Chapter 9

The Termination Clauses of The Lease:

Implied Covenants

IMPLIED COVENANTS

Generally, the clauses found in the oil and gas lease were written by attorneys who worked for the oil and gas companies. As would make sense, these clauses were weighted more heavily in the favor of the oil company than the mineral owner. Over the years, as courts became involved in lease issues and protecting the lessor's rights, they began to establish what is now known as the *implied covenants* of the lease.

As the phrase *implied covenants* suggests, they are not written within the body of the lease, rather they are *implied* by the lease itself. Therefore, courts have found that oil companies are bound and obligated to the lessor by these covenants, as if they *had* been written into the lease. As would make sense, these covenants are weighted more heavily in the favor of the mineral owner than the oil company.

Courts found that the very act of signing a lease established a statement of cooperation between both the lessor and the lessee. This principle of cooperation exits in all contracts and basically states that both parties have joined into a venture in order to accomplish the purpose of the agreement. This principle of cooperation also establishes the belief that each party agrees to do whatever is "reasonably" necessary to create financial success from the mineral lands. For the oil company, that means making a reasonable attempt to develop and produce the lease in order for the lessee to receive benefits from such development. It was this belief that gave way to the covenants as we know them today.

Since this principle of cooperation establishes the belief that both parties agree to do whatever is reasonably necessary, courts, when called upon to rule in these matters, attempt to find an outcome that is fair to both parties.

An Early Landmark Case

In Brewster v. Lanyon Zinc Co., one of the early cases dealing with implied covenants, the court stated:

> "It is conceded, as indeed it must be, that the lease contains no express stipulation as to what, if anything, should be done in the way of searching for and producing oil or gas after the first five years; but it does not follow from this that it is silent on the subject, or that the matter is left absolutely to the will of the lessee. Whatever is implied in a contract is as effectual as what is

expressed. Implication is but another name for intention, and if it arises from the language of the contract…it is controlling."[1]

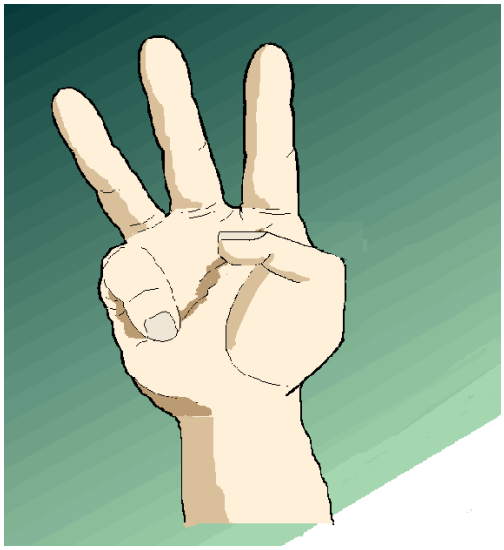
THE IMPLIED COVENANTS IN THE OIL AND GAS LEASE

THE IMPLIED COVENANT TO DEVELOP THE LEASEHOLD

Local, county or state governments would not look favorably upon a road construction company hired to build a four-lane highway, if the company stopped their construction when only two lanes had been completed. In a situation like this, the granting contract would have established, up front, a *four-lane highway*. Stopping short of that, the construction company would be in default of the contract.

In much the same way, the oil and gas lease implies an obligation on the part of the lessee to finish the job they first began. Once a discovery well has been located, there exists an implied duty to continue the development of the exploration for the oil or gas underlying the leased premises. Stopping short of that, the oil company could be found in default of the lease.

One of the standards by which the courts will make its ruling is the "Prudent Operator Standard". And the courts will ask this question, "Given these circumstances what action or inaction would a prudent operator normally take?"



The three-fold obligations defining a prudent operator are:

- ☐ A prudent operator will act in good faith
- ☐ A prudent operator will act competently

- A prudent operator will take into account the legitimate interests of the lessor [2]

The implied covenant to develop the leasehold asks the questions, “What action for further development would an economically stimulated, prudent operator take in order to develop the lease? Would they drill additional wells? Would they drill to other formations? Are the oil and gas minerals being produced quickly enough? Why is there such a long delay in the development of this field when it appears that other operators are developing their fields much more quickly?

The answer to these questions will often reflect the differing interests and motivations of the lessor v. the lessee.

Example 1:

Let’s say your company has drilled a producing well on a large tract of land covered by one lease. According to the reserve reports, the well will most likely continue to produce for the next thirty-five years. As long as those reserves stay in the ground, they are like money in a savings account for your company. The value of the reserves could actually be increasing year-by-year and your company may not be interested in drilling a second well that would deplete the reserves in fifteen years.

On the other hand, the lessor may be up in years and for him or her, a bird in the hand is worth two in the bush! The lessor’s motivation might be to drill four wells and deplete the reserves within the next seven years. “After all,” the lessor thinks, “I can’t take it with me.!”

The principle of cooperation suggests that, in a case like this, your company has the right to consider their own financial interests but they also have an obligation to consider the interests of the lessor. They must ask themselves the question, “What course of action would a prudent operator take given the same set of circumstances?”

Example 2:

Let’s say your company owns the Samson Morrison lease that covers over 2,000 acres. During the last fifteen years you have drilled eleven wells, all of which are productive from the same reservoir located at a depth of 9,500’. Over the years, the total production from the field has exceeded 2,000,000 barrels of oil and generated, on average, a royalty of $75,000 per month to the lessor, Samson Morrison.

Your company recently received a demand letter from the lessor stating that because you had not conducted exploration operations at a depth of 12,000' (another zone being produced by other operators in the area), the zones below 9,500' have automatically terminated.


Samson Morrison

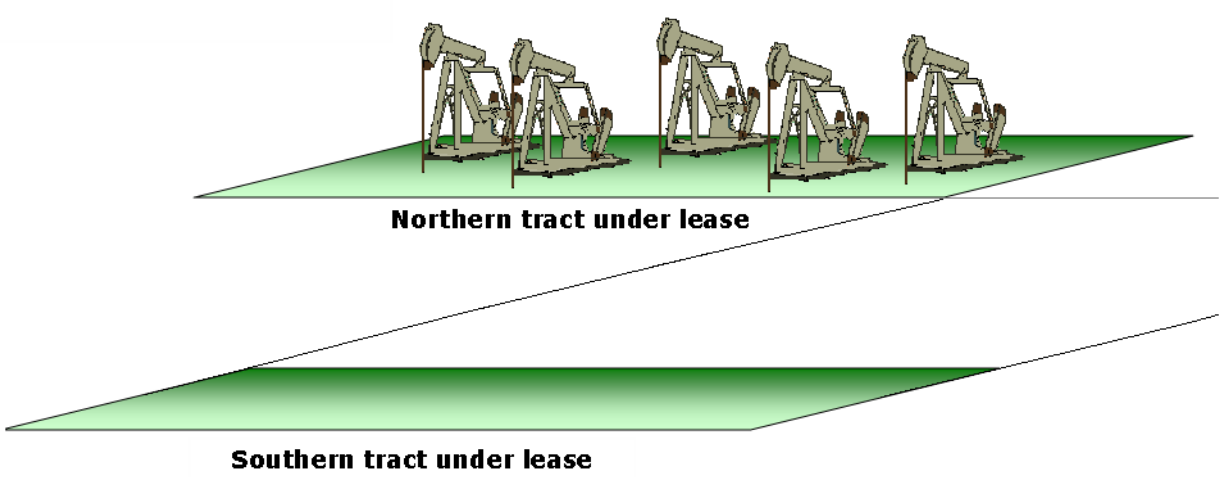
Does the lessor have a valid complaint? Based on the implied covenant to develop the leasehold have these lower zones been terminated?

Unlike the other termination clauses of the lease, since the implied covenants are *covenants* rather than *conditions* strictly set forth in the lease, automatic termination does not take place. The demand letter does, however, place your company on notice that an alleged breach of the lease exists. Before any termination could take place, your company would have an opportunity to correct any alleged breach.

In order for termination to happen, the lessor must bring some sort of court action against your oil company. During this action the lessor must prove that a prudent operator could have and would have drilled profitable wells in the deeper zones. The action might seek the cancellation of the lease except for lands or zones held within spacing units or the action might seek monetary damages. The burden of proof for any alleged breach of implied covenants rests entirely on the shoulders of the lessor. If a breach can be determined to have taken place, the courts might order a conditional cancellation of the lease. In other words, your company would be ordered to commence further exploration of the deeper zones or suffer cancellation of the lease in those zones.[3]

Example 3:

Let's say your company owned a lease that covered two non-contiguous tracts of land as illustrated in the diagram. Both tracts of land are held by production from the wells drilled in the northern tract. Over the last twenty years, your company has drilled several wells on this tract of land. None have been drilled on the southern tract of land. Your company recently stated that it had no intention of drilling any wells on the southern tract of land.



Under the covenant to develop the leasehold, would your company be obligated to drill a well on the southern tract of land?

If the courts became involved, they might indeed find in favor of the lessor. David Pierce in referencing Saunder v. Mid-Continent Petroleum Corp. states, "At some point in time the lessee is required to make a choice whether he will release undeveloped portions of the lease or conduct further exploration. This premise assumes at some point in time a prudent operator will explore all parts of the leased land." In the Saunder v. Mid-Continent case the court offered a conditional cancellation of those lands that had not been explored. [4]

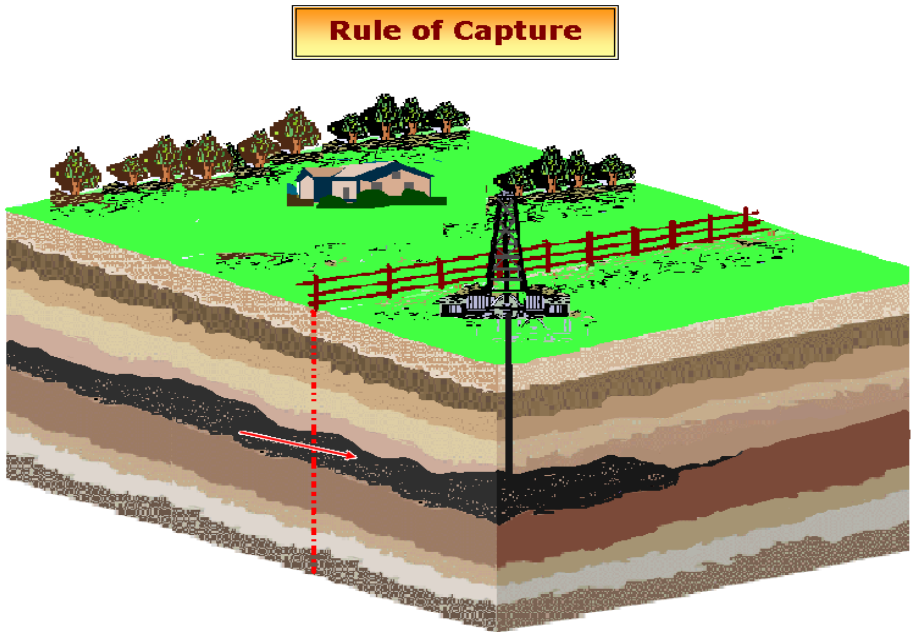
THE IMPLIED COVENANT TO PROTECT THE LEASEHOLD FROM DRAINAGE

In order to understand the importance of this covenant, one should first understand another concept called the Rule of Capture. The rule of capture

is applied to any and all mineral owners and briefly states that a mineral owner has the right to capture all of the oil and gas he or she brings to the surface through wells located on his or her own property and that such a mineral owner is the absolute owner of the captured oil or gas.

This ownership applies not only to the oil or gas that lies beneath the mineral owner's land, but also any and all oil and gas that is being drained from a neighboring tract of land. In such a case, the mineral owner extracting the oil and gas is not liable to make restitution of any kind to the adjacent landowner.[5]

This rule is based on the idea that oil and gas migrates or moves. Once the oil and gas has migrated from beneath the adjacent landowner's tract of land, it is no longer owned by this landowner but becomes the property of the mineral owner extracting the product from wells located on his or her land.



The producing owner has the right to capture all oil and gas brought to the surface - even though the oil and gas was drained from a neighbor's tract of land.

Once the oil and gas migrates from beneath the neighbor's land it becomes the property of the mineral owner extracting the product from wells located on his or her property.

The Ohio Supreme Court held:

> "Petroleum oil is a mineral, and while in the earth it is part of the realty, and, should it move from place to place by percolation or otherwise, it forms part of that tract of land in which it tarries for the time being, and, if it moves to the next adjoining tract, it becomes part and parcel of that tract; and it forms part of some tract until it reaches a well, and is raised to the surface, and then

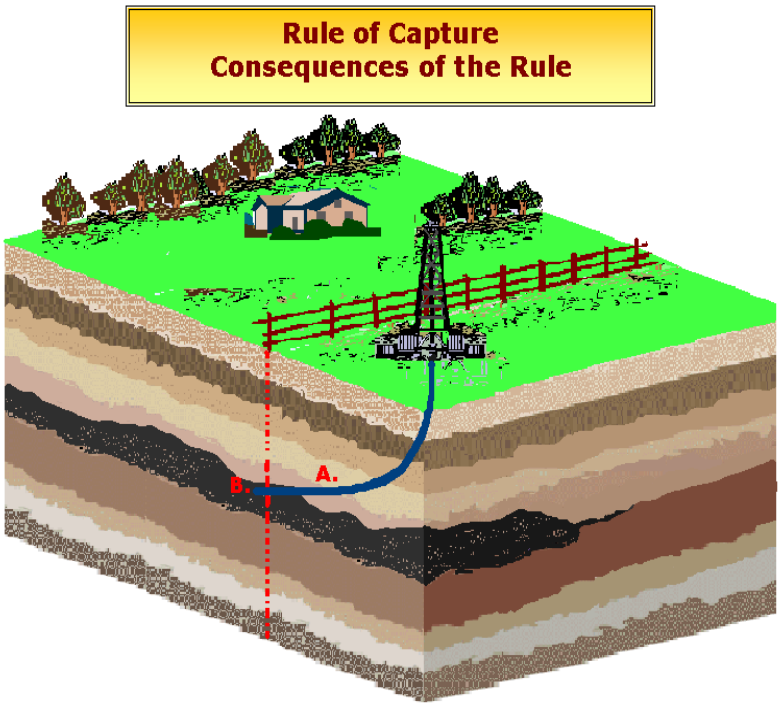
for the first time it becomes the subject of distinct ownership, separate from the realty, and becomes personal property- the property of the person into whose well it came. And this is so whether the oil moves, percolates, or exists in pools or deposits. In either event, it is the property of, and belongs to, the person who reaches it by means of a well, and severs it from the realty, and converts it into personalty."[6]

Consequences of the rule

Courts have also ruled that drilling directionally in order to capture oil and gas from beneath an adjacent tract of land constitutes "clear trespass".[7]

Also, if the well bore is drilled directionally and bottom holes beneath the adjacent tract of land, the oil or gas produced belongs to the landowner where the well bottom holed.

The conclusion of this matter is simple. Courts have determined that the appropriate solution for a landowner wishing to protect their land from drainage is simply to develop their own land through drilling their own well.[8]



A. Clear Trespass takes place when a company drills directionally in an attempt to intentionally capture oil and gas from an adjacent tract of land.

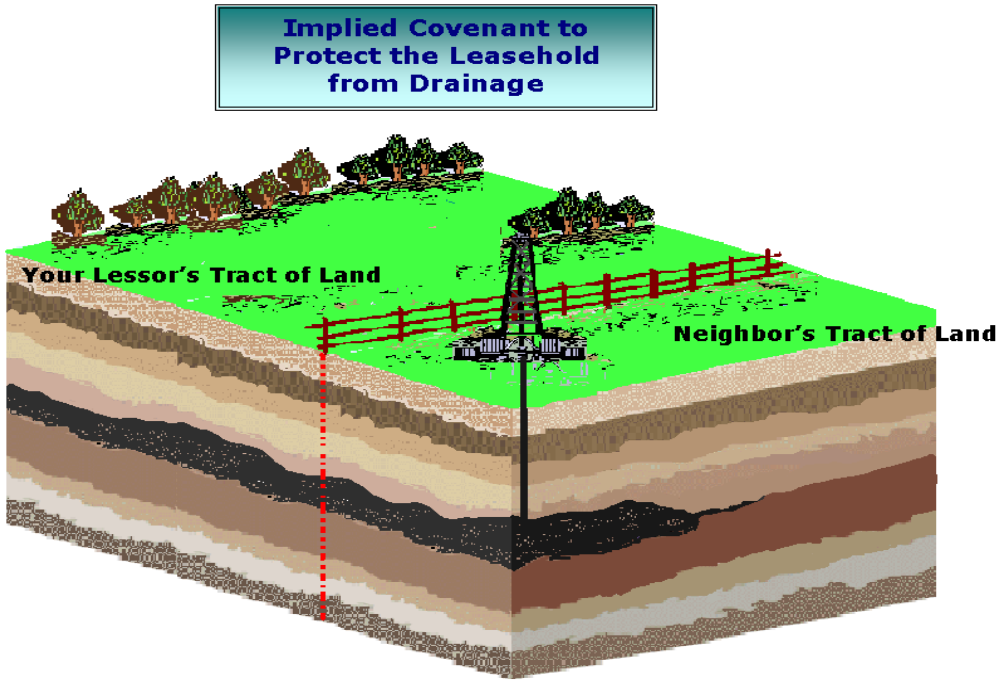
B. If the well bottom holes beneath an adjacent tract of land, the oil or gas produced belongs to the landowner under which the well was drilled.

For this reason, the second implied covenant exits - requiring that the Lessee act appropriately when drainage is occurring from their lessor's lands. The guidelines used to determine this fact are:

- Can it be shown that substantial drainage is occurring?
- Can it be determined that an offset well would most likely be profitable?

- Under the same circumstances would a reasonable prudent operator drill an offset well?

If it can be determined that (1) drainage is occurring; that (2) an offset well would be profitable and that (3) a prudent operator would drill such a well, then the Lessee would be required to drill a well in order to stop the drainage. Apart from drilling another well, other options might include compensating the lessor for lost revenue or pooling the lessor's lease with other leases.



This implied covenant exists during and after the primary term of the lease and cannot be ignored simply by making a delay rental payment during the primary term. This issue becomes a little greyer, however, when a delay rental payment is made and is also accepted by the lessor.

Burden of Proof

In order to establish the three facts as set out above, the burden of proof rests entirely on the shoulders of the lessor. Such proof must be in the form of technical evidence i.e. "the porosity and permeability of the reservoir and evidence of reservoir pressures".[9]

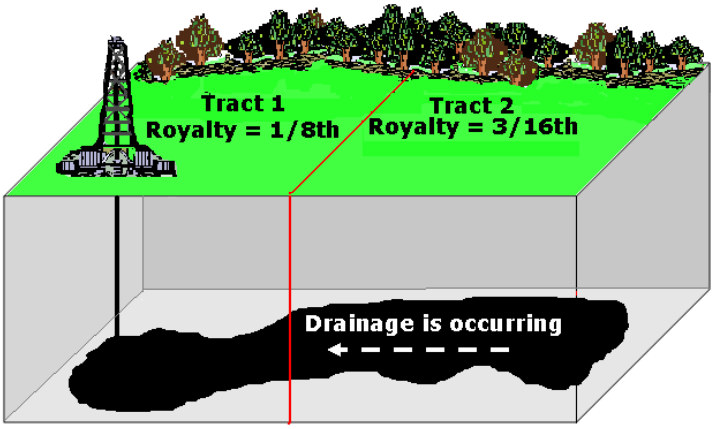
In a case where demands are made to drill another well but the operator still fails to stop the drainage by drilling, the courts might grant the operator a conditional cancellation of the lease and give them one last chance to drill a well. Apart from that, three decisions might follow:

1. The lease will terminate.
2. The lessor could be awarded damages.
3. The lessor could be awarded damages combined with the termination of the lease.

Example when the lessee owns both leases:

Let's say that an oil company owns two leases in an area as shown on the following diagram. Each lease has a different lessor and each lessor negotiated a different royalty amount.

- The Tract 1 lease royalty is 1/8$^{th.}$
- The Tract 2 lease royalty is 3/16th.



The same oil company owns both leases.

The oil company drilled one productive well on Tract 1. This well is draining oil from under Tract 2. In other words, the oil company is draining oil from beneath their own Tract 2 lease and producing it from their Tract 1 lease.

It is also evident that the oil company's NRI is higher from all production in the existing well than it would be if they drilled a second well on the Tract 2 lands. Tract 1 production would yield a higher profit with an 87.5% NRI on the dollar

than it would yield from Tract 2 production at only an 81.25% NRI on the dollar.

Since the oil company owns both leases, does the implied covenant to protect the Tract 2 lessor from drainage apply?

Courts, generally have maintained the same standards and guidelines in situations like this asking the questions, “What would a prudent operator do?” and “Would an offset well be capable of producing in paying quantities?” On the other hand, as stated by William Pearce, “There are cases which hold that the lessee is held to a higher standard in the common lessee situation, or, equivalently, that the lessor need not prove all of the same elements as in the ordinary case.”[10]

THE IMPLIED COVENANT TO MANAGE THE LEASE

Under this covenant the lessee is held responsible for making reasonable efforts to market production, manage operations with care, and conduct the operations in a diligent and proper manner. In cases where the lessee may not want to drill any well or wells, they may be held to the duty to farm their acreage out to another company so that exploration can proceed.

TWO RULES THAT APPLY TO IMPLIED COVENANTS

There are two rules that apply to implied covenants that are important to know. They are:

1. Any express provisions found in the lease will supersede any of the implied covenants.
2. Implied covenants must be able to co-exist with any provisions in the lease that are expressly set out.

MARKETING

Although this third implied covenant creates a duty upon the lessee to market production, if the lease contains express provisions which supersede this covenant, the lease language prevails. For instance, simply because a well is shut-in, does not relieve the lessee of its duty to market the gas. If a well is shut-in, the lessee has an obligation to diligently search for a market and to otherwise conduct itself under the prudent operator standard. However, if the lease contains specific shut-in language that would allow the lessee additional time in which to market because of a well or wells being shut in, the lease language would supersede the covenant.

If the lease language granted the lessee special provisions for marketing based on the best available price, the lease language would supersede the covenant.

Apart from additional or specific lease language, the lessee has an implied duty not only to find a reasonable market but also to obtain the highest price available for the product. In 1979, a Texas court awarded past, fair market value damages to several lessor's because the operator had failed to market the gas in good faith. They had marketed the gas at less than the prevailing prices. It was found that the marketing contracts, signed by the lessee, were to the oil company's advantage but to the lessor's disadvantage.[11]

In states like Oklahoma and Texas, the prudent operator standard allows companies to make shut-in payments while they are trying to find a more profitable market for the gas. Even if a purchaser is waiting at the door with pen in hand for a gas contract to be signed, courts have allowed the operator to wait in order to get better terms or to sign a better contract with a different purchaser.[12] The idea is if the oil company makes more money through negotiating a better contract the lessor will also make more money.

Kansas case law is different and is based upon the idea that the lessor is interested in any and all production money. Because of this, a well in Kansas cannot be shut-in while the lessee is attempting to find a more profitable market for gas.

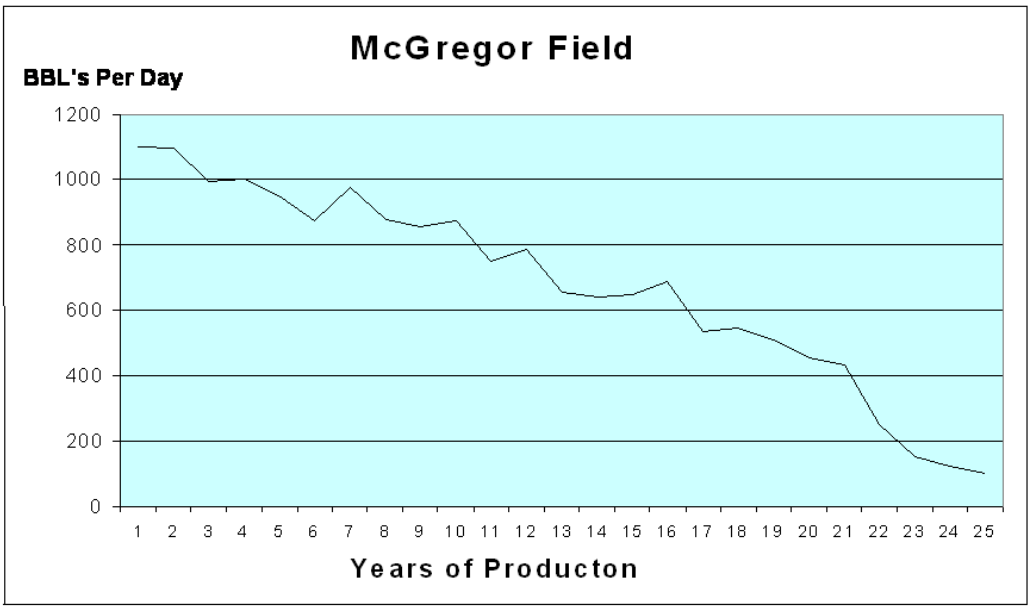
MANAGING OPERATIONS

This third implied covenant also requires the lessee to make proper and competent decisions in order to protect both the lessor and lessee. Generally, when a complaint arises citing an alleged breach of this covenant, the complaint will fall in one of four areas:

1. The lessee has caused damage to the property through negligence or incompetence.
2. The lessee has failed to protect the lessee from damages due to a premature abandonment of a well capable of producing in paying quantities.
3. The lessee has failed to use the latest production techniques in order to develop production.
4. The lessee has failed to protect the lessor by failing to seek favorable regulatory action. [13]

Example 1:

Your company has been the operator of an old oil field named the McGregor Field, which has produced for 25 years. The decline curve in production has shown a sharp drop over the last four years as seen the diagram.

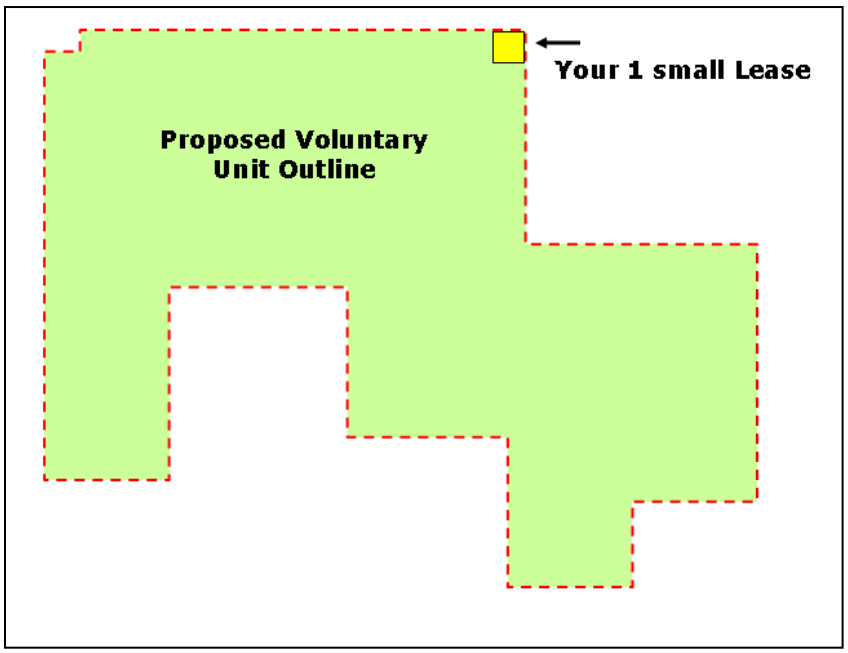


There has been talk among employees that the field is on its last leg. Recently, however, the lessor wrote a letter requesting that new life could be brought into the field if your company used enhanced recovery techniques in an attempt to capture reserves still left in the ground.

In a case like this, a prudent operator would consider the option of enhanced recovery techniques. If it was shown that such a venture could be profitable, a prudent operator would probably proceed with these types of operations.

Example 2:

Your company recently acquired 10,000 non-productive acres from a company that was going bankrupt. Most of the acreage is in an area that your company is very active in but one small lease falls outside this area and several miles to the south. The primary term is clicking on every lease and your priority is to save those leases within your known expertise area. Your company has no interest in developing the one southern lease.



Another operator, in that southern region, has recently proposed the formation of a voluntary unit that would include your small one lease.

To join the unit, would mean paying your share of expenses in any well drilled by this other operator.

Not to join the unit, would mean that the unit would not include your lessor's tract of land and your lessor would not receive any financial benefits from the unit. As a matter of fact, it might mean the exclusion of your lessor from becoming a part of any unit. Not to join the unit would also mean this lease would expire on its own term within the next eighteen months.

According to the implied covenant, to properly manage the leases what should your company do?

In a case like this, a prudent lessee would consider the option of profitability of the voluntary unit. Remember, the lessee is held to the standard of working on the behalf of both lessee and lessor. If your company did not feel it profitable to join the unit, they should, at least, attempt to farm their leasehold out to the company proposing the unit. In that way there would be an attempt to take into account the legitimate interests of the lessor.

FOOTNOTES:

[1]William P. Pearce, Basis of the Implied Covenants, RMMLF, Nov. 1986.

[2]An Introduction to Kansas Oil & Gas Law, 1988 Washburn Law School Oil & Gas Law Series, David E. Pierce, November, 1988, p.85.

[3]South Texas College of Law, Student Bar Association, Oil and Gas Outline, Professor Strausser, 2004 www.stcl.edu/students/sba/outlines.

[4]An Introduction to Kansas Oil & Gas Law, 1988 Washburn Law School Oil & Gas Law Series, David E. Pierce, November, 1988, p.89.

[5] U.S. Supreme Court, Del Monte Min. & Mill. Co v. Last Chance Min. & Mill., Co., 171 U.S. 55 (1898).

[6]Kelly v. Ohio Oil Co., 39 L.R.A. 765, the Supreme Court of Ohio.

[7]South Texas College of Law, Student Bar Association, Oil and Gas Outline, Professor Reed, 2000 www.stcl.edu/students/sba/OilandGas.

[8]Carlock v. Krug, 151 Kan. 407, 411, 99 P.2d 858, 861 (1940).

[9]An Introduction to Kansas Oil & Gas Law, 1988 Washburn Law School Oil & Gas Law Series, David E. Pierce, November, 1988, p. 91.

[10]William P. Pearce, Basis of the Implied Covenants, RMMLF, Nov. 1986.

[11]Amoco Production Co. v. First Baptist Church of Pyote, 579 S.W.2d 280 (Tex.Civ.App. 1979).

[12]South Texas College of Law, Student Bar Association, Oil and Gas Outline, Professor Reed, 2000.

[13]Ibid.