

**Presented:**  
44<sup>th</sup> Annual Ernest E. Smith  
Oil, Gas and Mineral Law Institute  
April 20, 2018  
Houston, TX

## **Outline on Implied Covenants**

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TABLE OF CONTENTS

I.	INTRODUCTION .....	1
II.	BACKGROUND .....	1
	A.    Our Starting Point: .....	1
	B.    Covenant Must Arise From Express Contract: .....	1
III.	DEFINITION OF THE IMPLIED COVENANTS.....	2
	A.    Definition.....	2
	B.    Standard of Care.....	3
	C.    Executive Rights Duty: Is it an Implied Covenant?.....	3
IV.	SPECIFIC COVENANTS .....	5
	A.    Implied Covenant to Develop.....	5
	1.    Actions Required.....	5
	a.    To Drill Initial Well? .....	5
	b.    To Develop After Initial Well.....	5
	c.    No Distinction Between Subsequent Development or Exploratory Wells.....	5
	2.    Remedies.....	6
	a.    Lost Royalty.....	6
	b.    Conditional Cancellation of Lease.....	7
	B.    Implied Covenant to Protect.....	8
	1.    Actions Required.....	8
	a.    In General.....	8
	b.    To Protect in Whatever Means Appropriate.....	8
	(1)    Drilling Offset Wells.....	8
	(2)    Seeking Administrative Relief.....	9
	(3)    Pooling in Good Faith.....	9
	c.    Each Lease Entitled to Protection.....	11
	2.    Remedies.....	11
	a.    Drainage Damages.....	11
	b.    Pooling Damages.....	12
	(1)    Unit Cancellation and Attendant Damages.....	12
	(2)    Partial Cancellation? .....	13
	(3)    Damages Based on Hypothetical Unit? .....	13
	3.    Implied Protective Covenant Versus Express Lease Terms.....	13
	a.    Implied Covenants Compliments Express Terms.....	13
	b.    Implied Covenants Do Not Negate Express Clauses.....	14
	C.    Implied Covenant to Manage and Administer the Lease.....	15
	1.    Actions Required.....	15
	2.    Duty to Market.....	15
	a.    The Covenant and “Proceeds” Leases .....	15
	b.    “Market Value” Leases Distinguished.....	17
	(1)    Sales to Affiliates.....	20
	(2)    Sales to Third Parties.....	21
	3.    Settlement of Contract Disputes .....	21
	4.    Implied Covenants Enforceable by Assignees.....	21
	5.    Class Actions .....	22
	6.    Other Obligations to Manage and Administer.....	23
	a.    Notice.....	23
	b.    Release of Lease .....	24
	7.    Force Majeure .....	25

TABLE OF AUTHORITIES

Cases

*Alameda Corp. v. TransAmerican Natural Gas Corp.*,  
950 S.W.2d 93 (Tex. App.—Houston [14<sup>th</sup> Dist.] 1997, writ denied) ..... 6, 21

*Amoco Prod. Co. v. Alexander*,  
622 S.W.2d 563 (Tex. 1981)..... passim

*Amoco Prod. Co. v. First Baptist Church of Pyote*,  
579 S.W.2d 280 (Tex. App.—El Paso 1979, writ ref’d n.r.e.), *per curiam*,  
611 S.W.2d 610 (Tex. 1980)..... 9, 15, 16, 17

*Andretta v. West*,  
415 S.W.2d 638 (Tex. 1967)..... 4

*Atl. Richfield Co. v. Gruy*,  
720 S.W.2d 121 (Tex. App.—San Antonio 1986, writ ref’d n.r.e.)..... 5

*Batex Oil Co. v. La Brisa Land and Cattle Co.*,  
352 S.W.2d 769 (Tex. Civ. App.—San Antonio 1961, writ dism’d.)..... 7

*Bolton v. Coats*,  
533 S.W.2d 914 (Tex. 1975)..... 21

*Bowden v. Phillips Petroleum Co.*,  
247 S.W.3d 690 (Tex. 2008)..... 22

*Browning Oil Co. v. Lueke*,  
38 S.W.3d 625 (Tex.App.—Austin, 2000, pet. den.)..... 12, 13

*Bryant v. Clark*,  
358 S.W.2d 614 (Tex. 1962)..... 13

*Cabot Corp. v. Brown*,  
754 S.W.2d 104 (Tex. 1987)..... 16, 17, 18

*Circle Dot Ranch, Inc. v. Sidwell Oil & Gas, Inc.*,  
891 S.W.2d 342 (Tex. App.—Amarillo 1995, writ denied) ..... 10

*Clifton v. Koontz*,  
160 Tex. 82, 325 S.W.2d 684 (Tex. 1959)..... 5

*Clifton v. Koontz*,  
325 S.W.2d 684 (Tex. 1959)..... 5, 9

*Coastal Oil & Gas Corp. v. Garza Energy Trust*,  
268 S.W.3d 1 (Tex. 2008)..... 11

*Cole Petroleum Co. v. U.S. Gas & Oil Co.*,  
121 Tex. 59, 41 S.W.2d 414 (Tex. 1931)..... 15, 21

## Implied Covenants

---

<i>Computer Assocs. Int’l, Inc. v. Altai, Inc.</i> , 918 S.W.2d 453 (Tex. 1996).....	23
<i>Condovest Corp. v. John Street Builders, Inc.</i> , 662 S.W.2d 138 (Tex. App.—Austin 1983, no writ).....	13
<i>Condra v. Quinoco Petroleum, Inc.</i> , 954 S.W.2d 68 (Tex. App.—San Antonio 1997, writ denied).....	6, 21, 22
<i>Cook v. Tompkins</i> , 713 S.W.2d 417 (Tex. App.—Eastland 1986, no writ).....	21
<i>Crim Truck &amp; Tractor v. Navistar Int’l Corp.</i> , 823 S.W. 2d 591 (Tex. 1992).....	3
<i>Danciger Oil &amp; Refineries, Inc. v. Hamill Drilling Co.</i> , 141 Tex. 153 S.W.2d 321 (Tex. 1943).....	19
<i>Danciger Oil &amp; Refining Co. of Texas v. Powell</i> , 154 S.W.2d 632 (Tex. 1941).....	2
<i>Elliott v. Davis</i> , 553 S.W.2d 223 (Tex. Civ. App.—Amarillo, 1977 writ ref’d n.r.e.) .....	9
<i>Enron Oil &amp; Gas Co. v. Joffrion</i> , 116 S.W.3d 215 (Tex. App.—Tyler 2003, no pet.) .....	3
<i>Expando Prod. Co. v. Marshall</i> , 407 S.W.2d 254, 260 (Tex. Civ. App.—Fort Worth 1966, writ ref’d n.r.e.) .....	9
<i>Exxon Corp. v. Atl. Richfield Co.</i> , 678 S.W.2d 944 (Tex. 1984).....	14
<i>Exxon Corp. v. Middleton</i> , 613 S.W.2d 240 (Tex. 1981).....	17, 19, 20
<i>Flanagan v. Chesapeake Exploration, LLC</i> , 2015 WL 6736648 (N.D. Tex., Dallas Div., 2015, no writ hist.).....	16
<i>Freeport Sulphur Co. v. Am. Sulphur Royalty Co.</i> , 117 Tex. 439, 6 S.W.2d 1039 (Tex. 1928).....	1, 7, 14
<i>Frost Nat’l Bank v. Matthews</i> , 713 S.W.2d 365 (Tex. App.—Texarkana 1986, writ ref’d n.r.e.).....	25
<i>Glassell v. Ellis</i> , 956 S.W.2d 676 (Tex. App.—Texarkana 1997, review dism’d w.o.j.) .....	22, 23
<i>Good v. TXO Prod. Corp.</i> , 763 S.W.2d 59 (Tex. App.—Amarillo 1988, writ denied) .....	9
<i>Grayson v. Crescendo Resources, L.P.</i> , 104 SW3d 736 (Tex.App. —Amarillo 2003, writ den.) .....	6

## Implied Covenants

---

<i>Grubb v. McAfee</i> , 109 Tex. 527, 212 S.W. 464 (Tex. 1919).....	1
<i>Gulf Prod. Co. v. Kishi</i> , 129 Tex. 487, 103 S.W.2d 965 (Tex. 1937).....	14
<i>HECI Exploration Co. v. Neel</i> , 982 S.W.2d 881 (Tex. 1998).....	passim
<i>Heritage Res., Inc. v. NationsBank</i> , 939 S.W.2d 118 (Tex. 1996) <i>rehr</i> 'g <i>overruled</i> , 960 S.W.2d 619 (Tex. 1997) .....	17, 19, 20
<i>Holbein v. Austral Oil Co., Inc.</i> , 609 F.2d 206 (5th Cir. 1980) .....	19
<i>Holman v. Meridian Oil, Inc.</i> , 988 S.W.2d 802 (Tex. App.—San Antonio 1999, pet. denied) .....	24
<i>Hooks v. Samson Lone Star, Ltd. Partnership</i> , 457 S.W.3d 52 (Tex. 2015).....	23
<i>Hurd Enters. Ltd. v. Bruni</i> , 828 S.W.2d 101 (Tex. App.—San Antonio 1992, writ denied).....	6, 21
<i>In Re: Bass</i> , 113 S.W.3d 735 (Tex. 2003).....	4
<i>In Re: XTO Energy Inc.</i> , 471 S.W.3d 126 (Tex.App—Dallas 2015, no writ hist.).....	2
<i>Johnson v. Snell</i> , 504 S.W.2d 397 (Tex. 1973).....	13
<i>Jones v. Killingsworth</i> , 403 S.W.2d 325 (Tex. 1965).....	9, 12
<i>Judice v. Mewbourne Oil Co.</i> , 939 S.W.2d 133 (Tex. 1996).....	19, 20
<i>KCM Financial LLC v. Bradshaw</i> , 457 S.W.3d 70 (Tex. 2015).....	4
<i>Kerr-McGee Corp. v. Helton</i> , 133 S.W.3d 245 (Tex. 2004).....	11
<i>Kidd v. Hoggett</i> , 331 S.W.2d 515 (Tex. Civ. App.—San Antonio 1959, writ ref'd n.r.e.).....	24
<i>Killam Oil Company v. Bruni</i> , 806 S.W.2d 264 (Tex. App.—San Antonio 1991, writ denied).....	6, 21
<i>Kodiak 1987 Drilling Partnership v. Delhi Gas Pipeline Corp.</i> , 736 S.W.2d 715 (Tex. App.—San Antonio 1987, writ ref'd n.r.e.).....	25

## Implied Covenants

---

<i>Le Cuno Oil Co. v. Smith</i> , 306 S.W.2d 190 (Tex. Civ. App.—Texarkana 1957, writ ref'd n.r.e.), <i>cert.</i> <i>denied</i> , 356 U.S. 974, 78 S. Ct. 1137, 2 L.Ed.2d 1147 (Jun. 02, 1958).....	19
<i>Lenape Res. Corp. v. Tenn. Gas Pipeline Co.</i> , 925 S.W.2d 565 (Tex. 1996).....	5
<i>Lesley v. Veterans Land Board</i> , 352 S.W.3d 479 (Tex. 2011).....	4
<i>Mandell v. Hammon Oil and Refining Co.</i> , 822 S.W.2d 153 (Tex. App.—Houston [1 <sup>st</sup> Dist.] 1991, writ denied) .....	6, 21
<i>Manges v. Guerra</i> , 673 S.W.2d 180 (Tex. 1984).....	4
<i>Marrs and Smith P'ship v. D.K. Boyd Oil and Gas Co., Inc.</i> , 223 S.W.3d 1 (Tex.App.—El Paso 2005, pet. denied) .....	4
<i>Martin v. Glass</i> , 571 F. Supp. 1406; (N.D. Tex. 1983), <i>aff'd</i> , 736 F.2d 1524 (5th Cir. 1984).....	19
<i>Modern Exploration, Inc. v. Maddison</i> , 708 S.W.2d 872 (Tex. App.—Corpus Christi-Edinburg 1986, no writ).....	24
<i>Occidental Permian Ltd. v. French</i> , 391 S.W.3d 215 (Tex. App.—Eastland, pet. granted) .....	17
<i>Occidental Permian Ltd. v. Helen Jones Foundation</i> , 333 SW3d 392 (Tex.App. —Amarillo 2001, pet. denied).....	16
<i>Parker v. TXO Prod. Corp.</i> , 716 S.W.2d 644 (Tex. App.—Corpus Christi 1986, no writ) .....	19, 20
<i>Phillips Petroleum Co. v. Johnson</i> , 155 F.2d 185 (5th Cir. 1946) .....	17
<i>Pickens v. Hope</i> , 764 S.W.2d 256 (Tex. App.—San Antonio 1988, writ denied).....	5
<i>Potts v. Chesapeake Exploration, L.L.C.</i> , 760 F. 3d 470 (5 <sup>th</sup> Cir. 2014).....	16
<i>Rhoades Drilling Co. v. Allred</i> , 123 Tex. 229, 70 S.W.2d 576 (Tex. 1934).....	15
<i>Roberts v. Lone Star Prod. Co.</i> , 369 S.W.2d 373 (Tex. Civ. App.—Eastland 1963, no writ).....	12
<i>ROCA Resource Company, Inc. v. Devon Energy Production L.P.</i> , 2015 WL 4479118 (United States District Court, W.D. Texas, Pecos Division) .....	3
<i>Rogers v. Ricane Enters., Inc.</i> , 772 S.W.2d 76 (Tex. 1989) (" <i>Ricane I</i> ") .....	8

## Implied Covenants

---

<i>Rogers v. Ricane Enters., Inc.</i> , 884 S.W.2d 763 (Tex. 1994) (" <i>Ricane II</i> ").....	8
<i>Rogers v. Westerman Farm Company</i> , 29 P.3d 887 (Colo. 2001).....	19
<i>Schlittler v. Smith</i> , 128 Tex. 628, 101 S.W.2d 543 (1937).....	4
<i>Shell Oil Co. v. Ross</i> , 356 S.W.3d 924 (Tex. 2011).....	24
<i>Shell Oil Co. v. Stansbury</i> , 401 S.W.2d 623 (Tex. Civ. App.—Beaumont 1966, writ ref'd n.r.e.), <i>per curiam</i> , 410 S.W.2d 187 (Tex. 1966).....	11, 13, 14
<i>Shivers v. Texaco Exploration and Prod., Inc.</i> , 965 S.W.2d 727 (Tex. App.—Texarkana 1998, writ denied).....	23
<i>Sinclair Oil &amp; Gas Co. v. Bryan</i> , 291 S.W. 692 (Tex. Civ. App.—Galveston 1927, writ ref'd).....	11
<i>Slaughter v. Cities Serv. Oil Co.</i> , 660 S.W.2d 860 (Tex. App.—Amarillo 1983, no writ).....	5, 7
<i>Southeastern Pipe Line Co., Inc. v. Tichacek</i> , 997 S.W.2d 166 (Tex. 1999).....	8, 10, 13
<i>Southland Royalty Co. v. Humble Oil &amp; Refining Co.</i> , 249 S.W.2d 914 (Tex. 1952).....	12
<i>Southwest Gas Prod. Co., Inc. v. Seale</i> , 191 So.2d 115 (Miss. 1966).....	13
<i>Sun Exploration and Prod. Co. v. Jackson</i> , 783 S.W.2d 202 (Tex. 1989).....	5, 6
<i>Sun Operating Ltd. P'ship v. Holt</i> , 984 S.W.2d 277 (Tex. App.—Amarillo 1998, pet. denied).....	25
<i>Tana Oil &amp; Gas Co. v. Bates</i> , 978 S.W.2d 735 (Tex. App.—Austin 1998, no pet.).....	22
<i>Texas Co. v. Davis</i> , 113 Tex. 321, 254 S.W. 304 (Tex. 1923).....	8
<i>Texas Oil &amp; Gas Corp. v. Hagen</i> , 1987 WL 47847 (Tex. 1987), <i>opinion withdrawn, case settled</i> , 760 S.W.2d 960 (Tex. 1988).....	3, 9, 20
<i>Texas Oil &amp; Gas Corp. v. Vela</i> , 429 S.W.2d 866 (Tex. 1968).....	17, 18

## Implied Covenants

---

<i>Texas Pac. Coal &amp; Oil Co. v. Barker</i> , 117 Tex. 418, 6 S.W.2d 1031 (Tex. 1928).....	6, 7, 8, 17
<i>TransAmerican Natural Gas Corp. v. Finkelstein</i> , 933 S.W.2d 591 (Tex. App.—San Antonio, 1996, writ denied).....	6, 21
<i>Union Pac. Res. Group, Inc. v. Hankins</i> , 111 S.W.3d 69 (Tex. 2003).....	22
<i>W. T. Waggoner Estate v. Sigler Oil Co.</i> , 118 Tex. 509, 19 S.W.2d 279 (Tex. 1929).....	1, 7
<i>West-Tex Land Co. v. Simmons</i> , 566 S.W.2d 719 (Tex. Civ. App.—Eastland 1978, writ ref'd n.r.e.).....	7, 21
<i>Witherspoon v. Green</i> , 274 S.W. 170 (Tex. Civ. App.—Dallas 1925, no writ).....	24
<i>Yzaguirre v. KCS Res., Inc.</i> , 53 S.W.3d 368 (Tex. 2001).....	17, 18

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H. Williams & C. Meyers, 5 <i>Oil and Gas Law</i> § 853, (1981) .....	15
H. Williams & C. Meyers, 8 <i>Oil and Gas Law</i> § 46 (Supp. 1995) .....	20
Koontz, 4 <i>The Law of Oil &amp; Gas</i> , § 48.3 (1972).....	9
R. Hemmingway, <i>The Law of Oil and Gas</i> , § 8.1 (1971) .....	3



## 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

## Implied Covenants

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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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First appeared as part of the conference materials for the 44<sup>th</sup> Annual Ernest E. Smith Oil, Gas and Mineral Law Institute session "Implied Covenants"