

OIL AND GAS

Faced with uncertain supply and escalating prices from foreign oil producers, public demand has shifted to domestic oil suppliers thereby causing the value of domestic oil and gas leases to experience a sharp upturn.¹ Consequently, owners of oil and gas leases are anxious to reap the mineral harvest lying beneath the surface and to collect the high dividends of the price rise. This accession to wealth depends, however, on an oil producing lessee. Where an oil or gas lease was entered into some years earlier, uncertainty as to the rights and duties of parties to the lease may develop.

In *Superior Oil Co. v. Devon Corp.*² the Eighth Circuit for the first time considered and affirmed the application of an implied covenant that the lessee further develop a Nebraska oil and gas lease.³ Where the lease agreement is silent, an implied covenant arises from the relationship between the lessor and lessee and governs the conduct of lease operations.⁴ When an implied covenant is breached,⁵ the lessor must notify the lessee of the breach and demand compliance before the lessor can terminate the lease.⁶ Under certain situations notice and demand are presumed waived by the lessee and forfeiture occurs.⁷ The issue addressed by the *Superior Oil* court was whether the facts of the case warranted a finding that notice and demand were waived resulting in the forfei-

1. *Superior Oil Co. v. Devon Corp.*, 604 F.2d 1063 (8th Cir. 1979).

2. 604 F.2d 1063 (8th Cir. 1979).

3. *Id.* at 1068-69.

4. Cohen, *Implied Covenants In Kansas Oil and Gas Leases* 9 KAN. L. REV. 7,7 (1960).

5. A "reasonably prudent operator" standard is used to determine whether a lessee fulfilled his responsibilities under an implied covenant to further develop. 604 F.2d at 1065.

6. *United States v. City of Pawhuska*, 502 F.2d 821, 823-24 (10th Cir. 1974); *Williams v. Humble Oil & Refining Co.*, 435 F.2d 772, 773 (5th Cir. 1970); *Leeper v. Lemon G. Neely Co.*, 293 F.2d 967, 970-71 (6th Cir. 1923); *Robinson v. Continental Oil Co.*, 255 F. Supp. 61, 64 (D. Kan. 1966); *Howerton v. Kansas Natural Gas Co.*, 81 Kan. 553, 564, 106 P. 47, 51 (1910), *rev'd on other grounds*, 82 Kan. 367, 108 P. 813 (1910); *Sapp v. Massey*, 358 S.W.2d 490, 492-93 (Ky. 1962); *Cameron v. Lebow*, 338 S.W.2d 399, 402 (Ky. 1960); *Doss Oil Royalty Co. v. Texas Co.*, 192 Okla. 359, 363, 137 P.2d 934, 938-39 (1943); R. HEMINGWAY, *THE LAW OF OIL AND GAS* § 8.11, at 401 (1971); H. WILLIAMS & C. MEYERS, *OIL AND GAS LAW* § 682, at 414-15 (abr. ed. 1975); Cohen, *supra* note 4, at 15-16.

7. *United States v. City of Pawhuska*, 502 F.2d 821, 824 (10th Cir. 1974); *Howerton v. Kansas Natural Gas Co.*, 81 Kan. 553, 564, 106 P. 47, 51 (1910); *Sapp v. Massey*, 358 S.W.2d 490, 493 (Ky. 1962); *Lawrence Oil Corp. v. Metcalfe*, 421 Ky. 353, —, 43 S.W.2d 986, 989 (1931); R. HEMINGWAY, *supra* note 6, at 401.

ture of the lease.⁸

FACTS AND HOLDING

Superior Oil Company obtained an oil and gas lease on various tracts of land in 1949.⁹ By its terms the lease was to run for a primary term of ten years and for as long thereafter as oil and gas may be produced.¹⁰ Although oil was discovered in the primary term of the lease and continued to be produced, after 1961 no further drilling was done by Superior or its assignees.¹¹

The original lessors were succeeded by the defendants, Schuler-Olsens.¹² In 1976 the Schuler-Olsens executed leases to another producer, Christensen, on tracts subject to the Superior lease.¹³

Christensen brought in a producing well on one of those tracts in February 1977.¹⁴ Superior learned of the new lease in an article published in an oil and gas newspaper reporting that a well had been drilled.¹⁵ Schuler-Olsens notified Superior that they considered the lease forfeited.¹⁶ Superior then brought suit against Schuler-Olsens for breach of contract and Christensen for trespass and conversion.¹⁷ Schuler-Olsens counterclaimed for breach of the implied covenant to further develop and abandonment seeking cancellation of the lease.¹⁸

The district court held that the implied covenant to further develop had been breached but that under the circumstances notice and demand were not required and granted cancellation of the lease.¹⁹ The court then dismissed the defendant Christensen since it was no longer necessary to determine his liability.²⁰ On appeal the Eighth Circuit reversed, determining that notice and demand were not waived under the circumstances.²¹ The case was remanded to determine Christensen's liability.²²

8. 604 F.2d at 1069-72.

9. *Id.* at 1066.

10. *Id.*

11. *Id.*

12. *Id.*

13. *Id.*

14. *Id.*

15. *Superior Oil Co. v. Devon Corp.*, 458 F. Supp. 1063, 1066 (D. Neb. 1978).

16. *Id.*

17. 604 F.2d at 1066.

18. *Id.*

19. *Id.* at 1067-68.

20. *Id.* at 1068.

21. *Id.* at 1069-73.

22. *Id.* at 1072.

BACKGROUND

Certain implied covenants are recognized in oil and gas lease law in addition to the express covenants in a lease agreement.²³ These implied covenants spring from the relationship between the parties to the lease contract²⁴ and require the lessee to perform his duties diligently with regard to the lessor's interest as well as his own.²⁵

One such implied covenant is the covenant to further develop the lease once production of oil or gas has been secured.²⁶ Breach of this covenant will not automatically result in forfeiture of the lease.²⁷ Usually some notice by the lessor pointing out the alleged breach along with a demand to conform to the implied covenant's terms within a reasonable time is required.²⁸ The reasoning behind this is to promote certainty in the law. By allowing the lessee to choose between either continuing to develop the lease or releasing his lease interest, inequitable results are avoided.²⁹ The lessor's royalty interest as well as the lessee's property interest is protected.³⁰ If the lessee then fails to comply, the lessor may sue for cancellation of the lease due to breach of the covenant.³¹ The exception to the requirement for notice and demand occurs when

23. *Brewster v. Lanyon Zinc Co.*, 140 F. 801, 810 (8th Cir. 1905); R. HEMINGWAY, *supra* note 6, at 364; H. WILLIAMS & C. MEYERS, *supra* note 6, at 457; Merrill, *The Oil and Gas Lease - Major Problems*, 41 NEB. L. REV. 488, 516 (1962); see *Sauder v. Mid-Continent Petroleum Corp.*, 292 U.S. 272, 279-80 (1934); *Trust Co. v. Samedan Oil Corp.*, 192 F.2d 282, 284-85 (10th Cir. 1951); Cohen, *supra* note 4, at 7.

24. Cohen, *supra* note 4, at 7.

25. *Brewster v. Lanyon Zinc Co.*, 140 F. 801, 814 (8th Cir. 1905); R. HEMINGWAY, *supra* note 6, at 366-67; H. WILLIAMS & C. MEYERS, *supra* note 6, at 464; Cohen, *supra* note 6, at 13-14.

26. *Sauder v. Mid-Continent Petroleum Corp.*, 291 U.S. 272, 279 (1934); *United States v. City of Pawhuska*, 502 F.2d 821, 824 (10th Cir. 1974); *Rogers v. Westhoma Oil Co.*, 291 F.2d 726, 733-34 (10th Cir. 1961); *Trust Co. v. Samedan Oil Corp.*, 192 F.2d 282, 284 (1951); *Brewster v. Lanyon Zinc Co.*, 140 F. 801, 810 (8th Cir. 1905); *Brixey v. Union Oil Co. of Cal.*, 283 F. Supp. 353, 358 (W.D.Ark. 1968); R. HEMINGWAY, *supra* note 6, at 368; H. WILLIAMS & C. MEYERS, *supra* note 6, at 462; Cohen, *supra* note 4, at 13; Merrill, *supra* note 23, at 517; Merrill, *The Implied Covenant of Further Exploration in Oklahoma*, 13 OKLA. L. REV. 249, 249 (1960).

27. *United States v. City of Pawhuska*, 502 F.2d 821, 824 (10th Cir. 1974); *Leeper v. Lemon G. Neely Co.*, 293 F. 967, 970-71 (6th Cir. 1923); *Robinson v. Continental Oil Co.*, 255 F. Supp. 61, 64 (D. Kan. 1966); *Howerton v. Kansas Natural Gas Co.*, 81 Kan. 553, 564, 106 P. 47, 51 (1910); *Sapp v. Massey*, 358 S.W.2d 490, 492-93 (Ky. 1962); *Cameron v. Lebow*, 338 S.W.2d 399, 402 (Ky. 1960); *Doss Oil Royalty Co. v. Texas Co.*, 192 Okla. 359, 363, 137 P.2d 934, 938-39 (1943); H. WILLIAMS & C. MEYERS, *supra* note 6, at 414; Cohen, *supra* note 4, at 16; Comment, 7 ST. MARY'S L.J., 180, 203 (1975).

28. See note 27 *supra*.

29. *Doss Oil Royalty Co. v. Texas Co.*, 192 Okla. 354, 363, 137 P.2d 934, 938-39 (1943); R. HEMINGWAY, *supra* note 6, at 364-67.

30. *Id.*

31. See note 27 and accompanying text *supra*. Damages or alternative cancellation decrees are also available remedies. 2 E. BROWN, LAW OF OIL AND GAS

the lessee has expressed by words or conduct that regardless of demand he will not develop the lease.³²

ANALYSIS

Relying on a Nebraska gravel mining lease case,³³ both the district and circuit court found that an implied covenant of further development would apply to oil and gas leases.³⁴ The underlying rationale recognized by the courts was that the lessee should not be able to deprive the lessor of either the expected royalties, or of the opportunity to make some other arrangements to avail himself of the mineral wealth of his land.³⁵ This decision marks the first time that this implied covenant has been recognized in Nebraska oil and gas lease law,³⁶ and is consistent with the body of oil and gas lease laws in other jurisdictions.³⁷

The court next addressed the question of whether notice and demand was required or waived on the facts of this case.³⁸ Superior had been producing oil and paying royalties at the time Schuler-Olsen declared the forfeiture.³⁹ No new wells had been drilled for sixteen years.⁴⁰ The district court found waiver of notice and demand relying on the unreasonableness of the length of time in which no development had occurred; the determination that the Schuler-Olsens had no actual knowledge of the Superior lease; and the equitable grounds that Schuler-Olsens were unsophisticated in oil and gas lease matters.⁴¹ The Eighth Circuit disagreed with the district court, finding notice and demand were required to inform the lessee of his breach and allow him an opportunity to correct the breach.⁴² The court found this to be consistent with due process and the abhorrence of forfeiture in the law as well as serv-

LEASES 16-116 (2d ed. 1973); Cohen, *supra* note 4, at 15-16; Merrill, *supra* note 6, at 513-14; see *Sauder v. Mid-Continent Petroleum Corp.*, 292 U.S. 272, 280-82 (1934).

32. *Harris v. Morris Plan Co.*, 144 Kan. 501, 506, 61 P.2d 901, 904 (1936); *Howerton v. Kansas Natural Gas Co.*, 81 Kan. 553, 564, 106 P. 47, 51 (1910); *Sapp v. Massey*, 358 S.W.2d 490, 493 (Ky. 1962); *Lawrence Oil Corp. v. Metcalfe*, 241 Ky. 353, —, 43 S.W.2d 986, 989-90 (1931); *R. HEMINGWAY*, *supra* note 6, at 401.

33. *George v. Jones*, 168 Neb. 149, 163-64, 95 N.W.2d 609, 617 (1959).

34. 604 F.2d at 1068-69.

35. *Id.* at 1069.

36. *Id.* at 1068-69.

37. *H. WILLIAMS & C. MEYERS*, *supra* note 6, at 458; see notes 26-32 and accompanying text *supra*.

38. 604 F.2d at 1069.

39. *Id.* at 1067.

40. *Id.* at 1066. After 1961 there was no further drilling by Superior on tracts covered by the lease. An oil well was successfully completed in 1977 by Christensen on tracts covered by the Superior lease.

41. *Id.* at 1070-71.

42. *Id.* at 1069.

ing to promote certainty in oil and gas leases.⁴³

The court then rejected the district court's finding that passage of an unreasonable length of time is a ground for waiver of notice and demand.⁴⁴ They distinguished other waiver cases as being instances where production had been totally shut down for an unreasonable length of time.⁴⁵ These cases were characterized as either abandonment,⁴⁶ or, in one instance, as a lease subject to a condition subsequent.⁴⁷ As the court noted, waiver would result not from unreasonable delay,⁴⁸ but from words or conduct of the lessee indicating to lessor that no further development would be attempted.⁴⁹

Many factors come into play in determining whether conduct of a lessee would breach an implied covenant.⁵⁰ In *Sinclair Oil and Gas Co. v. Masterson*,⁵¹ the court took into consideration the size of the lease, the number of wells already drilled, the amount of production and the wells on adjoining lands.⁵² Courts recognize that no single factor may be totally determinative.⁵³ But since the

43. *Id.*

44. *Id.* at 1070.

45. *Id.* at 1070-71.

46. *Id.* at 1070. Breach of an implied covenant is distinguishable from abandonment which is a separate ground for cancellation. In abandonment the covenants are breached but it is by the lessee physically relinquishing the lease or a total cessation of production for an unreasonable length of time. *See Cameron v. Lebow*, 338 S.W.2d 399, 407 (Ky. 1960) (no drilling or pumping by lessee for 17 years); *Smyth v. Koplín*, 294 S.W.2d 525, 526-28 (Ky. 1956) (eight years with no development or payment by the lessee); *American Wholesale Corp. v. F. & S. Oil & Gas Co.*, 242 Ky. 356, —, 46 S.W. 2d 498, 500 (1932) (lessee stopped pumping oil for 1 1/3 years); *Texas Co. v. Davis*, 113 Tex. 321, —, 254 S.W. 304, 309 (1923); *R. HEMINGWAY*, *supra* note 6, at 373-74; *Comment*, 7 ST. MARY'S L.J. 204 (1975).

47. 604 F.2d at 1071; *see Benedum-Trees Oil Co. v. Davis*, 107 F.2d 981, 985 (6th Cir. 1939), *cert. denied*, 310 U.S. 634 (1940). In *Benedum-Trees* the court found that the lessee's duty to further develop the lease was not a "mere implied covenant" but a condition subsequent. *Id.* The "condition subsequent" is defined as "[t]he power or right of a grantor or lessor to re-enter the estate granted or leased upon the occurrence of a stated event or breach of a condition and terminate the granted or leased estate." *H. WILLIAMS & C. MEYERS, MANUAL OF OIL & GAS TERMS* 340 (3d ed. 1971).

48. 604 F.2d at 1070; *see Sauder v. Mid-Continent Petroleum Corp.*, 292 U.S. 272, 279-82 (1934) (cancellation of lease requires lapse of an unreasonable length of time plus notice and demand); *Doss Oil Royalty Co. v. Texas Co.*, 192 Okla. 359, —, 137 P.2d 934, 938-39 (1943) (will allow the cancellation for unreasonable time lapse coupled with notice and demand).

49. 604 F.2d at 1070.

50. *Fontenot v. Austral Oil Exploration Co.*, 168 F. Supp. 36, 40 (W.D. La. 1958), *aff'd*, 266 F.2d 956 (5th Cir. 1959) (consider geological data, number and location of wells drilled, productive capacity of wells, cost, time and acreage); *R. HEMINGWAY*, *supra* note 6, at 369-70.

51. 271 F.2d 310 (5th Cir. 1959).

52. *Id.* at 317-23.

53. *See* note 50 and accompanying text *supra*.

Superior Court apparently perceived no conduct on the lessee's part that indicated he would not perform in accordance with the implied covenant, it found that no waiver was warranted.⁵⁴

In his dissent Judge Heaney proposed that waiver of the notice and demand requirement be broadened beyond circumstances where the lessee has indicated to the lessor by words or conduct that he would not further develop the lease regardless of demand.⁵⁵ The dissent argued that since the purpose of notice and demand is to put the lessee in default and allow him an opportunity to cure the breach, where the lessee knows he has breached the implied covenant and fails to correct it within a reasonable time, the requirement is obviated.⁵⁶ Judge Heaney also pointed out that the court could have found that *Superior* knew it had breached the implied covenant from a 1960 memo by *Superior Oil* in response to a farm-out request.⁵⁷

The dissent interpreted the memo to indicate an intent to hold the land for speculation,⁵⁸ which is clearly inconsistent with the rationale of implied covenants to develop.⁵⁹ If the dissent were correct then this would be an intentional breach of the implied covenant to further develop. It follows that notice and demand would be unnecessary since the lessee would already be aware that his actions breached the covenant. According to Judge Heaney, this behavior would seem to indicate that forfeiture without notice and demand was warranted.⁶⁰

But an intent to hold the lease for speculative purposes is not necessarily the only reasonable interpretation of the memo. The memo specifically discussed holding the lease while awaiting the results of drilling on farm-outs in the area.⁶¹ Oil production on adjoining tracts, as well as other economic factors, is relevant in determining whether a lessee must further develop the lease.⁶² Therefore, if *Superior's* decision not to develop the land is inter-

54. 604 F.2d at 1070-73 (Heaney, J., dissenting).

55. *Id.* at 1073.

56. *Id.*

57. *Id.* at 1073-74 (Heaney, J., dissenting). "A farm-out agreement is a contract to assign oil and gas lease rights in certain acreage upon the completion of drilling obligation." H. WILLIAMS & C. MEYERS, *supra* note 6, at 241.

58. 604 F.2d at 1074 (Heaney, J., dissenting).

59. *Sauder v. Mid-Continent Petroleum Corp.*, 292 U.S. 272, 280-81 (1934); *Sand Springs Home v. Clemens*, 276 P.2d 262, 263 (1954); *Doss Oil Royalty Co. v. Texas Co.*, 192 Okla. 359, —, 137 P.2d 934, 938 (1943); R. HEMINGWAY, *supra* note 6, at 373; H. WILLIAMS & C. MEYERS, *supra* note 6, at 521-22.

60. 604 F.2d at 1074 (Heaney, J., dissenting).

61. *Id.*

62. *See* notes 50-54 and accompanying text *supra*.

preted as a reasonable business decision it should still be entitled to notice and demand.

In remanding the case, the court construed section 57-208⁶³ of the Nebraska Revised Statutes to determine whether the working interest defendants (Christensens) had notice of the Superior lease.⁶⁴ The statute provides for recording an affidavit of production by the lessee if the well is producing at the end of the primary term.⁶⁵ The affidavit on record then "[s]hall be due notice to the public of the existence and continuing validity of the lease."⁶⁶ No Nebraska cases have yet involved construction of the statute.⁶⁷ Relying on cases interpreting a similar Kansas statute,⁶⁸ the court held it was a notice statute to the public and it did not affect the contractual relationship between Superior and the Schuler-Olsens.⁶⁹ Christensen was not charged with notice under the statute, however, the court remanded the case to determine whether Christensen had other actual or constructive notice.⁷⁰

CONCLUSION

The court has determined that even in an instance where the lessee may have failed to fully abide by the standard of a reasonably prudent operator, he is still entitled to notice and demand before forfeiture may be declared by the lessor. Conversely, the court will not allow the lessor to escape his obligation to give notice and demand through neglect.

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63. NEB. REV. STAT. § 57-208 (Reissue 1978).

64. 604 F.2d at 1072.

65. NEB. REV. STAT. § 57-208 (Reissue 1978).

66. *Id.*

67. 604 F.2d at 1072 n.11.

68. KAN. STAT. ANN. § 55-205 (1976).

69. 604 F.2d at 1072.

70. *Id.* at 1072-73.