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BREACH OF THE IMPLIED COVENANT IN AN OIL AND GAS LEASE

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Time and education have effected constant changes upon the interpretation of the law. The implied covenants in oil and gas law have been changing color in the eyes of the courts ever since 1859, when Colonel Drake's spring brought forth black mud instead of salt water for his livestock. It is the hope of the author that this article will serve, not to predict Colorado decision, but rather to point out some of the significant factors to be considered by the lawyer in his approach to the implied covenant of modern day oil and gas law.

WHAT ARE IMPLIED COVENANTS [1]

The production of petroleum is unique from most types of business in that it is but rarely performed by the party with the original right to do so. The need for specialized equipment and technical knowledge compels the land owner to seek an agreement with a party of these technical qualifications, generally known as an operator. The exclusive right to explore for, exploit, and market petroleum is granted to the operator, in return for which the land owner generally provides himself with remuneration in such forms as rent on the property, bonus for the execution of lease, and a percentage royalty of the proceeds from the sale of production.

The contract medium through which this agreement is effected is an oil and gas lease. Though not germane to the immediate discussion, it should be mentioned that the courts of Texas today view this instrument as a deed creating a determinable fee simple estate.[2] Notwithstanding the various opinions as to the interests, corporeal or incorporeal, created by the different types of granting clauses in the lease, it is generally conceded that the interest of the so-called lessee or operator is an interest in land subject to the recording acts, Statute of Frauds,[3] and the homestead acts.[4]

The early leases and, to a great extent, those of today contain no express covenants as to specific methods of development and lease operation to which the lessee must adhere. Nor would it be practical to agree in advance on a specific method for the develop-

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[1] Merrill, COVENANTS IMPLIED IN OIL AND GAS LEASES (2nd Edition 1940); Summers, THE LAW OF OIL AND GAS (2nd Edition 1938), Sec. 391, *et seq.*; Thornton, OIL AND GAS—WILLIS' (5th Edition), Sec. 503, *et seq.*

[2] Walker, *Nature of Property Interests Created by an Oil and Gas Lease;* 7 TEX. LAW REV. 554.

[3] Robinson v. Smalley, 102 Kan. 842, 171 P. 1155.

[4] Carter Oil Co. v. Popp, 70 Okl. 232, 174 P. 747.

ment of such uncertainties as subsurface oil and gas structures. The courts recognized this practical reason for the absence of express covenants, and as a result invoked equity upon the lessee to proceed with the diligence and care of a reasonably prudent operator. The lessor had granted away his legal right to develop the land, hence it seemed only fair that his remaining equitable interest should be given some protection. From this obligation there evolved a set of implied promises, more commonly known today as the implied covenants of the oil and gas lease. It has become customary to speak of these covenants as independent or separate obligations, but in reality they are simply part of the overall duty of the lessee, namely, to conduct operations as would a reasonably prudent operator.[5] Stated briefly there are five implied promises incumbent on the lessee in an oil and gas lease:

I. To drill an exploratory well.
II. To develop the premises with reasonable diligence after the discovery of oil or gas in paying quantities.
III. To operate the lease prudently.
IV. To market the product promptly.
V. To protect the premises against substantial drainage.

It must always be remembered that the foregoing implied covenants are necessary contributions by the courts and serve as an interpretation of the intention of parties who have remained silent on the subject of the implied covenant. Since impled covenants arise from necessity and from the absence of express covenants, it is obvious that the parties can avoid the implication of a particular covenant by express agreement.[6] For example, the first of the implied covenants, to drill, is practically extinct today, because the modern lease has expressly excluded any implication to drill during the primary term. The lessee generally has an election to drill or pay delay rentals to the lessor during the primary term of the lease. In like manner, the scope of the other implied covenants has been limited by such express provisions as the "shut in" clause in the marketing of gas, the designation of a certain depth formation from which production is sought, and definite footage limits from the edge of premises to determine lessee's duty of offset, regardless of drainage. However, for the purpose of this discussion, the implied covenants will be examined as if the lease contained no express covenants of limitation.

The remainder of this article will be devoted to the examination of the covenants with regard to the rights and duties arising under such covenants and to the remedies for breach of the same.

I. To Drill For An Exploratory Well

The early leases were generally given for a specific period of

[5] Davis v. Riddle, 25 Colo. 162, 136 P. 551 (1913).
[6] Gulf Production Co. v. Kishi, 129 Tex. 487, 103 S. W. (2d) 965.

time with no provisions for mandatory exploration or lease renewal. This was fair neither to the lessor who had granted away his right to explore, nor to the lessee who might have made a discovery after heavy exploration cost only to lose it on termination day of the lease. The courts therefore imposed an obligation on the lessee to drill an exploratory well within a reasonable time after the lease had been executed [7] or suffer damages and even possible forfeiture if damages proved inadequate. This resulted in a sequence of clauses being inserted in the lease imposing duties on the giving various rights to the parties. These included the "thereafter" clause, the "drill or pay" clause, and the "unless" clause. The end product of this sequence is our present day "habendum" clause with a limitation in the form of an "unless" clause:

A. The "Habendum" Clause
TO HAVE AND TO HOLD the same (subject to the other provisions herein contained) for a term of ten years from this date (called the "primary term") and as long thereafter as oil or gas or casinghead gas or either or any of them, is produced therefrom; or as much longer thereafter as the lessee in good faith shall conduct drilling operations thereon and, should production result from such operations, this lease shall remain in full force and effect as long as oil or gas or casinghead gas, shall be produced therefrom.

B. The "Unless" Clause
If operations for the drilling of a well for oil or gas are not commenced on said land on or before one year from this date, this lease shall terminate as to both parties, unless the lessee shall, on or before one year from this date, pay or tender to the lessor or for the lessor's credit in.....bank at.....or its successor or successors, which bank and its successors are lessor's agent and shall continue as depository regardless of changes in ownership of the land, the sum of .....dollars which shall operate as a rental and cover the privileges of deferring the commencement of operations for the drilling of a well one year from said date. In like manner and upon like payments or tenders the commencement of operations for the drilling of a well may be further deferred for like periods successively during the primary term of this lease. And it is understood and agreed that the consideration first recited herein, the down payment, covers not only the privileges granted to the date when said rental is payable as aforesaid, but also the lessee's option of extending that period as aforesaid, and any and all other rights conferred. All payments or tenders may be made by check or draft of lessee or any assignee thereof, mailed or delivered on or before the rental paying date.

[7] Davis v. Riddle, supra, note 5.

The effect of the "unless" clause is to provide for an automatic termination of the lease earlier than is provided for in the "habendum" clause. Its wording is such that if the well is not commenced and if rental is not paid as provided, the lease *ipso facto* terminates.

The "drill or pay" type clause, although not in common use today, should be noted for the reason that the federal oil and gas lease forms operate substantially on the same principal. The primary difference between the "unless" and "drill or pay" type lease is that in the latter an affirmative act is required of the lessee to drill, pay, or surrender the lease. The "unless" form, as stated before, terminates *ipso facto* without such affirmative action.

The effect, as a practical matter in today's lease, is to exclude any implication on the lessee to drill an exploratory well during the primary term.

II. To Develop Premises With Reasonable Diligence After The Discovery of Oil or Gas in Paying Quantities

It should be noted that the term "paying quantities" has two separate and distinct uses in oil and gas law. As used here in connection with the implied covenant, it means that oil and gas must be found in such paying quantities that an ordinarily prudent person, experienced in the business of oil and gas production, would, taking into consideration the surrounding circumstances, expect a reasonable profit over and above the entire cost of drilling, equipping, and operating the well or wells drilled.[8] On the other hand, where the term "paying quantities" is used in the habendum clause to express a condition precedent upon which the lease may continue, it is uniformly interpreted as requiring production in such quantities as will pay a small profit over the cost of operation of the well, although the cost of drilling may never be repaid, and the operation as a whole result in a loss to the lessee.[9]

Once production in paying quantities has been found, the delay rental clauses generally become inoperative and the lessee must satisfy the requirements of this covenant. This means drilling additional wells and performing all other functions which an ordinarily prudent person under similar circumstances would perform in order to fully develop the lease with regard for the best interests of both lessee and lessor.[10] If production ceases before the end of the primary term, the lessee generally has an option to resume delay rentals or proceed with drilling operations in order to maintain the lease. Whether a lease has been reasonably developed is a matter of fact depending on the surrounding circumstances, both economical and physical.

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[8] Manhattan Oil Co. v. Carroll, 164 Ind. 526, 73 N. E. 1084.
[9] Pine v. Webster, 118 Okla. 12, 246 P. 429.
[10] Texas Pacific Coal and Oil Co. v. Barker, 117 Tex. 418, 6 S. W. (2d) 1031.

Remedies for breach of the implied covenant to develop with reasonable diligence

A. Damages

The general remedy for breach of the lessee's duty to develop the premises is an action at law for damages. The principal objection to such an action is the difficulty in proving damages. Although such uncertainty would probably entitle the lessor to an equitable remedy, it does not prevent him from seeking his remedy at law if he so elects. In *Daughetee v. Ohio Co.*, [11] the court said:

> The rule is, that while the law will not permit witnesses to speculate or conjecture as to possible or probable damages, still the best evidence of which the subject will admit is receivable, and this is often nothing better than the opinion of well-informed persons upon the subject under investigation.

1. *Burden of proof*

The lessor who alleges the breach has the burden of proving by a preponderance of evidence that a specific amount of damages, usually in form of royalties, was incurred as a proximate result of the failure of the lessee to drill wells or perform other functions necessary for the reasonable development of the property.

2. *Measure of damages*

The measure of damages for breach of this implied covenant is generally the value of royalties which the lessor would have received if the lessee had complied with the obligation, less the value of royalties actually paid, plus interest at a legal rate on the unpaid royalties from the time they would have accrued.

B. Conditional decree of cancellation

Where an action at law for damages furnishes an inadequate remedy for any reason, the courts in the exercise of equity jurisdiction may, in one decree, order specific performance of the lessee's implied duties, and in the alternative, cancellation of the entire lease or any part thereof for failure to perform the order of the court. The action of the court in granting such relief in this class of cases is usually bottomed on three propositions, namely, the reluctance of equity to enforce forfeitures, the adequacy or inadequancy of legal remedies, and fraud in the performance of the contract.

III. To Operate The Lease Prudently

What is prudent operation? The interpretation of this covenant changes daily with the technical advances in petroleum pro-

[11] 263 Ill. 518, 105 N. E. 308.

duction. What would have been an acceptable method of operation twenty years ago might be rejected completely today. Modern equipment, subsurface knowledge, special service companies, unitization plans, secondary recovery programs, and many other factors spell out a new definition of prudent operation each day. It is here that the courts must rely on the technical opinion of expert witnesses in the fields of geology, petroleum production, and conservation of natural resources. The growing import of technical evidence in cases of this type has also been recognized by the lawyer, and more will be said later concerning the role of the lawyer in preparing an engineer witness for trial.

Remedies for breach of implied covenant to operate prudently

Again the general rule of damages for breach of covenant applies, with equitable relief available in form of a conditional decree if damages prove inadequate.

IV. To Market The Product Promptly

The other covenants would be of little value to the lessor if the lessee were allowed to cap the wells and refuse to market the product. Hence the courts have imposed a duty on the lessee to market the product as promptly as possible. Here again, however, just as in the case of "paying quantities" in the covenant to develop, and "prudent operation" in the covenant to operate prudently, the term "market" must be defined differently under different conditions, with different requirements in each case for satisfaction. For example, it is submitted that the Colorado courts would probably be reluctant to declare that a lessee had been guilty of breach of covenant to market, where the land was situated in "frontier or wildcat" territory, without pipeline, rail, or truck facilities. Another important factor for consideration in defining the term "market" is the nature of the product. Gas presents a problem of transportation, requiring pressurized equipment, generally a pipeline, and immediate shipment when taken from the ground. Oil, on the other hand, may be stored and transported with much less hardship. It should be said again that more often than not, the lease will contain express provisions to cover these various situations. The hardship of marketing gas is a good example in that most instruments contain a "shut in" clause, which allows the lessee to shut the gas in the formation until marketing facilities avail themselves. The lessee, in turn, pays rent to the lessor for this privilege, at the same time enjoying immunity from litigation on the implied covenant to market the product. This clause was not meant to serve as a permanent shield against the implied covenant however, and will become ineffective if it is shown that the lessee has not been diligent in his effort to overcome the market handicap.

Remedies for breach of implied covenant to market the product promptly

The lessor may proceed on three theories:

A. If the lessee has discovered oil or gas within the time limits of the primary term but has capped the well, the lessor may proceed on the theory that the failure of production through capping subjects the interest to termination at the end of the primary term, production in paying quantities being a condition precedent to the continued existence of the lease.[12]

B. The lessor may seek cancellation on the ground that the failure to market the product evinces an intent to abandon the incorporeal interest held by the lessee. This remedy depends, of course, on the type interest which an oil and gas lease creates in the particular jurisdiction.[13]

C. The lessor may seek damages or cancellation.[14]

V. To Protect The Premises Against Substantial Drainage

This is perhaps the most litigated of all the covenants. Because of the fluidity of oil and gas and the likelihood of their being withdrawn from the leased property by the operation of wells on adjoining lands, the law implies a duty on the lessee to protect the lessor's property by drilling protection wells to offset the drainage wells on adjacent property. The lessee is not obligated to protect against all drainage, however. The standard of conduct applied by the courts is that of an ordinarily prudent person under similar circumstances. The duty to offset arises only where it appears that the offset well would yield to the lessee a profit after drilling and operating expenses are deducted. Here again the court must depend on the expert opinion of those in the industry in order to determine whether or not a substantial quantity of oil is being drained so as to impose a duty on the lessee to offset. In addition to technical opinion, the conservation laws on spacing should be considered.[15]

Another interesting problem arises when the court considers whether or not payment of delay rentals relieves the lessee of the duty to protect against drainage. Although decisions have been rendered both ways, the prevailing view relieves the lessee of this duty on payment of rentals. This again applies only in absence of "specific footage" or similar clauses.

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[12] Chaney v. Ohio and Indiana Oil Co., 32 Ind. App. 193, 69 N. E. 477.
[13] Beatty-Nickel Oil Co. v. Smethers, 49 Ind. App. 602, 96 N. E. 19.
[14] Strange v. Hicks, 78 Okla. 1, 188 P. 347.
[15] 1951 Colo. Laws, ch. 230, p. 651.

Remedies for breach of implied covenant to protect against drainage

A. Damages

1. *Burden of proof*

The lessor must establish by a preponderance of evidence that wells on adjacent property are causing substantial drainage, and that if an offset was drilled, it would be sufficiently productive to yield a profit to the lessee after payment of drilling and operating expenses, and royalties to the lessor.

2. *Measure of damages*

The measure of damages to compensate for loss from breach of covenant to protect against drainage is generally the royalty which the lessor would have received had the protective well been drilled, computed from the date the well would have been drilled by an ordinarily prudent operator, together with interest thereon.

B. Conditional decree of cancellation

In most drainage cases, damages are adequate. However a conditional decree is available if the circumstances demand equity.

EXPERT OPINION ON PETROLEUM PRODUCTION

As indicated previously, the major problem confronting the lawyer in this type of litigation, lies, not in establishing liability, but rather in proving the damages. The question of damages almost invariably depends on the fact circumstance of each case. Further, it is no defense to an action for damages for breach of an implied covenant that the lessor depends on expert opinion to establish his case.[16] The day of obscure concepts that oil pools were lakes of infinite size fed by rivers of oil which dashed from place to place at will, is past. The courts now have a genuine respect for the opinions of engineers and geologists. Neither will the courts allow its normal policy of "stability through stare decisis" to prevail over these opinions.

It might be interesting to take one of the more common situations arising under the implied covenant to protect against drainage, and determine how the lawyer may best prepare his case in order to utilize the ability of the engineer witness to the fullest extent.

The situation referred to is that of the lessee who holds an oil and gas lease to property on or near the edge of a field which has been sufficiently exploited to define, approximately at least, the outer limits of the producing pool. The lessor of course demands protection wells to offset the wells drilled on the upstructure side

[16] Daughtee v. Ohio Oil C., 263 Ill. 518, 105 N.E. 308.

of his property. The lessee may feel that it would be an uneconomical risk to drill, claiming that the pool is an edge water drive reservoir, having depleted past and interlimital boundaries of his lease. The lessee almost always seeks delay, waiting for some other "edge" lessee to drill and thus prove the field limits—and so, litigation.

The following facts will be required for the cause of either party:

1. Is the reservoir pressurized by gas in solution or from an external source such as a downstructure water drive, or an upstructure gas cap in a dome or anticline.
2. Date of pool discovery and total production to date.
3. Porosity, permeability, thickness of producing sand, gas-oil ratios, bottonhole pressures, gravity and other properties of the gas and oil.
4. The conservation laws on spacing.
5. The time sequence of well development.
6. The cost of the wells.

THE LAWYER'S TASK

The lawyer's task now becomes one of furnishing the expert witness with the necessary information in order that the witness may best apply his ability in behalf of the cause at bar. This will include area maps, exploitation time sequence maps, logs from both the driller and the electric log service companies, core analyses, and isopachous or formation thickness maps. The engineer will then proceed as follows:

1. He will calculate the size of the pool, volume removed as production to date, and the potential volume remaining in the formation.
2. The exploitation maps will give him a record of producer wells, dry holes, and producers which have become gas or salt water wells.
3. The overall time sequence of the wells will show the source of reservoir energy as well as an approximate chronological record of the depleting pool boundaries.
4. The size of the pool and the production figures will aid in further establishing the present pool limits.
5. The porosity, permeability, and gravity will help to establish the tendency of the oil to migrate.

This approach to the problem would seem to indicate that the engineer, given the right tools of information, can become an invaluable assets to the oil and gas lawyer. The end result of the foregoing preparation, if done in good faith, is generally a case supported by the best evidence available even though based on technical opinion. And to repeat again, the courts are most willing to shed obsolete decision based on conjecture and be schooled in the modern version of this scientific industry.