Implied Covenants in Oil and Gas Leases in the Appalachian Basin

James C. Wright
Brian J. Pulito
Cheryl L. Davis

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IMPLIED COVENANTS IN OIL AND GAS LEASES IN THE APPALACHIAN BASIN

By James C. Wright,¹ Brian J. Pulito,² & Cheryl L. Davis³

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¹ Member, Steptoe & Johnson PLLC; President, West Virginia State Bar, 2012-2013.
² Associate, Steptoe & Johnson PLLC.
³ Of Counsel, Steptoe & Johnson PLLC.

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I. Introduction

The primary purpose of the oil and gas lease is to hold the oil and gas for development by the lessee, yet most oil and gas leases are silent as to the obligations of the lessee with respect to the conduct of operations after oil and gas is discovered. Leases typically do not address, for example, how the oil and gas will be marketed or whether the operator has an obligation to explore potentially productive strata that are not yet proven. The law of implied covenants has and will continue to regulate the relationship of lessors and lessees in many significant respects because the lessors and lessees cannot anticipate all of the particular circumstances that will exist when production is realized and both parties want to avoid express, specific provisions that will govern situations that cannot be foreseen when the lease is executed.

The Appalachian states where oil and gas production in the Marcellus Shale and the Utica Shale is occurring either have limited oil and gas jurisprudence or have oil and gas jurisprudence that is decades old. Regardless, all relevant case law was established long before the advent of horizontal shale drilling operations. Thus, the boom in exploration and development of the Marcellus and Utica Shale formations will create a dynamic tension between the rights and responsibilities of the oil and gas owners and producers, which will lead to judicial examination of existing case law and development of new case law on implied covenants in oil and gas leases.

The purpose of this Article is to examine existing case law on implied covenants in oil and gas leases in the Appalachian Basin states, identify gaps in case law, and as far as reasonably possible, to predict...
the issues that might be litigated in the future in light of the rush to develop the Marcellus Shale and Utica Shale formations.

II. STANDARD OF COMPLIANCE: IMPLIED-IN-LAW OR IMPLIED-IN-FACT?

In reviewing whether an implied covenant exists, one must also determine the standards to which the operator is held in complying with implied covenants. Case law establishes three basic standards for compliance by the operator: (1) the duties are absolute, (2) the duties are governed by a test of good faith, and (3) the duties are governed by the prudent operator standard.

The absolute standard holds that the operator is liable without fault for nonperformance of implied covenants. This standard has not been applied in any of the Appalachian Basin states.

The second standard measures the performance of the operator by his subjective good faith. The prudent operator standard is accepted by the majority of jurisdictions in the United States, and there is presently no reason to believe that this standard will be abandoned by any of the states within the Appalachian Basin.

Why is this distinction significant? If implied covenants are implied in fact, the parties may more easily disclaim, alter, or omit them. If, however, implied covenants are implied by law to prevent inequity, a specific disclaimer, modification, or omission of an implied covenant should not be given effect by a court and the implied covenant should be enforced to insure a fair and equitable result between the parties to the lease. Proponents of the implied-in-fact theory argue that the lease does not state the entire agreement of the parties and that the implied covenants are used to fill in the gaps and reflect the unexpressed intention of the parties when the lease was executed. Proponents of the implied-by-law theory argue that implied covenants are implied by law to equalize the imbalance in bargaining power between the parties. Implied covenants in oil and gas leases are described by William & Meyers as reflecting a broader principle of law applicable to all contracts—the principle of cooperation that requires the parties to cooperate in order to carry out the purposes of the agreement.4

Unfortunately, there is no clear case law on this distinction in Ohio or West Virginia.

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A. West Virginia

1. Prudent Operator or Subjective Good Faith Standard of Review?

Early West Virginia case law appears to rely inconsistently on both the good faith test and the prudent operator test as a measure of the lessee’s performance of implied contracts. A later West Virginia case, Adkins v. Huntington Development and Gas Co., trends toward the prudent operator standard, holding that the operator must exhibit sound judgment and reasonable discretion for the mutual advantage of all parties to the contract. More recent West Virginia cases establish a clear trend toward the prudent operator standard. In St. Luke’s United Methodist Church v. CNG Development Co., the Court held the lessee to a standard of ordinary prudence and experience of oil and gas operators in the same neighborhood and under similar conditions. Thus, it appears that the West Virginia courts will continue to follow and develop the prudent operator standard.

2. Implied Duties Applied in West Virginia

West Virginia has adopted three implied covenants: (1) the implied covenant to protect from drainage, (2) the implied covenant of reasonable development, and (3) implied covenant to market the product.

a. Covenant to Protect from Drainage

Oil and gas, unlike coal, moves freely beneath the surface of the earth and can move towards wellbores on adjoining property. The implied covenant to protect from drainage, also referred to as the offset well covenant, protects the lessor from permanent loss of oil and gas due to migration of the hydrocarbons to neighboring lands. This standard requires a prudent operator, under certain circumstances, to drill offset wells to prevent that migration.

In West Virginia, a cause of action for breach of the implied covenant against drainage is established when the lessor shows that the drainage is substantial and that an offset well would produce oil and gas in paying quantities, i.e., in quantities sufficient to repay the lessee the cost of drilling the well and to return a profit on the lessee’s investment in the well. The lessee, however, cannot use lack of profit from drilling an offset well to justify fraudulent activity. In E. C. Dillard v. United Fuel Gas
Co., the Court considered a situation in which the lessee was draining gas from the land of the lessor through wells operated by the lessee on adjoining land under a separate oil and gas lease. In Dillard, the Court stated that the fact that the lessee could not profitably drill an additional well or wells on the tract owned by the aggrieved lessor is not controlling, and that the profitability of the lessee is subordinate to the equity of the owner of the oil and gas which was being improperly drained by the wells on the adjoining land.

The West Virginia Supreme Court has recognized that the lessor may seek cancellation of the lease where fraudulent acts of the lessee caused the drainage. The Dillard Court stated that fraudulent conduct that would justify lease cancellation includes both intentionally fraudulent conduct by operator and the operator's failure to act in good faith to protect the interests of the lessor. When drainage is not caused by the acts of the lessee, dictum in Dillard v. United Fuel Gas Co. indicates that damages are the lessor's sole remedy.

b. Implied Covenant of Reasonable Development

The implied covenant of reasonable development, also referred to as the implied duty to develop, imposes a duty on the lessee to extract the hydrocarbons without unreasonable delay. This duty binds the lessee to drill such additional wells as are needed to develop the land as a reasonably prudent operator would drill under similar circumstances.

In applying the prudent operator standard to the implied covenant of reasonable development, the West Virginia Supreme Court held that one must consider whether further development would mutually benefit the parties by obtaining a benefit or profit for both lessor and lessee. The Court recognized the large expense associated with exploration and development, that the lessee must bear the loss if the operations are not successful, and that the interests of the lessor and lessee must be balanced. No obligation rests on the lessee to carry operations beyond the point where they will be profitable to him, even if some benefit to the lessor will result. Further, the lessee, however, is not entitled to have the minerals extracted as fast as they can be produced or to the quickest possible financial return from gas wells on the lessor's land.

It is only where the oil and gas will be extracted with benefit or profit to both the lessor and lessee that reasonable diligence to de-
velop is required, and whether or not diligent development is required 
to be exercised must be viewed in terms of what would reasonably be 
expected of operators of ordinary prudence.\textsuperscript{16}

In \textit{St. Luke's United Methodist Church}, the lessors sought complete 
or partial recession of an 1898 oil and gas lease for an 850-acre tract of 
land.\textsuperscript{17} The lessors alleged that only three marginally productive oil 
and gas wells were drilled and that the lessee had failed to satisfy its 
duty to reasonably develop the 850-acre tract.\textsuperscript{18} The lessee argued 
that it stood ready to further develop the land by additional drilling 
activity.\textsuperscript{19}

The Court held that since the lessee had three currently producing 
wells and had expressed a willingness to drill additional wells, it stood 
to reason that the lessee should be given an opportunity to further 
develop the land and that the lessors had failed to establish undue 
hardship sufficient to justify full or partial rescission of the lease.\textsuperscript{20} 
The Court remanded the case to the trial court to establish a reasonable 
period of time for the lessee to develop and held that if the trial 
court found that no significant development had been made by the 
lessee at the end of that period of time, the trial court should take 
evidence on whether breach by the lessee of the implied covenant of 
development or undue hardship could be established.\textsuperscript{21}

In \textit{Cotiga Development Co. v. United Fuel Gas Co.}, the West Virginia Supreme Court held that the measure of monetary damages was 
royalties on the gas that should have been marketed from the leasehold during the period in question but that the lessee would have the 
right to offset and take credit for such sums, dollar for dollar, on gas 
thereafter marketed from the leased premises.\textsuperscript{22} Although this case 
involved the implied covenant to market, discussed \textit{infra}, it is reasonable 
to assume that the same standard would be applied to damages 
awarded for breach of the implied covenant to reasonably develop. 

c. \textit{Implied Covenant of Further Exploration}

The reasonable development covenant, discussed \textit{supra}, is concerned with additional drilling in a proven field while the further exploration covenant deals with additional drilling and potentially productive strata that are yet unproved. Commentators suggest that 
to establish breach of the covenant of further exploration, the lessor 
must show that under the circumstances the failure to drill exploratory

\textsuperscript{16} See \textit{St. Luke's United Methodist Church}, 663 S.E.2d at 645.
\textsuperscript{17} \textit{Id.} at 647.
\textsuperscript{18} \textit{Id.}
\textsuperscript{19} \textit{Id.}
\textsuperscript{20} \textit{Id.} at 647–48.
\textsuperscript{21} \textit{Id.} at 648.
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wells in search of new producing formations is unreasonable.\textsuperscript{23} The case law with respect to this covenant is not well developed in any jurisdiction. \textit{Parish Fork Oil Co. v. Bridgewater Gas Co.}\textsuperscript{24} holds that a lessee may not refuse to develop the property, tie up the oil by his lease, and simply hold it for speculative purposes; however, to await an operator's own pleasure as to the time of development, there is no indication that the West Virginia courts would impose an obligation on him to explore unproven strata.

d. Implied Covenant to Market the Product

Upon discovery of minerals, the lessee is ordinarily under an implied duty to use due diligence to market the product.\textsuperscript{25} Case law on whether the lessee is bound to use reasonable efforts to market the product once produced is scarce. In \textit{McGraw Oil \\& Gas Co. v. Kennedy}, the royalty clause provided for a payment of $200 per year per well producing gas when gas was used and sold off the premises. Although no gas was sold or used off the premises, the lessee paid the royalty.\textsuperscript{26} \textit{McGraw} holds that the lease cannot be cancelled for breach of the covenant to market since the lessor received his full royalty, i.e., $200 per year per well, despite the fact that the gas had not been marketed. The \textit{McGraw} case is over 100 years old and addresses a royalty clause not used in modern leases so it is not a basis to predict how this issue will be treated in West Virginia courts.

B. Ohio

1. Implied Duties Applied in Ohio

Ohio has adopted two implied covenants: (1) the implied covenant to protect from drainage and (2) the implied covenant of reasonable development.

2. Prudent Operator Standard

Ohio has followed the prudent operator standard for over a century. In \textit{Harris v. The Ohio Oil Co.},\textsuperscript{27} the Supreme Court of Ohio described the standard to which the lessee is held as that usually found in the same business of an ordinarily prudent man, neither the highest nor lowest, but about medium or average.

a. Implied Covenant to Protect from Drainage

Ohio courts recognize that if the leases are silent as to the drilling of other wells for the protection of the property liens from drainage,

\textsuperscript{23} WILLIAMS \\& MEYERS, supra note 4, § 841.
\textsuperscript{24} Parish Fork Oil Co. v. Bridgewater Gas Co., 42 S.E. 655, 661 (W. Va. 1902).
\textsuperscript{25} WILLIAMS \\& MEYERS, supra note 4, § 853.
\textsuperscript{26} McGraw Oil \\& Gas Co. v. Kennedy, 64 S.E. 1027, 1027 (W. Va. 1909).
\textsuperscript{27} Harris v. Ohio Oil Co., 48 N.E. 502, 505 (Ohio 1897).
there is an implied lease covenant on the part of the lessee that he will drill and operate wells as would ordinarily be required for production of oil and gas contained in the leased land and afford ordinary protection against drainage. The Harris Court held that damages were the only appropriate remedy for breach of the implied covenant to protect against drainage unless the express terms of the lease provides that breach of such an implied covenant to develop or avoid or forfeit the lease.

The drainage cases discussed above involve traditional vertical wells. It is not clear if the drainage issues asserted by lessors in a vertical drilling situation will arise when the wells are horizontal shale wells. If drainage claims are asserted in regard to horizontal wells, the difficulty in proving the cause and extent of any drainage will be magnified many times due to the nature and scope of horizontal wells drilled from multiple well pads with laterals extending for thousands of feet versus a vertical well. If drainage claims are litigated in horizontal well drilling, the older jurisprudence on drainage and vertical wells will have to be examined and perhaps revised to account for the horizontal drilling techniques and technology.

b. Implied Covenant of Reasonable Development

The Ohio Supreme Court holds that damages are the only appropriate remedy for breach of the implied covenant to develop unless the express terms of the lease provides that breach of such an implied covenant to develop or avoid or forfeit the lease. The Harris Court referred to a Pennsylvania case, Bradford Oil Company v. Blair, for the measure of monetary damages in such cases. The Bradford Oil case involved a claim by the lessor that the lessee had not developed land subject to an oil lease. There was evidence to show that proper development of the land required an oil well for every five acres of land, but the lessor had only drilled two oil wells on the 154-acre lease tract. The measure of monetary damages for the failure to develop was held to be the value of the lessor's one-eighth royalty on oil that should have been produced, minus the cost of producing that oil under the circumstances and appliances then known, and upon the balance, interest would be computed from the time the oil should have been produced to the time of the computation of damages. Given the rapid pace of leasing activity in Ohio due to the exploration of the Utica Shale formation, it is likely that the Harris decision will be challenged by landowners seeking forfeiture of older oil and gas.

29. See Harris, 48 N.E. at 506.
30. See id.
leases so that they can lease the oil and gas underlying their land on more favorable economic terms.

C. Pennsylvania

Pennsylvania courts apply the subjective good faith standard. Additionally, Pennsylvania courts have expressly recognized an implied covenant to develop, to protect, and to market.

1. Prudent Operator or Subjective Good Faith Standard of Review?

It is unclear as to which standard, prudent operator or subjective good faith, applies in Pennsylvania. Some point to the supreme court case of Ray v. W. Pennsylvania Natural Gas Co. as proof that the prudent operator standard, and not the subjective good faith, is the standard applied in Pennsylvania.

However, a careful reading of Ray reveals that the Court there did not have to reach a conclusion on whether the prudent operator standard applied. In Ray, the Court never directly reached a conclusion as to which standard of review to apply to the lessee’s breach. Rather, the lease by its own terms required that the lessee drill a defined number of wells within a limited period of time.

The likely genesis for confusion as to which standard applies in Pennsylvania is the misreading by some of the Pennsylvania Supreme Court decision of Kleppner v. Lemon. The Court in Kleppner found that it was the express intent of the lessee to drain the lessor’s property from under the lessor’s neighbor’s land, on which the lessee also had wells.

From that fact, the Court held that

[t]he number and location of the wells necessary to carry out the purposes of the [lease] is a subject belonging primarily to the lessee.

... the lessee is bound to take into consideration the fact that his

32. See George A. Bibkos & Jeffrey C. King, A Primer on Oil and Gas Law in the Marcellus Shale States, 4 TEX. J. OIL GAS & ENERGY L. 155, 173 (2009) (noting apparent conflict of authority between Pennsylvania cases over whether reasonably prudent or subjective good-faith standard applies); but see 2 SUMMERS OIL & GAS § 18:4 (3d ed.) (writing that Pennsylvania applies the reasonable good-faith standard and contrasting Pennsylvania with other jurisdictions in which the prudent operator standard is applied).


34. Id. Moreover, not one Pennsylvania Supreme Court decision in which Ray was cited ever held that Ray adopted either the reasonably prudent operator standard or the subjective good-faith standard; instead, those courts cite Ray as an example of an early case that applied the implied duty to develop. See, e.g., Higbee v. Marietta, 131 A. 235, 235 (Pa. 1925).

35. See Kleppner v. Lemon, 35 A. 109 (Pa. 1896). Some commentators argues that the supreme court case of McKnight v. Mfrs. ' Natural Gas Co., 146 Pa. 185 (1892) also “reflected” the prudent operator standard.

36. Id. at 109.
lessor is the owner of the oil, and to arrange and conduct his efforts to bring it to the surface in such manner as shall best protect the interests of both parties to the contract.\textsuperscript{37}

The Court then went on to write that

[the lessee] is not bound to put down more wells than are reasonably necessary to obtain the oil of his lessor, nor to put down wells that will not be able to produce oil sufficient to justify the expenditure.\textsuperscript{38}

The Court finally concluded that in this case, the lessee was obligated to drill additional wells because it was unjust and fraudulent to permit the lessee to drain the lessor's property:

But that the oil may be obtained in time through other wells, on the lands of other owners, is not enough to excuse the lessee from his implied undertaking to operate the land for the best interests of both owner and operator.\textsuperscript{39}

\textit{Kleppner} is best reserved to its facts. In \textit{Kleppner}, there was incontrovertible evidence that the lessee acted in bad faith.\textsuperscript{40}

Any confusion as to which standard Pennsylvania applies is now resolved from a reading of the case law that emerged subsequent to \textit{Kleppner}. Other decisions of the Pennsylvania Supreme Court expressly adopt the subjective good faith standard.\textsuperscript{41} In \textit{Young v. Forest Oil Co.}, the Pennsylvania Supreme Court applied the subjective good faith standard.\textsuperscript{42} In \textit{Young}, the Court wrote that absent a showing of bad faith—fraud—on the part of the lessee in not drilling more wells, the lessee is not in breach:

[T]he operator, who has assumed the obligations of the lease, has put his money and labor into the undertaking, and is now called upon to determine whether it will pay to spend some thousands of dollars more in sinking another well to increase the production of

\textsuperscript{37} Id. at 110.
\textsuperscript{38} Id.
\textsuperscript{39} Id.
\textsuperscript{40} Id.; see Adams v. Stage, 18 Pa. Super. 308, 311 (1901) (holding Kleppler should be limited to its facts); Colgan v. Forest Oil Co., 45 A. 119, 120 (Pa. 1899); Young v. Forest Oil Co., 45 A. 121, 122 (Pa. 1899) ("[Klepper] rested on fraud alleged and proved, and fraud in fact, not merely inferred from a difference of judgment between the defendant and the court as to the profitable development of the leased premises."); Highfield Co. v. Kirk, 93 A. 815, 817 (Pa. 1915) (analogizing to Kleppner on grounds that the court there ruled on basis that lessee committed fraud). See also 2 Summers Oil \& Gas § 18:4 (3d ed.) (writing that Kleppner stands not as a case adopting the prudent operator standard but rather, as one in which the supreme court announced the baseline standard for review of a lessee's conduct: the mutual benefit of both lessee and lessor taking into consideration the circumstances of each lease).
\textsuperscript{41} See Young, 45 A. at 122 (holding trial courts misapplied the holding in Kleppner: "[Klepper] rested on fraud alleged and proved, and fraud in fact, not merely inferred from a difference of judgment between the defendant and the court as to the profitable development of the leased premises.").
\textsuperscript{42} Id.
the tract, is entitled to follow his own judgment. If that is exercised in good faith, a different opinion by the lessor, or the experts, or the court, or all combined, is of no consequence, and will not authorize a decree interfering with him.\(^{43}\)

Likewise, in \textit{Adams} v. \textit{Stage}, the Pennsylvania Superior Court also applied the subjective good faith standard.\(^{44}\) Again in \textit{Colgan} v. \textit{Forest Oil Co.}, the supreme court applied the subjective good faith standard and expressly rejected the application of the prudent operator standard.\(^{45}\) In support it wrote the following:

So long as the lessee is acting in good faith on business judgment, he is not bound to take any other party’s, but may stand on his own. Every man who invests his money and labor in a business does it on the confidence he has in being able to conduct it in his own way. No court has any power to impose a different judgment on him, however erroneous it may deem his to be. Its right to interfere does not arise until it has been shown clearly that he is not acting in good faith on his business judgment, but fraudulently, with intent to obtain a dishonest advantage over the other party to the contract.\(^{46}\)

Most recently, the subjective good faith standard was applied by the Pennsylvania Superior Court in \textit{T.W. Phillips Gas \\& Oil Co. v. Jedlicka}.\(^{47}\) At issue in \textit{Jedlicka} was whether a one-year lapse in production was sufficient to hold that the lease had not produced in paying quantities.\(^{48}\) The superior court held that simply showing no profits for a period of one year was not by itself proof that the lease did not produce in paying quantities.\(^{49}\) Rather, relying on \textit{Young v. Forest Oil}, the court held that in addition to a lease not being profitable in a given period, the lessor must also show that the lessee holds the lease in bad faith.\(^{50}\)

\(^{43}\) Id. In \textit{dicta}, the court in \textit{Young} also addressed whether the lessee had failed to produce oil or gas from the lease in paying quantities as required by the lease. \textit{Id.} In response, the court held that any analysis of the same also required a showing of bad faith by the lessee. \textit{Id.} at 250–51.

\(^{44}\) \textit{Adams}, 18 Pa. Super. at 312 (1901) (holding that absent fraud, a “lessee was not bound to work unprofitably to himself for the profit of the lessor”).

\(^{45}\) \textit{Colgan}, 45 A. at 120.

\(^{46}\) \textit{Id.} at 121.

\(^{47}\) \textit{T.W. Phillips Gas \\& Oil Co. v. Jedlicka}, 964 A.2d 13, 16 (Pa. Super. Ct. 2008); Annotation, \textit{Extent of Development Necessary to Comply with Express or Implied Covenant of Oil and Gas Lease as to Development}, 93 A.L.R. 460 (originally published in 1934); see also \textit{Adams}, 18 Pa. Super. at 312 (“[Q]uestion involving business judgment and management, the lessee was not bound to work unprofitably to himself for the profit of the lessor, and the question of further exploration was primarily to be determined by him who would have to foot the bill. If the judgment of the defendant was exercised in good faith, and involved no manifestly fraudulent use of opportunities, we cannot say that he failed to discharge any duty to the plaintiff arising out of his contract and the operations thereunder. . . .”).

\(^{48}\) \textit{T.W. Phillips Gas \\& Oil Co.}, 964 A.2d at 19.

\(^{49}\) \textit{Id.}

\(^{50}\) \textit{Id.}
The court held that the appellant failed to carry its burden to prove that the defendant was holding the lease in bad faith. The appellants in Jedlicka argued in favor of the court applying the prudent operator standard. The court expressly rejected that argument.

2. Implied Duties Applied in Pennsylvania

Pennsylvania has directly adopted three implied covenants: (1) the implied covenant to develop, (2) the implied covenant to market, and (3) the implied covenant to protect against drainage.

a. Implied Covenant to Develop

The most recent decision to address the implied covenant to develop is Jacobs v. CNG Transmission Corp. In Jacobs, the Pennsylvania Supreme Court took a certified question from the Third Circuit on whether Pennsylvania recognized an implied duty to develop in an oil and gas lease. In Jacobs, the Court specifically held that Pennsylvania did recognize an implied covenant to develop.

The Court did note that the duty was limited to only those leases that are silent on the number of wells to drill or to those leases in which a royalty on production is the only contemplated method of payment to the lessor. The Court explained that

[w]here . . . the parties have expressly agreed that the landowner shall be compensated if the lessee does not actively extract the resource, then the lessee has no implied obligation to engage in extraction activities. Thus, so long as the lessee continues to pay the landowner for the opportunity to develop and produce oil or gas, the lessee need not actually drill wells. At the point where that compensation ceases due to the expiration of the term of the lease, or pursuant to the terms of the lease itself, the lessee then has an affirmative obligation either to develop and produce the oil or gas or terminate the landowner's contractual obligations.

51. Id.
52. Id.
55. Id. at 446.
56. Jacobs, 772 A.2d at 252–53. Previously, the Pennsylvania Supreme Court wrote in dicta that in every oil and gas lease, there is an implied duty to develop. Stoddard v. Emory, 18 A. 339, 339 (Pa. 1889). The plaintiff in Stoddard sued for breach of an oral agreement to drill more wells than provided for in the lease. Id. The lease called for the lessee to drill one well within eight months and another at an unspecified time. Id. The Court held that the implied covenant to develop did not apply because the lease expressly called for the drilling of a specific number of wells. Id. at 339–40. The Court held that the implied covenant to develop is obviated when a lease calls for an express number of wells to be drilled. Id.
57. Id. at 451.
58. Id. at 455; see Jacobs v. CNG Transmission Corp., 332 F. Supp. 2d 759, 791 (W.D. Pa. 2004) (holding that when a lease is silent on the strata from which a lessee...
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b. Implied Covenant to Market

As with the implied covenant to develop, Pennsylvania was also the first jurisdiction to recognize that every oil and gas lease contains an implied duty to market. 59 That duty was first recognized in Iams v. Carnegie Natural Gas Co. 60 The lease in Iams provided that if the lessor found gas in sufficient quantities to “justify marketing,” that it would provide the lessor with a royalty equal to one-eighth of production. 61 The lessee found gas on the property but refused to market it. 62 The Court held that the lessee was required to market the gas and that such a duty was implied in every oil and gas lease. 63 That duty, the Court explained, does not require that the lessee to market his gas at a loss. 64 Rather, considerations such as distance to market and costs to transport the same are taken into consideration to determine if the duty to market was breached. 65

Until recently, there have not been many cases in which the duty to market or Iams were discussed. Recently, the decision of Iams and the concept of the implied covenant took on new significance with the filing of lawsuits under the Minimum Royalty Act (“MRA”). The MRA provides that

[a] lease or other such agreement conveying the right to remove or recover oil, natural gas or gas of any other designation from lessor to lessee shall not be valid if such lease does not guarantee the lessee at least one-eighth royalty of all oil, natural gas or gas of other designations removed or recovered from the subject real property. 66

The plaintiffs in those lawsuits argued that any oil and gas leases in which the lease permitted certain post-production deductions, such as the cost to transport, compress, or dehydrate natural gas, violated the MRA because the same would not net to the landowner a sum greater than one-eighth of the value of the oil and gas recovered from the lease. 67

In Kilmer v. Elexco Land Services, Inc., the Pennsylvania Supreme Court took extraordinary jurisdiction to address whether such deduc-

60. Id.
61. Id.
62. Id.
63. Id.
64. Id.
65. Id.; see also Summerville v. Apollo Gas Co., 56 A. 876, 877 (Pa. 1904) (holding that there was no duty to market oil or gas where the lease provided for a set rental in order to hold the lease); Clark v. Wright, 166 A. 775, 778 (Pa. 1935).
tions violate the MRA.68 In Kilmer, the plaintiffs argued, inter alia, that under lams, Pennsylvania adopted the first marketable product doctrine,69 which requires that in the absence of contrary language in an oil and gas lease, a lessee has a duty to incur all the costs associated with getting his gas to market.70

The Court in Kilmer expressly rejected the first marketable product doctrine.71 Importantly, however, the Court in Kilmer did not overturn lams. Rather, the Court refused to extend lams to require that the lessee, in addition to marketing gas, also had a duty to incur the costs of making that gas marketable.

c. Duty to Protect Against Drainage

One commentator has argued that the duty to protect is “subsumed” within the duty to develop.72 As that commentator noted, in Kleppner, the Court analyzed the duty to develop and the duty to protect as a single concept.73

3. Impact of Breaching an Implied Covenant
   Under Pennsylvania Law

Pennsylvania holds firm to the majority rule of law that the breach of an implied covenant does not subject the lessee to forfeiture of the lease unless the lease specifically calls for forfeiture.74 Instead, the courts have held that breach of contract is the most appropriate form

68. Id.; see also 42 PA. CONS. STAT. ANN. § 726 (West 2011) (authorizing the Supreme Court to take an appeal and bypass the intermediate court of appeals through extraordinary jurisdiction).
69. Kilmer, 990 A.2d at 1152.
70. Id.
71. Id. at 1153.
72. Bibikos & King, supra note 32, at 177.
73. Id.; see also Adams v. Stage, 18 Pa. Super. 308, 311 (1901) (discussing, without real distinction, the duties to protect against drainage and to develop); Munroe v. Armstrong, 96 Pa. 307, 310 (1880).
74. See, e.g., Girolami v. Peoples Natural Gas Co., 76 A.2d 375, 377 (Pa. 1950) (holding that absent an express forfeiture clause, there was no right to a judicial forfeiture in an oil or gas lease for failure to pay delay rental); Myers v. Ohio-Penn Gas & Oil Co., 144 A. 93, 96 (Pa. 1928) (“[F]orfeiture is not a favorite of the law . . .”); Penn-Ohio Gas Co. v. Franks’ Heirs, 185 A. 280, 282 (Pa. 1936) (“equity abhors a forfeiture”); Scilly v. Bramer, 85 A.2d 592, 593–94 (Pa. Super. Ct. 1952) (“[F]orfeiture is not looked upon with favor; that the right to declare a forfeiture must be distinctly reserved . . .”) (emphasis added). See also Williams & Meyers, supra note 4, at § 656.3 (“We are aware of no cases from other states [permitting judicial forfeiture for non-payment of royalties] absent an express forfeiture clause in the lease and we are of the opinion that other states should not follow the Louisiana cases in this regard. Other remedies for nonpayment of royalty are adequate and there is no necessity of adopting the punitive sanction of cancellation.”).
of relief. In this way, Pennsylvania follows the maxim that equity abhors forfeiture.

D. New York

New York does not have a developed oil and gas jurisprudence. What case law it does have on the subject reveals that New York likely adopts the implied covenant to market and applies the prudent operator standard.

1. Subjective Good Faith or Prudent Operator Standard of Review?

The New York Supreme Court Fourth Appellate Department applied the prudent operator standard to an oil and gas lease. The lawsuit was over several oil and gas leases that the defendant held pursuant to a statutory pooling agreement. The owners of several top leases sued for, inter alia, a declaratory judgment to have the underlying leases terminated. In support, the plaintiffs argued that the defendant had pooled the leases in bad faith. The trial court dismissed the complaint in favor of the defendant.

The intermediate appellate court overturned the trial court's decision. In reaching its conclusion, the court looked to the jurisprudence of other oil and gas producing states and held that

[i]t is not disputed that the purposes of unitization and pooling agreements are to permit the greatest extraction of oil or gas with the least waste, to eliminate unnecessary drilling and to permit the most equitable distribution of royalties among the landowners . . . . In jurisdictions where oil and gas wells are more numerous than in New York, it is the general rule that the lessee must exercise its pooling authority in good faith and as a prudent operator . . . . The rule should also be applied in New York . . . .

The court further reasoned that the prudent operator standard is appropriate because there is an implied duty of good faith and fair dealing in every New York contract. Most recently in Nickerson v.

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75. See, e.g., Girolami, 76 A.2d at 377 (holding that absent an express forfeiture clause, the appropriate remedy is one in damages for breach of the covenant of the lease).
76. Under Pennsylvania law, forfeiture clauses are highly disfavored and are thus, strictly construed. See, e.g., id.; Penn-Ohio Gas Co., 185 A. at 282; Scilly, 85 A.2d at 593.
78. Id.
79. Id. at 119–20.
80. Id. at 121.
81. Id.
82. Id. at 122 (citations omitted).
83. Id. (citing Boone, 217 F.2d 63); but see Ball v. Ball, 244 N.Y.S. 300, 300 (N.Y. Sup. Ct. 1930) (holding that the implied covenant to develop does not apply to "wild
Winkle, the court applied the prudent operator standard to another bad-faith pooling case.\textsuperscript{84}

2. Implied Duties Applied in New York

New York recognizes at least two implied covenants in every oil and gas lease: (1) the implied covenant to develop and (2) the implied covenant to market.

\textit{a. Implied Covenant to Develop}

The implied duty to develop was recognized in Becker v. New Penn Development Corp.\textsuperscript{85} Becker was decided on \textit{res judicata}.\textsuperscript{86} In the lawsuit from which the defense of \textit{res judicata} was raised, "Action No. 1," the plaintiff filed a lawsuit alleging causes of action based on, \textit{inter alia}, breach of the implied covenant to develop.\textsuperscript{87} The plaintiff acknowledged that the evidence for both causes of action was identical, but at the close of evidence in Action No. 1, the plaintiff withdrew its complaint regarding the breach of the implied covenant.\textsuperscript{88} At that time, the plaintiff was awarded and paid a judgment based upon a violation of the express covenant.\textsuperscript{89} Later in Becker, the plaintiff attempted to recover based upon the alleged breach of the implied covenant.\textsuperscript{90} The court did not reach the merits of the argument. Instead, the court declared that the plaintiff should be barred from bringing those claims because at the time of Action No. 1, the latter cause of action was ripe and involved the same parties.\textsuperscript{91} The New York Court of Appeals affirmed this holding.\textsuperscript{92}

\textit{b. Implied Covenant to Market}

The implied duty to market was recognized in Cherry v. Resources American, Inc.\textsuperscript{93} There, the lessors sued the lessee, requesting damages for, \textit{inter alia}, breach of the lessor’s fiduciary duty.\textsuperscript{94} In support of that claim, the lessee alleged that the lessor manipulated the resale price of the natural gas produced from the lease.\textsuperscript{95} The lower court

\begin{itemize}
  \item \textsuperscript{87} See id. at 838.
  \item \textsuperscript{88} id.
  \item \textsuperscript{89} id. at 838–39.
  \item \textsuperscript{90} id.
  \item \textsuperscript{91} id.
  \item \textsuperscript{92} See Becker v. New Penn Dev. Corp., 74 N.E.2d 193, 193 (N.Y., 1947).
  \item \textsuperscript{94} id. at 989.
  \item \textsuperscript{95} id.
\end{itemize}
denied the defendant's motion, from which an appeal was taken. In support, the court recognized an implied duty to market that originated from the duty of good faith and fair dealing implied in every contract. The intermediate appellate court of New York, in La Barte v. Seneca Resources Corp., also recognized an implied duty to market when it wrote the following:

[I]n at least one oil-producing State, it has been recognized that the operator of an oil and gas lease owes a fiduciary duty to royalty owners to market oil or gas at the highest market price available...

The court in La Barte reserved ruling that a lessee's actions violated that duty until it was determined if that duty was separate from any express duties contained in the lease.

3. Impact of Breaching an Implied Covenant
Under New York Law

In certain cases, New York courts will permit forfeiture for the breach of an implied covenant to develop. However, the lessor must first demand that the lessee develop the lease. Failure of the lessee to develop in accordance with that demand will then entitle the lessor to sue to forfeit the lease for breach of the implied duty to develop. Additionally, where the lease permits payment of a rental and does not provide a definite timeline within which the lease must be developed, the court will not permit a forfeiture. In Ball v. Ball, the court wrote in dictum that the absence of a forfeiture clause also precluded the grant of forfeiture.

E. Kentucky

Kentucky courts apply the prudent operator standard. Additionally, Kentucky courts recognize several implied covenants in any oil and gas lease.

96. Id.
97. Id. at 990.
98. Id.
100. Id.
101. Id.
102. Ball v. Ball, 244 N.Y.S. 300, 304 (N.Y. Sup. Ct. 1930) (citing Monarch Oil, Gas & Coal Co. v. Richardson, 99 S.W. 668, 668 (Ky. 1907)).
103. Id.
104. Id.
105. Id.
1. Subjective Good Faith or Prudent Operator Standard of Review?

In older cases, Kentucky applied the subjective good faith standard. One of the first cases to apply that standard was Union Gas & Oil Co. v. Diles. In Union, the lessor attempted to invalidate an oil and gas lease under a statute that was enacted after the execution of that lease. That statute required the lessee to drill an additional well on the lease upon notice to the lessee that a producing oil well had been drilled on adjoining property and within 200 feet of the lessor's line. When the lessee failed to drill an offset well, the lessor sought cancellation of the lease. The trial court granted judgment in favor of the lessor. The lessee appealed.

On appeal, the Court held that the lease did not require that the lessee protect against drainage under his neighbor's property. The Court did hold that there was an implied obligation in every lease to protect against the same. The Court noted that the implied covenant to protect against drainage was a general obligation and did not require that the lessee locate a well at a specific location. Furthermore, that obligation was exercised by the lessee under his good faith judgment. The Court held that the statute was unconstitutional because it upset the express and implied obligations of the parties established in the lease. The Court wrote that

the act was unconstitutional as impairing [the parties'] obligation. When the [lease] was entered into the general implied obligation rested upon the lessee to protect the leased property from drainage, and he had the right to exercise his judgment and discretion in good faith in determining when and how and to what extent such protection should be given, if at all. The statute in question, however, not only deprives him of the right which he had under the original contract to exercise his judgment and discretion, but it imposed upon him and undertakes to read into his contract an absolute duty upon his part to drill an offset well, if the well on the adjoining property is within 200 feet of the property line, and to complete such well diligently, or suffer the penalty of having his rights under the lease destroyed.

106. Union Gas & Oil Co. v. Diles, 254 S.W. 205, 207 (Ky. 1923).
107. Id. at 206.
108. Id.
109. Id.
110. Id.
111. Id.
112. Id.
113. Id.
114. Id.
115. Id.
116. Id. at 207.
117. Id.
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In 1957, in McMahen v. Boggess, the Kentucky Supreme Court expressly adopted the prudent operator standard and expressly rejected the subjective good faith standard.\textsuperscript{118} In McMahen, the lease was for a primary term of five years and for so long thereafter as gas or oil was produced.\textsuperscript{119} The lessees drilled one well that did not produce much oil, and the lessors demanded further development.\textsuperscript{120} When the lessee refused, the lessors sued to invalidate the lease.\textsuperscript{121} The Court held that the lease contained an implied obligation to develop the leasehold in good faith and with reasonable diligence.\textsuperscript{122} The lessees argued that any requirement to develop the lease with due diligence was governed by the good faith subjective standard.\textsuperscript{123} The Court expressly rejected this argument:

[The subjective good faith standard] is not the law of Kentucky. A lessee under a lease of this sort owes a duty of diligence which would be reasonably expected of an operator of ordinary prudence, having due regard for both the interest of the lessee and the interest of the lessor.\textsuperscript{124}

The Court held that the evidence at trial supported a finding that the lessee had not diligently developed the lease.\textsuperscript{125}

2. Specific Implied Covenants

Kentucky courts appear to recognize several implied covenants: (1) duty to develop, (2) duty to market, and (3) duty to protect against drainage.

a. Duty to Develop

From early in Kentucky's oil and gas jurisprudence, Kentucky courts have imposed an implied covenant in every lease to develop the lease.\textsuperscript{126} That duty requires that the lessee diligently attempt to explore for and develop an oil and gas lease.\textsuperscript{127} In Wilson v. Wilson, the Court of Appeals for Kentucky upheld a finding from the trial court below sitting in equity that an oil and gas lessee had failed to diligently develop his lease.\textsuperscript{128} In Wilson, the lessee was sued in equity to forfeit

\begin{itemize}
  \item \textsuperscript{118} McMahen v. Boggess, 302 S.W.2d 592, 594 (Ky. 1957).
  \item \textsuperscript{119} Id.
  \item \textsuperscript{120} Id.
  \item \textsuperscript{121} Id.
  \item \textsuperscript{122} Id.
  \item \textsuperscript{123} Id.
  \item \textsuperscript{124} Id.
  \item \textsuperscript{125} Id.; see also Hayes v. Equitable Energy Res. Co., 266 F.3d 560, 567 (6th Cir. 2001); Williams & Meyers, supra note 4, at § 806.2 (writing that Kentucky law applies the prudent operator standard).
  \item \textsuperscript{126} Wilson v. Wilson, 133 S.W.2d 722, 723 (Ky. 1939).
  \item \textsuperscript{127} Id.
  \item \textsuperscript{128} Id.
\end{itemize}
his lease for breach of the implied covenant to develop. The facts presented to the chancellor in equity revealed that the lessee began to drill but ceased drilling soon thereafter. The trial court granted a judgment in favor of the lessors. The court of appeals upheld the decision of the trial court.

In Kentucky, the duty to develop is not absolute. It gives way to cases in which the lease makes development discretionary. In Oliver v. Louisville Gas & Electric Co., the Court of Appeals of Kentucky held that a lessee had not breached an implied covenant to develop because the lease did not mandate that the lessee develop or drill any wells. The lease had a primary term of twenty years and for so long thereafter as the lease is used for the underground “storage of gas.” The lessee sued to invalidate the lease. On cross-motions for summary judgment, the trial court ruled that “the express language of the leases negated any implied covenant to drill and develop.” The court of appeals affirmed the trial court’s ruling that the express language of the leases negated any implied covenant to drill and develop. In support, the court noted that

while it is true that under some circumstances there exists an implied covenant in oil and gas leases that a reasonable attempt will be made to explore and develop the resources, there is no room for an implied covenant where the lease agreement itself makes the matter of development discretionary with the lessee. . . . A contract between parties dealing in oil and gas is subject to the same rules of construction as any ordinary contract, and courts will not undertake to write a different contract or alter terms where the parties’ intent is clearly expressed . . .

Because the lease permitted the storage of natural gas and did not mandate the development of the lease through drilled gas wells, the storage of natural gas was permissible to hold the lease and obviated the implied covenant to develop.

129. Id. at 722.
130. Id.
131. Id. at 723.
132. Id.
134. Id.
135. Id. at 510.
136. Id. at 511.
137. Id.
138. Id.
139. Id.
140. Id.
141. Id.
b. Duty to Market

The duty to market was recognized in Swamp Branch Oil & Gas Co. v. Rice.\(^{142}\) In that case, the Court addressed whether the lessee had exercised due diligence to market the gas available from gas wells it drilled upon the land of the lessor.\(^{143}\) The trial court had awarded judgment in favor of the lessor.\(^{144}\) The Court reversed the judgment.\(^{145}\) The Court held there was not sufficient evidence produced before the trial court that established that the lessee had not acted diligently in attempting to market the gas produced from the lease.\(^{146}\) The Court did note that there was an implied obligation on the part of the lessee to exercise ordinary diligence to market oil and gas from producing wells.\(^{147}\) That duty did not extend to require the lessee to market the gas in cases where doing so was impossible.\(^{148}\) Because the facts of record indicated that marketing the gas would be difficult or impossible, the Court held that the lessee acted diligently.\(^{149}\)

c. Duty to Protect Against Drainage

Kentucky courts have recognized the implied duty to protect against drainage. In Central Kentucky Natural Gas Co. v. Williams, the court of appeals heard a lawsuit in which the lessors sued to have the lease invalidated for breach of the implied duty to develop.\(^{150}\) The lessors had demanded that the gas company drill additional wells on their land to avoid what they perceived was the drainage of their natural gas from wells drilled by the lessee on neighboring land, and the lessee refused.\(^{151}\) A chancellor held for the lessors, and the lessee appealed.\(^{152}\) The court of appeals reversed.\(^{153}\) The court acknowledged that there is an implied duty to protect against drainage in every oil and gas lease.\(^{154}\) In support, the court wrote the following:

Where adjoining premises are operated or wells are being drilled, whether by the same or different operators, the doctrine of implied covenant imposes the duty upon the lessee, or owner of the lease, to protect the lessor against drainage from wells on the adjoining premises, and on default thereof the lessor may recover damage.\(^{155}\)

\(^{142}\) Swamp Branch Oil & Gas Co. v. Rice, 70 S.W.2d 3, 4 (Ky. 1934).
\(^{143}\) Id.
\(^{144}\) Id.
\(^{145}\) Id. at 5.
\(^{146}\) Id.
\(^{147}\) Id.
\(^{148}\) Id.
\(^{149}\) Id.
\(^{150}\) Cent. Ky. Natural Gas Co. v. Williams, 60 S.W.2d 580, 582 (Ky. 1933).
\(^{151}\) Id.
\(^{152}\) Id. at 580.
\(^{153}\) Id. at 584.
\(^{154}\) Id. at 583.
\(^{155}\) Id. at 583–84.
While acknowledging the duty, the court of appeals ultimately held that the lessors' claims failed due to a lack of proof and because they were speculative.156

3. Impact of Breaching an Implied Covenant to Develop Under Kentucky Law

Kentucky courts permit a forfeiture of an oil and gas lease for breach of the implied covenant to develop.157 In Monarch Oil, Gas & Coal Co. v. Richardson,158 the court of appeals held that

[fl]orfeitures for nondevelopment or delay [are] essential to private and public interest in relation to the use and alienation of property. Perhaps in no other business is prompt performance of contracts so essential to the rights of the parties, or delay by one party likely to prove so injurious to the other.159

Typically, a lessor must provide the lessee with notice of default and demand the lessee develop the lease before the lessor is entitled to seek forfeiture.160 However, a demand is not required in all cases. In American Wholesale Corp. v. F. & S. Oil & Gas Co., the court of appeals held that notice to the lessee was unnecessary where "abandonment of the [lease] may be inferred from the fact the lessee has been in default for an unreasonable time or has intentionally breached the obligations of the expressed or implied covenants."161

F. Tennessee

Tennessee courts apply the prudent operator standard. Tennessee courts have also recognized several implied covenants: (1) to drill an exploratory well, (2) to drill offset wells, (3) to drill additional wells during and after the exploratory period, and (4) to diligently operate and market the lease.

1. Subjective Good Faith or Prudent Operator Standard of Review?

While the courts in Tennessee have not directly referred to the standard of review they apply, it is likely that the standard they have applied is the prudent operator standard. In those cases in which the standard is discussed, the courts refer to the lessee's obligation to "diligently" operate under the lease.162

156. Id. at 584.
157. Monarch Oil, Gas & Coal Co. v. Richardson, 99 S.W. 668, 669 (Ky. 1907).
158. Id. at 668.
159. Id. at 669.
160. See id. at 669.
2. Specific Implied Covenants

While Tennessee courts have recognized several implied covenants, the courts have not specifically addressed the same in any reported case law.\textsuperscript{163} Instead, several cases have held that Tennessee has four implied covenants: (1) to drill an exploratory well, (2) to drill offset wells, (3) to drill additional wells during and after the exploratory period, and (4) to diligently operate and market the lease.\textsuperscript{164} These duties are waived if they conflict with the express terms of the lease.\textsuperscript{165}

3. Impact of Breach of an Implied Covenant to Develop Under Tennessee Law

Where an oil and gas lease is still in its primary term, Tennessee courts will speedily provide for the remedy of forfeiture. Where the lease enters its secondary term and thus becomes vested, Tennessee courts are more hesitant to provide such relief. In \textit{Benedum-Trees Oil Co. v. Davis}, the Sixth Circuit provided that

\begin{quote}
[w]here the right is inchoate, courts of equity quickly enforce forfeitures for failure of the lessee to comply substantially with the express or implied conditions of the lease. Where rights have vested, as here, leases will not terminate except pursuant to an express or implied condition. An implied condition may be inseparably annexed to a grant from its essence and constitution, although no condition be expressed in words.\textsuperscript{166}
\end{quote}

III. Conclusion

Litigation of this implied covenant is likely in the shale areas. Leasing of shale oil and gas production rights is proceeding at a frenzied pace. Low gas prices, lack of gathering and interstate pipeline infrastructure to move the gas from the well head to market, insufficient

\begin{footnotesize}163. Benedum-Trees Oil Co. v. Davis, 107 F.2d 981, 985 (6th Cir. 1939). In perhaps the strongest wordings suggestive that the prudent operator standard applies in Tennessee, the Sixth Circuit Court of Appeals held that “where the only substantial benefit accruing to a lessor from a lease is rental when gas is produced and marketed, inability of the lessee to do so after a reasonable time will not relieve him from his implied obligation and will not avoid a termination even if good faith be present.” \textit{Id.} \\
165. \textit{Waddle}, 551 S.W.2d at 327 (holding the clause that provided that “[i]t is agreed that this lease shall never be terminated, forfeited, or cancelled for failure to perform in whole or in part, any of its implied covenants, conditions, or stipulations, until it shall have been first finally determined that such failure exists, and after such final determination, lessee is given a reasonable time therefrom to comply with any such covenants, conditions, or stipulations” obviated any implied duty applied under Tennessee law on an oil and gas lease). \\
166. Benedum-Trees Oil Co., 107 F.2d at 985.\end{footnotesize}
gas storage capacity, a glut of gas on the market, or some combination of these factors may cause operators to develop leases only to a minimum extent needed to hold the acreage under the lease. In that case, lessors, many of whom have negotiated more than the traditional one-eighth royalty, may seek to invoke the implied covenant to reasonably develop to force the operator to develop the leasehold. Further, when oil and gas is encumbered by older multi-strata leases and the operator is not developing the shale formations, it is likely that landowners will assert breach of the implied covenant to further explore in order to obtain cancellation of the lease as to the undeveloped formations.

In view of the lack of case law and the extensive leasing which has occurred as a result of the Marcellus and Utica Shale boom, it appears clear that what constitutes an operator's due diligence to market will be an area of case law development. As noted above, low gas prices, lack of gathering and interstate pipeline infrastructure to move the gas from the well head to market, insufficient gas storage capacity, a glut of gas on the market, or some combination of these factors may cause operators to develop leases only to a minimum extent needed to hold the acreage under the lease, and once developed, the gas might be shut in and not marketed. In that case, lessors may seek to invoke the implied covenant to market so as to realize royalty payments.