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The Oil and Gas Lease, Part III: Implied Covenants

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IMPLIED COVENANTS

I. INTRODUCTION

The purpose of this paper is to provide an outline on implied covenants under Texas law, including duties imposed, standards applied, and remedies available. While the law on implied covenants has been well established and fairly well understood for several years, its application to specific facts continues to evolve. Recent Supreme Court of Texas cases have raised some new questions concerning proof and calculation of damages in implied covenant to protect cases and regarding duties owed by the executive rights owners to non-participating royalty interests. This paper will discuss the historic background of those principles and will look at what changes may yet come as the law continues to evolve.

II. BACKGROUND

A. Historical Basis.

Implied covenants are a part of all Texas leases and have been recognized as enforceable, contractual obligations since early in the twentieth century. *W. T. Waggoner Estate v. Sigler Oil Co.*, 118 Tex. 509, 19 S.W.2d 27, 29 (Tex. 1929) (when lease fails to define lessee's duty as regards development after discovery of paying production, the law implies the obligation to continue to develop and produce oil or gas with reasonable diligence); *Freeport Sulphur Co. v. Am. Sulphur Royalty Co.*, 117 Tex. 439, 6 S.W.2d 1039, 1042 (Tex. 1928) (an implied covenant for diligent and reasonable development and operation exists in a lease which makes the lessor's compensation depend upon development and operations); *Grubb v. McAfee*, 109 Tex. 527, 212 S.W. 464, 465 (Tex. 1919) (approving lower court holding that the law implies the obligation to exercise reasonable diligence to continue drilling after oil encountered in first well).

In *Freeport Sulphur Co.*, the Texas Supreme Court stated a covenant will be implied in a lease when it is "so clearly within the contemplation of the parties . . . that they deemed it unnecessary to express, and therefore omitted to do so, or that it is necessary to imply such covenant in order to give effect to and effectuate the purposes of the contract as a whole." *Freeport Sulphur Co.* at 117 Tex. 439, 6 S.W.2d at 1041-42 (Tex. 1928).

B. Must Arise From Express Contract.

Implied covenants arise out of the written agreement of the parties. The implied covenants must be complimentary, but not contrary to the express provisions of the lease. In *Danciger Oil & Refining Co. of Texas v. Powell*, 154 S.W.2d 632, 635 (Tex. 1941), the Court stated:

[I]t is not enough to say that an implied covenant is necessary in order to make the contract fair, or that without such a covenant it would be improvident or unwise, or that the contract would operate unjustly. It must arise from the presumed

intention of the parties as gathered from the instrument as a whole. . . . However, covenants will be implied in fact when necessary to give effect to the actual intent of the parties as reflected by the contract or conveyance as construed in its entirety in the light of the circumstances under which it was made and the purposes sought to be accomplished.

Similarly, in *HECI Exploration Co. v. Neel*, 982 S.W.2d 881 (Tex. 1998) the Court revisited the basis for implied covenants and reiterated the long-standing rule that implied covenants must spring out of the actual terms of the lease and not be contrary to it. “A covenant will not be implied unless it appears from the express terms of the contract that ‘it was so clearly within the contemplation of the parties that they deemed it unnecessary to express it’ and therefore they omitted to do so, or ‘it must appear that it is necessary to infer such a covenant in order to effectuate the full purpose of the contract as a whole as gathered from the written instruments.’” *HECI Exploration Co.*, 982 S.W.2d at 888 (quoting *Danciger Oil & Refining Co. of Texas v. Powell*, 154 S.W.2d at 635).

III. DEFINITION OF THE IMPLIED COVENANTS

A. Definition.

The landmark Supreme Court case describing covenants implied in oil and gas leases is *Amoco Prod. Co. v. Alexander*, 622 S.W.2d 563 (Tex. 1981). In that case, the Texas Supreme Court described the implied covenants as follows: (1) covenant to develop the lease: which may include an obligation to drill an initial well but is more usually defined as the obligation to develop the lease after production has been acquired; (2) covenant to protect the lease: which includes the obligation to protect against drainage and not to depreciate the lessors’ interest; and (3) covenant to manage and administer the lease: which includes the obligation to produce and market production, to operate with reasonable care, to use successful modern methods of production and development, and—under the appropriate circumstances—to seek favorable administrative action. *Amoco Prod. Co.*, 622 S.W.2d at 567 (quoting R. Hemmingway, *The Law of Oil and Gas*, § 8.1 (1971)).

B. Standard of Care.

Amoco also identifies the standard by which a lessee’s conduct under these implied covenants will be measured. The general duty of the lessee is to conduct operations as a reasonably prudent operator would to carry out the purposes of the oil and gas lease. *Amoco Prod. Co.*, 622 S.W.2d at 568. This standard is often described as the “reasonably prudent operator standard” and defined as “what a reasonably prudent operator would do under the same or similar circumstances.” This is not a fiduciary standard. Absent evidence of some special relationship between the lessor and the lessee, or some duty explicit in the language of the lease, the lessee does not owe a fiduciary duty to the lessor. *Texas Oil & Gas Corp. v. Hagen*, 1987 WL 47847 (Tex. 1987), *opinion withdrawn, case settled*, 760 S.W.2d 960 (Tex. 1988). Because there is no good faith or other fiduciary duty to perform any of the implied covenants, the breach

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