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Not All "Units" are Created Equal: How Hebble v. Shell Western E&P, Inc. Missed an Opportunity to Curb the Expansion of Fiduciary Obligations in Oklahoma Oil and Gas Law

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Not All "Units" Are Created Equal: How *Hebble v. Shell Western E & P, Inc.* Missed an Opportunity to Curb the Expansion of Fiduciary Obligations in Oklahoma Oil and Gas Law

I. Introduction

In *Hebble v. Shell Western E & P, Inc.*, the Oklahoma Court of Civil Appeals further expanded a line of cases that has imposed increasingly onerous fiduciary obligations upon oil and gas operators in Oklahoma.[1] Prior to *Hebble*, a fiduciary obligation was imposed on an operator only after the state modified rights of interested parties.[2] For example, such a modification occurs in a forced pooling action when the Oklahoma Corporation Commission (Commission) forces a landowner to transfer his mineral interest to an operator or else participate in the proposed drilling.[3]

The plaintiffs in *Hebble* sought compensation for underpaid royalties from wells drilled in the 1970s and argued for relief based both in tort and contract.[4] One of the wells implicated in this case, the Brittain Deep No. 2 Sycamore well, was drilled subject to a voluntary joint operating agreement.[5] The joint operating agreement did not implicate the police powers of the state because the Commission did not need to issue an order compelling the cooperative development of the unit.[6] With little explanation or discussion, the Oklahoma Court of Civil Appeals identified the drilling and spacing order as the state's modification of the plaintiffs' rights, despite the fact that the Oklahoma Supreme Court had declined to do so only five years earlier.[7]

Many oil and gas terms and statutes are interrelated in both function and purpose, leading to many instances in which distinct legal terms such as "drilling and spacing units," "forced pooling," and "unitization" are improperly used.[8] Even within one state, the distinctions between different types of oil and gas "units" can be subtle yet important. In *Hebble*, for example, the court ignored important distinctions and significantly

1. *See generally* 238 P.3d 939 (Okla. Civ. App. 2010).
2. *See* Howell v. Texaco, Inc., 112 P.3d 1154, 1160 (Okla. 2004).
3. *See* 52 OKLA. STAT. § 87.1(a) (2000).
4. *See Hebble*, 238 P.3d at 941.
5. *See id.* at 943.
6. *See id.*
7. *See id.*; *see also Howell*, 112 P.3d at 1160-61.
8. *See, e.g.*, Ward v. Okla. Corp. Comm'n, 501 P.2d 503 (Okla. 1972) (addressing the common confusion between drilling and spacing units and forced pooling).

expanded the circumstances in which an oil and gas operator can be burdened with fiduciary duties. The court inappropriately equated a Commission drilling and spacing order to a Commission unitization order.[9] The units resulting from these orders differ substantially in both form and purpose. A Commission order that unitizes a field for secondary recovery operations substantially alters the rights among the interested parties, whereas a drilling and spacing order merely sets out which parties have the rights to production within the unit.[10] The *Hebble* opinion provides little insight into which characteristics of a drilling and spacing order the court felt were similar enough to a unitization order to warrant the imposition of fiduciary obligations on the operator.[11]

In *Hebble*, the operator (Shell) was held liable for $53,625,000 in punitive damages based on its underpayment of roughly $750,000 in royalties owed on two wells drilled in the 1970s.[12] A punitive award of this magnitude has serious implications for the oil and gas industry in Oklahoma. An operator's potential liability resulting from this decision is incongruent with the simple nature and purpose of the drilling and spacing unit.

This note will attempt to present the *Hebble* opinion in a simple and understandable manner, point out the deficiencies in its reasoning, and explain how its holding can impact the oil and gas industry going forward. Part II explains the background and purpose of the Commission's regulation of the oil and gas industry and how the Commission uses its powers to further that purpose. Part II examines the cases prior to *Hebble* that discuss which actions by the Commission warrant an imposition of fiduciary duties upon oil and gas operators. Part III provides a summary of the facts in *Hebble*, as well as an account of the court's limited reasoning and analysis. Part IV points out the deficiencies in *Hebble*'s reasoning and details the implications for oil and gas operators in Oklahoma moving forward. Part V briefly concludes.

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9. *See Hebble*, 238 P.3d at 943.
10. *See generally* 52 OKLA. STAT. §§ 287.1-287.15, 87.1(a) (2000).
11. *See* Hebble, 238 P.3d at 943.
12. *See id.* at 942.

*II. Pre-*Hebble *Oklahoma Law Regarding the Relationship Between an Operator and Interested Parties to an Oil and Gas Lease*

A. The Statutory Power of the Oklahoma Corporation Commission

Beginning in the late-nineteenth century, courts throughout the country began to adopt and apply the rule of capture to oil and gas extraction by analogizing the movement of subsurface hydrocarbons to the movement of water and wild animals.[13] The rule of capture states: "[t]he owner of a tract of land acquires title to the oil and gas which he produces from wells drilled thereon, though it may be proved that part of such oil or gas migrated from adjoining lands."[14] According to the rule of capture, an adjoining landowner's only remedy is to drill his own well to "offset" the drainage by his neighbor.[15]

If left unregulated, the offset drilling remedy has many negative consequences. If too many offset wells are drilled, economic waste occurs because far more wells are drilled than are necessary to drain the oil and gas from the reservoir efficiently.[16] Over-drilling can also damage the natural reservoir energy necessary to extract the oil and gas and result in irreparable damage to the recoverability of valuable hydrocarbons.[17] Once the natural reservoir energy has dissipated, extraction of the oil or gas often becomes economically unfeasible.[18] In addition, excess drilling equipment and surface locations required to drill unnecessary offset wells result in additional environmental impacts.[19] Lastly, the high production rate causes supply to smother demand, resulting in price depression and environmental problems associated with storing the excess supply.[20]

The Oklahoma Corporation Commission has been granted administrative, legislative, and quasi-judicial powers allowing it to regulate Oklahoma's oil and gas industry and counteract the negative effects of the

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13. *See* Westmoreland Natural Gas Co. v. De Witt, 18 A. 724 (Pa. 1889).

14. Bruce M. Kramer & Owen L. Anderson, *The Rule of Capture—An Oil and Gas Perspective*, 35 ENVTL. L. 899, 900 (2005) (quoting Robert E. Hardwicke, *The Rule of Capture and Its Implications as Applied to Oil and Gas*, 13 TEX. L. REV. 391, 393 (1935)).

15. *See id.* at 909-10.

16. *See* Owen L. Anderson & Ernest E. Smith, *Exploratory Unitization Under the 2004 Model Oil and Gas Conservation Act: Leveling the Playing Field*, 24 J. LAND RESOURCES & ENVTL. L. 277, 278 (2004).

17. *See id.*

18. *See id.*

19. *See id.*

20. *Id.*

rule of capture.[21] The Commission's goals are two-fold: (1) to prevent surface, underground, and economic waste and (2) to protect the correlative rights of mineral owners so that each owner gets a fair and equitable share of the minerals beneath his tract.[22] The protection of "correlative rights" first began as a judicial effort designed to prevent operators from taking an undue proportion of oil or gas from a common source of supply by allowing all landowners the opportunity to obtain a fair and equitable share of the oil or gas. The protection of correlative rights is now made explicit by Oklahoma's conservation statute.[23] The Commission wields a variety of tools to enhance its efforts to prevent waste and protect correlative rights, including the establishment of drilling and spacing units, forced pooling, and unitization.[24]

1. Drilling and Spacing Units

The most important tool the Commission uses to protect against waste is the creation of drilling and spacing units.[25] The Commission can control how many wells are drilled in each reservoir by establishing drilling and spacing units, thereby preventing underground, economic, and surface waste and protecting the correlative rights of neighboring landowners.[26] The Commission reviews and interprets geological evidence to determine the proper size and shape of the unit, which should be uniform with other units in a common reservoir absent special geological justifications.[27] Oklahoma's current statute allows only one well to be drilled per spacing unit unless another well is reasonably necessary to drain a common source of supply efficiently.[28]

In addition to establishing the density and location of drilling, Oklahoma's statute apportions production to each owner within the unit on a net acreage basis regardless of the location of the well within the unit.[29] In other words, the drilling and spacing order pools the royalty interests—

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21. *See* Sw. Bell Tel. Co. v. Okla. Corp. Comm'n, 873 P.2d 1001, 1004 (Okla. 1994).
22. *See* 52 OKLA. STAT. § 87.1(a) (2000).
23. *See* Kingwood Oil Co. v. Okla. Corp. Comm'n, 396 P.2d 1008, 1010 (Okla. 1964).
24. *See* 52 OKLA. STAT. § 87.1; *see also* 52 OKLA. STAT. § 287.1.
25. Joseph R. Dancy & Victoria A. Dancy, *Regulation of the Oil and Gas Industry by the Oklahoma Corporation Commission*, 21 TULSA L.J. 613, 627 (1986); *see also* 52 OKLA. STAT. § 87.1(a).
26. *See* 52 OKLA. STAT. § 87.1(a).
27. *See id.* § 87.1(c).
28. *See id.*
29. *See id.* § 87.1(a).

those interests entitled to a proportion of the production—as if production is directly and proportionately attributable to each net acre within the unit.[30]

2. Forced Pooling

Oklahoma's forced pooling statute works in conjunction with the drilling and spacing order to prevent waste and protect correlative rights. When a drilling and spacing unit includes multiple undivided mineral interests or separately owned tracts, an agreement must be reached in order to pool lands for mutual development of the unit or else an account must be made to the non-consenting parties for their share of the profits.[31] Under Oklahoma's forced pooling statute, any party with a present right to drill can apply to force pool any interests that refuse to cooperate in the development of a valid drilling and spacing unit.[32] Although the forced pooling order alters the private property rights of the parties involved, the Oklahoma Supreme Court has held Oklahoma's forced pooling statute to be a valid exercise of the state's police power.[33]

The forced pooling statute encourages development of the state's natural resources by fairly apportioning risk. Without a forced pooling statute, a co-tenant who refused to participate in a well would still be entitled to his proportionate share of the proceeds minus his share of the reasonable and necessary costs.[34] If the operations failed and the operator lost the well, the co-tenant bore none of the risk of drilling and therefore would not be responsible for any of the costs of the failed well. To promote development, the forced pooling order requires the working interest owners to either participate in the well and pay their proportionate share of the well costs or transfer their interest to the participating parties on trade terms determined by the market value of similar transactions in the immediate vicinity.[35] At least two alternatives are offered to the non-participating party and the transfer can take various forms, such as a sale, lease, or farm-out agreement.[36]

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30. *See* Fleet v. Sanguine, Ltd., 854 P.2d 892, n.12 (Okla. 1993).
31. *See* Meeker v. Denver Producing & Ref. Co., 188 P.2d 854, 856 (Okla. 1947).
32. *See* 52 OKLA. STAT. § 87.1(e).
33. *See* Palmer Oil Corp. v. Phillips Petroleum Co., 231 P.2d 997 (Okla. 1951).
34. *See Meeker*, 188 P.2d at 856.
35. *See* 52 OKLA. STAT. § 87.1(e).
36. A farmout agreement is defined as:

a contract to assign rights in acreage upon the completion of a drilling obligation and the performance of the other provisions contained in the contract. Such an agreement allows a lessee who does not wish to drill to assign all or part of the lease to another operator who does wish to drill.

3. Unitization

In contrast to the forced pooling order, unitization usually encompasses an entire reservoir.[37] Drilling operations will eventually deplete the natural energy of a reservoir even if it is properly conserved.[38] Secondary or enhanced recovery operations are designed to maintain or artificially enhance depleted reservoir energy. To facilitate secondary recovery operations and protect correlative rights, a unitized reservoir is operated as a single unit by a single, Commission-appointed unit operator.[39] Unitization is often appropriate for mature, significantly depleted fields that require some type of extraordinary measures, such as waterflooding, to extract minerals from the subsurface after primary recovery techniques have been exhausted.[40] Since these techniques require operations throughout the entire reservoir, unitization is necessary to combine all of the property interests that overlay the reservoir.[41]

Similar to the forced pooling order, the unitization order sets forth the manner in which costs are to be allocated and appoints a single unit operator.[42] A unitization order differs from forced pooling and drilling and spacing units in that the unitization order takes into account prior production history and allocates production and costs based on those areas that have proven to be productive within the unit area.[43] Acreage geologically proven to be non-productive would not share in the production from a unitization order, unlike a drilling and spacing unit, in which all acreage shares equally based on the size of the interest instead of the productivity.[44]

Although secondary recovery techniques are often appropriate for many reservoirs, achieving unitization through voluntary agreement is generally difficult due to the transaction costs of securing multi-party agreements. Compulsory unitization partially addresses this problem, but Oklahoma law requires substantial voluntary agreement before the Commission may force

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58 C.J.S. MINES AND MINERALS § 385 (2010); *see also* Dancy & Dancy, *supra* note 25, at 643-44.

37. *See* Anderson & Smith, *supra* note 16, at 284.

38. *See id.*

39. *See* 52 OKLA. STAT. § 287.4.

40. *See* Howard R. Williams, *Conservation of Oil and Gas*, 65 HARV. L. REV. 1155, 1168 (1952).

41. *See id.*

42. *See* 52 OKLA. STAT. § 287.4.

43. *See id.*

44. *See id.*

holdouts to unitize.[45] Many times, the required percentage of voluntary agreement will not be reached even though the area is a prime candidate for unitization operations.

4. Private Joint Operating Agreements

Joint operating agreements are private, voluntary agreements among interested parties for the operation of a tract or leasehold for oil, gas, and other minerals.[46] The parties to a joint operating agreement typically agree to appoint one party as operator of the premises for the joint benefit of all parties, and the parties share in the expenses and proceeds.[47] Since no state action is involved, general contract principles require that the parties' relationship be governed by the express terms of the agreement.[48] In Oklahoma, no fiduciary duty arises from the parties entering into a joint operating agreement.[49] A fiduciary duty can arise from a voluntary agreement if specific facts suggest a special relationship of trust was contracted for among the parties.[50]

B. An Oil and Gas Operator's Fiduciary Obligations Prior to Hebble

Oklahoma's rule defining the relationship between a lessor and lessee of an oil and gas lease was stated in *Bunger v. Rogers* in 1941.[51] In that case, the lessor sued the lessee for underpayment of royalty.[52] According to the Oklahoma Supreme Court:

> The defendants were merely lessees under an oil and gas mining lease and were under no obligation to the plaintiff, other than to pay the rent and royalty provided in said lease, and if they breached this duty then their liability was purely a contractual one and in no sense fiduciary.[53]

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45. *See id. See generally* Anderson & Smith, *supra* note 16, at 284-86.
46. 3 NANCY SAINT-PAUL, SUMMERS OIL AND GAS § 29:6 (3d ed. 2010).
47. *See id.*
48. *See, e.g.*, Pitco Prod. Co. v. Chaparral Energy Inc., 63 P.3d 541 (Okla. 2003).
49. *See* Tarrant v. Capstone Oil & Gas Co., 178 P.3d 866, 870-71 (Okla. Civ. App. 2008).
50. *See* David E. Pierce, Transactional Evolution of Operating Agreements in the Oil and Gas Industry (Mar. 2008) (presentation before the Rocky Mountain Mineral Law Foundation).
51. *See* 112 P.2d 361, 362 (Okla. 1941).
52. *Id.*
53. *Id.* at 363.

A lessor and lessee are merely contracting parties, and thus no fiduciary relationship arises.

In contrast, the Oklahoma Supreme Court concluded in *Young v. West Edmond Hunton Lime Unit* that in a unitization, an appointed unit operator may owe fiduciary duties to other unitized parties.[54] In *Young*, the plaintiffs (lessors) leased their mineral rights to various oil companies (lessees).[55] A productive formation was subsequently found on the lessors' lands and the Commission, pursuant to its statutory authority, ordered this field to be produced as a single unit by an appointed unit operator.[56] This order allocated production to the interested parties based on the potential productivity of each tract in the unit and deprived the lessees of the right to produce oil or gas from the lessors' lands.[57] The mineral rights owners were compelled to give up their right to produce from their lands in exchange for a portion of the production from the larger unitized area.[58] The court analogized the position of the appointed operator of the unit to that of a trustee, because the royalty owners had no say in the management of the unit or in the selection of the unit operator.[59] On a subsequent appeal, the court further stated that "the Unit, under the circumstances of its fiduciary relationship as revealed by the record, must account to the royalty owners, as to its handling of their affairs."[60]

In *Olansen v. Texaco Inc.* the Oklahoma Supreme Court further emphasized what effect a state modification of rights had on the relationship between an operator and interest owner.[61] In 1961, the Commission created the East Glenn Unit pursuant to Oklahoma's unitization statute and named Texaco as the operator.[62] The unit was comprised of only one lease, in which the appellees owned an interest in forty of the 160 acres (25%).[63] Texaco neglected to check the county records in order to identify the interest held by the appellees and failed to pay the appellees their share of production.[64] Under the terms of the lease to Texaco, appellees were not entitled to share in the production unless a

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54. *See generally* 275 P.2d 304 (Okla. 1954).
55. *Id.* at 306.
56. *Id.*
57. *See id.*
58. *See id.* at 308.
59. *See id.* at 309.
60. W. Edmond Hunton Lime Unit v. Young, 325 P.2d 1047, 1052 (Okla. 1958).
61. *See generally* 587 P.2d 976 (Okla. 1978).
62. *Id.* at 978.
63. *Id.*
64. *Id.* at 979.

well was drilled directly on their forty-acre tract.[65] The unitization order, however, entitled the appellees to proportionally share in production from the entire unit despite such limitation.[66] The court noted that the Commission unitization order modified the rights between the parties and relied on this fact as the basis for its conclusion that Texaco owed the appellees a fiduciary duty.[67] The court rejected Texaco's reliance on *Bunger*, stating: "The pivotal issue here is not the relationship between a unit operator and a mineral owner but the critical concern involves the legal effect of resort to police powers of the state on the part of the lessee (Texaco) which modified and amended existing legal rights . . . ."[68]

The Oklahoma Supreme Court again distinguished the lease relationship from the unitization relationship in *Leck v. Continental Oil Co.*[69] On a federally certified question from the Tenth Circuit Court of Appeals, the Oklahoma Supreme Court reiterated that the lease agreement creates no fiduciary duty.[70] The court stated, "This duty is not created by the lease agreement but rather by the unitization order and agreement."[71]

Most recently, in *Howell v. Texaco Inc.,* the Oklahoma Supreme Court addressed whether a drilling and spacing unit alone created a fiduciary relationship.[72] The plaintiffs in *Howell* had entered into lease contracts and communitization agreements with Texaco, or in some instances with Texaco's predecessor, and sued Texaco for improper payment of royalties.[73] Although the Commission had unitized some of the plaintiffs' land, much of the land remained subject to the sole authority of the voluntary development agreements reached between the plaintiffs and Texaco.[74] Echoing previous holdings, the court stated, "The communitization agreements, unlike unitization orders, are contracts just as the leases are contracts . . . . the communitization agreements do not create a fiduciary duty on Texaco's part."[75]

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65. *Id.* at 981.
66. *See id.*
67. *See id.*
68. *Id.* at 985.
69. *See generally* 800 P.2d 224 (Okla. 1989).
70. *See id.* at 229.
71. *Id.*
72. *See generally* 112 P.3d 1154 (Okla. 2004).
73. *Id.* at 1157.
74. *Id.*
75. *Id.* at 1160.

The *Howell* plaintiffs explicitly petitioned the court to analogize the drilling and spacing unit to a unitization order in their briefs to the court.[76] Since part of the plaintiffs' lands had not been unitized by the Commission, the plaintiffs had to convince the court that a drilling and spacing unit (operated pursuant to a lease or communitization agreement) should impose the same fiduciary obligations on operators as unitization orders.[77] The court failed to see the merit in the plaintiffs' argument, stating:

> The plaintiffs have misconstrued [the] cases. This court has not held that a royalty lease alone creates a fiduciary relationship. To the extent that other courts have so held when applying Oklahoma law, they have misread our decisions. Texaco had no fiduciary duty to the plaintiffs based on the leases or the communitization agreement.[78]

Up until *Hebble v. Shell Western E & P, Inc.*, the creation of a drilling and spacing unit was not a valid basis for imposing a fiduciary duty on an operator.[79]

III. Hebble v. Shell Western E & P, Inc.: *The Oklahoma Court of Civil Appeals Imposes a Fiduciary Duty on an Operator Pursuant to a Drilling and Spacing Order of the Oklahoma Corporation Commission*

A. Facts and Procedural History

Shell desired to conduct secondary recovery operations on a lease (Crews Lease) in which the appellees (Owners) had reserved an interest in the net-profits from oil and gas operations.[80] Shell obtained unitization orders from the Commission and was appointed as the unit operator for the Brittain Sims Unit in 1964 and the Brittain Deese Unit in 1970.[81] Shell subsequently petitioned the Commission for a drilling and spacing unit for the Sycamore formation in 1972 and was granted an eighty-acre drilling and spacing unit.[82] Pursuant to a voluntary joint operating agreement, Shell was appointed the operator of the Brittain Deep No. 2 Sycamore well.[83]

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76. *See* Brief of Amicus Curiae for Defendants-Appellants at 5, Hebble v. Shell W. E&P, Inc., 238 P.3d 939 (Okla. Civ. App. 2010) (No. 106,470).

77. *See Howell*, 112 P.3d at 1160.

78. *Id.* at 1161.

79. 238 P.3d 939 (Okla. Civ. App. 2010) *cert. denied*.

80. *Id.* at 941-42; *see also* Shell Oil Co. v. Hebble, 131 S. Ct. 822 (2010), *cert. denied*.

81. *Hebble*, 238 P.3d at 941-42.

82. *Id.* at 942.

83. *Id.*

Shell eventually sold its interest in the Crews Lease to Maynard Oil Company (Maynard) in 1985.[84]

The Crews Lease—and therefore the Owners' net-profits interest—was included in the Brittain Sims Unit, Brittain Deese Unit, and Brittain Deep No. 2 Sycamore well.[85] However, Shell failed to pay the Owners $715,090 from the net-profits of the Brittain Deep No. 2 Sycamore well and $35,617 from the net-profits of the Brittain Deese Unit.[86] Owners brought suit against Shell and Maynard in 1995 based on tort theories as the five-year statute of limitations for contract had expired.[87] Maynard settled with the Owners, while Shell decided to litigate.[88] Shell made multiple motions for summary judgment based on its statute of limitations argument but the trial court ruled that Shell owed the Owners a fiduciary or quasi-fiduciary duty arising from the Commission's "unitization" orders.[89] The matter proceeded to a jury trial in 2008 and the Owners were awarded $13,205,916 in actual damages on grounds of: (1) false representation, nondisclosure or concealment, deceit, or constructive fraud, and (2) breach of fiduciary duty.[90] The Owners were also awarded $53,625,000 in punitive damages.[91]

B. The Opinion of the Oklahoma Court of Appeals

On appeal, the Oklahoma Court of Civil Appeals affirmed the trial court's decision.[92] Its opinion began with an examination of precedent regarding an operator's duty as fiduciary.[93] The court reasoned that because the unitization relationship is not voluntarily assumed by the parties, but instead is mandated by the state, the exercise of the police power of the state creates a trustee-like relationship between the operator and those parties interested in production from the unit.[94] The court of civil appeals then equated a unitization order under title, 52, section 287.1 of the Oklahoma Statutes, with a drilling and spacing order under title 52, section 87.1.[95]

84. *Id.*
85. *See id.*
86. *Id.*
87. *See id.*
88. *Id.*
89. *See id.*
90. *Id.*
91. *Id.*
92. *Id.* at 947.
93. *See id.* at 943.
94. *See id.*
95. *See id.*

Relying on existing precedent from *Howell* and *Leck*, the court characterized Shell's relationship to the Owners in the Brittain Deese Unit as fiduciary in nature since it arose from a Commission "unitization" order.[96] Because a private joint operating agreement was reached among the working interest partners, the court admitted that the Brittain Deep No. 2 Sycamore unit was "less clear-cut," but reasoned that since the Owners were not parties to the joint operating agreement, it had no bearing on the relationship between Shell and the Owners.[97] The court concluded that since the Brittain Deep No. 2 Sycamore was not drilled on the Crews Lease, Shell's duty to pay the Owners from the net-profits of the well arose from the drilling and spacing order of the Commission and therefore the police powers of the state.[98] The court affirmed the actual and punitive damages flowing from the fiduciary duty created by the Commission's exercise of state police power.[99]

IV. Hebble *Misunderstands the Nature of the Drilling and Spacing Unit, Misconstrues the Case Law, and Misguides the Future of Oklahoma Oil and Gas Law*

A. The Reasons Justifying a Fiduciary Standard for Unitization Orders Do Not Justify a Fiduciary Standard for a Drilling and Spacing Order

The Oklahoma Court of Civil Appeals fails to explain its view that a drilling and spacing order is analogous to a unitization order.[100] Although the court recites case law generally relevant to the fiduciary obligations of an operator, the court's analysis of the particular facts in *Hebble* provides no distinct justification for its expansion of fiduciary obligations to drilling and spacing units.[101] This expansion is justified neither by the nature of the drilling and spacing unit nor by Oklahoma's case law.

Olansen requires that the state modify the existing legal rights of interested parties before a fiduciary duty can be imposed on the operator.[102] Obtaining a drilling and spacing order is one of the initial steps in drilling a well that merely helps define the rights among the parties. The correlative rights doctrine gives royalty owners an opportunity to secure a fair share of

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96. *See id.*
97. *See id.*
98. *See id.*
99. *Id.*
100. *See id.*
101. *See id.*
102. *See* Olansen v. Texaco, 587 P.2d 976 (Okla. 1978).

oil or gas from a common reservoir; the establishment of a drilling and spacing unit does not change this fundamental right. In fact, the drilling and spacing order changes two things: (1) production from the unit is divided proportionately among all royalty owners within the unit regardless of which part of the unit production actually occurs and (2) the location of the well is determined by the drilling and spacing order. In *Hebble*, the plaintiffs owned a net-profits interest, which means the plaintiffs assigned their working interest (and accompanying right to drill) and reserved a right to a portion of the net proceeds from any subsequent oil or gas production.[103] Because the plaintiffs owned neither a royalty interest nor the right to drill, the drilling and spacing unit had no direct effect on the plaintiffs' net-profits interest. Conceptually, the plaintiffs' interest was nothing more than a contractual burden on a working interest owner to receive a portion of any net proceeds secured from oil and gas production.

A drilling and spacing order does not appoint an operator of the unit. In *Hebble*, Shell became the operator of the drilling and spacing unit by reaching a voluntary joint operating agreement with the other working interest owners. Prior to the joint operating agreement, any working interest owner could have force pooled the unit and petitioned the Commission to be appointed unit operator. Only after the joint operating agreement was signed did Shell have the exclusive right to drill. Having leased their working interest, the net-profits interest owners had no say in the choice of the operator. The plaintiffs or the plaintiffs' predecessors-in-interest had assigned that right away when they decided to lease their working interest rights. Misunderstanding the mechanics of the net-profits transaction, the court reasoned, "[h]ad the [net-profits] Owners been parties to the JOA, we would not find a fiduciary duty."[104] The court failed to recognize that the net-profits owners voluntarily assigned their right to be a party to a joint operating agreement when they leased their working interest, thereby voluntarily relinquishing any voice in the selection of an operator and implicitly approving any selection made.

Since the Brittain Deep No. 2 Sycamore well was drilled pursuant to a joint operating agreement, the police powers of the state were not implicated. The *Hebble* court's reliance on the drilling and spacing order as a state modification of existing legal rights of the parties contradicts the nature and purpose of the drilling and spacing unit. There are key statutory distinctions between a drilling and spacing unit and a unitization order that

103. *See Hebble*, 238 P.3d at 941.
104. *Id.* at 943.

makes imposing fiduciary obligations appropriate in one instance and not the other. Oklahoma's unitization statute expressly anticipates that the unitization order will modify the rights of the parties involved, providing: "Property rights, leases, contracts, and all other rights and obligations shall be regarded as amended and modified to the extent necessary to conform to the provisions and requirements of this act . . . ."[105] The statute authorizing the Commission to create drilling and spacing units contains no such provision, presumably because the statute was not intended to modify the rights of any parties involved.[106]

The unitization act also requires that "[e]ach unit shall be authorized on behalf and for the account of all the owners of the oil and gas rights within the area, *without profit* to the unit, to supervise, manage and conduct further development and operations for the production of the oil and gas . . . ."[107] The need for the "without profit" language is derived from the method of production allocation in the unitization act:

> A separately owned tract's fair, equitable and reasonable share of the unit production shall be measured by the value of each such tract for oil and gas purposes and its *contributing value to the unit in relation to like values of other tracts in the unit*, taking into account acreage, the *quantity of oil and gas recoverable therefrom*, location on structure, its probable productivity of oil and gas in the absence of unit operations, the burden of operation to which the tract will or is likely to be subjected, or so many of said factors, or such other pertinent engineering, geological, or operating factors, as may be reasonably susceptible of determination.[108]

Absent the "without profit" language, an operator could theoretically operate the unit in such a way as to maximize production from the areas in which the operator has the greatest interest and amend the unitization order to re-allocate a greater percentage of production to the operator-owned tracts.[109]

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105. 52 OKLA. STAT. § 287.9 (2000).
106. *See generally id.* §§ 87.1-87.5.
107. *Id.* § 287.8.
108. *Id.* § 287.4.
109. *See* Brief of Amicus Curiae for Defendants-Appellants, *supra* note 76, at 13 (providing a detailed analysis and discussion concerning why statutory protections exist to protect against conflicts of interest in the unitization statute, but are correctly absent from the drilling and spacing statute).

The drilling and spacing statute contains no such "without profit" language.[110] In contrast, an operator of an oil and gas lease in Oklahoma must make a profit from its operations to keep operating the lease.[111] Also, all tracts within a drilling and spacing unit share proportionately in production, regardless of profitability.[112] An operator gains no advantage by excluding production to those tracts within the drilling and spacing unit that are owned by the operator. Of course, other conflicts of interests can arise between an operator and royalty owners in a drilling and spacing unit but prior to *Hebble*, Oklahoma chose to handle those conflicts with an increased standard of judicial scrutiny, not the imposition of a fiduciary duty.[113] For instance, the Oklahoma Supreme Court developed a different method to calculate royalty payments when an operator sells production to an affiliated entity.[114]

B. Hebble *Misconstrues the Line of Cases Imposing Fiduciary Obligations on Operators and Unduly Expands Oklahoma's Jurisprudence*

Hebble principally relies on *Howell*, *Leck*, and *Olansen* to expand fiduciary obligations to drilling and spacing units. These cases provide no support for the conclusion reached in *Hebble*. In *Howell*, the court speaks expressly in terms of "unitization" when outlining the appropriate circumstances for the imposition of a fiduciary duty and refers to the term "unitization" with reference to Oklahoma's Unitization Act, not the drilling and spacing unit.[115] *Hebble* ignores this important distinction, stating, "After unitization, the leases no longer control," and inappropriately cites to *Howell* for support.[116] *Howell*'s interpretation of the unitization statute, while potentially useful to help interpret the drilling and spacing statute, does not provide direct support for the conclusion that a fiduciary duty accompanies a drilling and spacing unit. As stated *supra* in the discussion of the *Howell* opinion, the Oklahoma Supreme Court implicitly rejected the plaintiffs' argument that a drilling and spacing unit confers a fiduciary duty on an operator.[117]

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110. *See generally* 52 OKLA. STAT. §§ 87.1-87.5.
111. *See* Smith v. Marshall, 85 P.3d 830 (Okla. 2004).
112. *See* 52 OKLA. STAT. § 87.1(a).
113. *See* Brief of Amicus Curiae for Defendants-Appellants, *supra* note 76, at 13 (citing Howell v. Texaco, Inc., 112 P.3d 1154, 1160 (Okla. 2004); Spaeth v. Union Oil Co. of Cal., 710 F.2d 1455 (10th Cir. 1983)).
114. *See Howell*, 112 P.3d at 1160.
115. *See id.* at 1160-61.
116. Hebble v. Shell W. E&P, Inc., 238 P.3d 939, 943 (Okla. Civ. App. 2010).
117. *See* Brief of Amicus Curiae for Defendants-Appellants, *supra* note 76, at 5.

Leck also fails to provide direct support for *Hebble*'s holding. *Hebble* states, "The fiduciary duty of the unit operator arises not only from the creation of field-wide units for secondary recovery under Oklahoma's Unitization Act, but also from the creation of drilling and spacing units under 52 O.S.Supp.2007 §87.1" and cites *Leck* as an example.[118] The facts and language of *Leck* provide dubious support for this proposition. *Leck* states, "[A fiduciary duty] is not a duty created by a lease agreement but rather by the unitization order and agreement . . . . The only fiduciary duty owed the appellants was created by the unitization of Section 21."[119] The pure language of *Leck* appears to simply re-state and apply existing case law applying a fiduciary duty to a unitization order.

Unfortunately, *Leck* adds confusion to the case law because the unit at issue in that case was actually a drilling and spacing unit, not a unitization order.[120] The *Hebble* court seems to reconcile this inconsistency by assuming *Leck* meant to expand fiduciary duties to drilling and spacing units. An equally valid assumption, however, is that *Leck* simply confused the proper meaning of "unitization." In fact, all the cases *Leck* relies on use the term "unitization" in its proper statutory sense, referring to an order issued pursuant to Oklahoma's Unitization Act.[121] Surely *Leck* did not intend to expand fiduciary duties to drilling and spacing units without any mention or discussion of the consequences of this significant shift in jurisprudence. Regardless, the language in *Leck* should most properly be considered dicta since the true holding of *Leck* regarded the proper subject matter jurisdiction of the federal district court.[122]

Howell appears to provide strong support for the proposition that *Leck* simply confused "unitization" with a drilling and spacing unit. *Howell* held that no fiduciary relationship existed despite the fact that drilling and spacing units had been created on portions of the plaintiffs' lease and were at issue in that case.[123] After discussing Oklahoma's case law on the fiduciary duty of operators, including *Leck*, the *Howell* court concludes: "The plaintiffs [arguing for drilling and spacing units to trigger fiduciary duties] have misconstrued these cases . . . . To the extent that other courts have so held when applying Oklahoma law, they have misread our

118. *Hebble*, 238 P.3d at 942.
119. Leck v. Cont'l Oil Co., 800 P.2d 224, 229 (Okla. 1989).
120. *See id.* at 225.
121. *See id.* at 228-29.
122. *See id.* at 229.
123. *See* Brief of Amicus Curiae for Defendants-Appellants, *supra* note 76, at 5.

decisions."[124] Even assuming *Leck* actually meant to expand the case law as *Hebble* purports it does, *Howell* overrules this proposition.

Furthermore, *Leck* is distinguishable from *Hebble* because the Commission force pooled the unit in *Leck*.[125] Since the forced pooling order pools the cost-bearing interests and appoints an operator, some of the same elements that make a fiduciary duty appropriate for a unitization order are also present in a forced pooling order.[126] The key requirement that the state modify the rights of the parties is arguably satisfied by the forced pooling order, unlike the drilling and spacing unit.

Hebble goes on to state, "The critical factor is the resort to the police powers of the state on the part of a lessee in unitization proceedings which modify and amend existing legal rights" and cites *Olansen* for support.[127] *Olansen*'s fiduciary duty analysis refers specifically to Oklahoma's unitization statute and how a specific unitization order modified the legal rights of the parties affected.[128] Indeed, the *Olansen* opinion specifically notes that the unitization order is statutorily authorized to amend existing legal rights.[129] *Olansen*'s analysis also does not provide direct support for the proposition that a drilling and spacing unit should be treated like a unitization order. With regard to the fiduciary obligations of operators, the court in *Hebble* equates a drilling and spacing unit to a unitization order with no direct support for its proposition and no discussion of the justifications for its expansion of Oklahoma law.

*C. The Practical Realties of Operating an Oil and Gas Well Post-*Hebble

A state's legal landscape affects the attractiveness of doing business within that state's borders. Chesapeake Energy's recent experience in Roane County, West Virginia serves as a relevant and sobering example. In 2007, Chesapeake lost a judgment for $404 million, $270 million of which was punitive damages, for a case involving under-paid royalties.[130] West Virginia was one of only two jurisdictions at the time that did not provide

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124. Howell v. Texaco, Inc., 112 P.3d 1154, 1161 (Okla. 2004).
125. *See Leck*, 800 P.2d at 225.
126. *See* 52 OKLA. STAT. § 87.1(e) (2000).
127. Hebble v. Shell W. E&P, Inc., 238 P.2d 939, 942 (Okla. Civ. App. 2010).
128. *See generally* Olansen v. Texaco, Inc., 587 P.2d 976 (Okla. 1978).
129. *See id.* at 981.
130. Juliet A. Terry, *$404M Roane County Verdict Upheld*, WBOY.COM (June 28, 2007), http://66.118.80.206/story.cfm?func=viewstory&storyid=25731&catid=182.

an automatic appellate review procedure.[131] The Roane County judge simply reviewed jury's decision and upheld the entire jury award.[132]

The effect on both Chesapeake and West Virginia was substantial. Soon thereafter, Chesapeake announced that it was cancelling its plans to build a $40 million regional headquarters office in Charleston, West Virginia.[133] Aubrey McClendon, Chesapeake's CEO, commented, "At the time, we realized that until West Virginia's judicial system provides fair and unbiased access to its courts for everyone, a prudent company must be very cautious in committing further resources in the state."[134]

Likewise, *Hebble* puts Oklahoma at a competitive disadvantage with other states. Although oil and gas producing states have large and complicated bodies of case law defining an operator's appropriate standard of conduct in a variety of different factual scenarios, many states generally accept the proposition that the unique nature of a unitization order requires an enhanced standard of conduct by the operator.[135] However, *Hebble*'s imposition of a fiduciary standard on an operator because of a drilling and spacing (or analogous) order is unprecedented.[136] The vast majority of wells drilled in Oklahoma are drilled pursuant to a drilling and spacing order. The Commission rarely unitizes lands because of the substantial voluntary agreement required and the large amount of land such a unit encompasses.[137] *Hebble* imposes a fiduciary duty upon thousands of drilling and spacing unit operators, past and present.

Presumably, an operator who took the care to bargain expressly for no fiduciary responsibility will lose the benefit of this bargain when the operator becomes operator of a drilling and spacing unit. This is true even though the drilling and spacing statute contains no language authorizing the drilling and spacing order to amend the contracts between the parties.[138] *Hebble* re-writes the initial bargain and renders meaningless certain aspects of common oil and gas contracts such as leas, communitization agreements, nd JOAs.

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131. Justin Anderson & Chris Dickerson, *Chesapeake Partly Blames Verdict for Departure*, W.VA. RECORD (Feb. 26, 2009), http://www.wvrecord.com/news/217651-chesapeake-partly-blames-verdict-for-departure.

132. *See id.*

133. *Id.*

134. *See id.*

135. *See* BRUCE M. KRAMER & PATRICK H. MARTIN, THE LAW OF POOLING AND UNITIZATION § 19.04 (3d ed. 1994).

136. *See id.*

137. Anderson & Smith, *supra* note 16, at 285.

138. *See generally* 52 OKLA. STAT. §§ 87.1-87.5 (2000).

What liabilities does a company inherit when it takes over the operation of a well from another party? This was possibly the greatest unanswered question from *Hebble*. This question was left unanswered because Maynard, Shell's successor-in-interest, settled with the plaintiffs in *Hebble* and was dismissed from the case.[139] Successors-in-interest like Maynard could be acquiring decades of tort liability. Oil and gas companies must already pay for a rigorous due diligence process when acquiring properties. Adding an investigation into each well's fulfillment of its fiduciary obligations could be an untenable transactional cost. This scenario could be the next step in this line of fiduciary jurisprudence. Imposing higher transaction costs on one of Oklahoma's most important industries deserves far more scrutiny than the limited discussion offered by *Hebble*'s analysis. Hopefully, the Oklahoma Supreme Court will soon address the "Maynard Question" and will reexamine *Hebble*'s dubious foundation. Rather than dealing with the unwanted effects of *Hebble*, the court should overrule this opinion and return Oklahoma to the stable line of pre-*Hebble* fiduciary jurisprudence.

V. Conclusion

The purpose and statutory definition of the unitization order is distinct from the drilling and spacing unit. Such distinctions justify imposing a fiduciary burden on an operator only when a unitization order is involved. A drilling and spacing unit simply pools of the royalty interests. In contrast, a unitization order amends the legal rights of the parties involved by allocating all production and costs and appointing a unit operator. Oklahoma courts have consistently recognized the distinctions between a unitization order and a drilling and spacing unit and have imposed fiduciary obligations only where unitization orders have amended the legal rights of the parties involved. *Hebble* expands an operator's fiduciary obligation to drilling and spacing units without a statutory justification or precedent. The meager analysis in *Hebble* fails to communicate a logical basis for the expansion and creates a confusing legal landscape for past and future operators of drilling and spacing units currently attempting to negotiate oil and gas contracts and assess potential fiduciary liability.

Brad Secrist

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139. *See* Hebble v. Shell W. E&P, Inc., 238 P.3d 939, 942 (Okla. Civ. App. 2010).