



MASSIVE MINERALS

Implied Covenants

What is an implied covenant?

- An unwritten promise based on the assumed intention of the parties as gathered from a written instrument.

Oil & Gas Lease

- Based on the relationship of the parties and the objectives of the lease.
- Usually a duty is imposed on the Lessee and a protection is provided to the Lessor.
 - Can work the other way around → Good Title

An Implied Covenant is Not a Condition

- A **condition** is an uncertain future act or event whose occurrence or non-occurrence determines the rights or obligations of a party under a legal instrument.
- Example: An oil and gas lease granted for a primary term of 3 years and so long thereafter as oil or gas is produced.
 - If there is no production or substitute for production, the lease ends after 3 years.
 - The Lessee did not promise to obtain production. Production was a condition on the lease perpetuating into the secondary term.

Implied Covenants

- Failing to satisfy a covenant generally results in a breach of contract claim.
- The lease is unlikely to terminate.
- Lessor will be owed damages.

Implied Covenants in Oil & Gas Lease

- 1) To Protect Against Drainage
- 2) Reasonable Development
- 3) To Market
- 4) Proper Operation/Administration of Leasehold

Reasonable Prudent Operator (RPO)

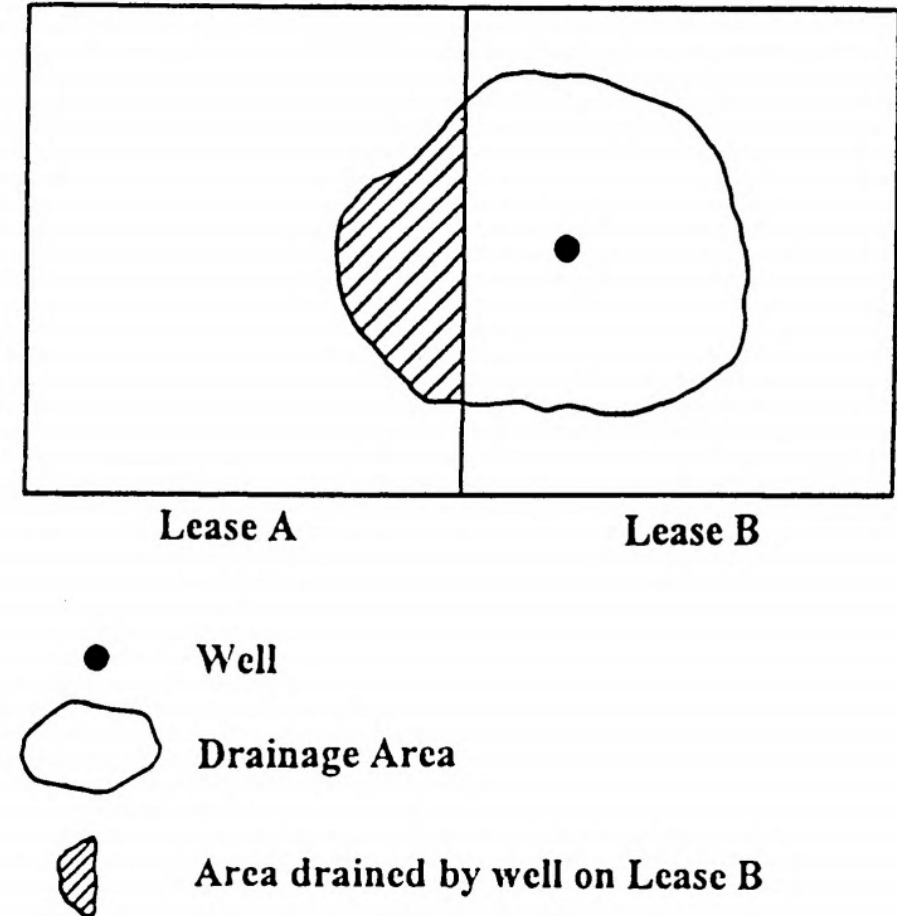
- The RPO standard underlies to all of the implied covenants.
- Higher standard than good faith, but not a fiduciary
- The RPO can act in his or her own self interest but must:
 1. Act in good faith
 2. Act competently
 3. Act with due regard for the interests of the Lessor
- If the Lessee fulfills the primary objectives of the lease under the reasonably prudent operator standard, all implied covenants should be satisfied.

Protect Against Drainage

- Helps protect the landowner from drainage from another tract
- Covenant also applies to protect against fieldwide drainage

Protect Against Drainage – Example

- Homer owns Lease A.
- Marge owns Lease B.
- Both lease to Springfield Oil & Gas, Inc.
- A well is drilled on Lease B and obtains production in paying quantities.
- A geological test reveals that Lease B is draining Lease A in the outlined area.
- However, the tests also show that the well on Lease B will never payout, so it is unlikely that a second well on Lease A would payout.
- Does Homer have a cause of action against Springfield Oil & Gas for violation of the covenant to protect against drainage?



Protect Against Drainage – Example

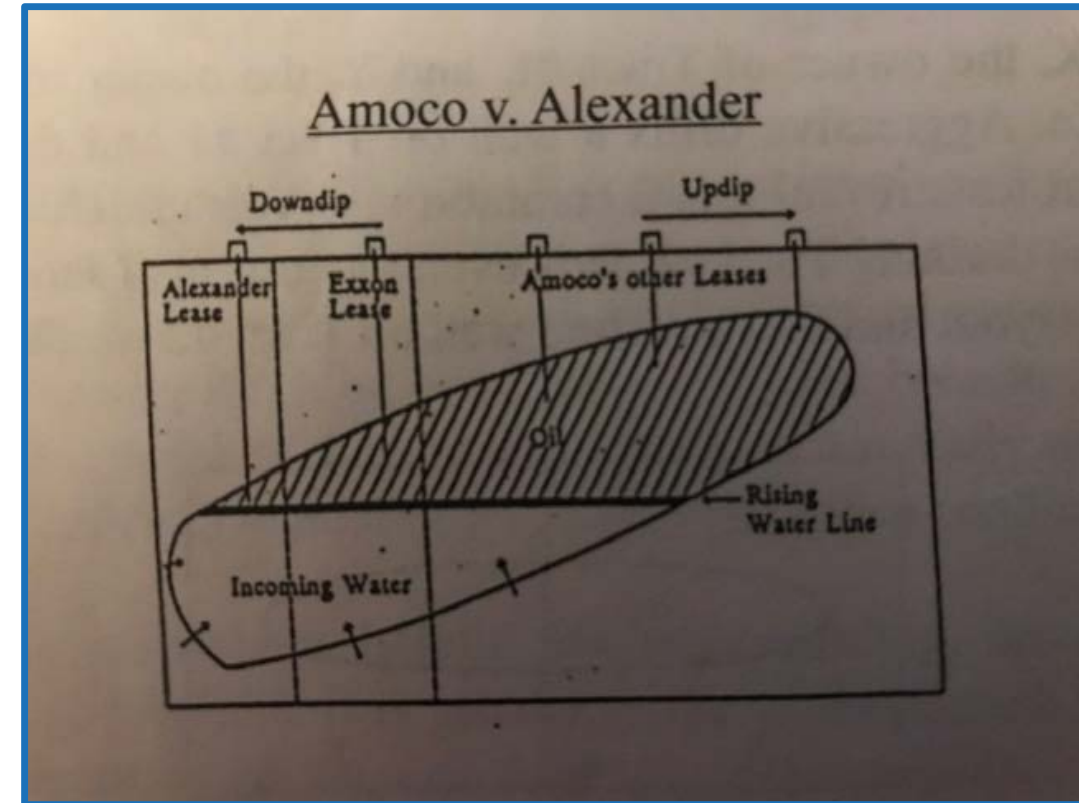
- Homer most likely does not have a cause of action.
- Homer would have to show:
 - Substantial drainage
 - Specific damages
 - Probability of profit – probability that production from the offset well would cover the costs of drilling the offset well plus yield a reasonable profit
- The RPO goal is to operate profitably.
- The RPO does not have an obligation to lose money in order to generate royalties for the Lessor or protect from drainage.

Supporting Lease Language

(d) In the event a well or wells producing oil or gas in paying quantities should be brought in as to depths covered by this Lease on adjacent property not owned by Lessor, or on any property adjacent to any unit formed under the terms of this Lease and not owned by Lessor, or on adjacent property owned by Lessor which are being explored and developed for oil or gas by a third party or by Lessee under a different lease, and said offset vertical well or wells and/or any take-point in a horizontal well or wells is located less than 330 feet from the Lease line and/or draining said Leased Premises, or lands pooled therewith, Lessee shall provide to Lessor a plat of such well or wells on adjacent property setting forth the location thereof and Lessee shall commence the actual drilling of an offset well or wells the earlier of 180 days after the completion of the well or wells on adjacent property, or within 120 days after the filing of a completion report on said well or wells, if the completion information was not available to Lessee except through the completion report. It is further provided that, in lieu of drilling an offset to any oil or gas well, Lessee shall have the option of (i) paying Lessor, as royalty in accordance with the terms of this Lease, a sum equal to the royalties which would be payable under this Lease on the production from such well had same been drilled and produced under this Lease, and, as long as Lessee may elect to pay such royalty in lieu of drilling an offset well, it will be considered that oil or gas is being produced from the Leased Premises as to the same number of acres and of the same configuration as would be ascribed to a similar well completed on the Leased Premises pursuant to the provisions of said Paragraph 11, or (ii) executing and delivering to Lessor a release of this Lease as to the acreage offsetting the producing well or wells, such released acreage to be of the same number of acres and of the same configuration and depth as would be allocated to a Producing Unit (as defined in paragraph 11 below) if Lessee had drilled and completed an offset well or wells on the Leased Premises.

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

- Amoco owned 80% of the leases in the field.
- Alexander was down-dip and was being drained by Amoco's up-dip wells.
- Exxon Lease in between Alexander and Amoco.
- Alexander alleged that Amoco plugged back wells on his lease in the lower part of the reservoir, which resulted in oil being drained by the up-dip wells.



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

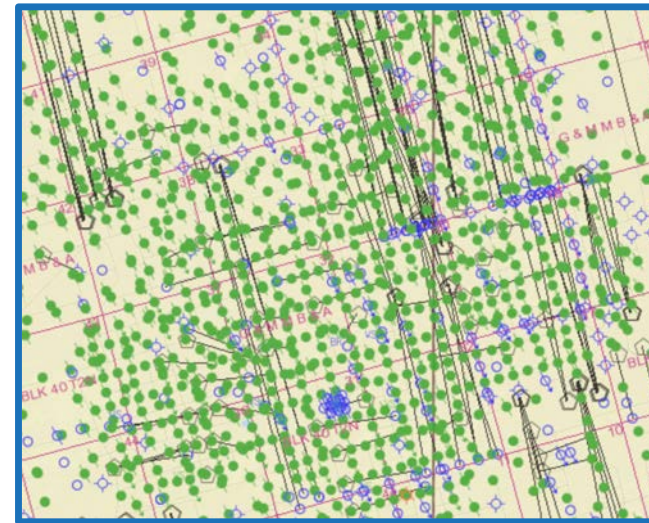
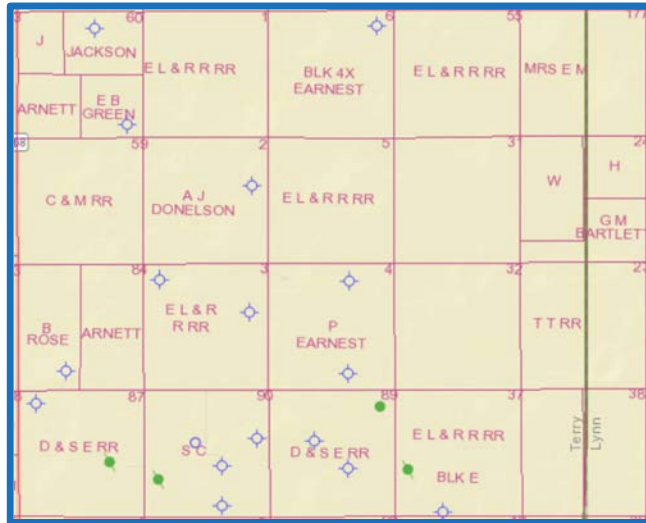
- Court held that Amoco had an obligation to protect Alexander's property against fieldwide drainage.
- Covenant applies to local and field wide drainage.
- Case is significant because the covenant was not limited to adjacent tracts but applied to the entire field.
- Court stated that Lessee owed the duty to Lessor to act as a reasonable prudent operator.

Reasonable Development

- Requires the Lessee to drill as many wells to develop the property as would a reasonable prudent operator.
- Before being required to drill additional wells, the Lessor must prove that there is a reasonable probability that drilling additional wells on the leased tract would be profitable.
 - Must be a reasonable expectation that Lessee would recover the costs of drilling, completing, and operating the well plus a reasonable profit.
- The covenant for further exploration is **not** separate and apart from the covenant of reasonable development in Texas.

Exploration vs. Development

- An exploratory well is a well drilled in unproven territory for the purpose of ascertaining the presence of commercial reserves.
- A development well is a well drilled in a known producing formation.
- Clear cases, such as a wildcat well vs. an infill well
- What about the gray area in between?



Supporting Lease Language

- Example:
 - “After the discovery of oil, gas, or other mineral in paying quantities on said premises, Lessee shall develop the acreage retained hereunder as a reasonably prudent operator but in discharging this obligation it shall in no event be required to drill more than one well per forty (40) acres of the area retained hereunder and capable of producing oil in paying quantities and one well per 640 acres plus an acreage tolerance not to exceed 10% of 640 acres of the area retained hereunder incapable of producing gas or other mineral in paying quantities.”

Limiting Implied Covenants

- The scope of implied covenants can be limited by express clauses in the lease.
 - Ex: density requirement regarding development wells
- No covenant can be implied in an oil and gas lease that expressly covers the subject matter of the alleged implied covenant.

Sun Exploration and Production Co. v. Jackson, 783 S.W.2d 202 (Tex. 1989).

- Sun had a 10,000-acre lease covering Jackson Ranch.
- Sun fully developed a small portion of the lease overlying a producing reservoir known as the Oyster Bayou Field.
- Sun did not further explore other portions of the leased land.
- Jury found that Sun did not fail to reasonably develop the Jackson Ranch lease.
- **Rule: In Texas, there is no implied covenant to further explore that exists independent of the implied covenant of reasonable development.**

To Market

Two duties imposed on Lessee:

1. To market oil and gas within a reasonable time
2. To market oil and gas at the best available price

Supporting Lease Language

- Shut-In Royalty Clause

(f) On each gas well located on any part of the Leased Premises and capable of producing commercial quantities of gas and from which gas is not being sold for lack of market, Lessee may pay for each such well as royalty on or before ninety (90) days after the date on which, (1) said well is shut in, or (2) the Leased Premises or any portion thereof is included in a pooled unit on which a shut-in well is located, or (3) this Lease ceases to be otherwise maintained as provided herein, whichever is the later date, and thereafter at annual intervals on or before the anniversary of the date the first payment is made, a sum equal to Fifty Dollars (\$50.00) per net mineral acre then covered by this Lease shall be made to Lessor, and if such payment is made or tendered, this Lease shall not terminate, and it will be considered that gas is being produced from this the Leased Premises in paying quantities, provided however, this Lease may not be maintained as to any acreage covered hereby solely by the payment of shut-in gas well royalty for a cumulative total of more than two (2) years.

Proper Operation/Lease Administration

- Very broad and can be used to apply to areas other than the specific implied covenants discussed previously.
- Example: Operator did not seek a favorable regulatory action
- Example: Operator did not use advanced technology

Implied in Fact vs. Implied by Law

- Implied In Fact: implied from and evidenced by the parties' conduct and course of dealing
- Implied by Law: covenants implied to equalize the imbalance of bargaining power between the parties; duties imposed in equity
- Legal scholars appear to be split as to whether implied covenants are implied in fact or implied by law.
- Texas cases seem to point in the direction that implied covenants are implied in fact.



QUESTIONS?

YOUR PARTNER IN CREATING MASSIVE, OUTSIZED VALUE