

**SUMMARY FOR PAPER #6**

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**THE CONTINUING ROLE OF IMPLIED COVENANTS  
IN DEVELOPING LEASED LANDS**

**by**

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This paper discusses implied covenants in oil and gas leases, with a focus on jurisprudence of the last few decades, particularly the last 15 years, as it relates to the implied covenants that concern development of leased lands. The paper also speculates about possible reasons for apparent stability of the law in this area and what changes might occur in the future.

**INTRODUCTION**

**History and Nature of Implied Covenants in Oil and Gas Leases**

For more than 100 years, courts also have recognized the existence of various implied covenants in oil and gas leases. Commentators and courts have debated why implied covenants exist in oil and gas leases. At least three reasons have been given -- filling gaps in leases so as to effect the implied intent of the parties, promoting fairness in leases, and promoting public policy. Part of this debate has concerned whether these covenants are implied in law or implied in fact, which can affect such issues as what limitations period applies to actions for breach of an implied covenant. Commentators have disagreed. Texas cases describe such covenants in a way that seems most consistent with the covenants being implied in fact. The Kansas Supreme Court has expressly concluded that such covenants are implied in fact.

**What implied covenants exist in oil and gas leases?**

Various courts and commentators recognize different implied covenants. Some of the most commonly recognized implied covenants are covenants that the lessee will: act as a

reasonably prudent operator; reasonably develop the leased premises after discovering oil or gas in paying quantities; protect the leased premises against drainage; and diligently market any oil and gas that is produced. Other implied covenants sometimes recognized are covenants to: drill one or more test wells promptly after entering the lease; conduct further exploration of non-productive areas after discovering oil or gas in paying quantities; operate diligently and prudently; and to restore the surface after expiration of the lease.

## **JURISPRUDENTIAL DEVELOPMENTS**

### **Implied Covenants to Drill, Reasonably Develop, and Protect Against Drainage**

Early in the oil and gas industry, courts held that a lessee had an implied duty to promptly begin drilling test wells. Now, it is so common for leases to provide for delay rentals, or to provide that the lease is a paid-up lease, that the implied duty to test is not often of significance. There has been little jurisprudence regarding this covenant in the last 15 years.

The implied covenant of reasonable development provides that once oil or gas is discovered in paying quantities, the lessee will drill as many wells as reasonably necessary to prudently develop the known field. The lessee must take into consideration the interests of the lessor, but the lessee is not required to engage in further development if to do so would be unprofitable. The implied covenant to protect the leased premises against drainage requires the lessee to drill one or more offset wells if the leased premises otherwise would suffer significant drainage and offset wells could be profitably drilled. Some cases have suggested that perhaps this implied covenant can be satisfied by seeking unitization. In the last 15 years, there have been a number of case in which lessors alleged breaches of these implied covenants, but there have not been significant changes to the duties imposed by these covenants.

### **Implied Covenant of Further Exploration**

Once production of oil or gas in paying quantities is obtained, is there a further duty to explore non-productive areas — a so-called implied covenant of further exploration? Some commentators suggest that such an implied covenant exists or should exist, while others disagree. Few states have expressly recognized any such duty. One Colorado appellate court has recognized such a duty. *Gillette v. Pepper Tank Co.*, 694 P.2d 369 (Colo. App 1984). The Texas Supreme Court has rejected the existence of any such duty. In Louisiana, the official comments to Mineral Code article 122 states that such an implied duty exists, but as the Louisiana Supreme Court reminded readers a few years ago, the comments ultimately are not the law. *See Terrebonne Parish School Board* decision (rejecting all but the most narrow implied duty to restore the surface, despite the facts that the comments to Mineral Code art. 122 state such a duty exists. Louisiana case law has not clearly recognized a duty of further exploration).

### **Avoiding Implied Covenants by Having the Lease Expressly Address Certain Duties.**

Courts uniformly hold that if the lease expressly addresses a topic, that no implied covenant will exist if the express provision completely addresses the topic, and that no implied covenant will exist that is actually inconsistent with the express provision. To the extent that states recognize an implied covenant to drill, the judicial acceptance of paid-up leases and delay rental clauses demonstrates this. Further, numerous opinions describe implied covenants as existing in every oil and gas lease that does not provide otherwise (though most of these opinions do not involve leases that actually involve express provisions that preclude the existence of an implied covenant). And some recent decisions have held that express provisions in contracts have precluded the existence of an implied covenant.

### **Lessor's 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. The law does not impose on the lessee the duties of a fiduciary, *see* La. Min. Code art. 122, and does not require the lessee to be perfect in its decision making about whether development would be prudent, so long as the lessee is reasonable and considers both his interest and those of his lessor. *See Sunbelt Exploration Co. v. Stephens Production Co.*, 896 S.W.2d 867 (Ark. 1995).

### **Remedies available for a breach of the implied covenants**

Possible remedies include monetary damages and lease cancellation. Some cases, including cases from Texas, state that monetary damages are the preferred remedy. When leases are cancelled, they can be cancelled in part, and this can be particularly appropriate if the cancellation is being ordered based on a breach of the implied duty to reasonably develop, but part of the leased premises has been developed. Most, but not all states, require that a lessee be given an opportunity to cure a breach of an implied covenant before a court will grant an award cancelling a lease. The opportunity to cure can be provided by the lessor making a pre-suit demand that the lessee perform within a reasonable time, or by a court granting a conditional cancellation that gives the lessee a reasonable time in which to perform in order to avoid cancellation. A recent Kansas decision held that this is the law in Kansas and that the Deep Horizons Act did not change this.

### **Must a Lessee Grant a Partial Release if it Would Not Be Economical to Develop Further?**

The lessee is not required to further develop the leased premises if doing so would be unprofitable. But if it would not be profitable to further develop the leased premises, and would not be profitable to do so in the foreseeable future, is the lessee obligated to grant a

release of the lease as to the areas that have not been developed? See *Whitham Farms LLC v. City of Longmont*, 97 P.3d 135, 137 (Colo. App. 2003), *cert. granted*, 2004 WL 2029371 (Colo. 2004) (denying such relief, but doing so under the facts of the case and noting a prior Colorado case that had reached a different result).

### **Does a Lessee Have an Implied Duty to Engage in Secondary Recovery?**

Few cases discuss whether a lessee has an implied duty to engage in secondary recovery, whether as part of his implied covenant to reasonably develop or as part of his implied covenant of prudent operation. One court recently referred to the possible existence of such a duty in *Crawford v. Hrabe*, 44 P.3d 4422 (Kan. 2002), but the court was not faced with the issue and did not state whether such a duty exists. Some older decisions from Illinois and one from Oklahoma state in dicta that a duty to engage in secondary recovery exists or may exist. In one Louisiana case, a court cancelled after finding that a lessee's failure to fireflood amounted to a failure to reasonably develop the leased premises. See *Waseco Chemical & Supply Co. v. Bayou State Oil Corp.*, 371 So. 2d 305, 313 (La. App. 2nd Cir.), *writ denied*, 374 So. 2d 656 (La. 1979).

### **CONCLUSIONS AND SPECULATION ABOUT FUTURE**

#### **Why have there not been more new developments in the law of implied covenants?**

Public policy and parties might be well served by changes in or limitations to implied covenants, but there have not been substantial changes in the law or how parties are contracting as to these covenants. Why have courts not done more to alter the implied covenants? Reasons probably include the common law's conservative nature. The common law's disinclination toward rapid change arguably is particularly justified when dealing with implied obligations in contracts, given that parties can, if they choose, explicitly address their various contractual obligations, and that changes could impose on lessees duties they never expected if changes were applied to existing leases. Many lessors may not be sophisticated

enough to bargain for more explicit duties to be imposed on the lessee. Perhaps lessees do not bargain more frequently for restrictions on the implied covenants because it might be difficult to get lessors to agree to and courts to enforce provisions that totally eliminate such duties as the duty to reasonably develop, and it can be difficult to know in advance what would be reasonable restrictions on such duties. Further, there could be significant effort necessary to try to make such an estimate in advance

**What to expect in the future?**

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