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**BASIS OF THE IMPLIED COVENANTS**

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It has been pointed out so often that citation to authorities is hardly necessary that whatever an ***oil*** and gas lease is, it certainly is not a "lease."[[1]](#footnote-2)1 Under the law of most jurisdictions which have been required to come to grips with the conceptual nature of the ***oil*** and gas lease, it is regarded as creating some sort of interest in land-[[2]](#footnote-3)2 The precise nature of that interest, which depends in many cases upon the context in which the query is posed, need not concern us here. One corollary that follows from the characterization of the lease as a grant of an interest in real property is that it is not a "contract."[[3]](#footnote-4)3 Though a court will often make loose statements to the effect that an ***oil*** and gas lease is a contract between the parties, what is usually meant is that the lease provisions will be construed to ascertain the parties' intent under the same rules as applied to written contracts-[[4]](#footnote-5)4 Yet the lease normally contains certain "contractual" provisions, principally the obligation to pay royalties, and perhaps also a provision to bury pipelines below plowing depth, or to compensate the surface owner for damage to growing crops, or to drill offset wells under specified conditions.

**ORIGIN OF THE IMPLIED COVENANTS**

The ***oil*** and gas lease, therefore, may be thought of as a grant burdened with certain contractual elements, which may be express or implied.[[5]](#footnote-6)5 If the lease really were, pure and simple, a grant of a fee simple determinable in the ***oil*** and gas in place, a doctrine first clearly articulated by the Texas courts and fairly widely followed,[[6]](#footnote-7)6 the lessee would retain ownership until the condition causing termination of the estate was triggered or until he abandoned the lease-[[7]](#footnote-8)7 In fact, however, his continued ownership of the leasehold is dependent on his continuing compliance with certain obligations, or covenants, which, although they appear nowhere in the lease, are nonetheless real and an ever-present source of concern to the lessee. It is these implied covenants fashioned by the courts that generate some of the unique flavor to the hybrid creature that we call an ***oil*** and gas lease.

It is well to keep in mind, however, that the existence of these implied covenants, which reflects the underlying presence of the contractual viewpoint in the analytical framework of the ***oil*** and gas lease, is not unique to this field of law. Williams and Meyers find the notion to be rooted in the contract law principle of cooperation:

"It is clear, however, that the implication of duties in an ***oil*** and gas lease is not an isolated phenomen peculiar to ***oil*** and gas law. On the contrary, the covenants implied in ***oil*** and gas leases reflect a broader principle of law applicable to all contractual arrangements. This is the principle of cooperation found in the law of contracts."[[8]](#footnote-9)8

The principle of cooperation dictates that the contracting parties cooperate with each other so as to accomplish the purpose of the agreement, and is based upon the reasonable expectations of the parties-[[9]](#footnote-10)9

The question naturally arises, therefore, whether the implied covenants are implied "in fact" or are they implied "in law." If they are implied in fact, the traditional framework of the law of implied contracts unfolds. The courts will read into the parties' express contract certain implied obligations and duties which are deemed to reflect their unspoken or unarticulated intent about what their expectations as to the performance of each would be had they thought about the particular item in question when writing the contract. If the covenants are implied in law, on the other hand, the courts will intervene, regardless of the actual or imputed intent of the parties, whenever it is perceived to be necessary to do justice between the parties. This is essentially the doctrine of quasi-contract, created in order to prevent one party from being unjustly enriched at the expense of the other. In theory, regardless of the parties' intent, the courts will act to balance the equities and preserve fairness between the parties.

Each of these views has had its adherents,[[10]](#footnote-11)10 but Williams and Meyers believe this to be "jurisprudentially, a false dichotomy," in the context of the ***oil*** and gas lease:

"If the principle of cooperation is accepted as the correct basis for implying covenants, then there is an element of both fact and law in the implication- The duty of cooperation requires the parties to conduct themselves in such a manner as to promote the basic objectives of the contract. To this extent it is rooted in fact, because undoubtedly parties do enter into a contract with the expectation that conduct will be directed towards the end of accomplishing its purposes. Undoubtedly the principle of cooperation also represents an ethical norm; but an ethical norm can be a fact, and can be the predicate for reasonable expectations. When it comes to the application of an implied covenant to a particular dispute, courts may move some distance away from the fact of the parties' intention and closer to the law as an instrument for enforcing ethical norms. Thus when the lessor sues the lessee for his failure to use sandfracing to increase production, he may claim as a fact that he expected diligent efforts to be made to maximize production, but he can hardly claim that he expected the use of sandfracing when the lease antedated the invention of the process."[[11]](#footnote-12)11

The theoretical distinction between covenants implied in fact and covenants implied in law, therefore, is much less important than the fact that the courts have traditionally used the notion of implied contracts as an instrument to accomplish what they perceive to be equitable results in specific cases.[[12]](#footnote-13)12 The fact that the implied covenants arise from equitable considerations and the natural expectations of the parties rather than from their express agreement, is the key-[[13]](#footnote-14)13

As with most bodies of law, a set of general rules has developed in the context of the implied covenants in ***oil*** and gas leases, which will be summarized below. The general approach in the balance of this paper will be to demonstrate how these principles have been applied by the courts in several recent cases and how the courts have used the general principles as a framework for fashioning equitable relief in specific cases. The aim is to stress that the forest should never be lost sight of in looking at the trees, that is that it should always be kept in mind that the origin of the implied covenants is equitable in nature. A particular case should be approached not with the goal of fitting it into a rigid pre-existing framework, but rather with the aim of using the framework as a starting point for achieving a desirable result. This process is always, of course, open to the criticism that stability and predictability may suffer, but is appears to be what the courts actually do in the implied covenant cases, and the results generally appear to be sound.[[14]](#footnote-15)14

The concept that law, whether codified in statutory form or as developed by the courts from basic common law traditions, is anchored upon a bedrock of equitable principles is an old one-[[15]](#footnote-16)15 It is not surprising that the early decisions recognizing the existence of implied covenants in ***oil*** and gas leases built upon this foundation. The landmark early case is Brewster v. Lanyon Zinc Co.,[[16]](#footnote-17)16 in which the court, although it couches its opinion in terms of the implied intentions of the parties, is clearly reaching for a result that is fair to both parties in the circumstances of ***oil*** and gas development:

"It is conceded, as indeed it must be, that the lease contains no express stipulation as to what, if anything, should be done in the way of searching for and producing ***oil*** or gas after the first five years; but it does not follow from this that it is silent on the subject, or that the matter is left absolutely to the will of the lessee- Whatever is implied in a contract is as effectual as what is expressed. Implication is but another name for intention, and if it arises from the language of the contract when considered in its entirety, and is not gathered from the mere expectations of one or both of the parties, it is controlling. Light will be thrown upon the language used, and the intention of the parties will be better reflected, if consideration is given to the peculiar and distinctive features of the mineral deposits which are the subjects of the lease. [discussing migratory character of ***oil*** and gas]

...

The implication necessarily arising from these provisions [the lease provisions theretofore reviewed by the court]-the intention which they obviously reflect-is that if, at the end of the five-year period prescribed for original exploration and development, ***oil*** and gas, one or both, had been found to exist in the demised premises in paying quantities, the work of exploration, development, and production should proceed with reasonable diligence for the common benefit of the parties, or the premises be surrendered to the lessor....

"Considering the migratory nature of ***oil*** and gas, and the danger of their being drawn off through wells on other lands if the field should become fully developed, all of which must have been in the minds of the parties, it is manifest that the terms of the lease contemplated action and diligence on the part of the lessee. ... [discussing the difficulty of expressly providing for the appropriate number of wells to be drilled] The subject was, therefore, rationally left to the implication, necessarily arising in the absence of express stipulation, that the further prosecution of the work should be along such lines as would be reasonably calculated to effectuate the controlling intention of the parties as manifested in the lease, which was to make the extraction of ***oil*** and gas from the premises of mutual advantage and profit."[[17]](#footnote-18)17

The real basis for the existence of implied covenants, therefore, is what is a fair and equitable result for both lessor and lessee- The parties are deemed to have implicitly contemplated such a result when the lease was granted. As in many other areas of the law the actual intentions of the parties entering into the arrangement were probably quite generalized, and it is illusory to attribute a complex set of specific expectations to lessor and lessee when the lease is granted. The lessee appreciates the cash bonus and hopes for future royalties and the lessee hopes to be allowed to carry out a rational exploration plan in the hope of bringing in successful wells. Through the implied covenants, the law has evolved a general framework of principles to help realize these expectations in an equitable manner for both parties. As Professor Merrill states:

"Of course, the implied covenant is a fiction, used like other fictions by the law in order to achieve a desirable result. The parties have not agreed consciously upon the terms which the law implies; it is even possible that they have never consciously directed their attention to the matter. The obligations are imposed, not by the agreement of the parties, but by operation of law. It might be better to speak of these obligations by some other name more indicative of their nature, but courts have talked of implied covenants in connection with ordinary leases and there is a natural tendency to apply the same term to the obligations in the case of an ***oil*** and gas lease."[[18]](#footnote-19)18

With this background in mind, it is useful to review the basic "rules" that have been developed in connection with the principal implied covenants, keeping in mind always that the rules should be viewed as a framework and not as a straitjacket-[[19]](#footnote-20)19

**REVIEW OF THE IMPLIED COVENANTS**

Three principal implied covenants have been found in ***oil*** and gas leases, as well as several subsidiary ones, the number depending on which authority is classifying them. These implied covenants are in effect judicially created contractual obligations on the part of the lessee, breach of which will give rise to a cause of action for damages and cancellation of all or portions of a leasehold. Since they are covenants and not conditions, there is no question of automatic termination of the lease. The lessor must bring a judicial action seeking damages or lease cancellation and the burden is normally on the lessor to prove his case.

**Covenant Against Drainage**

The first of the three principal implied covenants is the covenant to protect the leasehold from drainage by wells on adjoining tracts, sometimes called the "offset covenant", or "protection covenant." The term "drainage covenant" will be used here, since it seems to be the most descriptive. The theory behind implying this covenant is that the lessee, as exclusive holder of operating rights in the land, has the power to prevent drainage from occurring and the parties must have contemplated that the lessee would prevent drainage if it is economical to do so.[[20]](#footnote-21)20

The elements of the lessor's cause of action for breach of drainage covenant are that he must show that substantial drainage of hydrocarbons from the leased tract has taken place and that an offset well on the leased tract, that is a well offsetting the draining well or wells located on adjoining tracts, would produce hydrocarbons in paying quantities-[[21]](#footnote-22)21 For production to be in "paying quantities" in this context does not involve the same test as whether production is sufficient to maintain the lease in force during the secondary term. In the latter context, the question is whether production is sufficient to meet current operating costs and yield a reasonable profit. For purposes of showing a breach of the drainage covenant, on the other hand, for a well to produce in "paying quantities" means that it must repay the entire cost of drilling, equipping and operating the well, in addition to yielding a profit on the investment.[[22]](#footnote-23)22 The test is based on whether a prudent operator would have drilled an offset, or protection, well to prevent drainage of hydrocarbons from the tract-[[23]](#footnote-24)23 A prudent operator would not, of course, drill a well if it did not appear that it would yield a profit, so that the "paying quantities" test for this implied covenant necessarily must include the entire cost of the well.

It has been suggested that the two elements of this cause of action are really the same, that is that drainage is not "substantial" unless an offset well will produce in paying quantities.[[24]](#footnote-25)24 The generally accepted doctrine, however, is there must be a separate showing that substantial drainage from the tract has occurred- This is appropriate since the drastic consequence of lease cancellation should not be permitted when the evidence, which is always somewhat speculative in these cases since exact knowledge of reservoir conditions is impossible, indicates only minimal drainage.[[25]](#footnote-26)25 The question of how much drainage is "substantial" allows some latitude, of course, but there appears to be little authority on the issue.

The element of production in paying quantities is generally straightforward except that the issue of whether the lessee could make a reasonable profit over his total investment may be a difficult one.[[26]](#footnote-27)26 Since this is a high-risk industry, the expected return on the investment must be relatively high to justify the risk- There appears, however, to be essentially no case authority on what level of profit is "reasonable" in this context.[[27]](#footnote-28)27 This will presumably be analyzed on a case-by-case basis in the light of the prevailing market, the location of the well, other producing wells in the area, etc. Profitability of a well is usually measured in the industry in terms of the length of the payout period, the shorter the payout the more profitable is the well, but again there is little authority on the question of what payout period would be required for an offset well to be deemed reasonably profitable.[[28]](#footnote-29)28

It might be thought that if there is no net drainage from the leasehold, that is if the drainage away from the tract is balanced by drainage to the leasehold from other tracts, then the lessor suffers no harm and the drainage covenant is not breached- There is authority for this position, but it has been criticized by Williams and Meyers, who cite contrary authority and argue that the cases supporting the concept are distinguishable.[[29]](#footnote-30)29 In view of the support for the argument in some of the cases, the no net drainage concept is certainly a useful defense for the lessee to consider in a drainage covenant case. A related argument is that the covenant has not been breached if an existing well or wells on the tract have already produced the tract's fair share of the original recoverable hydrocarbons in the reservoir. The same authors criticize this position, quite justifiably, on the grounds that a profit-motivated reasonably prudent operator would very likely, under the rule of capture, seek to recover more than the original hydrocarbons in place under the tract if he could.[[30]](#footnote-31)30

The most interesting unsettled issue concerning the drainage covenant arises from the so-called "common lessee" or "fraudulent drainage" situation- Suppose that substantial drainage is occurring from the lease tract by a well on an adjoining tract that is leased to the same lessee, or at least in which the same lessee has an interest of some kind. That is, the lessee is draining from his own lease by operations on the adjoining tract. There is a common lessee and some decisions have used the term "fraudulent drainage" in such a case. How does this affect the cause of action for breach of the drainage covenant? The authorities are split on this question and several different rules have evolved.

In some cases, the fact that there is a common lessee is mentioned but apparently it was not regarded as significant and the cases were decided on the usual bases.[[31]](#footnote-32)31 More important are the cases that have expressly held that the fact that the common lessee has caused the drainage does not change the usual rules discussed above, so that the prudent operator standard is still the test and an offset well must be capable of producing in paying quantities-[[32]](#footnote-33)32 On the other hand, there are cases which hold that the lessee is held to a higher standard in the common lessee situation, or, equivalently, that the lessor need not prove all of the same elements as in the ordinary case.[[33]](#footnote-34)33

Several different approaches have been taken in the cases which hold that the lessor has a lighter burden in the common lessee situation- The most drastic view is that in this case the lessor does not need to show that an offset well would produce in paying quantities, that is that if substantial drainage is demonstrated the lessor will prevail without any further showing.[[34]](#footnote-35)34 The cases adopting this rule are the ones that have tended to apply the pejorative term "fraudulent drainage." Application of this rule appears to make the common lessee an insurer against substantial drainage caused by his operations.[[35]](#footnote-36)35 This rule has sometimes been called the "Millette doctrine" on the basis of the two well-known Mississippi decisions that articulated the principle-[[36]](#footnote-37)36 The authority of the decisions in Mississippi, however, has now apparently been limited by more recent cases.[[37]](#footnote-38)37

There appears to be no good theoretical basis for adoption of the Millette doctrine- The notion that the common lessee is getting something for nothing, in the sense that he can produce the drained ***oil*** from the adjoining tract without having to drill an offset well, is unsound. He is in the same position as the adjoining mineral owner, who is legally entitled under the rule of capture to produce whatever he can, and the lessee should not be penalized because he has leased adjoining tracts.[[38]](#footnote-39)38 It is true that the common lessee might be inclined in some cases to deal unfairly with a lessor, as when he has a larger net revenue interest in the lease on the adjoining tract so that production of ***oil*** and gas from that tract is more profitable to him than it would be from the lessor's tract. It has been proposed, and this is the other approach for lightening the plaintiff's burden in these cases, that the solution is to shift the burden of proof of profitability in the common lessee case to the defendant lessee. The lessee then must prove that an offset well would not be profitable if the lessor has proved that substantial drainage has occurred.[[39]](#footnote-40)39 This appears to be sound, reflecting the kind of equitable balancing that courts perform in applying the implied covenant "rules," and should not materially alter the lessee's approach to defense of the action in any case-

Various remedies have been utilized by the courts in the actions for breach of the drainage covenant, consisting basically of damages alone, or damages combined with outright cancellation of the lease or some form of conditional cancellation.[[40]](#footnote-41)40 Early cases often granted outright cancellation, in part because petroleum geology and engineering were not sufficiently well developed to make acceptable estimates of the amount of production that an offset well might provide, so that the remedy of damages was inadequate- Modern decisions, however, recognize that a conditional cancellation is more appropriate, giving the lessee a specified grace period within which to drill an offset well or suffer cancellation of his lease.[[41]](#footnote-42)41 The remedy of damages, usually based on the amount of dollars an offset well would have generated from the royalties on the ***oil*** and gas drained, is of course a proper form of relief.[[42]](#footnote-43)42

Finally, there are several possible defenses that may be raised in an action for breach of the implied covenant against drainage- The lease may contain express clauses that will displace the implied covenant. The force majeure clause, for example, may excuse performance of the implied covenant. More directly aimed at the implied covenant is an express offset covenant found in some leases, under which the lessee is required to drill an offset well if a draining well is located within a specified distance, 300 feet for example, from the leasehold boundary. The argument, then, would be that if the draining well is at a greater distance there is no covenant, implied or express, to drill an offset well. The courts have generally not accepted this position, however, and it has been held that the express offset covenant is not inconsistent with an implied covenant for distances greater than specified in the express covenant so that the express covenant does not displace the implied one.[[43]](#footnote-44)43 Thus the express covenant simply makes it clear that the lessee has obligated himself to drill an offset well to any well within the specified distance, whether it would be a profitable well or not.

**Covenant of Reasonable Development**

The implied covenant of reasonable development is the second major covenant that the courts have read into the ***oil*** and gas lease. As analyzed by some courts and commentators, it may overlap to some degree with a third covenant, the so-called implied covenant of further exploration, which will be discussed briefly below.[[44]](#footnote-45)44 The development covenant, although related in some ways to the drainage covenant, is conceptually aimed at a very different problem since it is concerned for the most part not with permanent loss of hydrocarbons from the leasehold but rather with delay in recovering the hydrocarbons-[[45]](#footnote-46)45

The question in an action for breach of the development covenant is essentially whether hydrocarbons are being produced rapidly enough from the leasehold, based on the existence of known producing formations in the area. Upon obtaining production on the leasehold, the lessee is obligated thereafter to drill such additional wells to develop the lease as a reasonably prudent operator would drill under similar circumstances. This covenant does not arise at all until production has been obtained, since it is not a covenant to drill an exploratory well.[[46]](#footnote-47)46 It can arise during the primary term, once production has been obtained but not if delay rentals have been resumed after a cessation of production or the completion of a dry hole, since the essence of delay rental payments is to excuse any need for drilling to maintain the lease-[[47]](#footnote-48)47 The underlying basis for the existence of the covenant appears to be the duty of the lessee to act so as to permit the lessor to receive the principal consideration for granting the lease, which is the hope of future royalty from production.[[48]](#footnote-49)48

The principal element the lessor must prove in an action for breach of this covenant, just as for the drainage covenant, is that a development well will probably produce in paying quantities, in the sense of allowing the lessee to recover his entire capital investment in the well, plus operating expenses and a reasonable profit- Just as for the drainage covenant the income in question is that which is attributable to the entire original working interest of the lessee, without allowance for overriding royalties or assigned interests, and the question of what constitutes a reasonable profit creates some difficulties. Payout periods of eighteen months and two and three quarters years have been held to mean a well would be profitable, whereas a six-year payout period has been held to show a well would not be profitable.[[49]](#footnote-50)49

The matter of whether a development well will be profitable is not the sole element of the plaintiff's cause of action. Market demand is a relevant factor, and lack of a market for ***oil*** or gas will justify the failure to drill additional wells,[[50]](#footnote-51)50 though this is perhaps simply another way of looking at the profitability question- Governmental well spacing is also an important element. If the permitted number of wells has already been drilled, it could not be a breach of the covenant to refuse to drill another well.[[51]](#footnote-52)51 Another factor the court will examine is the lapse of time since the last well was drilled. The longer the delay, the greater is the chance that a prudent operator would have drilled, if a profitable well could have been drilled.[[52]](#footnote-53)52 It has not proved possible to articulate any general formula for analyzing the risk to the lessee in a development covenant case- As the leading authorities point out, the test is a balance of fairness:

"[T]he fundamental problem faced by courts measuring the lessee's development operations under the prudent operator standard is to strike a balance between the number of development wells necessary to withdraw the minerals at a fair rate to the lessor and the number of wells the lessee can afford to drill and still receive a fair return for the risk he takes on the investment he makes.[[53]](#footnote-54)53

The remedies for breach of the development covenant are similar to those available for the drainage covenant- The lease may be cancelled outright except for the spacing units surrounding existing producing wells, or, more commonly, a conditional decree of cancellation may be entered, giving the lessee a specified grace period within which to drill a development well or wells or suffer the consequence of cancellation as to undeveloped acreage. Finally, the usual contractual remedy of damages for a breach is available, and a decree of cancellation may depend on a showing that the legal remedy of damages is inadequate.[[54]](#footnote-55)54 It is generally held that the lessor must first notify the lessee of his claim that reasonable development has not occurred and make a demand for a development well, allowing the lessee a reasonable time to comply, before an action for breach of the covenant will lie.[[55]](#footnote-56)55 It is possible, though quite unusual, if there has been a long delay, coupled with the apparent intent on the part of the lessee, for the court to find in a development covenant case that a lease has been abandoned by the lessee-[[56]](#footnote-57)56 The development covenant is indivisible, in the sense that so long as there is reasonable development of the property as a whole the lease will not be cancelled, even as to substantial tracts of undeveloped land.[[57]](#footnote-58)57

The remedy of damages for breach of the development covenant presents some problems as to the measure of damages- If the failure to develop results in permanent loss of hydrocarbons from the lease, then the measure of damages is simply the same as in the drainage case. If it is simply a matter of delay in recovery, however, which is the usual case, then permitting the lessor to recover the royalty that would have been produced will provide a double recovery if the lessor also receives actual royalty when a well is eventually drilled.[[58]](#footnote-59)58 It has been suggested in at least one early case that interest on the royalty that would have been paid is the proper measure, thereby compensating the lessor for the delay in receiving actual royalty, but this has been criticized as a very complex rule to administer and has generally been rejected by the courts.[[59]](#footnote-60)59

Presence of express covenants in the lease will, of course, displace inconsistent implied covenants to the extent of the inconsistency- As already mentioned, the delay rental clause will negate the application of the development covenant during any period when delay rentals are payable. There appears to be no direct authority as to whether the shut-in royalty clause will displace the implied development covenant, though the leading commentators believe that it should not.[[60]](#footnote-61)60 The shut-in royalty clause should not excuse the lessee from using due diligence to attempt to market the gas from the existing well and to drill whatever additional development wells a prudent operator would drill. It is very rare for leases, at least in the Rocky Mountain area, to contain express covenants specifying the number of wells to be drilled and the time frame for drilling them, but such drilling covenants have been included in some cases and would displace any implied covenant if the express covenant was intended to set forth the entire obligation of the lessee.[[61]](#footnote-62)61

**Covenant of Further Exploration**

Related to the implied covenant of reasonable development but distinct from it is the implied covenant of further exploration- The distinguishing feature is that the development covenant deals with additional drilling to a proven producing formation in the field, whereas the exploration covenant deals with further exploratory drilling to potential but as yet unproven formations. The exploration covenant is conceived to arise primarily from the policy against allowing the lessee to continue to hold a lease after the primary term for purely speculative purposes.[[62]](#footnote-63)62 During the primary term, of course, a lessee is entitled to hold a lease for whatever purposes he chooses so long as he pays proper delay rentals.

The covenant of further exploration has not been expressly accepted by some jurisdictions as a separate covenant from the covenant of reasonable development, but the courts over the years appear to have implicitly accepted this notion, or at least to have moved toward an expansion of the traditional development covenant.[[63]](#footnote-64)63 One essential difference in the proof of breach is that the lessor is not required to prove that a well would be profitable after paying drilling, equipping and operating costs, but rather he must show that under the circumstances the failure to drill wells to explore new producing formations is unreasonable-[[64]](#footnote-65)64 This is not necessarily a different matter in a given case, of course, than proving that a well would not be profitable, so the distinction may not be all that clear.

Some of the circumstances that have been deemed relevant to this test of unreasonableness are: (1) the period of time since the last well was drilled on the lease, (2) the size of the tract and number and location of existing wells on it, (3) the indicated existence of favorable but untested geological structures, (4) the lessee's attitude toward further testing and his other operations in the vicinity, (5) the economic feasibility of further drilling, and (6) whether there are portions of the lease outside producing units.[[65]](#footnote-66)65

As stated above, this covenant appears to be based on the policy against allowing the lessee to hold the lease for purely speculative purposes- This was also the traditional basis for requiring that production during the secondary term must be in paying quantities.[[66]](#footnote-67)66 Williams and Meyers see the exploration covenant as developing out of the original theory that speculative holding of a lease would be prevented by finding abandonment after unreasonable failure to carry out further exploration and testing.[[67]](#footnote-68)67 By unreasonably failing to explore, the lessee has in a sense abandoned the purpose of the lease, and to allow him to retain undeveloped portions would not be fair:

"To permit the lessee to hold the lease for an unreasonable length of time for merely speculative purposes, is to allow him to protect his own interest and to disregard the interest of the lessor- If conditions do not indicate to him that further development will be profitable, it is but fair that, after a reasonable time has expired, he surrender the undeveloped portions of the lease and allow the lessor to procure development by others or assume the burden of showing why in equity and good conscience the undeveloped portion should not be cancelled so that the owner may, if possible, get it developed by others."[[68]](#footnote-69)68

Although the articulation of a new covenant of further exploration has been criticized as attempting to put a label on something which is too elusive to categorize by any set of general rules, it does provide a category into which to fit the large number of cases in which the courts have granted relief to the lessor without a showing that further wells would probably be profitable.[[69]](#footnote-70)69 The fundamental equitable basis for implying the covenant is expressly recognized under this analysis-

Perhaps the most important factor in a further exploration case is the length of time that has elapsed since the last well was drilled. The periods of time in reported decisions have ranged from thirty-five years to only a few years, or even less than one year, so that no general rule can be extracted from the cases.[[70]](#footnote-71)70 The entire set of circumstances in each case will determine how the court will view the claim of breach of the covenant- Another important factor is the pattern of development, the courts being inclined to cancel the lease as to untested areas where the wells have all been concentrated for years in a small part of the whole leased tract, and whether the leased tracts are contiguous may be a factor.[[71]](#footnote-72)71 Since the covenant extends to a duty to explore untested formations, either shallower or deeper formations, in existing wells, the courts have sometimes in effect made a horizontal severance by decreeing cancellation as to unexplored formations, preserving the lease as to the producing formations.[[72]](#footnote-73)72

The normal remedy for a breach of the covenant of further exploration is cancellation of the lease as to the unexplored acreage, either absolute or conditional, leaving the lease intact as to the acreage around the producing wells-[[73]](#footnote-74)73 The more common conditional decree of cancellation gives the lessee a grace period within which to commence drilling to avoid termination, just as in the development covenant cases.[[74]](#footnote-75)74 It is generally felt that the legal remedy of damages is inadequate since the monetary loss from failure to reasonably explore is impossible to ascertain-[[75]](#footnote-76)75 As for the development covenant, notice of breach and demand for performance by the lessor, with a reasonable time given to cure the breach, is required before a cause of action for cancellation can arise.

The covenant of further exploration, as noted above, has been less clearly articulated by the courts than the covenant of reasonable development. Williams and Meyers find four categories of jurisdictions that can be isolated.[[76]](#footnote-77)76 First is the group of states with no case authority, including California, Montana, Wyoming, South Dakota, Indiana, Pennsylvania, West Virginia, New York, and Alabama- In the second group are states with faint authority in support of this covenant, including New Mexico, Utah, and possibly Nebraska and North Dakota.[[77]](#footnote-78)77 The third group, comprising states which have clearly recognized an obligation to drill exploratory wells without proof that they probably will be profitable, consists of Arkansas, Colorado, Kansas, Kentucky, and Louisiana.[[78]](#footnote-79)78

Although the Oklahoma court has stated that there is no implied covenant of further exploration, Williams and Meyers believe the Oklahoma implied development covenant is broad enough to accomplish the same thing-[[79]](#footnote-80)79 Finally, Texas seems to stand alone, with a complicated series of decisions that appear to suggest that Texas recognizes the principle but not as a separate covenant of further exploration, in effect perhaps falling into the same category as Oklahoma.[[80]](#footnote-81)80

The effect of express lease provisions on the exploration covenant is similar to the case of the development covenant except that the issue of this covenant does not arise at all during the primary term where delay rentals are payable-[[81]](#footnote-82)81

There are several other implied covenants that have been recognized by the courts, which will be touched on only briefly here. There is an implied covenant that the lessee, once he has discovered hydrocarbons on a leasehold, will use due diligence to market the product. This usually arises for gas production, where there will often be delay due to the need to connect the well to a pipeline gathering system. In states where discovery is equivalent to production for purposes of carrying the lease into its secondary term, notably Oklahoma, and where the lessee has a reasonable time after discovery to market the product, there is some blending of this implied covenant with the habendum clause.[[82]](#footnote-83)82 In most jurisdictions, however, there is a clear distinction between the two concepts: there must be production, either actual or constructive, at the end of the primary term (or drilling at that time) but the lessee has a reasonable time after completion to market the product-

The prudent operator standard is applicable as well to this marketing covenant. To prove a breach the lessor must show that ***oil*** or gas has been discovered on the leasehold, that there has been a failure to market it, that a reasonably prudent operator could have marketed it through reasonable diligence and the lessor has been damaged as a result.[[83]](#footnote-84)83 It is important to bear in mind that the mere fact that the lessee is paying shut-in royalty does not excuse him from using due diligence in seeking a market; the shut-in royalty prevents termination for lack of actual production but it does not negate the implied duty to market-[[84]](#footnote-85)84 The matter of whether the lessee may delay marketing gas in the hope of obtaining a better price later is controlled by the prudent operator standard, and the lessee is entitled to use its good business judgment if it is not unreasonable.[[85]](#footnote-86)85 If governmental regulation of the gas industry restricts the production or sale of gas, adherence to the restrictions will prevent breach of the marketing covenant-[[86]](#footnote-87)86

The remedies allowed in actions for breach of the marketing covenant are the legal remedy of damages, based on the lessor's royalty on the product that should have been marketed, and the remedy of absolute cancellation of the lease.[[87]](#footnote-88)87 Conditional cancellation is generally not allowed, the theory being that the lessor should be allowed by his own efforts to attempt to market the product if the lessee fails to do so, so that the lease should be turned over to the lessor, i-e. cancelled.[[88]](#footnote-89)88

There is another implied covenant that essentially encompasses a general catchall duty to conduct operations with reasonable care and due diligence. This may include a duty to use modern production techniques, including enhanced recovery methods.[[89]](#footnote-90)89 Probably the most interesting subcategory of this covenant is the growing recognition of a duty on the lessee's part to seek favorable administrative action from regulatory bodies, such as seeking exceptions and variances from administrative rules and orders, on the theory that a reasonably prudent operator would do so-[[90]](#footnote-91)90

**Implied Covenants Under Pooling and Unitization**

The effect of pooling and unitization upon the implied covenants is of considerable interest. With respect to the drainage covenant there are several possible situations that can arise.[[91]](#footnote-92)91 If there is drainage from the unit to nonunit premises, the drainage covenant applies, with the usual requirement that the offset well would be profitable- If, instead, there is drainage from the portion of the lease included in the unit to another part of the unit, there would be no liability. The lessor will receive royalty based on a pro rata share of the entire unit production, and this will not be changed by "internal" drainage to another portion of the unit, so the lessor suffers no damage in this case.[[92]](#footnote-93)92

If there is drainage from the portion of a lease outside a unit to the unit, the situation is somewhat more complicated. The lessor will receive some royalty from the production of hydrocarbons drained to the unit but of course it will be only a fraction of the royalty he would have received if the production had been from a well on his lease outside the unit, since he receives only a fraction of the royalty from any unit production. There appears to be essentially no case authority on this question but Williams and Meyers believe there is a strong case for granting the lessor relief in this situation, provided he could prove an offset well would be profitable.[[93]](#footnote-94)93

Perhaps of greater interest is the effect of pooling and unitization on the implied covenants of reasonable development and further exploration- Where all of the lease acreage is within the unit, there is no special problem. Development of the unit will constitute development of the lease and the usual rules associated with the covenants will apply.[[94]](#footnote-95)94 When only a part of the lease acreage is within the unit, it has long been established that the development and exploration covenants are applicable to the portions outside the unit boundaries.[[95]](#footnote-96)95 The only question is whether the duty of the lessee is any different than where no part of the lease is within a unit- There is some case authority for the proposition that the lessee's development and exploration obligations on the acreage excluded from the unit are greater than normal, but most cases apparently give no particular weight to the pooling or unitization of part of the lease.[[96]](#footnote-97)96

**ANALYSIS OF SPECIFIC CASES**

Having stated the premise that the principal implied covenants in ***oil*** and gas leases arose out of a desire by the courts to promote fairness and achieve a balance of equities between the lessor and the lessee, and having reviewed the usual "rules" governing the implied covenants, we may now analyze several recent cases in depth to see how the theory works in specific cases.

Sun Exploration & Production Co. v. Jackson,[[97]](#footnote-98)97 a very recent decision by the Texas Court of Appeals, provides a good illustration of a court's practical approach to the development and exploration covenants- The premises in question was the Jackson ranch in Chambers County, Texas, a 10,000-acre tract which had been leased to Sun ***Oil*** Company in 1938. In 1941 Sun completed the Jackson No. 3 well as the discovery well for the Oyster Bayou Field. Since that time Sun had drilled 64 additional wells and had 37 producing wells at the time of the trial, all producing from the Seabreeze Sands in the Oyster Bayou Field, which was located north of a farm-to-market road that divided the Jackson ranch into two parts. The total production from the lease exceeded 110,600,000 barrels of ***oil***, 110.3 billion cubic feet of gas and 53,500 barrels of condensate, resulting in an average royalty of more than $10,000 per day.[[98]](#footnote-99)98

During the lease term, Sun had generated 13 seismic surveys and had planned to conduct another one on both the north and south portions of the lease in 1979, but was unable to negotiate a seismic agreement with the Jacksons.[[99]](#footnote-100)99 The lessors then denied Sun access to the premises for the seismic work and claimed that the lease had terminated for failure to reasonably develop and explore- Sun brought this action for a declaratory judgment that the lease was in effect. The seismic program was competed on the north portion of the lease under a temporary restraining order obtained by Sun.

In 1981, after the action had been commenced, Sun drilled another well north of the road and attempted to obtain production in a deeper formation (Vicksburg Sands, at 14,500 feet). This was not successful and the well was subsequently completed as a producer in the established formation (Seabreeze Sands). In 1982, Sun did complete a well on the portion of the lease south of the road, in the Hackberry Sands (12,000 feet), but this well was quickly depleted and was abandoned.

The court recognized, of course, the usual prudent operator standard and set out the customary test for the development covenant:

"Thus, even though a lease may be held by production, the lessee is usually obligated to conduct further development operations on the leased premises if such operations would result in a benefit or profit for both the lessor and the lessee. (citation omitted) But this obligation is measured by the standard of reasonable diligence and unless there is a reasonable expectation of profit to both the lessee and lessor, the lessee is not required to act."[[100]](#footnote-101)100

The bone of contention in this case, however, was not the development covenant, but rather the covenant of further exploration:

"In this case, both sides agree that the Jackson lease carried with it the implied covenant of reasonable development after production- The disputed issue is whether Sun's duty to 'develop' included the obligation to drill 'exploratory' wells to test other 'known producing' formations of the lease."[[101]](#footnote-102)101

Sun took the not unreasonable position that there was no covenant of further exploration in Texas, based on the well-known decision of the Texas Supreme Court in Clifton v. Koontz, which had said so in so many words.[[102]](#footnote-103)102 The lessee's reliance on this language in Clifton, however, illustrates the danger of becoming bogged down in conceptual rules and labels at the expense of analysis of the circumstances of a particular case- As the court's analysis showed, it felt that Sun was in fact subject to something very much akin to the covenant of further exploration, Clifton v. Koontz notwithstanding.[[103]](#footnote-104)103 The court agreed that Sun was not obligated to drill "exploratory wildcat" wells, that is speculative wells that do not offer a reasonable expectation of profit to a reasonably prudent operator. It did not agree, however, with Sun that the lessee's obligations were necessarily met by merely continuing to drill additional development wells in the one known producing formation in the Oyster Bayou Field.

The jury found that Sun had not failed "to reasonably develop the Jackson lease," which under the jury instructions meant that Sun had acted as a prudent operator with respect to any known producing formations. The jury did find, however, that Sun had failed "to reasonably explore the portions of the Jackson lease which lie outside the Oyster Bayou Field." The jury instruction on this second issue was:

"In answering Special Issue No. 2, you are instructed that Sun must conduct itself as a reasonable and prudent operator would while exercising due diligence under the same or similar circumstances, with a reasonable expectation of profit, considering the interests of both the Lessors and the Lessee."[[104]](#footnote-105)104

Thus, although it may not be denominated as a separate covenant from the covenant of reasonable development, Texas appears to recognize the concepts inherent in the covenant of further exploration- The court is careful to make a distinction between "exploratory wildcat wells", which would not necessarily presuppose an expectation of profit and which are not required, and "exploratory development wells", which would be required if there is a reasonable expectation of profit.[[105]](#footnote-106)105

Having set forth the guiding principles, the court proceeded to analyze the conflicting expert testimony. It is apparent that it found the lessors' evidence, in the light of the history of development and exploration on the lease, to be more credible than the lessee's. The lessors' expert testified that there were five drilling prospects on the lease that a reasonably prudent operator would drill immediately, one in the known Seabreeze Sands formation, one in the Hackberry and three in the Vicksburg. The Seabreeze and Vicksburg prospects were outside the Oyster Bayou Field and would be exploratory wells. Although Sun contested each of the lessors' contentions through its own expert testimony, the court found that the jury could reasonably have chosen to believe the lessors' evidence to be more probative. It can be inferred that the court agreed with the lessors that Sun's seismic work was of poor quality and that the only usable seismic work was performed after the litigation had commenced, suggesting perhaps that the court doubted the lessee's complete good faith in conducting its seismic exploration. The court also noted Sun's required 30% return on investment formula was high and observed that Sun had never, in 47 years, granted a farmout request on the Jackson lease. The lessors' witness testified that 78% of the lease had never been properly explored.

Although the standard of review in a jury case is simply whether reasonable minds could have determined that the preponderance of the evidence supports the jury's verdict, it is often possible to infer from the appellate court's review of the evidence whether it would have reached the same conclusion as the jury. This appears to be true in this case, and the court seems to feel that Sun was less than fair and reasonable to the lessors in concentrating all of its efforts to the single formation in the one field. This can be seen in the relief granted by the decision. The trial court had unconditionally cancelled the lease as to all portions south of the road and west of Oyster Bayou Field and conditionally cancelled the lease for lands in the Oyster Bayou Field for depths below 8480 feet, that is below the known producing formation. The decree provided that such conditional cancellation would not take place as to any spacing unit for which a well capable of producing in paying quantities was drilled by December 9, 1985, that is essentially four months from the date of the court's opinion.

The different remedies approved by the court in the different portions of the field demonstrate the balancing of the equities between the parties discussed above. The unconditional cancellation of the lease outside the Oyster Bayou Field was approved. The court noted that outright cancellation was an extraordinary remedy, but that it was justified because Sun had done nothing in these portions of the field and apparently intended to do nothing, the clear implication being that this was manifestly unfair to the lessor:

"Recognizing the rule that unconditional cancellation should only be granted in extraordinary circumstances, we conclude that the trial court did not abuse its discretion in granting that relief in this case. Based on the Jacksons' evidence from which it might be inferred that Sun made no effort to develop the lease before institution of litigation, and Sun's own evidence, from which the trial court could reasonably have decided that Sun had no present intent to conduct further drilling operations outside the Oyster Bayou Field, the trial court was justified in deciding that a conditional decree would be futile. Based on the circumstances presented to it, the trial court could reasonably have concluded that Sun has expressly disclaimed any interest in further developing the lease outside the Oyster Bayou Field, and that it would be useless to require Sun to abide by a 'reasonable development' program on the premises south and west of the Oyster Bayou Field.[[106]](#footnote-107)106

Two interesting points emerge from this analysis: (1) the court seems to subsume the notion of "further exploration" into its concept of "reasonable development", and (2) it seems to be saying that the result might be different if Sun had shown any inclination or intent to conduct further exploration on other portions of the lease- The origin of the implied development and exploration covenants in the notion of abandonment can be sensed when the court notes that Sun had disclaimed any interest outside the Oyster Bayou field.

As to the trial court's conditional decree for the deeper formations in the Oyster Bayou Field, however, the court disagreed and implicitly found that this was unreasonable and unfair to the lessee. Sun had rightly pointed out that the trial court's decree would require it to drill 75 wells in a very short time period and to bring them all in as producers in order to retain the deeper formations in the entire Oyster Bayou Field. This was held to be unduly harsh:

"We agree that this portion of the decree imposes an unreasonable burden on Sun. Accordingly we reverse that portion of the decree and remand the cause to the trial court so that it may fashion a decree which will bear a reasonable relationship to Sun's ability, as a reasonable and prudent operator, to further develop that portion of the lease lying beneath the Oyster Bayou Field."[[107]](#footnote-108)107

The trial court is not provided with any guidelines for fashioning a decree except that the court cites a case which provided a five-year program, requiring drilling the first year and optional surrender of undrilled areas during the remaining four years-[[108]](#footnote-109)108 The appellate court evidently believed that the trial court should have the first hand in attempting to find an equitable middle ground.

The Sun case provides an excellent illustration of how a court will examine all of the facts and circumstances in a given case and seek to accomplish justice for both parties. The perception appeared to be that Sun was not really interested in the area outside the Oyster Bayou Field, or at least was unwilling to make any commitment of resources outside the known producing field or even to farm out acreage to another operator. It does not seem unreasonable, therefore, to give the lessor an opportunity to try to lease to another who would be more willing to explore. On the other hand, Sun had committed substantial resources to the Oyster Bayou Field, had produced a large amount of hydrocarbons, to the benefit of the lessors as well as to its own benefit, and should, in all fairness, be allowed to continue reasonable exploration of other potential formations in the field.[[109]](#footnote-110)109

A recent decision of the North Dakota Supreme Court provides an interesting comparison with Jackson v- Sun. In Johnson v. Hammil,[[110]](#footnote-111)110 the circumstances were such that, contrary to the situation in Jackson, the court found there was no breach of the development and exploration covenants even though the lessee had not drilled any wells on the lease. The tract in question comprised 678 acres, on which a lease with a 7-year primary term had been granted in 1974. By 1986 no wells had been drilled on the lease, but it was being held by production by virtue of the fact that a 40-acre tract within the lease was pooled into a 320-acre spacing unit on adjoining lands that contained two wells. Beginning in 1982 the lessors sought cancellation of the lease apart from the 40-acre tract, for failure to comply with the implied covenants. The trial court appeared to have looked at all three principal implied covenants, holding that there had been no breach of "any implied covenant to develop, explore or protect" the lease.[[111]](#footnote-112)111 The court easily disposed of the threshold argument by the lessors that the development covenant had necessarily been breached because there had been no drilling at all on the lease:

"Development and exploration are not carried out only by drilling operations- They are also performed by such other activities as geophysical surveys and farmout operations (citations omitted); efforts to gather geological information (citations omitted); and participation in the preliminary play to an eventual deep test in the area."[[112]](#footnote-113)112

The lessee took the position that the usual test for the development covenant applied, that is that it would only be required to drill if a well would be profitable. This was rejected by the court, which held that "a lessor may be entitled to relief upon a theory of breach of the implied covenant of reasonable development where a long period of time passes without drilling on substantial unexplored portions of a leasehold held by production on part of the leasehold without proving that a well on the undeveloped portion would be profitable."[[113]](#footnote-114)113 Although the court deemed it unnecessary to determine whether it should adopt a separate covenant of further exploration, it is apparent from its list of factors to be considered in applying the prudent operator test that the court is really talking about the usual bases for further exploration covenant, as discussed above (see Note 65 supra):

"(1) the quantity of ***oil*** and gas capable of being produced as indicated by prior exploration and development; (2) the local market and demand therefor; (3) the extent and results of the operations, if any, on adjacent lands; (4) the character of the natural reservoir-whether such as to permit the drainage of a large area by each well; (5) the usages of the business; (6) the cost of drilling, equipment, and operation of wells; (7) the cost of transportation, storage, and the prevailing price; (8) general market conditions as influenced by supply and demand or by regulation of production through governmental agencies; (9) evidence of the willingness of another operator to drill on the tract in question; (10) the attitude of the lessee toward further development; and (11) the elapsed time since drilling operations were last conducted-[[114]](#footnote-115)114

Thus a great many factors are blended into the court's test, including the elements of costs and prices, that is profitability of a well. This approach underscores the danger of relying on a specific "rule", such as the profitability test, in analyzing a particular implied covenant case. The court's test here is a composite mixture of many considerations and blends the traditional notions of the reasonable development and further exploration covenants.

Having set out all these elements, the court then looked at the history of this lease to determine whether the lessee's conduct has been prudent and reasonable: (1) the lease was being held by the two wells on the spacing unit that included 40 acres of the leased premises, completed in 1978 and 1979; (2) the lessee had in fact participated in those two wells throughout a farmout, though they were not located on this lease; (3) the lessee had granted a seismic option to another operator in 1979 on parts of the lease, and seismic operations were carried out, though that operator did not elect to acquire any interest by farmout from the lessee; (4) the lessee did negotiate a farmout to another operator in 1983 which did not actually drill a well to earn any acreage; (5) geologic evidence by the lessee indicated the lack in this tract of any structural closure in the Red River Formation; and (6) generally the lessee had demonstrated interest in continuing to develop and explore other formations in the lease, as indicated by the lessee's own regional seismic study conducted in close proximity to the lease in 1982 and the fact that the lessee's geologic staff evaluated the Johnson lease at least once a year to determine whether further development should occur.

The court also noted that the lessee's testimony showed that the industry practice was to complete wells in the deeper formations first and then to move uphole when the deeper zones were depleted. It was anticipated that this would occur when the Red River formation in adjacent tracts was depleted, which would then provide evidence of the potential for such other formations under the Johnson lease. This would be likely to occur in two to four years. Since the Red River showed no potential in the Johnson lease, it was prudent to wait for these developments on adjacent tracts:

"Based on geologic information reasonably available to it and the production data from nearby wells, (the lessee) has met the prudent operator standard in not drilling a well either to further develop the Red River formation or to explore potentially productive shallower zones. This is especially so because only one of the wells drilled in the area was a good producer, several were dry holes, and the others were marginal producers."[[115]](#footnote-116)115

In response to the lessors' assertion that the long period of time without drilling should be dispositive of the matter, the court stated:

"We have already noted that there has been substantial development and exploration activity in the form of seismic options, farm-out agreements, study of geologic data, seismic testing, study of production data from nearby wells, and actual production, both during the primary term of the lease and after the expiration of the primary term- [The lessee] has even engaged in some of these activities after the Johnsons began to assert that the lease had been forfeited."[[116]](#footnote-117)116

Although the court does not specifically speak in terms of trying to reach an equitable result in the particular circumstances, this is exactly what it implicitly does in the decision. It is apparent that it felt that the lessee had been active in various ways, and not simply holding the lease for speculation, and had invested a considerable amount of time and effort in studying its potential. There was no significant unfairness to the lessors, as was found in the Sun case where thousands of acres had been undeveloped and apparently unstudied by the lessee over many years. In Sun the lessee had been found to have had no interest in further development, as evidenced by its protracted inaction outside the known producing field. In the Johnson case, on the contrary, the lessee had been actively engaged on a number of fronts, though not yet including actual drilling on the lease. The question of the lessee's good faith is certainly an implicit factor that weighs in a court's deliberations. It is worth noting, however, that a cautionary note is sounded at the end of the opinion, lest the lessee become complacent as a result of prevailing in this particular case:

Such delay as was here shown may not continue until it becomes unreasonable or unconscionable and thus grow into valid ground for cancellation of the lease at some time in the future. As a corollary, it follows that our decision herein should not be interpreted as licensing the defendant to do nothing in the near future toward further development of the lease."[[117]](#footnote-118)117

In a recent decision of the Arkansas Supreme Court, Stevenson v- Barnes,[[118]](#footnote-119)118 it was also held, in a split decision, that the implied development covenant had not been breached. The tract covered by the lease consisted of three contiguous 40-acre parcels lying on a north-south line. These tracts were about a mile northwest of producing wells, but prior to 1977 there had been no activity in the immediate vicinity of the lease. A test well (Well No. 1) was completed by the lessee in June, 1977, located in the northeast 10 acres of the southernmost 40-acres. It was characterized in the testimony as "very, very good", though it was producing only about 4 barrels a day in 1984.

The lessee then drilled a dry hole to the west of that 40 acres, on another lease. He then drilled Well No. 2 on the adjacent 10 acres to the north of the original well, which was non-economic and was converted into a salt-water disposal well. Well No. 3 on the lease was completed in November 1978 on the southeast 10 acres of the lease, and produced 4 barrels a day. Well No. 4, drilled to the north of Well No. 2, was non-economic. Well No. 5, drilled in the center of the south 40-acre tract, was producing only 1 barrel a day at the time the action was brought in 1984. The lessee testified that his drilling showed that No. 1 was high on the structure and that the active water drive would cause the ***oil*** to migrate to that well so that "we will eventually get it all.[[119]](#footnote-120)119 The lessee also testified that he needed to keep all of the acreage under this lease to the west of Well No- 1 because he needed all the ***oil*** he could recover from No. 1 to make the entire venture profitable. If that acreage were released and another operator drilled there he would probably obtain a several-barrel per day well that would drain some of the ***oil*** the lessee eventually hoped to recover through No. 1.

For purposes of ready visualization, the pattern of wells drilled is sketched on the following page, insofar as the well location can be determined from the opinion. All five wells on the lease had been drilled to the same formation (Nacatoch Sands), and the Court found that there had been ample development of this formation. The lessee's level of activity had been entirely different from those in a 1983 decision by the same court, Byrd v. Bradham,[[120]](#footnote-121)120 in which the lessee of 80 acres had done nothing in 28 years except to allow 5 acres to be unitized with a neighboring tract:

"Here, by contrast, the lessee of 120 acres has drilled five wells in the most promising part of the lease, with good production from two of them, and has shown why he would be unduly harmed by cancellation-

He has also developed the leasehold systematically and proceeded in every direction as far as is reasonably practical. We are convinced that his actions have complied with the implied covenant to develop the leasehold at the Nacatoch level.[[121]](#footnote-122)121

As to the deeper formations, where no development had occurred on any portion of the lease, the lease was cancelled, but this was not a major issue, as the lessee had already released his interests in the deeper formations except for the 10-acre tracts surrounding each of Wells No- 1 and 3, and he had conceded he did not have sufficient acreage to justify drilling a deeper well.

As with all the implied covenant cases, the court looked at the particular circumstances and decided that the lessor had been dealt with fairly and that it was only fair to allow the lessee to produce all the ***oil*** he could from this 120-acre tract through the four producing wells (No. 1, 3, 4 and 5, though No. 4 was not economic.) There is no specific discussion in the opinion as to whether another well could be drilled and return a reasonable profit after all costs. The test appears to have been what was equitable between the lessor and lessee in the circumstances, not whether any specific "rule of law" was to be applied.

What is fair is, of course, a subjective question, and two judges dissented in the Stevenson case. Making no distinction between "exploration" and "development," the dissent stated that there was a "duty to explore" the entire tract once paying quantities of ***oil*** were found on part of the tract. The lessee's testimony that he could produce all the ***oil*** from the lease with his existing wells was disputed by the testimony of the lessor's expert that each well could drain 10 acres and no more than 20 acres. The dissenting judges assumed that since ***oil*** had been found in Well No. 4, better possibilities might exist in the totally-unexplored north 40 acres, to the north of No. 4. In any case, they found the lessee's theory that he could drain this north 40-acre tract by Well No. 1, across No. 4 and through No. 2, which had been converted to salt-water disposal, to be inherently incredible. In their opinion the lessee should have been willing to release the north 40 acres:

"Stevenson has the duty to explore the entire tract which includes the north forty with reasonable diligence. This he has not done. He assumes the position that the further north he goes the less ***oil*** he will find and there would be nothing for him to gain in exploration of this area. We have held that if there is nothing gained then there is nothing to lose by cancellation of the lease.[[122]](#footnote-123)122

With respect to the western part of the two lower 40-acre tracts (erroneously referred to in the opinion as the "eastern portion"), however, the dissent finds a closer question, since there were producing wells in the eastern portions of these tracts- On the implicit basis that it would be unfair to require the lessor to wait many years to receive all her royalties, even if all the ***oil*** could be produced by the existing wells, the dissenting judges would have affirmed cancellation of all except 10 acres around each producing well:

"By allowing the lessee to hold the entire leasehold, Mrs. Barnes is being deprived of potentially 'receiving royalties from another arrangement' as discussed in Byrd, supra. On the other hand, if one assumes that the appellants' producing wells can eventually take all the ***oil*** in the leasehold, to take such ***oil*** over a twenty year or so period, deprives Mrs. Barnes of her royalties over an unreasonable period of time.[[123]](#footnote-124)123

Thus, fairness lies in the eye of the beholder- It does appear that the majority opinion may have been overzealous in its protection of the lessee as to the north 40 acres, which he appeared to have little interest in seeking to develop. With the uneconomic performance of Well No 4, it may be unduly speculative to hold the north 40-acre tract indefinitely. As the court pointed out in North York Land Associates v. Bryan ***Oil*** Industries, Inc.,[[124]](#footnote-125)124 where a lessee fails to drill because drilling is not profitable, the lease can nonetheless still be cancelled for failure to develop when the lessee continues to hold the lease in the general hope that changing economic conditions will make drilling profitable.

These three recent cases are illustrative of the many that could be discussed in terms of the courts' attempting to weigh all of the factors and reach a result that is basically fair to both lessor and lessee. Some courts have expressly stated what they are doing, as for example in Rook v. James E. Russell Petroleum, Inc.:[[125]](#footnote-126)125

"Since the discovery of ***oil*** and gas in this state, our courts have sought to balance the interests of the landowners and ***oil*** producers by promoting development with all reasonable speed-"

For the most part, however, this concept is simply implicit in how the court analyzes the case and reaches a result. It is instructive that in none of the three cases discussed in detail above, that is the Sun, Johnson and Stevenson cases, does the decision expressly hinge on the usual "rule" in implied development covenant cases that the lessor must show that a profitable well could have been drilled by the lessee. This is certainly a factor in the analysis, but the court may or may not expressly pay lip service to it and the real basis of the decision cannot be explained merely by the application of a mechanical rule. As Professor Merrill states, in drawing conclusions from his pioneering study of the implied covenants:

"Is not the real basis of the doctrine of implied covenants in ***oil*** and gas leases to be found in a theory of enforcing that conduct which, under the circumstances, fair dealing between lessor and lessee fairly demands that the latter pursue? Do not the conditions which have been reviewed justify the judicial imposition of that standard of conduct upon the lessee? ... That such is the basis in the minds of the courts seems to be the conclusion fairly resulting from the grounds which are advanced for the doctrine and the limitations which are placed upon it. ... [F]air dealing on the part of the lessee requires that he shall not disappoint the reasonable expectations of development which the taking of the lease engenders in the lessor. ... [T]he tests adopted for measuring the lessee's compliance with the duty imposed by the covenants demonstrate the bases of the covenants as an enforcement of what fair dealing under the circumstances requires of persons in the relation of lessor and lessee.[[126]](#footnote-127)126

Professor Kuntz makes similar observations:

"The doctrine is one of general application that is designed to determine what constitutes fair and reasonable dealing between any lessor and his lessee in the implementation of their general intention that the lessee is to develop the leased premises for their mutual advantage-

...

Such covenants are, indeed, a convenient means of describing what the courts consider to be customary and fair in a relation where one of two parties undertakes to explore, develop and operate ***oil*** and gas bearing land of the other party for the mutual advantage of both parties. By enforcing the "covenants," the courts are holding the parties to customary and reasonable incidents of their relation which are necessary to achieve the general objective contemplated by the parties. Although the term 'implied covenants' is still used widely as a convenient means of reference, there are many judicial statements which are wholly consistent with the analysis that the 'implied covenants' are not so much covenants as they are recognized incidents of the relation of ***oil*** and gas lessor-lessee.[[127]](#footnote-128)127

Thus the implied covenants may be seen as arising very naturally out of the nature of the ***oil*** and gas lease itself, which as "property" is conceptually defined in terms of the relationship created by the lease between the lessee and the lessor-[[128]](#footnote-129)128

**CONCLUSION**

It has been pointed out that there is no area of ***oil*** and gas law about which more has been written than the implied covenants arising under the lease.[[129]](#footnote-130)129 The author of this paper does not presume to have provided any original new thoughts on these matters- The purpose of this review has simply been to try to provide an overall perspective on the subject and to underscore the notion that the doctrines that have developed in this field should not be viewed as creating a narrow set of rules that can be mechanically applied to decide any particular case.

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1. 11 Williams & Meyers § 202.1. In Spaulding v. Porter, 31 P.2d 711, 716 (Colo. 1934), for example, the court characterized the field of ***oil*** and gas leases as "utterly different from the field of the ordinary landlord and tenant." [↑](#footnote-ref-2)
2. 2Kansas is virtually unique among the ***oil*** and gas producing states in regarding the ***oil*** and gas lease as creating an interest in personal property rather than real property. Connell v. Kanawa ***Oil***, Inc., 170 P.2d 631, 634 (Kan. 1946). [↑](#footnote-ref-3)
3. 3A precise distinction between "property" and a contractual right is difficult to make because the courts have used the term "property" very broadly. Property rights are "manifold rights against innumerable unidentified persons, operating as a constraint upon their action for the benefit of the 'property owner'." 4 Corbin, Contracts § 860, at 418 (1951). In Professor Corbin's words, therefore:

   "It is quite clear that by nobody's usage is a contract right one of these manifold property rights just specified. A contract right is a right against a particular and identifiable person, operating as a constraint upon his action only. We may start, therefore, with the assumption that a contract right is not a 'property' right." Id.

   The courts have termed contract rights to be property, however, in the sense that a contract right may be regarded as the subject matter of property rights. That is, a contract right is a "thing" which may be owned or assigned and which is entitled to be enjoyed by the owner without interference by other persons. Id. at 418-19. [↑](#footnote-ref-4)
4. 4E.g., Johnson v. Mineral Estate, Inc., 343 N.W.2d 778, 780, 81 O.&G.R. 316 (N.D. 1984); Edington v. Creek ***Oil*** Co., 690 P.2d 970, 974-75, \_\_\_\_ O.&G.R. \_\_\_\_\_ (Mont. 1984); Kuehne v. Samedan ***Oil*** Corp., 626 P.2d 1035, 1038-39, 70 O.&G.R. 94 (Wyo. 1981). [↑](#footnote-ref-5)
5. 5In Estate of Sellens v. Home State Bank, 637 P.2d 483, 486 (Kan. App. 1981), the court termed the ***oil*** and gas lease a "grant with conditions." [↑](#footnote-ref-6)
6. 6"The common ***oil*** and gas lease creates a determinable fee. It vests the lessee with title to the ***oil*** and gas in place. (citation omitted) It logically follows, and has long been held by this court, that an ***oil*** and gas lease is a sale of an interest in land." Cherokee Water Co. v. Forderhause, 641 S.W.2d 522, 525, 76 O.&G.R. 602 (Tex. 1982).

   Other jurisdictions have agreed. E.g., Koenig v. Calcote, 25 So.2d 763 (Miss. 1946); Shields v. Moffitt, 683 P.2d 530, 532-33, 81 O.&G.R. 151 (Okla. 1984), but cf.Cate v. Archon ***Oil*** Co., Inc., 695 P.2d 1352, 83 O.&G.R. 576 (Okla. 1985); Bolack v. Hedges, 240 P.2d 844, 1 O.&G.R. 372 (N.M. 1952). [↑](#footnote-ref-7)
7. 7Abandonment of a lease by the lessee would entail the combination of an intention to abandon with an actual physical relinquishment of the premises. E.g., Olson v. Schwartz, 345 N.W.2d 33, 36-38 (N.D. 1984). [↑](#footnote-ref-8)
8. 85 H. Williams & C. Meyers, ***Oil*** & Gas Law § 802, at 7 (1985) [hereinafter "Williams & Meyers"]. [↑](#footnote-ref-9)
9. 9Id. at 9. [↑](#footnote-ref-10)
10. 10Id. § 803, at 24. [↑](#footnote-ref-11)
11. 11Id. [↑](#footnote-ref-12)
12. 12Blackstone wrote that implied contracts "are such as reason and justice dictate, and which therefore the law presumes that every man has contracted to perform." 3 W. Blackstone, Commentaries \*158. [↑](#footnote-ref-13)
13. 13This distinction was the subject of considerable confusion in the historical development of the common law:

    "The transitional nature of the late eighteenth century is thus revealed in the failure of eighteenth century lawyers to perceive any latent theoretical contradictions involved in joining counts on express and implied contract. ... Two very different conceptions of contract were submerged within actions on the common counts. One was based on an express bargain between the parties; the other derived contractual obligation from 'natural justice and equity'."

    M. Horwitz, The Transformation of American Law, 1780-1860 172 (1977). [↑](#footnote-ref-14)
14. 14The process involves the interplay of what are somewhat contradictory goals of the legal system, as Professor Bodenheimer points out:

    "It may happen, for instance, that a judge in a litigated case will come to the conclusion that the application of a rule laid down on an earlier case will not do full justice to one of the parties. He may nevertheless decide to follow the precedent because he sets great store by legal certainty and stability. In that event a conflict arises between the key values of the legal system which is resolved in favor of an orderly, predictable administration of the law. ... On the other hand, it may also happen that a judge or other organ connected with the administration of the legal system will determine that orderly continuity must in a particular case yield to imperative requirements of justice. In that event the customary generality of law is sacrificed in a concrete situation to the need of dispensing an individualized justice. A departure from, or realization of, fixed norms is deemed necessary in the interest of justice, while order tends to favor regularity and invariant adherence to rules."

    E. Bodenheimer, Jurisprudence 149 (1974). [↑](#footnote-ref-15)
15. 15The notion of equity as a set of principles invested with a sacred quality and requiring application independent of the consent of any legislative body dates back to Roman law. H. Sumner Maine, Ancient Law 17, 34-35 (1906). For the medieval philosopher, "equity" and "eternity" would be nearly the same thing, "for what exists from time eternal is equitable and what is equitable must somehow be traceable back to the eternal order of things. The old law is reasonable and reasonable law is old." F. ***Kern***, Kingship and Law in the Middle Ages 152 (1968). [↑](#footnote-ref-16)
16. 16140 F. 801 (8th Cir. 1905). [↑](#footnote-ref-17)
17. 17Id. at 809-11. [↑](#footnote-ref-18)
18. 18M. Merrill, Covenants Implied in ***Oil*** and Gas Leases, 27-28 (2d ed. 1940). [↑](#footnote-ref-19)
19. 19Williams and Meyers properly criticize any attempt to impose a rigid formalism on the implied covenants:

    "Brown [E. Brown, The Law of ***Oil*** and Gas Leases] appears to treat his list of implied covenants like common law forms of action - any claim to relief that fails to fit one of his categories must be denied. It is to be hoped that the law has long since shed such formalism and that relief will be granted or denied in accordance with criteria established by the duty of cooperation and prudent-operator standard."

    5 Williams & Meyers § 804, at 25n.2. [↑](#footnote-ref-20)
20. 205 Williams & Meyers § 815, at 70. [↑](#footnote-ref-21)
21. 21Id. § 822. [↑](#footnote-ref-22)
22. 22Whitaker v. Texaco Inc., 283 F.2d 169, 175-76, 13 O.&G.R. 502 (5th Cir. 1960); 5 Williams & Meyers § 822. [↑](#footnote-ref-23)
23. 23The reasonably prudent operator standard as a test of performance by the lessee under all the implied covenants seems to have been first clearly articulated in Brewster v. Lanyon Zinc Co., 140 F. 801, 814 (8th Cir. 1905), cited above. It is universally held to be a part of all the implied covenants. E.g., Amoco Production Co. v. Alexander, 622 S.W.2d 563, 72 O.&G.R. 125 (Tex. 1981). [↑](#footnote-ref-24)
24. 24Shell ***Oil*** Co. v. James, 257 So.2d 488, 40 O.&G.R. 215 (Miss. 1971). [↑](#footnote-ref-25)
25. 255 William & Meyers § 822.1. [↑](#footnote-ref-26)
26. 26It should be kept in mind that the question is whether a reasonable profit could be made on the entire working interest, undiminished by partial assignments or conveyances of nonproducing interests carved out of the working interest. Berry v. Wondra, 246 P.2d 282, 1 O.&G.R. 1099 (Kan. 1952). (The fact that the assignee could not make a profit on his interest, which was subject to a 3/16 overriding royalty interest in that case, was not relevant; the test measures the income on the entire original working interest.) [↑](#footnote-ref-27)
27. 27Chapman v. Sohio Petroleum Co., 297 S.W.2d 885, 7 O.G.&R. 463 (Tex.Civ.App. 1956), held there was no breach of the drainage covenant because the market value of offset wells, if they had been drilled, would have been less than the cost of drilling and equipping. The market value was deemed to include an allowance for a reasonable profit. [↑](#footnote-ref-28)
28. 28In Berry v. Wondra, supra, Note 26, a breach of the reasonable development covenant (discussed below) was found when a well producing only seven barrels per day would pay out in two and one-half years. Williams and Meyers suggest that a shorter period, that is a stronger showing of profitability by the lessor, would be required by most courts. 5 Williams & Meyers § 822.2, at 93. They also suggest, however, that a longer payout period may suffice in drainage covenant cases, that is a lesser standard of profitability, than in development covenant cases, because drainage cases involve a permanent loss of minerals to the leasehold. [↑](#footnote-ref-29)
29. 295 Williams & Meyers § 822.3. The authors cite Pan American Petroleum Corp. v. Hardy, 370 S.W.2d 904, 19 O.&G.R. 604 (Tex.Civ.App. 1963), in support of their view, and distinguish Carter ***Oil*** Co. v. Dees, 92 N.E.2d 519 (Ill.App. 1950), which seems to hold the covenant is not breached if there is no net drainage away from the leasehold. [↑](#footnote-ref-30)
30. 305 Williams & Meyers § 822.4. They cite in support the well-known recent decision of the Texas Supreme Court in Amoco Production Co. v. Alexander, 622 S.W.2d 563, 72 O.&G.R. 125 (Tex. 1981), which held that the drainage covenant extends to field-wide drainage. Amoco had eighty per cent of the field production with leases both updip and downdip from Exxon's leases between Amoco's. The reservoir was a water-drive one, so that as the updip wells were produced the downdip wells would gradually water out. Field-wide drainage occurs away from the downdip leases to the updip leases. The court held that the drainage covenant required Amoco to protect downdip lessees from the field-wide drainage caused by Amoco's production from the updip leases. [↑](#footnote-ref-31)
31. 31A number of cases are cited in 5 Williams & Meyers § 824, at 123n.2. [↑](#footnote-ref-32)
32. 32Monsanto Chemical Co. v. Andreae, 147 So.2d 116, 18 O.&G.R. 875 (Miss. 1962); Breaux v. Pan American Petroleum Corp., 163 So.2d 406, 417, 20 O.&G.R. 476 (La. App. 1964) ("We conclude, therefore, that plaintiffs in this suit have no greater rights and no different cause of action against defendants-lessees simply because the defendants are also the lessees, of the adjoining tract of land on which the alleged draining well is located."); Williams v. Humble ***Oil*** & Refining Co., 290 F.Supp. 408, 32 O.&G.R. 632 (E.D.La. 1968); 5 Williams & Meyers § 824, at 126-29. [↑](#footnote-ref-33)
33. 33Many cases are cited in 5 Williams & Meyers § 824, at 129n.7. [↑](#footnote-ref-34)
34. 34E.g.Phillips Petroleum Co. v. Millette, 72 So.2d 176, 3 O.&G.R. 803 (Miss. 1954); Cook v. El Paso Natural Gas Co., 560 F.2d 978, 58 O.&G.R. 206 (10th Cir. 1977) (construing New Mexico law); Pinson v. Depco, Inc., 602 F.Supp. 27, 83 O.&G.R. 391 (D.S.D. 1985) (holding that the reasonably prudent operator requirement would impose an unreasonable burden on the lessor in such a case); Bush ***Oil*** Co. v. Beverly-Lincoln Land Co., 158 P.2d 754 (Cal.App. 1945). [↑](#footnote-ref-35)
35. 355 Williams & Meyer § 824, at 132. [↑](#footnote-ref-36)
36. 36The basic holding is in the second Millette decision, Millette v. Phillips Petroleum Co., 72 So.2d 176, 3 O.&G.R. 803 (Miss. 1954), in which the doctrine was actually not based on the usual drainage covenant but rather on an implied duty of the lessee to protect the interests of the lessor against depletion by the acts of the lessee upon adjacent property. The court relied heavily on the Bush ***Oil*** Co. case from California cited in Note 34, supra. [↑](#footnote-ref-37)
37. 37Monsanto Chemical Co. v. Andreae, 147 So.2d 116, 18 O.&G.R. 875 (Miss. 1962), and Monsanto Chemical Co. v. Sykes, 147 So.2d 290, 18 O.&G.R. 884 (Miss. 1962), in the opinion of Williams and Meyers, "severely limit" the Millette doctrine. In these cases, the court finds no liability because there was no substantial drainage, but equates the requirement for substantial drainage with the requirement that the offset well be capable of producing in paying quantities. The court also points out that in Millette the lessee refused to drill, or to farm out or to release the lease, whereas in the Monsanto cases the lessee either farmed out the lease for drilling an offset well or drilled an unsuccessful offset well and then farmed out for drilling another well. Thus:

    "[I]n view of the foregoing, it seems probable that the rule of the second Millette case is no longer law in Mississippi and that a lessor must prove that a protection well will be profitable before he can recover damages for breach of the protection covenant, even though the lessee is causing the drainage. It is clear that this is true where lessee makes an effort to protect, as by farming out the lease; it seems likely to be true in all cases, although the Monsanto cases are not square holdings where the lessee refuses either to release or to make efforts to secure a protection well." 5 Williams & Meyers § 824, at 136.

    In Shell ***Oil*** Co. v. James, 257 So.2d 488, 40 O.&G.R. 215 (Miss. 1971), on the other hand, the court, citing its decision in Millette, held that the common lessee has the duty to protect the lessor by drilling an offset well if there is a "substantial amount" of ***oil*** and gas in place. The court seems to suggest that this is equivalent to saying that a well would return a profit, so perhaps the lessor still does have to show that a profitable offset well could be drilled in Mississippi. The court in Shell ***Oil*** distinguishes Monsanto Chemical Co. v. Andreae, supra, on the grounds there was no evidence of substantial ***oil*** and gas in place in that case. [↑](#footnote-ref-38)
38. 38This is the point made in Williams & Meyers § 824.1, § 824.2, where the authors examine the historical development of the "fraudulent drainage" theory and find that the early cases relied on as the origin of the doctrine do not support it at all. [↑](#footnote-ref-39)
39. 39Id. § 824.2, at 147-48. This proposal by Williams and Meyers to shift the burden of proof of lack of profitability to the common lessee was expressly approved and adopted by the federal court as the rule that would probably prevail in Kansas in Seacat v. Mesa Petroleum Co., 561 F.Supp. 98 (D.Kan. 1983), in which the court found the reasoning in the cases supporting the Millette doctrine to be weak and unsound. The lessee is in the better position anyway in these cases to be able to carry this burden since he is doing the draining and will have superior knowledge of the reservoir behavior. Dixon v. Anadarko Production Co., 505 P.2d 1394, 44 O.&G.R. 397 (Okla. 1973).

    It is not only unfairness by the lessee that should be a concern. The implied covenants may allow the lessor to be less than totally fair in his dealings as well. As one commentator states, "[O]ne must recognize that implied covenant demands are not infrequently simply convenient devices to aid lessors in seeking to unburden themselves from leases they do not regard as being to their maximum advantage." Donohoe, "Implied Covenants in ***Oil*** and Gas Leases and Conservation Practice," 33 Inst. on ***Oil*** & Gas Law & Tax'n 97, 100 (1982). [↑](#footnote-ref-40)
40. 40See 5 Williams & Meyers § 825, citing many cases. [↑](#footnote-ref-41)
41. 41Id. § 825.1. In Oklahoma, a decree of "horizontal cancellation" may be entered, that is cancellation as to certain formations being drained. Barnes v. Mack ***Oil*** Co., 376 P.2d 279, 17 O.&G.R. 538 (Okla. 1962). This is presumably possible in other states as well. [↑](#footnote-ref-42)
42. 425 Williams & Meyers § 825.2. In Texas, cancellation is not available unless the lessor proves that damages are impossible to determine. Christie, Mitchell & Mitchell Co. v. Howell, 359 S.W.2d 658, 17 O.&G.R. 420 (Tex.Civ.App. 1962). [↑](#footnote-ref-43)
43. 43E.g., Williams v. Humble ***Oil*** & Refining Co., 432 F.2d 165, 38 O.&G.R. 212 (5th Cir. 1970) (construing Louisiana law); 5 Williams & Meyers § 826.3, at 207. In Shell ***Oil*** Co. v. Stansbury, 401 S.W.2d 623, 25 O.&G.R. 559 (Tex.Civ.App. 1966), the court held in any case that in the common lessee context an express offset clause did not limit the implied covenant to drill an offset well. [↑](#footnote-ref-44)
44. 44See Pickerill, "Is There a New Implied Covenant of Explorvelopment?," 32 Inst. on ***Oil*** & Gas Law & Tax'n 245 (1980). [↑](#footnote-ref-45)
45. 45There may, of course, be cases where delay in drilling will result in permanent loss of recoverable hydrocarbons, as where failure to drill promptly to the ***oil***-producing zone in a gas cap field leaves ***oil*** in the formation due to pressure depletion, or where failure to drill promptly on updip leases in a water drive field prevents the maximum potential recovery from updip wells. Early cases on the implied covenant of reasonable development tended to rely on the notion of abandonment by the lessee to reach results that would now be characterized as a breach of the implied covenant. Rook v. James E. Russell Petroleum, Inc., 679 P.2d 158, 80 O.&G.R. 471 (Kan. 1984). This created considerable confusion in the analysis since the two concepts are not the same. See M. Merrill, Covenants Implied in ***Oil*** and Gas Leases, § 8, § 9 (2d ed. 1940). [↑](#footnote-ref-46)
46. 46Wilds v. Universal Resources Corp., 662 P.2d 303, 76 O.&G.R. 291, (Okla. 1983); State v. Worden, 103 P.2d 124 (N.M. 1940). [↑](#footnote-ref-47)
47. 47Fischer v. Magnolia Petroleum Co., 133 P.2d 95 (Kan. 1943). During any period when delay rentals are payable imposition of the development covenant would contradict the "unless" clause. Warm Springs Development Co. v. McAulay, 576 P.2d 1120, 60 O.&G.R. 516 (Nev. 1978). [↑](#footnote-ref-48)
48. 48Arkansas ***Oil*** & Gas, Inc. v. Diamond Shamrock Corp., 662 S.W.2d 824, 81 O.&G.R. 20 (Ark. 1984); 5 Williams & Meyers § 832, at 223. [↑](#footnote-ref-49)
49. 49Temple v. Continental ***Oil*** Co., 320 P.2d 639, 8 O.&G.R. 717 (Kan. 1958) (eighteen months); Berry v. Wondra, 246 P.2d 282, 1 O.&G.R. 1099 (Kan. 1952) (2 3/4 years); Fischer v. Magnolia Petroleum Co., 133 P.2d 95 (Kan. 1943) (six years). It has been suggested that the proper payout period may be shorter than for drainage cases, i.e. that a prudent operator may be entitled to a larger profit on development wells than he is on offset wells which are required to prevent permanent loss of hydrocarbons. 5 Williams & Meyers § 832.2, at 228. [↑](#footnote-ref-50)
50. 505 Williams & Meyers § 832.2 [↑](#footnote-ref-51)
51. 51The force majeure clause would also protect the lessee in this situation and excuse compliance with the implied covenant if another well is prohibited by a well spacing order. There may be a duty, however, to seek a variance for the drilling of a second well on the spacing unit. See Note 90 infra. [↑](#footnote-ref-52)
52. 52Mountain States ***Oil*** Corp. v. Sandoval, 125 P.2d 964 (Colo. 1942) (14-year lapse between wells); Temple v. Continental ***Oil*** Co., 320 P.2d 1039, 8 O.&G.R. 717 (Kan. 1958). [↑](#footnote-ref-53)
53. 535 Williams & Meyers § 832.2, at 231. [↑](#footnote-ref-54)
54. 54Id. § 834; Slaughter v. Cities Service ***Oil*** Co., 660 S.W.2d 860, 79 O.&G.R. 335 (Tex.Civ.App. 1983) (in which the court states that a case might arise where the facts are so bad that only unconditional cancellation will do justice, but that it had not found such a case in Texas); Vickers v. Vining, 452 P.2d 798, 32 O.&G.R. 678 (Okla. 1969); Meaher v. Getty ***Oil*** Co., 450 So.2d 443, 82 O.&G.R. 1 (Ala. 1984) (cancellation is unavailable unless the remedy at law is wholly inadequate). [↑](#footnote-ref-55)
55. 55Olson v. Schwartz, 345 N.W.2d 33, 81 O.&G.R. 105 (N.D. 1984); Kuehne v. Samedan ***Oil*** Corp., 626 P.2d 1035, 70 O.&G.R. 94 (Wyo. 1981); Superior ***Oil*** Co. v. Devon, 604 F.2d 1063, 65 O.&G.R. 368 (8th Cir. 1979) (stating that this is the general rule in the United States). Demand is not necessary if it can be shown that it would have been futile. Amoco Production Co. v. Douglas Energy Co., Inc., 613 F.Supp. 730, 85 O.&G.R. 466 (D.Kan. 1985). [↑](#footnote-ref-56)
56. 56Rook v. James E. Russell Petroleum, Inc., 679 P.2d 158, 80 O.&G.R. 471 (Kan. 1984) (fifteen-year time lapse, coupled with removal of equipment and no physical presence of lessee on the land after 1972). [↑](#footnote-ref-57)
57. 57Kothe v. Jefferson, 455 N.E.2d 73, 79 O.&G.R. 513 (Ill. 1983); Meaher v. Getty ***Oil*** Co., 450 So.2d 443, 82 O.&G.R. 1 (Ala. 1984); but cf.Arkansas ***Oil*** & Gas, Inc. v. Diamond Shamrock Corp., 662 S.W. 284, 81 O.&G.R. 20 (Ark. 1984), where the Court states that "the duty to explore extends to the entire tract." [↑](#footnote-ref-58)
58. 585 Williams & Meyers § 834, at 251. [↑](#footnote-ref-59)
59. 59Id. § 834, at 252-55. [↑](#footnote-ref-60)
60. 60Id. § 835.2. They cite Amerada Petroleum Co. v. Doering, 93 F.2d 540 (5th Cir. 1937), as authority that the shut-in royalty clause is not inconsistent with the development covenant. The acceptance by the lessor of shut-in royalty, therefore, as a substitute for actual production, does not constitute a waiver of his cause of action for breach of the development covenant. [↑](#footnote-ref-61)
61. 615 Williams & Meyers § 835.3. SeeGulf Production Co. v. Kishi, 103 S.W.2d 695 (Tex. 1937), for an example where this was in fact the case, so that no additional development obligation could be implied. In Devine v. Ladd Petroleum Corp., 743 F.2d 745, 82 O.&G.R. 103 (10th Cir. 1984), the Court held the express agreement to be inapplicable to the tract in question. [↑](#footnote-ref-62)
62. 62Meaher v. Getty ***Oil*** Co., 450 So.2d 443, 82 O.&G.R. 1 (Ala. 1984); Amoco Production Co. v. Douglas Energy Co., Inc., 613 F.Supp. 730, 85 O.&G.R. 466 (D.Kan. 1985). [↑](#footnote-ref-63)
63. 63Charles Meyers was the commentator who first clearly articulated this covenant and his treatise elaborates on it in great detail. See Meyers, "The Implied Covenant of Further Exploration," 34 Tex.L.Rev. 553 (1956); 5 Williams & Meyers § 841 - § 852. One writer has suggested that the courts are reaching for some concept that lies somewhere between development and exploration:

    "Exploration and development are difficult concepts to delineate with specificity, as hopefully this article has delineated. Rank 'wildcat' drilling is a recognized entity in the ***oil*** and gas industry, but there still exists a gray area between exploration and development as to how close known production must come to the lease before drilling becomes an unacceptable risk. ... Perhaps it can be said that the courts are only stretching the implied covenant to further develop deeper into the gray area which is neither development by definition nor exploration by definition, but explorvelopment."

    Pickerill, "Is There a New Implied Covenant of Explorvelopment?" 31 Inst. on ***Oil*** & Gas Law & Tax'n 245, 291-92 (1980). [↑](#footnote-ref-64)
64. 645 Williams & Meyers § 841. [↑](#footnote-ref-65)
65. 655 Williams & Meyers § 841, at 266.2(1) - 266.3. In Gillette v. Pepper Tank Co., 694 P.2d 369, 83 O.&G.R. 271 (Colo. App. 1984), the Court adds to this list the willingness of another operator to drill, which is certainly relevant, assuming he would actually be able to do so. See 5 Williams & Meyers, § 843.6. [↑](#footnote-ref-66)
66. 66Garcia v. King, 164 S.W.2d 509 (Tex. 1942). [↑](#footnote-ref-67)
67. 675 Williams & Meyers § 842.2, § 842.3, citing Doss ***Oil*** Royalty Co. v. Texas Co., 137 P.2d 934 (Okla. 1943), as the landmark case. [↑](#footnote-ref-68)
68. 68Id. at 938. The lessee in the Doss case had held the undeveloped portions of the lease for fourteen years without further drilling. [↑](#footnote-ref-69)
69. 69See Merrill, "The Implied Covenant for Further Exploration," 4 Rocky Mtn. Min. Law Inst. 205 (1958). [↑](#footnote-ref-70)
70. 705 Williams & Meyers § 843.1, at 287-89. [↑](#footnote-ref-71)
71. 71Id. at 291-93. [↑](#footnote-ref-72)
72. 72Sinclair ***Oil*** and Gas Co. v. Masterson, 271 F.2d 310, 11 O.&G.R. 632 (5th Cir. 1959); Sinclair ***Oil*** & Gas Co. v. Bishop, 441 P.2d 436, 30 O.&G.R. 614 (Okla. 1967). [↑](#footnote-ref-73)
73. 735 Williams & Meyers § 844. [↑](#footnote-ref-74)
74. 74Humble ***Oil*** & Refining Co. v. Romero, 194 F.2d 383, 1 O.&G.R. 358 (5th Cir. 1952) (sixty days); Fontenot v. Texas Co., 266 F.2d 956, 10 O.&G.R. 771 (5th Cir. 1959) (ninety days); Sinclair ***Oil*** and Gas Co. v. Masterson, 271 F.2d 310, 11 O.&G.R. 632 (5th Cir. 1959) (requiring six wells in a year, three during the first six months). [↑](#footnote-ref-75)
75. 75Webb v. Croft, 244 P. 1033 (Kan. 1926). [↑](#footnote-ref-76)
76. 765 Williams & Meyers § 845. [↑](#footnote-ref-77)
77. 77Clayton v. Atlantic Refining Co., 150 F.Supp. 9, 7 O.&G.R. 1426 (D.N.M. 1957); Meagher v. Unitah Gas Co., 185 P.2d. 747 (Utah 1947); Superior ***Oil*** Co. v. Devon Corp., 458 F.Supp. 1063, 61 O.&G.R. 61 (D.Neb. 1978); Olson v. Schwartz, 345 N.W.2d 33, 81 O.&G.R. 105 (N.D. 1984). [↑](#footnote-ref-78)
78. 78Skelly ***Oil*** Co. v. Scoggins, 329 S.W.2d 424, 12 O.&G.R. 163 (Ark. 1959); Gillette v. Pepper Tank Co., 394 P.2d 369, 83 O.&G.R. 271 (Colo.App. 1984); Webb v. Croft, 244 P. 1033 (Kan. 1926) (Kansas also has a statute, since 1983, the so-called "Deep Horizons," or "Deep Rights" legislation, deeming the covenant breached if horizons below the deepest producing formation have not been explored after fifteen years. See Amoco Production Co. v. Douglas Energy Co.. Inc.supra, at Note 62.); Cameron v. Lebow, 338 S.W.2d 399, 14 O.&G.R. 531 (Ky. 1960) (using the abandonment theory); Sohio Petroleum Co. v. Miller, 112 So.2d 695, 13 O.&G.R. 250 (La. 1959). [↑](#footnote-ref-79)
79. 79Mitchell v. Amerada Hess Corp., 638 P.2d 441, 449 (Okla. 1981) ("There is no implied covenant to further explore after paying production is obtained, as distinguished from the implied covenant to further develop."); Cf.Doss ***Oil*** Royalty Co. v. Texas Co., 137 P.2d 934 (Okla. 1943); 5 Williams & Meyers § 845.5, at 348.3. [↑](#footnote-ref-80)
80. 80Sinclair ***Oil*** & Gas Co. v. Masterson, 271 F.2d 310, 11 O.&G.R. 632 (5th Cir. 1959); Clifton v. Koontz, 325 S.W.2d 684, 10 O.&G.R. 1109 (Tex. 1959); 5 Williams & Meyers § 845.6. The authors also separately discuss Illinois, Mississippi and Ohio, all of which they conclude support the exploration covenant, more or less strongly. Id. § 845.7 - § 845.9. [↑](#footnote-ref-81)
81. 81Id. § 846. With respect to all of the implied covenants, the use of appropriate express clauses can be an effective tool for guarding against the risk of lease cancellation under an implied covenant:

    "Bearing in mind that express lease provisions override implied covenants, the inclusion of well-drafted dry hole, continuous operations, cessation of production, nonforfeiture, offset obligation, shut-in gas royalty, and force majeure clauses assume great importance in the light of the foregoing cases. In an era where the lessors are also increasingly concerned about and ever more sophisticated with respect to lease provisions favorable to them, it will not always be easy to obtain the lease desired, but to reduce the risk of future cancellation, a conscious effort should be made in every instance." Woodruff, "Lessees Under Siege: Recent Cases Involving Attempts to Terminate Producing Leases," 32 Inst. on ***Oil*** & Gas Law & Tax'n 187, 239 (1981).

    With respect to express lease clauses, a court may, in the exercise of its equitable powers, grant cancellation of a lease for flagrant and continued violation of the express clause. Thurner v. Kaufman, 699 P.2d 435, 85 O.&G.R. 119 (Kan. 1984) (clause concerning surface usage). [↑](#footnote-ref-82)
82. 825 Williams & Meyers § 854; Barby v. Cabot Corp., 550 F.Supp. 188, 74 O.&G.R. 313 (W.D. Okla. 1981). [↑](#footnote-ref-83)
83. 835 Williams & Meyers § 855. Even if the lessee is dilatory, if the product could not have been marketed in any case then he cannot, of course, be held to have breached the marketing covenant. Bristol v. Colorado ***Oil*** & Gas Corp., 225 F.2d 894, 5 O.&G.R. 50 (10th Cir. 1955). [↑](#footnote-ref-84)
84. 845 Williams & Meyers § 856.2. [↑](#footnote-ref-85)
85. 85Gazin v. Pan-American Petroleum Corp., 367 P.2d 1010, 16 O.&.G.R. 1009 (Okla. 1962). [↑](#footnote-ref-86)
86. 865 Williams & Meyers § 856.4. This result would also follow from application of the force majeure clause, under which compliance with governmental restrictions would excuse compliance with any inconsistent implied covenant. [↑](#footnote-ref-87)
87. 87Id. § 857. The monetary measure of damages is subject to the same problem of possible double recovery because the lessor will receive royalty when the product is eventually marketed. Id., at 417. [↑](#footnote-ref-88)
88. 88Id., at 416.4. [↑](#footnote-ref-89)
89. 89Id. § 861, § 869, at 468-69. See Lopez & Parsley, "Microbes, Simulators, and Satellites; The Prudent Operator Pursues Enchanced Recovery Under the Implied Covenants," 58 N.D.L.Rev. 501 (1982). [↑](#footnote-ref-90)
90. 90A number of decisions have recognized such a duty. E.g.Spaeth v. Union ***Oil*** Co., 710 F.2d 1455, 77 O.&G.R. 142 (10th Cir. 1983) (lessee had duty to seek administrative relief from a spacing order in a drainage covenant case); Amoco Production Co. v. Alexander, 622 S.W.2d 563, 72 O.&G.R. 125 (Tex. 1981) (lessee had duty to seek exception locations to protect lessor against fieldwide drainage); Sinclair ***Oil*** & Gas Co. v. Bishop, 441 P.2d 436, 30 O.&G.R. 614 (Okla. 1967) (administrative relief from gas flaring restriction should have been sought). This duty does not appear to be recognized in Arkansas. Amoco Production Co. v. Ware, 602 S.W.2d 620, 68 O.&G.R. 416 (Ark. 1980). Generally, however, there appears to be an increasing willingness of courts to recognize such an obligation. Donohoe, "Implied Covenants in ***Oil*** and Gas Leases and Conservation Practice," 33 Inst. on ***Oil*** & Gas Law & Tax'n 97, 112 (1982). [↑](#footnote-ref-91)
91. 916 Williams & Meyers § 955. The discussion of the effect of pooling and unitization here is based on the analysis by Williams and Meyers. [↑](#footnote-ref-92)
92. 92In the case of either pooling or field-wide unitization, this concept is often characterized by stating that there is no duty to protect against drainage across interior boundary lines in the unit. SeeSouthland Royalty Co. v. Humble ***Oil*** & Refining Co., 249 S.W.2d 914, 1 O.&G.R. 1431 (Tex. 1952). [↑](#footnote-ref-93)
93. 936 Williams & Meyers § 955.2, at 731-32. The situation may become more complicated if portions of the leased tract lie in several different contiguous units. [↑](#footnote-ref-94)
94. 94As far as pooling is concerned, of course, the unit normally is a single spacing unit so that it could contain only one well, unless an exception is granted. For fieldwide unitization there will often be express development provisions in the unitization plan, which will displace the implied covenants. Id. at 734. [↑](#footnote-ref-95)
95. 95E.g.Mize v. Exxon Corp., 640 F.2d 637, 69 O.&G.R. 437 (5th Cir. 1981); Jones v. Bronco ***Oil*** & Gas Co., 446 So.2d 611, 81 O.&G.R. 1 (Ala. 1984); Hunter Co. v. Shell ***Oil*** Co., 31 So.2d 10 (La. 1974). [↑](#footnote-ref-96)
96. 96Thus in Gregg v. Harper-Turner ***Oil*** Co., 199 F.2d 1, 5, 1 O.&G.R. 1685 (10th Cir. 1952), the court stated: "Their responsibilities as lessors become correspondingly greater toward the excluded acreage than it was before severing by unitization." In 6 Williams & Meyers § 955.3 a number of cases are cited which seem to attach no particular significance to the fact of pooling or unitization. [↑](#footnote-ref-97)
97. 97715 S.W.2d 199 (Tex.App. 1986). [↑](#footnote-ref-98)
98. 98It is important to keep in mind that the location of the lease within the ***oil***-producing areas of the United States will necessarily have a bearing on the requirements imposed by the implied covenants. By the standards applicable to North Dakota, for example, these production statistics are enormous, but the situation in Texas would be quite different. [↑](#footnote-ref-99)
99. 99Presumably the difficulty revolved around surface damage compensation, as Sun would normally have the right under its lease to conduct seismic operations. [↑](#footnote-ref-100)
100. 100715 S.W.2d at 201-02. [↑](#footnote-ref-101)
101. 101715 S.W.2d at 202. [↑](#footnote-ref-102)
102. 102325 S.W.2d 684, 696 (Tex. 1959) ("[T]here is no implied covenant to explore as distinguished from the implied covenant to conduct additional development after production in paying quantities has been obtained.") [↑](#footnote-ref-103)
103. 103See Note 80, supra. It is important in this area, as in any field of law, to bear in mind that what the courts say sometimes does not precisely conform to what they do. [↑](#footnote-ref-104)
104. 104715 S.W.2d at 203. [↑](#footnote-ref-105)
105. 105Id. [↑](#footnote-ref-106)
106. 106Id. at 206. [↑](#footnote-ref-107)
107. 107Id. [↑](#footnote-ref-108)
108. 108This was Sinclair ***Oil*** & Gas Co. v. Masterson, 271 F.2d 310 (5th Cir. 1959). [↑](#footnote-ref-109)
109. 109The problem of development of only a small area of a very large lease is often mitigated in modern leases by the inclusion of Pugh clauses, so that production within the small area will not hold the undeveloped portions of the lease. [↑](#footnote-ref-110)
110. 110392 N.W.2d 55 (N.D. 1986). [↑](#footnote-ref-111)
111. 111Id. at 56. [↑](#footnote-ref-112)
112. 112Id. at 57. [↑](#footnote-ref-113)
113. 113Id. [↑](#footnote-ref-114)
114. 114Id. at 58. [↑](#footnote-ref-115)
115. 115Id. at 60. [↑](#footnote-ref-116)
116. 116Id. [↑](#footnote-ref-117)
117. 117Id. at 61. This language is quoted by the Court from Shell ***Oil*** Co. v. Howell, 258 P.2d 661, 665 (Okla. 1953). [↑](#footnote-ref-118)
118. 118702 S.W.2d 787 (Ark. 1985). [↑](#footnote-ref-119)
119. 119Id. at 788. [↑](#footnote-ref-120)
120. 120655 S.W.2d 366, 78 O.&G.R. 1 (Ark. 1983). [↑](#footnote-ref-121)
121. 121702 S.W.2d at 788. [↑](#footnote-ref-122)
122. 122Id. at 789. [↑](#footnote-ref-123)
123. 123Id. at 790. [↑](#footnote-ref-124)
124. 124695 P.2d 1188, 84 O.&G.R. 69 (Colo. App. 1984). [↑](#footnote-ref-125)
125. 125658 P.2d 1059, 76 O.&G.R. 51 (Kan. App. 1983). [↑](#footnote-ref-126)
126. 126M. Merrill, Covenants Implied in ***Oil*** and Gas Leases 469-71 (2d ed. 1940) [↑](#footnote-ref-127)
127. 1275 E. Kuntz, The Law of ***Oil*** and Gas § 54.3, at 4-6. [↑](#footnote-ref-128)
128. 128The common law theory of ownership of private property is based on the relationship between the owner and all other persons. Oliver Wendall Holmes defined a legal right as follows:

     "A legal right is nothing but a permission to exercise certain natural powers, and upon certain conditions to obtain protection, restitution, or compensation by the aid of the public force. Just so far as the aid of the public force is given a man, he has a legal right....

     ...

     But what are the rights of ownership? ... Within the limits prescribed by policy, the owner is allowed to exercise his natural powers over the subject-matter uninterfered with, and is more or less protected in excluding other people from such interference. The owner is allowed to exclude all, and is accountable to no one."

     O. W. Holmes, The Common Law 214, 246 (1881). [↑](#footnote-ref-129)
129. 129Donohoe, "Implied Covenants in ***Oil*** and Gas Leases and Conservation Practice, 33 Rocky Mt. Min. L. Inst. 97 (1982).

     This paper is a draft of the final article which will appear in 32 Rocky Mt. Min. L. Inst. (1986). [↑](#footnote-ref-130)