Chapter 8

The Application of Oil & Gas Lease Implied Covenants in Shale Plays: Old Meets New

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§ 8.01. **Introduction.**

Oil and gas lessees generally are bound by several implied obligations that are often called “implied covenants.” This chapter reviews the law of implied covenants, discusses several ways that implied covenant disputes might arise in new or unique ways in the development of shale plays, and then analyzes how lessees might protect themselves from implied covenant disputes.

§ 8.02. **History of and Justifications for Implied Covenants.**

For more than 100 years, courts have held that a mineral lessee’s duties include various implied covenants that are not expressly stated in a lease. Perhaps the earliest case to recognize the existence of implied covenants was
Stoddard v. Emery,\(^1\) an 1889 case in which the Pennsylvania Supreme Court stated in dicta that oil and gas lessees are bound by an implied covenant to reasonably develop the leased premises. Three years later, the Pennsylvania Supreme Court again stated that a lessee was bound by an implied covenant of reasonable development,\(^2\) and just a few years later, the same court held that lessees are bound by an implied covenant to protect against drainage.\(^3\) Other jurisdictions, including Ohio, soon followed suit in recognizing implied covenants.\(^4\) Today, it appears that every state with any significant amount of oil and gas jurisprudence has recognized the existence of implied covenants.

Public policy occasionally is cited as a justification for implied covenants,\(^5\) but the two most commonly stated justifications are that implied covenants fill gaps in contracts and promote fairness.\(^6\) The need to fill gaps and ensure fairness is more important with respect to oil and gas leases than for many other types of contracts due to a particular characteristic of oil and

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1 Stoddard v. Emery, 18 A. 339 (Pa. 1889). Some prominent commentators have described Stoddard’s dicta as being the origin of implied covenants. See e.g., 5 Patrick H. Martin and Bruce A. Kramer, Williams and Meyers: Oil & Gas Law § 802 (1998).
4 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).

Occasionally, the outcome of a case can turn on whether a court concludes that implied covenants are “implied-in-fact” gap fillers or “implied-in-law” mechanisms to promote fairness. For example, in some states, the length of the statute of limitations may depend on whether the court concludes that an implied covenant is implied by the language of lease itself, or whether the covenant is imposed by jurisprudence to promote fairness. See, e.g., Smith v. Amoco Prod. Co., 31 P.3d 255 (Kan. 2001).
gas leases. Because of the complexities and uncertainties involved in oil and gas exploration and development, leases seldom state how many wells the lessee will drill, when and where he will drill, or to what depth. 7 Similarly, leases usually do not specify what a lessee will do to protect the leased premises against drainage or to market any product that is found. All these things are left to the discretion of the lessee, even though these aspects of the lessee’s performance are critical to the value the lessor receives from the lease transaction.8 One early commentator stated, “It is doubtful if any other character of legal instrument can be found in which one of the parties has so much potentially at stake with so little express contractual protection.”9 It is this characteristic of oil and gas leases that leads courts to impose implied covenants on lessees.10

§ 8.03. The Standard of Conduct for Compliance with Implied Covenants.

Although courts recognize several different implied covenants, a common characteristic of all implied covenants is the standard of conduct to which a lessee is held. Lessees are not held to a fiduciary standard,11 and are not required to exercise perfect judgment,12 but their exercise of discretion is

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7 See Patrick H. Martin, “A Modern Look at Implied Covenants to Explore, Develop, and Market Under Mineral Leases,” 27 Sw. Legal Fdn. Oil & Gas Inst. 177, 194 (1976)(“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.”); Brewster v. Lanyon Zinc Co., 140 F. 801, 810 (8th Cir. 1905)(noting impossibility of the lease itself stating how many wells should be drilled because that would depend “upon future conditions, which could not be anticipated with certainty” when the lease was entered).


10 See Hall, supra note 8, at 174.

11 See, e.g., Finley v. Marathon Oil Co., 75 F.3d 1225, 1229 (7th Cir. 1996)(under Illinois law, lessee does not owe fiduciary duties to lessor); La. Rev. Stat. 31:122 (mineral lessee is not a fiduciary).

12 See Davis v. Ross Prod. Co., 910 S.W.2d 209, 213 (Ark. 1995)(“due deference should be given to the judgment of the lessee,” but that the lessee must exercise “sound judgment”);
not unfettered. Courts universally hold that oil and gas lessees are required
to act as reasonably prudent operators, taking into consideration both their
own interests and those of their lessors. This modern description of the
“reasonably prudent operator” standard is very similar to that stated in a
1905 case that arose in Kansas, Brewster v. Lanyon Zinc Co., which still
is regarded as one of the leading cases on implied covenants. Brewster
stated, “Whatever, in the circumstances, would be reasonably expected of
operators of ordinary prudence, having regard to the interests of both lessor
and lessee, is what is required.”

§ 8.04. The Most Commonly Recognized Implied
Covenants.

The implied covenants that are recognized by jurisprudence can vary
slightly from state to state, but six of the most commonly recognized implied
covenants are the covenants to: (1) drill an initial test well; (2) reasonably
develop the leased premises; (3) conduct further exploration of the leased
premises; (4) protect the leased premises against drainage; (5) diligently

a reasonably prudent operator, but its actions should not be judged with the benefit of
“hindsight”).
13 See Hite v. Falcon Partners, 13 A.3d 942, 945 (Pa. Super. Ct. 2011); Appeal of Baird,
1913)(lessee must act as a reasonably prudent operator and consider interests of both itself and
lessor); La. Rev. Stat. 31:122 (mutual benefit and reasonably prudent operator standard).
14 Brewster v. Lanyon Zinc Co., 140 F. 801 (8th Cir. 1905).
15 See John S. Lowe, Oil and Gas Law in a Nutshell, 306 (4th ed. 2003)(describing
Brewster as a “leading case”); 5 Martin & Kramer, supra note 1, § 802 at 4 (characterizing
Brewster as a “landmark” case).
16 Brewster, 140 F. at 814. Although earlier implied covenant cases did not give as full
a description of the standard now called the “reasonably prudent operator” standard, the
standard imposed by those earlier cases also was one of reasonability. See, e.g., Harris v.
Ohio Oil Co., 48 N.E. 502 (Ohio 1897)(recognizing “implied covenant that the lessee shall
reasonably develop the lands and reasonably protect” against drainage).
market any oil or gas that is discovered in paying quantities; and (6) reasonably restore the surface of the leased premises after the lease is over.\textsuperscript{17}

[1] — Covenant to Drill a Test Well.

Early in the history of the oil and gas industry, courts recognized that a lessee has an implied duty to promptly drill at least one test well on the leased premises.\textsuperscript{18} Courts reached this conclusion in part because many leases provided for only a nominal bonus, so that the lessor might receive virtually no benefit from the lease — not even the benefit of someone having tested his land — in the event that the lessee did not drill. This raised issues of fairness, as well as the possibility that the transaction constituted an illusory promise, unless the lessee had an implied duty to drill. But lessees often were not prepared to promptly drill, so they began drafting their leases to include delay rental clauses.\textsuperscript{19} These clauses provided that, if the lessee had not begun drilling by the first anniversary of the granting of the lease, the lessee could pay “delay rentals” to defer or delay its obligation to drill a test well.\textsuperscript{20} Today, almost every lease contains a delay rental clause, unless

\textsuperscript{17} See, e.g., Lowe, supra note 15. Lowe states that common implied covenants include the duties to test, develop, explore, protect, and market. See id. at 313. Lowe also mentions an implied covenant of diligent and prudent operation, though he notes that it largely overlaps other implied covenants. See id. at 348.


\textsuperscript{18} See Lowe, supra note 15 at 202-3; Consumers Gas Trust Co. v. Littler, 70 N.E. 363, 366 (Ind. 1904).


\textsuperscript{20} See, e.g., Kachelmacher v. Laird, 110 N.E. 933, 935 (Ohio 1915).
the lease is a paid-up lease. Accordingly, the implied covenant to test is rarely litigated.


The implied covenant of reasonable development requires the lessee to drill as many wells as are reasonably necessary to develop a proven reservoir. This implied covenant does not apply until after oil or gas is found in paying quantities. Further, because a reasonably prudent operator would not drill an unprofitable well merely to drain a proven reservoir more quickly, this implied covenant does not require a lessee to drill wells that likely would be unprofitable. Moreover, it does not require the lessee to

21 A “paid-up lease” is “[a] lease effective during the primary term without further payment of delay rentals, the aggregate of rentals for the entire primary term having been paid in advance.” Martin & Kramer, Manual of Oil & Gas Terms at 685. Sometimes a paid-up lease will include a delay rental clause and the lessee will simply pay all delay rentals at the start of the lease. Other times, the lease will not contain a delay rental clause, and the lease will state that it is a paid-up lease. Sometimes the lease will contain neither a delay-rental clause nor a statement that the lease is a paid-up lease, but this method of drafting a paid-up lease should be discouraged because a court might conclude that the implied covenant to test has not been negated. See infra § 8.07[2][b] of this chapter.

22 See 5 Martin & Kramer, supra note 1, § 812.

23 McKnight, 23 A. at 166; Harris, 48 N.E. at 505; Jennings v. Southern Carbon Co., 80 S.E. 368, 369 (W. Va. 1913); see La. Rev. Stat. 31:122 cmt. (“Essentially, the relevant cases hold that after production in paying quantities has been obtained from a mineral formation, it is the duty of the lessee to develop the producing formation in the manner of a reasonable, prudent operator taking into consideration both its own interests and those of the lessor.”).

24 See Baker, 194 N.E.2d at 355 (“After the discovery of oil or gas in paying quantities, the law . . . implies a duty on the part of the lessee to reasonably develop the premises . . . .”); Martin & Kramer, supra note 1 at § 832; see also La. Rev. Stat. 31:122 cmt. (stating that, for both implied covenant to reasonably develop and implied covenant of reasonable development, “there must be discovery in paying quantities to make the obligations operative.”); Caddo Oil & Mining Co., 64 So. at 690.

25 Baker, 194 N.E.2d at 355 (there was a duty to develop “so long as the enterprise could be carried on at a profit”); Kleppner, 35 A. at 110 (lessee is not required “to put down wells that will not be able to produce oil sufficient to justify the expenditure”); Martin & Kramer, supra note 1 at § 832.
drill exploratory wells in unproven areas. The implied covenant of reasonable development, which probably was the first implied covenant to be recognized by courts,\textsuperscript{26} appears to be universally recognized.


Like the implied covenant of reasonable development, the implied covenant of further exploration only applies \textit{after} oil or gas is discovered in paying quantities.\textsuperscript{27} But unlike the covenant of reasonable development, which requires a lessee to reasonably develop a \textit{proven} formation, the implied covenant of further exploration applies to \textit{unproven} areas.\textsuperscript{28} This implied covenant requires a lessee to conduct further exploration of unproven areas to the extent that a reasonably prudent operator would do so.\textsuperscript{29}

The implied covenant of further exploration is of more recent origin, and its existence is more controversial, than some of the other implied covenants. Perhaps the earliest significant discussion of an implied covenant of further exploration dates to 1956, when a prominent commentator argued in a law review article that an implied covenant of further exploration exists, or should exist.\textsuperscript{30} Some other commentators promptly expressed disagreement,\textsuperscript{31} and the implied covenant of further exploration remains controversial.\textsuperscript{32} Further, relatively few courts have expressly recognized an implied covenant of further exploration.\textsuperscript{33}

\textsuperscript{26} See supra note 1.
\textsuperscript{27} See Martin & Kramer, supra note 1 at § 841; see also La. Rev. Stat. 31:122 cmt. (stating that, for both implied covenant to reasonably develop and implied covenant of reasonable development, “there must be discovery in paying quantities to make the obligations operative.”).
\textsuperscript{28} See La. Rev. Stat. 31:122 cmt.
\textsuperscript{29} See Gillette, 694 P.2d at 372.
\textsuperscript{32} See Kuntz: A Treatise on the Law of Oil and Gas, § 62.1 (discussing controversy over the existence and nature of the implied covenant of further exploration).
\textsuperscript{33} One of the decisions expressly recognizing such a duty is Gillette v. Pepper Tank Co., 694 P.2d 369 (Colo. App. 1984).
But at least two factors make the implied covenant of further exploration more important than might be suggested by the relatively few court decisions that have expressly recognized it. First, this implied covenant is frequently discussed in commentary, which may influence courts and future litigants. Further, in addition to the courts that have expressly recognized this covenant, several courts have applied other legal theories to reach results or impose duties similar to those one would expect by application of an implied covenant of further exploration. For example, some courts, including those in Oklahoma, have concluded that a lessee could be deemed to have abandoned its lease rights as to a portion of the leased premises that the lessee has not developed or explored for an extended period of time.

Further, although commentators tend to distinguish between a duty to develop proven areas and a duty to explore unproven areas, some courts have not been clear in distinguishing between these duties. Some courts have held that lessees breached a duty of “reasonable development” by failing to drill in areas that appear to have been unproven. Thus, the decisions seem to have imposed the substance of an implied covenant of further exploration, even while referring to a duty to “develop.” For example, several Louisiana decisions arguably have imposed an obligation to explore unproven areas, though those courts were applying a duty that they characterized as a duty to “reasonably develop” the leased premises. Further, although Texas rejects an implied covenant of further exploration by name, prominent commentators conclude that Texas recognizes “the substance” of such a covenant.

34 See, e.g., Martin & Kramer, supra note 1 at § 841; see also Hall supra note 8.
36 See Hall, supra, note 8 at 183-6 (the cited article notes that some commentators assert that Louisiana courts implicitly recognize a duty of further exploration, and that several decisions can be interpreted that way, but that there are certain ambiguities in this purported “line” of cases: one of the cases involved a lease with a clause that expressly requiring further exploration; two others made their statements about a duty to test in dicta; and, in one of the cases, there was testimony from which the court could have concluded that the area where no drilling had occurred was within a proven formation).
37 See 5 Martin & Kramer, supra note 1 at § 815.

The implied covenant to protect against drainage requires the lessee to take reasonable action to protect the leased premises against drainage from wells on nearby properties.\(^{38}\) The traditional way to protect the leased premises against drainage is to drill offset wells,\(^{39}\) though some cases have recognized that a lessee may be able to protect against drainage by seeking pooling or unitization.\(^{40}\) Because a lessee only is required to take reasonable steps to protect against drainage, and it would not be reasonable to drill a well that likely will lose money, a lessee does not have a duty to drill an offset well if the well probably would be unprofitable.\(^{41}\) The implied covenant to protect against drainage is widely recognized.


The implied covenant to market requires a lessee to diligently seek purchasers at a reasonable price for any oil or gas that is found in paying quantities.\(^{42}\) Disputes regarding this implied covenant most often involve natural gas, rather than oil.\(^{43}\) In part, this is because operators have fewer options for transporting natural gas to market than for transporting oil to market. Oil can be shipped via pipeline, or it can be temporarily stored in tanks located near the well and then periodically transported to a market via trailer truck or railcar. In contrast, the only viable option for transporting gas to market will be to ship it via pipeline. Traditionally, disputes regarding the implied covenant to market concerned disagreements regarding whether

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\(^{38}\) See Croston v. Emax Oil Co., 464 S.E.2d 728, 733 (W. Va. 1995); Klempner, 35 A. 109; Harris, 48 N.E. at 505; Jennings, 80 S.E. at 369; Swope v. Holmes, 124 So. 131 (La. 1929).

\(^{39}\) See, e.g., Kleppner, 35 A. at 110; see La. Rev. Stat. 31:122 cmt.

\(^{40}\) See Martin & Kramer, supra note 1 at § 821; Coastal Oil & Gas Corp. v. Garza Energy Turst Corp., 268 S.W.3d 1, 17 n.57 (Tex. 2008); Southeastern Pipe Line Co. v. Tichacek, 997 S.W.2d 166, 170 (Tex. 1999); Breaux v. Pan American Petroleum Corp., 163 So. 2d 406, 418 (La. App. 3d Cir. 1964), writ denied, 165 So. 2d 481 (La. 1964).

\(^{41}\) See Garza Energy, 268 S.W.3d at 17 n. 42.


\(^{43}\) See Martin & Kramer, supra note 1, § 853.
the lessee has been diligent in finding a buyer or in making connections to a pipeline so that the gas can be transported to market. 44

Those disputes still can arise, but another type of marketing dispute has often arisen in recent years. Many leases provide for a royalty to be paid based on the “value” of gas at the wellhead, but gas often is sold at a market quite a distance from the well. Further, gas at the wellhead sometimes is not suitable for immediate placement into a pipeline because the gas may contain impurities or it may be at too low a pressure. Operators often will incur significant expenses in treating the gas to bring its composition to pipeline specifications, and in compressing the gas in order to put it into a pipeline for transport to market. These steps cost money, but they also add value to the gas. And, absent these steps, the gas often would not be marketable.

To determine the value of the gas at the wellhead for purposes of calculating a royalty, operators generally have used a “net-back” or “workback” method. 45 This method assumes that the value of gas at the wellhead is the price received for the gas when it is sold at market, minus the post-production (i.e., post-wellhead) costs incurred by the operator. And, from a standpoint of economics, this makes sense. 46 If clean, high-pressure gas sells for $5 at a distant market, then dirtier, low-pressure gas at the wellhead logically is worth $4 if the costs of treatment, compression, and transport equal $1.

But lessors often have argued that the post-production tasks that an operator performs to gather, treat, dehydrate, and compress gas are all steps

44 See id.
45 “Under this method costs of transportation, processing and treatment are deducted from the ultimate proceeds of sale of the oil or gas . . . to ascertain wellhead value.” See Patrick H. Martin and Bruce M. Kramer, Manual of Oil & Gas Terms, (14th ed. 2009) at 1067.
46 See Schroeder v. Terra Energy, Ltd. 565 N.W.2d 887, 892 (Mich. Ct. App. 1997)(“Basic principles of economics require that, in determining the ‘gross proceeds at the wellhead’ in the absence of an actual sale of gas at the wellhead resulting in ascertainable gross proceeds, the gross proceeds from a sale elsewhere must be extrapolated, backwards or forwards, to reflect appropriate adjustments due to differences in the location, quality, or characteristics of what is being sold.”).
in the marketing of the gas.\footnote{47} Therefore, unless the lease expressly states that the lessee may deduct the costs of these steps prior to calculating the royalty, the implied duty to market requires the lessee to absorb the costs and to pay royalties on the full sale price of the gas. Some courts have accepted such an argument,\footnote{48} while others have rejected it.\footnote{49}


The implied covenant to restore the surface requires the lessee to restore the leased premises to a condition reasonably approaching its original condition after the lease terminates, or perhaps after operations terminate in the area at issue.\footnote{50} The implied duty of surface restoration is not widely recognized in jurisprudence, but some courts have recognized it\footnote{51} and it frequently is discussed in commentary.\footnote{52}

\footnote{48} Rogers v. Westerman Farm Co., 29 P.3d 887, 897 (Colo. 2001)(lessor’s implied covenant argument prevails).

In Oklahoma and Kansas, the implied covenant to market will require the operator to absorb post-production costs necessary to make natural gas marketable, but if the composition and pressure of the gas are such that the gas already is marketable, the lessee may deduct post-production costs for treatment and compression to the extent such costs are reasonable and add value to the gas. \textit{See} Mittelstaedt v. Santa Fe Minerals, Inc., 954 P.2d 1203 (Okla. 1998); Sternberger v. Marathon Oil Co., 894 P.2d 788, 800 (Kan. 1995).

\footnote{49} See Kilmer v. Elexco Land Servs., Inc., 990 A.2d 1147, 1152 (Pa. 2010)(rejecting lessors’ implied covenant to market argument, in addition to rejecting their arguments that were based on the Guaranteed Minimum Royalty Act); Poplar Creek Dev. Co. v. Chesapeake Appalachia LLC, 636 F.3d 235 (6th Cir. 2011)(under Kentucky law, rejecting argument that implied covenant to market prohibited deduction of post-production costs).


\footnote{52} See Martin, supra note 17; Hall, supra note 8 at 188-90; La. Rev. Stat. 31:122 cmt.
§ 8.05. Defenses and Remedies.

Courts have recognized several defenses and remedies.

[1] — Precluding Implied Covenants By Expressly Addressing Subject.

Courts will not impose an implied covenant that is expressly negated by the lease itself.53 Further, if a lease expressly imposes a duty of the same type that would be imposed by an implied covenant, courts generally will conclude that the parties intended the express duty to be the full extent of the lessee’s obligation with respect to that type of performance. Thus, even if the lease does not explicitly state that the express duty describes the full extent of the lessee’s obligation or that the lessee is not bound by an implied covenant, the court usually will reach that result. In other words, the duty expressly imposed by the lease will not be supplemented by an implied covenant.54 The express duty implicitly negates any implied covenant.

The most common lease clause that negates an implied covenant is the delay-rental clause, which negates the implied covenant to drill a test well. Delay rental clauses generally are an example of implicit negation of an implied covenant. Delay rental clauses generally either impose a duty to drill or pay delay rentals within the first year (in an “or” clause) or state that the lease will terminate unless the lessee drills or pays delay rentals within the first year (in an “unless” clause),55 but delay rental clauses generally do not state explicitly that the implied covenant to drill a test well is negated.

Express lease clauses also can be used to negate other implied covenants. For example, in Gulf Production Co. v. Kishi,56 the court held that an express

53 Kachelmacher, 110 N.E. at 935.
54 See Aye v. Philadelphia Co., 44 A. 555, 556 (Pa. 1899) (‘‘where the parties have expressly agreed on what shall be done, there is no room for the implication of anything not so stipulated for’’); Harris, 48 N.E. at 505 (‘‘The implied covenant arises only when the lease is silent on the subject.’’); Lundin/Weber Co. LLC v. Brea Oil Co., 11 Cal. Rptr. 3d 768 (Cal. App. 2004); Schroeder, 565 NW. 2d 887.
55 See Lowe, supra note 15 at 204-6 (discussing “or” clauses and “unless” clauses).
lease clause negated the existence of an implied covenant to reasonably develop. The case involved two leases. One required drilling a well every 60 days after discovery of oil until a total of twelve wells were drilled. The second lease required drilling a well every 90 days until four wells were drilled. The lessee complied with those terms, but the lessor argued that the lessee had breached an implied covenant of reasonable development because a reasonably prudent operator would drill several more wells than the lessee had drilled. A jury granted a verdict to the lessor, but the appellate court reversed, and the Texas Supreme Court affirmed the appellate court judgment, holding that the existence of an express clause imposing certain duties to develop precluded the existence of an implied covenant to reasonably develop. Thus, the express duty implicitly negated an implied covenant of reasonable development.

In *Lundin/Weber Company LLC v. Brea Oil Company, Inc.*, the court held that express drilling duties stated in a lease negated any implied covenant of further exploration. Two leases were at issue. The first lease stated that the lessee would drill 10 wells each year for the first four years of the lease, and that each well would be drilled to a depth of at least 1000 feet, unless oil was discovered in paying quantities at a shallower depth. The second lease provided that, once the lessee commenced drilling operations, it would “prosecute the drilling of a well or wells with reasonable diligence until oil or gas . . . is found in quantities deemed paying.” The lease discussed the lessee’s duty to execute partial releases of the lease, and required the lessee to “reasonably develop the acreage retained” after oil or gas was discovered in paying quantities, but the lease also stated that the lessee would “in no event be required to drill more than one well per ten” acres of area capable of producing oil or 160 acres of area capable of producing gas.

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57 *Lundin/Weber Co.*, 11 Cal. Rptr. 3d 768. Because the court determined that the express lease terms would negate an implied covenant, the court did not reach the issue of whether California would recognize an implied covenant of further exploration.

58 See id. at 769.

59 See id. at 772-3.

60 See id. at 774.
The lessor argued that the lessee breached a duty of further exploration by not drilling more wells to a depth of 3000 feet. The court rejected that argument. The court concluded that the terms of the two leases expressly imposed a duty of exploration that existed up until the time oil or gas was found in paying quantities, after which an expressly limited duty of reasonable development was imposed. Given that the leases expressly imposed duties of exploration that existed up until oil or gas was found in paying quantities, the court would not impose an implied duty of further exploration for the period after oil or gas was discovered in paying quantities.

In Schroeder v. Terra Energy, Ltd., the court concluded that the express terms of a lease precluded an argument that an implied covenant to market barred use of the “work back” method to calculate royalties. The lease stated royalties would be a specified fraction of “gross proceeds at the wellhead” or “the prevailing market rate at the wellhead.” The lessor argued that an implied covenant to market required the lessee to absorb post-production costs. The court disagreed. The court stated that, assuming Michigan recognizes an implied covenant to market, the covenant would not apply whenever the lease expressly addresses a subject. The court reasoned that the royalty clause expressly addressed how royalties should be calculated, and that the lease’s “at the wellhead” language should be interpreted as allowing use of the work back method whenever gas is sold at a distance from the well, rather than at the wellhead.

As for the duty to protect against drainage, numerous cases deal with the effect of a lease clause that expressly imposes duties to drill offset wells. Most of the clauses require the lessee to drill an offset well if a productive

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61 See id. at 770.
62 See id. at 774, 775.
63 Schroeder, 565 N.W. 2d 887.
64 See id. at 890.
65 See id. at 891.
66 The court did not reach the issue of whether such a duty exists under Michigan law. See id. at 895-6.
67 See id.
68 See id. at 894.
69 See generally, discussion at Martin & Kramer, supra note 1 § 826.3.
well is located on nearby land, within a specified distance of the leased premises. Such a clause might expressly require the lessee to drill an offset well if a productive well is located within 200 feet of the leased premises. But such clauses typically do not expressly address whether the lessee has any duty to drill an offset well if a well on nearby property is located further than the specified distance, perhaps 225 feet away.

Some courts and commentators seem to believe it would be unfair to allow such a clause to implicitly negate an implied covenant to protect against drainage. They reason that a prospective lessor who reads a proposed lease containing such a clause might understand the clause as imposing an extra duty on the lessee, when the primary effect, assuming the express clause is allowed to implicitly negate any implied covenant to protect, actually will be to decrease the lessee’s duties. Those authorities believe that an implied covenant to protect against drainage should co-exist with the express duty, assuming the lease does not explicitly negate an implied obligation.

Nevertheless, courts sometimes have held that such clauses implicitly negate any implied covenant to protect against drainage. Further, courts and commentators have stated that a clause that expressly negates or expressly limits an implied covenant to protect against drainage should be enforced.


Some jurisdictions require a lessor to give the lessee notice of an alleged breach of an implied covenant, and a reasonable opportunity to cure, before

70 See id.
71 See id.
72 See Hutchins v. Humble Oil & Refining Co., 161 S.W.2d 571 (Tex. Civ. App. 1942), writ refused w.o.m.
73 See, e.g., Shell Oil Co. v. Stansbury, 401 S.W.2d 623, 630 (Tex. App. 1966) (“A lessor and lessee may contract so that a lessee is never under obligation to drill an offset well. To so contract, however, the language must be very clear.”), writ refused n.r.e., Shell Oil Co. v. Stansbury, 410 S.W.2d 187 (Tex. 1966); 5 Martin & Kramer, supra note 1 § 826.3 (“No one would object to enforcing a clause that stated that lessee is not obligated to offset wells more than 150 feet from boundary lines.”).
bringing suit for such a breach. Additional jurisdictions require the lessor to give the lessee notice and a reasonable opportunity to cure before the remedy of lease cancellation is available. A letter to the lessee giving notice of an alleged breach and stating that the lease allegedly has terminated, or demanding release of a lease, does not satisfy the requirement that a lessor give notice and a reasonable opportunity to cure. Indeed, some courts have held that a lessee’s duty to perform is suspended pending resolution of the lessor’s allegation that the lease has terminated.


The potential remedies available for breach of an implied covenant include (1) monetary damages; (2) conditional cancellation; (3) partial cancellation; (4) complete cancellation; and (5) specific performance.

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75 See e.g., Hayes v. Equitable Energy Resources Co., 266 F.3d 560, 569 (6th Cir. 2001) (applying Kentucky law). Arkansas courts do not make notice and an opportunity to cure a prerequisite to a suit for lease cancellation. See Davis v. Ross Prod. Co., 910 S.W. 2d 209 (Ark. 1995). But the Arkansas Supreme Court has stated, if a lessor does not give pre-suit notice and an opportunity to cure, a conditional order of cancellation, giving the lessee an opportunity to cure, is preferable to an order of outright lease cancellation. See Roberson Enters., Inc. v. Miller Land and Lumber Co., 700 S.W. 2d 57, 58 (Ark. 1985).
76 See Ridl v. EP Operating Ltd., 553 N.W. 2d 784, 788 (N.D. 1996).
78 Harris, 48 N.E. at 506. Damages awards are not common in implied covenants cases because it often is difficult to prove the amount of damages. See Jennings, 80 S.E. at 372 (referring to “the impossibility of adequate proof of the extent” of injury); see also Breaux, 163 So. 2d at 414-16.
79 When a court awards conditional cancellation, it orders that the lease will be cancelled (in whole or part) unless the lessee renders a particular performance within a stated time. See, e.g., Kleppner, 35 A. at 110; see Roberson Enters., 700 S.W. 2d at 58 (referring to conditional cancellation as a possible remedy).
80 Often, if a lessee has one or more productive wells, but it has not reasonably developed or adequately explored the remainder of the leased premises, a court may allow the lessee to retain the lease as to some modest acreage around each productive well, while ordering lease cancellation as to the remainder of the leased premises. See, e.g., Kleppner, 35 A. at 110 (court orders a conditional, partial cancellation).
The most common remedies probably are the various forms of lease cancellation — total, partial, and conditional. Lease cancellation can be harsh, and generally is disfavored, but it often is the most practical remedy. Courts generally are unwilling to order specific performance of tasks as complex as those involved in complying with the implied covenants. Further, it is often difficult or impossible to quantify the damages that result from the breach of an implied covenant. Moreover, if notice and cure is required, this mitigates somewhat the harshness of cancellation, particularly if conditional cancellation is used in circumstances where the lessee had a good faith argument that it was not in breach.

§ 8.06. How Implied Covenant Disputes Might Arise in Unique Ways in Shale Plays.

Fact patterns unique to shale plays could cause implied covenant disputes to arise in several ways.

[1] — Failure to Use Hydraulic Fracturing or Horizontal Drilling.

Shale plays did not become economically feasible until relatively recently, with advances in two technologies — hydraulic fracturing and horizontal drilling — and those technologies continue to evolve. If an operator is maintaining a lease with production from a conventional formation, but is not using horizontal drilling and hydraulic fracturing to develop a shale

81 See Jennings, 80 S.E. at 372. Complete cancellation is considered a harsh remedy, but it sometimes is granted. For a case noting that cancellation is a harsh remedy, see St. Luke’s United Methodist Church v. CNG Dev. Co., 663 S.E. 639, 644 (W. Va. 2008); see also Robbins v. Chevron U.S.A., Inc., 785 P.2d 1010, 1016 (Kan. 1990)(“As a general rule, forfeiture of oil and gas lease for breach of an implied covenant is disfavored.”).

82 Courts generally are unwilling to order specific performance unless the performance required can be commanded in a straightforward order, such as an order to deliver property. Given that a lessee’s duties under implied covenants involve more complex obligations, such as an obligation to drill a well, an order of specific performance rarely will be appropriate as a form of remedy for breach of an implied covenant. See La. Rev. Stat. 31:134 cmt.
formation found within the leased premises, the lessor could argue that the operator has breached an implied covenant of reasonable development or further exploration. At least one lessor has made such an argument in a dispute regarding development arising in the Fayetteville Shale area. Further, there is some case law in which courts have held that an operator’s failure to use other advanced production techniques constituted a breach of the duty of reasonable development.

In *Waseco Chemical and Supply Co. v. Bayou State Oil Corp.*, the lessee was operating a well in an aging field, where production rates were declining. But other operators in the area had substantially increased rates of production by engaging in fireflood operations. The appellate court held that the lessee’s failure to conduct a fireflooding operation constituted a breach of the implied covenant of reasonable development.

In *Wadkins v. Wilson Oil Co.*, a lease covered 40 acres. The lessee was operating five wells that each were producing oil from the same chalk formation. But other operators in the area were obtaining much higher rates of production by drilling new wells into the chalk formation and acidizing the wells. The lessor demanded that the lessee drill and acidize new wells, but the lessee refused. The Louisiana Supreme Court affirmed the lower court’s order terminating the lease, stating that the lessee had breached the implied

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85 “Fireflood” has been defined as “an enhanced oil recovery process in which the subsurface oil is set afire. The heat makes the oil more fluid and the gases generated by the fire drives the oil to producing wells as air is pumped down injection wells.” See Norman J. Hyne, *Nontechnical Guide to Petroleum Geology, Exploration, Drilling, and Production* at p. 479 (2nd ed. 2001). The technique also sometimes is called “in-situ combustion.” See Patrick H. Martin and Bruce M. Kramer, *supra* note 45 at 473 (14th ed. 2009).
87 “Acidizing” has been defined as “a well stimulation technique used primarily on limestone reservoirs. Acid is poured or pumped down the well to dissolve the limestone and increase fluid flow.” See *supra* note 85 at 452. “Well stimulation” is “an engineering method used to increase the permeability of a reservoir around the wellbore to increase production. It includes acidizing and hydraulic fracturing.” See *id.* at 546.
covenant of reasonable development by failing to utilize a “modern process which had proved so successful on other leased properties adjoining and in the vicinity of the property in question.”


In some of the shale plays, companies have raced to get as much land under lease as possible. Although this also happens with newly discovered conventional fields, some of the lease rushes have been particularly intense in some of the shale plays. Further, many of the leases have relatively short primary terms, three years or shorter. Thus, lessees must keep a busy pace of drilling just to maintain their numerous new leases by drilling wells before the end of the primary term. And every time one of those initial wells establishes production in paying quantities, that triggers application of the implied covenant of reasonable development, as well as perhaps a covenant of further exploration. If a lessee that is having trouble keeping up with drilling obligations puts a priority on drilling a first well on each leased premises in order to maintain each lease, and neglects drilling of subsequent wells on each leased premises, the lessee might become vulnerable to an argument that it has breached the implied covenants of reasonable development and further exploration.


Operators are drilling a large number of wells in a relatively short time, and in some shale plays, drillers are almost never drilling a dry hole. Further, operators sometimes are drilling in areas that have not had much drilling in recent years. For these reasons, some operators may find that they have drilled a well capable of producing natural gas in paying quantities, but there is not a nearby pipeline, or there is not sufficient pipeline capacity to transport all the gas that can be produced. If lessees cannot get the gas to market, a lessor might allege a breach of the implied covenant to market.

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88 See Wadkins, 6 So. 2d at 668-9.
Further, given that operators in some shale plays are virtually never drilling a dry hole, some lessors might attempt to argue that a lessee should have begun working to find a market, build gathering systems, construct treatment facilities and ensure pipeline connections even before the first well is drilled on the leased premises.

[4] — Failure to Promptly Protect Against Drainage from Cross-Property Fracturing.

Because shale formations are not very permeable, a well on neighboring property is not likely to drain much oil or gas from the leased premises, assuming fractures do not cross property boundaries. But if fractures do cross property lines, substantial drainage could occur. Further, because production-decline curves for fractured wells in a shale formation are steeper than for a conventional well, the importance of protecting against drainage might be particularly acute. And, an aggressive lawyer representing the lessor likely could use to his advantage the facts that fractures, fracking water, “toxic” fracking additives, and proppants are “invading” the lessor’s property to facilitate the drainage.


A fifth way that implied covenants disputes could arise in unique ways is with regard to surface restoration issues. In some ways, surface restoration issues in shale plays probably are not much different from shale plays than for conventional operations. But the area occupied by a well pad for a shale gas well often will be larger than for a conventional well. Also, some shale plays are being developed in areas where there has not been significant oil and gas activity for several generations. In such areas, local citizens may be less accustomed to the trade-offs that come with the oil and gas industry, and more likely to seek relief in court, than are people in areas that have seen extensive oil and gas activity for several generations. Also water usage for

89 The Texas Supreme Court has held that a lessee does not commit a subterranean trespass when it causes fractures to cross property lines without permission. See Coastal Oil & Gas Corp., 268 S.W.3d 1.
fracking can be significant. If an operator drains a pond’s level for fracking fluid, a lessor might assert that the operator has a duty to restore the water level.

Further, lessors might argue that the duty to restore the surface can be extended to subsurface issues. If the operator uses groundwater for fracking and the level of an aquifer is reduced, that could result in the aquifer’s level dropping below the depth that a lessor’s water well reaches. The lessor might argue that the lessee is obligated to drill a deeper water well for the lessor, or supply the lessor with water. A lessor might even argue that that the lessee must somehow restore the aquifer level, or that the lessee must avoid using the aquifer in the first place.

A lessor who is worried that fracturing operations might contaminate groundwater could argue that the lessee has a duty to somehow remove all fracking water from the fractured formation, that the lessee must avoid using certain types of fracturing additives, or perhaps even that the lessee has a duty to avoid fracking altogether. As public concern about fracturing grows, lessors are likely to become creative in the judicial attacks they make against the process.

§ 8.07. Protecting a Lessee Against Implied Covenant Disputes.

Lessees can attempt to include in their leases certain types of clauses that will provide protection against claims based on any of the implied covenants, and also try to include certain clauses designed to protect against claims based on specific covenants.


Many states require a lessor to give the lessee notice of its alleged breach of an implied covenant, as well as a reasonable opportunity to cure the breach, before the lessor can bring suit for an alleged breach of an implied covenant. Nevertheless, lessees should consider drafting their leases to expressly state that the lessor cannot bring suit for an alleged breach of an implied covenant unless the lessee fails to initiate a cure of the alleged breach within some
stated period (say 180 days) of written notice or fails to diligently proceed with the cure after starting it. Such a clause also should provide that the written notice must describe the alleged breach with reasonable particularity, that the notice must be delivered to a particular person or company at a particular place, and that the notice is not effective if it is delivered at a time when the lessee is not in breach.

A contractually mandated notice and cure period has obvious benefits for the lessee in a jurisdiction that does not impose a jurisprudential notice and cure requirement as a prerequisite to suit. But even in states that do have a jurisprudentially imposed notice and cure requirement, including an express clause in the lease can be beneficial for the lessee. For example, the lessee may be able to negotiate for the lease to include a notice and cure provision that gives the lessee more time to cure than the lessee would have under a jurisprudentially required “reasonable” time to cure. Further, a contractually mandated notice and cure requirement might deter premature litigation by a lessor who is unaware of a jurisprudential notice and cure requirement.\(^\text{90}\)


The second and probably most important way that lessees can protect themselves from implied covenant claims is to take advantage of the fact that courts will not impose a particular type of implied duty if the lease expressly defines the scope of the lessee’s duty. A prospective lessee could try to negotiate for a lease to state that there are no implied covenants, or that particular implied covenants will not apply, but some prospective lessors would balk at such a clause. Further, courts might think a complete elimination of implied covenants is overreaching, prompting the courts to look for a basis not to enforce the provision that purports to exclude implied covenants altogether. Short of attempting to exclude implied covenants altogether, there are a number of ways to draft leases to protect the lessee by specifying and limiting the scope of each implied covenant, including the implied covenants to test, develop, explore, protect, market, and restore.

\(^{90}\) Other general clauses that might benefit the lessee include a clause stating that certain duties are suspended during a lease challenge brought by the lessor and a judicial ascertainment clause (some states may not enforce the latter).
[a] — Protecting the Lessee Against the Implied Covenant to Test.

Most lessees already protect themselves against the implied covenant to drill an initial test well. They do so by including delay rental clauses in their leases, or by including clauses expressly stating that the leases are paid-up leases.

Indeed, the use of delay rental clauses and paid-up leases is so common that parties sometimes fall into a pattern of thinking that every lease either contains a delay rental clause or is a paid-up lease. This sometimes leads to a potential mistake in drafting what the parties intend will be a paid-up lease. Sometimes parties will not include a delay rental clause, but also will not expressly state that the lease is a paid-up lease. This can work fine so long as everyone assumes that a lease must either contain a delay-rental clause or be a paid-up lease, but this ignores the possibility that a court could conclude that the parties have not negated an implied covenant to drill a test well, and that such a covenant therefore applies.

If a lessee intends a lease to be a paid-up lease, the safer course is to draft the lease in one of two ways. First, the lessee can include a delay rental clause in the lease, as well as an acknowledgement by the lessor that all delay rentals for the entire primary term have been paid. An alternative approach is to omit the delay rental clause, but to include a statement that the lease is a paid-up lease, and an explanation that the lessee therefore need not pay delay rentals or drill a test well during the primary term in order to maintain the lease and keep it in force.

[b] — Protecting the Lessee Against the Implied Covenant to Reasonably Develop.

One way is to protect against the covenant of reasonable development is to include in the lease a clause stating that drilling operations (which the lease can expressly define as including site preparation) and the ongoing drilling of any well (developmental or exploratory) will satisfy the implied covenant of reasonable development while the operations or drilling are ongoing, and for a reasonable period, not to be less than perhaps 180 days, thereafter. The lease clause can further provide that, after 180 days, the operator's duty will be no more than that of a reasonably prudent operator.
That is, there is no presumption that a lessee must begin drilling operations for a new well 180 days after completion of the prior well. Such a clause should protect a lessee against arguments that it should be drilling multiple wells simultaneously, or that it should start drilling a new well quickly after finishing a prior well.

And, if the lease has both a clause stating that the duty of reasonable development is satisfied for at least 180 days after completion of a well, and that the lessor must give the lessee at least 180 days after written demand in which to commence a cure of any breach, this should give the lessee a minimum of 360 days after completing one well before it must begin another well on the leased premises.

Third, if the lease tract is large, the lessee should consider including in its lease a provision that a lease well will satisfy the duty of reasonable development for an area around the well of some stated, minimum size, which may vary depending upon whether the well is an oil well or gas well, and upon local geology. 91

Fourth, a lessor could draft a lease to include a “deferred rental” clause that would be somewhat similar to a delay rental clause. Such a deferral rental clause would provide that a lessee can defer any implied duty of reasonable development by paying deferral rentals to defer that duty.

Suppose a lessee included all the clauses described above in its lease. As noted above, the lessee would have at least 360 days until it had to do something to satisfy the covenant of reasonable development because the implied covenant would be satisfied for at least 180 days after completing the prior well, and then the lessee would get at least a 180-day cure period after any demand. Further, the lessee would have more than 360 days if the lessee did not deliver a letter demanding additional development on the 181st

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91 A lessee might worry that stating a specific number of days that is a minimum cure period, and stating a specific acreage that is a minimum area for which a productive well satisfies the duty to develop, might be used against the lessee. The lessee might fear that even if the lease is written to state clearly that the stated number of days and stated acreage are minimums, a court might treat the stated numbers as a presumptive maximum amounts of time allowed between wells or acreage reasonably developed by a single well. But the benefits of having guaranteed, minimum “safe harbor” amounts should outweigh the risks, particularly if the lessee bargains for reasonably large minimums.
day. Then, if the lessee was not prepared to begin drilling a new well 360 days after completing the prior well (or after a longer period in the event the lessor did not make written demand on the 181st day), the lessee could pay deferral rentals to defer that obligation.

A few published cases demonstrate an alternative. Those cases involve leases that expressly obligated the lessee to drill a particular number of wells within a given time. Most modern lessees probably would not want to make such a commitment.

[c] — Protecting the Lessee Against the Implied Covenant of Further Exploration.

To protect against the implied covenant of further exploration, the lessee should consider clauses that are similar to those which it would use to protect against the duty of reasonable development. To maximize protection, the lessee can provide that drilling operations or the drilling of any well satisfies both the duty of reasonable development and the duty of further exploration, whether the well is a developmental well or an exploratory well. Further, the lease can provide that payment of deferral rentals defers both the duty of reasonable development and the duty of further exploration. Finally, given that many states do not recognize an implied covenant of further exploration, the lease should state that these clauses are not meant to create a covenant of further exploration, either express or implied, and that the clauses merely restrict the effect of any implied covenant that might otherwise apply.

[d] — Protecting the Lessee Against the Implied Covenant to Protect Against Drainage.

To limit the scope of its duties under the implied covenant to protect against drainage, the lessee should consider drafting the lease to state that the implied covenant to protect against drainage does not require to drill an offset well if the allegedly draining wellbore is more than some stated distance from the leased premises.\textsuperscript{92} The lessee should also consider drafting

\textsuperscript{92} Such a clause probably is more helpful for alleged drainage associated with conventional operations than shale plays. With shale plays, drainage is unlikely unless fractures cross property lines.
the lease to expressly state that the implied duty to protect against drainage can be satisfied by good faith efforts to obtain a unitization or pooling order or agreement that would provide adequate protection, or by good faith efforts to obtain a modification of an existing unitization or pooling order or agreement.

[e] — Protecting the Lessee Against the Implied Covenant to Diligently Market.

The payment of shut-in royalties does not necessarily negate the implied duty to market. The lessee should draft the lease to include a provision for shut-in royalties, and expressly provide that the lessee’s payment of shut-in royalties will satisfy the duty to market for the period for which shut-in payments are made.

In addition, if the lessee contemplates that the royalty on gas will be calculated after a deduction of post-production costs, the lease’s royalty clause should expressly provide for such deductions and should expressly negate any implied duty for the lessee to absorb the entirety of such costs.

[f] — Protecting the Lessee Against the Implied Covenant to Restore the Surface.

A lessee should attempt to expressly limit surface restoration duties to what it would do anyway. If there are certain things the lessee always does, such as removing storage tanks or pits, the lessee should consider explicitly promising to do those things. A court might interpret such a clause as implicitly negating an implied covenant of surface exploration. But ideally, the lease also would state that doing these things will fully satisfy the lessee’s duties relative to surface restoration.

The lessee should also consider whether to include a clause that attempts to cap damages by expressly limiting any damage award to the fair market value of the leased premises in a clean condition. Otherwise, a “runaway”

93 See Levin v. Maw Oil & Gas, LLC, 234 P.3d 805, 818 (Kan. 2010); see also Martin & Kramer, supra note 1 § 835.3 (“But we believe the premise that the shut-in clause negates the duty to market is incorrect.”); id. at § 858.2 (describing shut-in clause as modifying the habendum clause by allowing lessee to maintain lease without production, but not as negating the implied duty to use reasonable diligence to secure a market).
verdict is possible in a case in which restoration costs would exceed the value of the property. For example, in one Louisiana case, a lessor had negotiated for a clause expressly requiring the lessee to “reasonably restore the premises as nearly as possible to their present condition” upon termination of the lease. The lessor later brought suit, alleging that the lessee’s operations had contaminated the leased premises and that the lessee had failed to restore the surface. A jury found that the lessee was liable, and awarded the cost of restoring the surface, which was estimated at $33 million. The lessee argued that this damages award was excessive because the judgment exceeded the fair market value of the property in a clean condition, which the defendants estimated was only $108,000. But the Louisiana Supreme Court affirmed, holding that the lessee had promised to restore the property and that it should be held to its promise.

Finally, in the granting clause, the lessee should be sure to specifically list all the actions that the lessee can imagine it might wish to perform on the leased premises, including hydraulic fracturing and the drilling of horizontal, directional, or vertical wells. Specifically providing for such use could give some protection. In Louisiana, one of the states with shale plays, the state supreme court has stated that, when an operator is doing something that the

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95 See id. at 691.
96 The court’s reasoning turned in part on holding the lessee to its express bargain, and on that basis Corbello can be distinguished from a case involving an implied covenant of restoration. Further, the lease’s reference to restoration “as nearly as possible” to the original condition was problematic for the defendants. But the language of the express restoration clause began by stating that the lessee would “reasonably restore,” and that phrase could be used by a lessor who seeks to use Corbello in the context of an implied covenant to restore.
97 In shale plays, lessees generally may prefer to drill horizontal wells, but the lessee should make clear that it has a right to drill vertical wells. In some cases in which multiple vertical wells are drilled on different parts of a large leased premises, lessors could argue that a lessee should have minimized surface use by grouping well pads together and drilling directional wells, rather than drilling vertical wells. See, e.g., A-W Land Co. v. Anadarko E&P Co., LP, 2010 WL 3894107 (D. Colo. 2010); Zeiler Farms v. Anadarko E&P Co., LP, 2010 WL 2681724 (D. Colo. 2010). In both of the cited cases, the plaintiffs were surface owners who did not own the minerals beneath their land, but lessors can make similar arguments as did the surface owners in the cited case.
lease expressly gives it the right to do, there is no duty to restore the surface in the absence of excessive or abusive use.98

§ 8.08. Conclusion.
Because of the uncertainties inherent in oil and gas exploration, leases typically leave much to the discretion of the lessee. This prompts courts to enforce various implied covenants against lessees. The most commonly recognized implied covenants include covenants to drill a test well, reasonably develop the leased premises, conduct further exploration, diligently market any product that is found in paying quantities, protect the leased premises against drainage, and reasonably restore the surface condition of the leased premises. But courts generally will not impose an implied covenant that is inconsistent with the express terms of a lease. Accordingly, lessees can attempt to limit the scope of their duties under implied covenants by use of lease clauses that expressly limit their duties.

§ 8.09. Appendix.99
This Appendix contains examples of clauses to protect the lessee against implied covenant claims.

This lease is a paid-up lease. The lessee is not required to pay delay rentals or to drill any well, including an exploratory or test well, in order to maintain the existence of this lease during the primary term.100

In addition to whatever other rights are included in a granting clause, the lessee should draft the lease to include rights to:

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99 The draft clauses included in this Appendix are intended to illustrate concepts. They should not be viewed as providing language that is ready for insertion into a proposed lease.
100 See supra § 8.07[2][a] of this chapter for a discussion of the type of provision contained here.
. . . drill vertical wells, drill directional wells, or drill horizontal wells, . . . engage in well stimulation, including hydraulic fracturing or acidization, . . . engage in secondary, tertiary, or enhanced recovery operations.\textsuperscript{101}


As a prerequisite to any \textbf{Action}\textsuperscript{102} by \textbf{Lessor} against \textbf{Lessee} for any \textbf{Relief} based on Lessee’s alleged \textbf{Breach} relating to this Lease, Lessor must: (1) make \textbf{Delivery} of a \textbf{Notice of Breach} to Lessee; and (2) allow Lessee a \textbf{Reasonable Time to Initiate} a cure of the alleged \textbf{Breach}. If \textbf{Lessee} initiates a cure of the alleged \textbf{Breach}, \textbf{Lessor} must give \textbf{Lessee} a \textbf{Reasonable Time to Complete} the cure before \textbf{Lessor} initiates or pursues any \textbf{Action}. If \textbf{Lessee} completes a cure of any alleged \textbf{Breach} within a \textbf{Reasonable Time to Complete}, \textbf{Lessee} shall not initiate or pursue any \textbf{Action} based on that alleged \textbf{Breach} and shall not be entitled to any further \textbf{Relief} based on that alleged \textbf{Breach}, unless the alleged \textbf{Breach} is an express obligation to pay money. If the alleged \textbf{Breach} is the \textbf{Breach} of an express obligation to pay money, and the Lessee cures the \textbf{Breach} within a \textbf{Reasonable Time to Cure}, \textbf{Lessor} shall be entitled to interest on the amount of the non-payment or underpayment that constituted the \textbf{Breach} from the time payment was due until the time full payment was made, but \textbf{Lessee} will not be entitled to any other \textbf{Relief} unless there is a judicial determination that the non-payment or underpayment that constituted the \textbf{Breach} was willful or fraudulent.

\textbf{“Action”} means any lawsuit, arbitration, or other legal proceeding seeking Relief relating to this Lease or Lessee.

\textbf{“Lessor”} shall mean the original lessor under this \textbf{Lease}, [identify person or entity], together with is successors-in-interests, assigns, and [include whatever catch-all language you wish for related entities].

\textsuperscript{101} See supra § 8.07[2][f] of this chapter for a discussion of the type of provision contained here.

\textsuperscript{102} In this example, defined terms are underlined and in boldface, with leading letters capitalized. There also are other words that the parties might wish to define, such as “cure.”
“Lessee” shall mean the original lessee under this Lease, [identify person or entity], together with its assignees, sublessees, successors-in-interest, and [include whatever catch-all language you wish for related entities].

“Relief” means a request for any legal, statutory, or equitable relief, including any monetary judgment, declaratory judgment, award of specific performance, injunctive relief, lease cancellation (in whole or part), or conditional lease cancellation.

“Notice of Breach” means written notice, describing an alleged breach of obligation or duty with reasonable particularity. To be effective, Notice of Breach must be delivered to [specify person or entity] at [specify address].

A “Reasonable Time to Initiate Cure” will be an amount of time reasonably sufficient to evaluate Lessor’s allegation of a breach and initiate a cure of the alleged Breach, but in no event shall a Reasonable Time to Initiate Cure be less than 30 days. In the case of alleged breach of an implied covenant, a Reasonable Time to Initiate Cure shall be at least an amount of time reasonably sufficient to evaluate Lessor’s allegation of Breach and to initiate a cure, but in no event shall the Reasonable Time to Cure be less than 180 days. Further, if a cure of the alleged Breach would require some agency action, such as granting a drilling permit, an authorization or permit to work, or modification of a unitization or pooling order, or any other action, a Reasonable Time to Initiate Cure shall be no less than 180 days plus the number of days during which a request for the required agency action is pending.

A “Reasonable Time to Complete Cure” will be an amount of time reasonably sufficient to complete a cure of a Breach once work on the cure has begun. This amount of time will vary depending upon the circumstances, but shall be a period of time at least as long as Lessee pursues completion of the cure with reasonable diligence, without any unreasonably lengthy cessation of efforts to complete the cure.

“Delivery” shall mean delivery of a written Notice of Breach to [specify person or entity] at [specify address].

“Breach” means any alleged failure to perform, failure to timely or adequately perform, or any breach of any express duty, obligation, or covenant
relating to this Lease; or any implied duty, obligation, or covenant relating to this Lease.\textsuperscript{103}


The implied covenant of reasonable development shall be deemed satisfied during drilling operations (such steps as leveling the surface for a well pad, building roads to access the site, etc.) and also the drilling of any well (exploratory or developmental) on the Leased Premises or land unitized or pooled therewith, and for a reasonable period, not to be less than 180 days, after cessation of all drilling or drilling operations. Thereafter, Lessee shall not be in breach of the implied covenant of reasonable development unless Lessee has not drilled as many wells as a reasonably prudent operator would drill in the leased Premises for purposes of developing a proven formation.\textsuperscript{104}


In addition to protecting against the duty of further exploration with a clause similar to that used to protect against the covenant of reasonable development, the lessee should take care to make sure the lease does not appear to create a duty of further exploration (which otherwise might not exist) by discussing it. This is important given that relatively few jurisdictions expressly recognize an implied covenant of further exploration. A potential clause to address this is the following.

This clause is not intended to create an express covenant or an implied covenant of further exploration if one otherwise would not exist, or to expand the scope of such an implied covenant if one does exist. Further, this clause is not intended to suggest any minimum level of exploration that must be conducted in order to avoid a breach of an implied covenant of farther exploration, if such a covenant exists. The only intent of this clause is to specify certain “safe harbor” actions that will be deemed to satisfy any implied covenant of further exploration that might exist under law.\textsuperscript{105}

\begin{flushright}
\textsuperscript{103} See supra § 8.07[1] of this chapter.
\textsuperscript{104} See supra § 8.07[2][b] of this chapter.
\textsuperscript{105} See supra § 8.07[2][c] of this chapter.
\end{flushright}
[6] — **Protect Against Drainage.**

The implied covenant to protect against drainage shall be deemed satisfied during the drilling of any offset well. The implied covenant to protect against drainage shall also be deemed satisfied during any good faith effort by Lessee to secure unitization (or pooling), or a revision of unitization (or pooling), that would provide Lessor with a reasonable share of the proceeds from the well that allegedly is draining the Leased Premises.

[7] — **Implied Covenant to Market.**

The implied covenant to market shall not: (1) require Lessee to absorb all post-production costs associated with gathering, treating, dehydrating, compressing, and transporting a product to market; or (2) prohibit Lessee from deducting such costs from the price at which product is sold prior to calculating royalty.\(^\text{106}\)

The implied covenant to market gas from a well capable of producing gas in paying quantities shall be deemed to be satisfied by payment of shut-in royalties.\(^\text{107}\)

[8] — **Surface Restoration.**

This clause is not intended to create an express or implied covenant of surface restoration. If, however, an implied covenant of surface restoration is imposed as a matter of law, the Lessor and Lessee agree that the covenant will be satisfied if Lessee: (1) ________________; (2) ________________; (3) ________________ [specify steps that lessee generally will do even in the absence of this clause]. This clause is not intended to create duties greater than those which would be performed by a reasonably prudent operator. Instead, this clause is intended to create a “safe harbor” set of duties, the performance of which will be deemed to satisfy any implied duty of surface restoration that might exist. Accordingly, if any of the tasks listed above in this section

\(^{106}\) In addition, the royalty clause should expressly allow deduction of post-production costs from the ultimate price at which the product is sold, assuming that is the intent of the parties.

\(^{107}\) See supra § 8.07[2][e] of this chapter.
go beyond the requirements of reasonably prudent operation, this clause is not intended as creating a duty for Lessee to perform those tasks.  


As an alternative to drilling a well or conducting other operations, the Lessee may satisfy the implied covenant of reasonable development and the implied covenant of further exploration (assuming either or both would require additional drilling, development, or exploration) by paying Deferral Rentals of $______ annually to defer the obligation to drill, develop, explore, or conduct other operations. The payment of $______ in Deferral Rentals shall be deemed to satisfy both the implied covenant of reasonable development and the implied covenant of further exploration (if such an implied covenant exists) for one year. If Lessor delivers Notice of Breach specifying a breach of the implied covenant of reasonable development or the implied covenant of further exploration (assuming such a covenant exists), the fact that Lessee might choose to satisfy these implied covenants by paying Deferral Rentals, rather than by drilling or conducting other operations, shall not mean that Lessee has less than the Reasonable Time otherwise allowed to initiate a cure for a breach of an implied covenant. Thus, Lessee would have at least 180 days after delivery of Notice of Breach in which to cure any alleged breach by paying Deferral Rentals. Further, the fact that Lessee might choose to satisfy the implied covenant of reasonable development or further exploration by payment of Deferral Rentals does not transform the alleged breach of obligation into a breach of a duty to pay money. Therefore, the payment of Deferral Rentals shall cure any breach of the implied covenants of reasonable development and further exploration, as of the date of payment of Deferral Rentals, and the Lessee will have no duty to pay interest on the Deferral Rentals for any period during which Lessee allegedly was in breach of the implied covenants of reasonable development and further exploration.  

108  See supra § 8.07[2][f] of this chapter.
109  See supra § 8.07[2][b] of this chapter.
[10] — Suspension of Duties During Challenge to Lease.

If Lessor files an Action alleging that the Lease has terminated, or seeking an order to terminate the Lease, as to all or a portion of the Leased Premises, then any otherwise applicable implied covenants of reasonable development, further exploration, and protection against drainage shall be suspended during the period of time that the Action is pending (including any appeal). Such duties shall be suspended for the entire Leased Premises if the Lessor alleges that the Lease has terminated completely or if Lessor seeks an order of complete cancellation. Otherwise, such duties will be suspended as to the portion of the Leased premises for which lessee alleges the Lease has terminated or for which the Lessor seeks termination. This clause is not intended to supplement any jurisprudential, statutory, regulatory, or other suspension of such obligations, and is not intended to restrict, limit, or negate any broader suspension of duties. 110


In the event of an Action in which Lessor and Lessee dispute in good faith whether Lessee has breached an obligation under an implied covenant or an express clause of the Lease, the remedy of Lease termination (in whole or part) shall not be available unless Lessee fails to initiate (i) a cure within a reasonable time after a final, non-appealable judgment (or arbitration award in the event of arbitration), that the Lessee breached, or (ii) to diligently pursue the cure after initiating it. 111

110 See supra note 90.
111 See supra note 90.