (1931), Judge Miller held that in Arkansas

the implied covenants are divisible, that is, "The covenants to develop extend to the entire tract, and the development of a portion of the lease by either the original lessee or his assignee does not relieve the holders of the remainder of the lease from proceeding with the development of the tract as an entirety in the manner contemplated by the covenants of the lease." While one may argue as to the exact meaning of the language just quoted, (see the very interesting statements made by Mr. O'Connor in footnotes 7 and 37 of the paper presented at last year's meeting and mentioned at the outset) I think it is safe to say that Judge Miller's holding would be accepted now without question in the courts of this State. He buttressed his opinion by specifically referring to and relying upon the leading case of Thiessen v. Weber et al., 128 Kan. 556, 278 P. 770 (1929), which had a very similar factual situation in that some of the mineral owners refused to join with the plaintiff in the suit. Aside from the technical questions of divisibility or indivisibility of the covenants, the possibility of one tenant in common being blocked by some of his co-tenants, whose connections with the lessee may be of some moment, certainly appeals to the traditional conscience of courts of equity; and, possibly more important, the traditional American concern for the plight of the underdog.

While I have said that Judge Miller's decision would probably be accepted without question in the courts of this State, one possible exception should be mentioned and that is with respect to the heirs of the owners of the undivided 1/16 mineral interest in 10 acres who were not parties. While the opinion does not expressly except the rights of the absent heirs, presumably that was covered in the decree since, clearly, the court would have had no jurisdiction to cancel the lease as to that interest. As a practical matter, Gulf probably had no further interest in the 200 acres and made no issue of it, but surely no conclusion should be drawn from the failure of the opinion to deal specifically with the rights of these absent owners.

So much for the question of joinder of owners of "participating" interests in the oil, gas and minerals or, as is sometimes said, owners of the "reversionary" interests. We now consider the question of the joinder of parties who do not own an interest in the reversion nor a right to participate in the making of a new lease but who do own an interest in the production under the lease sought to be cancelled. Let us begin with the easy case and work to the hard case in the accepted pedagogical manner.

Is the owner of an overriding royalty interest a necessary party to an action to cancel the lease? Almost without looking at a book we would say so. In the language of the Arkansas Supreme Court, the overriding royalty owner's interest "will be materially affected by its results" and the determination of the controversy can hardly be done "without prejudice to those not before the court". While there are no cases in Arkansas dealing directly with the interest of the overriding royalty owner, the Federal case from Texas, Keegan v. Humble Oil & Refining Co. et al., 155 F. 2d 971 (5th Cir. 1946) is a leading case on the subject, and after some discussion of the rights of absent royalty owners and owners of reversionary rights, etc., the court comes down to decide the case solely upon the point that the owner of an overriding royalty interest was a necessary party, saying:

"We prefer, however, to rest our decision on the absence of the owners of the overriding royalty interest. This is an interest carved out of the lessee's share of the oil as distinguished from the owner's share. Wright v. Brush, 115 F. 2d 265 (10th Cir.). Their interests are so bound up with Humble Oil & Refining Company that the relief prayed for in the bill divesting Humble of its leasehold would deprive them of their right to share in the oil produced. These parties have no reversionary interest separable from their right to receive a portion of the oil produced. A decree depriving them of such interest without being heard could not be legally made, since no court can make a direct adjudication on rights of the parties not before it. Gregory v. Stetson, 133 U.S. 579, 10 S.C. 422, 33 L. Ed. 792.

"The absent defendants, Berry and others similarly situated are indispensable parties."

It should be clear, therefore, that owners of overriding royalty, oil payments and other interests carved out of the lessee's estate are, and should be, necessary parties to the litigation

since they will be directly and materially affected by any action respecting the validity of the lease.

A somewhat harder case is made with respect to the owners of "term" royalty. The Supreme Court of Texas has recently had occasion to pass on this question in Royal Petroleum Corporation et al. v. Dennis et al., ___ Tex. ___, 332 S.W. 2d 313, 12 O&GR 578 (1960). Plaintiffs executed an oil and gas lease in 1928 for a primary term of ten years and as long thereafter as production continued from the leased premises. Subsequent to the making of the lease, the lessors conveyed two royalty interests "conditioned that if there were no paying production on the land on September 24, 1950, and for six months thereafter, the conveyances should become null and void, otherwise they should remain in full force and effect as long as production continued." Other conveyances of perpetual mineral interests and fee interests were made. The court said that "the sole question presented is whether or not certain term royalty owners, as well as others who owned mineral interests in the land, are necessary parties to a suit brought by the lessor of an oil and gas lease in trespass to try title against the lessee." The suit was brought to have adjudicated the fact issue of whether the lease had terminated from cessation of production in paying quantities rather than to cancel on the basis of the implied covenants. In reversing the Court of Appeals and holding that the term royalty owners were necessary parties, the court said:

"The primary term of the lease extended to June 4, 1938, while the unconditional term of the royalty grants extended until six months after September 24, 1950. The record does not disclose when it is claimed that production ceased so as to terminate the lease, but that would seem to be immaterial so far as the result of this suit in its effect upon the outstanding royalty interest is concerned. If it were found as a fact in this cause that production had ceased and the lease, therefore, had terminated, theoretically that judgment would not be binding upon the royalty owners who were not made parties. But their rights would be determined for all practical purposes. Even theoretically the term of these royalties would end, for that judgment would oust the petitioners, entitle the respondents to possession of the premises and production would then quite likely cease without dispute. At least the matter would be entirely within the control of respondents."

The court held, however, that the owners of the mineral interests in fee were not necessary parties and that the plaintiffs had their right to maintain a suit without joinder of their co-tenants, citing Mitchell v. Mitchell, 80 Tex. 101, 15 S.W. 705; Carley v. Parton, 75 Tex. 98, 12 S.W. 950 (cf. Alphin v. Gulf Refining Co., supra).

Having seen that owners of overriding royalty interests are indispensable parties to a suit to cancel a lease, and rightfully so, it seems, and, further, that the owner of a term royalty interest is a necessary party where he would be affected by a decision as to cessation of production, consider now the hard question: Is the owner of a perpetual, non-participating royalty interest a necessary party to a suit to cancel an oil and gas lease? The rationale of the rule applied in the case of overriding royalty and term royalty is that those owners are necessary parties because their title is or will be directly affected by the court's holding. In the case of the overriding royalty owner, his interest will be completely extinguished if the lease is cancelled, and, in the case of the term royalty owner, the crucial question of whether his interest is maintained in force by production may likewise be settled, possibly not as directly, but in a practical aspect as real.

The owner of the perpetual royalty interest, however, owns his interest regardless of the existence or non-existence of an oil and gas lease. He is entitled to his proportionate part of the oil and gas produced, free of cost, if, as and when production is obtained and regardless of what lease is then in force. Furthermore, by express provision of his deed, he has no part in the making of the new lease. It would seem, therefore, that the non-participating royalty owner whose interest is fixed and perpetual would not be a necessary party in a suit to cancel an oil and gas lease-but this is not the law, at least not in Arkansas.

In Hunt v. McWilliams, 218 Ark. 922, 240 S.W. 2d 865 (1950), a majority of the court held that the owners of perpetual, non-participating royalty, whose deed expressly provided that they would have no part in the making of any oil and gas lease, were

nevertheless necessary parties to a suit to cancel a portion of the lease for breach of the implied covenant to develop. The court relied, primarily, upon Calcote v. Texas Pacific Coal and Oil Company, 157 F. 2d 216 (5th Cir. 1946) and seems to sum up its holding in the following language:

"Unfortunately cancellation of itself affected the holders of these interests, for the decree cleared the way for the landowner to contract anew. This later lease may or it may not be advantageous to the old royalty grantees; but the fact remains that the rights to oil and gas taken from property under a lease existing when the royalties were conveyed were destroyed as to that lease, and this was done while they were legally absent. This does not mean that, as to non-participating royalty owners, they would have to be consulted in circumstances where a new lease could be legally negotiated."

The dissenting opinion filed by Justice McFadden, in which Justice Milwee concurred, emphasized these provisions of the royalty deed: (1) That the exclusive leasing privileges remained in the grantor; (2) that the grantor would never execute an oil and gas lease which reserved less than 1/8 of all of the oil and gas produced and saved from the land; and (3) that the grantee should receive his proportionate fraction of the royalty reserved under any present or future lease and, in any event, should be entitled to receive his royalty portion times 1/8 of the gross production. Judge McFadden summarizes his dissent in the following language:

"I submit that if the holder of a non-participating royalty deed is a necessary party to a suit to cancel a pre-existing lease--as the majority holds--then the same reasoning carried to its logical conclusion would mean that the holder of a non-participating royalty deed is an essential party to sign a new oil and gas lease on the premises. I don't believe the majority of the court will ever go that far. It would certainly be revolutionary in the oil business for a person holding such an instrument as the one here copied to have to be consulted about the execution of a lease, when the very instrument under which he claims, says that he has no right to be consulted."

At the close of the majority opinion, Chief Justice Griffin Smith made this significant statement, which may have been the real point on which the decision turned for the majority:

"It is conceivable (though not suggested in this case) that collusive action between lessor and lessee could so adversely affect royalty grantees as to destroy or impair their property rights."

The type of royalty deed quoted in Hunt is discussed in a Comment in 3 Ark. L. Rev. 190. It will be noted that under the terms of the deed in question the owner of the leasing rights covenants not to make a lease reserving less than 1/8 royalty, provides that the grantee shall be entitled to a fraction of the royalty so reserved and shall in any event be entitled to his proportionate part of 1/8 of the gross production. Suppose that the lessor reserved a royalty of 1/4 rather than 1/8. Logically, the royalty owner would be entitled to receive his proportionate part of the royalty, be it 1/8 or 1/4. Jones, Non Participating Royalty, 1948, 26 Tex. L. Rev. 569. If the lease sought to be cancelled provided for a 1/4 royalty rather than 1/8, the non-participating royalty owner should be vitally affected by a cancellation of that lease and the subsequent making of a lease by the lessor which provided for only the regular 1/8 royalty. It could be that the majority in Hunt had this sort of situation in mind although the language does not indicate that their thinking had been refined to this point. In such a case, it would seem that a royalty owner would be a necessary party. Therefore, while we may still disagree with Hunt on the facts of that case, it is equally erroneous to lay down a general rule that non-participating royalty owners, even though their ownership be perpetual, should not in particular cases be necessary parties.

It follows, therefore, that under present Arkansas law, prudence will require that royalty owners be made parties as a precautionary measure. And, of course, there is little likelihood of the question reaching the appellate court since the careful attorney will always make them parties rather than jeopardize his client's case on the merits.

II.

There are few situations, from my experience, that leave the practitioner in such a desperate sense of helplessness and frustration as trying to give a client a definitive estimate of his rights and prospects in a lease cancellation case. But this is not entirely the fault of the decisions. It is inherent in the

application of broad equitable principles to the myriad factual situations. I have heard it said that the confusion that results from the application of the implied covenants is due to the fact that they are creatures of the courts. On the other hand, dissatisfaction with the courts' writing of the covenant has not led the draftsmen of oil and gas leases to attempt to write such a covenant in their own language. Until someone in the industry is willing to undertake that task, the inference must be drawn that what we have from the courts, with all its imperfections, is as good as the parties--and primarily the lessee--can devise.

In the early Arkansas cases dealing with long term leases (in some cases, 50 years) where no bonus was paid and the only consideration to the lessor was the royalty reserved, the court seemed to impose upon the lessee an "absolute duty" to proceed with the development of the premises within a reasonable time without regard to profitability of production or other considerations, Mansfield v. Alexander, 97 Ark. 167, 133 S.W. 837 (1911), Millar v. Mauney, 150 Ark. 161, 234 S.W. 498 (1921). However, in most of these cases there had been no development whatever on the leased premises for a substantial period of time, in some cases, 10 years or more; and under the terms of the lease, the lessee was not required to do anything for a period of 25 to 50 years. In those circumstances, the court was certainly justified in the rules that it then announced and its application of those rules.

However, in the 20's and early 30's, the lease with a primary term of ten years or less, as we know it today, began to reach the courts. In the early cases, the court said the burden was on the plaintiff to prove that the lessee had failed to act "in good faith" for the mutual interest of both lessor and lessee. In later cases, and at about the time of the adoption of the conservation laws of this State, the court began to talk of the burden of proof being upon the plaintiff to show that the lessee had not acted as a "reasonably prudent operator".

In Ezzell v. Oil Associates, Inc., 180 Ark. 802, 22 S.W. 2d 1015 (1930), following a review of the earlier cases involving the long term leases mentioned above, this transition is evident in the following language:

"Because of the absence of an express provision as to the number of wells to be drilled, it does not follow that this matter is subject alone to the will of the lessee. There is in every lease for the production of oil and gas, where the principal consideration is the payment of royalties, a condition, implied when not expressed, that, when the existence of either oil or gas in paying quantities is found from drilling wells on the leased premises, the lessee should drill such number of wells as in the exercise of sound judgment he may deem reasonably necessary to secure oil or gas for the mutual advantage of the lessor and the lessee."

In Wood v. Arkansas Fuel Oil Company et al., 40 F. Supp 42 (W.D. Ark. 1941), the reasonably prudent operator rule received its clearest statement. In denying cancellation, Judge Miller said:

"The production of oil from these and other leases is gradually diminishing, but in the absence of proof of facts which would justify a reasonably prudent operator to make additional tests, the defendants are entitled to retain possession of the leases.

"If, in the opinion of the plaintiff, the wells are not producing oil in paying quantities, and if he is able to produce testimony to show that a reasonably prudent operator would be justified in making the expenditure of money necessary for a deep test, he may make demand on the defendants to do so, and in the event of the failure of the defendants to take such action, then the plaintiff will be at liberty to take such action as may be necessary to protect his interest."

In Smith v. Moody, 192 Ark. 704, 94 S.W. 2d 357 (1936), a statement was made which was to plague the lessee unremittingly and sounded the death knell of the reasonably prudent operator test in Arkansas, or at least restricted its application to the very limited field which will be hereafter mentioned. In the Smith case the original lease covered 360 acres. Various portions had been acquired by different assignees, but nearly 11 years had elapsed between the drilling of the last well and institution of the suit. The court said:

"This delay would ordinarily support the finding that there had been a breach of the implied covenant to develop, if there were no facts to excuse the delay...."

The only discussion of an excuse is made and disposed of by the court in the following language:

"Much testimony was offered as to the necessity of drilling other wells, the contention being that the wells now producing were at the edge of the producing fields, and that new wells could not be drilled and

operated except at great loss. This contention may be disposed of by saying that, if true, the lessees have not been damaged by the cancellation of so much of the contract of lease as cannot be profitably performed."

One writer has very accurately described the impossible position in which this language places the defendant-lessee in the following:

"Taken literally, the last expression of the court presents the defendant-lessee with a first-class dilemma after the lessor has established that an unreasonable delay has occurred. The lessee must then go forward with evidence to show that a reasonably prudent operator would not drill additional wells. If he makes his proof sufficiently convincing to condemn the land for productive purposes, or to reveal that he has no intention of further development, the court may conclude that he suffers no harm from a partial cancellation." (Kuntz, The Prudent Operator and Further Development, 9 Okl. L. Rev., Page 255)

The extent to which this language has carried the courts, and the effect it has had upon the reasonably prudent operator rule, is clearly demonstrated in the recent Arkansas case of Nolan v. Thomas, 228 Ark. 572, 309 S.W. 2d 727 (1957). The lease in that case covered 160 acres, was made in 1944 and provided for a primary term of 10 years. Delay rentals had been seasonably paid throughout the primary term and in the last year of the lease the lessees assigned the lease as to certain formations to the defendants. The defendants drilled a well which was completed within the primary term and had been a small producer of oil at all times since. From the latter part of 1954 until May of 1956, some five or six letters were written requesting further development. The gist of the answers by the defendants was that the economics of the present well would not justify drilling an additional well, that a great deal of additional study would have to be given to drilling any further shallow wells because of the unfavorable results to date, and "regardless of what some other people might have thought of drilling some of the shallow wells, competent people have been consulting with us and have decided that this would not be a profitable undertaking for anyone...."

No evidence was offered by the plaintiffs as to whether additional drilling would be profitable or whether a reasonably

prudent operator would drill additional wells, the evidence consisting solely in the lapse of time (less than two years), the evidence of the well being drilled and its production history, and the letters which were written between November, 1954, and the filing of the suit in May, 1956. The defendants demurred to the evidence and, upon the demurrer being overruled, declined to plead further and the plaintiffs were granted the relief sought. In affirming, the Supreme Court held that the plaintiffs made a prima facie case "requiring the defendants to go forward and offer their proof upon the prudent operator matter when the plaintiffs showed these facts: (1) That the leases were made in 1944 and "allowed delay rentals to be paid each year for 10 years"; (2) that delay rentals were paid and no drilling was undertaken until the last year of the lease when the well was drilled and was a small producer; (3) that the plaintiffs insisted for more than two years that the defendants should drill other wells; (4) the defendants consistently refused to drill such wells; and (5) that the plaintiffs were not asking that the lease be cancelled on the forty acres on which the producing well was located.

Obviously, reasons 1, 2 and 5 have no application. The lessee should not be charged with delay during the primary term when rentals are paid for that delay. The fact that the drilling was undertaken in the last year of the primary term should not make any more difference, where delay rentals have been properly paid, than if the drilling had been commenced in the first year of the primary term. That partial cancellation only was asked has no bearing upon the breach of the implied covenant as to the remaining acreage.

So the two reasons which the court gives and which are pertinent are (1) that the plaintiffs insisted for more than two years that other wells be drilled and (2) that the defendants refused.

An excellent analysis of the holding in this case has been made by Professor Summers:

"The court did not require proof of breach of the lessee's implied covenant to reasonably develop the

premises under the reasonably prudent operator test. It even held that the defendant had the burden of proving that a reasonably prudent operator would not have drilled additional wells. The theory upon which this case was decided is not readily apparent. The court may have thought it was adopting the Oklahoma doctrine stated in Doss Oil Royalty Co. v. Texas Co., 1943, 137 P. 2d 934, 192 Okl. 359, but under that doctrine the burden is not shifted to the lessee unless development of a portion of the lease premises has been delayed for an unreasonable period of time. Here the delay was not unreasonable, being less than three years. The court seems to infer that the lessee's delay in drilling the test well until near the end of the primary term was unjustifiable and that this delay, added to the two years elapsing after the drilling of the test well, amounted to an unreasonable time which relieved the lessor of the burden of proving a breach of the implied covenant to reasonably develop the lease. Such inference is entirely erroneous, since the lessee contracted for the option to delay drilling during the primary term of the payment of delay rental. The court quoted from Sauder v. Mid-Continent Petroleum Corp., 1934, 54 S. Ct. 671, 292 U.S. 272, 78 L. Ed. 1255, 93 A.L.R. 454, rehearing denied 54 S. Ct. 856, 292 U.S. 613, 78 L. Ed. 1472, but that decision and the language quoted therefrom, did not support the court's decision, since there the delay in development was eight years." (3 Summers Oil and Gas, Section 465, 1962 Cumulative Pocket Parts)

The knock-out blow to the reasonably prudent operator was delivered by Justice McFadden in the following language:

"The question is not only whether the plaintiffs in the case at bar had to show that a prudent operator would drill on the other three forty-acre tracts here involved; but the question is also whether the defendants should be allowed to prevail on a policy of refusing to drill and at the same time holding the lease on the undeveloped three forty-acre tracts, thereby preventing the plaintiffs from having the privilege of obtaining other persons who might drill on these three forty-acre tracts." (Italics supplied)

The court buttressed this act by quoting and italicizing the old statement from Smith v. Moody, supra, to the effect that if the testimony of the lessees as to the unprofitability of further drilling is true they have not been damaged by cancellation of the lease as to such portion, which, according to their own testimony, cannot be profitably developed.

One further case needs to be mentioned, however, to illustrate the limited field in which the reasonably prudent operator test may remain pertinent. In Reynolds v. Smith, 231 Ark. 566, 331 S.W. 2d 112 (1960), suit was brought to cancel a lease as to 120 acres of an original 200 acre lease. The lease was made in March, 1953, for a primary term of six months with a 30-day drilling clause for

a 3500 foot well. The lessee had drilled seven wells upon the leased premises and contributed to the costs of drilling a dry hole on adjoining lands. Three of the wells were producing commercially at the time of the trial. In March, 1956, and thereafter up to December 3, 1957, lessors requested releases of the non-producing acreage. The lessors conceded that the entire 200 acres had been fully developed as to all known producing horizons in the area but contended that a deep test should be drilled. After quoting extensively from the Chancellor's opinion, the court said:

"The primary and decisive question, therefore, is: Did the lessee here exercise that degree of prudence as an operator reasonably expected of him in the circumstances? We hold that he had done so to date of trial." Wood v. Arkansas Fuel Oil Company, 40 F. Supp. 42 (1941).

At first glance, one would say that possibly some life had been breathed into the reasonably prudent operator in this case. On close examination, however, it would appear that this is the peculiar factual situation, as in the Wood case, of conceded adequate development of known producing horizons but grounded solely upon the plaintiff's demand for the drilling of a deeper test. This is in the nature of "wildcatting" rather than developing known producing formations. Apparently, in this rarefied factual atmosphere the reasonably prudent operator still lives in Arkansas.

Therefore, on the basis of these recent decisions of the Supreme Court, it would seem that Arkansas is now moving toward accord with the law of Oklahoma in this field. In an excellent treatment of the subject, Conn, Trends in the Application of the Implied Covenant of Further Development, 12 Okl. L. Rev. 470, an accurate analysis of what now appears to be the Arkansas law is made:

"Proof of probable profitability or non-profitability of drilling additional wells is not relevant in an action to cancel the undeveloped portion of a leasehold by reason of alleged breach of the implied covenant of further development. If the lessor adduces a preponderance of the evidence that additional drilling would be profitable, then, on that issue, the court must enter a decree of cancellation or cancellation in the alternative. If the lessee adduces a preponderance of evidence additional drilling would probably be unprofitable, the same result follows, for the proof demonstrates that

the lessee has no intention of drilling [Nolan v. Thomas, supra; Skelly Oil Co. v. Scoggins, 231 Ark. 357, 329 S.W. 2d 424 (1959)] or he desires to hold for speculative purposes or he seeks to keep that which is valueless.

"The lessee's delay, however, may be otherwise excusable. Thus, if the producing wells are adequately and efficiently draining all of the known producing horizons, [Smart v. Crow, supra,] he has performed all that is required of him. Nor is there any obligation on the lessee to drill deeper formations in absence of showing that there is a possibility of production at the greater depth, [Wood y. Arkansas Fuel Oil Company, supra; Reynolds v. Smith, supra]....

"If the lessee is engaged in activity consistent with the intention to drill the undeveloped acreage, the delay is excusable. Thus, if the lessee is waiting upon the results of geological studies being carried on at the time of trial, his delay is excusable. As to deeper formations, the lessee may stay future development until the results of nearby deep test are ascertained, [Sparks v. Midstates Oil Corp., 148 F. Supp. 551, 554 (E.D. OKI. 1957).]

"Further, if the lessee has entered into a farm-out agreement or if he agrees he will perform additional drilling, the entry of an alternative decree, rather than outright cancellation, would appear appropriate." [cf. Skelly Oil Co. v. Scoggins, supra]

CONCLUSION

On the question of necessary parties, the lesson that needs to be emphasized is that rules of thumb using general categories is dangerous, e.g., that royalty owners should be necessary parties. In some instances, non-participating royalty owners should not be classed as necessary parties where their interest in production is fixed. On the other hand, there are cases where non-participating royalty owners will be very definitely affected by the terms of a new lease, and so are necessary parties.

As to the matter of proof in cancellation cases involving the implied covenant to develop, the "reasonably prudent operator" test no longer appears to be pertinent in Arkansas except in cases seeking deeper drilling or what would amount to "wildcatting". The trend of Arkansas cases is toward the principles developed in Oklahoma following the Doss Oil Royalty Co. case. The duty to further develop has not yet reached the absolute, but the gap has been substantially closed. The time may have come when the only relief for the lessee lies in the introduction of express covenants, within permissible limits.