

The Continuing Role of Implied Covenants in Developing Leased Lands

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I. INTRODUCTION

The particular implied covenants that courts will recognize, the duties included under these covenants, and the type of relief available for breaches of the covenants have remained generally the same for many years. However, public policy that favors an increase in domestic production of oil and gas and changes in exploration, drilling, and enhanced recovery technologies, creates the potential that parties and courts will face new issues (and perhaps see new rules) in implied covenant litigation, particularly as to the implied covenants relating to the development and exploration of leased premises.

II. HISTORY AND NATURE OF IMPLIED COVENANTS IN OIL AND GAS LEASES

A “covenant” has been defined as an agreement or promise between two or more parties in writing, or, “[i]n its broadest usage . . . any agreement or contract.”¹ An implied covenant is one which may reasonably “be inferred from the whole agreement and the conduct of the parties.”² Jurisdictions within the United States almost universally recognize the existence of implied covenants in contracts generally, with the most commonly discussed covenant being the implied covenant of good faith and fair dealing.³

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1. BLACK’S LAW DICTIONARY 421 (9th ed. 2009).

2. *Id.* at 419.

3. See LA. CIV. CODE ANN. art. 1983 (2008); *Yarbrough v. Devilbiss Air Power, Inc.*, 321 F.3d 728, 732 (8th Cir. 2003) (applying Arkansas law); *Sparks v. Fidelity Nat’l Title Ins.*, 294 F.3d 259, 274 (1st Cir. 2002) (applying Massachusetts law); *Shoney’s, L.L.C. v. Mac East, L.L.C.*, No. 1071465, 2009 WL 2343674, at * 6 (Ala. July 31, 2009); *Smith v. CSK Auto, Inc.*, 204 P.3d 1001, 1010 (Alaska 2009); RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981) (“Every contract imposes upon each party a

Courts have found that this same implied duty of good faith and fair dealing exists in oil and gas leases.⁴ But for more than 100 years, courts also have held that other, more specific implied covenants exist in such leases.⁵ It is generally agreed that implied covenants in oil and gas leases originated in dicta from the 1889 Pennsylvania Supreme Court decision in *Stoddard v. Emery*.⁶ One of the leading early cases recognizing the existence of implied covenants in oil and gas leases is the United States Court of Appeals for the Eighth Circuit's 1905 opinion in *Brewster v. Lanyon Zinc Co.*⁷

The recognition of implied covenants in oil and gas leases is now widespread, if not universal. Indeed, Michigan statutory law expressly allows such covenants to exist in oil and gas leases, while generally prohibiting such covenants in real estate conveyances.⁸ The specific implied covenants that various jurisdictions recognize in oil and gas leases sometimes differ from one state to the next. Some of the most widely recognized implied covenants include duties of reasonable development, diligence in marketing, and protection against drainage.⁹ In addition, courts in some jurisdictions recognize an implied covenant of further exploration,¹⁰ and some have recognized an implied covenant to restore the surface of the land to its original condition after the lease is complete.¹¹

Different jurisdictions use different terminology to describe the

duty of good faith and fair dealing in its performance and its enforcement.”).

4. See, e.g., *Rogers v. Westerman Farm Co.*, 29 P.3d 887, 908 (Colo. 2001).

5. See, e.g., *McKnight v. Mfrs. Natural Gas Co.*, 23 A. 164, 166 (Pa. 1892) (finding an implied covenant of reasonable development).

6. 18 A. 339 (Pa. 1889); see also 5 PATRICK H. MARTIN & BRUCE A. KRAMER, WILLIAMS & MEYERS: OIL AND GAS LAW § 802, at 3 (2009) (describing *Stoddard's* dicta as the origin of implied covenants).

7. 140 F. 801 (8th Cir. 1905); see also JOHN S. LOWE, OIL AND GAS LAW IN A NUTSHELL 307 (5th ed. 2009) (describing *Brewster* as a “leading case”); 5 MARTIN & KRAMER, *supra* note 6, § 802, at 4 (describing *Brewster* as a “landmark” case).

8. MICH. COMP. LAWS ANN. § 565.5 (West 2006) (“No covenant shall be implied in any conveyance of real estate, except oil and gas leases . . .”).

9. Some have suggested that each of these actually is a specific application of a more general covenant. See, e.g., Joseph Shade, *The Oil & Gas Lease and ADR: A Marriage Made in Heaven Waiting to Happen*, 30 TULSA L.J. 599, 612-13 (1995) (noting that authorities have identified at least six different implied covenants, but stating that: “Today, there is a trend toward applying only one covenant—namely that the lessee will act as a reasonably prudent operator. This unitary analysis utilizes one basic implied covenant with a number of different applications, depending on an infinite variety of fact patterns.”). But see LOWE, *supra* note 7, at 311-12 (noting that a reasonable prudent operator standard is a common element of all implied covenants and acknowledging that some commentators have suggested that the implied promise to act as a reasonably prudent operator is the only covenant but stating that such “[a] unified analysis does not fit the case method by which the courts have developed the various implied covenants”).

10. See, e.g., *Gillette v. Pepper Tank Co.*, 694 P.2d 369, 372 (Colo. App. 1984).

11. The Arkansas Supreme Court has held that an implied duty to restore exists under Arkansas law. *Bonds v. Sanchez-O'Brien Oil & Gas Co.*, 715 S.W.2d 444, 445-46 (Ark. 1986). In that case, the Arkansas Supreme Court stated that a majority of courts had held that no such duty exists, but that there was a current trend toward finding such a duty, and the supreme court believed that courts following that trend had the better view. *Id.* The Arkansas Supreme Court reiterated the existence of an implied duty to restore the surface in *Chevron U.S.A., Inc. v. Murphy Exploration & Production Co.*, 151 S.W.3d 306, 310-12 (Ark. 2004).

implied covenants even when the covenants those states recognize are similar or identical in substance to those recognized in other states. For example, Texas recognizes implied duties to develop the premises, protect the leasehold, and administer the lease.¹² The duty to protect against drainage is included in the duty to protect the leasehold,¹³ and a duty to reasonably market oil and gas is part of the implied covenant to administer the lease.¹⁴ Colorado recognizes four implied covenants: (1) to conduct exploratory drilling; (2) to develop the leased premises after discovering resources that can be profitably developed; (3) to operate diligently and prudently (which includes an implied covenant to market); and (4) to protect the leased premises against drainage.¹⁵

A. Why Do Implied Covenants Exist?

Courts and commentators have expressed several explanations regarding the functions served by implied covenants and the theoretical source from which the covenants originate. The two most common explanations regarding function are that, implied covenants first, fill gaps in incomplete contracts and, second, promote fairness and equity.¹⁶ But at least one commentator has posited a third function—that implied covenants serve public policy.¹⁷ As for the theoretical source of implied covenants, a prominent treatise states that implied covenants arise from the general principle of cooperation that exists in the law of contracts.¹⁸ In Louisiana, however, the Supreme Court has stated that under its laws the implied covenants found in oil and gas leases do not originate from the general principle of cooperation found in the law of contracts,¹⁹ but instead, are particularized expressions of Louisiana Civil Code article 2710's requirement that a lessee use the "thing leased as a good administrator."²⁰

12. See *Yzaguirre v. KCS Res., Inc.*, 53 S.W.3d 368, 373 (Tex. 2001).

13. *Coastal Oil & Gas Corp. v. Garza Energy Trust*, 268 S.W.3d 1, 14 n.42 (Tex. 2008).

14. See *Yzaguirre*, 53 S.W.3d at 373.

15. *Garman v. Conoco, Inc.*, 886 P.2d 652, 659 (Colo. 1994); *Whitham Farms, L.L.C. v. City of Longmont*, 97 P.3d 135, 137 (Colo. App. 2003), cert. granted sub nom. *Whitham Farms, L.L.C. v. Encana Energy Res. Inc.*, No. 03SC652, 2004 WL 2029371 (Colo. Sept. 13, 2004). In addition, one of Colorado's appellate court divisions has held that the covenant to conduct exploratory drilling includes both exploration before discovering an initial reservoir and later exploration for additional reservoirs in unproven areas. See *Whitham Farms*, 97 P.3d at 137 (citing *Gillette v. Pepper Tank Co.*, 694 P.2d 369 (Colo. App. 1984)).

16. See David E. Pierce, *Exploring the Jurisprudential Underpinnings of the Implied Covenant to Market*, 48 ROCKY MTN. MIN. L. INST. 10-1, 10-9 (2002) (stating that "courts imply covenants in oil and gas leases for two reasons: (1) to complete an incomplete contract; (2) to make the 'unfair' contract 'fair,' or 'more fair'").

17. Jacqueline Lang Weaver, *Implied Covenants in Oil and Gas Law Under Federal Energy Price Regulation*, 34 VAND. L. REV. 1473, 1489-90 (1981) (identifying contractual, equity, and public policy theories).

18. 5 MARTIN & KRAMER, *supra* note 6, § 802.1, at 8.

19. Louisiana does recognize, however, a general obligation of good faith in contracts. LA. CIV. CODE ANN. art. 1983 (2008).

20. *Frey v. Amoco Prod. Co.*, 603 So. 2d 166, 174 (La. 1992).

In *Jacobs v. CNG Transmission Corp.*,²¹ the Pennsylvania Supreme Court held that, in an oil and gas lease in which the only compensation to the lessor is to be royalty payments, there is an implied obligation for the lessee to make diligent efforts to produce oil or gas.²² The court explained the reason for this implied covenant is that the lessor enters the bargain expecting to be compensated for the lease, “and principles of fairness dictate that the lessee be obligated to make diligent efforts to ensure that the lessor receives the benefit of his bargain.”²³

A question closely related to why covenants exist is whether such covenants are implied in law or in fact. A covenant is implied in fact if it can be inferred from the facts and circumstances of a contract, but the covenant is not explicitly stated in words.²⁴ A covenant is implied in law if it is not inferred from the contract itself, but is imposed by the law to prevent unjust enrichment or to otherwise ensure justice.²⁵

The classification of a covenant as implied in law or implied in fact can affect what statute of limitations will apply²⁶ and whether a lessee who has assigned the lease remains liable for satisfaction of the implied covenant,²⁷ as well as questions involving the parol evidence rule.²⁸ Some commentators have suggested that the classification of implied covenants as being implied in law or fact could affect venue²⁹ and the ease with which parties should be able to exclude the application of implied covenants by the use of express provisions in a lease.³⁰

Several commentators state that covenants are implied in fact, while others state that covenants are implied in law.³¹ Most courts that have explicitly addressed the issue hold that the covenants are implied in fact. One of the most recent cases to expressly address this issue was the Kansas Supreme Court’s decision in *Smith v. Amoco Production Co.*³² In *Smith*, lessors brought a class action against their lessee, alleging that the lessee had breached its implied covenant to diligently

21. 772 A.2d 445 (Pa. 2001).

22. *Id.* at 455.

23. *Id.* at 454. This could support either the implied-in-fact or implied-in-law theories—either the parties contemplated that the lessee would make reasonable efforts (thus, the covenant is implied in fact) or equity and fairness require the implied covenant (thus, the covenant is implied in law).

24. *Smith v. Amoco Prod. Co.*, 31 P.3d 255, 265 (Kan. 2001).

25. *Id.* at 267.

26. *See, e.g., id.*; LOWE, *supra* note 7, at 308; 5 MARTIN & KRAMER, *supra* note 6, § 803, at 18.3.

27. LOWE, *supra* note 7, at 308; 5 MARTIN & KRAMER, *supra* note 6, § 803, at 19.

28. *See Smith*, 31 P.3d at 267 (quoting commentary by Eugene Kuntz).

29. LOWE, *supra* note 7, at 308; 5 MARTIN & KRAMER, *supra* note 6, § 803, at 19.

30. LOWE, *supra* note 7, at 309; *see* 5 MARTIN & KRAMER, *supra* note 6, § 803, at 21.

31. 5 MARTIN & KRAMER, *supra* note 6, § 803, at 23 (stating that “we believe there is a large element of truth on both sides”); Patrick H. Martin, *Implied Covenants in Oil and Gas Leases—Past, Present and Future*, 33 WASHBURN L.J. 639, 640 (1994) (“While some have contended that implied covenants are implied in fact, candor requires us to acknowledge that implied covenants are judicial creations, just as we are all now legal realists who will admit that courts often make law rather than merely find it.”).

32. 31 P.3d 255 (Kan. 2001).

market natural gas produced from its leases with the class members.³³ The parties disputed whether the covenant to market diligently was a covenant implied in law, which would result in a three-year statute of limitations, or a covenant implied in fact, which would result in a five-year limitations period.³⁴ The Kansas Supreme Court surveyed a number of cases, both from Kansas and other jurisdictions, as well as the writings of several commentators.³⁵ The court noted that courts from Oklahoma,³⁶ Texas,³⁷ and Montana³⁸ have held that such covenants are implied in fact. Several of the commentators whose publications were discussed by the court similarly believed that covenants are implied in fact.³⁹ The Kansas Supreme Court determined that this was the better view and held that under Kansas law the duty to reasonably market is implied in fact.⁴⁰ Few, if any, states have expressly held that implied covenants are implied in law. But, the Colorado Supreme Court has reached decisions (particularly decisions regarding who may enforce implied covenants) that seem inconsistent with a theory that implied covenants are implied by the lease itself, yet are entirely consistent with a theory that implied covenants are implied by the law.⁴¹

B. Who Has the Right to Enforce Implied Covenants?

Some courts have addressed the issue of whether the lessee owes implied covenant duties to persons other than lessors, such as overriding royalty owners.⁴² In *Garman v. Conoco, Inc.*,⁴³ the Colorado Supreme

33. *Id.* at 257.

34. *Id.*

35. *Id.* at 265-68.

36. *Id.* at 265 (citing *Indian Territory Illuminating Oil Co. v. Rosamond*, 120 P.2d 349, 353-54 (Okla. 1941)). For a more recent Oklahoma case reaching a similar conclusion, see *New Dominion, L.L.C. v. Parks Family Co., L.L.C.*, 216 P.3d 292, 297 (Okla. Civ. App. 2008) (holding that operator did not owe duties to owner of forced pooling royalty interest under an implied covenant to market).

37. *Smith*, 31 P.3d at 265 (citing *Danciger Oil & Ref. Co. v. Powell*, 154 S.W.2d 632 (Tex. 1941)). The Texas Supreme Court continues to describe implied covenants in a way that suggests they are implied in fact, not law. It states that implied covenants are not favored and should only be found to exist when “legally necessary to effectuate the plain, clear, unmistakable intent of the parties.” *In re Bass*, 113 S.W.3d 735, 743 (Tex. 2003) (recognizing the existence of an implied covenant to reasonably develop leased premises). Further, “[a] court cannot imply a covenant to achieve what it believes to be a fair contract or to remedy an unwise or improvident contract.” *HECI Exploration Co. v. Neel*, 982 S.W.2d 881, 888-89 (Tex. 1999) (recognizing implied covenant to protect against drainage); see also *Union Pac. Res. Group, Inc. v. Neinast*, 67 S.W.3d 275, 282, 284 (Tex. 2002) (noting there cannot be an implied covenant if a lease expressly addresses the subject and stating that “[n]o covenant can be implied in an oil and gas lease without ‘first’ examining the express terms of the existing lease contract”).

38. *Smith*, 31 P.3d at 266. *Smith* cited two Montana cases that do not use the phrase “implied in fact,” but which state that covenants are implied in order to give effect to the intent of the parties. *Id.* (citing *Sundheim v. Reef Oil Corp.*, 806 P.2d 503, 507 (Mont. 1991); *U.V. Indus., Inc. v. Danielson*, 602 P.2d 571, 578 (Mont. 1979)).

39. *Id.* at 268.

40. *Id.*

41. See *Garman v. Conoco, Inc.*, 886 P.2d 652, 659 (Colo. 1994).

42. As part of the consideration for an oil and gas lease, the lessee typically agrees to pay the lessor a “royalty,” which will be a specified fraction of the value or proceeds of the oil and gas produced pursuant to the lease. The lessee is entitled to ownership of the remainder of the oil or gas

Court accepted a certified question from a federal district court regarding whether the owner of an overriding royalty is required to contribute a proportionate share of post-production costs when the assignment creating the overriding royalty is silent regarding allocation of such costs.⁴⁴

The overriding royalty owners argued that the implied covenant to market requires the lessee to bear all post-production costs necessary to make the gas marketable.⁴⁵ Conoco disagreed, arguing that the implied covenant to market does not require the lessee to bear post-production costs incurred in making the product marketable and that the implied covenant is not owed to overriding royalty owners.⁴⁶ The Colorado Supreme Court disagreed with both of Conoco's arguments.⁴⁷ In support of its conclusion that the implied covenant to market requires the lessee to pay the cost of making gas marketable, the court made an analogy to the implied obligation of the lessee to drill and noted that drilling must be done at the lessee's expense.⁴⁸ The court then noted that "[s]ome question exists whether the implied covenants under an oil and gas lease extend to overriding royalty owners," but the court concluded that fairness dictates that overriding royalty owners should receive the same protection from the implied covenant as do lessors.⁴⁹ The court noted that another reason lessors and royalty owners should not bear a share of costs is that, unlike working interest owners, lessors and overriding royalty owners do not have a voice in deciding what expenditures will be made.⁵⁰ Finally, the court rejected Conoco's argument that industry custom dictated a different result.⁵¹ The court stated that industry custom should not be binding on a person unless she knows of it or should know of it, and lessors and even overriding royalty owners reasonably might not have knowledge of industry custom.⁵² Based on these principles, the court concluded that in the absence of a contractual provision stating how post-production costs will be allocated, neither lessors nor overriding royalty owners should bear any

that is produced. But as part of a separate agreement, the lessee may agree to pay an "overriding royalty" to some third person. The overriding royalty, which typically will be a specified fraction of the value or proceeds of any oil and gas that is produced, might be paid to a geologist who helped determine the most promising place to drill or some other person involved in the prospecting process. Or, an assignee of the rights of the lessee might agree to pay an overriding royalty to the original lessee who made the assignment. Thus, the overriding royalty owner is not the lessor and typically is not a party to the oil and gas lease.

43. 886 P.2d 652 (Colo. 1994).

44. *Id.* at 653.

45. *Id.* at 656.

46. *Id.*

47. *See id.* at 660-61.

48. *Id.* at 659.

49. *Id.* at 659 n.23.

50. *Id.* at 660.

51. *Id.*

52. *Id.*

portion of the post-production costs necessary to make a product marketable.⁵³

The Oklahoma Supreme Court addressed this issue in *XAE Corp. v. SMR Property Management Co.*⁵⁴ In *XAE*, the lessee granted “[a]n overriding royalty interest of an undivided 1/8 of 7/8 of all gas . . . produced under . . . the leases described . . . to be delivered to the Assignees . . . free and clear of all costs and expenses whatsoever, save and except . . . taxes . . . chargeable thereto.”⁵⁵ The parties disputed whether the costs which were free to the owner of the overriding royalty were limited to production costs, so that the overriding royalty owner would have to bear a proportionate share of the post-production costs associated with gathering, transporting, and treating the gas.⁵⁶ The resolution of this question turned in part on whether the owner of the overriding royalty could enforce the lessee’s implied covenant to market. The Oklahoma Supreme Court determined that the owner of an overriding royalty cannot enforce the implied covenant to market unless the lessee has expressly agreed to assume such liabilities in the act assigning the overriding royalty (which the lessee in *XAE* had not done).⁵⁷ The Oklahoma Supreme Court’s conclusion in *XAE*, thus, contrasts with the Colorado Supreme Court’s conclusion in *Garman*. The Oklahoma Supreme Court concluded that the lessee’s implied covenant duties do not extend to overriding royalty owners and the Colorado Supreme Court decided otherwise.

III. JURISPRUDENTIAL DEVELOPMENTS

A. Implied Covenant to Test

Early in the oil and gas industry, courts concluded that a lessee has an implied duty to promptly begin drilling a test well or wells, generally within the first year of the lease.⁵⁸ But often, it was not practical for a lessee to begin drilling that quickly. In order to avoid an implied duty to drill a test well within a particular period, lessees began to draft leases with delay rental clauses.⁵⁹ Such clauses provided that the lessee could defer or delay any duty to begin drilling within the first year by paying a specified amount in delay rentals.⁶⁰ Generally, the delay-rental clause

53. *Id.* at 660-61.

54. 968 P.2d 1201 (Okla. 1998).

55. *Id.* at 1202.

56. *Id.*

57. *Id.* at 1207.

58. Gary B. Conine, *Speculation, Prudent Operation, and the Economics of Oil and Gas Law*, 33 WASHBURN L.J. 670, 683 (1994).

59. *Id.* at 684.

60. *Id.*

would allow the lessee to defer its obligation to drill test wells in subsequent years too, by paying delay rentals for each year that the lessee did not drill. Now, it is so common for oil and gas leases to explicitly address the lessee's duty to drill test wells—by providing that the lessee can delay such an obligation by paying delay rentals (or by providing that the lease is a paid-up lease)⁶¹—that the implied duty to test is seldom of significance.⁶²

B. Implied Covenant of Reasonable Development

Once oil or gas has been found in paying quantities, a lessee has a duty to reasonably develop the property. This duty has been recognized for over 100 years.⁶³ Whether the lessee has breached this duty is a fact issue.⁶⁴ Courts will consider a variety of factors in determining whether a lessee has breached this duty, including: (1) geological data; (2) the number and location of wells drilled on or near the leased premises; (3) productive capacity of existing wells; (4) cost of drilling compared with the profits reasonably expected; (5) time interval between completion of the last well and demand for additional performance; and (6) acreage involved in the lease being considered.⁶⁵

If a breach of the covenant is established, the lessor generally will be entitled to some sort of relief, typically an award of damages, lease cancellation in whole or part, or conditional cancellation.⁶⁶ If damages are awarded for such a breach, the measure of damages generally will be “the full value of royalty lost” by the lessor.⁶⁷ Awarding damages can involve considerations of whether the oil was simply produced later than it should have been, in which case the loss will involve interest, and the difference in prices between the time the oil was produced and the time it should have been produced.⁶⁸

C. Implied Covenant to Protect Against Drainage

A producing well drains oil or gas from the surrounding area, and when a producing well is located close enough to a property boundary,

61. In a paid-up lease, a lessee typically makes an up-front payment that serves as both the “bonus” that lessees typically pay lessors upon grant of a lease as well as compensation for the privilege of delaying the duty to drill test wells.

62. *See id.* at 684.

63. *See, e.g.,* McKnight v. Mfrs.' Natural Gas Co., 23 A. 164, 166 (Pa. 1892).

64. *See, e.g.,* Sohio Petroleum Co. v. Miller, 112 So. 2d 695, 699 (La. 1959); *see also* LOWE, *supra* note 7, at 316; *cf.* 5 MARTIN & KRAMER, *supra* note 6, § 833.3, at 240-41 (discussing evidentiary issues related to whether a duty has been breached).

65. *E.g.,* Edmundson Bros. v. Montex Drilling Co., 731 So. 2d 1049, 1055 (La. Ct. App. 1999).

66. LOWE, *supra* note 7, at 322; 5 MARTIN & KRAMER, *supra* note 6, § 834, at 245-46, 249 (noting when a “conditional cancellation” is granted, the court orders that the lease will be cancelled if the lessee does not remedy the breach within a specified period of time).

67. Coastal Oil & Gas Corp. v. Garza Energy Trust, 268 S.W.3d 1, 19 (Tex. 2008).

68. *Id.*

the well will drain oil or gas from beneath the neighboring property. Since at least 1896, courts have recognized that a lessee has a duty to protect the leased premises from drainage by wells located on neighboring properties.⁶⁹ To establish a breach of the implied covenant to protect against drainage, a lessor must prove that substantial drainage from the lessee's field occurred and that a reasonably prudent operator would have acted to prevent the drainage.⁷⁰ The primary means of protecting against drainage historically has been the drilling of offset wells, but the lessee does not have a duty to drill offset wells unless doing so would be profitable.⁷¹ Further, the drilling of offset wells is not the only way to protect against drainage. Another way is through pooling or unitization.⁷²

Some courts suggest that a lessee should be held to a higher standard than the reasonably prudent operator standard when the it is the lessee of the land being drained, as well as the operator of the well that is doing the draining.⁷³ But other courts have rejected arguments for a higher standard in such situations.⁷⁴

Courts have reached different conclusions about the measure of damages for a breach of the duty to protect against drainage. In *Coastal Oil & Gas Corp. v. Garza Energy Trust*,⁷⁵ the Texas Supreme Court clarified that, under Texas law, the correct measure of damages for a breach of the implied covenant to protect against drainage is the value of the royalty lost to the lessor because of the lessee's failure to act as a reasonably prudent operator.⁷⁶ Although *Garza* rejected other measures of damages on grounds that they sometimes will overcompensate the lessor, the court noted that, depending on whether the offset exceeded the drainage, the correct measure of damages for a breach of the duty to protect against drainage are the royalty that would have been received on the production from an offset well or that would have been paid on the amount of oil or gas drained from the lessor's

69. See *Kleppner v. Lemon*, 35 A. 109, 109 (Pa. 1896); see also *Bradford Oil Co. v. Blair*, 4 A. 218, 220 (Pa. 1886). In Texas, the duty to protect against drainage exists, but courts refer to the duty to protect against drainage as being part of a general duty to protect the leasehold. *Garza*, 268 S.W.3d at 14 n.42 (citing *Amoco Prod. Co. v. Alexander*, 622 S.W.2d 563, 568 (Tex. 1981)).

70. *Garza*, 268 S.W.3d at 17-18 n.57 (citing *Kerr-McGee Corp. v. Helton*, 133 S.W.3d 245, 253 (Tex. 2004)).

71. See *id.* at 17.

72. See *Pipe Line Co. v. Tichauhek*, 997 S.W.2d 166, 170 (Tex. 1999) (stating that pooling can be used to satisfy the duty to protect against drainage); see *Breaux v. Pan Am. Petroleum Corp.*, 163 So. 2d 406, 415 (La. Ct. App. 1964) (noting that lessee possibly could satisfy the duty to protect against drainage by seeking compulsory unitization), *application denied*, 165 So. 2d 481 (La. 1964); cf. *Garza*, 268 S.W.3d at 17-18 n.57 (referring to the possibility of a lessee protecting against drainage by seeking voluntary unitization or field-wide regulatory action).

73. See *Cook v. El Paso Natural Gas Co.*, 560 F.2d 978, 984 (10th Cir. 1977).

74. *Garza*, 268 S.W.3d at 19 n.63.

75. 268 S.W.3d 1 (Tex. 2008).

76. *Id.* at 18-19.

property.⁷⁷ Other authorities have also noted these two ways to measure damages for a breach of this duty.⁷⁸

D. Implied Covenant of Further Exploration

As noted above, there is an implied covenant to develop reasonably known productive formations once oil or gas is discovered in paying quantities. But after production in paying quantities is established, is there also a duty to explore further non-productive areas where the existence of an oil or gas formation has not been established—a so-called implied covenant of further exploration? Some commentators suggest that there is, or at least should be, a duty to explore non-productive areas,⁷⁹ while other commentators argue otherwise.⁸⁰ Texas rejects the existence of any such duty that is separate from the duty of reasonable development,⁸¹ as does Oklahoma.⁸²

The Louisiana Mineral Code does not state whether such a duty exists. The redactors' official comment to mineral code article 122 states that there is such an implied duty,⁸³ and the comments have persuasive authority.⁸⁴ But comments to code articles are not law, as the Louisiana Supreme Court has stated on numerous occasions and as the court has demonstrated by sometimes rejecting statements made in the comments.⁸⁵ Indeed, the comment to article 122 also states that there is an implied duty to restore the surface, and the Louisiana Supreme Court has repudiated that statement.⁸⁶ Thus, one must look to court decisions to determine whether a duty of further exploration exists under Louisiana law.

Although a prominent treatise states that “Louisiana courts are probably the most severe in the country in enforcing an implied duty to explore further,”⁸⁷ relatively few Louisiana cases discuss an implied covenant or obligation or duty of “further exploration” in those terms. Those who assert that such an implied obligation exists under Louisiana

77. *Id.*

78. *See, e.g.*, 5 MARTIN & KRAMER, *supra* note 6, § 825.2, at 161 to 168.3.

79. *See* Charles J. Meyers, *The Covenant of Further Exploration: A Comment*, 37 TEX. L. REV. 179 (1958); C. J. Meyers, *The Implied Covenant of Further Exploration*, 34 TEX. L. REV. 553 (1956).

80. *See* Earl A. Brown, *The Proposed New Covenant of Further Exploration: Reply to Comment*, 37 TEX. L. REV. 303 (1959).

81. The leading case is *Clifton v. Koontz*, 325 S.W.2d 684, 696 (Tex. 1959). Other Texas cases have followed *Clifton*. *See, e.g.*, *Sun Exploration & Prod. Co. v. Jackson*, 783 S.W.2d 202, 204 (Tex. 1990).

82. *Mitchell v. Amerada Hess Corp.*, 638 P.2d 441, 449 (Okla. 1981).

83. LA. REV. STAT. ANN. § 31:122 cmt. (2000).

84. *See, e.g.*, *Caskey v. Kelly Oil Co.*, 737 So. 2d 1257, 1262 (La. 1999) (citing LA. REV. STAT. ANN. § 31:122 cmt.).

85. *See, e.g.*, *Terrebonne Parish Sch. Bd. v. Castex Energy, Inc.*, 893 So. 2d 789, 797 (La. 2005) (stating that comments to the Mineral Code are not law); *Ramirez v. Fair Grounds Corp.*, 575 So. 2d 811, 813 (La. 1991) (same).

86. *Terrebonne*, 893 So. 2d at 797.

87. 5 MARTIN & KRAMER, *supra* note 6, § 845.4, at 341.

law point to a line of cases that begins with the Louisiana Supreme Court's decision in *Carter v. Arkansas Louisiana Gas Co.*⁸⁸ In that case, a fault divided the leased premises.⁸⁹ The lessee had drilled two paying gas wells on the 493 acres that were on one side of the fault, but the lessee had not drilled any wells on the 824 acres located on the other side of the fault.⁹⁰ The lessee introduced testimony of two geologists who thought it was unlikely that gas would be found on the side of the fault where the lessee had not drilled.⁹¹ The lessee then argued that he had reasonably developed the property and any wells drilled on the undeveloped side of the fault would be wildcat, exploratory wells.⁹²

The Louisiana Supreme Court affirmed the lower court's order granting partial cancellation of the lease, and some of the language in the case supports the view that the case was effectively imposing on the lessee a duty of further exploration, subsequent to the finding of gas in paying quantities.⁹³ The language most often noted in *Carter* is language quoted from an Oklahoma case, *Fox Petroleum Co. v. Booker*,⁹⁴ which stated that "it is an implied condition that the lessee will test every part" of the leased premises.⁹⁵ *Carter* also relied in part on *Sauder v. Mid-Continent Petroleum Corp.*,⁹⁶ but a close reading of *Carter* shows some potential ambiguity. Although the defendant offered testimony of "two reputable and well qualified geologists" who opined there likely was not gas in paying quantities on the undeveloped side of the fault, *Carter* noted:

All the testimony introduced both by plaintiffs and by defendant is to the effect that, according to the history of all such faults in proven oil and gas fields, production has been had on both the up-throw and down-throw side thereof, with possibly one exception named by defendant's geologist. . . . Plaintiffs' expert testified that he knew of no instance where production was not obtained from both sides of such fault in a proven field.⁹⁷

Further, the plaintiff called an experienced operator who was familiar

88. 36 So. 2d 26 (La. 1948).

89. *Id.* at 27.

90. *Id.*

91. *Id.* at 28.

92. *Id.* at 27.

93. *Id.* at 29.

94. 253 P. 33 (Okla. 1926).

95. *Id.* at 38. *Fox* contains some language that would be supportive of the existence of an implied covenant of further exploration, but this does not mean that such a duty exists under Oklahoma law. The issue in *Fox* was whether the lessee had abandoned a portion of the leased premises, not whether the lessee had an implied duty of further exploration. *Id.* at 34. Further, the court held that the lessor had not carried its burden of proving that the lessee had abandoned any portion of the leased premises. *Id.* at 39. Moreover, *Fox* and its progeny have not been the basis for a large number of lease cancellations based on abandonment. Finally, the Oklahoma Supreme Court has held that Oklahoma law does not recognize an implied covenant of further exploration. See *Mitchell v. Amerada Hess Corp.*, 638 P.2d 441, 449 (Okla. 1981) ("We thus hold there is no implied covenant to further explore after paying production is obtained")

96. 292 U.S. 272 (1934).

97. *Carter*, 36 So. 2d at 26, 28.

with the area and had seismic work done in the area.⁹⁸ That operator testified that he would be willing to drill a well on the property if he owned the lease.⁹⁹ This language suggests that the court may have reached its holding based on a conclusion that the lessee had not reasonably developed a known field, rather than on the conclusion that there existed a further duty to explore.

Another case from this line of jurisprudence is *Wier v. Grubb*.¹⁰⁰ In *Wier*, the plaintiff was a lessee-sublessor who sought cancellation of the sublease from the defendants.¹⁰¹ The defendants had drilled three producing wells, one of which quit producing after a year, then drilled a fourth well that was a dry hole.¹⁰² The plaintiff made a written demand for further development, but the defendants performed no more drilling, and the plaintiff brought suit for partial termination of the sublease.¹⁰³ The evidence showed the four wells drilled by the defendants were all on the far eastern end of the property in a relatively small area compared to the 335 acres that were subject to the sublease.¹⁰⁴

The defendant argued they had reasonably developed the subleased premises and that geological information showed it was highly improbable that oil or gas would be found on the undeveloped portion of the subleased tract.¹⁰⁵ The court nevertheless granted partial termination, and some language in the opinion seemed to support the existence of a duty of further exploration (though not using that phrase).¹⁰⁶ But, it is noteworthy that the sublease had language, italicized by the court, that adopted the terms of the lease, and the lease contained terms, also italicized by the court, which provided that if the lessee discovered oil or gas in paying quantities, it would diligently develop the lease premises and “release such portions of the leased area as Lessee may be unwilling to develop.”¹⁰⁷ Thus, the court’s partial termination of the sublease appears to have been based in large part, if not entirely, on enforcement of the lease’s express obligations, rather than on an implied duty to further explore.

Other cases in this line of jurisprudence include *Sohio Petroleum Co. v. Miller*,¹⁰⁸ *Sandfer Oil & Gas, Inc. v. Duhon*,¹⁰⁹ and *Noel v.*

98. *Id.* at 29.

99. *Id.*

100. 82 So. 2d 1 (La. 1955).

101. *Id.* at 2.

102. *Id.* at 4.

103. *Id.*

104. *Id.* at 5.

105. *Id.* at 3.

106. *Id.* at 5.

107. *Id.* at 4.

108. 112 So. 2d 695 (La. 1959). In *Miller*, the Louisiana Supreme Court ordered a partial lease cancellation and cited *Carter* in support of its order. *Miller* involved a lease that expressly obligated the lessee to develop reasonably the leased premises, and the court may have relied in whole or in

*Amoco Production Co.*¹¹⁰ On the whole, these cases may effectively establish an implied duty of further exploration in Louisiana, but the establishment of such a duty is not as clear as some have suggested.¹¹¹

In other jurisdictions, such as Arkansas, the courts have described the duty of further development broadly enough that some commentators have suggested Arkansas tacitly recognizes a duty of further exploration,¹¹² though the state's courts do not appear to have applied by name a duty of "further exploration." In *Gillette v. Pepper Tank Co.*,¹¹³ a Colorado appellate court held that an implied duty of further exploration exists under Colorado law.¹¹⁴ However, neither the Colorado Supreme Court nor any other Colorado appellate court has reached this issue. In Kansas, the Deep Horizons Act¹¹⁵ has been described as imposing a statutory requirement for further exploration.¹¹⁶ This statute deserves mention when discussing the possible existence in leases of an implied duty of further exploration, but the statute's provisions for further explanation are express, not implied, and, of course, are imposed by the statute, not by a lease.

E. What If It Would Be Uneconomical to Develop Further?

The implied covenant of reasonable development does not require a lessee to engage in development that is likely to be unprofitable.¹¹⁷ Thus, the lessee is not required to develop further the leased premises if doing so would be unprofitable. But, if it would not be profitable to develop further the leased premises and the lessee refuses to release the undeveloped areas, is the lessee holding those areas improperly for speculative purposes—something which would be disfavored in many

part on that express provision of the lease, as opposed to an implied covenant. *Id.* at 699.

109. 961 F.2d 1207 (5th Cir. 1992). In *Duhon*, the court cited *Carter v. Arkansas Louisiana Gas Company*, 36 So. 2d 26 (La. 1948) and referred in dicta to a possible duty of further exploration. *Id.* at 1211.

110. 826 F. Supp. 1000 (W.D. La. 1993). *Noel* cites *Carter* and specifically refers to *Carter* as having established a duty of further exploration. *Id.* at 1005. But *Noel*, a federal district court case, is not a reliable basis for predicting how the Louisiana Supreme Court would decide the issue of whether there exists an implied duty of further exploration.

111. The lack of clarity in the Louisiana jurisprudence is recognized by a prominent commentator from Louisiana, Professor Patrick H. Martin, who has stated that Louisiana "perhaps tacitly" recognizes an implied covenant of further exploration. Martin, *supra* note 31, at 650-51.

112. *Id.* (describing Arkansas as perhaps recognizing such a duty). Courts state that, under Arkansas law, there exists in any oil and gas lease in which a payment of royalties constitutes the chief consideration, an implied covenant that the lessee will explore the property with reasonable diligence, so as to produce oil and gas in paying quantities throughout the entire tract. *Davis v. Ross Prod. Co.*, 910 S.W.2d 209, 213 (Ark. 1995).

113. 694 P.2d 369 (Colo. App. 1984).

114. *Id.* at 372.

115. KAN. STAT. ANN §§ 55-223 to 55-229 (2008).

116. Conine, *supra* note 58, at 688 n.73; see also JOHN S. LOWE ET AL., CASES AND MATERIALS ON OIL AND GAS LAW 506 (5th ed. 2008).

117. See *Rush v. King Oil Co.*, 556 P.2d 431, 435 (Kan. 1976); *Sun Exploration & Prod. Co. v. Jackson*, 783 S.W.2d 202, 204 (Tex. 1989); *Sonat Exploration Co. v. Superior Oil Co.*, 710 P.2d 221, 228-29 (Wyo. 1985).

jurisdictions? In *Whitham Farms L.L.C. v. City of Longmont*,¹¹⁸ the plaintiff argued that the implied covenant to develop requires a lessee to release land that has not been developed if it would not be economically prudent to develop.¹¹⁹ The parties presented the case to the trial court based on stipulated facts and briefs.¹²⁰ The case involved three oil and gas leases that covered a total of 310 acres.¹²¹ The three leases contained provisions giving the lessees the right to enter into pooling agreements, which the lessees subsequently exercised to develop the three tracts as a single unit.¹²² The only well on the property was drilled in 1982 and was recompleted as a producing well in 1997.¹²³

One of the surface and mineral owners demanded in 1999 that the lessees release the lease, except for the area associated with the one producing well.¹²⁴ Another of the surface and mineral owners made the same demand in 2001.¹²⁵ The lessees refused to release any of the leases, and the two surface and mineral owners who demanded releases brought suit, requesting a judgment terminating the lease.¹²⁶

Both sides agreed that it would not be economically prudent for the operator to develop further the oil and gas reserves from the leased premises.¹²⁷ Yet, they disagreed about the implication of that fact.¹²⁸ The lessor argued that the lessee's failure to release the undeveloped portions of the lease, despite the lessee's contention that it would not be economically prudent to develop further the leased premises, demonstrated that the lessee was holding those areas for speculative purposes.¹²⁹

The court disagreed, holding that, under the pooling agreement, production from a single well was sufficient to maintain the entire pooled area.¹³⁰ Further, prior Colorado cases had held that a single well may be sufficient to satisfy implied covenants as to the entire unitized areas.¹³¹ Moreover, the lessor had not presented evidence that the resources could not be profitably developed within a reasonable time.¹³²

Thus, the lessee prevailed, and the lease was not cancelled. But significantly, the court stated that legal authority exists for terminating

118. 97 P.3d 135 (Colo. App. 2003), *cert. granted sub nom.* *Whitham Farms, L.L.C. v. Encana Energy Res. Inc.*, No. 03SC652, 2004 WL 2029371 (Colo. Sept. 13, 2004).

119. *Id.* at 137.

120. *Id.*

121. *Id.* at 136.

122. *See id.* at 139.

123. *See id.* at 136.

124. *Id.*

125. *Id.*

126. *Id.*

127. *See id.* at 137.

128. *Id.*

129. *Id.*

130. *Id.* at 139.

131. *Id.*

132. *Id.*

leases on the grounds that they are being held for speculative purposes if: (1) the lessee is not developing an area; (2) it appears that it is not economically prudent to develop the area; and (3) the lessee is holding on to its lease rights in the area for the “mere speculative and remote hope that the economics might change and non-viable mineral holdings might become profitable at some unspecified time in the future.”¹³³ Although it does not seem that courts have aggressively used this to cancel leases, the language of the case does suggest that if a lessee has not promptly developed an area and the lessor brings suit for an alleged failure to reasonably develop, the lessee should be careful regarding arguments that further development would be uneconomical.

IV. AVOIDING COVENANTS BY DRAFTING THE LEASE TO DEFINE THE LESSEE’S DUTIES

Numerous cases demonstrate that an implied covenant will not apply so as to contradict directly the express terms of a lease. Moreover, an implied covenant likely will not impose a particular type of duty if the lease’s express provisions impose the same type of duty, even if a duty under an implied covenant would not directly contradict the express terms of the lease. Thus, a lessee can avoid or limit its obligations under an implied covenant by negotiating for the lease to govern expressly and preclude the existence of an implied duty.

One of the recent cases illustrating this principle is *Lundin/Weber Co. L.L.C. v. Brea Oil Co.*,¹³⁴ a 2004 California appellate court decision. In *Lundin/Weber*, the defendant was the lessee under two leases—one granted in 1926 and the other in 1995—covering certain land in Kern County, California.¹³⁵ The plaintiff was the landowner and lessor.¹³⁶ The lessee drilled several oil and gas wells on the leased property and was paying royalties to the lessor.¹³⁷ The lessor brought suit, asserting that California should recognize an implied covenant of further exploration and that the lessee had breached this covenant by failing to drill more wells at a depth greater than 3,000 feet and by not drilling a well deeper than 5,000 feet.¹³⁸

The lessee argued that California had never recognized an implied covenant of further exploration and should not do so now.¹³⁹ The lessee also argued that even if an implied obligation of further exploration did

133. *Id.* at 138 (quoting *N.Y. Land Ass’n v. Byron Oil Indus.*, 695 P.2d 1188 (Colo. App. 1984)).

134. 11 Cal. Rptr. 3d 768 (Ct. App. 2004).

135. *Id.* at 769.

136. *Id.*

137. *Id.*

138. *Id.* at 769-70.

139. *See id.* at 770.

exist under California law, such a duty should not apply in this case.¹⁴⁰ The lessee argued that when a lease expressly defines the scope of a particular type of duty, the lease does not contain an implied covenant for the same sort of duty (for example, if a lease stated how many exploratory wells the lessee must drill, there would be no implied duty to drill exploratory wells). Here, the lease expressly defined the lessee's drilling and exploration obligations by explicitly stating the number of wells that would satisfy its drilling and exploration obligations.¹⁴¹ Therefore, argued the lessee, the court should not find the existence of an implied covenant of further exploration in the two leases at issue in this case, even if the court otherwise would have been prepared to hold that California law recognizes an implied covenant of further exploration in leases that do not expressly define the lessee's exploration obligations.¹⁴²

The court briefly discussed the implied covenant of further exploration concept, citing a couple of respected treatises and law review articles, without concluding whether this covenant generally will exist in oil and gas leases under California law.¹⁴³ The court then examined whether the terms of the two particular leases would preclude the existence of an implied covenant to explore further.¹⁴⁴ The court noted that, in the absence of a contrary provision in the lease, California law does recognize in each oil and gas lease an implied covenant that the lessee will use reasonable diligence in the exploration for and production of oil.¹⁴⁵ Further, California law will allow implied covenants to coexist with express covenants if the express covenants do not address all phases of a lessee's obligations as to exploration, development, and protection of the leased premises.¹⁴⁶ However, the court stated that implied covenants cannot conflict with express covenants.¹⁴⁷

In this case, the 1926 lease stated that the lessee would drill ten new wells in each of the first four years of the lease, and that the lessee would drill those wells to a depth of 1,000 feet, unless oil was discovered in paying quantities at a lesser depth.¹⁴⁸ The lessor in this case was not complaining about drainage, but the 1926 lease also happened to define the lessee's duty regarding offset wells.¹⁴⁹ Relying in part on a 1921 California case, the court in *Lundin/Weber* determined that the lease's

140. *See id.*

141. *Id.* at 772-75.

142. *See id.* at 769.

143. *Id.* at 771 (citing Martin, *supra* note 31).

144. *Id.* at 772-75.

145. *Id.* at 771.

146. *Id.*

147. *Id.*

148. *Id.* at 772-73.

149. *Id.*

express provisions regarding the lessee's drilling obligations were sufficient to cover all of the lessee's drilling obligations; thus, there was no room for the existence of an implied covenant of further exploration in the 1926 lease.¹⁵⁰

The 1995 lease stated that, subject to the lessee's right to defer drilling obligations by paying annual delay rentals, the lessee would commence drilling operations during the primary term "and thereafter . . . prosecute the drilling of a well or wells with reasonable diligence until oil or gas . . . is found in quantities deemed paying by [l]essee."¹⁵¹ The lease further provided that "[a]fter the discovery of oil, gas or other leased substances in paying quantities . . . [l]essee shall reasonably develop the acreage retained . . . but . . . shall in no event be required to drill more than one well per ten (10) acres" of retained area capable of producing oil in paying quantities or 160 acres of retained area capable of producing gas in paying quantities.¹⁵² The lease also discussed the lessee's obligations, subsequent to the primary term, to execute partial releases of the lease.¹⁵³

The court determined that the express terms of the lease created an obligation to drill exploratory wells until oil or gas was found in paying quantities.¹⁵⁴ After that time, the lease created an obligation to develop reasonably the acreage it retained, defined what would constitute reasonable development, and addressed the parties' rights as to retention and release of acreage.¹⁵⁵ Given these provisions, there was no room for the existence of an implied covenant of further exploration.¹⁵⁶ Because the court determined the express terms of the two leases precluded the existence of implied covenants of further exploration, the court chose not to express an opinion regarding whether California law recognizes an implied covenant of further exploration when the terms of a specific lease do not preclude such a covenant.¹⁵⁷

Another case illustrating that express lease provisions can supersede implied covenants on the same subject is *Schroeder v. Terra Energy, Ltd.*,¹⁵⁸ a 1997 appellate court case from Michigan. *Schroeder* involved litigation over whether the lessee could deduct post-production treatment and transport costs from the sale price of natural gas sold at a market miles from a well, when the parties' agreements provided that

150. *Id.* at 773-74.

151. *Id.* at 744.

152. *Id.*

153. *Id.* at 774-75.

154. *Id.* at 775.

155. *Id.* at 774.

156. *Id.* at 775.

157. *Id.*

158. 565 N.W.2d 887 (Mich. Ct. App. 1997).

royalties would be computed as a fraction of “gross proceeds at the wellhead” and also referred to paying royalties based on “the prevailing market rate at the wellhead.”¹⁵⁹ The court noted the issue was one of first impression in Michigan.¹⁶⁰ The plaintiff lessors argued that Michigan law imposes on lessees an implied covenant to market oil and gas, and this covenant obligates lessees to bear the costs of making gas saleable.¹⁶¹ The lessors also argued that the lessees breached the implied covenant by not obtaining the “best available market price” for gas.¹⁶²

The court disagreed and concluded that it need not decide whether an implied covenant to market exists under Michigan law.¹⁶³ The court reasoned that even if such a covenant exists, it would not override express contractual provisions stating how the royalty was to be calculated.¹⁶⁴ The court interpreted “gross proceeds at the wellhead” as allowing a deduction for post-production costs of treatment and transport and interpreted the contract’s reference to payment of royalties based on the “prevailing market rate” as negating plaintiff’s argument that the lessee was obligated to obtain the best possible market price.¹⁶⁵ In holding that the lessee could deduct costs of treatment and transportation, the court reasoned that the result was consistent with economic theory.¹⁶⁶ Because there was no market at the wellhead, the value at the wellhead should be calculated based on taking the value at the market where the gas was sold and deducting the costs—treatment and transport—that made the gas saleable at that location.¹⁶⁷ The court noted that other state courts have reached this conclusion, as have commentators.¹⁶⁸ Further, although no Michigan court had decided the issue in the context of a royalty dispute, Michigan used this work-back method to calculate the value of gas at the wellhead for purposes of severance tax calculations.¹⁶⁹ *Schroeder*, thus, stands for the proposition that if an oil and gas lease provides that a portion of the post-production costs incurred to make gas marketable are to be allocated to the lessor, an implied covenant to market does not supersede such provisions in a lease so as to require a lessee to bear the entirety of such post-production costs.

159. *Id.* at 890.

160. *Id.* at 891.

161. *Id.*

162. *Id.*

163. *Id.* at 895.

164. *Id.* at 896.

165. *See id.*

166. *Id.* at 895.

167. *Id.*

168. *Id.*

169. *Id.*

Similarly, in *Yzaguirre v. KCS Resources, Inc.*,¹⁷⁰ the Texas Supreme Court stated that the lessors' argument regarding the scope of the implied covenant to market was inconsistent with the express terms of the lease and that an implied covenant to market could not override express terms of an oil and gas lease.¹⁷¹ In an earlier case, the Texas Supreme Court explained: "We have imposed implied covenants only when they are fundamental to the purpose of a mineral lease and when the lease does not expressly address the subject matter of the covenant sought to be implied."¹⁷² Numerous other courts have reached similar results.¹⁷³

V. LESSEES' STANDARD OF CONDUCT

Throughout the United States, the standard to which lessee-operators are held is that of a reasonably prudent and capable operator, who takes into consideration both his own interests and those of the lessor.¹⁷⁴ Even states with rules generally favorable to lessors have not imposed fiduciary duties¹⁷⁵ or strict liability on lessees.¹⁷⁶ For example, Arkansas, unlike most states, recognizes an implied covenant to restore the surface.¹⁷⁷ Further, Arkansas jurisprudence does not require, as a prerequisite to a lease termination order, that a lessor make pre-suit demand and give the lessee a chance to perform.¹⁷⁸ And Arkansas is one of the states that has a statutory Pugh clause.¹⁷⁹ Yet, Arkansas

170. 53 S.W.3d 368 (Tex. 2001).

171. *Id.* at 373.

172. *HECI Exploration Co. v. Neel*, 982 S.W.2d 881, 889 (Tex. 1998).

173. *See, e.g., Williamson v. Elf Aquitaine, Inc.*, 138 F.3d 546, 552 (5th Cir. 1998) (holding that in take or pay litigation, under Mississippi law, an implied covenant would not exist when the lease had an express provision that covered the topic); *Jacobs v. CNG Transmission Corp.*, 332 F. Supp. 2d 759, 784 (W.D. Pa. 2004) (stating that implied covenant to develop the leased premises "appropriately exists where the compensation to the landowners is derived solely from royalty payments," but if the lease provides for "adequate" compensation to the lessor if the lessee elects not to drill during the term of the lease, then there is not an obligation to develop and produce); *Meisler v. Gull Oil, Inc.*, 848 N.E.2d 1112, 1116 (Ind. Ct. App. 2006) ("Initially we note that the implied covenant of reasonable development applies only when there is no express provision in the lease governing such matters."); *Coastal Oil & Gas Corp. v. Garza Energy Trust*, 268 S.W.3d 1, 19 n.64 (Tex. 2008) (stating when an oil and gas lease provides for royalties and "fail[s] to define the lessee's duty as regards development after discovery of paying oil or gas, the law implic[s] the obligation from the lessee to continue the development and production of oil and gas with reasonable diligence") (quoting *W.T. Waggoner Estate v. Sigler Oil Co.*, 19 S.W.2d 27, 29 (Tex. 1929)); *Croston v. Emax Oil Co.*, 464 S.E.2d 728, 733 (W. Va. 1995) ("This duty to protect against drainage is predicated upon the notion that, in the absence of an express provision to the contrary in a lease, there is an implied covenant in the lease that the lessee will protect the lessor's property against substantial drainage.").

174. *E.g., LA. REV. STAT. ANN. § 31:122* (2000); *see Davis v. Ross Prod. Co.*, 910 S.W.2d 209, 213 (Ark. 1995).

175. *E.g., LA. REV. STAT. ANN. § 31:122* (providing that a lessee does not owe a fiduciary duty to a lessor); *Finley v. Marathon Oil Co.*, 75 F.3d 1225, 1229 (7th Cir. 1996) (noting that a lessee is not a fiduciary of a lessor under Illinois law).

176. The standard of conduct instead is one of reasonably prudent operation. *E.g., LA. REV. STAT. ANN. § 31:122.*

177. *See, e.g., Bonds v. Sanchez-O'Brien Oil & Gas Co.*, 715 S.W.2d 444, 446 (Ark. 1986).

178. *See, e.g., Davis*, 910 S.W.2d at 212, 214.

179. *See ARK. CODE ANN. § 15-73-201* (1994).

recognizes that a lessee is entitled to some deference in deciding how many wells to drill and acknowledges that a lessee's judgments and actions need not be perfect.¹⁸⁰

For example, in *Sunbelt Exploration Co. v. Stephens Production Co.*,¹⁸¹ the lessors and a top lessee joined in a suit seeking cancellation of the original leases on the basis of alleged failures to develop reasonably and protect against drainage.¹⁸² In *Sunbelt*, the original lessees held leases in the Gregory Unit and in three adjoining units south of the Gregory Unit.¹⁸³ These four units shared multiple reservoirs.¹⁸⁴ The lessees drilled the Gregory No. 1 Well on the Gregory Unit in 1959, but did not complete it at the so-called Dunn Reservoir level.¹⁸⁵ In 1961, the lessees completed a well at the Dunn Reservoir level in one of the three southern units, and from 1961 to 1985, they drilled offset wells into the Dunn Reservoir on the other two southern units.¹⁸⁶

In coming back to the Gregory Unit, the lessee finally recompleted its Gregory No. 1 Well into the Dunn reservoir in 1971.¹⁸⁷ In 1990, it was confirmed that a fault ran through the Gregory Unit, from east to west, thereby preventing the Gregory No. 1 Well from draining the portion of the Dunn Reservoir that lay south of the fault.¹⁸⁸ The lessee then promptly drilled additional wells on the Gregory Unit south of the fault.¹⁸⁹

In seeking cancellation of the original lease, the lessor and top lessee argued that the original lessee breached implied covenants in three ways: (1) by failing to recomplete the Gregory No. 1 Well into the Dunn Reservoir prior to 1971; (2) by not discovering the fault earlier; and (3) by not protecting the Gregory Unit from drainage.¹⁹⁰ The plaintiffs also cited jurisprudence from other states for the proposition that, because one of the lessees owned the draining well, the original lessees had the burden of proving that their conduct was reasonable.¹⁹¹

The Arkansas Supreme Court rejected each of these arguments. First, the court noted that, under Arkansas law, the party alleging a breach of the implied covenant has the burden of proof.¹⁹² As to the

180. See *Davis*, 910 S.W.2d at 213 ("While due deference should be given to the judgment of the lessee as operator to determine how many wells should be drilled, the lessee must use sound judgment, and promote and protect the interests of both himself and the lessor.").

181. 896 S.W.2d 867 (Ark. 1995).

182. *Id.* at 870.

183. *Id.* at 869.

184. *Id.*

185. *Id.*

186. *Id.*

187. *Id.*

188. *Id.* at 869-70.

189. *Id.* at 869.

190. *Id.* at 871.

191. *Id.*

192. *Id.* at 872.

claim that the lessee unreasonably failed to recomplete the Gregory No. 1 Well into the Dunn Reservoir earlier than 1971, the court noted that uncontroverted evidence showed that when the Gregory No. 1 Well was drilled in 1959, technology was not available to determine whether the Dunn Reservoir had significant amounts of gas.¹⁹³ Furthermore, when the lessee finally recompleted the well into the Dunn Reservoir in 1971, the only reason the lessee was able to produce significant quantities of gas from that reservoir was by use of what the court called “extraordinary measures,” such as sandfracing.¹⁹⁴ Consequently, even though the reservoir did contain significant gas, it was not unreasonable to have waited until 1971 to recomplete into that reservoir.¹⁹⁵

As for the lessee’s failure to discover the fault until 1990, the court noted that the top lessee’s own geologist testified that he missed the fault when he reviewed data in 1981.¹⁹⁶ One of the original lessee’s geologists testified that he saw evidence of what might be a fault but concluded incorrectly that the data merely showed a thinning of the reservoir.¹⁹⁷ Another geologist, who had done some mapping for the original lessee in the late 1980s, testified that he previously concluded that there probably was a fault but could not tell in what direction the fault ran.¹⁹⁸ He also made recommendations for the drilling of a well, which the original lessee eventually drilled, confirming the existence of the fault.¹⁹⁹ Based on this evidence, the court concluded that the original lessee had not breached its duty to act as a reasonably prudent operator by failing to discover the fault earlier.²⁰⁰

Finally, the court concluded that the lessee did not breach its duty by failing to drill offset wells.²⁰¹ Under Arkansas Oil and Gas Commission rules, an operator normally would not be allowed to drill more than one well from the same unit into the same reservoir unless there was a fault dividing the two wells.²⁰² Thus, the court’s conclusion that the original lessee had not been unreasonable in failing to find the fault earlier conceivably could have been enough for the court to reject the drainage claim, but the court also noted that the testimony of geologists did not support a contention that there had been significant drainage.²⁰³ Accordingly, the court also rejected the claim for failure to

193. *Id.* at 871.

194. *Id.* at 871.

195. *Id.* at 872.

196. *Id.*

197. *Id.*

198. *Id.*

199. *Id.*

200. *Id.* at 873.

201. *Id.*

202. *Id.* at 872.

203. *Id.*

protect against drainage.²⁰⁴

VI. PREREQUISITES TO THE REMEDY OF LEASE CANCELLATION

If a lessee breaches its duty under an implied covenant, the lessor might be entitled to an award of monetary damages or to cancellation of the lease, depending upon the jurisdiction as well as the type of duty that was breached and other circumstances. But cancellation of a lease is a harsh remedy.²⁰⁵ Accordingly, some jurisdictions have developed a preference for awards of damages, rather than lease cancellation, and most jurisdictions that allow lease cancellation as a remedy require that the lessor must first give the lessee notice of the breach and a reasonable opportunity to cure the breach before the lessor may seek lease cancellation.²⁰⁶ This principle was illustrated in *Lewis v. Kansas Production Co.*,²⁰⁷ when the Kansas appellate court was called upon to resolve an issue of first impression under the Kansas Deep Horizons Act.²⁰⁸ In *Lewis*, the lessee breached its implied covenant to explore and develop the leased premises.²⁰⁹ The lessor sued for termination of the lease.²¹⁰ Although the lessor sent a pre-suit letter to the lessee alleging breach, the letter did not suggest that the lessor would accept efforts to develop the leased premises, and the district court determined the letter did not constitute a demand for the lessee to comply with its obligations to develop the property.²¹¹ The district court granted a termination without giving the lessee a chance to cure the breach.²¹²

204. *See id.* at 872-73.

205. *See* McDowell v. PG&E Res. Co., 658 So. 2d 779, 784 (La. Ct. App. 1995) (noting that cancellation of a lease is a harsh remedy), *writ denied*, 661 So. 2d 1382 (La. 1995); *cf.* St. Luke's United Methodist Church v. CNG Dev. Co., 663 S.E.2d 639, 644 (W. Va. 2008) (noting courts developed a preference for monetary damages as a remedy, rather than termination of leases, "based upon the significant investment intrinsic to oil and gas exploration and development").

206. *See, e.g.*, Hayes v. Equitable Energy Res. Co., 226 F.3d 560, 569 (6th Cir. 2001) (holding that, under Kentucky law, a lessor must give the lessee notice of an alleged breach of the implied covenant of reasonable development and demand performance within a reasonable time before the lessor can be entitled to termination of the lease for breach of the implied covenant); Northrup Props., Inc. v. Chesapeake Appalachia, L.L.C., No. 07-30-ART, 2008 WL 818995, at *6 (E.D. Ky. Mar. 25, 2008); *McDowell*, 658 So. 2d at 783 (holding that lessor must give lessee notice and a reasonable opportunity to perform before seeking cancellation of a lease for alleged breach of implied duty); Ridl v. EP Operating Ltd., 553 N.W.2d 784, 789 (N.D. 1996). An oil and gas lease may be terminated for a breach of the implied covenant to market the product, *see* Pack v. Santa Fe Minerals, 869 P.2d 323, 330 (Okla. 1994), though, the lessor must first demand that the lessee comply with the implied covenant and give the lessee a reasonable time to do so. *See* James Energy Co. v. HCG Energy Corp., 847 P.2d 333, 338 (Okla. 1993); Crain v. Hill Res., Inc., 972 P.2d 1179, 1181 (Okla. Civ. App. 1998) (awarding lease cancellation); *see also* Danne v. Texaco Exploration & Prod., Inc., 883 P.2d 210, 218 (Okla. Civ. App. 1994) (affirming cancellation of lease for breach of implied covenant to market). Some jurisdictions also make pre-suit demand a prerequisite to a suit for damages for the breach of an implied covenant. *E.g.*, LA. REV. STAT. ANN. § 31:136 (2000).

207. 199 P.3d 180 (Kan. Ct. App. 2009).

208. KAN. STAT. ANN. §§ 55-223 to 55-229 (2008).

209. *Lewis*, 199 P.3d at 183.

210. *Id.* at 182.

211. *See id.*

212. *Id.*

The lessee appealed, arguing that it should be given a reasonable time to develop the property.²¹³

The appeal turned on the meaning of section 55-226 of the Kansas Deep Horizons Act, which provides that all oil and gas leases include an implied covenant to explore and develop reasonably the leased premises.²¹⁴ The act provides that when a lessee has breached this implied covenant, the court may give the lessee a reasonable time to comply, or the court may enter an order terminating the lease.²¹⁵ However, the last section of the act states that the act “shall not alter or affect substantive rights or remedies under any such mineral leases under the common law.”²¹⁶ After reviewing past Kansas jurisprudence, the court determined that the rule under the common law in Kansas was that if the lessor had not made a demand that the lessee develop the leased premises, a court had to give the lessee a reasonable time to develop the premises unless demand for development would be futile or the lessee had abandoned the lease.²¹⁷ If the lessee failed to develop reasonably the premises within the time given, the court could then grant termination.²¹⁸ The court determined that this rule still applied.²¹⁹ Thus, section 55-226 and section 55-229 could be reconciled by interpreting 55-226 as allowing a court to grant termination without giving the lessee time to cure its breach if, but only if, the lessor made a demand for development, or demand would be futile, or the lessee had abandoned the lease.²²⁰

In this case, the lessee had not abandoned the lease.²²¹ Further, because the lessee had expressed a desire to develop the leased premises, demand would not be futile.²²² The trial court implied that demand would be futile because the lessee had not taken steps to develop the leased premises during the course of litigation.²²³ But the appellate court held that under Kansas law the lessee’s duty to perform was suspended while its title to the lease was under attack.²²⁴

Like Kansas, other jurisdictions requiring notice and an opportunity to cure have held that notice terminating the lease, because of an alleged breach, is insufficient without offering the lessee a chance to cure.²²⁵ Indeed, if a lessor wrongfully repudiates a lessee’s title to the

213. *Id.*

214. *See id.* at 183.

215. KAN. STAT. ANN. § 55-226 (2008).

216. KAN. STAT. ANN. § 55-229 (2008).

217. *Lewis*, 199 P.3d at 185-86.

218. *Id.* at 186.

219. *Id.* at 187.

220. *See id.*

221. *Id.*

222. *Id.*

223. *Id.*

224. *Id.*

225. *Ridl v. EP Operating Ltd.*, 553 N.W. 2d 784, 788 (N.D. 1996).

lease, the lessee's duty to perform is suspended.²²⁶

Arkansas law is an exception to the general rule that a lessor must make pre-suit demand on the lessee and give the lessee a reasonable opportunity to cure a breach before the lessor can be entitled to lease cancellation. If the lessor has not previously given the lessee notice and an opportunity to cure, the Arkansas Supreme Court has stated that a conditional cancellation, giving the lessee an opportunity to cure the breach, is preferred.²²⁷ Yet, though a conditional cancellation may be preferred, an unconditional cancellation may sometimes be granted. For example, in *Davis v. Ross Production Co.*,²²⁸ the Arkansas Supreme Court affirmed an unconditional cancellation of a portion of a lease in a case in which there apparently was no pre-suit demand to perform.²²⁹ In *Davis*, a lessor granted an oil and gas lease covering 120 acres in 1979.²³⁰ The 120-acre tract was divided into three 40-acre drilling units, and wells were drilled on each of the three units. But only one of those wells was productive, and no wells were drilled after 1984.²³¹ In late 1992, the lessor granted a top lease that covered one of the 40-acre units that did not have a productive well.²³² In early 1994, the original lessee wrote a letter to the top lessee, stating that the original leases were still valid and that the top lessee, therefore, must release his top leases.²³³ In response, the top lessee demanded that the original lessee release his lease rights to the extent the rights related to the particular 40-acre unit that was the subject of the top lease.²³⁴ The top lessee's letter to the original lessee was not quoted in the court's opinion, but the letter apparently did not demand that the original lessee perform its obligations.²³⁵ Further, the lessor never demanded that the original lessee perform.²³⁶

Both the top lessee and the original lessee filed applications with Arkansas's Conservation Commission for a permit to drill a well on the disputed unit.²³⁷ Both applicants proposed a location that would be as close as possible, under the applicable spacing orders, to the productive well on the neighboring unit.²³⁸ Thus, by its actions, the original lessee indicated a willingness to perform.

The original lessee filed a petition to quiet the title to its lease-hold rights, and the top lessee counterclaimed asking for an order cancelling

226. *Coastal Oil & Gas. Corp. v. Garza Energy Trust*, 268 S.W.3d 1, 20 (Tex. 2008).

227. *See Roberson Enters. v. Miller Land & Lumber Co.*, 700 S.W.2d 57, 58 (Ark. 1985).

228. 910 S.W.2d 209 (Ark. 1995).

229. *Id.* at 211.

230. *Id.* at 210.

231. *Id.*

232. *Id.* at 210-11.

233. *Id.* at 211.

234. *Id.*

235. *See id.*

236. *See id.*

237. *Id.*

238. *Id.*

the original lessee's lease as to the 40-acre unit at issue.²³⁹ The court found that the approximately eleven-to-twelve year period without any activity on the unit at issue constituted a breach of the implied covenant to explore the land.²⁴⁰ The supreme court granted partial cancellation of the lease, specifically cancelling the original lessee's lease as to the 40 acres in dispute.²⁴¹ In doing so, the supreme court reversed the lower court's holding that there had been no breach of the implied covenant and that cancellation was improper.²⁴² Further, the supreme court unconditionally granted cancellation of the disputed portion of the lease in spite of the absence of any pre-suit demand for performance by either the lessor or the top lessee who requested cancellation.²⁴³

A. Questions of Law and Fact

Oil and gas leases are contracts, and the general rules relating to contracts and contract interpretation apply. Because lessees often supply the language of the lease, and because lessees often are presumed to have more bargaining power, courts sometimes state that any ambiguities should be construed in favor of the lessor, or stated another way, against the draftsman.²⁴⁴ Whether an implied covenant exists is a matter of law.²⁴⁵ Whether an implied covenant has been breached is a question of fact.²⁴⁶

B. Burden of Proof

Commentators and courts note that lessors have difficulty carrying their burden of proof in breach of implied covenant cases.²⁴⁷

239. *Id.*

240. *Id.* at 213.

241. *Id.* at 214.

242. *Id.*

243. *Id.*

244. *See, e.g.*, *Jacobs v. CNG Transmission Corp.*, 332 F. Supp. 2d 759, 773 (W.D. Pa. 2004).

245. Interpretation of contracts generally is an issue of law. *See, e.g.*, *MCI Telecomms. Corp. v. Texas Utils. Elec. Co.*, 995 S.W.2d 647, 650 (Tex. 1999). Furthermore, litigants sometimes dispute not just the meaning of a particular contract, but whether a particular state's laws recognize a particular type of implied covenant at all. *See, e.g.*, *Terrebonne Parish Sch. Bd. v. Castex Energy, Inc.*, 893 So. 2d 789, 801 (La. 2005) (holding Louisiana does not recognize an implied duty to restore the surface); *Mitchell v. Amerada Hess Corp.*, 638 P.2d 441, 449 (Okla. 1981) (stating Oklahoma does not recognize an implied covenant of further exploration.).

246. *Finley v. Marathon Oil Co.*, 75 F.3d 1225, 1228 (7th Cir. 1996) (noting that whether lessee breached duty to protect against drainage was a question of fact); *Whitham Farms, L.L.C. v. City of Longmont*, 97 P.3d 135, 139 (Colo. App. 2003); *Ridl v. EP Operating Ltd.*, 553 N.W.2d 784, 788 (N.D. 1996); *Sonat Exploration Co. v. Superior Oil Co.*, 710 P.2d 221, 226 (Wyo. 1985); *see Carter v. Ark. La. Gas Co.*, 36 So. 2d 26, 28 (La. 1948).

247. *Coastal Oil & Gas Corp. v. Garza Energy Trust*, 268 S.W.3d 1, 16 (Tex. 2008) (referring to the difficulty of proving the amount of oil or gas lost to drainage); *see, e.g.*, *Jacqueline Lang Weaver, When Express Clauses Bar Implied Covenants, Especially in Natural Gas Marketing Scenarios*, 37 NAT. RESOURCES J. 491, 491 n.2 (1997) (speculating that the invention of 3-D seismic technology might make it easier for lessors to prove that lessees have failed to drill profitable wells, and thereby might "reinvigorat[e] the implied covenant to develop").

Accordingly, one can argue for the burden of proof to be placed on lessees to prove that their actions have been reasonable. So far, that generally has not happened.²⁴⁸ The lessor has the burden of proof to show breach of an implied covenant.²⁴⁹

Courts generally will give some deference to lessees in their decisions about development.²⁵⁰ And, because lessees presumably are driven by a profit motive, a lessee does not breach the implied covenant to develop unless he fails to drill wells that likely would be profitable. One commentator has argued that a lessee's decisions regarding development "should be entitled to enjoy a powerful presumption of compliance with his implied covenant duties."²⁵¹ But other commentators have concluded, "it is impractical to rely on the self-interest of the lessee alone" given the divergence of interest that results from "the fact that the lessee has the risk- and cost-bearing working interest under the lease, while the lessor retains a cost-free royalty interest."²⁵² Despite the general rule that the lessor alleging a breach of an implied covenant has the burden of proving each element of his claim, some courts have allowed the burden to shift to the lessee in certain situations.²⁵³

VII. DOES THE IMPLIED COVENANT OF REASONABLE DEVELOPMENT OR PRUDENT OPERATIONS REQUIRE THE LESSEE TO ENGAGE IN WELL STIMULATION OR SECONDARY RECOVERY?

Although at least one commentator has argued that the implied covenant of reasonable production already leads to overproduction,²⁵⁴ a more prevalent view is that public policy should favor increased

248. There are some exceptions. One statutory exception is the Kansas Deep Horizons Act. See KAN. STAT. ANN. § 55-223 (2009) (providing that, as a matter of public policy, an implied covenant of reasonable development and exploration exists); see *id.* § 55-224 (providing for circumstances in which there will be a rebuttable presumption that lessee has breached the implied covenant established by § 55-223); see *id.* § 55-225 (providing that lessee has the burden of proof in rebutting the existence of a presumed breach).

249. *Whitham Farms*, 97 P.3d at 138-39; *Sonat Exploration*, 710 P.2d at 228-29.

250. *E.g.*, *Davis v. Ross Prod. Co.*, 910 S.W.2d 209, 213 (Ark. 1995).

251. Stephen F. Williams, *Implied Covenants' Threat to the Value of Oil and Gas Reserves*, 36 INST. ON OIL & GAS L. & TAX'N 3-1, 3-7 (1985).

252. *Finley v. Marathon Oil Co.*, 75 F.3d 1225, 1230 (7th Cir. 1996) (noting conflict of interest between lessor and lessee arising from fact that lessor does not share in the costs and, therefore, the risk of drilling); *Conine*, *supra* note 58, at 676.

253. At least one court shifted the burden to the lessee in a case in which the lessor alleged a breach of the duty to protect against drainage. The lessor had made an initial showing that drainage existed, and the defendant-lessee also was the operator of the well on neighboring property that allegedly was draining the plaintiff-lessor's land. *E.g.*, *Elliott v. Pure Oil Co.*, 139 N.E.2d 295 (Ill. 1956). In addition, Professor Lowe states that when a lessor alleges a breach of the implied covenant of reasonable development: "In Oklahoma and perhaps a few other states . . . the burden of proof shifts to the lessee when an unreasonable period of time has elapsed after the initial discovery." Lowe, *supra* note 7, at 316-17.

254. See Patrick H. Martin, *A Modern Look at Implied Covenants to Explore, Develop, and Market Under Mineral Leases*, 27 INST. ON OIL & GAS L. & TAX'N 177, 205-06 (1976).

production, including increased production from existing fields.²⁵⁵ Further, the lessor will benefit from increased production by way of more royalties. Thus, both public policy and the interests of lessors might dictate that lessees be required to use advanced technology to increase production. And operators have been using various technologies to increase production since nearly the beginning of the oil and gas industry.

One type of technology used to increase production is well stimulation—which includes various methods, such as fracturing. Operators have been engaged in fracturing, beginning with explosive fracturing, since the 1860s to create cracks in underground rocks in order to increase production.²⁵⁶ Fracturing is common now, but it is likely to be even more important in the future. Shale plays are becoming increasingly important in natural gas production, and “fracing” often is the only method to extract profitably natural gas from shale formations.²⁵⁷

Other types of technology, such as secondary recovery and enhanced recovery techniques, attempt to produce more oil and gas than is possible using only primary recovery. “Primary recovery” refers to the production of oil and gas using the pressure contained in the underground formation where the oil and gas is found. However, primary recovery can leave up to 70% of the petroleum in the reservoir.²⁵⁸ Secondary recovery involves supplementing the pressure of the underground reservoir by injecting gas or water, both of which typically are found naturally in underground formations, to boost the underground pressure. Operators have also engaged in secondary recovery for many years and also now commonly engage in enhanced recovery, which involves the underground injection of substances not normally found in underground formations.²⁵⁹

Over the years, secondary recovery, enhanced recovery, and well-

255. See, e.g., *Pennzoil v. Fed. Energy Regulatory Comm.*, 645 F.2d 360, 380 n.39 (5th Cir. 1981) (discussing federal incentives for production from stripper wells).

256. See NORMAN J. HYNE, *NONTECHNICAL GUIDE TO PETROLEUM GEOLOGY, EXPLORATION, DRILLING, AND PRODUCTION* 422 (2d ed. 2001); see also *Roberts v. Dickey*, 20 F. Cas. 880, 883-84 (W.D. Pa. 1871) (discussing patent granted in 1866 for use in explosive fracturing). Hydraulic fracturing was developed in 1948, and operators sometimes use acidizing for the same purpose. See HYNE, *supra* at 422-23. Fracturing is particularly useful in recovering gas from low permeability or “tight” formations. E.g., *Coastal Oil & Gas Corp. v. Garza Energy Trust*, 268 S.W.3d 1, 6-7 (Tex. 2008) (discussing the hydraulic “fracing” process).

257. See Hannah Wiseman, *Untested Waters: The Rise of Hydraulic Fracturing in Oil and Gas Production and the Need to Revisit Regulation*, 20 *FORDHAM ENVTL. L. REV.* 115, 123 (2009).

258. See JAMES G. SPEIGHT, *THE CHEMISTRY AND TECHNOLOGY OF PETROLEUM* 146 (2d ed. 1991).

259. See HYNE, *supra* note 256, at 523. The first method of secondary recovery of oil probably involved the reinjection of natural gas into reservoirs, which was first performed prior to 1900. SPEIGHT, *supra* note 258, at 149. Enhanced recovery is the production of more oil from an otherwise depleted reservoir by injection of fluids not found naturally in a producing reservoir. HYNE, *supra* note 256, at 477.

stimulation technology has advanced.²⁶⁰ Nevertheless, surprisingly few recent cases discuss whether a lessee has an implied duty to engage in well stimulation, secondary recovery, or enhanced recovery as part of the lessee's obligations under the implied covenant to develop reasonably or as part of his implied covenant of prudent operation.²⁶¹ In one Louisiana case, a court awarded cancellation of a lease because the court found that a lessee's failure to fireflood amounted to a failure to develop reasonably the leased premises.²⁶²

For the most part, other cases merely have stated that such a duty might exist or their statements that such a duty exists have appeared only in dicta. The Kansas Supreme Court referred to the possible existence of such a duty in *Crawford v. Hrabe*,²⁶³ in which the court held that a lessee had the right, without its lessor's permission, to use and inject salt water from other properties into a producing formation on the lessee's premises for purposes of a secondary-recovery project.²⁶⁴ The court, however, did not go so far as to opine that such a duty exists.

Several older decisions from Illinois—usually in the context of stating that a lessor has the right to engage in secondary recovery—state in dicta that a duty to engage in secondary recovery exists.²⁶⁵ In addition, an older case from Oklahoma notes that some commentators have stated such a duty might exist.²⁶⁶

VIII. RUMINATIONS ON THE STABILITY OF IMPLIED COVENANT LAW

Changes to the law of implied covenants, or changes brought about by parties drafting leases that expressly define the scope of duties that otherwise would be imposed by implied covenants, could come from three sources—government, lessors, or lessees. Public policy might be

260. See also PATRICK H. MARTIN & BRUCE M. KRAMER, WILLIAMS & MEYERS: MANUAL OF OIL AND GAS TERMS 1033 (12th ed. 2003) (stating in reference to “secondary recovery” that: “Broadly defined, this term includes all methods of oil extraction in which energy sources extrinsic to the reservoir are utilized in the extraction”).

261. The *Manual of Oil and Gas Terms* does not define “well stimulation,” but it notes that “stimulate” is defined by a West Virginia statute as “any action taken by well operator to increase the inherent productivity of an oil or gas well including, but not limited to, fracturing, shooting or acidizing, but excluding cleaning out, bailing or workover operations.” *Id.* at 1092.

262. *Waseco Chem. & Supply Co. v. Bayou State Oil Corp.*, 371 So. 2d 305, 313 (La. Ct. App. 1979), writ denied, 374 So. 2d 656 (La. 1979). In an older Louisiana decision, a court held that a lessee breached its duty to develop reasonably the premises by failing to use acidizing technology—a type of well stimulation. See *Wadkins v. Wilson Oil Corp.*, 6 So. 2d 720 (La. 1942).

263. 44 P.3d 442 (Kan. 2002).

264. *Id.* at 453.

265. *E.g.*, *Reed v. Tex. Co.*, 159 N.E.2d 641, 644 (Ill. App. Ct. 1959) (noting older Illinois cases stating that “it was an implied right, and even a duty, for a reasonably prudent operator to adopt a repressuring system for the secondary recovery of oil”); *Bi-County Props. v. Wampler*, 378 N.E.2d 311, 315 (Ill. App. Ct. 1978).

266. *In re Shailer's Estate*, 266 P.2d 613, 616-17 (Okla. 1954) (noting that “[t]here is respectable authority to the effect that there is an implied covenant in oil and gas leases that a lessee should resort to a secondary recovery method shown to be practical and presumably profitable as a means of getting additional return from the lease”).

well served by changes to the law of implied covenants.²⁶⁷ Why have courts not done more to alter the implied covenants? One reason probably is that the common law is conservative, in the sense of being stable and generally slow to change or innovate. And this disinclination toward rapid innovation and change arguably is particularly justified when dealing with implied obligations in contracts, given that parties can, if they choose, explicitly address the nature and scope of their various contractual obligations. Indeed, as to mineral leases that already have been executed, any significant expansion of implied covenants could impose on lessees duties that the parties did not bargain for or even contemplate at the time they entered the lease.

This concern was expressed by the Louisiana Supreme Court when it ruled that Louisiana law does not recognize an implied covenant to restore the surface in *Terrebonne Parish School Board v. Castex Energy, Inc.*²⁶⁸ In that case, the lessor was the school board of a parish on the Louisiana Gulf Coast.²⁶⁹ The school board sued several former lessees for restoration of the surface in certain coastal areas.²⁷⁰ The school board prevailed in the lower courts, which rejected the lessees' argument that there is no implied duty to restore the surface.²⁷¹ The lessees sought and obtained supreme court review, but the lessees' chances of prevailing in the supreme court could not have looked promising; comments to the Louisiana Mineral Code state that such a duty exists, and though such comments are not law, they have persuasive authority.²⁷² Further, the Louisiana Supreme Court itself previously had stated in dicta that such a duty exists.²⁷³ Moreover, coastal erosion is a significant problem in Louisiana, it is widely accepted that oil and gas activities in the coastal marshes exacerbate the problem, and there is some degree of public support for requiring oil and gas producers to help solve the problem. Nevertheless, the Louisiana Supreme Court reversed the lower court, holding that there is no implied duty to restore the surface and stating that a contrary holding would impose duties on the lessee which the parties had not

267. See, e.g., Martin, *supra* note 31, at 658 (predicting in 1994 the future expansion of recognition of the implied covenant to restore the surface). So far, though, there has not been any significant increase in the number of states recognizing this implied covenant. Texas, which long has rejected any implied duty to restore the surface, has maintained that position. See *Fenner v. Samson Res. Co.*, No. 01-03-00049, 2005 WL 2123043, at *5 (Tex. App. Aug. 31, 2005); see also *Exxon Corp. v. Pluff*, 94 S.W.3d 22, 29-30 (Tex. App. 2002) (rejecting claims that lessee had a duty to remove equipment and materials) (citing *Warren Petroleum v. Monzingo*, 304 S.W.2d 362 (Tex. 1957)). Furthermore, the Louisiana Supreme Court has pulled back from prior dicta suggesting that such an implied duty exists. See *Terrebonne Parish Sch. Bd. v. Castex Energy, Inc.*, 893 So. 2d 789, 802 (La. 2005).

268. 893 So. 2d 789 (La. 2005).

269. *Id.* at 791-92.

270. *Id.* at 793.

271. *Id.* at 794.

272. See *supra* notes 83-86 and accompanying text.

273. *Caskey v. Kelly Oil Co.*, 737 So. 2d 1257, 1261 (La. 1999).

contemplated and for which they had not bargained.²⁷⁴

But courts are just one branch of government. Duties expressly imposed by legislation or regulation might not literally qualify as “implied covenants,” but legislation and regulation could have some effect on implied covenants. Why have legislatures and administrative agencies not done more? Legislatures have enacted some statutes that affect directly or indirectly the implied covenants relating to development. Some states have enacted what are effectively statutory Pugh clauses, which affect the extent to which a lessee will have to develop the premises in order to maintain the entire lease.²⁷⁵ Kansas has passed the Deep Horizons Act, which under certain circumstances creates a rebuttable presumption that the implied covenant of reasonable development has been breached.²⁷⁶ And of course, there exists some legislation and regulation relating to liability for oil spills and regarding oilfield cleanup, which are relevant to any implied covenant to restore the surface.²⁷⁷ One of the reasons there has not been more legislation and regulation is likely that lawmakers and regulators are reluctant to alter duties under existing private contracts to any substantial degree.

The second group that could be a source for change is lessors. Some have suggested that lessors would become more sophisticated with time and bargain for more lessor-favorable provisions in leases.²⁷⁸ And some lessors do bargain for favorable provisions. In Louisiana, for example, many leases still are based on standard forms. But it is not uncommon for prospective lessors, including persons unsophisticated in oil and gas matters, to retain counsel and bargain for lessor-favorable provisions such as standard-Pugh clauses and horizontal-Pugh clauses,²⁷⁹ as well as provisions explicitly requiring restoration of the surface to pre-lease conditions. Indeed, substantial litigation has been generated in the last several years by a Louisiana Supreme Court opinion that held when a lessee contractually obligates itself to restore the surface to pre-lease conditions, it is obligated to do just that, even if the cost of restoration will exceed the market value of the land in its restored

274. *Terrebonne Parish*, 893 So. 2d at 802.

275. *See, e.g.*, ARK. CODE ANN. § 15-73-201 (1994).

276. *See* KAN. STAT. ANN. §§ 55-223 to 55-229 (2008).

277. *See* Oil Pollution Act of 1990, 33 U.S.C. §§ 2701-2762 (2006); LA. REV. STAT. ANN. § 30:4(c)(1) (2007) (granting Louisiana Department of Natural Resources, Office of Conservation the authority to promulgate regulations for various purposes, including preventing the escape of oil and gas); LA. ADMIN. CODE tit. 43, §§ 101-641 (providing regulations that cover, among other things, proper plugging and abandonment of wells and actions to prevent escape of oil and gas).

278. *See* LOWE, *supra* note 7, at 352 (noting that some have predicted that “implied covenants will become less important as lessors become more sophisticated and demand express covenants”).

279. *See, e.g.*, *Sandfer Oil & Gas, Inc. v. Duhon*, 961 F.2d 1207, 1208 (5th Cir. 1992) (involving dispute between lessee and lessors who were natural persons over interpretation of a horizontal Pugh clause).

condition.²⁸⁰ But, the lessors have not driven any wholesale change. As for why lessors collectively have not done more, there are probably at least three answers. First, many lessors still are unsophisticated and do not retain counsel or other expert assistance. Second, for any provision to be incorporated into a lease, the lessor must not only bargain for it, but must prevail in convincing the lessee to agree to the provision, and sometimes that will be difficult. Third, as for duties relating to development, it probably is difficult at the beginning of the lease to define what should be done, and, therefore, it can be difficult for even a knowledgeable lessor to know what specific obligations for which he should bargain to impose on the lessee.

Why have lessors not done more in the way of filing lawsuits? Why have they not sought to use new seismic or other exploration technology to show that lessees have not reasonably developed the leased premises or asserted that lessees have not adequately used new technology—either exploration or enhanced recovery technology? Lack of sophistication amongst lessors is probably one reason. Limited access to such data and the significant expense of utilizing such technology is another. Third, to the extent the lessors will be relying on truly new technology, a lessee probably has not been unreasonable in failing to previously use the technology. Finally, the burden of proof can often be difficult for lessors to carry in cases involving an alleged breach of the implied covenant of reasonable development.

The third group that could be a source for change is lessees. Lessees probably are in the best position of the three groups to change the landscape of implied covenant law. Lessees are in a better position than government and the courts because lessees are parties to leases and, thus, can bargain for specific provisions. Also, lessees tend to be more sophisticated than lessors. Case law is essentially unanimous in holding that if a lease expressly addresses a subject, a court should not find an implied covenant regarding that subject. And, because lessees are the parties that bear the burden of implied covenants, they have an incentive to bargain for lease provisions that eliminate, limit, or at least specifically define their duties. So, why have lessees not done more?

First, it is noteworthy that lessees have done some things to limit implied covenants. One of the implied covenants that has been recognized since the early days of oil and gas jurisprudence is an implied covenant to drill a test well or wells promptly.²⁸¹ But this implied covenant rarely is an issue anymore because virtually all oil and gas leases have provisions that expressly address the duty to drill—either delay-rental provisions or a provision making the lease a paid-up

280. *Corbello v. Iowa Prod.*, 850 So. 2d 686, 693 (La. 2003).

281. *Conine*, *supra* note 58, at 683.

lease—which, therefore, preclude the existence of an implied covenant to drill.²⁸² And occasionally one encounters or reads a case regarding a lease that expressly defines the extent of the lessee’s duty to drill wells to develop the leased premises, such as by providing that if the lessee drills a certain number of wells, the lessee need not drill any more.²⁸³ Further, some leases specifically define the circumstances in which the lessee must drill an offset well. Yet, most leases do not contain such provisions. Why not?

Provisions obligating the lessee to drill a minimum number of wells could disadvantage the lessee if the property turns out to be non-productive. A provision could provide some protection to the lessee by stating that if the lessee drills a certain number of wells, he need not (but may) drill more wells. However, such a provision could backfire. Even if the lease clearly does not require the drilling of a stated number of wells, a court could view the stated number of wells as evidence of what the parties thought was a reasonable number of wells. Further, such clauses would require the consent of all parties to the lease, and prospective lessors, particularly more sophisticated lessors, might resist such provisions. And, if lessees successfully bargained for provisions that went beyond limiting the scope of implied covenants, to eliminating or virtually eliminating all duties to develop, courts might find such provisions unenforceable as a matter of public policy or might find other case-specific ways to avoid enforcing such provisions. Further, it is difficult at the beginning of a lease to know what will be reasonable development of the property. Finally, there would be some transactional costs in seeking such provisions. Negotiations with prospective lessors might become lengthier. Also, to the extent the lessees might attempt to tailor provisions relating to their development duties to the circumstances of specific proposed leases, much more analysis and work might be required on the front end of transactions.²⁸⁴

IX. CONCLUSION AND WHAT TO EXPECT IN THE FUTURE

Implied covenants are obligations not expressly stated in a contract, but which a court will impose on one or both parties. Since the early days of the oil and gas industry in the late 1800s, courts have imposed a variety of implied covenants on lessees, including covenants to drill test wells, to develop reasonably the property after discovery of oil and gas in paying quantities, and to protect the leased premises

282. *Id.* at 684.

283. *See, e.g.*, *Lundlin/Weber Co. v. Brea Oil Co.*, 11 Cal. Rptr. 3d 768, 773 (Ct. App. 2004).

284. *Cf.* Conine, *supra* note 58, at 684 (noting that common use of delay rental provisions arose because “[leases] are often hastily accomplished in an effort to beat competitors in the acquisition of drilling rights,” frequently prior to conducting geological studies and sometimes before titles are cleared).

against drainage of oil and gas by wells on neighboring property. Authorities disagree on whether these covenants are implied by the terms of an oil and gas lease itself and are used by courts to affect the will of the parties or whether these covenants are implied by law and used by courts to promote fairness and equity. Both these theories about the source of implied covenants probably have some merit.

Although there have been significant advances in technology and shifts in public policy, implied covenant law has changed remarkably little over the course of 100 years. Further, because implied covenant law tends not to differ dramatically from one state to the next, the shift in the center of gravity of the oil and gas industry from Pennsylvania in the early days of the industry to southern and western states has not had dramatic effects on the obligations lessees bear under implied covenants. Moreover, although some commentators have predicted that implied covenant law would become less significant as parties became more sophisticated and bargained for lease terms that expressly define a lessee's specific duties, this generally has not happened and implied covenant law remains highly relevant as part of oil and gas law.

It is tempting to predict that advances in technology, changes in public policy to favor increased production and tighter pollution controls, and a hypothesized increase in sophistication of both lessors and lessees will lead to significant changes in implied covenant law in upcoming years as well as the decreased significance of such covenants. But the lesson of history suggests that the law of implied covenants instead will change relatively little and will remain highly significant in the coming years.