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IMPLIED COVENANTS OF THE OIL AND GAS LEASE

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There has developed in the case law of most of the oil and gas producing states a considerable body of judicial opinion which recognizes the existence of implied covenants in oil and gas leases. The purpose of this paper is to outline the covenants generally and call your attention to decisions of the Colorado Supreme Court in which some of the covenants are or could have been invoked. For a thorough discussion of the covenants, you are referred to some of the texts which have considered them in detail.[1]

Initially, it should be observed that implied covenants are not peculiar to the law of oil and gas. They have been imposed by law in many contracts where a court believed them necessary to carry out the purposes for which the contracts were made.[2] They have been imposed in connection with the ordinary landlord and tenant relationship.[3]

The oil and gas lease has been a fruitful force for the development of implied covenants by reason of its very nature. By execution of an oil and gas lease, the owner of mineral rights in land places in the lessee the exclusive right to explore for, to produce and, in the usual case, to market all oil and gas that may be taken from the land during the term of the lease. By such contract the lessor effectively bars himself from taking any action during the term of the lease to capture any oil or gas that may be beneath his land, to operate any wells thereon, to market any oil and gas that may be produced therefrom, or to protect himself from loss of oil or gas that may be beneath his land through wells drilled on adjoining lands.[4] As a result of such arrangement, in cases where the lessor and lessee fail to agree specifically on the conduct that the lessee must follow to accomplish the purpose of the lease, to-wit, the discovery, production and marketing of oil or gas, the courts have implied covenants on the part of the lessee which serve to protect the lessor's interest. This result has generally been induced by reason of the fact (which is the usual situation) that the lessor's principal compensation for executing the lease is the royalty he hopes to receive on oil or gas produced by the lessee under the terms of the lease.

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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] 14 Am. Jur. 490, Sec. 14.

[3] 32 Am. Jur. 145, Sec. 143; Milheim v. Baxter, 46 Colo. 155, 103 Pac. 376; 133 Am. St. Rep. 59 (1909); Thomas Cusack Company v. Pratt, 78 Colo. 28, 239 Pac. 22 (1925); Boyle v. Bay, 81 Colo. 125, 254 Pac. 156 (1927).

[4] Merrill, *supra*, Sec. 147, O'Neil v. Sun Oil Co., 58 Tex. Civ. A 167,123 SW 172 (1909).

It is impossible when an oil and gas lease is drafted, as it is impossible in the drafting of any other contract, to anticipate every situation which might arise in connection with operations under the lease. If one undertakes to enumerate all conditions and provide guidance in each case, he will run the risk that by detailed listing of numerous situations he will exclude what he might later desire to imply when a situation arises which was not contemplated by the parties. Conditions that may arise under an oil and gas lease are literally innumerable. For this reason it is a common practice today to use only a limited number of express covenants in the lease and to rely upon the now fairly well defined implied covenants to afford relief when the appropriate occasion arises. By employing the implied covenants the courts have been in a position to require the oil and gas lessee to do equity under situations which were unforeseen when the lease was executed. While there are implied covenants on the part of the lessor as well as the lessee, those most often invoked run in favor of the lessor.

Many authorities on the subject have undertaken to classify the covenants implied in oil and gas leases. Our court has itself had occasion to adopt a classification. In its opinion in *Mountain States Oil Corporation v. Sandoval*[5] the following appears:

> Perhaps a better statement of implied covenants in gas and oil leases, such as those in the case at bar, is that found in Thornton Oil and Gas-Willis (5th Ed.) section 503, reading as follows: 'The implied covenants in an oil and gas lease are generally four, to drill, to develop after discovery of oil or gas in paying quantities, to operate diligently and prudently and to protect the leased premises against drainage. The basis of the implication in each instance is the presumed intention of the parties. "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 mineral deposits which are the subjects of the lease." * * *.' The inner quotation in this statement is from the case of *Brewster v. Lanyon Zinc Co.*, 8 Cir., 140 F. 801, one of the leading cases on implied covenants in oil and gas leases.

The first of the implied covenants to drill, or, as another writer has expressed it, to drill an exploratory well,[6] will arise

[5] 109 Colo. 401, 125 Pac. 2nd 964 (1942).
[6] Merrill, *supra*, Sec. 4.

in an oil and gas lease where the lease contains no provision for payment of rental for delay in drilling. Since, in the usual case, the principal benefit that a lessor expects to receive from the execution of the oil and gas lease is his royalty share of the oil or gas produced, it is clear that he will receive no benefit, except bonus paid for execution of the lease and rental, if any, if there is no development. He has no right under the lease contract to drill a well himself. As a consequence, the courts in such a circumstance have implied a covenant to drill on exploratory well.

FORFEITURE MAY RESULT

In the Colorado case of *Davis v. Riddle*,[7] the plaintiff executed an oil and gas lease for a 40-year term in consideration of what amounted to a 1% royalty, should the lessee see fit to develop the land and obtain oil and gas. After 18 months, the lessor brought an action to quiet his title against the lessee. Since the lessee had done nothing toward development of the land, the court reached the conclusion that the lessee had forfeited whatever rights he had under the lease by his failure to prospect for oil and gas in the absence of any explanation for his failure. While the court did not mention any implied covenant on the part of the lessee to drill an exploratory well, the facts in this case present a situation where such a covenant will be implied and the conclusion reached is the same as that which would be reached had the decision been based upon the implied covenant to drill an exploratory well.

It should be observed, however, that at the present time leases of this type are seldom used. Customarily, present day oil and gas leases contain a provision for the commencement of a well on the leased lands within a prescribed time, unless the lessee pays a rental of an agreed amount for the privilege of deferring commencement of the well for an additional period.[8] In such cases the parties expressly agree in regard to the terms upon which the drilling of an exploratory well may be deferred and no implied covenant should arise. This is the general rule, but, as Professor Merrill points out,[9] there has developed a minority view which holds that the lessor may decline to accept delay rental and insist upon drilling.

[7] 25 Colo. App. 162, 136 Pac. 551 (1913).

[8] The following is typical: "If no well be commenced on said land on or before one year from the date hereof, this lease shall terminate as to both parties unless the lessee on or before that date shall pay or tender to the lessor or to the lessor's credit in the First National Bank at Hometown, U.S.A., or its successors, which shall continue as the depository regardless of changes in the ownership of said land, the sum of One Hundred and Sixty ($160.00) and No./100 DOLLARS, which shall operate as a rental and cover the privilege of deferring the commencement of a well for twelve months from said date. In like manner and upon like payments or tenders the commencement of a well may be further deferred for like periods of the same number of months successively."

[9] Merrill, *supra*, Sec. 29.

The situation in Colorado in this respect is not well defined. There is one case on the point, *Florence Oil & Refining Co. v. Orman*,[10] but it is an old case and the opinion does not make the facts entirely clear. In this case the lessee, under a lease executed by the State Land Board, was required to drill two wells to a certain depth by specified dates. If the wells were unproductive, the lessee was obliged to pay a rental of $50 per year until more wells were drilled. Failure to pay the rental would result in forfeiture of the lease. The two required wells were timely drilled and were dry. Two additional wells were also drilled within the first two years of the lease and were dry. Drilling then ceased. Nothing is said in the opinion as to whether or not the annual rental was paid, but presumably it was because its non-payment would afford a simple basis for deciding the case adversely to the lessee. Approximately six years after issuance of the lease the Land Board cancelled the lease. The lessee then brought suit to set aside the cancellation. The Colorado Court sustained the cancellation by the following reasoning:

> Here the number of wells to be sunk during the first 18 months of the term was provided, but not the number to be sunk during the remaining 18 years of the term. As to this part of the term, the lease being silent as to the work to be done, the implication arose that the lessee should search with reasonable diligence for oil and gas to 'success or abandonment'; and because this condition precedent to the continuance of the rights under the lease was not satisfied, appellant's rights were at an end.

It is submitted that this decision reaches a conclusion directly contrary to the express agreement of the parties on the subject in controversy. The language employed in the lease appears to leave no room for implication of a covenant to drill further wells in the event the required wells are dry. This case has never since been referred to by the Colorado Court. While it appears wrong in principle, it does indicate that our court is disposed to imply covenants rather freely.

The second implied covenant referred to by our Supreme Court is the covenant to develop after discovery of oil or gas in paying quantities. Professor Merrill states this covenant more broadly, to-wit: "To drill additional wells,"[11] while Professor Summers states the covenant still differently, to-wit: "If oil or gas be found in paying quantities, to proceed with reasonable diligence in drilling sufficient number of wells to reasonably develop the premises."[12]

The statement of the covenant by Thornton and Summers

[10] 19 Colo. App. 79, 73 Pac. 628 (1903).
[11] Merrill, *supra*, Sec. 4.
[12] Summers, *supra*, Sec. 395.

does not take into consideration the question raised by Professor Merrill's statement, that is, what is the obligation of the lessee where the first well does not produce oil or gas in paying quantities? Where there is no provision for delay rental, it would seem that in such case the implied covenant to drill additional wells would arise for the same reasons that give rise to the covenant to drill an initial exploratory well where there is no provision for delay rentals. However, where a lessee has already drilled one or more dry holes there is not as strong a basis for imposition of the covenant in the absence of additional information indicating the possibility of discovery of oil or gas. Where there is a provision for delay rentals and the first well or wells are dry, no covenant should arise in view of the express agreement of the parties in this regard. This statement is, of course, contrary to the conclusion of our court in *Florence Oil & Refining Co. v. Orman, supra.*

OBLIGATION TO FURTHER DEVELOP

Where a well has been drilled and produces oil or gas in paying quantities there appears to be no question but what an obligation to drill further wells does arise, subject to certain limitations which will be mentioned later. As is the case with the first implied covenant, this covenant is based upon the fact that the lessor has, for the term of the lease, surrendered to the lessee exclusive dominion over the premises so far as oil and gas are concerned and is unable to develop the land himself. Hence, the courts have concluded that there is an implied covenant in such cases to drill additional wells.

The Colorado Court in *Mountain States Oil Corporation v. Sandoval, supra,* has occasion to consider the obligation for further development. In that case the lease was executed in 1925 and covered 6,000 acres. By 1928 four gas wells had been drilled and by 1939, when the action was brought, no more wells had been drilled. A further fact, which no doubt affected the Court's decision, was the failure of the lessee to supply the lessor with the production information which he was required to furnish under the terms of the lease and its failure to pay royalty as required by the express covenants of the lease.

The trial court found that the defendant had not developed the property with due diligence and the Supreme Court agreed with this finding. The court observed that the determination of whether or not the implied covenants are breached in any case is primarily a question of fact. As a result of the finding mentioned the court decreed cancellation of the lease as to all of the premises not related to or affected by the four wells which had been drilled and were still producing. This case indicates that the Colorado Court has recognized the implied covenant for further development.

The third implied covenant is that for diligent and proper, or prudent, operation of the premises and for marketing of the product if oil or gas is discovered in paying quantities. This covenant probably will be the source of a great amount of litigation in the days to come because of advances in the science of drilling, testing, completing and producing oil and gas wells. Technical opinion frequently differs with respect to the best method of spacing, testing, completing and producing oil and gas wells, and the types of secondary recovery operations that are best suited to a given reservoir if, in fact, any are indicated at all.

Since, in the usual case, the principal compensation of the lessor is the royalty which he is to receive on oil or gas produced and since he has no power to control the operation of the wells, it is incumbent upon the lessee to operate the wells efficiently and prudently in order that both the lessor and lessee may receive the greatest benefit. This covenant has been well developed in oil and gas producing states and its development will no doubt continue as improved methods of producing oil and gas are developed.

ROYALTY MAY BE PAID IN KIND

With respect to the marketing of oil and gas produced it should be observed that in most leases the production is sold or used by the lessee and the lessor receives his royalty from the proceeds received from such sale. In some instances, notably in leases executed by the United States and by most of the states, the right is reserved to take royalty oil and gas in kind. Such right would be of little use to most individual lessors and for that reason it is seldom included in the usual lease. Where the marketing of the product is under the control of the lessee an implied covenant to market the production arises. For this reason the lessee may not delay the marketing of production to suit some particular interest of its own, but must proceed diligenely to market the product, having regard to the best interests of both the lessor and lessee.

Our court has had one occasion to pass upon the marketing phase of this implied covenant, although it did not expressly mention it in its opinion. In *Hoff v. Girdler Corporation*,[13] the lessee had drilled a well and had discovered helium gas. The gas was carried through a pipeline to the lessee's plant and was sold to the United States Government until August 1, 1930. On that date, the government ceased purchasing gas and made purchases only through the Bureau of Mines from a government plant at Amarillo, Texas. At approximately the same time Congress prohibited sales of helium abroad. The lessee tried diligently to develop other markets and other uses for helium gas and, in the meantime, kept its equipment in good working order. In spite of its effects, however, it was unable to find a market for the

[13] 104 Colo. 56, 88 Pac. 2nd 100 (1939).

helium, although it was at all times ready to sell the same. The lessee sued to cancel the lease on the ground of abandonment. The court denied cancellation on this ground because abandonment is of course a matter of intention and no intention to abandon was shown in this case. On the contrary, the actions of the lessee indicated an intention not to abandon. The lessor's demand for cancellation was denied under the circumstances, but he was invited to return at a later date if new developments warranted further consideration of the case. While the court did not mention any implied covenant to market, this is a case where the covenant would arise but performance would be temporarily excused because of the circumstances which existed.

THE MOST COMMON IMPLIED COVENANT

Perhaps the fourth implied covenant is the most widely known and is the one most often invoked. The covenant requires the lessee to protect the leased premises from drainage. It is now generally accepted as a fact that oil and gas are susceptible to migration in the underground formations in which they occur. Thus, it is possible for a well drilled near the boundary line of a leased tract to remove oil or gas which lies beneath adjoining lands. If the adjoining land owner or his lessee does not undertake to protect his land from drainage by drilling an offset well, he may in the course of time suffer the loss of some of the oil or gas which originally was in place under his land.

As has been frequently pointed out above, the lessor is unable to take action to protect his own interest because of the exclusive grant to the lessee of the right to explore for oil or gas. For this reason the courts have uniformly implied in the lease agreement a covenant on the part of the lessee to protect the leased land from drainage. Frequently lessors who are not familiar with the implied covenant to protect again drainage feel it necessary to write into the lease agreement an express covenant defining the obligation to protect the land against drainage. It would seem that this is not only an unnecessary addition to a lease but may even be unwise. Since the covenant has received universal recognition from courts which have had occasion to consider the problem, an attempt to define the obligation in advance may limit the protection which the lessor might otherwise hope to obtain. A court might conclude that it was not at liberty to imply a covenant to protect against drainage which differs in any way from that written into the lease.

How much drainage must take place before the covenant arises? The lessee should not have to protect against all drainage since production from an offset well may be so small that it would be uneconomical to drill it. The standard most generally applied in connection with this covenant, and the covenants for further development and prudent operation, is that of the ordinarily

prudent operator.[14] For example, in connection with the covenants for further development and protection against drainage it is assumed that an ordinarily prudent operator would drill a well when it appears that he could recover his costs of drilling, testing, completing and equipping such well plus a reasonable profit. This test of course involves a fact situation which must be established in order to invoke the covenants.

To date no decision of the Colorado Court has been observed which has undertaken to invoke the fourth implied covenant. This probably arises from the fact that the majority of the oil now produced in Colorado comes from lands owned by the United States. In the extensive development now being carried on in northeastern Colorado, occasion will probably arise for application of this covenant, and no doubt within the next few years the Colorado Supreme Court will be called upon to define the manner in which it will apply this covenant. Based upon the Colorado decisions previously mentioned, there is little doubt but what the court will invoke this covenant when the proper situation is presented. Certainly, lessees recognize its existence and conduct their operations with this covenant in mind.

Two Interesting Possibilities

One interesting sidelight on implied covenants is a consideration of the effect conservation laws have upon them. It is possible to envision situations where, under an implied covenant, a well should be drilled, but under a conservation law the lessee is prohibited from drilling. The same situation may arise where necessary materials cannot be obtained in periods of national emergency by reason of restrictions imposed by governmental authority. Both of these problems may be presented to the Colorado Court in the years to come, since we are currently in one of these emergency periods and we now have a conservation law in Colorado.[15]

It is impossible in the space allotted to give a detailed study to these covenants. All that can be done is to arouse interest in them. No attempt has been made to define the remedies that have been applied. They are numerous and vary with the circumstances. Litigation in regard to implied covenants is probably just as extensive as that which involves express covenants and has probably resulted in as much or more benefit to lessors as the express covenants for the lessor's benefit which are intentionally employed when the lease agreement is drawn.

Blood is urgently needed for Korean casualties. Members are asked to call their local Red Cross office and arrange for a donation.

[14] Merrill, *supra*, Sec. 122.

[15] 1951 Laws, page 651; Colo. Stat. Ann., c. 118 § 68.