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The Oil & Gas Lease, Part III: Implied Covenants

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IMPLIED COVENANTS¹

Implied covenants are obligations that are not expressly imposed by a contract, but which courts nevertheless find are binding on one or more parties to the contract.² Courts in Texas and other states routinely hold that oil and gas lessees are bound by several implied covenants. This paper begins by discussing the reason that implied covenants exist, then it reviews the various implied covenants that courts have recognized, as well as a number of issues that can arise in implied covenant disputes, such as the elements necessary to establish a breach of an implied covenant, defenses, and remedies that are available. The paper emphasizes Texas law, but is not limited to it.

I. History of and justifications for implied covenants

For more than 100 years, courts in Texas and elsewhere have held that mineral leases contain various implied covenants—that is, obligations that are not expressly stated in a lease, but which are nevertheless binding on lessees. For example, in 1891, the Texas Supreme Court declared that a person holding a mining lease had an implied duty to reasonably develop the leased premises.³ In 1904, a Texas appellate court stated that an oil and gas lessee had an implied duty “to explore and develop the land with diligence.”⁴ And in 1919 the Texas Supreme Court recognized that oil and gas leaseholders are bound by implied covenants.⁵

¹ Portions of this paper are adapted from the author’s prior papers and articles on implied covenants, including papers prepared in connection with Rocky Mountain Mineral Law Foundation events. *See also* Keith B. Hall, *Implied Covenants and Changing Technology*, Proceedings of the 60th Annual Mineral Law Institute (2013); Keith B. Hall, *The Application of Oil & Gas Lease Implied Covenants in Shale Plays: Old Meets New*, Proceedings of the 32nd Annual Energy and Mineral Law Institute (2011); Keith B. Hall, *Implied Covenants: Claims Under Mineral Code Article 122*, Proceedings of the 57th Annual Mineral Law Institute (2010); Keith B. Hall, *The Continuing Role of Implied Covenants in Developing Leased Lands*, 49 Washburn L.J. 313 (2010).

² Black’s Law Dictionary (6th edition 1990) defines “covenant” as an agreement or promise, and an “implied covenant” as one which may reasonably “be inferred from the whole agreement and conduct of the parties.” *See also* Johnson v. Gurley, 52 Tex. 222, 226 (1879) (“A covenant is an agreement duly made between the parties to do or not to do a particular act.”); Landscape Design and Const., Inc. v. Harold Thomas Excavating, Inc., 604 S.W.2d 374, 376 (Tex. App.—Dallas 1980) (“A covenant ... is an agreement to act or refrain from acting in a certain way.”).

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

⁴ J.M. Guffey Petroleum Co. v. Oliver, 79 S.W. 884, 888 (Tex. Ct. Civ. App. 1904). *See also* J.M. Guffey Petroleum Co. v. Jeff Chaisson Townsite Co., 107 S.W. 609, 612 (Tex. Civ. App. 1907) (lessee had implied obligation “to use reasonable diligence and care to develop and protect the property, and this obligation required it to sink as many wells as the exercise of such diligence and care would suggest under the circumstances”).

Guffey Petroleum, whose first operations were conducted in south Texas, would later become Gulf Oil. *See* Anthony Sampson, THE SEVEN SISTERS: THE GREAT OIL COMPANIES & THE WORLD THEY SHAPED 37-40 (1975); Daniel Yergin, THE PRIZE: THE EPIC QUEST FOR OIL, MONEY & POWER 71-6 (1991)

⁵ Grubb v. McAfee, 212 S.W.2d 464, 465-6 (Tex. 1919).

With respect to oil and gas leases, certain states recognized implied covenants even earlier than did Texas. The earliest oil and gas case to recognize the existence of implied covenants in oil and gas leases may have been *Stoddard v. Emery*, a case in which the Pennsylvania Supreme Court stated in dicta in 1889 that oil and gas lessees are bound by an implied covenant to reasonably develop the leased premises.⁶ Three years later, the Pennsylvania Supreme Court again stated that a lessee was bound by an implied covenant of reasonable development,⁷ and just a few years later, the same court held that lessees are bound by an implied covenant to protect against drainage.⁸ Ohio soon followed suit in recognizing implied covenants,⁹ as did the United States Eighth Circuit in *Brewster v. Lanyon Zinc Co.*,¹⁰ a decision that has been cited with approval by the Texas Supreme Court¹¹ and which is recognized by several commentators as being one of the leading cases on implied covenants.¹² Today, implied covenants appear to be recognized in every state with any significant amount of oil and gas jurisprudence.¹³

⁶ 18 A. 339 (Pa. 1889); *see also* Patrick H. Martin and Bruce A. Kramer, 5 WILLIAMS AND MEYERS OIL & GAS LAW § 802 (prominent commentators describing *Stoddard's* dicta as being the origin of implied covenants).

⁷ *See McKnight v. Manufacturers Natural Gas Co.*, 23 A. 164, 166 (Pa. 1892).

⁸ *See Kempner v. Lemon*, 35 A. 109 (Pa. 1896).

⁹ *See, e.g.*, *Harris v. Ohio Oil Co.*, 48 N.E. 502 (Ohio 1897) (recognizing implied covenants to reasonably develop the premises and to protect against drainage); *see also* *Brewster v. Lanyon Zinc Co.*, 140 F. 801 (8th Cir. 1905).

¹⁰ 140 F. 801 (8th Cir. 1905).

¹¹ *Cole Petroleum Co. v. U.S. Gas & Oil Co.*, 41 S.W.2d 414, 417 (Tex. 1931); *Freeport Sulphur Co. v. American Sulphur Royalty Co.*, 6 S.W.2d 1039, 1043-4 (Tex. 1928) (implied obligation to mine sulphur); *Texas Pacific Coal & Oil Co. v. Barker*, 6 S.W.2d 1031, 1036 (Tex. 1928).

¹² A treatise on Texas oil and gas law states, “The rationale advanced by Texas courts for implying covenants echoes that of the Eighth Circuit in *Brewster v. Lanyon Zinc Co.*” Ernest E. Smith and Jacqueline Lang Weaver, TEXAS LAW OF OIL AND GAS at 5-9 (2nd ed. 2015). *See also* Martin and Kramer, *supra* n. 6 at § 802 (describing *Brewster* as “landmark” case); John S. Lowe, OIL AND GAS LAW IN A NUTSHELL (5th ed. 2009) (hereinafter, “Lowe, NUTSHELL”) (describing *Brewster* as a “leading case”); Jacqueline S. Weaver, *When Express Clauses Bar Implied Covenants, Especially in Natural Gas Marketing Scenarios*, 37 Nat. Resources J. 491, 492 n.6 (1997).

¹³ Numerous Texas cases recognize implied covenants, *see, e.g.*, *Coastal Oil & Gas Corp. v. Garza Energy Trust*, 268 S.W. 3d 1, 154, n.42 (Tex. 2008), as do a multitude of cases from other jurisdictions. *See, e.g.*, *Bonds v. Sanchez O’Brien Oil & Gas Co.*, 715 S.W. 2d 444, 445-6 (Ark. 1986); *Garman v. Conoco, Inc.* 886 P.2d 652, 659 (Colo. 1994); *Jacobs v. CNG Transmission Corp.*, 772 A.2d 445 (Pa. 2001); *Smith v. Amoco Production Co.*, 31 P.3d 255 (Kan. 2001); *Sundheim v. Reef Oil Corp.*, 806 P.2d 503, 507 (Mont. 1991); *Croston v. Emax Oil Co.*, 464 S.E.2d 728, 733 (W. Va. 1995); *Meisler v. Gull Oil, Inc.* 848 N.E.2d 1112, 1116 (Ind. Ct. App. 2006); *Ridl v. EP Operating Ltd.*, 553 N.W.2d 784, 789 (N.D. 1996); *Harris v. Ohio Oil Co.*, 48 N.E. 502 (Ohio 1897); *Pack v. Santa Fe Minerals*, 869 P.2d 323, 330 (Okla. 1994); *Continental Oil Co. v. Blair*, 397 So. 2d 538, 540 (Miss. 1981); *Caddo Oil & Mining Co. v. Producers Oil Co.*, 134 La. 701, 717, 64 So. 684, 690 (1914).

Various commentators have noted that implied covenants seem to have been recognized in the oil and gas jurisprudence of all states with any significant oil and gas activity. Smith and Weaver, *supra* n. 12 at 5-17 (“The [implied] covenant [of reasonable development] is recognized in all oil- and gas-producing

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