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IMPLIED DUTIES UNDER OIL AND GAS LEASES[1]

Implied covenants 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 paper are adapted from the author's prior papers and articles on implied covenants, including papers prepared in connection with Rocky Mountain Mineral Law Foundation events. *See also* Keith B. Hall, *Implied Covenants and Changing Technology*, PROC. OF THE 60TH ANNUAL MINERAL L. INST. (2013); Keith B. Hall, *The Application of Oil & Gas Lease Implied Covenants in Shale Plays: Old Meets New*, PROC. OF THE 60TH ANNUAL MINERAL L. INST. (2011); Keith B. Hall, *Implied Covenants: Claims Under Mineral Code Article 122*, PROC. OF THE 57TH ANNUAL MINERAL 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 in Louisiana, Texas, and other states routinely hold that oil and gas lessees are bound by several implied covenants. This Article begins by discussing the reason that implied covenants exist, then it reviews the various implied covenants that courts have recognized, as well as a number of issues that can arise in implied covenant disputes, such as the elements necessary to establish a breach of an implied covenant, defenses, and remedies that are available. This Article emphasizes Louisiana and Texas law, though some cases from other jurisdictions are mentioned.

I. HISTORY OF AND JUSTIFICATIONS FOR IMPLIED COVENANTS

For more than 100 years, courts in Louisiana, Texas, and elsewhere have held that mineral leases contain various implied covenants—that is, obligations that are not expressly stated in a lease but which are nevertheless binding on lessees. For example, in 1891, the Texas Supreme Court declared that a person holding a mining lease had an implied duty to reasonably develop the leased premises.[3] In 1904, a Texas appellate court stated that an oil and gas lessee had an implied duty "to explore and develop the land with diligence."[4] And, in 1919, the Texas Supreme Court recognized that oil and gas leaseholders are bound by implied covenants.[5] In 1913, the Louisiana Supreme Court stated: "[W]hen the existence of oil in paying quantities is made apparent, the lessee shall put down as many

2. *Covenant*, BLACK'S LAW DICTIONARY (6th ed. 1990) 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." *See also* Johnson v. Gurley, 52 Tex. 222, 226 (1879) ("A covenant is an agreement duly made between the parties to do or not to do a particular act."); Landscape Design & Const., Inc. v. Harold Thomas Excavating, Inc., 604 S.W.2d 374, 376 (Tex. Civ. App. 1980) ("A covenant . . . is an agreement to act or refrain from acting in a certain way.").

3. Benavides v. Hunt, 15 S.W. 396, 401 (Tex. 1891).

4. J.M. Guffey Petroleum Co. v. Oliver, 79 S.W. 884, 888 (Tex. App. 1904). *See also* J.M. Guffey Petroleum Co. v. Jeff Chaisson Townsite Co., 107 S.W. 609, 612 (Tex. App. 1907) (lessee had implied obligation "to use reasonable diligence and care to develop and protect the property, and this obligation required it to sink as many wells as the exercise of such diligence and care would suggest under the circumstances . . . ."). Guffey Petroleum, whose first operations were conducted in south Texas, would later become Gulf Oil. *See* ANTHONY SAMPSON, THE SEVEN SISTERS: THE GREAT OIL COMPANIES & THE WORLD THEY SHAPED 37–40 (1975); Daniel Yergin, THE PRIZE: THE EPIC QUEST FOR OIL, MONEY & POWER 71–76 (1991).

5. Grubb v. McAfee, 212 S.W. 464, 465–66 (Tex. 1919).

wells as may be reasonably necessary to secure the oil, for the common benefit of himself and the lessor."[6] In 1921, the Louisiana Supreme Court recognized an implied duty to market any product found in paying quantities.[7] Further, in 1932, more than 90 years ago, the Court recognized an implied covenant to protect against drainage.[8]

With respect to oil and gas leases, certain states recognized implied covenants even earlier than Louisiana and Texas. The earliest oil and gas case to recognize the existence of implied covenants in oil and gas leases may have been *Stoddard v. Emery*, a case in which the Pennsylvania Supreme Court stated in dicta in 1889 that oil and gas lessees are bound by an implied covenant to reasonably develop the leased premises.[9] Three years later, the Pennsylvania Supreme Court again stated that a lessee was bound by an implied covenant of reasonable development,[10] and just a few years later, the same court held that lessees are bound by an implied covenant to protect against drainage.[11] Ohio soon followed suit in recognizing implied covenants,[12] as did the United States Eighth Circuit in *Brewster v. Lanyon Zinc Co*.,[13] a decision that has been cited with approval by the Texas Supreme Court[14] and recognized by several commentators as one of the leading cases on implied covenants.[15] Today,

6. Caddo Oil & Mining Co. v. Producers' Oil Co., 64 So. 684 (La. 1913).

7. Hutchinson v. Atlas Oil Co., 87 So. 265 (La. 1920).

8. McCoy v. State Line Oil & Gas Co., 143 So. 58 (La. 1932).

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

10. *See* McKnight v. Mfrs. Nat. Gas Co., 23 A. 164, 166 (Pa. 1892).

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

12. *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).

13. *Brewster*, 140 F. 801.

14. Cole Petroleum Co. v. U.S. Gas & Oil Co., 41 S.W.2d 414, 417 (Tex. 1931); Freeport Sulphur Co. v. Am. Sulphur Royalty Co. of Tex., 6 S.W.2d 1039, 1043–44 (Tex. 1928) (implied obligation to mine sulfur); Tex. Pac. Coal & Oil Co. v. Barker, 6 S.W.2d 1031, 1036 (Tex. 1928).

15. A treatise on Texas oil and gas law states, "The rationale advanced by Texas courts for implying covenants echoes that of the Eighth Circuit in *Brewster v. Lanyon Zinc Co.*" ERNEST E. SMITH & JACQUELINE LANG WEAVER, TEXAS LAW OF OIL AND GAS 5-9 (2nd ed. 2015). *See also* MARTIN & KRAMER, *supra* note 9, § 802 (describing *Brewster* as "landmark" case); JOHN S. LOWE, OIL AND GAS LAW IN A NUTSHELL (5th ed. 2009) (hereinafter, "LOWE, NUTSHELL") (describing *Brewster* as a "leading case"); Jacqueline S. Weaver, *When Express*

implied covenants appear to be recognized in every state with any significant amount of oil and gas jurisprudence.[16]

Implied covenants can be found in many types of contracts—such covenants are not unique to oil and gas leases[17]—but implied covenants seem to play a greater role in the jurisprudence relating to oil and gas leases

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Clauses Bar Implied Covenants, Especially in Natural Gas Marketing Scenarios, 37 NAT. RES. J. 491, 492 n.6 (1997).

16. Numerous Texas cases recognize implied covenants, as do a multitude of cases from other jurisdictions. *See, e.g.*, Coastal Oil & Gas Corp. v. Garza Energy Tr., 268 S.W. 3d 1, 154, n.42 (Tex. 2008); *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); Jacobs v. CNG Transmission Corp., 772 A.2d 445 (Pa. 2001); Smith v. Amoco Prod. 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. P'ship, 553 N.W.2d 784, 789 (N.D. 1996); *Harris*, 48 N.E. 502; Pack v. Santa Fe Mins., a Div. of Santa Fe Int'l Corp., 869 P.2d 323, 330 (Okla. 1994); Cont'l Oil Co. v. Blair, 397 So. 2d 538, 540 (Miss. 1981); Caddo Oil & Mining Co. v. Producers' Oil Co., 134 La. 701, 717 (1913). Various commentators have noted that implied covenants seem to have been recognized in the oil and gas jurisprudence of all states with any significant oil and gas activity. SMITH & WEAVER, *supra* note 15, at 5-17 ("The [implied] covenant [of reasonable development] is recognized in all oil- and gas-producing states . . . ."); Hall, *The Continuing Role of Implied Covenants in Developing Leased Lands*, *supra* note 1 ("The recognition of implied covenants in oil and gas leases is now widespread, if not universal.").

17. *See, e.g.*, Wood v. Lucy, Lady Duff-Gordon, 118 N.E. 214 (N.Y. 1918). *Lucy, Lady Duff-Gordon* is a famous case in which the court held that a party was bound by an implied duty to use "reasonable efforts." *See also* Zilg v. Prentice-Hall, Inc., 717 F.2d 671 (2nd Cir. 1983). Further, the basic law of contracts generally provides that all parties to a contract are bound by an implied covenant of good faith and fair dealing. Such a duty is recognized in court opinions from virtually every state, including Louisiana, as well as by the Restatement (Second) of Contract. For example, Louisiana Civil Code article 1759 states, "Good faith shall govern the conduct of the obligor and obligee in whatever pertains to the obligation." Further, Louisiana Civil Code article 1983 provides, "Contracts must be performed in good faith." Mineral Code article 122 requires a mineral lessee to perform its obligations in good faith. *See also* RESTATEMENT (SECOND) OF CONTRACTS § 205 (AM. L. INST. 1981). Texas contract law may be an exception. *See* City of Midland v. O'Bryant, 18 S.W.3d 209, 215 (Tex. 2000) (finding no general duty of good faith and fair dealing). Although Texas does seem to recognize a general duty of good faith and fair dealing, the state's jurisprudence clearly recognizes that oil and gas lessees are bound by implied covenants. *See, e.g.*, Coastal Oil & Gas Corp. v. Garza Energy Trust, 268 S.W.3d 1, 18–19 (Tex. 2008) (discussing an implied covenant to protect against drainage).

than in the jurisprudence relating to many other types of contracts. The reason for this relates to a distinction between the typical oil and gas lease and those other types of contracts. Many contracts specify the performance that is expected from each party. But this is seldom the case for oil and gas leases. Because of the complexities and uncertainties involved in oil and gas exploration and development, the typical oil and gas lease does not impose many specific obligations on the lessee. For example, the typical lease does not require the lessee to drill any particular number of wells or specify where and to what depth any wells must be drilled.[18] Similarly, leases usually do not specify what a lessee must do to protect the leased premises against drainage or to market any product that is found.[19] All of 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 will receive from the lease transaction.[20] Indeed, 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."[21] There is widespread agreement that it is this lack of detail regarding the lessee's

18. *See* SMITH & WEAVER, *supra* note 15, at 5-3 (" . . . inherent uncertainty makes an express formulation of a sensible development program, offset well provisions, and marketing requirement exceptionally difficult"); Martin, *A Modern Look at Implied Covenants to Explore, Develop, and Market Under Mineral Leases*, 27 S.W. LEGAL FDN. OIL & GAS INST. 172, 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).

19. SMITH & WEAVER, *supra* note 15, at 5-2 (stating that, in typical oil and gas lease, "Except for the royalty clause, relatively little is said about the rights of the lessor, and virtually nothing about the duties of the lessee.").

20. *See* Martin, *A Modern Look at Implied Covenants to Explore, Develop, and Market Under Mineral Leases*, supra note 18, at 194; see *also* Keith B. Hall, *Implied Covenants Claims Under Article 122*, 57TH MIN. L. INST. 172, 173–74 (2010).

21. A.W. Walker, Jr., *The Nature of Property Interests Created by an Oil and Gas Lease in Texas*, 11 TEX. L. REV. 399 (1933); *see also* Bruce M. Kramer & Chris Pearson, *The Implied Marketing Covenant in Oil and Gas Leases: Some Needed Changes for the 80's*, 46 LA. L. REV. 788, 788–89 (1986) (quoting A.W. Walker, Jr., *The Nature of Property Interests Created by an Oil and Gas Lease in Texas*, 11 TEX. L. REV. 399 (1933)).

performance which explains why implied covenants play such a significant role in oil and gas jurisprudence.

On the other hand, there has been substantial disagreement regarding the theoretical or doctrinal basis for implied covenants. Public policy is occasionally cited as a justification for implied covenants,[22] but there are two other theories that are more commonly advanced.[23] One of the two main theories is that implied covenants fill gaps in contracts, thereby giving expression to the parties' own implicit intent. Thus, courts do not *impose* implied covenant obligations on a lessee. Instead, the court merely *finds* the common intent of the parties. Under this theory, implied covenants are implied-in-fact. The second main theory is that courts *impose* implied covenants on lessees as a means to promote fairness.[24] Under this theory, implied covenants are implied-in-law.[25] Prominent commentators have come to different conclusions regarding which theory provides the foundation of implied covenants, and certain commentators have suggested that there might be some truth in both theories.

Of course, the theoretical foundation could be different in different states. Certain prominent commentators have suggested that, in Texas,

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22. Public policy was also cited in the concurring opinion in *Coastal Oil & Gas Corp*., 268 S.W.3d at 46–47. *See also* 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 (1991); Dawes v. Hale, 421 So. 2d 1208, 1211 (La. App. 1982); Kramer & Pearson, *supra* note 21, at 790; Taussig v. Goldking Props. Co., 495 So. 2d 1008, 1014 (La. Ct. App. 1986) (stating that the implied covenant of reasonable development serves public policy), *writ refused*, 502 So. 2d 111 (La. 1987).

23. *See* David E. Pierce, *Exploring the Jurisprudential Underpinnings of the Implied Covenant to Market*, 48 ROCKY MTN. MIN. L. INST. 10-5 (2002).

24. *See, e.g.*, Jacobs v. CNG Transmission Corp., 772 A.2d 445, 455 (Pa. 2001) (referring to fairness); *see also* Pierce, *supra* note 23, at 10-9.

25. 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 9, § 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. *Id.* § 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 Louisiana Civil Code article 1983, the Louisiana Supreme Court 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 Production Co., 603 So. 2d 166, 174 (La. 1992); *see also* LA. REV. STAT. ANN. § 31:122 cmt (1975).

implied covenants are implied-in-fact.[26] Their position seems to be well-supported by statements found in Texas jurisprudence. For example, although the Texas Supreme Court has not expressly resolved whether implied covenants are implied-in-fact or implied-in-law in Texas, the Court has strongly suggested that such covenants are implied-in-fact, stating in one case:

> An implied covenant must rest entirely on the presumed intention of the parties as gathered from the terms as actually expressed in the written instrument itself, and it must appear that it was so clearly within the contemplation of the parties that they deemed it unnecessary to express it, and therefore omitted to do so, or it must appear that it is necessary to infer such a covenant in order to effectuate the full purpose of the contract as a whole as gathered from the written instrument. It is not enough to say that an implied covenant is necessary in order to make the contract fair, or that without such a covenant it would be improvident or unwise, or that the contract would operate unjustly. It must arise from the presumed intention of the parties as gathered from the instrument as a whole.[27]

In another case, the Court stated: "We have consistently stated that implied covenants are not favored by law and will not be read into contracts except as legally necessary to effectuate the plain, clear, unmistakable intent of the parties."[28] Thus, although considerations of fairness and equity might influence Texas courts, the Texas Supreme Court's explanation is clearly consistent with a doctrine that covenants are implied-in-fact.

In the vast majority of cases involving implied covenant disputes, however, the theoretical basis of such covenants never becomes an issue. The parties' dispute will turn on the scope and extent of the lessee's implied covenant duties, on some factual dispute, on a procedural issue relating to implied covenants, or on some issue unrelated to implied covenants, not on whether the covenant at issue is implied-in-fact by the parties' contractual intent or implied-in-law to ensure fairness. But

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26. SMITH & WEAVER, *supra* note 15, at 5-9; Jacqueline L. Weaver, *When Express Clauses Bar Implied Covenants, Especially in Natural Gas Marketing Scenarios*, 37 NAT. RES. J. 491, 497 (1997); A.W. Walker, Jr., *The Nature of the Property Interests Created by an Oil and Gas Lease in Texas*, 11 TEX. L. REV. 399, 404 (1933).

27. Danciger Oil & Refining Co. v. Powell, 154 S.W.2d 632 (Tex. 1928).

28. *In re* Bass, 113 S.W.3d 735, 743 (Tex. 2003).

occasionally, the theoretical basis of implied covenants will matter to the resolution of a dispute. For example, in *Smith v. Amoco Production Co.*,[29] the Kansas Supreme 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 limitations would apply depending on whether the covenant was based on the implied intent of the parties or a rule of fairness imposed by law. Based on similar reasoning, the question of whether covenants are implied-in-law or implied-in-fact might influence resolution of a dispute regarding venue. Moreover, whether covenants are implied-in-law or implied-in-fact might influence a court's resolution of the scope of an implied covenant.

II. THE STANDARD OF CONDUCT FOR COMPLIANCE WITH IMPLIED COVENANTS

Although courts in Texas and elsewhere recognize several different implied covenants, there is a universal standard of conduct for complying with each of the covenants. These courts hold that to comply with each of the implied covenants, oil and gas lessees are required to act as reasonably prudent operators, taking into consideration both their own interests and those of their lessors.[30] 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.*[31] In that case, the United States Tenth Circuit 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."[32] Lessees are

29. 31 P.3d 255, 265 (Kan. 2001).

30. *See, e.g.*, HECI Exploration Co. v. Neel, 982 S.W.2d 881, 887 (Tex. 1998); Amoco Production Co. v. Alexander, 622 S.W.2d 563, 567–79 (Tex. 1981). *See also* 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) (recognizing that a lessee must act as a reasonably prudent operator and consider interests of both itself and lessor); LA. REV. STAT. § 31:122 (1975) (mutual benefit and reasonably prudent operator standard).

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

32. *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).

not held to a fiduciary standard[33] and they are not required to exercise perfect judgment.[34]

III. IMPLIED COVENANTS RECOGNIZED IN JURISPRUDENCE AND DISCUSSED IN COMMENTARY

The jurisprudence of various states and the writings of individual commentators recognize different lists of implied covenants. Part A of this section of this Article discusses the implied covenants that are recognized in Louisiana and Texas. Part B discusses certain implied covenants that either are not or may not be recognized in these two states.

As a broad, preliminary note, readers should be aware that many of the differences in the lists of implied covenants recognized by the various states and commentators are merely semantic. A particular jurisdiction or commentator will use one name to describe an implied covenant, while some other jurisdiction or commentator will use another to describe the same covenant. Or, one jurisdiction will group two or three implied duties under one implied covenant, while another jurisdiction will characterize each of the duties as a separate implied covenant.[35] In addition to these differences in terminology, there also are some substantive differences

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33. *See, e.g.*, *In re* Bass, 113 S.W.3d 735, 743 (Tex. 2003) (involving a mineral estate, rather than a mineral lease, but referring to mineral leases); *HECI Exploration Co.*, 982 S.W.2d at 888 ("Texas law has never recognized a fiduciary relationship between a lessee and royalty owners."). *See also* 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 (1975) (mineral lessee is not a fiduciary).

34. *See* Davis v. Ross Prod. 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").

35. For example, Texas recognizes implied covenants to develop the premises, protect the leasehold, and manage 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., Inc., 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).

between the implied covenants recognized in the various states,[36] both with respect to the substantive duties recognized and the elements necessary to prove a breach. For the most part, however, the similarities tend to be more significant than the differences.

A. Implied Covenants Recognized in Texas and Louisiana.

The various implied covenants can be categorized in various ways. In one way of viewing implied covenants, there are three main implied covenants—(1) a duty to develop the leased premises; (2) a duty to protect the leased premises against drainage; and (3) a duty to diligently market any oil or gas that the lessee finds in paying quantities.[37] In Louisiana, courts seem to recognize a similar grouping of implied covenants.[38]

1. Covenant to Develop the Premises

a. The Texas Duty to Develop

As recognized in Texas jurisprudence, the covenant to develop the premises consists of three duties: (i) the duty to drill an initial test well; (ii) the duty of reasonable development; and (iii) a duty of further exploration.[39]

36. 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 Expl. & Prod. Co. v. Jackson, 783 S.W.2d 202, 204 (Tex. 1990).

37. The Texas Supreme Court has stated that the state recognizes three implied covenants, including duties to: (1) develop the premises; (2) protect the leasehold (which primarily includes a duty to protect against drainage); and (3) administer the lease (which includes a duty to market product). Yzaguirre v. KCS Res., Inc., 53 S.W.3d 368, 373 (Tex. 2001); *HECI Expl. Co*., 982 S.W.2d at 889; Amoco Prod. Co. v. Alexander, 622 S.W.2d 563, 567 (Tex. 1981).

38. *See* LA. MIN. CODE ANN. art. 122 cmt. (1975); Caddo Oil & Mining Co. v. Producers' Oil Co., 64 So. 684 (La. 1913) (reasonable development); McCoy v. State Line Oil & Gas Co., 143 So. 58 (La. 1932) (protection against drainage); Hutchinson v. Atlas Oil Co., 87 So. 265 (La. 1920) (diligent marketing).

39. *HECI Expl. Co*., 982 S.W.2d at 889 (recognizing that implied covenant to develop includes duty to drill an initial well and to reasonably develop the leased premises); Sun Expl. & Prod. Co. v. Jackson, 783 S.W.2d 202 (Tex. 1989)

i. Initial Test Well

Early in the history of the oil and gas industry, courts recognized that a lessee has an implied duty to drill at least one test well on the leased premises within a reasonable time after executing the lease.[40] In part, courts reached this conclusion because many early 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. Further, some leases had long fixed terms, while some "no term" leases allowed a lessee to keep the lease alive indefinitely by paying annual rentals (with the annual rentals sometimes being only a modest amount). This raised issues of fairness and, with some leases, even the possibility that the transaction constituted an illusory promise, unless the lessee had an implied duty to drill within a reasonable time.

But lessees often were not prepared to promptly drill, so they began drafting their leases to include delay rental clauses.[41] These clauses typically provided that if the lessee had not begun drilling by the first anniversary of the granting of the lease, the lease would terminate unless the lessee paid "delay rentals."[42] As interpreted by courts, such clauses eliminate the implied covenant to drill a test well.[43] Parties began including delay rental clauses in their leases more than one hundred years ago. Later, some parties began to draft their leases as "paid up" leases, in which the initial payment to the lessor is deemed to include both a lease bonus and an advance payment of delay rentals for the entire primary term.

(implying that implied covenant to develop could include the drilling of exploratory wells).

40. *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, NUTSHELL, *supra* note 15, at 202–03, 314; Consumers Gas Trs. Co. v. Littler, 70 N.E. 363, 366 (Ind. 1904). *See also* Magnolia Petroleum v. Page, 141 S.W.2d 691 (Tex. App. 1940); Van Every v. Peterson, 24 F.2d 26 (5th Cir. 1928).

41. *See* Conine, *supra* note 40, at 684; 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.

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

43. Magnolia Petroleum v. Page, 141 S.W.2d 691, 693 (Tex. App. 1940):

> . . . when . . . there is no provision for the payment of delay rentals in lieu of drilling . . . there is an implied covenant requiring the lessee to use such diligence in drilling and developing the lease for oil and gas as a reasonable prudent operator would use under the same or similar circumstances.

In fact, for many decades now, almost every oil and gas lease entered in the United States provides either for delay rentals or for an initial payment that is deemed to include delay rentals.[44] In either case, there is no implied duty to drill a test well.[45] For this reason, the implied covenant to drill a test well is rarely significant today,[46] except as part of the historical explanation of the development of leases and delay rental clauses. Indeed, the use of delay rental clauses became so common and occurred so early in the history of the industry[47] that it is challenging to find Texas cases that address the implied covenant to drill an initial well,[48] and those cases which can be found tend to be cases from the first half of the 1900s.[49] Further, sometimes these cases do not clearly distinguish a

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44. MARTIN & KRAMER, *supra* note 9, § 812; Hall, *supra* note 1. 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 M. KRAMER, MANUAL OF OIL & GAS TERMS 685 (14th ed. 2009). 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.

45. Jacqueline Lang Weaver, *When Express Lease Clauses Bar Implied Covenants Especially in Natural Gas Marketing Scenarios*, 37 NAT. RES. J. 491, 502–03 (1997).

46. *See* MARTIN & KRAMER, *supra* note 9, § 812; *see also* Martin, *A Modern Look at Implied Covenants to Explore, Develop, and Market Under Mineral Leases*, *supra* note 18, at 179 ("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.").

47. In a 1933 article, Professor Walker notes that the use of delay rental clauses became common before oil and gas production began in Texas. A.W. Walker, Jr., *The Nature of the Property Interests Created by an Oil and Gas Lease in Texas*, 11 TEX. L. REV. 399, 412 (1933).

48. In his 1933 article, Professor Walker noted that relatively few Texas cases address the question of an implied duty to drill an initial well. *Id.*

49. *Id.* (noting early use of delay rental clauses in Texas). As in Texas, parties in other states began using delay rentals clauses early in the industry's history. At least three reported cases from the author's home state of Louisiana deal with leases granted in early 1901 that contained delay rental clauses. *See* Murray v. Barnhart, 42 So. 489 (La. 1906) (lease granted in March 1901); Jennings-Heywood Oil Syndicate v. Houssiere-Latreille Oil Co., 44 So. 481 (La. 1907) (lease apparently granted in early 1901); Houssiere-Latreille Oil Co. v. Jennings-

duty to drill an initial well from a general duty to develop, but prominent commentators have concluded that the cases established an implied duty to drill an initial well,[50] though the jurisprudence cited for such a conclusion is not wholly free from ambiguity on this point.[51]

Assuming that a lease is not a paid-up lease and that it does not otherwise provide for delay rentals, an implied duty to drill a test well may exist. To establish a claim for breach of the implied covenant to drill an initial test well, a lessor must prove: (1) an unreasonable delay in drilling an initial well; and (2) that the lessor gave notice of the breach and made a demand for performance.[52] A prominent treatise suggests that a lessor would not have to prove that a test well would produce oil or gas in paying quantities, but the treatise also notes a Texas appellate court case that reached a contrary result.[53] Historically, the typical remedy for breach of an implied covenant to drill a test well was termination of the lease.[54]

ii. Reasonable Development

The implied covenant of reasonable development appears to be the first implied covenant that courts applied to mineral lessees,[55] and this

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Heywood Oil Syndicate Co., 38 So. 932 (La. 1905) (lease granted in 1901); *see also* Saunder v. Busch-Everett Co., 71 So. 153 (La. 1916) (leases granted in 1909); Busch-Everett v. Vivian Oil Co., 55 So. 564 (La. 1911) (lease granted in 1909).

50. Walker, Jr., *supra* note 47, at 412; SMITH & WEAVER, *supra* note 15, at 5-15 to 5-16.

51. *See, e.g.*, Carpenter v. Smith, 272 S.W. 128 (Tex. Com. App. 1925), *reversing* 257 S.W. 637 (Tex. Civ. App. 1923).

52. MARTIN & KRAMER, *supra* note 9, § 811.

53. *Id.* (citing Gay v. Grinnan, 218 S.W.2d 1021 (Tex. Ct. App. 1949, *writ ref'd n.r.e.*)). There is also language in *Magnolia Petrol. Co. v. Page*, 141 S.W.2d 691 (Tex. Civ. App. 1940) that could be read as suggesting that a profitability requirement would apply to all claims for breach of the implied covenant to develop, including the implied covenant to drill an initial well, but that language should be considered in the context of the facts of the case, in which it seems to have involved the duty of reasonable development, not the duty to drill an initial well.

54. MARTIN & KRAMER, *supra* note 9 § 811. The cited treatise notes that one Texas appellate court case concluded that a damages award is the appropriate remedy. *Id.* (citing Gay v. Grinnan, 218 S.W.2d 1021 (Tex. Civ. App. 1949, *error refused n.r.e.*)). The treatise persuasively asserts, however, that lease cancellation is a more appropriate remedy because lessors typically will find it impossible to prove that a *test* well would produce oil or gas in paying quantities. *Id.*

55. *See* MARTIN & KRAMER, *supra* note 9, § 802.

covenant seems to be universally recognized in states that have oil and gas jurisprudence.[56] The Texas Supreme Court recognized this implied covenant as being binding under a mining lease in 1891.[57] Texas appellate courts recognized this implied duty in oil and gas leases no later than 1904,[58] and the Texas Supreme Court did so by 1919.[59] With respect to oil and gas leases, the implied covenant of reasonable development generally does not apply until the lessee has established production in paying quantities from the leased premises.[60] After such production is established, this covenant generally requires the lessee to drill as many wells as are reasonably necessary to develop a *proven* formation.[61] Further, Texas

56. *See, e.g.*, Clifton v. Koontz, 325 S.W.2d 684 (Tex. 1959).

57. Benavides v. Hunt, 15 S.W. 396, 401 (Tex. 1891).

58. J.M. Guffey Petroleum Co. v. Oliver, 79 S.W. 884, 888 (Tex. Ct. Civ. App. 1904). *See also* J.M. Guffey Petroleum Co. v. Jeff Chaisson Townsite Co., 107 S.W. 609, 612 (Tex. Ct. Civ. App. 1907) (lessee had implied obligation "to use reasonable diligence and care to develop and protect the property, and this obligation required it to sink as many wells as the exercise of such diligence and care would suggest under the circumstances").

59. Grubb v. McAfee, 212 S.W. 464, 465-6 (Tex. 1919).

60. This is implicit in the language in *Clifton v. Koontz*, 325 S.W.2d 684, 693 (Tex. 1959):

> The courts generally have recognized the implied covenant to reasonably develop the premises after production is obtained. Such implied covenant requires a lessee, after production is discovered on the premises, to conduct further development with reasonable diligence, to the end that such operations would result in a benefit or profit for both the lessor and the lessee.

See also 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 9, § 832; *see also* LA. REV. STAT. ANN. §31:122 cmt. (1975) (stating that, for both an implied covenant to reasonably develop and an implied covenant of reasonable development, "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).

61. Clifton v. Koontz, 325 S.W.2d 684, 693–94 (Tex. 1959); McKnight v. Mfrs. Nat. Gas Co., 23 A. 164, 166 (Pa. 1892); 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); *see* LA. REV. STAT. ANN. § 31:122 cmt. (1975):

> Essentially, the relevant 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.

jurisprudence also suggests that this covenant sometimes imposes a duty to rework an existing well. 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 unless it is likely that the wells would be profitable.[62]

Elements of a Cause of Action for Breach of Duty of Reasonable Development

The elements of a claim for breach of the duty of reasonable development are that production in paying quantities has been obtained on the premises and that a reasonably prudent operator would drill additional wells to develop the proven formation. Because a reasonably prudent operator would not drill a development well unless it is likely to be profitable, proof of the second element—that a reasonably prudent operator would drill one or more additional wells—requires the lessor to prove that an additional well likely would be profitable.

Remedies for Breach of Duty of Reasonable Development

Two potential remedies for breach of the duty of reasonable development are monetary damages and lease cancellation. Courts in Texas and elsewhere have stated that an award of monetary damages is the

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The Louisiana Supreme Court described the implied covenant of reasonable development in 1914 in *Caddo Oil & Mining Co. v. Producers' Oil Co*., 64 So. 684, 690 (1914). 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.

See id. (*quoting* THORNTON ON OIL AND GAS, § 111) [hereinafter THORTON].

62. Clifton v. Koontz, 325 S.W.2d 684, 695–96 (Tex. 1959); Baker v. Collins, 194 N.E.2d 353, 355 (Ill. 1963) (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 9, § 832.

favored remedy.[63] These courts sometimes explain that lease cancellation would be a harsh remedy and that money damages are an adequate remedy. If a court chooses to award a money judgment, a question arises as to the appropriate quantum. The Texas Supreme Court has stated that the lessor is entitled to recover "the full value of royalty lost to him."[64] Some court opinions contain language suggesting that the proper measure of damages is the difference between the royalty income that the lessors should have earned and the royalty income that they actually received.[65]

One potential measure of this difference is the royalty that would have been owed on the amount of oil or gas that would have been produced if the lessee had timely satisfied its development obligation. This is a particularly appropriate measure if the breach of the covenant leads to a permanent loss of the ability to produce certain oil and gas–one source cites as an example of a lessee's failure to drill wells to produce oil from the oil zone of a gas-cap-drive field prior to the depletion of reservoir pressure from the production of gas.[66]

But the more common consequence of a lessee's breach of its duty of reasonable development will not be a permanent loss of the hydrocarbons but instead merely a delay in their production. Accordingly, recent decisions in Texas seem to have recognized that the proper measure of damages for a breach of the implied duty of reasonable development sometimes will be interest on the difference obtained when the amount of royalties actually paid is subtracted from the amount that would have been due if the lessee had not breached its duty.[67] It will not always be easy, however, to determine this amount. Unless the hydrocarbons that should have been produced early have been produced by the time of trial, it will be difficult to calculate an amount of interest that grants complete relief because the court will not know when the hydrocarbons will be produced.

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63. *See, e.g.*, W.T. Waggoner Est. v. Sigler Oil Co., 19 S.W.2d 27, 29 (Tex. 1929).

64. Coastal Oil & Gas Corp. v. Garza Energy Trust, 268 S.W.3d 1, 19 (Tex. 2008); Tex. Pac. Coal & Oil Co. v. Barker, 6 S.W.2d 1031, 1038 (Tex. 1928).

65. *See, e.g.*, *Tex. Pac. Coal & Oil Co*., 6 S.W.2d at 1038.

66. MARTIN & KRAMER, *supra* note 9, § 831.

67. For example, in *Garza*, the appellate court rejected the lessors' argument that the trial court erred by failing to award the difference between the royalties that should have been paid and those that actually were paid, and by instead only awarding interest on that sum. Mission Resources, Inc. v. Garza Energy Trust, 166 S.W.3d 301, 320 (Tex. App. 2005). By the time that case reached the Texas Supreme Court, the lessors apparently conceded that they would not be owed the full difference between the royalties that should have been paid and those which were paid. *Coastal Oil & Gas Corp*., 268 S.W.3d at 19.

Further, changes in the price of oil or gas can further complicate a calculation of the "interest" measure of damages. Should an adjustment upward or downward in the amount of an award be made because of changes in price? This was an issue in the *Garza* case.[68] In *Garza*, by the time the case reached the Texas Supreme Court, the parties claimed that the proper measure of damage for a delay in production would include interest and an adjustment for a change in prices between the time the product should have been produced and the time that it was produced.[69] The Texas Supreme Court seemed to accept this as the proper measure (though it should be acknowledged that because the parties were in agreement on this point, the Supreme Court was not actually required to rule on the issue).

Moreover, it should be noted that an early decision of the Texas Supreme Court—*Texas Pacific Coal & Oil Co. v. Barker*—seemed to conclude that interest is not an adequate measure of damages.[70] The court stated that such a measure is "impracticable in actual application because of difficulties in fixing the period of which interest should be awarded."[71] If, for example, oil has still not been produced, what length of time should be used in calculating interest? Suppose that the court uses the period of time between the date when oil should have been produced and the date of trial, but the oil still has not been produced. In such a case, the lessor will continue to incur delay damages after trial, but the award does not compensate him for those post-trial damages. A response to this dilemma could be that the lessor brings a second suit, but such a multiplicity of actions is undesirable. Accordingly, the Texas Supreme Court reasoned that a lessor should be entitled to the full amount that would have been paid on the production from additional development wells, not merely the interest on such a sum.[72]

The second potential type of remedy is lease cancellation. Texas courts have recognized that, although money damages are the favored remedy, lease cancellation sometimes can be most appropriate.[73] There can be different degrees of cancellation. For example, there can be cancellation of the entire lease or cancellation of only the portions of the lease that the lessee has failed to appropriately develop. Texas courts typically will not grant complete cancellation. Instead, when courts grant cancellation, they typically will cancel the areas where there has been a

68. *Mission Resources, Inc.*, 166 S.W.3d at 320.
69. *Id.*
70. *Tex. Pac. Coal & Oil Co*., 6 S.W.2d at 1037.
71. *Id.* at 1037.
72. *Id.*
73. *Id.*

lack of development.[74] Such an order of cancellation may take the form of canceling the lease, except for a specified number of acres around each productive well.

Further, a cancellation can be conditional or unconditional. A conditional cancellation is a court order stating that the lease or portions of it will be canceled if the lessee does not drill a specified number of development wells by some specified date.[75] A conditional cancellation gives the lessee a last chance to perform before the harsh remedy of cancellation is imposed. In contrast to a court order that provides for conditional cancellation, an unconditional cancellation simply cancels the lease or portions of it. Texas courts rarely grant an unconditional cancellation.[76]

Finally, it should be noted that if the lessor wishes to bring suit for a breach of the duty to develop, the lessor might not be entitled to bring suit unless he has given the lessee notice of the alleged breach and a reasonable opportunity to cure it. Some states make notice and opportunity to cure a prerequisite to any suit for breach of the duty to develop.[77] This potential requirement is mentioned in the "remedy" section of this paper because, in some states, the necessity for notice will depend on the remedy sought by the lessor. In such states, notice and an opportunity to cure is a prerequisite to any suit seeking lease cancellation for an alleged breach of implied covenants, but not for a suit that merely seeks a money judgment. A prominent secondary authority implies that notice and an opportunity to cure may be a prerequisite to a suit seeking cancellation in Texas.[78] Further, some leases contain clauses that expressly make notice and an opportunity to cure a prerequisite to filing suit, and courts generally will enforce such clauses.

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74. *See, e.g.*, W.T. Waggoner Estate v. Sigler Oil Co., 19 S.W.2d 27, 32 (Tex. 1929).

75. *Id.*

76. SMITH & WEAVER, *supra* note 15, at 5-22 to 5-23 (noting that Texas courts have recognized that unconditional cancellation could be proper in the event of "egregious conduct by the lessee," the authors were not aware of cases in which unconditional cancellation was awarded as a remedy for a breach of the duty of reasonable development). *See also* Slaughter v. Cities Service Oil Co., 660 S.W.2d 8860 (Tex. App. 1983).

77. *See, e.g.*, LA. REV. STAT. § 31:136 (1975).

78. SMITH & WEAVER, *supra* note 15, at 5-18 to 5-19.

iii. Further Exploration

The preceding subsection of this paper discusses the duty of reasonable development, which requires the operator to drill as many wells as reasonably necessary to develop a proven formation. Such a duty protects the interests of lessors, who have an obvious interest in the development of proven formations. But, as a supplement to this duty, some commentators have endorsed the recognition of an implied covenant for the further exploration of unproven areas and depths.

For example, in an article published in the Texas Law Review in 1956, Professor Meyers argued that some cases had implicitly recognized an implied duty to conduct further exploration in unproven areas, even while referring to a duty to develop, and that courts should expressly recognize a duty to explore. [79] Professor Meyers asserted that, in order for a lessor to prove a breach of such a covenant, the lessor should not have to prove that an exploration well would be profitable.[80] He asserted that proving the probability of profit is an appropriate requirement for a lessor's claim that a lessee should drill an additional well into a proven formation from which the lessee already is producing hydrocarbons on the leased premises.[81] But this standard is not appropriate with respect to exploration wells. Lessors have an interest in seeing further exploration and because of the enormous benefit that can come from the discovery of a new formation, a reasonably prudent lessee sometimes would drill an exploratory well even if there is not a greater-than-even chance that such a well will yield a profit. Therefore, Professor Meyers asserted, a lessor should be able to show a breach of an implied duty of further exploration by showing that the lessee has failed to drill an exploratory well that a reasonably prudent operator would drill, even though the available evidence does not establish that an exploratory well would likely be profitable.

Some other commentators promptly expressed disagreement,[82] and the implied covenant of further exploration remains controversial.[83] But at least one court outside of Texas has recognized such an implied duty.[84]

79. Charles J. Meyers, *The Covenant of Further Exploration*, 34 TEX. L. REV. 553 (1956).

80. *Id.* at 557.

81. *Id.*

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

83. *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).

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

Otherwise, Professor Meyers's recommendation that courts should explicitly recognize a duty of further exploration that does not depend on likely profitability, and which is a separate duty from the duty of reasonable development, has not found much support in jurisprudence. Nevertheless, courts in multiple jurisdictions have implicitly recognized a duty to explore.

Where does Texas stand on this question? In a couple of cases, the Texas Supreme Court has addressed the issue.[85] In those cases, the Texas Supreme Court held that, in Texas, there is not an implied covenant of further exploration that is separate and apart from the duty of development. Instead stated the Court, putting aside for a moment the entirely separate issue of protection against drainage, any claim that a lessee breached an implied covenant to drill a well—whether a development well or an exploratory well—would fall under the implied covenant to develop the leasehold. Thus, the Court seemed to suggest that a lessor could assert a potentially valid claim based on a lessee's failure to drill an exploratory well but that such a claim simply would have to come under the already-recognized implied covenant to develop the lease. The author of this Article is not the only commentator to interpret the Texas Supreme Court's language as recognizing a duty to explore as part of the development covenant. A prominent treatise on Texas oil and gas law reaches the same conclusion.[86]

So, would a Texas lessor who brings a claim for breach of a duty to explore have to prove that an exploratory well likely would be profitable? Here, the Texas Supreme Court's prior decisions are clear.[87] Because likely-profitability is a required element of a claim for breach of the implied covenant of reasonable development, a Texas lessor who alleges a breach of the duty to explore generally would have to show that an exploratory well would probably be profitable. As a practical matter, this generally will make it very challenging for a lessor in Texas to prevail on a duty-to-explore claim.

It is possible, however, that there may be a limited exception to the profitability requirement. The first of two cases in which the Texas Supreme Court addressed a claim relating to an alleged breach of a duty to explore was *Clifton*, which involved a lease that covered about 350 acres. In that case, the lessee drilled the first well on the leased premises in 1949 and acidized the well in 1950. The lessors filed suit in

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85. Sun Expl. & Prod. Co. v. Jackson, 783 S.W.2d 202 (Tex. 1989); Clifton v. Koontz, 328 S.W.2d 684 (Tex. 1959).

86. SMITH & WEAVER, *supra* note 15.

87. *Sun Expl. & Prod. Co.*, 783 S.W.2d 202; *Clifton*, 328 S.W.2d 684.

approximately 1956, at which time the lessee had not drilled any additional wells. The court rejected the lessors' implied covenant claims—as well as the existence of an implied covenant of further exploration that is separate from the duty to develop, but the court also stated:

> However, it should be noted that we do not have a factual situation where the lease covers several thousand acres and an effort is being made to hold such vast acreage by showing production from a comparatively small area. Neither are we confronted with a situation where an unreasonably long length of time has elapsed since the last development of the leased premises. Therefore, we do not pass upon these questions.

In *Sinclair Oil & Gas Co. v. Masterson*, the lessor granted a total of 31 leases between 1916 and 1938, with the leases collectively covering a total of nearly 90,000 acres. The company holding the natural rights drilled 114 wells, and evidence suggested that oil might be present in formations deeper than those from which gas was being produced, but as of early 1955, Sinclair, which held the right to explore for and produce oil, had not drilled any wells.[88] The lessors brought suit.[89] By the time the first hearing was held, about two years after the filing of suit, Sinclair had drilled eight wells, six of them successful, with seven of the eight being located in the same general area.[90] A year later, when a second hearing was held, Sinclair had drilled three more wells, with two of them being successful.[91] The district court entered judgment for the lessors, holding that Sinclair had breached an implied duty to explore.[92] Sinclair appealed, arguing that the judgment should be reversed because evidence did not show that additional exploratory wells likely would be profitable, but the appellate court affirmed, noting the above-quoted language from *Clifton*.[93]

Thus, *Masterston* suggests that a lessor might be able to show a breach of the duty to explore merely by showing that a lease covers a large area and that the lessee has only explored a small portion of it. It is not clear, however, whether *Masterson* provides a correct expression of Texas law. The language from *Clifton* that provides support for a "*Clifton* exception" to the profitability rule was dicta. And, even though the *Sun Exploration* case involved a large leasehold, the Texas Supreme Court did not refer in

88. 271 F.2d 310 (5th Cir. 1959).
89. *Id.*
90. *Id.*
91. *Id.*
92. *Id.*
93. *Id*.

that case to any exception to the profitability rule. Further, a Texas appellate court has concluded that such a *Clifton* exception is not valid under Texas law.[94] But until the Texas Supreme Court definitively resolves the question, the possible existence of a *Clifton* exception remains open.

It is noteworthy that a potential *Clifton* exception would be somewhat similar to results reached in other states. In some jurisdictions, courts have held that a portion of a leasehold was abandoned when a long period passed without exploration activities in unproven areas, without requiring proof that an exploration well would probably be profitable. For example, some courts 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 neither developed, nor explored, despite the passage of a significant amount of time.[95]

Other jurisdictions have found a breach of the covenant to develop, without requiring the lessor to prove that an exploratory well would be profitable (and typically without the court clearly acknowledging the potential difference between a failure to drill development wells and a failure to drill exploratory wells). For example, several Louisiana decisions arguably have imposed an obligation to explore unproven

94. *See* Atlantic Richfield Co. v. Gruy, 720 S.W.2d 121, 124 (Tex. App. 1986). It should be noted, however, that *Atlantic Richfield* relied in part on *Felmont Oil Corp. v. Pan Am. Petroleum Corp*., 334 S.W.2d 449, 458 (Tex. App. 1960), a prior appellate court decision that criticized *Masterson* on the basis that the case treated the nearly-90,000 acres at issue in that case as if they were covered by a single lease, when actually a total of 31 leases covered tracts that collectively totaled nearly 90,000 acres. But such criticism, while perhaps valid, does not undermine the possible existence of a *Clifton* exception for circumstances involving an alleged failure to conduct appropriate exploration of a particular leasehold.

95. *See* Fox Petroleum Co. v. Booker, 253 P. 33 (Okla. 1927) (abandonment). But Oklahoma rejects an "implied covenant of further exploration," at least by name. *See* Mitchell v. Amerada Hess Corp., 638 P.2d 441, 449 (Okla. 1981).

areas,[96] though those courts were applying a duty that they characterized as a duty to "reasonably develop" the leased premises.[97]

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*.[98] In *Carter*, a fault crossed the leased premises.[99] The lessee had drilled wells and developed the property on one side of the fault, but not the other.[100] The lessor demanded that the lessee drill on the other side, but the lessee did not do so.[101] The lessor sued for lease cancellation.[102] The trial court granted partial cancellation, dissolving the lease as to the portion of the property that had not been developed.[103] The lessee appealed the order of partial cancellation (the lessor did not appeal the trial court's refusal to order complete cancellation).[104]

The Louisiana Supreme Court affirmed, after reviewing the evidence and concluding that it showed that a reasonably prudent operator would

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96. *See* Hall, *Implied Covenants: Claims Under Mineral Code Article 122*, *supra* note 1, 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 required further exploration; two others included statements about a duty to test, but the statements were 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* MARTIN & KRAMER, *supra* note 9, § 845.4 ("Louisiana courts are probably the most severe in the country in enforcing an implied duty to explore further").

97. *See* LA. MIN. CODE ANN. art. 122 cmt. (1975); *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 (La. 1948)—refers to the issue in the case as being whether the lessee had reasonably developed the leased property.

98. *Carter*, 36 So.2d 26.

99. *Id.*

100. *Id.*

101. *Id.*

102. *Id.*

103. *Id.*

104. *Id.*

have drilled wells on the side of the fault that had not been developed.[105] 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 suggests 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 by 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 will test every part.[106]

The reference to a duty to "test every part," assuming it was not dicta, effectively recognized an implied duty of further exploration.

Elements of a Claim for Breach of the Duty to Explore

Under Texas law, a lessor who seeks to establish a breach of the implied duty to develop will need to prove that the lessee has obtained production in paying quantities from the leased premises[107] and that a reasonably prudent operator would drill an exploratory well. For purposes of Texas law, in order to prove that a reasonably prudent operator would drill an exploratory well, a lessor generally will need to prove that such a well probably would be profitable.

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105. *Id.*

106. *See id.* 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).

107. For purposes of Texas law, the fact that the duty of further exploration does not arise until there is production in paying quantities follows from the fact that the duty to explore is part of the implied covenant to develop, which typically does not apply (the duty to drill a test well is an exception) until there is production in paying quantities. *See also* MARTIN & KRAMER, *supra* note 9, § 841 (duty to explore arises after there is production in paying quantities). The same rules apply in other states. *See, e.g.*, LA. REV. STAT. ANN. § 31:122 cmt. (1975) (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").

If the so-called *Clifton* exception is valid, a lessor potentially could establish a breach of the duty to explore by proving that the lessee has obtained production in paying quantities from the leased premises and that the lease includes a large area that the lessee has failed to explore for an extended period. The United States Fifth Circuit recognized the existence of such an exception in *Masterson*.[108] Although decisions of Texas courts subsequent to *Masterson* arguably cast doubt on the validity of a *Clifton* exception, the Texas Supreme Court has never addressed the issue expressly. Accordingly, litigants in federal courts in Texas have a strong argument, based on the Fifth Circuit's *Masterson* precedent, that such an exception exists. Federal court litigants opposing such an exception can argue, however, that even though the Texas Supreme Court has not expressly addressed the issue, subsequent decisions undermining the existence of a *Clifton* exception are sufficient to render *Masterson* no-longer-controlling. And of course, in any given case, opponents typically will have a strong argument that even if such an exception exists, it is not applicable under the facts of the case.

Remedies for Breach of Duty to Explore

In theory, the preferred remedy under Texas law for a breach of the duty of further exploration should be money damages. There are two potential elements to the loss—the fact that the property has not been explored and the loss of whatever royalties might have been paid on the production from an exploratory well. It will be difficult to estimate and prove the amount of lost royalties, but in order to prove a breach, a lessor will need to show that an exploratory well probably would have been profitable. If a lessor can prove that, then perhaps the lessor will be able to prove an amount of lost royalties. It may be more difficult to put a dollar figure on the lessor's loss due to the lack of exploration itself, as opposed to the royalties that would have been earned on the production from an exploratory well.

Perhaps, because of such difficulties in determining damages, when a failure to explore has been sufficient to justify the grant of some remedy, the typical remedy granted in other states has been either absolute cancellation of the lease, partial cancellation, or conditional cancellation.[109]

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108. Sinclair Oil & Gas Co. v. Masterson, 271 F.2d 310 (5th Cir. 1959).
109. MARTIN & KRAMER, *supra* note 9, § 844.

b. The Louisiana Duty to Develop

Louisiana jurisprudence recognizes a duty of development that includes a duty to reasonably develop proven formations. In addition, some Louisiana jurisprudence has recognized a duty of further exploration of unproven areas. Such an exploration duty may exist as a subpart of the development covenant or perhaps as a separate covenant.

i. Reasonable Development of Proven Formations

The Louisiana Supreme Court recognized the existence of an implied covenant of reasonable development in 1914 in *Caddo Oil & Mining Co. v. Producers' Oil Co.*[110] There, 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.[111]

In *Caddo Oil*, the lessee had drilled eight wells, each of which produced oil, though the rate of production slowed down considerably with time.[112] The lessor demanded on several occasions that the lessee drill additional wells, but the lessee refused.[113] The lessor sued, seeking a judgment that the lease was void.[114] At the time the lessor filed suit, each of the eight wells still were producing, but only three still were producing by the time of trial.[115] The lower court granted partial dissolution, allowing the lessee to retain its lease rights as to an area around each of the three wells still producing oil, but otherwise dissolving the lease.[116]

On original hearing, the Louisiana Supreme Court affirmed, suggesting that the lessee had abandoned the lease as to the areas in which

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110. 64 So. 684, 690 (1914).
111. *See id.* (quoting THORNTON, *supra* note 61).
112. *Caddo Oil & Mining Co.*, 64 So. at 690.
113. *Id.*
114. *Id.*
115. *Id.*
116. *Id.*

production had ceased production or where the lessee had never drilled.[117] On rehearing, the Louisiana Supreme Court reversed the lower court and granted judgment for the lessee.[118] The court declared that the lessee only had a duty to reasonably develop the property and that whether the lessee had complied with that duty was an issue of fact.[119] Several individuals associated with either the lessor or the lessee had testified.[120] None of the witnesses had testified that the lessee's development of the property had not been reasonable.[121] On the other hand, some of the witnesses testified that the lessee's development of the property had been reasonable.[122] Therefore, the lessor's demand was dismissed in its entirety.[123]

A similar result was reached in *Gennuso v. Magnolia Petroleum Co.*[124] In that case, the lessee leased approximately 185 acres, on which it had drilled one productive well.[125] The lessor made a written demand that the lessee drill additional wells.[126] The lessee did not drill additional wells, and the lessor sued for cancellation.[127] The trial court granted partial cancellation, allowing the lessee to keep its lease rights to 25 acres around the productive well.[128] The Louisiana Supreme Court reversed, noting that the lessee's geologist had testified that a prudent operator would not drill additional wells and that the lessor had not presented any evidence to the contrary.[129] The court held that the lessor's demand should be dismissed altogether because the lessor had not proven a breach of the lessee's duty of reasonable development.[130]

In contrast, the court concluded in *Vetter v. Morrow*[131] that the lessee had breached its implied duty to reasonably develop the premises. In that case, about 110 acres of the leased premises were included in units from which minerals were being produced.[132] Another 250 acres of the leased premises were not in a unit, and the lessee had not conducted any drilling

117. *Id.*
118. *Id.*
119. *See id.*
120. *Id.*
121. *Id.*
122. *Id.*
123. *Id.*
124. 14 So. 2d 445 (1943).
125. *Id.*
126. *Id.*
127. *Id.*
128. *Id.*
129. *See id.* at 446.
130. *See id.* at 447.
131. 361 So. 2d 898, 901 (La. Ct. App. 1978).
132. *Id.*

on that portion of the leased premises.[133] The lessor demanded that the lessee drill on that portion.[134] The lessee failed to do so, and the lessor sued for partial cancellation of the lease.[135] The evidence at trial showed that the land at issue was located to the west of two productive wells and that the proven formation into which those productive wells had been drilled extended to the west, in the direction of the portion of the leased premises that was at issue.[136] The trial court concluded that the lessee had failed to reasonably develop that portion of the leased premises, and granted cancellation of the lease as to that area.[137] The appellate court affirmed that partial cancellation.[138]

ii. Further Exploration

As noted above, some national commentators have argued that oil and gas lessees should be bound by an implied covenant of further exploration that is separate from the implied covenant of reasonable development, while others have criticized the suggestions that such a covenant exists.

The comment to Mineral Code article 122 discusses a potential implied covenant of further exploration, but provides that Louisiana jurisprudence has not clearly distinguished between obligations of reasonable development and further exploration, but the comment suggests that Louisiana cases effectively have recognized a covenant of further exploration.[139] Some commentators also have taken the position that Louisiana effectively recognizes such a covenant.[140]

Those who say that Louisiana recognizes an implied obligation of further exploration typically point to a line of cases headed by *Carter v.*

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133. *Id.*
134. *Id.*
135. *Id.*
136. *See id.* at 900.
137. *Id.*
138. *See id.* at 901.
139. *See* LA. MIN. CODE ANN. ART. 122 cmt. (1975); *cf.* Harrell, *supra* note 97, at 390 (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 (La. 1948)—refers to the issue in the case as being whether the lessee had reasonably developed the leased property.
140. *See* MARTIN & KRAMER, *supra* note 9; *See* 5 WILLIAMS & MEYERS: OIL AND GAS LAW, *supra* note 9, § 845.4 at 341 ("Louisiana courts are probably the most severe in the country in enforcing an implied duty to explore further").

Arkansas Louisiana Gas Co.[141] In *Carter*, a fault crossed the leased premises.[142] The lessee had drilled wells and developed the property on one side of the fault, but not the other.[143] The lessor demanded that the lessee drill on the other side, but the lessee did not do so.[144] The lessor sued for lease cancellation.[145] The trial court granted partial cancellation, dissolving the lease as to the portion of the property that had not been developed.[146] The lessee appealed the order of partial cancellation (the lessor did not appeal the trial court's refusal to order complete cancellation).[147]

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.[148] 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.[149] Thus, a reader could conclude that *Carter* simply was enforcing the 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 used broader language, stating:

> The principle, as we understand it, is that development of every part of the lease is an implied condition. Therefore, whether the undeveloped portion by 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 will test every part.[150]

Another Louisiana Supreme Court case that is sometimes cited for the proposition that Louisiana recognizes an implied obligation of further

141. *Carter*, 36 So. 2d 26.
142. *Id.*
143. *Id.*
144. *Id.*
145. *Id.*
146. *Id.*
147. *Id.*
148. *Id.*
149. *Id.*
150. *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).

exploration is *Wier v. Grubb*.[151] In *Wier*, the plaintiff subleased 335 acres to the defendant.[152] The defendant drilled three productive wells and one dry hole within a relatively small portion of the leased premises.[153] The plaintiff demanded that the defendant drill additional wells, and the defendant failed to do so.[154] The plaintiff then sued for partial cancellation, which the court granted, rejecting the sublessee's arguments that he had reasonably developed the premises and that geological information showed that any well drilled on the undeveloped portion of the leased premises was not likely to be productive.[155] The court's opinion granting partial cancellation contains some language that suggests an implied duty of further exploration might exist, but the court also italicized for emphasis in its opinion a portion of the sublease that expressly required the sublessee to release his sublease rights as to any area that he did not develop. Accordingly, one reasonably could argue that the court's holding was based on the express terms of the sublease, rather than an implied duty of further exploration.

Several other cases also cite *Carter*'s reference to the lessee having an obligation to test every portion of the leased premises.[156] Collectively, these cases may establish a covenant of further exploration, though the issue is not wholly unambiguous, because generally the cases involved leases with *express* duties to develop all portions of the leased premises retained by the lessee, or the cases made their references to the duty to test all portions of the leased premises in dicta only, or the cases were litigated

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151. 82 So. 2d 1 (La. 1955). *See* LA. REV. STAT. ANN. § 31:122 cmt. (1975) (citing *Wier* for the proposition that Louisiana recognizes an implied duty of further exploration).

152. *Wier*, 82 So. 2d 1.

153. *Id.*

154. *Id.*

155. *Id.*

156. Middleton v. California Co., 112 So. 2d 704, 706 (La. 1959), (development of every part of the leased premise was "an express condition"); Sohio Petroleum Co. v. Miller, 112 So. 2d 695, 699 (La. 1959) (*Miller* involved a lease that had a clause expressly requiring the lessee to reasonably develop the leased premises); Reagan v. Murphy, 105 So. 2d 210, 214 (La. 1958) (stating in dicta that a lessee has a duty to test every part of the leased premises "or suffer a partial cancellation"); Sandefer Oil & Gas Inc. v. Duhon, 961 F.2d 1207, 124 (5th Cir. 1992) (a federal case referring in dicta to the possible existence of a duty of further exploration); Noel v. Amoco Production Co., 826 F. Supp. 1000, 1005 (W.D. La. 1993) (stating that *Carter* established a duty of further exploration).

in a federal court, not in a state court, much less the Louisiana Supreme Court.[157]

2. Covenant to Protect Against Drainage

Both Louisiana and Texas recognize an implied covenant to protect the leased premises against drainage.

a. The Texas Duty to Protect

Texas recognizes a general duty to protect the leasehold. This duty includes both duties to (1) protect the leasehold against drainage and (2) protect the leasehold in other ways.

i. Texas Duty to Protect Against Drainage

The most important part of the implied covenant to protect the leasehold is an implied duty to protect the leased premises against drainage. This duty requires the lessee to take reasonable action to protect the leased premises against substantial drainage from wells on nearby properties.[158] Many states and commentators refer to this duty as being its own implied covenant.[159] Texas jurisprudence characterizes this duty as being part of an implied covenant to protect the leasehold.[160] An implied duty or covenant to protect against drainage is widely recognized in the United States, and is one of the earliest of the implied covenants to be recognized.[161] In Texas, an implied duty to protect against drainage has

157. *Cf.* Patrick H. Martin, *Implied Covenants in Oil and Gas Leases ─ Past, Present and Future*, 33 WASHBURN L.J. 639, 640 (1994) (stating that Louisiana "'perhaps tacitly' recognizes an implied covenant of further exploration").

158. *See* Kerr-McGee Corp. v. Helton, 133 S.W.3d 245, 253 (Tex. 2004); Amoco Production Co. v. Alexander, 622 S.W.2d 563, 568 (Tex. 1981).

159. *See, e.g.*, LA. REV. STAT. ANN. § 31:122 cmt (1975).

160. *Amoco Production Co*., 622 S.W.2d at 568.

161. *Id*. at 568; *see also* Croston v. Emax Oil Co., 464 S.E.2d 728, 733 (W. Va. 1995); Klempner v. Lemon, 35 A. 109 (Pa. 1896); 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); Swope v. Holmes, 124 So. 131 (La. 1929); LA. REV. STAT. ANN. § 31:122 cmt. (1975). Voluntary pooling and modern conservation regulations, such as well spacing rules, setback rules, and compulsory pooling, decrease the frequency of drainage disputes, though such disputes still sometimes occur. Many of the contemporary disputes involve facts other than the classic, local drainage dispute. *See, e.g.,* Coastal Oil & Gas Corp. v. Garza Energy Trust Corp., 268 S.W.3d 1 (Tex. 2008) (drainage dispute regarding alleged cross-boundary

been recognized since the early 1900s.[162] Such a covenant was recognized as early as 1896 in Pennsylvania,[163] and shortly thereafter in Ohio.[164]

The traditional way to protect the leased premises against drainage is to drill offset wells,[165] though some cases have recognized that a lessee may have the option or obligation to protect against drainage by other methods, such as re-working existing wells or seeking pooling or unitization, or other appropriate administrative relief.[166] Because a lessee only is 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.[167]

An issue on which courts in different states have reached different results is whether the substance of the lessee's duty or the allocation of the burden of proof is altered in a situation where the lessee that is alleged to have breached the covenant to protect against drainage also happens to be the company that is operating the nearby well that allegedly is draining the lessor's premises. Such cases sometimes are called "common lessee" cases because the same company is lessee of both the plaintiff-lessor's land and the neighboring land on which the draining well is located. In some states, courts may impose a heightened duty on the lessee in the "common lessee" situation or switch the allocation of the burden of proof by requiring the defendant-lessee to prove the reasonableness of its conduct.[168]

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fracturing); *Amoco Production Co.,* 622 S.W.2d at 568 (fieldwide drainage dispute).

162. Texas Pac. Coal & Oil Co. v. Barker, 6 S.W.2d 1031 (Tex. 1928).

163. *See Kleppner*, 35 A. 109.

164. *See Harris*, 48 N.E. 502.

165. *Texas Pac. Coal & Oil Co*., 6 S.W.2d 1031 (referring to duty to drill offset wells). The same is true in other states. *See, e.g.*, Kleppner v. Lemon, 35 A. 109, 110 (Pa. 1896); LA. REV. STAT. ANN. 31:122 cmt. (1975); 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 ref'd,* 165 So. 2d 481 (La. 1964).

166. *See* MARTIN & KRAMER, *supra* note 9, § 821; *Coastal Oil & Gas Corp.*, 268 S.W.3d at 17 n.57; *Amoco Production Co*., 622 S.W.2d at 568; Southeastern Pipe Line Co. v. Tichauhek, 997 S.W.2d 166, 170 (Tex. 1999); HECI Exploration Co. v. Neel, 962 S.W.2d 881, 889 (Tex. 1998); *Amoco Production Co*., 622 S.W.2d at 568; *Breaux*, 163 So. 2d at 418.

167. *See Costal Oil & Gas Corp*., 268 S.W.3d at 17 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").

168. *See* LOWE, NUTSHELL, *supra* note 15, at 336–37.

But other states do not appear to apply different rules in such a situation.[169] In Texas, the fact that the lessee who allegedly failed to protect against drainage is also the operator that caused the drainage does not subject the lessee to a higher duty and does not appear to alter the burden of proof.[170] Of course, if the lessee is the operator of the well on the neighboring tract, a lessor may be able to use that fact to its advantage in an action alleged a breach of the duty to protect against drainage. The lessor could assert that a reasonably prudent operator would have drilled an offset well and that the lessee's conflict-of-interest, not a reasoned business judgment, explains the lessee's failure to do so.

Elements of a Cause of Action for Breach of the Duty to Protect Against Drainage

To establish a breach of the duty to protect against drainage, a lessee must prove that a well on other lands is causing substantial drainage from beneath the leased premises and that a reasonably prudent operator would have taken steps to protect against drainage. The typical way that a lessee protects against drainage is by drilling an offset well. To prove that a reasonably prudent operator would have drilled an offset well, a lessor must prove that an offset well probably would have been profitable.[171] A lessee does not need to prove that the lessee has established production in paying quantities. Further, under the prevailing view, existence of a delay rental clause does not eliminate the implied covenant to protect against drainage.[172] Further, a Texas appellate court held that a lessor's acceptance of delay rental payments does not bar the lessor from recovering damages for drainage that occurs during the period covered by the rental payment, even if the lessor was aware of the drainage.[173] But the Texas Supreme Court has yet to rule on whether the lessor's acceptance of delay rental payments will affect his right to recover for drainage, and the majority position in other jurisdictions appears to be that a lessor cannot recover for drainage that occurs during a period covered by delay rental payments that he accepts while knowing about the drainage.[174]

169. *See id.* at 416; *Breaux*, 163 So. 2d 406, 416–17 (La. Ct. App. 1964).

170. *Coastal Oil & Gas Corp.*, 268 S.W.3d at 19 n.63; *Amoco Production Co*., 622 S.W.2d at 572.

171. HECI Expl. Co. v. Neel, 982 S.W.2d 881, 889 (Tex. 1998).

172. Texas Co. v. Ramsower, 7 S.W.2d 872 (Tex. Comm'n App.), *aff'd on rehearing*, 10 S.W.2d 537 (Tex. Comm'n App. 1928); SMITH & WEAVER, *supra* note 15, at 5-37 to 5-38; MARTIN & KRAMER, *supra* note 9, at § 826.2.

173. *Texas Co.*, 7 S.W.2d 872.

174. MARTIN & KRAMER, *supra* note 9, § 826.2.

Remedies for Breach of Duty to Protect Against Drainage

Under Texas law, the favored remedy for a breach of the duty to protect against drainage is an award of money damages. As for the proper measure of damages, Texas courts have not always been consistent. In *Garza*, the Texas Supreme Court acknowledged that it had not always been consistent, then it went on to clarify the correct measure, stating:

> We have held that "[o]ne measure of damages" for breach of the implied covenant of protection is "the amount of royalties that the lessor would have received from the offset well on its lease." But this would overcompensate the lessee if production from the offset well exceeded the drainage. Another measure of damages is the value of the royalty on the drained gas, but this, too, would overcompensate the lessee if not all of the drainage could have been prevented, either because of the nature of the field, or the regulatory system, or for whatever reason. The correct measure of damages for breach of the implied covenant of protection is the amount that will fully compensate, but not overcompensate, the lessor for the breach—that is, the value of the royalty lost to the lessor because of the lessee's failure to act as a reasonably prudent operator.[175]

Thus, the proper measure of damages is the amount of royalties lost because of the breach.[176]

There also is some Texas authority that, if damages are impossible to ascertain, lease cancellation may be granted.[177]

ii. Texas Duty to Protect Leasehold Against Other Harms

Virtually all of the cases in which a lessor alleges a breach of the implied covenant to protect the leasehold are based on an alleged breach of the duty to protect against drainage.[178] But the covenant to protect the leasehold occasionally may require the lessee to protect the leasehold against other harms. The Texas Supreme Court describes the covenant to

175. 268 S.W.3d at 18–19 (internal footnotes omitted).

176. *Id*. at 18.

177. Christie, Mitchell & Mitchell Co. v. Howell, 359 S.W.2d 658 (Tex. Civ. App. 1962,) *error ref'd n.r.e.*.

178. This is recognized by prominent commentators. SMITH & WEAVER, *supra* note 15, at 5–32.

"protect the leasehold" as "includ[ing] protection from local and field-wide drainage,"[179] suggesting that the covenant could include other duties.

In *HECI v. Neel*, the lessor complained about the lessee's failure to give the lessor notice of certain circumstances.[180] The operator of a neighboring tract had produced hydrocarbons at a rate higher than was allowed under the Texas Railroad Commission's rules.[181] The lessee initiated administrative action with the Commission and the neighboring operator halted its excessive production.[182] Later, however, the neighboring operations again began operating at an illegally rapid rate.[183] This began to cause damage to the common reservoir that underlies the lessor's tract and the neighboring tract.[184] The lessee again initiated proceedings before the Railroad Commission and the operator of the neighboring tract was enjoined from operating at an excessive rate.[185] By that time, however, the reservoir had been damaged.[186] The lessee brought suit against the neighboring operator and obtained a damages award to compensate the lessee for the damages it incurred because of the harm to the reservoir.[187]

The lessee did not notify the lessor about these circumstances and the lessors did not learn about the court action until after the lessee had obtained a money judgment.[188] The lessors brought suit against the lessee, asserting that the lessee had an implied duty to notify the lessors of the need to sue the neighboring operator and an implied duty to notify the lessors of the lessee's intent to bring suit on its own behalf.[189] The Texas Supreme Court was presented with the question of whether such implied duties exist under Texas law and the facts of the case. The Court did not reach the merits of the first claim—the claim that the lessee had an implied duty to notify the lessors of the need to sue—because the Court concluded that any such claim was time-barred.[190] The Court concluded that there was no implied duty to inform the lessors of the lessee's intent to sue on

179. HECI Expl. Co. v. Neel, 982 S.W.2d 881 (Tex. 1998).
180. *Id.*
181. *Id.*
182. *Id.*
183. *Id.*
184. *Id.*
185. *Id.*
186. *Id.*
187. *Id.*
188. *Id.*
189. *Id.*
190. *Id.*

its own behalf.[191] The Court noted that the lessee had no authority to sue on behalf of the lessors, that the lessee was only entitled to recover compensation for its seven eighths share of the potential production lost because of damage to the reservoir, that the lessee's suit on behalf of itself would not have any collateral estoppel effect as to the lessors, and that the lessors had a right to bring their own action against the neighboring operator for their one eighth share of the potential production lost because of the damage to the reservoir.[192] Under these circumstances, the Court saw no need to hold that the lessee was bound by an implied duty to notify the lessors of the lessee's own intent to bring suit.[193]

Thus, *HECI v. Neel* is not an example of a successful action alleging the existence of a duty to protect the leasehold in ways other than protecting against drainage, but it does stand as an example of an implied covenant claim that was not a drainage claim, and (although the lessors' suit was not successful) it illustrates the fact that, in unusual fact patterns, there might be circumstances where there are ways to protect the leasehold other than by protecting against drainage.

b. Louisiana Duty to Protect Against Drainage

As implied by the discussion above regarding the Texas duty to protect against drainage, oil and gas will move from a point of higher pressure to a point of lower pressure. Because a wellbore provides an area of lower pressure, it is able to drain oil or gas from the surrounding areas. And, if a well is drilled close enough to a property line, it will drain oil or gas from beneath the land on the other side of the property line from the well. For this reason, Louisiana jurisprudence recognizes that an oil and gas lessee is bound by an implied covenant to protect the leased premises from having substantial drainage of oil or gas drained from beneath its surface by a well or wells on other land.[194]

The traditional way for a lessee to comply with the duty to protect against drainage is to drill offset wells on the leased premises.[195] In this way, the lessor would obtain production of minerals from the common

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191. *Id.*
192. *Id.*
193. *Id.*
194. *See* LA. REV. STAT. ANN. § 31:122 cmt. (1975).
195. *See* Breaux v. Pan American Petroleum Corp., 163 So. 2d 406, 415 (La. Ct. App. 1964) (describing implied covenant to protect against drainage as being "actually an implied obligation to drill offset wells" when necessary to prevent drainage), *writ refused*, 165 So. 2d 481 (La. 1964).

reservoir before the reservoir was exhausted.[196] Some courts have recognized, however, that a lessee might be able to satisfy its duty to protect against drainage by seeking unitization.[197]

The lessee's duty is judged by the standard of what a reasonably prudent operator would do, taking into consideration both its interest and that of the lessor.[198] A corollary of this reasonability standard is that a lessee need not drill an offset well if it likely would be unprofitable to do so.[199] Cases from some states have held lessees to a higher standard of conduct if they also happen to be the operator of the well on the neighboring property, or have shifted the burden of proof from the lessor to the lessee to show the reasonability of the lessee's conduct. But in Louisiana, courts do not appear to apply different rules in such a situation.[200]

The implied covenant to protect against drainage was recognized as early as 1896 in Pennsylvania,[201] and shortly thereafter in Ohio.[202] It is one of the most commonly recognized covenants. One of the early Louisiana cases to recognize that a lessee has a duty to protect its lessor against drainage was the 1929 Louisiana Supreme Court case, *Swope v. Holmes*.[203] In *Swope,* the lessor sued, seeking cancellation of a lease as to 440 of the 2500 acres covered by the original lease.[204] The lessor argued that 400 of those acres never had been developed, and the lease was subject to cancellation as to that area because of the non-development.[205] The lessor sought cancellation as to 40 additional acres on the basis that the lessee had abandoned a well that was located on the 40 acres, and was allowing those 40 acres to be drained by wells on an adjoining property, which the lessee happened to own.[206] The trial court granted partial cancellation as to the 40 acres on that basis, and the Louisiana Supreme Court affirmed.[207] The Court did not, however, state a standard for evaluating whether a

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196. *See id.*
197. *See, e.g., id.*
198. *See* LA. REV. STAT. § 31:122 (1975).
199. *See* 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").
200. *See id.* at 416.
201. *See* Kleppner v. Lemon, 35 A. 109 (Pa. 1896).
202. *See* Harris v. Ohio Oil Co., 48 N.E. 502 (Ohio 1897).
203. 124 So. 131 (La. 1929).
204. *Id.*
205. *Id.*
206. *Id.*
207. *See id.*

lessee had breached a duty to protect against drainage.[208] Since then, Louisiana courts have stated that, in order for the lessor to show that the lessee breached the implied covenant to protect against drainage, the lessor must show that there was substantial drainage and that an offset well likely would have been profitable.[209] Well-spacing rules, setback rules, and compulsory unitization can decrease the frequency of drainage disputes, but such disputes still can occur.

3. Covenant to Diligently Market Oil and Gas Found in Paying Quantities

Both Louisiana and Texas recognize an implied covenant to diligently market any oil or gas found in paying quantities.

The implied covenant to diligently market can include a few parts. Traditionally, the main part of the marketing covenant was a duty to diligently seek a market. In some cases, the marketing covenant can include a duty to seek the best price reasonably available—particularly if the lease royalty is based on the sales price, as opposed to the market price.

Finally, some states have held that the implied covenant to diligently market can include a duty for the lessee to base the royalty on a sales price (or a value of the oil or gas after it has been made "marketable"), as opposed to the market value of the oil or gas at the well. However, Louisiana and Texas have both rejected the existence of such a duty, and such a duty seems inconsistent with the language of the royalty clauses used in many leases. This rejected duty relates to so-called "post-production" costs. The duty also is sometimes described as a duty of the lessee to put product in a marketable condition, though this is a misnomer. In most cases in which lessees have allegedly violated this duty, the lessee has put the product in a marketable condition. Thus, the complaint of lessors in these cases is *not* that the lessee has failed to put the product in a marketable condition. Rather, the lessors in these cases complain about *calculation* of the royalty. This is why many states (including Louisiana and Texas) reject this duty, holding that the royalty clause of the lease controls the question of how to calculate the royalty.

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208. *See id.*

209. *See* LA. MIN. CODE ANN. art. 122 cmt. (1975); *see also* Breaux v. Pan American Petroleum Corp., 163 So. 2d 406 (La. Ct. App. 1964).

a. Texas Duty to Manage and Administer (Including Marketing Product)

As recognized in Texas jurisprudence, the implied covenant to diligently market is part of an implied duty to manage and administer the lease, and it includes a duty to market.[210] The implied covenant to manage and administer may also include a second part, a duty to seek appropriate administrative action, and perhaps other duties, and perhaps a third part, a duty to use new technology to the extent that a prudent operator would, but an implied covenant to diligently market probably is the most significant part of this duty.[211]

i. Texas Duty to Diligently Market

In Texas, the duty includes two components—first, an obligation to diligently seek a purchaser for oil or gas that can be produced from the leased premises, and second, an obligation to obtain a reasonable price for the product. In some jurisdictions, the duty to market contains a third component, an obligation sometimes described as a "duty to put the product in a marketable condition," though this duty more accurately is described as being a duty to calculate the royalty in a particular way. This latter duty has been rejected by Texas courts (as well as the courts of

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210. Bowden v. Phillips Petroleum Co., 247 S.W.2d 690, 708 (Tex. 2008); Yzaguirre v. KCS Resources, Inc., 53 S.W.3d 368, 373 (Tex. 2001); Amoco Prod. Co. v. First Baptist Church of Pyote, 622 S.W.2d 563, 567 n.1 (Tex. 1980).

211. Such a duty seems to apply in all states that have any significant amount of oil and gas jurisprudence, but in many jurisdictions it is characterized as its own implied covenant, rather than as part of an implied covenant to manage and administer the lease. *See* LOWE, NUTSHELL, *supra* note 15, 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 Ch. 6 (2003); Weaver, *supra* note 15; Pierce, *supra* note 23, at Ch. 10; Kramer & Pearson, *supra* note 21; Martin, *A Modern Look at Implied Covenants to Explore, Develop, and Market Under Mineral Leases*, *supra* note 18.

Louisiana and several other states), but it is a subject of significant litigation in some states.

Disputes regarding this implied duty most often involve natural gas, rather than oil.[212] In part, this is because operators typically have fewer options for transporting natural gas to market than for transporting oil to market. 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 or railcar. In contrast, the only viable option for transporting gas to market will be to ship it via pipeline.

Texas Duty to Diligently Seek a Purchaser

Under Texas law, a lessee generally has an implied duty to market that includes two components. The first is an obligation to market the product with due diligence.[213] This obligation can include efforts to find a buyer and to make connections to a pipeline so that gas can be transported to market. Traditionally, most disputes regarding the implied covenant to market involved allegations that the lessee had not been sufficiently diligent in finding a buyer or in making connections to a pipeline so that the gas could be transported to market.[214]

Duty to Obtain a Reasonable Price

Under Texas law, the second component of the lessee's implied duty to market is a duty to obtain the best price reasonably available.[215] When disputes regarding this duty arise, they often result in situations in which a lessee has committed to sell natural gas under a long-term contract and market conditions change such that the contract price is below the market price for new sales. In some situations, the only viable purchaser may be a company that seeks a long-term sales contract rather than short-term sales arrangements.

Under Texas law, the duty to obtain a reasonable price can only apply if an oil and gas lease provides for the lessee to pay the lessor a royalty based on proceeds from the sale of product.[216] A duty to obtain a reasonable price does not apply if the oil and gas lease provides for the

212. *See* MARTIN & KRAMER, *supra* note 9, § 853.

213. Cabot Corp. v. Brown, 754 S.W.2d 104, 106 (Tex. 1987) ("the lessee must market the production with due diligence").

214. *See* MARTIN & KRAMER, *supra* note 9, § 853.

215. *Cabot Corp.*, 754 S.W.2d at 106.

216. 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).

lessee to pay the lessor a royalty based on market price because, in such a case, the royalty to be paid to the lessor does not depend on the price at which the lessee sells the oil or gas that it produces.[217] Instead, the royalty is based on the market price, which might be higher or lower than the price at which the lessee sells the oil or gas that it produces from the leased premises.

The Rejected Duty Regarding "Post Production Costs"

In Texas, as well as in other states, many royalty disputes relate to post-production costs incurred by the lessee. Some states have recognized a third component of the marketing covenant—a component that is relevant to post-production costs. Texas does not recognize this third component of the marketing component, but this component merits discussion for at least three reasons: (1) the possibility that lessors will persist in asking Texas courts to recognize this component of the implied duty to market; (2) the importance that this component plays in some other states, where Texas lawyers may occasionally litigate; and (3) the light, if any, that it may shed in a general way on post-production costs disputes.

The third component of the implied duty to market relates to the royalty calculation. Many leases provide for a royalty to be paid based on the "value" of gas at the wellhead, but often the gas is sold at a market quite a distance from the well.[218] Further, gas at the wellhead sometimes is not suitable for immediate placement into a pipeline because the gas may contain impurities or it may be at too low a pressure. Because there is no sale at the well, there is no wellhead sales price to use as evidence of the value at the well. Further, 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.[219] 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

217. *Union Pac*., 111 S.W.3d at 72; *Yzaguirre*, 53 S.W.3d at 374.

218. Other leases may provide for calculating royalties based on "proceeds received from the sale of gas at the mouth of the well." Hutchings v. Chevron U.S.A., Inc., 862 S.W.2d 752, 757–58 (Tex. Ct. App.).

219. "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* MARTIN & KRAMER, *supra* note 9, at 1067.

the post-production (*i.e.*, post-wellhead) costs incurred by the operator. And, from a standpoint of economics, this makes sense.[220] If sweet, dehumidified, high-pressure gas sells for $5 at a distant market, then sour, 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.[221] Therefore, 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,[222] while others have rejected it.[223] Texas does not appear to accept such an argument.[224] 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.[225]

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220. *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.

221. For further discussion of such marketing disputes, see Pierce, *supra* note 211, at Ch. 10; David W. Hardymon, *Adrift on the Implied Covenant to Market: Regulation by Implication*, 24 ENERGY & MIN. L. INST. 209 (2003).

222. 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. Rogers v. Westerman Farm Co., 29 P.3d 887, 897 (Colo. 2001) (lessor's implied covenant argument prevails); *see* Mittelstaedt v. Santa Fe Min., Inc., 954 P.2d 1203 (Okla. 1998); Sternberger v. Marathon Oil Co., 894 P.2d 788, 800 (Kan. 1995).

223. *See* Kilmer v. Elexco Land Servs., 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 Dev. Co. v. Chesapeake Appalachia, L.L.C., 636 F.3d 235 (6th Cir. 2011) (under Kentucky law, rejecting argument that implied covenant to market prohibited deduction of post-production costs).

224. Heritage Res., Inc. v. NationsBank, 939 S.W.2d 118, 122 (Tex. 1996). *See also* SMITH & WEAVER, *supra* note 15, at 5-46 to 5-47.

225. MARTIN & KRAMER, *supra* note 9, at 356.

ii. Texas Duty to Protect by Seeking Administrative Action

Various commentators have suggested that the duty to manage and administer the lease may include an implied duty of the lessee to seek administrative action for the benefit of the lease.[226] A prominent treatise on Texas oil and gas law characterizes such a duty as being part of the duty to manage and administer the lease,[227] though in certain cases a duty to seek administrative relief might fit under another implied covenant—if, for example, a lessee needed to seek a waiver of spacing rules in order to drill an offset well to protect against drainage.[228]

A potential implied duty to seek administrative action is not discussed very much in jurisprudence, but there are some cases that suggest that such a duty may exist under certain circumstances. For example, in *Amoco Production Co. v. Alexander*, lessors asserted a claim for a breach of the duty to protect against drainage. The lessee asserted various reasons why it should not be liable for the alleged breach, including the fact that existing spacing rules precluded the drilling of an offset well.[229] The Texas Supreme Court rejected that argument, stating that the lessee might have a duty to seek compulsory pooling or an exception to the applicable spacing rules.[230] Commentators or courts have suggested that, in other circumstances, a lessee might sometimes have a duty to seek an increase in a well allowable or an exception to zoning rules that prevent drilling.[231]

iii. Duty to Use New Technology

The technology used in oil and gas exploration and development is continuously evolving and improving. This raises a question. Are lessees bound by an implied covenant to use new technology?

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. But new technology can help a lessee operate more economically and more 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

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226. *See, e.g.*, SMITH & WEAVER, *supra* note 15, at 5-43 to 5-45; Maurice H. Merrill, *Current Problems in the Law of Implied Covenants in Oil and Gas Leases*, 23 TEX. L. REV. 137 (1945).

227. SMITH & WEAVER, *supra* note 15, at 5-43 to 5-45.

228. Amoco Prod. Co. v. Alexander, 622 S.W.2d 563, 570 (Tex. 1981).

229. *Id.*

230. *Id.*

231. SMITH & WEAVER, *supra* note 15, at 5-44 to 5-45.

functions to the same extent that a reasonably prudent operator would under the same circumstances.[232] Accordingly, a better question might be whether a lessee that fails to perform at the level of a reasonably prudent operator is excused for such failure if the lessee's performance meets the lower standard of performance that a reasonably prudent operator would have obtained using only the technology that existed at the time the lease was granted. Suppose that an operator has not adopted new and accepted technology, and the operator is producing significantly less oil or gas than the operator would be able to produce if it utilized new technology, would the operator be liable for a breach of its implied covenant obligations?

This issue has not been frequently addressed in jurisprudence or commentary, but the answer seems to be clear that an operator can be liable in such circumstances. An operator is required to perform to the level that a reasonably prudent operator would under similar circumstances—one of the circumstances being the current state of technology. Thus, the operator cannot insulate itself from liability by asserting that its performance is adequate if evaluated based on the use of older technology, such as that which existed when the lease was granted.

Few Texas cases have discussed this issue. In *Rhoads Drilling Co. v. Allred*, however, a Texas appellate court concluded that, after an oil well quit flowing on its own, the operator was obligated to install a pump if doing so reasonably could be expected to yield a profit.[233] A pump would hardly be considered new technology, even at the time of the *Rhoads* case, but the case stands for the proposition that the lessee's implied obligations relating to operations can include a duty to use appropriate equipment and technology.[234] This is very analogous to a proposed duty to use new technology when such technology would yield significantly greater or more rapid production.

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232. Amoco Prod. Co., 622 S.W.2d at 567–68. Later in the *Amoco* decision, the Texas Supreme Court stated: "However, because of the complexity of the oil and gas industry and changes in technology, the courts cannot list each obligation of a reasonably prudent operator which may arise." *Id.* at 568. Although the court seemed to be discussing the course of jurisprudential explanations of the implied covenant duties, rather than the possibility that the specifics of an operator's duties under a particular lease would change with time, the statement still seems to support the idea that an operator may be obligated to adopt new technologies as they develop, provided that a reasonably prudent operator would do so and that the new technology would help the lessee produce significantly more hydrocarbons or produce hydrocarbons at a significantly rate.

233. 70 S.W.2d 576 (Tex. Ct. App. 1934).

234. *Id.*

Some of the leading cases on a potential duty to use new technology are from outside Texas. In *Wadkins v. Wilson Oil Co.*,[235] the plaintiffs granted a mineral lease that covered 40 acres of land in Louisiana. 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.[236] The plaintiffs' land contained two existing wells.[237] The defendant produced oil from those two wells until the wells quit producing.[238] 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.[239] 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 40 acres.[240]

The five wells were still producing oil in 1941, but their rate of production had decreased.[241] 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.[242] 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.[243] The plaintiffs demanded that the defendant drill new wells, but the defendant declined to do so.[244] The plaintiff sued for lease cancellation and obtained such an order from the trial court.[245] 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

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235. 6 So. 2d 720 (La. 1942).
236. *Id.*
237. *Id.*
238. *Id.*
239. *Id.*
240. *Id.*
241. *Id.*
242. *Id.* "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 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 id.* at 546.
243. Wadkins v. Wilson Oil Co., 6 So. 2d 720 (La. 1942).
244. *Id.*
245. *Id.*

> with the modern process which had proved so successful on other leased properties adjoining and in the vicinity of the property in question.[246]

A somewhat analogous fact pattern was presented by *Waseco Chemical & Supply Co. v. Bayou State Oil Corp*.[247] *Waseco* concerned a 1934 lease that covered 80 acres in the Bellevue Field in Bossier Parish, Louisiana.[248] The field contained a shallow sand—at about 350 to 500 feet below the surface—that contained a heavy, viscous oil.[249] 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 12 hours.[250] Bayou State acquired the lease at issue, the Scanland lease, in the early 1950s.[251] At that time, about 50 wells had been drilled on the 80-acre lease tract.[252] Most of the wells were producing, with total production being about 46 barrels per day.[253] Over the next 24 years, Bayou State did not drill any more wells on the leased premises or make any capital expenditures, and by 1976, about 9 wells on the property still were producing, at a cumulative rate of about six barrels per day.[254]

Other operators in the area were doing somewhat better. In 1963, Getty had begun using fireflood operations in the Bellevue Field and had dramatically increased rates of production.[255] Initially, Getty's fireflood project was just a pilot project, but, within a few years, it was evident that the project was successful and Getty expanded its fireflood operations rapidly.[256] Cities Service began extensive use of fireflood operations in the area, starting in 1971.[257] Bayou State itself used a fireflood operation on a different lease tract in 1970, but did not perform such operations on the Scanland lease.[258] Evidence showed that fireflooding could significantly increase total recovery.[259] With the use of fireflooding, operators could

246. *See* 6 So. 2d at 668–69.
247. 371 So. 2d 305 (La. Ct. App. 1979).
248. *Id.*
249. *Id.*
250. *Id.*
251. *Id.*
252. *Id.*
253. *Id.*
254. *Id.*
255. *Id.*
256. *Id.*
257. *Id.*
258. *Id.*
259. *Id.*

recover about 60% of the heavy oil in place, compared to recovery of about 5% when they did not use fireflooding.[260] Fireflooding also significantly increased the rate of production.[261] 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.[262] The lessors brought suit against Bayou State, seeking lease cancellation.[263] The trial court granted an order of lease cancellation, citing *Wadkins*, and the Louisiana Second Circuit affirmed.[264]

In *Utilities Production Corporation v. Carter Oil Co.*,[265] 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. The lessor argued that the lessee did not because such operations were not widely known at the time the parties entered the lease.[266] 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.[267] 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."[268]

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.[269] 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 profitable as a means of getting additional return from the lease."[270] 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

260. *Id.*
261. *Id.*
262. *Id.*
263. *Id.*
264. *Id.*
265. 72 F.2d 655 (10th Cir. 1934).
266. *Id.*
267. *Id.*
268. *Id.* at 659.
269. 266 P.2d 613 (Okla. 1954).
270. *Id*. at 616–17.

providing for the secondary recovery of oil."[271] 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.[272] One classic authority on implied covenants states that, "The obligation to adopt new and improved methods of development and operation as their practicability and superiority become obvious is manifest."[273] 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.[274]

There has been some discussion regarding whether an operator would breach the implied covenant to reasonably develop the premises or some other implied covenant if he does not perform as well as he should because he fails to use new technology that a reasonably prudent operator would use. One commentator has suggested that secondary recovery processes and stimulation processes applied to existing wells might not be part of the

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

272. Conine, *supra* note 40, 689–90 (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.").

273. MAURICE H. MERRILL, THE LAW RELATING TO COVENANTS IMPLIED IN OIL AND GAS LEASES § 225 (1940).

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

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."[275] But another oil and gas scholar discussed the potential obligation to use new technology as potentially coming under the development obligation.[276] 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.[277]

Finally, the rationales used to justify the existence of implied covenants similarly suggest 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, then the lessee should be liable for breach of an implied covenant. Different commentators suggest different rationales, but each supports this conclusion.

One explanation is that parties to leases do not specify a lessee's duties in detail because they lack sufficient information at the time of lease execution to specify exactly what the lessee should do, but that 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 and expectations. Assuming that the parties implicitly

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275. Laura H. Burney and Norman J. Hyne, *Hydraulic Fracturing: Stimulating Your Well or Trespassing*, 44th ROCKY MTN. MIN. L. INST., no.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 9, § 861.3.

276. Martin, *Implied Covenants in Oil & Gas Leases – Past, Present & Future*, *supra* note 157, at 648–49.

277. 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 Article 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.

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 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 inevitably will be behind others. 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 does not use new technology.

iv. Louisiana Implied Covenant to Diligently Market

Louisiana jurisprudence recognizes that an oil and gas lessee is bound by an implied covenant to exercise reasonable diligence in marketing minerals that the lessee finds.[278] The lessee's obligation is to attempt to find a buyer, with the most significant challenge typically being to arrange for natural gas to be transported to a place where it can be sold, though the lessee also might need to do work to treat the natural gas (particularly if it is sour gas or wet gas) to bring it to pipeline specifications.[279] This covenant is most often an issue with natural gas. There usually is not much difficulty in marketing oil because oil can be produced and then temporarily stored at the well site in storage tanks that are economical to construct, and because oil can be transported not only by pipeline, but also by barge, rail car, or truck. On the other hand, the only economic way to transport natural gas from the well to a market typically is by pipeline. Thus, if the well site is not located near an established pipeline, or a gathering network for a pipeline, then the gas may be unmarketable until piping is laid from the well site to the nearest pipeline. Sometimes this will be very expensive and take a considerable length of time.

An early Louisiana case that recognized an implied covenant to market, though it did not use that terminology, was *Risinger v. Arkansas-Louisiana Gas Co.*[280] In *Risinger*, the defendants drilled a well that was shown to be capable of producing gas in significant quantities.[281] But the well also produced a substantial amount of salt water.[282] The defendants shut-in the well, and made shut-in payments as required by the lease.[283] The lessors demanded that the lessees connect the well to the nearest

278. *See* LA. REV. STAT. ANN. § 31:122 cmt. (1975). 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.*, Anderson, *supra* note 211; Lowe, *supra* note 211, at Ch. 6; Weaver, *supra* note 15; Pierce, *supra* note 23, at Ch. 10; Kramer & Pearson, *supra* note 21; Martin, *A Modern Look at Implied Covenants to Explore, Develop, and Market Under Mineral Leases*, *supra* note 18.

279. *See* LA. MIN. CODE ANN. art. 122 cmt (1975).

280. 3 So. 2d 289 (La. 1941).

281. *Id.*

282. *Id.*

283. *Id.*

pipeline, which was three miles away.[284] When the defendants refused, the plaintiffs sued for lease cancellation, arguing that the defendants had breached an obligation to market the gas.[285] The defendants apparently did not contest the existence of an implied duty to market[286] but asserted that under the circumstances—the high costs of equipment to separate salt water, the costs of employees to operate the separators, and the cost of running pipe to connect the well to the pipeline that was about three miles away—they would lose money by operating the well. Thus, they argued, they had not acted unreasonably in declining to connect the well to the pipeline and to operate the well.[287] The Court seemed to assume that an implied duty to market exists, but ruled for the defendants, concluding that the defendants had not acted unreasonably.[288]

In *Lelong v. Richardson*,[289] the court also rejected a lessor's request for an order that the lease had terminated because of the lessee's failure to market gas from a well on the property that had been shown to be capable of producing gas. The court held that, under the circumstances, the lessee's conduct had not been unreasonable.[290] Again, the court did not speak in terms of an implied duty to market. Instead, the court discussed whether the lessee had breached an obligation of "reasonable development," but in substance, the court clearly was talking about an implied duty to market.[291]

Sometimes, lessors argue that the implied covenant to diligently market product requires a lessee to pay for the entirety of post-production costs associated with that product, absent an express provision to the contrary in the lease. This is contrary to the expectation in the oil and gas industry, where the typical expectation is that the lessee will pay for the entirety of production costs, which includes drilling costs and costs to maintain the well, but that the lessee is not expected to pay the entirety of post-production costs, which may include costs to transport product to market or to treat the product to remove impurities before the product is sold. The typical expectation is that the lessee will deduct those post-

284. *Id.*

285. *Id.* Although the opinion does not refer expressly to an "implied" obligation, the court quoted various sections of the lease, and neither those sections nor any discussion in the opinion suggests that the lease contained an express duty to market.

286. *Id.* The court noted that the defendants did not argue that they could pay shut-in royalties indefinitely.

287. *Id.*

288. *See id.* at 293.

289. 126 So. 2d 819 (La. Ct. App. 1961).

290. *Id.*

291. *Id.*

production costs from the gross revenue from sales of the product and that the lessee will pay lease royalties to the lessor based on the net revenue that remains after the deduction of post-production costs. Thus, the lessor and lessee effectively share in the payment of post-production costs, with the lessor's fractional share of those costs equaling his royalty fraction.

In some states, lessors have succeeded in arguing that the implied covenant to market requires lessees to pay the entirety of post-production costs. In other states, courts have rejected such arguments. There do not seem to be any Louisiana cases that have held that the implied covenant to market requires lessees to pay the entirety of post-production costs.

B. Other Potential Implied Covenants

Oil and gas commentators and courts in other jurisdictions often recognize different lists of implied covenants that are different from the list recognized, or widely discussed, in Texas and Louisiana. Some of these are discussed below.

1. Implied Covenant to Restore the Surface

A potential implied covenant to restore the surface would require 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.[292] The Texas Supreme Court has rejected the existence of such an implied covenant,[293] as have cases in Oklahoma[294] and New Mexico.[295] The implied duty of surface restoration is not widely recognized in jurisprudence, but Arkansas has recognized it[296] and it is sometimes discussed in commentary.[297]

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292. *See* Martin, *Implied Covenants in Oil and Gas Leases – Past, Present & Future*, *supra* note 157, at 658.

293. Warren Petroleum Corp. v. Monzingo, 304 S.W.2d 362, 362–63 (Tex. 1957).

294. Fox v. Cities Serv. Oil Co., 200 P.2d 398, 400 (Okla. 1948).

295. McNeil v. Burlington Res. Oil & Gas Co., 182 P.3d 121, 129 (N.M. 2008).

296. *See, e.g.*, Chevron U.S.A., Inc. v. Murphy Expl. & Prod. 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).

297. *See* Martin, *Implied Covenants in Oil and Gas Leases – Past, Present & Future*, *supra* note 157, at 658; Keith B. Hall, *Implied Covenants: Claims Under Article 122*, 57 ANN. INST. ON MIN. L. 172, 188–90 (2010); LA. REV. STAT. ANN. § 31:122 cmt. (1975). 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

An implied covenant of surface restoration also has been discussed in numerous Louisiana court decisions. Quite a number of oilfield contamination lawsuits—often called "legacy litigation"—are litigated in the state. In one case, 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 amount of wear and tear on the property was not excessive.[298] If there is significant contamination, however, there seems to be some duty to restore even in the absence of an express contractual obligation to restore. The extent of such a duty, which appears to be based on principles contained in the Louisiana Civil Code, rather than on a lessee's duty to behave as a reasonably prudent operator, is often disputed.

2. Miscellaneous Implied Covenants That Might Exist

Some commentators have suggested that other implied covenants might exist, with one potential convent being a duty to properly represent the lessor's interests before the regulator (this potential duty is also discussed above, with respect to Texas, as potentially part of the duty to manage and administer the lease, so in this section it is primarily discussed from the standpoint of Louisiana law).[299] This implied covenant has not been expressly recognized in jurisprudence, but neither has it been rejected, so perhaps a court would recognize such a duty under appropriate facts.[300] On the other hand, a court might reject the existence of such a

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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 Prod. Co., 507 So. 2d 11, 13 (La. Ct. App. 1982).

298. Terrebonne Parish School Board v. Castex Energy, Inc., 893 So. 2d 789, 801 (La. 2005).

299. Martin, *Implied Covenants in Oil and Gas Leases—Past, Present & Future*, *supra* note 157, at 660–61; *see* John M. McCollam, *Impact of Louisiana Mineral Code on Oil, Gas and Mineral Leases*, 22 MIN. L. 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").

300. 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 Am. Petroleum Corp., 163 So. 2d 406, 415 (La. Ct. App. 1964), *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

duty or the collateral attack rule might serve as a barrier to claims that a lessee did not adequately represent the lessor before regulatory authorities.[301] The collateral attack rule is a jurisprudential doctrine that restricts claims that are based on the premise that a regulator's decision was incorrect.

In Louisiana, the collateral attack doctrine complements Louisiana Revised Statutes section 30:12. That statute provides that the only way a person may judicially challenge an order of the Commissioner of Conservation is to bring an action for judicial review within 60 days of the order in the Nineteenth Judicial District Court. The statute also provides that a person who brings such a challenge generally will not be allowed to offer in court any evidence that is not in the administrative record.[302] Thus, the statute regulates and restricts direct attacks on rulings of the Commissioner.

The collateral attack rule supplements the effect of Louisiana Revised Statutes section 30:12 by barring court actions that indirectly challenge an order of the Commissioner of Conservation, such as a suit that seeks to force a private citizen or company to act in a way inconsistent with the Commissioner's decision. The collateral attack rule goes further, however, even barring lawsuits that do not seek to force someone to violate the Commissioner's orders, but which call into question the correctness of a Commissioner's order.

In *Trahan v. The Superior Oil Company*,[303] the plaintiffs brought suit seeking to dissolve a mineral lease that they had granted. The plaintiffs asserted that a well on a nearby tract was draining their land.[304] The Commissioner had created a unit for the well, but the unit did not include any of the plaintiffs' land.[305] The plaintiffs based their suit for lease cancellation on a contention that the unit should have included some of plaintiffs' land, and that the Commissioner would have included a portion of plaintiffs' land in the unit if the plaintiffs' lessee had presented appropriate evidence to the Commissioner.[306] Although the remedy sought by the plaintiffs—lease cancellation—would not have forced the lessee or anyone else to act in a manner inconsistent with the Commissioner's order, the court held that the plaintiffs' claim was barred by the collateral attack

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415. But few other cases suggest this possibility. *See also* McCollam, *supra* note 72, at 68–69, 77–78.

301. *See, e.g.*, Trahan v. Superior Oil Co., 700 F.2d 1004 (5th Cir. 1983).
302. LA. REV. STAT. § 30:12 (1983).
303. *Trahan*, 700 F.2d 1004.
304. *Id.*
305. *Id.*
306. *Id.*

rule because the claim was based on a premise that the unitization order was incorrect.[307]

Some commentators have suggested an implied covenant to use reasonable care in producing minerals (for example, to take sufficient care to avoid accidents).[308] These proposed implied covenants have been rarely litigated (or at least not to cases that produce published opinions), but perhaps a court would recognize such a duty under appropriate facts. On the other hand, a court might reject an argument that implied covenants provide the basis for a contractual claim when accidents occur, and might hold that a plaintiff's claim sound in tort only.

IV. DEFENSES AND OTHER ISSUES

Courts have recognized several defenses to implied covenant claims.

A. Precluding Implied Covenants by Expressly Addressing Subject

Courts will not impose an implied covenant that is expressly negated by the lease itself.[309] Further, if a lease expressly deals with some subject matter, such as by expressly imposing some duty, the general rule is that the lessee will not be bound by an implied duty of the same type, even if the lease has not explicitly stated that the express duty is the sole duty with respect to that subject matter.[310] In other words, the duty expressly imposed by the lease will not be supplemented by an implied covenant.[311] The express duty implicitly negates any implied covenant.

307. *Id.*

308. *See, e.g.*, Martin, *A Modern Look At Implied Covenants to Explore, Develop, and Market Under Mineral Leases*, *supra* note 18, at 179. 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.

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

310. Yzaguirre v. KCS Res., Inc., 53 S.W.3d 368, 373 (Tex. 2001) ("However, there is no implied covenant when the oil and gas lease expressly covers the subject matter of an implied covenant."); HECI Expl. Co. v. Neel, 982 S.W.2d 881, 888 (Tex. 1998); Magnolia Petroleum Co. v. Page, 141 S.W.2d 691, 693 (Tex. App. 1940) ("when expressed covenants appear in the lease, implied covenants disappear").

311. *See* Aye v. Phila. 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

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" lease) or state that the lease will terminate unless the lessee drills or pays delay rentals within the first year (in an "unless clause" lease).[312] Delay rental clauses generally do not state explicitly that the implied covenant to drill a test well is negated, but delay rental clauses are interpreted as eliminating any such implied covenant.

Express lease clauses also can be used to negate other implied covenants. For example, in *Gulf Production Co. v. Kishi*,[313] the Texas Supreme Court held that an express lease clause negated the existence of an implied covenant to reasonably develop. The case involved two leases. One required drilling a well every 60 days after discovery of oil until a total of 12 wells were drilled.[314] The second lease required drilling a well every 90 days until four wells were drilled.[315] 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 operator would drill several more wells than the lessee had drilled.[316] 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.[317] Thus, the express duty implicitly negated an implied covenant of reasonable development.

Courts in other jurisdictions generally reach a similar result. In *Lundin/Weber Company LLC v. Brea Oil Company, Inc.*,[318] a California

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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 Co. LLC v. Brea Oil Co., Inc., 11 Cal Rptr. 3d 768 (Cal. App. 2004); Schroeder v. Terra Energy, Ltd., 565 N.W. 2d 887 (Mich. Ct. App. 1997).

312. *See* LOWE, NUTSHELL, *supra* note 15, at 204–06 (discussing "or" clauses and "unless" clauses).

313. 103 S.W.2d 965 (Tex. 1937).

314. *Id.*

315. *Id.*

316. *Id.*

317. *Id.*

318. *Lundin*, 11 Cal. Rptr. 3d 768 (Ct. App. 2004). Because the court determined that the express lease terms would negate an implied covenant, the

appellate court held that express drilling duties stated in a lease negated any implied covenant of further exploration. Two leases were at issue.[319] 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 1000 feet unless oil was discovered in paying quantities at a shallower depth.[320] 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."[321] The second 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.[322]

The lessor argued that the lessee breached a duty of further exploration by not drilling more wells to a depth of 3000 feet.[323] The court rejected that argument. The court 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-limited duty of reasonable development was imposed. 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.[324]

In *Schroeder v. Terra Energy, Ltd.*,[325] a Michigan appellate 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. The lease stated royalties would be a specified fraction of "gross proceeds at the wellhead" or "the prevailing market rate at the wellhead."[326] The lessor argued that an implied covenant to market required the lessee to absorb post-production costs.[327] The court disagreed.

court did not reach the issue of whether California would recognize an implied covenant of further exploration.

319. *See id.* at 769.
320. *See id.* at 772–73.
321. *See id.* at 774.
322. *See id.*
323. *See id.* at 770.
324. *See id.* at 774–75.
325. *Schroeder*, 565 N.W.2d 887.
326. *See id.* at 890.
327. *See id.* at 891.

The court stated that, assuming Michigan recognizes an implied covenant to market,[328] the covenant would not apply whenever the lease expressly addresses a subject.[329] 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.[330]

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.[331] 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. For example, such a clause might expressly require the lessee to drill an offset well if a productive well is located within 200 feet of the leased premises. 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, perhaps 225 feet away.

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.[332] 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 may be to *decrease* the lessee's duties.[333] 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.

Nevertheless, Texas courts sometimes have held that such clauses implicitly negate any implied covenant to protect against drainage.[334] Further, courts and commentators have stated that a clause that expressly

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

329. *See id.*

330. *See id.* at 894.

331. *See generally*, discussion at MARTIN & KRAMER, *supra* note 9, § 826.3.

332. *See id.*

333. *See id.*

334. *See* Hutchins v. Humble Oil & Refining Co., 161 S.W.2d 571 (Tex. App. 1942), *writ refused w.o.m.*; Magnolia Petroleum Co. v. Page, 141 S.W.2d 691, 693 (Tex. Civ. App. 1940).

negates or expressly limits an implied covenant to protect against drainage should be enforced.[335]

There seem to be relatively few reported cases in which parties expressly negate the existence of implied covenants, as opposed to implicitly negating implied covenants by explicitly imposing a duty that requires a type of performance similar to the performance that would be required under an implied covenant. But occasionally, parties enter a lease that expressly negates one or more implied covenants. Indeed, on occasion, parties enter a lease that expressly negates the existence of all implied covenant. The most notable examples come from Ohio, which has produced a handful of such cases. For example, a lease at issue in *Bilbaran Farm, Inc. v. Bakerwell, Inc.*[336] 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.

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.[337] The lessor brought suit in state court in Ohio, asserting that the lessee had breached the implied covenant to fully develop the property.[338] The defendant moved to dismiss, arguing that the plaintiff's complaint failed to state a cause of action.[339] 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.[340] In doing so, the appellate court from Ohio's Fifth District rejected the lessor's argument that the lessee's failure to further develop

335. *See, e.g.*, Shell Oil Co. v. Stansbury, 401 S.W.2d 623, 630 (Tex. App. 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."), *writ refused n.r.e.*, 410 S.W.2d 187 (Tex. 1966); MARTIN & KRAMER, *supra* note 9, § 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.").

336. Bilbaran Farm, Inc. v. Bakerwell, Inc., 993 N.E.2d 795, 801 (Ohio Ct. App. 2013).

337. *Id.* at 799.

338. *Id.*

339. *Id.*

340. *Id.* at 801.

the property was "unfair and inequitable."[341] The court noted that parties generally have freedom of contract and that courts typically should not override the terms of a contract.[342] The court also cited a prior case that reached a similar result.[343]

That prior case was *Bushman v. MFC Drilling*,[344] an unpublished case from the Ninth District Court of Appeals. The parties in *Bushman* entered a lease in 1990 that covered about 27 acres.[345] About 10 of those acres were part of a drilling unit that contained a unit well that produced in paying quantities.[346] The lessor brought suit, arguing that the lessee had breached an implied covenant to reasonably develop the property because 17 acres remained undeveloped.[347] 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.[348]

The district court granted the motion and dismissed the lessor's claims.[349] On appeal, the lessor argued that "public policy prohibits a general disclaimer of the implied covenant to develop the leased property."[350] Thus, only a clause that referred specifically to the implied covenant to develop the leased premises could preclude the existence of such a covenant.[351] Here, asserted the lessor, the clause disclaiming implied covenants was too "vague and general" to preclude the existence of an implied covenant.[352] 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.[353]

341. *Id.*
342. *Id.*
343. *Id.*
344. Bushman v. MFC Drilling Inc., 1995 WL 434409 (Ohio Ct. App. 9th Dist. 1995).
345. *Id.*
346. *Id.* at *1.
347. *Id.*
348. *Id.*
349. *Id.*
350. *Id.*
351. *Id.*
352. *Id.*
353. *Id.* at *2.

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.[354] Relying on general principles of contract law, the appellate court rejected this argument too.[355]

Appellate courts from two additional appellate districts in Ohio have likewise concluded that general waivers of implied covenants are enforceable.[356] 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.*,[357] though the statement in that case was dicta. The other case was *State ex rel. Claugus Family Farm, L.P. v. Seventh District Court of Appeals*.[358] 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.[359] The court then stated, "In addition, there is specific language in the lease that disclaims any implied covenant."[360] 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."[361] 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, Texas and most other states have few, if any, published cases that address enforcement of a clause that purports to make a general waiver of all implied covenants. Nevertheless, it seems that such a clause should be enforceable. The Texas Supreme Court has stated that "there is no implied covenant when the oil and gas lease expressly covers the subject matter of an implied covenant."[362] The Court did not make this statement in the context of a clause that purported to waive all implied

354. *Id.*

355. *Id.* at *3.

356. *See* Belmont Hills Country Club v. Beck Energy, No. 13BE18, 2015 WL 1592999 (Ohio Ct. App. 2015); Bohlen v. Anadarko E&P Onshore, LLC, 26 N.E.3d 1176, 1186 (Ohio Ct. App. Mar. 31, 2015); Taylor v. MFC Drilling, Inc., No. 94CA14, 1995 WL 89710 (Ohio Ct. App. Feb. 27, 1995) (general waiver of implied covenants was effective); Holonko v. Collins, No. 87CA120, 1988 WL 70900 (Ohio Ct. App. June 28, 1988) (same).

357. Alford v. Collins-McGregor Operating Company, 95 N.E.3d 382 (Ohio 2018).

358. Claugus Family Farm, L.P., 47 N.E.3d 836, 843 (Ohio 2016).

359. *Id.*

360. *Id*.

361. *Id.*

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

covenants, but if the clause is taken at face value, it indicates that a general waiver should be enforceable. Further, as previously noted, in *Gulf Production Co. v. Kishi*,[363] the Texas Supreme Court held that a clause that expressly imposed certain drilling duties had the effect of negating any implied covenant of reasonable development, even though the clause did not state that any implied covenant was being eliminated. This suggests that a general waiver of implied covenants should be enforceable in Texas.

The only potential hurdle to the enforceability of a general waiver of all implied covenants would be a conclusion by a court that public policy so favors the protection of lessees that a general waiver should not be enforced. Notably, a state appellate court in Louisiana stated that, for reasons of public policy, "the obligation of good faith prudent development cannot be abrogated" though "it may be contractually defined by the parties."[364] It is not clear that the statement is a correct expression of Louisiana law, much less that of Texas or 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.[365]

Just as there are relatively few reported cases dealing with leases in which parties expressly negated all implied covenants, there are relatively few cases dealing with leases in which the parties negated the existence of a particular implied covenant. Of the few cases dealing with such a lease is another case from Ohio, *Linn v. Wehrle*.[366] 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).[367] A state appellate court from Ohio held that this clause precluded the existence of an implied covenant to drill or protect against

363. Gulf Production Co. v. Kishi, 103 S.W.2d 965 (Tex. 1937).
364. Dawes v. Hale, 421 So. 2d 1208 (La. Ct. App. 1982).
365. *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)).
366. 172 N.E. 288, 289 (Ohio Ct. App. 1928).
367. *Id.*

drainage.[368] The parties to an oil and gas lease could use similar language to expressly preclude one or more implied covenants. If a similar clause appeared in a Texas lease, the courts likely would enforce it.

B. Demand and Opportunity to Cure

Some jurisdictions require a lessor to give the lessee notice of an alleged breach of an implied covenant, and a reasonable opportunity to cure, before bringing suit for such a breach.[369] In addition to the jurisdictions that make notice and an opportunity to cure a prerequisite to the filing of any implied covenant claim, additional jurisdictions require the lessor to give the lessee notice and a reasonable opportunity to cure before the remedy of lease cancellation will be available.[370] A letter to the lessee giving notice of an alleged breach and stating that the lease allegedly has terminated, or demanding release of a lease, does not necessarily satisfy the requirement that a lessor give both notice of the alleged breach *and* a reasonable opportunity to cure.[371]

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 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

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368. *Id.*

369. *See, e.g.*, LA. REV. STAT. §§ 31:135, 136 (1975). Further, some leases also include clauses stating that the lessor must give the lessee notice and an opportunity to cure before bringing suit.

370. *See, e.g.*, Hayes v. Equitable Energy Res. Co., 226 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 (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).

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

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.[372]

In Texas, it appears to be the rule that notice and an opportunity to cure is not required (assuming that the lease itself does not require notice) before suing for damages. In the extraordinary case in which money damages is not sufficient or cannot be determined, conditional cancellation can be appropriate, and this is preferred over outright cancellation.[373] Pre-suit notice and an opportunity to cure might not be required before filing suit, but the lessee generally will have an opportunity to cure.

C. The Effect of a Lessor's Unsuccessful Suit Seeking Judgment That a Lease Has Terminated

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.[374] Such a rule is sometimes called the "repudiation doctrine." The doctrine generally is based on fairness and equity.[375] 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.[376]

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372. For a thorough discussion of judicial ascertainment clauses, see MARTIN & KRAMER, *supra* note 9, §§ 682–82.5.

373. Slaughter v. Cities Serv. Oil Co., 660 S.W.2d 8860 (Tex. App. 1983).

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

375. In Louisiana, however, courts reach this result via the reasoning that the lessor's challenge to the validity of the lease is a breach of the lessor's implied duty to maintain the lessee in peaceable possession.

376. 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 damages claim for reduced value of property for mineral leasing if company that lacks an enforceable lease drills dry hole), *cf.* Layne Louisiana Co. v. Superior Oil Co., 26 So. 2d 20 (La. 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).

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 lessor was not drilling additional wells while the lessor's original complaint was pending.

D. 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.[377] The question of whether a lessee has breached an implied covenant is an issue of fact.[378] The lessor generally has the burden of proving that the lessee had breached an implied obligation of the lease.[379] An exception is that 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.[380] Typically, parties will need expert testimony to prove what a reasonably prudent operator would or would not have done.

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377. For example, in *Clifton v. Koontz*, 325 S.W.2d 684, 695 (Tex. 1959), the Texas Supreme Court rejects the plaintiff's argument that there is an implied covenant of further exploration that is distinct from the implied covenant of reasonable development. The Court seems to treat the issue as a matter of law. *See also* Terrebonne Par. Sch. 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).

378. This certainly is true in Texas. *See, e.g.*, Amoco Prod. Co. v. Alexander, 622 S.W.2d 563, 572 (Tex. 1981) ("In drainage cases, Texas courts place upon the lessor the burden to prove that substantial drainage has occurred and that an offset well would produce oil or gas in paying quantities."); *Clifton*, 325 S.W.2d at 695 ("The petitioners did not discharge the burden which rested upon them to prove, as required, that the lessees failed to measure up to the standard of the prudent operator."); Van Every v. Peterson, 24 F.2d 26, 27 (5th Cir. 1926) (applying Texas law). It also is true in other states. *See* Carter v. Arkansas Louisiana Gas Co., 36 So. 2d 26, 28 (La. 1948); Caddo Oil & Mining Co. v. Producers' Oil Co., 64 So. 2d 684, 690 (1914); Mountain States Oil Corp. v. Sandoval, 125 P.2d 964, 967 (Colo. 1942).

379. Coyle v. North Am. Oil Consol., 201 La. 99, 105 (1942) (lessor has the burden of proving a breach of the implied obligation to protect against drainage); Saulters v. Sklar, 158 So. 2d 460, 463 (La. App. 1963) (lessor plaintiff had burden of proving lessee had not reasonably developed the premises).

380. *See* LOWE, NUTSHELL, *supra* note 15, at 336–37.

V. CONCLUSION

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. Under Louisiana and Texas law, there are three main implied covenants: (1) an implied covenant to develop proven formations; (2) an implied covenant to protect against drainage; and (3) an implied covenant to diligently market oil or gas found in paying quantities. There may also be a duty to drill exploratory wells in unproven areas or depths. As a general rule, a court will not hold that a lease contains an implied covenant of a particular type if the lease contains language expressly dealing with that sort of duty.

The favored remedy for a breach of implied covenants is a damages award, but occasionally lease cancellation is an available remedy. Lease cancellation may be partial, rather than complete. For example, if a lessee has breached a duty to develop, the lease might remain in effect as to areas where the lessee has drilled wells, while being canceled in others. Further, the cancellation might be conditional—that is, the order of cancellation will apply only if the lessee fails to render some performance specified in the court order (such as drilling a specified number of additional wells) by a specified date.

For all implied covenants, the standard of performance required of the lessee is that of a reasonably prudent operator. That is, the lessee must do what a reasonably prudent operator would do under the same circumstances.

In Louisiana, a lessor generally must give the lessee notice and an opportunity to cure before bringing suit for an alleged breach of implied covenants. In Texas, the lessor probably needs to give such notice before seeking the remedy of lease cancellation.