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A Modern Look at Implied Covenants to Explore, Develop, and Market Under Mineral Leases [reprint, first published 1976]

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ONE J

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A MODERN LOOK AT IMPLIED COVENANTS
TO EXPLORE, DEVELOP, AND MARKET
UNDER MINERAL LEASES*
[reprint, first published 1976]

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Introduction

It has now been twenty years since Professor Charles Meyers published his article which initiated an often-heated dispute over whether there is an implied covenant of further exploration.¹ Since that debate, relatively little controversy has been generated in the law of implied covenants.² This is unfortunate for it is a matter of some significance to the nation. In light of recent developments affecting the petroleum industry, it is time for a fundamental reexamination of certain aspects of implied covenant law. The purpose of this discussion is to begin such a reexamination.

* This article was originally published in the *Twenty-seventh Annual Institute on Oil and Gas Law and Taxation*. See Patrick H. Martin, *A Modern Look at Implied Covenants to Explore, Develop, and Market Under Mineral Leases*, 27 INST. ON OIL & GAS L. & TAX'N 177 (1976). Reprinted with permission. Copyright 1976 Matthew Bender & Company, Inc., a LexisNexis company. All rights reserved.

1. Meyers, "The Implied Covenant of Further Exploration," 34 Texas L. Rev. 553 (1956). On the dispute, see the materials cited in N. 39 *infra*.

2. This should be qualified by reference to current debate with respect to the implied covenant against drainage. See the materials in N. 12 *infra*.

Briefly stated, my suggestion is that the corporate lessee today has responsibilities in national energy development and environmental protection that often require it to consider the long-term consequences of its actions without regard to short-term profit, that our concept of the “prudent operator” should be modified to give due regard to the modern role of the lessee, and that courts should less readily find breach of implied covenant duties in order that implied covenant law not hinder lessees in fulfilling their national responsibilities. The prudent operator standard, a judicially fashioned rule, is sufficiently flexible to accommodate change. For those who might find a modified approach to implied covenant law offensive because of the rule of stare decisis or because lessors have had expectations created by existing case law, I offer Sir Edward Coke’s statement: “How long soever it hath continued, if it be against reason, it is of no force in law.”³

The Implied Covenants

There is an extensive literature on the subject of implied covenant law that has been written by a number of very able authorities. One cannot begin to consider the subject seriously without reference to the writings of Merrill,⁴ Williams and Meyers,⁵ Summers,⁶ Brown,⁷ and Walker⁸ and others who have dealt with particular aspects of the subject. The works of these writers go into the large body of case law in far greater detail than the scope of the present discussion permits, and it should be understood that I am not attempting to duplicate their treatment of these numerous cases.⁹

3. *Coke on Littleton, First Institute* § 80.

4. Merrill, *Covenants Implied in Oil and Gas Leases* (2d ed. 1940 and 1964 Supp.).

5. Williams and Meyers, *Oil and Gas Law* §§ 801–878. Additional articles by Professor Meyers are listed separately in N. 39 *infra*.

6. Summers, *Oil and Gas* §§ 395–416.

7. Brown, *The Law of Oil and Gas Leases* (2d ed. rev. 1973).

8. Walker, “The Nature of the Property Interests Created by an Oil and Gas Lease in Texas,” 11 *Texas L. Rev.* 399 (1933).

9. The court observed in *Clayton v. Atlantic Refining Co.*, 150 F. Supp. 9, 13, 7 O. & G.R. 1426 (D.N.M. 1957), that “the law dealing with the implied covenant to drill additional wells is monumental in volume, and the Federal and State Reports from all oil and gas producing jurisdictions are replete with cases on the question.”

Although the authorities and the cases have enumerated many implied covenants in mineral leases under various headings, the implied covenants will be treated here as being in six categories:¹⁰

- (1) The implied covenant to drill an initial exploratory well;
- (2) The implied covenant to protect against drainage;
- (3) The implied covenant to use reasonable care in producing the minerals;
- (4) The implied covenant of reasonable development;
- (5) The implied covenant of further exploration; and
- (6) The implied covenant to market the product.

The first three categories will not be included in this paper. 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.¹¹ The implied covenant to protect against drainage involves special considerations that are of limited pertinency to the present discussion and warrant separate treatment.¹² The implied covenant to use reasonable care in producing the minerals often concerns questions of negligence which may be treated under the law of torts,¹³ and the covenant does not involve the same policy considerations as the latter three implied covenants.

10. This classification essentially follows that of Williams and Meyers, N. 5 *supra* at § 804. For other classifications, see Merrill, N. 4 *supra*, § 4; Summers, N. 6 *supra*, § 395; Brown, N. 7 *supra*, § 16.02 at 16-6; and Walker, N. 8 *supra* at 401.

11. See Moses, "The Evolution and Development of the Oil and Gas Lease," 2d *Oil & Gas Inst.* 1 (Matthew Bender 1951).

12. See Seed, "The Implied Covenant in Oil and Gas Leases to Refrain from Depletory Acts," 3 U.C.L.A. L. Rev. 508 (1956); Hardy, "Drainage of Oil and Gas from Adjoining Tracts—A Further Development," 6 Nat. Res. J. 45 (1966); Brooks, "Liability of an Oil and Gas Lessee for Causing Drainage: A Standard for Texas," 51 Texas L. Rev. 546 (1973); *Shell Oil Co. v. Stansbury*, 401 S.W.2d 623, 25 O. & G.R. 559 (Tex. Civ. App. 1966), *error ref'd, n.r.e.*, 410 S.W.2d 187, 25 O. & G.R. 578 (Tex. 1967); *Shell Oil Co. v. James*, 257 So.2d 488, 40 O. & G.R. 215 (Miss. 1971); *Williams v. Humble Oil & Refining Co.*, 432 F.2d 165, 38 O. & G.R. 212 (5th Cir. 1970), *cert. denied* 402 U.S. 934 (1971); *Carter Oil Co. v. Dees*, 340 Ill. App. 449, 92 N.E.2d 519 (1950).

13. See Brown, "Oil and Gas Lease—Implied Covenant to Use Due Care," 19 Texas L. Rev. 80 (1940), and Brown, N. 7 *supra*, § 16.02 at 16-67.

The Implied Covenant of Reasonable Development

The implied covenant of reasonable development arises after the drilling of an initial producing well¹⁴ and applies in the primary term of the lease as well as the secondary.¹⁵ It is concerned with additional development in known producing formations,¹⁶ although some writers¹⁷ and jurisdictions¹⁸ would consider the question of drilling in unproven formations under this same general heading.

The principle of reasonable development is easily stated and similar terminology is employed in most jurisdictions. As stated in the case of *Temple v. Continental Oil*,¹⁹ which will be examined in some detail, "It is well settled that where the existence of oil in paying quantities is made apparent . . . it is the duty of the lessee to continue the development of the property and to put down as many wells as may be reasonably necessary to secure the oil for the common advantage of both the lessor and lessee."²⁰ The standard applied to determine whether the lessee has fulfilled the implied covenant is also virtually the same in almost all jurisdictions. It is the prudent operator standard that is stated in the *Temple* case as follows:

"[W]hat is required of a lessee, under the implied covenant to develop an oil and gas lease, is reasonable diligence in doing what would be expected of an operator of ordinary prudence, *in the furtherance of the interests of both lessor and lessee*. Under this rule neither the lessor nor the lessee of an oil and gas lease is the sole judge of what constitutes prudent development of the tract."²¹ [Emphasis in original, citations omitted.]

Since the implied covenant of reasonable development and the test for compliance with it are so well established, one might conclude that it should present few problems as a guide for lessees and for courts.

14. The payment of a cash sum or an annual rental to delay drilling precludes an implied development covenant. *State ex rel. Comm'rs of Land Office v. Couch*, 298 P.2d 452, 6 O. & G.R. 346 (Okla. 1956).

15. *Berry v. Wondra*, 173 Kan. 273, 246 P.2d 282, 1 O. & G.R. 1099 (1952).

16. *Williams and Meyers*, N. 5 *supra*, § 831.

17. *Merrill*, N. 4 *supra*, Ch. III ("The Implied Covenant to Drill Additional Wells"); Hemingway, *Oil and Gas* § 8.3 (1971).

18. Oklahoma, for example, as discussed *infra* p. 183 and N. 29.

19. 182 Kan. 213, 320 P.2d 1039, 8 O. & G.R. 717, *on motion for reh'g* 183 Kan. 471, 328 P.2d 358, 9 O. & G.R. 642 (958).

20. 8 O. & G.R. at 736.

21. 8 O. & G.R. at 724.

Unfortunately this is not so, for each case is “governed by its own facts within the principle of equitable justice.”²² The facts will, of course, be different for each case, and notions of what constitutes equitable justice vary widely. However, a number of common factors are generally considered in determining whether there has been reasonable development of the lease. A recent Kansas decision²³ has listed the factors as follows:

- (1) The quantity of oil and gas capable of being produced as indicated by prior exploration and development;
- (2) The local market and demand therefor;
- (3) The extent and results of the operations, if any, on adjacent lands;
- (4) The character of the natural reservoir—whether such as to permit the drainage of a large area of each well;
- (5) The usages of the business;
- (6) The cost of drilling, equipment, and operation of wells;
- (7) Cost of transportation, cost of storage, and the prevailing price; and
- (8) General market conditions as influenced by supply and demand or by regulation of production through governmental agencies.

In addition, some cases give weight to evidence of the willingness of another operator to drill on the tract in question,²⁴ the attitude of the lessee toward further development,²⁵ and the elapsed time since drilling operations were last conducted.²⁶ The possibility of profitable production has been of

22. Crocker v. Humble Oil & Refining Co., 419 P.2d 265, 266, 25 O. & G.R. 681 (Okla. 1965).

23. Sanders v. Birmingham, 214 Kan. 769, 522 P.2d 959, 966, 50 O. & G.R. 468 (Kan. 1974). For an earlier but similar listing, see Ramsey Petroleum Corp. v. Davis, 184 Okla. 155, 85 P.2d 427, 430 (1938), or Spiller v. Massey & Moore, 406 P.2d 467, 472, 23 O. & G.R. 767 (Okla. 1965). See also, Williams and Meyers, N. 5 *supra*, § 833, and Merrill, N. 4 *supra*, § 123.

24. Berry v. Wondra, N. 15 *supra*. Amerada Petroleum Co. v. Doering, 93 F.2d 540 (5th Cir. 1937); Humble Oil & Refining Co. v. Romero, 194 F.2d 383, 1 O. & G.R. 358 (5th Cir. 1952) (a further exploration case).

25. McMahan v. Boggess, 302 S.W.2d 592, 7 O. & G.R. 1396 (Ky. 1957); Vickers v. Vining, 452 P.2d 798, 32 O. & G.R. 678 (Okla. 1969).

26. Texas Consolidated Oils v. Vann, 208 Okla. 673, 258 P.2d 679, 680, 2 O. & G.R. 1335 (1953) (“A lapse of time is sufficient to show unreasonable delay, in a proper case.”);

primary consideration in the implied covenant of reasonable development, and all of the above factors except the last two have significance because they assist in determining whether drilling may be profitable to lessor and lessee. That profit is of paramount importance is indicated in Williams and Meyers' statement that "if the lessee can make a profit by drilling additional wells, he should be required to do so"²⁷

Ordinarily the burden of proof to establish a breach of the implied covenant of reasonable development is on the lessor, and this burden may be satisfied by showing there is a reasonable expectation that additional development will be profitable.²⁸ However, in Oklahoma, the passage of an unreasonable length of time will result in a shifting of the burden of proof from the lessor to the lessee which must establish that there has been reasonable development of the lease.²⁹

When a breach of the implied covenant of reasonable development has been established, several remedies may be granted by the court, either singly or in combination. Damages may be awarded, the court may order cancellation of the undeveloped portion of the lease, or a conditional decree may be given that the undeveloped portion of the lease will be cancelled if

Fontenot v. Austral Oil Exploration Co., 168 F. Supp. 36, 10 O. & G.R. 764 (W.D. La. 1958); Lake v. Ohio Fuel Gas Co., 2 Ohio App. 2d 227, 207 N.E. 2d 659, 22 O. & G.R. 625 (1965).

27. N. 5 *supra*, § 815 at 72. Merrill similarly states that the lessee "should engage in further development where the indications point to profit." N. 4 *supra*, § 122 at 283.

28. See the cases cited in Brown, N. 7 *supra*, § 16.03(5) at n. 48. Several recent cases of interest in which the lessors were unable to meet this burden are Sanders v. Birmingham, N. 23 *supra*, and Brixey v. Union Oil Co., 283 F. Supp. 353, 28 O. & G.R. 541 (W.D. Ark. 1968). On satisfying the lessor's burden, see N. 82 *infra*.

29. Doss Oil Royalty Co. v. Texas Co. 192 Okla. 359, 137 P.2d 934 (1943); Skelly Oil Co. v. Boles, 193 Okla. 308, 142 P.2d 969 (1943); Wolfson Oil Co. v. Gill, 309 P.2d 282, 7 O. & G.R. 300 (Okla. 1957); Crocker v. Humble Oil & Refining Co., N. 22 *supra*. Mere lapse of time alone without further development will not result in a breach of the implied covenant. Union Oil Co. of California v. Jackson, 489 P.2d 1073, 39 O. & G.R. 645 (Okla. 1971). See also Miller, "The Element of Time in Relation to Breach of the Implied Covenant to Further Development in Oklahoma," 25 Okla. B. A. J. 765 (1954). The dilemma of the Oklahoma lessee is that in establishing there is no likelihood of commercial production from the portion of the lease in question it must then explain why it wishes to retain the unproductive portion of the lease. It is then impaled on the policy against speculation. Coal Oil & Gas Co. v. Styron, 303 P.2d 965, 6 O. & G.R. 827 (Okla. 1956); Carter v. United States Smelting, Refining & Min. Co., 485 P.2d 748, 39 O. & G.R. 295 (Okla. 1971); Vickers v. Vining, N. 25 *supra*; Conn, "Trends in the Application of the Implied Covenant of Further Development," 12 Okla. L. Rev. 470, 489 (1959). The author acknowledges the research assistance of Mr. James Gillett on Oklahoma law on further development.

drilling thereon is not commenced by a set date.³⁰ There is generally no loss of mineral in a breach of the implied covenant of reasonable development, so the only damage, if any,³¹ to the lessor is the loss of interest he might have earned on the royalty on the delayed production. Nevertheless, when a court does award damages, it is in the amount of the royalty that would have been paid, not the interest that the royalty would have earned.³² Conditional cancellation appears to be the favored remedy.³³

A case that well illustrates an application of the implied covenant of reasonable development is the case mentioned previously, *Temple v. Continental Oil Co.*³⁴ Between 1936 and 1953, defendants had drilled seven wells on a lease covering a quarter section. At the time of filing of the suit in late 1955, defendants had produced almost a million barrels of oil and had released ten acres which were then turned over to another operator. Plaintiffs sought cancellation of the lease as to ten acres in the northeast corner of the leasehold on the ground that an operator of ordinary prudence would have drilled a well on this ten-acre tract in the furtherance of the interests of both lessors and lessees. The trial court accepted plaintiffs' expert witnesses' testimony that the ten-acre tract had "good possibilities of producing oil commercially" and rejected the defendants' experts' testimony that water encroachment had reduced the amount of producing

30. See *Christie, Mitchell & Mitchell Co. v. Howell*, 359 S.W.2d 658, 17 O. & G.R. 420 (Tex. Civ. App. 1962), *error ref'd, n.r.e.*; *Vickers v. Vining*, 452 P.2d 798, 32 O. & G.R. 678 (Okla. 1969); *Elliott v. Pure Oil Co.* 139 N.E.2d 295, 7 O. & G.R. 228 (Ill. 1956); *Skelly Oil Co. v. Scoggins*, 231 Ark. 257, 329 S.W.2d 424, 12 O. & G.R. 163 (1959); LeBlanc, "Cancellation Decrees—Vertical and Horizontal Cancellation," 17th *Ann. Inst. on Min. L.* 154 (L.S.U. 1970); Krieg, "Lease Termination for Breach of the Implied Obligations of the Lessee," 3 *Rocky Mt. Min. L. Inst.* 697 (1957).

31. The mineral may increase in value substantially if production is delayed. When this increase in value is greater than the interest the lessor could have earned on the royalty had the mineral been produced earlier, the lessor has suffered no loss. To illustrate this, consider the lessor who received a 37.5-cent royalty on a barrel of oil produced and sold for \$3 in 1967. Invested at 8 percent, its total value would be 64.3 cents in 1974. Had the oil been produced at \$11.50 in 1974, the royalty would have been \$1.44 or almost 80 cents more in value over time. Recognizing the possibility of an increase in the value of the petroleum, at least one court has required an award of damages to the lessor yet has still permitted him to benefit from any increase in value that may result from the delay of production. See *Cotiga Development Co. v. United Fuel Gas Co.*, 147 W. Va. 484, 128 S.E.2d 626, 17 O. & G.R. 583 (1962). It seems inappropriate to award a party damages because he has been wronged and then allow him the benefit of the supposed wrong.

32. *Ibid.*, reversing a trial court award of damages under the interest rule.

33. *William and Meyers*, N. 5 *supra*, § 834; *Krieg*, N. 30 *supra* at 709–710.

34. N. 19 *supra*.

formation to a point where little or no recoverable oil remained under the tract. The Kansas Supreme Court accepted as fact that eventually the defendants' existing well would produce all the recoverable oil but held that the lessors' successors were "entitled to the benefit of oil produced from the lease at the time it should be produced and not at some remote period of time in the future."³⁵ Defendants were given four months in which to commence the drilling of a well or have the lease cancelled as to the ten acres.

It should be mentioned that there are several matters that are related to the implied covenant of reasonable development that have yet to be the subject of much litigation, but which may assume increased importance with the expansion of governmental regulation of the petroleum industry and the decline in production from older fields. Most important of these are the questions of the extent of the obligations of lessees to represent lessors in administrative proceedings³⁶ and to effect unitization and utilize secondary recovery methods.³⁷

The Implied Covenant of Further Exploration

Professor Meyers, the leading proponent for the recognition of an implied covenant of further exploration, has acknowledged that this covenant is "regarded as controversial" and is in a developmental stage.³⁸ His proposal for recognition or adoption of this covenant has been without doubt a matter of controversy.³⁹ Although the implied covenant of further

35. 8 O. & G.R. at 737.

36. Merrill, "Fulfilling Implied Covenant Obligations Administratively," 9 Okla. L. Rev. 125 (1956); *Baldwin v. Kubetz*, 148 Cal. App.2d 937, 307 P.2d 1005, 7 O. & G.R. 407 (1957); *Sinclair Oil & Gas Co. v. Bishop*, 441 P.2d 436, 30 O. & G.R. 614 (Okla. 1967); *Sunray DX Oil Co. v. Crews*, 448 P.2d 840, 32 O. & G.R. 200 (Okla. 1968). For detailed criticism of the Merrill position, see Conn, N. 29 *supra* at 485-489.

37. Merrill, "Implied Covenants and Secondary Recovery," 4 Okla. L. Rev. 177 (1950). See also the opinions in *Shailer's Estate*, 266 P.2d 613, 3 O. & G.R. 1397 (Okla. 1954), and *Wolfson Oil Co. v. Gill*, N. 29 *supra*.

38. Meyers, "The Effect of Express Provisions in an Oil and Gas Lease on Implied Obligations," 14th *Ann. Inst. on Min. L.* 90, 115 (L.S.U. 1967).

39. A partial listing of the articles and books which have followed the Meyers article cited in N. 1 *supra* includes: Brown, N. 7 *supra*, § 16.05; Merrill, "The Implied Covenant of Further Exploration," 4 *Rocky Mt. Min. L. Inst.* 205 (1958); Meyers, "The Covenant of Further Exploration: A Comment," 37 *Texas L. Rev.* 179 (1958); Brown, "The Proposed New Covenant of Further Exploration: Reply to Comment," 37 *Texas L. Rev.* 303 (1959); Boone, "The Implied Covenant for Additional Development," 31 *Miss. L. J.* 34 (1959); Galvin, "Meyers v. Brown—Jurisprudence in Action," 7 *U.C.L.A. L. Rev.* 589 (1960); Merrill, "The Implied Covenant of Further Exploration in Oklahoma," 13 *Okla. L. Rev.* 249 (1960); Cohen, "Implied Covenants in Kansas Oil and Gas Leases," 9 *Kan. L. Rev.* 7 (1960);

exploration has been expressly repudiated by the Texas courts on several occasions,⁴⁰ I believe that it is fair to say that it has had at least some development since it was first proposed.⁴¹

Briefly stated, the implied covenant of further exploration would require the lessee to undertake additional operations in unexplored strata, both

Annot., 79 A.L.R. 2d 792 (1961); Meyers and Williams, "The Implied Duty to Explore Further: Recent Texas Developments," 41 Texas L. Rev. 789 (1963); Smith, "The Implied Duty to Explore Further: Recent Texas Developments A Disagreement," 42 Texas L. Rev. 199 (1963); see also Munster, "Implied Covenants in Oil and Gas Leases in Ohio," 26 Ohio St. L.J. 404 (1965). The author acknowledges the assistance of Mr. Rodney Edwards for research on the implied covenant of further exploration.

40. Meyers' proposal was embraced by the Texas Court of Civil Appeals and applied in *Willingham v. Bryson*, 294 S.W.2d 421, 6 O. & G.R. 1094 (Tex. Civ. App. 1956). This decision was disapproved by the Texas Supreme Court in *Clifton v. Koontz*, 160 Tex. 82, 325 S.W.2d 684, 10 O. & G.R. 1109 (1959). In a case arising in Texas decided shortly thereafter, the Fifth Circuit distinguished *Clifton v. Koontz* and held that there was an implied covenant of further exploration. *Sinclair Oil and Gas Co. v. Masterson*, 271 F.2d 310, 11 O. & G.R. 632 (1959), *cert. denied* 362 U.S. 952 (1960). Professor Merrill has found this to be a proper application of the *Erie* doctrine in "Sinclair-Masterson: A Study in the Role of Federal Courts in Applying State Law," 14 Okla. L. Rev. 1 (1961). Nevertheless, the Texas Court of Civil Appeals rejected *Masterson* and the further exploration covenant in *Felmont v. Pan American Petroleum Corp.*, 334 S.W.2d 449, 12 O. & G.R. 717 (Tex. Civ. App. 1960), *error ref'd, n.r.e.*, and the Fifth Circuit has conceded it may thus have been overruled. *Weymouth v. Colorado Interstate Gas Co.*, 367 F.2d 84, 25 O. & G.R. 371 at 393, n. 47 (5th Cir. 1966). In a recent case, although not necessary for its decision, the Texas Court of Civil Appeals has reasserted the *Clifton v. Koontz* holding that "there is no implied obligation to explore as to oil, gas and mineral leases in Texas." *Shell Oil v. Stansbury*, N. 12 *supra*, 401 S.W.2d at 636. The Mississippi Supreme Court has also expressly rejected the existence of a separate implied covenant of further exploration. *Monsanto Chemical Co. v. Sykes*, 147 So.2d 290, 296, 18 O. & G.R. 884, (Miss. 1962), 149 So.2d 20, 18 O. & G.R. 898 (Miss. 1963).

41. Discussions of state law by several writers have indicated support for the implied covenant to explore other strata, Cohen, N. 39 *supra* at 16-18, Munster, N. 39 *supra* at 415. Several courts have expressly declined to hold that there is no such implied covenant or have acted as though there is this covenant though not so stating (see the case by case analysis in Williams and Meyers N. 5 *supra*, § 845), and it may be said that the newly adopted Louisiana Mineral Code does establish the implied covenant of further exploration. Article 122 of the Code, La. Rev. Stat. § 31:122 (1974), imposes the lessee's obligation to act as a reasonably prudent operator, and the comments to this article, while viewing the implied covenant as an "evolutionary offshoot" of the reasonable development obligation, state explicitly: "The jurisprudence since the *Carter* decision [*Carter v. Arkansas-Louisiana Gas Co.*, 213 La. 1028, 36 So.2d 26 (1948)] has recognized that the obligation of further exploration is embodied in our law." It is perhaps noteworthy that Williams and Meyers have commented that the Louisiana courts have pushed the duty to explore too far. Williams and Meyers, N. 5 *supra*, § 845.4 at 341.

vertically and laterally on the leasehold. To establish breach of the covenant, the lessor would have to give evidence that the strata is potentially productive and that it is unreasonable not to drill exploratory wells even though the lessor cannot prove that the drilling would probably be profitable.⁴² The loss to the lessor from breach of the implied covenant is said to be the value of a test on the land for new producing horizons. Since this is largely unquantifiable, the remedy is not damages, but cancellation or conditional cancellation of the unexplored portions of the lease should the lessee refuse to drill.⁴³ The prudent operator, it is presumed, would, under the proper circumstances, drill exploratory wells without a reasonable expectation of profitable production from its operations. The factors to be shown by the lessor to establish breach of the covenant are similar to the ones discussed in relation to the implied covenant of reasonable development.⁴⁴

It is Professor Meyers' position that the courts have long enforced a duty to explore without referring to an implied covenant of further exploration. Without quibbling over the rationale given in particular cases,⁴⁵ I believe it is beyond question that there are many implied covenant decisions in favor of lessors in which the lessors have either failed or have not been required

42. Williams and Meyers, N. 5 *supra*, § 841.

43. *Ibid.* Of course, if there are minerals that have not been produced, the lessor has lost the interest that would have accrued had the minerals been produced at an earlier time. An interesting case would be that in which the lessor establishes that a prudent operator should have undertaken further exploration several years earlier, the court awards conditional cancellation, the lessee drills and produces great quantities of minerals, and the lessor then seeks to recover the interest he could have received had those minerals been produced at the time when the exploration should have commenced. Reasoning from Williams and Meyers' premises, there is nothing to prevent the lessor from recovering.

44. See text at Ns. 23-26 *supra*. See also Meyers, N. 1 *supra* at 562-571.

45. See the discussion of cases in Brown, N. 7 *supra*, § 16.05. In the case of *Sauder v. Mid-Continent Petroleum Corp.*, 292 U.S. 272 (1934), a case relied upon heavily by Professor Meyers, the Supreme Court may have been influenced by the fact that it was believed that Kansas law (until *Fischer v. Magnolia Petroleum Co.*, 156 Kan. 367, 133 P.2d 95 (1943)) imposed an absolute duty to drill on lessees, contrary to the law of other jurisdictions. That is, had the Supreme Court decided otherwise than it did, it would have had to decide the question of the existence of a federal common law, a question it preferred to leave unanswered until *Erie R.R. v. Tompkins*, 304 U.S. 64 (1938). See Merrill, N. 4 *supra*, § 144 at 332. *Sawder* is, however, relied upon in some cases in other states to impose a requirement of further exploration without reference to this aspect of the case; e.g., *Nolan v. Thomas*, 228 Ark. 572, 309 S.W.2d 727, 9 O. & G.R. 1 (1958). The Oklahoma cases turn on the failure of the lessee to explain an unreasonable delay in further drilling. Still other cases turn on the willingness of another operator to drill in the face of the lessee's declared intent not to undertake additional drilling.

to prove that drilling will probably result in commercial production, whether in a known producing formation or in unexplored strata. The usefulness of Professor Meyers' observation is to call attention to what the courts have expected of prudent operators. Not only have they required drilling when there was a basis for believing that drilling would be profitable, but also when there was no such basis because there had been no exploration.

The problem with Professor Meyers' proposal to recognize this as a separate implied covenant is that once an idea or theory is given recognition, it takes on a life of its own, separate from the considerations which gave rise to it. This is, perhaps, what Meyers intended, for he has since given greater emphasis to public policy reasons⁴⁶ for implying such a separate covenant, irrespective of the factors that originally led courts to require drilling or cancellation in unexplored areas. The danger lies in the tendency of ideas to be carried step by step to their logical extreme. Once it is accepted that a lessee has a duty to explore and that the public has an interest in exploration, the lessor will need to show relatively little else to convince judge or jury that the lessee is not fulfilling that duty in a disputed case.⁴⁷ For reasons which follow, I believe it would be preferable not to focus on whether a known formation or unexplored strata is involved, but rather on the standard by which one measures prudent operation under a lease. Since my suggestion is that further drilling requirements be looked upon with greater disfavor by the courts, it is not of much significance whether that drilling be in a known or an unexplored area. In short, my position is that it is often unwise to require drilling by a lessee even if the lessor can show a likelihood of commercial productivity. Before getting into that, I will treat briefly the implied covenant to market the product.

The Implied Covenant to Market

The implied covenant to market the product from the lease has primarily had case law significance with respect to natural gas. The reasons for this have been the necessity of extending expensive pipeline facilities to the point of production, the length of time necessary to establish a market for the gas, and the disparity in pricing between the interstate and the intrastate markets for gas resulting from Federal Power Commission control of

46. Meyers and Williams, "The Implied Duty to Explore Further: Recent Texas Developments," N. 39 *supra* at 808–809.

47. Professor Meyers has conceded that "the covenant of further exploration is subject to abuse." N. 1 *supra* at 581.

interstate prices.⁴⁸ The implied covenant is to the effect that the lessee is under a duty to use due diligence in marketing the product⁴⁹ once it has been discovered and produced.⁵⁰

The prudent operator standard is generally held to apply to this covenant also,⁵¹ but there is language in some of the cases that suggests a lesser standard.

There are several aspects of the marketing covenant to which I wish to call attention and to suggest a problem I feel they pose. First, there is considerable authority that there is a duty owed by the lessee to obtain the best price possible for the gas,⁵² a duty which can arise either under a “market value” or a “proceeds” royalty clause.⁵³ Second, there are several

48. See *Lelong v. Richardson*, 126 So.2d 819, 823, 14 O. & G.R. 951 (La. App. 1961), and the authorities cited *infra* Ns. 53–54.

49. *Wolfe v. Texas Co.*, 83 F.2d 425 (10th Cir.), *cert. denied* 299 U.S. 553 (1936); *Craig v. Champlin Petroleum Co.*, 435 F.2d 933, 37 O. & G.R. 457 (10th Cir. 1971); *Merrill*, N. 4 *supra* at § 84; *Williams and Meyers*, N. 5 *supra*, § 853; *Brown*, N. 7 *supra*, § 16.02(4).

50. In most jurisdictions, a lease will terminate automatically if the oil or gas is not being marketed at the end of the primary term and the lease is not being held under a shut-in royalty clause. *Stanolind Oil & Gas Co. v. Barnhill*, 107 S.W.2d 746 (Tex. Civ. App. 1937). However, in Oklahoma, once petroleum is found in paying quantities, the lessee has a reasonable time in which to market the product even if this extends beyond the primary term. *Flag Oil Corp. v. King Resources Co.*, 494 P.2d 322, 41 O. & G.R. 545 (Okla. 1972). *Williams and Meyers*, N. 5 *supra*, § 853 at 391.

51. Although the phrase “due diligence” is used generally, the courts seem to put more emphasis on good faith than in implied covenant of reasonable development cases. See *Greenshields v. Warren Petroleum Corp.*, 248 F.2d 61, 8 O. & G.R. 937, 942 (10th Cir.), *cert. denied* 355 U.S. 907 (1957); *Waechter v. Amoco Production Co.*, 537 P.2d 228, — O. & G.R. — (Kan. 1975). See also *Nordan-Lawton Oil & Gas Corp. of Texas v. Miller*, 272 F. Supp. 125, 137, 27 O. & G.R. 593, 608 (W.D. La.) (“operators are not held to such an all-knowing standard that is only revealed by *ex post facto* judgments”), 276 F. Supp. 16, 27 O. & G.R. 610 (W.D. La. 1967), *aff’d* 403 F.2d 946, 31 O. & G.R. 526 (5th Cir. 1968), which cites the section in *Williams and Meyers*, N. 5 *supra*, § 856.3, which argues in favor of a less onerous standard.

52. *Merrill*, N. 4 *supra*, § 84 at 212–213 states that “the concept of diligence in marketing should include the duty to realize the highest price obtainable by the exercise of reasonable effort,” and cites a number of cases in accord in the 1964 Supplement at 66–67. See also *Johnson v. Jernigan*, 475 P.2d 396, 37 O. & G.R. 240, 245 (Okla. 1970) (“The lessee is obligated to develop the commodity he has found so that it will bring the highest possible market price.”); *Harding v. Cameron*, 63 F. Supp. 466, 19 O. & G.R. 352 (W.D. Okla. 1963).

53. In several recent cases, the lessee has been held to be under a duty to pay a royalty on the “market value” of the gas, as determined by other transactions in the area, even though this is at a higher rate than that received by the lessee. *Foster v. Atlantic Refining Co.*, 329 F.2d 485, 20 O. & G.R. 422 (5th Cir. 1964); *Texas Oil & Gas Corp. v. Vela*, 429

significant cases holding that a prudent operator would withhold production of gas for a time while waiting to obtain the best price possible for the gas even though the operator has an opportunity to sell before that time at a lower price.⁵⁴ The problem I see is that a lessee may have a duty to sell gas in the intrastate market if it can get a higher price there even if it would prefer to sell into the interstate market and even if this requires shutting in the gas for a time while awaiting a market. The concerns that this presents are twofold. First, the obligation to the lessor to obtain the highest price may be forcing gas into the intrastate market that the lessee might otherwise sell into the interstate market despite the lower price, and such gas may be going to inferior uses.⁵⁵ Second, there is a possibility a producer who shuts in gas wells in order to obtain a higher price for the gas is subjecting itself to federal investigation, not to mention adverse public reaction.⁵⁶ Both of these concerns can affect the decision-making process of the prudent operator.

These then are the three implied covenants and what they are generally held to require of lessees when they are found to apply. Now, it is time to consider their basis and their wisdom.

S.W.2d 866, 29 O. & G.R. 121 (Tex. 1968); and see *Weymouth v. Colorado Interstate Gas Co.*, 367 F.2d 84, 25 O. & G.R. 371 (5th Cir. 1966). While such cases have turned on the interpretation of “market value” in the lease, the same result might be reached from an implied covenant to market approach. See also Morris, “The Gas Royalty Clause—What is Market Value?” *25th Oil & Gas Inst.* 63 (Matthew Bender 1974).

54. *Gazin v. Pan-American Petroleum Corp.*, 367 P.2d 1010, 16 O. & G.R. 1009 (Okla. 1961); *Poafpybitty v. Skelly Oil Co.*, 517 P.2d 432, 47 O. & G.R. 168 (Okla. 1973). See *Norton-Lawton Oil & Gas Corp. of Texas v. Miller, N.* 51 *supra*, 27 O. & G.R. at 608. See also Sandlin, “Intrastate Marketing of Gas, The Implied Covenant to Market and the Shut-In Gas Well Royalty,” 17 *Ark. L. Rev.* 104 (1963).

55. Partly in recognition of the burden on interstate commerce caused by the duty to pay market value royalties to lessors, the Federal Power Commission attempted to assert jurisdiction over royalty payments, but the Court of Appeals for the District of Columbia Circuit held that the Commission had no such jurisdiction under the Natural Gas Act; the case presented, the court said, only “a cursory ‘makeweight’ reference to a possible theory of economic burden. . . .” *Mobil Oil Corp. v. Federal Power Commission*, 463 F.2d 256, 43 O. & G.R. 106, 119 (D.C. Cir. 1971), *cert. denied* 406 U.S. 976, *reh’g denied* 409 U.S. 902 (1972). For discussion of the effects of the differentiation in price between the interstate and the intrastate markets, see MacAvoy, “The Regulation-Induced Shortage of Natural Gas,” 14 *J. Law & Econ.* 167 (1971), and Breyer and MacAvoy, “The Natural Gas Shortage and the Regulation of Natural Gas Producers,” 86 *Harv. L. Rev.* 941 (1973).

56. See *Energy Users Report*, Oct. 30, 1975, A-13; Dec. 11, 1975, A-1, A-15.

The Basis of Implied Covenants

There are several views as to how implied covenants arise. The position of Professor Walker in his influential series of articles in the *Texas Law Review* was that the implication of covenants “is predicated upon the intention of the parties and is one of fact and not of law.”⁵⁷ The contrary view is that of Professor Merrill, who has maintained that an implied covenant is a fiction adopted by a court to do justice to the lessor.⁵⁸ “The obligations,” he states, “are imposed, not by the agreement of the parties, but by operation of law.”⁵⁹ The Williams and Meyers treatise attempts a synthesis of these two views, saying that implied covenants arise in fact and in law and rest ultimately upon the contract principle of cooperation.⁶⁰ The most tenable position is Professor Merrill’s, and it is important that this he recognized, for, if the covenants are court-created, they can more readily be court-modified.

When the parties enter into a lease, they typically provide expressly for the drilling of a well⁶¹ and, if there is production, that the lease shall remain in effect for the entire premises so long as there is production from the lease. 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.⁶² When an implied covenant case arises, the lessee

57. Walker, N. 8 *supra* at 405. There are several cases specifically holding that covenants are implied in fact. *Texas & Pacific Coal & Oil Co. v. Stuard*, 7 S.W.2d 878 (Tex. Civ. App. 1928), *error ref’d*; *Indian Territory Illuminating Oil Co. v. Rosamond*, 190 Okla. 46, 120 P.2d 349 (1941). It should be noted that each gave the lessors the benefit of a longer statute of limitations; it would be anomalous for a court to imply a right in favor of a lessor and then diminish or destroy that right by holding that such a right is a fiction indulged in by courts to aid a lessor.

58. Merrill, N. 4 *supra*, §§ 7, 220.

59. *Id.*, §7 at 27.

60. Williams and Meyers, N. 5 *supra*, § 802.1.

61. The drilling may be excused by the payment of delay rentals. If neither is done, the lease terminates automatically. For reasons for the development of the lease in this form, see Moses, N. 11 *supra*.

62. Once the lease is executed, the lessor’s role is entirely passive; all he must do is to allow the lessee to use the surface, if the lessor owns it, to the extent that is reasonably necessary to develop the minerals. See Gray, “A New Appraisal of the Rights of Lessees under Oil and Gas Leases to Use and Occupy the Surface,” 20 *Rocky Mt. Min. L. Inst.* 227 (1975). He generally receives a cost-free royalty on production while the lessee must bear all the risks of exploration and development. Because the lessor will receive a royalty on any production from the lease, regardless of whether production will be sufficient to repay the costs of finding and producing it, he has no economic disincentive to demanding additional drilling.

has fulfilled his express obligation to drill, the lease is being held by production, and the lessor is receiving royalties. The lessor's complaint is that the lessee has exercised his judgment and discretion improperly or in bad faith to the detriment of the lessor. What the court must pass judgment on is the conduct of the lessee in meeting the express duty to produce in order to prevent automatic termination of the lease.

Thus, it can be seen that the implication of a covenant is inextricably intertwined with the test to determine whether the covenant has been fulfilled, the prudent operator standard. Recognition of this has prompted several authorities to suggest there is, indeed, only one implied covenant, an implied covenant of prudent operation.⁶³

The implied covenants arise, then, as a means of measuring the exercise of the judgment and discretion of the lessee, and some courts state frankly that they are seeking to protect the lessor from the inequality of position that exists between the lessor and lessee and correct inequity.⁶⁴ As Professor Kuntz has pointed out in reexamining the fact-law distinction, the implied covenants do not arise as a matter of extending the conscious intention of the lessor and lessee to cover matters not mentioned in the agreement, but as a matter of determining the duties that should be incident to the relation of the parties.⁶⁵ "This situation," he states, "is much more accurately described as involving rights implied in law rather than as involving rights implied in fact."⁶⁶ This becomes most obvious when a court refuses to give effect to an express lease provision because it "smacks of fraud or unfair dealing," and goes on to find an implied covenant binding the lessee.⁶⁷

63. See Masterson, "A 1952 Survey of Basic Oil and Gas Law," 6 Sw. L.J. 1, 45 (1952); Galvin, N. 39 *supra* at 605-606; and Huie, Woodward and Smith, *Oil and Gas Cases and Materials* 594 (2d ed. 1972). As stated previously, implied covenants in Louisiana all fall within Article 122 which provides simply that a mineral lessee is obligated "to develop and operate the property leased as a reasonably prudent operator for the mutual benefit of himself and his lessor." La. Rev. Stat. § 31:122.

64. See the court's statement to this effect in *Ferguson v. Gulf Oil Corp.*, 192 Okla. 355, 137 P.2d 940, 943 (1943).

65. Kuntz, "Professor Merrill's Contribution to Oil and Gas Law," 25 Okla. L. Rev. 484 (1972).

66. *Id.* at 488.

67. *Williams v. Humble Oil & Refining Co.*, N. 12 *supra*, 432 F.2d at 178. Implied covenants can be displaced by express covenants, *Gulf Production Co. v. Kishi*, 129 Tex. 487, 103 S.W.2d 965 (1937), *Labbe v. Magnolia Petroleum Co.*, 350 S.W.2d 873, 15 O. & G.R. 526 (Tex. Civ. App. 1961), *error ref'd, n.r.e.*, but such provisions will be strictly construed, and the lessee will still be held to a good faith standard. See Merrill, "Lease Clauses Affecting Implied Covenants" 2d *Oil & Gas Inst.* 141 (Matthew Bender 1951), and Meyers, N. 38 *supra*.

The Williams and Meyers principle of cooperation has some appeal, but I believe it is ill-founded as a basis for imposing the prudent operator standard upon lessees. In putting forth their position, they rely on two lines of contract cases that they feel may be treated together as the principle of cooperation.⁶⁸ One line is that in which the contractual obligations of both parties are clear, such as one party must obtain a building permit and the other party must do the construction, but they have failed to specify the time of performance. Where the construction cannot go forward without the permit, the court will find that the obligation must be fulfilled within a reasonable time.⁶⁹ This is far different from the implied covenant case in which not only is time a factor, but there is also a dispute whether there is even an obligation to drill a particular well or do some similar act. Multiple variables of great complexity that involve numerous matters of professional business and scientific judgment are present in an implied covenant case.⁷⁰

The other type of case relied on by Williams and Meyers is exemplified by the well-known *Lucy, Lady Duff-Gordon* case.⁷¹ In this famous case, the defendant was a fashion designer who gave the plaintiff the exclusive right to place her indorsements and market, or license others to market, her designs, in return for which the plaintiff was to give her fifty percent of any profits he made. The fashion designer then went to another party and placed indorsements in violation of the agreement. When the plaintiff sued her, she took the position that the contract was invalid because the plaintiff had not bound himself to do anything. Mr. Justice Cardozo, then on the New York bench, overcame this argument by implying a promise on the part of the plaintiff to use “reasonable efforts to place the defendant’s indorsements and market her designs.”⁷² Cardozo was finding valuable consideration so as to uphold the contract for the plaintiff; he was not passing judgment on

68. Williams and Meyers, N. 5 *supra*, § 802.1.

69. *Weeks v. Rector, etc., of Trinity Church*, 56 App. Div. 195, 67 N.Y. Supp. 670 (1900). In this case, relied on by Williams and Meyers, it was a statute that put the duty upon the defendant to procure the necessary permit, and not only did the defendant admit that it had a duty to get the permit but had, in fact, attempted to do so. It had filed forms so defectively that the superintendent of buildings refused to issue a permit; and after being notified of the defeat, it refused or neglected to remedy it until it was too late to obtain a permit—a strange case to carry one to the point of finding an implied duty of further exploration in an oil and gas lease.

70. See generally, Campbell, *Oil Property Evaluation* (1959), and Megill, *Exploration Economics* (1971).

71. *Wood v. Lucy, Lady Duff-Gordon*, 222 N.Y. 88, 118 N.E. 214 (Ct. App. 1917).

72. *Ibid.*

the performance of the plaintiff in meeting his express obligation.⁷³ The standard used to judge whether “reasonable efforts” have been made in this type of contract case is a good faith test. The contract law in this area is summarized in *American Jurisprudence 2d*:

“As a general rule, there is implied in every contract for work or services a duty to perform it skilfully, carefully, diligently, and in a workmanlike manner.

...

“. . . It seems, however, that he [the promisor] is not liable for an error due to an honest mistake of judgment, and not to gross ignorance.”⁷⁴

Williams and Meyers, however, treat the *Lucy, Lady Duff-Gordon* case as though it imposed on the plaintiff not only a promise to make reasonable efforts to carry out his side of the bargain but also an objective standard in measuring whether he had used “due diligence” in fulfilling the implied promise. They state, “[T]he good faith test fails to meet the requirements of the principle of cooperation upon which implied covenants ultimately rest.”⁷⁵ In other words, they use the principle of cooperation both to find a promise and to impose an objective standard of conduct in fulfilling that promise. This, I believe, goes beyond what most courts have done in contract law cases invoking a principle of cooperation.

The law of implied covenants, then, does not arise from the intent of the parties nor from an analogous principle in contract law. Rather it grows out of an attempt on the part of the courts to promote what they perceive to be justice and fair dealing by requiring lessees to adhere to a particular norm of conduct, the prudent operator standard. If it appears that justice, fair dealing, and the best interests of society are not served by imposing a certain type of conduct on lessees, then there is nothing to hinder the courts in modifying the content of the prudent operator standard.⁷⁶

73. See also *McMichael v. Price*, 177 Okla. 186, 58 P.2d 549 (1936).

74. 17 Am. Jur. 2d, “Contracts” § 371. Cf. *Sylvan Crest Sand & Gravel Co. v. United States*, 150 F.2d 642 (2d Cir. 1945).

75. Williams and Meyers, N. 5 *supra*, § 806.2 at 35.

76. Even where the state has adopted a prudent operator rule by statute, there should be no barrier to reconsidering the meaning of “prudent.”

The Prudent Operator Standard

The prudent operator standard, as mentioned previously, has been widely adopted to measure a lessee's conduct under a mineral lease. While generally regarded as a middle ground between a good faith test and the imposition of some form of absolute duty on the lessee,⁷⁷ it is quite impossible to say precisely what the standard is, for its application varies from court to court. Some cases relying on the prudent operator standard could easily have been decided under a good faith test. Other cases using the same words of the prudent operator standard seem to impose absolute duties on a lessee without regard to what a truly *prudent* operator would do.⁷⁸

The prudent operator standard presumes generally that a prudent operator will drill whenever it can make a profit for itself and for the lessor.⁷⁹ The issue normally presented is whether there would be profit from drilling. The test apparently employed in many, though certainly not all, cases is whether there is a reasonable basis for believing that it would be profitable to drill.⁸⁰ If the lessor sustains the burden of showing this, he often wins. As applied, the prudent operator standard appears to differ from a good faith test⁸¹ in that even though it is established that a lessee believes it is acting as a prudent operator and even though it is established that there is a reasonable basis for the lessee to believe this, the prudent operator standard will permit a judge or jury to find that the lessee has not acted as a prudent operator.⁸²

77. Merrill, N. 4 *supra*, Ch. VI; Williams and Meyers, N. 5 *supra*, § 806. It is interesting to note that Illinois gives the lessee the *right* to act as a prudent operator. Smith-Hurd Ann. Stat., Ch. 104, § 89.

78. Professor Kuntz has observed that to keep his lease free from liability, the lessee "may be required to do something downright reckless." Kuntz, "The Prudent Operator and Further Development," 4th *Ann. Inst. on Min. L.* 1, 15 (L.S.U. 1956).

79. See text at N. 27.

80. See *Cowden v. General Crude Oil Co.*, 217 S.W.2d 109, 114 (Tex. Civ. App. 1948), *error ref'd, n.r.e.* ("It is thought under the implied covenant to reasonably develop the duty to drill on any particular portion of the leased area arises when there is a reasonable prospect of developing paying production.") and other cases discussed in Williams and Meyers, N. 5 *supra*, § 833.3.

81. E.g., *Kellar v. Craig*, 126 Fed. 630, 633 (4th Cir. 1903): "The lessee or his assigns are permitted to determine the character of the work to be done, and such ascertainment by him or them, in the absence of fraud disposes of the question."

82. See *Vonfeldt v. Hanes*, 196 Kan. 719, 414 P.2d 7, 11-12, 25 O. & G.R. 127 (1966): "It is universally recognized that geology is not an exact science. Therefore, in cases of this type courts are concerned with probabilities or reasonable expectations. Thus, when a qualified expert witness expresses an opinion that oil could be produced from the undeveloped portion of a tract in question with reasonable expectations that it would be produced

When this approach is combined with a policy in favor of development⁸³ and a policy against “speculation,”⁸⁴ the lessor needs to show relatively little to prevail and receive an award of damages and/or conditional cancellation of a portion of the lease which would otherwise be continued in effect by the express provisions of the lease.

The most authoritative, and most often relied upon, case for the prudent operator standard is *Brewster v. Lanyon Zinc*,⁸⁵ a 1905 opinion by Mr. Justice Van Devanter, then on the Eighth Circuit Court of Appeals. The case should be placed in its proper perspective, for it has been used rather indiscriminately by the courts for many years. It is true that Van Devanter set forth a higher standard than good faith, but the reasons for this higher standard have often been overlooked. *Brewster* was a drainage case, and Van Devanter specifically said that the reason for imposing a higher duty was the fugacious nature of petroleum. He stated:

“Considering the migratory nature of oil and gas, and the danger of their being drawn off through wells on other lands if the field should become fully developed, all of which must have been in the minds of the parties, it is manifest that the terms of the lease contemplated action and diligence on the part of the lessee. . . .

“

“If [operations] do not proceed with reasonable diligence, and by reason thereof the oil and gas are diminished or exhausted through the operation of wells on adjoining lands, the lessor loses, not only royalties to which he would otherwise be entitled, but also his contingent interest in the oil and gas which thus passes into the control of others.”⁸⁶

therefrom in paying quantities, it is sufficient evidence upon which to base a finding that the lessee has failed to comply with the obligation imposed by the implied covenant to develop the lease, provided the facts upon which an expert opinion is based afforded a reasonably accurate basis for the conclusion reached, as distinguished from a mere guess or conjecture.” (quoting *Stamper v. Jones, Shelburne & Farmer, Inc.*, 188 Kan. 626, 364 P.2d 972, 15 O. & G.R. 12 (1961)).

83. *Renner v. Monsanto Chemical Co.*, 187 Kan. 158, 354 P.2d 326, 333, 13 O. & G.R. 448 (1960); *Davenport v. Shoenfelt*, 191 Ky. 234, 229 S.W. 1043 (1921).

84. *Vickers v. Vining*, N. 25 *supra*; *Carter v. United States Smelting, Refining & Min. Co.*, N. 29 *supra*; *Banks v. Calstar Petroleum Co.*, 82 Cal. App. 2d 789, 187 P.2d 127, 128 (1947).

85. 140 Fed. 801 (8th Cir. 1905).

86. *Id.* at 810, 814.

Van Devanter noted that it was a “plain and substantial disregard” of the requirement of prudent operation that constituted a breach of the covenant.⁸⁷ In addition, the “existence of gas in paying quantity in one of the tracts was an ascertained fact,” admitted by the lessee,⁸⁸ and not a matter of honest dispute between the parties.

A higher standard than good faith is perhaps defensible for drainage cases, but not for cases involving the development and further exploration covenants. Loss to the lessor in these cases is generally at best conjectural. It can be surmised that the standard was carried into these other cases because the courts did not distinguish among the covenants due to the primitive state of scientific knowledge⁸⁹ and because lessors have often alleged drainage and failure to develop at the same time.⁹⁰

Separating the drainage question from the issue, how is the higher standard imposed on mineral lessees than on other businessmen to be justified in reasonable development and exploration cases? As noted already, only a good faith test is generally required under analogous circumstances in the law of contracts.⁹¹ In measuring the performance of corporate officers and directors in the exercise of their judgment and discretion in corporation law, a business judgment rule is employed which tests good faith. This rule has been stated as follows:

“Under the business judgment doctrine, acts of directors, within the powers of the corporation, in the furtherance of its business, made in good faith and in the exercise of an honest judgment, are valid and conclude the corporation and its shareholders. Questions of management policy, contract expediency and adequate consideration are left to their honest and unselfish decision, judgment and discretion and may not be interfered with or restrained.”⁹²

87. *Id.* at 815.

88. *Ibid.*

89. See the discussion in Moses, N. 11 *supra* at 3–5. He notes that as late as 1921, a Texas court stated that oil and gas “are supposed to percolate restlessly about under the surface of the earth, even as the birds fly from field to field and the beasts roam from forest to forest. . . .” quoting *Medina Oil Development Co. v. Murphy*, 233 S.W. 333, 335 (Tex. Civ. App. 1921).

90. E.g., *Vickers v. Vining*, N. 25 *supra*.

91. See text at N. 74.

92. *Heimann v. American Express Co.*, 279 N.Y.S.2d 867, 881, 53 Misc. 2d 749 (Sup. Ct. 1967).

It may be felt that lessors need special protection from lessees.⁹³ What is so extraordinary about the interest of the lessor that it must be given a higher degree of protection than the shareholder of the same lessee? It is the lessor's oil, some may argue. But so, too, is it the shareholder's money. If anything, the lessor's interest may be less deserving of protection, for the shareholder's investment often represents an accumulation of capital earned by work while the lessor's interest is more likely to be acquired as a fortuitous incident to the purchase of land for its surface uses. It is also worthy of note that by the time a suit to cancel a portion of a lease has been brought, the lessee has, in most cases, already invested a great deal more in the leased premises than the lessor. Once the lessee has established that it is acting in good faith (i.e., not in the deliberate disregard of the lessor's interest) and that there is a reasonable basis for its belief it is acting prudently, why should the lessee's interest not be given greater weight than it often is?⁹⁴ While I believe the basis for the high standard for judging business decisions of mineral lessees has always been rather dubious, there are other reasons for modifying the current notions of the prudent operator standard.

Not only was scientific knowledge relatively primitive when the prudent operator standard was formulated, but so too was our understanding of economics and our perception of the public interest. The social and economic context in which the prudent operator standard arose has changed radically since *Brewster v. Lanyon Zinc*, but the courts have, for the most part, failed to take these changed conditions into consideration in implied covenant cases. They continue to act as though implied covenant cases should only redress an imbalance of power between lessor and lessee, and they fail to recognize the larger consequences of their rulings. The role and responsibilities of the corporate lessee have changed greatly, and there are a great many more restraints upon the corporation today than three-quarters

93. See Merrill, N. 4 *supra*, § 221 at 468.

94. Williams and Meyers, N. 5 *supra*, § 847 at 385, argue that the loss to the lessee from cancellation of unexplored acreage or formations is relatively slight. The loss is all the minerals that the lessee might have recovered had the lessee been allowed to proceed with further exploration at the rate it thought prudent. There will also be a loss to the public if drilling is required and the capital and materials could be put to better use elsewhere. The loss when a portion of a lease is cancelled for failure to develop reasonably is the same; in addition, if new wells are drilled by another operator, they may drain production the lessee would otherwise have had from existing wells. Further, cancellation of a portion of a lease may hinder greatly the undertaking of secondary recovery operations at a later date. See Vonfeldt v. Hanes, N. 82 *supra*.

of a century ago. At that time, corporations were expected to seek to be profit maximizers and were expected to take all actions necessary to this end unless positively prohibited from specific acts by law. In the classic model of capitalism then prevailing, corporations and individual businessmen would thereby promote the general economic welfare.⁹⁵ This concept of the proper role of the corporation is, if not entirely discredited, languishing today. In the face of vigorous onslaughts on private business, it is recognized by many commentators within as well as outside of business that corporations must, in order to survive, consider the public interest as part of any business decision and must in some instances put immediate profit second to other considerations; corporations must work in cooperation with government, almost as an arm of the state, lest the state entirely absorb the present functions of private business.⁹⁶ Adolf Berle has observed that in twentieth century capitalism, increasingly “the development is toward a mixed system in which governmental and private property are inextricably mingled.”⁹⁷ Public opinion, he notes, must be considered in business decisions, and the “real guarantee of non-statist industrial organization in America is a substantially satisfied public.”⁹⁸

Prudence, then, dictates that the corporate lessee consider the long-term economic and political consequences of its actions, regardless of whether these actions will result in immediate profit. It must respond to what it perceives to be governmental policy and to what it believes to be the most likely to maintain long-term favorable public opinion, regardless of the fact that the state has not mandated or prohibited a particular course of action. In sum, the prudent operator today would consider a much wider range of factors than a prudent operator of a half century or more ago. A standard that presumes a prudent operator will drill any time there is a probability of profit is outmoded and is possibly harmful to the best interests of the public.

95. See *Dodge v. Ford Motor Co.*, 204 Mich. 459, 170 N.W. 668 (1919); Cochran, *The American Business System: A Historical Perspective 1900-1955*, pp. 98–100 (1957); Cochran and Miller, *The Age of Enterprise: A Social History of Industrial America* 119–128 (rev. ed. 1961); Galbraith, *Economics and the Public Purpose* 103–104 (Signet ed. 1973).

96. See the discussion of the scope of corporation directors' responsibilities in Cary, *Corporations* 237–243 (4th ed. 1969). See also, Wilcox, *Public Policies Toward Business* 13–14 (4th ed. 1971); Berle and Means, *The Modern Corporation and Private Property* (rev. ed. 1967); Galbraith, *The New Industrial State* 399–400 (Mentor ed. 1967); Drucker, *Concept of the Corporation* 15–19, 209–229 (1946); Drucker, *Management*, Chs. 26–27 (1973); Silk, “The Role of the Business Corporation in the Economy and Society,” in Smith and DeVyver, *Economic Systems and Public Policy* (1966).

97. Berle, *The 20th Century Capitalist Revolution* 109 (1954).

98. *Id.* at 59.

When the lessee's interest is subordinated to the public interest, it is only proper that the lessor's interest likewise be subordinated. If the lessee is to be penalized for acting in what it believes to be the public interest, the lessee is less likely to act in the public interest. The only loss to the lessor with respect to the implied covenants under consideration is that there is a possibility he may not realize his maximum profit. The same may be said of the lessor that John Kenneth Galbraith has said of the shareholder:

“As the public character of the mature corporation comes to be recognized, attention will doubtless focus on the position of the stockholder in this corporation. This is anomalous. He is a passive and functionless figure, remarkable only in his capacity to share, without effort or even without appreciable risk. . . .”⁹⁹

It is my proposal that the prudent operator standard be modified to give due regard to the fact that the lessee must often act upon its perceptions of its duties under express and implied governmental policies and public opinion. When public interest factors are arguably present in measuring a lessee's conduct under a mineral lease, in a case brought by the lessor or his successor in interest, the proper test is whether the lessee has acted in good faith and had a reasonable basis for its judgment. This is the truer test of the prudent operator.¹⁰⁰ The way in which public interest factors may arise will be considered under the next heading.

Recent Legislation and Regulation Affecting Implied Covenants

From the perspective these last several troubled years have given us, it seems a reasonable conclusion that the law of implied covenants has ill-served the nation. Reasonable development for the lessor historically has meant overdevelopment for the country. It has led to extravagant, wasteful consumption of petroleum and too rapid a depletion of this finite resource. By fostering production when its desirability has been questionable, it has prevented the proper functioning of market mechanisms that would balance supply and demand over time.

Cognizant of the excessive production caused by the rule of capture and the development obligations of lessees, the producing states four decades

99. Galbraith, N. 96 *supra* at 401.

100. I see no reason why this test should present any more difficulty in its application than the determination of what an objective prudent operator would do. Cf. Williams and Meyers, N. 5 *supra*, § 806.2 at 34–35. And see *Blythe v. Sohio Petroleum Co.*, 271 F.2d 861, 11 O. & G.R. 609 (10th Cir. 1959).

ago enacted conservation laws. Their purpose was to restrain and rationalize production.¹⁰¹ That these laws and the regulatory agencies acting pursuant to them have had a significant effect upon the law of implied covenants is unquestionable. However, the courts have treated the laws and regulations as having only a force majeure effect¹⁰² rather than as modifying the policies in favor of development and against "speculation."¹⁰³ That is to say, the implied covenants are still applicable and must be fulfilled unless the lessee is prevented from doing so by the well-spacing or prorationing restrictions of the state. The plea of a perceptive speaker¹⁰⁴ before this Institute twenty-two years ago for the replacement of the development philosophy by a philosophy of conservation in implied covenant litigation was largely unheeded.

The law of implied covenants, even after the institution of a regime of conservation, has required operators to maximize short-term profitability rather than seek long-term maximization (which may be regarded as long-term profitability or as institutional survival). If the operator has the possibility of making a profit now by drilling, he must, even though it might make more for both the lessor and itself over the long term by delaying development. The law at present regards a willingness to delay development and further exploration as speculation. The field of economics

101. See generally, Murphy (ed.), *Conservation of Oil and Gas in Legal History* (1948); Interstate Oil Compact Commission, *A Study of Conservation of Oil and Gas in the United States* (1964); Lovejoy and Homan, *Economic Aspects of Oil Conservation Regulation*, Ch. 2 (1967); McDonald, *Petroleum Conservation in the United States: An Economic Analysis* 35-38 (1971); Summers, "The Modern Theory and Practical Application of Statutes for the Conservation of Oil and Gas," in *Legal History of Conservation of Oil and Gas* 1, 4-5 (1938).

102. *Railroad Commission v. Humble Oil & Refining Co.*, 19 S.W.2d 824 (Tex. Civ. App. 1946), *error ref'd, n.r.e., aff'd per curiam* 331 U.S. 791, *reh'g denied* 332 U.S. 786 (1946); *Renner v. Monsanto Chemical Co.*, N. 83 *supra*; Richardson, "Doctrine of Development Covenants Re-examined in Light of Express Covenants and Conservation," *9th Oil & Gas Inst.* 321 (Matthew Bender 1958); Cline, "Implied Covenants—The New Look Under Conservation Laws," *6 Rocky Mt. Min. L. Inst.* 471 (1961).

103. Indeed, the fact that the state regulatory body does not prohibit the drilling of certain wells may be used to imply a covenant that such wells should be drilled. See *Vickers v. Vining*, N. 25 *supra* at 803, and *Temple v. Continental Oil*, N. 19 *supra*. See also Meyers, "The Effect on Implied Covenants of Conservation Laws and Practices," *4 Rocky Mt. Min. L. Inst.* 463 (1953).

104. Eberhardt, "Effect of Conservation Laws, Rules and Regulations on Rights of Lessors, Lessees and Owners of Unleased Mineral Interests," *5th Oil Gas Inst.* 125 (Matthew Bender 1954). See also Siefkin, "Effect of Proration on Implied Covenants," 19 Okla. B.A.J. 1652 (1948).

might regard it as a means of optimizing the benefits of energy development over the long run. Speculation is a highly pejorative term which in economic fact means simply that the person possessing the commodity or controlling the activity believes that it may be worth more at a later time than at the present. This in turn means that the optimum value of the goods or activity to society, as reflected through the market mechanism, may be at a later time than at present.

To see this, let us assume for a moment that there is only a limited supply of materials that can be used to manufacture automobiles. It would be a foolish law that would permit a shareholder in the company to force the company to turn out automobiles as long as there is a reasonable basis for believing a profit can be made. The result would be too many automobiles now and not enough later. But this is exactly what the law of implied covenants has done over the years. The law of implied covenants has told operators that even if they felt it was optimal for themselves and for society to develop the scarce petroleum resources under their control over time, they had to realize their short-term profit or receive nothing at all. Faced with such a choice, operators have naturally taken the short-run profits, and this has resulted in resource misallocation for society as a whole. This has been bad law and bad policy. Commenting on the prevailing system of conservation, with implied covenant law fostering rapid development, one economist has recently observed that the system has failed “to provide a framework within which the benefits from oil and gas may be maximized before they cease to be economic resources.”¹⁰⁵

Because the country is now experiencing domestic shortages, some may feel this discussion is of historic interest only. After all, sound policy demands exploration and development now, does it not? Yes, but accepting this does not tell us where and at what rate exploration and development should take place. The best interests of the country may be served by having assured supplies of petroleum over a longer time period. From a policy standpoint, slow development of known formations may be preferable to a more rapid rate of development that would return the maximum short-term benefits to the lessor. Through price differentials and

105. McDonald, N. 101 *supra* at 188. Lovejoy and Homan came to somewhat similar conclusions, N. 101 *supra* at 102–119. Professor Howard R. Williams has recently inveighed against “profligate waste of resources expended in the drilling of unnecessary wells.” Williams, “Some Ingredients of a National Oil and Gas Policy,” 27 *Stanford L. Rev.* 969, 973 (1975). It is hoped his criticism also has reference to the unnecessary drilling brought about by implied covenant law. Economic waste is also involved in the premature drilling of marginal wells.

through announced policy, Congress, the Federal Energy Administration, and the President are encouraging and discouraging exploration and development in different areas.¹⁰⁶ Lessees, perhaps, do not need additional incentives from the courts, and judicial encouragement of exploration or development could hinder national efforts. No doubt the lessor thinks the 10,000 foot horizon on his forty acres is as deserving of further exploration or development and is as important to the national energy supply as a 5,000-acre tract in the Gulf of Mexico. The corporate lessee with limited capital and materials and with national responsibilities must view the matter from a different perspective, and the government, too, views it differently. In 1974, for example, the Secretary of the Interior told a congressional subcommittee that until 1970, there had been slow development of the Outer Continental Shelf “so as not to cause abandonment and reduction in onshore oil and gas production.”¹⁰⁷ Speaking in support of the administration’s revised OCS policy, he continued:

“We realize that the proposed acceleration of Outer Continental Shelf leasing will put a great deal of pressure on limited resources in rigs, labor and oil country goods. However, we have confidence in the capacity of the industry to expand to meet this need, and in the meantime to employ scarce resources where they will be most productive.”¹⁰⁸

The prudent and responsible operator will heed such policy statements and will delay onshore exploration and development if necessary. Failure to do so may encourage congressional proposals to take over OCS development.¹⁰⁹ However, the law of implied covenants allows the forty-acre lessor to force the lessee to take away capital and materials from OCS development to devote it to the forty acres or to suffer the loss of a portion of a lease in which it has already invested substantial funds. This leads to a misallocation of resources for society, and it does not mean that society gets the benefit of production from both the OCS and the cancelled portion of the forty acres if the lessee chooses, or is forced, to give up part of the

106. The new rules under the Energy Policy and Conservation Act (Pub. L. No. 94-163) are found at 41 Fed. Reg. 4931 (Feb. 3, 1976). Additional rules with production incentives are to follow shortly.

107. Remarks of Secretary Morton in Hearings on Outer Continental Shelf Oil and Gas Before the Subcommittee on Immigration, Citizenship, and International Law of the House Committee on the Judiciary, 93d Cong., 2d Sess., Ser. No. 93-31 at 4 (1974).

108. *Id.* at 6. See also, *Energy Under the Oceans* 225–226, 316 (1973).

109. See *Oil & Gas J.*, April 7, 1975, at 64.

lease. No, the lessor is free to engage in speculation of his own by seeking another lessee who will pay a high bonus and high delay rentals for a substantially explored leasehold, and production may be further delayed for years. The fact that a court can cancel a portion of a lease for failure to develop does not mean the cancellation will be followed by development.

A similar line of reasoning can apply to the implied covenant to market gas. If a Texas lessee decides it is more prudent to sell gas into the interstate market on a long-term contract to keep North Carolina's textile mills in operation rather than to sell it in the Texas market for a higher short-term price for boiler fuel use, the decision may be reasonable and prudent. The lessee's decision may well represent the most beneficial use of the gas, and it may help forestall a congressional drive to control the price of all natural gas.¹¹⁰ To allow the lessors to challenge successfully good faith business judgments of this sort forces lessees to weigh lessors' interests more heavily than the public interest.

Price controls should have significance for implied covenant questions in another way. For several years now there has been uncertainty over precisely how some phases of the controls have operated. Lessees have had difficulty in determining to what "property" they applied,¹¹¹ whether a new well would result in "new oil" or simply raise a declining production level back to its base figure,¹¹² whether a property or a particular operation qualified for a special exemption¹¹³ and so forth. These controls, with frequent changes, will be around for another thirty-eight months at a bare minimum. Price on production can go up or down on new or old oil in the exercise of executive or legislative discretion. With regulatory and market conditions so volatile, something more should be required of a lessor in an implied covenant case than a witness with an educated guess that a particular well will be or would have been profitable. A matter of honest dispute should be decided in favor of the lessee.

A lessee should also be able to exercise considerable discretion if environmental factors are present in an implied covenant case. Many acts, rules, and regulations for environmental protection have flowed from state and federal legislative and administrative bodies in recent years, far too

110. *Id.*, Feb. 24, 1975, at 46; *Energy Users Report*, Jan. 22, 1976, A-23-24.

111. 10 C.F.R. § 212.72 ("Property") ("New Crude Oil"); FEA Ruling 1975-15.

112. *Ibid.*

113. E.g., *Shar-Alan Oil Co.*, 2 F.E.A. ¶ 83,023 (Jan. 21, 1975); *Empire Drilling Co.*, 2 F.E.A. ¶ 83,142 (May 9, 1975).

many to enumerate here.¹¹⁴ Will these have only a force majeure significance for implied covenant cases as did conservation legislation, or will they be regarded as establishing a new ethic that should be recognized when the lessee raises environmental concerns as a reason for not undertaking a particular operation? What, for example, if a lessee decides not to dig salt water and mud pits, lay plank roads, bring in power equipment, and drill in a portion of a large lease near a pristine lake or where an endangered species lives for a portion of the year? Later technological innovation may reduce the impact of development on the environment, and the lessee decides to await such innovation. The decision is prudent even though there is no express prohibition on development, for development could invite suits under novel theories from environmentalists and encourage still more restrictive land use planning and environmental legislation. It should be remembered that the lessor may not own the surface, and the surface owner as well as the lessee may oppose further development.¹¹⁵ Under such circumstances, the question raised is whether the lessee has a duty to pollute or disturb the environment until positively prohibited from doing so by governmental authority? If lessees cannot exercise discretion in such matters, further regulation will be forced upon them, and, indeed, lessors as a class are likely to suffer with them. As one industry critic has stated, "Unless industry takes the initiative in self-imposed environmental control, government will impose increasingly upon the free enterprise system by environmental regulations."¹¹⁶

Conclusion

Current legal notions of the prudent operator must expand to take economic and social factors into consideration in addition to the profitability criterion. It would not be going too far to suggest that the existence of the petroleum industry as we know it today depends upon the

114. E.g., Federal Water Pollution Control Act, 33 U.S.C. §§ 1151 *et seq.*; Coastal Zone Management Act, 16 U.S.C. §§ 1451 *et seq.*; Safe Drinking Water Act, 42 U.S.C. § 300 (f-j 9); Energy Users Report, Oct. 9, 1975, A-1. See also, Ashworth and Calhoun, "Control of Oil Production Pollution," 48 Texas L. Rev. 1086 (1970). A case in which environmental regulation had an effect on the lessee's implied covenant obligation is *Feland v. Placid Oil Co.*, 171 N.W.2d 829, 34 O. & G.R. 416 (N.D. 1969).

115. The extent to which the interests of the lessor and surface owner may be opposed is well illustrated in *Sun Oil v. Whitaker*, 483 S.W.2d 808, 42 O. & G.R. 256 (Tex. 1972).

116. Victor Yannacone, Jr., 4 *Environment Reporter* 9 (May 4, 1973), quoted in Friedman, "The Operational Impact of NEPA and Related Environmental Laws, Regulations, and Orders on Mineral Operations," 19 *Rocky Mt. Min. L. Inst.* 47, 79 (1974).

exercise of sound discretion by industry on numerous difficult policy matters. The exercise of that discretion should not be hindered by excessive and unwarranted attention to the short-term profit interests of lessors. If industry cannot respond intelligently to changing economic and political developments and consider the long-term as well as short-run profitability, the government will increasingly take over the lessee's functions. Judging from past experience, it is most doubtful that government will better serve the interest of the lessor than do today's operators.