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Implied Covenants in Oil and Gas Law Under Federal Energy Price Regulation

*Jacqueline Lang Weaver**

I. INTRODUCTION

In the last decade federal intervention into the oil and gas industry has grown at an unprecedented rate. This surge has been particularly marked in the pricing and allocation of oil and natural gas, as a consequence of the federal government's struggle to cope with both the energy shortages and price increases resulting from the economic and political power of the Middle Eastern oil-producing countries. Federal intrusion into all facets of domestic oil and gas pricing has generated much political debate over the wisdom of such a policy and much litigation and legal commentary on its meaning and enforcement through the administrative and judicial processes. The impact of the new legislation on the relationship between the lessee and lessor under an oil and gas lease, however, has received relatively little attention. Although few courts have addressed the subject, the probable impact of this federal regulation on the doctrine of implied covenants in oil and gas law is important to lessees and lessors alike.¹

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1. Despite the recent deregulation of crude oil price controls in fulfillment of President Reagan's campaign promise, the issues discussed in this Article are of continuing significance. Crude oil is subject to a windfall profits tax through 1990 that affects producers

This Article seeks to determine whether the federal pricing regulations have imposed new duties on the lessee in his relationship to a lessor, and, if so, the nature, scope, and consequences of those duties. The Article contends that the federal pricing schemes in oil and gas will lead to a renaissance of certain implied covenants that the law has traditionally recognized—albeit now framed in a new setting. The Article focuses on those issues that are likely to require resolution under both the implied covenant to market and the less well-known implied covenant to seek favorable administrative action.

II. THE FEDERAL REGULATORY FRAMEWORK

The federal response to the energy crisis, which former President Carter once called the “moral equivalent of war,” forged legislative armaments along a broad front that included energy production, pricing, allocation, transportation, conversion, and conservation.² The fusillade of greatest concern to the lessee/lessor relationship, because of its immediate impact on revenues received by both parties, is that which aimed at direct federal control over the prices of oil and gas. This part of the Article, therefore, briefly describes the basic regulatory framework for crude oil and natural gas pricing under which implied covenants in oil and gas law are likely to arise. Within this federal framework of price regulation, the Article then examines the relationship between the oil and gas lessee and lessor under implied covenant law.³

A. *Crude Oil Pricing*

The price of domestic crude oil was subject to almost continuous mandatory federal controls from August 15, 1971—when Presi-

and royalty owners in much the same way as crude oil price regulations. The existing federal regulation of natural gas prices is likely to continue, perhaps with some modification, for several more years. In addition, the re-imposition of price controls on crude oil and their further extension to natural gas are possible if another embargo or a drastic change in American political fortunes occurs. Even if all oil and gas is deregulated by the end of this decade, many of the issues discussed in this Article are relevant to other types of state and federal laws that affect the industry such as environmental permit regulations.

2. For a listing of 35 major energy laws passed in the 1970s, see [1981] 1 ENERGY MNGM'T (CCH) 229.

3. The Article focuses on natural gas pricing because the well determination process under the Natural Gas Policy Act of 1978 (NGPA), 15 U.S.C. §§ 3301-3432 (Supp. III 1979), clearly requires administrative action to receive the benefits of incentive prices. The Act is thus likely to force explicit attention to the implied covenant to seek favorable administrative action. Nonetheless, most of the principles that this Article discusses apply to the pricing of both crude oil and natural gas.

dent Nixon first imposed a general wage-price freeze as an anti-inflation measure—until January 1981 when President Reagan eliminated the controls.⁴ The federal pricing system was intended to protect the consumer from rapid price increases by establishing maximum lawful prices on oil discovered before the “energy crisis,” while still maintaining price incentives for producers to explore for new reserves, to keep marginal wells in existence, and to rework existing fields with new technologies to increase recovery rates. The inevitable tension between these two objectives resulted in an increasingly complex system of price controls and incentives, under which the price of a barrel of domestic crude oil could range from seven dollars to almost forty dollars depending on its classification.⁵

4. For a general history of the federal crude oil pricing system, see [1981] 1 ENERGY MNGM'T (CCH) ¶¶ 3001-3018 and sources cited in note 5 *infra*. The Energy Policy and Conservation Act of 1975 (EPCA), Pub. L. No. 94-163, §§ 1-552, 89 Stat. 871 (codified in scattered sections of 15, 42, 50 U.S.C.), controlled the weighted average price of first sales of all domestic crude oil through May 31, 1979. 15 U.S.C. §§ 753(a)-(e), 757 (1976). Since June 1, 1979, the President has had authority to control oil prices in any manner desired until September 30, 1981. Under President Carter, crude oil decontrol was to have been accomplished by October 1, 1981; President Reagan simply speeded up the process. 15 U.S.C. § 760g (1976). Many enforcement actions and lawsuits involving past compliance with the crude oil pricing regulations are still in the process of being adjudicated by the federal agencies or the courts. Despite the Reagan Administration's commitment to reducing the federal budget, funding for crude oil pricing compliance was increased from \$12-20 million for fiscal 1982. Energy Management Newsletter (CCH), Oct. 6, 1981, at 1.

5. The average refinery cost in June 1980 for nine categories of crude oil illustrates the range of prices:

<u>Category</u>	<u>Cost Per Barrel</u>
Newly discovered	\$37.69
Stripper well	\$34.98
Alaskan exempt	\$34.41
Heavy and market	\$33.51
Naval reserve	\$33.46
Tertiary	\$27.49
Alaskan upper tier	\$23.97
Upper tier	\$15.03
Lower tier	\$ 7.20

Energy Management Newsletter (CCH), Sept. 9, 1980, at 4.

The pricing rules for all categories of crude oil appear in the Code of Federal Regulations. 10 C.F.R. §§ 212.51-78 (1981). For more details on federal crude oil pricing regulations, see [1981] 1 ENERGY MNGM'T (CCH) ¶¶ 3008-3019; Allott, *Crude Oil Deregulation*, 25 ROCKY MTN. MIN. L. INST. 15-1 (1979); Beck, *Crude Oil Issues*, 30 INST. OIL & GAS L. & TAX. 1 (1979); Lang, *DOE Organization: The Limits of Regulatory Power*, 30 INST. OIL & GAS L. & TAX. 119 (1979); Mode, *Federal Petroleum Regulation in the Courts*, 29 INST. OIL & GAS L. & TAX. 39 (1978); and Richardson, *Crude Oil Pricing—Current Regulations and Practices*, 23 ROCKY MTN. MIN. L. INST. 803 (1977).

The crude oil pricing scheme was largely self-policing. No firm could charge a price for crude oil that exceeded the maximum permitted by law.⁶ Crude oil producers were required to file reports with the federal government and to prepare and maintain records of prices, production volumes, and the data used to classify the oil.⁷ Producers also had to furnish, for each separate property, a written certification, with supporting data, to each purchaser of crude oil that stated the category for which the property qualified.⁸ No firm could sell domestic crude oil unless it provided the required documentation and no firm could knowingly purchase domestic crude oil that lacked certification.⁹ The Economic Regulatory Administration (ERA) of the Department of Energy (DOE) was responsible for enforcement of the crude oil pricing regulations,¹⁰ and both civil and criminal sanctions could be levied for violations of either the price ceilings or the reporting requirements.¹¹

Not surprisingly, the crude oil regulatory machinery that the federal government established failed to run smoothly. The price

6. 10 C.F.R. § 212.10 (1981).

7. *Id.* §§ 212.126-.128.

8. *Id.* § 212.131.

9. *Id.* § 212.131(c).

10. The regulations for crude oil pricing investigations, violations, sanctions, and judicial actions appear in the Code of Federal Regulations. *Id.* §§ 205.200-.204. The responsibilities and internal structure of the ERA are explained in [1981] 1 ENERGY MNGM'T (CCH) ¶ 2532, at 2534-35. Under the Department of Energy Organization Act (DOE Organization Act), 42 U.S.C. §§ 7101-7375 (Supp. III 1979) and the Department of Energy Delegation Order No. 0204-4, 10 C.F.R. app. § 1001.1 (1981), the ERA replaced the Federal Energy Administration (FEA) as the primary agency for crude oil pricing compliance. The DOE Organization Act also created the Federal Energy Regulatory Commission (FERC), which is a five-member independent commission within the DOE that shared some of the authority over crude oil pricing with the ERA. *See* 42 U.S.C. §§ 7172(c)(1), 7193, 7194 (Supp. III 1979). *See also* Craven, *New Dimensions in Federal Regulation of Crude Oil and Petroleum Products Under the Department of Energy*, 29 INST. OIL & GAS L. & TAX. 1 (1978); Lang, *supra* note 5.

11. 10 C.F.R. § 205.203 (1981). While the largest vertically integrated petroleum companies were subject to intensive investigation by the ERA's Office of Special Counsel for Compliance, enforcement policy towards smaller petroleum reselling and retailing firms was more relaxed. Audits were not performed on these firms except on suspicion of a willful violation. [1974-1981 Transfer Binder] ENERGY MNGM'T (CCH) ¶ 15,400A. Small crude oil producers, however, were not so favored. An inventory of FEA audits of energy projects in the Southwest District (Arkansas, Louisiana, New Mexico, Oklahoma, and Texas) from January 1, 1977, through May 1979, for example, showed that crude oil producers were involved in two-thirds of the audits (1,069 of the total 1,598 audits). *Adequacy of the Administration's Anti-Inflation Program: Hearings Before the Commerce, Consumer, and Monetary Affairs Subcomm. of the House Comm. on Gov't Operations*, 96th Cong., 1st Sess. 24 (1979) (statement of Herbert F. Buchanan).

regulations originally were forged as a temporary, emergency, anti-inflation—and then anti-embargo—defense measure. They were poorly designed to cope with the long-term nature of the Organization of Oil Exporting Countries' (OPEC) power over oil prices and supplies or with the complexities of the petroleum industry. Crude oil prices became one of the most sensitive and volatile political issues the nation had ever faced.¹² Crude oil pricing legislation, therefore, was erratic and unpredictable: temporary price control authority would expire and then be extended, only to expire again;¹³ certain oil production was uncontrolled, controlled, and then uncontrolled;¹⁴ and congressional price rollbacks and Presidential price freezes caused instability in producers' price expectations and business planning.¹⁵ In addition, the political pressures on the successive federal pricing agencies were enormous and sometimes irresistible, and often resulted in violations of the principles of fundamental fairness and due process to firms in the industry.¹⁶ Numerous committees and task forces investigated and

12. See Mitchell, *The Basis of Congressional Energy Policy*, 57 Tex. L. Rev. 591 (1979). Mitchell documents the dominant role of ideology in the determination of energy policy, especially natural gas deregulation. Ideology of congressmen, measured by the liberal/conservative ratings of the Americans for Democratic Action, could be used to predict correctly a congressman's vote on natural gas deregulation 90% of the time. *Id.* at 598. Indeed, votes on oil and gas decontrol were more ideologically oriented than votes on abortion and welfare policies. *Id.* at 605-06.

13. Crude oil prices were controlled first in Phases I and II of the general wage-price freeze that began on August 15, 1971. In January 1973 Phase III commenced, in which Congress relied upon the oil industry to exercise voluntary restraints on price increases. Two months later, however, mandatory controls were reinstated. Finally, from January 1974 to January 1976, the FEA controlled crude oil prices under the Emergency Petroleum Allocation Act of 1973, 15 U.S.C. §§ 751-760h (1976), which Congress had to extend three times—twice after a hiatus. [1981] 1 ENERGY MNGM'T (CCH) ¶ 3001.

14. The Emergency Petroleum Allocation Act of 1973, 15 U.S.C. §§ 751-760h (1976), expressly exempted oil that was drawn from "stripper wells" (*i.e.*, oil from properties that produced less than 10 barrels/day/well). *Id.* § 757(i). The EPCA, see note 4 *supra*, however, placed controls on stripper well prices from February 1976 to September 1976, when Congress reversed itself again and exempted stripper well oil in the Energy Conservation and Production Act of 1976, Pub. L. No. 94-385, § 121, 90 Stat. 1125, 1132-33 (codified at 15 U.S.C. § 757 (1976)).

15. The EPCA forced the weighted average domestic crude oil price down to \$7.66 per barrel in February 1976, and limited future price increases to no more than 10% per year. The Ford Administration froze prices at their June 1976 level through August 1976 because of miscalculations in the schedule of allowable price increases. Rollbacks and freezes continued under President Carter; prices did not begin rising again until September 1977. [1981] 1 ENERGY MNGM'T (CCH) ¶¶ 3007-3018.

16. See, *e.g.*, *Standard Oil Co. v. FEA*, 453 F. Supp. 203 (N.D. Ohio), *aff'd sub nom. Standard Oil Co. v. DOE*, 596 F.2d 1029 (Temp. Emer. Ct. App. 1978). The court in *Standard Oil Co.* invalidated the FEA's interpretation of the refiner's cost sequence rule because of a lack of procedural safeguards. In tracing the history of the FEA's erratic interpretation

frequently sustained congressional charges of inadequate enforcement policies.¹⁷ Moreover, judicial review provided an inadequate check on the federal price control agencies' discretion, since the agencies' legislative charters were far too vague and broad to provide meaningful standards for the courts to apply.¹⁸

The complexity, size, and enormous importance of the petroleum industry simply defied easy regulatory or political formulas to reconcile the conflicting goals of encouraging domestic energy production and protecting consumers from rocketing price increases for such an essential commodity. The permanence of the regulatory apparatus required that the rules be sufficiently defined and detailed to apprise regulated firms of the law and still be sufficiently flexible to accommodate individual situations. The regulators, however, often were not knowledgeable enough about the industry to accomplish these dual goals.¹⁹ In sum, legislation and regulations passed in haste and ignorance were poorly understood by the regulators and ambiguous to the regulated.²⁰ The agency

of this rule, the court found that the political pressure exerted by Congressman Dingell as chairman of the Subcommittee on Energy and Power of the House Committee on Interstate and Foreign Commerce had caused the FEA to reverse its previously announced course. 596 F.2d at 1038. See also Cockrell, *Invalidation of Federal Petroleum Regulations on the Basis of Procedural Rulemaking Deficiencies*, 57 TEX. L. REV. 535 (1979); Elkins, *The Temporary Emergency Court of Appeals: A Study in the Abdication of Judicial Responsibility*, 1978 DUKE L.J. 113; McMillin, *Principled Fairness in the Regulation of Petroleum Prices*, 57 TEX. L. REV. 573 (1979); Note, *Retroactivity and Pricing Regulations*, 29 BAYLOR L. REV. 1033 (1977).

17. See, e.g., FEDERAL ENERGY ADMINISTRATION: TASK FORCE ON COMPLIANCE AND ENFORCEMENT (1977) (also known as SPORKIN REPORT) (detailing major shortcomings in the FEA's compliance and enforcement program); TASK FORCE ON REFORM OF FEDERAL ENERGY ADMINISTRATION, FEDERAL ENERGY ADMINISTRATION REGULATION REPORT OF THE PRESIDENTIAL TASK FORCE (P. MacAvoy ed. 1977). See also Trowbridge, *Enforcement of Criminal Sanctions for the Violation of Federal Controls on the Prices of Crude Oil and Petroleum Products*, 17 AMER. CRIM. L. REV. 201, 201-03, 212-13 (1979).

18. See, e.g., 15 U.S.C. § 753(b)(1) (1976) (nine objectives specified to guide the FEA's regulatory efforts, under the Emergency Petroleum Allocation Act of 1973, all of which are broadly drawn and inherently contradictory). See also Elkins, *supra* note 16, at 144-51.

19. Congress had a vehemently negative reaction to the FEA's hiring of former petroleum industry employees whose experience and knowledge would have aided the regulatory effort. See *The Relationship Between the Department of Energy and Energy Industries: Hearings Before the Senate Comm. on Energy and Natural Resources*, 95th Cong., 2d Sess. 1-161 (1978); Johnson, *Why U.S. Energy Policy Has Failed*, in ENERGY SUPPLY AND GOVERNMENT POLICY 299-304 (R. Kalter & W. Vogely eds. 1976).

20. See, e.g., *Longview Ref. Co. v. Shore*, 554 F.2d 1006 (Temp. Emer. Ct. App.), cert. denied, 434 U.S. 836 (1977). The court in *Longview* described the plight of small refiners who were unable to understand and comply with the regulatory price formulas. The Temporary Emergency Court of Appeals noted, "It is difficult, even for experts, to understand these complex regulations, as is evidenced by the frequent correction, modification, change, and clarifying rulings . . ." *Id.* at 1023.

was not staffed to provide the legal guidance necessary either to ensure fundamental fairness to the firms under scrutiny or to assure the public that their interests were being protected by proper enforcement of the pricing regulations.

The recent decontrol of oil prices does little to alter this regulatory framework. Congress passed the Crude Oil Windfall Profit Tax Act of 1980,²¹ which is due to be phased out by December 1990,²² to absorb much of the increased profits that would have accrued to oil producers from price decontrol. To minimize the tax's adverse effect on producers' incentives, the Act imposes lower rates on certain classifications of crude oil and even exempts some types of crude oil.²³ Congress also levied lower tax rates on the first one thousand barrels a day of an independent producer's output.²⁴ Thus, the tax rate on a barrel of crude oil now may vary from zero to seventy percent, depending on the oil's classification under the former crude oil pricing regulations—incorporated almost *in toto* into the tax act—and the status of the producer. Since royalty owners are also subject to the tax,²⁵ a producer's diligence in seeking a classification with the lowest legally permissible tax rate is of major financial consequence to lessors.²⁶ The Windfall Profit Tax,

The very definition of terms that are basic to the regulatory scheme took years to accomplish and was the cause of numerous lawsuits. A clear definition for terms such as "property," "transactions," "posted price," and "base production control level," for example, has been essential to crude oil price determinations since 1973; FEA rulings on the proper meaning of these terms, however, did not appear until 1975 or later. See Beck, *supra* note 5, at 1-26; Richardson, *supra* note 5, at 808-12; Trowbridge, *supra* note 17, at 214-17.

As another example, the certification procedures allowing tertiary oil to be sold at market prices were so complicated that few producers participated in the program. DOE acknowledged this problem and amended the procedures to ease the regulatory burden. Ligon, *Crude Oil Pricing: Current Regulations and the Shift to Decontrol*, 31 INST. OIL & GAS L. & TAX. 1, 19-20 (1980).

21. I.R.C. §§ 4986-4998.

22. *Id.* § 4990.

23. *Id.* §§ 4987, 4991.

24. *Id.* §§ 4987, 4992.

25. *Id.* § 4996.

26. The following example illustrates both this proposition and the complexity of the Act:

[I]f a producer discovers a new reservoir in 1980 on a lease with an existing reservoir, the producer for DOE purposes may elect to treat the lease as a single property or each reservoir as separate properties. This same election also is available for IRS purposes. Because these elections are independent of each other, the producer, for instance, may treat the lease as a single property for IRS purposes and as two separate properties for DOE purposes. These elections might enable the production from the new reservoir to be sold at uncontrolled prices and result in a lower WPT [windfall profit tax] because of the impact of the net income limitation.

The significance of the DOE property determination becomes even greater because

however, not only embodies all of the problems inherent in the crude oil pricing system, but it also adds new complexities of its own.²⁷ In addition, producers now face a new enforcement bureaucracy—the Treasury Department—that is likely to be less familiar with the oil and gas industry in general and the DOE regulations in particular. Until the tax phases out in 1990, price decontrol has simply added to the regulatory maze confronting oil and gas producers.

B. Natural Gas Pricing

Serious natural gas shortages in the last decade forced Congress and the executive branch to focus their attention on the reform of natural gas pricing.²⁸ After much rancorous debate, the Natural Gas Policy Act of 1978 (NGPA) was enacted in late 1978.²⁹ Since the NGPA also attempted to balance the consumer's interest in low prices against the need for adequate incentives to producers, strong parallels exist between the NGPA and the crude oil pricing

of the impact of the WPT. For pricing purposes, stripper-well oil and newly discovered oil both are exempt from price ceilings; but, the WPT will be greater for stripper-well oil not qualifying for the special independent producer rates. By effective evaluations of property definition alternatives, producers may be able to classify oil production into WPT tiers with lower tax rates.

ARTHUR ANDERSEN & Co., CRUDE OIL WINDFALL PROFIT TAX: TAX AND BUSINESS STRATEGIES 20 (1980).

27. For additional examples, see Ligon, *supra* note 20, at 4-5.

28. The federal government has regulated the price of natural gas sold in interstate commerce since 1954, when the Supreme Court held in *Phillips Petroleum Co. v. Wisconsin*, 347 U.S. 672 (1954), that the Federal Power Commission (FPC) had such authority under the Natural Gas Act of 1938, 15 U.S.C. §§ 717-717w (Supp. III 1979). The FPC's authority also extends to end use controls and allocation of natural gas. *Id.* § 717 f. Thus, the OPEC embargo of 1973 did not necessitate immediate congressional intervention into the natural gas industry like it did into the crude oil industry. For the history of natural gas regulation before 1978, see Breyer and MacAvoy, *The Natural Gas Shortage and the Regulation of Natural Gas Producers*, 86 HARV. L. REV. 941 (1973); Nordhaus, *Producer Regulation and the Natural Gas Policy Act of 1978*, 19 NAT. RES. J. 829, 829-41 (1979); Comment, *Independent Natural Gas Producers, the FPC and the Courts: A Case of Judicial Intermeddling*, 53 TEX. L. REV. 784 (1975).

29. 15 U.S.C. §§ 3301-3432 (Supp. III 1979). The rancor and length of the debate primarily were due to the large differences between the Senate and the House bills. The Senate bill would have deregulated all new natural gas within five years and significant amounts within two years. The House bill, on the other hand, would have established a permanent ceiling price for new natural gas at the price equivalent of domestic crude oil and extended this ceiling to the unregulated intrastate market. One study concluded that, in the first eight years, the cost to consumers of the Senate's proposal would have been \$52 billion more than the cost of the House's program. STAFF OF SUBCOMM. ON ENERGY AND POWER OF THE HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, 95TH CONG., 1ST SESS., REPORT ON ECONOMIC ANALYSIS OF NATURAL GAS POLICY ALTERNATIVES 8 (Comm. Print 1977).

scheme. These parallels include: Continuation of price controls on already discovered natural gas to prevent windfall profits to producers;³⁰ incentive pricing for newly discovered gas, for stripper wells (to prevent their abandonment), and for certain categories of high cost gas;³¹ eventual price decontrol of certain categories of natural gas;³² and extensive recordkeeping and filing requirements for producers.³³ As a result, the NGPA has twenty-seven different categories of wells with twelve different ceiling prices.³⁴ Thus, as with crude oil, a well's classification can make a substantial difference in the amount of royalties that a lessor receives.

The NGPA pricing framework, however, differs from crude oil regulation in several respects. First, certain categories of natural gas are never decontrolled.³⁵ Second, the NGPA requires a more

30. Certain NGPA categories set ceiling prices based on either the just and reasonable rates under the Natural Gas Act of 1938 or previous contract prices. See 15 U.S.C. §§ 3314, 3315, 3316, 3319 (Supp. III 1979).

31. Certain NGPA categories established incentive prices to encourage certain types of production. See *id.* §§ 3312, 3313, 3317, 3318.

32. The government has already deregulated certain categories of high-cost natural gas. See *id.* § 3331(b). Deregulation of new natural gas, certain natural gas from new onshore wells, and certain gas sold under intrastate contracts is scheduled for January 1, 1985; an additional category of new onshore gas is scheduled for decontrol in July 1987. *Id.* § 3331(a)-(b). Either the President or Congress may reimpose price controls on natural gas after July 1, 1985, and before June 30, 1987, for a maximum 18-month period. *Id.* § 3332(a)-(d).

One commentator has discussed the probability that the NGPA incentive prices will raise natural gas prices to market clearing levels by 1985, which would obviate the pressure for continued controls thereafter. See MacAvoy, *The Natural Gas Policy Act of 1978*, 19 NAT. RES. J. 811, 824-28 (1979). See also note 89 *infra* and accompanying text.

33. The NGPA requires detailed information on a well's geophysical characteristics and production history in order to qualify for an incentive price. 18 C.F.R. §§ 274.201-.207 (1980). To qualify as new natural gas from a new onshore well under the NGPA's § 102(c)(1)(B)(ii), 15 U.S.C. § 3312(c)(1)(B)(ii) (Supp. III 1979), for example, the applicant must present, among other things, a location plat that identifies the new well. The plat also must identify all other wells that presently are producing natural gas—or which produced it after January 1970—and that are within a 2.5 mile radius of the new well. Also, the applicant must furnish the agency with a list of the deepest completion locations for all these wells. 18 C.F.R. §§ 274.202(c)(2)(iii)-(iv) (1980). In developed fields this may entail checking the location and depths of hundreds of wells. Charles Curtis, Chairman of FERC, has admitted that the information required for determining section 102 eligibility will be "a record development task that will go on for a number of years." *Impact of Natural Gas Prices on Consumers: Hearings before the Subcomm. on Intergovernmental Relations of the Senate Comm. on Governmental Affairs*, 96th Cong., 1st Sess. 7 (1979) (Statement of Charles B. Curtis) [hereinafter cited as *NGPA Impact Hearings*].

34. See Erck, *Current Major Developments in Federal Natural Gas Legislation and Regulation*, 30 INST. OIL & GAS L. & TAX. 155, 159, 178 app. I (1979). As of December 1978 maximum lawful prices in these categories ranged from \$332 per million British thermal units (MMBtu) to \$2.224 per MMBtu. *Id.* at 191-92 app. II.

35. All categories of gas that are not deregulated under 15 U.S.C. § 3331 (Supp. III

complex scheme for classifying wells in particular price categories than the crude oil self-policing apparatus of recordkeeping, certified sales, and compliance audits. Thus, to take advantage of incentive pricing, a producer must file under oath specific forms³⁶ that document the legally required characteristics of each well for which he is seeking an incentive price. Two administrative agencies, the relevant state jurisdictional agency and the Federal Energy Regulatory Commission (FERC), must review these classification forms for accuracy.³⁷ Third, rather than delegating the responsibility to an agency's discretion, Congress itself defined the natural gas categories and set their maximum allowable prices. This strategy alleviated somewhat the problem of agencies being subject to the intense political pressures that they had encountered in administering crude oil prices.³⁸ Last, Congress devoted substantial attention to the enforcement, compliance, and penalty features of the NGPA in an attempt to avoid charges that the Act was a sell-out to the gas producers.³⁹

1979), remain price-controlled indefinitely. These include stripper well gas, as well as several other categories of gas. See Pierce, *Producer Regulation Under the Natural Gas Policy Act*, 31 INST. OIL & GAS L. & TAX. 99, 103-10 (1980). The categories of gas that will be price-decontrolled in the 1980s, however, still must be qualified through agency determinations. In other words, all gas will remain regulated under such nonprice provisions of the NGPA as the reporting and record retention requirements. 15 U.S.C. §§ 3331, 3371-3375 (Supp. III 1979).

36. The oath required in filing for a well determination for natural gas produced from a new onshore reservoir, for example, includes the following statements:

(1) That the applicant has made, or has caused to be made pursuant to his instructions, a diligent search of all records (including but not limited to production, State severance tax, and royalty payment records and records of jurisdictional agency determinations) which are reasonably available and contain information relevant to the determination of eligibility;

(2) Describing the search made, the records reviewed, the location of such records, and a description of any records which the applicant believes may contain information relevant to the determination but which he has determined are not reasonably available to him;

(3) That the applicant has no knowledge of any other information not described in the application which is inconsistent with his conclusion that the well qualifies for the well category determination sought.

18 C.F.R. § 274.202(e) (1980).

37. 15 U.S.C. § 3413 (Supp. III 1979); 18 C.F.R. §§ 274.201-.207 (1980).

38. See text accompanying notes 15 & 16 *supra*. As the Chairman of the FERC has stated, "In short, the Congress has replaced the Commission in determining the balance between the consumer and producer interests and it has placed that balance at the maximum lawful prices contained in this act." *NGPA Impact Hearings, supra* note 33, at 8. But see text accompanying note 49 *infra*.

39. A proposed draft of the NGPA was circulated for comment and received vociferous criticism from the FERC's Office of Enforcement. See note 44 *infra*. As a result, significant changes were made in the NGPA, including stronger enforcement and penalty provisions

Despite Congress' efforts to structure natural gas pricing and compliance procedures to avoid some of the major problems that had arisen under crude oil regulation, the NGPA has been criticized as vociferously as the crude oil pricing scheme. Because of its complexity, the Act was denounced immediately as unenforceable.⁴⁰ Legal commentators billed the Act as perhaps "the most complicated and ambiguous statute ever enacted"⁴¹ and predicted that small producers might find the NGPA pricing and filing requirements so burdensome that they simply would ignore them.⁴² Industry trade journals are replete with diatribes against the massive paper work and regulatory costs imposed on firms under the

and the requirement of state and federal determinations of qualifications to collect incentive prices. Chairman Curtis concluded that with these changes the NGPA could be effectively administered and enforced. See Letter from Chairman Curtis to Senator Henry Jackson (Sept. 8, 1978), reprinted in [1979] 1 NGPA INFO. SERV. ¶¶ 21-23 [hereinafter cited as Letter]; Correspondence from Sheila Hollis, Director of the Office of Enforcement, to Chairman Curtis (Sept. 7, 1978), reprinted in [1979] 1 NGPA INFO. SERV. ¶ 26. The administrative and enforcement provisions of the NGPA are codified in 15 U.S.C. §§ 3411-3418 (Supp. III 1979). Both civil and criminal penalties can be levied either for selling natural gas at a first sale price that exceeds any applicable maximum lawful price or for violating any other provision of the NGPA. *Id.* § 3414. For a description of FERC's enforcement procedures and its commitment to vigorous pursuit of NGPA violations, see Morgan & Garrison, *Enforcement Policies and Procedures of the Federal Energy Regulatory Commission*, 15 TULSA L.J. 501 (1980). See also *NGPA Impact Hearings*, supra note 33, at 8 (Chairman Curtis' comments on enforcement).

40. See note 39 supra.

41. Moody & Garten, *The Natural Gas Policy Act of 1978: Analysis and Overview*, 25 ROCKY MTN. MIN. L. INST. 2-1, 2-1 (1979).

42. Morgan, *Application and Enforcement of the Natural Gas Policy Act of 1978: Administrative and Legal Problems*, 25 ROCKY MTN. MIN. L. INST. 13-1, 13-11 (1979). This response may be especially prevalent among those intrastate producers who were never subject to federal price regulation of natural gas under the Natural Gas Act of 1938. This group could be numerous, since about 40% of the natural gas flowing before the enactment of the NGPA was uncontrolled. Erck, supra, note 34, at 156. See also Leufven, *The Natural Gas Policy Act of 1978: What It Means to the Independent Producer*, 20 S. TEX. L.J. 19 (1979). Leufven states that

[m]any independent producers, unfamiliar with federal regulation of gas sold to intrastate pipelines, may consider the reporting and other regulatory requirements of the FERC to be low priority and unworthy of legal planning, counseling, and fees. Rather than stressing the civil or criminal penalties for non-compliance with the Act, counsel for independent gas producers should stress that serious legal consideration of the producer's present and planned operations may result in a higher maximum lawful selling price than would otherwise apply.

Id. at 42. Counsel should also recognize that a failure to seek the highest lawful selling price may subject the producer to a suit for breach of an implied covenant. See text accompanying notes 140-53 *infra*.

Other commentators have predicted that the NGPA's complexity will force many small producers to go out of business. *NGPA Impact Hearings*, supra note 33, at 51, 82-83 (statements of James F. Flug and William W. Winpisinger speaking as a panel).

NGPA.⁴³ Judicial recognition of the Act's complexity and ambiguity has already occurred,⁴⁴ and the Chairman of FERC has predicted many more lawsuits.⁴⁵ Furthermore, several states have enacted laws that restrain prices below the NGPA's ceilings, which adds to the regulatory burden.⁴⁶ Thus, two years after the passage of the NGPA, the areas of uncertainty in legal rights and duties created by the Act have come to outnumber the areas of clarity.⁴⁷

In spite of all the detail and definition that Congress imposed on natural gas pricing through the long months of debate and compromise, Congress failed to avoid the two basic problems that were inherent in the crude oil pricing regulations—complexity and ambiguity. The complexity arises from the very nature of the task to be performed—regulating the details of an economically vital, technically sophisticated industry comprising thousands of producers.⁴⁸ The ambiguity stems from the inability of Congress to understand all the details of the industry and also, perhaps, from the purposeful delegation to FERC of those issues over which a com-

43. See, e.g., OIL & GAS J., Nov. 19, 1979, at 207. In this article Sun Gas Company stated that in the first year of operation under the NGPA, it had filed 4,500 pounds of paper to receive price determinations for 1,500 producing wells at a cost of \$1.5 million. Sun officials said that it had delayed the drilling of eight wells because of backlogs in state agency approval proceedings. See also Thomas, *Oil Exploration: Booming Again as Wildcatters Return to Fields*, Hous. Bus. J., Oct. 1, 1979, at 1. Thomas quotes an independent producer's one firm rule on crude pricing: "If there is a cloud over it, we don't touch it. We saw a beautiful deal, a re-entry on a gas well. But there was a question about the gas already being dedicated, so we walked away."

44. In *Columbia Gas Transmission Corp. v. Allied Chem. Corp.*, 470 F. Supp. 532 (E.D. La. 1979), the court stated,

A model of clarity the NGPA is not. It was assessed by the Office of Enforcement of the FERC (successor to the FPC) on August 14, 1978, as being ". . . so complex, ambiguous and contradictory that it would be virtually impossible for this Commission to enforce it in a conscientious and equitable manner."

Id. at 548 (quoting 124 CONG. REC. H13108 (daily ed. Oct. 14, 1978)).

45. The NGPA will undoubtedly engender a significant number of court actions before the full expression of the statutory requirements are defined and understood. One must recall that this is a highly litigious subject and many millions of dollars and substantial volumes of one of this Nation's most precious resources are at stake. Letter, *supra* note 39, at ¶ 21.

46. Section 602 of the NGPA specifically authorizes states to restrain prices below the federal ceilings. 15 U.S.C. § 3432 (Supp. III 1979). New Mexico, Oklahoma, and Kansas have done so. Pierce, *supra* note 35, at 113.

47. For a description of some of the many difficult interpretative provisions that face producers attempting to apply the NGPA well classification rules, see Pierce, *supra* note 35, at 118-27.

48. Complexity is enhanced because producers were subject to interim regulations before the final regulations were promulgated and therefore must struggle with two sets of regulations.

promise was simply too difficult to reach.⁴⁹

III. FRAMEWORK OF IMPLIED COVENANTS IN OIL AND GAS LAW

The law of implied covenants is well established, yet its doctrinal origins and continuing vitality and validity in light of changing public policy are still a matter of some controversy. This part of the Article briefly describes the development of implied covenants in oil and gas law, the different principles that courts use to resolve implied covenant disputes, and how these principles may affect the use of implied covenants in the oil and gas business today.

Implied covenants developed in oil and gas law primarily because of two constants in the oil and gas business.⁵⁰ First, it is impossible to specify in a lease contract all of the details of exploration, production, and development that will be required of a lessee in the future. Despite the marvels of modern engineering and technology, it is still not possible to know whether a drilling operation will result in a "gusher" or a "duster." For this reason, lessees are unwilling to commit themselves to a program of development in the lease contract that subsequent information may indicate to be an unprofitable venture. Lessors are also wary of express lease provisions that might unduly limit the lessee's obligations. Thus, the typical oil and gas lease passes to the lessee the exclusive right to

49. The area rate clause controversy is an example of this type of delegation. FERC has experienced great difficulty in determining whether contracts in existence when the NGPA became law authorize producers to collect NGPA ceiling prices through the operation of area rate price escalator clauses in the contracts. Literally billions of dollars are at stake in this single unresolved issue. One authority states that the resolution of this issue may not occur for at least a decade. Pierce, *supra* note 35, at 117. See also Ligon, *Problems of Contractual Authorization to Collect NGPA Wellhead Prices*, 57 TEX. L. REV. 551 (1979); Moody & Garten, *supra* note 41, at 2-16 to 2-22.

Another source of complexity in this area is the interaction of the Crude Oil Windfall Profit Tax Act of 1980 with the NGPA of 1978. I.R.C. § 44D(e). The difficulty that this interaction poses for producers is well illustrated by the requirement in the NGPA that producers elect—within 30 days after passage of the Act or before well drilling commences, whichever is later—to take advantage of the provisions on either incentive prices or tax benefits for § 107 high-cost natural gas; producers are not allowed to take advantage of both. 15 U.S.C. § 3317(d) (Supp. III 1979). The tax credit under the Windfall Profit Tax Act is insubstantial; many producers, however, have overlooked the necessity of filing the required election forms. As a result, they will not be able to claim the incentive price for high-cost gas without legislative relief. Letter from the Texas Independent Producers and Royalty Owners Association (TIPRO) to Jacqueline Weaver (July 21, 1980).

50. See generally 2 E. BROWN, THE LAW OF OIL AND GAS LEASES §§ 16.01-.05 (2d ed. 1977); R. HEMINGWAY, THE LAW OF OIL & GAS §§ 8.1-.13 (1971); E. KUNTZ, LAW OF OIL & GAS §§ 54.1-62.5 (1978); M. MERRILL, COVENANTS IMPLIED IN OIL & GAS LEASES (2d ed. 1940 & Supp. 1964); W. SUMMERS, OIL & GAS §§ 371-472 (1959); 5 H. WILLIAMS & C. MEYERS, OIL & GAS LAW §§ 800-899 (1980) [hereinafter cited as WILLIAMS & MEYERS].

explore, produce, and develop the property and often specifies little else.

The second constant is that the lessor's primary consideration for granting an oil and gas lease is usually the right to receive a royalty, which is a cost-free, fractional share of any oil and gas produced. If the lessee does not develop the property, the lessor will receive little in return for his grant.⁵¹ Under the typical oil and gas lease, lessees bear all the costs of exploring, producing, operating, and developing the property. Thus, while lessees and lessors have a strong mutual interest in finding and producing oil and gas, conflicts between them are inevitable because they have different interests in the cost factor.

These inherent characteristics of the lessee/lessor relationship commanded the early attention of the courts to resolve controversies between the two parties, and, as a result, the common law of implied covenants was born. The Eighth Circuit's landmark decision in *Brewster v. Lanyon Zinc Co.*⁵² is cited most often as the embodiment of the principles of implied covenant law:

It is conceded, as indeed it must be, that the lease contains no express stipulation as to what, if anything, should be done in the way of searching for and producing oil or gas after the first five years; but it does not follow from this that it is silent on the subject, or that the matter is left absolutely to the will of the lessee. Whatever is implied in a contract is as effectual as what is expressed. Implication is but another name for intention, and if it arises from the language of the contract when considered in its entirety . . . it is controlling.

. . . The subject was, therefore, rationally left to the implication . . . that the further prosecution of the work should be along such lines as would be reasonably calculated to effectuate the controlling intention of the parties as manifested in the lease, which was to make the extraction of oil and gas from the premises of mutual advantage and profit.

. . . 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 carry the operations beyond the point where they will be profitable to him, even if some benefit to the lessor will result from them . . . 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.⁵³

Despite general agreement with the reasons enunciated in *Brewster* for implying covenants in oil and gas leases, controversy

51. Lessors also typically receive bonus, which is a front-end cash payment, and delay rentals, which are payable during the primary term to delay drilling.

52. 140 F. 801 (8th Cir. 1905).

53. *Id.* at 809-11, 814.

still exists among courts and commentators over whether the courts should recognize additional doctrinal factors to expand or narrow the application of implied covenants in oil and gas law. Merrill's classic work on implied covenants acknowledges that judicial recognition of implied covenants has proceeded largely because of the peculiar nature of the oil and gas lease and the unique relationship it creates between lessee and lessor.⁵⁴ Merrill also argues that the lessee/lessor relationship is by its very nature tainted with unequal bargaining power, and courts, therefore, should embrace willingly the doctrine of implied covenants to ensure fair dealing.⁵⁵

Professor Walker, on the other hand, found that implied covenants in oil and gas law were restricted in scope because these covenants were implied "in fact" rather than "in law."⁵⁶ Covenants are implied in fact only when necessary to give effect to the actual intent of the parties to the contract—not to promote fair dealing.⁵⁷ Thus, according to Walker, the lessor's reservation of royalty as the primary remuneration for the execution of the lease is the only reason for enforcing implied covenants against a lessee.

Brown acknowledges that the courts generally have accepted Merrill's wider view of implying covenants "in law" in oil and gas leases. He, however, asserts that, as a result, "[p]robably there is no area of contractual law in which one party to the contract is favored quite so much as the lessor in an oil and gas lease."⁵⁸ By emphasizing the mutuality of interests that bind lessee and lessor rather than the conflicts which might divide them, Brown argues that courts should be extremely cautious in expanding the doctrine of implied covenants into new and uncharted areas.⁵⁹

54. M. MERRILL, *supra* note 50, §§ 1-3, 221-23.

55. *Id.* § 221. The author states that "[i]t must be borne in mind that lessor and lessee do not usually deal on an equal footing, as two businessmen contracting at arms length. The lessor is ordinarily of limited education and business experience, unfamiliar with the subject-matter of the lease." *Id.* at 468. Merrill, however, would not require the courts to justify the application of the implied covenant doctrine with a finding of unequal bargaining power. He believes, "It would impede the administration of justice if the courts were required in each case to embark upon a calculation of the relative knowledge and of the bargaining power of the parties. Thus the doctrine applies though the lessor is the government or a large corporation." *Id.* at 469 (Supp. 1974) (footnotes omitted).

Kuntz adopts Merrill's analysis that implied covenants derive from the common-law concept of relation and are implied in law, but he does not accept Merrill's additional factor of unequal bargaining power. E. KUNTZ, *supra* note 50, § 54.3.

56. Walker, *The Nature of the Property Interests Created by an Oil and Gas Lease in Texas*, 11 *TEX. L. REV.* 399, 399-406 (1933).

57. *Id.* at 402.

58. 2 E. BROWN, *supra* note 50, § 16.04, at 16-122.

59. *Id.* at 16-118 to 16-124.

Much of Brown's opposition to judicial expansion of implied covenants in the lessee/lessor relationship is directed at the position taken by Professors Williams and Meyers, which would infuse the doctrine of implied covenants with the public interest. Although Williams and Meyers accept the traditional origins of implied covenant law,⁶⁰ they believe that courts should consider public policy as an important factor in the resolution of conflicts between lessees and lessors. For example, they emphasize public policy considerations when advocating judicial recognition of an implied covenant to explore.⁶¹ This approach marks a wide departure from the traditional viewpoint, which bases implied covenants on the nature of the typical oil and gas lease and the relationship it creates.

The infusion of public policy concerns into the private relationship that an oil and gas lease creates has also been urged by those who want to redress the imbalance that Brown perceives to have resulted from the courts' overly zealous protection of lessors under implied covenant law. Professor Martin, for example, has argued recently that courts should be more cautious in finding a breach of implied covenant duties, so that corporate lessees can better fulfill their obligations to national energy development and environmental protection without being constrained by a lessor's interests in short-term returns.⁶² He contends that the law of im-

60. 5 WILLIAMS & MEYERS, *supra* note 50, §§ 802-803. The authors argue that implied covenants in oil and gas law are firmly rooted in the common-law contractual principle of cooperation, which includes elements of both fact (the reasonable expectations of the parties) and law (the ethical norms of conduct).

61. *Id.* § 802.2. The authors state that

[t]here can be no doubt that public policy favors exploration: witness the intangible drilling deduction and the depletion allowance in the federal income tax law and the discovery allowables in state conservation regulation. . . .

When parties write an open-end contract like an oil and gas lease, they commit to the courts in advance the resolution of conflicts they cannot presently resolve. It does no violence to this incomplete bargain that public policy should weigh in the decisional process; and when the subject matter . . . is a natural resource as vital as oil and gas, the public interest dictates that it should.

Id.

62. Martin, *A Modern Look at Implied Covenants to Explore, Develop, and Market Under Mineral Leases*, 27 INST. OIL & GAS L. & TAX. 177 (1976). Martin, for example, believes that a lessee should have the freedom to follow the Secretary of the Interior's policy statements that support expanded offshore oil and gas development—even if this delays onshore drilling on a lessor's tract—if the lessee's decision is made under the good faith belief that more offshore drilling will forestall congressional proposals to take over development of the Outer Continental Shelf. Similarly, Martin would immunize a lessee's good faith decision not to seek a higher intrastate market price, if this decision is made to forestall

plied covenants has "ill-served the nation"⁶³ because it has promoted both the rapid depletion of reserves and the wasteful consumption of petroleum.⁶⁴ Professor Martin believes that the public interest in energy conservation demands the subordination of the lessor's right to self-interested pursuit of private gain through implied covenant litigation.⁶⁵

The different perceptions of the bases for implying covenants in oil and gas law may well influence a court's decision to accept or reject, or to expand or limit, the operation of implied covenants in a particular instance. Furthermore, the recent extensive federal regulation of the oil and gas industry in the wake of this decade's turbulent energy markets is likely to trigger renewed examination of the proper role of these doctrinal factors in the application of implied covenant law. The previous discussion suggests that three different models are used to resolve implied covenant disputes, which are as follows:

1. The equity model. This model holds that covenants are implied in law primarily to prevent unfairness to lessors. The

congressional price controls on all natural gas.

63. *Id.* at 205.

64. Professor Martin's statement echoes the criticism of implied covenant law that arose several decades ago when most states adopted conservation legislation, such as prorationing, well spacing rules, and compulsory pooling statutes, and thereby wrought pervasive changes in the oil and gas industry. Commentators argued that the public interest in conservation, which this state regulation evidenced, had supplanted the philosophy of development that had nurtured the doctrinal roots of implied covenant law. These commentators, therefore, contended that implied covenants had been extinguished, or at least severely restricted. See, e.g., Eberhardt, *Effect of Conservation Laws, Rules and Regulations on Rights of Lessors, Lessees, and Owners of Unleased Mineral Interests*, 5 INST. OIL & GAS L. & TAX. 125 (1954). Eberhardt argued that the doctrine of implied covenants is inextricably bound to the common-law "rule of capture," which courts adopted in the beginnings of the petroleum industry. The rule of capture is the legal rule of nonliability for causing oil or gas to migrate across property lines. H. WILLIAMS & C. MEYERS, OIL AND GAS TERMS 519 (4th ed. 1976). The rule of capture developed because of a lack of scientific knowledge about the nature of oil and gas reservoirs, including the assumption that oil and gas reservoirs were inexhaustible. According to Eberhardt, the growth in knowledge about reservoir mechanics led to the passage of conservation legislation that countered the inefficient effects of the rule of capture, with the coincident result that implied covenant law was completely abrogated. Martin reaffirms this reasoning by using language in *Brewster v. Lanyon Zinc Co.*, 140 F. 801 (8th Cir. 1905), to show that this seminal case resulted from a fact situation concerning the migratory nature of oil and gas under the rule of capture. Martin would limit the reasonably prudent operator test to those implied covenant cases that involve drainage, and he would use the standard of the lessee's good faith in all other implied covenant situations. Martin, *supra* note 62, at 200-01.

65. Martin, *supra* note 62. Martin states, "From a policy standpoint, slow development of known formations may be preferable to a more rapid rate of development that would return the maximum short-term benefits to the lessor." *Id.* at 208.

actual language of the lease may be and often is considered evidence of the parties' intentions, but this does not necessarily control the outcome; whatever is considered fair is determinative. The measure of fairness springs from equitable norms developed in the common law that need not be manifested in an express public policy.⁶⁶ The model often presumes the superior bargaining power of lessees: that lessors are handed a standard printed lease form and are simply unequal to the task of protecting their interests through negotiation.⁶⁷

2. The contract or relational model. This model closely adheres to the "implied in fact" theory and limits the courts' inquiry to what the parties reasonably would have intended given the nature and purpose of the specific contract and the circumstances under which it was made. Considerations of public policy may enter into the inquiry, but only if the court finds that the parties reasonably would have expected a particular policy to serve as the method for defining those rights and duties that could not be expressed in advance.⁶⁸

3. The policy model. This model allows public policy values—external to the parties' expectations or to judicial norms of equity—to influence the outcome of implied covenant litigation.⁶⁹ These policy values are most often ascertained through an analysis of legislated expressions of national or state priorities.⁷⁰

The relative merits of these models are immediately apparent.

66. The cases that deal with a lessee draining his own lessor's tract from a well that is located on adjacent property are good illustrations of the equity model. See *Williams v. Humble Oil & Ref. Co.*, 432 F.2d 165 (5th Cir. 1970); *Phillips Petroleum Co. v. Millette*, 221 Miss. 1, 72 So. 2d 176 (1954).

67. See note 55 *supra* and accompanying text. In its extreme form this is a "lessor always wins" model. When applied more moderately, the model simply may amount to an analogue of the standard rule that contracts are to be construed against their makers when doubt exists about the parties' intent. The extreme form should be and generally is avoided as the basis of implied covenant law. When overreaching and unconscionability clearly exist in a lease transaction, contract law can deal effectively with these problems without the doctrine of implied covenants.

68. Economic efficiency is an often cited policy goal of the American private enterprise system, but the parties to an oil and gas lease may also have expected that efficiency would delineate many of their rights and duties. On the other hand, a public policy of reducing oil and gas prices on behalf of consumers is most unlikely to have been within the parties' intent in an oil and gas lease.

69. The policy model, in contrast to the equity model, may favor lessees rather than lessors. For example, a policy favoring economic efficiency would clearly favor lessees.

70. *Williams* and *Meyers* point to the federal tax laws and state prorationing rules to show that public policy favors exploration. See note 61 *supra*.

The equity model allows the common law to function as an instrument of justice; it may do so, however, at the expense of stability in both the law and the parties' expectations from a contract.⁷¹ The contract model is most likely to provide this stability, but perhaps with unfair results. The policy model allows the common law to adapt more readily to changing social and political values, yet it may frustrate either the parties' expectations or judicial norms of fairness. Each model, however, can claim to be fair: the first because it expressly considers equity; the second because fairness in contract law is defined as that which most closely approximates the parties' intentions; and the third because fairness is best measured by the norms that are expressed in the political process.

The choice of one model over another is itself a value judgment that can influence—indeed determine—the outcome of a case.⁷² One result of the nation's energy crisis is that the equity and policy models are likely to receive more judicial attention. The extraordinary events that have occurred in the energy sphere in the past decade probably will give rise to new facts and circumstances that are less easily placed within the parties' contractual expectations. Without well-worn paths to follow, the courts may veer more readily from the written words of the contract and base their decisions in equity.

Given the importance of oil and gas to the maintenance of our daily lives, the temptation to rely on public policy in making deci-

71. See, e.g., *Southland Royalty Co. v. Pan Am. Petroleum Corp.*, 378 S.W.2d 50 (Tex. 1964). In *Southland Royalty Co.* the court allowed the successor to a lessor's interest to escape from a gas royalty clause that fixed the royalties due at \$100 per year. The court ostensibly relied on the principles of contract interpretation to give lessor the victory. The dissent, however, saw the majority's rationale as a charade masking a decision based on equity:

One is tempted to join in the majority opinion solely because of what, for want of a better term, we sometimes call the equities of the case. The idea that respondents could produce gas worth millions of dollars and pay as royalty only \$100.00 per well per year is as shocking to my sense of fairness as it is to the other members of the Court. A judge would perhaps be less than human if he never experienced the desire to patch up, within what he conceives to be the limits imposed by law, deficiencies in an agreement which later turns out to be a bad bargain for one of the parties.

Id. at 70.

72. The models, however, are not mutually exclusive. The court in *Millette v. Phillips Petroleum Co.*, 209 Miss. 687, 48 So. 2d 344 (1950), for example, used state conservation legislation as well as equity to support its opinion. Similarly, the implied covenant to explore may be supported on equity grounds, by contract principles—that exploration, even without the prospect of assured profitability, is within the expectations of the parties because of the intrinsically risky nature of the oil and gas business—or from a public policy standpoint.

sions may be virtually irresistible.⁷³ If so, a clear danger exists that the law of implied covenants will become as unpredictable and irreconcilable as the energy policy that it mirrors. It is ironic that the three strongest advocates of factoring public policy into the resolution of private disputes between lessees and lessors are on opposing platforms. Williams and Meyers seek to induce more exploration by strengthening the lessor's hand with a perceived public interest in exploration; Martin, on the other hand, believes that the public interest in conservation demands that greater deference should be given the lessee's business judgment to delay exploration. The irony is inevitable because opinions of what "the public interest" in energy policy demands today span a range of values broad enough to attract polar opposites. National energy policy, particularly in the area of oil and gas price regulation, is ambiguous, inconsistent, and unstable.⁷⁴ This source of contrariety suggests that courts should apply the policy model cautiously lest "energy policy" and "the public interest" become rubber stamps for poorly reasoned decisions that ignore bargained-for expectations and fair dealing between lessee and lessor.

Since public policy probably will be a factor in the resolution of many implied covenant cases in the future, a threshold issue is whether the pervasiveness of federal regulation in oil and gas pricing has preempted implied covenant law in this area. Any suggestion of preemption, however, should be rejected for two reasons. First, the federal energy pricing regulations, as pervasive as they are, do not expressly preempt the common law of implied covenants. Courts have demonstrated a reluctance to attribute a pre-

73. At least one court seems to have surrendered to this temptation. In *Superior Oil Co. v. Devon Corp.*, 604 F.2d 1063 (8th Cir. 1979), the court affirmed the lower court's finding of a breach of the implied covenant to reasonably develop. As an additional justification for its decision, the court stated,

We further note that at this particular point in time the public interest in encouraging the prudent development of oil and gas leases is particularly important. The development of domestic sources of oil will reduce the amount of oil which has to be imported and will thereby redound to the national interest by helping to reduce the deficit trade balance and to render the nation less susceptible to economic dislocations arising from political disturbances in foreign oil producing nations.

Id. at 1069.

74. See text accompanying notes 4-49 *supra*. Now that Congress has passed the windfall profit tax and reduced the favorable income tax treatment once given to the oil industry under the percentage depletion allowance, the proposition that "public policy favors exploration" is not as irrebuttable as Williams and Meyers argue. See note 61 *supra*. For further criticism of the Williams and Meyers position, see Williams, *Implied Covenants for Development and Exploration in Oil and Gas Leases—The Determination of Profitability*, 27 KAN. L. REV. 443, 452-53 (1979).

emptive intent to federal pricing regulations in other contexts, and this approach is sound.⁷⁵ Second, the minimal effect that state conservation legislation had on the viability of implied covenants is a strong precedent for the continuing role of implied covenants under federal pricing legislation. Courts generally rejected the argument that this state legislation evidenced a new public ethic which required the demise of implied covenant law. These courts held that the conservation legislation preempted implied covenant law only when the latter expressly and directly conflicted with the new statutory scheme.⁷⁶ Thus, the doctrine of implied covenants survived virtually unscathed and continued to serve its vital function of resolving disputes between the lessee and lessor under an oil and gas lease.

In sum, neither the federal pricing regulations nor national energy policy should be found to have preempted the doctrine of implied covenants.⁷⁷ The general principles of implied covenant law,

75. In *Intercity Oil Co. v. Murphy Oil Corp.*, [1980] 1 ENERGY MNGM'T (CCH) ¶ 9722 (D. Minn. 1976), the court rejected defendant's contention that the federal petroleum price regulations so pervasively controlled its pricing behavior that they served as a basis for implied immunity from an antitrust suit for predatory pricing and solicitation. The court found that the federal pricing regulations were not intended to replace voluntary commercial relationships, and that pricing below the federally allowed maximum price was not immune from antitrust scrutiny.

In *Shell Oil Co. v. FERC*, 566 F.2d 536 (5th Cir. 1978), *aff'd by an equally divided court*, 440 U.S. 192 (1979), the court concluded that an extension of FERC's jurisdiction to encompass the physical activities and facilities of production and development was beyond FERC's statutory authority and would encroach on areas traditionally reserved to the states. The court thus held invalid a FERC order that would have imposed a prudent operator standard, which is derived from implied covenant law, on all certified producers who are developing and maintaining reserves for delivery into the interstate market. In affirming the continuing, preeminent role of state authority in these areas, the court's decision arguably stands for the proposition that the state common law also remains vital.

76. See 5 WILLIAMS & MEYERS, *supra* note 50, §§ 865-867; note 235 *infra*. Somewhat surprisingly, the issue whether state conservation legislation has preempted common-law causes of action is still being litigated. In *U.V. Indus., Inc. v. Danielson*, 602 P.2d 571 (Mont. 1979), defendant-lessees argued unsuccessfully that the Montana Oil & Gas Conservation Act of 1953 had abolished the common-law cause of action for breach of the implied covenant to protect against drainage.

77. In certain circumstances the specifics of the federal pricing regulations will directly contravene the application of a particular implied covenant principle, *see* text accompanying notes 141-42 *infra*, but this does not prove that Congress intended the wholesale demise of the doctrine of implied covenants. Indeed, it arguably affirms a congressional intent to disallow only specific applications.

Implied covenant litigation over the federal crude oil pricing rules may conflict with the congressional objective of centralized judicial review of these regulations. Under the Emergency Petroleum Allocation Act of 1973, 15 U.S.C. § 754(a)(1) (1976); Economic Stabilization Act of 1970, Pub. L. No. 91-379, §§ 211(b)(1)-(2), 84 Stat. 796 (1971) (prior to expiration), a special national court of appeals, which was designated the Temporary Emergency

which are founded on the nature of the relationship between the lessee and lessor that an oil and gas lease creates—and embellished with considerations of equity and public policy—still hold much opportunity for controversy and discussion in their specific application to the new federal regulatory framework.

IV. THE EFFECT OF FEDERAL PRICE LAWS ON IMPLIED COVENANTS

A. Introduction

The implied covenant to act as a reasonably prudent operator in the *Brewster v. Lanyon Zinc Co.*⁷⁸ mold can be classified into specific categories that the courts have developed. The classifications differ somewhat among commentators,⁷⁹ but there is general agreement on the following categories:⁸⁰

Court of Appeals (TECA), was given exclusive jurisdiction over all cases arising under the petroleum price regulations. One rationale for establishing this special court was that the price regulations would then be interpreted consistently on a nationwide basis, which in turn would allow for a coordinated response to the national emergency in energy. See Elkins, *supra* note 16, at 115-19. This congressionally perceived need for consistency in judicial interpretation of federal petroleum pricing regulations has been used to argue against the application of general federal criminal statutes to alleged violations of the price regulations, since this application could result in the circumvention of TECA's jurisdiction. See Trowbridge, *supra* note 17, at 222-26. In this respect, private litigation of implied covenant disputes over the crude oil pricing rules may result in a judicial interpretation of pricing rules that is inconsistent with either TECA's or other courts' holdings.

Nevertheless, the benefits of centralized judicial review do not outweigh the arguments for recognizing the continued vitality of the doctrine of implied covenants. See text accompanying notes 50-76 *supra*. Moreover, congressional dedication to centralized judicial review of federal energy pricing is hardly absolute. The Emergency Petroleum Allocation Act, for example, specifically allowed buyers who were alleging price overcharges in the sale of crude oil or petroleum products to bring private enforcement actions in non-TECA courts. 15 U.S.C. § 754 (1976). In addition, judicial review of issues arising under the NGPA is not centralized in TECA, except for the review of certain emergency gas allocation orders. 15 U.S.C. § 3363 (Supp. III 1979). Furthermore, courts that entertain private enforcement actions under the federal petroleum pricing regulations can minimize the risk of inconsistent interpretations either through careful application of the doctrine of primary jurisdiction or by requiring joinder of the federal agency as a party. See Mode, *supra* note 5, at 102-08; Comment, *The Private Cause of Action in the Enforcement of Oil and Petroleum Price Regulations*, 27 AMER. U.L. REV. 901 (1978).

78. 140 F. 801 (8th Cir. 1905); see note 53 *supra*.

79. The different classification schemes of Professors Merrill, Walker, Summers, and Williams & Meyers are summarized in 5 WILLIAMS & MEYERS, *supra* note 50, § 804.

80. While the classifications listed here are useful and have become customary in implied covenant litigation and commentary, they do not define the limits of the general duty of a lessee to act as a reasonably prudent operator. Thus, even though a lessee's particular action or failure to act under certain circumstances may not fall into one of these four categories, the lessee is not immunized from a suit alleging breach of the implied duty to act as a reasonably prudent operator.

Furthermore, classifications may overlap. The implied covenant to protect against

1. The implied covenant to protect against drainage.
2. The implied covenant to drill additional wells once production has been obtained. Some courts and commentators further separate this category into two distinct covenants: (a) An implied covenant to develop in proven territory, and (b) an implied covenant to explore new areas.
3. The implied covenant to market.
4. The implied covenant to manage and administer the lease with reasonable care, which includes the covenant to seek favorable administrative action.

Three major characteristics of the federal energy regulatory framework described earlier in this Article are likely to inspire implied covenant litigation. They may be articulated as follows:

1. Revenues from oil and gas production are tied to statutory price and tax schedules that allow rising prices (or lower tax rates) and the eventual decontrol of several categories.
2. The pricing rules are complex, ambiguous, and have a high cost of compliance.
3. The rules often necessitate administrative action to achieve the benefits of higher prices or lower taxes.

The primary impact of these three characteristics falls correspondingly on (1) the implied covenant to develop and to explore further; (2) the implied covenant to market; and (3) the implied covenant to seek favorable administrative action. This part of the Article examines the relationship between each covenant and its respective regulatory characteristic. In particular, this part discusses which issues are likely to arise, what precedents exist to resolve these issues, whether the precedents are persuasive, and, if not, what alternative solutions might be available.

B. The Drilling Covenants: The Effects of Scheduled Price Rises and Decontrol

Under the drilling covenants, a lessor seeks to impose upon his lessee the obligation to drill a well, for the purpose of protecting against drainage, or developing or exploring further an already producing property. To the extent that public debate both before and after the passage of the federal energy price laws has fostered

drainage, for example, may also include the duty to seek favorable administrative action to secure a drilling permit. *See Amoco Prod. Co. v. Alexander*, 594 S.W.2d 467 (Tex. Civ. App. 1979), *aff'd*, 24 Tex. Sup. Ct. J. 581 (1981).

greater knowledge among lessors of the potential profit in oil and gas leasing, one can anticipate more litigious lessors to take a more active interest in the development of their properties. Of course, when present and projected price increases of oil and gas clearly indicate that drilling would be profitable, lessees can be expected to drill many wells without lessors' prodding.⁸¹ When the two parties' financial interests or opinions on the proper pace of development diverge, however, implied covenant litigation is likely to arise.⁸² Litigation is possible even over lands on which lessors previously have brought unsuccessful suits to compel performance of a drilling covenant, since a change in conditions occasioned by higher oil and gas prices will often render the doctrine of *res judicata* inapplicable to a previous judgment that oil and gas production would not be in paying quantities.⁸³

1. The Implied Covenant to Reasonably Develop

The implied covenant to reasonably develop requires that once a discovery is made on the leasehold, lessees must continue to drill and develop the property with the diligence of a reasonably prudent operator.⁸⁴ To establish a breach of this covenant, the lessor must prove that the desired development wells would be profitable for lessee to drill.⁸⁵ This covenant presents the issue of the timing of development, which currently is particularly important because of the rising prices of oil and gas. Few courts have had to address this issue yet, since the prices of oil and gas were fairly constant—if not declining—in the years before 1970,⁸⁶ and therefore

81. For example, four geographic areas accounted for almost 90% of the increase in natural gas drilling activity from 1978 to 1979. These four areas contained gas that was either deregulated or eligible for one of the highest NGPA pricing categories. Written Statement of Dr. Benjamin Schlesinger, Vice-President for Policy, Evaluation, and Analysis, American Gas Ass'n, before the Federal Energy Regulatory Commission at the Informal Public Conference on Gas Supply and Demand (April 2, 1980).

82. In *Rush v. King Oil Co.*, 220 Kan. 616, 556 P.2d 431 (1976), for example, the court found a breach of the implied covenant to develop based on expert testimony that oil from additional wells might be classified as new oil and bring \$11.00 per barrel, which would have been a substantial increase over the price of \$5.17 per barrel from then existing wells. *Id.* at 623, 556 P.2d at 438.

83. 5 WILLIAMS & MEYERS, *supra* note 50, § 833.4. This possibility may be especially likely with stripper and marginal wells, since they are given fairly high incentive prices under both the oil and gas price regulations. See notes 5 & 31 *supra*.

84. For a general discussion of this covenant, see 5 E. KUNTZ, *supra* note 50, §§ 58.1-.5; M. MERRILL, *supra* note 50, §§ 49-71; WILLIAMS & MEYERS, *supra* note 50, §§ 831-835.

85. 5 WILLIAMS & MEYERS, *supra* note 50, §§ 832.1, 833.3.

86. STATISTICAL ABSTRACT OF THE U.S. (1978), at 607; STATISTICAL ABSTRACT OF THE U.S. (1971), at 335. The composite price of oil and gas in constant dollars was the same in

little incentive existed for producers to delay drilling in the expectation that later development would be more profitable than present operations. The rapid increase in oil and gas prices since 1970, however, and their expected upward trend under the price regulations, make it easy to visualize a situation in which an alert operator would want to delay drilling to achieve greater profitability. Indeed, one of the major criticisms of the NGPA is that it rewards past delays in drilling and encourages producers to withhold drilling or marketing of gas because of the price escalator factors allowed for categories of new gas.⁸⁷ These escalators are statutorily guaranteed to be equal to or in excess of the inflation rate.⁸⁸ The prospective deregulation of certain natural gas in 1985 also may encourage a delay in drilling if lessees anticipate a price jump at that time to parity with world crude oil prices.⁸⁹

As an example of a situation in which a lessor and a lessee might disagree over a delay in drilling, consider a lessor who brings suit in 1980 alleging that his lessee failed to drill development wells in 1975 that a reasonably prudent operator would have drilled. The lessor proves that the wells would have been profitable to drill at the then prevailing long term contract price of \$0.50/thousand cubic feet (MCF) in the interstate market, the only market available in that field at that time. Using traditional implied covenant principles, courts have often granted judgment for the lessor under these facts and awarded damages or a conditional cancellation decree under which lessee must either drill the development wells within a specified time or forfeit the lease. If lessee drilled the decreed wells in 1980, they probably would qualify under the NGPA for an incentive price of \$1.75/MCF (in 1978 dol-

1971 as it was in 1946. OIL & GAS J., Nov. 10, 1980, at 177.

87. NGPA Impact Hearings, *supra* note 33. During the NGPA hearings, Dr. Paul Davidson, Professor of Economics at Rutgers University stated, "The Administration-hacked compromise gas bill would legalize the increased value of gas in the ground. Hence there is a strong incentive to delay production, for with the prospects of deregulation, gas left in the ground is better than money in the bank." *Id.* at 101-03.

The NGPA contains provisions that disallow incentive prices for natural gas which was withheld from the market prior to the passage of the NGPA for the purpose of obtaining a higher or deregulated price. 15 U.S.C. § 3312(c)(1)(C)(ii)-(iii) (Supp. III 1979). This "behind the pipeline" exclusion, however, is fairly narrowly drawn and does not apply at all to wells that were not drilled until after the passage of the NGPA.

88. 15 U.S.C. §§ 3312(b), 3313(b), 3317(a), 3318(a), 3319(b) (Supp. III 1979).

89. See note 32 *supra*. If natural gas were currently priced at parity with oil (according to its BTU equivalent), natural gas would be priced twice as high as its current average wellhead price. PETROLEUM ENGINEER INT'L, Nov. 15, 1980, at 6. This statistic suggests that some lessees might benefit if they delay drilling until decontrol in 1985.

lars), escalated by the rate of inflation.⁹⁰ Under these circumstances, the lessor has not necessarily proven his case. Lessee may be able to show that a prudent operator would have delayed drilling until 1980—or even later—to secure greater returns for himself. Under implied covenant law, of course, the lessee is not the sole arbiter of when drilling should occur; courts also consider the harmful effects of the lessee's actions on the lessor's interests.⁹¹ The lessor might argue, for example, that he would have had access to the royalty cash flow much sooner if the well had been drilled in 1975, and that the higher prices obtained by delaying production do not compensate for this loss in the use of capital. The financial interests of a lessee and lessor will often conflict in this manner.⁹² How the courts should resolve this new source of conflict between the lessee and lessor is the next problem to be addressed.⁹³

Because of the current pricing situation, Professor Stephen Williams suggests that courts should require lessors to prove both the likelihood of profitability for the development wells sought and the likelihood that the drilling schedule which the lessor seeks would be more profitable than development at any other time.⁹⁴ Since this latter element imposes additional and rather formidable

90. This figure is the NGPA § 103 price for new onshore production wells that were commenced after February 19, 1977. 15 U.S.C. § 3313(b) (Supp. III 1979). To accentuate the potential benefit for the lessee, the example also assumes that the § 103 price escalator exceeds any inflation adjustment that could have been negotiated in a long-term sales contract made in 1975.

91. See text accompanying notes 52-53 *supra*.

92. In some instances a lessee may be able to argue that the lessor cannot prove any actual damages from the lessee's delay in drilling. One could certainly construct a mathematical example in which the expected price of gas from a well drilled in 1980 is so much higher than the price which would have been realized under an earlier contract that the lessor as well as the lessee profits from delay. The lessor, however, is unlikely in this example to bring suit for breach of the drilling covenant. Moreover, a fact situation in which the time/price differential is so large is probably not common. In most situations the lessor does not share the lessee's financial advantage in delay. The lessor also may experience difficulty and incur significant expenses if he attempts to sell his interest and secure an earlier cash flow. See Williams, *supra* note 74, at 443 n.1, 453-54.

93. The conflict is not entirely new. Some courts have recognized that they must balance the lessor's interest in having the minerals produced sooner by drilling additional development wells against the lessee's interest—and the public interest—in producing the minerals at a slower rate and at a lower cost by using fewer wells to drain the tract. See, e.g., *Temple v. Continental Oil Co.*, 182 Kan. 213, 320 P.2d 1039, *on rehearing*, 183 Kan. 471, 328 P.2d 358 (1958). These cases, however, do not consider the additional complication of delayed production being more valuable to the lessee than current production because of the projected price increases.

94. Williams, *supra* note 74, at 445-48.

burdens of proof on the lessor, an attractive alternative to Williams' proposal would be for courts to transfer some of this burden to lessees who are better able to bear it. Clarity and judicial economy would be served if the lessor did not have to refute the superior profitability of an almost unlimited number of alternative drilling plans. Thus, once a lessor has proven a traditional prima facie case of a breach of the development covenant, the lessee should have the burden of proving that his delay in drilling was warranted under the reasonably prudent operator standard because the development plan he had mapped out for the leased premises was more profitable than the lessor's desired plan. Thus, in the illustration above, if the lessee showed that he had made an annual study of the profit potential of the leased premises since 1975, and that based on reasonable projections of estimated oil and gas prices—including forecasts of the effects of federal price laws and regulations—these studies supported a delay in drilling to maximize profits, then this showing might well rebut lessor's prima facie case and result in judgment for lessee.⁹⁵ This type of planning and analysis would demonstrate that lessee had taken an active interest in attending to the leased property and that he had been sufficiently diligent under the reasonably prudent operator standard to justify the delay in drilling.⁹⁶

Although some precedent does support Williams' approach,⁹⁷

95. Other factors that courts traditionally analyze in implied covenant to develop cases may also be relevant and could either weaken or strengthen the lessee's rebuttal. See 5 WILLIAMS & MEYERS, *supra* note 50, § 832.2. But see Williams, *supra* note 74. Professor Stephen Williams argues that the lessee's successful rebuttal should result in a judgment in his favor so that the benefits to society of economic efficiency are realized.

96. A lessee, of course, cannot delay drilling forever. If the lessee fails to drill wells according to the planned schedule that was described in court, the lessor should be able to bring another suit—without prejudice—for breach of the development covenant. See, e.g., Clayton v. Atlantic Ref. Co., 150 F. Supp. 9 (D.N.M. 1957). If the court determines that the potential burden of bringing multiple lawsuits is too heavy for the lessor, it may want to retain jurisdiction over the case until the wells that the lessee plans to drill actually are completed.

97. In Blythe v. Sohio Petroleum Co., 271 F.2d 861 (10th Cir. 1959), lessee's plan to drill a deeper test well in the near future defeated a finding of a breach of the implied covenant to develop. Professors Williams, Meyers and Hemingway have collected other cases in which courts have held that a lessee's planning and exploratory activity (short of actual drilling) evidenced sufficient interest in the development of the premises to justify a delay in drilling. R. HEMINGWAY, *supra* note 50, at 374 n.32; 5 WILLIAMS & MEYERS, *supra* note 50, § 843.8.

Careful trial preparation is essential in cases in which the lessee alleges that planning and information-gathering activity justifies delayed drilling. Compare Petersen v. El Paso Natural Gas Co., 462 F. Supp. 479 (W.D. Okla. 1978) with Vetter v. Morrow, 361 So. 2d 898 (La. App. 1978). In Petersen lessee proved to the court's satisfaction that a prudent opera-

many courts would view this delay as "speculation" and grant judgment for lessor.⁹⁸ Authority for this result may have been sound in an era of expected constant prices when a court could easily find that a delay in drilling violated the reasonably prudent operator standard, since lessees would have difficulty rationalizing the delay in terms of greater profitability. Under these circumstances, a lessee's failure to drill a well that would be profitable probably was due to incompetence, neglect, inability to perform, or a vague hope that prices and market conditions would improve sometime in the indefinite future. Neither equity, contractual expectations, nor public policy would justify holding the lessor's royalty hostage to such a lessee. Courts, therefore, rightly condemned lessee's failure to drill as an attempt to hold a lease for "mere speculation," rather than for development, which is the intended purpose of an oil and gas lease. This situation, however, is a far cry from the actions of an alert, profit-minded lessee whose delay in drilling is rationally based on statutory price schedules and market shortages, both of which foretell rising prices with great certainty. No doubt this lessee is "speculating" when he awaits a price rise, but a prudent operator might do precisely the same thing. Speculation of this type no longer warrants automatic judicial disapproval. Thus, past cases that give short shrift to the reasonableness of the lessee's "speculation" are poor precedent for today's conditions and should be applied with great caution.

On the other hand, just because the lessee's delay in drilling is based on strong profit-maximizing considerations does not mandate an immediate judgment in his favor under implied covenant principles. The ultimate resolution of the conflict between the landowner and his producer will depend largely on the doctrinal model of implied covenant law chosen by the court. Professor Stephen Williams emphasizes public policy in his argument that the lessee should always prevail when he can show that his develop-

tor would have awaited the results from the wells being drilled nearby because existing wells in the field were not very profitable, drilling costs were high, and lessee had participated actively in 21 other wells in the field, which showed his diligence rather than "indifference" to the development potential of the reservoir. In contrast, lessor in *Vetter* proved that the well at issue would probably be quite profitable. Lessee seemed to agree, but argued that his delay was justified because he was waiting for the results from a well he was drilling on another section. Lessee, however, failed to produce appropriate geological or economic evidence that a reasonably prudent operator also would have waited, and the court granted judgment for the lessor.

98. See 5 WILLIAMS & MEYERS, *supra* note 50, §§ 842-842.4.

ment plan is more profitable than lessor's.⁹⁹ The policy objective of Professor Williams is to maximize the value of the oil and gas resource to society, and allowing the efficiency-minded lessee to prevail is the best way to achieve this goal.¹⁰⁰ Williams' argument is persuasive as an economics lesson, but it does not derive from the traditional origins of implied covenant law, which are based on contractual expectations and ethical norms of fair dealing. The proposition depends instead on the courts' adoption of the policy model of implied covenant law, and, as discussed above, courts should disfavor this model in resolving implied covenant disputes.¹⁰¹ Courts, however, could reach the same result under the contract model and thereby achieve efficiency without having to rely on public policy. The rationale under the contract model would be that in a private enterprise economy the parties to a commercial transaction such as an oil and gas lease can reasonably be held to expect that profit-maximizing behavior will delineate the scope of their implied duties, including the timing of drilling decisions.¹⁰² Of course, under traditional implied covenant princi-

99. Williams, *supra* note 74.

100. If society values oil and gas more highly in the future than it does now, which the expectation of a price rise for these products evidences, then oil and gas should be produced later rather than now to maximize social welfare. To economists, a delay in drilling and production due to rational expectations of higher prices in the future is an efficient response that maximizes the value of the resource to society as a whole and not just to producers. See G. STIGLER, *THE THEORY OF PRICE* 91-102 (1966); Williams, *Running Out: The Problem of Exhaustible Resources*, 7 J. LEGAL STUD. 165 (1978). To noneconomists, however, the response is usually termed "speculation" and is the subject of frequent opprobrium.

101. See text accompanying notes 60-75 *supra*. The nation clearly has not chosen efficiency as the paramount goal of energy policy. The equitable concepts of protecting consumers from large price increases and preventing windfall profits to producers have been important legislative concerns. See text accompanying notes 4-27 *supra*. See also J. GRIFFIN & H. STEELE, *ENERGY ECONOMICS AND POLICY* 243-53 (1980). Griffin and Steele show that the consumer protection rationale for price controls on oil and gas results in a misallocation of resources and social welfare losses of several billion dollars.

102. By using the contract model rather than the policy model, courts could avoid what seems to be an error in one of Williams' arguments. Professor Williams argues that in circumstances in which the lessor fails to prove the expected profitability of drilling and the optimum time pattern for it, he should nonetheless be entitled to conditional cancellation "if it can be shown that immediate development is better for society than development at any other future time." Williams, *supra* note 74, at 457-58. The reason that the lessor may be able to demonstrate a societal benefit—in the sense of maximizing the value of the oil and gas resource—which is different from lessee's profitability is that the lessor's cost-free royalty causes a discrepancy between society's standard and the lessee's standard of maximizing benefits. A reasonably prudent operator is guided by whether his share of the well's expected proceeds after the deduction of the landowner's royalty is greater than the well's expected costs, all of which the lessee must bear. As far as society is concerned, however, the royalty is simply a transfer payment between the lessee and lessor and is irrelevant to efficiency. Thus, a well may be unprofitable to a prudent operator, but if the royalty were not

ples, equitable considerations are also relevant, and if a long delay in drilling imposes an unusual hardship on a lessor, courts may hold in his favor. The courts would emphasize the contractual reality that a lessor's primary consideration for the lease is his royalty, and therefore fair dealing demands that this compensation is made to the lessor as soon as it is profitable for the lessee to do so, regardless of the lessee's interest in later and greater profitability.¹⁰³

If judgment for the lessor is granted, courts then must find the appropriate remedy. Generally, the value of royalties that a devel-

deducted from the expected value of the well's production, the well still might be profitable to society as a whole. Williams argues that if the lessor can prove this point, then the public policy of maximizing resource values dictates conditional cancellation of the lease.

This reasoning assumes that the traditional lease form, which is based on a fixed fractional royalty, is of no inherent utility. Since this lease form has withstood the test of time for almost a century, this proposition is difficult to accept. Many alternative leasing systems such as profit-sharing between the lessee and lessor, sliding scale royalties, and variable bid royalties are available, but they have not replaced the traditional form.

The advantages of the fixed royalty lease are several. First, the fractional royalty is a hedge against uncertainty for both the lessee and the lessor. If the entire compensation for an oil and gas lease were paid at the outset, one party eventually would conclude that he made a bad deal. If the land proves very productive, the lessor would feel cheated because he did not have a share of the pot of gold; if the land proves to be barren, on the other hand, the lessee will complain that he paid a large bonus "for nothing." Of course, risks could be shared more equally between the two parties if the compensation were stated in terms of profit-sharing rather than a cost-free royalty to the lessor. Profit-sharing, however, essentially puts the lessor in partnership with the lessee. To check on the accuracy of his payment, lessor must monitor all the financial records of the lessee, including prices, output levels, and costs. This relationship not only invites lessors to "second-guess" the lessee's business decisions and makes lease management more difficult, but also promotes litigation. As Merrill states in his discussion of the relational origins of implied covenant law in its attempt to assure "fair dealing" between the lessee and lessor,

[T]here are claims on the part of the operator to freedom of decision as to management and operation and to be secure against unreasonable demands of the lessor, founded upon the extent of the investment, the hazards of the business and the need for security in property rights, which ought to be given effect so far as possible.

M. MERRILL, *supra* note 50, § 223, at 473-74. See also R. HEMINGWAY, *supra* note 50, § 5.1, nn.20-27 (citing cases on the problems of accounting to nonjoined cotenants, which is a situation that is analogous to profit-sharing).

The longevity and near universality of the fixed royalty lease show that its utility outweighs the efficiency loss which Williams emphasizes. See S. McDONALD, *THE LEASING OF FEDERAL LANDS FOR FOSSIL FUELS PRODUCTION* 95-120 (1979). While the courts are not likely to adopt Williams' suggestion that leases be conditionally cancelled in the circumstances he describes—because the underlying analysis is so complex and extended from both an economic and legal standpoint—it is nevertheless reassuring to know that the court's failure to adopt this standard is also the wiser course.

[Ed. Note: Professor Williams subsequently has changed his position to coincide with the views that the author expresses in this Article. See Williams, *Implied Covenants in Oil and Gas Leases: Some General Principles*, 29 KAN. L. REV. 153, 164-72 (1981).]

103. See, e.g., *Temple v. Continental Oil Co.*, 182 Kan. 213, 320 P.2d 1039, *on rehearing*, 183 Kan. 471, 328 P.2d 358 (1958).

opment well would have produced had it been drilled diligently is the measure of damages in an implied covenant dispute.¹⁰⁴ If the lessor, however, proves a breach and is awarded damages under this measurement, he ultimately will receive a double recovery: Immediate royalties as damages and future royalties when the minerals are produced. The better measure of damages, therefore, is the interest on the royalties that would have been paid if no breach had occurred, but the courts have rejected this measure as too complex.¹⁰⁵ Some courts have turned instead to the equitable remedy of conditional cancellation to avoid the problems inherent in the damages remedy.¹⁰⁶ This remedy may have been appropriate in the past, but today conditional cancellation would be likely to result in inefficiently timed drilling.¹⁰⁷ If the lessee refuses to drill and the lease is cancelled, the lessor is free to lease to another producer and obtain a new bonus payment, which might have the effect of eliminating the lessor's cash flow problem. The second lessee, however, is probably no more willing than the first to drill the wells on the lessor's desired schedule.

One possible solution to the remedy problem is to award the lessor the royalties that he would have received had the well been drilled earlier, but allow the lessee a credit for these royalties if the oil and gas actually is produced later.¹⁰⁸ This advance royalty measure of damages would provide the lessor with his expected cash flow without requiring the lessee to drill prematurely or to pay double royalties.¹⁰⁹

Providing a remedy that is fair to both parties in implied covenant to develop cases is difficult, and the uncertainty about how courts will resolve the timing conflict compounds the problem. This difficulty suggests that the parties negotiating a lease today should make every effort to draft provisions that either expressly

104. 5 WILLIAMS & MEYERS, *supra* note 50, § 834.

105. Daughette v. Ohio Oil Co., 151 Ill. App. 102, 109-10 (1909), *aff'd*, 263 Ill. 518, 105 N.E. 308 (1914); Midland Gas Corp. v. Reffitt, 286 Ky. 11, 17, 149 S.W.2d 537, 540 (1941); Texas Pac. Coal & Oil Co. v. Barker, 117 Tex. 418, 434, 6 S.W.2d 1031, 1037 (1928).

106. 5 WILLIAMS & MEYERS, *supra* note 50, § 834.

107. See note 100 *supra* and accompanying text.

108. The court in Texas Pac. Coal & Oil Co. v. Barker, 117 Tex. 418, 438-39, 6 S.W.2d 1031, 1039 (1928), suggested this solution, and the Supreme Court of West Virginia adopted it in a marketing covenant case. Cotiga Dev. Co. v. United Fuel Gas Co., 147 W. Va. 484, 502-03, 128 S.E.2d 626, 638-39 (1962).

109. Advance royalties typically are paid under leases for hard minerals such as coal. Some advance royalty clauses allow crediting the payments against later production royalties. See, e.g., Buchanan, *Near Surface Minerals*, in OIL & GAS LAW FOR THE GENERAL PRACTITIONER, at G-31 to G-53 (State Bar of Texas Institute 1981).

address the timing of drilling or expressly protect a lessor's interest in an early cash flow when the latter is important to him. Advance royalty clauses, minimum royalty clauses, or larger cash bonuses—each negotiated in exchange for a smaller royalty fraction or for an express clause allowing the lessee's good faith business decisions to determine the pace of drilling—are some of the possible solutions.

2. The Implied Covenant to Explore Further

The implied covenant to explore further imposes a duty on the lessee of a tract that is currently under production to drill additional wells into either new, potentially productive strata or areas covered by the lease that are as yet unproven and unexplored.¹¹⁰ Whether this covenant is a separately recognized duty is a subject of much debate.¹¹¹ The debate, however, is largely academic because regardless of whether the covenant is given a name that is distinct from the implied covenant to develop, the courts have recognized that the duty to act as a reasonably prudent operator may in some circumstances require the lessee to drill wells that the lessor has not been able to show would be profitable.¹¹² The lessor has the burden of proving that the stratum is potentially productive and that a reasonably prudent operator would explore it, but the lessor need not, and by definition cannot, prove that drilling would be profitable. Since it is impossible to measure the value of royalties that the lessor would have obtained had the exploratory well been drilled, the remedy for breach of the duty to explore is conditional cancellation of the lease.¹¹³

The federal pricing regulations are likely to foster litigation over the implied covenant to explore. Sections of the NGPA and the crude oil pricing regulations were specifically designed to encourage the exploration and development of new deposits of oil and gas. An example is section 107 of the NGPA, which allows unregulated prices for certain high cost natural gas.¹¹⁴ Lessors who

110. See generally E. KUNTZ, *supra* note 50, §§ 62.1-.5; 5 WILLIAMS & MEYERS, *supra* note 50, §§ 841-847.

111. The debate is especially intense between Brown and Professors Williams and Meyers. See 2 E. BROWN, *supra* note 50, § 16.05; 5 WILLIAMS & MEYERS, *supra* note 50, § 847.

112. See 5 WILLIAMS & MEYERS, *supra* note 50, §§ 842, 845 and cases cited therein.

113. *Id.* § 844.

114. 15 U.S.C. § 3317 (Supp. III 1979). One commentator has traced the legislative history of this section of the NGPA. See Note, *Regulatory Opportunity and Statutory Ambiguity in the Search for High-Cost Natural Gas*, 57 TEX. L. REV. 641 (1979).

reside in or near areas of section 107 potential—such as the tight sands of the Rockies or Devonian shale in the Appalachians—may well urge the courts to force lessees to take exploratory action if their lessees' drilling does not match the public accounts of other drilling activity in these areas.¹¹⁵

The same problems that were discussed under the development covenant can be anticipated in implied covenant to explore cases, but these problems are magnified because of the already controversial nature of this covenant. For example, the same conflict between the lessee and lessor over the optimal time for drilling may arise, but since the anchor of profitability no longer exerts stability on the law, an even greater risk exists that public policy and inapposite precedent will be used to direct judicial resolution of the conflict. The lessor is likely to advance pro-exploration and antispeculation public policy arguments to support his position,¹¹⁶ while the lessee will stress proconservation and efficiency considerations.¹¹⁷ The contrariety of the policy model and the unsoundness of its use have already been discussed.¹¹⁸

Williams and Meyers have made heroic attempts to give some stability and predictability to the implied covenant to explore by isolating and analyzing the various factors to be used in judging the reasonableness of the lessee's conduct.¹¹⁹ Nevertheless, this covenant still defies rational standards for judicial application.¹²⁰ More often than not the factors that are used seem to be *ex post*

115. Section 107 price incentives have received substantial attention in the financial press. See, e.g., Born, *Tight-Sands Gas*, *Barron's*, April 14, 1980, at 4, col. 1.

116. See text accompanying notes 60-62 *supra*. Professor Martin's fear that the implied covenant to explore will become so infected with a pro-exploration policy that cases will be decided largely on this public interest factor is a real one. Martin, *supra* note 62, at 189. Courts foreseeably could find that the incentive prices under the NGPA and the crude oil pricing regulations manifest a congressional policy of encouraging exploration. While this congressional intent is undoubtedly real, it does not justify encouraging exploration regardless of what a reasonably prudent operator would do.

117. See text accompanying notes 62-65 *supra*; notes 100-02 *supra*.

118. See text accompanying notes 73-74 *supra*.

119. See, e.g., 5 WILLIAMS & MEYERS, *supra* note 50, §§ 843, 847.

120. The search for clearly expressed judicial standards in implied covenant to explore cases defeated even the dauntless Professor Merrill:

I think we shall have to give up the search for convenient rules of thumb. If there is a dominant principle, it may be expressed best by the old maxim that equity looks to the substance and not to the form. In the last analysis, victory will go to the party whose lawyer succeeds in convincing the court that the substance of justice rests with his client rather than with the adversary.

Merrill, *The Implied Covenant of Further Exploration in Oklahoma*, 13 OKLA. L. REV. 249, 263 (1960).

facto rationalizations for a decision which is based on the court's subjective belief that the lessee's behavior either does or does not evidence speculation.¹²¹ Since courts have ruled that speculation serves no useful purpose and indeed is contrary to the intended purpose of the lease, lessees who are "speculators" are held to have breached their implied obligation to explore further.¹²² As previously noted, however, a delay in drilling for purposes of speculation in the new pricing context may no longer reflect the lessee's idle management of resources.

This antispeculation approach is evident in the primary importance that courts have attributed to the length of time which has expired since drilling in finding a breach of the implied covenant to explore.¹²³ Most courts measure the delay from the time that the last well was drilled, although some date the delay from either the time that the lease was executed or the date on which the lessee took the lease assignment.¹²⁴ How these measures of delay are relevant—much less of primary importance—is unclear. Production from old wells sustains many leases in existence today, and no exploratory drilling on these tracts of deeper wells or other high-cost wells has occurred for many years. The incentive to drill deeper wells at a higher cost is a fairly recent phenomenon, and cases that measure delay from the date of either the lease execution or the last well drilled are poor precedents in this new context.¹²⁵ Courts should measure any relevant delay from the time when material changes in economic, regulatory, or geological factors become or should have become known to a reasonably prudent operator.¹²⁶

An even better approach to the timing conflict in implied cov-

121. 5 WILLIAMS & MEYERS, *supra* note 50, §§ 842.1-3, 847.

122. Merrill, *The Implied Covenant for Further Exploration*, 4 ROCKY MTN. MIN. L. INST. 205, 222-29 (1958).

123. Indeed, in some cases the time factor alone seems to be the determinant of whether the lessee has breached the implied covenant. 5 WILLIAMS & MEYERS, *supra* note 50, § 843.1.

124. *Id.* § 843.1 nn.2-4.

125. Even in the past era of nearly constant prices, a lessee's initial decision not to explore further because of an expected lack of favorable returns might remain prudent for several decades, absent any other change in conditions. Moreover, the standard for an unreasonable delay is terribly vague; the courts have found unreasonable periods of time that range from 35 years to 5 months. *Id.* § 843.1.

126. Some precedent exists for this proposal. In *Blythe v. Sohio Petroleum Co.*, 271 F.2d 861 (10th Cir. 1959), for example, the court measured the relevant period of delay from the time that other operators became interested in potentially productive strata near the lease.

enant to explore cases is to focus on those factors that relate more directly to what a prudent operator would do—for example, the likelihood of profitability from further exploration and the diligence of the lessee in pursuing this matter. Professor Stephen Williams has suggested that the same type of analysis which is used in implied covenant to develop cases can be applied in exploration cases, with the exception that the latter analysis must be specifically formulated in terms of probabilities and expected profitability. Under Williams' scheme, the lessor must prove that the desired exploratory well is expected to be profitable and that the lessor's timetable for drilling is superior from a profitability standpoint to any schedule which the lessee has proposed.¹²⁷

This suggestion is basically sound, but in some exploration cases a rigorous probability analysis based on numerical values may be impossible to perform or too hypothetical to be valid. If so, courts should nevertheless eschew the public policy model and seek other evidence of factors that are related to expected profitability and the lessee's diligence in pursuing it. Examples of this type of evidence include the following: The existence of favorable geological prospects in the area; the cost of exploratory drilling; the number, depth, and location of other wells on the tract; demonstrations of the lessee's interest in the tract; and the expected price of any discoveries.¹²⁸ In presenting this evidence, the federal regulatory environment and the lessee's knowledge of it are particularly germane. A lessee's "exploratory" legal work to understand the incentives that the NGPA offers is as relevant to a determination of diligence as a lessee's exploratory seismic work. Demonstrated knowledge of the federal incentives to explore and their possible applicability to the leased premises is evidence of an active interest in the land's potential and, if the lessee's plans show that a pru-

127. Professor Williams gives an example of this type of analysis. Suppose a well has a $\frac{1}{8}$ probability of producing \$4 million of revenues; a $\frac{2}{8}$ probability of \$2 million; and a $\frac{5}{8}$ probability of zero income. The expected value of the future income from the well is then \$1 million. If costs are expected to be \$700,000, then the proposed well looks profitable—one that a reasonably prudent operator would drill—even though it is more likely than not that the well will be dry. Williams, *supra* note 74, at 455. Even implied covenant to develop cases sometimes speak in terms of expected profitability. See, e.g., *Clifton v. Koontz*, 160 Tex. 82, 325 S.W.2d 684 (1959).

The burden of proof on the second element probably should be shifted to the lessee. The lessee would thus be required to prove that his desired drilling plans result in a greater expected profitability than the schedule that the lessor advocates. See text accompanying notes 94-95 *supra*.

128. Courts in implied covenant to explore cases traditionally have utilized some of these factors. See 5 WILLIAMS & MEYERS, *supra* note 50, § 843.

dent operator would delay drilling until a more favorable time, this planning may rebut the lessor's allegations of a breach.¹²⁹

If litigants and judges in implied covenant cases carefully focus on those factors that bear on the expected profitability of drilling—and the diligence of the lessee in maximizing that profitability by calculating the optimal time for drilling—the law in this area will be freer of ambiguity and arbitrariness.¹³⁰ If, after such careful analyses, lawyers and judges still wish to add that public policy supports their position, then theoretically this will be harmless rhetoric and dictum, although the danger is obvious that it will not be.¹³¹

When a lessee's lack of exploratory diligence results in a judgment for the lessor, the remedy problem appears again. Damages under any measure are virtually impossible to award, even if the court undertakes a rigorous numerical probability analysis of prof-

129. Williams and Meyers state that "in general the courts are reluctant to cancel a lease when the lessee has shown even minimal interest in exploring the land for new productive formations." *Id.* § 843.8, at 321. *But see* note 97 *supra*. Planning activity, however, cannot justify holding the lease indefinitely. *See* note 96 *supra*.

130. The ultimate resolution of the conflict under traditional implied covenant principles will depend on the individual facts and circumstances of each case, as well as on whether courts follow the contract or equity model. *See* text accompanying notes 99-103 *supra*.

131. *See* Superior Oil Co. v. Devon Corp., 604 F.2d 1063 (8th Cir. 1979). In *Devon*, Superior Oil held an oil and gas lease on 3,440 acres as a result of production from a unit well drilled in 1961. Fifteen years passed without further development. In 1976 lessors executed a second lease on some of the same acreage subject to Superior's lease. Superior brought a breach of contract suit against lessors, and lessors countered by alleging a breach of the implied covenant to develop and seeking cancellation of the lease. The district court found for the lessors on the implied covenant issue, even though evidence supported the inference that Superior recognized the worth of the lease and was holding it for a better market. The court may have held as it did because Superior did not present a well-reasoned argument supporting the profitability of delay. The Eighth Circuit Court of Appeals, however, viewed the district court's result approvedly based on "the public interest in encouraging the prudent development of oil and gas," *id.* at 1069, but it found error in the order cancelling Superior's lease because no notice and demand had been served on lessee. The dissent rejected the argument that the lessor must serve notice and demand, since "[o]nce Superior made the decision to hold the lease for speculative purposes, it knowingly assumed the risk that the lessor would terminate the lease." *Id.* at 1074 (Heaney, J., dissenting). To be sure, a second lessee had drilled a new well on the premises that was productive, and this fact undoubtedly caused the dissent to view Superior's defense that further drilling would not have been profitable with a jaundiced eye. Nevertheless, hindsight should not guide courts in applying the prudent operator standard.

The main point, however, is that the courts' and lawyers' analysis in this case falls short of the type of reasoning that would promote predictability and stability in the law of implied covenants. Reliance upon the "public interest" and "antispeculation" is too often a shortcut to a judgment that lacks sound reasoning.

itability.¹³² Conditional cancellation of the lease thus is the best remedy available.

3. The Implied Covenant to Protect Against Drainage

The last of the drilling covenants is the implied covenant to protect against drainage. To prevail under this cause of action, the lessor must prove that substantial drainage from his tract is occurring and that an offset well would be profitable to drill and produce.¹³³ The timing conflict between the lessee and lessor that is typical under the other drilling covenants is not likely to arise in drainage cases, since the oil and gas which belongs to both parties is being drained and will not be available later on for production. When the loss in drainage is less than the expected gain from a delay in drilling because of rising prices, however, the same problems would arise that were discussed under the other drilling covenants.

Courts usually recognize monetary damages as the proper remedy for breach of the protection covenant, and some jurisdictions hold that they are the exclusive remedy in the absence of extraordinary circumstances.¹³⁴ As with the other covenants, however, this remedy may no longer be appropriate in drainage cases. Damages for past drainage may be ascertainable, but the problems of estimating damages for future drainage under the current complex, ambiguous regulatory framework and unstable market conditions may well cause courts to adopt conditional cancellation of the lease as the proper remedy for future compensation.¹³⁵ The Mississippi Supreme Court formulated an alternative remedy in a recent case in which it overturned an award of lump sum damages for drainage projected twenty years into the future. The court stated that

132. See note 127 *supra*. The proposed exploratory well that the lessor seeks more often than not will be dry, even though a prudent operator would nonetheless drill it since there is a long shot that it will be profitable. Theoretically, damages could be measured by the royalty share of the expected value of the well's future income, but this could result in double recovery for the lessor if production is achieved later. Advance royalties are not a good solution in implied covenant to explore cases, since only a small probability exists that the royalties ever will be recouped from actual production. The speculative nature of damage awards based on probabilities militates against their use.

133. See 5 WILLIAMS & MEYERS, *supra* note 50, § 822.

134. *Id.* § 825.2. Courts measure damages as the amount of royalty that the lessor would have received on the oil and gas that was drained away, or the amount that he would have collected on oil produced from an offset well. Which of the two rules is applied depends on the state law.

135. *Id.* § 825.5.

the market value of oil and oil products is directly affected, not only by world economic conditions, but by unpredictable political upheavals and the world-wide conflicts of nations, as well as by embargoes and tariffs . . . These and other factors are rationally unpredictable and are not so clearly foreseeable as to be reasonably capable of supporting an award of damages extended many years into the future.¹³⁶

The court remanded with instructions that the future damages award be calculated on a continuing basis as the royalty on one-half of the production from the draining well—without prejudice to the lessee to mitigate damages by drilling an offset well.¹³⁷

C. *The Implied Covenant to Market: The Effects of Complexity and the High Cost of Compliance*

1. Introduction

The federal pricing regulations are complex, ambiguous, and costly to comply with, and they present legal risks that many producers previously have not encountered.¹³⁸ Although these traits are relevant to all of the implied covenants,¹³⁹ they particularly affect the implied covenant to market, which may well experience a revival because of the importance and difficulty of correctly pricing oil and gas under the federal regulations. This covenant requires that a lessee make diligent efforts to market oil and gas after their discovery so the lessor can realize his royalty. The covenant includes the duty to exercise reasonable efforts to obtain the highest

136. *America Southwest Corp. v. Allen*, 336 So. 2d 1297, 1300 (Miss. 1976).

137. *Id.* at 1301. The NGPA has eased the burden of estimating damages for some cases, since the Act's well classifications determine not only the present price but also the price escalators to be applied through 1985. 15 U.S.C. §§ 3311, 3312(b), 3313(b), 3317(a), 3318(a), 3319(b) (Supp. III 1979). The burden is only eased, however, if the NGPA regulations relevant to the well at issue are clearly defined, and the courts can readily ascertain which category the offset well belongs to.

138. See text accompanying notes 4-49 *supra*. One study estimated that the cost of the FPC regulation of interstate gas sales was 7% of the base price of the natural gas. Gerwig, *Natural Gas Production: A Study of Costs of Regulation*, 5 J. L. & ECON. 69 (1962). See also Thomas, *supra* note 43, at 1, col. 1. This article reports on new methods that small producers are using to finance the large costs of regulatory compliance—for example, giving a percentage share of the company's stock to attorneys and accountants for their services and cost-sharing with other small companies or joint venture partners. Without these devices, the article reports, regulatory costs are prohibitively expensive for small producers.

139. A lessee's decision whether or not to drill often depends on the expected price classification of the oil or gas that might be found. When this classification is unclear due to an ambiguity in the regulations, drilling might be forestalled. Similarly, when the cost of securing data that is needed to justify an incentive price category for a proposed well's output is higher than any expected benefits from drilling the well, the lessee might decide against drilling at all.

price possible.¹⁴⁰

Even though oil and gas are subject to extensive federal price regulations—including price ceilings—this should not bar the operation of the implied covenant to market.¹⁴¹ A valid price ceiling clearly precludes recovery for failure to market oil and gas at a price exceeding the maximum allowed. The federal pricing laws, however, do not require producers to sell at the maximum price—or even at an uncontrolled price, if one is allowed—and this leaves room for the operation of the implied covenant to market.¹⁴² Public policy also should not be used to prevent lessors from alleging a breach of the implied covenant to market at the maximum lawful price on the ground that lower oil and gas prices better serve the perceived “public interest.”¹⁴³ The federal pricing regulations cannot possibly be interpreted to embody a consistent public purpose that favors either producers or consumers, lessees or lessors.¹⁴⁴ At most, a court could find that the pricing laws are evidence of a national energy policy aimed at securing a balance between consumer and producer interests that is specifically measured by the maximum lawful prices allowed under the acts.¹⁴⁵ This standard of measuring the balance accords a continuing and important role for the doctrine of unplied covenants in oil and gas law. The question of why this doctrine will be needed to resolve conflicts between lessors and lessees under the federal pricing regulations is the next issue to be addressed.

Since both the lessee and lessor benefit, often handsomely, from obtaining the highest price allowed under law, conflicts should be rare. Nevertheless, they may occur,¹⁴⁶ especially now

140. For general discussions of the implied covenant to market, see E. KUNTZ, *supra* note 50, §§ 60.1.-5; M. MERRILL, *supra* note 50, §§ 73, 84; 5 WILLIAMS & MEYERS, *supra* note 50, §§ 853-858.

141. Federal energy regulation, though it may be pervasive, does not preempt implied covenants in oil and gas law. See notes 75-76 *supra* and accompanying text.

142. *But see* McCue v. Deerfield Gas Prod. Co., 173 Kan. 302, 245 P.2d 1191 (1952) (a minimum price order enacted for conservation purposes negated the implied covenant to realize the best return).

143. See text accompanying notes 73-74 *supra*.

144. See text accompanying notes 4-49 *supra*.

145. See note 38 *supra*. In some instances, the pricing regulations may be applied to favor producers over royalty owners. For example, exceptions that allow producers to price above the legal maximum generally are granted only to working interest owners who can prove that operations are not profitable at the maximum legal price. Royalty owners who do not bear the costs of production, therefore, cannot share in the higher price allowed by exception. See Ligon, *supra* note 20, at 18.

146. The complexity of marketing natural gas through long-term supply contracts during a time of growing natural gas shortages and federal regulation of interstate gas sales

that compliance with the NGPA and crude oil pricing and tax rules is expensive, difficult, and sometimes legally risky. A lessee acting in good faith, for example, may classify a well in the wrong category and obtain a lower price than he could have received if he had understood the regulations.¹⁴⁷ Upon considering the complex and ambiguous laws, a producer simply may refuse to file for a higher priced well category because he views the risk of an enforcement action by FERC or the expense of protracted litigation to secure an interpretation of the rule to be not worth the possible benefits.¹⁴⁸ Alternatively, the producer may decide that the cost of obtaining data to file for a higher priced category, which can be substantial,¹⁴⁹ is too high to justify the expected increased revenues, even though the category itself is well defined. Finally, a producer may disregard opportunities for achieving a higher price because of ignorance, negligence, or an obstinate refusal to learn new

already has resulted in serious conflicts between lessees and lessors under *express* lease clauses which base royalties on a fractional share of the "market value" of natural gas. In *Texas Oil & Gas Corp. v. Vela*, 429 S.W.2d 866 (Tex. 1968) and *Foster v. Atlantic Ref. Co.*, 329 F.2d 485 (5th Cir. 1964), for example, the courts held that market value was to be determined at the time that the gas is delivered to the purchaser, not by its price under a long-term gas supply contract. Many long-term gas supply contracts have price provisions that hold the contract price far below the prices of more current sales of similar gas in the field. Thus, the *Vela* holding assumed enormous import when natural gas shortages developed and the price differential widened between sales in interstate commerce under long-term contracts regulated by the FPC and unregulated intrastate sales (as well as between intrastate sales themselves). See, e.g., *Lightcap v. Mobil Oil Corp.*, 221 Kan. 448, 562 P.2d 1 (1977); *Exxon Corp. v. Middleton*, 613 S.W.2d 240 (Tex. 1981). None of these cases is an implied covenant case. Indeed the parties in *Vela* and *Foster* stipulated that the gas sales contracts were as good or better than any that could have been made at the time of contract. The distinctions and interrelationships between these cases and implied covenant to market cases are important to note. First, cases like *Vela* arise under leases which specify that royalties are to be based on market value; implied covenant cases, on the other hand, can just as easily arise under "net proceeds" leases as under "market value" leases. See *Amoco Prod. Co. v. First Baptist Church*, 579 S.W.2d 280 (Tex. Civ. App. 1979), *aff'd per curiam*, 611 S.W.2d 610 (Tex. 1980). Second, courts in both "*Vela*-type cases" and in cases that find a breach of the implied covenant to market must determine the actual value of the natural gas at issue to award damages. This problem of measuring damages has required lessors and judges to expend enormous efforts to determine the meaning and existence of comparable sales in a market. See *Phillips Petroleum Co. v. Bynum*, 155 F.2d 196 (5th Cir. 1946).

147. A gas well may fit into several NGPA categories. It is entitled to the highest priced category, but the state jurisdictional agency or FERC is under no duty to tell the producer what the highest priced category is for his well.

148. See text accompanying notes 40-47 *supra*.

149. For example, in densely drilled fields—similar to the ones in East Texas—a lessee may need to search the records of hundreds of wells within a two and one-half mile radius to qualify for the incentive price under § 102 of the NGPA. See 15 U.S.C. § 3312 (Supp. III 1979). See also text accompanying notes 33 & 36 *supra*.

tricks.¹⁵⁰

The general elements of the cause of action that a lessor must prove to establish a breach of the implied covenant to market, once oil and gas have been discovered, are as follows:¹⁵¹ (1) That the lessee failed or delayed in selling the product, or that he failed or delayed in selling the product at a higher price;¹⁵² (2) that a reasonably prudent operator would have been able to sell the product at a higher price;¹⁵³ and (3) that the lessor suffered damages as a result of the lessee's action. If the lessor proves that the lessee has not marketed oil and gas from a well at the maximum price allowed by law, this does not establish a per se breach of the implied covenant to market.¹⁵⁴ Courts look at all the facts and circum-

150. See, e.g., *Waseco Chem. & Supply Co. v. Bayou State Oil Corp.*, 371 So. 2d 305 (La. App. 1979).

151. 5 WILLIAMS & MEYERS, *supra* note 50, § 855.

152. The latter is the most likely element under federal pricing regulations. It often may include the lessee's failure or delay to seek favorable administrative action to secure the best possible price. See text accompanying notes 227-324 *infra*.

153. If no market is available at any price or at the maximum lawful price sought by the lessor, then the lessee has not breached the marketing covenant, even if the lessee has never made any effort to secure a market. See *Weymouth v. Colorado Interstate Gas Co.*, 367 F.2d 84 (5th Cir. 1966). In *Weymouth* the court assumed that lessee had indeed lacked diligence, but it nevertheless upheld the lower court's judgment for lessee on the ground that lessor had offered no proof that reasonable efforts—if made—would have increased the amount of gas marketed.

Implied covenant cases should be carefully distinguished from habendum clause cases on the issue of this second element of proof of breach. In states such as Oklahoma in which the discovery of oil and gas—rather than its actual production—satisfies the habendum clause, diligent efforts to market the product may well be necessary to hold the lease in effect, even if the efforts have little chance of success. To terminate the lease under the habendum clause, the lessor needs to prove only that the lessee lacked diligence in seeking a market; he need not prove that a reasonably prudent operator could have marketed the product. In these states a lessee's long delay in securing a market because of regulatory problems under the federal pricing statutes may terminate the lease under the habendum clause, but it will not terminate the lease in a cause of action based on the implied covenant to market. Nevertheless, a decision in one context may be persuasive precedent for the other context. *M. MERRILL*, *supra* note 50, § 91; 5 WILLIAMS & MEYERS, *supra* note 50, §§ 855-856.2.

154. See, e.g., *Craig v. Champlin Petroleum Co.*, 435 F.2d 933 (10th Cir. 1971). In *Craig* the highest price in the field was not conclusive evidence either of a breach of the implied covenant or of the fair market value of lessor's gas. The court found that the highest field price was due to special factors, and that lessee's prices were in line with sales to other, more comparable gas plants. Similarly, in *Greenshields v. Warren Petroleum Corp.*, 248 F.2d 61 (10th Cir. 1957), the court held that a lower price for gas was justified because of its lower quality and the necessity to market it immediately to prevent its waste. See also *Weymouth v. Colorado Interstate Gas Co.*, 367 F.2d 84 (5th Cir. 1966) (discussed in note 153 *supra*); *Newell v. Phillips Petroleum Co.*, 144 F.2d 338 (10th Cir. 1944) (no breach of the implied covenant to market when no market exists for additional production, even though the prorationing order limiting production was invalid); *Amoco Prod. Co. v. First Baptist*

stances surrounding both the lessee's actual sales price and the higher price sought by the lessor. The lessor has the burden of proving not only that the lessee legally could have received a higher price but also that a reasonably prudent operator would have sought such a price and could have sold the product at the higher price. Thus, the same legal complexities and high costs that face lessees when they try to fulfill their pricing duties under the marketing covenant also confront lessors, who must bear the burden of proof to establish a breach of the covenant.

With this background in mind, it is now possible to examine the issues that are likely to arise in implied covenant to market cases. One of these issues is what standard of care the lessee owes to his lessor, and another related issue is the scope of the lessee's duty to account for royalties owed. Lessors undoubtedly would like a fiduciary standard to be applied to the lessee's accounting for royalties in an effort to avoid the difficult burdens of proof that lessors otherwise must shoulder. Lessees, on the other hand, would benefit from a good faith standard in the pricing of oil and gas and would like to find ways to avoid responsibility for marketing—for example, reliance on in kind royalty clauses to negate implied marketing duties.

One issue that is not likely to be raised, but which is highly relevant, is whether the lessee should bear all of the regulatory costs or whether he may allocate a proportionate share to the lessor's account. Conventional methods of apportioning these costs between the lessor and lessee are not helpful in resolving this question.¹⁵⁵ Strong reasons, however, can be advanced for placing the costs on the lessee alone. First, trade practices and customs sup-

Church, 579 S.W.2d 280 (Tex. Civ. App. 1979), *aff'd per curiam*, 611 S.W.2d 610 (Tex. 1980) (failure to sell at market value may be probative, but not conclusive evidence of a breach of the marketing covenant). Certainly, however, the highest price that a purchaser in the area pays for similar oil and gas is pertinent evidence of a breach, and a lessee would be foolish not to present rebuttal evidence that, in the lessee's particular circumstances, this price was not the highest one obtainable through the exercise of reasonable diligence. M. MERRILL, *supra* note 50, § 82.

155. Some cases analyze the cost-bearing issue in terms of whether an expense is "extraordinary"; if so, it is to be shared. R. HEMINGWAY, *supra* note 50, § 7.4(E). The meaning of "extraordinary," however, is difficult to delineate. Merrill's general rule that "[n]o part of the costs of marketing or of preparation for sale is chargeable to the lessor" is certainly too broad a statement to be either true or useful, since compression and dehydration costs generally are shared. 2 E. BROWN, *supra* note 50, § 6.03; M. MERRILL, *supra* note 50, § 85. Kuntz would have the courts decide whether the activity is primarily production, in which case the lessee should bear all the costs, or whether it is marketing and processing, in which case the costs should be shared. E. KUNTZ, *supra* note 50, § 39.4. It is unclear whether the well pricing classification process is integral to marketing or production.

port this view, and the case law indicates that lessees generally accept regulatory costs.¹⁵⁶ Second, the very nature of the typical oil and gas lease, which uses a "cost-free" royalty as the primary compensation for a grant of exclusive management control to the lessee, argues for placing the costs with the lessee unless the facts clearly show that the lessor had agreed to bear a share of the expenses. Despite the high cost of compliance and the uncertainty in the law on this issue, lessees are not likely to bring this issue before the courts because of custom and their strong desire for exclusive control over the leased premises.

In the other respects noted, however, the costs and legal complexities of the pricing regulations should revive implied covenant to market litigation. Therefore, analysis of these issues, their likely resolution under past case law, and the wisdom of the probable results are discussed next.

2. The Proper Standard for Implied Covenant to Market Cases

The standard that courts generally use in evaluating a lessee's conduct in implied covenant cases is the reasonably prudent operator standard.¹⁵⁷ Substantial support, however, exists for the proposition that a more relaxed criterion should be used to judge a lessee's performance in arranging for the sale of oil and gas. Williams and Meyers argue, that "[t]he greatest possible leeway should be indulged the lessee in his decisions about marketing gas, assuming no conflict of interest between lessor and lessee."¹⁵⁸ They propose a standard of "good faith business judgment" for cases in which the lessor complains that the lessee failed to obtain the best possible market.¹⁵⁹ Professor Martin also argues for the adoption

156. *Reese Enterprises v. Lawson*, 220 Kan. 300, 553 P.2d 885 (1976) (lessee's operating costs included license and permit fees; indeed, the cost of the permit fees resulted in lessee's failure to produce in paying quantities, and the lease was terminated). Producers in the past typically have accepted the costs of negotiating sales contracts and complying with state and federal regulations. The costs of NGPA or crude oil pricing compliance are difficult to distinguish from these types of activities, except perhaps by the larger dollar amounts. Moreover, the Federal Power Commission expressly included regulatory expense—the cost of filing required reports, participating in administrative proceedings, and other activities that state and federal regulation required—in setting producers' rates based on costs. See *Shell Oil Co. v. FPC*, 520 F.2d 1061 (5th Cir. 1975), cert. denied, 426 U.S. 941 (1976). But see *Le Cuno Oil Co. v. Smith*, 306 S.W.2d 190 (Tex. Civ. App. 1957), cert. denied, 356 U.S. 974 (1958).

157. E. KUNTZ, *supra* note 50, § 60.3; 5 WILLIAMS & MEYERS, *supra* note 50, § 856.3.

158. 5 WILLIAMS & MEYERS, *supra* note 50, § 856.3, at 410-11.

159. *Id.* The authors would continue to use the reasonably prudent operator test in drilling covenant cases and in marketing cases when either the lessee failed to provide any

of a good faith standard in implied covenant cases. He fears that courts might misapply the reasonably prudent operator standard by failing to look at all the facts and circumstances—particularly the longer term public policy considerations and regulatory framework—relevant to assess a lessee's conduct.¹⁶⁰

Courts, however, should avoid the good faith standard in implied covenant to market cases. No sound reasoning can distinguish marketing cases from other implied covenant cases. Williams and Meyers justify the lower standard by pointing out that the interests of the lessee and lessor usually coincide in the marketing area and that marketing cases do not seek to impose the large costs of drilling on the lessee.¹⁶¹ This rationale, however, fails to consider that the two parties' interests often coincide in preventing drainage and developing the leasehold and that marketing expenses can often be significant. In addition, it is often difficult to separate a marketing decision from a drilling decision.¹⁶² The cases that Williams and Meyers rely on to advocate the lower standard deal with specific circumstances in which a producer is faced with alternative marketing decisions, all of which appear reasonable.¹⁶³ In this context, the reasonably prudent operator should be free to use his judgment in choosing the best alternative. Indeed, pricing decisions made under the rapidly changing markets and regulatory conditions of today require that the lessee be able to use his business judgment to assess the risks and costs of alternative marketing strategies. The use of a less burdensome good faith test to achieve this result, however, is unnecessary; properly applied, the prudent operator test allows the lessee to use his business judg-

market at all or the interests of the lessee and lessor diverged.

160. Martin, *supra* note 62, at 201-05.

161. 5 WILLIAMS & MEYERS, *supra* note 50, § 856.3.

162. In *Gazin v. Pan Am. Petroleum Corp.*, 367 P.2d 1010 (Okla. 1962), for example, lessee's decision to refuse the first offer to buy natural gas coincided with his decision to continue development drilling in the field to establish proven reserves and attract a better sales contract. Similarly, the decision to drill in today's regulatory environment cannot be made rationally without considering the price classification of the resulting well.

163. 5 WILLIAMS & MEYERS, *supra* note 50, § 856.3. The authors primarily rely on *Gazin v. Pan Am. Petroleum Corp.*, 367 P.2d 1010 (Okla. 1962). In *Gazin* lessee refused to accept the first purchaser's offer of \$.10/thousand cubic feet (MCF) without a "take or pay" provision. Over three years later, lessee negotiated a contract at \$.15/MCF with a "take or pay" provision. The court held that there had been no breach of the implied covenant to market even under the standard of reasonable diligence.

Professor Kuntz also would use the good faith test in certain cases in which reasonable minds could differ about what a prudent operator would do, but he admits that the good faith test may well be the same as the reasonably prudent operator test when a decision either way is "prudent." E. KUNTZ, *supra* note 50, § 59.3.

ment to choose among reasonable alternatives, especially since the burden of proof in implied covenant cases is on the lessor.¹⁶⁴ A good faith subjective standard, on the other hand, invites the needless opportunity to abuse the relational basis of the doctrine of implied covenants by allowing lessors' royalties to be determined by apparently sincere, but nonetheless negligent, efforts of lessees.¹⁶⁵ Furthermore, the good faith standard is not as well defined as the reasonably prudent operator measure.¹⁶⁶

Professor Martin cites no cases to support his fear that courts might not consider all the facts and circumstances of the regulatory framework that oil and gas producers confront. In fact, the courts have considered such factors. A good example is *Sword v. Rains*,¹⁶⁷ in which the court held that lessee's delay of seven months from the time of well completion to a sales contract was

164. One can, of course, find cases that seem wrongly decided under the reasonably prudent operator test. See, e.g., *Hutchinson v. McCue*, 101 F.2d 111 (4th Cir.), cert. denied, 308 U.S. 564 (1939). This authority, however, does not prove that the standard is wrong. The court in *Hutchinson*, for example, seemed to use hindsight to gauge the reasonableness of lessee's marketing behavior, which is clearly an improper consideration. Thus, the use of a good faith standard in this case probably would not have helped lessee at all.

165. Several courts have defined good faith to mean the absence of fraud on the part of the lessee. See M. MERRILL, *supra* note 50, §§ 125-134 and cases cited therein. In these cases a lessee's error in judgment always prevails, regardless of how egregious the error is. Deliberate bad faith that amounts to fraud often will be difficult for the lessor to prove, and thus the standard affords little protection to royalty owners.

166. The definition of good faith in implied covenant cases ranges from the absence of fraud to an honest, fair, and nonarbitrary business judgment, the latter of which is almost equivalent to the reasonably prudent operator test. *Id.* When the good faith standard approximates the prudent operator test, retaining the latter standard is preferable to creating an apparent exception to it, which would be subject to misuse by the courts. See, e.g., *Amoco Prod. Co. v. First Baptist Church*, 579 S.W.2d 280 (Tex. Civ. App. 1979), *aff'd per curiam*, 611 S.W.2d 610 (Tex. 1980). In *Amoco* the court used the good faith standard to measure lessee's marketing duties and quoted Williams and Meyers as support. In this case, however, since a conflict of interest existed between lessee and lessor, even Williams and Meyers would have disfavored the good faith test. See note 158 *supra*.

Professor Martin advocates that the courts should adopt a subjective good faith test which requires that a lessee have a reasonable basis for his belief that he is acting prudently. Martin, *supra* note 62, at 202. Martin equates his test to the "business judgment rule" that courts use to measure the performance of corporate officers and directors; he argues that lessees should have the same latitude as corporate directors in making management decisions. The courts, however, have for the most part supplanted the business judgment rule with a duty of care which they express as "that care which a reasonably prudent director of a similar corporation would have used under the circumstances of the particular case." L. LATTIN, *THE LAW OF CORPORATIONS* 272 (1971). Indeed, many have criticized those courts that have used the good faith test for corporate managers because it allows directors to act imprudently without liability. *Id.* at 274.

167. 575 F.2d 810 (10th Cir. 1978). The *Sword* case arose under the habendum clause of the lease, not under the implied covenant to market, but the issue whether lessee's delay in marketing was reasonable is the same under either cause of action.

reasonable. The court placed considerable emphasis on the "rather chaotic and uncertain market conditions" that had resulted from litigation over a Federal Power Commission (FPC) order which was crucial to the small producer's ability to sell at a price in excess of the then existing FPC area rate.¹⁶⁸ Many implied covenant cases have carefully considered the nature of the oil and gas business when judging the lessee's performance as a reasonably prudent operator.¹⁶⁹ Thus, the courts will probably also consider the difficulties and costs that producers face under the federal pricing regulations to be an important factor in assessing the reasonableness of a lessee's delay in marketing or failure to market at the maximum price allowed under federal law.¹⁷⁰

Assuming that the courts reject the good faith standard, the question remains whether a fiduciary standard is the appropriate one for the duty to obtain the best possible price under the federal pricing rules. Brown makes the broad statement that "[i]n the responsibility for marketing the production from an oil and gas lease,

168. *Id.* at 814.

169. *See, e.g.,* Craig v. Champlin Petroleum Co., 435 F.2d 933 (10th Cir. 1971); Christianson v. Champlin Ref. Co., 169 F.2d 207 (10th Cir. 1948); Nordan-Lawton Oil & Gas Corp. v. Miller, 272 F. Supp. 125 (W.D. La. 1967); Tate v. Stanolind Oil & Gas Co., 172 Kan. 351, 240 P.2d 465 (1952); Poafpybitty v. Skelly Oil Co., 517 P.2d 432 (Okla. 1974); Townsend v. Creekmore-Rooney Co., 358 P.2d 1103 (Okla. 1960). Indeed in *States v. Phillips Petroleum Co.*, 161 S.W.2d 366 (Tex. Civ. App. 1942), the court found no breach of the implied covenant to protect against drainage because lessee had reasonably anticipated the prospective effect of the Texas Railroad Commission's field classification. *See also* 2 E. BROWN, *supra* note 50, § 16.02 (discussing the effect of trade usages on the implied covenant to market).

Most implied covenant to market cases deal with natural gas rather than oil because gas is more difficult to market. Gas is not easily stored above ground and can be transported only by pipeline. Moreover, gas pipelines require large capital investments and can be justified only if the pipeline owner has secure sources of supply under long-term gas purchase contracts.

170. A lessee, of course, must be diligent in presenting to the court the relevant facts that he claims justify delay or lower prices.

The strongest argument for the use of the good faith or business judgment standard is that lessees should be free to assess risks and exercise discretion without the courts second-guessing them because it is their own money and labor—not the lessors'—that is invested in the business. Oil and gas operations in particular require large amounts of capital in very risky investments; lessees who bear all the costs and risks must be able to manage these operations as they see fit, especially considering the politically charged, complex laws and policy that envelop the oil and gas industry today. Nevertheless, the shortcomings of the good faith test, *see* notes 165-86 *supra*, outweigh these factors. If lessees feel that the reasonably prudent operator standard does not give them the required discretion to adjudge risks in the federal regulatory context, then they perhaps should negotiate for an express good faith standard in their leases. If such an express standard is included in the lease, courts should interpret it to require more than a simple lack of fraud, and they at least should require that the lessee's honest belief in his own prudence is reasonably based.

the lessee stands in a fiduciary relationship."¹⁷¹ His authority for this statement is scant, however, compared to the general rule that reasonable diligence is the proper standard.¹⁷² Moreover, despite Brown's broad statement, the context in which he argues for a fiduciary standard is fairly narrow—a lessee's refusal to pay royalties that already had accrued on past oil and gas production.¹⁷³ This situation is readily distinguishable from those implied covenant cases that deal with a lessee's business decisions about how and when to market oil and gas in today's regulatory environment. If the courts were to apply a fiduciary standard to such complex and intricate marketing decisions, they would create a gross imbalance in implied covenant law because the standard would not allow a court to consider the costs and risks that are inherent in the lessee's marketing responsibility.

3. The Duty to Account

As previously noted, the lessor ordinarily bears the burden of proof in implied covenant cases, which includes both the burden of going forward with the evidence and the burden of persuasion.¹⁷⁴ The dearth of decisions that shift this burden in marketing cases indicates that most courts accept this rule. Some commentators argue that certain "special circumstances" should trigger a shift in the burden of proof,¹⁷⁵ but generally the courts show firm allegiance to lessor's bearing the burden in marketing cases. This allegiance follows the general rule that the party with the burden of pleading a fact generally has the burden of proving it as well; it is based on the rationale that whoever seeks to change the current state of affairs naturally should expect to bear the risk of failure of proof.¹⁷⁶ The rule also comports with the well-established principle

171. 2 E. BROWN, *supra* note 50, § 16.02(4)D, at 16-83 to 16-89.

172. *Id.* at 16-77, 16-83 to 16-85. The courts expressly have rejected the fiduciary standard in implied covenant to market cases. *See, e.g.,* Craig v. Champlin Petroleum Co., 435 F.2d 933 (10th Cir. 1971). *Contra*, Young v. West Edmond Hunton Lime Unit, 275 P.2d 304 (Okla. 1954), *appeal dismissed*, 349 U.S. 909 (1955).

173. 2 E. BROWN, *supra* note 50, § 16.02(4)D, at 16-85 to 16-89.

174. M. MERRILL, *supra* note 50, § 91; 5 WILLIAMS & MEYERS, *supra* note 50, § 856.

175. Williams and Meyers, for example, advocate such a shift when shut-in royalty payments are supporting the lease and also when a lessee's failure to market oil and gas from the lessor's land results in the lessee himself draining the land by production from an adjacent tract. 5 WILLIAMS & MEYERS, *supra* note 50, §§ 856, 856.2. This author suggests a shift in certain drilling covenant cases to economize the court's time and relieve the lessor of additional burdens of proof when he has presented a prima facie case. *See* text accompanying notes 94-95 *supra*.

176. C. McCORMICK, McCORMICK'S HANDBOOK OF THE LAW OF EVIDENCE § 337 (2d ed.

that assigns the burden of proof according to an estimate of the probabilities of the situation. Under this principle, the burden is placed on the party who is contending that the more unusual event has occurred.¹⁷⁷ Generally, the lessee can be expected to sell at the highest possible price, so the burden of proving that the price is too low is placed on the lessor.¹⁷⁸ This placement usually results even though lessees may have better access to information and superior knowledge about the best price possible under the regulations and market conditions,¹⁷⁹ and even though lessor's burden may be a difficult one.¹⁸⁰

E. Cleary ed. 1972) [hereinafter cited as McCORMICK].

177. *Id.*

178. Indeed, Merrill argues that the lessor's proof of the failure to market with due diligence must be clear, since presumably the lessee will do his best to obtain the highest possible price. M. MERRILL, *supra* note 50, § 91.

This placement of the burden of proof comports best with the contract model of implied covenants in its reliance on the natural expectations of the parties. Under the typical lease, the lessor has recognized the lessee's superior expertise and has agreed to accept the lessee's exclusive control of the property in exchange for a cost-free royalty. The lessor is thus free of the burdens of running a business, and the lessee is free of this source of "back-seat driving." The implied covenant doctrine is a guard against the lessee's abusive or negligent use of the exclusive power over the producing property, but it is not a device that is designed to make the lessor a partner in the business. If the lessor wants to control the operation, then the lessor should have to prove that the performance could be better.

179. Lessees ordinarily will have the books and records on their own well depths, spacings, and completion dates, and they will be more familiar with similar information on other wells in the area and business and marketing conditions, including the regulatory environment.

Courts seldom have held that one party's superior knowledge is the controlling reason for assigning the burdens of proof. McCORMICK, *supra* note 176, § 337. Expanded discovery procedures have weakened this reason for assigning the burden even further. Nevertheless, courts that embrace the equity model of implied covenants may feel that fair dealing requires lessees to bear the burden of going forward with the evidence because they have superior knowledge. See text accompanying notes 189-98 *infra*.

180. Lessors who pursue a breach of covenant action for failure to price at the maximum allowed by law must prove all the facts required to classify the well at the highest possible price, as well as prove that any ambiguities in the law would be resolved to allow the higher price sought. The expense and difficulty of proving these matters may be the very reason that a lessee did not seek the well classification himself; indeed, these problems ultimately may absolve the lessee from a breach of any duty. The lessor also must prove that a reasonably prudent operator could sell the oil and gas at the higher price, and this proof requires a solid knowledge of marketing conditions in the area.

Lessors encounter great difficulties of proof in drilling covenant cases. These difficulties, however, have not persuaded the courts to shift the burden of proof. Thus, lessors in these cases must learn the intricacies of petroleum geology and engineering—subjects that are difficult to master and typically more familiar to lessees. This issue of who should bear the burden of proof has arisen in cases brought by lessors alleging that insufficient royalties have been paid to them under the express terms of the lease royalty clause. These lessors, in the absence of any actual transactions by the lessee based on the "market price" or "market value" that was contracted for in the royalty clause, have had to prove the actual market

When presented with this situation, lessors may seek to circumvent the difficulties of proving a breach of the implied covenant to market by alleging that the covenant includes a duty to account. This duty, according to lessors, would have the following elements: (1) That the lessee is expressly obligated to pay the lessor the fraction of royalty specified in the lease, which impliedly should be the best that a reasonably prudent operator could obtain; (2) that the lessee must account for this amount; and (3) that in the accounting the lessee must provide the lessor upon request with all the relevant records and information that are required to assure the lessor of the accuracy of the payment. In this way, lessors seek indirectly to impose a fiduciary standard upon the lessee through the duty to account rather than through the broader implied covenant to market and thereby avoid the burden of proof in implied covenant actions.¹⁸¹

A duty to account is unquestionably an element of the duty to market.¹⁸² The parameters of this duty, however, are unclear. Case law on the subject is minimal probably because recordkeeping in the past has had little relation to the lessee's ability to sell the

value of the natural gas sold from evidence of other similar sales. Despite the difficulty and high cost of such proof, the courts generally have required lessors to bear this burden, although not without sympathy for the lessor. See text accompanying notes 189-98 *infra*.

181. The relationship between the lessor's suit for an accounting and the assignment of burdens of proof is aptly demonstrated in *Williams v. Humble Oil & Ref. Co.*, 432 F.2d 165 (5th Cir. 1970). In *Williams* lessors brought suit under the implied covenant to protect against drainage and demanded an accounting—for the value of the royalty oil drained away—rather than damages (in the amount of royalty oil that an offset well would have produced). The court in *Williams*, however, refused to allow an action for an accounting and stated that “[s]ince an order of accounting would require Humble [the defendant-lessee] to determine the amount of oil and gas drained, it is inconsistent with the rigorous burden of pleading and proof that *Breaux* places on aggrieved landowners.” *Id.* at 171. The court, however, noted in dictum that an action for accounting would lie whenever a lessee unjustifiably fails to pay his lessor royalties on oil produced from wells on a lessor's land. This is the same situation in which Brown argues that a fiduciary standard should be applied against the lessee. See text accompanying notes 171-73 *supra*. This situation, however, is clearly distinguishable from the cause of action discussed in this Article, which assumes that the lessee is willing to pay royalties to the lessor on all producing wells, but the lessor alleges that the price received for the product is insufficient. In this cause of action, the lessee is not withholding royalties in an attempt to coerce the lessor to accept a certain royalty formulation. To avoid possible accounting actions, however, the lessee should be careful to place disputed royalty funds in escrow.

It should be noted that the court in *Williams* refused to grant an accounting and allow the burden of proof to shift, even though the case dealt with lessee's drainage of his own lessor's tract, a situation which Williams and Meyers classify as a “special circumstance” that merits such a shift. 5 WILLIAMS & MEYERS, *supra* note 50, § 824.2, at 147.

182. M. MERRILL, *supra* note 50, § 88.

product at the best possible price.¹⁸³ Therefore, recordkeeping and accounting have been relatively simple. As already noted, however, the federal pricing regulations now require extensive data collection and recordkeeping on the lessee's wells—and on wells in the surrounding area that belong to other operators—to qualify for incentive prices.¹⁸⁴ Further case law is sure to arise from these requirements, which should define more clearly the scope of the duty to account.

Case law to date on the duty to account largely has dealt with the duty to measure the product accurately and to pay the royalties due within a reasonable time.¹⁸⁵ Several cases also hold that the lessee must keep adequate books and records to enable the account to be accurately determined.¹⁸⁶ When applying these narrow principles to the new regulatory context, the duty to account should require the lessee, at a minimum, to keep accurate records of the physical characteristics and sales proceeds of wells under his control. For example, if a delay or failure in classifying a well for the incentive price that is available to NGPA stripper wells was due to the lessee's failure to keep accurate records of the well's output levels, a court ordinarily would find a breach of the implied covenant to market.¹⁸⁷

Whether the duty to account can be expanded to require the

183. The scarcity of cases on the implied duty to account also may be due to express provisions in many leases concerning the records to be kept and the lessor's access to them. See 4 WILLIAMS & MEYERS, *supra* note 50, § 671.6.

184. See text accompanying notes 33-43 *supra*.

185. M. MERRILL, *supra* note 50, § 88.

186. Phillips Petroleum Co. v. Johnson, 155 F.2d 185 (5th Cir. 1946). In *Johnson* the court, on the first motion for rehearing, stated that "as the accounting party [lessee] ought to have a record of [the royalty proceeds] or bear the inconvenience of its failure to keep it." *Id.* at 194. See also *Harding v. Cameron*, 220 F. Supp. 466 (W.D. Okla. 1963).

Some courts also have held that the lessee must provide lessors with full information about the condition of the wells and should allow the lessor to check reports that are relevant to determining the accuracy of the royalty payments. *Blackstock Oil Co. v. Caston*, 184 Okla. 489, 87 P.2d 1087 (1939); *Lamp v. Locke*, 89 W. Va. 138, 108 S.E. 889 (1921). Indeed, the difficulty of determining whether the lessee has complied with the prudent operator standard requires that the lessor be given reasonable access to relevant information in the lessee's possession. The lessor, however, must bear the expense of his own tests and checks. *Hamilton v. Empire Gas & Fuel Co.*, 117 Kan. 25, 230 P. 91 (1924). Since this record search often is quite costly, the access to information is little solace for a lessor who is attempting to verify the accuracy of a well's classification under the federal regulatory scheme.

187. Stripper well natural gas receives one of the highest NGPA incentive prices. 15 U.S.C. § 3318 (Supp. III 1979). Wells qualify for this category only if the well's production rate did not exceed an average of 60 MCF per production day during the preceding 90-day period. Production in excess of 60 MCF per day may continue to qualify as stripper well gas if the increase was due to enhanced recovery techniques.

lessee to provide the lessor with data about the market value of oil and gas from other wells in the area, as well as the physical and legal characteristics of these wells, is still unresolved. If it can, this duty effectively would shift much of the burden of proof to the lessee. An example that would arise from this expanded duty is whether the lessee must provide the lessor with records which show that the well in question does not qualify for a higher section 102 price because it is not one thousand feet deeper than any other well within a two and one-half mile radius.¹⁸⁸ Merrill concludes that the Fifth Circuit Court of Appeals in *Phillips Petroleum Co. v. Johnson*¹⁸⁹ imposed such an expanded duty to account when it stated,

It was the lessee's duty to know and to report truly the volume of gas it was taking out, and the disposition made of it, and the net proceeds if sold, for the facts were within its own knowledge. This duty greatly reduces the diligence necessary on the lessor's part to inform himself.¹⁹⁰

This language, however, does not expand the duty of the lessee to provide additional information beyond the facts concerning the proceeds from the lessor's particular well. The holding in the case still clearly requires that the lessor bear the burden of proof and use the rules of procedure and discovery to extract additional information.¹⁹¹ The court, on the first motion for rehearing, expressly noted that the market value of the product at issue was a matter which was equally accessible to both parties.¹⁹²

Thus, the case law simply does not support a broad fiduciary duty to account.¹⁹³ This result is both sound and in keeping with the doctrinal principles of implied covenant law, which considers the lessee's costs and risks in assessing whether he has acted as a

188. This is the type of data required for new onshore wells under § 102(c)(1)(B) of the NGPA, 15 U.S.C. § 3312(c)(1)(B) (Supp. III 1979).

189. 155 F.2d 185 (5th Cir. 1946). This case dealt with allegations of insufficient payment of royalties under the lease's express royalty clause—rather than under an implied covenant—but the same issues of the duty to account and bear the burden of proof arise in both instances. After quoting *Johnson*, Merrill argues that the basis for a fiduciary obligation to account for proper royalties lies in the implied covenant concept. M. MERRILL, *supra* note 50, § 88 (Supp. 1964). The sections of his treatise cited to support this statement, however, do not use a fiduciary standard. Indeed, Merrill's text argues vigorously for the reasonably prudent operator standard. *Id.* §§ 145, 223.

190. 155 F.2d at 191.

191. *Id.*

192. *Id.* at 194. The Fifth Circuit's statements on the burden of proof issue, however, are dicta, since the court below had made no rulings on this issue, and the lessor did not raise it at the appellate level.

193. A fiduciary duty would exist only in the instance in which the lessee is unjustifiably refusing to pay accrued royalties. See text accompanying notes 171-73 *supra*.

prudent operator. The cost of obtaining the information that is necessary to qualify for certain price categories—including the cost of legal proceedings to resolve ambiguities in the definitions of pricing categories—should be a relevant factor in judging the lessee's actions under the duty to account. Undoubtedly, the new regulatory environment will result in prudent operators investing greater efforts and funds in data collection and recordkeeping. The prudent operator, however, presumably would balance the increased opportunities to profit from collecting and analyzing additional data against their cost, which would include any legal risks in ultimately using the data to seek a higher price.¹⁹⁴ The duty to account in this context is not—and should not—be a fiduciary one, and suits for an accounting should not be used to achieve this result indirectly or to relieve the lessor of his burdens of proof.

Nevertheless, the courts may well be sympathetic to the plight of a plaintiff-lessor who faces the arduous and expensive task of proving what the proper royalty amount should be in a marketing case. In a companion case to *Johnson* the Fifth Circuit stated,

We have not looked with approval upon the action of the defendant in sitting back and offering no proof to aid the Court in the solution of this question, and in effect saying to its lessor: "We have taken and used, as we have seen fit, your 1/8 part of the gas. Now it's up to you to prove, if you can, what we and other manufacturers pay other people, similarly situated, for their gas." We have searched for some principle of law that would permit us to announce that when the defendant takes all the gas from the well and makes such disposition of it as best suits its purpose under a contract which does not state a definite sum to be paid for such gas, there arose either a fiduciary relation or a relation as principal and agent which would place the lessee under the duty to keep his principal fully informed and to disclose all facts that came to his knowledge and to fully and faithfully account to the lessor. But in view of the Texas law that the royalty owner has no title even to the 1/8 part of the gas, and that only the contractual relation of debtor and creditor exists, we are unable to fasten the obligation to make a full disclosure where it really ought to be.¹⁹⁵

194. Since the implied covenant to market applies to wells that the lessee already has drilled, the prudent operator test normally would only require evidence that the action which the lessor seeks would produce revenues over and above operating expenses—excluding drilling expenses. While this limitation may ease considerably the lessor's burden of proof, the lessee's regulatory expenses and risks incident to marketing in today's environment are not nominal, and the lessor must still show that these risks and expenses would not prevent a reasonably prudent operator from trying to secure a higher price. See *Gazin v. Pan Am. Petroleum Corp.*, 367 P.2d 1010 (Okla. 1961).

195. *Phillips Petroleum Co. v. Bynum*, 155 F.2d 196, 199 (5th Cir. 1946). Judge McCord stated in dissent that the burden to go forward with the evidence should shift to the defendant-lessee. *Id.* at 200; accord, Comment, *Value of Lessor's Share of Production Where Gas Only is Produced*, 25 TEX. L. REV. 641, 652 (1947).

Prudent lessees should be aware of this court's tendency to have sympathy for the plaintiff's plight, as well as its unguarded threat to lessees who refused to present evidence.¹⁹⁶ While the arguments advanced above for keeping the burden of proof on the lessor remain sound, lessees would be well advised to present rebuttal evidence on their diligence in the marketing effort after the lessor has presented the facts and arguments for a finding of a breach of the implied covenant.¹⁹⁷ Lessees should be aware that if judicial experience with these cases indicates that lessors suffer such a serious handicap in bearing the burdens of proof, courts may shift the burden of going forward with the evidence to the lessee once the lessor has presented some proof that a diligent lessee could have obtained a higher price. While the burden of persuasion ostensibly would remain with the lessor, the lessee would have to present evidence that a prudent operator would not have sought or achieved the higher price which the lessor has submitted, or suffer an adverse ruling on the issue.¹⁹⁸

4. In Kind Royalty Clauses

The Fifth Circuit Court of Appeals' language in *Phillips Petroleum Co. v. Bynum*,¹⁹⁹ which is quoted above, apparently supports a fiduciary accounting duty and a shift in the burden of proof when leases contain in kind royalty clauses. The effect of an in kind royalty clause is that the lessor retains title to and control over his fractional share of the oil and gas produced from his land. The oil royalty clause in most leases entitles the lessor to receive his royalty in kind. Most gas royalty clauses, on the other hand, provide for monetary payments to the lessor that are based on ei-

196. In *Johnson* the court, on the second motion for rehearing, stated that "[s]erious presumptions sometimes arise against a person who is bound to make an account if he keeps no books or vouchers and produces no other satisfactory evidence of the account. And the scope of admissible evidence may be thereby widened." *Phillips Petroleum Co. v. Johnson*, 155 F.2d at 195-96.

197. Oklahoma courts hold that the burden of proof shifts to the lessee once the lessor has made a prima facie case of unreasonable delay in drilling. See, e.g., *Crocker v. Humble Oil & Ref. Co.*, 419 P.2d 265 (Okla. 1965).

198. This scenario seems to have occurred in *Elliott v. Pure Oil Co.*, 10 Ill. 2d 146, 139 N.E.2d 295 (1956). The Illinois Supreme Court held that to defeat plaintiffs' prima facie case, the burden of proceeding with the evidence was on defendant. The court stated that "[t]he defendant possessed technical information concerning the oil underlying the land in this area, and, within human limitations, knew the capacity of this land to produce oil. . . . The defendant, not the plaintiffs, was in the position to know whether or not further commercial development of this acreage was practicable." *Id.* at 151, 139 N.E.2d at 298.

199. 155 F.2d 196 (5th Cir. 1946). See note 195 *supra* and accompanying text.

ther market value, price, or proceeds.²⁰⁰ Under gas royalty clauses, title to all the natural gas passes to the lessee, who simply covenants to pay the lessor his proper amount of the money due from sales of the gas. The difference between oil and gas royalty clauses is attributable to the difficulty of storing and transporting natural gas, which renders the delivery of gas in kind to a lessor economically infeasible. Many in kind royalty clauses impose the duty on the lessee at the lessor's option to purchase or dispose of the lessor's royalty oil or gas.²⁰¹ Few leases, however, contain express provisions concerning the lessee's obligation to sell, to treat, or to dispose of royalty products; thus, the nature and scope of this duty—if a court recognizes it at all—is largely undefined.²⁰²

Whether the in kind provision imposes any greater or lesser duty on the lessee to market the lessor's oil and gas is the next question that needs to be addressed.²⁰³ The question is important under the federal pricing regulations because lessors who are seeking to avoid the burden of proof and increase their chances of success in implied covenant litigation will use the language in *Bynum* to argue that a fiduciary standard should be applied to lessees who dispose of in kind royalty oil or gas. Lessees are sure to argue in response that the lessor's ability to dispose of and control in kind royalty oil or gas is a complete defense to implied covenant suits that allege deficiencies in the lessee's marketing. Under this the-

200. See Heare, *Effect of Gathering and Processing on Payment of Gas Royalties and Similar Interests*, 10 *INST. OIL & GAS L. & TAX.* 153 (1959). "In kind" royalty clauses for natural gas became more common in the early 1970s as gas became more valuable because of natural gas and other energy shortages. Indeed, several states enacted statutes to require or allow these clauses in leases of state lands. 3 *WILLIAMS & MEYERS, supra* note 50, § 643.1.

An incentive to in kind royalty clauses for natural gas also may have originated from the Federal Power Commission's efforts to solve the natural gas shortage by exempting small producers from federal price regulation. Of course, royalty owners who took their natural gas in kind attempted to qualify as small producers. See W. HUIE, M. WOODWARD & E. SMITH, *OIL & GAS: CASES & MATERIALS* 713 (2d ed. 1972); H. WILLIAMS, R. MAXWELL & C. MEYERS, *OIL & GAS: CASES & MATERIALS* 42-59 (4th ed. 1979). In a recent decision, *Jicarilla Apache Tribe v. FERC*, 578 F.2d 289 (10th Cir. 1978), the court held that a lessor who exercises the right to take the royalty gas in kind cannot remove the royalty gas from the interstate dedication that a lessee had made without FERC abandonment authorization. The court, however, held that the lessor could benefit from the small producer classification and receive small producer rates on its interstate sale, even though the lessee originally had committed the gas to interstate commerce in its status as a large producer.

201. 3 *WILLIAMS & MEYERS, supra* note 50, § 642.5.

202. *Id.* § 654.

203. The consequences of in kind versus monetary royalty clauses are significant in other contexts—for example, in determining the burden of taxation, venue, the lessor's ability to use gas on the premises for fuel, and the necessity of joining lessors in signing division orders. See E. KUNTZ, *supra* note 50, § 39.2.

ory, lessees may seek to avoid all responsibility for marketing the in kind royalty oil and gas.²⁰⁴ Neither argument, however, is persuasive, and in kind royalty clauses generally should have no effect on the operation of the implied covenant to market. As previously discussed, the argument for a fiduciary standard is unsupportable either in the case law²⁰⁵ or on policy grounds.²⁰⁶

Similarly, the proposition that in kind royalty clauses bar any marketing duty on the part of the lessee to the royalty owner is difficult to support with either precedent or policy. An in kind royalty clause admittedly provides the lessor who is unhappy with his lessee's efforts with the self-help remedy of taking his own royalty product in kind and marketing it himself. Indeed, a desire for greater control over marketing may have inspired the lessor to bargain for an in kind clause.²⁰⁷ The courts, however, have held that the lessor's legal right to market his own product does not negate the lessee's duty to market with due diligence when the lessor has not availed himself of the power to take in kind. When the lease contains a royalty clause that requires delivery of oil and gas in kind, the lessee discharges this duty by delivering the product to the pipeline for the credit of the lessor; the lessee has no express duty actually to make a contract for the sale of the royalty oil or gas.²⁰⁸ The implied duty exists, however, and this duty provides the lessee with the authority to sell the lessor's royalty oil or gas when, as is typical, the royalty clause is silent with respect to sales and marketing and when the lessor has made no other arrangements.²⁰⁹ The lessee's diligence in this effort includes the duty to

204. See text accompanying notes 286-95 *infra* (an analogous issue under the administrative covenant).

205. See text accompanying notes 171-93 *supra*.

206. See text accompanying notes 173 & 193-94 *supra*.

207. See Walker, *The Nature of the Property Interests Created by an Oil and Gas Lease in Texas*, 10 TEX. L. REV. 291 (1932); note 200 *supra*.

208. *McDonald v. O'Meara*, 259 F.2d 425 (5th Cir. 1958), *cert. denied*, 359 U.S. 910 (1959).

209. *Wolfe v. Texas Co.*, 83 F.2d 425 (10th Cir.), *cert. denied*, 299 U.S. 553 (1936). The court in *Wolfe* stated that "[p]ersons, who enter into a contract in the ordinary course of business, unless the terms of the contract indicate a contrary intention, are presumed to have incorporated therein any applicable, existing general trade usage relating to such business." *Id.* at 429. Lessee in *Wolfe* argued for the application of a trade usage that when lessor failed either to provide storage for the royalty oil or to sell it, lessee had the authority to sell the royalty oil along with the working interest oil at the posted price and on the customary terms. *Id.* at 430. Similarly, in *Wolfe v. Prairie Oil & Gas Co.*, 83 F.2d 434 (10th Cir. 1936), the Tenth Circuit noted,

In the absence of an express provision in an oil and gas lease with respect to marketing the production, there is an implied duty on the part of the lessee to make dili-

obtain the highest price possible under the reasonably prudent operator standard.²¹⁰ Moreover, the lessor's refusal to exercise his right of self-help by marketing the royalty oil and gas himself does not bar his cause of action to recover damages for breach of the implied covenant to market,²¹¹ although a court may relieve the lessee from the implied covenant to market when the terms of the lease clearly demonstrate that the royalty owner intended to market his own oil or gas.²¹²

The refusal of the courts to attribute different treatment to implied covenant cases merely because of the presence of an in kind royalty clause is soundly based under either the contract or the equity model of implied covenant law. In most cases, the parties to the lease, particularly the lessor, are unlikely to have in-

gent efforts to market the production in order that the lessor may realize on his royalty interest.

Therefore, when Wolfe [the lessor] failed either to provide storage or to arrange for the marketing of his share of the royalty oil, not only was the Amerada impliedly authorized to sell it as his agent, but it became its duty so to do.

Id. at 437 (footnote omitted). See generally 2 E. BROWN, *supra* note 50, § 16.02; E. KUNTZ, *supra* note 50, §§ 39.4, 40.5, 60.5; M. MERRILL, *supra* note 50, § 84; Annot., 71 A.L.R.2d 1219 (1960) (duty of lessee or assignee of oil or gas lease to market or deliver to lessor for marketing the oil and gas discovered); see also *Molter v. Lewis*, 156 Kan. 544, 134 P.2d 404 (1943); *Gex v. Texas Co.*, 337 S.W.2d 820 (Tex. Civ. App. 1960).

Similarly, the literal provisions of a "proceeds" royalty clause require only that the lessee pay a royalty based on the sales proceeds. This requirement, however, does not discharge the lessee's duty under the implied covenant to market with diligence. See, e.g., *Amoco Prod. Co. v. First Baptist Church*, 579 S.W.2d 280 (Tex. Civ. App. 1979), *aff'd per curiam*, 611 S.W.2d 610 (Tex. 1980).

210. See note 209 *supra* and sources cited therein. But see 3 WILLIAMS & MEYERS, *supra* note 50, § 654(4). See also *id.* § 654(1). Williams and Meyers unaccountably fail to use the reasonably prudent operator standard of implied covenant law to analyze the issue whether the lessee's refusal to sell gas is appropriate when it is due to a reluctance to become subject to Federal Power Commission regulation.

211. The court in *Carroll Gas & Oil Co. v. Skaggs*, 231 Ky. 284, 21 S.W.2d 445 (1929), stated,

Conceding that the lessors may have been within their rights in taking possession of the lease, yet they were under no obligation to do so, and they were within their rights in standing on the contract as it was written. Lessors are not ordinarily men who are experienced in the operation of gas wells, and they are not often in position to do that which is necessary to market the gas, and it would be a harsh rule if it should be held that the lessees may abandon a producing well to the damage of the lessors, and the lessors should be deprived of a recovery on the ground that they should have taken possession of the lease and operated it themselves.

Id. at 289, 21 S.W.2d at 448.

212. *Cedar Creek Oil & Gas Co. v. Archer*, 112 Mont. 477, 117 P.2d 265 (1941). Similarly, when the lessor's conduct evidences an intention to market his own royalty products, and the lessee relies on this conduct to his detriment, estoppel would be a defense to a suit alleging breach of the marketing covenant.

tended that any such difference should exist.²¹³ Under the typical lease, the lessor expects the lessee to exercise exclusive control over the administration of the premises, which frees the lessor from the burdens of lease management. Unless a contrary intent is clearly shown, the lessee's duty to market the royalty oil or gas should exist in all cases.²¹⁴

In sum, a lessee ordinarily cannot use an in kind royalty clause as a bar or defense to a cause of action brought for breach of the implied covenant to market oil or gas diligently under the federal regulatory pricing scheme. A lessee also cannot use the in kind clause to relieve himself of the implied covenant to market—and its inherent risks and costs—by declaring that the lessor must market the oil or gas on his own. The lessor, on the other hand, cannot argue for any greater standard than that of a reasonably prudent operator because of the in kind clause, notwithstanding the Fifth Circuit's language in *Bynum*.

5. Defenses and Remedies in Implied Covenant to Market Cases

Oil and gas leases may contain express provisions that negate or supersede any implied covenants, although express provisions dealing with marketing are relatively rare.²¹⁵ The parties may bind themselves to a standard other than the highest obtainable market

213. Of course, in some instances the parties may have intended just such a difference. See note 200 *supra*.

214. Merrill made a similar argument in criticizing a series of California cases that burdened royalty owners with certain costs:

Too much dependence is placed upon the language of a printed form, in the preparation of which at least one party has had no part and to the selection of which the other frequently has given no consideration, if upon a variance in that language a difference is established in a duty not specifically referred to. The lessor in the normal lease wants no oil or gas. He would not be prepared to deal with it or to handle it if it were tendered him. The sole thought associated with royalties in his mind is monetary return, and it is erroneous to read into the royalty clauses stipulations concerning the cost of marketing and preparation which are not specifically expressed.

M. MERRILL, *supra* note 50, § 85.

215. Many in kind royalty clauses, however, do impose a duty on the lessee to purchase or dispose of the royalty oil. Williams and Meyers give an example of such a clause: "At said Lessor's option, Lessee will purchase said royalty oil from Lessor, and shall pay said Lessor therefor the current price paid by the Lessee for oil of like grade and gravity at the wells of production in the same vicinity." 3 WILLIAMS & MEYERS, *supra* note 50, § 642.5, at 516. An issue may well arise under this in kind royalty clause over what price the lessee must pay to the lessor for the royalty oil since oil of like grade and gravity in the nearby area may not be of the same legal classification and, therefore, may not be comparable.

price or a reasonably prudent operator standard if the proper contractual elements are present.²¹⁶ In general, courts construe express clauses that purport to negate or limit implied covenants narrowly and strictly against the lessee. Unless the express clause directly conflicts with the operation of an implied duty, the duty is likely to survive.²¹⁷ The lessor's execution of division orders,²¹⁸ and his subsequent acceptance of royalties, generally is not a bar to his bringing an action for breach of an implied covenant.²¹⁹

Absent express provisions on remedies for a breach of any obligations, courts must choose the proper remedy for breach of the implied covenant to market. The normal remedy for failure to

216. *Brimmer v. Union Oil*, 81 F.2d 437 (10th Cir.), cert. denied, 298 U.S. 668 (1936); *Labbe v. Magnolia Petroleum Co.*, 350 S.W.2d 873 (Tex. Civ. App. 1961); *Gex v. Texas Co.*, 337 S.W.2d 820 (Tex. Civ. App. 1960); *Coats v. Brown*, 301 S.W.2d 932 (Tex. Civ. App. 1957); *Magnolia Petroleum Co. v. Page*, 141 S.W.2d 691 (Tex. Civ. App. 1940).

217. Thus, a gas royalty clause that expressly bases payment on a fixed dollar amount per time period would relieve the lessee of the implied covenant to market. The lessee's payments of shut-in royalty or delay rentals, however, ordinarily will not displace the implied covenant to market. See generally *E. KUNTZ*, *supra* note 50, § 60.2; *M. MERRILL*, *supra* note 50, §§ 199-202; *5 WILLIAMS & MEYERS*, *supra* note 50, § 858.

218. A division order is a contract of sale to the purchaser of oil or gas that directs the purchaser to make payment for the value of the products taken in the proportions set out in the contract. The division order is typically terminable at the will of either party. *H. WILLIAMS & C. MEYERS*, *supra* note 64, at 159.

219. *E. KUNTZ*, *supra* note 50, § 43; *M. MERRILL*, *supra* note 50, §§ 209, 209A; *3 WILLIAMS & MEYERS*, *supra* note 50, § 658.2; *4 id.* § 706; *5 id.* § 873.

Several courts have held that a lessor's execution of division orders creates a binding contract with the lessee that may modify the express terms of the lease—at least until it is revoked by either party. See *Exxon Corp. v. Middleton*, 613 S.W.2d 240 (Tex. 1981). In *Middleton* the division orders had the effect of transforming a lease's "market value" royalty clause into a "proceeds" clause. The courts, however, are not likely to allow any provisions in division orders to negate the implied covenant to market. The Texas Supreme Court in *Middleton* noted,

We should not be understood as holding that the execution of division orders would prevent relief from fraud, accident or mistake or preclude the correction of mathematical calculations. Nor do we in any way indicate that relief could not be obtained from unusual or unfair provisions imposed by a party having a superior bargaining power or position.

Id. at 251 n.8. The court in *Middleton* obviously was concerned with the unfairness to lessors that is inherent in allowing seemingly routine documents—whose primary purpose historically has been to arrange for the mechanics of paying royalties—to be transformed into contracts with major effects on a lessor's right to challenge the royalties that the lessee owes him. Indeed, the court had held in its first decision in *Middleton*, which was subsequently withdrawn, that division orders could never afford a lessee the opportunity to amend a lease. *Exxon Corp. v. Middleton*, No. B-7979 (Tex. Oct. 1, 1980). Trade customs and usages support the use of division orders to bind lessors to the proceeds method of accounting, see *Exxon Corp. v. Middleton*, 571 S.W.2d 349, 353 (Tex. Civ. App. 1978), but not to negate the implied covenant to market. See also *Amoco Prod. Co. v. First Baptist Church*, 579 S.W.2d 280 (Tex. Civ. App. 1979) (division orders based on net proceeds did not relieve lessee from implied covenant to market), *aff'd per curiam*, 611 S.W.2d 610 (Tex. 1980).

market at the highest possible price is damages equal to the difference between the price received and the price a reasonably prudent operator would have obtained. When the breach consists of an unexcused delay in marketing, the damages remedy usually is less preferable, since the lessor is likely to receive a double recovery—royalties now as damages and royalties later when the oil and gas is actually sold.²²⁰ Courts have not accepted the solution of awarding interest on delayed royalties,²²¹ but at least one court did allow the lessee to credit royalty payments against future production to prevent a double recovery.²²²

Cancellation of the lease is a possible remedy in certain instances, although the courts recognize that it is a harsh punishment since the lessee already has invested substantial funds into drilling the wells. Thus, outright cancellation generally is not favored in marketing cases.²²³ When damages are too difficult to ascertain²²⁴ and cancellation is judged to be too harsh, courts may order conditional cancellation, as they commonly do in other implied covenant cases; thus, the lessee must either market the oil or gas properly within a certain time period or forfeit the lease. Conditional decrees, however, are not common in marketing cases²²⁵ and are probably inappropriate when a lessee has demonstrated such incompetence or negligence in the marketing function that little would be gained by allowing him more time.²²⁶

D. The Implied Covenant to Seek Favorable Administrative Action

The implied covenant to seek favorable administrative action often is classified under the more general implied covenant to operate the leased premises with diligence.²²⁷ This latter covenant is something of a "catch-all" for obligations like the duty to use mod-

220. See text accompanying notes 105-10 *supra*.

221. *Id.*

222. *Cotiga Dev. Co. v. United Fuel Gas Co.*, 147 W. Va. 484, 128 S.E.2d 626 (1962). The court in *Texas Pac. Coal & Oil Co. v. Barker*, 117 Tex. 418, 6 S.W.2d 1031 (1928), also suggested this remedy. Moreover, Kuntz advocates allowing such a right under certain circumstances. *E. KUNTZ*, *supra* note 50, § 60.5.

223. *E. KUNTZ*, *supra* note 50, § 60.5.

224. One commentator has collected data that illustrates the lessors' difficulties in proving damages in implied covenant cases. *M. MERRILL*, *supra* note 50, § 157.

225. 5 *WILLIAMS & MEYERS*, *supra* note 50, § 857.

226. See, e.g., *Waseco Chem. & Supply Co. v. Bayou State Oil Corp.*, 371 So. 2d 305 (La. App. 1979).

227. See generally *R. HEMINGWAY*, *supra* note 50, § 8.9(D); *M. MERRILL*, *supra* note 50, §§ 72-83; 5 *WILLIAMS & MEYERS*, *supra* note 50, § 861.

ern production and recovery techniques that do not fit neatly into the other well-defined covenants. This catch-all covenant may receive more attention in the future, since lease management now demands more technologically and legally sophisticated skills.²²⁸ The main area of interest, however, is likely to be the lessee's duty to seek favorable administrative action under the network of federal and state regulation that now covers the oil and gas industry. This implied covenant is still in its infancy compared with the traditional covenants already discussed. It can be expected to grow to maturity, however, in the current regulatory environment that places a premium on the lessee's ability to understand and successfully pursue the administrative actions that are necessary to secure the best possible price for production. This section of the Article briefly surveys the historical background of this covenant. The section then examines in some detail the most important issues that the covenant raises and their treatment in the case law to date. The section concludes with an analysis of the covenant's relevance and possible application to cases in the future that are based on the lessee's duty to secure favorable administrative action under the federal pricing regulations.

1. Background of the Administrative Covenant

The extensive state regulation of oil and gas production that was promulgated for conservation purposes in the 1930s and 1940s, coupled with federal regulations on well spacing that were imposed during World War II to cope with equipment shortages,²²⁹ gave rise in the literature to the implied covenant to seek favorable adminis-

228. Some categories of incentive prices under the NGPA and the crude oil regulations are designed to encourage advanced technology such as tertiary and enhanced recovery projects. *See, e.g.*, 15 U.S.C. § 3318(b)(2) (Supp. III 1979); 10 C.F.R. § 212.78 (1980). The reasonably prudent operator certainly should be aware of the financial opportunities that these price categories offer and the possibilities of applying new recovery techniques to his leaseholds. Lessees must "develop the leased premises according to the recognized custom and progressive practices among operators in the field." *Wadkins v. Wilson Oil Corp.*, 199 La. 656, 658, 6 So. 2d 720, 721 (1942). *See also* *Shaw v. Henry*, 216 Kan. 96, 531 P.2d 128 (1975); *Waseco Chem. & Supply Co. v. Bayou Stata Oil Corp.*, 371 So. 2d 305 (La. App. 1979). That a particular process was unknown at the time the lease was executed is no defense to a cause of action for breach of the implied covenant to operate with diligence. *Wadkins v. Wilson Oil Corp.*, 199 La. at 658, 6 So. 2d at 721. Clearly, if lessees have a duty to keep abreast of technological advances in oil and gas production, they also have a duty to keep abreast of regulatory actions that affect profitability, even if these actions were non-existent and unforeseeable at the time that the parties executed the lease.

229. *Note, Effect of Conservation Order M-68 on Implied Covenants in Oil and Gas Leases*, 10 GEO. WASH. L. REV. 926 (1942).

trative action. The leading proponent of this covenant was Professor Merrill, who first suggested it in 1945 and subsequently advocated it at some length.²³⁰ The extensive conservation regulations on the oil and gas industry raised the question whether a lessee could defend himself against suits for breach of an implied covenant by simply pointing to a law that on its face seemed to prohibit the lessee from acting. Professor Merrill's answer was a resounding "no," which he based on two factors.²³¹ First, most conservation regulations were administered with a great deal of flexibility because amendments and individual exceptions to statewide rules were as much a part of the regulation as the general standard itself.²³² Second, the lessee's superior knowledge and resources dictated that he be the one to seek the administrative action necessary to develop the lease diligently. Merrill described the scope of the lessee's duty as follows:

It seems obvious that he should be diligent in attempting to procure a proper formulation of the rules when they originally are promulgated, as well as in seeking relief from rules which work improperly, whether by way of exception, revision, amendment or abrogation. If the administrative agency improperly refuses to act when its jurisdiction is invoked, it may be necessary to resort to mandamus to compel the assumption of its duties. The order issued may be contrary to law or to constitutional limitations. That may necessitate an invocation of judicial review, perhaps to appellate courts or even to the highest available tribunal, in order that the lessee may be adjudged free to carry out his duties as an operator ordinarily prudent. A lessee who has failed to exhaust his remedies to secure freedom so to act must be adjudged to have fallen short of his obligation to his lessor, unless he can show by clear and convincing evidence that the effort would have been fruitless.²³³

Merrill later added the duty to participate in rate-setting proceed-

230. The chronology of Merrill's crusade is as follows: Merrill, *Current Problems in the Law of Implied Covenants in Oil and Gas Leases*, 23 TEX. L. REV. 137 (1945); Merrill, *Fulfilling Implied Covenant Obligations Administratively*, 9 OKLA. L. REV. 125 (1956); Merrill, *Response to Conn's Connings*, 13 OKLA. L. REV. 34 (1960); M. MERRILL, *supra* note 50, § 228 (Supp. 1964); Merrill, *The Modern Image of the Prudent Operator*, 10 ROCKY MTN. MIN. L. INST. 107 (1965).

231. Merrill, *Current Problems in the Law of Implied Covenants in Oil and Gas Leases*, *supra* note 230, at 143-44.

232. For example, in Texas exceptions to rule 37—the well spacing regulation—were so common that the Texas Railroad Commission used a standard printed form to grant them. The denial of permit exceptions was so rare that a printed form was not justified. In 1971, 1617 exception permits were granted and only 13 were denied. H. WILLIAMS, R. MAXWELL & C. MEYERS, *supra* note 200, at 612-13.

233. Merrill, *Current Problems in the Law of Implied Covenants in Oil and Gas Leases*, *supra* note 230, at 145-46 (footnotes omitted). Consistent with this scope, Merrill asserted that lessees could not rely on federal wartime regulations as a defense against implied covenants unless they first established that the regulations were constitutional. *Id.* at 146-48.

ings before the Federal Power Commission so that the viewpoint of those interested in higher natural gas prices would be represented and would counterbalance the opposing interests of gas purchasers and consumers.²³⁴

The proposition that lessees should, under certain circumstances, seek favorable administrative action received general acceptance, although the grand sweep of Merrill's suggested duties and his misplaced burden of proof received strong criticism.²³⁵ Merrill subsequently suggested that the burden of proof be returned to the lessor in accordance with other implied covenant litigation,²³⁶ but he otherwise continued to propound the broad duty to seek administrative action described above. The duty is one that, in Merrill's terms, would intimidate even the most alert and active lessees, especially when applied in the current context of federal pricing regulations rather than the traditional state conservation regulation that Merrill had as his only background. Merrill advocated not only that the lessee should seek exceptions for his leasehold when authorized and appropriate, but also that he should seek amendments to rules of general applicability, participate in original rulemaking proceedings, and pursue layers of judicial review.²³⁷ In this thesis, however, Merrill appears to have lost sight of the reasonably prudent operator standard; he does not consider that an operator might be justified in foregoing these activities under certain circumstances such as the high costs of pursuing administrative relief and the high risks incurred in defying what may be an invalid order.²³⁸ Merrill does not analyze suffi-

234. M. MERRILL, *supra* note 50, § 228 (Supp. 1964). This section of Merrill's treatise propounds his view of the scope of the lessee's duty in even stronger terms than is quoted in the text.

235. Cline, *Implied Covenants—The New Look Under Conservation Laws*, 6 ROCKY MTN. MIN. L. INST. 471 (1961); Conn, *Trends in the Application of the Implied Covenant of Further Development*, 12 OKLA. L. REV. 470 (1959); Eberhardt, *supra* note 64; George, *The Impact of Conservation Laws and Decisions upon the Mutual Obligations of the Mineral Lease*, 24 LA. L. REV. 571 (1964); Gibhens, *The Effect of Conservation Legislation on Implied Covenants in Oil and Gas Leases*, 4 OKLA. L. REV. 337 (1951).

236. Merrill, *Fulfilling Implied Covenant Obligations Administratively*, *supra* note 230, at 126-27. Under Merrill's scheme, the lessee still has the burden of exonerating himself once the lessor has made a prima facie case that the regulation which the lessee is invoking as a shield to implied covenant liability is invalid or could have been excused or modified. *Id.* at 131.

237. Logically, Merrill's administrative covenant also would include a duty to lobby the state legislature and participate in hearings on laws that affect the lessee's and lessor's interests. *See, e.g.*, note 49 *supra*.

238. Merrill made the comment in his treatise that a court's decision was "grotesque" in allowing a lessee to excuse his failure to produce after the state commission had ordered

ciently the role of the administrative agency in the relationship between a lessee and lessor and whether the existence of an independent agency that acts in the public interest, and which is open to the views of all interested parties, might relieve the lessee of the duty to represent the lessor—or at least alter the duty in some fashion. Merrill's position seems to devolve into the simplistic equation that because the lessee is more knowledgeable about oil and gas operations and the effects of regulations, he must represent the lessor before the agency in all matters affecting the lessor's interest.²³⁹

Part of the problem with Merrill's exposition of the administrative covenant can be traced to the cases he originally used to support his newly named covenant. Since no precedent directly supported this covenant, Merrill used case law that indicated judicial recognition of the lessee's role as a representative of the lessor.²⁴⁰ These cases, however, did not recognize a *duty* of the lessee to act in this way, nor did they recognize the lessee's role as a representative of the lessor except in very narrow circumstances.²⁴¹ Merrill's use of these cases caused the administrative covenant to be phrased as the lessee's duty to represent the lessor's interest rather than as the lessee's duty to seek favorable administrative action when a reasonably prudent operator would do so—taking into consideration the interests of *both* the lessee and the lessor.

all wells to shut down. The Texas Supreme Court later invalidated the commission's order; therefore, according to Merrill, the lessee should have disobeyed the order. *M. MERRILL*, *supra* note 50, at 237 (Supp. 1964). Merrill would only rarely—"outside of emergency conditions"—allow a lessee to establish that under the facts and circumstances, it would have been useless for the lessee to try to secure administrative relief. Merrill, *Fulfilling Implied Covenant Obligations Administratively*, *supra* note 230, at 131.

239. Merrill, *Response to Conn's Connings*, *supra* note 230, at 38.

240. Merrill, *Current Problems in the Law of Implied Covenants in Oil and Gas Leases*, *supra* note 230, at 144-45.

241. The two principal cases that Merrill used addressed the legal issue whether royalty owners were necessary parties to Texas Railroad Commission proceedings. In both cases the court found that royalty owners were not necessary parties because lessee fully represented lessors' interests. *Shell Petroleum Corp. v. Railroad Comm'n*, 137 S.W.2d 797 (Tex. Civ. App. 1940); *Railroad Comm'n v. Humble Oil & Ref. Co.*, 101 S.W.2d 614 (Tex. Civ. App. 1936), *rev'd on other grounds*, 133 Tex. 330, 128 S.W.2d 9 (1939). The court, however, did expressly note that it was not dealing with a situation in which lessors' interests may have diverged from lessee's. The court stated,

There is no suggestion of criticism by interveners [lessors] of any act done by Humble [lessee] which to any degree worked to their detriment, or affected their interests deleteriously. Whether under other circumstances lessors under mineral leases are necessary parties to proceedings of this character, we are not called upon to decide.

101 S.W.2d at 623.

2. Issues Arising Under the Administrative Covenant

The increasing invocation of the administrative covenant is probable because of today's regulatory environment and is likely to bring many issues concerning the scope and operation of this covenant to the courts. A discussion of these issues, the judicial treatment of them to date, the conflicts that have arisen, and suggested resolutions of those conflicts is the subject of this subsection.

(a) *Judicial Recognition of the Administrative Covenant*

One commentator has suggested that the rule of stare decisis may bar judicial recognition of a new covenant that is substantially different in nature from the lessee's traditional implied duties.²⁴² The latter duties entail physical acts on the leased premises rather than representation of a lessor's interest in a hearing room or courthouse. Furthermore, other commentators have criticized the administrative covenant because it requires the courts to engage in matters that are entirely too speculative to be susceptible of proof.²⁴³ The first suggestion is untenable in light of the widely recognized implied covenant to market, which requires nonphysical acts such as negotiating sales contracts. Moreover, the traditional implied covenants often require some administrative action—for example, securing drilling permits. The administrative covenant should not be viewed as a new separate duty, but as part of the general duties of a reasonably prudent operator to develop, produce, and market oil and gas. If diligence in these acts requires seeking administrative action, then the operator should proceed to do so.

The second suggestion, that proof of a breach of the administrative covenant requires too much speculation, is also unfounded. Several courts have recognized the implied covenant to seek favorable administrative action and have found the problem of proving a breach entirely manageable. In the leading case of *Baldwin v. Kubetz*,²⁴⁴ for example, lessee attempted to defend his failure to comply with the continuous drilling provision of his lease by alleging that he was unable to procure a zoning exception which would permit further drilling. The court rejected lessee's contention because the zoning ordinance specifically granted exceptions for drilling whenever it appeared probable that oil existed under-

242. Gibbens, *supra* note 235, at 354.

243. Conn, *supra* note 235, at 488; Eberhardt, *supra* note 64, at 160-61 n.87.

244. 148 Cal. 2d 937, 307 P.2d 1005 (1957).

neath the land, and because the practices of the zoning commission were flexible enough that the conditions necessary to obtain a permit were easy to meet.²⁴⁵ Indeed, lessee had already obtained permits for other wells nearby. Similarly, in *Amoco Production Co. v. Alexander*,²⁴⁶ the lessor, Alexander, sued his lessee, Amoco, for breach of the implied covenant to protect against drainage. Amoco contended that it could not have drilled protection wells without securing exception permits from the Texas Railroad Commission, and that any expert testimony concerning what the Commission would have done if Amoco had applied was purely speculative and hypothetical.²⁴⁷ The court disagreed with Amoco and pointed to a number of factors that weighed in its decision: That the Commission's rule on well spacing specifically provided for exceptions to protect against confiscation; that the adjacent lessee, Exxon, probably would not have protested these exception requests because it also needed protection wells and in fact had been granted them—despite protests from Amoco; and that the Commission had granted Amoco exception wells on other leaseholds without protest from Exxon.²⁴⁸

Several other courts also have accepted the administrative covenant without undue concern that it was creating a judicial nightmare.²⁴⁹ In certain cases relief may well be speculative in the

245. *Id.* at 942, 307 P.2d at 1008.

246. 594 S.W.2d 467 (Tex. Civ. App. 1979), *aff'd*, 24 Tex. Sup. Ct. J. 581 (1981).

247. *Id.* at 474.

248. *Id.* at 476-77.

249. See notes 251-59 *infra*. The status of the administrative covenant is unclear in Oklahoma, even though the Oklahoma courts have dealt with the issue more often than any other jurisdiction. In *Sinclair Oil & Gas Co. v. Bishop*, 441 P.2d 436 (Okla. 1968), lessees shut in an oil well because its production would have resulted in large amounts of gas being flared, and lessees believed that this situation would be contrary to a statute prohibiting waste. Adjacent operators in the field, however, were producing their wells, which was resulting in drainage of the lessors' tract. The Oklahoma Supreme Court stated,

We cannot establish a rule which requires the lessee to waste oil or gas in violation of a statute prohibiting waste, merely because drainage is occurring by other operators. On the other hand we cannot overlook lessees' obligation to use every reasonable measure to protect from drainage. The remedy or relief in such a case rests in the Corporation Commission, which is by law delegated to prevent waste and protect correlative rights. . . .

. . . .

The question then arises as to the extent of lessors' damages which occurred as a result of lessee failing either to produce the well as lessor demanded, or seek relief from the Corporation Commission. Had lessee gone to the Corporation Commission, the relief which would have been accorded appears speculative but in any event the lessee would have exhausted all legal avenues available. On the other hand had the lessee produced the well as lessors urged then lessors maximum loss can be ascertained.

sense that the lessor will be unable to prove exactly what administrative action a reasonably prudent operator would have obtained, but in those cases the lessor's cause of action should fail.²⁵⁰ This situation is no reason to reject the administrative covenant *in toto* and preclude the lessor from a forum in which to try his case.

(b) *The Scope of the Lessee's Duty Under the Administrative Covenant*

To delineate the scope of the administrative covenant, it is helpful to analyze its contours in the case law to date. The courts have discussed the lessee's duty to seek administrative action in the following contexts:

1. To secure a drilling permit exception to a zoning ordinance as part of the implied covenant to develop.²⁵¹

Id. at 446-47. The court then ordered a judgment granting lessors damages in the amount of royalties that were lost during the period when the well was shut in. In a subsequent case, *Sunray DX Oil Co. v. Crews*, 448 P.2d 840 (Okla. 1968), the same court refused to recognize expressly the validity of the administrative covenant; instead, it held that lessee/defendant need not have appeared before the Corporation Commission on behalf of lessors to protest an adjacent operator's applications for increased oil allowables under the facts and circumstances shown.

In *Hall Jones Oil Corp. v. Claro*, 459 P.2d 858 (Okla. 1969), lessors/plaintiffs asserted that lessees/defendants were required to prevent drainage by seeking administrative relief from well spacing regulations. The court avoided the issue, however, since the facts in the case showed that lessees had falsified reports to the Commission, which resulted in the particular well spacing order; the defendants were not to be permitted to benefit from this wrongdoing.

In *Forman v. MacKellar Drilling Co.*, No. 43818 (Okla. Feb. 8, 1972), the Oklahoma Supreme Court reversed a summary judgment for lessee/defendant. The court held that lessor/plaintiff had stated a cause of action in his allegation that defendant had the duty to resist an application by adjacent lessees before the Corporation Commission and had failed to do so.

250. In *Weymouth v. Colorado Interstate Gas Co.*, 367 F.2d 84 (5th Cir. 1966), lessor brought suit against lessee for underproducing gas in violation of the implied covenant to market with diligence. The Fifth Circuit reversed a judgment for lessors because they had not proved that lessee could have secured an increase in allowables from the Commission, and that such an increase, if granted, would have produced more gas. The case was remanded to enable lessors to meet their burden of proof. The case thus stands for the proposition that when evidence of administrative relief is speculative, the lessor's case will fail. Indeed, the court's detailed examination of the statewide allowables nomination process indicated little confidence in lessor's ability to prove that relief was not speculative. *But see Sinclair Oil & Gas Co. v. Bishop*, 441 P.2d 436 (Okla. 1968). *See also Simmons v. Pure Oil Co.*, 241 La. 592, 129 So. 2d 786 (1961) (lessor's suit dismissed for cancellation of the lease on the ground that the allegations of injury were pure speculation and incapable of proof). The *Sinclair* decision may be criticized because it gives relief to lessors on a speculative basis without adequate proof of what the Corporation Commission would have done, if it had been requested to act. *See note 249 supra.*

251. *Baldwin v. Kubetz*, 148 Cal. 2d 937, 307 P.2d 1005 (1957); *cf. Stockburger v. Do-*

2. To secure exceptions to a well spacing order to ensure that the leased tract is protected against drainage and reasonably developed.²⁵²

3. To seek administrative relief—of an unspecified nature—to prevent drainage of the tract.²⁵³

4. To seek an increase in the allowables from the lessor's tract to fulfill the implied covenant to market with diligence.²⁵⁴

5. To resist applications of adjoining lessees for well spacing exceptions and increased allowables that, if granted, would drain the tract.²⁵⁵

6. To resist invalid statewide prorationing orders in order to comply with the implied covenant to operate diligently.²⁵⁶

7. To secure administrative and judicial rulings to invalidate a gas sales contract that prevented lessees from marketing their natural gas at the best price.²⁵⁷

lan, 14 Cal. 2d 313, 94 P.2d 33 (1939) (if drilling for oil is illegal under a zoning ordinance, and the lease is silent on whether the lessee should procure a variance to drill, then evidence of an oral agreement—made contemporaneously with the lease—that the lessee agreed to seek a variance, but did not do so diligently, was admissible because it would be consistent with the lease terms).

252. *Amoco Prod. Co. v. Alexander*, 594 S.W.2d 467 (Tex. Civ. App. 1979), *aff'd*, 24 Tex. Sup. Ct. J. 581 (1981); *see text accompanying notes 246-48 supra*. *See also U.V. Indus., Inc. v. Danielson*, 602 P.2d 571 (Mont. 1979) (the applicable well spacing regulations would not have prohibited lessees from drilling an offset well if lessees had pursued this action); *Hall Jones Oil Corp. v. Claro*, 459 P.2d 858 (Okla. 1969) (lessees not permitted to benefit from well spacing order issued on the basis of falsified reports); *Willingham v. Bryson*, 294 S.W.2d 421 (Tex. Civ. App. 1956) (lessee defended against breach of an implied covenant by asserting an additional well could not be drilled under the spacing rules. The burden was on lessee to prove that he did not breach an implied covenant because an additional well could not be drilled under the spacing rules; since lessee presented no evidence on the point, lessor is entitled to judgment).

253. *Sinclair Oil & Gas Co. v. Bishop*, 441 P.2d 436 (Okla. 1968); *see note 249 supra*.

254. *Weymouth v. Colorado Interstate Gas Co.*, 367 F.2d 84 (5th Cir. 1966); *see note 250 supra*.

255. *Forman v. MacKellar Drilling Co.*, No. 43818 (Okla. Feb. 8, 1972); *Sunray DX Oil Co. v. Crews*, 448 P.2d 840 (Okla. 1968); *see note 249 supra*. *See also Sun Oil Co. v. Potter*, 182 S.W.2d 923 (Tex. Civ. App. 1944), *rev'd on other grounds*, 144 Tex. 151, 189 S.W.2d 482 (1945). These cases only indirectly support judicial recognition of the administrative covenant.

256. *Newell v. Phillips Petroleum Co.*, 144 F.2d 338 (10th Cir. 1944). In *Newell* the court found that defendant/lessee had acted as a reasonably prudent operator in restricting production to comply with prorationing orders that were later adjudged void. The judgment for lessee was based on an examination of those factors relevant to determining whether lessee had acted diligently. The court did not rely on the theory that lessee was protected solely by the prorationing orders. Thus, the court, by implication, recognized a duty on the part of lessee to disobey orders or take legal action against orders if a reasonably prudent operator would have done so.

257. *Fisher v. Superior Oil Co.*, 390 P.2d 521 (Okla. 1964). The issue in *Fisher* was

8. To secure pooling—by compulsory process if necessary—under the implied covenant to protect against drainage.²⁵⁸

9. To refrain from providing false information to the administrative agency that would result in orders which are harmful to the lessor.²⁵⁹

A common theme in these cases is that the lessee's conduct falls short of what typically is demanded under the traditionally recognized covenants because he has failed to take action that is "incidental" to the major purposes of the lease—the production, development, and marketing of oil and gas.²⁶⁰ Another common theme is that the cases generally involve securing administrative action limited to the leased tract—for example, an individual exception or pooling order—rather than actions that would affect numerous people through changes in statewide or fieldwide rules.²⁶¹

whether royalty owners had to contribute legal expenses to pay the attorney who had successfully sought a judicial decree invalidating a natural gas contract that provided for no payment for the natural gas other than for its liquid hydrocarbon content. The court recognized the duty of lessee to protect the interests of royalty owners when marketing the natural gas and, therefore, would have had the lessees bear all the attorney's fees. Recognition of this duty is dictum, however, since no attorney's fees were actually awarded.

258. *Williams v. Humble Oil & Ref. Co.*, 432 F.2d 165 (5th Cir. 1970); *Breaux v. Pan Am. Petroleum Corp.*, 163 So. 2d 406 (La. App. 1964); see text accompanying notes 277-79 *infra*.

259. *Pan Am. Petroleum Co. v. Hardy*, 370 S.W.2d 904 (Tex. Civ. App. 1963). In *Hardy* defendant/lessee had fraudulently led the Railroad Commission to classify two sands as one reservoir to avoid further drilling. The court held that lessee had breached his duty to act as a reasonably prudent operator and awarded exemplary damages to lessor in compensation for the expense of employing experts and attorneys to study the geology of the field and ascertain the truth. Similarly, in *Hall Jones Oil Corp. v. Claro*, 459 P.2d 858 (Okla. 1969), lessee was draining lessor's tract by operations on adjacent land and filed false reports with the Commission to conceal this drainage. The court rejected lessee's defense to the implied covenant cause of action that well spacing regulations forbid drilling an offset well. The court found it unnecessary to determine whether lessee would have been required to seek administrative relief to secure a drilling exception permit, since lessee's conduct amounted to oppression, fraud, and malice.

260. One court stated that "it has become accepted law in this state that there is an implied covenant of diligent exploration and diligent operation of any producing wells. Immanent in this implied obligation is that of doing such incidental or subsidiary acts as may be reasonably necessary to accomplish the major purpose . . ." *Baldwin v. Kubetz*, 148 Cal. 2d 937, 943, 307 P.2d 1005, 1009 (1957) (citations omitted). Similarly, in *Sun Oil Co. v. Potter*, 182 S.W.2d 923 (Tex. Civ. App. 1944), *rev'd on other grounds*, 144 Tex. 151, 189 S.W.2d 482 (1945), the court noted that "the lessees are invested with full control over the leased premises, including the right of possession and to develop and the incidental right to apply for the necessary drilling permits. These rights import corresponding duties of the lessees for breach of which they would be liable." *Id.* at 926.

261. The leading case that addressed the issue of a lessee's failure to resist a statewide prorationing order held that lessee acted as a reasonably prudent operator in doing so.

This common scenario is not surprising, since a lessor would find it difficult to prove that his lessee's participation or nonparticipation in a general rulemaking proceeding or court challenge of importance to the entire oil and gas industry was the cause of the lessor's individual injury. The reasonably prudent operator rule does not require diligence from a lessee when the effort would be unavailing or unnecessary because of the actions of others.

Another important feature of these cases is that the lessee and lessor typically share a mutual interest in the general objective of the administrative order that is either sought or resisted, although not in its specific application to the lease at issue. For example, if their tract of land is being drained, both the lessee and lessor want an exception to drill an offset well; similarly, both parties generally desire a favorable allowable formula for their well. The implied covenant cases arise because under the specific facts of each case, a conflict between the two parties exists as a result of the lessee's desire for greater profits—or his reluctance to pursue seemingly unprofitable ventures²⁶²—or as a result of the lessee's negligence.²⁶³

Newell v. Phillips Petroleum Co., 144 F.2d 338 (10th Cir. 1944). See also Weymouth v. Colorado Interstate Gas Co., 367 F.2d 84 (5th Cir. 1966) (discussing lessor's difficult burden of proof in cases that deal with the statewide allowables system). The court in Amoco Prod. Co. v. Alexander, 594 S.W.2d 467 (Tex. Civ. App. 1979), *aff'd*, 24 Tex. Sup. Ct. J. 581 (1981), held that the lessee, Amoco, had an implied duty to protect the leased tract against fieldwide drainage. The Texas Supreme Court upheld the lower court's decision that Amoco had breached its implied covenant duties by failing to seek rule 37 exceptions to drill replacement wells on the lessor's tract. In dictum, the supreme court stated that the duties of a reasonably prudent operator also may include seeking fieldwide regulatory action, including voluntary unitization. *Id.* at 583. In this case, Amoco owned 80% of the production from the field. If Amoco had been a small operator in the field, its failure to seek fieldwide action may not have violated the reasonably prudent operator standard.

262. The conflict in implied covenant cases usually arises because of different opinions about whether an operation—usually drilling a well—would be profitable. Other sources of conflict of interest, however, also appear in several of these cases. In Amoco Prod. Co. v. Alexander, 594 S.W.2d 467 (Tex. Civ. App. 1979), *aff'd*, 24 Tex. Sup. Ct. J. 581 (1981), plaintiff/lessor's royalty was $\frac{1}{6}$ of the oil and gas produced. The royalty owed lessors on adjoining tracts that the same lessee had leased was $\frac{1}{8}$, which created an incentive for lessee to drain plaintiff/lessor by sweeping oil up the structure, away from lessor's tract. In Weymouth v. Colorado Interstate Gas Co., 367 F.2d 84 (5th Cir. 1966), lessee had "take or pay" sales contracts with pipeline purchasers for gas from adjoining tracts that he leased, which created an incentive for lessee to underproduce lessor's tract. In Williams v. Humble Oil & Ref. Co., 432 F.2d 165 (5th Cir. 1970), lessee was the operator of the well on the adjoining tract that was draining lessor.

263. Negligence was the issue in Newell v. Phillips Petroleum Co., 144 F.2d 338 (10th Cir. 1944); Baldwin v. Kubetz, 148 Cal. 2d 937, 307 P.2d 1005 (1957); Sunray DX Oil Co. v. Crews, 448 P.2d 840 (Okla. 1968); and Sinclair Oil & Gas Co. v. Bishop, 441 P.2d 436 (Okla. 1968). See also Continental Inv. Corp. v. State Corp. Comm'n, 156 Kan. 858, 137 P.2d 166 (1943).

In these situations, courts generally do not allow lessees to use administrative rules as a shield against greed or incompetence, if a reasonably prudent operator would have acted differently.²⁶⁴

No cases have yet decided the issue whether the lessee should

264. A few cases seem not to recognize the administrative covenant, but a close examination of the facts shows that these cases are not conclusive on this point. In *Chenoweth v. Pan Am. Petroleum Corp.*, 314 F.2d 63 (10th Cir. 1963), for example, lessor sued lessee for breach of the implied covenant to reasonably develop because of an alleged failure to drill wells into other formations on the leased premises. The court found that a reasonably prudent operator would not have drilled such a well because its costs probably would have exceeded its revenues. Lessor also objected to the original order of the Oklahoma Corporation Commission, which found one formation to be a common source of supply. Lessor contended that this order was erroneous because two separate sources of supply existed. The court concluded that "[a]ppellants [lessors] have not sought to have this order amended by the Commission as they are permitted to do under Oklahoma law. Thus such an administrative remedy is still available." *Id.* at 65. Lessors apparently did not plead that the duty to seek such an amendment was the lessee's under the doctrine of implied covenants.

In *Simmons v. Pure Oil Co.*, 241 La. 592, 129 So. 2d 786 (1961), lessor alleged that lessee violated its implied obligations by seeking an exception well that, when drilled, offered new geological evidence which caused the Conservation Commissioner to reform a pre-existing unit in which lessor was participating. The reformed unit included only 20 acres of lessor's land versus the 60 acres included in the first unit. Lessor contended that lessee failed to inform him of the possible result of the exception well—and, in fact, actively concealed this possibility from him—because lessee had property adjoining the unit that it wanted to include in the reformed unit to lessor's detriment. The Louisiana Supreme Court dismissed the cause of action because of lessor's failure to prove any injury other than of a purely speculative nature. The court, however, did observe that lessor should have known that unitization orders are always subject to change by the Commission—after notice and hearing—based on new geological evidence. The court seemed to use this observation to reduce lessee's duty to disclose information to lessor. The court also held lessor's charge that lessee manipulated Commission processes by concealing his true purpose in seeking an exception well to be a collateral attack on the Commission's findings and thus not allowable.

Another case in this area, *Mims v. Hilliard*, 125 So. 2d 205 (La. App. 1960), dealt with the sale of a lease and thus is not directly relevant to the doctrine of implied covenants. *Mims* held that lessee/purchaser was under no duty to tell lessors—in the absence of an inquiry from lessors—that 14 acres of the tract being bargained for was already in a unit. The court noted that the existence of the Commissioner's unit was a public matter about which lessors could easily have obtained information.

Finally, in *Savoy v. Tidewater Oil Co.*, 218 F. Supp. 607 (W.D. La. 1963), *aff'd per curiam*, 326 F.2d 757 (5th Cir. 1964), the court upheld a summary judgment for lessee on the ground that lessor's allegation of breach of the administrative covenant—that lessee should have requested the Commissioner to place the leased tract in a more favorable unit—was a collateral attack on the Commissioner's decision. Under Louisiana statutes, lessor must exhaust all administrative remedies and seek direct review of the Commissioner's order.

These cases show that Louisiana statutes may preclude judicial recognition of the administrative covenant in circumstances that would amount to a collateral attack on a Commission order. In this event, the lessor must exhaust his administrative remedies by opposing the order before the Commission and then appealing the order directly. When the lessor alleges that the lessee failed to take any administrative action—and the validity of a Commission order thus is not at issue—the Louisiana statutes should not preclude judicial recognition of the lessee's duty to seek favorable administrative action.

be held to represent the lessor when no mutual interest exists in the general objective of the administrative action that is sought or resisted. Such a situation, however, may arise. For example, no mutual interest would exist in state commission proceedings to determine the proper well spacing for fields. In these proceedings, the lessee generally argues for large drilling units, since he bears the costs of drilling and obviously wants to minimize the number of wells that are required to develop a field. The lessor generally advocates smaller drilling units, since his interest is cost-free and his time frame generally is shorter; he prefers his royalties now rather than later.²⁶⁵ Although the interests of the lessee and lessor generally coincide in federal pricing matters, this is not always the case. The tertiary incentive crude oil pricing category, for example, allowed qualified producers to sell crude oil at market prices and recoup up to seventy-five percent of certain expenses incurred in the tertiary operation.²⁶⁶ The regulations, however, were silent on the issue whether royalties were to be paid on the basis of the market price without adjustments for that portion of the price which represents tertiary incentive revenues. If so, the net amount of expenses that the producer recouped would be less than the seventy-five percent provided in the regulations. Clearly, in a rulemaking or administrative hearing on this subject, the lessees' interest would be opposed to the lessors'.

The rights of lessees and lessors are difficult to balance in this situation. On the one hand, to impose a duty on the lessee to represent the lessor's interest in these circumstances appears unsound and unrealistic. The administrative agency is charged with

265. This example of a conflict between the lessee and lessor resembles the facts in *Oil & Gas Bd. v. Mississippi Mineral & Royalty Owners*, 258 So. 2d 767 (Miss. 1971). Royalty owners sued the Mississippi Corporation Commission for establishing statewide spacing units of 80 acres instead of 40 acres. They sought to have the order overturned as arbitrary and capricious because it was based largely on the profitability of drilling—that is, on the producers' interests—rather than on the statutory mandate to prevent waste and protect correlative rights. The majority held that the order was not arbitrary, since one objective of the conservation legislation was to develop the state's resources; thus, the profitability of drilling was validly considered. A vigorous dissent argued that the order was arbitrary and capricious and deprived royalty owners of a valuable right. The dissent pointed out that these owners did not have the expertise to prove that exceptions to 80-acre spacing should be granted in particular cases, with the result that lessors undoubtedly would suffer a decline in royalties. *Id.* at 780. According to the dissent the Commissioner should retain the 40-acre spacing rule and let lessees who have the expertise obtain exceptions for 80-acre units in deep reservoirs. While this point of view has merit, it does not follow that the lessee should have the duty to present the lessor's position on statewide spacing before the Commission. See text accompanying note 268 *infra*.

266. 10 C.F.R. § 212.78 (1981).

promulgating regulations in the public interest defined by its charter. Lessees and lessors may well differ on how this public interest should best be achieved. Each party, then, should represent his own interest. The reasonably prudent operator is not required to consider his lessor's well-being to the detriment of his own. It would be asking too much of a lessee to present with equal vigor both sides of the matter to the administrative agency.²⁶⁷ Such a duty could well have a chilling effect on the lessee, with the result that the commission would be deprived altogether of the benefit of the lessee's knowledge and expert opinion.²⁶⁸ To hold that the lessee has no duty to represent the lessor's interests in this situation, however, does not grant him a license to abuse the administrative process or fraudulently prevent the lessor's views from being represented.²⁶⁹ The effect of limiting the scope of the administrative covenant in this manner is to impose more responsibility on the lessor to familiarize himself with the regulations of the oil and gas business and the administrative procedures that are necessary to protect his interests. This result contravenes Merrill's view;²⁷⁰ the more dispassionate observer, however, may accept it as the price one pays for owning an interest in a natural resource of such vital economic importance that the public interest requires its regulation by an administrative agency.²⁷¹

267. See E. KUNTZ, *supra* note 50, § 59.1.

268. The imposition of such a duty would endanger the lessee under the perjury laws as well. In *Sunray DX Oil Co. v. Crews*, 448 P.2d 840 (Okla. 1968), the Oklahoma Supreme Court overturned the lower court's order that required defendant/lessee to appear before the state commission and to resist the applications that adjoining landowners had filed. The court stated,

If defendant herein did in good faith rely on the judgment of its experts in regard to the application for increased allowables, the judgment of the court below places it in somewhat of a dilemma. If it had appeared before the Corporation Commission to defend or help defend against the Shell applications, as it was ordered to do, it would have had either to submit evidence detrimental to plaintiffs' position or to commit or condone perjury.

Id. at 845.

269. See *Hall Jones Oil Corp. v. Claro*, 459 P.2d 858 (Okla. 1969); *Pan Am. Petroleum Corp. v. Hardy*, 370 S.W.2d 904 (Tex. Civ. App. 1963) (sustaining punitive damages of \$25,000 to punish lessee and to deter others from intentionally giving false information to the state agency); note 259 *supra*.

One commentator has suggested the imposition of a duty of fair dealing to measure the lessee's obligation to the lessor under the administrative covenant when their interests conflict. George, *supra* note 235, at 577-78.

270. Merrill, *Response to Conn's Connings*, *supra* note 230, at 38; Merrill, *Fulfilling Implied Covenant Obligations Administratively*, *supra* note 230, at 131.

271. The crude oil windfall profit tax legislation, as originally passed, may have taught lessors the lesson that protection of their royalty interests requires greater vigilance on their

On the other hand, to impose no duty on the lessee in this situation overlooks other important features of the real world and may reflect an overly complacent attitude towards lessors' ability to function before administrative agencies. Lessors in fact often lack the knowledge and expertise required to argue successfully on their own behalf, and they must acquire this knowledge only at considerable expense.²⁷² The state administrative agencies that govern the oil and gas industry often view their role as advocates of oil and gas development, and this posture has resulted in a natural propensity to favor producers.²⁷³ The state jurisdictional agencies that administer the NGPA well classification process usually are the same familiar agencies that have regulated the industry under the conservation laws.²⁷⁴ Moreover, judicial review of agency actions under the arbitrary and capricious standard is lax, which renders lessors' challenges on appeal of agency decisions that unduly favor lessees a virtual nullity. Firmer judicial review of agency action, or reform of an agency's charter, procedures, or personnel, in cases in which the agency is deemed too biased towards producers' interests are long-term political measures that give no relief to lessors with an immediate problem. Under these circumstances, if the lessee's duty to represent the lessor when their interests conflict on the administrative objective sought is limited to avoiding fraud on the lessor,²⁷⁵ then state agencies are not likely to receive a balanced presentation of all points of view on an issue, and agency

part. At first, royalty owners were not exempted from paying the tax. Only after the receipt of diminished royalty checks did royalty owners organize to protest the tax. In the words of one royalty owner, "If we'd had this kind of unity in the first place, we might not be in this predicament. . . . When the original bill was being debated the big oil companies looked after their interests and the independent producers looked after theirs, but nobody looked after ours." Schlender, *Windfall Tax on Little Oil*, Wall St. J., July 7, 1980, at 10, col. 4, col. 6.

The royalty owners' organizations that sprang up after passage of the windfall profit tax legislation convinced Congress to pass a one-time tax credit or refund of \$1000 of the windfall profit tax liability by exercising political clout and turning media attention to the plight of poor widows whose royalty income was severely cut by the tax. I.R.C. § 6429.

272. See, e.g., *Oil & Gas Bd. v. Mississippi Mineral & Royalty Owners*, 258 So. 2d 767 (Miss. 1971); *Pan Am. Petroleum Co. v. Hardy*, 370 S.W.2d 904 (Tex. Civ. App. 1963).

273. See, e.g., *Oil & Gas Bd. v. Mississippi Mineral & Royalty Owners*, 285 So. 2d 767 (Miss. 1971).

274. For example, the Texas Railroad Commission is the jurisdictional agency for NGPA filings. A list of all the state agencies with NGPA jurisdiction appears in 18 C.F.R. § 274.501 (1980).

275. The lessor who questions the lessee about the latter's intended participation in agency proceedings surely is entitled to truthful answers. See note 259 *supra*. The lessor with enough knowledge to ask the lessee these questions, however, is likely to represent only a select group of lessors.

decisionmaking is liable to reflect this disparity.

A balance perhaps can be achieved by imposing a limited disclosure duty on the lessee. When the lessee proposes to take an active part in administrative or judicial hearings on a subject that conflicts with the interests of his royalty owners, the lessee should disclose the fact of his participation to the lessor, provide a brief description of his position on the issue, and advise the lessor to seek his own legal representation if he so desires. This procedure would absolve the lessee from the impossible two-faced duty of testifying with equal ardor on both sides of the issue, and at the same time it would alert lessors to the issue and the possible need to pursue separate actions.²⁷⁶

Support for such a duty to disclose within the scope of the administrative covenant can be found in *Williams v. Humble Oil & Refining Co.*²⁷⁷ In this case the court held that the scope of lessee's implied obligation to protect against drainage included a duty to unitize. The court then stated,

Indeed, if he [lessee] deems it inadvisable or unprofitable to drill offset wells or unitize the premises, the prudent administrator should perhaps disclose the fact of drainage to the lessor so that he [lessor] may apply to the Louisiana Commissioner of Conservation for the establishment of a drilling unit. In appropriate circumstances failure to make a full disclosure may provide the basis for a cause of action for damages.²⁷⁸

The *Williams* case concerned a lessee who was draining his own lessor's property by production from an adjoining tract. The duty to disclose language can be restricted to this particular factual setting, in which the potential severity of the conflict between the lessee and lessor and the lessee's clearly superior knowledge about the facts of drainage—and strong incentive to hide these facts—would justify such a duty.²⁷⁹ The case, however, affords a clear analogy to the administrative setting in which the lessee deems it inadvisable and unprofitable to pursue an administrative objective that would favor the lessor's interests at his own expense. The duty to disclose is an appropriate mechanism for resolving the conflicting interests of the lessee and lessor in this setting as well.

276. The administrative agency's notice requirements may not suffice to alert lessors to the fact or nature of their own lessee's opposing testimony.

277. 432 F.2d 165 (5th Cir. 1970).

278. *Id.* at 173.

279. The *Williams* situation also justifies the elimination of the profitability standard in determining what a reasonably prudent operator would do, since the lessee's capital already is invested in the draining well. See Hardy, *Drainage of Oil and Gas From Adjoining Tracts—A Further Development*, 6 NAT. RES. J. 45, 57-58 (1966).

How broadly this duty to disclose should apply in the administrative context is the next question. The issue is whether the lessee, who has determined that it is too costly or too risky to pursue an administrative action which would be likely to benefit the lessor, should be obligated to tell his lessor about the potential benefits available or injuries to be averted so that the lessor can use a self-help remedy. Imposing such a duty would put the lessee in the uncomfortable position of either going forward with an unprofitable venture or—if he decides not to pursue the matter—inviting his lessor to sue him for breach of an implied covenant.²⁸⁰ A lessee, after careful consideration, may determine that it would be unprofitable to seek administrative action. If such a lessee were required to disclose this fact to the lessor for the purpose of allowing the lessor to proceed independently and seek administrative relief, then the lessor who believes that the lessee has overestimated the risks and costs of proceeding—or who believes that the lessee should proceed regardless of these costs—may well sue under the administrative covenant. If the lessor himself proceeds to seek the administrative action and succeeds, he undoubtedly will sue the lessee for the costs incurred in securing action that the lessor now firmly believes should have been the lessee's duty.²⁸¹ Even though the lessor should lose the lawsuit under the facts posed, the lessee is nevertheless burdened with the costs of litigation.²⁸²

This discussion suggests that the duty to disclose should be

280. For example, this duty to disclose could result in a reasonably prudent operator being forced to fasten—or at least hasten—an unprofitable pooling venture on himself. If pooling would be unprofitable—because of, for example, a statutory requirement that the lessee contribute his pro rata share of drilling costs and the draining well has a dubious pay out—this fact normally would bar the lessee's duty to seek pooling. If the lessee, however, must disclose the fact of drainage to the lessor, then the noncost bearing royalty owner may well find it advantageous to invoke the pooling statute. The administrative covenant was never meant to force the lessee to act perversely by ignoring his own vital interests. Of course, if the lessee in the example is doing the draining, this result is not so perverse.

281. *Cf. Fisher v. Superior Oil Co.*, 390 P.2d 521 (Okla. 1964) (producers alone should bear the cost of attorney's fees incurred in a successful court action to obtain higher natural gas prices that benefited both producers and royalty owners).

If the lessee and lessor faced differences in the costs or risks of seeking administrative action, the lessor might successfully obtain the relief sought; the lessee, however, still could show that a reasonably prudent operator would not have pursued the action. Of course, the lessee might be expected to obtain lessor's help voluntarily under these circumstances.

282. In addition, courts have difficulty avoiding the improper use of hindsight to judge the reasonably prudent operator's actions. *See, e.g., Hutchinson v. McCue*, 101 F.2d 111 (4th Cir.), *cert. denied*, 308 U.S. 564 (1939). Thus, the lessor might succeed in court when perhaps he should not.

limited to circumstances in which lessees and lessors have conflicting interests in the general objective of the administrative action that is sought. When their interests are mutual, the courts should not impose a duty to disclose, since the lessee's failure to seek the agency action can be presumed to be the result of the inherent high costs and risks. To impose such a duty simply would invite litigation. If the lessee's failure to seek administrative action is due to incompetence or neglect rather than any conflict in interest, then the general principles of implied covenant law suffice to protect the lessor, and no duty to disclose is necessary.²⁸³

Imposing a duty to disclose in the manner outlined above would be an extension of existing case law in the implied covenant area. Thus, courts that follow the equity model of implied covenants are more likely to adopt this duty. The disclosure obligation proposed in this Article can also be viewed as consonant with the contract model. The very nature of the oil and gas lease contemplates development of the premises to the mutual benefit of both parties. A central motivation of lessors in granting a lease is to transfer the management and operation of the premises to experienced lessors, including the management of regulatory affairs to which lessors also may have access.²⁸⁴ In turn, a principal motivation of lessees in accepting the contractual burden of paying a cost-free royalty is to avoid interference from the lessor in running the business. Thus, a disclosure duty ordinarily should not force the lessee to invite the lessor to manage leasehold affairs. When the two interests inevitably diverge over a certain administrative objective, however, the parties would probably expect that the lessee would at least tell the lessor to pursue his interests independently.²⁸⁵

283. Furthermore, to impose a duty to disclose ignorance is obviously unreasonable.

284. See text accompanying notes 285-95 *infra* (concerning the effect on the administrative covenant of the lessor's ability to petition for and pursue agency action on his own).

285. One oil company seems to have adopted a disclosure policy concerning litigation over the crude oil pricing regulations. The Department of Energy (DOE) has made it a practice to seek refunds for pricing overcharges against the operator of a tract rather than against all the interest owners, which leaves the operator to seek contribution from the royalty owners and other working interest owners. See Lavenant, *Operator's Liability for Overcharges in the Sale of Production*, 31 *INST. OIL & GAS L. & TAX.* 131 (1980). This practice is a heavy administrative burden for the lessee/operator to bear. In the midst of lengthy litigation between DOE and Exxon over alleged crude oil pricing violations, Exxon, the operator, notified more than 2000 working interest and royalty interest owners in the field that they were included in the lawsuit against DOE, which gave these owners the opportunity to participate actively in the lawsuit and defend their individual interests directly against DOE's claim. Generally, Exxon and the royalty owners have a mutual interest in the

(c) *The Ability of the Lessor to Represent Himself and the Scope of the Administrative Covenant*

Many of the implied covenant cases discussed above deal with the duty to seek a drilling permit. The typical oil and gas lease vests the lessee with the exclusive right to drill and produce. The lessor, therefore, often has no right to seek such a permit. The courts have recognized this fact and generally have refused to allow lessees to escape the administrative covenant when a reasonably prudent operator would have sought the drilling permit.²⁸⁶ In other contexts, however, the lessor may have equal access to the administrative or judicial forum.²⁸⁷ The state jurisdictional agencies that perform NGPA well classifications may allow any interested person—including royalty owners—to file for well applica-

litigation, and Exxon's defense serves the interests of both parties. If Exxon, however, argues in court that each interest owner should be individually responsible for paying the refunds, this position could conflict with the royalty owners' interests by transferring some of the administrative burden of compliance to them. Exxon's actions simply may have been a desire to achieve royalty owner unity in its defense, but it also may reflect an effort to avoid potential conflict of interest problems. Hous. Chronicle, Dec. 19, 1980, § 2, at 12, col. 1. Exxon's attempt to withhold payment to royalty owners of the amount of the alleged overcharge provoked a lawsuit by some royalty owners. *Jarvis Christian College v. Exxon Corp.*, No. TY-80-432 (E.D. Tex., filed Nov. 19, 1980). For additional background on the conflict, see *United States v. Exxon*, [1981] 4 ENERGY MNGM'T (CCH) ¶ 26,269.

286. *Baldwin v. Kubetz*, 148 Cal. App. 2d 937, 307 P.2d 1005 (1957); *U.V. Indus., Inc. v. Danielson*, 602 P.2d 571, 581 (Mont. 1979) (lessors had no right to obtain a drilling permit, since the lease gave lessees the sole and exclusive right to drill). Similarly, in *Railroad Comm'n v. Humble Oil & Ref. Co.*, 101 S.W.2d 614 (Tex. Civ. App. 1936), *rev'd on other grounds*, 133 Tex. 330, 128 S.W.2d 9 (1939), the court's recognition of lessee's role as a representative of lessor clearly was predicated on the consideration that lessors did not have an in kind royalty clause and lacked title to any natural gas.

The legislative wisdom of allowing only lessees to petition for compulsory unitization under a state statute was upheld in *Palmer Oil Corp. v. Phillips Petroleum Co.*, 204 Okla. 543, 231 P.2d 997 (1951), in which the court stated,

The royalty owners are those who have committed to lessees their right to produce in exchange for a definite share in the production. . . . By reason of [lessees'] knowledge of the problems they, necessarily, are in a better position than the royalty owners to appraise the practicability and hence the wisdom of unification. . . . The royalty owners, who by their own acts have completely divorced themselves from the activity, are often not conveniently accessible and could afford little if any helpful information if available, but they are granted the right of an appeal from the action of the Commission

Id. at 550, 231 P.2d at 1005.

The legislative rationale for denying lessors access to the unitization petition makes it all the more important that courts recognize the administrative covenant and that state commissions are staffed with independent and competent personnel.

287. For example, royalty interest owners may apply for compulsory pooling under many state statutes. See, e.g., TEX. RES. CODE ANN. tit. 3, § 102.012 (Vernon 1978). Lessors who own in kind oil or gas royalties can market it themselves—if they so desire—and make their own sales contracts.

tions.²⁸⁸ Whether the courts will still impose the administrative covenant on the lessee in this situation is the next question. In several cases, the answer clearly was yes,²⁸⁹ but not all courts are certain to agree.²⁹⁰

The availability of self-help to the lessor should not affect the scope of the administrative covenant. It certainly should not bar an action for breach of an implied covenant, nor should it constitute an absolute defense to such a breach. The reasoning for this proposition is the same as under the implied covenant to market when the lessor owns in kind royalty oil or gas and theoretically has a self-help remedy in marketing it.²⁹¹ Under the typical oil and gas lease, the lessor neither desires the burden of day-to-day operations of the lease nor is qualified to carry such a burden.²⁹²

288. FERC regulations permit the state jurisdictional agencies that perform NPGA well classifications to determine who can make the well applications. Many states once required that only the operator could make the application, while other states permitted "any interested person" to file. Still others required the operator to file, but permitted a nonoperator/seller to file by making reference to the operator. Address by Eaton, *Houston Law Review Energy Symposium on Oil and Gas: Impact of the Federal Regulatory System* (March 8, 1979). Many state agencies have since revised their rules after gaining experience with the well application process, but the procedures still vary from state to state.

289. *Williams v. Humble Oil & Ref. Co.*, 432 F.2d 165 (5th Cir. 1970), cert. denied, 402 U.S. 934 (1971); *U.V. Indus., Inc. v. Danielson*, 602 P.2d 571 (Mont. 1979); *Sinclair Oil & Gas Co. v. Bishop*, 441 P.2d 436 (Okla. 1967); *Fisher v. Superior Oil Co.*, 390 P.2d 521 (Okla. 1964); *Amoco Prod. Co. v. Alexander*, 594 S.W.2d 467 (Tex. Civ. App. 1979), *aff'd*, 24 Tex. Sup. Ct. J. 581 (1981).

290. See note 264 *supra* and cases cited therein (appearing to bar the administrative covenant). In holding for the lessee, courts have specifically pointed to the following considerations, among others: That lessor had access to the information that lessee allegedly concealed, *Mims v. Hilliard*, 125 So. 2d 205 (La. App. 1960); that lessor had equal access to the administrative process, *Chenoweth v. Pan Am. Petroleum Corp.*, 314 F.2d 63 (10th Cir. 1963); that lessor should have known the nature of agency orders, *Simmons v. Pure Oil Co.*, 241 La. 592, 129 So. 2d 786 (1961); and that lessor both was equally bound by state statutes requiring direct review of agency orders and had equal access to the courts to challenge these orders, *Savoy v. Tidewater Oil Co.*, 218 F. Supp. 607 (W.D. La. 1963), *aff'd per curiam*, 326 F.2d 757 (5th Cir. 1964).

291. See text accompanying notes 199-214 *supra* (discussing effects of in kind royalty clauses).

292. This reasoning has been adopted in the following cases: *Williams v. Humble Oil & Ref. Co.*, 432 F.2d 165, 173 n.9 (5th Cir. 1970); *U.V. Indus., Inc. v. Danielson*, 602 P.2d 571, 581 (Mont. 1979); *Sinclair Oil & Gas Co. v. Bishop*, 441 P.2d 436, 447 (Okla. 1967) ("Although both the lessor and the lessee had access to the Corporation Commission for relief, we feel the greater responsibility was with the lessee."); *Amoco Prod. Co. v. Alexander*, 594 S.W.2d 467, 474 (Tex. Civ. App. 1979) ("Under the leases in question Amoco had the exclusive right to drill and otherwise operate the premises. It would know almost exclusively whether and when to apply for relief from the Commission, armed as it was with all of the relevant data."), *aff'd*, 24 Tex. Sup. Ct. J. 581 (1981). *But see* 5 WILLIAMS & MEYERS, *supra* note 50, § 861.4. Williams and Meyers suggest that the lessor's ability to challenge a regulation could relieve the lessee of this duty.

Similarly, the availability of self-help to the lessor in the administrative arena should be irrelevant to the standard that the courts use to judge a lessee's conduct. The courts should not impose a less rigorous standard on the lessee than that of the reasonably prudent operator simply because the lessor also has access to the administrative forum.²⁹³ Conversely, if the lessor lacks this access, this impediment should not elevate the lessee to the standard of a fiduciary.²⁹⁴ The lessor's ability to contest administrative rulings himself may be one factor among many that courts should consider in determining whether, in the given circumstances, the lessee has acted as a reasonably prudent operator. This ability, however, should be irrelevant to a court's decision whether, as a matter of law, the administrative covenant is recognizable. It should also be irrelevant to a court's determination of the legal standard to use in measuring the lessee's conduct under this covenant.²⁹⁵

(d) *Application of the Administrative Covenant Under the Federal Pricing Regulations*

Recognition of the administrative covenant is particularly appropriate in the federal pricing context. Clear injury to a lessor often results from a lessee whose negligence, timidity, or lack of diligence causes the royalty owner's share of oil and gas to be priced at less than the maximum allowable under the regulations and the prevailing market conditions. The lessee's duty to secure the best possible price under federal regulations is viewed correctly as an obligation that is incidental to the traditionally recognized

Cline makes the curious argument that because the lessee has a duty to represent the lessor in some types of administrative actions, the lessor has a duty not to interfere with the lessee's bona fide presentation; in other words, the lessor has no right to this self-help remedy, but only to damages as a remedy for breach. This argument is unsound, however, and begs the question whether Cline would deprive the lessor of the right to market his own in kind oil or gas just because the lessee has a duty to market it in the absence of the lessor's exercise of this power. Cline, *supra* note 235, at 491-93.

293. See text accompanying notes 163-66 *supra* and cases cited therein (discussing the inappropriateness of a good faith standard). See also text accompanying notes 209-12 *supra* (discussing effect of lessor's self-help remedy on the marketing covenant).

294. See notes 193-94 *supra* and accompanying text (discussing the inappropriateness of a fiduciary standard in implied covenants). If the statutes or regulations deny the lessor access to the administrative forum, he may have to enforce his right to procedural due process through the courts. Cf. *Palmer Oil Corp. v. Phillips Petroleum Co.*, 204 Okla. 543, 231 P.2d 997 (1951) (acknowledging the lessor's right to appeal the agency's action).

295. Under the proper circumstances, either estoppel or laches could apply against a lessor who has the ability to seek administrative action for himself.

implied covenant to market with diligence. The lessee's duty often requires compliance with standard regulations to obtain a higher price rather than the more complex process of obtaining an individual variance or exception. In general, the lessee's and lessor's interests are mutual under this covenant—both would benefit from the increase in price; thus, the possibility of conflicting objectives that would bar the lessee's duty to represent the lessor does not exist.²⁹⁶ A dispute between the lessee and lessor that leads to allegations of breach of the implied covenant normally derives from the same sources of conflict that cause other implied covenant suits: The high costs and risks that the lessee alone must bear, or the lessee's negligence.

To succeed in a cause of action for breach of the administrative covenant, the lessor must prove that the lessee, if diligent, probably would have succeeded in achieving the administrative result that the lessor seeks.²⁹⁷ Such proof requires examining the regulatory environment that confronted the lessee.²⁹⁸ This environment includes the following elements: The cost of securing information that is necessary to meet the filing requirements of the pricing rules;²⁹⁹ the complexity of the regulations;³⁰⁰ the regulatory uncertainty of ambiguously defined terms and rules;³⁰¹ the length

296. When conflict arises between the two parties over the objective of a judicial or administrative hearing, the lessee need not represent the lessor's position, but he may have a duty to disclose his opposing participation in the hearings and advise the lessor to seek his own representation. See text accompanying notes 265-85 *supra*.

297. *Weymouth v. Colorado Interstate Gas Co.*, 367 F.2d 84 (5th Cir. 1966); *Bruce v. Ohio Oil Co.*, 169 F.2d 709 (10th Cir. 1948); *Baldwin v. Kubetz*, 148 Cal. App. 2d 937, 307 P.2d 1005 (1957); *Sunray DX Oil Co. v. Crews*, 448 P.2d 840 (Okla. 1968); *Amoco Prod. Co. v. Alexander*, 594 S.W.2d 467 (Tex. Civ. App. 1979), *aff'd*, 24 Tex. Sup. Ct. J. 581 (1981). See also *Sword v. Rains*, 575 F.2d 810 (10th Cir. 1978); *Meeker v. Ambassador Oil Co.*, 308 F.2d 875 (10th Cir. 1962), *rev'd on other grounds*, 375 U.S. 160 (1963).

Hindsight is irrelevant to a judgment on the probability of success. *McDonald v. Grande Corp.*, 214 So. 2d 795 (La. App. 1968); *Crocker v. Humble Oil & Ref. Co.*, 419 P.2d 265 (Okla. 1965). Furthermore, if no probability of success exists, the lessee's lack of diligence in seeking administrative relief is irrelevant. See note 153 *supra*.

298. See notes 4-49 *supra* and accompanying text. The highly political and complex legislation on federal oil and gas pricing provides a very different framework for the operation of the administrative covenant than the state conservation laws that Merrill used to illustrate the operation of this covenant. Certainly, to seek a rule 37 spacing exception, see note 232 *supra*, is quite different from seeking an exception to the crude oil pricing rules, which requires a showing of gross hardship or inequity and three levels of administrative review before exhaustion of all administrative remedies. Lang, *supra* note 5, at 144. In addition, the federal exception process—even if successful—does not always benefit the lessor. See note 305 *infra*.

299. See note 149 *supra* and accompanying text.

300. See text accompanying notes 41, 44-45 *supra*.

301. See notes 19-20 & 44-45 *supra* and accompanying text.

of agency and court delays in resolving legal issues that are relevant to determining whether a particular price would be applicable;³⁰² the risks of enforcement actions against the lessee for ignoring what he considers to be invalid regulations;³⁰³ the risks imposed on the lessee for violating the oath required in filing for certain price classifications;³⁰⁴ evidence of the procedures that are necessary to obtain variances or exceptions, and whether the exceptions would benefit royalty owners;³⁰⁵ and evidence that market conditions would support the higher price.³⁰⁶

The court also typically inquires into the lessee's diligence within this regulatory environment, considering these factors: The efforts that the lessee made to keep abreast of the regulations, including seeking legal advice or accounting expertise;³⁰⁷ whether the lessee actually considered the applicability of the price regulations to the lease at hand; whether the lessee reasonably relied on others to seek the administrative action under consideration;³⁰⁸ and

302. See note 20 *supra*. For another example of the effects of regulatory delay, see *Gillespie v. Simpson*, 41 Colo. App. 577, 588 P.2d 890 (1978), in which the Oil and Gas Conservation Commission's three year delay in issuing geothermal regulations required for well drilling allowed lessee to suspend paying delay rentals under the force majeure clause of the lease.

303. See notes 39-47 *supra* and accompanying text.

304. At least one court has recognized the relevance of the lessee's oath requirements in seeking administrative action. See *Weymouth v. Colorado Interstate Gas Co.*, 367 F.2d 84, 99 (5th Cir. 1966). See also *Amoco Prod. Co. v. Alexander*, 594 S.W.2d 467, 475 (Tex. Civ. App. 1979), *aff'd*, 24 Tex. Sup. Ct. J. 581 (1981).

305. See text accompanying notes 245-48 *supra*. The DOE's Office of Hearings and Appeals generally limits the price incentives that are granted in exceptions cases to the working interest share of production because it believes that economic incentives to keep properties in production do not affect royalty owners who do not bear the costs of production. See, e.g., *Osro Cobb*, [1979 Transfer Binder] 3 DOE Dec. (CCH) ¶ 81,055 (1979).

306. See note 153 *supra* and accompanying text.

307. *Sword v. Rains*, 575 F.2d 810 (10th Cir. 1978); *Williams v. Humble Oil & Ref. Co.*, 53 F.R.D. 694, 696 (E.D. La. 1971) ("To determine what a prudent person would do in any given situation, it is indispensable to ascertain what information he *actually* had available and what additional information he *might* have obtained had he exercised reasonable diligence in making efforts to learn the facts.") (emphasis in original); *Shaw v. Henry*, 216 Kan. 96, 531 P.2d 128 (1975); *Tate v. Stanolind Oil & Gas Co.*, 172 Kan. 351, 240 P.2d 465 (1952); *Continental Inv. Corp. v. State Corp. Comm'n*, 156 Kan. 858, 137 P.2d 166 (1943). See also *Dupree v. Relco Exploration Co.*, 354 So. 2d 1083 (La. App. 1978) (lessee's continuing efforts to gather and study geological information that was relevant to determining the profitability of a deep well test sufficed to defend against a breach of the implied covenant to develop); *Crocker v. Humble Oil & Ref. Co.*, 419 P.2d 265 (Okla. 1965) (act of negotiating for water flooding operation was reasonable excuse for delay in sandfracing).

308. For example, if lessors or other lessees or trade associations had access to the administrative forum, this might be an indication that the lessee was relying on others. If the lessee can show that he reasonably expected others to pursue the administrative actions sought, and that their actions, if successful, would have benefitted him, he may well be

whether the lessee actually sought a variance, exception, or interpretative ruling from the agency in pursuit of the higher price. Evidence of what other similarly situated lessees have done is also relevant to many of these matters.³⁰⁹

Lessors also must prove that the benefits of seeking the administrative action outweigh the costs and risks of doing so; the reasonably prudent operator need not undertake unprofitable pursuits. The lessee's refusal to sell at a higher price because of legal ambiguities in the federal regulations may be justified, even though a court subsequently might find that, as a matter of law, the oil or gas in question could have been sold at the higher price. If high risks warranted the lessee's refusal to sell at the higher price, or if high costs justified his failure to seek a judicial or administrative interpretation of the right to do so, then the court should find no breach.³¹⁰

All of these factors are relevant to determining whether the lessee, under the particular circumstances in question, acted as a reasonably prudent operator. If they justify a delay in seeking or a failure to seek a higher price, judgment is awarded for the lessee. Likewise, when injury to the lessor is speculative, courts should find for the lessee. The remedy typically is damages, which are calculated as the loss in royalty that the lessee's failure to secure or delay in securing the maximum possible price caused. Immediate forfeiture or a conditional decree that requires the lessee to seek the highest price allowed within a fixed period or forfeit the lease is also possible.³¹¹

excused for failing to enter the hearing room or courthouse himself.

309. *Newell v. Phillips Petroleum Co.*, 144 F.2d 338 (10th Cir. 1944) (about 90% of the producers in the field acted as defendant/lessee had acted); *Amoco Prod. Co. v. Alexander*, 594 S.W.2d 467 (Tex. Civ. App. 1979), *aff'd*, 24 Tex. Sup. Ct. J. 581 (1981). *But see Sinclair Oil & Gas Co. v. Bishop*, 441 P.2d 436 (Okla. 1967).

310. In *Amoco Prod. Co. v. Alexander*, 24 Tex. Sup. Ct. J. 581 (1981), the court stated that "there is no duty unless such an amount of oil can be recovered to equal the cost of administrative expenses . . . , and yield to the lessee a reasonable expectation of profits." *Id.* at 583. *But see* 5 WILLIAMS & MEYERS, *supra* note 50, § 861.4. Williams and Meyers state in their discussion of the administrative covenant that the lessee is bound to know the law at his peril. The implication that the lessee has an absolute duty to challenge the regulations or disobey them regardless of costs and risks is not in accord with the prudent operator standard and is unsound, particularly in the federal pricing context.

311. The issues of the effect of express clauses on the administrative covenant and the remedies available for breach should be analyzed largely as described under the implied covenant to market. *See* text accompanying notes 215-26 *supra*. Damages would be the normal remedy—including punitive damages, if appropriate. *See* note 259 *supra*. *See also* *Amoco Prod. Co. v. Alexander*, 24 Tex. Sup. Ct. J. 581 (1981) (breach of the implied covenant to protect against drainage is an action sounding in contract and will not support re-

The burden of proof is on the lessor to show that if the lessee had acted as a reasonably prudent operator, a higher price would have been achieved.³¹² Because lessees normally can be expected to seek the best possible price, no reason exists to shift this burden to the lessee. Nor should the duty to account to the lessor for royalties be used to rationalize a transfer of the burdens to the lessee. The duty to account and to market with diligence in this new regulatory context, however, undoubtedly will require lessees to keep careful records and information systems to ascertain those characteristics of wells that are relevant to the federal pricing classifications.³¹³

The scope of the lessee's duty should not vary with the lack or availability of a self-help remedy for the lessor. No greater duty should exist because of the lessor's inability to seek a higher price, and a muted duty should not suffice simply because the lessor could have taken action of his own.

(e) *The Advisability of a More Relaxed Standard for Small Producers*

Operators in the oil and gas industry unquestionably confront a difficult task in attempting to chart a course between the Scylla of pricing above the legal maximum, and facing a government enforcement action, and the Charybdis of pricing below the maximum, and risking a lawsuit by a lessor that alleges breach of the implied covenant to market with diligence. The peril is especially acute for small independent gas producers, some of whom had never been under federal price regulation before the NGPA was passed. The national policy for years has been to foster and maintain competition in the petroleum industry.³¹⁴ This policy has re-

covery of exemplary damages absent proof of an independent tort). Forfeiture of the lease is possible when the lessee seems hopelessly inept or opposed to the lessor's interest. *Baldwin v. Kubetz*, 148 Cal. App. 2d 937, 307 P.2d 1005 (1957). The remedy of ordering the lessee to appear before the agency and to take the appropriate action to correct the breach might be possible under some circumstances—mainly when the lessee's breach is due to negligence—but not when it would jeopardize the lessee under perjury statutes. See *Sunray DX Oil Co. v. Crews*, 448 P.2d 840 (Okla. 1968).

312. See text accompanying notes 174-98 *supra*.

313. See text accompanying notes 187-98 *supra*.

314. The federal crude oil pricing and allocation statutes were to be administered with this policy specifically in mind. Under the Emergency Petroleum Allocation Act of 1973, Congress directed the federal energy agency to promulgate regulations that provided for "preservation of an economically sound and competitive petroleum industry; including the priority needs to restore and foster competition in the producing, refining, distribution, marketing, and petrochemical sectors . . ." 15 U.S.C. § 753(b)(1)(D) (1976).

sulted in a history of special legislative and regulatory provisions for small producers, ranging from tax relief³¹⁵ to price advantages.³¹⁶ In addition, courts have recognized the special importance of small producers.³¹⁷ Thus, the question arises whether this public policy justifies a reduction in the scope or standard of the small producers' implied obligations to their lessors.

For several reasons, courts should eschew this approach when resolving conflicts between lessees and lessors in implied covenant cases. First, the use of an amorphously defined public policy factor in judging implied covenant cases should be disfavored.³¹⁸ Second, if fostering competition in oil and gas production is a worthwhile public goal, then the public, rather than individual royalty owners, should bear the cost of this goal. Last, the reasonably prudent operator standard is flexible enough to prevent undue hardship to small operators.³¹⁹ This standard is not based on the best operator in the field or the one with the most capital, most highly skilled labor force, and most experienced attorneys and accountants.³²⁰ The implied covenant doctrine looks at the trade usages and business customs in the field, and evidence of what other similarly situated lessees are doing is relevant to the facts and circumstances of the case.³²¹ In addition, most of the factors that enforcement offi-

315. The Tax Reduction Act of 1975, Pub. L. No. 94-12, § 501(a), 89 Stat. 26 (codified in scattered sections of 26 U.S.C.), which virtually eliminated the favorable percentage depletion tax allowance for major integrated firms in the petroleum industry, exempted certain independent producers. I.R.C. § 613A(c). The Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223, § 1, 94 Stat. 229 (codified in scattered sections of 26 U.S.C.) also allows lower tax rates for independent producers. I.R.C. §§ 4987(b)(2), 4992.

316. The Federal Power Commission allowed gas producers selling less than ten million cubic feet of natural gas per year to charge 130% of the maximum price permitted large producers. 18 C.F.R. § 157.40(c) (1980). See generally Comment, *supra* note 28.

317. The court in Permian Basin Area Rate Cases, 390 U.S. 747 (1968), stated, Although the resources of the small producers are ordinarily more limited, their activities are characteristically financially more hazardous. It appears that they drill a disproportionately large number of exploratory wells, and that these are frequently in areas in which relatively little exploration has previously occurred. Their contribution to the search for gas reserves is therefore significant, but it is made at correspondingly greater financial risks and at higher unit costs.
Id. at 784-85 (citations omitted).

318. See text accompanying notes 60-74 *supra*.

319. Actually, some question exists about how much special protection from undue hardship "small" producers need. The Crude Oil Windfall Profit Tax Act of 1980 accords favorable tax treatment to an independent producer's first 1000 barrels per day of production. At an unregulated price, this producer's revenues may amount to \$33,000 per day or over \$12 million a year—hardly a "mom and pop" operation.

320. M. MERRILL, *supra* note 50, §§ 81 & 121.

321. *Id.* See also text accompanying notes 167-69 & 309 *supra*.

cial examiners to determine whether a violation of the federal regulations has occurred are the same factors that a court considers to ascertain whether the lessee has acted as a reasonably prudent operator in implied covenant cases.³²² A lessee, therefore, is not apt to face a double standard.

Nevertheless, the increased regulation of the oil and gas industry may well force small operators out of business, or at least foreclose certain opportunities from them.³²³ If this problem is serious, Congress should correct it through appropriate legislation.³²⁴ Courts, however, should not alter the tenets of implied covenant law to achieve this result.

V. CONCLUSION

This Article has addressed the impact of federal energy pricing policies and regulations on the doctrine of implied covenants in oil and gas law. The framework of federal energy regulations in crude oil and natural gas pricing and taxation offers much opportunity for profit to alert lessees, but not without significant costs and risks arising from the complexity, ambiguity, and politically sensitive nature of the pricing laws. The doctrine of implied covenants arose in oil and gas law because of the unique relationship

322. See Trowbridge, *supra* note 17, at 209-10 n.57.

323. According to the Independent Petroleum Association of America, it would be difficult to imagine a law more filled with traps so certain to lead to litigation, delay, confusion and turmoil. The result surely will be to send independent explorers, their expertise and their dollars fleeing from natural gas exploration and development into alternative enterprises of less risk and regulatory burden. CITIZEN/LABOR ENERGY COALITION, FACTBOOK ON THE PROPOSED NATURAL GAS BILL (1978), reprinted in *NGPA Impact Hearings*, *supra* note 33, at 82.

324. One commentator has made the argument that the FERC should establish higher incentive prices that reflect risk premiums for classes of small producers under the authority of § 107 of the NGPA. Note, *supra* note 114.

The new Regulatory Flexibility Act of 1980, Pub. L. No. 96-354, 94 Stat. 1164, 5 U.S.C.A. §§ 601-612 (Supp. 1981), which amends the Administrative Procedure Act by adding a new chapter six, may spur efforts to relieve small producers of the regulatory burden. In promulgating the Act, Congress found that "uniform Federal regulatory and reporting requirements have in numerous instances imposed unnecessary and disproportionately burdensome demands including legal, accounting and consulting costs upon small businesses" and declared a new "principle of regulatory issuance that agencies shall endeavor, consistent with the objectives of the rule and of applicable statutes, to fit regulatory and informational requirements to the scale of the businesses." Pub. L. No. 96-354, § 2, 94 Stat. 1164, 1164 (1980). The Act requires that federal agencies prepare "regulatory flexibility analyses" of the impact of proposed rules on small businesses, 5 U.S.C.A. § 603 (West 1981), and a plan for periodic review of already existing rules that have a significant economic impact on small businesses. The planned review is specifically based on the rule's complexity and the nature of complaints about it. *Id.* § 610.

between the lessee and lessor that an oil and gas lease creates. This relational basis of implied covenant law, whether founded mainly in law or in fact, is a principle that should be applied to resolve disputes between lessees and lessors which may arise from the new context of federal pricing legislation. Courts should avoid infusing broad notions of public policy into the lessee/lessor relationship, since this practice inevitably would make implied covenant law as unpredictable and inconsistent as the energy policy it ostensibly mirrors. This unpredictability and inconsistency in policy is nevertheless an important factor in assessing the actions of a lessee as a reasonably prudent operator under the federal regulations.

Many important issues can be expected to arise from the lessee/lessor relationship under federal energy price regulation that the doctrine of implied covenants will be called on to resolve. In actions to enforce the drilling covenants, the doctrine of implied covenants—if applied with the proper focus on expected profitability and a clear recognition that delayed development may be both profitable and prudent in the new pricing context—can protect lessors' interests without forcing premature or wasteful drilling on lessees. In the marketing area, the doctrine of implied covenants can operate to secure for lessors their expectation of receiving the best price possible and at the same time consider lessees' risk and costs in obtaining this price. The implied covenant to seek favorable administrative action is soundly based in the relational nature of the oil and gas lease and should be judicially recognized and given the scope and operation described above.

This Article has explored many issues that are likely to arise in the new pricing context. The courts have yet to resolve these issues, and the case law that does exist is often inapposite. Even without the use of the public policy model of implied covenant law, the courts' choice between the contract model and the equity model may well determine the ultimate resolution of the issue. Given these sources of uncertainty in the law, both lessees and lessors may want to negotiate express clauses that deal with the important issues, even though such clauses have not been common in the past. An express clause, for example, might address one or more of the following matters: The timing of drilling wells; royalty payments or delay rentals that are designed to assure minimum levels of cash flow to the lessor; stipulations that the lessee's good faith efforts in marketing will suffice; detailed drilling and market-

ing provisions that are keyed to NGPA pricing categories;³²⁵ and recognition of the lessee's duty to seek favorable administrative action in accordance with the reasonably prudent operator standard.³²⁶

When express provisions are either lacking or too difficult to negotiate in advance of actual drilling and production, implied covenant law should be used to resolve the conflicts between the lessee and lessor. In these cases, the doctrine of implied covenants, properly applied, can serve as an appropriate mechanism for determining the proper balance between the conflicting interests of the two parties that arise from the federal energy pricing regulations. The doctrine can also help to assure that the nation's oil and gas resources are developed with both fairness and efficiency weighing in the balance.

325. The following paragraph, which was used in a recently negotiated lease, addresses lessee's drilling and marketing activities under the NGPA:

For so long as any natural gas produced from said land is subject to a maximum ceiling price under the Natural Gas Policy Act of 1978 ("Act"), and unless and until such gas is deregulated as to sales price, then for purposes of Paragraph 3 of this lease, the "market value" at the well or at the plant, as applicable, for the part of such gas which at that date is not deregulated shall mean the highest ceiling price at that date produced for which the gas could qualify under the Act. Lessee covenants and agrees to conduct all drilling and producing activities on said land so that all gas produced therefrom will qualify for the maximum applicable ceiling price at the date produced specified in Sections 102(b), 107 or 108 of the Act; provided, however, that, if Lessee, acting as a reasonable and prudent operator, after due investigation and consideration of all relevant facts and circumstances relating to the qualification of all gas production under Sections 102(b), 107 and 108 of the Act, determines that it is impractical to conduct drilling and producing activities which would so qualify all gas so produced for the maximum applicable ceiling price specified in Sections 102(b), 107 or 108 of the Act, Lessee may conduct drilling and producing activities on said land so that any gas produced which would be impractical to produce and qualify for the maximum ceiling price specified in Sections 102(b), 107 or 108 of the Act, will qualify for the maximum ceiling price at the date produced specified in Section 103 of the Act. Lessee will not, without the prior written consent of Lessor, permit or conduct any drilling and producing activities on said land which would result in any gas so produced qualifying for a maximum ceiling price under the Act other than a maximum ceiling price specified in Sections 102(b), 103, 107 or 108 of the Act. If the Act is superseded or modified by subsequent federal legislation, rule, or order which prolongs or extends price regulation of any natural gas produced from said land, then in such event it is the intent of the parties, and they hereby agree, that the provisions of this Paragraph 4(b) shall continue to apply for the duration of such extended period of price regulation under such subsequent federal legislation, with the Section references to the Act as above contained being revised as necessary to effectuate the parties' intent.

326. See *Bruce v. Ohio Oil Co.*, 169 F.2d 709 (10th Cir. 1948) (a rare example of an express provision to seek administrative action).

Environmental regulation of oil and gas activity is another important and growing area that requires the lessee's administrative diligence. See *Shaw v. Henry*, 216 Kan. 96, 531 P.2d 128 (1975).

