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Chapter 15

Oil and Gas Development Obligations Under the Oil, Gas, and Gas Storage Lease

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Synopsis

§ 15.01. Introduction.

In the past, gas companies have acquired gas storage rights from landowners and, as part of the same or a contemporaneous transaction, acquired oil and gas development rights to the lands encompassed by the storage rights.[1] Although the oil and gas development rights are typically acquired to protect the storage rights, the gas storage lessee confronts the dilemma of either having too many rights, or not enough rights. Since the gas storage lessee probably has no intention of exercising its development rights while gas storage is taking place, they may have too many rights.

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[1] *See, e.g.*, Oliver v. Louisville Gas and Elec. Co., 732 S.W.2d 509, 510 (Ky. Ct. App. 1987)(landowner entered into "oil, gas and gas storage" leases); Thomas Well Service, Inc. v. Williams Natural Gas Co., 873 F. Supp. 474, 479 (D. Kan. 1994)(landowner entered into oil and gas leases at approximately the same time they entered into gas storage leases), *aff'd*, 64 F.3d 670 (10th Cir. 1995).

However, since they do not own the oil and gas rights in fee, but merely a leasehold interest, they may not have enough rights to refrain from oil and gas development while storage is taking place. This chapter examines the oil and gas development obligations of the oil, gas, and gas storage lessee in situations where the leased acreage is being held beyond the primary term through a gas storage activity.

§ 15.02. Protecting Gas Storage Rights by Controlling Oil and Gas Development Rights.

Typically the motivating force for a gas storage company to acquire oil and gas development rights has been to avoid development activities that could interfere with gas storage operations. Although the same protection could be obtained by restricting the grantor's ability to use the storage areas for oil and gas development,[2] this has not been the industry practice. Perhaps gas storage companies view the oil and gas development rights as a valuable additional asset which can be maintained indefinitely through gas storage operations. However, ownership of the development rights may include an obligation to do something with them.[3]

When the oil and gas development rights are not necessary to protect storage rights, the equities are fundamentally different. If development of oil and gas rights can proceed without interference with storage rights, the failure to develop will be subject to closer scrutiny. This will often be the case when the development concerns depths above or below the storage reservoir,[4] or beyond the areal boundaries of the storage reservoir.[5] It could even include pockets of oil located within the storage reservoir when the oil can be produced without jeopardizing gas storage activities.[6]

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[2] For example, the grantor could convey the storage rights to the gas storage company and also agree to restrictive covenants limiting the grantor's use of the balance of its mineral interests while the gas storage rights are in existence. If the grantor retained the oil and gas development rights, they could not complain about their nonuse. Similarly, if the grantor conveyed all its rights in the oil and gas mineral interest, they could not complain about their nonuse.

[3] *See* discussion *infra* § 15.05.

[4] Vertically distinct areas.

[5] Horizontally distinct areas.

[6] Thomas Well Service, Inc. v. Williams Natural Gas Co., 873 F. Supp. 474, 483 (D. Kan. 1994)(top lessee sued gas storage operator seeking right to explore for oil within the gas

§ 15.03. Maintaining Oil and Gas Development Rights Through Gas Storage.

Development issues arise only when oil and gas development rights are linked with gas storage rights under a habendum clause extending all rights so long as the gas storage rights are maintained.[7] The express terms of the habendum clause[8] and the non-divisibility doctrine regarding lease covenants[9] generally combine to extend the oil and gas development rights for so long as gas storage rights are being used or maintained.

[1] — Operation of the Habendum Clause.

The first inquiry, when evaluating development obligations, is to determine whether gas storage activities will extend oil and gas development rights beyond the primary term of the applicable lease. The focus will be

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storage zone), *aff'd*, 64 F.3d 670 (10th Cir. 1995). In a Gas Storage Agreement form used by Northern Natural Gas Company, the possibility of oil development within the granted gas storage zones was specifically addressed as follows:

> In the event any formation or formations utilized for gas storage is capable of producing oil (including condensate and distillate), Grantor hereby grants exclusively unto Grantee the right to utilize the Premises for the purposes of recovering, saving, transporting and owning the oil within said formations provided that Grantee delivers as a royalty, free of cost, to Grantor at the wells, or to the credit of Grantor, one-eighth (1/8) part of all oil recovered and saved from the Premises, or at Grantee's option pay to Grantor for such one-eighth (1/8) royalty the posted market price at the well in the field or the area for oil of like grade and gravity prevailing on the day such oil is run into the pipeline or sold from the storage tanks. . . .

Gas Storage Agreement, ¶ 5(c), at 2, dated August 15, 1995 between Northern Natural Gas Company and The Peoples Bank, Pratt, Kansas, Trustee (on file with author).

[7] *E.g.*, Rook v. James E. Russell Petroleum, Inc., 679 P.2d 158, 160 (Kan. 1984)("This lease shall remain in force for a term of ten years from this date and so long thereafter as oil, gas, casinghead gas or other kindred products [are] produced *or the storage right is being exercised as hereinafter set forth.*")(emphasis added).

[8] Including the terms of collateral agreements linked to the habendum clause. *E.g.*, Thomas Well Service, Inc. v. Williams Natural Gas Co., 873 F. Supp. 474, 482 (D. Kan. 1994)("[I]t is agreed that at any time when this storage lease is in good standing by reason of rental payments *any valid oil and gas lease now upon said lands shall not be subject to attack on the ground of lack of production* . . . .)(emphasis added), *aff'd*, 64 F.3d 670 (10th Cir. 1995).

[9] *See* discussion *infra* § 15.03.

on the substances covered by the habendum clause,[10] the geologic zones covered by the habendum clause,[11] and the areal extent of the lease.[12] If the substance, formation, or area is not perpetuated beyond the primary term by gas storage activities, then a traditional oil and gas lease analysis will apply to determine whether the lease has terminated due to a lack of production — or if maintained by production — whether the lessee is complying with implied development obligations.

The development problems addressed in this chapter arise when the gas storage facility operator, who is typically disinterested[13] in developing the productive potential of the leased land, nevertheless holds and maintains the exclusive right to develop through collateral gas storage activities. To ensure oil and gas development in the leased area is kept at bay while the primary activity of gas storage is being pursued, the habendum clause typically extends the oil and gas development rights for so long as gas storage activities are being pursued.

The express terms of the habendum clause, in conjunction with the granting clause, will determine the duration of the rights granted. For example, the following clauses illustrate the manner in which oil and gas development rights can be perpetuated by gas storage activities totally unrelated to the exploration and production of oil and gas:

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10 For example, will *gas* storage maintain the *oil* rights?

11 For example, will it extend rights only to a specified formation or formations, such as the "Simpson and Arbuckle Formations"? *See* Gas Storage Agreement, ¶1, at 1, dated August 15, 1995 between Northern Natural Gas Company and The Peoples Bank, Pratt, Kansas, Trustee (on file with author)(conveying "that part of the subsurface rock formations lying below the following described land comprising the Simpson and Arbuckle Formations . . . ."). Will it extend rights only to a specified depth in the granted land? *See* Reese Exploration, Inc. v. Williams Natural Gas Co., 983 F.2d 1514, 1519 (10th Cir. 1993)(conveying the right to "store its gas in sands or strata not exceeding [1,050 feet] below the surface.").

12 For example, the storage lease will typically cover an area that extends beyond the geologic boundaries of the storage reservoir. *See* Rook v. James E. Russell Petroleum, Inc., 679 P.2d 158, 160 (Kan. 1984)(oil and gas lessee entered into "supplemental agreement" with lessor to expand rights under oil and gas lease to include gas storage).

13 In many situations the gas storage facility operator is motivated not merely by a lack of interest toward oil and gas development, but rather a basic hostility toward development because of the potential interference it may cause to its primary mission of storing gas.

Lease #1

To Have and to Hold unto and for the use of the Lessee for the term of 20 years from the date hereof and as much longer as oil or gas is produced in paying quantities *or as the property continues to be used for the underground storage of gas.*[14]

Lease #2

To have and to hold the said oil and gas lease . . . for a term of ten years, and so much longer . . . as *gas is being produced, stored, withdrawn, or held in storage* . . . in the sub-surface sands . . . .[15]

Lease #3

This lease shall remain in force for a term of ten years from this date and so long thereafter as oil, gas, casinghead gas or other kindred products [are] produced *or the storage right is being exercised* as hereinafter set forth.[16]

Lease #4

[T]his [Gas Storage] Agreement shall remain in force for a term of twenty-five (25) years from this date and as long thereafter as *gas is being stored, held in storage or withdrawn from the land described above or from land in the vicinity of the land described above* by Grantee. It is further understood that for storage purposes a well or wells need not be drilled on the land described above, and that Grantee shall be the sole and exclusive judge as to whether gas is being stored under the land described above or held in storage under said land, and that its determination shall be final and conclusive.[17]

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[14] Oliver v. Louisville Gas and Elec. Co., 732 S.W.2d 509, 510 (Ky. App. 1987)(leases were identified by the court as "'oil, gas and gas storage' leases")(emphasis added).

[15] Rayl v. East Ohio Gas Co., 348 N.E.2d 385, 387-88 (Ohio Ct. App. 1973)(terms added to existing oil and gas lease by "Supplemental Gas Storage Agreement")(emphasis added).

[16] Rook v. James E. Russell Petroleum, Inc., 679 P.2d 158, 160 (Kan. 1984)(emphasis added).

[17] Gas Storage Agreement, ¶ 3, at 1, dated August 15, 1995 between Northern Natural Gas Company and The Peoples Bank, Pratt, Kansas, Trustee (on file with author)(emphasis added).

> Lease #5
> The term of said oil and gas lease shall be and is hereby enlarged so as to run as long as oil and gas or either of them is produced, and as long thereafter as the *premises above described shall be utilized for the introduction, storage and/or removal of natural gas (whether introduced into or withdrawn from this or other land) and/or as long as the storage rentals hereinafter fixed shall be paid.*[18]

The goal in evaluating the express terms of the habendum clause, and the granting clause, will be to determine whether the oil and gas development rights are being maintained by the express document terms. For example, referring to the Lease #5 habendum clause, could it be argued that the lease can be maintained only through oil or gas production *and* a gas storage activity — instead of one or the other? The clause provides: "The term of said oil and gas lease shall be and is hereby enlarged so as to run as long as oil and gas or either of them is produced, *and* as long thereafter as the premises . . . shall be utilized for the introduction, storage and/or removal of natural gas . . . ."[19] The drafter was careful to use "oil and gas *or either of them*" and the phrase "and/or" in addressing alternatives within each activity. However, they used the unaltered term "and" to connect the two general types of activity; this could suggest a limitation of the habendum clause instead of an expansion.[20] If the issue is a close one, courts may be inclined to resolve it in favor of the oil and gas lessor; particularly if a contrary ruling would give the gas storage operator the oil and gas development rights without having any obligation to develop the oil and gas.

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[18] Rook v. James E. Russell Petroleum, Inc., 679 P.2d 158, 160 (Kan. 1984)(emphasis added).

[19] *Id.*

[20] If this were litigated, however, I think a court would not interpret "and" in the conjunctive in this case since it is preceeded by the statement: "The term of said oil and gas lease shall be and is hereby *enlarged* . . . ." *Rook*, 679 P.2d at 160 (emphasis added). The intent of the parties, with the "enlarged" language, appears to have been to use the word "and" in the disjunctive so as to expand, "enlarge," the events that would perpetuate the oil and gas lease. *See generally*, Scott J. Burnham, Drafting Contracts § 7.4.1, at 97 (2d ed. 1993)("The word *and* is generally conjunctive, uniting things, while *or* is generally

If the express terms of the document permit the maintenance of oil and gas development rights through gas storage activities, the second inquiry is whether events, or other express terms of the document, have caused the rights to be de-linked. This requires an examination of the divisibility concept.

[2] — The Divisibility Concept.

Oil and gas lease covenants are generally treated as being "indivisible" unless the express terms of the lease make them "divisible."[21] Therefore, if a lessor grants a lease covering Section 30 (640 acres), an assignment of the Southeast Quarter of Section 30 (160 acres) to a third party will not cause a division of the original lease, for habendum clause purposes, where the term is for "as long . . . as the lessee produced oil and gas . . . from said land."[22] "Said land," referring to all of Section 30, would permit the special limitation to be satisfied by production associated with any portion of Section 30 — regardless of who owned the various portions of the lease covering Section 30.[23] A similar analysis has been applied to other lease clauses that expand the events that will perpetuate the lease beyond those specified in the habendum clause.[24]

However, in *Cosden Oil Co. v. Scarborough*,[25] the court held that the implied covenant to develop was a divisible covenant which applies when a larger leased area is subsequently assigned to several different owners.[26] Therefore, when Cosden was assigned 400 acres out of a 10,254-acre lease, Cosden's implied obligation must be defined by what a prudent operator would do as lessee of the 400-acre tract, not what a prudent operator would

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disjunctive, separating things. The problems arise because *and* has both a *several* and a *joint* sense, and *or* has both an *inclusive* and *exclusive* sense . . . .").

21 David E. Pierce, "An Analytical Approach to Drafting Assignments," 44 *Sw. L.J.* 943, 962-64 (1990).

22 *See* Cowan v. Phillips Petroleum Co., 51 P.2d 988, 990 (Kan. 1935).

23 *Id.* at 991.

24 *E.g.*, Wilson v. Texas Co., 76 P.2d 779, 782 (Kan. 1938)(benefits under dry hole clause are indivisible).

25 Cosden Oil Co. v. Scarborough, 55 F.2d 634 (5th Cir. 1932).

26 *Cosden*, 55 F.2d at 638.

do, or had done, as the owner of a single 10,254-acre lease.[27] Distinguishing the habendum clause issue from the implied covenant issue, the court stated:

> Of oil and gas leases generally it may be said that ordinarily they are regarded as indivisible as to the express conditions which fix the vesting of the determinable fee, such as the . . . obtaining of production . . . and that assignees under an original lease hold their titles to their several tracts without the necessity of further rental payments, or of further compliance with these express drilling conditions when they have been complied with on any part of the lease. . . . On the other hand, as to the implied covenant, which running with the land is imposed on each taker of any part of the lease as a consideration for his holding it, we think it is quite generally held that the contract is severable, imposing upon the holder of each segregated part the obligation to develop that part without reference to the others.[28]

The basis for the court's decision was that the lessor's primary consideration for entering into the oil and gas lease was the generation of either delay rental income or royalty income. Because a producing well on another portion of the leased premises eliminated any obligation to pay delay rental,[29] the "consideration" for the assignee holding their portion of the leased land was their obligation to diligently develop their tract as a prudent operator.[30] The court also relied upon the terms of a "divisibility" clause concerning delay rental payments.[31]

The only instance in which the typical form of oil and gas lease expressly addresses divisibility is with regard to the payment of delay rental. For example, a common Texas lease form provides:

> In the event of an assignment of this Lease as to a segregated portion of said land, the rental payable hereunder shall be apportioned as between the several leasehold owners ratably

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27 *Id.*

28 *Cosden*, 55 F.2d at 637-38.

29 Production was obtained during the first two years of the 10-year primary term so the lessee was relieved of paying delay rental. *Cosden*, 55 F.2d at 635-36.

30 *Cosden*, 55 F.2d at 638.

31 *Id.*

> according to the surface area of each, and default in rental payment by one shall not affect the rights of other leasehold owners.[32]

This language is designed to protect the lessee of a divided interest in a larger leased tract from having their interest terminate when another divided interest owner fails to properly pay their share of delay rental.

In *Cosden* the court, reciting a clause similar to the delay rental divisibility clause, stated:

> [T]he provision that separate payment of rentals as to portions assigned shall be sufficient to keep alive the particular portion on which rentals have been paid, show, we think, in the plainest kind of way that the parties contemplated a lease divisible as to the consideration for it, both before and after the discovery of minerals; before discovery, as to the payment of cash rentals; after discovery, as to the payment of that which was in lieu of cash rentals, the development of oil from the land for the purpose of paying over to the lessor his part of the production.[33]

However, the court failed to focus on another clause in the lease that was perhaps more to the point:

> [N]otwithstanding such change in ownership [assignment], in whole or in part, *the lessee may develop and operate the land conveyed by this lease as an entirety*, and there shall be no obligation on his part to offset wells on separate tracts into which the land conveyed by this lease may be hereafter divided by either sale, devise or inheritance . . . .[34]

Although the holding in the *Cosden* case may be open to challenge, the message is clear: given the appropriate facts and lease language, a lessor may be able to successfully argue that a lease is "divisible" for certain purposes. This concept would seem particularly useful when applied to oil and gas development rights that have been assigned to a third party and the

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32 Eugene O. Kuntz, *et al.*, Forms Manual to Accompany Cases and Materials on Oil and Gas Law 13 (2d ed. 1993).

33 *Cosden*, 55 F.2d at 638.

34 *Cosden*, 55 F.2d at 635 (emphasis added). This language immediately preceded the language making the delay rental payment obligation divisible.

lessor is asserting that gas storage activities should not continue to perpetuate the segregated development rights. If the rights are held to be divisible — for purposes of the habendum clause — oil and gas development would be required to maintain the assigned oil and gas development rights. Although no cases have addressed this issue in the divisibility context, it has been addressed in an abandonment context.

§ 15.04. The Abandonment Theory.

Before implied covenants became an accepted adjunct to oil and gas jurisprudence, courts often relied upon abandonment as a remedy for failure to explore and develop leased lands.[35] Even after implied covenants became firmly entrenched in oil and gas jurisprudence, litigants often turned to abandonment to try and avoid prior demand requirements under implied covenant law, or to achieve automatic termination of an interest.[36] However, successful use of the abandonment theory has been limited when dealing with oil and gas interests since they are often classified as real property and the burden of proof in abandonment cases is demanding.

[1] — Basic Property Issues.

Personal property interests can be lost by abandonment; real property interests are lost by adverse possession. Generally, a real property interest which cannot automatically vest in an estate from which it was carved cannot be abandoned. Therefore, a title in fee simple cannot be lost by mere abandonment.[37] If a fee simple estate could be abandoned, until the abandoned property was claimed, title to the estate would not be vested in anyone — a concept foreign to the common law.[38] Therefore, the first step

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[35] *See, e.g.*, Nigh v. Haas, 31 P.2d 28 (Kan. 1934). *See also* 1 David E. Pierce, Kansas Oil and Gas Handbook § 8.10 (1986)("Abandonment").

[36] *E.g.* Amoco Production Co. v. Douglas Energy Co., 613 F. Supp. 730, 733-34 (D. Kan. 1985)(unsuccessful attempt to claim abandonment to avoid prior demand requirement under implied covenants). *See* Stockert v. East Ohio Gas Co., No. CA-5741 (Ohio Ct. App. May 26, 1982)(slip opinion)(LEXIS State library, Ohio file)(whether abandonment remedy was encompassed by "forfeiture or rescission" notice provision).

[37] Kimberlin v. Hicks, 94 P.2d 335, 339 (Kan. 1939)(can "surrender" life estate to remaindermen and an estate for years to reversioners).

[38] However, it is possible that dormant mineral or mineral lapse statutes could create a situation where title is in limbo for a period of time. *See* Ronald W. Polston, "Recent Developments in Oil and Gas Law," 6 *E. Min. L. Inst.* ch.19-1, 19-21 (1985).

in evaluating an abandonment theory is to classify the property interest as either "real" or "personal."

Oil and gas interests present a special challenge since various interests in land are classified differently by the states; often within a single state a type of interest will have multiple classifications depending upon why the inquiry is being made. For example, in Kansas an oil and gas lease is classified as an interest in personal property.[39] However, the oil and gas lease has been effectively reclassified by statute for certain limited purposes, such as the recording of instruments[40] and procedural issues such a venue.[41]

If the property interest cannot be classified as personal property, a common law abandonment theory will not be available.[42] For example, in Texas an oil and gas lease, and assignments out of the lease, convey interests in real property. Under Texas law title to real property interests acquired under an oil and gas lease cannot be abandoned.[43] Contrast the Texas approach with Kansas, where an oil and gas lease conveys an interest in

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[39] Burden v. Gypsy Oil Co., 40 P.2d 463, 466 (Kan. 1935)(characterizing the personal property interest as a *profit a prendre*).

[40] Kan. Stat. Ann. §58-2221 (1994)("Every instrument in writing that conveys real estate, any estate or interest created by an oil and gas lease . . . .").

[41] Kan. Stat. Ann. § 60-601 (1994)("The term real property, as used in this section, includes any interest or estate created by an oil, gas or mineral lease, or an oil, gas or mineral royalty. Actions concerning real property must be brought in the county designated in this section. . . .").

[42] The interest, whether classified as real or personal property, may still be subject to challenge under various statutory remedies designed to extinguish mineral interests and interests carved out of mineral interests. *See generally* Southwestern Oil Co. v. Wolverine Gas and Oil Co., 450 N.W.2d 1, 3 (Mich. Ct. App. 1989)(mineral interests in oil, and gas below the Marshall Formation were "abandoned" to the surface owner under Michigan's dormant mineral act; gas storage operations by third party in the Marshall Formation did not preserve other interests). In *Jolynne Corp. v. Michels*, 446 S.E.2d 494, 501 (W. Va. 1994), the court relied upon West Virginia's statutory rebuttable presumption of abandonment which applies when a lessee fails "to produce and sell or produce and use for its own purpose for a period of greater than twenty-four months, . . . oil and/or gas produced from such leased premises . . . ." W. Va. Code § 36-4-9a (Supp. 1995). However, the statute contains the following exception: "This rebuttable presumption shall not be created in instances (i) of leases for gas storage purposes, ..." *Id.*

[43] Rogers v. Ricane Enterprises, Inc., 772 S.W.2d 76, 80 (Tex. 1989).

personal property which can be abandoned.[44] Once it is determined that the property interest can be abandoned, the second level of analysis is determining whether an intent to abandon can be proven.

[2] — Proving Abandonment.

In the gas storage situation, abandonment is typically used to terminate oil and gas development rights that would otherwise be perpetuated by gas storage activities. However, this remedy would seem to be plausible only when the oil and gas development rights have been severed in some manner from the gas storage rights. This is sometimes done by assigning the oil and gas development rights to a third party.[45] Although a gas storage operator may be reluctant to assign development interests to unrelated third parties, they may assign the oil and gas development rights to a parent, subsidiary, or sister corporation, or other affiliated entity. The abandonment analysis should be the same whether the assignee is an affiliated entity or an unaffiliated entity.

The assignment activity is what will trigger a sort of divisibility analysis where the oil and gas development rights are conceptually segregated from the storage rights. This was accomplished by the Kansas Supreme Court in *Rook v. James E. Russell Petroleum, Inc.*[46] by relying upon language commonly found in the assignment clause of oil and gas leases. The assignment clause in one of the oil, gas, and gas storage leases provided:

> Lessee shall have the right to assign this lease as to all or any portion of the acreage covered thereby or as to any interest therein, and upon any such assignment Lessee shall have thereafter no personal liability as to any covenant thereof in respect to the acreage or interest as to which assignment has been made, and the default of either owner shall not affect the other.[47]

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[44] Rook v. James E. Russell Petroleum, Inc., 679 P.2d 158, 167 (Kan. 1984)(oil and gas lease rights could be severed from gas storage rights; oil and gas lease rights were abandoned by the lessee).

[45] *E.g.*, Rook v. James E. Russell Petroleum, Inc., 679 P.2d 158, 160-61 (Kan. 1984)(individual obtained oil and gas development rights and gas storage rights and then assigned the gas storage rights to a third party retaining the oil and gas development rights).

[46] *Rook*, 679 P.2d 158 (Kan. 1984).

[47] *Rook*, 679 P.2d at 160-61.

Reasoning from this clause, and the subsequent division of ownership between development rights and gas storage rights, the Kansas Supreme Court found:

> [T]he parties contemplated, upon assignment of the leases, the severability of the storage portion of these leases from the oil and gas production portion of the leases. Furthermore, it is clear a default in either the storage portion of these leases or the oil and gas production portion of these leases would not affect the other.[48]

Without an assignment to sever development rights from storage rights, it would be difficult to assert that by exercising only the gas storage right — that maintains the lease in effect as to storage and development rights — the owner intended to abandon the development rights.[49] The intent to abandon in such a case would have to be explicit.

In the *Rook* case, the oil, gas, and gas storage rights at issue were consolidated in W.S. Fees in 1936.[50] In 1937 Fees assigned the gas rights, and gas storage rights, extending from the surface to 1,050 feet below the surface, to Cities Service Gas Company; Fees retained the rights to oil at all depths, and gas and gas storage rights at depths below 1,050 feet.[51] In 1963 Fees assigned all his interest in the leased land to James E. Russell; in 1973 Russell assigned the interests to James E. Russell Petroleum, Inc. When Russell took control of the property it contained sixteen oil wells. Total production from all the wells in 1965 was only 48 barrels.[52] Russell ceased production from these wells in 1966 and conducted no further operations on the leased land through January 1980 when the lessor filed

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48 *Rook*, 679 P.2d at 164.

49 *See* Thomas Well Service, Inc. v. Williams Natural Gas Co., 873 F. Supp. 474, 485 (D. Kan. 1994), *aff'd*, 64 F.3d 670 (10th Cir. 1995)("*Rook* is distinguishable from the case at bar in that WNG nor its predecessor assigned its oil and gas rights to another party, nor was there a severance of those rights from its gas storage rights."). *See also* Reese Exploration, Inc. v. Williams Natural Gas Co., 983 F.2d 1514, 1520-21 (10th Cir. 1993)(rejecting argument that gas storage operator, which had right to store gas in the Squirrel sand and the Bartlesville sand, abandoned its right to store gas in the Squirrel sand when it intentionally tried to confine its storage to the Bartlesville sand).

50 *Rook*, 679 P.2d at 160.

51 *Rook*, 679 P.2d at 161.

52 *Id.*

suit.[53] Throughout the time Russell owned the leases, Cities Service continually exercised its storage rights[54] which, the parties agreed, would maintain the storage rights and the oil and gas development rights under the terms of the habendum clause of each lease.[55] The habendum clause of the two leases involved provided:

> Lease #1:
> The term of said oil and gas lease shall . . . run as long as oil and gas or either of them is produced, and as long thereafter as the premises . . . shall be utilized for the introduction, storage and/or removal of natural gas (whether introduced into or withdrawn from this or other land) and/or as long as the storage rentals hereinafter fixed shall be paid.[56]
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> Lease #2:
> This lease shall remain in force for a term of ten years from this date and so long thereafter as oil, gas, casinghead gas or other kindred products [are] produced or the storage right is being exercised as hereinafter set forth.[57]

Although the court accepted that all lease rights were being maintained by gas storage operations for purposes of the habendum clause, the court found the assignment clause contemplated the rights held by Russell and Williams could be divisible for other purposes — such as the ability of one owner to abandon their rights without adversely impacting the other owner's rights.[58] The court also noted that the oil and gas development rights could be divisible for purposes of implied covenants imposed on oil and gas lessees.[59]

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53 *Id.* at 161, 162.

54 *Id.* at 161.

55 *Id.* at 163.

56 *Rook*, 679 P.2d at 160.

57 *Id.*

58 *Rook*, 679 P.2d at 163, 164, 165.

59 The court summarized the trial court's analysis, which the court affirmed, as follows:
> Here the trial court determined the oil and gas production portion of these leases was severable from the gas storage rights of Cities Service, and correctly ruled the oil and gas production portion of these oil and gas leases could be terminated for abandonment of the lease or for failure to comply with the implied covenant

The evidence relied upon by the court to find the requisite "intentional and voluntary relinquishment of rights under the leases"[60] by Russell included the following:

> [T]erminating production of all wells on these two leases with no further production activity on these leases for fifteen years, permitting equipment left on the property to rust and deteriorate, tearing down and removing the pump house after it was partially demolished in a storm, removing the power source equipment, and not physically going onto the premises in any manner after 1972.[61]

But for the express terms of the habendum clauses in this case, the court's abandonment analysis would be difficult to challenge. However, Russell testified that he acted, or failed to act, as he did precisely because under the habendum clause of each lease he did not think more was required.[62] He simply felt he had the luxury, under the habendum clause, to wait for better oil prices. Other than Russell's failure to do anything on the leased land for 15 years, the evidence supported Russell's claim that at no time did he, or his corporation, intend to abandon their rights in the oil and gas leases.[63]

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of diligent and prudent operation, while the gas storage rights of Cities Service were retained intact. The trial court terminated the oil and gas production portion of these leases upon a finding of abandonment — the intentional and voluntary relinquishment of rights under the leases. *Rook*, 679 P.2d at 166-67.

60 *Id.* at 167.

61 *Id.*

62 Russell testified:

> The corporation believed they were protected while not developing by the habendum clause contained in the leases, in that as long as the gas storage rentals were paid to the landowner they could postpone resuming production until the most economically advantageous time, which would be beneficial for both the corporation and the landowner. *Rook*, 679 P.2d at 162.

63 Russell testified:

> [T]he corporation intended at all times to resume production when it would be more economically advantageous under existing market conditions. The leases were continually evaluated to effectuate that purpose.... The leases were always considered to be assets by the corporation, property taxes were paid each year on one of the leases, and the required semiannual reports were submitted to the Kansas Corporation Commission designating all the wells as temporarily abandoned but unplugged and available for future use. The plaintiffs never

The *Rook* case demonstrates the importance courts place on the time factor in abandonment cases. After a certain period of time, the lessee's characterization of their intent may be overcome by the court's unspoken belief that simply too much time has passed and the lessor should have the opportunity to find a more diligent lessee.[64] The importance of the time factor is also reflected in *Stockert v. East Ohio Gas Co.*,[65] where the court granted summary judgment to a lessor and held the oil, gas, and gas storage lessee had abandoned their lease by "capping a well coupled with a cessation and a subsequent fourteen-year period of failure to make payments due under the lease."[66] The *Stockert* case is unique since it appears the court held the oil and gas development rights obtained in 1934 and the supplemental gas storage rights obtained in 1961 were abandoned when, through a clerical error, the lessee failed to pay gas storage rentals.[67]

The abandonment theory in most situations will be of limited assistance to a lessor attempting to secure development of oil and gas rights being held by gas storage activities. First, the facts necessary to support an abandonment argument will seldom exist when the development rights and

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requested that the appellant resume production or inquired as to its plans for future development. . . . *Id.*

64 Arguably this theory is demonstrated by the several twists and turns the court takes in the *Rook* case to ensure an effective remedy for the plaintiffs — cancellation of Russell's lease. For example, the court was quite creative with its interpretation of Russell's obligations contained in the assignment from Fees. Since Fees retained a production payment to recover the $75,000 purchase price for the assignment to Russell, Russell agreed it would not abandon a well capable of producing in paying quantities. However, Russell could abandon wells not capable of producing in paying quantities and Russell agreed to comply with all implied covenants. The court relied on this language as a "written acknowledgement" that Russell knew "the production portion of these leases assigned to him could be terminated by abandonment of production . . . ." *Rook*, 679 P.2d at 167. This doesn't seem to add anything to whether Russell's actions constituted an "intentional and voluntary relinquishment of rights under the leases."

65 No. CA-5741 (Ohio Ct. App. May 26, 1982)(slip op.)(LEXIS State library, Ohio file).

66 *Stockert*, No. CA-5741, LEXIS slip op. at 14.

67 *Id.* at 13. Apparently the failure to pay rentals was not a special limitation on the grant. Instead, the lease required written notice as a condition precedent to any right of "forfeiture or rescission." The court held "abandonment" was not encompassed within the notice provision. *Id.*

storage rights are held by a single owner. Second, even when the rights are held by separate owners, an informed holder of the development rights should be able to maintain a factual record that would belie any basis for claiming they intended to relinquish their rights. Third, the classification of the oil, gas, and gas storage leasehold interest as real property will make the theory unavailable in many states. In most instances, the lessor will have to turn to implied covenant law to police the indolent holder of oil and gas development rights under the oil, gas, and gas storage lease.

§ 15.05. The Implied Covenant Theory.

Implied covenant law is particularly well-suited to dealing with situations where a party holds all the rights to do something — but really isn't interested in doing anything. The two major shortcomings of implied covenant law, from the lessor's perspective, are (1) it is a highly factual inquiry;[68] and (2) even if the lessor proves their case, the remedy may not be worth the effort.[69] However, absent a serious drafting flaw in the habendum clause of the oil, gas, and gas storage lease, most lessors will have to rely upon an implied covenant theory to define and enforce their lessee's oil and gas development obligations.

The first hurdle in the implied covenant analysis will be determining whether there is any room for the "implied" in light of what has been "expressed" by the parties in the oil, gas, and gas storage lease.

[1] — Express Lease Terms Can Limit the Implied.

It is almost axiomatic that the law of implied covenants operates only to the extent the matter has not been expressly addressed by the parties in their oil and gas lease. Therefore, "'[i]f the parties to the lease have expressly stated the extent of lessee's development obligations, such express covenants will control.'"[70] This means the first step in the implied covenant analysis

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68 This means it will often be expensive to litigate with the ultimate outcome difficult to predict.

69 The remedy for breaching an "implied" *covenant* is typically the same as the remedy for breaching an "express" *covenant* — damages. Often, unless the lessor, or their toplessee, can terminate the lease under attack, there may not be a sufficient economic incentive to pursue the matter.

70 Thomas Well Service, Inc. v. Williams Natural Gas Co., 873 F. Supp. 474, 487 (D.

must be determining whether the issue has been addressed by the express terms of the relevant documents.

For example, in *Oliver v. Louisville Gas and Electric Co.*,[71] the leases covered "oil, gas and gas storage" rights and were for a primary term of 20 years[72] "'and as much longer as oil or gas is produced in paying quantities or as the property continues to be used for the underground storage of gas.'"[73] Each lease also provided: "'Lessee may, *but is not obligated or required to drill the leased premises*.'"[74] In 1981 the lessor requested their lessee to commence an oil and gas test well or release the formations not being used for gas storage. Another request was made in 1983. When no action was taken by the lessee, the lessor brought suit alleging breach of an implied covenant of reasonable development.[75]

The Kentucky Court of Appeals rejected the lessor's claim stating:

> While it is true that under some circumstances there exists an implied covenant in oil and gas leases that a reasonable attempt will be made to explore and develop the resources, *there is no room for an implied covenant where the lease agreement itself makes the matter of development discretionary with the lessee*.[76]

Applying this rule to the lease at issue, the court found "the express language of the lease itself expressly negates any implied covenant to explore and develop."[77] A similar analysis was applied in *Holonko v. Collins*[78] where the lease contained the following clauses:

> The consideration, land rentals, well rentals or royalties paid and to be paid . . . are and will be accepted by the Lessor as adequate

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Kan. 1994)(quoting 1 David E. Pierce, Kansas Oil and Gas Law Handbook § 10.01 at 10-4 (1986)), *aff'd*, 64 F.3d 670 (10th Cir. 1995).

71 Oliver v. Louisville Gas and Electric Co., 732 S.W.2d 509 (Ky. Ct. App. 1987).

72 One beginning in 1957 and the other in 1963. *Oliver*, 732 S.W.2d at 510.

73 *Oliver*, 732 S.W.2d at 510.

74 *Id.* (emphasis added).

75 *Id.*

76 *Id.* at 511 (emphasis added).

77 *Id.*

78 Holonko v. Collins, No. 87 C.A. 120, 1988 Ohio App. LEXIS 2647 (Ohio Ct. App. June 29, 1988).

> and full consideration for all the rights herein granted to the Lessee and the further right of drilling or not drilling on the leased premises, whether to offset producing or gas storage wells on adjacent and adjoining land or otherwise, as the Lessee may elect, regardless of the purposes for which the leased premises are used hereunder. . . .
>
> It is mutually agree[d] that this instrument contains and expresses all the agreements and understandings of the parties in regard to the subject matter thereof, and no implied covenant, agreement or obligation shall be read into this agreement or imposed upon the parties or either of them.[79]

The court held "'there can be no implied covenant in a contract in relation to any matter that is specifically covered by the written terms of the contract itself.'"[80]

Although many implied covenant claims may be eliminated by express terms contained in the oil, gas, and gas storage lease, many leases will be silent on the issue, and some will be subject to interpretation. For example, in *Thomas Well Service Inc. v. Williams Natural Gas Co.*,[81] the lease provided:

> It is mutually understood that production under an oil and gas lease and storage and extraction of storage gas under a storage lease *cannot be successfully carried on from the same sands at the same time* and it is agreed that at any time when this storage lease is in good standing by reason of rental payments any valid oil or gas lease now upon said lands *shall not be subject to attack on the ground of lack of production or of proper development as to the sand and depths involved herein* . . . .[82]

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79 *Holonko*, 1988 Ohio App. LEXIS 2647 at 11 (emphasis added).

80 *Id.* at 12. In *Holonko* the lessee had four leases covering a total of 430 acres. A well had been drilled on each lease in 1973 and production began in 1974. The lessors brought suit in 1985 seeking to have the leased land fully developed relying upon an implied covenant theory. The lessee replied stating their leases were not subject to any sort of implied covenant to develop. The court held for the lessee. *Id.* at 10-11.

81 873 F. Supp. 474, 479 (D. Kan. 1994), *aff'd*, 64 F.3d 670 (10th Cir. 1995).

82 *Thomas*, 873 F. Supp. at 482 (emphasis added).

Clearly, this clause does not relieve the lessee from development obligations in any area where gas is not actually being stored. Therefore, the express limitation on the implied development covenant would not apply to "the sand and depths" outside of those being used for gas storage.
An interpretive argument might also be made that the clause operates to exempt production of oil within the storage "sand and depths" only when the desired development "cannot be successfully carried on from the same sands at the same time . . . ."[83] If technological improvements make it possible to safely remove oil from within the storage zone without impacting storage operations, will that negate an implied covenant limitation based upon a now erroneous presumption that development in the storage zone was not technically possible?[84]

In the reported decision, the parties, and therefore the court, focused on habendum clause issues and whether the limitation on Williams' development obligations violated public policy. The interpretive argument concerning the scope of the development covenant provision was not addressed — probably because the lessor, or more precisely, their toplessee, needed to obtain a termination of Williams' oil rights as an effective remedy. Merely finding a breach of the implied covenant to develop would not have helped the toplessee much, unless the court would have been willing to grant the rather extraordinary remedy of cancellation. However, if the toplessee was able to win on the habendum clause issues, termination of Williams' oil rights would have been automatic.

The *Thomas* case, however, raises another issue concerning the use of express covenants to negate implied obligations: can it be done?[85] In most states this will not be an issue and the parties can, within the confines of

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83 *Id.*

84 This argument gains further support when there is evidence the lessee has, in fact, been engaging in oil development in other parts of the storage reservoir. In *Thomas* it appeared that Williams had entered into a farmout agreement with KLM Exploration, Inc. in 1992 to conduct operations within the storage zone. Although the court does not comment on the details of the farmout, Williams could have been pursuing it to try and address lessor implied development claims. *Thomas*, 873 F. Supp. at 482.

85 This was the plaintiffs' public policy attack on the gas storage lease. *Thomas*, 873 F. Supp. at 487.

basic contract law principles,[86] agree to limit the lessee's implied obligations through express lease provisions. The plaintiffs in *Thomas* argued that the terms of a unique Kansas statute[87] established a public policy that prevented Williams from lawfully extending oil and gas development rights through non-developmental gas storage activities. The court adopted Williams' argument that the act could not apply to the leases at issue since they were entered into 35 years before the Kansas Deep Rights Act was enacted.[88] Although not mentioned in the court's opinion, there were two basic reasons why the express terms of the Kansas Deep Rights Act might not have applied to this situation: first, the act only applies to leases that are "held by production."[89] Second, the Kansas *Deep* Rights Act applies only to *deep* rights, which are defined by the act as follows: "Nothing in this act shall apply to the interval from the surface of the land to the base of the deepest producing formation as of the date of such action."[90] This requirement should exclude the storage zone and limit the statutory obligations only to zones somewhere beneath the storage zone.[91]

Another interpretive issue could arise when the covenant sought to be implied relates to something other than activities contemplated by the further development covenant. For example, will an express clause in the lease relieving the lessee of development obligations apply when the issue is protecting the leased land from drainage? Professor Hemingway addressed this issue in the oil and gas lease context stating:

> [I]t is not every express clause that will displace the implied covenant to protect against drainage. In numerous cases the parties have inserted express clauses relating to reasonable development of the lease. Such clauses are normally construed as relating only

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86 For example, the clause is not prohibited by law thereby making it an "illegal" contract.

87 The "Kansas Deep Rights Act" found at Kan. Stat. Ann. §§ 55-223 to 55-229 (1994).

88 *Thomas*, 873 F. Supp. at 487, 488.

89 Kan. Stat. Ann. § 55-223 (1994). If the lease rights were being maintained by gas storage, the court would have had to extended the operation of the act to such non-production situations. This raises the interpretive issue of whether the legislature intended the act to apply in non-production situations, such as gas storage.

90 Kan. Stat. Ann. § 55-227 (1994).

91 There may be an issue as to whether § 55-227 limits the operation of the first section of the act, § 55-223, which provides:

> to the implied covenant to develop and do not affect or displace the implied covenant to offset. To remove the implied obligation to offset, the express clause must relate to protection wells as well as to exploration and development of the lease.[92]

Therefore, the way the lessor "categorizes" its implied covenant claim may determine whether it will be foreclosed by the express terms of the lease. For example, although the ultimate goal of a drainage claim is to have the lessee further develop the property, the lessor will characterize it as a covenant to "protect" the lease from outside activities that would permanently reduce the value of the lessor's interest. Express language in the lease addressing "development" issues may not be precise enough to negate "protection" issues.

In many cases the oil, gas, and gas storage lease will not mention anything about development obligations.[93] When the lease is silent on such

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> As a matter of Kansas public policy, all oil and gas leases and subleases for the exploration, development and production of oil, gas or other minerals, or any combination thereof, which are held by production shall be presumed to contain, in addition to any expressed covenants therein, an implied covenant to reasonably explore and to develop the minerals which are the subject of such lease. Such implied covenant shall be a burden upon the lessee and any successor in interest.

Since the statute provides oil and gas leases shall be "presumed" to contain implied covenants, it might be argued that it doesn't change existing law: if the parties expressly address the matter, there is nothing to imply — and if you make it clear what you mean, no implied rights will be "presumed." However, another provision of the act, Kan. Stat. Ann. § 55-228 (1994), provides: "As created by this act it shall be against Kansas public policy to provide for a waiver of the presumption, established by K.S.A. 55-223, in any lease or sublease for the exploration, development or production of oil, gas or other mineral, or any combination thereof." Since the provisions of the act contain several internal references to other provisions of the act, it is doubtful any single provision, such as Kan. Stat. Ann. § 55-223, should be read in isolation of the other provisions of the act, such as Kan. Stat. Ann. § 55-227 limiting its operation to depths below "the base of the deepest producing formation as of the date of such action."

92 Richard W. Hemingway, *The Law of Oil and Gas 472* (3d ed. 1991).

93 *E.g.*, Rook v. James E. Russell Petroleum, Inc., 679 P.2d 158, 160-61 (Kan. 1984)(apparently the lease documents did not address additional development issues). In a lease form used by Northern Natural Gas Company, the gas storage lessee is also given what appears to be an executory interest in oil lease rights in the storage zone that will come into existence "[i]n the event any formation or formations utilized for gas storage is

matters, courts will likely turn to implied covenant law to define the parties' respective rights and obligations.[94]

[2] — Prudent Operation Under the Oil, Gas, and Gas Storage Lease.

If the gas storage lessee owns the oil and gas development rights in a formation or area, when must they take action to explore, develop, or operate their oil and gas rights when the lease is silent on the matter? There doesn't appear to be any reason to treat the oil, gas, and gas storage lessee any different from the oil and gas lessee when it comes to implied covenant

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capable of producing oil (including condensate and distillate) . . . ." Gas Storage Agreement, ¶ 5(c) at 2, dated August 15, 1995 between Northern Natural Gas Company and The Peoples Bank, Pratt, Kansas, Trustee (on file with author). The clause is silent regarding the lessee's implied oil development rights. However, the lessee may be trying to use the conditional nature of the oil rights as a running defense against an implied covenant claim. For example, if the storage lessee has done nothing with regard to oil, it could defend lessor development claims by saying it did not have the oil rights because the condition, "formations utilized for gas storage is capable of producing oil," has not occurred. A third party would never try to develop the oil because if they did, they would trigger the condition that would vest ownership in the gas storage lessee. With the Kansas Legislature's adoption of the Uniform Statutory Rule Against Perpetuities, Kan. Stat. Ann. §§59-3401 to 59-3408 (1994), such creative property law puzzles are possible. However, the lessor may respond with their own limiting arguments. For example, the relevant language provides:

> In the event any formation or formations utilized for gas storage *is* capable of producing oil (including condensate and distillate), Grantor *hereby grants* exclusively unto Grantee the right to [oil rights in the storage zone] . . . .

Gas Storage Agreement, ¶ 5(c) at 2 (emphasis added). The lessor could argue that since the condition and the granting language are in the present tense, the condition must be fulfilled to vest oil rights in the lessee, if at all, at the time the storage lease is granted. Therefore, if at the time the storage lease was granted none of the granted storage formations were "capable of producing oil (including condensate and distillate)," then the storage lessee did not receive any oil rights.

[94] In *Reese Exploration, Inc. v. Williams Natural Gas Co.*, 983 F.2d 1514 (10th Cir. 1993), the court, addressing other issues, observed: "We would also be hesitant at applying the doctrine of implied covenants to gas storage leases since Kansas courts have yet to expressly do so and since neither party raised the issue." *Reese*, 983 F.2d at 1521 n.7. In *Reese* the issues focused on alleged negligent gas storage operations by the gas storer and their impact on a separate owner of the oil development rights. Implied development obligations were not at issue.

issues.[95] Therefore, if in the oil and gas lease context the state would recognize implied covenants to explore, develop, produce, and protect, similar covenants should be recognized in the oil, gas, and gas storage lease context. The only major operational difference will be that in many situations the oil, gas, and gas storage lease will be held by storage activities instead of production activities. This may make it more difficult to establish a development covenant claim.[96]

The Kansas Supreme Court, in *Rook v. James E. Russell Petroleum, Inc.*,[97] held that the lessee's failure to produce or develop the lease for over 15 years[98] breached an implied covenant "to operate the leasehold efficiently."[99]

> It appears the court focused on this covenant, instead of the development covenant, to try and avoid demand and cure requirements associated with the development covenant.[100] In *Rook* the court ultimately affirmed the trial court relying upon an

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95 *See generally* Tom R. Mason, "The Yeas and Nays of Implying a Duty on a Producing Oil and Gas Lessee to Explore the Lease Further," *15 E. Min. L. Inst.* 439 (1995)(summarizing implied covenant law and then addressing the case for and against recognizing an implied covenant to further explore).

96 However, if there is development surrounding the leased area, the evidence to support a development claim, and perhaps a protection/drainage claim, may be readily available.

97 679 P.2d 158 (Kan. 1984).

98 The lease was being held beyond its primary term through gas storage activities. *Rook*, 679 P.2d at 161-62.

99 *Id.* at 166. Noting the unique situation of having development rights extended by gas storage activities, the court stated:

> Such implied covenant requires the lessee, as part of its duty of diligent and prudent operation, to produce and market oil or gas after discovery. It is rarely invoked to require a lessee to produce, because ordinarily a failure to produce after the primary term because production is no longer profitable will result in termination of the lease. *Id.*

100 *Id.* The court also arguably made some inaccurate factual assumptions to support its use of the efficient operation covenant instead of the development covenant. First, the court said the leases had been "fully developed." *Id.* at 167. Second, the court assumed there were wells on the property that could be "operated efficiently." *Id.* at 166. The facts instead indicated there were 16 holes in the ground, none of which were capable of producing oil or gas. *Id.* at 161, 162. The real issue would seem to be whether a prudent operator would have pursued enhanced recovery operations on the leased lands in a more diligent

abandonment theory.[101] However, the court indicated its willingness to police oil and gas development rights, in the gas storage context, applying the same body of implied covenant law employed to police non-storage oil and gas lease situations.[102]

The oil and gas development obligations under the oil, gas, and gas storage lease will be guided by the general principles articulated over 90 years ago by Justice Van Devanter while a member of the Circuit Court of Appeals for the Eighth Circuit:

> In the absence of some stipulation to that effect, we think an oil and gas lease cannot be said to make the lessee the arbiter of the extent to which, or the diligence with which, the exploration and development shall proceed. . . . The object of the operations being to obtain a benefit or profit for both lessor and lessee, it seems obvious, in the absence of some stipulation to that effect, that neither is made the arbiter of the extent to which or the diligence with which the operations shall proceed, and that both are bound by the standard of what is reasonable. . . . Whatever, in the circumstances, would be reasonably expected of operators of ordinary prudence, having regard to the interests of both lessor and lessee, is what is required.[103]

Therefore, "absent some stipulation to that effect,"[104] the gas storage lessee, holding the exclusive right to develop oil and gas in the leased area, must act with due regard for its lessor's interests as well as its own. The

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manner. This is a development covenant issue since a substantial capital investment would be required for which the developer would expect a profit commensurate with the projected risks.

101 *Id.* at 167.

102 The court noted:

> Here the trial court determined the oil and gas production portion of these leases was severable from the gas storage rights of Cities Service, and correctly ruled the oil and gas production portion of these oil and gas leases could be terminated for abandonment of the lease *or for failure to comply with the implied covenant of diligent and prudent operation*, while the gas storage rights of Cities Service were retained intact. *Id.*

103 Brewster v. Lanyon Zinc Co., 140 Fed. 801, 813-14 (8th Cir. 1905).

104 Such as an express lease provision addressing the implied covenant issue.

lessee cannot obtain and hold oil and gas development rights merely to ensure nobody interferes with its storage rights — unless such a right is clearly articulated in the lease. Instead, the lessee must consider the competing interest of the lessor to have the oil and gas rights developed so they can generate royalty income.

To consider what a "prudent operator" would do under the oil, gas, and gas storage lease, it appears the court must factor in the gas storage context. For example, what might be imprudent of an operator without gas storage concerns may nevertheless be prudent in the storage context.[105] However, courts may not find too many instances where the gas storage context relieves the lessee of its oil and gas lease obligations. This goes back to the fundamental problem facing the gas storage lessee: they may have too many rights — but still not enough. If the storage operator doesn't want to be bothered by the additional problems posed by oil and gas development, they should have obtained the mineral rights in fee. However, although they do not own the mineral rights in fee, they do hold the exclusive right to develop the oil and gas rights. With these exclusive rights come obligations. In most cases, the lessee's obligations will be defined by a prudent operator standard, under an implied covenant analysis, similar to that developed under each state's existing oil and gas jurisprudence.

§ 15.06. Conclusion.

When evaluating oil and gas development under the oil, gas, and gas storage lease, the first step will be to examine the habendum clause to determine whether gas storage activities will perpetuate oil and gas development rights.[106] The second step will be to determine whether there has been any de-linkage of storage and development activities under other

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105 Although there are no cases addressing this from the perspective of the gas storage operator, in *Michigan Wis. Pipeline Co. v. Michigan Nat'l Bank*, 324 N.W.2d 541 (Mich. Ct. App. 1982), the court held the lessee acted prudently when it ceased operations in an area that was to be condemned as a gas storage facility. *But see* Zimmerman v. Mormack Industries, Inc., No. C.A. 2430, 1989 Ohio App. LEXIS 1725 (Ohio Ct. App. May 10, 1989)(oil and gas lessee was not justified in failing to develop leased lands encompassed by gas storage company's "protective area" or "buffer zone" surrounding underground gas storage reservoir).

106 *See* discussion *supra* § 15.03[1].

clauses of the lease, such as the assignment clause.[107] The third step will be to consider whether an abandonment theory could be used to attack the continuing validity of the development rights.[108] The final level of analysis, and the one under which most development disputes will be evaluated, is the implied covenant theory with its own two-step analysis: first, is the matter addressed by the express language of the relevant document?[109] If so, the terms of the document will control. If not, the second step is to consider oil and gas lease implied covenant law to determine, under the circumstances, what a prudent operator would do — considering the dual interests of the lessor and lessee.[110]

> Development issues under the oil, gas, and gas storage lease should be resolved applying contract law and oil and gas law. No special gas storage "public policy" considerations should be injected into the analysis. Courts have generally rejected the lessee's invitation to apply any sort of public policy analysis to resolve development issues.[111]

In essence, the underlying basis for rejecting the lessee's public policy argument is that if they have too many rights, they can give some back; if they don't have enough rights, they can acquire what they need by purchase or condemnation.

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107 *See* discussion *supra* § 15.03[2].

108 *See* discussion *supra* § 15.04.

109 *See* discussion *supra* § 15.05[1].

110 *See* discussion *supra* § 15.05[2].

111 For example, in *Rayl v. East Ohio Gas Co.*, 348 N.E.2d 385, 389 (Ohio Ct. App. 1973), the court discussed the issue as follows:

> Does the public necessity for an ample supply of gas justify the extension of the principle? We do not think so. The legislature has recognized the public necessity by granting the right of eminent domain to gas companies for storage purposes under certain conditions. This prevents the deprivation of property without due process of law. If we were to force this lease upon the lessors for that reason alone, it would be an appropriation of property without due process of law.