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Outline on Implied Covenants

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IMPLIED COVENANTS

I. INTRODUCTION

The purpose of this paper is to present an outline of Texas law regarding the covenants implied in oil and gas leases, including the specific duties imposed upon the lessee, standards applied in measuring whether those duties are met, and the remedies available to the lessor when they are not. As you can imagine, an oil, gas and mineral law practitioner in Texas needs a clear understanding of implied covenant law in order to analyze, protect and enforce the rights and obligations of parties to leases here and in many other jurisdictions. While that law has been well established and fairly well understood for several years, its application to specific facts continues to evolve. This paper will outline the development of these principles, changes that have occurred in recent years, and where the current “hot buttons” for implied covenant dispute can be found now. In addition, this paper briefly addresses the duty owed by an executive to its non-participating interest owner, how that duty is different from duties owed under the implied covenants, and why.

II. BACKGROUND

A. Our Starting Point:

Implied covenants are a part of all Texas oil, gas and mineral 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 held 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. Covenant 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

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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).

Courts ruling on current implied covenant disputes continue to cite these same concepts. In a case questioning whether the beneficiary of a royalty trust had the authority to bring suit on behalf of the trust against the lessee for breach of the implied duty to market as a reasonably prudent operator, the court relied on tried and true case law regarding the basis of implied covenants in its ruling dismissing the action. While the case centered on whether the beneficiary of a trust had authority to act when the trustee did not, the holding required an analysis of the underlying claim for breach of an implied duty because the beneficiary based her authority to act on a claim that the trustee had wrongfully failed to do so. Presented with the actual contract between the trust and the lessee regarding sales of production, the court found no wrongful act by trustee as the implied covenant the beneficiary was relying on had in fact been specifically addressed (and amended) by the contract. “Covenants will be implied only where necessary to give effect to the actual intent of the parties as reflected by the contract or conveyances as a whole. . . . Covenants are implied when deemed fundamental to the purpose of the contract as expressed in the instrument and only where the contract does not expressly address the subject matter of the covenant sought to be implied.” See *In Re XTO: Energy Inc.*, 471 S.W.3d 126, 135 (Tex.App—Dallas 2015, no writ hist.)

III. DEFINITION OF THE IMPLIED COVENANTS

A. Definition.

The landmark Texas Supreme Court case describing covenants implied in oil and gas leases is *Amoco Prod. Co. v. Alexander*, 622 S.W.2d 563 (Tex. 1981). There the Court defined

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