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Implied Covenants and the Drafting of Oil and Gas Leases

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INTRODUCTION

Implied covenants[1] are obligations that are not expressly imposed by a contract, but which courts nevertheless find are binding on one or more

1. Portions of this Article draw on the author's prior articles on implied covenants. *See* Keith B. Hall, *Defining the Lessee's Covenants to Drill and Develop a Lease*, Rocky Mountain Mineral Law Foundation Special Institute on Drafting and Negotiating the Modern Oil and Gas Lease (2018); Keith B. Hall, *Implied Covenants and Changing Technology*, Proceedings of the 60th Annual Mineral Law Institute (2013); Keith B. Hall, *The Application of Oil & Gas Lease Implied Covenants in Shale Plays: Old Meets New*, Proceedings of the 32nd Annual Energy and Mineral Law Institute (2011); Keith B. Hall, *Implied Covenants: Claims Under Mineral Code Article 122*, 57 ANNUAL MIN. L. INST. (2010); Keith B. Hall, *The Continuing Role of Implied Covenants in Developing Leased Lands*, 49 WASHBURN L.J. 313 (2010).

parties to the contract.[2] Courts routinely hold that oil and gas lessees are bound by several implied covenants. This Article reviews the various implied covenants that courts have recognized as binding on oil and gas lessees and examines the justifications for recognizing those covenants. The Article then discusses various issues that sometimes arise in implied covenant disputes, including the remedies that are available, certain procedural issues, and the question of whether a lessee must continue to perform his implied contractual duties while a lawsuit over the validity or continuing existence of the lease is pending. Finally, the Article addresses the application of implied covenants in situations involving new technology and discusses the application of implied covenants in shale plays.

I. A PRIMER ON IMPLIED COVENANTS

Both within the oil and gas context and outside it, courts sometimes conclude that parties to a contract are bound by implied obligations.[3] In oil and gas leases, however, implied obligations play a much larger role than they do in contracts generally. The "Primer" Section of this Article examines the reasons for this heightened role and provides the reader with background on the law of implied covenants in oil and gas leases.

A. History of and Justifications for Implied Covenants

For more than 100 years, courts have held that a mineral lessee's duties include various implied covenants that are not expressly stated in a lease. The earliest case to recognize the existence of implied covenants may have been *Stoddard v. Emery,* an 1889 case in which the Pennsylvania Supreme Court stated in dicta that oil and gas lessees are bound by an implied covenant to reasonably develop the leased premises.[4] Three years later, the Pennsylvania Supreme Court again stated that a lessee was bound

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2. Black's Law Dictionary defines "covenant" as an agreement or promise, and an "implied covenant" as one which may reasonably "be inferred from the whole agreement and conduct of the parties." *Black's Law Dictionary* 443 (9th ed. 2009).

3. An interesting case outside the oil and gas context is Wood v. Lucy, Lady Duff-Gordon, 118 N.E. 214 (N.Y. 1917). The remainder of this Article cites numerous examples of cases within the oil and gas context.

4. 18 A. 339 (Pa. 1889); *see also* PATRICK H. MARTIN & BRUCE A. KRAMER, 5 WILLIAMS & MEYERS OIL AND GAS LAW § 802 (prominent commentators describing *Stoddard*'s dicta as being the origin of implied covenants).

by an implied covenant of reasonable development,[5] and just a few years later, the same court held that lessees are bound by an implied covenant to protect the leased premises against drainage.[6] Ohio soon followed suit in recognizing implied covenants,[7] as did the United States Eighth Circuit in *Brewster v. Lanyon Zinc Co.*,[8] a decision which is recognized by several commentators as one of the leading cases on implied covenants.[9] Today, every state with any significant amount of oil and gas jurisprudence has recognized the existence of implied covenants.[10]

Implied covenants exist with respect to contracts generally and are not unique to oil and gas leases. Indeed, in most states, the basic law of contracts provides that all parties are bound by an implied covenant of good faith and fair dealing.[11] But that is a very general duty. With respect to oil and gas leases, courts hold that oil and gas lessees are bound by

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5. *See* McKnight v. Manufacturers Natural Gas Co., 23 A. 164, 166 (Pa. 1892).

6. *See* Kempner v. Lemon, 35 A. 109 (Pa. 1896).

7. *See, e.g.*, Harris v. Ohio Oil Co., 48 N.E. 502 (Ohio 1897) (recognizing implied covenants to reasonably develop the premises and to protect against drainage); *see also* Brewster v. Lanyon Zinc Co., 140 F. 801 (8th Cir. 1905).

8. 140 F. 801 (8th Cir. 1905).

9. *See* MARTIN & KRAMER, *supra* note 4, at § 802 (describing *Brewster* as "landmark" case); JOHN S. LOWE, OIL AND GAS LAW IN A NUTSHELL (5th ed. 2009) (describing *Brewster* as a "leading case"); Jacqueline S. Weaver, *When Express Clauses Bar Implied Covenants, Especially in Natural Gas Marketing Scenarios,* 37 NAT. RESOURCES J. 491, 492 n.6 (1997).

10. *See, e.g.*, Bonds v. Sanchez O'Brien Oil & Gas Co., 715 S.W.2d 444, 445-46 (Ark. 1986); Garman v. Conoco, Inc. 886 P.2d 652, 659 (Colo. 1994); Coastal Oil & Gas Corp. v. Garza Energy Trust, 268 S.W.3d 1, 154, n.42 (Tex. 2008); Jacobs v. CNG Transmission Corp., 772 A.2d 445 (Pa. 2001); Smith v. Amoco Production Co., 31 P.3d 255 (Kan. 2001); Sundheim v. Reef Oil Corp., 806 P.2d 503, 507 (Mont. 1991); Croston v. Emax Oil Co., 464 S.E.2d 728, 733 (W. Va. 1995); Meisler v. Gull Oil, Inc., 848 N.E.2d 1112, 1116 (Ind. Ct. App. 2006); Ridl v. EP Operating Ltd., 553 N.W.2d 784, 789 (N.D. 1996); Harris v. Ohio Oil Co., 48 N.E. 502 (Ohio 1897); Pack v. Santa Fe Minerals, 869 P.2d 323, 330 (Okla. 1994); Continental Oil Co. v. Blair, 397 So. 2d 538, 540 (Miss. 1981); Caddo Oil & Mining Co. v. Producers Oil Co., 134 La. 701, 717, 64 So. 684, 690 (1914).

11. The implied covenant of good faith and fair dealing is recognized in court opinions from virtually every state, as well as in the Restatement (Second) of Contracts. *See* Restatement (Second) of Contracts § 205. An exception is Texas, which does not recognize a general duty of good faith and fair dealing, though it does recognize the existence of implied covenants in oil and gas leases. City of Midland v. O'Bryant, 18 S.W.3d 209, 215 (Tex. 2000) (no general duty of good faith and fair dealing); Coastal Oil & Gas Corp. v. Garza Energy Trust, 268 S.W.3d 1, 18-19 (Tex. 2008) (discussing implied covenant to protect against drainage).

several implied covenants that include much more specific duties. Further, implied covenants seem to play a bigger role in the law of oil and gas leasing than in general contract law.

The reason that implied covenants play a more significant role in oil and gas leases than in some other contracts is probably due to a particular characteristic of oil and gas leases. Namely, because of the complexities and uncertainties involved in oil and gas exploration and development, leases seldom state how many wells the lessee will drill, when and where he will drill, or to what depth he will drill.[12] Similarly, leases usually do not specify what a lessee will do to protect the leased premises against drainage or to market any product that is found. All these things are left to the discretion of the lessee, even though these aspects of the lessee's performance are critical to the ultimate benefit that the lessor receives from the lease transaction (particularly given that a major part of the benefit allocated to the lessor is the right to a royalty based on production).[13] One early commentator stated, "It is doubtful if any other character of legal instrument can be found in which one of the parties has so much potentially at stake with so little express contractual protection."[14] It is this characteristic of oil and gas leases that provides a "practical" explanation of why courts hold that lessees are bound by implied covenants.

Although implied covenants are universally recognized in U.S. oil and gas law, authorities have disagreed about the theoretical justification for such covenants. One theory is that a public policy favoring production of oil and gas is a valid justification for implied covenants.[15] But two other

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12. *See* Patrick H. Martin, *A Modern Look at Implied Covenants to Explore, Develop, and Market Under Mineral Leases*, 27 SW. LEGAL FDN. OIL & GAS INST. 177, 194 (1976) ("Because there are many unknowns involved when the lease is executed, it is understood that much must be left to the judgment and discretion of the lessee."); Brewster v. Lanyon Zinc Co., 140 F. 801, 810 (8th Cir. 1905) (noting impossibility of the lease itself stating how many wells should be drilled because that would depend "upon future conditions, which could not be anticipated with certainty" when the lease was entered).

13. *See* Patrick H. Martin, *A Modern Look at Implied Covenants to Explore, Develop, and Market Under Mineral Leases*, 27 SW. LEGAL FDN. OIL & GAS INST. 177, 194 (1976); *see also* Keith B. Hall, *Implied Covenants Claims Under Article 122*, 57 ANNUAL INST. ON MIN. L. 172, 173-74 (2010).

14. A.W. Walker, Jr., *The Nature of Property Interests Created by an Oil and Gas Lease in Texas*, 11 TEX. L. REV. 399, 399 (1933).

15. *See, e.g.*, Jacobs v. CNG Transmission Corp., 332 F. Supp. 2d 759, 779 (W.D. Pa. 2004); Jacqueline L. Weaver, *Implied Covenants in Oil and Gas Law Under Federal Energy Price Regulation*, 34 VAND. L. REV. 1473, 1489-90 (1981); *see also* Dawes v. Hale, 421 So. 2d 1208, 1211 (La. Ct. App. 1982); Bruce M. Kramer & Chris Pearson, *The Implied Marketing Covenant in Oil & Gas*

theories are more common.[16] One of these more common theories is that implied covenants fill gaps in contracts, giving particularized expression to the parties' own implicit intent. Thus, courts do not *impose* implied covenant obligations on lessee. Instead, the court merely *finds* the common intent of the parties. Under this theory, implied covenants are implied-in-fact. The other common theory is that courts *impose* implied covenants on lessees as a means to promote fairness.[17] Under this theory, implied covenants are implied-in-law.[18]

In the vast majority of cases involving implied covenant disputes, the theoretical basis of implied covenants is merely an academic question. The parties' dispute will turn either on the scope and extent of the lessee's implied covenant duties, on some procedural issue relating to implied covenants, or on some issue unrelated to implied covenants, not on whether the covenant at issue is implicit in the parties' contractual intent or imposed as a matter of law by courts. Nevertheless, in rare cases, the theoretical basis of implied covenants will determine the resolution of a dispute. For example, in *Smith v. Amoco Production Co.*, the court had to determine whether a lessee's implied covenants were implied-in-law or implied-in-fact because, reasoned the court, a different statute of

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Leases: Some Needed Changes for the 80's, 46 LA. L. REV. 787, 790 (1985); *see also* Taussig v. Goldking Properties Co., 495 So. 2d 1008, 1014 (La. Ct. App. 1986) (stating that the implied covenant of reasonable development serves public policy), *writ denied,* 502 So. 2d 111 (La. 1987).

16. *See* David E. Pierce, *Exploring the Jurisprudential Underpinnings of the Implied Covenant to Market*, 48 ROCKY MTN. MIN. L. INST. § 10, at 9 (2002).

17. *See, e.g.,* Jacobs v. CNG Transmission Corp., 772 A.2d 445, 455 (Pa. 2001) (referring to fairness); *see also* David E. Pierce, *Exploring the Jurisprudential Underpinnings of the Implied Covenant to Market*, 48 ROCKY MTN. MIN. L. INST. §10, at 9 (2002).

18. One oil and gas law treatise notes that there probably is some truth to both the implied-in-fact and implied-in-law theories. MARTIN & KRAMER, *supra* note 4, at § 803. The same treatise states that implied covenants can be justified by the general principle of cooperation that exists in the contract law of most states. MARTIN & KRAMER, *supra* note 4, at § 802.1. But in Louisiana, the highest court has found a different justification. Although Louisiana recognizes an implied covenant of good faith and fair dealing in contracts, *see* LA. CIV. CODE art. 1983, the Louisiana Supreme Court has stated that the implied duties in oil and gas leases are particularized expressions of Louisiana Civil Code article 2710's requirement that a lessee use the "thing leased as a good administrator." *See* Frey v. Amoco Prod. Co., 603 So. 2d 166, 174 (La. 1992); *see also* LA. REV. STAT. § 31:122 cmt. (WEST 2018).

limitations would apply depending on whether the covenant was based on the implied intent of the parties or on a rule of fairness imposed by law.[19]

B. The Standard of Conduct for Compliance with Implied Covenants

With respect to implied covenant duties, lessees are not held to a fiduciary standard,[20] and they are not required to exercise perfect judgment.[21] On the other hand, a lessee's discretion is not unfettered. Courts universally hold that oil and gas lessees are required to act as reasonably prudent operators, taking into consideration both their own interests and those of their lessors.[22] This modern description of the "reasonably prudent operator" standard is very similar to that stated in a 1905 case that arose in Kansas, *Brewster v. Lanyon Zinc, Co.*[23] *Brewster* stated, "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."[24]

Depending on one's viewpoint, the reasonably prudent operator standard is either the standard of conduct that applies when determining whether the lessee has complied with each one of several implied covenants to which lessees are bound, or the reasonably prudent operator standard itself is the sole implied covenant, though there are several different types of situations that recur with sufficient frequency that it is

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19. 31 P.3d 255, 265, 269-76 (Kan. 2001).

20. *See, e.g.*, Finley v. Marathon Oil Co., 75 F.3d 1225, 1229 (7th Cir. 1996) (under Illinois law, lessee does not owe fiduciary duties to lessor); LA. REV. STAT. § 31:122 (mineral lessee is not a fiduciary).

21. *See* Davis v. Ross Production Co., 910 S.W.2d 209, 213 (Ark. 1995) ("due deference should be given to the judgment of the lessee," but the lessee must exercise "sound judgment"); Robbins v. Chevron U.S.A., Inc., 785 P.2d 1010, 1015 (Kan. 1990) (lessee must act as a reasonably prudent operator, but its actions should not be judged with the benefit of "hindsight").

22. *See* Hite v. Falcon Partners, 13 A.3d 942, 945 (Pa. Super. Ct. 2011); Appeal of Baird, 6 A.2d 306, 311 (Pa. 1939); Jennings v. Southern Carbon Co., 80 S.E. 368, 370 (W. Va. 1913) (lessee must act as a reasonably prudent operator and consider interests of both itself and lessor); LA. REV. STAT. § 31:122 (mutual benefit and reasonably prudent operator standard).

23. Brewster v. Lanyon Zinc Co., 140 F. 801 (8th Cir. 1905).

24. *Id.* at 814. Although earlier implied covenant cases did not give as full a description of the standard now called the "reasonably prudent operator" standard, the standard imposed by those earlier cases also was one of reasonability. *See, e.g.,* Harris v. Ohio Oil Co., 48 N.E. 502 (Ohio 1897) (recognizing "implied covenant that the lessee shall reasonably develop the lands and reasonably protect" against drainage).

useful to discuss the lessee's implied duty in each of those types of situations as being a separate implied covenant. Thus, the text below discusses the lessee's implied duties as being separate implied covenants.

C. The Most Commonly Recognized Implied Covenants

There is substantial similarity between the particular implied covenants recognized by different jurisdictions and various commentators. Some of the implied covenants most frequently recognized in jurisprudence or commentary are covenants to: (1) promptly drill an initial test well; (2) reasonably develop the premises; (3) conduct further exploration; (4) protect against drainage; (5) diligently market minerals; and (6) restore the surface.[25] Nevertheless, there are some differences in the implied covenants that different jurisdictions recognize.[26]

Further, different jurisdictions sometimes use different terminology to describe implied covenants that are the same in substance.[27] For example,

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25. *See, e.g.*, JOHN S. LOWE, OIL AND GAS LAW IN A NUTSHELL (6th ed. 2014). Professor John Lowe states that common implied covenants include the duties to test, develop, explore, protect, and market. *See id.* at 313. He also mentions an implied covenant of diligent and prudent operation, though he notes that it largely overlaps other implied covenants. *See id.* at 348.
The implied covenant of surface restoration also frequently is discussed in commentary. *See e.g.*, Patrick H. Martin, *Implied Covenants in Oil and Gas Leases—Past, Present and Future*, 33 WASHBURN L.J. 639, 658-60 (1994); Keith B. Hall, *The Application of Oil & Gas Lease Implied Covenants in Shale Plays: Old Meets New*, Proceedings of the 32 ANN. ENERGY & MIN. L. INST. 304 (2011).

26. Some have recognized an implied covenant to restore the surface of the land to its original condition after the lease is complete. *See* Bonds v. Sanchez-O'Brien Oil & Gas Co., 715 S.W.2d 444, 446 (Ark. 1986), and some have rejected such an implied covenant. *See* Terrebonne Parish Sch. Bd. v. Castex Energy, Inc., 893 So. 2d 789 (La. 2005). Some courts have recognized an implied covenant of further exploration. *See* Gillette v. Pepper Tank Co., 694 P.2d 369, 372 (Colo. App. 1984), while others have rejected such a duty. *See* Sun Exploration & Production Co. v. Jackson, 783 S.W.2d 202, 204 (Tex. 1989).

27. For example, Texas recognizes implied duties to develop the premises, protect the leasehold, and administer the lease. The duty to protect against drainage is included in the duty to protect the leasehold, and a duty to reasonably market oil and gas is part of the implied covenant to administer the lease. *See* Yzaguirre v. KCS Res., 53 S.W.3d 368, 373 (Tex. 2001). 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. *See* Garman v. Conoco, Inc., 886 P.2d 652, 659 (Colo. 1994).

the Texas Supreme Court sometimes states that there are three implied covenants—covenants to (1) develop the premises, (2) protect the leasehold, and (3) manage and administer the lease.[28] But a duty to protect against drainage is part of the general duty to protect the leasehold;[29] a duty to market is part of the duty to manage and administer the lease;[30] and a duty to explore may be included in the duty to develop.[31]

1. Covenant to Drill a Test Well

Early in the history of the oil and gas industry, several courts held that a lessee had an implied duty to drill at least one test well on the leased premises relatively soon after the lease was executed.[32] The courts reached this conclusion in part because many leases provided for only a nominal bonus, so that the lessor might receive virtually no benefit from the lease—not even the benefit of someone having tested his land—in the event that the lessee did not drill. The absence of benefit to the lessor raised issues of fairness, as well as the possibility that the transaction constituted an illusory promise, unless the lessee had an implied duty to drill. But lessees often were not prepared to promptly drill, so they began drafting their leases to include delay rental clauses.[33] These clauses provided that, if the

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28. Sun Exploration and Production Co. v. Jackson, 783 S.W.2d 202, 204 (Tex. 1989); Amoco Production Co. v. Alexander, 622 S.W.2d 563 (Tex. 1981).

29. Amoco Production Co. v. Alexander, 622 S.W.2d 563, 568 (Tex. 1981); *see also* ERNEST E. SMITH & JACQUELINE L. WEAVER, TEXAS LAW OF OIL AND GAS at 5-32 (2015 LexisNexis).

30. Yzaguirre v. KCS Resources, Inc., 53 S.W.3d 368, 373 (Tex. 2001); Amoco Production Co. v. Alexander, 622 S.W.2d 563, 567 n.1 (Tex. 1981); *see also* ERNEST E. SMITH & JACQUELINE L. WEAVER, TEXAS LAW OF OIL AND GAS at 5-5 (2015 LexisNexis).

31. Sun Exploration and Production Co. v. Jackson, 783 S.W.2d 202, 204 (Tex. 1989); Clifton v. Koontz, 325 S.2d 684, 696 (Tex. 1959); *see also* ERNEST E. SMITH & JACQUELINE L. WEAVER, TEXAS LAW OF OIL AND GAS at 5-30 thru 5-31 (2015 LexisNexis).

32. *See* Gary B. Conine, *Speculation Prudent Operation, and the Economics of Oil and Gas Law*, 33 Washburn L.J. 670, 683 (1994); *see also,* LOWE, *supra* note 25 at 202-3, 314 (4th ed. 2009); Consumers Gas Trust Co. v. Littler, 70 N.E. 363, 366 (Ind. 1904).

33. *See* Gary B. Conine, *Speculation, Prudent Operation, and the Economics of Oil and Gas Law*, 33 WASHBURN L.J. 670, 684 (1994); Hite v. Falcon Partners, 13 A.3d 942, 946 (Pa. Super. Ct. 2011); Jacobs v. CNG Transmission Corp., 332 F. Supp. 2d 759, 766 n.3 (W.D. Pa. 2004). Lessees began using delay rental clauses early in the history of the oil and gas industry. For example, at least three reported cases from the author's home state of Louisiana deal with leases granted

lessee had not begun drilling by the first anniversary of the granting of the lease, the lessee could pay "delay rentals" to defer or delay its obligation to drill a test well.[34] Today, almost every lease contains a delay rental clause, unless the lease is a paid-up lease.[35] Accordingly, the implied covenant to drill a test well is rarely litigated.[36]

2. Covenant to Reasonably Develop

The implied covenant of reasonable development requires the lessee to drill as many wells as are reasonably necessary to develop a *proven* formation—that is, a formation where drilling has confirmed the existence of oil or gas in paying quantities.[37] The implied covenant of reasonable

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in early 1901 that contained delay rental clauses. *See* Murray v. Barnhart, 117 La. 1023, 42 So. 489 (1906) (lease granted in March 1901); Jennings-Heywood Oil Syndicate v. Houssiere-Latreille Oil Co., 119 La. 793, 44 So. 481 (1907) (lease apparently granted in early 1901); Houssiere-Latreille Oil Co. v. Jennings-Heywood Oil Syndicate Co., 115 La. 107, 38 So. 932 (1905) (lease granted in 1901); *see also* Saunder B. Busch-Everett Co., 138 La. 1049, 71 So. 153 (1916) (leases granted in 1909); Busch-Everett v. Vivian Oil Co., 128 La. 886, 55 So. 564 (1911) (lease granted in 1909).

34. *See, e.g.,* Kachelmacher v. Laird, 110 N.E. 933, 935 (Ohio 1915).

35. A "paid -up lease" is "[a] lease effective during the primary term without further payment of delay rentals, the aggregate of rentals for the entire primary term having been paid in advance." PATRICK H. MARTIN & BRUCE A. KRAMER, 8 WILLIAMS AND MEYERS OIL & GAS LAW 738 (2018) (hereafter, the "MANUAL OF OIL & GAS TERMS"). Sometimes a paid-up lease will include a delay rental clause and the lessee will simply pay all delay rentals at the start of the lease. Other times, the lease will not contain a delay rental clause, and the lease will state that it is a paid-up lease. Sometimes the lease will contain neither a delay-rental clause nor a statement that the lease is a paid-up lease, but this method of drafting a paid-up lease should be discouraged because a court might conclude that the implied covenant to test has not been negated. *See infra* Section III(A) of this Article.

36. *See* MARTIN & KRAMER, *supra* note 4, at § 812; *see also* Patrick H. Martin, *A Modern Look at Implied Covenants to Explore, Develop, and Market Under Mineral Leases*, 27 SW. LEGAL FDN. OIL & GAS INST. 177, 179 (1976) ("The implied covenant to drill an initial well is no longer of significance because the typical lease today terminates automatically if a well is not drilled or excused by delay rentals within a fixed period.").

37. Whitham Farms LLC v. City of Longmont, 97 P.3d 135, 137 (Colo. App. 2003); Wilds v. Universal Resources Corp., 662 P.2d 303, 306 (Okla. 1983); Clifton v. Koontz, 324 S.W.2d 684, 693 (Tex. 1959); McKnight v. Manufacturers Natural Gas Co., 23 A. 164, 166 (Pa. 1892); Harris v. Ohio Oil Co., 48 N.E. 502, 505 (Ohio 1897); Jennings v. Southern Carbon Co., 80 S.E. 368, 369 (W. Va. 1913); *see* LA. REV. STAT. 31:122 cmt. (WEST 2018) ("Essentially, the relevant

development appears to be the first implied covenant to be recognized by courts,[38] and it seems to be universally recognized. Because the duties associated with this implied covenant relate to proven formations, this covenant does not apply until *after* oil or gas is found in paying quantities.[39] Further, because a reasonably prudent operator would not drill an unprofitable well merely to drain a proven formation more quickly, this implied covenant does not require a lessee to drill wells that likely would be unprofitable.[40]

The Louisiana Supreme Court described the implied covenant of reasonable development in 1914 in *Caddo Oil & Mining Co. v. Producers' Oil Co.*[41] The court stated:

> It is an implied covenant of every lease of land, for the production of oil therefrom, that, when the existence of oil, in paying quantities, is made apparent, the lessee shall put down as many wells as may be reasonably necessary to secure the oil for the common advantage of both lessor and lessee. Whatever ordinary knowledge and care would dictate, as to the proper thing to be done for the interest of the lessor and lessee, under any given circumstances, is that which the law requires to be done, as an implied stipulation of this lease.[42]

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cases hold that after production in paying quantities has been obtained from a mineral formation, it is the duty of the lessee to develop the producing formation in the manner of a reasonable, prudent operator taking into consideration both its own interests and those of the lessor.").

38. *See* MARTIN & KRAMER, *supra* note 4, at § 802.

39. *See* Baker v. Collins, 194 N.E.2d 353, 355 (Ill. 1963) ("After the discovery of oil or gas in paying quantities, the law … implies a duty on the part of the lessee to reasonably develop the premises…."); MARTIN & KRAMER, *supra* note 4, at § 832; *see also* LA. REV. STAT. 31:122 cmt. (WEST 2018) (stating that, for both implied covenant to reasonably develop and implied covenant of further exploration, "there must be discovery in paying quantities to make the obligations operative."); Caddo Oil & Mining Co. v. Producers Oil Co., 64 So. 684, 690 (La. 1914).

40. 194 N.E.2d at 355 (there was a duty to develop "so long as the enterprise could be carried on at a profit"); Kleppner v. Lemon, 35 A. 109, 110 (Pa. 1896) (lessee is not required "to put down wells that will not be able to produce oil sufficient to justify the expenditure"); MARTIN & KRAMER, *supra* note 4, at § 832.

41. 64 So. at 690.

42. *See id.* (quoting W. THORNTON, THE LAW RELATED TO OIL AND GAS § 111 (2d ed. 1904)).

The implied covenant of reasonable development, as contemplated herein,[43] does not in itself require the lessee to drill exploratory wells in unproven areas, though the lessee nevertheless may have a duty to do so in certain circumstances, as discussed in the next section.[44]

3. Covenant of Further Exploration

Some courts have held that lessees are bound by an implied covenant of further exploration that is a separate obligation from the implied covenant of reasonable development.[45] Like the implied covenant of reasonable development, the implied covenant of further exploration does not apply until *after* oil or gas is discovered in paying quantities.[46] But unlike the covenant of reasonable development, which requires a lessee to reasonably develop a *proven* formation, the implied covenant of further exploration applies to *unproven* areas.[47] This implied covenant requires a lessee to conduct further exploration of unproven areas to the extent that a reasonably prudent operator would do so, taking into consideration the mutual benefit of the operator and lessor.[48]

Recognition of an implied covenant of further exploration is much more recent than the recognition of an implied covenant of recent development. Further, an implied covenant of further exploration is not as widely accepted as several of the other implied covenants. Perhaps the earliest significant discussion of an implied covenant of further exploration dates back to 1956, when a prominent commentator argued in a law review article that that an implied covenant of further exploration

43. As noted in Section I(C)(3), courts do not always distinguish clearly between the duties of reasonable development and further exploration.

44. *But see infra* notes 50-53 and the accompanying text (noting that some courts have imposed duties to duties to explore in unproven areas—duties that commentators and other courts would describe as duties associated with an implied covenant of further exploration—even while characterizing the exploration duty as being included under the implied covenant of reasonable development).

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

46. *See* MARTIN & KRAMER, *supra* note 4, at § 841; *see also* LA. REV. STAT. 31:122 cmt. (WEST 2018) (stating that, for either the implied covenant to reasonably develop or the implied covenant of further exploration to apply, "there must be discovery in paying quantities to make the obligations operative").

47. *See* LA. REV. STAT. § 31:122 cmt. (WEST 2018).

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

exists, or should exist.[49] Some other commentators promptly expressed disagreement,[50] and controversy over this implied covenant continued over the decades.[51] Further, relatively few courts have expressly recognized an implied covenant of "further exploration" by name.[52]

Nevertheless, the implied covenant of further exploration is more important than might be suggested by the relatively small number of courts that have expressly recognized such a covenant. First, this implied covenant is frequently discussed in commentary,[53] which may influence courts and future litigants. Further, in addition to the courts that have expressly recognized an implied covenant of "further exploration" by name, several courts have applied other legal theories to reach results or impose duties similar to those one would expect by application of such an implied covenant. For example, some courts, including those in Oklahoma, have concluded that a lessee could be deemed to have abandoned its lease rights as to a portion of the leased premises that the lessee has not developed or explored for an extended period of time.[54]

Moreover, although commentators typically distinguish between an implied covenant of reasonable development and an implied covenant of further exploration, courts do not always clearly distinguish the duty or alleged duty at issue. For example, although the Texas Supreme Court has expressly rejected the existence of an implied covenant of further exploration by name,[55] the language of the Court's cases seems to suggest that the duty of "reasonable development" could include a duty to explore

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49. *See generally* Charles J. Meyers, *The Covenant of Further Exploration*, 34 TEX. L. REV. 553 (1956); *see also* Charles J. Meyers, *The Covenant of Further Exploration: A Comment*, 37 TEX. L. REV. 179 (1958).

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

51. *See* KUNTZ: A TREATISE ON THE LAW OF OIL AND GAS, § 62.1 (discussing controversy over the existence and nature of the implied covenant of further exploration).

52. Gillette v. Pepper Tank Co., 694 P.2d 369, 372-73 (Colo. App. 1984) (expressly recognizing a duty for further exploration).

53. *See, e.g.*, MARTIN & KRAMER, *supra* note 4, at § 841; *see also* Keith B. Hall, *The Continuing Role of Implied Covenants in Developing Leased Lands*, 49 WASHBURN L.J. 313 (2010).

54. *See* Fox Petroleum Co. v. Booker, 253 P. 33, (Okla. 1927) (Recognizing abandonment of lease rights). *But see* Mitchell v. Amerada Hess Corp., 638 A.2d 441, 449 (Okla. 1981) for a rejection of an "implied covenant of further exploration," at least by name.

55. *See* Sun Exploration & Prod. Co. v. Jackson, 783 S.W.2d 202, 204 (Tex. 1990); Clifton v. Koontz, 325 S.W.2d 684, 696 (Tex. 1959).

new areas.[56] Indeed, some prominent commentators have concluded that Texas recognizes "the substance" of a duty to explore as part of the duty to reasonably develop.[57] It may be difficult, though, for a lessor to prevail in a suit complaining about the failure of a lessee to drill a well to an unproven formation because the Texas Supreme Court has held that, in any reasonable development case, whether the lessor is complaining about the lessee's failure to drill an additional well to a proven formation or an unproven formation, the lessor must prove that the undrilled well probably would have been profitable.[58]

In *Alford v. Collins-McGregor Operating Co.*, the Ohio Supreme Court recently held that, "under Ohio law concerning oil and gas leases, there is no implied covenant to explore further separate and apart from the implied covenant of reasonable development."[59] The Court's discussion can be read, however, as suggesting that a lessor would not be precluded from basing an alleged breach of an implied covenant of reasonable development on a failure to explore new formations. For example, the Court stated, "We also note that that the implied covenant of reasonable development is well suited to address the primary driver of the Landowners' interest here, namely the emergence of new drilling technologies permitting production from deep strata that could not be obtained before."[60]

Somewhat similarly, several Louisiana decisions arguably have imposed an obligation to explore unproven areas,[61] even though the courts

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56. ERNEST E. SMITH & JACQUELINE L. WEAVER, TEXAS LAW OF OIL AND GAS at 5-31 thru 5-32 (2015 LexisNexis).

57. *See* MARTIN & KRAMER, *supra* note 4, at § 815.

58. *See* Sun Exploration & Prod. Co. v. Jackson, 783 S.W.2d 202, 204 (Tex. 1990); Clifton v. Koontz, 325 S.W.2d 684, 696 (Tex. 1959).

59. 95 N.E.3d 382, 388 (Ohio 2018).

60. *Id.* at 388 (The lessor originally had alleged breaches of an implied covenant of reasonable development and an implied covenant of further exploration. At the Ohio Supreme Court, the lessor chose to rely only on its theory that the lessee had breached an implied covenant of further exploration).

61. *See* Keith B. Hall, *Implied Covenants: Claims Under Mineral Code Article 122*, Proceedings of the 57th Annual Mineral Law Institute (2010) at 183-6 (noting that some commentators assert that Louisiana courts implicitly recognize a duty of further exploration, and that several decisions can be interpreted that way, but that there are certain ambiguities in this purported "line" of cases: one of the cases involved a lease with a clause that expressly requiring further exploration; two others made their statements about a duty to test in dicta; and, in one of the cases, *Carter*, there was testimony from which the court could have concluded that the area where no drilling had occurred was within a proven formation). *See also* MARTIN & KRAMER, *supra* note 4, at § 845.4 ("Louisiana

reached their decisions based on a duty that they characterized as a duty to "reasonably develop" the leased premises.[62] Those who say that Louisiana recognizes an implied obligation of further exploration typically point to a line of cases headed by *Carter v. Arkansas Louisiana Gas Co*.[63] In *Carter,* a fault crossed the leased premises. The lessee had drilled wells and developed the property on one side of the fault, but not the other. The lessor demanded that the lessee drill on the other side, but the lessee did not do so. The lessor sued for lease cancellation. The trial court granted partial cancellation, dissolving the lease as to the portion of the property that had not been developed. The lessee appealed the order of partial cancellation. The lessor did not appeal the trial court's refusal to order complete cancellation.

The Louisiana Supreme Court affirmed, after reviewing the evidence and concluding that it showed that a reasonably prudent operator would have drilled wells on the side of the fault that had not been developed. Some of that evidence suggested that the proven field, which the lessee had developed on one side of the fault, likely existed on both sides of the fault. Thus, the Court could have simply based its decision on the lessee's implied duty to reasonably develop a proven field of oil or gas after production from the field is established in paying quantities. But the Court's opinion included the following language that suggested the existence of a duty to explore unproven areas:

> The principle, as we understand it, is that development of every part of the lease is an implied condition. Therefore, whether the undeveloped portion be a single tract remote from the rest, or a consideration portion of a very large tract, or the east one hundred acres of a tract of 160, it is an implied condition that the lessee

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courts are probably the most severe in the country in enforcing an implied duty to explore further.").

62. *See* LA. REV. STAT. § 31:122 cmt (WEST 2018); *cf.* Thomas A. Harrell, *A Mineral Lessee's Obligations to Explore Unproductive Portions of the Leased Premises in Louisiana*, 52 LA. L. REV. 387, 390 (1991) (noting that Louisiana courts have referred to the lessee's obligation to reasonably "develop" the premises both when discussing the obligation to develop proven reservoirs and the obligation to explore non-productive areas). Indeed, the case that some commentators point to as being the leading case that establishes a duty of further exploration in Louisiana ─ Carter v. Arkansas Louisiana Gas Co., 36 So. 2d 26 (1948) ─ refers to the issue in the case as being whether the lessee had reasonably developed the leased property.

63. 36 So. 2d 26 (1948).

will test every part.[64]

Such language, assuming it was not dicta, effectively imposed an implied duty of further exploration.

A question whose answer might vary by jurisdiction is whether a lessor who alleges a breach of an implied covenant to explore a new area must prove that the new area likely contains oil or gas in paying quantities. It appears that such proof would be required in Texas.[65] But an appellate court in Colorado stated that a plaintiff need not show that an exploratory well probably would be profitable.[66] Instead, a plaintiff only needs to show that a reasonably prudent operator would drill an exploratory well.[67] In states that require the plaintiff to prove that an exploratory well probably would have been profitable, that required element of proof makes it challenging for lessors to prevail in a claim that the lessee has breached a duty to conduct further exploration.

4. Covenant to Protect Against Drainage

The implied covenant to protect against drainage requires the lessee to take reasonable action to protect the leased premises against substantial drainage from wells on nearby properties.[68] The implied covenant to protect against drainage is widely recognized, and it is one of the earliest of the implied covenants to be recognized.[69] The implied covenant to

64. *See* 36 So. 2d at 29 (quoting Fox Petroleum Co. v. Booker, 253 P. 33 (Okla. 1927), a case in which the issue was whether the lessee had abandoned a portion of the leased premises, and not whether a duty of further exploration existed or whether such a duty had been reached).

65. *See* Sun Exploration & Prod. Co. v. Jackson, 783 S.W.2d 202, 204 (Tex. 1990); Clifton v. Koontz, 325 S.W.2d 684, 696 (Tex. 1959).

66. Gillette v. Pepper Tank Co., 694 P.2d 369, 372 (Colo. App. 1984).

67. *Id.*

68. *See* Coastal Oil & Gas Corp. v. Garza Energy Trust Corp., 268 S.W.3d 1, 17 (Tex. 2008); Whitham Farms LLC v. City of Longmont, 97 P.3d 135, 137 (Colo. App. 2003); Croston v. Emax Oil Co., 464 S.E.2d 728, 733 (W. Va. 1995); Rogers v. Heston Oil Co., 735 P.2d 542, 546 (Okla. 1984); Klempner v. Lemon, 35 A. 109 (Pa. 1896); Harris v. Ohio Oil Co., 48 N.E. 502, 505 (Ohio 1897); Jennings v. S. Carbon Co., 80 S.E. 368, 369 (W. Va. 1913); Swope v. Holmes, 124 So. 131 (La. 1929); LA. REV. STAT. § 31:122 cmt.

69. Modern conservation statutes and regulations, such as well spacing rules, setback rules, and compulsory unitization can decrease the frequency of drainage disputes, but such disputes still can occur. *See, e.g.,* Coastal Oil & Gas Corp. v. Garza Energy Trust Corp., 268 S.W.3d 1 (Tex. 2008).

protect against drainage was recognized as early as 1896 in Pennsylvania[70] and shortly thereafter in Ohio.[71] The traditional way to protect the leased premises against drainage is to drill offset wells,[72] though some courts have recognized that a lessee may be able to protect against drainage by seeking pooling or unitization.[73] In some cases, spacing rules may prohibit the drilling of a well that would protect against drainage. In such a case, if the regulator will grant exceptions to the usual spacing rules, the lessee may have an obligation to seek such an exception.[74] On the other hand, because a lessee is only required to take *reasonable* steps to protect against drainage, the lessee need not drill an offset well if it likely would be unprofitable to do so.[75]

In some states, if the lessee of the property being drained happens to be the operator of the neighboring well that is draining the lessor's property, courts may hold the lessee to a higher standard of conduct than in cases in which the operator of the draining well is someone else, or courts may shift the burden of proof from the lessor to the lessee to show the reasonability of the lessee's conduct.[76] But other states do not appear

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70. *See* Kleppner v. Lemon, 35 A. 109 (Pa. 1896).

71. *See* Harris v. Ohio Oil Co., 48 N.E. 502 Ohio (1897).

72. *See, e.g.,* Kleppner v. Lemon, 35 A. 109, 110 (Pa. 1896); *see* LA. REV. STAT. § 31:122 cmt.; Breaux v. Pan American Petroleum Corp., 163 So. 2d 406, 415 (La. Ct. App.) (describing implied covenant to protect against drainage as being "actually an implied obligation to drill offset wells" when necessary to prevent drainage), *writ denied*, 165 So. 2d 481 (La. 1964). One prominent treatise states that an offset well is "[a] well drilled on one tract of land to prevent the drainage of oil or gas to an adjoining tract of land, on which a well is being drilled or is already in production." MANUAL OF OIL & GAS TERMS, *supra* note 35, at 684.

73. *See* MARTIN & KRAMER, *supra* note 4, at § 821; Coastal Oil & Gas Corp. v. Garza Energy Trust Corp., 268 S.W.3d 1, 17 n.57 (Tex. 2008); Southeastern Pipe Line Co. v. Tichauhek, 997 S.W.2d 166, 170 (Tex. 1999); Breaux v. Pan American Petroleum Corp., 163 So. 2d 406, 418 (La. Ct. App.), *writ denied*, 165 So. 2d 481 (La. 1964).

74. Amoco Prod. Co. v. Alexander, 622 S.W.2d 563, 568 (Tex. 1981); Spaeth v. Union Oil Co., 710 F.2d 1455, 1458 (10th Cir. 1983) (noting that Oklahoma law allows the Corporation Commission to authorize exceptions to spacing rules and stating that "Union had a duty, which it could not ignore, to seek administrative relief.").

75. *See Garza Energy*, 268 S.W.3d at 14 n.42; *Breaux*, 163 So. 2d at 415 (to prove a breach of the implied covenant to protect against drainage, the lessor must show that "it would have been economically feasible for the lessee to drill such offset wells").

76. *See* LOWE, *supra* note 25, at 336-37.

to apply a heightened standard of conduct or to shift the burden of proof in such a common-lessee situation.[77]

5. Covenant to Diligently Market

The implied covenant to market requires a lessee to diligently seek purchasers at a reasonable price for any oil or gas that is found in paying quantities.[78] Disputes regarding this implied covenant most often involve natural gas, rather than oil.[79] In part, this is because operators have fewer options for storing natural gas and transporting it to market than they have for storing and transporting oil. Oil can be shipped via pipeline, or it can be temporarily stored in tanks located near the well and then periodically transported to a market via trailer truck, railcar, or barge. In contrast, pipelines typically are the only practical option for transporting natural gas to market. Sometimes a connection to a pipeline will be readily available, but that is not always the case, and building entirely new pipelines or even long connections to existing pipelines can be expensive and time-consuming.

The implied covenant to diligently market has at least two components. The first is a duty to diligently seek a buyer and a pipeline to transport the gas to the buyer. The second is a duty to seek the best price reasonably available, though this duty is only triggered if the lease

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77. *Id.* at 416.

78. *See* LOWE, *supra* note 25, at 338-39; Iams v. Carnegie Natural Gas Co., 45 A. 54, 55 (Pa. 1899); Risinger v. Arkansas-Louisiana Gas Co., 3 So. 2d 289 (La. 1941).

The implied covenant to market has been the subject of significant case law across the nation, as well as commentary by nationally prominent oil and gas scholars. *See, e.g.,* Owen L. Anderson, *Royalty Valuation: Should Overriding Royalty Interests and Nonparticipating Royalty Interest, Whether Payable in Value or in Kind, Be Subject to the Same Valuation Standards as Lease Royalty?*, 35 LAND & WATER L. REV. 1 (2000); John S. Lowe, *Interpreting the Royalty Obligation: The Role of the Implied Covenant to Market*, ROCKY MTN. MIN. L. SPECIAL INST. ON PRIVATE OIL & GAS ROYALTIES, Chapter 6 (2003); Jacqueline S. Weaver, *When Express Clauses Bar Implied Covenants, Especially in Natural Gas Marketing Scenarios*, 37 NAT. RESOURCES J. 491 (1997); David E. Pierce, *Exploring the Jurisprudential Underpinnings of the Implied Covenant to Market*, 48 ROCKY MTN. MIN. L. INST., Ch. 10 (2002); Bruce M. Kramer and Chris Pearson, *The Implied Marketing Covenant in Oil & Gas Leases: Some Needed Changes for the 80's*, 46 LA. L. REV. 788 (1986); Patrick H. Martin, *A Modern Look at Implied Covenants to Explore, Develop, and Market Under Mineral Leases*, 27 SW. LEGAL FDN. OIL & GAS INST. 177 (1976).

79. *See* MARTIN & KRAMER, *supra* note 4, at § 853.

provides for a royalty that is based on the sales price or the proceeds from sale.[80] If the royalty is based on the market value, the duty to seek the best price reasonably available would not be triggered because the royalty owed to the lessor is independent of the price that the leaseholder actually obtains for the gas, and instead depends only on the market value. In some states, the marketing covenant has a third component—a duty for the lessee to absorb all post-production costs unless the lease makes it clear that the lessee is not solely responsible for those costs.

Traditionally, disputes regarding the implied covenant to market concerned disagreements between the lessor and lessee regarding the first component of the marketing covenant, the lessee's duty to be diligent in finding a buyer or in making connections to a pipeline so that the gas can be transported to market.[81] Occasionally, disputes arose regarding the second component of the marketing covenant—the lessee's duty to seek the best price reasonably available.

Disputes regarding the first two components of the marketing covenant still can arise, but another type of "marketing" dispute has often arisen in recent years. Many leases provide for a royalty to be paid based on the "value" of gas at the wellhead, but gas often is sold at a market quite a distance from the well. Further, gas at the wellhead sometimes is not suitable for immediate placement into a pipeline because the gas may contain impurities or be at too low a pressure. Operators often will incur significant expenses in treating the gas to bring its composition to pipeline specifications and in compressing the gas in order to put it into a pipeline and transport it to market. These steps cost money, but they also add value to the gas. And absent these steps, the gas often would not be marketable.

To determine the value of the gas at the wellhead for purposes of calculating a royalty, operators generally have used a "net-back" or "workback" method.[82] This method assumes that the value of gas at the wellhead is the price received for the gas when it is sold at market, minus the post-production (*i.e.*, post-wellhead) costs that the operator incurs between the wellhead and the place of sale. And, from a standpoint of

80. Union Pacific v. Hankins, 111 S.W.3d 69, 72 (Tex. 2003); Yzaguirre v. KCS Resources, Inc., 53 S.W.3d 368, 374 (Tex. 2001).

81. *Id.*

82. "Under this method costs of transportation, processing and treatment are deducted from the ultimate proceeds of sale of the oil or gas … to ascertain wellhead value." *See* MANUAL OF OIL & GAS TERMS, *supra* note 35, at 1154.

economics, this makes sense.[83] If sweet,[84] dehumidified, high-pressure gas sells for $5 at a distant market, then sour,[85] humid, low-pressure gas at the wellhead logically is worth $4 if the costs of treatment, dehydration, compression, and transport equal $1.

But lessors often have argued that the post-production tasks that an operator performs to gather, treat, dehydrate, and compress gas are all steps in the marketing of the gas.[86] Therefore, their argue continues, unless the lease expressly states that the lessee may deduct the costs of these steps prior to calculating the royalty, the implied duty to market requires the lessee to absorb the costs and to pay royalties on the full sale price of the gas. Some courts have accepted such an argument,[87] while others have rejected it.[88] A rule that lessees are responsible for all post-production costs, up to the point that the gas becomes marketable, is sometimes called the first marketable product rule.[89]

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83. *See* Schroeder v. Terra Energy, Ltd., 565 N.W.2d 887, 892 (Mich. Ct. App. 1997) ("Basic principles of economics require that, in determining the 'gross proceeds at the wellhead' in the absence of an actual sale of gas at the wellhead resulting in ascertainable gross proceeds, the gross proceeds from a sale elsewhere must be extrapolated, backwards or forwards, to reflect appropriate adjustments due to differences in the location, quality, or characteristics of what is being sold.").

84. Sweet gas is natural gas with a relatively low hydrogen sulfide content.

85. Sour gas is natural gas with a relatively high hydrogen sulfide content.

86. For further discussion of such marketing disputes, *see* David E. Pierce, *Exploring the Jurisprudential Underpinnings of the Implied Covenant to Market*, 48 ROCKY MT. MIN. L. INST., Ch. 10 (2002); David W. Hardymon, *Adrift on the Implied Covenant to Market: Regulation by Implication*, 24 ENERGY & MIN. L. INST. 209 (2003).

87. Rogers v. Westerman Farm Co., 29 P.3d 887, 897 (Colo. 2001) (lessor's implied covenant argument prevails).
In Oklahoma and Kansas, the implied covenant to market will require the operator to absorb post-production costs necessary to make natural gas marketable, but if the composition and pressure of the gas are such that the gas already is marketable, the lessee may deduct post-production costs for treatment and compression to the extent such costs are reasonable and add value to the gas. *See* Mittelstaedt v. Santa Fe Minerals, Inc., 954 P.2d 1203 (Okla. 1998); Sternberger v. Marathon Oil Co., 894 P.2d 788, 800 (Kan. 1995).

88. *See* Kilmer v. Elexco Land Services, Inc., 990 A.2d 1147, 1152 (Pa. 2010) (rejecting lessors' implied covenant to market argument, in addition to rejecting their arguments that were based on the Guaranteed Minimum Royalty Act); Poplar Creek Development Co. v. Chesapeake Appalachia LLC, 636 F.3d 235 (6th Cir. 2011) (under Kentucky law, rejecting argument that implied covenant to market prohibited deduction of post-production costs).

89. MANUAL OF OIL & GAS TERMS, *supra* note 35, at 383.

6. Covenant to Restore the Surface

The implied covenant to restore the surface requires the lessee to restore the leased premises to a condition reasonably approaching its original condition after the lease terminates, or perhaps after operations terminate in the area at issue.[90] The implied duty of surface restoration is not widely recognized in jurisprudence, but Arkansas has recognized it,[91] and it frequently is discussed in commentary.[92] Texas and New Mexico appear to have rejected such a duty.[93] Louisiana also has rejected an implied covenant of surface restoration—at least for cases in which the lessee's conduct that caused the surface impacts was authorized by the lease and the use of the surface was not "excessive."[94]

7. Other Implied Covenants that Might Exist

Some commentators have suggested that other implied covenants might exist, including covenants to use reasonable care in producing minerals (for example, to take sufficient care to avoid accidents)[95] and to

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90. *See* Patrick H. Martin, *Implied Covenants in Oil and Gas Leases – Past, Present & Future*, 33 WASHBURN L.J. 640, 658 (1994).

91. *See, e.g.,* Chevron U.S.A., Inc. v. Murphy Exploration & Production Co., 151 S.W.3d 306, 310-12 (Ark. 2004); Bonds v. Sanchez-O'Brien Oil & Gas Co., 715 S.W.2d 444 (Ark. 1986).

92. *See* Martin, *supra* note 90, at 658; Keith B. Hall, *Implied Covenants: Claims Under Mineral Code Article 122*, pp. 188-90 Proceedings of the 57th Annual Mineral Law Institute (2010); LA. REV. STAT. 31:122 cmt. The official comment to Louisiana Mineral Code article 122 suggests that, after the lease ends, a mineral lessee might have an implied obligation "to restore the surface of the lease premises as near as is practical to original condition." Subsequent to enactment of the Mineral Code, the Louisiana Supreme Court had stated in dicta that such a duty exists, Caskey v. Kelly Oil Co., 737 So. 2d 1257, 1261 (La. 1999), and lower courts had held that such a duty exists. *See, e.g.,* Edwards v. Jeems Bayou Production Co., 507 So. 2d 11, 13 (La. App. 2d Cir. 1982). But in Terrebonne Parish School Board v. Castex Energy, Inc., 893 So. 2d 789 (La. 2005), the Louisiana Supreme Court held that a general implied obligation to restore the surfaces does not exist under Louisiana law, at least in circumstances in which the lessee was authorized by the lease to conduct the activities that it did and the wear and tear on the property was not excessive.

93. Warren Petroleum Corp. v. Monzingo, 304 S.W.2d 362 (Tex. 1957); Amoco Production Co. v. Carter Farms, 703 P.2d 894 (N.M. 1985).

94. Terrebonne Parish School Board v. Castex Energy, Inc., 893 So. 2d 789 (La. 2005).

95. *See, e.g.,* Patrick H. Martin, *A Modern Look at Implied Covenants to Explore, Develop, and Market Under Mineral Leases*, 27 SW. LEGAL FDN. OIL &

properly represent the lessor's interests before state conservation agencies.[96] These proposed implied covenants have not been recognized in jurisprudence, but neither have they been rejected, so perhaps a court would recognize such a duty under appropriate facts.[97] But a court might reject an argument that implied covenants provide the basis for a contractual claim when accidents occur, and instead hold that a plaintiff's claim sounds in tort only. And, in some states, a collateral attack rule might serve as a barrier to claims that a lessee did not adequately represent the lessor before regulatory authorities.[98]

D. Defenses, Remedies, and Other Issues

In some circumstances, lessees will have meritorious defenses to otherwise valid implied covenant claims. The following subsections of this Article first discuss some of the defenses that courts have recognized and then discuss some of the remedies that may be available in the event a lessor prevails on an implied covenant claim.

GAS INST. 177, 179 (1976). The proposed implied covenant to use reasonable care likely overlaps with negligence law. *See id.* at 179-80. Because the lessor would be able to recover in a tort action, there sometimes would be no reason for a court to determine whether a contractual duty was breached, though in some situations it might be necessary to reach that issue, as when the applicable limitations period depends on whether a plaintiff's claim sounds in contract or tort.

96. Patrick H. Martin, *Implied Covenants in Oil and Gas Leases — Past, Present & Future*, 33 WASHBURN L.J. 639, 660-1 (1994); *see* John M. McCollam, *Impact of Louisiana Mineral Code on Oil, Gas and Mineral Leases*, 22 MIN. LAW INST. 37, 68-9 (1975) (referring to a "possibly emerging obligation to represent the lessor's interest fairly before regulatory agencies such as the Louisiana Commissioner of Conservation," but stating "it is probably not correct to characterize this as a recognized implied obligation in Louisiana").
Professor John Lowe states that common implied covenants include the duties to test, develop, explore, protect, and market. *See* LOWE, *supra* note 25, at 313. He also mentions an implied covenant of diligent and prudent operation, though he notes that it largely overlaps other implied covenants. *See id.* at 348.

97. Courts have recognized, at least in dicta, that a lessee might be able to satisfy its duty to protect against drainage by appropriately seeking unitization. *See* Breaux v. Pan American Petroleum Corp., 163 So. 2d 406, 415 (La. App. 3d Cir.), *writ denied,* 165 So. 2d 481 (La. 1964). *Breaux* also suggested that a lessee's failure to seek unitization possibly could be a basis for liability. *See* 163 So. 2d at 415. But few other cases suggest this possibility. *See also* McCollam, *supra* note 96 at 68-9, 77-8.

98. *See, e.g.,* Trahan v. The Superior Oil Co., 700 F.2d 1004 (5th Cir. 1983).

1. Precluding Implied Covenants by Expressly Addressing Subject

Courts will not impose an implied covenant that is expressly negated by the lease itself.[99] Further, if a lease expressly imposes a duty of the same type that would be imposed by an implied covenant, courts generally will conclude that the parties intended the express duty to be the full extent of the lessee's obligation with respect to that type of performance. Thus, even if the lease does not explicitly state that the express duty describes the full extent of the lessee's obligation or that the lessee is not bound by an implied covenant, courts usually will reach that result. In other words, a duty expressly imposed by the lease will generally not be supplemented by an implied covenant.[100] The express duty implicitly negates any implied duty for the same variety of performance.

The most common lease clause that negates an implied covenant is the delay-rental clause, which negates the implied covenant to drill a test well. Delay rental clauses generally are an example of implicit negation of an implied covenant. Delay rental clauses generally either impose a duty to drill or pay delay rentals within the first year (in an "or" clause) or state that the lease will terminate unless the lessee drills or pays delay rentals within the first year (in an "unless" clause"),[101] but delay rental clauses generally do not state explicitly that the implied covenant to drill a test well is negated.

Express lease clauses also can be used to negate other implied covenants. For example, in *Gulf Production Co. v. Kishi*, the Texas Supreme Court held that an express lease clause negated the existence of an implied covenant to reasonably develop.[102] The case involved two leases. One required drilling a well every sixty days after discovery of oil until a total of twelve wells were drilled. The second lease required drilling a well every ninety days until four wells were drilled. The lessee complied with those terms, but the lessor argued that the lessee had breached an implied covenant of reasonable development because a reasonably prudent

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99. Kachelmacher v. Laird, 110 N.E. 933, 935 (Ohio 1915).

100. *See* Aye v. Philadelphia Co., 44 A. 555, 556 (Pa. 1888) ("where the parties have expressly agreed on what shall be done, there is no room for the implication of anything not so stipulated for"); Harris v. Ohio Oil Co., 48 N.E. 502, 505 (Ohio 1897) ("The implied covenant arises only when the lease is silent on the subject."); Lundin/Weber Company LLC v. Brea Oil Company, Inc., 11 Cal Rptr. 3d 768 (Cal. Ct. App. 2004); Schroeder v. Terra Energy, Ltd., 565 N.W. 2d 887 (Mich. Ct. App. 1997).

101. *See* LOWE, *supra* note 25 at 204-06 (discussing "or" clauses and "unless" clauses).

102. 103 S.W.2d 965 (Tex. 1937).

operator would drill several more wells than the lessee had drilled. A jury granted a verdict to the lessor, but the appellate court reversed, and the Texas Supreme Court affirmed the appellate court judgment, holding that the existence of an express clause imposing certain duties to develop precluded the existence of an implied covenant to reasonably develop.[103] Thus, the express duty implicitly negated an implied covenant of reasonable development.

In *Lundin/Weber Company LLC v. Brea Oil Company, Inc.*, a California court held that express drilling duties stated in a lease negated any implied covenant of further exploration.[104] Two leases were at issue.[105] The first lease stated that the lessee would drill ten wells each year for the first four years of the lease, and that each well would be drilled to a depth of at least 1,000 feet, unless oil was discovered in paying quantities at a shallower depth.[106] The second lease provided that, once the lessee commenced drilling operations, it would "prosecute the drilling of a well or wells with reasonable diligence until oil or gas . . . is found in quantities deemed paying."[107] The lease discussed the lessee's duty to execute partial releases of the lease and required the lessee to "reasonably develop the acreage retained" after oil or gas was discovered in paying quantities, but the lease also stated that the lessee would "in no event be required to drill more than one well per ten" acres of area capable of producing oil or 160 acres of area capable of producing gas.[108]

The lessor argued that the lessee breached a duty of further exploration by not drilling more wells to a depth of 3,000 feet.[109] The court rejected that argument and concluded that the terms of the two leases expressly imposed a duty of exploration that existed up until the time oil or gas was found in paying quantities, after which an expressly delimited duty of reasonable development existed. Given that the leases expressly imposed duties of exploration that existed up until oil or gas was found in paying quantities, the court would not impose an implied duty of further exploration for the period after oil or gas was discovered in paying quantities.[110]

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103. *Id*.

104. 11 Cal. Rptr. 3d 768 (Cal. Ct. App. 2004). Because the court determined that the express lease terms would negate an implied covenant, the court did not reach the issue of whether California would recognize an implied covenant of further exploration.

105. *See id.* at 769.

106. *See id.* at 772-3.

107. *See id.* at 774.

108. *Id.*

109. *See id.* at 770.

110. 11 Cal. Rptr. 3d. at 774-75.

In *Schroeder v. Terra Energy, Ltd.*, a Michigan court concluded that the express terms of a lease precluded an argument that an implied covenant to market barred use of the "work back" method to calculate royalties.[111] The lease stated royalties would be a specified fraction of "gross proceeds at the wellhead" or "the prevailing market rate at the wellhead."[112] The lessor argued that an implied covenant to market required the lessee to absorb post-production costs.[113] The court disagreed. The court stated that, assuming Michigan recognized an implied covenant to market,[114] the covenant would not apply whenever the lease expressly addresses a subject.[115] The court reasoned that the royalty clause expressly addressed how royalties should be calculated, and that the lease's "at the wellhead" language should be interpreted as allowing use of the work back method whenever gas is sold at a distance from the well, rather than at the wellhead.[116]

As for the duty to protect against drainage, numerous cases deal with the effect of a lease clause that expressly imposes duties to drill offset wells.[117] Most of the clauses require the lessee to drill an offset well if a productive well is located on nearby land, within a specified distance of the leased premises. Such a clause might expressly require the lessee to drill an offset well if a productive well is located within 150 feet of the leased premises.[118] But such clauses typically do not expressly address whether the lessee has any duty to drill an offset well if a well on nearby property is located further than the specified distance. This leads to the question of whether the lessee is bound by both the express covenant and an implied covenant to protect against drainage, or whether the express covenant precludes the existence of an implied covenant. If the logic of the three cases noted above—*Kishi*, *Lundin/Weber*, and *Schroeder*—applies in the context of an express offset well covenant, such an express covenant would preclude the existence of an implied covenant to protect against drainage. And that is the result a Texas appellate court reached in *Hutchins v. Humble Oil & Refining Co*.[119]

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111. 565 N.W.2d 887 (Mich. Ct. App. 1997).

112. *See id.* at 890.

113. *See id.* at 891.

114. The court did not reach the issue of whether such a duty exists under Michigan law. *See id.* at 895-96.

115. *See id.*

116. *See id.* at 894.

117. *See generally*, discussion at MARTIN & KRAMER, *supra* note 4, at § 826.3.

118. *See, e.g.*, Williams v. Humble Oil & Refining Co., 432 F.2d 165, 174 (5th Cir. 1970).

119. 161 S.W.2d 571, 573 (Tex. App. 1942). Other Texas cases have suggested that the express offset clause only applies during the primary term,

But in other cases, courts have reached contrary results, particularly if the lessee that is accused of breaching an implied covenant to protect against drainage is also the operator of the draining well on the neighboring property. For example, in *Shell Oil Co. v. Stansbury*, the Texas Supreme Court held that, if a leased premises is being drained, an express offset well covenant will not preclude the existence of an implied covenant to protect against drainage if the lessee is the operator of the draining well on the neighboring property.[120] In *Stansbury*, the Court expressly rejected *Hutchins* to the extent that *Hutchins* suggested that an express offset clause would preclude a lessor's implied covenant claim against his lessee if the lessee also was the operator of the draining well.

Similarly, a California appellate court concluded that an express offset well would not preclude the existence of an implied covenant to protect against drainage if the lessee of the premises being drained was also the operator of the draining well on the neighboring tract.[121] In *Williams v. Humble Oil & Refining Co.*, the United States Fifth Circuit concluded that this would also be the result under Louisiana law.[122] Similarly, in *Millette v. Phillips Petroleum Co.*, the Mississippi Supreme Court concluded that an express offset well covenant would preclude an implied covenant to protect against drainage, but that if the lessee was the operator of the draining well, the lessee would be liable for breach of an implied covenant that he do nothing to impair the value of the lease.[123]

Further, in certain cases, particularly when offset well covenants are triggered only by wells that are closer to the leased premises than would generally be allowed under spacing rules, some courts and commentators seem to believe it would be unfair to allow such a clause to implicitly negate an implied covenant to protect against drainage.[124] They reason that a prospective lessor who reads a proposed lease containing such a clause might understand the clause as imposing an *extra* duty on the lessee, when the primary effect, assuming the express clause is allowed to implicitly negate any implied covenant to protect, actually will be to *decrease* the

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though it is not clear why this would be so. *See also* Coats v. Brown, 301 S.W.2d 932 (Tex. App. 1957); Magnolia Petroleum Co. v. Page, 141 S.W.2d 691, 693 (Tex. Civ. App. 1940).

120. 410 S.W.2d 187 (Tex. 1967).

121. R.R. Bush Oil Co. v. Beverly-Lincoln Land Co., 158 P.2d 754 (Cal. App. 158 P.2d 754 (Cal. App. 1945).

122. 432 F.2d 165 (5th Cir. 1970).

123. 48 So. 2d 344 (Miss. 1950). *See also* Phillips Petroleum Co. v. Millette, 72 So. 2d 176 (Miss. 1954).

124. *See* MARTIN & KRAMER, *supra* note 4, at § 826.3; *see also* Williams v. Humble Oil & Refining Co., 432 F.2d 165, 174 (5th Cir. 1970).

lessee's duties.[125] Those authorities believe that an implied covenant to protect against drainage should co-exist with the express duty, assuming the lease does not explicitly negate an implied obligation.

Relatively few leases expressly negate the existence of an implied covenant to protect against drainage, but courts and commentators have stated that, whenever the parties have agreed to a clause that expressly negates or limits an implied covenant to protect against drainage, the clause should be enforced.[126]

2. Demand and Opportunity to Cure

Before filing suit based on an alleged breach of an implied covenant, a lessor sometimes must give the lessee a notice of the alleged breach and a reasonable time to cure the breach. In Louisiana, for example, the Mineral Code requires a lessor to provide the lessee with written notice of an alleged breach, and a reasonable opportunity to cure it, before filing a suit based either on drainage or the lessee's alleged failure to develop and operate the leased premises as a prudent operator.[127]

In most other jurisdictions, case law makes notice and a reasonable opportunity to cure a prerequisite to a suit seeking an order terminating the lease as a remedy for a breach of implied covenants.[128] Those jurisdictions

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125. *See* MARTIN & KRAMER, *supra* note 4, at § 826.3.

126. *See, e.g.*, Shell Oil Co. v. Stansbury, 401 S.W.2d 623, 630 (Tex. Civ. App.—Beaumont 1966), *writ refused n.r.e.*, 410 S.W.2d 187 (Tex. 1966) ("A lessor and lessee may contract so that a lessee is never under obligation to drill an offset well. To so contract, however, the language must be very clear."); MARTIN & KRAMER, *supra* note 4, at § 826.3 ("No one would object to enforcing a clause that stated that lessee is not obligated to offset wells more than 150 feet from boundary lines."); Linn v. Wehrle, 35 Ohio App. 107, 109, 172 N.E. 288, 289 (5th Dist. 1928).

127. *See* LA. REV. STAT. § 31:136; *see also* LA. REV. STAT. § 31:135 & cmt. Notably, the Louisiana Supreme Court has held that Mineral Code article 136 does not require the lessor to provide notice and an opportunity to cure as a perquisite to a suit seeking restoration of the land.

128. *See e.g.,* Smith v. Tull, 43 P.2d 84, 85 (Okla. 1935); Hayes v. Equitable Energy Resources Co., 266 F.3d 560, 569 (6th Cir. 2001) (applying Kentucky law). Arkansas courts do not make notice and an opportunity to cure a prerequisite to a suit for lease cancellation. *See* Davis v. Ross Production Co., 910 S.W. 2d 209, 212-13 (Ark. 1995). But the Arkansas Supreme Court has stated, if a lessor does not give pre-suit notice and an opportunity to cure, a conditional order of cancellation, giving the lessee an opportunity to cure, is preferable to an order of outright lease cancellation. *See* Roberson Enterprises, Inc. v. Miller Land and Lumber Co., 700 S.W. 2d 57, 58 (Ark. 1985).

do not necessarily make notice and opportunity to cure a prerequisite to an action for damages, but lease termination is such a commonly-sought remedy for alleged breaches of implied covenants that notice and an opportunity to cure effectively become a prerequisite in most implied covenant cases. The rationale for requiring notice and an opportunity to cure as a prerequisite for the remedy of lease termination is that such termination can be a harsh remedy. Further, unless the lease itself expressly provides for termination in the event of a breach, termination is an equitable remedy,[129] rather than a legal remedy, and equity "abhors a forfeiture."[130] Moreover, if a person seeks equity, that person must act equitably, and it is fair for the lessor to give the lessee an opportunity to cure a breach before seeking lease termination.

Depending on the language of the particular lease, a requirement that the lessor give notice and an opportunity may be a prerequisite to any suit by the lessor that is based on an alleged breach of express or implied terms of the lease, or the clause may make it a prerequisite only for certain types of claims or claims seeking certain types of relief, such as lease termination. If the lease requires notice and an opportunity to cure, the lessor typically must demand that the lessee cure the alleged breach. If the lessor sends the lessee a letter that simply inquires about a matter, or the lessor sends a notice asserting that the lease has terminated because of an alleged breach, such a communication probably will not satisfy the requirement for notice *and* a reasonable opportunity to cure.[131]

Finally, it should be noted that some leases contain a judicial ascertainment clause. Such clauses typically provide that a lease cannot be terminated as a remedy for a breach of an implied covenant until the lessee has been given a reasonable opportunity to cure after a court determines that the lessee was in breach of an implied covenant. In the absence of such a clause, lessees sometimes can find themselves in a difficult situation. Suppose the lessor alleges a breach of an implied covenant to reasonably develop and demands that the lessee cure the alleged breach by drilling one or more wells, which will be very expensive. Further, suppose that

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129. ERI Consulting Engineers, Inc. v. Swinnea, 318 S.W.3d 867, 872 (Tex. 2010); Rockefeller v. Grabow, 39 P.3d 577, 583 (Idaho 2001); Columbus Hotel Co. v. Pierce, 692 So. 2d 605, 609-10 (Miss. 1993); Ionno v. Glen-Gery Corp., 443 N.E.2d 504, 509 (Ohio 1983).

130. *See, e.g.*, Fisher v. Heirs and Devisees of T.D. Lovercheck, 864 N.W.2d 212, 217 (Neb. 2015); Wagner & Brown Ltd. v. Sheppard, 282 S.W.3d 419, 429 (Tex. 2008); Columbus Hotel Co. v. Pierce, 629 So. 2d 605, 609 (Miss. 1993); Thurner v. Kaufman, 699 P.2d 435, 438 (Kan. 1985) (referring to "the oft-repeated maxim that 'equity abhors a forfeiture'").

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

there exists a good faith disagreement regarding whether the lessee has breached an implied covenant, but the lease is valuable, and the lessee does not want to risk litigation because, if it loses the litigation, the court may award lease termination. A judicial ascertainment clause can save the lessee from that dilemma by giving it the option to defend a suit alleging a breach of an implied covenant without risking losing the lease.[132]

3. The Effect of a Lessor's Unsuccessful Suit Seeking Lease Cancellation

Some courts have held that a lessee's duty to perform is suspended pending resolution of the lessor's allegation that the lease has terminated.[133] Such a rule sometimes is called the repudiation doctrine. The doctrine is based on fairness and equity. A lessee should not be expected to spend money on drilling additional wells at the same time that the lessor is seeking a court ruling that the lease has terminated.[134] Accordingly, if the lessor fails to obtain lease termination based on his original complaint, the lessor should not then be allowed to pursue an argument that the lease should be terminated based on the fact that the lessee was not drilling additional wells while the lessor's original complaint was pending. The repudiation doctrine is widely recognized, but the Pennsylvania Supreme Court recently rejected it.[135]

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132. For a thorough discussion of judicial ascertainment clauses, *see* PATRICK H. MARTIN & BRUCE A. KRAMER, 5 WILLIAMS AND MEYERS OIL & GAS LAW, §§ 682-682.5.

133. *See e.g.*, Coasted Oil & Gas Corp. v. Garza Energy Trust, 268 S.W.3d 1, 20 (Tex. 2008); Lewis v. Kansas Production Co., Inc., 199 P. 3d 180, 187 (Kan. App. 2009).

134. If a lease already has terminated, or if it never was valid, then the putative lessee is at substantial risk if he drills more wells. He will be required to account to the lessor for all production. Further, even if the well is successful and he has to turn the well over to the plaintiff, the putative lessee might not be entitled to reimbursement for his drilling costs. And if the putative lessee drills a dry hole, he might even be liable for damages for having reduced the leasing value of the property by drilling a well that shows the property is not a good prospect for mineral production. Greer v. Carter Oil, 25 N.E.2d 805, 810-11 (Ill. 1940) (noting the possibility of a damages claim for reduced value of property for mineral leasing if a company that lacks an enforceable lease drills a dry hole), *cf.* Layne Louisiana Co. v. Superior Oil Co., 209 La. 1014, 26 So. 2d 20, 22 (1946) (upholding damage for land's reduced value for mineral leasing after a company conducted seismic operations without authority and those operations showed the land was a poor candidate for drilling).

135. Harrison v. Cabot Oil & Gas Corp., 110 A.3d 178 (Pa. 2015).

4. Issues of Law vs. Fact and the Burden of Proof

The question of whether a particular implied covenant exists generally will be a matter of law.[136] The question of whether a lessee has breached an implied covenant is an issue of fact.[137] The lessor generally has the burden of proving that the lessee had breached an implied obligation of the lease.[138] Nevertheless, some courts have suggested that the burden of proof might be placed on the lessee to show the reasonability of his conduct if he is accused of breaching the implied covenant to protect against drainage and the lessee happens to be the operator of the well on neighboring property that is draining the leased premises.[139]

136. *See, e.g.,* Terrebonne Parish School Bd. v. Castex Energy, Inc., 893 So. 2d 789 (La. 2005) (discussing whether an implied obligation to restore surface exists as a matter of Louisiana law).

137. *See* Carter v. Arkansas Louisiana Gas Co., 36 So. 2d 26, 28 (La. 1948); Caddo Oil & Mining Co. v. Producers' Oil Co., 134 La. 701, 717, 64 So 684, 690 (1914).

138. Whitham Farms LLC v. City of Longmont, 97 P.3d 135, 138-39 (Colo. App. 2003); Coyle v. North American Oil Consolidated, 201 La. 99, 105, 9 So. 2d 473, 475-76 (1942) (lessor has burden of proving a breach of the implied obligation to protect against drainage); Saulters v. Sklar, 158 So. 2d 460, 463 (La. App. 2nd Cir. 1963) (lessor plaintiff had burden of proving lessee had not reasonably developed the premises).

139. *See* LOWE, *supra* note 25, at 336-37.

5. Remedies Available

The potential remedies available for breach of an implied covenant include: (1) monetary damages;[140] (2) conditional cancellation;[141] (3) partial cancellation;[142] (4) complete cancellation;[143] and (5) specific

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140. Clovis v. Pacific Northwest Pipeline Corp., 345 P.2d 729, 731 (Colo. 1959); Harris v. Ohio Oil Co., 48 N.E. 502, 506 (Ohio, 1897). Damages awards are not common in implied covenants cases because it often is difficult to prove the amount of damages. *See* Jennings v. Southern Carbon Co., 80 S.E. 368, 371372 (W. Va. 1913) (referring to "the impossibility of adequate proof of the extent" of injury); *see also* Breaux v. Pan American Petroleum Corp., 163 So. 2d 406, 414-16 (La. App.), *writ denied*, (La. 1964); LA. REV. STAT. 31:136 (referring to the possibility of a damages award); Williams v. Humble Oil & Refining Co., 432 F.2d 165, 173 (5th Cir. 1970), *cert. denied*, 91 S. Ct. 1526 (1971). *See also* Coasted Oil & Gas Corp. v. Garza Energy Trust, 268 S.W.3d 1, 18-19 (Tex. 2008) (discussing in dicta what would be the appropriate measure of monetary damages for a breach of the implied covenant to protect against drainage).
See, e.g., Coastal Oil & Gas Corp. v. Garza Energy Trust, 268 S.W.3d 1, 19 (Tex. 2008) (citing cases and discussing three possible measures of damages for breach of the implied covenant to protect against drainage).

141. When a court awards conditional cancellation, it orders that the lease will be cancelled (in whole or part) unless the lessee renders a particular performance within a stated time. *See, e.g.,* Kleppner v. Lemon, 35 A. 109, 110 (Pa. 1896); *see* Roberson Enters. v. Miller Land Lumber Co., 700 S.W. 2d 57, 58 (Ark. 1985) (referring to conditional cancellation as a possible remedy); Stubbs v. Imperial Oil & Gas Co., 164 La. 689, 695, 114 So. 595 (1927); Cutrer v. Humble Oil & Refining Co., 202 F. Supp 568, 572-73 (E.D. La.), *aff'd,* 309 F.2d 752 (5th Cir. 1962), *cert. denied*, 83 S. Ct. 883 (1963).

142. Often, if a lessee has one or more productive wells, but it has not reasonably developed or adequately explored the remainder of the leased premises, a court may allow the lessee to retain the lease as to some modest acreage around each productive well, while ordering lease cancellation as to the remainder of the leased premises. *See, e.g.,* Robinson v. Miracle, 293 P. 211 (Okla. 1930); Kleppner v. Lemon, 35 A. 109, 110 (Pa. 1896) (court orders a conditional, partial cancellation); LA. REV. STAT. § 30:142; Eota Realty Co. v. Carter Oil Co., 225 La. 790, 74 So. 2d 30 (1954) (lessee's failure to develop part of leased premises only justified cancellation of lease as to the portion that had not yet been developed); *see also* Sohio Petroleum Co. v. Miller, 237 La. 1015, 1030-1, 112 So. 2d 695, 701 (1959) (awarding partial cancellation).

143. *See* Jennings v. Southern Carbon Co., 80 S.E. 368, 372 (W. Va. 1913). Complete cancellation is considered a harsh remedy, but it sometimes is granted. For a case noting that cancellation is a harsh remedy, *see* St. Luke's United Methodist Church v. CNG Development Co., 663 S.E.2d 639, 644 (W. Va. 2008); *see also* Robbins V. Chevron U.S.A., Inc., 785 P.2d 1010, 1016 (Kan. 1990) ("As a general rule, forfeiture of oil and gas lease for breach of an implied covenant is

performance.[144] The most common remedies probably are the various forms of lease cancellation—total, partial, and conditional. Lease cancellation can be harsh, and generally it is disfavored, but it sometimes is the most practical remedy. Further, if notice and cure are required, this somewhat mitigates the harshness of cancellation, particularly if conditional cancellation is used in circumstances where the lessee had a good faith argument that it was not in breach. A damages award would be preferable to lease cancellation, but it is often difficult or impossible to quantify the damages that result from the breach of an implied covenant. And courts generally are unwilling to order specific performance of tasks as complex as those involved in complying with implied covenants.

In an interesting, recent development, a few cases from Ohio have issued rulings holding either that an oil and gas lease is not subject to partial abandonment by depth or that that partial termination by depth is not a permissible remedy for an alleged breach of an implied covenant.[145]

On the other hand, courts in other jurisdictions have been willing to order, or at least consider, partial terminations by depth. For example, in a 1962 decision, the Oklahoma Supreme Court affirmed a judgment that granted a termination of a lease as to certain depths for 120 of the 160 acres covered by a lease.[146] Because only the lessor appealed the lower

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disfavored."); LA. REV. STAT. § 31:142 (stating in part that, "A mineral lease may be dissolved partially or in its entirety.").

144. Courts generally are unwilling to order specific performance unless the performance required is can be commanded in a straightforward order, such as an order to deliver property. Given that a lessee's duties under implied covenants involve more complex obligations, such as an obligation to drill a well, an order of specific performance rarely will be appropriate as a form of remedy for breach of an implied covenant. *See* LA. REV. STAT. 31:134 cmt. (stating that specific performance may be awarded in appropriate circumstances, but also stating that "[m]andatory injunctions may be unavailable in some instances, such as a request that a lessee be compelled to drill a well").

145. Beer v. Griffith, 399 N.E.2d 1227, 1230 (Ohio 1980). *See also* Cable v. Cubbon, 5 Ohio Law Abs., 1926 WL 2884 (Ohio Ct. App. 7th Dist. 1926); Hartline v. Statoil USA Onshore Properties, Inc., 2017 WL 1014377 (S.D. Ohio 2017) (forfeiture was not an available remedy for alleged breach of oil and gas lease because lease provided for forfeiture in some circumstances, but did not expressly provide for forfeiture for the type of breach alleged, and lessors did not assert that damages would be an inadequate remedy; note that court seemed to erroneously refer to termination of lease upon certain conditions as a forfeiture, as opposed to a termination of a lease by its own terms).

146. Barnes v. Mack Oil Co., 376 P.2d 279, 280 (Okla. 1962). In prior decisions, the Oklahoma Supreme Court had declined to order partial termination based on depth, but had suggested that such relief could be granted under

court judgment, the decision demonstrates only that a lessee's breach of implied covenant duties as to certain depths does not entitle the lessee to a cancellation of the lease as to all depths. The case does not authoritatively establish that lessees have no basis to complain about partial terminations by depth. But nothing in the decision suggests that the court thought that a partial termination by depth was inappropriate.

E. Is There an Implied Covenant to Use New Technology?

The technology used in oil and gas exploration and development evolves continuously. In 1859, Edwin Drake drilled the first oil well in the United States. He chose the drill site based on the proximity of natural seeps, and he used a cable tool rig to drill. He found oil at a depth of about 69½ feet. His workers were a blacksmith, whom Drake hired because the blacksmith had experience making tools for persons who drilled water wells, and the blacksmith's sons.[147]

Today, companies use high-speed computers to process complex seismic data in order to create three-dimensional maps of subsurface geology. Companies can begin drilling vertically, and then turn the direction of drilling to proceed diagonally or even horizontally. They often drill to depths tens of thousands of feet beneath the surface and drill on the outer continental shelf, sometimes in water that is a mile deep. They can fracture formations that have low permeability in order to release oil or gas found in the pore spaces of such formations, and they also can use sophisticated secondary and tertiary recovery techniques in order to produce more oil than could be produced using only primary recovery. The technology is very sophisticated, and workers are often well-trained and experienced.

Such technology can increase the likelihood of finding oil or gas, increase the total ultimate recovery from a reservoir, increase the rate of recovery, and make it economical to drill in circumstances in which drilling otherwise would not be economical. This raises a question: Are lessees bound by an implied covenant to use new technology as it is developed?

If the question is taken literally, the correct answer clearly is, "No." A lessee does not have a duty to use new technology for the sake of using new technology. Accordingly, there is no "implied covenant to use new technology." But new technology can help a lessee operate more

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appropriate circumstances. *See, e.g.*, McKenna v. Nichlos, 145 P.2d 957, 960 (Okla. 1944).

147. Daniel Yergin, THE PRIZE: THE EPIC QUEST FOR OIL, MONEY, AND POWER 27 (1991).

effectively. Thus, a lessee who does not use new technology might not perform as effectively as operators who use newer technology. Further, implied covenants require a lessee to perform certain functions to the same extent that a reasonably prudent operator would. Accordingly, a better question might be whether there can be circumstances in which an operator who performs as effectively as reasonably can be expected using the technology that existed at the time the lease was executed can be liable for a breach of one of the traditional implied covenants if the use of newer technology would allow such an operator to perform better. This issue has not been addressed extensively in jurisprudence or commentary, but the answer seems to be that an operator can be liable in such circumstances.

Two of the leading cases on this issue are from Louisiana. In *Wadkins v. Wilson Oil Co.*, the plaintiffs granted a mineral lease that covered forty acres of land.[148] For the first several years after the plaintiffs granted the lease to the defendant in 1923, the defendant operated as diligently as other operators who held leases in the same general area. The plaintiffs' land contained two existing wells. The defendant produced oil from those two wells until the wells quit producing. The operator then plugged the two wells back to a shallower chalk formation, re-perforated both wells, and successfully put one of the two wells back into production. The defendant also drilled four additional productive wells into the same chalk formation on the leased premises, so that there were five producing wells on the forty acres.

The five wells were still producing oil in 1941, but their rates of production had decreased. Other operators in the same general area were getting much higher production rates from the same chalk formation by drilling new wells and acidizing them.[149] Experience in the area had shown that acidizing did not work as effectively on existing wells as on new wells, so it was necessary to drill new wells to get the full benefit of acidizing. The plaintiffs demanded that the defendant drill new wells, but the defendant declined to do so. The plaintiff sued for lease cancellation

148. Wadkins v. Wilson Oil Co., 6 So. 2d 720 (La. 1942).

149. "Acidizing" has been defined as "a well stimulation technique used primarily on limestone reservoirs. Acid is poured or pumped down the well to dissolve the limestone and increase fluid flow." *See* NORMAN J. HYNE, NONTECHNICAL GUIDE TO PETROLEUM GEOLOGY, EXPLORATION, DRILLING, AND PRODUCTION at p. 452 (2nd ed. 2001). "Well stimulation" is "an engineering method used to increase the permeability of a reservoir around the wellbore to increase production. It includes acidizing and hydraulic fracturing." *See* NORMAN J. HYNE, NONTECHNICAL GUIDE TO PETROLEUM GEOLOGY, EXPLORATION, DRILLING AND PRODUCTION at p. 546 (2nd ed. 2001).

and obtained such an order from the trial court. The Louisiana Supreme Court affirmed, stating:

> It is our opinion that the trial judge, under the evidence, correctly held that the defendant had failed to fulfill its implied obligation and covenant to further develop the property by drilling new wells with the modern process which had proved so successful on other leased properties adjoining and in the vicinity of the property in question.[150]

A somewhat analogous fact pattern was presented by *Waseco Chemical & Supply Co. v. Bayou State Oil Corp*.[151] *Waseco* concerned a 1934 lease that covered eighty acres in the Bellevue Field in Bossier Parish. The field contained a shallow sand—at about 350 to 500 feet below the surface—that contained a heavy, viscous oil. That reservoir had little pressure and little tendency for gas drive or water drive. Operators tended to produce oil from the formation at low rates, from densely-spaced wells (about one per acre) that could be drilled inexpensively in about twelve hours. Bayou State acquired the lease at issue, the Scanland lease, in the early 1950s. At that time, about fifty wells had been drilled on the eighty-acre lease tract. Most of the wells were producing, with total production being about forty-six barrels per day. Over the next twenty-four years, Bayou State did not drill any more wells on the leased premises or make any capital expenditures, and by 1976, about nine wells on the property still were producing, at a cumulative rate of about six barrels per day.

Other operators in the area were doing somewhat better. In 1963, Getty had begun using fireflood[152] operations in the Bellevue Field and had dramatically increased rates of production. Initially, Getty's fireflood project was just a pilot project, but within a few years it was evident that

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150. *See Wilson Oil Co*., 6 So. 2d 720 at 724.

151. Waseco Chemical & Supply Co. v. Bayou State Oil Corp., 371 So. 2d 305 (La. App. 2d Cir. 1979).

152. "Fireflooding" is a method for recovering high-viscosity oil that would be difficult or impossible to recover by other means. In this method, the operator ignites the oil in a portion of the formation where it is found. The heat from this "in-situ combustion" causes the oil near the fire to break down into lighter, less viscous compounds. The less viscous compounds will flow more easily and therefore can be recovered more easily. This process also creates coke. The coke burns, creating more heat. The "combustion front" advances, helping to cause a similar breakdown of the viscous oil in portions of the formation further from the initial point of combustion. The operator injects air into the formation to supply the oxygen needed to keep the fire alive. MANUAL OF OIL & GAS TERMS, *supra* note 35, at 508.1 (definition of "*in situ* combustion").

the project was successful, and Getty began expanding its fireflood operations rapidly. Cities Service began extensive use of fireflood operations in the area, starting in 1971. Bayou State itself used a fireflood operation on a different lease tract in 1970, but did not perform such operations on the Scanland lease. Evidence showed that fireflooding could significantly increase total recovery. With the use of fireflooding, operators could recover about 60% of the heavy oil in place, compared to recovery of about 5% when they did not use fireflooding. Fireflooding also significantly increased the rate of production. Lessors could expect about $1200 per acre per month in royalties when fireflood operations were used, compared to about $3 per acre per month when fireflooding was not used. The lessors brought suit against Bayou State, seeking lease cancellation. The trial court granted an order of lease cancellation, citing *Wadkins*, and the Louisiana Second Circuit affirmed.[153]

Courts in other states have reached similar conclusions. In *Rhoads Drilling Co. v. Allred*, a Texas appellate court concluded that, after an oil well quit flowing, the operator was obligated to install a pump if doing so reasonably could be expected to yield a profit.[154]

In *Utilities Production Corporation v. Carter Oil Co.*, the issue actually in dispute was somewhat different—whether the lessee had a right to use natural gas produced from the lease for repressuring operations.[155] The lessor argued that the lessee did not because such operations were not widely known at the time the parties entered the lease. The court rejected that argument, stating that oil and gas methods continually evolve and that the parties must have anticipated that new techniques would be developed and used during the life of the lease. The court added, "In fact, the lessor would doubtless have just cause to complain if an inefficient operation of the leases resulted from the failure of the lessees to use improved methods which came in common use during the terms of the leases."[156]

Courts in other states have suggested in dicta that implied covenants might require a lessee to use advanced recovery techniques. For example, in *In re Shailer's Estate*, the owner of a life estate and the remainderman disputed the right to proceeds from secondary recovery operations.[157] In deciding that issue, the Oklahoma Supreme Court noted in dicta, with apparent approval: "There 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

153. 371 So. 2d at 313.
154. Rhoads Drilling Co. v. Allred, 70 S.W.2d 576 (Tex. Comm'n App. 1934).
155. Utilities Production Corp. v. Carter Oil Co., 72 F.2d 655 (10th Cir. 1934).
156. *Id*. at 659.
157. In re Shailer's Estate, 266 P.2d 613 (Okla. 1954).

profitable as a means of getting additional return from the lease."[158] An Illinois appellate court stated that, "It is an implied right and duty of a reasonably prudent operator under an oil and gas lease to adopt a system providing for the secondary recovery of oil."[159] Thus, to the extent that courts have addressed the issue, they have concluded that a lessee sometimes will have to use new technology in order to satisfy one of the traditional implied covenants.

Commentators have likewise concluded that the implied covenants require a lessee to utilize advances in technology to the extent that a reasonably prudent operator would do so.[160] One classic authority on implied covenants stated that, "The obligation to adopt new and improved methods of development and operation as their practicability and superiority become obvious is manifest."[161] The authors of a more recent paper stated:

> That is, to determine whether a lessee is required to drill a well under the reasonable development covenant or the drainage covenant, the basic question to be answered is whether a similarly-situated, reasonably prudent operator would drill the well. As technology changes, the prudent operator standard changes with technology. If it can be established that other operators use 3-D seismic techniques, or use satellite imagery, or use horizontal drilling, there can be little doubt that a lessee, to meet the prudent operator standard, will be required to use the same technology to meet its obligation to develop the premises, to explore the premises, or to protect the premises.[162]

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158. *Id*. at 616-17.

159. Bi-County Properties v. Wampler, 378 N.E.2d 311, 315 (Ill. Ct. App. 1978); *see also* Reed v. Texas Co., 159 N.E.2d 641, 644 (Ill. Ct. App. 1959).

160. Gary B. Conine, *Speculation, Prudent Operation, and the Economics of Oil and Gas Law*, 33 WASHBURN L.J. 670, 689-90 (1994) (suggesting that the prudent operator standard can be used to determine whether the lessee is required to "use new processes developed in the industry); see also Gloria L. Scott, *Development Obligations of the Oil and Gas Lessee*, 13 ST. MARY'S L.J. 846, 865 (1982) ("The implied obligation to maximize recovery, for example, may require the lessee to use modern production techniques.").

161. Maurice H. Merrill, THE LAW RELATING TO COVENANTS IMPLIED IN OIL AND GAS LEASES, § 225 (1940).

162. Taylor Reid and John W. Morrison, *Doing the Lateral Lambada: Negotiating the Technical and Legal Challenges of Horizontal Drilling*, 43rd ROCKY MTN. MIN. L. INST., Paper No. 16 (1997).

There has been relatively little commentary regarding which implied covenant is at issue if an operator's failure to use new technology causes him to produce less oil or gas than a reasonably prudent operator would produce. One commentator suggested that secondary recovery and stimulation processes applied to existing wells might not be part of the duty to develop, but that doing such things could fit within "the implied covenant to manage and administer the lease, which includes a duty to use modern methods of production."[163] But another oil and gas scholar discussed the potential obligation to use new technology as potentially coming under the development obligation.[164] Perhaps more important than the commentators' possible disagreement regarding which implied covenant is at issue is their apparent agreement that a lessee who performs poorly because he fails to use new technology can be liable for breach of some type of implied covenant.[165] It seems clear, then, that, if a lessee's failure to use new technology results in his failure to develop, explore, protect, or market to the extent that a reasonably prudent operator would do so, the lessee should be liable for breach of an implied covenant. This seems true under any of the major theoretical justifications for implied covenants.

For example, consider the implied-intent justification. This theory provides that parties to leases do not specify a lessee's duties in detail

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163. Laura H. Burney and Norman J. Hyne, *Hydraulic Fracturing: Stimulating Your Well or Trespassing*, 44TH ROCKY MTN. MIN. L. INST., Paper 19 (1998). A prominent treatise similarly discusses a lessee's failure to use "modern production techniques" under a section of the treatise that examines an implied covenant to conduct operations with reasonable care and diligence. *See* MARTIN & KRAMER, *supra* note 4, at § 861.3.

164. Patrick H. Martin, *Implied Covenants in Oil & Gas Leases – Past, Present & Future*, 33 WASHBURN L.J. 639, 648-9 (1994).

165. When the lessor's complaint is that the lessee did not produce oil or gas from a proven formation as quickly as he should or that he did not obtain as large an ultimate recovery he should, the author of this paper suggests that the alleged breach relates to the implied covenant of reasonable development. The classic description of the implied covenant of reasonable development states that the covenant requires a lessee to drill as many wells as reasonably necessary to develop a proven formation. An alleged duty to use acidizing, fireflooding, or some other technology might not seem to fit within this description. But one could argue that the classic description refers to drilling as man wells as is reasonably necessary because the classic way to further develop the premises is to drill more wells. If a reasonably prudent operator would further develop a proven formation by using well stimulation, secondary recovery, or some other technology, there seems little reason why a duty to do that cannot be considered part of the covenant of reasonable development.

because they lack sufficient information at the time of lease execution to specify exactly what the lessee should do, but the parties' implied intent is that the operator will act as a reasonably prudent operator. Under this explanation, implied covenants are an application of the parties' implied intent. Assuming that the parties implicitly expected a lessee to drill as many wells as a reasonably prudent operator would drill for the purposes of developing proven formations, to explore unproven areas to the extent that a prudent operator would, to protect the leased premises against drainage to the same extent that a reasonably prudent operator would, and to market product as diligently as a prudent operator would, there seems no reason to believe that they would not also expect an operator to use new technology that a reasonably prudent operator would use.

Another explanation for implied covenants is that courts impose such covenants to promote fairness, driven in part by the fact that the nature of oil and gas leasing results in leases that do not have many explicit protections for lessors. This explanation leads to a similar conclusion regarding a lessee's duty to use new technology. In the same way that the parties lack sufficient information at the time of contracting to specify how many wells an operator should drill, they also lack information to specify what techniques an operator should use. This is particularly true given that leases can last for decades, spanning time during which technology advances significantly. If a particular operator recovers less product than a reasonably prudent operator would recover because the particular operator fails to use new technology that reasonably prudent operators are using, that seems just as unfair to a lessor as when a particular operator recovers less product because he drills fewer wells than a reasonably prudent operator would drill.

Finally, commentators occasionally cite public policy as a reason for courts to impose implied covenants. If public policy favors production of oil and gas, and a particular operator produces less oil or gas than a reasonably prudent operator would produce, the public policy that favors production seems equally offended whether the shortfall in production is a result of drilling fewer wells or failing to use new technology.

Thus, the logic behind implied covenants, as well as the existing jurisprudence and commentary, all suggest that a lessee can breach his implied obligations if his failure to use new technology causes his performance to be substandard relative to that of a reasonably prudent operator. Accordingly, it seems safe to conclude that a lessee, as a practical matter, sometimes will have a duty to use new technology. An operator will not have an obligation to use technology as soon as it becomes available or is proven. Courts should be cautious in reaching a conclusion that a particular lessee has breached an implied covenant. Even if every

operator that exists was reasonably diligent, they would not all begin using new technology simultaneously. Some operator inevitably will be the first to implement new technology, and some operator inevitably will be the last. The mere fact that an operator has not yet started using technology that some other operators are using should not be a basis to find that the operator breached implied covenant duties. But when an operator fails to act as a reasonably prudent operator, it is not a valid defense that the operator is performing as well as can be expected for someone who uses outdated technology.

The emergence of shale plays and the techniques used in them illustrate the importance of technological revolution. Shale plays did not become economically feasible until relatively recently, with advances in two technologies—hydraulic fracturing and horizontal drilling—and those technologies continue to evolve. If an operator is maintaining a lease with production from a conventional formation, but is not using horizontal drilling and hydraulic fracturing to develop a shale formation found within the leased premises, the lessor could argue that the operator has breached an implied covenant of reasonable development or further exploration. At least one lessor has made such an argument in a dispute regarding development arising in the Fayetteville Shale area,[166] and another made the argument in a case relating to the Haynesville Shale.[167] Further, there is some case law in which courts have held that an operator's failure to use other advanced production techniques constituted a breach of the duty of reasonable development.

The development of shale plays also raises the potential for such claims. Successful development of shale formations is expensive. Several of the shale formations are located in deep strata, and economic development often requires horizontal laterals that are a mile or more in length. For this reason, drilling is expensive. Further, hydraulic fracturing is necessary and fracturing operations add still more expense. Indeed, the expense of drilling and completing such wells may be beyond the capability of some companies. But some of those companies may have leases that are held by production—perhaps shallow oil or gas production—in the area where shale plays are located. This creates the potential for lessors to conclude that such a lessee's failure to drill wells to develop the shale formation is a breach of the lessee's duty of reasonable development. Or, perhaps the lessee has drilled and fractured some wells

166. *See* Acre v. Spindletop Oil & Gas Co., 2011 WL 902186, at *1 (E.D. Ark.).

167. Ferrara v. Questar Exploration and Production Co., 70 So. 3d 974 (La. App. 2d 2011).

to the shale formation, but the lessor believes that the lessee has not drilled enough wells.

Such a claim was brought in *Ferrara v. Questar Exploration and Production Co*., a dispute that arose in an area where the Haynesville Shale is located.[168] In that case, the lessor gave notice to the lessee and then brought suit for an alleged breach of implied covenant duties not long after news of early success in the shale play first became public. The Louisiana Second Circuit held that the lessors failed to prove that a reasonably prudent operator would have responded that quickly and therefore failed to prove that the lessee had breached its implied covenant duties. A similar claim was made by a lessor who owned land in the area of Arkansas where the Fayetteville Shale is located.[169] In the Arkansas case, the lessee's motion for summary judgment was denied and the case continued.

A recent case from Ohio also noted the role that implied covenants might play in protecting lessors' interests as technology changes. Specifically, in *Alford v. Collins-McGregor Operating Co.*,[170] the Ohio Supreme Court stated: "We also note that the implied covenant of reasonable development is well suited to address the primary driver of the Landowners' interest here, namely the emergence of new drilling technologies permitting production form deep strata that could not be obtained before."[171]

F. Summary of Implied Covenants Primer

Because of the uncertainties inherent in oil and gas exploration, leases typically leave much to the discretion of the lessee. This prompts courts to enforce various implied covenants against lessees. The implied covenants most commonly recognized by courts and commentators include covenants to drill a test well, reasonably develop the leased premises, conduct further exploration, diligently market any product that is found in paying quantities, protect the leased premises against drainage, and reasonably restore the surface condition of the leased premises. But courts generally will not impose an implied covenant that is inconsistent with the express terms of a lease. Accordingly, lessees can attempt to limit the scope of their duties under implied covenants by use of lease clauses that expressly limit their duties.

In most states, a lessor must give his lessee notice and opportunity to cure an alleged breach of an implied covenant before bringing suit. If a

168. *Id.*
169. Acre v. Spindletop Oil & Gas Co., 2011 WL 902186, at *1 (E.D. Ark. 2011).
170. Alford v. Collins-McGregor Operating Co., 95 N.E.3d 382 (Ohio 2018).
171. *Id.* at 309.

lessor brings suit, seeking lease termination or a declaration that the lease already has terminated, the jurisprudence of several states provides that a lessee's duties to drill additional wells is suspended while the suit is pending; this is sometimes called the repudiation doctrine. The existence of implied covenants, as well as their nature and scope, are issues of law. The question of whether a lessee has breached an implied covenant generally is an issue of fact, and the lessor who brings an implied covenant claim generally will have the burden of proof.

II. POTENTIALLY EMERGING ISSUES

Changes in technology are raising new issues. For example, under certain fact patterns, lessors might choose to assert arguments that their lessees breached implied covenant duties by failing to utilize 3-D seismic or horizontal drilling or hydraulic fracturing. But arguably some of the most interesting emerging issues may relate to the implied covenant to protect against drainage and express offset well covenants.

A. Duty to Protect Against Drainage by Fractures that Cross Property Lines

Coastal Oil & Gas v. Garza Energy Trust is best known for its decision regarding a subsurface trespass claim.[172] In this case, the plaintiffs brought a claim for subsurface trespass, alleging that the defendant had committed a subsurface trespass by conducting a hydraulic fracturing operation on neighboring land in such a manner that fractures crossed into the subsurface of the area where the plaintiffs owned mineral rights (they had granted a lease covering those rights). The only harm alleged by the plaintiffs was the drainage of hydrocarbons. The court held that, under these circumstances, the rule of capture precluded recovery for the drainage of hydrocarbons and that the plaintiffs did not have an actionable trespass. But *Garza* also recognized that a lessee might have a duty under an implied covenant to protect its lessor against such drainage.

B. Duty to Protect Against Drainage in Vertical Direction

Severances of interests by depth seem to be becoming more common. This may lead to drainage disputes between working interest owners when the plane that divides the two lessees' interests bisects a productive formation (and possibly even if the plane does not bisect a productive

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

formation if the plane is near enough to a productive formation). In most cases, the same lessor will own both the shallow and the deep rights. But if different lessors own deep and shallow rights, or if the same lessor owns mineral rights as to all depths, but the two leases provide for substantially different royalty amounts, a lessor may assert a drainage dispute about drainage in the vertical direction, as opposed to the more typical drainage complaint about drainage in the horizontal direction. Further, in some jurisdictions, it may not be clear how the regulator will apply pooling and spacing rules when competing wells are separated vertically, rather than horizontally.

C. What is an Offset Well, and is There Really Drainage?

In *Adams v. Murphy Exploration and Production Co.-USA*, the lessors asserted that the lessee breached an express offset well covenant.[173] The covenant provided that:

> [I]n the event a well is completed as a producer of oil and/or gas on land adjacent and contiguous to the leased premises, and within 467 feet of the premises covered by this lease, that Lessee herein is hereby obligated to, within 120 days after the completion date of the well or wells on the adjacent acreage, as follows:
> (1) to commence drilling operations on the leased acreage and thereafter continue the drilling of such off-set well or wells with due diligence to a depth adequate to test the same formation from which the well or wells are producing from on the adjacent acreage; or
> (2) pay the Lessor royalties as provided for in this lease as if an equivalent amount of production of oil and/or gas were being obtained from the off-set location on these leased premises as that which is being produced from the adjacent well or wells; or
> (3) release an amount of acreage sufficient to constitute a spacing unit equivalent in size to the spacing unit that would be allocated under this lease to such well or wells on the adjacent lands, as to the zones or strata producing in such adjacent well.[174]

An operator on the neighboring tract drilled a horizontal well that triggered application of this covenant. In response, Murphy Exploration drilled a horizontal well on the leased premises. The horizontal well on the leased

173. Adams v. Murphy Exploration & Prod. Co.-USA, 497 S.W.3d 510 (Tex. App. 4th Dist. 2016).
174. *Id*. at 512.

premises was spaced about 2,100 feet from the horizontal well that triggered the offset well covenant. The lessor brought suit in state court in Texas, asserting that the well that Murphy drilled did not qualify as an offset well. The district court granted summary judgment in favor of Murphy Exploration, dismissing the lessor's claim. The lessor appealed.

The San Antonio appellate court concluded that the commonly understood meaning of "offset well" is a well that is used to protect against drainage. After considering the summary judgment evidence, the court held that Murphy Exploration "failed to prove as a matter of law" that the well drilled on the leased premises was protecting the premises from drainage by the well on the neighboring tract.[175] For this reason, the appellate court reversed the summary judgment in favor of Murphy Exploration.

The Texas Supreme Court reversed the appellate court's judgment and reinstated the trial court's judgment.[176] The Court noted that the offset well clause did not specify how close to the lease lines the offset well needed to be drilled.[177] The Court acknowledged that an offset well often has been viewed as a well that protects against drainage, but in the context of a low-permeability formation, hydrocarbons do not migrate "in the same fashion" as in a conventional reservoir.[178] This suggests that neither the existence *vel non* of drainage nor the effectiveness of a well in protecting against drainage depends on proximity of either well to lease lines. The Texas Supreme Court ultimately viewed the offset well clause as simply triggering an obligation that the lessee drill a well in the specified formation, now within any given distance from the lease lines.

The lessee eventually prevailed, but this case was a close call. Six judges (the trial court judge and five justice of the Texas Supreme Court) viewed the offset well clause as the lessee did, while seven judges (three appellate court judges and four justices of the Texas Supreme Court) viewed the clause as the lessor did. This illustrates that parties should carefully consider the language of any express offset well covenants. For example, do the parties intend that the lessee can satisfy the clause by drilling any well to the same formation as the neighboring well that triggered the offset well clause, or must the offset well be close enough to the lease lines to protect against drainage? Does it matter whether the neighboring well is drilled into a conventional formation or a low-permeability formation? If hydraulic fracturing is being used in an area,

175. *Id*. at 517.

176. Murphy Exploration & Production Co.–USA v. Adams, 560 S.W.3d 105, 114 (Tex. 2018).

177. *Id.* at 111.

178. *Id.* at 112-13.

what distance should the parties choose as the distance within which a well on neighboring property will trigger an offset well covenant? Does it matter if the neighboring well is not likely to drain the leased premises because fractures are not likely to extend to the leased premises?

If the appellate court's conclusion that a well must protect against drainage in order to qualify as an "offset well" had prevailed—a result that might be the outcome in some other state--would the lessor for lessees be that they should insist that express offset well covenants be drafted to avoid using the term "offset well," and instead merely require that the lessee drill a well within a specified distance of the lease line? If parties decide to retain the phrasing that requires the lessee to drill an "offset well," the lessee also might benefit by language stating that this obligation can be satisfied by drilling a well within a specified distance of the lease line. Otherwise, the lessee would have to litigate whether its new well is "close enough" to the lease boundary to protect against drainage and qualify as an offset well.[179]

III. DRAFTING CONSIDERATIONS

There are various considerations that parties should keep in mind with respect to implied covenants when drafting or negotiating leases. These considerations include clauses for the benefit of either the lessee or lessor. This Article identifies more clauses that could be used to benefit lessees than lessors. In part, this is because implied covenants burden lessees, not lessors. And, in part, this is because most of the provisions that lessors might use are clauses that impose *express* covenants or which convert certain types of performance by a lessee from being covenants to being limitations or conditions.

A. Clauses to Benefit Lessee

There are several types of clauses relating to implied covenants that a lessee can utilize to protect itself. These include clauses that give the lessee an opportunity to correct any alleged breach, clauses that limit the remedies available in the case of breach, and clauses that lessen the lessee's implied contractual obligation by eliminating all (or some) implied covenants or by restricting the obligation due under such covenants. Some types of clauses that would benefit a lessee are discussed below.

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179. Presumably, a well drilled close to the lease line would protect against drainage—in the sense of protecting against the possibility of drainage—even if no drainage were occurring.

1. Notice and Cure Clause

Lessees should consider including in their leases a clause that requires a lessor to give the lessee written notice of any alleged breach of an implied covenant, as well as a reasonable opportunity to cure the breach, before the lessor files suit based on the alleged breach. Someone could ask whether including a contractual notice-and-cure clause in a lease will really matter. After all, at least one jurisdiction generally makes notice and an opportunity to cure a prerequisite to any implied covenant claim,[180] and, in many other states, jurisprudence provides that the equitable remedy of lease cancellation is unavailable if a lessor fails to give the lessee notice and a reasonable opportunity-to-cure before bringing suit.[181]

Nevertheless, a contractual notice-and-cure clause can provide certain benefits to the lessee. First, an occasional court may not follow the generally accepted jurisprudential rule that makes notice and an opportunity to cure a prerequisite to a suit for lease termination even when a lease does not contain a notice-and-cure clause. But such a court may enforce a contractual agreement for notice and an opportunity to cure. Because lease termination can be a harsh remedy, the lessee may greatly benefit from having notice of any alleged breach and an opportunity to cure it.

Second, in many states, jurisprudence does not make notice and an opportunity to cure a prerequisite to a lessor's suit for damages.[182] In some circumstances, a lessee may be able to cure an alleged breach and preclude an action for damages altogether, provided that the lessee is given notice of the breach and time to make a cure. If the lessee does so, this could save legal costs by avoiding litigation. It also could help prevent the lessee from being on the losing end of a money judgment, and it might help preserve some degree of a working relationship between the lessor and lessee. Even if those benefits cannot be obtained, the requirement of notice and opportunity to cure may provide a modest benefit by delaying litigation.

If parties agree to include a notice-and-cure clause in their lease, they will need to decide whether notice and an opportunity to cure will be a prerequisite to: any action by the lessor; any action for breach of covenants—whether implied or express; any action based on implied covenants; or any action seeking lease termination. In addition, they will need to decide the length of the cure period. Will the lessee be allowed a

180. *See* LA. REV. STAT. § 31:136.
181. *See* MARTIN & KRAMER, *supra* note 132, at § 682.
182. *See id.*

"reasonable" time, a specifically-stated number of days, or the greater of either a reasonable time or a specified number of days?

In addition, they will need to decide whether the lessee must commence a cure or complete a cure. Given that planning, drilling, and completing a well can be a lengthy process, and that curing an alleged breach often will involve these tasks, the lessee should bargain for the clause to be drafted so that it merely requires the commencement of a cure, rather than the completion of a cure. If the clause merely requires commencement of the cure, the lessor should ask for the clause to require that, once commenced, the process of curing the alleged breach must be prosecuted to completion with reasonable diligence. As an alternative to merely requiring that a cure be commenced with the cure period, a lessee could protect itself by bargaining for a lengthy cure period, but a lessor probably will want a reasonably short period for commencement of a cure.

The language of a notice and cure clause will depend in part on the parties' choices regarding these issues. A lease from North Dakota contained a clause that allowed the lessee a specified number of days to commence a cure. The clause stated:

> In the event Lessor considers that Lessee has failed to comply with any obligation hereunder, express or implied, Lessor shall notify Lessee in writing specifying in what respects Lessor claims Lessee has breached this lease. The service of such notice and the lapse of sixty days without Lessee's meeting or commencing to meet the alleged breaches shall be a condition precedent to any action by Lessor for any cause. If within sixty days after receipt of such notice Lessee shall meet or commence to meet the breaches alleged by Lessor, Lessee shall not be deemed in default hereunder. The breach by Lessee of any obligation hereunder shall not work a forfeiture or termination, in whole or in part, of this lease.[183]

A lease at issue in a case from Tennessee contained a clause that appears to require the lessor to give the lessee a specified number of days to complete a cure, though the specified cure period seems too short to be of much use to the lessee unless the lessor alleges a breach that is very simple to cure. The clause states:

> Lessors shall make no claim of default against Lessees or their assigns until Lessors, or their assigns, first notify the Lessees

183. Ridl v. EP Operating Ltd. P'shp, 553 N.W.2d 784 (N.D. 1996). For additional examples, *see* MARTIN & KRAMER, *supra* note 132, at § 682.1.

> herein of such claim and unless such default is not cured within 10 days after notice. Notice of default is effective when delivered or placed in the U.S. Mail, certified, addressed to the Lessees named herein at.[184]

If the parties preferred to specify that the lessee would have a reasonable time to cure, they could substitute "a reasonable time" in place of the reference to a specific number of days in the examples above. An alternative that would be even better for the lessee would be to substitute something like "the greater of a reasonable time or sixty days" (or some larger number of days) in place of "sixty days" in the first example quoted above.

If a lessee is concerned that it is difficult to predict how long it will take to complete a cure of a breach, he might seek to add language such as, "Lessee shall not, however, be deemed to be in default while work is in progress in good faith which when completed will constitute compliance with such condition or covenant."[185]

2. Judicial Ascertainment Clause

Lessees should consider adding a judicial ascertainment clause to their oil and gas leases, using such a clause as a supplement to a clause requiring that the lessor give the lessee notice and an opportunity to cure before filing suit for an alleged breach of implied covenants. A judicial ascertainment clause seeks to address a dilemma that lessees sometimes face—a dilemma that the notice-and-cure clause, to which the judicial ascertainment clause is often compared, cannot resolve.

Suppose, for example, that a lessor gives written notice to the lessee, asserting that the lessee had breached the implied covenant of reasonable development and demanding that the lessee drill an additional well within a reasonable time. The lessee believes in good faith that the proposed well is unnecessary and that it might even be counterproductive. Further, drilling the well would be very expensive. But a contrary reading of the geologic evidence is plausible. If the lessee drills, it will spend a large amount of money on a well that might be unprofitable and even counterproductive. If the lessee refuses to drill the proposed well, the lessor might bring suit. If a jury finds that the lessor's expert is sufficiently convincing, the lessor might prevail, and a possible remedy could be lease

184. Lone Star Oil & Gas, Inc. v. Howard, No. E2009-00428-COA-R3-CV, 2010 WL 520934, at *2, n.6 (Tenn. Ct. App. Feb. 12, 2010).

185. This clause is quoted in a prominent treatise. *See* MARTIN & KRAMER, *supra* note 132, at § 681.1.

termination. The lessee would be willing to spend the money to drill if it had to do so in order to save the lease, but the lessee would like its "day in court" to contest the need for the proposed well.

This is a type of situation in which a judicial ascertainment clause can help a lessee. Such a clause provides that the lease will not be terminated on account of a breach of the implied covenants until there is a judicial determination that there has been a breach and the lessee fails to drill after having been given a reasonable amount of time to do so. A key question is whether judicial ascertainment clauses are enforceable. In some jurisdictions, courts have indicated that such clauses are enforceable. Examples include the Louisiana Supreme Court[186] and a Colorado appellate court.[187] In other jurisdictions, courts have indicated that judicial ascertainment clauses are not enforceable. Examples include the West Virginia Supreme Court,[188] an Ohio appellate court,[189] and a Texas appellate court.[190]

The courts that have held that judicial ascertainment clauses are not enforceable have expressed three concerns. First, judicial ascertainment clauses would result in piecemeal litigation that "would require at least two trials and two final judgments."[191] Second, some of the courts rejecting judicial ascertainment clauses have concluded that the lessee often has greater resources than the lessor, and that a lessee might take advantage of a judicial ascertainment clause to extract concessions from the lessor.[192] And finally, certain courts have said that, in a jurisdiction that recognizes that leases can terminate by abandonment, a judicial ascertainment clause should not affect termination by abandonment.[193]

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186. *See* Melancon v. Texas Co., 89 So. 2d 135 (La. 1956). *See also* B.A. Kelly Land Co. v Questar Expl. and Prod. Co., 106 So. 3d 181, 192 (La. App. 2d 2012) (judicial ascertainment clause was enforceable).

187. Gillette v. Pepper Tank Co., 694 P.2d 369, 374 (Colo. App. 1984).

188. Wellman v. Energy Res., Inc., 557 S.E.2d 254, 262 (W. Va. 2001) (under West Virginia law, judicial ascertainment clause in oil and gas lease is void as against public policy).

189. Conny Farms, Ltd. v. Ball Res., Inc., No. 09 CO 36, 2011 WL 5053625, at *5 (Ohio Ct. App. Sep. 27, 2011) (under Ohio law, judicial ascertainment clause is against public policy and is void).

190. Frick-Reid Supply Corp. v. Meers, 52 S.W.2d 115, 118 (Tex. App. 1932).

191. A Texas appellate court stated this, *Frick-Reid*, 52 S.W.2d at 118 and the West Virginia Supreme Court quoted *Frick-Reid* on this point. *Wellman*, 557 S.E.2d at 259-60. The Ohio appellate court cited both *Frick-Reid* and *Wellman*. *See Conny Farms*, 2011 WL 5053625.

192. *See, e.g.*, *Wellman*, 557 S.E.2d at 260.

193. *Id.*

But these concerns seem misplaced. The first concern is the concern that a judicial ascertainment clause would result in piecemeal litigation, requiring "two trials," but application of a judicial ascertainment clause would not require two full trials. If the lessee prevailed in the "first" trial, that would be the end of the litigation. If the lessor prevailed, the court would find liability and enter an order that the lease would terminate if the lessee does not drill an additional well within a time specified in the order. If the lessee timely drills the required well, the lease will continue and there is no need for a second trial. If the lessee fails to do that, there will be no need for a second trial. Only if it is unclear whether the lessee has complied will there be a need for another hearing, and, in such a case, the only issue to resolve would be a narrow one—whether the lessee timely drilled the well required in the original order. There would be no need to re-litigate whether a prudent lessee would drill the well because that issue was decided in the first trial.

Further, there is another strong argument as to why the concern about piecemeal litigation is misplaced. As noted in the Section of this Article dealing with remedies for the breach of an implied covenant, many jurisdictions have held that conditional termination is a permissible remedy.[194] That is, a court that finds that a lessee has breached an implied covenant may enter an order stating that the lease will terminate (in whole or part) unless the lessee drills a sell by a specified date. Indeed, some courts have stated that, although outright termination is also a permissible remedy, conditional termination is favored over outright termination.

The widespread acceptance of conditional terminations is important because a judicial ascertainment clause is essentially a clause stating that, if a court is going to order termination as a remedy, the order should provide for conditional termination, not outright termination.[195] Thus, if use of conditional termination does not create an undue risk of piecemeal litigation, the enforcement of a judicial ascertainment clause should not create undue risk of piecemeal litigation because all the clause does is mandate that any termination will be a conditional termination. This is notable because, although West Virginia's Supreme Court has stated that

194. *See supra* Section I(D)(5).

195. A prominent commentator noted the seeming incongruity between concerns about piecemeal litigation and the general acceptance of conditional termination. See Maurice H. Merrill, THE LAW RELATING TO COVENANTS IMPLIED IN OIL AND GAS LEASES, § 201 (1940) (referring to the "alternative decree"). Further, in Gillette v. Pepper Tank Co., 694 P.2d 369, 373-4 (Colo. App. 1984), the court concluded that the lack of an adequate remedy at law, combined with the existence of a judicial ascertainment clause a lease, justified the trial court's award of a conditional decree of cancellation.

judicial ascertainment clauses are void (in part because of the danger of piecemeal litigation), that court has accepted the use of conditional termination.[196] And, although a Texas appellate court concluded that a judicial ascertainment clause is void (in part because of the danger of piecemeal litigation), the Texas Supreme Court has expressed approval for the use of conditional termination.[197]

As for the concern that lessees often have more resources than lessors and that they might abuse a judicial ascertainment clause, there are several responses. Of course, though lessees often have more resources than lessors, this is not always the case. Moreover, if the covenant that allegedly has been breached is a covenant to develop or explore, the lessor will be receiving royalties (those covenants do not apply until production has been established) and any delay in additional development or exploration will not cause a permanent loss. Instead, it will simply mean a delay in the lessor receiving an even higher instream of royalty income. Further, it seems unlikely that a lessee will typically be in a position to coerce concessions from a lessor merely by delaying the commencement of drilling or other activities that would increase the lessor's stream of royalties. Of course, if the implied covenant to protect against drainage is at issue, a delay in performance could result in a permanent loss, but a lessor can pursue a money damages award for drainage. Judicial ascertainment clauses typically apply only to actions for lease termination, not to claims for money damages.

Nevertheless, to the extent that a court is worried about the potential abuse of judicial ascertainment clauses, the court could follow the lead of the Louisiana Supreme Court, which stated that judicial ascertainment clauses are enforceable, provided that there is a bona fide dispute.[198] That is, a lessee cannot simply refuse to perform when it has no valid defense, then invoke a judicial ascertainment clause to escape consequences. Also, it is worth noting that there have not been widespread reports of abuse of judicial ascertainment clauses in the jurisdictions where these clauses are enforceable.

The third and final argument against the enforceability of judicial ascertainment clauses is that it would be unreasonable to enforce such a clause when a lease has been abandoned. But for a couple of reasons this

196. *See* Dillard v. United Fuel Gas Co., 173 S.E. 573 (W. Va. 1934); Adkins v. Huntington Development & Gas Co., 168 S.E. 366 (W. Va. 1932).

197. W.T. Waggoner Estate v. Sigler Oil Co., 19 S.W.2d 27, 32 (Tex. 1929) (referring to "alternative decree"). *See also* Slaughter v. Cities Service Oil Co., 660 S.W.2d 860 (Tex. App. 1983); Wes-Tex Land Co. v. Simmons, 566 S.W.2d 719 (Tex. App. 1978).

198. Melancon v. Texas, 89 So. 2d 135, 146 (La. 1956).

argument cannot plausibly support a general rule against the enforcement of judicial ascertainment clauses. For one thing, not all states recognize that leases can be lost by abandonment. More important, even in states that take the view that leases are subject to abandonment, this final concern need not stand in the way of enforcing judicial ascertainment clauses in circumstances that do not involve an abandoned lease. In other words, the fact that a judicial ascertainment clause would not apply if a lease has been abandoned should not preclude application of a judicial ascertainment clause when a lease has *not* been abandoned and the lessor merely alleges a breach of an implied covenant.

In short, the main arguments against enforcement of judicial ascertainment clauses seem flawed. Further, there are policy reasons that weigh in support of the enforceability of such clauses. One such policy reason is the public policy favoring freedom of contract. Second, there is widespread recognition that lease termination can be a harsh remedy. An order of conditional termination, pursuant to a judicial ascertainment clause, allows the lessee to avoid the harsh remedy of outright termination.

Third, use of conditional termination can even benefit the lessor. Suppose, for example, that a court concludes that the lessee has breached an implied covenant, and the court enters an order that the lease will terminate unless the lessee drills a well by a certain time. If the lessee performs in response to a court's decision, the lessor will receive the benefit of that performance.[199] Indeed, in such a case, the lessor will probably receive the benefit of performance (the drilling of the well) sooner than if the court had granted an order cancelling the lease outright and the lessor had been put in the position of finding a new lessee or turning to a top lessee. The main downside is that, in the event that the lessee does not perform, the ultimate lease termination will be delayed by the amount of time that the lessee was given to perform, but that delay likely will be short in relation to the time that the litigation will take. Such a potential delay would seem to be outweighed by the benefits of enforcing the judicial ascertainment clause to which the parties agreed.

Nevertheless, in some jurisdictions, courts hold that judicial ascertainment clauses are unenforceable. In such jurisdictions, rather than drafting leases to include a judicial ascertainment clause, lessees should consider drafting clauses in which the parties agree that any order granting termination as a remedy should be an order of conditional termination, rather than outright termination (see the next Section of this Article,

199. Of course, damages may also have to be awarded in order to give a complete remedy in the event that the particular implied covenant that has been breached is the implied covenant to protect against drainage.

Section III(A)(3) below). If, however, a prospective lessee negotiates to include a judicial ascertainment clause in a lease, a question may arise as to the specific language that would be used. The following are examples of judicial ascertainment clauses.

Example from Louisiana

> After production of oil, gas, sulphur or other mineral has been secured from the land covered hereby or land pooled therewith, this lease shall not be subject to forfeiture or loss, either in whole or in part, for failure to conduct operations in compliance with this contract except after judicial ascertainment that Lessee has failed to conduct such operations and has been given a reasonable opportunity after such judicial ascertainment to prevent such loss or forfeiture by complying with and discharging its obligations as to which Lessee has been judicially determined to be default.[200]

Example from Montana

> This lease shall never be forfeited or cancelled for breach of implied covenant until it shall have been finally judicially determined that such breach exists and lessees shall have failed within a reasonable time of such final determination, to remedy such breach.[201]

Readers should note that the typical judicial ascertainment clause limits the circumstances in which forfeiture of a lease is a permissible remedy for breach of a covenant; such clauses typically have no application to limitations that provide for automatic termination of the lease or to conditions that give the lessor the right to terminate it.[202] Nevertheless, a judicial ascertainment clause could be drafted so that it applies to limitations and conditions, effectively modifying them so that they do not provide for termination unless the lessee fails to correct them after a judicial ascertainment of facts that otherwise would terminate the lease. Examples of judicial ascertainment clauses that are drafted to apply to

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200. B.A. Kelly Land Co., L.L.C. v. Questar Exploration and Production Co., 106 So. 3d 181, 184-5 (La. App. 2d Cir. 2012), *writ denied*, 112 So. 3d 223 (La. 2013) (judicial ascertainment clause was enforceable).

201. Eddington v. Creek Oil Co., 690 P.2d 970, 974 (Mont. 1984).

202. King v. Estate of Gilbreath, 215 F. Supp. 3d 1149, 1177 (D. N. Mex. 2016); Tisdale v. Walla, 1994 WL 738744 (Ohio Ct. App. 11th Dist.); Babb v. Clemenson, 687 A.2d 1120, 1122 (Pa. Super. 1996); Eddington v. Creek Oil Co., 690 P.2d 970, 974 (Mont. 1984).

limitations and conditions, not just breaches of covenants, are shown below.

Example from Colorado

> It is agreed that this lease shall never be forfeited or cancelled for failure to perform in whole or in part any of its implied covenants, conditions, or stipulations until it shall have first been finally judicially determined that such failure exists, and after such final determination, lessee is given a reasonable time therefrom to comply with any such covenants, conditions, or stipulations.[203]

Example from Ohio

> It is agreed that this lease shall never be forfeited or cancelled for failure to perform, in whole or in part, any of its covenants, conditions or stipulations, until it shall have been first finally judicially determined that such failure exists, and after such final determination, lessee is given a reasonable time therefrom to comply with any such covenants, conditions or stipulations.[204]

Example from West Virginia

> This lease shall never be forfeited or terminated for failure of Lessee to perform in whole or in part any of its express or implied covenants, conditions or obligations until it shall have been first finally judicially determined that such failure exists, and Lessee shall have been given a reasonable time after such final determination within which to comply with any such covenants, conditions or obligations.[205]

3. Clause Restricting Termination Remedy to Conditional Termination

Prospective lessees should consider including in their leases a clause in which the parties agree that, if the court decides to grant lease termination as a remedy, the order granting such relief will be an order of conditional termination, rather than an order of outright termination. Such

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203. Gillette v. Pepper Tank Co., 694 P.2d 369, 371 (Colo. App. 1984).

204. Conny Farms, Ltd., 2011 WL 5053625, at *3 (Ohio Ct. App. 7th Dist.).

205. Wellman v. Energy Resources, Inc., 557 S.E.2d 254, 258 (W. Va. 2001). The West Virginia Supreme Court held that judicial ascertainment clauses are unenforceable, so this clause was not enforced, but the court's reasoning was not based on the particular wording of the clause.

a clause could be called a "conditional termination" clause. The enforcement of such a clause would provide the same benefits as would be provided by the enforcement of a judicial ascertainment clause. Thus, a conditional termination clause might be particularly useful in states where courts refuse to enforce judicial ascertainment clauses.

It is possible that a jurisdiction that bars enforcement of judicial ascertainment clauses might choose to bar enforcement of a conditional termination clause. On the other hand, some of the same jurisdictions that bar enforcement of judicial ascertainment clauses allow the use of conditional termination. Further, courts often will follow the terms of a retained acreage clause, and a conditional termination clause is somewhat similar to a retained acreage clause. A retained acreage clause purports to preclude complete termination while allowing partial termination. A conditional termination clause likewise purports to preclude outright termination, while allowing conditional termination.

In order to drive home the analogy between the conditional termination clause and a retained acreage clauses, the parties should consider combining the two clauses into a single section of the lease, and drafting the language of the conditional termination clause to track the language of the retained acreage clause. Such a combined clause might read as follows:

> In case of cancellation or termination of this lease for any cause, the cancellation or termination shall be a partial cancellation or termination, meaning that lessee shall have the right to retain under the terms hereof, ____ acres of land around each oil or gas well producing, being working on, or drilling hereunder (as long as such operations are continued in good faith) such tract to be designated by lessee in as near a square form as practicable. Further, the parties agree that, if any cancellation or termination of this lease is granted as a remedy for any breach of an implied or express covenant to drill a development, exploratory, or offset well, the cancellation or termination shall be a conditional cancellation or termination, meaning that the remedy shall be an order (sometimes called an "alternative decree") that the lessee must drill such a well within a reasonable time or the lease will be cancelled or terminate automatically, except as to ____ acres of land around each oil or gas well producing, being working on, or drilling hereunder.[206]

206. The clause proposed above does not come from an actual lease. The retained acreage portion of the clause is a modified version of a retained acreage

4. Clause Restricting Termination Remedy to Partial Termination

A prospective lessee should consider use of a retained acreage clause in order to limit a lessor's remedy for breach of implied covenants to partial termination.

As noted in the Section of this Article that discusses remedies, if a court finds that a lessee has breached implied covenants and that the proper remedy is lease termination, the court sometimes will decide even in the absence of a retained acreage clause to order partial termination, rather than complete termination. Such an order might terminate the lease as to areas that the lessee had not prudently developed or explored, or where the lessee had not protected against drainage, while allowing the lessee to retain its rights as to the other portions of the lease. As a slight variation on this concept, an order might terminate the lease except for the wellbore of any productive wells and perhaps a modest amount of acreage around each. But in other cases, a court might order complete lease termination, even if the lessee had one or more productive wells. Such an order could be very costly. A retained acreage clause is a provision by which the parties agree that any time lease termination is ordered as a remedy, the termination will be partial termination, not complete termination.

If the parties agree to such a clause, the clause should address certain issues such as whether the clause applies to any lease terminations or only terminations that are based on a certain cause. Another issue is the amount of acreage that the lessee will retain. Some clauses allow the lessee to retain a specified number of acres, while other clauses may vary the size of the retained area depending on the depth of the well, whether the well is an oil well or a gas well, or the spacing and pooling rules and orders of the state's oil and gas regulator. Another issue is whether the lessee will retain rights as to all depths within the retained acreage, or only certain depths. Another issue to consider is the shape of the retained area.

Finally, the lessee will want to ensure that a clause is not written too narrowly. The lessee will want to draft the clause to retain acreage around wells that are being drilled or reworked, in addition to any wells that are producing at the time of the order of termination. Further, a lessee should consider including in the clause provisions that will preserve certain surface rights even as to the areas where the lease is terminated. For example, the lessee will want the right to continue using any pipelines,

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clause quoted elsewhere in this Article. *See supra* note 202 and accompanying text. The conditional termination portion was drafted by the author of this Article. Other drafters may be able to improve upon it.

support facilities, or access roads, even if those are located on lands where the lessee's working interest is terminated.[207]

An example of a retained acreage clause that allowed the lessee to keep a specified number of acres around each well stated:

> In case of cancellation or termination of this lease for any cause, lessee shall have the right to retain under the terms hereof, twenty (20) acres of land around each oil or gas well producing, being working on, or drilling hereunder (as long as such operations are continued in good faith) such tract to be designated by lessee in as near a square form as practicable.[208]

A lease involved in another case contained a clause stating that the lessee would be entitled to retain the greater of forty acres or the amount of acreage allotted to the well under a spacing order or rule of the state's oil and gas regulator. This clause stated:

> In case of cancellation or termination of this lease for any cause, Lessee shall have the right to retain under the terms hereof forty acres of land around each well producing, being worked on, or drilling hereunder, unless there be in force in said area at such time a spacing order or regulation of the Conservation Commissioner or other governmental agency allocating more than forty acres to each well, in which case Lessee shall have the right to retain around each such well the number of acres allocated to each well under such order or regulation. The tract so retained shall be designated by Lessee in as near a square form as practicable.[209]

A clause that provides for the lessee retaining producing wells (and wells being drilled), but which does not expressly provide for the retention of acreage around the wells, provided:

> Notwithstanding any forfeiture of this lease, the Lessee shall have the right to retain any and all wells being drilled, or producing or capable of producing oil or gas in paying quantities, at the time of

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207. "Working interest" has been defined as the "operating interest under an oil and gas lease." MANUAL OF OIL & GAS TERMS, *supra* note 35, at 1156..

208. Francis v. Pritchett, 278 S.W.2d 288 (Tex. Civ. App. 1955, error ref'd). The clause quoted above, as well as some of the other clauses quoted above and yet other clauses are cited in a prominent treatise. *See* MARTIN & KRAMER, *supra* note 132, at § 681.1.

209. Melancon v. Texas Co., 89 So. 2d 135 (La. 1956).

such forfeiture.[210]

A prominent treatise quotes clauses from two California leases that sought to preserve certain surface rights that it might need in the area where its lease rights otherwise were terminated. One of the leases contained a clause stating:

> A termination of this lease as to a part only of the leased land or as to a part only of Lessee's rights shall not affect such rights of way and easements as may be necessary in Lessee's operations on the part of the leased land as to which no such termination shall have occurred.[211]

The clause in the other California lease stated:

> Notwithstanding any partial termination of this lease, whether by surrender, forfeiture, or otherwise, Lessee shall have such rights-of-way over, upon, and across the land with respect to which this lease has terminated as are necessary or convenient for Lessee's operations hereunder on the leased land retained by it.[212]

5. Clause to Preclude Termination as a Remedy

In some leases, parties have agreed to a clause that purports to preclude termination as a remedy. An example of such a clause states:

> [N]o part of this lease shall be forfeited or terminated by reason of the breach of any implied condition or covenants thereof.[213]

6. Clause Suspending Implied Covenant Duties During Challenge to Lease

A prospective lessee should bargain for its oil and gas lease to include a clause that suspends the lessee's implied covenant obligations during any period when the lessor or some other person challenges a lease. Such a challenge could be a lawsuit or arbitration in which the lessee seeks a ruling that terminates the lease as a remedy for the lessee's alleged breach of some obligation. Alternatively, the challenge may involve an assertion

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210. Danker v. Lee, 137 Cal. App. 2d 797, 291 P.2d 73, 5 O.&G.R. 313 (1955).
211. *See* MARTIN & KRAMER, *supra* note 132, at § 681.3.
212. *Id*.
213. Stanolind Oil & Gas Co. v. Christian, 83 S.W.2d 408 (Tex. Civ. App. 1935, error ref'd).

by the lessor or some other person that the lease is unenforceable because it allegedly has terminated, was procured by fraud, or was granted by someone who lacked title to the minerals covered by the lease. Absent a lease clause that suspends the lessee's implied covenant obligations during such a challenge, the lessee may face an unpleasant choice.

One choice is that the lessee can spend money on drilling or other development activities, even though that investment may be lost if the lessor prevails on its challenge to the lease. Given that drilling and other development activities can be costly, this choice is risky. Indeed, if the lessor or other person challenging the lease asserts that the lease is not enforceable (as opposed to seeking termination of an enforceable lease as a remedy), a lessee who drills an additional well faces risks beyond the possibility of losings its investment. If a putative lessee drills a dry hole at a time that the lessee lacked any rights under the lease, the lessee may have trespass liability. Such liability may require the company to pay money damages to compensate the owner of the mineral rights for any loss of leasing opportunity or diminution in value of the minerals that might be caused by news of the dry hole.[214] Given these risks, lessees often conclude that the most prudent course is to refrain from further development until the challenge to the lease is resolved.

But if the lessee chooses to refrain from additional investment until a challenge is resolved, that choice could raise certain questions. For example, could the lessee's lack of further drilling while the lease was being challenged constitute a breach of one of the implied covenants? If the original challenge to the lease is found to be valid, this question may be irrelevant because the success of the original challenge may mean that the lease is unenforceable anyway. But if a court rejects the original challenge, holding that it lacked merit, it may be very relevant to know whether the lessee's lack of drilling during the challenge to the lease constitutes a breach—perhaps even a breach that would justify lease termination. If the original challenge to the lease is brought during the primary term, at a time when the lessee has not yet established production, a somewhat similar question can arise. If the primary term ends while the challenge to the lease is pending, will the lease terminate for a lack of production in paying quantities if the lessee refrains from drilling during the lease challenge?

In most states that have significant oil and gas jurisprudence, case law protects the lessee by extending the primary term (if a challenge to the

214. Humble Oil & Refining Co. v. Kishi, 291 S.W. 538 (Tex. App. 1927); Humble Oil & Refining Co. v. Kishi, 276 S.W. 190 (Tex. App. 1925).

lease occurs during the primary term)[215] and by providing that the lessee's implied covenant duties are suspended while a suit is pending in which the lessor alleges that the lease has terminated or requests termination as a remedy.[216]

Such jurisprudence seems appropriate. Given the substantial costs of drilling and completing wells, and the economic risks inherent in almost any drilling project, it generally would be unfair to expect a lessee to drill on the leased premises while a challenge to the lease is pending. In such cases, it simply is not prudent or practical for the lessee to engage in drilling. This is true whether the challenge to the lease is brought by the lessor or some other person, but when the challenge is asserted by the lessor, it would be doubly unfair to expect the lessee to conduct drilling or other significant operations while the challenge is pending. In such cases (and remember, we are now considering cases in which the original challenge to the lease lacked merit), the lessor himself has interfered with the lessee's rights and created the circumstances that make it impractical for the lessee to drill. The lessor should not be allowed to profit from its own erroneous challenge.

Moreover, if the law did not excuse a lessee from any expectation of drilling wells during a challenge to the validity of the lease, a lessee would sometimes be put in the position that, in order to protect its rights or fulfill its contractual obligations, it must go onto the lessor's property to drill a well in direct defiance of the lessor's claim that the lessee is trespassing on the property and has no right to be there. This risks an escalation of disputes.

Finally, it is notable that, if a lessor seeks termination of a lease as a remedy because the lessee allegedly breached the lease by failing to drill during the original challenge to the lease, the lessee would be seeking an equitable remedy. Equity seeks to do justice and achieve fairness. It can hardly be said to be just or fair to reward a lessor for bringing a lease challenge that lacks merit, thereby effectively punishing the lessee who was the victim of the original, meritless challenge. These are the reasons why states that have addressed the issue have been virtually unanimous in concluding that the lessee's implied covenant duties are suspended during

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215. Baker v. Potter, 223 La. 274, 65 So. 2d 598 (La. 1953); Sw. Energy Prod. Co. v. Elkins, 2010 Ark. 481, 374 S.W.3d 678, 685 (2010); Greer v. Carter Oil Co., 373 Ill. 168, 25 N.E.2d 805, 810 (1940); *cf.* Kothmann v. Boley, 158 Tex. 56, 308 S.W.2d 1, 4 (1957); Bingham v. Stevenson, 148 Mont. 209, 420 P.2d 839, 842 (1966).

216. *See, e.g.*, Spaeth v. Union Oil Co., 710 F.2d 1455, 1458 (10th Cir. 1983) (Oklahoma law); Doss Oil Royalty Co. v. Texas Co., 137 P.2d 934, 938-9 (Okla. 1943).

the time that the lessor challenges the lease, and that the primary term is extended.

But at least one state has staked out a contrary position, at least with respect to the question of whether the primary term is extended. In *Harrison v. Cabot Oil & Gas Corp.*, an oil and gas lessor filed suit during the primary term, alleging that the lease had been fraudulently induced and therefore was invalid.[217] Approximately two days before the end of the primary term, the federal district court issued a summary judgment dismissing the lessor's claims, stating that he had "not offered any evidence" to support his claim.[218] But the district court refused to extend the primary term.[219] The lessee appealed to the United States Third Circuit Court of Appeals, which certified a question to the Pennsylvania Supreme Court as to whether Pennsylvania follows the so-called repudiation doctrine, also sometimes called the lessor-interference doctrine, which provides that the primary term of a lease is extended when a lessor file suit challenging the validity of a lease.[220] The Pennsylvania Supreme Court accepted the certified question, then held that, under Pennsylvania law, a lessor's filing and prosecution of an action asserting that a lease is invalid is not sufficient to justify an extension of the primary term.[221]

Of course, *Harrison* dealt only with the question of whether the primary term of a lease would be extended, not whether a lessee's implied covenant duties would be suspended. Sound arguments exist for the proposition that implied covenant duties should be suspended, even if the primary term is not extended. For example, *Harrison*'s refusal to extend the primary term was merely a refusal to use the unfairness of lessor's erroneous challenge to a lease as grounds to modify the lease (by

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217. 110 A.3d 178 (Pa. 2015).

218. Harrison v. Cabot Oil and Gas Corp., 887 F. Supp. 2d 588, 594 (M.D. Pa.) (the judgment is dated August 14, 2012, whereas the lease, which had a five-year primary term, was signed on August 16, 2007).

219. *Id*. at 597.

220. Harrison v. Cabot Oil and Gas Corp., 110 A.3d 178, 179 (Pa. 2015).

221. *Id.* at 185. The court said that it would not rule out an equitable extension of the primary term if the lessor made a more "affirmative repudiation of a lease" than merely filing a suit alleging that the lease was unenforceable because allegedly it had been fraudulently induced. *Id.* at 186. Many observers might conclude that such a lawsuit is an affirmative repudiation of the lease. Perhaps one of the types of action that the court would consider a more affirmative repudiation than such a lawsuit would be a lessor's "affirmative" refusal to allow the lessee to enter the property. *See id*. at 186, n.6.

extending the primary term).[222] But if a court imposed liability on a lessee for "breaching" implied covenant duties by failing to drill wells during the time when the lessor himself makes such drilling impractical, such a holding could be remarkably unfair. Further, although damages are sometimes awarded as a remedy for breach of an implied covenant, it is notable that a common form of remedy is a form of equitable relief, forfeiture of the lease. Given that equity generally abhors a forfeiture, it would be odd for a court to exercise its equitable powers by terminating a lease in these circumstances, thereby punishing the lessee that is the victim of the lessor's initial, erroneous challenge to the lease, and allowing the lessor to benefit from his erroneous challenge.

Nevertheless, it is easy to imagine that a lessor may attempt to extend *Harrison*, citing it as support for an argument that implied covenant duties should not be suspended during an erroneous challenge to a lease. Accordingly, lessees should consider including in their leases a clause that expressly suspends implied covenant duties for a period in which a lessor seeks lease termination or asserts that the lease already has terminated. Such a clause could also provide for an extension of the primary term. (In *Harrison*, the court asserted that the lessee should have bargained for such a clause.) A lease form commonly used in Louisiana states:

> Should the right or interest of Lessee hereunder be disputed by Lessor, or any other person, the time covered by the pendency of such dispute shall not be counted against Lessee either as affecting the term of the lease or for any other purpose, and Lessee may suspend all payments without interest until there is a final adjudication or other determination of such dispute.[223]

Such language might work, but it does not expressly provide for a suspension of implied covenants. Something like the following language would be more explicit:

> If the Lessee or any other person seeks termination of the Lease (in whole or part) or asserts that that the Lease is not valid or not enforceable (in whole or part), any implied covenant duties will be suspended during such a challenge to the Lease. Further, any time during which a court action, arbitration, or regulatory

222. This statement is not intended to diminish the unfairness of allowing the lessor in *Harrison* to benefit from its wrongful filing of a lawsuit that alleged fraud even though the lessor had no evidence of fraud.

223. The quoted language comes from paragraph 11 of Bath's Form Louisiana Spec. 14-BR1-2A/12/79, which is available from M.L. Bath Company Ltd., Inc. in Shreveport, Louisiana.

> challenge to the Lease is pending, shall not be counted against the Lessee for purposes of the Lease, including, but not limited to, the running of the time allowed for the primary term, any time periods allowed under any saving clauses, and the time limits (if any) on the duration of any force majeure situation or application of a shut-in well clause.

A much lengthier, but even more explicit clause might read:

> While a Lease Termination Action is pending,[224] the Lessee will not have any implied covenant obligations[225] with respect to any portion of the Leased Premises where the Lessor or some other person contends the Lease should be terminated, cancelled, or forfeited, or where the Lessor or some other person contends the Lease already is void, unenforceable or has terminated. Further, if a Lease Termination Action is asserted during the primary term of the Lease, the primary term will be extended by the length of time that the Lease Termination Action is pending. Similarly, whether a Lease Termination Action is asserted during or after the primary term, the time during which a Lease Termination Action is pending will not count against the Lessee for purposes of any time limit to act to maintain this Lease under a lease savings clause or for any other purpose, except that the time for payment of any lease royalties on actual production will not be delayed if there is no dispute regarding what person is entitled to receive such payments.[226] For purposes of this clause, a "Lease Termination Action" is a lawsuit, arbitration, or similar proceeding in which Lessor or some other person contends: that the Lease (in whole or part) is void, invalid, abandoned, or otherwise unenforceable; that the Lease (in whole or part) is no longer valid and enforceable; or that the Lease (in whole or part) should be terminated, cancelled,

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224. The lessee should consider whether this clause should be broadened to cover both circumstances in which a suit has been filed and circumstances in which a suit has not been filed, but the lessor or some other person has challenged the lease.

225. The lessee should consider whether there are any express obligations that should be suspended.

226. The lessee should consider whether there are any other time limits that should be extended during the pendency of a Lease Termination Action. If so, perhaps the lease should expressly note that those time periods will be extended also. For example, if a lease limits the length of time that a lessee can rely on a force majeure clause or a shut-in clause, the lessee might want for the lease to expressly provide that such time is extended during a Lease Termination Action.

or forfeited as a form of remedy or relief.

7. Clause Providing for a General Waiver of Implied Covenants

A prospective lessee that wishes to protect itself from implied covenant claims could consider bargaining for a clause that disclaims all implied covenants. As previously discussed in this Article, it is well-accepted that the express terms of a lease can preclude the existence of an implied covenant. Courts from several jurisdictions have stated this. Typically, such statements are made in cases that involve a lease that imposes some express duty, and the court is addressing whether the express duty precludes the existence of an implied covenant that imposes a particular duty. For example, a court might consider whether an express offset well clause precludes the existence of an implied covenant to protect against drainage. There are far fewer cases involving leases that purport to eliminate all implied covenants. But there a handful of such cases from Ohio.

For example, a lease at issue in *Bilbaran Farm, Inc. v. Bakerwell, Inc.* contained a clause stating:

> This lease contains all of the agreements and understandings of the Lessor and the Lessee respecting the subject matter hereof and no implied covenants or obligations, or verbal representations or promises, have been made or relied upon by Lessor or Lessee supplementing or modifying this lease or as an inducement thereto. [227]

The lessee was operating three wells on the approximately 276-acre property covered by the lease, but a portion of the property had not been developed.[228] The lessor brought suit in state court in Ohio, asserting that the lessee had breached the implied covenant to fully develop the property. The defendant moved to dismiss, arguing that the plaintiff's complaint failed to state a cause of action. The district court granted the motion and the appellate court affirmed, holding that the lease's general waiver precluded the existence of an implied covenant to develop the property.[229] In doing so, the appellate court from Ohio's Fifth District rejected the lessor's argument that the lessee's failure to further develop the property was "unfair and inequitable."[230] The court noted that parties generally have

227. 993 N.E.2d 795, 801 (Ohio Ct. App. 5th Dist.).
228. *Id.* at 799.
229. *Id.* at 801.
230. *Id.*

freedom of contract and that courts typically should not override the terms of a contract.[231] The court also cited a prior case that reached a similar result.[232]

That prior case was *Bushman v. MFC Drilling*, an unpublished case from the Ninth District Court of Appeals.[233] The parties in *Bushman* entered a lease in 1990 that covered about twenty-seven acres. About ten of those acres were part of a drilling unit that contained a unit well that produced in paying quantities.[234] The lessor brought suit, arguing that the lessee had breached an implied covenant to reasonably develop the property because seventeen acres remained undeveloped. The lessee moved for summary judgment, noting that a clause in the lease stated, "It is mutually agreed that this instrument contains and expresses all of 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."[235] The district court granted the motion and dismissed the lessor's claims. On appeal, the lessor argued that "public policy prohibits a general disclaimer of the implied covenant to develop the leased property."[236] Thus, only a clause that referred specifically to the implied covenant to develop the leased premises could preclude the existence of such a covenant. Here, asserted the lessor, the clause disclaiming implied covenants was too "vague and general" to preclude the existence of an implied covenant. The appellate court disagreed, concluding that, under Ohio contract law, a general waiver should be sufficient and that no authority called for a different result to apply for an oil and gas lease.[237] The lessor in *Bushman* also argued that, under the facts of the case, a general waiver of the implied covenant to develop the premises was unconscionable. Relying on general principles of contract law, the appellate court rejected this argument too.[238]

Appellate courts from two additional appellate districts have likewise concluded that general waivers of implied covenants are enforceable.[239]

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231. *Id.*
232. *Id.*
233. 1995 WL 434409 (Ohio Ct. App. 9th Dist. 1995).
234. *Id.* at *1.
235. *Id*. at *2.
236. *Id*.
237. *Id.*
238. *Id.* at *3.
239. *See* Belmont Hills Country Club v. Beck Energy, 2015 WL 1592999 (Ohio Ct. App. 7th Dist. 2015); Bohlen v. Anadarko E&P Onshore, LLC, 26 N.E.3d 1176, 1186 (Ohio Ct. App. 4th Dist. 2014); Taylor v. MFC Drilling, Inc., 1995 WL 89710 (Ohio Ct. App. 4 Dist. 1995) (general waiver of implied

Further, in two recent cases, the Ohio Supreme Court has suggested that general waivers of implied covenants are enforceable. One of these was *Alford v. Collins-McGregor Operating Co.*, though the statement in that case was dicta.[240] The other case was *State ex rel. Claugus Family Farm, L.P. v. Seventh District Court of Appeals*.[241] In *Claugus*, the court stated that there would not be an implied covenant of reasonable development because the lease stated a period within which development must begin. The court then stated, "In addition, there is specific language in the lease that disclaims any implied covenant."[242] The court then declared, "For these reasons, we hold that . . . the leases preclude the imposition of an implied covenant of develop within the primary term of the lease."[243] These cases from multiple appellate districts, combined with the statements from the Ohio Supreme Court, should suffice to make a general waiver enforceable anywhere in that state.

In contrast to Ohio, most states do not have any cases that address a general waiver of all implied covenants. As previously noted, though, courts from several jurisdictions have stated that express lease clauses can negate the existence of an implied covenant. Further, some states have cases holding that a lease clause need not expressly negate an implied covenant in order to preclude the existence of such a covenant. Instead, it is sufficient that an express clause addresses the same type of performance as that which is covered by the implied covenant. Thus, a clause that expressly imposes a duty to drill a specified number of wells may preclude the existence of an implied covenant of reasonable development. Such cases could be cited in support of the proposition that a general waiver of implied covenants is enforceable.

The only potential hurdle to the enforceability of a general waiver of all implied covenants would be a conclusion by a court in some jurisdiction that public policy so favors the protection of lessees that a general wavier should not be enforced. But the authorities previously cited, along with a general public policy favoring freedom of contract, would weigh in favor of the enforcement of a general waiver of all implied covenants.

Nevertheless, a state appellate court in Louisiana stated that, for reasons of public policy, the parties to a lease do not have the contractual freedom to preclude altogether the implied covenant of reasonable

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covenants was effective); Holonko v. Collins, 1988 WL 70900 (Ohio Ct. App. 7th Dist. 1988) (same).

240. 95 N.E.3d 382 (Ohio 2018).

241. 47 N.E.3d 836, 843 (Ohio 2016).

242. *Id*.

243. *Id.*

development.[244] But it is not clear that the statement is a correct expression of Louisiana law, much less the law of any other jurisdiction, and the statement certainly was dicta. The case did not even involve a lease that purported to eliminate the implied covenant of reasonable development or to eliminate all implied covenants. Instead, it involved a retained acreage clause. Further, a Louisiana Supreme Court case cited by the appellate court merely said that "it would require a very clear and unmistakable contract" to preclude a duty to drill and market, not that public policy would bar enforcement of a clause that disclaimed implied covenants.[245]

8. Clause Making an Express Disclaimer of Specific Implied Covenants

Rather than disclaiming all implied covenants, a lease could disclaim one or more specific implied covenants. Some leases do this by expressly imposing upon the lessee a specifically defined duty involving the same type of performance as is required by one of the implied covenants, but without expressly disclaiming the implied covenant. It seems that relatively few leases contain a clause that expressly precludes specific implied covenants. Certainly, few cases deal with an express waiver of a specific implied covenant, but one such case is *Linn v. Wehrle*.[246] In *Linn*, a lessor brought suit, asserting that the lessee had breached the implied covenant to protect against drainage, but the lease expressly stated that "there shall be no implied covenant to drill or protect lines" (to "protect lines" was to protect against drainage). A state appellate court from Ohio held that this clause precluded the existence of an implied covenant to drill or protect against drainage. The parties to an oil and gas lease could use similar language to expressly preclude one or more implied covenants.

Parties should also keep in mind that some court decisions hold that a lease clause that expressly imposes a particular type of duty will preclude the existence of an implied covenant for the same type of performance.

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244. Dawes v. Hale, 421 So. 2d 1208 (La. App. 2d Cir. 1982).

245. *Id*. at 1211 (citing Hutchinson v. Atlas Oil Co., 87 So. 265 (La. 1921)). The state appellate court also cited a United States Fifth Circuit case, but the Fifth Circuit, sitting as an *Erie* court, merely stated that "[i]t would require a clear and unequivocal clause in a lease" to preclude implied covenants. *Id.* (citing Williams v. Humble Oil & Refining Co., 432 F.2d 165 (5th Cir. 1970)).

246. 172 N.E.2d 288, 289 (Ohio Ct. App. 5th Dist. 1928).

9. Restriction of Marketing Covenant

Traditionally, the implied covenant to diligently market required the lessee to diligently seek a market and perhaps to seek the best price reasonably available. In some states, however, courts have held that the implied covenant to diligently market requires the lessee to absorb the entirety of so-called post-production costs, unless the royalty clause in the lease expressly provides to the contrary.

This issue arises most often with respect to the lease royalties to be paid on natural gas. As noted in the "Primer" Section of this Article, the royalty clauses of many oil and gas leases provide for a royalty on natural gas to be paid based on the value of gas at the wellhead (or based on the amount received on the sale of the gas, but "calculated at the wellhead"). In the past, gas often was sold at or near the wellhead, and the calculation of the royalty was straightforward. But now, natural gas is often sold at a market a great distance away. Further, after the gas is brought to the surface at the well, but before the gas is sold at a market some distance away, the lessee often incurs "post-production" costs for tasks that increase the value of the gas.

This leads to disputes regarding how to calculate the royalty. Lessees typically use a "workback" method, estimating the value at the well as being equal to the ultimate sales price, minus any post-production costs. This method is accepted in several states, but in some jurisdictions lessors have successfully argued that the implied covenant to diligently market requires the lessee to absorb the entirety of post-production costs, or at least those costs necessary to make the gas "marketable," even if that means the royalty is calculated based on a sales price that is greater than the value that the gas had at the well. The lessee obviously would prefer to avoid this result.

Under the basic tenets of implied covenant law, parties should be able to preclude the existence of any implied covenant with express language in the lease. Thus, in states that have held that the implied covenant to diligently market generally precludes use of the workback method, lessees who wish to pay a royalty based on the value of gas at the well should include in the lease language that specifically provides for the royalty on natural gas to be paid based on a sales price minus any post-production costs incurred up until the time of sale. Such a clause might read (assuming for purposes of this example a 20% royalty):

> The royalty to be paid on natural gas that is produced and sold will be one-fifth of the difference between the sales price and the post-production costs that the lessee incurs for the gathering, dehydration, sweetening, treatment, compression, and transport of

> such natural gas. The lessee will not be bound by an implied covenant or obligation to absorb all costs up to the point that the gas becomes marketable or to pay a royalty based on the price or value of natural gas after the gas has been made marketable.[247]

B. Clauses to Benefit Lessors

Like lessees, lessors also can bargain for lease clauses that will provide greater protection to them than would be provided by implied covenants jurisprudence. Arguably, such clauses are outside the scope of an "implied covenant" topic because the clauses that would provide such protection to lessors typically either establish: *express* covenants; or convert the type of performance that otherwise would have an implied covenant into a limitation or condition, rather than a covenant. Nevertheless, because the clauses that benefit lessors are closely related to the topic of implied covenants, and often will have the effect of precluding the existence of an implied covenant, some of the types of clauses that could benefit a lessor are discussed below.

1. Termination if Breach is Not Corrected Within Specified Time of Occurrence of Breach

Lessors can use lease language to provide themselves with greater protection or benefits than are supplied under jurisprudentially-recognized implied covenants. They can do so by imposing express duties that either replace or supplement the implied covenants or by using express clauses to convert the implied covenants from mere covenants to either conditions or limitations.[248] For example, a lessor could propose language that provides that the lease terminates automatically if the breach of an implied

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247. The language above is not quoted from a case or from an actual lease. The language was drafted by the author of this Article. Others may be able to improve on this language.

248. By definition, lessors generally cannot use lease language to obtain greater protection from implied covenants than is provided by the jurisprudentially-recognized implied covenants. If a lessor uses the lease to expressly impose certain duties, those duties are express covenants, not implied covenants. If a lessor includes in the lease language that provides for automatic termination if a breach of an implied covenant occurs or if a breach is not corrected within a certain time, that language converts the implied covenant into a condition or limitation. Here, by "limitation," the author refers to an event or circumstance that leads to automatic termination of the lease, without any action of the lessor. A "condition" would be an event or circumstance that makes the lease subject to termination at the option of the lessor.

covenant is not corrected within a certain amount of time from the first date on which the lessee had an implied duty to act. For example, such a clause might read:

> Whenever the lessee is bound by an implied covenant, this lease will terminate unless the lessee takes the actions that a reasonably prudent operator would take within ninety days after the first existence of circumstances that give rise to an implied duty to act.[249]

A clause specifically directed to the duty to protect against drainage might read:

> If production from a well on lands other than the leased premises begins draining hydrocarbons from beneath the leased premises, this lease will terminate unless the lessor commences action to protect the leased premises from drainage within ninety days of the start of the drainage.[250]

Of course, a lessee should try to avoid the use of such lease clauses. Assuming the lessor bargains for such a clause and has the bargaining power to obtain the lessee's consent, the lessee should make sure that the clause gives the lessee an adequate time to act *after* the duty to act arises. Otherwise, the lessee would have to anticipate potential duties in advance of the duties arising.

2. Termination if Breach Not Cured or Cure Not Commenced Within Specified Time of Demand for Cure

Rather than providing for automatic termination if the lessee does not act within a specified time of a duty to act arising, a lessor could bargain for a clause that provides for automatic termination or termination at the option of the lessor if the lessee does not correct a breach within a specified time of the lessor giving the lessee notice of the breach. Such a clause might read:

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249. This language does not come from an actual lease. It was drafted for purposes of illustration by the author. Others may be able to improve on this language.

250. This language does not come from an actual lease. It was drafted for purposes of illustration by the author. Others may be able to improve on this language. If the lessor does not own mineral rights at all depths, the lessor should consider use of a clause that requires protection against drainage from wells drilled at depths above or below the depths where the lessor has rights.

> If the Lessee shall fail for a period of sixty (60) days after written notice given to it by the Lessor to comply with any provision of this lease, the Lessor may, at his option, terminate this lease.[251]

If a lessor bargains for such a clause, it should consider replacing "provision" with "express or implied covenant" or some similar language to make clear that the clause applies to implied covenant duties, not just express lease provisions.

3. Express Clauses that Specify Certain Duties

Implied covenants provide some protection or benefits to lessors. Lessors can obtain additional protection by negotiating for express lease clauses that either replace or supplement particular implied covenants. Because such clauses impose express duties, and because this Article deals with implied covenants, this Article will not attempt to address in any detail the clauses that a lessor may wish to include in a lease. Nevertheless, this Section of this Article will briefly identify some of the substantive clauses that a lessor might wish to consider that modify, supplement, or relate most closely to the types of duties imposed by implied covenants.

For example, to encourage more exploration or development, prospective lessors can negotiate for a Pugh Clause. Such a clause alters the general rule regarding the effect production (and drilling) from a pooled unit. Under the default rule, production in paying quantities from a pooled unit that includes a portion of the leased premises will be sufficient to maintain the entire lease, even if portions of the leased premises are not included in the unit. A Pugh Clause provides that production from a pooled unit will not maintain the lease as to any areas that are outside the unit. A Pugh Clause can have the effect of encouraging additional drilling by the lessee in order to maintain the lease as to areas outside the pooled unit.

The following is an example of a Pugh Clause that was contained in a lease in Texas:

> In the event a portion or portions of the land herein leased is pooled or unitized with other land so as to form a pooled unit or units, operations on, completion of a well upon, or production from such unit or units will not maintain this lease in force as to the land not included in such unit or units. The lease may be maintained in force as to any land covered hereby and not included

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251. This clause appeared in Renner v. Huntington Hawthorne Oil & Gas Co., 238 P.2d 35 (Cal. App. 1951), vacated by 244 P.2d 895 (Cal. 1952). *See also* MARTIN & KRAMER, *supra* note 132, at § 682.1.

> in such unit or units in any manner provided for herein; provided that if it be by rental payments, rentals shall be reduced in proportion to the number of acres covered hereby and included in such unit or units.[252]

There is no standard language for a Pugh Clause. Thus, the parties should carefully consider the effect of the language used with respect to questions such as: whether the Pugh Clause applies with respect to any unit well or only unit wells not located on the leased premises; and whether the Pugh Clause applies only when a unit includes both a portion of the leased premises and also lands not covered by the lease, or whether the Pugh Clause also will apply in the event that all the lands in the unit are covered by the lease.

Prospective lessors should note that a Pugh Clause does not limit the lease maintenance effect of a well that is not a unit well. Thus, if a well that is not a unit well is located on the leased premises and is producing in paying quantities, that well will maintain the entire lease. A prospective lessor may want to consider negotiating for a lease clause that limits the lease maintenance effect of a well that is not a unit well to a specified area. That area could be a set number of acres or it could be based on the spacing rules that apply in the area. For example, the lease maintenance effect of a lease would be limited to 160 acres. The next question to answer would be the boundaries of the area. One possibility is for the lease clause to require the lessee to designate, within a specified time, the area that will be maintained by production from the well. Other alternatives are to provide that a well will not maintain the lease as to any area outside the governmental survey section (if the well will be allowed to maintain 640 acres) or quarter section (if the well will be allowed to maintain 160 acres) where the well is located. But lessees should be wary of such a clause that is based on governmental survey areas. Depending on the location of the well relative lease lines and the section or quarter section boundary lines, limiting the effect of lease maintenance in such a way might yield odd results.

Alternatively, if a lessor has the bargaining power, it can seek to have the lease specify a minimum number of wells that must be drilled with a certain time. Or, the lease could require a new well be started with a specified amount of time from the completion of the prior well. The lease could provide that once the lessee fails to begin a new well within the specified time, the lease will terminate as to all areas not within either a pooled unit that has production in paying quantities or within a specified area around any well that is producing in paying quantities that is not a unit well.

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252. Friedrich v. Amoco Production Co., 698 S.W.2d 748, 750 (Tex. App. 1985).

A lessor should also consider limiting the effect of lease maintenance by depth. Under the general rule, production in paying quantities from anywhere on the lease will maintain the entire lease—both as to areal coverage and as to all depths. That is, production that maintains the lease as to a certain area on a map would maintain the lease as to all depths beneath that area. Both a *traditional* Pugh Clause and the type of clause discussed in the immediately preceding paragraph modify the general rule by restricting the effect of lease maintenance, but the restriction only applies to the areal extent of lease maintenance. In contrast, a "horizontal Pugh Clause" regulates and limits the lease maintenance effect of production or drilling by depth. The following language is an example of a lease clause that combines a traditional Pugh clause with a horizontal Pugh Clause, with the horizontal Pugh Clause language being showing in italics:

> This lease shall expire at the end of the primary term hereof or any extension thereof by reason of operations being conducted at the end of the primary term hereof as to all land outside any pooled and/or proration unit assigned to any well theretofore completed as a well capable of producing oil and/or gas *and also shall expire as to all depths below the deepest depth drilled theretofore established in a well located on lands covered by this lease.*[253]

A horizontal Pugh Clause can encourage the lessee to explore or develop the leased premises at deeper depths.

Given that many states allow the use of the workback method for calculating the royalty on natural gas, a lessor may wish to negotiate for the royalty clause to provide that the royalty will be based on the price obtained in the first arms-length sale of the gas or perhaps the first sale to a buyer that is not an affiliate of the lessee.

In addition, prospective lessors may wish to negotiate for an offset well covenant. An offset well covenant is a clause in a lease that requires the lessee to drill an offset well in the event that a well located within a specified distance of the leased premises begins producing oil or gas. Such a covenant can provide protection to the lessor by imposing a requirement on the lessee to drill a well, even without the lessor necessarily having to prove that a reasonably prudent operator would drill such a well in order to protect against drainage. If the parties agree to such a clause, the clause should address issues as:

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253. Albert v. Dunlap Exploration, Inc., 457 S.W.3d 554, 557 (Tex. App. 2015).

> How close must a well on a neighboring tract be from the leased premises in order to trigger the offset well covenant?
> Is the specified distance based on the surface location of the neighboring well, the wellbore's nearest approach to the leased premises, the perforation of the wellbore that is closed to the leased premises?
> Is the distance the same for oil wells versus gas wells?
> Does the distance depend on whether the well has been hydraulically fractured? and
> Is it necessary that there be drainage in order for the express offset clause to apply?

The following is an example of an offset well covenant:

> In the event a well or wells producing oil or gas in paying quantities should be brought in on adjacent lands and within one hundred fifty (150) feet of and draining the leased premises, lessee agrees to drill such offset wells as a reasonably prudent operator would drill under the same or similar circumstances.[254]

Lessors should note, however, that this clause is probably too narrow to provide much protection, and that the lessor therefore likely would want to modify the language. There are several reasons why this clause provides very little protection for the lessor. First, the spacing or setback rules of many states will require a well to be more than 150 feet from a lease line, so few wells will trigger the clause. Second, the clause only requires the lessee to drill offset wells that a reasonably prudent operator would drill. Thus, the clause adds nothing to the duties that would be imposed by an implied covenant to protect against drainage. Further, the existence of an express offset well covenant might prompt a court to conclude that the express covenant precludes the existence of an implied covenant. If that happens, the lessee might have a narrower duty to protect against drainage

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254. Hutchins v. Humble Oil & Refining Co., 161 S.W.2d 571, 573 (Tex. App. 1942). An express offset well covenant in a Louisiana lease form contains almost identical language. Paragraph 9 of Bath's Form Louisiana Spec. 14-BR1-2A/12/79, which is available from M.L. Bath Company Ltd., Inc. in Shreveport, Louisiana, states:

> In the event a well or wells, producing oil, gas, casinghead gas or condensate in paying quantities should be brought in on adjacent lands not owned by the Lessor and within one hundred fifty feet of and draining the leased premises, Lessee agrees to drill such offset well or wells as a reasonably prudent operator would drill under the same or similar circumstances.

than if the lease lacked an express well covenant because an implied covenant to protect against drainage often would require the lessee to provide more protection against drainage than is required by the above-quoted express offset well covenant.

From the standpoint of the lessor, a much better example of an offset well covenant is quoted in *Adams v. Murphy Exploration and Production Co.-USA*.[255] In that case, an express offset well covenant imposes duties on the lessee whenever "a well is completed as a producer of oil and/or gas on land adjacent and contiguous to the leased premises, and within 467 feet of the premises covered by this lease." Note that, under this clause, the lessee's duties are triggered by a well much further from the leased premises than in the other example quoted above. Further, the triggering of the lessee's duty does not depend on whether a reasonably prudent operator would drill an offset well.

If the lessor only owns minerals as to certain depths, the lessor may wish to include lease language that ensures that the duty to protect against drainage and any offset well duty applies so as to protect the leased area against drainage from a well located at a different depth, and not merely to protect against drainage from a well located beneath a neighboring tract of land.

In addition, given that most states that have addressed the issue have rejected an implied covenant of surface restoration, prospective lessors may wish for a clause that requires the lessee to take reasonable steps to restore the surface to its original condition after the lease terminates and possibly also during the life of the lease as to areas where drilling or production is no longer active. This could include a duty to remove equipment, tanks, piping, and concrete slabs, and to fill any pits and perhaps restore sod or other vegetation.

Finally, if a lessor does negotiate to include such clauses in a lease, the lessor should keep in mind that courts typically hold that a lease clause that addresses a particular type of duty (such as by imposing a specific duty) will have the effect of precluding any implied covenant, even if the clause does not expressly negate the implied covenant. Thus, the express clause might replace the implied covenant, rather than supplementing it. For this reason, the lessor should consider some language to provide that the implied covenants that otherwise would exist are not negated. Such a clause might be an introductory phrase to a clause imposing a specific duty, with the introductory phrase stating something like, "Without negating the existence of any implied covenant that otherwise would exist,

255. 497 S.W.3d 510 (Tex. App.—San Antonio 2016), *rev'd*, 560 S.W.3d 105 (Tex. 2018), *opinion corrected and superseded* (Nov. 30, 2018).

the parties hereby agree that . . . ." Or, the parties could supplement the express duty with a duty to also take the steps that a reasonably prudent operator would take. For example, after specifying express offset duties, the lease could include a clause stating, "In addition, the lessee will drill any additional offset wells or take other appropriate steps to protect against drainage to the extent that a reasonably prudent operator would."

CONCLUSION

Implied covenants are obligations that are not expressly stated in an oil and gas lease, but that are nevertheless binding on lessees. Some of the most significant implied covenant obligations require a lessee to develop proven formations, explore new areas, protect the leased premises against drainage, and diligently market any oil and gas discovered to the extent that a reasonably prudent operator would. Parties can supersede or supplement implied covenants with express lease clauses.