PROBLEMS IN DEVELOPMENT OF LEASED LANDS*

In seeking to find what duties a lessee owes to his lessor to develop lands covered by an oil and gas lease, we find that the lease document itself affords little help in the way of explicit covenants. With the exception of the offset well clause which is found in most leases today, the common forms of lease are surprisingly silent as to such duties.

An oil and gas lease is a contract which is intended to be complete and which goes into considerable detail in setting out the rights and duties of the lessor and lessee. The terms of the lease however, do not usually specify how many wells will be placed on the land, the depth of each well, or the spacing of the wells on the surface. These factors will all depend on facts to be ascertained through drilling, and therefore it would be dificult, if not impossible, to put adequate express provisions into the lease to cover development of the leased premises.[1] Similarly, due to the vagaries of market conditions, it would be extremely difficult to frame adequate provisions relating to the duty of the lessee to market production.

Because of this difficulty of providing express terms in the lease to govern these most important areas, the doctrine of implied covenants in oil and gas leases has evolved in the United States over the last half century.[2]

While the relationship between a lessor and lessee is seldom described in fiduciary terms, one will be sure to find this doctrine resorted to in any consideration of implied covenants. Therefore, it is proposed to examine first the fiduciary duty as it relates to a lessee under an oil and gas lease.

Fiduciary Obligations of Lessee

The question of implied covenants in the oil and gas lease is dealt with in other articles of this issue.[3] It is the purpose of this paper to investigate the lessor-lessee relationships, having regard to those situations in which a Court may impose a fiduciary obligation on the lessee. There is a dearth of law on this subject in Canada, and, for that matter, in the United States.

By way of introduction, one could not do better than to refer to the paper given by Professor Williams, to the Thirteenth Annual Institute on Oil and Gas Law and Taxation of the South Western Legal Foundation at Dallas, Texas, in February, 1962.[4]

In this paper Professor Williams refers to the paper delivered to the Twenty-second Annual Meeting of the State Bar of California in 1949 by Professor Scott of Harvard University Law School, entitled, "The Fiduciary Principle."[5] In that paper, Professor Scott asks the question,

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1 Pressler, *Implied Covenants In Oil and Gas Leases,* (1947), 18 Miss. L.J. 415.

2 Merrill, *Covenants Implied in Oil and Gas Leases,* (2nd ed. 1940).

3 *Ante* at pp. 208, 261.

4 Report of proceedings of 13th Annual Institute of Oil & Gas Law & Taxation, South Western Legal Foundation, page 201.

5 37 Calif. L. R., 539; also Proceedings of California State Bar Association, 1949, 104.

"Who is a Fiduciary?". He answers his own question by defining a Fiduciary as,

> a person who undertakes to act in the interest of another person. It is immaterial whether the undertaking is in the form of a contract. It is immaterial that the undertaking is gratuitous.

Professor Williams points out[6] that it has not been customary to describe the relationship between lessor and lessee under an oil and gas lease in fiduciary terms. He noted, however, that much of the law of implied covenants is consistent with the application of fiduciary principles to the relationship of lessor-lessee.

The relationship of lessor and lessee begins with an oil and gas lease. Few, if any, such leases refer to or delineate any fiduciary relationships on the part of the lessee. Some leases do, however, expressly repudiate the existence of implied covenants. It may well be argued that the oil and gas lease itself contains the whole agreement between the parties and that there is, therefore, no room for fiduciary obligations on the part of the lessee.

Mr. Justice Egbert advanced this argument in a case dealing with joint adventurers. In *Merrill Petroleums Limited* v. *Seaboard Oil Company et al*, he stated:[7]

> The rights and duties of co-adventurers are defined by the agreement constituting their adventure, and whatever may be their duty of 'joint loyalty' to their co-adventurers, this duty cannot override the specific provisions of an agreement voluntarily entered into by the parties.

Similarly, in the case of *Midcon Oil and Gas Ltd.* v. *New British Dominion Oil Company*, another case of joint adventurers, the trial judge, Primrose, J., said,[8]

> In my view, the operating agreement negatives any relation of a fiduciary nature between the parties either as trustee or partner . . . Having regard to all the provisions of the agreement I am forced to conclude that there were no provisions in it which established a partnership or that the corporate defendant was in any sense in a fiduciary relationship to the plaintiff.

However, in the Court of Appeal, in the same case, Johnson, J.A., giving the judgment of the majority rejected this argument. He said,[9]

> Counsel for the respondents argues that the agreement negatives a fiduciary relationship because it spells out in detail the duties, responsibilities and liabilities of the parties, particularly the corporate respondent as operator, and it is suggested that the parties intended no other liability than that set out in the agreement. *If this is a case of joint adventure, it is doubtful if detailing the operator's duty in the manner which is here done would prevent a fiduciary relationship being created. Certainly no cases were cited in support of this.* [Emphasis added]

In the *Midcon* case the operator, New British Dominion, was given the right to negotiate contracts for the sale of the joint gas production, subject, it appears, to the right of Midcon to approve the contract.

Paragraph 20 of the Operating Agreement said, in effect, that the relationship existing between them in carrying out the terms of the agreement was neither a partnership nor that of principal and agent.

In dealing with the obligation of New British Dominion to market the joint products, Johnson, J.A., said,[10]

> If I am correct (that is in the obligation to market and account for oil and gas produced) then the corporate respondent became the agent of the appellant to

6 *Ante* n. 4 at 215.
7 (1957), 22, W.W.R., (N.S.) 529 at p. 560 8 O. & G. R., 169, 193.
8 19 W.W.R. 317, 329 6 O. & G. R. at p. 769, 777.
9 (1957), 21 W.W.R. 288, at p. 235 7 O. & G. R. 758 at p. 762.
10 *Ibid.*

sell or at least to find a purchaser for the appellant's share of the gas and this agency created a fiduciary relationship requiring the utmost good faith on the part of the agent.

And again at page 236, Johnson, J.A., says,

The duty of a fiduciary to account for any advantage gained or acquired by him as a result of his position or by the use of another's property, is stated in many cases.

Mr. Justice Locke, in the Supreme Court of Canada, did not go quite so far. He stated:[11]

While the agreement expressly provided that the operator should not act qua agent, which I think should be taken to apply not merely to what was done regarding the development and operation of the property but in the sale or attempted sale of the minerals discovered, and while any such sale could be made only on terms approved by the other party, this does not mean that the respondent company did not owe to the appellant the duty to act in good faith in its efforts to sell. Thus, by way of illustration, had the respondent company, having in mind its own interest or prospective interest in the chemical company, negotiated a sale to that company at what was, to its knowledge, less than the fair value of the gas or less than could have been obtained, and without disclosing that fact induced the appellant to agree, I think an action for the resulting damage would lie.

Similarly, Mr. Justice Rand in delivering the dissenting judgment on behalf of himself and Mr. Justice Cartwright, said with regard to the operator's right to market the product on behalf of Midcon;[11a]

At the trial Primrose, J., rejected the contention that the operator bore in any degree, a fiduciary relation to Midcon and dismissed the action. In the Appellate Division the Court found that relation present. With this finding I agree; the operator, so developing, exploiting and marketing a jointly-owned product for a joint benefit has reposed in him that reliance and confidence which constitute a trust relation.

He continues at page 335,

The question to be answered is this: In what capacity did New British participate in the promotion? And the answer is, in its capacity as operator. That special capacity was a matter of indifference to the associates and was unknown to them; its significance was solely to Midcon . . . . The fiduciary relation is that of a trust in one who is to act in relation to the beneficial interest in another. It creates a standard of loyalty which calls for a refined sensibility to duty, the exclusion of all personal advantage and the total avoidance of any personal involvement in the interests being served or protected, a sense of obligation not always appreciated by those who enter upon it. [Emphasis added]

It is submitted that what was said of the position of New British Dominion in marketing Midcon's share of the gas is equally applicable to a lessee marketing the lessor's share of production. In marketing the lessor's share, it is submitted that a fiduciary obligation is owed to the lessor,

1. to account for all receipts and revenues,
2. to deal with the lessor's production without discrimination in favour of his own,
3. to take all reasonable steps to maximise the return to the lessor.

Other fiduciary problems may arise with respect to the marketing of the lessor's share of production, which give rise to fiduciary obligations. For example, there may be some question as to the value of the production. In this connection, Sneed[12] points out that gas used for manufacturing carbon black cannot bring the same price as gas used for light and fuel purposes and therefore, that the price will vary depending

11 [1958] S.C.R., at 326.
11a At p. 329.
12 *Value of Lessor's Share of Production Where Gas Only is Produced*, Sneed, (1947), 25 Tex. L. R., 641.

upon how the gas is utilised. The problem will be more complicated if the lessee operates a whole gas field and utilises the gas for the purpose of heating and lighting neighbouring towns. In such a case, there would be a "market" but there might not be a "market price" to be used in reference to the lease royalty clause calling for the lessee to pay the lessors the "market price".

Additionally, gas purchase contracts are frequently of long term duration with escalating price provisions. Consequently the rapid increase in the value of gas has frequently resulted in a situation where the prices under the contract fall below current market value. However, it is submitted that if the lessee has used reasonable judgment in entering into the contracts, he is fulfilling his fiduciary obligation.

Similarly, "cycling" can present problems to the lessee. Andrew P. Johnson[13] in a casenote dealing with the case of *Tidewater Oil Company* v. *Stott*[14] discusses these problems. In that case, the Plaintiff-Lessor brought action against Tidewater Oil Company because of the cycling operations which Tidewater had carried out as lessee of the Plaintiff's property and other properties. All the other lessors in the field, except the Plaintiff, had joined in approving the cycling project. The Plaintiff had been offered an opportunity to join but had refused. The Plaintiff brought action on the ground that his leasehold property was being depreciated since dry gas was replacing wet gas in the cycling operation.

Mr. Johnson says;[15]

> It is submitted that there is an implied duty imposed on the lessee to do everything a reasonably prudent operator should do to insure a reasonably rapid accrual of the largest royalties practicable, due consideration being given to the interests of both lessor and lessee.

In support of this proposition he cites *Brewster* v. *Lanyon Zinc Co.*,[16] and with reference to that case said:

> While the Court in the principal case did not acknowledge the existence of a duty of such broad scope, it did apparently recognize a duty of fair dealing imposed by the lessee's offer to allow the plaintiffs to participate in the cycling operations on a fair and reasonable basis.

It is submitted that the duty of fair dealing, referred to by Mr. Johnson, is much like the duty to act in good faith, enunciated by Mr. Justice Locke in the Midcon case.[17]

The "take or pay" clause in a gas sales contract could also conceivably impose a fiduciary obligation upon the lessee. A situation could arise where a pipeline company is unable to take gas but is required under a "take or pay" clause to pay for gas not taken. The question immediately arises, "Is a share of the money received by the lessee for gas paid for but not taken payable to the lessor?" It is suggested that there is an obligation and that the lessee is required to account to the lessor for monies received under the "take or pay" clause.

The pooling clause in the lease may give rise to fiduciary obligations. Ralph B. Shanks[18] in considering a pooling clause which gave the lessee,

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13 (1947), 25 Tex. L. R., 690.

14 159 Fed. (2d), 174, (C.C.A. 5th), (1946).

15 *Ante* n. 13 at 691.

16 140 Fed. 801, (C.C.A. 8th) (1905); See also, *Texas Pacific Coal and Oil Company* v. *Gholson*, 1 S.W. (2d) 649, (Tex. Civ. App. 1927); Merrill, *Covenants Implied in Oil and Gas Leases*, (2d ed. 1940) 21; Walker, *The Nature of the Property Interests Created by an Oil and Gas Lease in Texas*, (1933), 11 Tex. L. R. 399.

17 *Ante* n. 8.

18 (1945), 23 Tex. L. R. 150. See also *Boone* v. *Kerr-McGee Oil Ind. Inc.* 4 O. & G. R. 370. As to duties of person holding the leasing power see *Allison* v. *Smith* 4 O. & G. R. 1136 and *Hudgins* v. *Lincoln Nat. Life Ins. Co.* 6 O. & G. R. 1063.

> the right to pool or unitise this lease, the land covered by it or any part thereof with any other land, lease, leases, mineral estates or parts thereof for the production of oil, gas or any other minerals.

asks if such a clause renders the lessee the agent of the lessor. He says at P. 156:

> If the lessee is the agent of the lessor, does a confidential relationship exist, and to what extent? It seems that up to now, absent a pooling clause, courts have refused to find a principal-agency relationship between the lessor and lessee. In *Imes* v. *Globe Oil and Refining Co.*, the Supreme Court of Oklahoma had before it a case in which twenty-one lot owners had executed a community lease containing a provision 'that any lot, lots or parcels of land embraced within the outer boundary lines of the above-described block . . . . to Oklahoma City, may at any time be included within the terms hereof and become a part of the lease premises covered hereby'. The lease also provided 'that lessee may at any time, without the consent of lessors, consolidate, jointly operate, and develop this lease and the land covered hereby, with any other lease or leases covering any lot . . . embraced within the outer boundary lines . . . . '. Two wells were brought in on the lots covered by the leases, in 1931 and 1933, respectively. Subsequently ,in 1934, the lessee sought to bring in six other leases covering lots within the agreed boundary. The original lot owners objected. In holding that the lessee could not bring in additional lot owners subsequent to production, the court said:
>
> > 'In their efforts to procure a group of owners of a sufficient area they virtually made lessee and his assigns their agent . . . . As pointed out above, the lessee was virtually the agent of the lessors, and for this reason he was bound to use good faith'.
>
> The Supreme Court of Texas has said, in a case involving the right of a grantee to lease land without the joinder of his grantor, where the grantor has reserved an undivided one-half interest in and to the royalty rights, that the grantee in stipulating the amount of royalty payable under a lease was required to exercise 'the utmost fair dealing'. The Supreme Court of Texas has also said, in a case construing Senate Bill 310 and House Bill 358 (Vacancy Act of 1931) reserving to the State a free royalty interest in grants of school lands:
>
> > 'The owner of the land acts as agent of the State in making the mineral leases. This calls for the exercise of a duty by the landowner to the State. The landowner owes to the State good faith in the performance of a duty which he has assumed, and he should discharge that duty with prudence and good faith, and with ordinary care and diligence'.

Similarly, it would appear that the power to unitise the lease gives rise to like obligations. It is submitted that the lessee owes a fiduciary duty to the lessor to protect the lessor's interest where the leased lands are voluntarily unitized.

Merrill[10] points out that the lessor's income from a lease under unitization is still dependent on the diligence and skill with which operations are carried on; that conflicts of interest between operators and royalty interests are still likely to arise; and that the disparity of interest between the operator and the royalty owner is only augumented by unitization.

While conceding that unitization will remove some of the incidences of the doctrine of fiduciary or implied obligations it will not, as has been suggested by some, eliminate its function.

OBLIGATIONS WITH RESPECT TO OFFSET WELLS*

In dealing with offset obligations a very brief review of the historical background may be helpful.

During the early years of the oil industry in the United States it was thought that oil flowed in streams under the ground. This notion demanded the prompt and immediate development of a lease before the oil moved elsewhere. This theory, as a reason for immediate development, was later discredited. Nevertheless, immediate development was practically the

10 *Implied Covenants and Secondary Recovery*, 4 Okla. L. Rev. 177.

* This portion of the paper was written by G. W. Brown, Canadian Fina Oil Limited.

sole consideration in the earliest leases and if the lease did not specify the extent of exploration and development, then implied covenants were read into the leases necessitating prompt development of the land. The later leases provided for payment of bonuses and delay rentals, and it is now recognized that the parties contract on a basis requiring no obligation to develop immediately. In these later leases, the measure of diligence of a lessee is controlled by the express provisions of the lease contract and if the lease is explicit no covenants will be implied. Even where actual drainage occurs the situation is still governed by the express or implied covenants in the lease.

A complete statement of the evolution and development of the oil and gas lease in the United States may be found in a paper given by Mr. Leslie Moses.[20] In Canada, an article by D. E. Lewis,[21] contains some valuable historical information. Suffice it to say that the vast majority of leases taken in Western Canada since the discovery of oil in Leduc in 1947 do not demand prompt and immediate development and contain provisions for cash bonus and delay rentals, and where offsetting production occurs the entire obligation of the Lessee to develop is set out in a so-called "offset" clause.

It has been said that the offset clause is particularly appropriate in Western Canada as it is questionable whether Canaidan courts will imply development covenants as readily as the courts in the United States have done for many years. In fact, as will be shown later in this paper, the question whether development covenants are to be implied, has been raised in only two Canadian cases.

An offset clause frequently encountered in Canadian leases reads as follows:

> In the event of commercial production being obtained from any well drilled on any drilling unit laterally adjoining the said lands and not owned by the Lessor, the Lessee shall commence, within six (6) months from the date of such well being placed on production, the drilling of an offset well on the drilling unit of the said land laterally adjoining the said drilling unit on which production is being so obtained and thereafter shall drill the same to the horizon in the formation from which production is being obtained from the said drilling unit; Provided that if such well drilled on lands adjoining the said lands has been proved to be productive primarily or only of natural gas, the Lessee shall not be obligated to drill an offset well unless an adaquate and commercially profitable market for natural gas which might be produced from the offset well can be previously arranged and provided.

In conjunction with the foregoing clause the following definition of commercial production is given:

> Commercial production shall mean the output from a well of such quantity of the leased substances or any of them as, considering the cost of drilling and production operations and price and quality of the leased substances, after a production test of thirty (30) consecutive days would commercially and economically warrant the drilling of a like well in the vicinity thereof.

The offset clause as set out here, was considered in the leading case of *Albrecht* v. *Imperial Oil Limited*[22] where the facts were as follows:

1. In 1947 Albrecht granted a ten year P & NG lease to Imperial.
2. On November 16, 1953 a well completed on a drilling unit laterally adjoining the Albrecht parcel was placed on production.
3. On December 16, 1953, the thirty day production test was completed and the well was accordingly declared a commercial producer.
4. In January, 1954 water entered the offset well and reached such serious proportions that by June, 1954 the well had to be abandoned.

20 *The Evolution and Devolution of the Oil and Gas Lease*, (1951), 2nd Ann. Institute on Oil and Gas Law and Taxation, 1.
21 Lewis, *The Canadian Petroleum and Natural Gas Lease*, (1952), 30 Can. Bar. Rev. 965.
22 (1957), 21 W.W.R. 560.

It was held that Imperial's obligation to drill the offset well arose upon the expiration of the thirty day production test (ie. December 16, 1953) and not at the expiration of six months from November 16, 1953 as contended by the defendant.

It was evident by January, 1954 (barely a month later), that Albrecht's land was underlaid principally by water and that a well drilled on Albrecht's land would not be commercially productive. There was evidence of slight drainage of gas from the Plaintiff's land, but the estimated royalty of such drainage amounted to only $11.50.

Albrecht introduced evidence showing that upon the successful completion of the adjoining well, he had received offers of $3,000 per point for his royalty and had turned these offers down. It was also shown that upon the spudding in of a well on Albrecht's land his royalties would have been worth $6,000 per point. The Court awarded damages consisting of (1) the amount which Albrecht would have received in royalties, and (2) an amount to compensate him for the deprivation of the opportunity to realize upon what at the material times was shown to have been a valuable asset.

Ballem[23] in criticizing this part of the case, points out that as a practical matter it was not the failure of the lessee to drill the offset well which abated the interest of possible purchasers but the production characteristics of the nearby well, which well had given rise to the offset obligation. Mr. Ballem states[24] that:

> The Plaintiff did not accept any of the offers which he had received and this can only mean that he elected to retain his entire interest and run the risk that gas in commercial quantities would be discovered beneath his land. This is purely a matter of individual business judgment and one over which the defendant has no control.

Nevertheless, the *Albrecht* case clearly indicates at what time the Lessee's obligation to drill an offset well arises under the terms of such offset clause. The lessee has six months to commence the drilling of an offset well. During such period the lessee should either commence to drill the necessary offset well, or surrender its interest in the spacing unit concerned, if the lease so permits. Otherwise, at the end of the six month period the lessee is in default under the terms of the lease and not only is the lease itself subject to termination but the lessee also becomes liable for possible damages on the basis of the principles enunciated in the *Albrecht* case. It is sometimes suggested that the lessee can avoid the foregoing result by payment of compensatory royalty. This route is only open if the lease includes a provision providing for it, which is not at all common in freehold leases. It is always possible of course for the lessee to negotiate with the lessor before default occurs and to pay a cash consideration for a collateral agreement extending the time for commencing the necessary well. This procedure is sometimes useful where the continued productivity of the offset well is in doubt.

Damages for breach of a covenant to drill has been considered by Canadian courts on two other occasions in recent years. The case law in this area is quite sparse and not altogether reconcilable. The first and controlling case is a decision of the Supreme Court of Canada, *Cotter* v.

23 (1957), 35 Can. B. Rev. 971.
24 *Ibid* at 978.

General Petroleums Ltd.[25] The Supreme Court rejected the argument that the measure of damages should be determined on the basis of the estimated cost to the lessee of performing its obligations. Instead, the court applied the principle that the damages would be based on the actual loss suffered by the non-defaulting party. In this case the plaintiff failed to show any loss and the court refused to speculate on what his loss was in fact. At no point, however, did the court indicate any reluctance to award proper and substantial damages if such damages could be firmly established.

The second case is *Prudential Trust Co. Ltd. and Wagner* v. *Wagner Oils Limited.*[26] The same trial judge as in the *Cotter* case decided this case, and held that the *Cotter* case prohibited him from fixing substantial damages and limited the award to nominal damages. Ballem,[27] in commenting on this case said:

> . . . . this limitation is an unjustifiable extension of the Cotter rationale which went no further than stating that damages should be confined to the proved and established loss of the plaintiff. In a proper case, there can be no doubt that the latter decision would permit the recovery of very substantial damages, and nowhere does it contain any implication that damages should be treated as purely nominal.

The *Albrecht* case and the implications arising from it have been dealt with at some length. However, offset clauses are occasionally encountered which are worded somewhat differently than that in the *Albrecht* case. For example, in the case of *Crommie* v. *California Standard Company*[28] the offset clause related only to drainage by an oil well and the lease was silent as to drainage by a gas well. The lessor attempted, unsuccessfully, to have the lease set aside on the ground that the lease was unconscionable and that he had been induced to enter into it by misrepresentation. It does not appear from the report of the case that there was actual offsetting commercial production of natural gas and, if there had been, it is suggested that this is a case where a covenant might have been implied.

Another different feature is that the offset clause in the *Crommie* case provides that the offset obligation arises after the drilling of a commercially productive oil well within 660 feet of the outside boundary of the leased premises. However, in Alberta, section 124 of the Oil and Gas Conservation Act[29] will override the lease terms in this regard, as by that section, offset obligations are fixed on a drilling spacing unit basis. The effect of this provision is that the lessee's obligation to drill an offset well arises regardless of the location of the well on the laterally adjoining drilling spacing unit.

Occasionally an offset clause will be encountered which includes a reference to drainage. The following is an example:

> In the event a well or wells producing oil or gas in paying quantities and draining the leased premises should be brought in on a legal subdivision immediately adjoining the leased premises, Lessee agrees to drill such offset well or wells as a reasonably prudent operator would drill under the same or similar circumstances, provided, . . .

Under such a clause, it would appear that an obligation on the part of the Lessee to drill an offset well does not arise on a date which may be de-

25 [1951] S.C.R. 154.
26 (1954), 11 W.W.R. 371.
27 *Ante* n. 23 at 976.
28 (1962), 38 W.W.R. 447.
29 Alta., 1957, c. 63.

finitely determined as under the offset clause in the *Albrecht*[80] case. Instead the lessor is faced with the formidable task of establishing that his land is being drained and that is so even after production in paying quantities is being taken from an immediately adjoining legal subdivision. To make matters worse, the term "paying quantities" is not defined in this particular lease and the lessor would also have to assume the onus of showing that a reasonably prudent operator would drill under the existing circumstances. It is difficult to see how such matters could be resolved without resort to the courts. The default clause under this lease is of little assistance to the lessor and in fact it contains further obstacles. It reads as follows:

> The breach by Lessee of any obligation arising hereunder shall not work a forfeiture or termination of this lease, nor cause a termination or reversion of the estate hereby created, nor be ground for cancellation hereof in whole or in part save as herein expressly provided. If any implied obligation hereunder should require the drilling of a well or wells, Lessee shall have ninety (90) days after ultimate judicial ascertainment of the existence of such obligation within which to begin the drilling of a well, and the only penalty for failure to do so shall be the termination of this lease save as to such area for each well being worked on and/or being drilled and/or producing oil or gas as will embrace the minimum area required under the applicable laws, orders and/or regulations for the drilling, work and/or producing of such well, and will embrace one such well.

No attempt will be made to analyze the above clause in detail but it is enough to say that the effect of such clause, together with its offset clause, is that the lessor cannot readily terminate the lease if the latter refuses to drill.

As is well known, wells can only be drilled in accordance with spacing regulations prescribed under the Oil and Gas Conservation Act of the Province concerned. Consequently whether the lessee is obligated to drill an offset well may depend on the area under lease and the spacing unit required under such regulations. Let us assume a parcel containing 120 acres is offset under the terms of a lease but the required spacing unit under regulations is 160 acres. As no well can be drilled in violation of such regulations, it might be thought that the lessee is under no obligation to drill except in compliance with such regulations. Here again conflicting views have been expressed and there is also a dearth of authority on this point in Canada. In the case of *Reynolds* v. *Ackerman*[81] the lease covered only 10 acres and it was argued that no covenant to drill could be implied or enforced as the lease did not contain the minimum spacing of 40 acres provided by regulations. However, the trial judge stated that the regulations in question were no excuse for the defendant's non-performance of the implied covenant which otherwise appears on the face of the instrument. This statement by the trial judge appears to be *obiter* but nevertheless it indicates that if an obligation to drill an offset well exists under the terms of a lease, Canadian courts may not be prepared to accept the excuse that a full spacing unit is not held under the lease. Perhaps there is an inference that the lessee in such a case should attempt to obtain a special spacing unit or arrange for pooling with the balance of the acreage comprising the spacing unit. This particular case will be considered more fully in the next part of this paper under the heading of implied covenants.

80 (1957), 21 W.W.R. 560, *ante* n. 23.
81 (1953), 32 W.W.R. 289, (Alta.).

Another practical problem exists in connection with the obligation to drill an offset well with reference to the exercise of the surrender privilege. It will be recalled that under the offset clause in the *Albrecht*[32] case, the lessee had six months to commence the drilling of an offset well after the obligation arose upon the expiration of a 30 day production test. Mention was made that during such 6 month period the lessee should either commence to drill the necessary offset well or surrender its interest in the spacing unit concerned, if the lease so permits. However, as pointed out in Lewis and Thomson[33] the effect of a surrender clause will depend upon its wording, which is strictly construed against the lessee. It is also important to note that while the exercise of the surrender privilege relieves the lessee from future obligations under the lease, it will not ordinarily relieve him from liability in respect of obligations incurred before the surrender. The authors also express the view that if the lessee has made default in drilling an offset well within the time stipulated in the offset clause, he will be liable for damages for such default notwithstanding the surrender of the lease, in the absence of an express provision to the contrary, and that he may not even be permitted to surrender at all until such default is remedied.

IMPLIED OBLIGATIONS TO EXPLORE AND DEVELOP*

Any study of the oil and gas lease forms in use in Western Canada gives rise to a consideration of the question as to whether there are presently, or may in the future be implied by our courts, covenants on the part of a lessee to carry out drilling operations, to explore the leased premises and to develop the same. As is the case with many aspects of the development of oil and gas law in Canada, it is useful and instructive to first turn to the development of the principles of implied covenants as developed in the courts of the various jurisdictions in the United States. In United States jurisdictions the treatment of the implied covenant to drill falls into three general categories:

1. The duty to drill an exploratory well or wells.
2. The duty to drill additional development wells once production has been established on the lease.
3. The duty to protect the lease from drainage, generally referred to as the duty to drill offset wells. This third category dealing with offset wells has been covered in detail in an earlier part of this paper and will not be discussed here.

It should be pointed out that, while for discussion purposes it is convenient to divide the subject into these three categories, in fact there is a considerable overlapping in the cases in which they are considered and to a considerable extent the underlying reasons for implying the duty in each category are very similar.

It is intended to first look at these categories as they have been developed in United States jurisdictions and then to venture a few thoughts on whether or not these developed principles should be, or are likely to be followed by our Canadian courts in the circumstances in which oil and gas leasing has developed in this country.

* This portion of the paper was written by K. J. Boyd, Texaco Exploration Company.

32 (1957), 21 W.W.R. 560.
33 *Canadian Oil and Gas*, vol. 1, sec 119.

In considering the implied covenant to drill exploratory and development wells as it exists in the United States, it is important to bear in mind some of the underlying reasons giving rise to the development of this implied covenant and also the historical context in which it was developed.[34] Some points to be borne in mind are:

1. It must be recognized that at the outset the United States courts were faced with interpreting a type of lease very different from those commonly used today. These old forms of lease were most often granted for a long term, had no delay or other rental provision and covered very large tracts of land.
2. At the time when this implied covenant began to emerge, there were no well spacing and other conservation laws and practices such as we know them today.
3. The form of oil and gas lease in use in early days contained no express covenants on the part of the lessee with respect to exploration and development on the leased lands.
4. In the absence of express provisions for exploration and development, the courts were faced with the problem of determining what the intention of the parties to the lease was in this respect, spelling out what duties such intention imposed, how those duties must be carried out, and the penalties incurred in default of carrying out such duties.

It was in the context of this background that the implied covenant to drill was developed and enunciated by the courts. First, we will look very briefly at the implied covenant to drill an exploratory well or wells on the lease. Generally this covenant is implied only in those cases where a lease is granted without specifying any time within which exploratory work shall be commenced and where there is no express provision for delaying the commencement of such work. Under these circumstances the courts found that *the main consideration for the conveyance of mineral rights by the lessor was the expectation of receiving payments of royalties from minerals taken from the leased lands and that consequently there was an implied obligation on the lessee to explore and develop the minerals with reasonable diligence.* This led to the enunciation of the principle that there was an implied covenant by the Lessee to drill an exploratory or test well within a reasonable time from the date of granting the lease. In this connection there was a further problem which arose in the case where the initial well was drilled but turned out to be unproductive. What then was the obligation of the lessee with reference to exploratory work? Here again, the principle generally invoked was that the lessee must continue with reasonable diligence to drill further wells to test the property or the lease would terminate.

Brown[35] summarizes the law relative to the implied covenant to drill an exploratory well as follows:

1. Where the lease contract is silent as to when development shall be conducted the law implies a covenant to drill within a reasonable time under all the facts and circumstances of the case.

[34] Merrill, *Covenants Imrlied in Oil and Gas Leases*, c. 3 (2nd ed. 1940); Earl A. Brown, *The Law of Oil and Gas Leases*, c. 16, (1958); Nelson Jones, *Rights and Remedies for Non Development and Failure to Offset (Legal Aspects)*, (1953) 4th Ann. Institute on Oil and Gas Law 57.

[35] *Ante* n. 24 at 231.

2. Where the lease contract contains express provisions for delays in development as by payment of delay renatls or otherwise no implied covenant is applicable.

It will be readily apparent that the development of the modern oil and gas lease with its fixed primary term and provision for payment of delay rentals and resumption of the payment of delay rentals once a well has been drilled and found to be dry, has largely taken this matter out of the field of implied covenants and has rendered the number of cases in which this principle must be considered very small.

With these few comments on the implied covenant to drill exploratory or test wells, the more important problem today, namely the implied covenant to drill *additional development wells once production has been established* on a lease will now be considered.

This covenant is stated by Brown[36] to be as follows:

> This covenant does not arise until there has been some development of the premises, oil or gas is being produced in paying quantities and there are no express provisions in the lease as to further development.

He goes on to say:

> In such case it has been uniformly held that there is an implied covenant to continue development with reasonable diligence subject to certain qualifications hereinafter enumerated until a sufficient number of wells are drilled to reasonably develop the premises for oil and gas.

It is clear that where the matter of development drilling on leased premises is expressly provided for in the lease, there can be no application of the doctrine of the implied covenant to develop. By way of illustration reference will be made to the form of lease commonly granted by the C.P.R. in which one finds the following provision:

> If and when production is found in commercial quantities in any well drilled in the leased area the Lessee shall continue diligently to drill for and develop production from the leased area (not more than sixty days to elapse between the completion or abandonment of any well and the commencement of drilling of another well) having regard to existing geological and marketing conditions and with a view to the ordinary development of the leased area on geological lines (rather than on property divisions) and in the manner best suited to the recovery of the greatest quantity of the leased substances at the least cost.

It is clear that in a lease containing this or a similar provision setting out a specific program for the development of the leased premises, the parties have expressly declared their intention and the courts should not find it necessary to imply a covenant to drill development wells. In fact, this is the position which has been taken by the United States courts.

However, in many leases commonly in use today one does not find any provision similar to that quoted above, and the matter of the development of the leased premises may well be said to be left to implication. From the quotation of Brown's mentioned above,[37] it seems clear that at least insofar as United States jurisdictions are concerned, there is no doubt that the courts imply a covenant to carry out such development drilling in a reasonably diligent manner in such cases.

In applying the concept of an implied covenant to continue development with reasonable diligence, regard must be had to certain exceptions or qualifications to the general rule which the courts have developed. First, there is the point referred to above, that if there are express covenants in the lease specifying the extent of further development required

36 *Id* at 281.
37 *Ante* p. 281.

thereunder, then there is no implied covenant of development. Secondly, in developing the rule, the courts have had to evolve standards for measuring the extent to which, and the diligence with which the implied covenant must be fulfilled. It has been consistently held that neither the lessor nor the lessee is the arbiter in such matters. In *Brewster* v. *Lanyon Zinc Company*[38] the court stated this proposition in this way:

> The object being to obtain a benefit or profit for both the lessor and the lessee it seems obvious, in the absence of some stipulation to that effect, that neither is made the arbiter of the extent to which or the diligence with which the operations shall proceed and that both are bound by the standard of what is reasonable.

The courts in the United States have in a long line of cases wrestled with the problem of determining "the standard of what is reasonable" in applying the implied covenant to develop and certain guide lines have been adopted and followed. Briefly, these are:

(a) There *is no obligation on the Lessee to carry the operations beyond the point where such operations will be profitable* to him, even though it can be demonstrated that some additional benefit may accrue to the lessor by doing so. It is well settled that the lessee is not under a duty to drill a well at a loss to himself in order to further develop the leased lands.

(b) In determining the diligence required of the lessee in carrying out the implied obligation, *the test to be applied is what in the circumstances would a reasonably prudent operator do, having regard to the interests of both the lessee and the lessor.* Much has been written on the meaning of the phrase "reasonably prudent operator" and the temptation to digress into a lengthy discussion on that subject will be resisted here. Suffice it to say, that in determining whether or not the lessee has fulfilled the implied covenant to develop, the concept of the "prudent operator" comes into full play and is one of the tests or standards applied. In applying the test of what the prudent operator would do, regard must be had to the facts, conditions and circumstances which bear upon the the lessee's obligation to develop the lands with reasonable diligence. Again, the court in the *Brewster*[39] case admirably sum up this matter as follows:

> Whether or not in a particular instance such diligence is exercised depends upon a variety of circumstances, such as the quantity of oil and gas capable of being produced from the premises, as indicated by prior exploration and development, the local market or demand therefor or the means of transporting them to market,the extent and results of the operations, if any, on adjacent lands, the character of the natural reservoir—whether such as to permit the drainage of a large area by each well—and the usages of the business. Whatever, in the circumstances, would be reasonably expected of operators of ordinary prudence having regard to the interests of both lessor and lessee is what is required.

In *Becker* v. *Submarine Oil Company*[40] the California Court of Appeal expressed the principle in this way:

> As a net result of consideration of the cases which hold that, in the absence of express and definite stipulation as to the measure of diligence, an implied covenant exists demanding reasonable diligence in the development of the premises leased, it may be fairly said, in determining whether or not other wells should have been drilled, consideration must be given to a number of facts regarded collectively. Some of these are: The result of oil operations on adjacent premises; the extent of the subterranean oil reservoir; also its character and contour as affecting

38 140 Fed. 801, (1905).
39 *Ibid.*
40 55 Cal. App. 698, 204 Pac. 245, (1922).

the question of drainage to and from the property in question; market conditions; the quantity and quality of oil thus far produced; the prospects for further production as indicated, and the knowledge possessed by those expert in locating oil bodies; the demands made upon the lessee in the maintenance of the wells already drilled, and his diligence in operating them to secure the greatest possible production. The record contains no information concerning many of these important considerations. Leases are intended for the benefit of both parties. The lessee has a right to regard his own interest as well as that of the lessor. In short, the diligence required of the lessee involves such a course of conduct upon his part as operators of ordinary diligence would pursue having in mind the securing of the financial benefits sought by both lessor and lessee. To warrant a forfeiture upon this ground in any case it must appear affirmatively from all the circumstances that the lack of diligence is both certain and substantial.

Up to this point, in discussing the implied covenant to drill additional wells, the situation where production has been established in a particular stratum or zone and the lessee's obligation to fully develop that production have been dealt with. However, there are other interesting applications or possible applications of this implied covenant and the implied covenant to drill exploratory wells. For example,

(a) *If gas is discovered* upon the leased premises, is the lessee under any obligation to continue exploration for *oil?*

(b) If production (either gas or oil) is discovered at a *shallow depth* on the leased premises and deeper drilling in the locality of the lease establishes production at lower depths, *is the lessee obligated then to drill to much deeper horizons* on the leased premises?

To some extent, the problems presented in these examples may be resolved by the operation of expressed or implied offset drilling requirements. However, there may still be an area in which the implied covenant for exploratory or development drilling could come into play and while the matter has not been fully explored and developed in the United States courts up to the present, there has been sufficient comment to warrant the assumption that these implied covenants can have application in such cases.

To summarize this discussion of the Unitel States law on implied covenants with respect to development drilling, it is clear that the courts in that country have developed a substantial body of law on the subject and it is equally clear that the lessee has been firmly saddled with the responsibility of reasonably and diligently developing the leased premises.

Now to turn to the Canadian scene. In Canadian jurisdictions, there has to date been little or no development of the doctrine of the implied covenant to drill. There are only two Canadian cases which have touched on this subject and it is submitted that neither of those cases is particularly conclusive or helpful.

The first of these cases is *Docker* v. *London Elgin Oil Company.*[41] In arguing this case it was contended for the lessor that the purpose of the lease was to secure to him the development of his land and that since no operations had been commenced the lease was forfeited. The lease provided for a term of ten years and stipulated that "this lease is made for the purpose of enabling the lessee and his assigns—to sink or drill oil wells—subject only to the payment of the rental hereinbefore reserved." The lessee covenanted to commence operations on or before a specified date "or will pay to the lessor or his assigns the sum of Six ($6.00) Dollars per

41 (1908), 11 W.W.R. 726.

month from the date hereof until operations are commenced on the said premises." The lessee did not commence any operations but instead tendered rental payments. The court held that the lease did not create a duty on the lessee to operate, but merely conferred upon him the right to do so with the alternative of paying rent in lieu of commencing operations and that therefore there was no support for the contention which had been made that the real purpose of the lease was to secure to the lessor the operation of the lands.

Thus, in this case the *court in effect rejected the contention that there is an implied covenant to carry out exploratory drilling*. However, it must be borne in mind that there was provision in the lease for delaying operations by the payment of rental, which in itself, based on the United States law on the subject, would be sufficient to negative any implied covenant to drill.

The other Canadian case is *Reynolds* v. *Ackerman*.[42] The decision in this case was handed down by Mr. Justice Boyd McBride of the Trial Division of the Supreme Court of Alberta. Reynolds had sought a declaration that an oil lease granted to him by Ackerman was in full force and effect. The lease was held to have terminated on grounds of improper compliance with the Dower Act and failure to properly pay rentals. However, in his reasons for judgment, the Trial Judge did discuss the matter of an implied covenant to drill and indicated that had it been necessary he was prepared to find an implied covenant on the part of the lessee to drill.

The facts of the case were that Ackerman had granted to Reynolds a lease covering ten acres for a term of three years. It contained a provision that "The lessee shall pay to the lessor for the said period of three years of this lease the sum of two hundred ($200.00) Dollars upon execution of this lease (receipt whereof is hereby acknowledged). This lease shall be subject to renewal for a further term from year to year by the lessee paying to the lessor in advance the sum of one ($1.00) dollar per acre per year, provided that all the covenants of the lessee therein contained have been fully done and performed." The lease contained no express covenant to drill and no provisions for termination if nothing was done by the lessee in the way of drilling or exploration during the three-year term or during renewal terms. In dealing with the matter of an implied covenant to drill, the court stated that it was neither a reasonable nor a proper construction of the renewal provision that by simply paying ($10.00) dollars per year the lessee could retain the lease for an indefinite number of years. While there was no express covenant to drill, the express purpose of the whole instrument would quite obviously and definitely be defeated if the lessee could hold the land indefinitely by paying the comparatively insignificant rental and doing nothing in the way of drilling. The court went on to state: "That being so, if I were required to make a finding on the question now under discussion I should find that there was an implied covenant."

There is one further point in this judgment which should be noted. Apparently an argument had been advanced before the court that no covenant to drill could be implied or enforced because the lease covered

42 (1953), 32 W.W.R. 289, (Alta.).

only ten acres and the minimum spacing for wells provided by regulations was forty acres. The Trial Judge's comment was:

> I find no excuse or explanation in any regulations, or the fact that maybe a minimum acreage of forty acres is required, to resolve in favour of the Plaintiff the implied covenant in question which otherwise appears on the face of the instrument.

Lewis and Thompson in discussing implied covenants make this statement:[43] "It is not likely that Canadian courts will prove as fertile ground for the growth of such covenants as were the courts of the United States when the policy of development dominated judicial thought." The writer is inclined to agree with this view and it may be of interest to explore very briefly a few of the reasons why:

1. Relatively speaking a very small proportion of the mineral rights in Western Canada are owned by individuals and subject to freehold lease. The large mineral owners such as the Crown and corporations such as the C.P.R. and Hudson's Bay have developed lease forms which by and large include express provisions for exploratory and development drilling. This in itself greatly reduces the number of instances in which the problem of an implied covenant to drill can arise.
2. The majority of freehold leases in Western Canada cover relatively small tracts of land, ranging from 160 acres to perhaps 640 acres. This again tends to reduce the incidence of the problem of failure to develop such leases.
3. As pointed out earlier, provisions in modern oil and gas leases stipulating a fixed primary term and payment of rentals to delay drilling have virtually ruled out the application of an implied covenant to drill exploratory wells.
4. Because of the size and location of freehold leases, it is likely that in most instances the problems of drilling on such leases will arise by virtue of offset drilling and drainage of such leases rather than by virtue of failure to develop once production has been established.
5. Virtually since the discovery of oil and gas in Western Canada both members of the oil industry and the various governments have been very much aware of the necessity for and the value of conservation of these resources. This awareness has resulted in a high degree of regulation of the operations of the oil and gas lessees and of the spacing of wells, prorationing of production, prohibition of waste, etc. These regulations create a vastly different environment from that in which the principles of the implied covenants were conceived and developed in the United States. One need oniy look at the number of unitization schemes which have been put in effect and the speed with which such units are formed to realize that many problems of exploratory and development drilling are met before they have the opportunity to materialize.

The foregoing factors do not mean in any way that the rights of lessors are being injuriously affected but simply mean that there is not the same need to develop implied covenants to drill as was the case in the United States at the time when these concepts were developed and ap-

43 *Canadian Oil and Gas*, vol. 1, s. 121.

plied. Consequently the adoption of such concepts by Canadian courts may be slow in coming and may be limited in its application.

Based on the very scant expression of Canadian judicial opinion on the subject referred to earlier, it cannot be said that the principle of an implied covenant to drill exploratory or development wells has been established in Canadian jurisdictions. On the other hand however, it does not seem unreasonable to assume that if, and when, the question comes squarely before the Canadian courts they will, if the circumstances warrant it, find an implied covenant to drill development wells and will adhere in general to the principles that have evolved and been established in United States jurisdictions.

IMPLIED OBLIGATION TO MARKET*

Once production has been obtained pursuant to the duty to develop the leased lands, a duty to market such production arises by implication. This duty to market is not set forth in express terms in the lease but is implied from the factual situation which will necessarily arise.

While it is most common in leases currently in use, to provide in the royalty clause for a royalty based on a portion or percentage of the current market value at the well of all oil produced, saved and marketed, most earlier leases provided for delivery of the lessor's share of production at the well or into the pipeline to which the well was connected. However, in fact, the lessor rarely contemplates the taking of his share of production in specie. Rather, he looks for a "royalty" which is a proportionate share of the proceeds of production when sold. Nevertheless, in either case it is unlikely that the wording of the royalty clause could be construed so as to impose an obligation on the lessee to market the production. Therefore, in the United States, there has developed the principle that the lessee is under an implied obligation "to make a diligent effort to market the production in order that the lessor may realize on his royalty interest". In *Wolfe* v. *Texas Co.*,[44] the Court said:

> In the absence of an express provision in an oil and gas lease with respect to marketing the production there is an implied duty on the part of the lessee to make diligent efforts to market the production in order that the lessor may realize on his royalty interest.

One might pause at this juncture to reflect on the dilemma of a lessee who has obtained production and has not found a market. The habendum clause provides that the lease shall continue in force and effect beyond the primary term so long as leased substances are produced, with a proviso that if operations are interrupted or suspended for reasons beyond the control of the lessee, such interruption or suspension shall not be counted against the lessee. Therefore, it might be argued that although such a provision imposes an "obligation" to produce, if such obligation is frustrated by the lack of a market the lessee is relieved from forfeiture by virtue of the force majeure provision.

However, a Canadian case[45] held that there is no "obligation" to produce even though the consequence of failure to produce would be the automatic termination of the lease. In this case the lessee relied upon

* This portion of the paper was written by J. C. Bjornson, Richfield Oil Corporation.

[44] *Wolfe* v. *Texas Co.* 83 F (2d) 425), (1963).

[45] *Canadian Superior Oil of Californit* v. *Kanstrup*, (1964), 47 W.W.R. 129; 43 D.L.R. (2d) 261.

the "force majeure" clause to excuse his failure to produce because of want of a market coupled with conservation laws forbidding waste. While this case involved pooling and payment of shut-in royalty, it is significant for purposes of this paper because the courts found that under the particular lease in question there was no obligation to produce and the lease was therefore forfeited as the force majeure provision did not become operative.

In the United States the majority of the courts hold the oil and gas lease to be a "determinable fee" with the lease determining at the expiration of the primary term if there is no production at that time. In States where the determinable fee principle is not applied, it is generally the rule that where a well capable of producing in paying quantities is drilled and completed within the primary term but the operator is unable to market the product immediately on account of a lack of available market or pipeline connection, the lease will not terminate if the operator exercises due diligence in seeking a market, and the market is found within a reasonable time. This distinction arises out of differences in opinion as to the nature of the interest of a lessee in the leased substances. Some are of the opinion that it is a profit a prendre, others, that it is a licence.

In Canada an oil and gas lease is categorized as a profit aprendre. The Supreme Court of Canada so held in *Berkheiser* v. *Berkheiser*.[46] It follows therefore, that in Canada the courts would likely hold that the duty of the lessee is to make reasonable efforts to market production.

United States Courts have held that the implied obligation to market carries with it certain other obligations. These are stated by Merrill to be:[47]

1. To market within a reasonable time.
2. To realize the highest price obtainable by the exercise of reasonable effort.[48]
3. To prepare the product for market.
4. To transport the product to a market.
5. To construct facilities to utilize production or furnish an outlet.
6. To account, measure, etc.

Duty to Market Within a Reasonable Time

In the case of *Carroll Gas and Oil* v. *Skaggs*,[49] it was held by Logan J. of the Kentucky Court of Appeal that "there was a necessary inference that the gas be marketed in a reasonable time" and " An oil and gas lease may, in general terms, expressly state that the lessee is under a duty to market the oil or gas found in the land. In the absence of such a provision there is an implied duty of the lessee to market the product".[50]

There is a wide variation in judicial decision as to what constitutes a reasonable time, which depends upon the facts in each case. In one instance it was found that a reasonable time is the time it would take to construct a pipeline to the nearest market. In another instance the term of three years was found to be a reasonable time. Obviously, it is ex-

46 *Berkheiser* v. *Berkheiser*, [1957] SCR 387; 7 DLR (2d) 721.
47 *Covenants Implied in Oil and Gas Leases*, 212 (2nd ed. 1940).
48 *Livingston Oil Corp.* v. *Waggoner*, 273 S.W. 903, (1925).
49 *Carroll Gas and Oil Co.* v. *Skaggs*, 21 S.W. (2d) 445, (1929).
50 Quoted with approval, in Summers, *Oil and Gas*.

tremely difficult to determine what would be considered a reasonable time in any given factual situation.

Duty to Realize the Highest Price Obtainable

Livingstone Oil Co. v. *Waggoner*[51] is authority for the proposition that the lessee is under a duty to realize the highest price obtainable. In this case it was found that casing head gas produced with oil and used in a vacuum process was "oil" and that royalty was payable thereon even though the casing head gas was not sold.. Williams[52] states that this duty does not purport to maximize the non-operators' receipts at the operators' expense. The standard of a "reasonably prudent operator" does not place so onerous a burden upon a lessee.

Some United States cases indicate that a lessee is under no duty to extract liquid hydrocarbons or casing head gas unless it can be shown that such products can be extracted at a profit.

In Canada, conservation legislation has all but removed from the area of implied covenant this problem of the duty to realize the highest price obtainable.

Preparation for Market

In the United States the main trend is in support of the theory that the lessee must at his own expense prepare the product for market. California and Louisana are exceptions to this general rule, the former following the custom that the lessee need only account for the oil after removing free water and the latter looking to the royalty clause and if it calls for delivery of the product the lessee must bear the cost of preparing it for market and if it provides for a share of royalty in money the lessor must bear his share of the expense.

In some areas purchasers deduct a flat percentage, usually three (3%) percent of the oil purchased, to provide against impurities. The question then arises whether a lessee should protect his lessor from such a deduction where the amount of impurities is less than the amount deducted.

In Canada some lease forms in use provide for a royalty on oil "produced and saved" from the lands. More commonly, the royalty is based on the current market value at the well of all oil produced, saved and marketed and may go on to add that the market value is to be determined after deducting any expenses for treating the oil or rendering it merchantable.

With reference to gas, the lessee ordinarily must see to it that the gas is of a standard acceptable to the purchaser and royalty is paid on the purchase price after deduction of a gathering and processing charge. While the various United States jurisdiction, relying on custom and usage, have treated this matter in varying ways and have developed divergent principles, there is little case law in Canada which would support an implied obligation to prepare the product for market. The specific royalty clause now contained in most oil leases removes much of the difficulty in determining whether or not a lessee must prepare the product for market at its own expense. However, there are many leases in existence which do not explicitly state that deductions may be made for pro-

51 *Ante* n. 48.
52 *Fiduciary Principle in the Law of Oil and Gas*, 13th Ann. Institute on Oil and Gas, 201.

cessing the product. Merrill points out in considering the Louisana rule that it very often works inequities when strict adherence is given to the wording of the individual leases. He states that most lessors do not appreciate the significance of the crucial words in the royalty clause by which the courts determine whether royalty is a portion of the production, in which event no processing charge would be allowed, or whether it is a portion of the proceeds of production, in which case such processing charges are deemed to be chargeable against the lessor.

One Canadian case appears to follow the principle of adhering to the wording of the lease. In the Ontario case of *Myers* v. *Union Natural Gas Co.*,[58] it was found that royalty was payable "on all gas sold". This case did not relate to processing charges but rather to the deduction of exchange, and the court found that no new agreement could be construed from the conduct of the defendant company and that the words of the agreement should be given their ordinary meaning.

In Canada, another factor which would limit the freedom of a lessee in this area is the existence of regulatory bodies, such as the Gas Utilities Board and the Oil and Gas Conservation Board, whose operations work to standardize matters relating to the processing and transportation of the product to market. This area is fraught with difficulties and might certainly be a fruitful ground for litigation. It remains to be seen whether Canadian courts will be inclined to impose on lessees a duty to use efficient methods of processing so as to preserve the full value of the royalty to the lessor.

Duty to Transport The Product to Market

Merrill states that the lessee's duty is merely to arrange for the sale of the product from the lease. If the lessee does transport the product to a market, on what basis must he account? Merrill raises three alternatives:

1. The lessee cannot claim a deduction for transportation.
2. The lessee must account on the basis of the price received less a reasonable deduction for transportation.
3. The lessee can purchase the product at the outlet at its fair value and keep any amount received in excess of transportation costs.

Merrill favours the second alternative and it certainly removes some of the obvious fiduciary pitfalls inherent in the third alternative. The first alternative he finds insupportable.

It is again strictly an area of speculation as to whether or not Canadian courts will find a duty to transport the product to market but such a possibility appears extremely remote.

Construction of Facilities

There appears to be no authority in Canada or the United States for extending the principle of the implied obligation to market to include an obligation to construct facilities to utilize production or furnish an outlet for it, although at least one writer has suggested the possibility.

Other Duties

The remaining areas under the general heading of Implied Covenant to Market, namely to account, including measuring, and the duty to pay

58 (1922), 53 O.L.R. 88.

taxes on production have been removed, insofar as they pertain in Canada by government regulations in the former case and by a tax clause in the lease in the latter.

Other Problems

If the doctrine of the implied covenant to market were to be applied in Canada, it is interesting to speculate as to the effect this doctrine would have on the shut-in gas clause found in most leases in current use. At what point would the lessee have exhausted the possibility of marketing production?

Also of interest is the question of the effect of conservation legislation on the implied obligation to market. For example, if an extra-provincial market is available, is it an answer to the lessor that provincial legislation prohibits export to a market outside a Province?

Conclusion

In conclusion, the implied covenant to market production is virtually an unexplored territory in Canada. The United States experience, while helpful from a historical point of view, should have very limited application in Canada because of the early enactment of conservation legislation, the more explicit and extensive nature of the leases in use in Canada and the pronounced reluctance of Canadian Courts to develop the doctrine of implied covenant beyond its historical limitations.