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The Arkansas Law of Oil and Gas: Chapter V

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THE ARKANSAS LAW OF OIL AND GAS*

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Following is Chapter V of a multichapter short treatise on the Arkansas law of oil and gas. Other chapters appear in Volumes 9 and 10 of *UALR Law Journal.**** This treatise is not intended as an in-depth analysis, but rather as a description of the current state law which, the author hopes, will be helpful to those not regularly engaged in the oil and gas law practice.

CHAPTER V
IMPLIED COVENANTS IN OIL AND GAS LEASES

This chapter focuses on the development of the Arkansas law of implied covenants in oil and gas leases by discussing court decisions on the offset well covenant and the development covenant. As to each covenant, this chapter includes the elements of the covenant, what constitutes a breach, whether the lessee must give notice of the breach as a prerequisite to bringing suit, and the proper remedies.

The topic of this chapter was the subject of a book by the late Professor Maurice Merrill of the University of Oklahoma Law Center.[1] It is also the subject of numerous other scholarly efforts.[2]

A. The Offset Well Covenant

This covenant, also known as the covenant to protect against drainage, arises, as do other implied covenants, from the conflict of

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*** Chapters I and II concern the Nature of Oil and Gas Interests and Multiple Ownership of Oil and Gas Interests and appear at 9 UALR L.J. 223 (1986-87). Chapter III is on Conveyances of Oil and Gas Interests by Deed and appears at 9 UALR L.J. 467 (1986-87). Chapter IV considers the Oil and Gas Lease and appears at 10 UALR L.J. 5 (1987-88).

1. M. MERRILL, COVENANTS IMPLIED IN OIL AND GAS LEASES (2d ed. 1940). Of course, Professor Merrill's treatise is not confined to the law of a particular jurisdiction.

2. *E.g.,* Martin, *A Modern Look at Implied Covenants to Explore, Develop, and Market under Mineral Leases,* 27 S.W. LEGAL FOUND. OIL & GAS INST. 177 (1976); Vander Ploeg, *The Implied Covenant of Reasonable Development—A Delicate Balance,* 3 E. MIN. L. INST. 18-1 (1982); Williams, *Implied Covenants in Oil and Gas Leases: Some General Principles,* 29 U. KAN. L. REV. 153 (1981).

interest between the lessor and lessee.[3] The fugacious character of oil and gas permits a well located on one landowner's property to withdraw oil and gas from a common pool, thereby taking oil or gas, or both, from the land of neighboring property owners. The rule of capture permits this,[4] and the obvious solution for any landowner in this predicament is to drill his own well to produce minerals from the common pool.[5] However, if the landowner has executed an oil and gas lease to the property, he has conveyed the right to drill a well to his lessee. The lessee might not be disposed to drilling a well, either because he has an interest in the draining well or because he does not believe that an offset well[6] would be profitable. On the other hand, the lessor, whose royalty is paid from production without deduction for expenses, receives royalty despite the profitability or unprofitability of a well. Therefore, an offset well would be in the best interest of the lessor, but not necessarily in the best interest of the lessee.

In the foregoing situation the lease governs the rights between the lessor and lessee. If the lease has a specific provision governing the drilling of offset or protection wells, that provision might be enforced,[7] at least if the lessee is not responsible for the drainage.[8] Leases usually do not provide for this situation, but as shown below, the courts have found an implied covenant on the part of the lessee to protect the premises from drainage. The covenant is not breached by drainage alone. The lessor must prove breach by establishing that the drainage from his property is substantial and that an offset well would be profitable to the lessee.[9] Thus, the lessee is bound by the "prudent

3. See M. MERRILL, *supra* note 1, at 15-19, for a discussion of the inherent conflicts of interest between the parties to an oil and gas lease.

4. The rule of capture is discussed in Wright, *The Arkansas Law of Oil and Gas (Chapter I)*, 9 UALR L.J. 223, 230 (1986-87).

5. The common law permitted this, but today well spacing rules and forced pooling might prevent a landowner from taking this action. The law of pooling is the subject of a subsequent chapter.

6. An offset well is defined as "[a] well drilled on one tract of land to prevent the drainage of oil or gas to an adjoining tract of land, on which a well is being drilled or is already in production." H. WILLIAMS & C. MEYERS, MANUAL OF OIL AND GAS TERMS 568 (6th ed. 1984).

7. *E.g.*, Millette v. Phillips Petroleum Co., 209 Miss. 687, 48 So. 2d 344 (1950).

8. However, if the plaintiff's lessee is responsible for the drainage a specific offset well covenant might not be enforced. *E.g.*, Williams v. Humble Oil and Ref. Co., 432 F.2d 165 (5th Cir. 1970), *reh'g denied*, 435 F.2d 772 (1971); Shell Oil Co. v. Stansbury, 410 S.W.2d 187 (Tex. 1966).

9. In Arkansas Natural Gas Corp. v. Pierson, 84 F.2d 468, 471 (8th Cir. 1935) (quoting Brewster v. Lanyon Zinc Co., 140 F. 801, 814 (8th Cir. 1905)), the court explained why the law does not require the lessee to proceed if a well will not be profitable. *See* 5 H. WILLIAMS & C. MEYERS, OIL AND GAS LAW § 822 (1986) and cases cited. Profitability to the lessee means

operator" standard, which governs other implied lease obligations as well.[10]

If the lessee is responsible for drainage from the lessor's property, some jurisdictions do not apply the prudent operator rule and hold the lessee liable for breach of the implied offset well covenant even if the lessor cannot prove that an offset well would be profitable.[11] Arkansas has never recognized this exception to application of the prudent operator rule. In *Blair v. Clear Creek Oil & Gas Co.*[12] the Arkansas Supreme Court applied a standard tantamount to the prudent operator standard to a situation in which the lessee was operating the draining well:

> The practical test is to be found in the question, are the outside wells, as for example, the wells on the Grieg and Bryant tracts, draining the [plaintiff's] land to such an extent that, if the wells on the Grieg and Bryant tracts were operated by a third party, appellee as lessee of the [plaintiff's] tract, would find it good management to put down protection wells to save its own leased territory from exhaustion?[13]

Thus, in Arkansas the lessee is held to a uniform standard which is not affected by whether the lessee is the party responsible for the drainage. Authorities differ concerning whether this is the better rule. Williams and Meyers take the position that the Arkansas approach is preferable because it preserves the requirement of profitability of an offset well.[14] However, there is a persuasive argument that when the lessee is operating the draining well, he should be liable, perhaps on the basis of another implied covenant, one "to refrain from activities that would injure [the lessor's] interest."[15] It seems that the latter

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that the lessee should be able to recover a profit after drilling and operating expenses. *See, e.g.*, Gerson v. Anderson-Pritchard Prod. Corp., 149 F.2d 444 (10th Cir. 1945). This measure of profitability is *not* the same as the test for determining whether there is production in "paying quantities" sufficient to keep the lease alive under the habendum clause. *See, e.g.*, Clifton v. Koontz, 160 Tex. 82, 325 S.W.2d 684 (1959), in which the court considered only costs of production (or lifting costs) to determine whether a well was producing in paying quantities for purposes of the habendum clause.

10. *See* R. HEMINGWAY, THE LAW OF OIL AND GAS § 8.5, at 430 (2d ed. 1983); 5 H. WILLIAMS & C. MEYERS, *supra* note 9, § 806.3.

11. *E.g.*, Cook v. El Paso Natural Gas Co., 560 F.2d 978 (10th Cir. 1977).

12. 148 Ark. 301, 230 S.W. 286 (1921).

13. *Id.* at 309, 230 S.W. at 288.

14. 5 H. WILLIAMS & C. MEYERS, *supra* note 9, § 824.2, suggests that where the lessee is responsible for the drainage the burden of persuasion of profitability of an offset well should be on the lessee.

15. Cook v. El Paso Natural Gas Co., 560 F.2d 978, 984 (10th Cir. 1977). Other decisions adopting this type of covenant include R.R. Bush Oil Co. v. Beverly-Lincoln Land Co., 69 Cal. App. 2d 246, 158 P.2d 754 (1945); Millette v. Phillips Petroleum Co., 209 Miss. 687, 48 So. 2d

approach is a better one, as it encourages the lessee to treat the lessor fairly by drilling on the lease, pooling the lease with the site of the producing well, or paying compensatory royalties to the lessor for oil or gas that is being drained from the lease.

Some of the Arkansas decisions on the implied covenant to protect against drainage confront the effect of delay rentals upon the covenant. In the *Blair* decision the Arkansas Supreme Court noted that delay rentals should not affect the lessee's obligations under the covenant:

> For the rental reserved, [the lessor] is neither selling his oil or gas, nor relinquishing his ownership thereof, nor consenting to severance or abstraction thereof. He expects it to remain in the land until the rental period ends, whether it ceases by the drilling of a well or expiration of the term. Nor can it be doubted that the lessee contemplated the same result. Neither could have intended that he should take out the mineral through wells on other lands.[16]

In *Blair* the lessee was successful in his suit to have the lease forfeited and to recover damages for the royalty value of the gas drained from the lease.[17]

In two subsequent decisions the Arkansas Supreme Court interpreted its holding in *Blair* as to the effect of delay rentals upon the implied covenant to protect against drainage. In *Clear Creek Oil & Gas Co. v. Brunk*,[18] the lessor made demand upon the lessee to drill protection wells because the lessee was draining the lessor's property with wells on adjacent land. The lessee then tendered, and the lessor accepted, increased delay rentals "until [the lessee] could drill a well."[19] The lessee never drilled a well, but continued to pay delay rentals (which the lessor continued to accept) until the lessee surrendered the lease. The lessor then sued for damages. The court held for the lessee, reasoning that the lessor's acceptance of increased delay rentals after the alleged breach of the covenant barred the lessor from

344 (1950). See Seed, *The Implied Covenant in Oil and Gas Leases to Refrain from Depletory Acts*, 3 UCLA L. REV. 508 (1955-56), for the position that there is a separate "depletory covenant." See Williams, *Implied Covenants' Threat to the Value of Oil and Gas Reserves*, 36 S.W. LEGAL FOUND. OIL & GAS INST. 3-1 (1985), for the view that this covenant might not be recognized by Texas despite the decision in Shell Oil Co. v. Stansbury, 410 S.W.2d 187 (Tex. 1966).

16. 148 Ark. at 309, 230 S.W. at 289 (quoting Carper v. United Fuel Gas Co., 78 W. Va. 433, 439, 89 S.E. 12, 15 (1916)).

17. *Id.* at 311, 230 S.W. at 290.

18. 160 Ark. 574, 255 S.W. 7 (1923).

19. *Id.* at 577, 255 S.W. at 7.

a suit for damages.[20] The court noted that in *Blair* the lessor had refused to accept delay rentals and had immediately declared a forfeiture upon learning of the breach.[21] The court reasoned that it logically follows from the *Blair* decision that the lessor waives the breach when he consents to further delay by accepting payment for it.[22]

In *Carson v. Ozark Natural Gas Co.*,[23] the lessor made demand on the lessee, which was draining the lessor's gas through wells on adjacent land, to drill protection wells. The lessor accepted increased delay rentals in lieu of drilling for one year, but refused to accept increased rentals the following year and again demanded that the lessee drill an offset well. The lessee executed a release of the lease, and the lessor sued for damages for breach of the implied covenant for protection against drainage. Citing the holding in *Brunk*, the court held that the lessor could not recover damages for the period for which he had accepted increased rentals. However, the court found that the release was ineffective because the lessee had laid pipeline on the property in accordance with the terms of the lease. Thus, the lessor was entitled to damages for breach of the implied covenant.[24]

The *Carson* case arguably indicated that a lessee could cancel or release the lease prior to the end of the primary term and thereby avoid liability for breach of the implied covenant to protect against drainage. The Eighth Circuit Court of Appeals, in *Arkansas Natural Gas Corp. v. Pierson*,[25] held that a lessee could not so easily escape liability. In that case the lessor alleged that the lessee was draining gas from the leasehold through nearby wells, demanded that the lessee drill an offset well, and refused to accept delay rental payments.[26] The lessee, without informing the lessor, filed a release of the lease and maintained that, in any event, the lease terminated when the lessor refused the delay rentals.[27] The court held for the lessor, affirming the lower court in awarding damages based upon the royalty value of the gas drained from the plaintiff's property. The court reasoned that the implied covenant is for the benefit of the lessor, that the

20. *Id.* at 579, 255 S.W. at 8.

21. *Id.* at 578, 255 S.W. at 8.

22. *Id.* at 579, 255 S.W. at 8.

23. 191 Ark. 167, 83 S.W.2d 833 (1935).

24. *Id.* at 171, 83 S.W.2d at 835. The lease provided for a fixed royalty of $200 per year for each gas well. The lessor's counsel had agreed that one well would have sufficed under the lease, so the plaintiff's damages equaled $200 per year.

25. 84 F.2d 468 (8th Cir. 1936).

26. It seems that perhaps the lessor or his counsel was aware of the holding in Clear Creek Oil & Gas Co. v. Brunk, 160 Ark. 574, 255 S.W. 7 (1923).

27. 84 F.2d at 472.

breach of the covenant does not automatically result in forfeiture of the lease, and that the lessor may chose to enforce the lease and sue for breach of the covenant.[28] However, the court allowed damages only for the duration of the primary term on grounds that the habendum clause of the lease relates "to gas produced by reason of the development of the leasehold under the lease."[29] The lower court had awarded the lessor damages beyond expiration of the primary term, reasoning that the drainage was continuing and that the lease would continue "as long thereafter as oil or gas, or either of them is produced from said land by the lessee."[30] Although the lower court's holding might have appeal for a victimized lessor, the approach by the appellate court, limiting the damages to the primary term, would generally allow the lessor time to find another operator willing to drill.[31]

There are cases from other jurisdictions which have found breach of the implied covenant against drainage in situations in which the lessee, as a prudent operator, would not have drilled an offset well but would have taken some other action, such as pooling the lease[32] or applying for well spacing exceptions[33] or for compulsory pooling.[34] These decisions seem sound, as they consistently require that the lessee act as a reasonably prudent operator.

The Arkansas Supreme Court has never discussed whether a lessee can be liable for breach of the covenant from failure to take action other than drilling an offset well. However, in *Amoco Production Co. v. Ware*[35] the lessor alleged that the lessee had permitted drainage from the leasehold, had wrongfully failed to appeal an Oil and Gas Commission order unitizing the lease with adjacent property, and had entered into a field-wide unitization agreement which diluted the lessor's royalty interest. The supreme court refused to affirm the chancellor's finding that drainage had occurred[36] and held that the lessee had acted prudently.[37] Because the court did not find that

28. *Id.*

29. *Id.* at 473.

30. *Id.*

31. It is assumed that the lessor could find an operator willing to drill, because an offset well would be profitable; otherwise, there would be no breach of the covenant.

32. *E.g.*, Williams v. Humble Oil & Ref. Co., 432 F.2d 165, *reh'g denied*, 435 F.2d 772 (5th Cir. 1970), *cert. denied*, 402 U.S. 934 (1971). *See* Pierce v. Goldking Properties, Inc., 396 So. 2d 528, 532, *writ denied*, 400 So. 2d 904 (La. Ct. App. 1981) (placing land in unit satisfied obligation to protect from drainage).

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

34. *E.g.*, U.V. Indus., Inc. v. Danielson, 184 Mont. 203, 602 P.2d 571 (1979).

35. 269 Ark. 313, 602 S.W.2d 620 (1980).

36. *Id.* at 322, 602 S.W.2d at 624.

37. *Id.* at 323, 602 S.W.2d at 625.

drainage had occurred, the decision leaves open the question whether the covenant against drainage may be breached by the lessee's action (or inaction) before the Oil and Gas Commission and in the courts. However, the court pointed out that the lessor himself could have appealed the decision of the Commission,[38] perhaps indicating that there would have been no breach of the covenant even if the lessor had established drainage.

In summary, the Arkansas cases on breach of the offset well covenant indicate that a lessor should not accept delay rental payments after he learns of a breach of the covenant. In the event of breach, the cases allow the lessor to obtain cancellation of the lease and to recover damages based upon the amount of drainage. However, the Arkansas law apparently does not permit a lessee to avoid liability for damages during the primary term by releasing the lease or by claiming that the lease has been terminated by the lessor's refusal to accept rentals. Arkansas has not yet decided that the offset well covenant might require the lessee, as a prudent operator, to seek administrative relief or to take action other than to drill an offset well.

B. The Covenant for Reasonable Development

This covenant, like the offset well covenant, requires the lessee to develop the lease with the diligence of a prudent operator. Arkansas has recognized this covenant in many cases, most of which are discussed herein. The Arkansas Supreme Court has stated on numerous occasions that this implied covenant exists when the principal consideration for the lease is royalties.[39] Thus the covenant seems to be one implied in fact, that is, implied from the parties' agreement and reflecting their intent that the lessee develop the premises with due diligence.[40] Breach ordinarily occurs after the lessee has produced oil or gas but has not proceeded diligently with further development.[41]

38. *Id.* at 321, 602 S.W.2d at 624. The court cited ARK. STAT. ANN. § 53-120 (1971) (currently codified at ARK. CODE ANN. § 15-72-110 (1987)).

39. *E.g.,* Skelly Oil Co. v. Scoggins, 231 Ark. 566, 331 S.W.2d 112 (1960); Smart v. Crow, 220 Ark. 141, 246 S.W.2d 432 (1952); Ezzell v. Oil Assocs., Inc., 180 Ark. 802, 22 S.W.2d 1015 (1930); Mansfield Gas Co. v. Parkhill, 114 Ark. 419, 169 S.W. 957 (1914).

40. Whether covenants are implied in fact or implied in law has not been discussed directly by the Arkansas Supreme Court. Covenants implied in fact are those which the parties actually intend, while those implied in law arise from the relationship of the parties. The late Maurice Merrill contended that lease covenants are implied in law. M. MERRILL, *supra* note 1, § 220. For a view that they are implied in fact, see Walker, *The Nature of the Property Interests Created by an Oil and Gas Lease in Texas,* 11 TEX. L. REV. 399, 402-06 (1933). For the significance of the distinction, see H. WILLIAMS, R. MAXWELL, C. MEYERS, & S. WILLIAMS, OIL AND GAS, CASES AND MATERIALS 491 (5th ed. 1986).

41. *E.g.,* Stevenson v. Barnes, 288 Ark. 147, 702 S.W.2d 787 (1986); Byrd v. Bradham,

1. *Effect of Delay Rental Payments*

Delay rental payments permit the lessee to postpone development during the primary term. Therefore, a lessor should not be able to establish breach of the covenant for reasonable development during the primary term when the lease provides for payment of delay rentals and rentals are tendered by the lessee.[42] However, in the Arkansas Supreme Court decision *Poindexter v. Lion Oil Refining Co.*,[43] the lessor prevailed in a suit for breach of the covenant when he had rejected delay rentals tendered by the lessee. The court found that the lessee was obligated to develop the lease, pointing out the lower court's finding that the wells on adjacent tracts had " 'a tendency to drain oil from under the lands involved in this suit.' "[44] Perhaps this decision is actually based upon the implied covenant to protect against drainage, but in reaching its conclusion, the court relied on earlier decisions applying the implied covenant for reasonable development.[45]

2. *Elements of Breach*

At the heart of the implied covenant for reasonable development is the intent of the parties that the lessee develop the lease as a prudent operator. The Arkansas Supreme Court recognized this covenant as early as 1911 in the decision *Mansfield Gas Co. v. Alexander*:[46]

> And the general rule for the construction of mineral leases, such as is involved in this case, is that the law implies a covenant upon the part of the lessee to make the exploration and search for the minerals in a proper manner and with reasonable diligence and to work the mine or well when the mineral is discovered, so that the lessor may obtain the compensation which both parties must have had in contemplation when the agreement was entered into.[47]

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280 Ark. 11, 655 S.W.2d 366 (1983); Nolan v. Thomas, 228 Ark. 572, 309 S.W.2d 727 (1958). However, at least one older Arkansas case applied the covenant in absence of prior development when the lease contained no delay rental clause. *See* Mansfield Gas Co. v. Alexander, 97 Ark. 167, 133 S.W. 837 (1911).

42. *See* 5 H. WILLIAMS & C. MEYERS, *supra* note 9, § 832. One Arkansas decision expressly pointed out that the lessor's acceptance of delay rentals precluded a cause of action for breach of the implied development covenant. Clear Creek Oil & Gas Co. v. Bushmaier, 161 Ark. 26, 255 S.W. 37 (1923).

43. 205 Ark. 978, 167 S.W.2d 492 (1943).

44. *Id.* at 987, 167 S.W.2d at 497.

45. *Id.* at 984-87, 167 S.W.2d at 495-97. These decisions include Smith v. Moody, 192 Ark. 704, 94 S.W.2d 357 (1936); Standard Oil Co. v. Giller, 183 Ark. 776, 38 S.W.2d 766 (1931); Ezzell v. Oil Assocs., Inc., 180 Ark. 802, 22 S.W.2d 1015 (1930).

46. 97 Ark. 167, 133 S.W. 837 (1911).

47. *Id.* at 171, 133 S.W. at 838-39.

The court in *Mansfield* had no difficulty finding that the covenant was part of the lease, as the lessor's only compensation, other than a nominal sum of one dollar recited in the lease, was the royalties payable out of production.[48] The court cancelled the lease because the lessee, which had developed surrounding property, refused to develop the plaintiff's leasehold for eight years. The primary term of the lease was fifty years and there was no provision for payment of delay rentals. Had the court decided for the lessee, the lessor's property might have been subject to the lease for fifty years, during which time the lessee might not have developed it and the lessor would have been unable to develop it himself or lease it to another.

Apparently the foundation of the covenant is the parties' intent at the time the lease was executed.[49] For example, in the federal court decision *Wood v. Arkansas Fuel Oil Co.*,[50] the court held that the lessor had not established that the lessee breached the prudent operator standard by failing to explore horizons deeper than the Nacatoch sand, from which there was production. At the time the lease was executed, the Nacatoch sand was the only known producing formation, and the court reasoned that "[a] covenant should not be implied . . . to meet a situation that was not in the minds of either the lessor or lessee at the time the lease was executed."[51] A later Arkansas Supreme Court decision, *Reynolds v. Smith*,[52] similarly held that the lessee had not violated the prudent operator standard in failing to drill below the Travis Peak formation, which was the formation the parties had in mind at the time of the lease. The court pointed out that since that time new information had indicated that there might be deeper producing formations, but that the evidence indicated that a prudent operator would not drill to the deeper horizons without additional acreage.[53]

In many cases the Arkansas Supreme Court has held that the covenant of development extends to the entire leased premises.[54] In most cases involving this covenant the lessor alleges breach after the lessee has drilled at least one producing well and fails to develop and explore additional lease acreage, claiming that the entire lease is held

48. *Id.* at 169, 133 S.W. at 838.

49. In this respect the covenant in Arkansas is probably implied in fact (as opposed to in law). *See supra* note 40.

50. 40 F. Supp. 42 (W.D. Ark. 1941).

51. *Id.* at 46.

52. 231 Ark. 566, 331 S.W.2d 112 (1960).

53. *Id.* at 571, 331 S.W.2d at 116.

54. *E.g.*, Enstar Corp. v. Crystal Oil Co., 294 Ark. 77, 740 S.W.2d 630 (1987); Byrd v. Bradham, 280 Ark. 11, 655 S.W.2d 366 (1983).

by production. For example, in *Drummond v. Alphin*[55] one lease covered a total of 1947 acres on twenty-seven scattered tracts, and another lease covered 1710 acres on thirty-one different tracts. There was one producing well on each lease, and the lessees and their assignees claimed that the leases were held by production under the lease terms.[56] The court affirmed the lower court in cancelling the portions of the leases which had not been explored.[57] Likewise, the court cancelled all of the lease except ten acres surrounding a producing well in *Ezzell v. Oil Associates, Inc.*[58] In that case the lessee drilled two wells, one a dry hole and the other a producer, on an 1170-acre leasehold and claimed to hold the lease by production without further exploration. The last well was completed in 1922, the primary term of the lease expired in 1924, and the lessor brought suit to cancel in 1928, after unsuccessfully demanding that the lessee drill additional wells. The court described the nature of the covenant as follows:

> So it may be taken, as the well-settled rule in this State, that there is an implied covenant on the part of the lessee in oil and gas leases to proceed with reasonable diligence in the search for oil and gas, and also to continue the search with reasonable diligence, to the end that oil and gas may be produced in paying quantities *throughout the whole of the leased premises.*[59]

The court applied this principle in the 1960 decision *Skelly Oil Co. v. Scoggins*,[60] cancelling the lease as to 280 acres which the lessee had not developed in the thirteen years of the existence of the lease, although the lessee had developed forty acres. The court again found breach of the implied covenant of reasonable development in the 1983 decision *Byrd v. Bradham*,[61] cancelling seventy-five acres of an eighty-acre lease which the lessee had failed to develop for twenty-eight years.

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55. 176 Ark. 1052, 4 S.W.2d 942 (1928).

56. The leases contained the following unusual clause which does not appear in a typical modern lease:

> In case [lessee] should bore and discover either oil or gas, then in that event this grant, incumbrance or conveyance shall be in full force and effect for twenty-five years from the time of the discovery of said product, and as much longer as oil or gas may be produced in paying quantities thereon.

Id. at 1055, 4 S.W.2d at 942. The court held that despite this clause, the lessee was obligated to continue operations following discovery of oil during the 25-year term. *Id.*

57. *Id.* at 1061, 4 S.W.2d at 945.

58. 180 Ark. 802, 22 S.W.2d 1015 (1930).

59. *Id.* at 810, 22 S.W.2d at 1018 (emphasis added).

60. 231 Ark. 357, 329 S.W.2d 424 (1960).

61. 280 Ark. 11, 655 S.W.2d 366 (1983).

However, in a 1986 decision, *Stevenson v. Barnes*,[62] a majority of the Arkansas Supreme Court did not require that the lessee develop the entire leased premises when evidence indicated that two producing wells on the 120-acre lease would eventually produce all of the oil available from the lease because one well was high on the producing structure.[63] The lessee contended that he should be permitted to hold the undeveloped portions of the lease because additional wells drilled by another lessee would deprive him of recoverable oil.[64] However, two dissenting justices took the position that each of the existing wells could drain no more than ten acres and that the lessee was in violation of the covenant to develop with due diligence.[65] The dissent also took the position that even if the existing wells could recover all of the available oil, the lessee would be depriving the lessor of "a receipt of her royalties over an unreasonable period of time."[66]

The Arkansas Supreme Court has not been hesitant to apply the covenant to a small lease or to a situation in which there has already been substantial development. For example, in *Standard Oil Co. v. Giller*,[67] the court cancelled the undeveloped portion of the forty-acre lease, preserving the lease as to ten acres drained by a producing well.[68] An example of a situation in which the court required more development of a lessee who had already undertaken extensive development is found in the 1952 decision *Smart v. Crow*.[69] In that case the lessees had drilled twelve producing wells on a 150-acre leasehold, but the lessor sued to cancel the lease as to four ten-acre tracts on grounds that one well drained only ten acres. The supreme court affirmed the chancellor's finding that the development was reasonable as to two of the four tracts, but that the lessees would be required to develop the other two tracts within a prescribed period of time.[70]

Determining what a prudent operator would do under the circumstances can be a matter of debate. But a recent Arkansas Supreme Court decision indicates that a lessee probably violates that standard when he chooses not to drill on the basis of the same information which leads another operator to drill successfully. *Enstar*

62. 288 Ark. 147, 702 S.W.2d 787 (1986).
63. *Id.* at 148, 702 S.W.2d at 788.
64. *Id.*
65. *Id.* at 151, 702 S.W.2d at 789 (Holt, C.J., dissenting).
66. *Id.* at 152, 702 S.W.2d at 790 (Holt, C.J., dissenting).
67. 183 Ark. 776, 38 S.W.2d 766 (1931).
68. *Id.* at 779, 38 S.W.2d at 767.
69. 220 Ark. 141, 246 S.W.2d 432 (1952).
70. *Id.* at 144, 246 S.W.2d at 434.

Corp. v. Crystal Oil Co.[71] involved a leasehold of 241 acres, part of which had been unitized in 1949. The lessee drilled one well which stopped producing in 1952 on a nonunitized eighty-acre tract of the leasehold. The lessee had not drilled or otherwise developed this tract when the lessor executed a second lease to this tract in 1974 to Crystal Oil Company, which drilled one producing well in 1976 and another in 1978. The trial judge found that the initial lessee had "abandoned" the lease on this tract and had breached the implied covenant to develop. The supreme court affirmed, reasoning that the appellant had violated the prudent operator standard, as evidenced by Crystal's successful wells, which Crystal had decided to drill after studying the appellant's wells logs.[72] In this regard the court distinguished its holding in *Saulsberry v. Siegel*,[73] in which the lessee was able to retain a lease after several years of nondevelopment even though a subsequent lessee drilled a producing well. The court in that case pointed out that there was no evidence on why the subsequent lessee decided to drill but that there was evidence supporting the first lessee's decision not to drill.

In *Enstar* the court was not persuaded by the appellant's argument that the price of oil between 1952 and 1974 was too low to justify additional drilling, pointing out that the appellant did not evidence any intent to drill after 1974 and did not even bring suit to protect its lease until five years after Crystal had completed its first producing well.[74]

One can infer from the foregoing decisions that a lessee may not hold a lease for purposes of speculation for an unreasonable period of time without breaching the development covenant. A lessee might argue that it is "prudent" to hold a lease without further development under some circumstances, but such a position is contrary to the prudent operator standard, which requires the lessee to act in the best interest of both the lessee and the lessor.[75] This standard requires that the lessee "must not consider his own interest wholly or for the most

71. 294 Ark. 77, 740 S.W.2d 630 (1987).

72. *Id.* at 80-81, 740 S.W.2d at 632.

73. 221 Ark. 152, 252 S.W.2d 834 (1952).

74. 294 Ark. at 81, 740 S.W.2d at 632.

75. *See, e.g.,* Enstar Corp. v. Crystal Oil Co., 294 Ark. 77, 80, 740 S.W.2d 630, 631 (1987); Byrd v. Bradham, 280 Ark. 11, 14, 655 S.W.2d 366, 367 (1986); Amoco Prod. Co. v. Ware, 269 Ark. 313, 319, 602 S.W.2d 620, 623 (1980); Smart v. Crow, 220 Ark. 141, 143, 246 S.W.2d 432, 434 (1952); Poindexter v. Lion Oil Ref. Co., 205 Ark. 978, 985, 167 S.W.2d 492, 496 (1943); Standard Oil Co. v. Giller, 183 Ark. 776, 778, 38 S.W.2d 766, 767 (1931); Ezzell v. Oil Assocs., Inc., 180 Ark. 802, 811, 22 S.W.2d 1015, 1018 (1930).

part."[76] In the 1958 decision *Nolan v. Thomas*[77] the court was explicit in finding that the lessee may not hold undeveloped portions of the lease indefinitely, quoting from the United States Supreme Court decision *Sauder v. Mid-Continent Petroleum Corp.*:[78]

> The production of oil on a small portion of the leased tract cannot justify the lessee's holding the balance indefinitely and depriving the lessor, not only of the expected royalty from production pursuant to the lease, but of the privilege of making some other arrangement for availing himself of the mineral content of the lands.[79]

Similarly, a lessee might argue that there can be no breach of the development covenant in absence of the lessor's proving that additional wells would be profitable.[80] The Arkansas Supreme Court, in applying the prudent operator standard, has never required the lessor to prove that additional wells would be profitable. In *Smith v. Moody*[81] the court held that the contention of the lessee that additional wells would be unprofitable "may be disposed of by saying that, if true, the lessees have not been damaged by the cancellation of so much of the contract of lease as cannot be profitably performed."[82] The court cited this decision in 1959 in *Skelly Oil Co. v. Scoggins*,[83] pointing out that a lessee should not complain of cancellation of a lease which cannot be profitably developed.[84]

Similarly, in the 1983 decision *Byrd v. Bradham*,[85] the Arkansas Supreme Court found breach of the implied development covenant and granted the lessor cancellation of the undeveloped portion of the lease despite the lessee's contention that she had no obligation to develop the remaining acreage because the area was a "wildcat" area

76. Poindexter v. Lion Oil Ref. Co., 205 Ark. 978, 985, 167 S.W.2d 492, 496 (1943); Ezzell v. Oil Assocs., Inc., 180 Ark. 802, 811, 22 S.W.2d 1015, 1018 (1930).

77. 228 Ark. 572, 309 S.W.2d 727 (1958).

78. 292 U.S. 272 (1934).

79. 228 Ark. at 578, 309 S.W.2d at 731 (quoting 292 U.S. at 281).

80. In some jurisdictions the lessor must establish that additional wells would be profitable. *See infra* note 91. One noted oil and gas scholar, Judge Stephen Williams, would apply a "modified" profitability test, requiring that development not only be profitable but that it be more profitable to develop at the present rather than at a future time. Williams, *Implied Covenants for Development and Exploration in Oil and Gas Leases—The Determination of Profitability*, 27 U. KAN. L. REV. 443 (1979).

81. 192 Ark. 704, 94 S.W.2d 357 (1936).

82. *Id.* at 707, 94 S.W.2d at 358. *See also* Byrd v. Bradham, 280 Ark. 11, 14, 655 S.W.2d 366, 367 (1983); Skelly Oil Co. v. Scoggins, 231 Ark. 357, 329 S.W.2d 424 (1960); Nolan v. Thomas, 228 Ark. 572, 577, 309 S.W.2d 727, 730 (1958).

83. 231 Ark. 357, 329 S.W.2d 424 (1959).

84. *Id.* at 359, 329 S.W.2d at 426.

85. 280 Ark. 11, 655 S.W.2d 366 (1983).

and any well drilled would be a gamble.[86] As to this contention, the court wrote that "if there is nothing for [the lessee] to gain, then she has lost nothing by cancellation of the lease."[87] One can take issue with the court's reasoning that the lessee had nothing to lose, for the court seems to be taking the position that the speculative value of a leasehold of unknown producing potential is worth nothing, a premise which defies economic reality.[88] Nevertheless, the result of the case may be justified on another ground: the court held that twenty-eight years without development was too long and cancelled the lease on the undeveloped acreage, following its previous holdings to the effect that the lessee may not "hold the entire leasehold indefinitely" through production on only a small part of the lease.[89]

From the foregoing decisions one can conclude that the prudent operator standard in Arkansas does not permit a lessee to hold undeveloped portions of a lease indefinitely, even in absence of proof that additional wells are likely to be profitable. This version of the prudent operator standard is harsher on the lessee than the rule recognized in some other jurisdictions which requires that the lessor prove that additional development would probably be profitable to the lessee.[90]

In Arkansas it is not always necessary that the lessor make demand that the lessee drill additional wells in order to obtain cancellation for breach of the development covenant. For example, in *Byrd v. Bradham*[91] the court granted cancellation despite the lack of such demand, citing as precedent a 1914 decision, *Mansfield Gas Co. v. Parkhill*,[92] in which the lessor had made no demand for performance but was successful in the suit to cancel the lease on grounds that the lessee had been inactive for ten years.

3. *Remedies*

Remedies for breach of the implied development covenant in Arkansas include cancellation, partial cancellation, and conditional cancellation of the lease. Courts in other jurisdictions have on occasion

86. *Id.*
87. *Id.*
88. In Texas a mineral owner recovered for the loss of his property's speculative value. Humble Oil & Ref. Co. v. Kishi, 299 S.W. 687 (Tex. Civ. App. 1927).
89. 280 Ark. at 14, 655 S.W.2d at 367.
90. *E.g.*, Baker v. Collins, 29 Ill. 2d 410, 194 N.E.2d 353 (1963); Townsend v. Creekmore-Rooney Co., 358 P.2d 1103 (Okla. 1960); Clifton v. Koontz, 160 Tex. 82, 325 S.W.2d 684 (1959). For other cases requiring that the lessor show the likelihood of profitability, see R. HEMINGWAY, *supra* note 10, § 8.3, at 416 n.6.
91. 280 Ark. 11, 655 S.W.2d 366 (1983).
92. 114 Ark. 419, 169 S.W. 957 (1914).

awarded a lessor damages for breach of this covenant, although an award of damages based upon royalties which would have been forthcoming leaves open the possibility of double recovery when the lease is actually developed.[93]

As pointed out in a previous chapter, the Arkansas Supreme Court has granted cancellation of a lease on grounds that the lessee has "abandoned" the lease by failure to develop it.[94] It is likely that these cases are actually based upon the implied covenant for reasonable development. In the 1914 decision *Mansfield Gas Co. v. Parkhill*,[95] the Arkansas Supreme Court quoted one of its earlier decisions[96] to the effect that the "implied covenant is in effect a condition upon which the lease was made; a failure or refusal to perform that condition results in a forfeiture of the lease."[97] This language indicates that the court was basing its decision on the implied covenant, not on the lessee's abandonment.

As noted above, a lessor usually alleges breach of this covenant after the lessee has drilled at least one producing well and is holding the lease by production. In such a situation, if the court finds breach of the covenant and finds that cancellation is appropriate, it is likely to grant cancellation of the lease only as it applies to undeveloped tracts. Such partial cancellation was the remedy in many Arkansas decisions, including *Enstar Corp. v. Crystal Oil Co.*,[98] *Byrd v. Bradham*,[99] *Skelly Oil Co. v. Scoggins*,[100] *Nolan v. Thomas*,[101] *Smith v. Moody*,[102] *Standard Oil Co. v. Giller*,[103] *Ezzell v. Oil Associates, Inc.*,[104]

93. *E.g.*, Daughetee v. Ohio Oil Co., 263 Ill. 518, 105 N.E. 308 (1914) (limiting plaintiff's recovery to interest on royalties which would have been forthcoming had the lessee not breached the covenant); Texas Pac. Coal & Oil Co. v. Barker, 117 Tex. 418, 6 S.W.2d 1031 (1928) (granting the plaintiff royalties which would have been paid had the lessee not breached the covenant, but providing for credit to the lessee for these royalties upon actual development); Cotiga Dev. Co. v. United Fuel Gas Co., 147 W. Va. 484, 128 S.E.2d 626 (1962).

94. Wright, *Arkansas Law of Oil and Gas (Chapter IV)*, 10 UALR L.J. 5, 34 (1987-88). Cases cited are Zappia v. Garner, 259 Ark. 794, 536 S.W.2d 714 (1976); Millar v. Mauney, 150 Ark. 161, 234 S.W. 498 (1921); Mansfield Gas Co. v. Alexander, 97 Ark. 167, 133 S.W. 837 (1911).

95. 114 Ark. 419, 169 S.W. 957 (1914).

96. Mansfield Gas Co. v. Alexander, 97 Ark. 167, 133 S.W. 837 (1911).

97. Mansfield Gas Co. v. Parkhill, 114 Ark. 419, 421, 169 S.W. 957, 958 (1914).

98. 294 Ark. 77, 740 S.W.2d 630 (1987).

99. 280 Ark. 11, 655 S.W.2d 366 (1983).

100. 231 Ark. 357, 329 S.W.2d 424 (1959).

101. 228 Ark. 572, 309 S.W.2d 727 (1958).

102. 192 Ark. 704, 94 S.W.2d 357 (1936).

103. 183 Ark. 776, 38 S.W.2d 766 (1931).

104. 180 Ark. 802, 22 S.W.2d 1015 (1930).

and *Drummond v. Alphin.*[105] Partial cancellation might also be an appropriate remedy when the lessee has failed to drill to all producing horizons. For example, in *Stevenson v. Barnes*[106] the Arkansas Supreme Court confirmed the chancellor's cancellation of the lease as to all horizons below the Nacatoch sand, from which there was production.

Conditional cancellation is certainly the least harsh remedy against a breaching lessee, for it gives the lessee additional time to develop and save the lease. In *Poindexter v. Lion Oil Refining Co.*[107] the Arkansas Supreme Court found breach of the development covenant and ordered the lease cancelled unless the lessee commenced operations within a reasonable time, which it found to be six months.[108] There was a similar result in *Smart v. Crow*[109] in which the court gave the lessees a prescribed period of time to drill on the undeveloped parts of the lease.[110]

One decision, *Arkansas Oil & Gas, Inc. v. Diamond Shamrock Corp.*,[111] seemed to indicate that a court may determine what will constitute a future breach of the development covenant. The lessor sought cancellation of the undeveloped portion of the lease, but the chancellor held that the lessee had a reasonable time in which to develop and that a reasonable time would be until January 1, 1984. The Arkansas Supreme Court affirmed. In a later decision, *Roberson Enterprises, Inc. v. Miller Land & Lumber Co.*,[112] the Arkansas Supreme Court held that conditional cancellation is inappropriate in absense of a finding that the lessee is in breach of the covenant. In that case the lessee sought cancellation of the undeveloped portions of the lease. The chancellor found that the lessee was not in breach of the development covenant but ordered the lessee to execute a release on February 5, 1986, unless it had begun operations or had drilled a producing well by that date. The supreme court reversed, pointing out that the chancellor should not have assumed that the covenant would be breached by a certain date, as the chancellor could not have known of conditions prevailing on the future date.[113] The court distinguished

105. 176 Ark. 1052, 4 S.W.2d 942 (1928).
106. 288 Ark. 147, 702 S.W.2d 787 (1986).
107. 205 Ark. 978, 167 S.W.2d 492 (1943).
108. *Id.* at 989, 167 S.W.2d at 498.
109. 220 Ark. 141, 246 S.W.2d 432 (1952).
110. *Id.* at 144, 246 S.W.2d at 434. The lessee had sixty days to begin drilling a well on one tract and twenty days after completion of that well to begin a well on another tract.
111. 281 Ark. 207, 662 S.W.2d 824 (1984).
112. 287 Ark. 422, 700 S.W.2d 57 (1985).
113. *Id.* at 426, 700 S.W.2d at 59.

its earlier decision in *Arkansas Oil & Gas Co. v. Diamond Shamrock Corp.*,[114] pointing out that no issue was raised contesting the remedy of conditional cancellation in that case.

4. *Effect of Express Lease Covenants*

Express lease covenants on development can negate the implication of an implied covenant for reasonable development, which is implied only because it conforms with the parties' intent.[115]

The decision in *Mansfield Gas Co. v. Alexander*[116] confronted the question whether an express lease covenant concerning development supplanted the implied covenant. The lease contained a provision that it would be forfeited if the lessee, within one year from the date of the lease, failed to prospect and develop the leased lands or other lands within four miles thereof. The court held that this provision only concerned the time when operations were to commence and did not concern when and how development was to continue. The court reasoned that there was an implied covenant that the lessor would "prosecute the operations with due and proper diligence after beginning same."[117] The court pointed out that to permit the lessee to keep the lease solely on grounds that it had developed nearby property within the one-year period would be to the detriment of the lessor because of drainage, and that "[t]he plain purpose of the lease was that the lessee should develop the land of the lessor."[118] This decision is consistent with holdings from other jurisdictions to the effect that express provisions concerning initial development are not intended to supplant the implied covenant of reasonable development.[119]

C. Other Implied Covenants

The Arkansas Supreme Court has not decided any definitive case on implied covenants other than the offset well covenant and the covenant for reasonable development. However, this does not indicate that the court would not find other implied covenants consistent with the intent of the parties.

One implied covenant recognized in a few jurisdictions is for the lessee "to refrain from acts which deplete the lands of his lessor and

114. 281 Ark. 207, 662 S.W.2d 824 (1984).
115. Again, this assumes that the covenants are implied in fact. *See supra* note 40.
116. 97 Ark. 167, 133 S.W. 837 (1911).
117. *Id.* at 174, 133 S.W. at 840.
118. *Id.*
119. *E.g.*, Sinclair Oil & Gas Co. v. Masterson, 271 F.2d 310 (5th Cir. 1959), *cert. denied*, 362 U.S. 952 (1960).

thus impair the value of the property."[120] This covenant would be useful to a lessor whose lessee is draining oil or gas from the leasehold but who cannot prove that an offset well would be profitable and thus cannot establish breach of the offset well covenant. Arguably the Arkansas Supreme Court rejected implication of this covenant when it ruled that the standard of conduct required of the lessee is the same whether or not the lessee is responsible for drainage from the leasehold.[121] As noted above, whether the requirement of profitability of an offset well should be eliminated, even if the lessee is responsible for the drainage, is a matter of some debate.[122]

One leading treatise has suggested that there is an implied covenant of further exploration, distinguished from the implied development covenant.[123] According to this authority, the implied development covenant "is concerned with additional drilling in a proven field,"[124] and requires the lessor to establish that additional wells would be profitable, while the implied covenant for further exploration "deprives the lessor of the opportunity of having his land tested for new producing horizons."[125] It appears that the Arkansas cases encompass the implied exploration covenant within the development covenant, because the Arkansas Supreme Court has not required a lessor to prove that additional development would be profitable.

The implied covenant to market requires the lessee to market production with due diligence and within a reasonable time.[126] There are no Arkansas cases specifically addressing the breach of this covenant, which is almost always applied to gas, not to oil, because the marketing of gas requires construction of pipelines and because gas cannot be feasibly stored except underground. This covenant has particular significance in Oklahoma, where marketing is not considered part of "production" under the habendum clause and a gas lease may be held under the habendum clause by the mere discovery of gas in

120. Cook v. El Paso Natural Gas Co., 560 F.2d 978, 983 (10th Cir. 1977). *See also* R.R. Bush Oil Co. v. Beverly-Lincoln Land Co., 69 Cal. App. 2d 246, 158 P.2d 754 (1945). *See The Implied Covenant in Oil and Gas Leases to Refrain from Depletory Acts*, 3 UCLA L. REV. 508 (1955-56).

121. Clear Creek Oil & Gas Co. v. Brunk, 160 Ark. 574, 255 S.W. 7 (1923). *See supra* text accompanying notes 12-14.

122. *See supra* text accompanying notes 14-15.

123. 5 H. WILLIAMS & C. MEYERS, *supra* note 9, § 841.

124. *Id.* § 266.1.

125. *Id.* § 266.2.

126. *E.g.*, Gazin v. Pan-American Petroleum Corp., 367 P.2d 1010 (Okla. 1961).

paying quantities.[127] Thus, an Oklahoma gas lease may be held in the secondary term without production if gas has been discovered in paying quantities as long as the implied covenant to market is not breached. This is in contrast to the rule in Texas, where lawsuits on the implied covenant to market are not as frequent as in Oklahoma because gas must be produced, either actually or constructively (as by payment of shut-in royalties), in order to hold the lease in the secondary term under the habendum clause.[128] Thus, Texas and jurisdictions following its rule will not permit a lessee to hold a lease in the secondary term solely by diligent efforts to market within a reasonable time. However, the implied covenant to market has importance in these jurisdictions, and a lessee can breach it by failing to market the gas when a market is available,[129] by failing to negotiate a price in accordance with the prudent operator standard,[130] and by self-dealing.[131]

Another implied covenant, which is really a catch-all, is the covenant "to use reasonable care in operations"[132] or to "conduct operations with reasonable care and due diligence."[133] According to commentators, this covenant should afford the lessor relief for harm caused by negligent operations, from failure to use modern recovery techniques, and from failure to seek administrative action which would be beneficial to the lessor.[134] There are no Arkansas cases expressly applying this covenant, although there is no reason to expect that Arkansas would not recognize such a covenant if it were within the intent of the parties to the lease.

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127. *E.g.*, Bristol v. Colorado Oil & Gas Corp., 225 F.2d 894 (10th Cir. 1955).

128. *E.g.*, Gulf Oil Corp. v. Reid, 161 Tex. 51, 337 S.W.2d 267 (1960).

129. *E.g.*, Carroll Gas & Oil Co. v. Skaggs, 231 Ky. 284, 21 S.W.2d 445 (1929).

130. *See* Miller v. Nordan-Lawton Oil & Gas Corp., 403 F.2d 946 (5th Cir. 1968); Piney Woods Country Life School v. Shell Oil Co., 539 F. Supp. 957 (1982), *aff'd in part, rev'd in part, and remanded,* 726 F.2d 225 (5th Cir. 1984), *cert. denied*, 471 U.S. 1005 (1985) (finding that lessee had met prudent operator standard).

131. *E.g.*, Texas Oil & Gas Corp. v. Hagen, 683 S.W.2d 24 (Tex. Ct. App. 1984).

132. *See* R. HEMINGWAY, *supra* note 10, § 8.9, at 439.

133. 5 H. WILLIAMS & C. MEYERS, *supra* note 9, § 861.

134. *See* R. HEMINGWAY, *supra* note 10, § 8.9, at 439; 5 H. WILLIAMS & C. MEYERS, *supra* note 9, § 861.