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Cancellation of Oil and Gas Lease for Failure to Market Product or to Develop Leased Premises After Discovery of Oil or Gas

Maurice H. Merrill

University of Idaho College of Law

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CANCELLATION OF OIL AND GAS LEASE FOR FAILURE TO
MARKET PRODUCT OR TO DEVELOP LEASED
PREMISES AFTER DISCOVERY OF OIL OR GAS

Among the problems which vex the courts in connection with oil and gas leases is the question of the effect of a failure by the lessee to operate the wells and to market the product or to develop the leased premises after oil or gas has been found thereon. Under certain circumstances the continuation of the lease expressly depends upon production of oil or gas. Under modern leases, after the expiration of a fixed "exploratory period," the duration of the lease is usually expressed as "so long as oil or gas is produced" or "so long as oil or gas is found." The phrase "in paying quantities" is often added to the above expressions.¹ Where duration of the lease is dependent upon the continuation of production, an utter failure to operate the premises terminates the lease.² But if the production is not required to be in "paying quantities," it seems that any actual production, no matter how small will satisfy the requirement,³ while, if production in "paying quantities" is called for, the rule is that, if exercised in good faith, the judgment of the lessee is binding as to whether the production does come up to that standard.⁴ Where the continuation of the lease is dependent merely upon the "finding" of oil or gas, it seems fair to say that, so far as express stipulations are concerned, neither production nor the absence thereof has an effect upon the duration of the term.⁵

This does not mean, however, that the lessee is freed from all obligation to market the product or to develop the lease. In the absence of express stipulations governing the subject, the courts have worked out the rights and liabilities of the parties upon a theory of covenants

¹ The exact language used varies, of course, in particular leases. For an excellent discussion of the evolution of the terms of oil and gas leases, see James A. Veasey, "The Law of Oil and Gas," 18 MICH. LAW REV. 652.

² *Gaylor v. Bankers Oil Co.*, 110 Kan. 224, 203 Pac. 735; *Cassell v. Crotners*, 193 Pa. St. 359, 44 Atl. 446; See also *Collins v. Mt. Pleasant Oil Co.*, 85 Kan. 483, 118 Pac. 54 38 L. R. A. (N. S.) 134.

³ *Gillespie v. Ohio Oil Co.*, 260 Ill. 169, 102 N. E. 1043; *Reynolds v. White Plains Oil Co.*, 199 Ky. 243, 250 S. W. 975. In Kentucky, the production must be "in such quantities as to be susceptible of division, so as to pay the landowner a royalty even though small." *Enfield v. Woods*, 198 Ky. 328, 248 S. W. 842.

⁴ *Hennessy v. Junction Oil & Gas Co.*, 207 Pa. St. 334, 56 Atl. 876; *Texas Pacific Coal & Oil Co. v. Bruce* (Tex. Civ. App.) 233 S. W. 535; *McGraw Oil & Gas Co. v. Kennedy*, 65 W. Va 595, 64 S. E. 1027, 28 L. R. A. (N.S.) 959; *Barbour, Stedman & Herod v. Tompkins*, 81 W. Va. 116, 93 S. E. 1038, L. R. A. 1913 B, 365. But see *Union Gas & Oil Co. v. Adkins* (6th Circ.) 278 Fed. 854 indicating a contrary view, as to oil leases.

⁵ See *Dickey v. Coffeyville Vitrified Brick & Tile Co.*, 76 Pac. 398, 69 Kan. 106; *Roach v. Junction Oil & as Co.*, 72 Okla. 213, 179 Pac. 935; *Texas Pacific Coal & Oil Co. v. Bratton*, (Tex. Civ. App.) 239 S. W. 688.

for operation and development implied in the lease.⁶ That an implied covenant for operation of wells and marketing of the product exists when oil or gas is discovered upon the leased premises is recognized by numerous decisions.⁷ The implication of this covenant is based upon the necessity of operation in order to secure to the lessor the returns provided for by the lease upon oil or gas when produced.⁸ If this is secured to him the lessor has no claim to dictate the use which the lessee shall make of the wells.⁹ Where the compensation for a gas well is fixed at a definite annual sum, the extent to which the well is or is not operated has no effect upon the lessor's return. Accordingly the lessee may pay the rental and hold the lease without operating the well or wells and such conduct does not breach the implied covenant for operation.¹⁰ If no market is available,¹¹ as, for example, in the case of a "wildcat" well in a territory having no pipe line facilities,¹² it seems clear that a failure to operate the wells does not constitute a breach of duty on the part of the lessee. Where there has been a failure to comply with the obligations imposed upon the lessee by this covenant, the lessor may declare a forfeiture of the lease.¹³

Moreover, the lessor may not safely content himself with merely operating the discovery well. Upon the discovery of oil or gas, there is an implied obligation on the part of the lessee to continue the development of the leased premises with reasonable diligence.¹⁴ This

⁶ The writer has treated the whole subject of implied covenants in detail in a forthcoming book entitled COVENANTS IMPLIED IN OIL AND GAS LEASES.

⁷ *Acme Oil & Mining Co. v. Williams*, 140 Cal. 681, 74 Pac. 296; *Gadbury v. Ohio & Indiana C. N. & I. G. Co.*, 162 Ind. 9, 67 N. E. 259, 62 L. R. A. 895; *American Window Glass Co. v. Williams*, 30 Ind. A. 685, 66 N. E. 912; *Howerton v. Kansas Natural Gas Co.*, 81 Kan. 553, 106 Pac. 47, 34 L. R. A. (N. S.) 34; *Hails v. Johnson*, 204 Ky. 94, 263 S. W. 679; *Indiana Oil, Gas & Development Co. v. McCrory*, 42 Okla. 136, 140 Pac. 610; *Iams v. Carnegie Natural Gas Co.*, 194 Pa. St. 72, 45 Atl. 54.

⁸ *Gadbury v. Ohio & Indiana C. N. & I. G. Co.*, *American Window Glass Co. v. Williams*, *supra*.

⁹ See *McGraw Oil & Gas Co. v. Kennedy*, 65 W. Va. 595, 64 S. E. 1027, *Hamilton v. Empire Gas & Fuel Co.*, 117 Kan. 25, 230 Pac. 911; and *Roach v. Junction Oil & Gas Co.*, 72 Okla. 213, 179 Pac. 935.

¹⁰ *Sunneverville v. Apollo Gas Co.*, *Texas Pacific Oil & Gas Co. v. Bruce*, *McGraw Oil & Gas Co. v. Kennedy*, *supra*.

¹¹ *Transcontinental Oil Co. v. Spencer*, (5th Circ.) 6 F. (2d) 866.

¹² *Strange v. Hicks*, 78 Okla. 1, 188 Pac. 347. See also *Masterson v. Amarillo Oil Co.* (Tex. Civ. App.) 253 S. W. 908.

¹³ *Acme Oil & Mining Co. v. Williams*, 140 Cal. 681, 74 Pac. 296; *Gadbury v. Ohio & Indiana C. N. & I. G. Co.*, 162 Ind. 9, 67 N. E. 259, 62 L. R. A. 895.

¹⁴ *Daughetee v. Ohio Oil Co.*, 263 Ill. 518, 105 N. E. 308, *Culbertson v. Iola Portland Cement Co.*, 87 Kan. 529, 125 Pac. 81, Ann Cas. 1924 A, 610; *Dinsmoor v. Combs*, 177 Ky. 740, 198 S. W. 58; *Brown v. Producers' Oil Co.*, 134 La. 672, 64 So. 674; *Harris v. Ohio Oil Co.*, 57 Oh. St. 118, 48 N. E. 502; *Indiana Oil, Gas & Development Co. v. McCrory*, 42 Okla. 136, 140 Pac. 610; *Harris v. Michael*, 70 W. Va. 356, 73 S. E. 934.

obligation, however, arises only if the development is likely to be profitable to the lessee.¹⁵ According to the weight of authority, forfeiture of the lease may be invoked as a remedy for breach of one of its implied covenants.¹⁶ Partial cancellation may be granted where the tract has been developed in part and a total cancellation would be unjust to the lessee.¹⁷ Some courts, however, deny the right to forfeit the lease for a breach of the implied covenants,¹⁸ and permit the lessor to recover damages instead.¹⁹

A recent case in the Federal Courts involves in an interesting manner the principles herein discussed.²⁰ Plaintiffs in 1916 executed an oil and gas lease covering 900 acres of land. The term of the lease was five years and "as much longer as oil or gas is found thereon," referring to the leased premises. The lease provided for a payment of one-eighth royalty on all oil "produced or saved" in case oil was "found in paying quantities." If gas was "found in paying quantities," the lessee was to pay "\$100 each year for the product of each well while the same is being sold off the premises." Two wells were drilled upon the land during the five year period, gas being found in both, but no gas was marketed from them for the reason "that there was no market for gas in that neighborhood, and that the pressure was so low it could not be transported to distant markets." The stipulated rental was, however, paid upon these wells. No other drilling was done. The plaintiffs brought suit in 1922 to cancel the lease, except as to a small tract surrounding each well. The lower court entered a decree for the defendant and the plaintiffs appealed. *Held:*

¹⁵ *Becker v. Submarine Oil Co.*, 55 Cal. App. 698, 204 Pac. 245; *Daughetee v. Ohio Oil Co.*, 263 Ill. 518, 105 N. E. 308; *Hughes v. Busseyville Oil & Gas Co.*, 180 Ky. 545, 203 S. W. 515; *Davenport v. Schoenfelt*, 191 Ky. 234, 229 S. W. 1043; *Rains v. Kentucky Oil Co.*, 200 Ky. 480, 255 S. W. 121; *Ardis v. Texas Co.*, 155 La. 790, 99 So. 600.

¹⁶ *Mansfield Gas Co. v. Alexander*, 97 Ark. 167, 133 S. W. 837; *Davis v. Riddle*, 25 Colo. App. 162, 136 Pac. 551; *Consumers' Gas Trust Co. v. Littler*, 162 Ind. 320, 70 N. E. 363; *Gadbury v. Ohio & Indiana C. N. & I. G. Co.*, 162 Ind. 9, 67 N. E. 259, 62 L. R. A. 895; *Puritan Oil Co. v. Meyers*, 39 Ind. App. 695, 80 N. E. 851; *Mills v. Hartz*, 77 Kan. 218, 94 Pac. 152; *Monarch Oil, Gas & Coal Co. v. Richardson*, 124 Ky. 602, 99 S. W. 668, 30 Ky. Law Rep. 824; *Dinsmoor v. Combs*, 177 Ky. 740, 198 S. W. 58; *Keystone Gas Co. v. Salisbury*, 192 Ky. 643, 234 S. W. 290; *Pelham Petroleum Co. v. North*, 78 Okla. 39, 188 Pac. 1069; *Brewster v. Lanyon Zinc Co.*, (8th Circ.) 140 Fed. 801, 72 C. C. A. 213.

¹⁷ *Day v. Kansas City Pipe Line So.*, 87 Kan. 617, 125 Pac. 43; *Pelham Petroleum Co. v. North*, 78 Okla. 39, 188 Pac. 1069.

¹⁸ *Becker v. Submarine Oil Co.*, 55 Cal. App. 698, 204 Pac. 245; *Harris v. Ohio Oil Co.*, 57 Oh. St. 118, 48 N. E. 502; *Grubb v. McAfee*, 109 Tex. 527, 212 S. W. 464. An early case in the Appellate Court of Indiana (*Carr v. Huntington Light & Fuel Co.*, 33 Ind. App. 1, 70 N. E. 552) asserts this view but seems clearly in conflict with the cases cited in note 16.

¹⁹ *Daughetee v. Ohio Oil Co.*, 263 Ill. 518; 105 N. E. 308; *Ohio Oil Co. v. Harris*, 57 Oh. St. 118, 48 N. E. 502; *Hall v. South Penn. Oil Co.*

²⁰ *White v. Green River Gas Co.* (6th Circ.) 8 F. (2d) 261.

that the lease should be cancelled. The decree was reversed, with instructions to take evidence as to the amount of territory that should be reserved around each well and to enter a decree cancelling the lease as to the residue of the premises.

The court does not seem entirely clear as to the ground upon which it bases its decision. Three separate theories are apparent in the opinion. The first seems to be that the lease, rightly construed, is to continue for a term of "five years and as much longer as either gas or oil is produced and sold therefrom in paying quantities," and that this last requirement has not been met. The answer to this seems to be that the lease does not make any such requirement. It expressly makes the continuance of the lease depend upon finding them in paying quantities. Where the continuance of the lease is predicated upon the discovery of "either gas, petroleum, coal or other mineral substances," it has been held that the court may not read into the instrument the words "in paying quantities."²¹ We have seen that a similar distinction is made between "produced" and "produced in paying quantities."²² But granting that it is proper to read the words, "in paying quantities," into the instrument, it does not follow that the lease in this case was subject to termination for want of production in paying quantities. The lessee considered the production sufficiently valuable to justify the payment of the stipulated rentals. Moreover, the result reached is inconsistent with this theory. If the lease had terminated by failure to find oil or gas in paying quantities, it was at an end as to the entire tract by virtue of its own terms.²³ Consequently, there is no basis upon which the lessee is entitled to hold the wells actually drilled, as he is permitted to do by the decision.

The second theory seems to be one of a forfeiture of the lease for breach of an implied covenant to operate the wells in which gas was found. The term implied covenant is not specifically employed by the court but the statement that the lessee must be charged with knowledge that "he would be required to find a market for that gas" strongly indicates this view. But the lessors secured all that they would have been entitled to in the way of rentals had the wells been operated, and there was no market for the gas, so it seems clear that there was no breach of the implied covenant for operation.

The third theory, and it is submitted the only one upon which the case can be supported, is that of a breach of the implied covenant for further development. As the court remarks, "Two wells in five years upon 900 acres of land would not seem to be a reasonable development." It is therefore possible to sustain the case upon the theory of a forfeiture for breach of the implied covenant for development.

²¹ *Texas Pacific Coal & Oil Co. v. Bratton*, (Tex. Civ. App.) 239 S. W. 688.

²² See authorities cited in note 3.

²³ See cases cited in note 2.

But as the drilling of further wells would have been a highly unprofitable adventure in the absence of a market for the gas, the propriety of the decision, even upon this theory, seems doubtful.

MAURICE H. MERRILL.

University of Idaho College of Law.