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I. INTRODUCTION

The implied covenant of exploration is the most controversial of the covenants that may be read into an oil and gas lease. Courts and commentators disagree not only about the substance of the implied covenant, but also about the existence of the implied covenant of exploration independent from the implied covenant of development.

In 1959, the Texas Supreme Court squarely addressed the issue in *Clifton v. Koontz*.[1] The court held that there was no implied covenant of exploration in Texas as distinguished from the implied covenant of development. This position was recently affirmed by the Texas Supreme Court in *Sun Exploration & Production Co. v. Jackson*.[2]

The Arkansas courts have similarly refused to recognize an implied covenant of exploration independent from the implied covenant of development.[3] The implied covenant of development, however, is so broadly defined in Arkansas that lessors are essentially entitled to the protections of the implied covenant of exploration under the rubric of the implied covenant of development.

This article will first review the rationale for implying covenants in oil and gas leases. Then, the traditional definitions of, and distinctions between, the implied covenant of exploration and the implied covenant of development will be examined. Thereafter, the case law from Texas and Arkansas will be reviewed and the law of the two states compared and contrasted. The remedies available in implied covenant of exploration cases will be discussed, and finally, the effects of certain express lease provisions upon the implied covenant of exploration will be examined.

II. THE FUNDAMENTALS OF IMPLIED COVENANTS

Courts analyze implied covenants within the framework of three fundamental issues. First, the courts determine the rationale for imposing obligations upon a lessee in instances where the lease is silent on the subject. The courts and commentators have proposed several theories both for and against implying covenants in oil and gas leases. As a result, both lessors and lessees involved in implied covenant litigation can cite a variety of theories in favor of their respective positions.

Second, once an implied duty has been imposed on a lessee, the courts will ascertain the test or standard of conduct that will be utilized to determine if the implied duty has been breached by the lessee.[4] The generally accepted standard of conduct is that of a "reasonable prudent operator." The reasonable prudent operator standard, however, is not uniformly defined or applied by the courts.

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1. 160 Tex. 82, 325 S.W.2d 684 (1959).
2. 783 S.W.2d 202 (Tex. 1989).
3. *See, e.g.*, Byrd v. Bradham, 280 Ark. 11, 655 S.W.2d 366 (1983).
4. 5 H. WILLIAMS & C. MEYERS, OIL AND GAS LAW § 802 (1986).

Third, courts and commentators have debated whether implied covenants are "implied in law" or "implied in fact." This issue is relevant in the analysis of a variety of issues, including the analysis of whether an express provision in an oil and gas lease supersedes an implied covenant on the same subject.[5]

A. The Rationale for Imposing Implied Covenants

Courts and commentators generally cite one or more of four rationales for implying covenants in oil and gas leases: (a) the nature of the oil and gas lease due to the inability of lessor and lessee to predict future events; (b) the contractual principle of cooperation; (c) the competing interests of lessor and lessee; and (d) public policy considerations.

1. *The Nature of the Oil and Gas Lease*

Courts have found it necessary to imply covenants into oil and gas leases due to the fundamental uncertainties of the oil and gas business. Lessors and lessees cannot predict whether or not their leases will result in the discovery and production of hydrocarbons, and they cannot predict all of the technological, political, economic, and legal developments that will be applicable to such production in the event it is obtained. Due to this uncertainty, lessees are unwilling to commit in advance to lease provisions that would set forth specific obligations regarding exploration, production, or development, and lessors are wary of leasehold provisions that may unduly limit the lessee's future obligations.[6]

As a result, leases are generally silent regarding many of the fundamental duties of the lessee and rights of the lessor. The doctrine of implied covenants was developed in order to define those rights and duties of the parties that were by necessity left out of the oil and gas lease.

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5. *See infra* text accompanying notes 28-29.

6. There could not well have been an express stipulation as to the number of wells to be drilled, as to when the wells, other than the first, should be drilled, or as to the rate at which the production therefrom should proceed, because these matters would depend in large measure upon future conditions, which could not be anticipated with certainty, such as the extent to which oil and gas, one or both, could be produced from the premises . . . . The subject was, therefore, rationally left to the implication . . . .

Brewster v. Lanyon Zinc Co., 140 F. 801, 810 (8th Cir. 1905). Amoco Production Co. v. Alexander, 622 S.W.2d 563, 567 (Tex. 1981); 5 H. WILLIAMS & C. MEYERS, *supra* note 4, § 802; 1 E. SMITH & J. WEAVER, TEXAS LAW OF OIL AND GAS 241 (1989); Weaver, *Implied Covenants in Oil and Gas Law Under Federal Energy Price Regulation*, 34 VAND. L. REV. 1473, 1485 (1981).

2. *The Principle of Cooperation*

Certain commentators have stated that the law of implied covenants is based upon the principle of cooperation that has been developed in the law of contracts. The principle of cooperation requires the parties to a contract to cooperate for the purpose of carrying out the objects of their agreement. The principle creates implied duties in contracts based upon the reasonable expectations of the parties and in order that the purposes of their contracts may be achieved.[7]

The principle of cooperation is said to be applicable to oil and gas leases due to the fact that oil and gas leases typically cannot set forth all obligations or rights of the lessor and lessee. Cooperation between the parties is necessary to effectuate the unwritten intent of the oil and gas lease, and the principle of cooperation will effectuate this intent by implying conditions and covenants in the lease.[8]

3. *Competing Interests of Lessor and Lessee*

Although the lessor and lessee to an oil and gas lease share a common interest in locating and producing hydrocarbons, conflicts of interest between the lessor and lessee are inevitable because of the cost factors involved in locating and producing hydrocarbons.[9] The potentially greatest consideration that a lessor receives for an oil and gas lease is the right to receive a royalty, which is an expense-free fractional share of oil and gas production. Conversely, the lessee must bear all of the cost of exploring, producing, operating, and developing the leased property. These different interests in the cost factors of the oil and gas lease often result in conflicts over the pace of exploration and development activity.[10]

4. *Public Policy Considerations*

Some commentators have argued that covenants should be implied

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7. 5 H. WILLIAMS & C. MEYERS, *supra* note 4, § 802; Meyers, *The Effect of Express Provision in an Oil and Gas Lease on Implied Obligations*, 14 INST. ON MIN. L. 90 (1967). *But see* Martin, *A Modern Look at Implied Covenants to Explore, Develop, and Market Under Mineral Leases*, 27 INST. ON OIL AND GAS L. AND TAX'N 177, 195 (1976).

8. Meyers, *supra* note 7, at 91; 5 H. WILLIAMS & C. MEYERS, *supra* note 4, § 802; Note, *Texas Oil and Gas Leases Contain Separate and Distinct Implied Covenant to Further Explore After Lucrative Production*, 20 ST. MARY'S L.J. 981, 985 (1989).

9. Weaver, *supra* note 6, at 1486.

10. *Id.* 1 E. SMITH & J. WEAVER, *supra* note 6, at 242; Bullock, *Implied Obligations of Oil and Gas Lessees*, 1969 NAT'L INST. FOR PETROLEUM LANDMEN 127, 128.

in oil and gas leases as a means of advancing certain public policy considerations. For example, Williams and Meyers have argued that the implied covenant of exploration is supported by the "overall public policy of the national government . . . in favor of the development of new domestic reserves of oil and gas, as is reflected in the percentage depletion allowance and the intangible drilling costs deduction."[11] The duty of a lessee to develop the entire leased premises has also been described as an application of the public policy against lessees holding nonproductive portions of productive leases for speculative purposes.[12]

Other commentators have argued that public policy considerations do not support the imposition of implied covenants in oil and gas leases. For example, Professor Martin has argued that certain implied covenants result in the rapid depletion of reserves and the wasteful consumption of hydrocarbons, and defeat the public policy in favor of conservation of natural resources.[13] To this dialogue may be added the observation of the court in *Labbe v. Magnolia Petroleum Co.*: "As parties bind themselves so shall they be bound. One of the basic public policies of this State is the right of parties to contract and to have their contracts enforced by the courts."[14]

B. The Reasonable Prudent Operator Standard

Regardless of the rationale utilized by a court for the implication of covenants in oil and gas leases, the determination of whether the lessee has performed an implied covenant must be measured under a standard of performance. In the overwhelming majority of jurisdictions, the standard of performance for all purposes of an oil and gas lease is the "reasonable prudent operator" standard.[15] Recognition of this standard as the performance standard for all implied covenants has led

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11. 5 H. WILLIAMS & C. MEYERS, *supra* note 4, §§ 847, 802.3. *But see* Williams, *Implied Covenants for Development and Exploration in Oil and Gas Leases—the Determination of Profitability*, 27 U. KAN. L. REV. 443, 453 (1979).

12. 5 E. KUNTZ, A TREATISE ON THE LAW OF OIL AND GAS § 62.1 (1978); Meyers, *supra* note 7, at 117; *see also* Meyers & Crafton, *The Covenant of Further Exploration—Thirty Years Later*, 32 ROCKY MT. MIN. L. INST. 1-1, 1-20 (1986) (arguing that implied covenants are needed to prevent opportunistic behavior by lessees under relational contracts); *see also* Mansfield Gas Co. v. Alexander, 97 Ark. 167, 172, 133 S.W. 837, 839 (1911).

13. Martin, *supra* note 7, at 205-06; Weaver, *supra* note 6, at 1488; 1 E. SMITH & J. WEAVER, *supra* note 6, at 246.

14. 350 S.W.2d 873, 875 (Tex. Civ. App.--San Antonio 1961, writ ref'd n.r.e.).

15. 5 H. WILLIAMS & C. MEYERS, *supra* note 4, §§ 801, 806.3; 1 E. SMITH & J. WEAVER, *supra* note 6, at 244.

some commentators to state that there is actually only one implied covenant: the implied covenant of prudent operation.[16]

The reasonable prudent operator standard was first articulated in *Brewster v. Lanyon Zinc Co.*[17] In *Brewster* the plaintiff was the lessor of an oil and gas lease that provided, among other things, for a five-year primary term. No wells were drilled prior to the fifth year of the primary term. During the fifth year, an assignee of the original lessee drilled a gas well on the lease. No further exploration or development was conducted by the assignee. During the same period, many successful wells were drilled in the near vicinity. Sixteen months after the completion of the well on plaintiff's lease, plaintiff filed suit for cancellation of the lease, alleging failure of development and breach of the duty to protect against drainage.[18]

The court in *Brewster*, applying Kansas law, held that the plaintiff was entitled to terminate the lease due to the assignee's failure to exercise due diligence. In reaching this conclusion, Judge Van Devanter set forth the following standard of performance for a lessee under an oil and gas lease: "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."[19]

An essential element of the reasonable prudent operator standard set forth in *Brewster* is that a lessee must do what is required of a reasonable prudent operator "in the circumstances."[20] As a result, the standard of the reasonable prudent operator varies from situation to situation. For example, in *Brewster*, it was alleged that the lessee had not adequately developed the leasehold or protected it against drainage. In response, Judge Van Devanter stated that an operator need not develop the leasehold or protect it from drainage unless such an operation would result in a profit to both the lessor and the lessee:

> The large expense incident to the work of exploration and development, and the fact that the lessee must bear the loss if the operations are not successful, require that he proceed with due regard to his own interests, as well as those of the lessor. No obligation rests on him to

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16. Martin, *supra* note 7, at 194.

17. 140 F. 801 (8th Cir. 1905); 5 H. WILLIAMS & C. MEYERS, *supra* note 4, § 802.

18. 140 F. 801.

19. Brewster v. Lanyon Zinc Co., 140 F. 801, 814 (8th Cir. 1905). This case has been cited by the Texas Supreme Court in a significant number of landmark decisions in the field of oil and gas jurisprudence, including Clifton v. Koontz, 160 Tex. 82, 92, 325 S.W.2d 684, 695 (1959).

20. Brewster v. Lanyon Zinc Co., 140 F. 801, 814 (8th Cir. 1905).

> carry the operations beyond the point where they will be profitable to him, even if some benefit to the lessor will result from them. It is only to the end that the oil and gas shall be extracted with benefit or profit to both that reasonable diligence is required.[21]

The inclusion of this profit element in the test enunciated in *Brewster* raised a variety of questions. For example, would the courts require a finding of profitability in all implied covenant cases?[22] Also, if profit is an essential element of the reasonable prudent operator standard in certain circumstances, "[t]he question remains how much profit must be in prospect ere the law will compel the operator to act under the implied covenants?"[23]

The courts have answered these queries in a variety of ways. The Texas courts include the element of profitability in the reasonable prudent operator standard in most cases involving implied covenants. For example, in a recent case involving the implied covenant to protect the leasehold,[24] the Texas Supreme Court held as follows: "There is no duty [to protect the leasehold] unless such an amount of oil can be recovered to equal the cost of administrative expenses, drilling or reworking and equipping a protection well, producing and marketing the oil, and yield to the lessee a reasonable expectation of profit."[25]

As will be discussed below, different jurisdictions reach different conclusions in resolving the question of whether or not this element of profitability is included in the reasonable prudent operator standard in cases involving the implied covenant of exploration.[26] Frequently, this issue of profitability becomes the determinative issue in cases involving the implied covenant of exploration.

C. Implied in Law or Implied in Fact

The courts and commentators have also debated whether implied covenants are implied in law or implied in fact.[27] A covenant that is implied in fact gives effect to the presumed intent of the parties as evidenced by the entirety of their contract and the purposes of the

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21. *Id.*
22. M. MERRILL, COVENANTS IMPLIED IN OIL AND GAS LEASES 290 (1940).
23. *Id.*
24. Amoco Prod. Co. v. Alexander, 622 S.W.2d 563 (Tex. 1981).
25. *Id.* at 568.
26. *See infra* text accompanying notes 54-149.
27. *See generally*, 5 H. WILLIAMS & C. MEYERS, *supra* note 4, § 803; 1 E. SMITH & J. WEAVER, *supra* note 6, at 245; R. HEMINGWAY, THE LAW OF OIL AND GAS § 8.1 (1983).

transaction.[28] A covenant that is implied in law is not predicated upon the intent of the parties; rather, it is implied in order to assure fair dealing and to prevent unfairness.[29]

This distinction is relevant to the topic of this article because the determination of whether an implied covenant is implied in law or implied in fact may affect, at least in part, whether an express provision of an oil and gas lease will supersede an implied covenant on the same subject. Under the theory that implied covenants are implied in law, express lease language, while relevant, will not necessarily be determinative in a disagreement over a lessee's implied obligations.[30] Under the theory that implied covenants are implied in fact, express lease provisions are presumed to set forth the intent of the parties and, absent gross overreaching or unconscionability, the express lease provisions generally supersede implied covenants on the same subject.[31]

The Texas courts have generally treated implied covenants as implied in fact,[32] although certain statements to the contrary can be found in the case law.[33] Although the Arkansas courts do not appear to have directly discussed this issue, one commentator has stated that the Arkansas courts generally treat implied covenants as implied in fact.[34]

III. The Implied Covenant of Exploration in General

Not all jurisdictions and commentators recognize an implied covenant of exploration distinct from the implied covenant of development.

A. Classifications of Implied Covenants

Various states and commentators have developed different classifications and listings of implied covenants. For example, Professor Merrill has classified the implied covenants as follows:

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28. 1 E. Smith & J. Weaver, *supra* note 6, at 245; 5 H. Williams & C. Meyers, *supra* note 4, § 803; R. Hemingway, *supra* note 27, § 8.1.

29. 1 E. Smith & J. Weaver, *supra* note 6, at 244; 5 H. Williams & C. Meyers, *supra* note 4, § 803; Martin, *supra* note 7, at 193.

30. 1 E. Smith & J. Weaver, *supra* note 6, at 245.

31. *Id.*; *see infra* text accompanying notes 179-226.

32. *See, e.g.*, Gulf Prod. Co. v. Kishi, 129 Tex. 487, 103 S.W.2d 965 (Tex. Comm'n App. 1937); 1 E. Smith & J. Weaver, *supra* note 6, at 247.

33. *See, e.g.*, W. T. Waggoner Estate v. Sigler Oil Co., 118 Tex. 509, 19 S.W.2d 27 (1929); 1 E. Smith & J. Weaver, *supra* note 6, at 247.

34. Wright, *The Arkansas Law of Oil and Gas*, 10 U. Ark. Little Rock L.J. 699, 705 (1987).

I. The implied covenant to drill an exploratory well.
II. The implied covenant to drill additional wells.
III. The implied covenant for diligent and proper operation of the wells and for marketing the product, if oil or gas is discovered in paying quantities.
IV. The implied covenant to protect the leased premises against drainage by wells on adjoining land.[35]

Williams and Meyers offer a more expansive listing of the implied covenants, expressly including an implied covenant of exploration:

(1) The covenant to drill an initial exploratory well.
(2) The covenant to protect the leasehold from drainage.
(3) The covenant to reasonably develop the premises.
(4) The covenant to explore further.
(5) The covenant to market the product.
(6) The covenant to conduct with reasonable care and due diligence all operations on the leasehold that affect the lessor's royalty interest.[36]

The classification of implied covenants set forth by the Texas Supreme Court does not include an implied covenant of exploration: "There are three generally recognized implied covenants in Texas: (1.) to develop the premises, (2.) to protect the leased premises, and (3.) to manage and administer the lease."[37]

Despite the fact that Texas does not recognize an implied covenant of exploration, some other jurisdictions and commentators recognize the implied covenant of exploration as a separate and distinct covenant from the implied covenant of development. The following is a brief review of the distinctions between the covenants.

B. The "Traditional" Definition of the Implied Covenant of Development

Under the traditional definition of the implied covenant of development, the covenant is the duty implied in an oil and gas lease that obligates the lessee, after obtaining production in paying quantities from a leasehold, to drill additional wells to further develop the prem-

35. M. MERRILL, *supra* note 22, at 23; *see also* 5 H. WILLIAMS & C. MEYERS, *supra* note 4, § 804; R. HEMINGWAY, *supra* note 7, § 8.1; Martin, *supra* note 7, at 179.

36. 5 H. WILLIAMS & C. MEYERS, *supra* note 4, § 804.

37. Sun Exploration & Prod. Co. v. Jackson, 783 S.W.2d 202, 204 (Tex. 1989); *see also* Amoco Prod. Co. v. Alexander, 622 S.W.2d 563 (Tex. 1981); 1 E. SMITH & J. WEAVER, *supra* note 6, at 243.

ises.[38] The lessor has the burden, under the traditional formulation of the covenant, to prove that an additional well "would result in a benefit or profit for both the lessor and the lessee."[39] As a practical matter, this burden of proof requires the lessor to establish that the producing geologic stratum requires additional wells, or that there is a reasonable probability that a different productive stratum exists.[40] This traditional definition of the implied covenant of development is not followed in all states.[41]

C. The "Traditional" Definition of the Implied Covenant of Exploration

The statement of a uniform definition of the implied covenant of exploration is not possible due to the differing treatment afforded the covenant by the various jurisdictions and commentators. Under the traditional definition,[42] however, the implied covenant of exploration would impose upon a lessee, after obtaining production in paying quantities from the leasehold, the obligation to explore undeveloped portions of the leasehold, both vertically and laterally, for new, potentially productive formations.[43] In order to prove breach of the covenant, a lessor would establish such facts as the length of time that has expired without drilling, minimal drilling activity in relation to the size of the tract, and lack of seismic or other exploratory activity.[44] The lessor would not be required to prove that any further drilling would be profitable "because the requirement [of profitability] is not material to ordinary prudent operation in unproven territory."[45]

D. The Theoretical Difference Between the Implied Covenant of Development and the Implied Covenant of Exploration

The leading proponents of the implied covenant of exploration,

38. Pickerill, *Is There A New Implied Covenant of Explorvelopment*, 31 INST. ON OIL AND GAS L. AND TAX'N 245, 247 (1980); Clifton v. Koontz, 160 Tex. 82, 90 325 S.W.2d 684, 693 (1959).

39. Clifton v. Koontz, 160 Tex. 82, 90, 325 S.W.2d 684, 693 (1959); *see also* Sun Exploration & Prod. Co. v. Jackson, 783 S.W.2d 202 (Tex. 1989).

40. Clifton v. Koontz, 160 Tex. 82, 92, 325 S.W.2d 684, 695 (1959).

41. *See, e.g.*, Byrd v. Bradham, 280 Ark. 11, 655 S.W.2d 366 (1983).

42. Meyers, *The Implied Covenant of Further Exploration*, 34 TEX. L. REV. 553 (1955).

43. 1 E. SMITH & J. WEAVER, *supra* note 6, at 259; Martin, *supra* note 7, at 188; 8 H. WILLIAMS & C. MEYERS, OIL AND GAS LAW 385 (1987).

44. Meyers, *supra* note 42, at 563.

45. *Id.*; Martin, *supra* note 7, at 188; 1 E. SMITH & J. WEAVER, *supra* note 6, at 259.

Williams and Meyers, have argued that the implied covenant of exploration should be recognized as a separate and distinct covenant from the implied covenant of development because the two covenants attempt to redress distinct forms of injury to the lessor.[46] In a development case, the lessor seeks more wells in a known producing formation because he suffers from the harm of delayed recovery of, or permanent loss of, recoverable reserves. In an exploration case, the lessor seeks the drilling of exploratory wells in new formations; since the lessor granted the exclusive right of exploration to the lessee, if the lessee will not drill exploratory wells, they will not be drilled.[47]

Williams and Meyers argue that the distinct harms suffered by the lessor in development and exploration cases must be redressed by the adoption of different standards of what a reasonable prudent operator would do in each situation. In a development case, a reasonable prudent operator would not drill into a known producing horizon unless he could be reasonably assured that the development well would be profitable. In an exploration case, however, Williams and Meyers argue that a reasonable prudent operator would not need to be assured that the exploratory well would be profitable.[48] As a result, the burden of proof on a lessor in an exploration case would not be to demonstrate that an exploratory well promises a reasonable expectation of profit to both lessor and lessee, but rather to show that under the circumstances the failure to drill the exploratory well has been unreasonable.[49] Among the circumstances that Williams and Meyers consider relevant to this inquiry are the length of time since the last well was drilled, the number and location of the wells on the leasehold premises in comparison to the size of the tract, and the existence of untested geologic formations that appear favorable to the accumulation of hydrocarbons.[50]

Some states, including Arkansas, appear to have adopted an implied covenant very similar to that proposed by Williams and Meyers, although the covenant is often included within the covenant of development rather than adopted as a separate covenant.[51] In contrast, the Texas Supreme Court has rejected the implied covenant of exploration

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46. Meyers, *supra* note 42, at 555; 5 H. WILLIAMS & C. MEYERS, *supra* note 4, § 841; Meyers & Williams, *The Implied Duty to Explore Further: Recent Texas Developments*, 41 TEX. L. REV. 789 (1962).

47. Meyers, *supra* note 42, at 555.

48. *Id.* at 557; 5 H. WILLIAMS & C. MEYERS, *supra* note 4, at § 841.

49. 5 H. WILLIAMS & C. MEYERS, *supra* note 4, at § 841.

50. *Id.*

51. R. HEMINGWAY, *supra* note 27, § 8.3; Wright, *supra* note 34, at 716.

as formulated by Williams and Meyers.[52] Under Texas law, there is no implied requirement to drill a well where profitability cannot be demonstrated. This requirement of profitability effectively defeats the implied covenant of exploration, whether the covenant is identified by name or included within the rubric of the implied covenant to develop.[53]

IV. THE IMPLIED COVENANT OF EXPLORATION IN TEXAS

The implied covenant of exploration has been discussed in relatively few cases in Texas. In 1956, a Texas appellate court adopted the implied covenant of exploration in *Willingham v. Bryson.*[54] Three years later, the Texas Supreme Court overruled *Willingham v. Bryson* and established the modern Texas rule in *Clifton v. Koontz.*[55] This decision was followed by a succession of cases[56] that did not add much to Texas law, but which provided opportunities for commentators to raise questions about the rule set forth in *Clifton.* During the latter part of 1989, the Texas Supreme Court issued its decision on rehearing in *Sun Exploration & Production Co. v. Jackson,*[57] clarifying Texas law and strongly affirming the rule of *Clifton v. Koontz.*

A. *Clifton v. Koontz*

The Texas Supreme Court set forth the basis for the current Texas law regarding the implied covenant of exploration in *Clifton v. Koontz.*[58] In 1940, the lessor executed an oil and gas lease covering 350 acres of land for a ten year primary term. A marginally profitable oil well was drilled in 1949. No other operations were conducted on the leased premises until 1956 when the well was reworked by "sandfracting." Prior to the reworking of the well, the lessor filed suit seeking

52. *See* Clifton v. Koontz, 160 Tex. 82, 325 S.W.2d 684 (1959) (overruling Willingham v. Bryson, 294 S.W.2d 421 (Tex. Civ. App.--Fort Worth 1956, no writ)); Sun Exploration & Prod. Co. v. Jackson, 783 S.W.2d 202 (Tex. 1989).

53. Meyers, *supra* note 42, at 557.

54. 294 S.W.2d 421 (Tex. Civ. App.--Fort Worth 1956, no writ).

55. 325 S.W.2d 684 (Tex. 1959).

56. *See, e.g.*, Sinclair Oil & Gas Co. v. Masterson, 271 F.2d 310 (5th Cir. 1959), *cert. denied*, 362 U.S. 952 (1960); Felmont Oil Corp. v. Pan Am. Petroleum Corp., 334 S.W.2d 449 (Tex. Civ. App.--El Paso 1960, writ ref'd n.r.e.); Atlantic Richfield Co. v. Gruy, 720 S.W.2d 121 (Tex. Civ. App.--San Antonio 1986, writ ref'd n.r.e.).

57. 783 S.W.2d 202 (Tex. 1989).

58. 160 Tex. 82, 325 S.W.2d 684 (1959); *see also* MEYERS & WILLIAMS, *supra* note 46, at 791 (discussing decisions prior to Clifton v. Koontz).

cancellation of the lease on the theory that the lessee "breached an implied covenant to reasonably develop the property and to 'reasonably explore the same for the production of minerals therefrom.' "[59]

The trial court ordered cancellation of the lease, except as to productive horizons, unless the lessee commenced a test well within sixty days of the judgment. The action of the trial court was consistent with the rule previously set forth in *Willingham v. Bryson.*[60] In *Willingham* the appellate court stated:

> [A] lessee impliedly covenants reasonably to explore a lease after production has been obtained, under penalty of cancellation if he fails so to do; . . . the lessor is not required to prove that the drilling of an additional well would probably result in a profit; and . . . the prudent operator rule was satisfied upon a showing that no well had been drilled . . . since the discovery of gas on . . . [the leasehold], coupled with the testimony of one witness that he would be willing to drill another well.[61]

The court of appeals in *Clifton* reversed the trial court's requirement that the lessee drill another well and rendered judgment for the lessee. The Texas Supreme Court affirmed, overruling *Willingham v. Bryson.*

The Texas Supreme Court stated that the lessor had the burden of proving that the lessee had violated the implied covenant of development. In order to meet this burden, the lessor would have to prove that a reasonable probability exists that a development well drilled to the producing stratum, or to a strata different from the producing stratum, would result in profit to both the lessor and lessee. The court held that the lessor in *Clifton* had failed to meet this burden of proof:

> The petitioners did not discharge the burden which rested upon them to prove, as required, that the lessees failed to measure up to the standard of the prudent operator. While it is true that each separate stratum or horizon would be entitled to separate development, yet it is equally true that the burden rests upon the lessor to prove that the producing stratum required additional wells, or that strata different from that from which production is being obtained, in reasonable probability exist, and that by the drilling of additional wells there would be a reasonable expectation of profit to the lessee. Under such circumstances, the lessee's obligation as to development is measured

59. Clifton v. Koontz, 160 Tex. 82, 86, 325 S.W.2d 684, 687 (1959).
60. 294 S.W.2d 421 (Tex. Civ. App.--Forth Worth 1956, no writ).
61. *Id.* at 425.

> by the rule of reasonable diligence or what an ordinarily prudent and diligent operator would do, and he is not required to continue in the performance of these duties or to engage in the performance of such implied duties unless there is a reasonable expectation of profit, not only to the lessor, but also to the lessee.[62]

The court then specifically rejected the theory that there was an implied covenant of exploration distinct from the implied covenant of development: "We hold that there is no implied covenant to explore as distinguished from the implied covenant to conduct additional development after production in paying quantities has been obtained."[63] The principal basis for rejecting the implied covenant of exploration was that "[t]his theory is untenable and is diametrically opposed to our established 'prudent operator' rule where expectation of profit is an essential element."[64]

Despite the holding of the court, the opinion in *Clifton* seemingly left open an exception to the general rule:

> However, it should be noted that we do not have a factual situation where the lease covers several thousand acres and an effort is being made to hold such vast acreage by showing production from a comparatively small area. Neither are we confronted with a situation where an unreasonably long length of time has elapsed since the last development of the leased premises. Therefore, we do not pass upon these questions.[65]

The opinion of the Texas Supreme Court has provided arguments to both opponents and proponents of the implied covenant of exploration. Opponents of the covenant argued that the court had effectively eradicated the implied covenant of exploration in two ways. First, the court had expressly denounced the covenant of exploration as a distinct covenant from the implied covenant of development. Second, by means of the requirement that a lessor show a reasonable expectation of profit to both lessor and lessee from any additional well, the court had prevented the covenant of exploration from expanding the implied covenant of development.

Proponents of the implied covenant of exploration cited the "exception" set forth by the court for large tracts of land as support for

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62. Clifton v. Koontz, 325 S.W.2d 684, 695 (Tex. 1959).
63. *Id.* at 696; *see* 1 E. SMITH & J. WEAVER, *supra* note 6, at 260.
64. Clifton v. Koontz, 325 S.W.2d 684, 697 (Tex. 1959).
65. *Id.* at 696.

their argument that the implied covenant of exploration remained viable in Texas under certain factual circumstances. Also, the proponents stated that the burden of proof regarding the profitability of an exploratory well was not necessarily an impossible burden to meet if courts interpreted the phrase "reasonable expectation of profit" in light of the realities of an exploratory operation.[66]

B. *Sinclair Oil & Gas Co. v. Masterson*

The Court of Appeals of the Fifth Circuit rendered its opinion in *Sinclair Oil & Gas Co. v. Masterson*[67] soon after the Texas Supreme Court's decision in *Clifton v. Koontz*. The lessors in *Masterson*, between 1916 and 1938, had executed thirty-one separate oil and gas leases covering their 90,000 acre ranch. By mesne conveyances, the gas rights were owned by Colorado Interstate Gas Company and the oil rights were owned by Sinclair. Colorado and its predecessors in title had fully explored and developed the leased premises for gas by 1955, but Sinclair had not drilled any oil wells.

The lessors filed suit against Sinclair "to enforce the implied covenant or covenants, alleged to exist in and as a part of each of such leases, for adequate exploration and development of the lands covered by such leases insofar as oil is concerned."[68] The trial court granted a form of conditional cancellation of the leases, and Sinclair appealed.

The Fifth Circuit distinguished the facts of *Clifton v. Koontz* from the facts in *Masterson*. Based upon the "exception" for large tracts of land set forth in the Texas Supreme Court's decision in *Clifton*,[69] the Fifth Circuit affirmed the judgment of the trial court without requiring proof that any drilling by the lessee would result in a profit to both lessor and lessee.[70]

A subsequent Texas Court of Appeals decision refused to follow *Masterson*, stating: "We do not think this case has distinguished the facts of the [*Clifton*] case, nor do we believe it follows it."[71] In a subsequent decision, the Fifth Circuit acknowledged that its decision in

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66. 5 H. WILLIAMS & C. MEYERS, *supra* note 4, § 845.6.

67. 271 F.2d 310 (5th Cir. 1959), *cert. denied*, 362 U.S. 952 (1960).

68. *Id.* at 313.

69. *See supra* text accompanying notes 62-64.

70. 1 E. SMITH & J. WEAVER, *supra* note 6, at 264.

71. Felmont Oil Corp. v. Pan Am. Petroleum Corp., 334 S.W.2d 449, 458 (Tex. Civ. App.--El Paso 1960, writ ref'd n.r.e.); *see also* Atlantic Richfield Co. v. Gruy, 720 S.W.2d 121, 124 (Tex. Civ. App.--San Antonio 1986, writ ref'd n.r.e.).

Masterson had been repudiated by the Texas courts.[72] Thus, the decision of the Fifth Circuit in *Masterson* should not be considered as an authoritative statement of Texas law.

C. *Felmont Oil Corp. v. Pan American Petroleum Corp.*

In *Felmont Oil Corp. v. Pan American Petroleum Corp.*[73] the lessors sued for partial cancellation of two leases covering an aggregate of 31,260 acres of land "based on the alleged ground that the defendant-lessees and their predecessors in title had breached the implied covenant in the leases to explore . . . ."[74] After a trial to a jury, a take-nothing judgment was rendered on the verdict in favor of the lessees. The court of civil appeals affirmed, stating, "We hold here, as was held by the Supreme Court in the [*Clifton*] case, that there is no implied covenant to explore, as distinguished from the implied covenant to conduct additional development after production in paying quantities has been obtained."[75]

The court of civil appeals recognized that it was faced with a situation similar to that suggested by the Texas Supreme Court in the *Clifton* "exception,"[76] but held that the "exception" was inapplicable. In reaching this conclusion, the court reaffirmed the principle that the implied covenant of development applies to the lease in its entirety and not to any particular portion of the lease. *Felmont* was cited and followed by the Texas Supreme Court in both of its decisions in *Sun Exploration & Production Co. v. Jackson.*[77]

D. *Atlantic Richfield Co. v. Gruy*

In *Atlantic Richfield Co. v. Gruy*[78] the lessors executed two leases in 1944. Through mesne conveyances and releases, the Atlantic Richfield Company (ARCO) had become the lessee of 1,888 acres as to all depths below 3,750 feet. The leases were held by production in paying quantities from shallow zones above 3,750 feet, but no wells had been drilled to the deeper zones prior to the date of the lawsuit. The lessors

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72. Weymouth v. Colorado Interstate Gas Co., 367 F.2d 84 (5th Cir. 1966).
73. 334 S.W.2d 449 (Tex. Civ. App.--El Paso 1960, writ ref'd n.r.e.).
74. *Id.* at 451.
75. *Id.* at 457 (citations omitted).
76. *Id.* at 456; *see supra* text accompanying note 65.
77. 31 Tex. Sup. Ct. J. 604 (July 13, 1988); 783 S.W.2d 202 (Tex. 1989).
78. 720 S.W.2d 121 (Tex. Civ. App.--San Antonio 1986, writ ref'd n.r.e.).

sued to cancel the leases as to depths below 3,750 feet.[79]

The trial to a jury found that ARCO had failed to develop the leased premises as a reasonable prudent operator would have under similar circumstances. The lessors, however, had failed to introduce any evidence that development below 3,750 feet would lead to any discovery of hydrocarbons. The only evidence introduced to indicate a lack of due diligence by ARCO was that no wells had been drilled in over twenty-six years.[80]

The court of civil appeals reversed on the basis that there was no evidence to support the findings of the jury. According to the court, "the unrefutable fact remains that a 'prudent operator' would not drill absent some evidence the drilling would be profitable."[81]

E. *Sun Exploration & Production Co. v. Jackson*

Sun Exploration & Production Co. v. Jackson[82] is the most recent statement by the Texas Supreme Court regarding the implied covenant of exploration.

1. *Facts*

In March of 1938, Ocie R. Jackson and other interested members of the Jackson family executed an oil, gas, and mineral lease to Sun covering 10,000 acres of the Jackson Brothers Ranch. A portion of the working interest was subsequently conveyed to Amoco Production Company. In 1941, Sun discovered on the leased premises a reservoir commonly known as the Oyster Bayou Field. Subsequently, Sun drilled sixty-four additional wells on the leased premises.[83] At the time of trial, thirty-seven wells were producing hydrocarbons, all from the Seabreeze Sands in the Oyster Bayou Field.[84] The Oyster Bayou Field comprised about 1,800 acres of the 10,000-acre leased premises.[85]

Sun had conducted thirteen seismic surveys on the leased premises prior to 1979. In 1979, Sun attempted to conduct another seismic survey of the premises, but the Jacksons refused to negotiate a seismic

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79. *Id.* at 122.
80. *Id.* at 123.
81. *Id.* at 124.
82. 783 S.W.2d 202 (Tex. 1989).
83. Sun Exploration & Prod. Co. v. Jackson, 715 S.W.2d 199, 201 (Tex. Civ. App.--Houston [1st Dist.] 1986).
84. *Id.*
85. Sun Exploration & Prod. Co. v. Jackson, 31 Tex. Sup. Ct. J. 604, 605 (July 13, 1988).

agreement and denied Sun access to the leased premises.[86] Sun and Amoco sued the Jacksons to establish the validity of the lease and to enjoin the Jacksons from interfering with their right to enter the leased premises. The Jacksons counterclaimed, alleging breach of implied covenants to reasonably develop and explore the entire lease, and seeking cancellation of the lease.[87]

2. *The Decision of the Trial Court*

The suit was tried on its merits in 1984. The two issues submitted to the jury, and the jury's responses thereto, were as follows:

> Special Issue No. 1: Do you find from a preponderance of the evidence that Sun has failed to reasonably develop the Jackson Lease?
>
> Answer: 'Sun has failed' or 'Sun has not failed' in the space provided.
>
> Answer: Sun has not failed.
>
> In answering Special Issue No. 1, you are instructed that the term 'to reasonably develop' means the development which a prudent operator would do with respect to any known producing formation of the lease. In this context, reasonable development may include the drilling of additional wells into any such producing formation. A prudent operator will undertake to drill additional wells into such producing formation only if there is a reasonable expectation that the proceeds, if any, from the production obtained, if any, as a result of such drilling will exceed the cost of drilling and operating the well and still produce a reasonable profit for the operators, bearing in mind the interests of both the Lessors and Lessee.
>
> Special Issue No. 2: Do you find from a preponderance of the evidence that Sun has failed to reasonably explore the portions of the Jackson Lease which lie outside the Oyster Bayou Field:
>
> Answer: 'Sun has failed' or 'Sun has not failed.'
>
> Answer: Sun has failed.
>
> In answering Special Issue No. 2, you are instructed that Sun must conduct itself as a reasonable and prudent operator would while exercising due diligence under the same or similar circumstances, with a reasonable expectation of profit, considering the interests of both the

86. *Id.*
87. *Id.*

Lessors and the Lessee.[88]

Based upon the responses of the jury to the Special Issues, the trial court rendered judgment for the Jacksons. The trial court unconditionally cancelled portions of the lease on which Sun had not drilled extensively. The court also conditionally cancelled other portions of the lease below the depth to which Sun had drilled in the Oyster Bayou Field, subject to the right of Sun and Amoco "to earn back such portions by drilling additional wells."[89]

3. *The Decision of the Court of Appeals*

The court of appeals affirmed the trial court's unconditional cancellation and reversed and remanded as to the conditional cancellation.[90] In reaching this decision, the court of appeals classified oil and gas wells in three categories: wildcat wells, exploratory development wells, and additional development wells.[91]

"Wildcat wells" were defined by the court as being wells drilled into unproven sand in a new field.[92] "Exploratory development wells" were defined as wells drilled into an unproven but potentially productive formation.[93] "Additional development wells" were defined as wells that tap into an already producing formation.[94] The court of appeals stated that the decision to drill wildcat wells was not necessarily based on a "prudent operator's reasonable expectation of profit."[95] Conversely, exploratory development wells and additional development wells would necessarily be drilled based upon a reasonable expectation of profit to the lessor and the lessee.[96]

The court of appeals reviewed the findings of the jury in light of these three categories of wells. The court interpreted the word "develop" in Special Issue No. 1 as referring to the drilling of additional wells to the one "known producing" formation in the Oyster Bayou Field. The word "explore" in Special Issue No. 2 was interpreted as

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88. *Id.* at 608.
89. Sun Exploration & Prod. Co. v. Jackson, 715 S.W.2d 199, 200 (Tex. Civ. App.--Houston [1st Dist.] 1986).
90. *Id.*
91. *Id.* at 202.
92. *Id.*
93. *Id.*
94. *Id.*
95. *Id.*
96. *Id.* at 202.

referring to the drilling of additional wells to test potentially producing formations outside of the Oyster Bayou Field. Based on this distinction, the court reasoned that a jury finding that Sun had failed to "explore" by drilling wildcat wells would have violated the rule of *Clifton v. Koontz*, because such a finding could not have been based upon a reasonable expectation of profit to the lessor and lessee. A jury finding that Sun had failed to "explore" by drilling exploratory development wells, however, could be supported under the rule of *Clifton v. Koontz*.[97]

The court of appeals concluded that the jury's finding, that Sun had failed to reasonably explore the portions of the Jackson lease which lie outside the Oyster Bayou Field, was a finding that Sun had failed to drill exploratory development wells rather than wildcat wells.[98] As a result, the court affirmed the unconditional cancellation of undeveloped portions of the lease. The court reversed and remanded, however, the conditional cancellation of depths below the Oyster Bayou Field on the grounds that the conditions imposed on Sun and Amoco by the trial court were unreasonable.

4. *The Original Opinion of the Texas Supreme Court*

The Texas Supreme Court has rendered two opinions in this case; the first opinion was withdrawn and the opinion on the motion for rehearing was substituted in its place. The content of the court's first opinion, which was joined by only three justices, and the concurring opinions, are worthy of note.[99]

The Texas Supreme Court dismissed the court of appeals' categorization of types of wells as being "unimportant."[100] The court in *Clifton* had intended the implied covenant of development to apply to "the drilling of all additional wells after production on the lease is obtained."[101] Thus, categorization of wells was unnecessary; the critical inquiry as to all additional wells was "whether the lessor could prove a

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97. *Id.*

98. *Id.* at 203.

99. The authors of two of the concurring opinions expressed the view ultimately adopted by the court on rehearing that Clifton v. Koontz, 160 Tex. 82, 325 S.W.2d 684 (1959), controlled and that the jury finding in Special Issue No. 1 was dispositive of the case. Sun Exploration & Prod. Co. v. Jackson, 31 Tex. Sup. Ct. J. 604 (July 13, 1988) (Wallace, J., concurring, and Kilgarlin, J., concurring).

100. Sun Exploration & Prod. Co. v. Jackson, 31 Tex. Sup. Ct. J. 604, 609 (July 13, 1988).

101. *Id.*

reasonable expectation of profit to lessor and lessee."[102]

The court then departed from the holding of *Clifton* and divided exploration and development activities into two separate covenants. The court, however, stated that this distinction was for definitional purposes only:

> In the case at hand, we have confusion of labels rather than confusion of substance. We could retain the single label of "the covenant of reasonable development," however, it is a more descriptive and technically differentiating view to distinguish between development and exploration activities. By recognizing the difference in the activities, the allegations in the pleadings, the proof presented, and the issues to be tried will be clearer to all parties, and the trial will be conducted more efficiently. All the activities taking place within a known or producing formation come under the implied covenant of reasonable development. All those activities outside a known producing formation come under the implied covenant of further exploration.[103]

Although the exploration and development activities that were previously included under the implied covenant of development were now "technically redefined" as the bases for separate covenants, the court stated that the substance of *Clifton* remained the same.[104] Under both the implied covenant of exploration and the implied covenant of development, "[i]n order for the court to impose an obligation on the lessee, the activity must hold a reasonable expectation of profit to the lessor and lessee."[105]

The court then turned to the question: "What do we mean by reasonable expectation of profitability in the exploratory context?"[106] The Jacksons had presented evidence at trial based upon the "expected value" test of profitability. According to the court, this test would "compare the estimated costs of drilling a given well against the possible income from the well and the probability that the income will actually be realized."[107] Under this test, a low probability of success for a given well could be outweighed by the possibility of large profits.[108]

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102. *Id.*
103. *Id.* at 610.
104. *Id.*
105. *Id.*
106. *Id.*
107. *Id.* at 611.
108. *Id.*; *see* Williams, *supra* note 11; Allison, *Explorvelopment: A Theoretical Hybrid Searching for Fertile Legal Soil In An Unfertile Economy*, 39 INST. ON OIL AND GAS L. AND TAX'N. 9-1, 9-11 (1988); 1 E. SMITH & J. WEAVER, *supra* note 6, at 261.

The court rejected the "expected value" test in favor of a more traditional test that focuses upon the probability of discovering hydrocarbons from any given well. The court recognized that this test imposed a difficult burden on a lessor in an exploration case, but indicated that the future development of oil and gas technology would perhaps lessen the burden.[109] Based upon the foregoing standard of profitability, the court concluded that the Jacksons had not proven a reasonable expectation of profit.

The Jacksons argued that it would not be necessary to show a reasonable expectation of profit under the exception for large tracts of land set forth in *Clifton v. Koontz*; that is, no reasonable expectation of profit is necessary "where the lease covers several thousand acres and an effort is being made to hold such vast acreage by showing production from a comparatively small area."[110] The Texas Supreme Court stated, "while this exception language may hold true under the appropriate circumstances, the circumstances at hand do not warrant an exception to the rule."[111] In reaching this conclusion, the supreme court cited evidence presented at trial that more than $24,800,000 had been spent on the Jackson lease, that approximately sixty-six wells had been drilled on the lease, including at least sixteen wells outside of the Oyster Bayou Field, and that royalties on production at times exceeded $10,000 per day. These facts, according to the court, "are not the facts that would support an exception to the rule that the lessor prove a reasonable expectation of profit to both the lessor and lessee."[112]

Accordingly, the supreme court reversed the judgment of the court of appeals and declared the lease to be valid.

5. *The Opinion of the Texas Supreme Court on Motion for Rehearing*

On motion for rehearing, the court rendered a terse opinion that it substituted for the previous opinion. The court's opinion on the motion for rehearing affirmed the rule of *Clifton v. Koontz*.[113]

The court reaffirmed the holding of *Clifton* that no implied covenant of exploration exists independent of the implied covenant of development. The single covenant applies to the drilling of all additional

109. Sun Exploration & Prod. Co. v. Jackson, 31 Tex. Sup. Ct. J. 604, 611 (July 13, 1988).
110. *Id.* at 612 (citing Clifton v. Koontz, 160 Tex. 82, 325 S.W.2d 684, 696 (1959)).
111. Sun Exploration & Prod. Co. v. Jackson, 31 Tex. Sup. Ct. J. 604, 612 (July 13, 1988).
112. *Id.*
113. 160 Tex. 82, 325 S.W.2d 684 (1959).

wells after production on the lease is obtained. The court restated the *Clifton* definition of "additional wells" as "both additional wells in an already producing formation or stratum, or additional wells in 'strata different from that from which production is being obtained.' "[114] The critical question, according to the court, continues to be "whether the lessor could prove a reasonable expectation of profit to lessor and lessee."[115]

The court then analyzed the jury's findings in light of the foregoing statement of Texas law. In answer to Special Issue No. 1, the jury found that Sun had not failed to "reasonably develop the Jackson Lease."[116] The supreme court held that this finding was dispositive of the case:

> The law of Texas does not impose a separate implied duty upon a lessee to further explore the leasehold premises; the law recognizes only an implied obligation to reasonably develop the leasehold. Because the jury determined that Sun has not failed to reasonably develop the Jackson lease, the court of appeals should have rendered judgment for Sun. In failing to do this, the court erred.[117]

The court stated that the court of appeals misinterpreted Special Issue No. 1. The court of appeals had interpreted the issue and the instructions that accompanied it as limiting the jury's review of the issue of reasonable development to the drilling of additional development wells within the Oyster Bayou Field. That is, the court of appeals had interpreted the phrase "known producing formation of the lease" as limiting the issue of reasonable development to "formations which are *currently* producing hydrocarbons on the Jackson lease."[118]

The correct view, according to the Texas Supreme Court, was that the reference in Special Issue No. 1 to a "known producing formation of the lease" referred to "any formation on the lease that is currently producing or that has been determined to be productive of hydrocarbons but is not producing now."[119] In addition, the court stated that the instruction accompanying Special Issue No. 1 allowed the jury to consider reservoirs other than the Oyster Bayou Field in its analysis of the

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114. Sun Exploration & Prod. Co. v. Jackson, 783 S.W.2d 202, 204 (Tex. 1989).
115. *Id.*
116. Sun Exploration & Prod. Co. v. Jackson, 31 Tex. Sup. Ct. J. 604, 608 (July 13, 1988).
117. Sun Exploration & Prod. Co. v. Jackson, 783 S.W.2d 202, 204 (Tex. 1989).
118. *Id.* at 205 (emphasis in original).
119. *Id.*

development issue.[120] As a result, according to the supreme court, the jury deliberations regarding Special Issue No. 1 encompassed all elements of the Texas implied covenant of reasonable development, and therefore the jury's finding on the issue was dispositive of the case.

The Texas Supreme Court reversed the judgment of the court of appeals, and held that the Jackson lease was still valid.

6. *The Current Status of Texas Law*

The Texas Supreme Court denied a motion for a rehearing of its decision in *Sun Exploration & Production Co. v. Jackson* on February 21, 1990.[121] As a result, the current status of Texas law remains as it has been for many years:

(i) No implied covenant of exploration exists independent of the implied covenant of reasonable development.

(ii) In order to prove that the lessee has violated the implied covenant of reasonable development, the lessor has the burden of proving that the lessee failed to act as a reasonable prudent operator in the circumstances. That is, in cases involving the implied covenant of development, the lessor must prove that a reasonable prudent operator would drill an additional well or wells on the leased premises.

(iii) In order to prove that the lessee failed to act as a reasonable prudent operator by failing to drill an additional well, the lessor has the burden of establishing that the well would be profitable to the lessee. This profitability element in the reasonable prudent operator standard is applicable to the drilling of all additional wells after production on the lease is obtained.

V. THE IMPLIED COVENANT OF EXPLORATION IN ARKANSAS

The Arkansas courts have not recognized an implied covenant of exploration by name.[122] The implied covenant of development, however, is defined and applied so broadly in Arkansas that it has become, in effect if not in name, very similar to the traditional definition[123] of the implied covenant of exploration.

The principal reason for the broad scope and application of Arkan-

120. *Id.*
121. *Id.* at 202.
122. Wright, *supra* note 34, at 716.
123. *See supra* text accompanying notes 38-41.

sas' implied covenant of development is the particular reasonable prudent operator standard utilized by Arkansas courts in development cases. Under the Arkansas standard, a lessee is not permitted to hold undeveloped portions of a lease indefinitely, even in the absence of proof that additional wells are likely to be profitable.[124] Failure to continue the search for oil and gas with reasonable diligence throughout the entirety of a lease will constitute a breach of the implied covenant of development.[125] As a result, the Arkansas law is much harsher on the lessee than the law of Texas.

The Arkansas Supreme Court cases *Skelly Oil Co. v. Scoggins*[126] and *Byrd v. Bradham*[127] demonstrate the scope of Arkansas' implied covenant of development.

A. *Skelly Oil Co. v. Scoggins*

In *Skelly Oil Co. v. Scoggins*,[128] an oil and gas lease was executed in 1943 covering 360 acres of land. Skelly, as successor to the original lessee, drilled five wells between 1945 and 1953. One well was a dry hole, and Skelly subsequently released the forty acre tract where the dry hole had been drilled. The other four wells were producing from a single forty acre tract. Skelly refused to drill a well on the remaining 280 acres, and the lessors sued to cancel the lease as to said 280 acres.

In holding that the lessors were entitled to cancellation as to the 280 acres, the Arkansas Supreme Court stated the Arkansas rule 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 a 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.[129]

Skelly contended that additional wells could not be drilled and operated except at a great loss. The court replied: "This contention may be disposed of by saying that, if true, the lessees have not been dam-

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124. Wright, *supra* note 34, at 716.

125. *See, e.g.*, Ezzell v. Oil Assocs., Inc., 180 Ark. 802, 810, 22 S.W.2d 1015, 1018 (1930).

126. 231 Ark. 357, 329 S.W.2d 424 (1959).

127. 280 Ark. 11, 655 S.W.2d 366 (1983).

128. 231 Ark. 357, 329 S.W.2d 424 (1959).

129. *Id.* at 358, 329 S.W.2d at 425 (quoting Ezzell v. Oil Assocs., Inc., 180 Ark. 802, 22 S.W.2d 1015 (1930)).

aged by the cancellation of so much of the contract of lease as cannot be profitably performed."[130] Based on this much-quoted statement, the reasonable prudent operator standard in Arkansas development cases does not include an element of profitability.

The holding in *Skelly* appears to be based on the United States Supreme Court decision in *Sauder v. Mid-Continent Petroleum Corp.*[131] and the public policy disfavoring lessees holding undeveloped acreage out of commerce:

> 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 arrangements for availing himself of the mineral contents of the land.[132]

B. *Byrd v. Bradham*

In *Byrd v. Bradham*,[133] an oil and gas lease covering eighty acres of land was executed in 1952, for a primary term of ten years. In 1958, the lessee pooled five acres of the lease with other lands and drilled a producing well on the pooled unit. The lessor sued to cancel the lease as to acreage outside of the pooled unit.

In holding that the lessor was entitled to a cancellation as to the unproductive seventy-five acres, the Arkansas Supreme Court provided the following summary of the Arkansas law regarding the implied covenant of development:

> In oil and gas leases where royalties constitute the chief consideration, an implied covenant exists that the lessee will explore and develop the property with reasonable diligence. The duty to explore extends to the entire tract, and this is especially true where paying quantities of oil have been found on a part of the tract.
>
> Of course, due deference must be given to the judgment of the lessee in determining whether to drill, but the lessee must not act arbitrarily. Furthermore, the lessee must act not only for his own benefit but also for the benefit of the lessor. The lessee's obligation to explore is a continuing one, even after paying quantities of oil are discovered,

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130. *Id.* at 359, 329 S.W.2d at 426 (quoting Smith v. Moody, 192 Ark. 704, 707, 94 S.W.2d 357, 354 (1936)).

131. 292 U.S. 272 (1934).

132. Skelly Oil Co. v. Scoggins, 231 Ark. 357, 359, 329 S.W.2d 424, 426 (1959) (quoting Sauder v. Mid-Continent Petroleum Corp., 292 U.S. 272 (1934)).

133. 280 Ark. 11, 655 S.W.2d 366 (1983).

> in order to effect the purpose of the lease. Production on only a small portion of the leased land does not justify allowing lessees to hold the entire leasehold indefinitely, thus depriving the lessor of receiving royalties from another arrangement.[134]

The lessee argued that she was under no obligation to develop the leasehold because any additional well would be a "wildcat" well. The court dismissed this argument, stating that if there was nothing for the lessee to gain by drilling the wildcat well, then the lessee has lost nothing as a result of the cancellation of the lease.[135]

C. The Current Status of Arkansas Law

The current status of Arkansas law regarding the lessee's obligation to explore the leased premises can be summarized as follows:

(a) No implied covenant of exploration exists independent of the implied covenant of development. The implied covenant of development, however, is defined broadly enough to encompass the traditional definition of the implied covenant of exploration.

(b) A lessee has an implied duty to explore and develop the entire leased premises with reasonable diligence. Production from only a small portion of the leased premises does not justify allowing a lessee to hold the entire leasehold indefinitely.

(c) In order to prove that the lessee has violated the implied covenant of development, the lessor has the burden of proving that the lessee failed to act as a reasonable prudent operator in the circumstances. In order to meet this burden of proof, the lessor need not prove that there is a reasonable expectation of profit from the drilling of any additional well. Instead, the lessor must demonstrate that, given the circumstances, the lessee has acted in an unreasonable manner in failing to drill additional wells. Circumstances that the courts have considered in making this determination include the following:

(i) Inactivity by the lessee for an unreasonable length of time;[136]

(ii) Requests by lessors for further exploration or development of the leased premises, and refusal by the lessee;[137]

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134. *Id.* at 13-14, 655 S.W.2d at 367 (citations omitted).

135. *Id.*

136. *See, e.g.*, Byrd v. Bradham, 280 Ark. 11, 655 S.W.2d 366 (1983) (inactivity by lessee as to 75 acres for 28 years); Enstar Corp. v. Crystal Oil Co., 294 Ark. 77, 740 S.W.2d 630 (1987) (inactivity for 24 years).

137. *See, e.g.*, Skelly Oil Co. v. Scoggins, 231 Ark. 357, 360, 329 S.W.2d 424, 426 (1959) (The evidence showed "that over a long period of time the lessors attempted to get Skelly to drill

(iii) Evidence of lack of intent by the lessee to further explore or develop the leased premises;[138]

(iv) An unreasonably large amount of acreage held by production by too few wells or by wells located on only a small portion of the leased premises;[139] and

(v) Interest of other operators in exploring the leased premises.[140]

VI. COMPARISON OF TEXAS AND ARKANSAS LAW

Neither Texas nor Arkansas recognizes an implied covenant of exploration independent from the implied covenant of development. In Texas, the scope of the implied covenant of development is relatively narrow. Conversely, in Arkansas, the implied covenant of development is relatively broad. As a result, Arkansas lessors can pursue exploration cases under the guise of the implied covenant of development.

The distinction between the implied covenants of development as implemented in Texas and Arkansas lies in the difference between the reasonable prudent operator standards utilized by the courts. In Texas, a reasonable prudent operator would not drill an additional well unless there was a reasonable probability that the drilling of the additional well would result in a profit to both lessor and lessee. This is consistent with the seminal case, *Brewster v. Lanyon Zinc Co.*[141] Arkansas has drifted away from this concept. In Arkansas, a reasonable prudent operator would presumably continue to explore and develop the leased premises without regard to whether any additional well would result in a reasonable expectation of profit.

The Texas rule has been criticized as imposing a standard of conduct for a reasonable prudent operator that is inappropriate in the exploration context.[142] Since exploratory operations by their nature con-

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on the property in question and the lessors did nothing to waive their rights in that respect.").

138. *See, e.g.*, Skelly Oil Co. v. Scoggins, 231 Ark. 357, 360, 329 S.W.2d 424, 426 (1959) ("Up to the time of the filing of this suit in January, 1956, 13 years after obtaining the lease, Skelly had evinced no intention of drilling on the 280 acres.").

139. *See, e.g.*, Byrd v. Bradham, 280 Ark. 11, 655 S.W.2d 366 (1983) (one well on 80 acres); Ezzell v. Oil Assocs., Inc., 180 Ark. 802, 22 S.W.2d 1015 (1930) (one well on 1,170 acres).

140. *See, e.g.*, Skelly Oil Co. v. Scoggins, 231 Ark. 357, 329 S.W.2d 424 (1959); Byrd v. Bradham, 280 Ark. 11, 655 S.W.2d 366 (1983).

141. 140 F. 801 (8th Cir. 1905).

142. Note, *The Implied Covenant for Further Exploration - Does It Exist in Oklahoma?*, 36 OKLA. L. REV. 164, 167 (1983); The policy considerations cited by the proponents of the implied covenant of exploration, such as Williams and Meyers, also argue against the Texas rule. *See, e.g.*, Meyers, *supra* note 42; 5 H. WILLIAMS & C. MEYERS, *supra* note 4, § 841.

template drilling into unproven formations, a requirement that a lessor must establish the potential profitability of the additional well may in effect impose an impossible burden of proof.[143] Thus, it has been asserted that the Texas rule allows mineral interests to remain burdened by "leases that have lost their vitality."[144] These criticisms lose sight of two facts. First, in Texas an oil and gas lease is not a lease, it is the conveyance of a fee simple determinable estate.[145] The lessee owns the minerals in place. Second, the Texas law in this area has been well defined for many years. There is nothing to prevent a lessor from writing into his contract an obligation to drill additional wells or release portions of the lease.

The Arkansas rule has been criticized on the basis that the purposes and intent of the contracting parties in an oil and gas lease have been defeated if the lessor does not have the burden of showing that additional drilling would be profitable to the lessee.[146] The Arkansas courts have rejected this criticism, reasoning that a lessee that has held a large undeveloped tract of land for a lengthy period of time by virtue of production from a small portion of the tract is not harmed by cancellation of the undeveloped portions of the lease because the lessee was apparently not going to drill anyway.[147] This argument seems to assume that the right to delay exploration of the undeveloped portions of a leasehold is worth nothing to a lessee, a premise that is not compatible with economic reality and ignores the fact that the lessor and lessee may have included this speculative value in the negotiation of their oil

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143. The Texas Supreme Court acknowledged the difficulty of meeting this burden of proof in its first opinion in Sun Exploration & Prod. Co. v. Jackson, 31 Tex. Sup. Ct. J. 604, 610 (July 13, 1988) ("Practically speaking, it will be more difficult to prove a breach of the covenant of further exploration than breach of the covenant of reasonable development.").

144. Allison, *supra* note 108, at 9-5.

145. The term 'lease' when used in an oil and gas context, is a misnomer. The estate created by the oil and gas lease is not the same as those interests created under a 'lease' governed by the law of landlord and tenant. The common oil and gas lease creates a determinable fee. It vests the lessee with title to oil and gas in place.

Cherokee Water Co. v. Forderhause, 641 S.W.2d 522, 525 (Tex. 1982).

146. Allison, *supra* note 108, at 9-8; Note, *supra* note 142, at 168, 175; *see* Mitchell v. Amerada Hess Corp., 638 P.2d 441, 448 (Okla. 1981)

Failure to recognize the profit motive as an instrumental force in oil and gas leases on behalf of lessee and lessor is to ignore the very essence of the contract. It is unquestionable that both the lessee and lessor intended to benefit monetarily from the produce of the land through sale of its hydrocarbons.

Id.

147. Skelly Oil Co. v. Scoggins, 231 Ark. 357, 329 S.W.2d 424, 426 (1959); Byrd v. Bradham, 280 Ark. 11, 14, 655 S.W.2d 366, 367 (1983).

and gas lease.[148]

The Arkansas rule is further subject to the criticisms that have been levied against the traditional formulation of the implied covenant of exploration. Commentators have criticized the covenant as requiring lessees to become unwilling wildcatters, forced to continually drill in order to retain leasehold acreage.[149] The covenant is also criticized as sacrificing long term economic interests in national energy development and environmental protection in favor of the short term interests of individual lessors.[150] As stated by Professor Martin:

> The law of implied covenants, even after the institution of a regime of conservation, has required operators to maximize short-term profitability rather than seek long-term maximization (which may be regarded as long-term profitability or as institutional survival). If the operator has the possibility of making a profit now by drilling, he must, even though it might make more for both the lessor and itself over the long term by delaying development. The law at present regards a willingness to delay development and further exploration as speculation. The field of economics might regard it as a means of optimizing the benefits of energy development over the long run. Speculation is a highly pejorative term which in economic fact means simply that the person possessing the commodity or controlling the activity believes that it may be worth more at a later time than at the present. This in turn means that the optimum value of the goods or activity to society, as reflected through the market mechanism, may be at a later time than at present.[151]

The Texas courts and the Arkansas courts have reached opposite results in cases involving the implied covenant of exploration. Both positions have been criticized. It is the authors' view that neither rule is subject to valid criticism at this date. The law of both states has been well defined for many years. Lessors and lessees alike know, or should know, what the law is, and the courts cannot be faulted for continuing to apply existing law.

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148. Wright, *supra* note 34, at 712.

149. *See, e.g.*, Brown, *The Proposed New Covenant of Further Exploration: Reply to Comment*, 37 TEX. L. REV. 303 (1959).

150. *See, e.g.*, Frois, *Suggested Solutions to Lessee's Dilemma Over the Development and Exploration Covenants in Louisiana*, 30 INST. ON MIN. L. 54 (1983); Martin, *supra* note 7.

151. Martin, *supra* note 7, at 207.

VII. REMEDIES

A. General Remedies in Implied Covenant of Exploration and Development Cases

The remedies that are discussed in implied covenant cases generally include damages, cancellation, and conditional cancellation.[152] Based upon the traditional definitions of the implied covenants of development and exploration,[153] different remedies would be appropriate for the breach of each covenant.

In cases involving the traditional implied covenant of development, damages would be the proper remedy. The damages would be measured by the royalty on the oil or gas that the additional development well would have produced from the time it ought to have been drilled.[154]

In cases involving the traditional implied covenant of exploration, damages would not be a proper remedy because it is not possible to calculate the amount of royalties on the oil or gas, if any, that would have been produced from an additional well drilled to an unproven formation. Accordingly, the favored remedy has been cancellation or conditional cancellation.[155]

B. Damages

As a general rule, the proper remedy for breach of the implied covenant of development is damages for the amount of royalty the lessor would have recovered had a reasonable prudent operator developed the lease.[156] The remedy of damages is generally considered to be inappropriate in exploration cases because of the inability to quantify the damages.[157] At least two methods of quantifying damages in exploration cases have been proposed, neither of which appears to be practicable.

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152. Wright, *supra* note 34, at 712.

153. *See supra* text accompanying notes 38-45.

154. 5 H. WILLIAMS & C. MEYERS, *supra* note 4, § 841; Meyers and Williams, *supra* note 46, at 802.

155. Meyers, *supra* note 42, at 571; Weaver, *supra* note 6, at 1509.

156. R. HEMINGWAY, *supra* note 27, § 8.10 (recognizing the potential for "double recovery" by a lessor).

157. *See, e.g.*, Meyers, *supra* note 42, at 573.

1. *Lost Royalty*

Damages could be based upon an amount equal to the royalty that would have been realized from an exploratory well had it been drilled. This is not an appropriate measure of damages because of its speculative nature; it is not possible to ascertain in advance with any degree of certainty how much oil and gas, if any, will be produced from an exploratory well.[158] It has been suggested that the "expected value" test discussed in the Texas Supreme Court's first opinion in *Sun Exploration & Production Co. v. Jackson*[159] may be an appropriate method to calculate damages based upon lost royalty from an undrilled exploratory well, but this remedy is defective because the quantum of the award is too speculative and uncertain.[160]

2. *Lost Bonus*

A second potential measure of damages would be an amount equal to the bonus lost by the lessor due to his inability to execute a new lease. This measure of damages has been criticized because it does not redress the essential harm suffered by either the lessor or the public interest. According to this criticism, the lessor has been most severely harmed by the loss of royalty on his mineral deposits, and society has been harmed by the removal of undeveloped lands from commerce.[161] Neither is relieved by a measure of damages based upon the lost bonus.

C. Cancellation

In some jurisdictions, the equitable remedy of cancellation is available where it is shown that a remedy in damages is inadequate.[162] For example, in a case involving the implied covenant of development, the Texas courts have stated:

> The usual remedy for breach of the lessee's implied covenant for reasonable development of oil and gas is an action for damages, though, under extraordinary circumstances—where there can be no other adequate relief—a court of equity will entertain an action to cancel the lease in whole or in part.[163]

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158. *Id.*; 5 E. KUNTZ, *supra* note 12, at § 62.5.
159. 31 Tex. Sup. Ct. J. 604 (July 13, 1988).
160. *See* Weaver, *supra* note 6, at 1508-09.
161. 5 H. WILLIAMS & C. MEYERS, *supra* note 4, § 844.3.
162. R. HEMINGWAY, *supra* note 27, § 8.11.
163. W. T. Waggoner Estate v. Sigler Oil Co., 118 Tex. 509, 518, 19 S.W.2d 27, 29

Other states, including Arkansas, have utilized the remedy of cancellation for breach of an implied covenant without the necessity of first pursuing a remedy in damages.[164] The basis for this remedy is either a finding that the lessee has "abandoned" the leased premises,[165] or a finding that the implied covenant is in effect a condition, the failure of which will entitle the lessor to cancellation.[166] In such jurisdictions, the remedy of cancellation is an equitable remedy and the court has flexibility to fashion a remedy that is appropriate to the circumstances. Courts frequently grant partial cancellations, reserving to the lessee those portions of the lease that he has in fact developed.[167] The partial cancellation may be on a horizontal or vertical basis.[168]

In Texas, the remedy of unconditional cancellation is not available:

> Under the decision in *Waggoner Estate v. Sigler Oil Co.*, [the remedy of absolute cancellation] is regarded as unavailable in Texas. In a proper case, cancellation of a lease may be decreed but the decree must be conditional; that is, cancellation must be conditioned on the refusal of the lessee to perform the covenant as directed by the decree.[169]

Prior to the court of appeals' decision in *Sun Exploration & Production Co. v. Jackson*,[170] there was no Texas appellate court decision upholding an unconditional cancellation of an oil and gas lease. The court

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(1929). (The cancellation remedy referred to by the court is conditional cancellation, not an absolute cancellation.); *see* Lido Oil Co. v. W. T. Waggoner Estate, 31 S.W.2d 154 (Tex. Civ. App.--Amarillo 1930, writ ref'd). (This case is W. T. Waggoner Estate v. Sigler Oil Co. on remand; following the remand Sigler Oil Co. changed its name to Lido Oil Co.)

164. R. HEMINGWAY, *supra* note 27, § 8.11; Byrd v. Bradham, 280 Ark. 11, 655 S.W.2d 366 (1983).

165. 5 E. KUNTZ, *supra* note 12, at § 62.5; Wright, *supra* note 34, at 713.

166. R. HEMINGWAY, *supra* note 27, § 8.11; Wright, *supra* note 34, at 713; *see* Mansfield Gas Co. v. Alexander, 97 Ark. 167, 173-74, 133 S.W. 837, 840 (1911) ("This 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.").

167. 5 E. KUNTZ, *supra* note 12, at § 62.5; Emanual, *Remedies for Breaches of Implied Covenants and Express Obligations to Drill in Oil and Gas Agreements*, E. MIN. L. INST. § 16.06[5][a]; *see, e.g.*, Byrd v. Bradham, 280 Ark. 11, 655 S.W.2d 366 (1983); Nolan v. Thomas, 228 Ark. 572, 309 S.W.2d 727 (1958).

168. 5 H. WILLIAMS & C. MEYERS, *supra* note 4, § 844.2; *see, e.g.*, Stevenson v. Barnes, 288 Ark. 147, 702 S.W.2d 787 (1986).

169. 5 H. WILLIAMS & C. MEYERS, *supra* note 4, at § 845.6 (citing W. T. Waggoner Estate v. Sigler Oil Co., 118 Tex. 509, 19 S.W.2d 27 (1929)).

170. 715 S.W.2d 199 (Tex. Civ. App. --Houston [1st Dist.] 1986), *rev'd*, 783 S.W.2d 202 (Tex. 1989).

of appeals unaccountably cited as authority for the remedy of unconditional cancellation, two cases involving the remedy of conditional cancellation, both of which stated that the remedy of unconditional cancellation was not available in Texas.[171] The granting of the remedy of unconditional cancellation by the court of appeals in *Sun Exploration & Production Co. v. Jackson* was not supported by Texas law and is not authority for the remedy of unconditional cancellation in Texas.

D. Conditional Cancellation

The remedy of conditional cancellation gives the lessee the opportunity to further explore the lease in order to prevent cancellation. The decree can be fashioned in a variety of ways. For example, the court can order cancellation of the lease if the lessee does not commence operations within a fixed time period.[172] Alternatively, the decree may order outright cancellation as to a portion of the leased premises and conditional cancellation as to other portions.[173]

Texas courts will recognize the remedy of conditional cancellation in instances where damages are not ascertainable. A decree of conditional cancellation is not, however, to be simply fashioned from the conscience of the court. It should follow from fact findings that a failure to develop has occurred and that a reasonable prudent operator would have drilled a well or wells at specified locations to specified depths. The remedy of conditional cancellation offers the lessee a choice: the lessee may drill the well or wells that the fact finder determined that a reasonable prudent operator would have drilled, or the lessee may elect not to take the risk the fact finder says a reasonable prudent operator would have taken.[174]

E. The Requirement of Notice

Whether or not notice and demand are a prerequisite to an action

171. Slaughter v. Cities Serv. Oil Co., 660 S.W.2d 860 (Tex. Civ. App.--Amarillo 1983, no writ); Wes-Tex Land Co. v. Simmons, 566 S.W.2d 719 (Tex. Civ. App.--Eastland 1978, writ ref'd n.r.e.).

172. *See, e.g.*, Arkansas Oil and Gas, Inc. v. Diamond Shamrock Corp., 281 Ark. 207, 662 S.W.2d 824 (1984).

173. 5 E. KUNTZ, *supra* note 12, § 62.5.

174. W. T. Waggoner Estate v. Sigler Oil Co., 118 Tex. 509, 19 S.W.2d 27 (1929); Lido Oil Co. v. W. T. Waggoner Estate, 31 S.W.2d 154 (Tex. Civ. App. -- Amarillo 1930, writ ref'd). (This case is W. T. Waggoner Estate v. Sigler Oil Co. on remand; following the remand Sigler Oil Co. changed its name to Lido Oil Co.)

to enforce the implied covenant of exploration depends upon the relief sought by the lessee and the terms of the oil and gas lease.[175] Generally, notice and demand are not required in an action for damages.[176] A lessee must generally give notice and demand if he is seeking cancellation of the lease.[177] Such notice may not be required, however, where the lessee's breach is egregious or where a demand would be futile.[178]

VIII. EXPRESS LEASE PROVISIONS[179]

As previously discussed,[180] the courts of both Texas and Arkansas imply covenants in oil and gas leases in order to give effect to the presumed intent of the parties. One of the results of categorizing implied covenants as implied in fact is that, absent fraud, express lease provisions generally supersede implied covenants on the same subject.[181]

An example of the effect of express lease provisions on implied covenants is represented by *Gulf Production Co. v. Kishi*.[182] The lessors sued the lessee, alleging failure to develop the leased premises with reasonable diligence. The two leases involved contained extensive provisions regarding the drilling of the initial exploratory well, the drilling of additional test wells, and the drilling of additional development wells after the discovery of production.

The lessors in *Kishi* argued that an implied covenant of development was implied into every lease, and that only a lease provision excusing the lessee from the exercise of reasonable diligence in developing the premises could defeat the implied covenant. The court replied that the implied covenant of development could be superseded by an express

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175. *See generally*, 5 H. WILLIAMS & C. MEYERS, *supra* note 4, § 682.

176. R. HEMINGWAY, *supra* note 27, § 8.11.

177. *Id.*

178. 5 E. KUNTZ, *supra* note 12, § 62.4; Skelly Oil Co. v. Scoggins, 231 Ark. 357, 329 S.W.2d 424 (1959); Byrd v. Bradham, 280 Ark. 11, 655 S.W.2d 366 (1983).

179. The express lease provisions discussed in this article have been culled from various cases and articles. The authors neither endorse nor recommend the use of any such general or specific lease provisions.

180. *See supra* text accompanying notes 27-34.

181. 1 E. SMITH & J. WEAVER, *supra* note 6, at 245; Wright, *supra* note 34, at 715; *see* Magnolia Petroleum Co. v. Page, 141 S.W.2d 691, 693 (Tex. Civ. App. --San Antonio 1940, writ ref'd) ("[W]hen expressed covenants appear in the lease, implied covenants disappear."); *see also* Mansfield Gas Co. v. Alexander, 97 Ark. 167, 174, 133 S.W. 837, 840 (1911) ("It is true that when such a lease expressly provides when and how the search for the minerals shall be made upon the leased lands, then there can be no reason for implication relative thereto, and such provision expressly made must control.").

182. 129 Tex. 487, 103 S.W.2d 965 (Tex. Comm'n App. 1937).

development plan: "The true rule is that the implied covenant arises only out of necessity and in the absence of an express stipulation with respect to development of the leased premises."[183]

After reviewing the express lease provisions, the court held that the implied covenant of development had been negated by the lease:

> It is our opinion that the parties expressed, in the third paragraph of the first lease and in the fourteenth paragraph of the second lease, their agreements and intentions as to the number of wells required to be drilled by the lessee in the development of the premises covered by the two leases and as to the time when the wells should be drilled; in other words, that these two paragraphs contain the agreements of the parties upon the subject of development and the subject of diligence of development. This being true, there is no necessity for the implication of a covenant for development with reasonable diligence. To imply such a covenant would be to make an agreement for the parties upon a subject about which they have in their written contracts expressly agreed.[184]

Although it has been stated that there can be no implied covenant on any general matter that is the subject of an express covenant, the view of some text writers is that an implied covenant will be superseded only to the extent that it is inconsistent with the express provision.[185] There are at least six different types of express clauses that can be drafted to supersede or revise the implied covenant of exploration.

A. Delay Rental Clauses

The standard delay rental clause supersedes the implied covenant of exploration for so long as delay rentals are tendered during the primary term.[186] The rationale is that the lessee has bargained for the right to hold the minerals without exploring for them during the primary term upon the tender of delay rentals.[187] The tender of rentals is a payment in lieu of exploration.[188] In general, "paid-up" leases have also been held to supersede the implied covenant of exploration during

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183. *Id.* at 492, 103 S.W.2d at 968.

184. *Id.* at 494-95, 103 S.W.2d at 969.

185. *See, e.g.*, 5 E. KUNTZ, *supra* note 12, § 62.2.

186. 5 H. WILLIAMS & C. MEYERS, *supra* note 4, § 846; Bullock, *supra* note 10, at 145; Meyers, *supra* note 7, at 116; Merrill, *Lease Clauses Affecting Implied Covenants*, 2 INST. ON OIL AND GAS L. AND TAX'N 141, 150 (1951).

187. Meyers, *supra* note 7, at 116.

188. 5 H. WILLIAMS & C. MEYERS, *supra* note 4, § 846.

the primary term.[189]

The incompatibility of the delay rental clause and the implied covenant of exploration appears to be the majority rule, and is followed in the state of Texas.[190] A minority position, the so-called Indiana rule, provides that a lessor may refuse payment of delay rentals and demand exploration after reasonable notice.[191]

The existence of the delay rental clause does not necessarily excuse the lessee from the obligations of exploration or development during the entirety of the primary term. If production is obtained during the primary term, and the delay rental clause loses its efficacy, then the duties to explore and develop may arise.[192]

B. Express Drilling Clauses

The lessor and lessee may provide for a predetermined plan of development. This can be achieved by means of a "continuous development" clause or by a clause that prescribes the number of wells to be drilled.[193] These clauses have become popular in Texas as lessors and lessees have become more sophisticated. Some text writers assert that express drilling clauses have gained widespread use in Texas due to the unavailability of the implied covenant of exploration and the difficulty and expense of proving a breach of the implied covenant of development.[194]

A continuous development clause may provide that, after an initial well is completed, the lessee shall drill additional wells, without a lapse of more than a specified period of time between the completion of one well and the commencement of the next well, until the premises are fully explored or until a set number of wells are drilled. If the lessee fails to continue drilling, the typical provision will provide for termination of the lease as to undeveloped acreage.[195]

The primary issue regarding express drilling clauses is whether the clause sets forth the entire drilling obligation of the lessee, or whether the clause merely sets forth the initial obligations of the lessee, leaving

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189. Merrill, *supra* note 186 at 150; *but see* Malone, *Problems Created by Express Lease Clauses Affecting Implied Covenants*, 2 ROCKY MT. MIN. L. INST. 133, 140 (1956).

190. Malone, *supra* note 189, at 140.

191. *Id.*; Bullock, *supra* note 10, at 145; Merrill, *supra* note 186, at 150.

192. Meyers, *supra* note 7, at 116.

193. 1 E. SMITH & J. WEAVER, *supra* note 6, at 256; 5 E. KUNTZ, *supra* note 12, § 62.2.

194. 1 E. SMITH & J. WEAVER, *supra* note 6, at 256.

195. *Id.*

further exploration to implication.[196] In such instances, the court must examine the lease in its entirety and in light of the circumstances in order to determine whether the parties intended obligations beyond those set forth in the express provision.[197]

An example of an express drilling clause was set forth in *Gulf Production Co. v. Kishi*:[198]

> Should oil in paying quantities be found on the leased premises, then additional wells shall be drilled thereon until as many as four producing wells are drilled and such additional wells shall be drilled within not more than 90 days interval between the completion or abandonment of one and commencement of work on another and a failure to drill such wells shall terminate this lease as to all land except 5 acres in a square around each producing well, with the well in the center.[199]

As previously discussed,[200] the express drilling clause in *Kishi* was held to supersede the implied covenant of development.

A contrary result was reached by the Court of Appeals for the Fifth Circuit in *Sinclair Oil & Gas Co. v. Masterson*.[201] Three of the leases in *Masterson* collectively covered approximately 40,000 acres. Each lease provided for the drilling of two wells on the leased premises. In response to the lessor's claim that Sinclair had not adequately explored the leased premises, Sinclair argued, relying on *Kishi*, that the express lease provisions negated the implied covenant of exploration. The court rejected Sinclair's argument, stating:

> It would put a hard strain upon one's sense of proportion to assume that a landowner would be content with six wells on a little less than forty thousand acres. A reading of the three leases involved here convinces us that the parties had no such intention, but were merely speeding up the implied covenant of the lessees for reasonably diligent exploration and development by setting a deadline for at least two wells under each lease.[202]

Professor Merrill set forth several express lease provisions in his

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196. R. HEMINGWAY, *supra* note 27, § 8.4; 5 H. WILLIAMS & C. MEYERS, *supra* note 4, § 846; Bullock, *supra* note 10, at 148.

197. Bullock, *supra* note 10, at 148-49.

198. 129 Tex. 487, 103 S.W.2d 965 (Tex. Comm'n App. 1937).

199. *Id.* at 491, 103 S.W.2d at 967.

200. *See supra* text accompanying notes 182-84.

201. 271 F.2d 310 (5th Cir. 1959), *cert. denied*, 362 U.S. 952 (1960).

202. *Id.* at 323.

article on this subject,[203] including the following provision:

> After the discovery of oil, gas or other mineral in paying quantities on the land embraced by this lease, Lessee shall reasonably develop the acreage retained hereunder, but in discharging this obligation, Lessee shall in no event be required to drill more than one well per ____ acres of the area retained hereunder and capable of producing oil, gas or other minerals in paying quantities.[204]

As a general rule, courts will strictly construe such provisions.[205] Courts are also reluctant to find that any one lease provision negates more than one of the implied covenants.[206]

C. Pugh Clauses[207]

In certain states, a Pugh Clause can provide to a lessee an incentive to continue to explore the leased premises. Such a clause typically provides that drilling operations on or production from a pooled unit or units shall maintain the lease in force only as to lands included within such unit or units.[208] A typical Pugh Clause would provide as follows:

> Notwithstanding anything to the contrary herein contained, drilling operations on or production from the pooled unit or units established by the Commissioner of Conservation embracing land covered hereby and other land shall maintain this lease in force only as to the land included in such unit or units, whether the operations be on the land covered by this lease or on other lands in the unit. This lease may be maintained in force as to the remainder of the land in any manner herein provided for . . . .[209]

A modified form of a Pugh Clause can be drafted providing that, at the end of the primary term, the lease shall terminate as to all lands except for a specified number of acres around producing wells.

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203. Merrill, *supra* note 186.

204. *Id.* at 154.

205. 1 E. SMITH & J. WEAVER, *supra* note 6, at 259.

206. Malone, *supra* note 189, at 138; Merrill, *supra* note 186, at 157.

207. According to Williams & Meyers, the "Pugh Clause" is said to have been originated in 1947 by Lawrence C. Pugh of Crowley, Louisiana and to take its name from him. 8 H. WILLIAMS & C. MEYERS, *supra* note 43, at 788.

208. *Id.*

209. 4 H. WILLIAMS & C. MEYERS, OIL AND GAS LAW § 669.14 (1986) (citing Fawvor v. U.S. Oil of La., Inc., 162 So. 2d 602 (La. App. 1964), *writ denied*, 165 So. 2d 479 (1964).

D. Clauses Describing the Circumstances in Which Exploration Must Occur

Professor Kuntz cites the Texas case, *Hancock v. Texaco, Inc.*, as providing an example of a lease clause that describes the circumstances in which further exploration may be required:[210]

> [S]hould commercial oil production be discovered on the Withers Pool structure, Wharton County, Texas, within four thousand (4,000) feet of said well in a new sand, at a greater depth than the sand horizons now producing in said Withers Field, then and in that event lessee hereby bind and obligate themselves, within one year from the date of such discovery to prosecute the necessary drilling operations of a well on said land to develop commercial oil production from such new or deeper sand horizon, said well for the production of such new or deeper production to be drilled and completed in such new or deeper sand horizon only and at no shallower depth. Should lessee for any reason make default in complying with the foregoing obligation to drill said well to the new or deeper sand horizon, and shall fail to remedy or correct such default . . . then and in that event lessee hereby agrees that this lease shall be forfeited and surrendered in so far only as such new or deeper sand horizon is concerned, and a release thereof shall be delivered by lessee to lessor.[211]

These clauses appear to be rare, possibly due to the difficulty in anticipating all future circumstances that would lead a lessor to desire further exploration and the unwillingness of the lessee to agree in advance to bear the cost of such operations. Also, the parties may simply prefer to rely on established law and let future operations be determined by emerging facts.

E. Good Faith or Discretion Clauses

A clause may be inserted into a lease that attempts to change the standard of conduct by which the lessee's performance may be measured.[212] For example, in Texas, the standard of good faith may be substituted for the standard of a reasonable prudent operator.

A clause of this type was discussed in *Magnolia Petroleum Co. v.*

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210. 5 E. KUNTZ, *supra* note 12, § 62.2 (citing Hancock v. Texaco, Inc., 520 S.W.2d 466 (Tex. Civ. App. -- Corpus Christi 1975, writ ref'd n.r.e.)).

211. Hancock v. Texaco, Inc., 520 S.W.2d 466, 468 (Tex. Civ. App. -- Corpus Christi 1975, writ ref'd n.r.e.).

212. Merrill, *supra* note 186, at 188; *see also* R. HEMINGWAY, *supra* note 27, § 8.4.

Page.[213] The lessors sued to recover damages for failure of the lessee to prevent drainage and to develop the leased premises. The lease contained a provision that stated: "The judgment of the lessee, when not fraudulently exercised, in carrying out the purposes of this lease shall be conclusive."[214] The court held that before the lessors could recover from the lessee, the lessors would have to prove that the lessee's decisions not to drill an offset well to protect the leasehold against drainage and not to further develop the leased premises were made "fraudulently, or at least in bad faith."[215]

A similar result was reached in *Labbe v. Magnolia Petroleum Co.*[216] The lease at issue contained the same provision as the lease in *Magnolia Petroleum Co. v. Page*:[217] "The judgment of the lessee, when not fraudulently exercised, in carrying out the purposes of this lease shall be conclusive."[218] In the absence of this provision, the court stated that "there would be an implied covenant requiring the lessee after the discovery of oil or gas in paying quantities, to use such diligence in drilling and developing the lease for oil and gas as a reasonably prudent operator would under the same or similar circumstances."[219] In light of the express provision, however, the court held that "the lessee would not be required to further develop the lease unless lessee in making a decision not to do so acted fraudulently or at least in bad faith."[220] In reaching this conclusion, the court stated: "The obligation of a lessee to develop as a reasonably prudent operator may be relieved by contract."[221] The court also addressed and rejected the contention that the express provision was contrary to public policy.[222]

Another type of lease clause may be drafted in order to alter the profitability element of the reasonable prudent operator standard:

> In recognition of the fact that lessee has paid lessor bonus calculated on the premise that lessee shall endeavor throughout to maximize its

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213. 141 S.W.2d 691 (Tex. Civ. App. -- San Antonio 1940, writ ref'd).

214. *Id.* at 693 (citing the lease).

215. *Id.*

216. 350 S.W.2d 873 (Tex. Civ. App. -- San Antonio 1961, writ ref'd n.r.e.).

217. 141 S.W.2d 691 (Tex. Civ. App. -- San Antonio 1940, writ ref'd).

218. Labbe v. Magnolia Petroleum Co., 350 S.W.2d 873, 876 (Tex. Civ. App. -- San Antonio 1961, writ ref'd n.r.e.) (citing the lease).

219. *Id.*

220. *Id.*

221. *Id.* at 875; *see also* Bullock, *supra* note 10, at 145.

222. Labbe v. Magnolia Petroleum Co., 350 S.W.2d 873, 875 (Tex. Civ. App. -- San Antonio 1961, writ ref'd n.r.e.); *see also*, Brewster v. Lanyon Zinc Co., 140 F. 801 (8th Cir. 1905) (establishing the reasonable prudent operator standard).

> profits from this lease, and from the field in which the leased tract is located, the parties hereby agree that under each and every covenant that may be implied under this lease, the lessee shall never be obligated to drill any well or perform any other act unless such drilling or other act will tend to maximize lessee's profits under this lease and from the field in which the leased tract is located.[223]

The continuing viability of these clauses has been questioned on the grounds that such clauses are relatively innocuous and can be inserted into lengthy lease forms where they may be overlooked by a lessor.[224] It is fundamental, however, that parties should understand their agreements and be held to them; courts should not rewrite contracts entered into by parties in their free will.

F. Clauses Expressly Disclaiming Implied Covenants

Professor Meyers, the leading advocate of the implied covenant of exploration, has suggested that the implied covenant of exploration could be negated by the following lease provision: "[A]fter discovery and production of oil or gas on the premises, lessee shall have no duty to drill any additional well on the leasehold for the purpose of extending the limits of the existing field, or to explore either laterally or vertically for additional producing formations."[225]

Two other commentators have cited the following provision as an annulment of implied covenants in general: "This agreement covers the entire understanding of the parties. There are no oral agreements, promises or representations inconsistent with or supplementary to the agreement herein expressed."[226]

IX. CONCLUSION

Under the traditional definition of the implied covenant of exploration, the covenant would impose upon a lessee, after obtaining production in paying quantities from a leasehold, the obligation to explore undeveloped portions of the leasehold, both vertically and laterally, for new, potentially productive formations. In order to prove breach of the covenant, a lessor would prove that, under the circumstances, a reason-

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223. Williams, *Implied Covenants' Threat to the Value of Oil and Gas Reserves*, 37 INST. ON OIL AND GAS L. AND TAX'N 3-1, 3-20 (1985).

224. Merrill, *supra* note 186, at 188.

225. Meyers, *supra* note 7, at 118.

226. Merrill, *supra* note 186, at 148; Bullock, *supra* note 10, at 144.

able prudent operator would have drilled an additional well or wells. This burden of proof could be met by a combination of factors, including the length of time that has expired without drilling, minimal drilling activity in comparison to the size of the tract, and lack of intent by the lessee to further explore.

The implied covenant of exploration has not received uniform treatment by the courts of the various hydrocarbon-producing states. In Texas, the supreme court has stated that there is no implied covenant of exploration independent from the implied covenant of development.

The Arkansas courts have similarly refused to recognize the implied covenant of exploration separate from the implied covenant of development. The implied covenant of development appears to be defined so broadly in Arkansas, however, that a lessor will be entitled to the full protections of the traditional implied covenant of exploration under the implied covenant of development. Under the Arkansas formulation of the implied covenant of development, a lessor need not prove that there is a reasonable expectation of profit to the lessor and lessee from the drilling of any additional well. Instead, the lessor must prove that, given the circumstances, the lessee acted unreasonably in failing to drill an additional well. Lessors who meet this burden of proof are entitled to cancellation or conditional cancellation of the lease.

The difference between the Texas and Arkansas rules lies in the different formulations of the reasonable prudent operator standard used by the courts in implied covenant of development cases. The Texas courts require evidence of a reasonable expectation of profit to the lessor and lessee from any additional well, but the Arkansas courts do not have such a requirement. Both rules are criticized: the Texas rule being regarded as too favorable to the lessee and the Arkansas rule being regarded as too favorable to the lessor. These criticisms should be tempered, however, by the fact that, as of this date, the law in both Texas and Arkansas is well settled. It is not the function of the courts to rewrite agreements or to alter longstanding rules of property, especially in the field of oil and gas jurisprudence where millions of dollars are expended through exploration operations, loans, purchases, and other investments on the belief that the courts will continue to apply established law on a consistent basis.