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**IMPLIED COVENANTS BETWEEN OTHERS
THAN LESSORS AND LESSEES**

MAURICE H. MERRILL*

Most cases in which the doctrine of implied covenants arises grow out of controversies between lessors and lessees. In a variety of situations, however, the control over mineral exploitation of a tract of land may be in the hands of one person, while there are others who are beneficially interested in the prompt and efficient prosecution thereof. The conflict of interest between these persons may be quite as real as that between the lessors and the lessees for the police of which the doctrine of implied covenants was evolved. Increasingly the courts are being faced with the claim that the doctrine applies to these situations as well. It is the purpose of this paper to analyze the decisions to date and to endeavor to suggest the considerations which should influence the judicial approach to this problem.

GRANTORS AND GRANTEEES

The owner of a tract of land may convey the mineral rights therein, reserving to himself a royalty interest. Except for the fact that the mineral interest is transferred in perpetuity, this transaction does not differ greatly from the ordinary oil and gas lease, upon a royalty basis. In each case the grantor has an interest the value of which is dependent upon prompt and efficient development and operation. Where no substantial consideration moves to him at the time of the transfer, there has been judicial recognition of the fact that the law should throw the protection of the implied covenant doctrine around his claim to

* Professor of Law, University of Oklahoma School of Law.

have the mineral resources developed in due course.¹ On the other hand, where a substantial sum has been paid him at the time of the grant, two decisions by Courts of Civil Appeals in Texas deny the applicability of the implied covenants.² West Virginia has come to the same conclusion in a case involving a conveyance of solid minerals.³ The reason for this distinction is not evident. The Kentucky Court of Appeals well expressed the case for extending the implied covenant doctrine in favor of the grantor of the mineral interest when it said: "Under such a contract the consideration is a continuing one, to be paid only by the labor of the grantee in the development of the property. The grantor has a continuing interest in the estate conveyed, and the grantee is not at liberty to do with the property as he pleases. He cannot use or fail to use it to the prejudice of the grantor who has rights that must be respected."⁴ These reasons seem as cogent in their application to him who receives a present sum in money as to him who does not. That portion of the consideration which depends upon production is no less "continuing" in character by reason of the substantial cash payment. The grantor was not content with the cash alone. He stipulated for a share in future production. It never has occurred to anyone that the payment of a substantial cash bonus for the execution of a lease precludes the existence of the implied covenant obligations in favor of the lessor. In fact, there is direct authority to the contrary.⁵ It is submitted that there is nothing in the fact that the mineral rights are transferred by a perpetual grant which should give rise to a distinction not recognized in respect to transfers by lease.

What I have just indicated to be the better rule was given express recognition by the Fort Worth, Texas, Court of Civil Appeals in *Powell v. Danciger Oil & Refining Company*.⁶ The judgment in that case but recently has been reversed by the

1. *Eastern Kentucky Min. & Timber Co. v. Swann-Day Lbr. Co.* (1912) 148 Ky. 82, 146 S. W. 438, 46 L. R. A. (N. S.) 672.

2. *Doehring v. Gulf Prod. Co.* (Tex. Civ. App. 1928) 8 S. W. (2d) 723 (resting in part upon an express stipulation against implied covenants); *Loomis v. Gulf Oil Corp.* (Tex. Civ. App. 1938) 123 S. W. (2d) 501.

3. *Feather v. Baird* (1920) 85 W. Va. 267, 102 S. E. 294.

4. *Eastern Kentucky Min. & Timber Co. v. Swann-Day Lbr. Co.* (1912) 148 Ky. 82, 89, 146 S. W. 438, 46 L. R. A. (N. S.) 672.

5. *Ezzell v. Oil Associates* (1930) 180 Ark. 802, 22 S. W. (2d) 1015.

6. (Tex. Civ. App. 1939) 134 S. W. (2d) 493.

Supreme Court of Texas in an opinion which seems destined to confuse rather than to clarify the law.⁷ The discussion commences with a statement that, "An implied covenant must rest entirely on the presumed intention of the parties as gathered from the terms as actually expressed in the written instrument itself, and it must appear that it was so clearly within the contemplation of the parties that they deemed it unnecessary to express it, and therefore omitted to do so, or it must appear that it is necessary to infer such a covenant in order to effectuate the full purpose of the contract as a whole as gathered from the written instrument. It is not enough to say that an implied covenant is necessary in order to make the contract fair, or that without such a covenant it would be improvident or unwise, or that the contract would operate unjustly."⁸ The first part of the statement, of course, has no significance as applied to the doctrine of implied covenants in mineral leases where the nature of the subject matter precludes that the parties should contemplate clearly what is to be done.⁹ The second portion is fairly acceptable as a statement of the foundation of the mineral doctrine,¹⁰ were it not for the denial that fairness and justice between the parties is an essential element. The Supreme Court of Texas earlier had approved a statement which recognized the importance of this factor in determining what is necessary to realize the presuppositions of the lease.¹¹ The present opinion suggests a reversal of viewpoint, and gives an apparent approval to the notion that the implied covenants are implied in fact rather than in law.¹² The entire opinion seems written under the influence of this idea, which, as I have suggested elsewhere,¹³ is utterly inconsistent with the factual situations to which the doctrine of implied covenants is applied. The confusion resultant from this conception appears as the court proceeds expressly to say that there may be an implied covenant for development al-

7. *Danciger Oil & Ref. Co. v. Powell* (Tex. 1941) 154 S. W. (2d) 632.

8. *Id.* at 635.

9. See Merrill, *Covenants Implied in Oil and Gas Leases* (2d ed. 1940) §2.

10. *Id.* at §§17, 61, 73, 94, 221-223.

11. *W. T. Waggoner Est. v. Sigler Oil Co.* (1929) 118 Tex. 509, 19 S. W. (2d) 27.

12. See Walker, *The Nature of the Property Interests Created by an Oil and Gas Lease in Texas* (1933) 11 Tex. L. Rev. 399, 402, cited in the principal opinion.

13. See Merrill, *Covenants Implied in Oil and Gas Leases* (2d ed. 1940) §220.

though the transaction takes the form of conveyance rather than of lease, and then, inconsistently, makes the statement that there is less occasion for imposing the implied covenant obligation under a grant than under a lease. Why this should be so is not readily apparent, and the succeeding discussion brings no enlightenment.

The court makes, only substantially to reject, the point that the grant is unlimited in time while the lease is for a term. The wisdom of the retreat is obvious. Many leases are made for long fixed terms. Every lease potentially may endure until the oil beneath the land is exhausted. Many early instruments drafted in the form of an absolute conveyance of the oil beneath the land, without limitation as to term, have been treated as leases and under them the lessee has been subjected to the implied covenant obligations.¹⁴ Finally, in the state of Texas every lease executed in the common form amounts to a conveyance of the minerals in place, subject to being defeated upon certain conditions.¹⁵ Whatever the form of the instrument, the right to exploit the oil resources is placed in one man's hands and a right to a share of the product is placed in another's. The potential conflict of interests thus created jeopardizes the non-operator's position as greatly in one case as in the other, and it was to prevent the operator from serving his own ends at the expense of the non-operator's legitimate claims that the courts devised the doctrine of implied covenants. Hence the reasons of policy upon which it rests are as strong in the one case as in the other, and no significance should be attached to differences in the length of the term.

More reliance is placed on the assumed distinction that "the predominating purpose of a lease is to secure the exploitation and development of the property for the purposes set out in the lease," while "conveyances of minerals are frequently actuated by a motive of investment on the part of the grantee and the cash consideration or other down payment is the moving cause for the conveyance by the grantor."¹⁶ This, it is submitted, is

14. *Gadbury v. Ohio & Ind. Consol. Nat. & Ill. Gas Co.* (1903) 162 Ind. 9, 67 N. E. 259, 62 L. R. A. 895 is an example.

15. See Walker, *The Nature of the Property Interests Created by an Oil and Gas Lease in Texas* (1929) 7 *Tex. L. Rev.* 539, 554.

16. *Danciger Oil & Ref. Co. v. Powell* (Tex. 1941) 154 S. W. (2d) 632, 635-636.

an assumption which may or may not be true, according to the facts of the particular case. No doubt if it can be shown that the instrument was not executed with an intent to procure a speedy development of the land, there is reason to say that the presupposition lying back of the covenant for exploration is absent. It is on this ground that the great weight of authority denies the existence of that covenant as against the privilege of deferring exploration created by a delay rental provision.¹⁷ It might be argued, although less plausibly that evidence of indifference toward prompt exploitation cuts the ground from beneath the covenant for further development, as well. But there is no reason to believe that, once production is obtained, claims for diligent operation and for protection against drainage may be disregarded. And even as to exploration itself the question of the presence or absence of the desire for development as a motivating factor surely is a question to be determined from the evidence in the particular case. Its absence is not to be presumed from the payment of a substantial money consideration, as the Supreme Court of Texas previously has held by necessary implication.¹⁸ It would be as sound to infer that the payment of a large bonus for a lease indicates that the lessor does not want development, and we know that is not the law.¹⁹ The proper analysis of the problem would seem to be that the grantor's stipulation for a royalty interest in addition to the cash consideration for the grant is an indication that he does want development, to be overcome only by definite proof to the contrary, a proof which was lacking in the case under discussion, wherein the grant was executed after development was undertaken in the general territory, and in which the grantee was not an investor but an active oil operator.

Finally, the court lays emphasis upon a clause in the instrument giving to the grantee "the right at any time to prospect and develop * * * subject only to the limitations and covenants here-

17. See Merrill, *Covenants Implied in Oil and Gas Leases* (2d. ed. 1940) §28.

18. *Freeport Sulphur Co. v. American Sulphur Royalty Co.* (1928) 117 Tex. 439, 6 S. W. (2d) 1039, 60 A. L. R. 890. Cf. *W. T. Waggoner Est. v. Sigler Oil Co.* (1929) 118 Tex. 509, 19 S. W. (2d) 27.

19. *Ezzell v. Oil Associates* (1930) 180 Ark. 802, 22 S. W. (2d) 1015; *W. T. Waggoner Est. v. Sigler Oil Co.* (1929) 118 Tex. 509, 19 S. W. (2d) 27.

inafter set forth."²⁰ The court indicates its belief that, as the document contains no express provision for any set program of development, these words constitute an express stipulation against the implied covenant obligation. The language itself seems inapt to convey such a meaning. Similar phraseology has been employed in many oil leases under which the courts have recognized the implied covenant obligation as existing.²¹ Now to give them this meaning seems to fly in the face of the established doctrine that agreements in derogation of implied covenants are to be strictly construed.²² It is regrettable that the Supreme Court of Texas which has played so significant a part in the development of the law of implied covenants should lend its countenance to a view that opens the door to the perpetration of grave injustice against persons whose interests need and merit the protection of that law. It seems proper to suggest that the *Powell* case²³ ought not to be followed in other jurisdictions.

Suppose, instead of a sale of the oil rights, we have a sale of the land itself, with a reservation of a part of the oil interest. Here I think we must realize that there are two possible situations. The transaction may be a sale of the land to a grantee who is interested primarily in exploiting it for agricultural or other purposes, the grantor seeking to retain a share in a possible future mineral development. In such a case the parties do not contemplate that the grantee will embark upon a career of exploration or development and there is no reason for implying any covenant to do so, since fair dealing does not call for it. In other words, we have a situation that really presents the factors which the Supreme Court of Texas seems to have read into the *Powell* case.²⁴ On the other hand, the sale may be to an operator for the express purpose of promoting the exploitation of the mineral wealth. In such a case it seems clear that the implied covenants should operate in favor of the grantor and against the grantee. The Supreme Court of Texas has so held in a case involving land valuable for sulphur²⁵ and there seems no good

20. *Danciger Oil & Ref. Co. v. Powell* (Tex. 1941) 154 S. W. (2d) 632, 636.

21. *Emery v. League* (1903) 31 Tex. Civ. App. 474, 72 S. W. 603.

22. See Merrill, *Covenants Implied in Oil and Gas Leases* (2d ed. 1940), §§199-200.

23. *Danciger Oil & Ref. Co. v. Powell* (Tex. 1941) 154 S. W. (2d) 632.

24. *Danciger Oil & Ref. Co. v. Powell* (Tex. 1941) 154 S. W. (2d) 632.

25. *Freeport Sulphur Co. v. American Sulphur Royalty Co.* (1928) 117 Tex. 439, 6 S. W. (2d) 1039, 60 A. L. R. 890.

reason for denying its applicability to oil. A somewhat similar situation is presented where an oil operator, owning a tract of land in fee sells it, excepting the minerals and the right of exploitation and agreeing to pay a royalty upon the minerals produced from the land. In the one case²⁶ involving such a situation, the court in effect enforced an implied covenant duty, although the language of the opinion does not indicate full perception of what it was doing.²⁷ These contrasting situations lend point to a distinction made by the Supreme Court of Oklahoma, in another case, which does not seem to afford an apt occasion for its application,²⁸ to the effect that where the object of the transaction is not the search for and production of oil, the implied covenants do not apply.

ASSIGNOR RESERVING ROYALTY

Very frequently, when an oil lease is assigned, the assignor reserves an overriding royalty either as his sole consideration²⁹ or in addition to a cash price.³⁰ The greater number of cases uphold the existence of the implied covenants for development and operation in favor of the assignor and against the assignee,³¹ especially where the assignee has agreed to advance money for the development of the property,³² or where the transaction assumes the technical form of a sub-lease.³³ The existence of such a covenant is denied flatly in one Oklahoma case,³⁴ chiefly upon the obviously fallacious ground that an implied covenant must rest upon an express obligation to drill. Later, however, the Supreme Court of Oklahoma was confronted with a suit in which a lease was assigned subject to the retention of an overriding royalty by the assignor with a stipulation that the assignor's

26. *Jackson v. Texas Co.* (C. C. A. 10, 1935) 75 F. (2d) 549.

27. See Merrill, *Covenants Implied in Oil and Gas Leases* (2d ed. 1940) §411.

28. *Kroeger v. Martin* (1919) 72 Okla. 198, 180 Pac. 955.

29. *Phillips Pet. Co. v. Taylor* (C. C. A. 5, 1941) 116 F. (2d) 994.

30. *Cole Pet. Co. v. United States Gas & Oil Co.* (1931) 121 Tex. 59, 41 S. W. (2d) 414, 86 A. L. R. 719.

31. *Sunburst Oil & Ref. Co. v. Callender* (1929) 84 Mont. 178, 274 Pac. 884; *Stone v. Marshall Oil Co.* (1904) 208 Pa. 85, 57 Atl. 183, 65 L. R. A. 218; *Cole Pet. Co. v. United States Gas & Oil Co.* (1931) 121 Tex. 59, 41 S. W. (2d) 414, 86 A. L. R. 719.

32. *Stanolind Oil & Gas Co. v. Kimmel* (C. C. A. 10, 1934) 68 F. (2d) 520.

33. *Akin v. Marshall Oil Co.* (1898) 188 Pa. 602, 41 Atl. 748.

34. *Kile v. Amerada Pet. Corp.* (1926) 118 Okla. 176, 247 Pac. 681.

rights should extend "to all modifications, renewals, * * * or extensions" of the original. The assignee attempted to surrender and to take a new lease before the expiration of the old. Although this was not technically either a modification, a renewal or an extension, the court refused to allow the assignee to cut off the assignor's interest in this manner, reasoning that his conduct amounted to a breach of a fiduciary relation existing between the parties to the assignment.³⁵ The recognition of such a fiduciary obligation is inconsistent with the conception that an assignee under such an assignment may do as he will with the lease, and it may be that the Oklahoma court will desire to re-examine its earlier decision in the light of its recognition of this relation of trust.

In another class of cases, the assignor has reserved no permanent interest in the land in the form of an overriding royalty but stipulates for a payment in oil to be produced from the leased premises. The majority of the jurisdictions which have dealt with transactions of this sort have held that, in the absence of express agreement to do so, the assignee owes no duty to the assignor to seek to discover and develop production from which the payment may be made.³⁶ On the other hand, a number of cases, chiefly in the federal courts, have affirmed the existence of implied covenant obligations as essential to enable the assignor to have a fair chance of receiving the contingent payment for which he has bargained.³⁷ In Oklahoma again we find the authorities in some confusion. Two cases are in accord with the numerical weight of authority.³⁸ On the other hand, in *Hivick v.*

35. *Probst v. Hughes* (1930) 143 Okla. 11, 286 Pac. 875, 69 A. L. R. 929.

36. *Henderson Co. v. Murphy* (1934) 189 Ark. 87, 70 S. W. (2d) 1036; *Matthews v. Ramsey-Lloyd Oil Co.* (1926) 121 Kan. 75, 245 Pac. 1064; *Goocey v. Hopkins* (1925) 206 Ky. 176, 266 S. W. 1087; *Smith v. Munhall* (1891) 139 Pa. 253, 21 Atl. 735; *Tunstill v. Gulf Prod. Co.* (Tex. Civ. App. 1935) 79 S. W. (2d) 657; cf. *Simms Oil Co. v. Colquitt* (Tex. Com. App. 1927) 296 S. W. 491, (Tex. Com. App. 1928) 2 S. W. (2d) 421.

37. *Pritchard v. McLeod* (C. C. A. 9, 1913) 205 Fed. 24, 123 C. C. A. 332; *United Central Oil Corp. v. Helm* (C. C. A. 5, 1926) 11 F. (2d) 760, cert. den. (1927) 271 U. S. 686; *Van Every v. Peterson* (C. C. A. 5, 1928) 24 F. (2d) 26; *Mackenzie Oil Co. v. Omar Oil & Gas Co.* (Del. Super. 1929) 4 W. W. Harr. 435, 154 Atl. 883, aff'd (Del. 1930) 4 W. W. Harr. 460, 154 Atl. 894; *Honaker v. Guffey Pet. Co.* (Tex. Civ. App. 1927) 294 S. W. 259. Cf. *Empire Gas & Fuel Co. v. Pendar* (Tex. Civ. App. 1922) 244 S. W. 184.

38. *McGee v. Urschel* (1936) 177 Okla. 337, 58 P. (2d) 1228; *Phoenix Oil Co. v. Mid-Continent Pet. Corp.* (1936) 177 Okla. 530, 60 P. (2d) 1054, 11 A. L. R. 504.

Urschel,³⁹ an assignee subject to an oil payment, who allowed the lease to lapse and took a new one for himself, was held to acquire it impressed with a constructive trust in favor of the assignor to the extent necessary to cover the oil payment. The court said, "By the terms of the contract herein involved, the assignee was bound to exercise the utmost good faith in the development of the lease prior to its expiration."⁴⁰ This language, as well as the recognition of the trust, seems thoroughly in disharmony with the other two decisions. Perhaps this question also is open for re-examination in Oklahoma.

Except for the fact that the overriding royalty is an interest in land,⁴¹ there is so little difference in the situations of the assignor retaining such a royalty interest and of the assignor who stipulates for an oil payment that it seems proper to consider the merits and demerits of imposing the implied covenant obligation in both situations together. The argument chiefly relied upon by the courts which have refused to impose the obligation to explore and develop is that one of the essential characteristics of the modern oil lease is the privilege on the part of the lessee either to develop or to pay delay rentals and at the end of the exploratory term to let the lease lapse without liability. When the lease is assigned, it is said, this privilege is transferred to the assignee, and to imply a covenant for development in the assignor's favor is to reduce the property right which he got by his assignment.⁴² This argument, however, begs the fundamental question of what the assignee really gets by the assignment. The privilege of postponed drilling is entirely a creature of the delay rental clause, which, of course, operates only as against the lessor. Were there no such clause, the lessor would be entitled to insist upon prompt exploration.⁴³ If the assignment transferred the lease outright, no doubt it would be proper to say that the assignee acquired the privilege of postponing, or

39. (1935) 171 Okla. 17, 40 P. (2d) 1077.

40. *Hivick v. Urschel* (1935) 171 Okla. 17, 22, 40 P. (2d) 1077, 1082.

41. *Tennant v. Dunn* (1937) 130 Tex. 285, 110 S. W. (2d) 53.

42. *Matthews v. Ramsey-Lloyd Oil Co.* (1926) 121 Kan. 75, 245 Pac. 1064; *Goocey v. Hopkins* (1925) 206 Ky. 176, 266 S. W. 1087; *Simms Oil Co. v. Colquitt* (Tex. Com. App. 1927) 296 S. W. 491, (Tex. Com. App. 1928) 2 S. W. (2d) 421; *Tunstall v. Gulf Prod. Co.* (Tex. Civ. App. 1935) 79 S. W. (2d) 657.

43. See *Merrill, Covenants Implied in Oil and Gas Leases* (2d ed. 1940) c. 2.

even of completely foregoing, development by virtue of the delay rental clause. But where an overriding royalty or an oil payment is stipulated for by the assignor, the assignee does not acquire the full interest which the lessee had as against the lessor. His interest comes to him burdened, not only with the interest retained by the lessor, but also with the interest for which the assignor has bargained. This interest is of the same nature as that which, in the absence of a delay rental clause, has been adjudged to give rise to the exploratory obligation in favor of the lessor. No delay rental clause operates against the assignor. That the assignor stands in as grave danger as the lessor of having his interest defeated by the assignee's neglect, the cases attest. There is, in fact, this distinction, which weighs heavily in favor of imposing the implied obligation in favor of the lessor, that when the lease expires without exploration, the lessor will get his mineral rights back, with whatever wealth there may be under his land unimpaired, and may try his luck with another lessee. The assignor, on the other hand, will have nothing. The really effective argument against implying the covenant in favor of the assignor seems to me to arise from the fact that most transactions of assignment will take place between persons engaged in the oil business so that the assignor is much more likely to be on an equality with the assignee, in regard to knowledge and to bargaining power alike, than is the lessor with respect to the lessee. Hence it might be proper to assume that if the assignor does not insert in the assignment an express obligation on the part of the assignee to engage in exploratory activity, he is willing to run the risk of the latter's slothfulness. It is true that it may not be feasible to place in the assignment specific provisions as to what wells shall be drilled, or the depth to which exploration shall be carried, or other details of the exploratory program,⁴⁴ but at least a general stipulation for exploration might be inserted. On the other hand, such a general clause would add nothing to the obligations which an implied covenant would impose, and it may be that the general concept of a duty to explore which the law of implied covenants imposes upon the lessee or assignee in favor of the lessor has permeated so thoroughly the thinking of oil men that the failure to include specific exploratory

44. Cf. the stipulation in *Patsy Oil & Gas Co. v. Baker* (1927) 127 Okla. 76, 259 Pac. 864.

obligations in most assignments of the type we are discussing may be explained on the ground that the parties assume their existence as a matter of course. As yet, the courts do not seem to have given attention in their opinions to the relative weight that should be accorded these factors.

When we leave the realm of the covenant for exploration and inquire whether the implied covenants for further development, for diligent operation, and for protection are existent between the assignor and the assignee, the considerations in favor of an affirmative answer seem much more cogent. The option to drill or to let the lease expire upon which the opinions denying the existence of the covenant to explore have relied so heavily has passed with the obtention of production upon the premises, or with the bringing in of adjacent wells which must be offset. The cry of the assignor for protection against arbitrary conduct on the part of his assignee is more appealing, for it now is apparent that his interest can be made fruitful to him. The specific acts necessary to comply with the obligations of a diligent and careful operator are so varied and unpredictable that any attempt to set them down would be futile, and there is no reason for the law to insist upon the insertion of an empty formula couched in general terms. In the cases wherein the courts have refused to award damages to the assignor because of the assignee's failure to operate the lease, the evidence has shown that profitable operation was impossible.⁴⁵ In one of them, the court expressly recognizes the existence of a duty on the part of the assignee to conform to the conduct of a reasonably prudent operator.⁴⁶ In a very recent decision the assignee's obligation to protect against drainage has been enforced, the court expressly saying that the same reasons which support the implications of a covenant in favor of the lessor apply in favor of the assignor retaining an overriding royalty.⁴⁷

A recent Montana case⁴⁸ makes an interesting distinction. The lessee in that litigation, instead of assigning the lease, entered into what was termed a "drilling agreement" with an "operator"

45. *United Central Oil Corp. v. Helm* (C. C. A. 5, 1926) 11 F. (2d) 760; *Henderson Co. v. Murphy* (1934) 189 Ark. 87, 70 S. W. (2d) 1036; *Tunstall v. Gulf Prod. Co.* (Tex. Civ. App. 1935) 79 S. W. (2d) 657.

46. *United Central Oil Corp. v. Helm* (C. C. A. 5, 1926) 11 F. (2d) 760.

47. *Phillips Pet. Co. v. Taylor* (C. C. A. 5, 1941) 116 F. (2d) 994, cert. den. (1941) 313 U. S. 565.

48. *Cedar Creek Oil & Gas Co. v. Archer* (Mont. 1941) 117 P. (2d) 265.

according to which the latter was to drill certain wells and to have "the exclusive right to go upon the leased land to explore for oil and gas. If oil was found, the lessee was to have 7½ per cent produced and saved free in the operator's tanks at the well or to the lessee's credit with such pipe line as might connect its lines with the tanks. Twenty-five per cent of the gas produced was retained by the lessee "free of charge at the pipe line" and seventy-five per cent was granted to the operator. For failure to drill, as prescribed in the instrument, forfeiture was provided. The operator was given an option to purchase the lessee's share of the oil or gas produced from the leased lands at the wells or in the tanks or in the pipe lines, at the market price. Gas production was obtained, but only a limited market was obtainable and a dispute seems to have arisen between the parties as to who must assume the burden of finding a market. This dispute culminated in litigation whereby the lessee sought to cancel the drilling agreement. The second well prescribed by the contract had not been drilled, but apparently the lessee was estopped from claiming a forfeiture on that ground by having indicated a willingness to have the drilling postponed until a market could be secured for the product. This point is inadequately treated in the opinion, and apparently it was not relied upon by the Supreme Court of Montana. That tribunal devoted considerable effort to making the point that the drilling agreement could not be considered as a sublease and that the trial court was in error in giving to the lessee "the status of a land owner lessor." The court specifically denied the existence of any implied covenant on the part of the operator to find a market for the gas. As to the particular agreement and facts in litigation, the court probably is correct. The express option given the operator to purchase the lessee's share of the oil and gas implies rather strongly that the lessee ordinarily will take care of the task of selling his share. Moreover, even had there been an obligation on the part of the operator to find a market for the lessee's gas, the evidence showed that a sale to the only purchaser available was thwarted by the lessee's refusal to sign the contract. Under such circumstances a lessee would not be liable to a lessor for failure to market.⁴⁹ But if the court's opinion is to be taken

49. *Transcontinental Oil Co. v. Thomas* (C. C. A. 5, 1928) 29 F. (2d) 733.

as conveying the broad implication that there can be no implied covenant obligation under such an instrument, its propriety is doubtful. The position of the parties is substantially that obtaining between an assignor retaining an overriding royalty and his assignee, and the same reasoning which justifies the imposition of implied covenant duties upon the assignee seems to call for their imposition upon the operator under a so-called "drilling agreement" of this particular type. The court makes no mention of *Sunburst Oil & Refining Company v. Callender*,⁵⁰ in which it had enforced the implied covenant for operation in favor of a lessee-assignor, retaining an overriding royalty. Presumably, therefore, that case is to be regarded as distinguishable and not as overruled. The most available grounds of distinction seem to be those discussed above. That the royalty provision is phrased in terms of delivery in kind is not of itself significant, for many oil leases read in the same manner, and yet the lessee is regarded as under a duty to use diligence in providing a market for the lessor.⁵¹

OPERATORS AND GRANTEEES OF SHARE-INTERESTS

The Montana case just discussed⁵² suggests another interesting inquiry. The operator sold to other persons royalty interests as a means of raising funds with which to develop the property. In the end he had left for himself no more than four per cent of the gas and nine per cent of the oil. What was the position of his assignees with respect to the activities of exploration, development, operation and protection? This is a very common method of financing oil and gas development. Dependent upon whether there is an assignment of a royalty interest, or a mere contract for payment out of the proceeds of production, it appears that those furnishing money or supplies get either an overriding royalty interest, or an equitable lien upon the leasehold securing an oil payment.⁵³ In either case, the same factors which justify the implication of covenants between lessor and lessee seem operant. It must be remembered that units or shares of

50. (1929) 84 Mont. 178, 274 Pac. 834.

51. See Merrill, *Covenants Implied in Oil and Gas Leases* (2d ed. 1940) §84.

52. *Cedar Creek Oil & Gas Co. v. Archer* (Mont. 1941) 117 P. (2d) 265.

53. See Blake, *The Oil and Gas Lease—II* (1940) 13 So. Calif. L. Rev. 398, 422.

this type are sold frequently to people of little acquaintance with the oil business, and the courts should be vigilant to exact fair dealing in their favor. It is submitted, therefore, that the implied covenants are existent in favor of the holders of interests of this sort.⁵⁴

⁵⁴. See Merrill, *Covenants Implied in Oil and Gas Leases* (2d ed. 1940) 419.