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IMPLIED COVENANTS IN OIL AND GAS LEASES IN CANADA

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I. Introduction

The first well successfully drilled in North America for crude oil production was in Canada at Oil Springs, Ontario, in 1857. The Canadian industry was, nevertheless, soon outstripped in production by its United States counterpart. By 1940, Canada produced only 0.4 percent of the world's oil as compared to the United States' 62 percent of world production. In 1947, however, the discovery of a three billion barrel reservoir at Leduc, Alberta, marked the birth of the modern Canadian oil and gas industry. By 1974, Canada's share of an exploding world production had increased to 6 percent.

The Canadian oil and gas industry between 1857 and 1947 did not generate a body of jurisprudence adequate to regulate the industry in its immense subsequent growth. The "casual" approach to mineral leasing previously employed, where each lease was typed individually, was no longer appropriate. After reviewing United States jurisprudence and benefiting from its 100 years of drafting and litigation experience, Canadian lawyers in 1947 developed a standardized form based on the United States Producers 88 Lease.[1] The lease sought by express provision to minimize the significance of implied covenants. Modern private and Crown leases have continued this approach. The use of these standardized leases, however, has not completely precluded the implication of covenants in Canadian gas and oil leases. This article will discuss implied covenants in Canadian gas and oil leases and compare them with covenants implied in oil and gas leases in the United States.

II. Implied Covenants to Develop

A. *In the United States*

The United States doctrine of implied covenants to develop in oil and gas leases has been attributed to several industry practices and notions present at the end of the 19th and beginning of the 20th centuries, notably the

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1. J. Ballem, The Oil and Gas Lease in Canada 8 (1973).

following:[2] (1) the primary object and principal consideration of an oil and gas lease was the payment of royalties; (2) minerals were both inexhaustible and fugacious[3] and of no value until captured and marketed; thus it was in the best interests of lessor, lessee and the general public that they be captured as quickly and completely as possible; (3) the need to protect the substantial pecuniary interest of the lessor over which the lessee has control. In response to these ideas, United States courts fashioned a doctrine of implied covenants,[4] which embraced: (1) the implied covenant to drill an exploratory well; (2) the implied covenant to conduct additional development after paying production is obtained; (3) the implied covenant for diligent and proper operation of wells; (4) the implied covenant to market or utilize the products; and (5) the implied covenant to protect the leased premises against drainage by wells drilled on adjoining lands.

The Court in *Brewster v. Lanyon Zinc Co.*[5] offered the following rationale for the implication of covenants in oil and gas leases:

> Considering the migratory nature of oil and gas, and the danger of their being drawn off through wells on other lands if the field should become fully developed, all of which must have been in the minds of the parties, it is manifest that the terms of the lease contemplated action and diligence on the part of the lessee. There could not well have been an express stipulation as to the number of wells to be drilled, as to when the wells, other than the first, should be drilled, or as to the rate at which the production therefrom should proceed, because these matters would depend in large measure upon future conditions, which could not be anticipated with certainty . . . . The subject was, therefore, rationally left to implication, necessarily arising in the absence of express stipulation, that the further prosecution of the work should be along such lines as would be reasonably calculated to effectuate the controlling intention of the parties as manifested in the lease, which was to

2. *See* Eberhardt, *Effect of Conservation Laws, Rules and Regulations on Rights of Lessors, Lessees and Owners of Unleased Mineral Interests*, 5TH ANN. INST. ON OIL AND GAS LAW AND TAXATION 125 (1954). Moses, *Development of Modern Oil and Gas Lease*, 2ND ANN. INST. ON OIL AND GAS LAW AND TAXATION 1 (1951). *See also* M. MERRILL, COVENANTS IMPLIED IN OIL AND GAS LEASES 23 (2nd ed. 1940).

3. Brewster v. Lanyon Zinc. Co., 140 F. 801 (8th Cir. 1905).

> Unlike coal, iron, and other minerals, [oil and gas] do not have a fixed situs under a particular portion of the surface, but are capable of flowing from place to place and of being drawn off by wells penetrating their natural reservoir at any point. They are part of the land, and belong to the owner so long as they are in it, or are subject to his control; but when they flow elsewhere, or are brought within the control of another by being drawn off through wells drilled in other land, the title of the former owner is gone.

Id. at 809.

4. E. BROWN, THE LAW OF OIL AND GAS LEASES § 16.02 (1958).

5. 140 F. 801, 810 (8th Cir. 1905).

> make the extraction of oil and gas from the premises of mutual advantage and profit.[6]

In construing oil and gas leases, United States courts generally favor implied covenants for development.[7]

B. *In Canada*

The need for express provisions in Canadian leases might be questioned insofar as the influential circumstances fostering the doctrine of implied covenants in the United States were and are absent in the growth and development of the modern Canadian oil and gas industry. Erroneous beliefs as to the availability and properties of oil and gas have long since been corrected. It is obvious today that the world's resources of oil and gas are finite and that oil does not "flow in streams." Today's marketing requirements encourage conservation. Stable market conditions demand a steady and certain supply of oil; such may be obtained by securing reserves for the future. The Canadian climate is one in which conservation is demanded along with production.[8]

This attitude is manifested in Canada's conservation legislation. Section 5 of the Alberta Oil and Gas Conservation Act[9] provides, *inter alia:*

> The purposes of this Act are (a) to effect the conservation of, and to prevent the waste of, the oil, gas and crude bitumen resources of Alberta; (b) to secure the observance of safe and efficient practices . . . (c) to afford each owner the opportunity of obtaining his share of production of oil or gas from any pool or of crude bitumen from any oil sands deposit . . . .

The statutes of British Columbia,[10] Saskatchewan,[11] and Canada[12] afford similar declarations of public policy. It thus appears that Canadian courts will not be as well-disposed as United States courts to the implication of covenants to develop in oil and gas leases.

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6. *Id.* at 811-12. *See* H. WILLIAMS & C. MEYERS, 5 OIL AND GAS LAW § 802 (1972).

7. E. BROWN, THE LAW OF OIL AND GAS LEASES § 16.01 (1958).

8. 1914 was the year of the first major oil discovery in Canada at Turner Valley in Alberta. Flaring of residue gas up to 600 million cubic feet per day upon 4,000 barrels of condensate during production has limited the possible amount recoverable to 1.2 million barrels of condensate. It is estimated that with proper production techniques it would have been possible to recover half a billion barrels. "It was Alberta's first, and last costly lesson in petroleum conservation." E. GRAY, IMPACT OF OIL 11 (1969).

The judicial approach at the turn of the century is indicated in Lang v. Provincial Gas and Fuel Co., [1908] 12 O.L.R. 262. Chancellor Boyd commented:

> In oil contracts, time is of the essence of the bargain, and a strict rather than a lax reading would be appropriate with reference to the drilling or sinking of a well.

9. R.S.A. 1970 c. 267.

10. Petroleum and Natural Gas Act S.B.C. 1965 c. 33.

11. The Mineral Resources Act R.S.S. 1965 c. 50.

12. Oil and Gas Production and Conservation Act. R.S.C. 1970 c. 0-4.

Although a policy of conservation may predominate, it does not preclude the implication of obligations to develop upon the lessee arising from his relationship to the lessor. Canadian courts will respect the intentions of the parties to the lease. The task of the Canadian court in the interpretation of documents was described in *Toronto Railway Co. v. City of Toronto:*[13]

> In construing an instrument in writing, the court is to consider what the facts were in respect to which the instrument was framed, and the object as appearing from the instrument, and taking all these together it is to see what is the intention appearing from the language when used with reference to such facts and with such an object . . . .[14]

The Appellate Division of the Supreme Court of Alberta recently applied such analysis to an oil and gas lease in *Cull v. Canadian Superior Oil.*[15]

Unlike United States courts,[16] however, Canadian courts do not follow the maxim that an oil and gas lease should be construed in favor of the lessor and against the lessee. The validity of the maxim in Canada would seem confined to securing construction of a lease against the party who prepared it, in cases of ambiguity or uncertainty and where other rules of construction fail.[17] Canadian courts do, nevertheless, recognize that parties ordinarily contract under the assumption that the other party will cooperate in order to carry out the purposes of the contract. In 1849, Chief Justice Wilde[18] concluded that an agreement between *A* and *B* that *A* shall buy certain property from *B* imports an understanding by *B* to sell the property to *A*. The learned Chief Justice commented:

> The form of the deed does not shew clearly in one part a covenant by the plantiff, and in another part a covenant by the defendants:

13. [1906] 37 Can. S. Ct. 430.
14. *Id.* at 434 (Sedgewick, J.).
15. [1970] 75 W.W.R. 606, 611; *See also* 16 D.L.R. 3d 709, 713 (Alta. C.A.), *aff'd,* [1971] 3 W.W.R. 28; [1971] 20 D.L.R. 3d 360 (S. Ct. Can.), where the court commented: "In interpreting these clauses we must keep in mind the realities of the situation and the purposes which are contemplated by the lease."
16. E. BROWN, LAW OF OIL AND GAS LEASES § 16.04 (1958).
17. Shell Oil Co. v. Gibbard, [1961] S.C.R. 725

> The lease, as stated, was proposed in its present form by Griffith and, in my opinion, if there were ambiguity in the language employed and doubt raised as to the meaning of such language, it should, if need be, be construed in accordance with the maxim *verba chartarum fortius accipintur contra proferentem* . . . .
> This rule of construction is to be applied only when other rules of construction fail . . . .

Id. at 731. This approach indicates little judicial sympathy for the "poor, ignorant and illiterate farmer," whose persona as lessor has been suggested as promoting the doctrine of implied convenants. Williams, *Comments on Oil and Gas Jurisprudence in Canada and the United States,* 4 ALTA. L. REV. 189, 190 (1965-66). The rule might also work against the Crown as lessor in the development of Crown minerals but for an ancient rule of uncertain efficacy: "The King's grant is taken most strongly against the grantee and most favourably for the King." Willion v. Berkley [1562] 1 Pl. Com. 223, 243.
18. Wood v. The Governor and Company of Copper Miners in England, [1849] 7 C.B. 906.

> but it is an instrument under seal, and the intention of the parties is sufficiently apparent from the whole language of it: it shews, with reasonable certainty, what it is that was intended to be contracted for by each party.[19]

The modern United States doctrine of implied covenants is suggested to rest upon this notion—"the principle of co-operation."[20] Such an approach was approved by the Appellate Division of Alberta Supreme Court in the interpretation of an oil and gas contract in *Canadian Delhi Oil Ltd. v. Alminex Ltd.*[21] The unstartling conclusion is that courts will try to afford proper recognition to the lessee's need to control or administer the lessor's mineral interest and effectuate the objects of the parties as indicated by the language of the lease. Canadian courts may therefore imply covenants to develop in situations where such covenants were intended by the parties and do not conflict with the public policy reflected in the Canadian conservation legislation.

III. The Effect of Conservation Legislation on Implied Covenants

Conservation legislation in Canada imposes spacing[22] and prorationing[23] requirements that differ from the obligations that might otherwise be implied under an oil and gas lease. Drilling is regulated by the spacing requirement, albeit at limited injury to lessor or lessee because the requirement is based on the notion of efficient drainage of a reservoir. Production is controlled by the prorationing allowance attributable to the well.

The particular significance of such legislation arises from the presumption that the parties intend to contract with reference to the law existing at the time the contract is made. No covenant will be implied that is inconsistent with legislation in effect at the time of the formation of the lease, and, in the event subsequent legislation renders performance impossible,

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19. *Id.* at 936.

20. H. Williams & C. Meyers, 5 Oil and Gas Law § 802.1 (1972).

21. [1967] 62 W.W.R. 513.

> It is necessary first to ascertain what is the commercial nature or purpose of the adventure that is the subject of the contract; that ascertained, it has next to be asked what within this scope are the essential terms, which, so far as not expressed, must be implied in order to make the contract efficacious as a business instrument.

Id. at 523, *quoting* Lord Radcliffe in Tsakiroglou & Co. v. Noblee Thor. 1, [1962] A.C. 93, 122, [1961] 2 W.L.R. 633.

22. Canadian conservation legislation essentially provides that only one oil well may be drilled per 160 acres and one gas well per 640 acres. This minimum surface area is called the spacing unit.

23. The Energy Resources Conservation Board (in the province of Alberta) or the Oil and Gas Conservation Board (in the Provinces of British Columbia and Saskatchewan) allocates a maximum amount that may be produced from each well. This is called the "allowable" for that well. The "allowable" for each well is determined according to the available market for production and/or the maximum efficient rate of production for each well.

the covenantor will be excused from performance.[24] This reasoning was applied in *Vulcan-Brown Petroleums v. Mercury Oils Ltd.*,[25] where the court found no promise to drill a second well because such drilling would have contravened drilling regulations.[26]

In *Reynolds v. Ackerman*,[27] however, the Alberta Supreme Court concluded that the conservation legislation did not excuse a failure to drill on the part of the covenantor.[28] At the time of the formation of the lease, conservation legislation required a minimum spacing unit requirement in Alberta of 40 acres; the lease encompassed only 10 acres. The trial judge's decision may be explained on the basis that the covenant implied did not impose a duty inconsistent with the legislation. "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."[29] This explanation is not evident in the court's language, but both traditional[30] and American[31] authority does support such a position.

Lessees have sought to ensure that no liability is imposed for breach of an implied covenant when performance will be in contravention of conservation legislation by the use of "compliance with laws" clauses. An example of such a clause:

> The lessee shall conduct all its operations on the said lands . . . in compliance with the provisions of law applicable to such operations, and where such provisions of law conflict or are at variance with the provisions of this lease, such provisions of law shall prevail.

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24. Baily v. De Crespigny, [1869] L.R. 4 Q.B. 180; 8 Hals. Laws (3rd ed.) 'contracts', § 319. *See also* § 21 Oil and Gas Conservation Act R.S.A. 1970 c. 267, which declares that conservation legislation regulation and orders override conflicting terms of any contract and such terms are unenforceable.

25. Vulcan-Brown Petroleum Ltd. v. Mercury Oils Ltd., [1942] 1 W.W.R. 138, [1942] 1 D.L.R. 209 (Alta. C.A.), *aff'd*, [1943] S.C.R. 37, [1943] 1 D.L.R. 369.

26. *Id.* at 150. The court, per Justice Clarke, reasoned:

> In the present case I think there was no absolute promise [to drill a second well in an oil and gas lease]. It is evident that the plaintiff could not fulfill the agreement to drill the second well, and also observe the regulation which prevent the drilling, so it is necessary to infer an implied term, and I think it a reasonable implication that the agreement to drill is subject to there being no prevention by the regulation which both parties were bound to observe.

27. [1960] 32 W.W.R. 289 (Alta. S.C.).

28. Justice McBride commented:

> I find no excuse or explanation in any regulation, or the fact that maybe a minimum acreage of 40 acres is required, to resolve in favour of the plaintiff the implied covenant in question which otherwise appears on the face of the instrument.

Id. at 298.

29. Brown, *Problems in Development of Leased Lands*, 4 ALTA. L. REV. 302. *See also* Canada-Cities Service Petroleum Corp. v. Kininmonth, [1964] 34 W.W.R. 392, 43 D.L.R. (2d) 56.

30. J. W. Taylor & Co. v. Landowner & Co., [1940] 4 All E.R. 335.

31. *See* H. WILLIAMS & C. MEYERS, 5 OIL AND GAS LAW § 861.4 (1972) (list of authorities).

The efficacy of this clause was upheld by the Supreme Court of Canada in *Mercury Oils v. Vulcan-Brown Petroleums.*[32] The court affirmed the reasoning of the Alberta Court of Appeal, which Justice Ford had expressed as follows:

> In my opinion the proper view is that while the covenant to commence the drilling of a second well within the time stipulated is not 'repealed' by the supervening illegality or impossibility, the consequences of not so commencing do not presently arise.[33]

In order to secure the protection of the "compliance with laws" clause it must be established that the covenanted performance is rendered impossible of performance by the conservation legislation. The protection of the clause was denied to a lessee in *Canadian Superior Oil Ltd. & Sourry-Rainbow Oil Ltd. v. Kanstrup.*[34] The lease provided for its termination in the event of a failure to produce at the expiration of the primary term. The lessee contended that regulations requiring him to keep his well capped excused, under a "compliance with laws" clause, his failure to produce during the primary term.[35] The court found that the lessee's failure to produce for sale or use was because there was no market or use for the gas, and not because of the regulations.[36]

IV. Certain Express Provisions Common in Canadian Leases and Their Effect on Implied Covenants

> It is, of course, impossible to imply in a contract any term or condition inconsistent with its express provisions, or with the intention of the parties as gathered from those provisions.[37]

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32. [1943] Can. L.R. 37 (1942), [1943] 1 D.L.R. 369 (1942).

33. [1942] 1 W.W.R. 138, 152, [1942] 1 D.L.R. 209, 228. The court met the lessor's argument that the lessee should have foreseen the change in the regulations as follows:

> The argument that the change in the regulations, to which, as is common ground the impossibility of performance is due, is something which should have been foreseen by the respondent and provided against, and of which he must be deemed to have taken the risk, is answered by this, that it was foreseen as much by one party as the other and was guarded against by the requirement that all regulations present or future were to be obeyed.

Id. at 152.

34. [1965] Can. L.R. 92 (1964), 49 W.W.R. 257, 47 D.L.R. 2d 1.

35. The lessee argued that he

> was precluded by law from blowing gas from its well into the air, and as it was bound by a Board order to keep the well capped, compliance with these legal requirements should not, under [a 'compliance with laws' clause], constitute a cause for the termination of the lease.

Id. at 103-04.

36. *Id.* at 103-04.

37. F.A. Tamplin S.S. Co. v. Anglo-Mexican Petroleum Products Co., [1916] 2 A.C. 397, at 422, 85 L.J.K.B. 1389, per Lord Parker, quoted with approval by Smith, C.J.A., in Canadian Delhi Oil v. Aliminex, [1967] 62 W.W.R. 513, 525 (Alta. S.C., App. Div.).

A. *Private Leases*

Private leases are those held from a party other than the Crown. The form of the typical lease owes much to the experience of the oil and gas industry in the United States.

"[T]he western Canadian oil industry has absorbed not only engineering and geological techniques developed in the United States, but also documents which had their origin and *raison d'etre* in the judicial pronouncements of the Texas and Oklahoma courts."[38]

The majority of private Canadian oil and gas leases are drawn up by the lessee oil companies. In contrast to these leases is the so-called "lessor's lease." Substantial holdings of minerals by a few large corporations, in particular the Hudson's Bay Company and the Canadian Pacific Railway, have enabled them to impose terms which differ considerably from those found in other private leases. The Hudson's Bay Company obtained 7 million acres, from which it reserved mineral rights upon transfer to settlers after 1908, in return for its efforts in the development of Canada. The Canadian Pacific Railway obtained 22 million acres, from which it reserved mineral rights after 1902, in return for the building of the trans-Canada railway. The Canadian Pacific Railway conducts its oil and gas operations under the name Pan Canadian Petroleum. The terms of a lessor's lease are generally more protective of the lessor's interests than are the "lessee's leases" normally employed by the oil companies.

1. The Covenant to Drill Exploratory Wells Promptly

The implication of covenants requiring prompt exploratory and developmental drilling in the United States led to the emergence of express provisions dealing with delays in development.[39] Compensation for such delays was provided in the form of cash bonuses at the time of the agreement to lease and by the payment of "delay rentals." The oil and gas leases in use in Canada reflect such development and an "unless" clause or "drill or pay" clause is invariably present.

A "drill or pay" clause was litigated in 1906 in *Docker v. London-Elgin Oil Co.*[40] The plaintiff sought to establish a breach of a covenant to drill. The lease was for a ten-year term and provided:

> This lease is made for the purpose of enabling the lessee and his assigns, and he is and they are hereby authorized and empowered to sink or drill oil wells . . . .
> . . . [the lessee] will commence operations upon the said premises

38. Ballem, *The Perilous Life of an Oil and Gas Lease*, 44 CAN. BAR REV. 523, 528 (1966).
39. Lewis, *The Canadian Petroleum and Natural Gas Lease*, 30 CAN. BAR REV. 965 (1952); Moses, *Development of Modern Oil and Gas Lease*, 2ND ANN. INST. ON OIL AND GAS LAW AND TAXATION 1 (1951).
40. [1907] 10 O.W.R. 1056 affirmed [1908] 11 O.W.R. 726 C.C.A. 1.

> on or before the first day of November, 1902, or will pay to the lessor or his assigns the sum of $6 per month from the date hereof until operations are commenced on the said premises.

Chief Justice Mulock concluded:

> I do not construe the covenant as an unconditional one to make such commencement [of operations], but an alterative covenant to do one of two things namely, either to make such commencement or to pay $6 a month from the date of the lease.[41]

The court went so far as to grant the lessee equitable relief from forfeiture for nonpayment of the rent.[42]

The "unless" clause[43] was similarly declared effective to preclude the implication of a covenant to drill an exploratory well in *East Crest Oil Co. v. Strohschein.*[44] This might suggest that in Canada, the implied covenant to drill an exploratory well "has been rendered a dead letter by the development of the oil and gas lease form."[45]

Such a conclusion, however, may be premature. In *Reynolds v. Ackerman,*[46] the parties in 1949 prepared a two-page typewritten lease which provided:

> 'lessor', did thereby demise and lease unto the plaintiff as the 'lessee' for the sole and only purpose of mining and operating for water, oil and gas and of laying pipeline and of building tanks, stations and structures thereon necessary and convenient to take care of the said products, all of the lands which are then described . . . .

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41. *Id.* at 1057-58.
42. *Id.* at 1059-60.

Plaintiff's counsel contended that the real object of the lease was to secure to the plaintiff the operation of the lands for mining purposes, and that, therefore, no equitable relief could be given to the defendants, because of their default in payment of the rent, and he relied upon the words quoted above from the lease: 'This lease is made for the purpose of enabling the lessee, his heirs and assigns, and he is and they are hereby authorized and empowered, to sink, drill,' etc. The fair meaning of these words is not to create a duty on the lessee to operate, but merely to confer upon him the right to do so, and therefore they in no way modify the nature of the alternative covenant above quoted, which is the only provision in the lease obliging the defendants and then only in the alternative, to operate.

43. A typical "unless" clause is found in East Crest Oil Co. v. Strohschein, [1951-52] 4 W.W.R. (N.S.) 553, 555 [1952] 2 D.L.R. 432, 433-34 (Alta. S.C. App. Div.).

> Provided that if operations for drilling are not commenced on the said land on or before one year from the date hereof the lease shall then terminate as to both parties unless on or before such anniversary date the Lessee shall pay or tender to the Lessor . . . the sum of One Hundred and Sixty Dollars which shall be known as delay rental and shall cover the privilege of deferring the commencement of drilling operations for a period of one year.

Id. at 555, [1952] 2 D.L.R. at 433-34.

44. [1951-52] 4 W.W.R. (N.S.) 553, [1952] 2 D.L.R. 432 (Alta. S.C. App. Div.).
45. H. WILLIAMS & C. MEYERS, 5 OIL AND GAS LAW § 812 (1972).
46. [1960] 32 W.W.R. 289 (Alta. S.C.).

> . . . for a term of three years from the date thereof at a rental of one-eighth part of all oil produced and saved on the said lands . . . . The lessee shall pay to the lessor for the said period of three (3) years of this lease the sum of Two Hundred ($200.00) Dollars upon the 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, shall have been fully done and performed.[47]

Even though there was no express covenant to drill, the court held that there was an implied covenant to drill an exploratory well. The basis for the implied covenant was that there was no provision terminating the lease if the lessee failed to conduct drilling or exploration.[48] The court distinguished *East Crest* by noting that the lease in that case did contain a termination clause, but did not contain any provision for extension of the term or for delay rental.[49] The court believed that allowing the lessee to hold the land for an indefinite number of years simply by paying the insignificant "rental" in the lease could not have been the intention of the parties.[50]

The learned judge described the renewal payment as "rental." *Reynolds* appears to be founded on the doctrine established in the Indiana decision of *Consumers Gas Trust Co. v. Littler*,[51] described by Summers as follows:

> In the light of the relations of the parties under the forms of lease above mentioned [nominal initial cash consideration for a 'long-term' or 'no-term' lease reserving nominal rental for delay] and the well-established principles of law and policy with respect to the construction and interpretation of oil and gas leases, it is not at all strange that the courts, to effect justice, overlooked the express intention of the parties in such leases, to the effect that development of the property might be indefinitely postponed by the payment of delay rental, and found that their intent was that the land should be developed within a reasonable time, and enforced that intention by implying into such leases a condition to develop the land within a reasonable time after notice on the pain of forfeiture.[52]

Littler was decided in accord with the then well established principle of

47. *Id.* at 290.
48. *Id.* at 297-98 (McBride, J.).
In the case at bar that is a very material distinction. Here we have no provision which terminates the lease if nothing is done by the lessee in the way of drilling or exploration during the first term of three years, nor, for that matter, if the lease is capable of renewal from year to year, is there any express covenant on the part of the lessee to drill during any of those subsequent renewals. 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.
49. *Id.* at 297.
50. *Id.* at 298.
51. 162 Ind. 320, 70 N.E. 363 (1904).
52. W. SUMMERS, 2 OIL AND GAS § 397, at 541 (1959).

construction that oil and gas leases should be so construed as to promote development and prevent delay. It is suggested that the application of the principle of *Littler* to the circumstances of *Reynolds* is regrettable. The decision might better have emphasized the small amount of consideration given for the lease, *i.e.*, the cash consideration *and* royalties from production. Such analysis would also entail the implication of a covenant to drill. The principle of *Littler* was inappropriate to *Reynolds* because the language of the *Reynolds* lease referred to renewal, not rental, and thus did not indicate a consideration in lieu of drilling.

Reynolds is especially significant because at least two major oil and gas enterprises use "rental clauses" that do not expressly defer the obligation to drill. The leases employed by the Hudson's Bay Company and Petrofina Canada provide:

> The lessee will pay or cause to be paid to the lessor an annual rental of ________ Dollars, being at the rate of One ($1.00) Dollar per acre payable in advance on the ________ day of ____________ in each year of the term of the lease.

It is suggested that the moving consideration for such a lease is the royalties from production, depending on the size of the initial cash consideration and length of the term of the lease. *Reynolds* suggests that a Canadian court would not be reluctant to imply a covenant to drill an exploratory well in such circumstances.

2. The Covenant of Diligent and Proper Operation

United States jurisprudence has established an implied covenant for diligent and proper operation of wells. The imposition of such a duty on the lessee would seem in accord with a modern understanding of the expectations of reasonable men in the positions of the lessor and lessee. The significance of the implied covenant in Canada, however, is limited by the prevalence of express provisions and the regulation of drilling practices by legislation.

Only one oil company[53] indicated that it employed a lease without an express provision concerning operations, and even the form of lease there employed contained a "compliance with laws" clause. The overwhelming majority of private leases used in the industry contain the following:

> The lessee shall conduct all its operations on the said lands in a diligent, careful and workmanlike manner and in compliance with the provisions of law applicable to such operations, and where such provisions of law conflict or are at variance with the provisions of this lease, such provisions of law shall prevail.

The clause is a mere restatement of the provision that might otherwise be implied. A "lessor's lease" that appears to impose a higher standard is that of Pan Canadian Petroleum Ltd.:

53. Amoco Canada Petroleum Co. Ltd.

> The lessee shall conduct its operations on the said lands in a diligent, careful and workmanlike manner with a view to the maximum recovery of the leased substance from the said lands and in compliance with the law applicable to such operations . . . .

Conservation statutes and regulations set down mandatory procedures in drilling operations. Such procedures may conflict with that demanded by the duty to conduct operations in the "diligent, careful and workmanlike manner" specified in the lease provisions above. The "compliance with laws" provisions seek to protect the lessee in such circumstances.

3. The Covenant to Protect the Premises Against Drainage

> In the absence of an express covenant the [United States] courts uniformly hold that there is an implied covenant on the part of the lessee to drill wells offsetting those on adjoining lands which are draining oil or gas from his leased property, provided the drilling of such offset wells will be profitable.[54]

The covenant described above has never been implied in Canada. Almost every private lease in use in Canada contains an express provision concerning offset wells.[55] The provision typically provides that, within six months after regular commercial production has been obtained from a well drilled on any spacing unit not owned by the lessor which laterally adjoins the leased lands, the lessee must either drill an offset well, surrender such part of the leased premises where an offset well can be drilled or surrender all formations other than the one the neighboring well is using and from which the lessee is obtaining production.[56] The express clause imposes obligations on the lessee less burdensome than might otherwise be implied. The obliga-

54. E. BROWN, 2 THE LAW OF OIL AND GAS LEASES § 16.02 (1958).

55. The only two exceptions in company practice were the lease forms employed by Home Oil Company Ltd. and Texaco Exploration Canada Ltd. in Ontario. Both forms contain an exclusion clause which seeks to exclude implied covenants.

56. A typical provision is as follows:

OFFSET WELLS:

In the event of commercial production being obtained from any well drilled on any spacing unit laterally adjoining the said lands and not owned by the lessor, or, if owned by the lessor, not under lease to the lessee, then unless a well has been or is being drilled on the spacing unit of the said lands laterally adjoining the said spacing unit on which production is being so obtained and to the horizon in the formation from which production is being so obtained, the lessee shall, within six (6) months from the date of said well being placed on regular production, do one of the following:

(a) Commence or cause to be commenced within the six (6) month period aforesaid operations for the drilling of an offset well on the spacing unit of the said lands laterally adjoining the said spacing unit on which production is being so obtained, and thereafter drill the same to the horizon in the formation from which production is being obtained from the said adjoining spacing unit; or

(b) Surrender all or any portion of the said lands pursuant to the provisions of paragraph 12 hereof, provided that the lands surrendered shall include that portion of the said lands comprised in the said tion to drill is solely dependent on the obtaining of commercial production from the adjoining well. Drainage in other circumstances does not require the drilling of an offset well. The offset well obligation arises, however, regardless of the profitability of the drilling of the offset well.

A clause that was the subject of litigation in *Crommie v. California Standard Co.*[57] provided that the obligation to drill an offset well arose only upon commercial production of *petroleum* from a well within "660 feet of an exterior boundary." No obligation to drill arose upon commercial production of gas from an adjoining property. It was contended that the clause was "grossly unfair, improvident and unconscionable." The Alberta Supreme Court rejected the contention and in doing so emphasized the traditional limitations of the equitable doctrine of constructive fraud in the obtaining of an unconscionable bargain. The doctrine demands proof of inequality in the positions of the parties arising from ignorance, need or distress of the weaker.[58] The case indicates that the express clauses will be maintained unless they severely derogate from obligations that might otherwise be implied.

Consideration by the Canadian judiciary of the implied covenant to protect leased premises against drainage by wells drilled on adjoining lands is confined to *Farmers Mutual Petroleum Ltd. v. United States Smelting Refining and Mining Co.*[59] The lease provided:

> The company shall use reasonable diligence to protect any tracts covered hereby from drainage by reason of commercial wells producing on land not included in the tracts . . . and in meeting the provisions of this covenant shall and may be governed by good oil field practices and by the requirements of the statutes . . . .

Chief Justice Bence appeared to accept the defendant's contention that the clause "merely expressed what would have been implied in any event." The learned Chief Justice then examined the ambit of the duty imposed by the implied covenant in the United States and concluded:

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spacing unit laterally adjoining the said spacing unit on which production is being so obtained; or

(c) Where production is being obtained from the said lands from a formation other than the formation from which commercial production is being obtained on the spacing unit laterally adjoining the said lands, surrender all formations which lie within the said lands from which the lessee is obtaining production.

PROVIDED, that if such well drilled on lands laterally adjoining the said lands is productive primarily of only of natural gas, the lessee shall not be obligated either to drill an offset well or to surrender said spacing unit unless and until an adequate and commercially profitable market for natural gas which might be produced from the offset well can be previously arranged and provided.

57. [1962] 38 W.W.R. 447 (Alta. S.C.) (affirmed without written reasons on appeal to C.A. and to S.C.C. April 25, 1962).
58. Morrison v. Coast Finance Ltd., [1966] 55 D.L.R. 2d 710, 713 (1965).
59. [1962] 39 W.W.R. 682 (Sask. Q.B.).

> [The clause] does not require the defendants to drill for such purpose unless by so doing there is a reasonable possibility of obtaining oil in commercial quantities from such drilling.
> It seems to be an absurd requirement that the defendants should drill on a parcel just because there may be some recoverable oil in place no matter how little . . . . It would mean that the defendants might be continually drilling for the benefit of the plaintiff and with a loss to themselves.[60]

The implied covenant to protect the leased premises against drainage by wells drilled on adjoining lands is less significant in Canada than it was in the United States in the days before conservation legislation. Canada's prorationing legislation precludes unrestrained production that might otherwise drain a reservoir swiftly and effectively.

4. Express Attempts to Preclude Implied Covenants: Exclusion Clauses

a. Private Leases

The use of express provision in Canadian private leases exempts the lessee from liability for breach of obligations which would otherwise be imposed by an implied covenant. Areas remain, however, in which Canadian draftsmen have been reluctant to venture, for example, additional development after the obtaining of paying production, and marketing.[61] In these areas as in oil and gas leases in general, the major obstacle to the development of a body of Canadian jurisprudence corresponding to the United States doctrine of implied covenants is the widespread use of exclusion clauses.

Inquiry into practice in the Canadian oil and gas industry revealed the widespread use of clauses that seek to preclude the implication of implied covenants. Such a clause is that of *Home Oil Company:*[62]

> The parties hereto agree that they have expressed herein their entire understanding and agreement concerning the subject matter of this lease and grant and it is expressly agreed that no implied covenant, condition, term or reservation shall be read into this lease and grant relating to or concerning the subject matter hereof or any matter or operation provided for herein.

In 1951, Merrill[63] described such clauses as being comparatively rare in the United States, being found in only a few forms in use in California, Ohio

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60. *Id.* at 689.

61. As Merrill commented, "[T]he industry is notoriously subject to vicissitudes of production and of price which render it well nigh impossible to enter into specific agreements as to future operation and development". M. MERRILL, COVENANTS IMPLIED IN OIL AND GAS LEASES 19 (1940).

62. Similar clauses are found in the lease forms employed by Amoco, B.P.O.G., Gulf Oil, Hudson's Bay Company, Husky Oil, Marathon Oil, Mobil Oil, Petrofina and Sun Oil.

63. Merrill, *Lease Clauses Affecting Implied Covenants,* 2ND ANN. INST. ON OIL AND GAS LAW AND TAXATION 147 (1951).

and Texas. Both Merrill[64] and Williams[65] have acknowledged the willingness of the courts in the United States to give effect to such provisions. Such efficacy is, of course, subject to a construction that would not "tend to prevent the accomplishment of the purpose for which the lease was made, that is, the production of oil and gas with payment of royalty to the lessor."[66] The doctrine of "fundamental breach" in Anglo-Canadian jurisprudence imposes a similar limitation on the efficacy of an exclusion clause. Lord Hodson described the doctrine in *Suisse Atlantique Societe v. N.V. Rotterdamsche Kolen Centrale,*[67] to the effect that there is a strong, though rebuttable, presumption that exclusion clauses were not intended by the parties to excuse breaches of the fundamental terms of the contract. No precise formula has emerged for the determination of a fundamental breach. Phrases such as "an event going to the root of the contract" are conventionally employed. The doctrine may well deny efficacy to the exclusion clauses presently employed in the Canadian oil and gas industry where there is a sufficiently serious breach of an implied covenant.

Merrill[68] points out that exclusion clauses are strictly construed in the United States. To similar effect is the *contra proferentem* rule of Anglo-Canadian jurisprudence.[69] Merrill further contends:

> While the parties should be free to contract to limit or exclude the operation of the implied covenants, the bare phraseology of the lease should not be accepted as establishing that they have done so. There should be clear proof that the clause actually was called to the lessor's attention, that its effect was explained to him, that he assented freely and willingly without undue compulsion or persuasion.[70]

It has long been established that actual knowledge is not material to the determination of assent, and in particular that a person who signs a con-

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64. M. MERRILL, COVENANTS IMPLIED IN OIL AND GAS LEASES 434 (1940).
65. H. WILLIAMS, 4 OIL AND GAS LAW § 671.1 (1959).
66. Cowden v. Broderick & Calvert, Inc., 131 Tex. 434, 114 S.W.2d 1166 (1938).
67. [1966] 2 All E.R. 61, 89 (H.L.).

> [W]here there is a breach of a fundamental term . . . there is a strong, though rebuttable presumption that, in inserting a clause of exclusion or limitation in their contract, the parties are not contemplating breaches of fundamental terms and such clauses do not apply to relieve a party from the consequences of such a breach even where the contract continues in force. This result has been achieved by a robust use of a well-known canon of construction, that wide words which taken in isolation would bear one meaning must be so construed as to give business efficacy to the contract and the presumed intention of the parties, on the footing that both parties are intending to carry out the contract fundamentally.

Id. at 89.

68. M. MERRILL, COVENANTS IMPLIED IN OIL AND GAS LEASES 431 (1940).
69. Wallis v. Pratt & Haynes, [1911] A.C. 394; Andrews v. Singer, [1934] 1 K.B. 17 (C.A.).
70. M. MERRILL, COVENANTS IMPLIED IN OIL AND GAS LEASES 437 (1940).

tractual document is bound by its terms even though he has not read them.[71] The approach advocated by Merrill is not available to restrict the operation of exclusion clauses in Canadian private oil and gas leases.

b. Crown Leases

> [T]he major Alberta producers are lessees and obliged to meet the conditions established by the Government . . . .[72]

Oil and gas production in Canada occurs predominantly in the Western provinces. Percentages of Canada's oil and gas production in 1970 were as follows:[73]

	Oil	*Gas*
Alberta	75.3 percent	72.9 percent
Saskatchewan	17.8 percent	19.0 percent
British Columbia	5.4 percent	5.7 percent
Manitoba	1.4 percent	1.4 percent

Significant areas in terms of oil and gas potential are areas under federal jurisdiction in the Yukon, the Northwest Territories, the Arctic Islands and offshore the East Coast.

All land in Canada was originally owned by the Crown. The Crown transferred land ownership to homesteaders as they moved from east to west. After 1889, these land transfers were subject to a reservation of mines and minerals to the Crown. The result today is that Crown ownership of mineral rights increases drastically as one moves west into areas of settlement after 1889. In those areas of Manitoba suitable to oil and gas production, 15 percent of mineral rights are held by the Crown, in Saskatchewan 70 percent, in Alberta 90 percent, and 99 percent in northeast British Columbia. In the areas of federal jurisdiction, the Crown owns almost 100 percent of mineral rights.

Production of oil and gas of which the Crown owns the mineral rights is conducted on the terms set down by the Crown. The lessee's bargaining position is such that it must either conduct its operations on those terms or not at all. The terms of the lease are set forth in legislation such as the Alberta Mines and Minerals Act.[74] The nature of the lessee's obligation is not merely that of economic subjugation to terms. The Crown is also the law-making body. This aspect of the lessor-lessee relationship is recognized by clauses that clearly incorporate subsequent laws into the lease.[75] These

71. L'Estrange v. Graucob, [1934] 2 K.B. 394 (Div. Ct.).
72. Per Premier Lougheed of Alberta, Star-Phoenix, Saskatoon, February 28, 1974.
73. Statistics Canada, Canada Year Book (1972).
74. R.S.A. 1970 c. 238 (1970).
75. The Alberta Petroleum and Natural Gas Lease (1972) provides:
The lessee shall comply with the provisions of the Mines and Minerals Act and any Act passed in substitution therefor, and any regulations that

clauses provide what Thompson described as a "legal mechanism for controlling oil agreements so that the relationship between the government and the oil company can be made responsive to change which the public interest dictates."[76]

Under the Alberta Mines and Minerals Act, an oil and gas lease is granted for a ten-year term, subject to continuation upon the drilling of a producing well.[77] Section 125.1 provides:

> (1) . . . a lessee shall commence drilling operations on the location within one year from the date the Minister gives notice requiring him to do so and the lessee shall continue such drilling operations . . . with a view to the discovery of petroleum or natural gas.
> (2) The notice referred to in subsection (1) shall not be given in respect of any lease
> (a) that has in the location a producing well . . . .
> (3) The notice referred to in subsection (1) may be given to the lessee as to any lease that has reached the end of the 10th year of its term . . . .

The provision excludes any possibility of implying a covenant to drill an exploratory well. The terms of section 164 are obviously more advantageous to the Crown than might be the implication of such a covenant.

The implied covenant to protect the leased premises against drainage by wells drilled on adjoining lands is denied by section 134.

> (1) In this section . . . 'freehold well' means a well that produces petroleum or natural gas from a spacing unit, the petroleum or natural gas in which is not owned by the Crown in the right of Alberta.
> (2) In the event of petroleum being produced from a freehold well in a spacing unit directly offsetting a location, the lessee shall, within a period of 90 days of the date of such well coming into production commence the drilling of a well on the location to offset the freehold well and shall drill the same continuously and diligently to the strata from which the petroleum is produced.

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at any time may be made under the authority of the said Acts, and all such provisions and regulations that prescribe, relate to or affect the rights and obligations of lessees of petroleum and natural gas rights, the property of the Crown shall be deemed to be incorporated into this lease and shall bind the lessee in the same manner and to the same extent as if the same were set out herein and covenants on the part of the lessee. Each and every provision or regulation hereafter made shall be deemed to be incorporated into this lease and shall bind the lessee as and from the date it comes into force, but in the event of conflict between any regulation hereafter made and any regulation previously made the regulation last made shall prevail.

76. Thompson, *Sovereignty and Natural Resources—A Study of Canadian Petroleum Legislation*, 4 U.B.C. L. Rev. 161, 166 (1969).

77. R.S.A. c. 238, § 126 (1970).

Diligent and proper operation of wells is also secured by express covenants.[78] Legislation does not, however, impose lease provisions concerning the lessee's duty to market the product or to conduct additional development after paying production is obtained.

It has been remarked in the United States that "the [United States] Government is not content to rely upon implied covenants"[79] in the development of oil and gas production. After examining the terms imposed by the Crown as lessor in federal jurisdiction oil and gas leases, this comment also seems appropriate to the Canadian situation. The Canada Oil and Gas Land Regulations[80] provide that oil and gas leases shall be granted for a term of 21 years, subject to renewal if "capable of producing oil and gas."[81] Section 89 provides:

> The Minister may at any time, except during the three years next following the issue of a lease, order the lessee to commence and continue the drilling of a well to the satisfaction of the Minister within 90 days from the date of the order.

Section 94 provides:

> Where a lessee is producing oil or gas in commercial quantity, the Chief may order the lessee to drill further wells on the lease area and to continue producing oil or gas so long as that area continues to yield oil or gas in commercial quantity.

Such provisions suggest a very limited reliance by the Crown upon the doctrine of implied obligations to protect its interest as lessor.

Provincial Crown leases, on the other hand, contain the following curious provision:

> No implied covenant or liability of any kind on *Her Majesty's* part is created by the use of the words 'lessee' or 'lease' herein, or by the use of any other word or words herein, or shall otherwise arise by reason of the lease or anything herein contained.

Whatever reliance on the doctrine of implied covenants the Crown would prefer to render unnecessary on its part, it seeks to ensure that no reliance

78. The Alberta Crown Petroleum and Natural Gas Lease provides:
The lessee shall comply with the provisions of The Oil and Gas Conservation Act, and The Gas Resources Preservation Act, and any Act or Acts passed in substitution for them or either of them, and any order of the Energy Resources Conservation Board made pursuant to any of such Acts, and any regulations that at any time may be made under the authority of any of such Acts, and all such provisions, orders and regulations shall bind the lessee in the same manner and to the same extent as if the same were set out herein as covenants on the part of the lessee. Each and every provision, order or regulation hereafter made shall be deemed to be incorporated into this lease and shall bind the lessee as and from the date it comes into force, but in the event of conflict between any order or regulation hereafter made and any order or regulation previously made the order or regulation last made shall prevail.

79. Malone, *Oil and Gas Leases on United States Government Lands,* 2ND ANN. INST. ON OIL AND GAS LAW AND TAXATION 309, 339 (1951).

80. S.O.R./61-253 Under Territorial Lands Act R.S.C. 1970 C.T. 6 and Public Land Grants Act R.S.C. 1970 c. P-29.

81. *Id.* at §§ 62-63.

is available to a lessee. The significance of the doctrine of implied covenants in the protection of the lessor's interest is markedly reduced by this device. The doctrine, however, is not wholly insignificant as the Crown's discretion as law-maker is not, of course, unlimited. The limitations were indicated by the Hon. N.E. Turner, Minister of Lands and Mines for the Province of Alberta in 1949:

> Those charged with the development of the mineral resources as trustees for the people of the Province find themselves in the position where they must at all times be fair and just both to the people and to those persons who risk their money in providing the means whereby the resources are developed. In the very nature of things, there could not be prolonged failure in the discharge of that trust.[82]

The doctrine of implied covenants is founded upon the parties' contractual intention. Reliance by the lessor upon such doctrine does not appear "unfair or unjust."

V. The Implied Covenant to Conduct Additional Development After Paying Production Is Obtained

A leading United States authority has commented:

> Absent from most lease forms are covenants relating to development and further exploration, and hence it seems probable that Canadian courts will in time be led to find implied obligations of the lessee in these connections.[83]

It still remains an open question as to when a Canadian court will imply a covenant for additional development in an oil and gas lease.

The vagaries of the oil and gas business make it impossible to categorically state in a lease how many wells should be drilled, or what strata should be explored in a given tract of land. While it is true that modern techniques for surveying subterranean strata are more accurate in determining possible oil and gas deposits,[84] it is still as much a truism today as when it was first uttered that "oil is where you find it." It is these uncertainties that have contributed to the absence of express covenants to further develop and explore in oil and gas leases.

A. *In the United States*

In the United States there has been considerable controversy concerning implied covenants to conduct additional development and exploration after paying production has been obtained. It is not intended, in this article, to become embroiled in the debate, but merely to examine the propositions advanced and to consider how they might be applied in Canada.

82. Turner, *The Oil and Gas Law of the Province of Alberta, Canada,* 1st. Ann. Inst. on Oil and Gas Law and Taxation 313, 320 (1949).
83. Williams, *Comments on Oil and Gas Jurisprudence in Canada and the United States,* 4 Alta. L. Rev. 189, 194 (1965-66).
84. *See* Am. Petroleum Institute, History of Petroleum Engineering, (1961).

Williams and Meyers[85] see the lessee's obligations as falling into two categories: (1) The covenant of reasonable development, and (2) The covenant of further exploration. They expand on this classification as follows:[86]

> The reasonable development covenant is concerned with additional drilling in a proven field. The further exploration covenant is concerned with additional drilling in potentially productive strata that are yet unproven. Breach of the reasonable development covenant causes loss to the lessor by depriving him of the use of capital represented by minerals remaining in the ground that ought to have been produced. Breach of the further exploration covenant deprives lessor of the opportunity of having his land tested for new producing horizons.

It is beyond dispute that United States courts[87] have consistently implied a covenant to continue development with reasonable diligence until a sufficient number of wells have been drilled to reasonably develop the property. The major qualification to this covenant is that the lessor must show that production from the additional wells would yield a reasonable profit. In other words, the question to be asked is, "What in the circumstances would a reasonably prudent operator do?" In *Becker v. Submarine Oil Co.*[88] the test was put in these words:

> The lessee has a right to regard his own interest as well as that of the lessor. In short, the dilligence 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.[89]

It is with regard to the existence of an implied covenant of future exploration that the controversy has arisen. Meyers first articulated the view that the United States courts[90] had implicitly developed a covenant to use due diligence to explore further, untested portions of leased lands.[91] This covenant was to be implied whether or not there was any reasonable expectation of profit from the enterprise. This publication lit the fuse for the academic debate that followed.[92] The Supreme Court of Texas height-

85. 5 H. WILLIAMS & C. MEYERS, OIL AND GAS LAW 258 (1972).
86. *Id.* at 258-59.
87. For a list of such decisions, *see* E. BROWN, 2 THE LAW OF OIL AND GAS LEASES § 16.02 (1973).
88. 55 Cal. App. 698, 204 P. 245 (1921).
89. *Id.* at 703, 204 P. at 247.
90. *See, e.g.,* Sauder v. Mid-Continent Pet. Corp., 292 U.S. 272 (1934).
91. Meyers, *The Implied Covenant of Further Exploration,* 34 TEXAS L. REV. 553 (1956).
92. *See* E. BROWN, 2 THE LAW OF OIL AND GAS LEASES § 16.05 (1973); Brown, *The Proposed New Covenant of Further Exploration: Reply to Comment,* 37 TEXAS L. REV. 303 (1959); Brown, *The Implied Covenant for Additional Development,* 13 S.W.L.J. 149 (1959); Endom, *Implied Covenants of Exploration in Oil and Gas Leases,* 37 TUL. L. REV. 90 (1962); Merrill, *The Implied Covenant for Further Exploration,* 4 ROCKY MT. MINERAL L. INST. 205 (1958); Meyers, *Two Drilling Covenants Implied in Oil and Gas Leases,* 38 MINN. L. REV. 127, 141 (1954); Meyers, *The Covenant of Further Exploration: A Com-*

ened[93] the issue in *Clifton v. Koontz.*[94] *Koontz* rejected the argument that there is an implied covenant to explore which is separate and distinguishable from the implied covenant to conduct additional development after production is obtained.[95] Because there was no implied covenant to explore, the lessees had no obligation to drill additional wells where there was no expectation that the additional wells would yield a profit.[96]

The interpretations of *Koontz* are as varied as there are opinions as to the existence of the implied obligation to further develop. Meyers and Williams interpret the case in this way:[97]

> It thus appears then an exploration obligation may exist in Texas law but that it must not be labeled as a covenant to explore further. Rather, the duty should be denominated as an implied covenant to reasonably develop, governed by the prudent operator standard, but not subject to the requirement of proof of production in paying quantities . . . .

Another writer in countering this contention has stated:[98]

> As do many other Texas lawyers I believe that the Supreme Court of Texas, in *Clifton v. Koontz,* held squarely that there is no implied covenant for further exploration appurtenant to an oil and gas lease, as distinguished from the existing implied covenant for development.

This debate does not appear to have been resolved in the United States.

B. *In Canada*

The United States controversy over the implied covenant to explore and the attendant discussion of all points of view indicate that there is a basis on which Canadian courts might intervene on behalf of the lessor. It is submitted that the following possibilities should be considered in Canada with regard to the implied covenant to further develop and explore the leased premises:[99] (1) The obligation to explore for and develop minerals

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ment, 37 TEXAS L. REV. 179 (1958); Meyers, *The Effect on Implied Covenants of Conservation Laws and Practices,* 4 ROCKY MT. MINERAL L. INST. 463 (1958); Meyers & Williams, *The Implied Duty to Explore Further: Recent Texas Developments,* 41 TEXAS L. REV. 789 (1963).

93. *See* Merrill, *Sinclair-Masterson: A Study in the Role of Federal Courts in Applying State Law,* 14 OKLA. L. REV. 1 (1961).

94. 160 Tex. 82, 325 S.W. 2d 684 (Tex. 1959). Further fuel was added by the cases of Sinclair Oil and Gas Co. v. Masterson, 271 F. 2d (5th Cir. 1959), *cert. denied,* 362 U.S. 952 (1960) and Felmont Oil Corp. v. Pan Am. Pet. Corp. 334 S.W.2d 449 (Ct. Civ. App. Tex. 1960).

95. Clifton v. Koontz, 160 Tex. 82, 98, 325 S.W.2d 684, 696 (Tex. 1959).

96. *Id.* at 98, 325 S.W.2d at 697.

97. Meyers & Williams, *The Implied Duty to Explore Further: Recent Texas Developments,* 41 TEXAS L. REV. 789, 798 (1963).

98. Smith, *The Implied Duty to Explore Further: Recent Texas Developments —A Disagreement,* 42 TEXAS L. REV. 199 (1963).

99. These obligations might be fulfilled by express covenants in the lease. For instance the offset well obligation may necessitate the drilling of additional wells or existing wells to lower horizons in order to prevent drainage.

other than oil and gas; (2) the obligation to drill and explore to lower horizons; and (3) the obligation to drill further producing wells where there is already production.

1. Private Canadian Leases

An examination of current Canadian private leases shows that the covenant to conduct additional development is one which is not generally expressed. It would appear therefore, that such leases would provide fertile ground for the implication of a covenant to further develop and explore. Notwithstanding this situation, no such covenant has yet become a part of Canadian oil and gas jurisprudence. The explanation is suggested to be a lack of appropriate litigation rather than judicial antipathy.

a. The Obligation to Explore For and Develop Other Minerals

Merrill in discussing this possible obligation frames it in this way:[100]

> A variant of the problem as to exploring other strata arises in connection with leases which by their terms extend to more than one mineral. While production of any one of the substances covered by such a lease may be adequate to preserve the leasehold where it is specified that it shall continue so long as any of the minerals are produced, do not the implied covenant obligations require exploration within a reasonable time for each mineral embraced within its terms, at least wherever there is reasonable cause to infer that the substance might be found on the premises? What authority exists seems to point in this direction.

The private oil and gas lease in Canada provides considerable scope for the implication of this obligation. The granting clause of the lease determines which mineral rights have been granted to the lessee. The Chevron Standard granting clause is typical of granting clauses employed by Canadian industry. Under this clause the lessor disposes of:

> All of the petroleum, natural gas (including but not limited to all hydrocarbon gas, hydrogen sulphide and helium) and related hydrocarbons other than coal, and all other gases and all minerals and substances (whether liquid or solid and whether hydrocarbons or not) found or produced in association with any of the foregoing or in any water contained in any reservoir containing petroleum, natural gas and related hydrocarbons . . . .

It is submitted that a clause of this kind will not impose any obligation on the lessee to search for other minerals once he has achieved production of oil or gas. The very wording of the clause restricts the lessee's right to only those other minerals found or produced in association with oil and gas.

The granting clause employed by Shell Oil (Canada) Ltd., on the other hand, is more likely to give rise to the implied obligation that Merrill suggests exists. Under this clause the lessor grants to the lessee:

100. M. MERRILL, COVENANTS IMPLIED IN OIL AND GAS LEASES, Pocket Supplement 34 (1964).

> All of the said lands for the purpose and with the exclusive right of exploring, drilling, mining, operating for, producing, winning, taking, removing, storing, treating, processing and disposing of petroleum and natural gas, and all related hydrocarbons and *all other minerals comprised in the lessor's title* hereinbefore referred to, (hereinafter called "the leased substances") within upon or under the said lands . . . .[101]

This clause clearly goes beyond the one previously examined. It appears to be an outright grant of all minerals to the lessee. The lessee's right to such minerals is not restricted to the situation where they are produced in conjunction with oil and gas. The nature of the grant provided to the lessee is reinforced by the royalties clause which specifically provides for a fixed royalty on sulphur produced and a 10 percent royalty on all (except oil and gas) other minerals produced. Under this type of clause there is no doubt that the lessor could not give a mineral lease to a third party, for, say, coal, because he has already granted same to the lessee. This clause gives the lessee a valuable right.[102] Coextensive with this interest, however, is the lessee's obligation to explore for and develop *all* minerals contained in his grant. To hold otherwise would frustrate the intention of the parties as expressed in the lease.

The policy behind this implied covenant is to prevent the lessee from nominally satisfying the terms of the lease by paying a small royalty from the working of one mineral without searching for other minerals that may be equally important substances.[103] The covenant, however, might well leave many lessees in a quandry, particularly those that have drafted a lease to specifically include as many minerals as possible. One Canadian writer has suggested the problem could be solved by making the lease severable with regard to the minerals included and the particular formations:

> In this way, a company producing, say, oil from a spacing unit of one legal subdivision where the lease covers oil and gas in a full section might be in breach of the implied covenant insofar as other substances and other formations are concerned, but would not be in default insofar as the producing area is concerned.[104]

This approach might be a valid method of dealing with existing leases that cover all minerals. It is suggested, however, that lessees in the future will have to be careful in drafting the granting clause. If they take a complete mineral lease they may find themselves saddled with the obligation to develop minerals other than oil and gas.

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101. Emphasis added.
102. This is particularly so in the Province of Saskatchewan where substantial deposits of potash have been discovered.
103. *See* Cain v. Neumann, 316 S.W.2d 915 (Tex. Civ. App. 1958); Price v. Nicholas, 19 F. Cas. 1320 (No. 11, 415) (C.C.W.D. Va. 1878).
104. Dea, *A Look at the Lease From the Lessor's Point of View,* 4 ALTA. L. REV. 208, 211 (1965/66).

b. The Obligation to Drill and Explore to Lower Horizons[105]

Given the dispute over this covenant in the United States[106] and Canadian legislation regulating drilling and production, it appears that there is little likelihood of the obligation to drill and explore to lower horizons being litigated in Canada. At the most basic level, it is unlikely that the fact situations which prompted the leading United States cases in this area will arise under the private lease in Canada.

Most private leases in Canada, for historical reasons, cover only small tracts of land ranging from 160 to 640 acres. *Clifton v. Koontz,*[107] the leading case dealing with the covenant to drill and explore to lower horizons, involved a relatively small tract comparable to the majority of private Canadian holdings.[108] In refusing to imply the covenant, the court pointed out that the case was not one in which the "lease covers several thousand acres and an effort is being made to hold such vast acreage by showing production from a comparatively small area."[109] It is precisely into the *Koontz* situation that most Canadian private leases would fall. Canada simply does not have the large private tracts which are capable of being tied up by production from a small area. Consequently, there appears to be no real basis, in Canada, on which a covenant to explore further and drill to lower horizons could be implied.

c. The Obligation to Drill Further Producing Wells Where There Is Already Production

The nature of this obligation has been put succintly in these words:

> [U]pon securing production of oil or gas from the leasehold, the lessee is bound thereafter . . . to develop the premises as a reasonably prudent operator . . . would drill under similar circumstances.[110]

The rationale for such an implied covenant exists in the notion of what do the parties "reasonably expect" from the lease. Where the lessor is paid a royalty on production, it has been said that it would be "unjust, unreasonable,

105. Lower horizons refers to the fact that oil and gas can be found at varying depts in stratified layers. A lessee may drill and find gas, yet if he were to drill deeper to a lower horizon, he may find oil. The problem is to determine whether drilling to one producing horizon is sufficient to satisfy the terms of any lease.

106. It would appear that the more controversial a United States decision is, the less likely it will be followed by a Canadian court as a precedent.

107. 325 S.W.2d 684 (Tex. 1959).

108. *Id.* at 688 (350 acres).

109. *Id.* at 696. *But cf.* Felmont Oil Corp. v. Pan Am. Pet. Corp., 334 S.W.2d 449 (Tex. Civ. App. 1960) (no implied covenant to explore in two leases covering a total of 19,010 acres).

110. H. WILLIAMS & C. MEYERS, 5 OIL AND GAS LAW 832 at 215 (1972). *See also* E. BROWN, 2 THE LAW OF OIL AND GAS § 16.02 (1973); M. MERRILL, 2 COVENANTS IMPLIED IN OIL AND GAS LEASES 154 (1940); W. SUMMERS, 2 OIL AND GAS, § 398 (1959).

and countervene the nature and spirit of the lease, to allow the lessee to continue to hold his term for a reasonable length of time, without making any effort to work the mine."[111]

This implied covenant, as applied in the United States, is subject to several qualifications: (1) It only arises after production has been obtained;[112] (2) the lessor must show that additional development wells will produce oil and gas in "paying quantities";[113] and (3) the test for "paying quantities" is whether sufficient oil and gas will be produced from the additional well so as to allow the lessee to make a reasonable profit over and above his capital and operating expenses.[114]

The application of these criteria will ultimately depend on the facts of each particular case. This makes it impossible to categorically state in what circumstances such an obligation will be implied. The reason advanced for the dearth of judicial intervention under this head in Canada is that conservation legislation has strictly regulated the number of wells that can be drilled or produced from in any tract.[115] The oil and gas conservation legislation in the three Western Canadian provinces specifically states that one of the functions of the legislation is to secure safe and efficient practices in the location and spacing of wells.[116]

Conservation legislation has been primarily directed at oil and gas well spacing, pooling and unitization. Wells can only be drilled pursuant to a license and in the area specified.[117] The normal minimum drilling spacing unit for an oil well is one well per 160 acres; for a gas well, the normal unit is one well per 640 acres.[118] Generally, the drilling spacing unit will become the production spacing unit. Special spacing units may be prescribed by the oil and gas conservation boards, and the normal unit can be reduced if certain criteria are satisfied.[119]

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111. George v. Jones, 168 Neb. 149, 164, 95 N.W.2d 609, 617 (Neb. 1959). Although this case involved a gravel mine its comments can be validly extrapolated to cover any type of mineral lease.

112. *See* Fischer v. Magnolia Pet. Co., 156 1 Can. 367 (1943).

113. *See* Hayes v. Southwest Nat. Gas Co., 123 F.2d 1011 (5th Cir. 1941).

114. *See* Myers v. Shell Petroleum Co., 153 1 Can. 287 (1941).

115. *See* J. BALLEM, THE OIL AND GAS LEASE IN CANADA 182 (1973).

116. *See* Oil and Gas Conservation Act, R.S.A. 1970, c. 267 § 5(b) (Alberta); Petroleum and Natural Gas Act of Mar. 26, 1965 Stat. B.C. 199, 206, c. 33 §§ 18, 42 (under definition of wasteful operations) (British Columbia; Oil and Gas Conservation Act R.S.S. 1965 c. 360 § 3(b) (Saskatchewan).

117. *See* Oil and Gas Conservation Act, R.S.A. 1970, c. 267 § 23 (Alberta); Petroleum and Natural Gas Act Stat. of Mar. 26, 1965, B.C. 199, 206, c. 33 §§ 18, 42 (British Columbia); Oil and Gas Conservation Act R.S.S. 1965 c. 360 § 8 (Saskatchewan).

118. *See* Oil and Gas Conservation Regulations Alta. Reg. 151/71 Regulation 4.020(1) (3) (Alberta); Drilling and Production Regulations B.C. Reg. 60/69 Regulations 11.01, 12.01, 13.01 (British Columbia); Spacing Regulations O.C. 713/166; Sask. Reg. 186/74; 167/64 (Saskatchewan).

119. *See, e.g.,* Alberta Oil and Gas Conservation Regulations, Alta. Reg. 151/71 4.030.

These spacing units obviously created difficulties for the owners of small tracts. The method traditionally used to avoid this problem was to combine several small tracts to make a drilling unit. Most Canadian oil and gas leases contain a clause whereby the lessee may

> pool or combine the said lands, or any portion thereof, or any zone or formation underlying the said lands or any portion thereof, with any other lands or any zone or formation underlying the same, but so that the lands so pooled and combined . . . shall not exceed one (1) spacing unit as hereinbefore defined.[120]

Petroleum, *in situ,* does not conform to surface property lines. Unitization[121] therefore developed as a method to form a common production unit covering large field-wide or pool-wide areas. The advantage of this system is that the pool can be effectively developed without drilling unnecessary wells. The interests of the mineral owners are recognized in the "tract formula" which allocates production from the unit.

A lessee wanting to bring a tract into a unit agreement will normally require the further consent of the lessor, rather than relying on the pooling clause in his lease. Some Canadian oil and gas leases, however, have inserted an express unitization clause:[122]

> The lessee is hereby given the right and power to unitize the said lands or any portion or portions thereof with any other lands in the vicinity of the said lands whether the said lands be now or hereunder grant or lease to the lessee to the end that all lands so unitized shall be jointly developed as an entirety.

This clause appears in a lease used in the Province of Saskatchewan. That Province has a provision for both compulsory[123] and voluntary[124] unitization. Other provinces, notably Alberta,[125] rely on voluntary unitization with the threat of compulsory unitization if agreement cannot be reached.[126]

Recognizing that conservation legislation regulates the Canadian industry with regard to operations carried on after production is obtained, the problem remains to determine the extent implied covenants to drill further wells are obviated by such legislation. The position in the United States is unclear. Certain authors believe there is no scope for an implied covenant to further develop in a pooled or unitized field.[127] Other authors feel the

120. Sun Oil Co. Lease Clause 9.
121. For a full discussion of unitization, *see* C. MEYERS, THE LAW OF POOLING AND UNITIZATION (1957).
122. Gulf Oil Ltd. (Saskatchewan) Lease.
123. Oil and Gas Conservation Act Rev. Stat. Sask. c. 360 §§ 34-43 (1965).
124. *Id.* §§ 30(1), 43(a).
125. Oil and Gas Conservation Act, Stat. Alta. 1969 c. 83 §§ 87-95 (1969). This Act has provisions for compulsory unitization but they have not been proclaimed to be in force.
126. For a discussion as to the merits of compulsory versus voluntary unitization, *see* Hardwicke, *Unitization Statutes: Voluntary Action or Compulsion,* 24 ROCKY MT. L. REV. 29 (1951).
127. *See* Gibbens, *The Effect of Conservation Legislation on Implied Covenants in Oil and Gas Leases,* 4 OKLA. L. REV. 337, 362 (1951); Siefkin, *Effect of Proration on Implied Covenants,* 19 OKLA. B.A.J. 1652, 1656 (1948).

implied covenant to develop lives on in the face of conservation legislation,[128] even though the obligation relates to the unitized area and not a specific tract. In Canada, the policy underlying the conservation legislation does not preclude implied covenants for further development. Conservation legislation exists to promote conservation, not necessarily to prevent further development. In discussing the "compliance with laws clause" commonly found in Canadian gas and oil leases,[129] it was suggested that, to excuse performance, it must be established that the convenanted performance is rendered impossible by the conservation legislation requirements. Implicit in that conclusion is the notion that the lessee must still do everything possible to fulfill his obligations, be they expressed or implied. If such development within the unit is possible under the law, then the lessee should be obliged to undertake it. This, after all, is asking the lessee to do no more than fulfill the reasonable expectation of the parties.

It is one thing to convince a court of the existence of such an obligation to develop on the part of the lessee. It is a very different thing to secure the enforcement of that obligation. As a practical matter, the enforcement of the obligation will be predicated on the lessor having information concerning the strata or the existence of other minerals. It appears unlikely that a court would enforce such an obligation on the unsubstantiated word of the lessor. Where can the lessor obtain the necessary evidence? A lessor may be able to observe operations and production from adjacent tracts and on this evidence make inferences about his own land. This is, however, a highly speculative process. The best source of information is, of course, the lessee. Lessees, however, tend to restrict the amount of information they give to lessors. This secrecy is presumably to keep such information from falling into the hands of competitors and other prospective lessors.

A lease drafted by a lessor, will probably demand detailed information on all aspects of the operations. The lessee's interest in keeping the information confidential can be protected by the lessor agreeing not to reveal the information he has been given. The Pan Canadian Petroleum lease is a good example of the lessor's lease.[130]

128. *See* J. Eberhardt, *Effect of Conservation Laws, Rules and Regulations on Rights of Lessors, Lessees and Owners of Unleased Mineral Interests,* 5 S.W.L.F. 125, 143 (1954); Merrill, *Implied Covenants, Conservation and Unitization,* 2 OKLA. L. REV. 469 (1949); Meyers, *The Effect on Implied Covenants of Conservation Laws and Practices,* 4 ROCKY MT. MIN. L. INST. 463 (1958).

129. *See* text accompanying notes 32-36 *supra.*

130. Clause 10 provides in part:

. . . .

(b) During the drilling of each well on the said lands, the lessee shall:

(i) furnish the lessor with written advice of the date of spudding thereof;

(ii) furnish the lessor with daily drilling reports;

(iii) take formation samples at such intervals and at such depths as

Lessees in drafting leases, on the other hand, generally obligate themselves to make available production statistics only. For example, the Gulf Oil (Canada) lease states, in clause nine:

> The lessee shall make available to the lessor during normal business hours at the lessee's address hereinafter mentioned the lessee's records relative to the quantity of leased substances produced from the said lands and sold or allocated to the said lands . . . .

It would appear that by expressly obligating himself to provide only production statistics, the lessee can avoid any liability to deliver further information to the lessor. This places the lessor under a lessee's lease in the difficult position of being "unable to determine whether or not the lessee is performing the express or implied covenants of the lease when such information is not made available to him and when he has no way of compelling its production."[131]

While the lessee is obligated to bring most of the needed information to the attention of the appropriate conservation board, delivery of this information to such an agency does not necessarily make it a matter of public record. This information is delivered to the board for conservation purposes and not to enable the lessor to use it to compel the lessee to perform express or implied obligations. One avenue the lessor could explore, however, in order to obtain information is that of "fiduciary duty." It could be argued that because operations and information are in the exclusive hands of the lessee and the lessor has a real interest in what is being done, the lessee has a fiduciary duty to make such information available to the lessor.

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the lessor may prescribe and furnish the lessor with a complete set of samples, washed and in suitable containers;

(iv) furnish the lessor; with chip samples at 2 foot intervals and at lithologic changes throughout the length of all cores taken;

(v) furnish the lessor with immediate advice of any porous zones or showings of the leased substances;

(vi) take representative mud samples and drillstem test fluid samples in order to obtain accurate resistivity readings of mud filtrate and formation water and furnish the lessor with all information relative thereto;

(vii) furnish the lessor with two copies of the drill stem test and service report on each drill stem test run, including copies of pressure charts;

(viii) permit representatives of the lessor to have access to the wellsite including derrick floor at all reasonable times to inspect and observe and make records relating to the operations of the lessee.

. . . .

(f) With respect to each well drilled on the said lands, the lessee shall furnish the lessor with a copy of all reports required to be filed with such government body.

(g) Except for information which is available to the public from any governmental authority, the lessor, if requested by the lessee, shall treat as confidential during the term of this lease all or any part of the information contained in any reports of the lessee furnished, given or delivered to the lessor pursuant to this clause 10, provided, however, that this sub-clause (g) shall not prevent the lessor from divulging any information to a subsidiary of the lessor.

131. Dea, *A Look at the Lease from the Lessor's Point of View,* 4 ALTA. L. REV. 208, 214 (1965).

2. Crown Leases

Crown leases contain provisions that could be used to make lessees conduct additional development once paying production[132] has been obtained. These provisions are contained in the legislation that governs the lease. Normally, the Crown has discretion to require the drilling of further wells after production has been obtained.[133] To enforce such a covenant, the Crown has expressly provided that it shall have access to all the lessee's records.[134] This discretion is not unfettered, however, because Crown leases are also subject to conservation legislation. Although the effect of conservation legislation on express and implied covenants has already been discussed, it should be re-emphasized that conservation legislation will take precedence over an express covenant.

The realities of the oil and gas business are such that the Crown will not be in a position to arbitrarily enforce its express covenant for further development. The Crown will have to be fair and just in dealing with the lessees if it is to secure development of the leased land for the public's benefit. Circumstances may arise in the future when the Crown may well be justified in demanding increased development. It has prepared for this contingency by the inclusion of the express covenant to further develop.

VI. The Implied Covenant to Market the Production

A. *In General*

The United States jurisdictions have recognized such an implied covenant: "Generally, even in the absence of an express covenant to produce and

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132. Crown leases specifically restrict the grant under the lease to petroleum and natural gas.

There may be dispute whether a mineral such as helium falls under the general expression "natural gas." *See* McCombe, *Helium and its Place in the Petroleum and Natural Gas Lease,* 2 Alta. L. Rev. 9 (162-64). Saskatchewan Crown leases, however, specifically reserve helium to the Crown in the following words:

> SAVING AND RESERVING nevertheless unto the lessor the helium in, from or found combined with, or extractable from, or that may be obtained out of, the petroleum within or mined
>
> . . . .

Production under a Crown lease in Saskatchewan will therefore be restricted to petroleum and natural gas.

133. *See, e.g.,* Canada Oil and Gas Land Regulations S.O.R./61-253 Regulation 94.

134. *E.g.,* the Saskatchewan Crown Lease provides, *inter alia:*

> The lessee shall permit the Minister or his authorized agent at the responsibility, risk and expense of the Minister or his Agent, at any time and from time to time to enter upon the said lands and into or upon the office or place where the lessee's books and records are kept, and inspect and examine the operations of the lessee and the plant, work, books and records used or kept or having any reference to the operations, examine samples of minerals and other substances encountered during the operations, make copies of such books and records or any part thereof and carry out tests and examinations . . . .

market, there is an implied covenant that the lessee will do so."[135] In dealing with this covenant, the courts examine the lessee's conduct in attempting to market the products.[136] Resort is then made to the mythical "prudent operator"[137] in deciding whether the lessee has exhibited the necessary due care and diligence.

Each case will depend on its particular facts, so any formulation of the conditions in which such a covenant will be implied is speculative. One authority, however, has suggested the following concerning the covenant:

> (1) There is an implied covenant that requires a lessee to market the production from his lease, including the lessor's royalty, unless the lessor elects to market his own share of the production.
> (2) In marketing the lessor's royalty oil or gas the lessee acts as agent of the lessor, in accordance with trade usages in the industry.
> (3) The diligence required of the lessee in such marketing is "reasonable diligence" and the time in which the marketing is to be done is a "reasonable time" under all the facts and circumstances of the case.
> (4) The price at which such production shall be sold is the reasonable market value of the product.[138]

No express covenant[139] to market appears in current Canadian oil and gas leases. On the contrary, one particular lease attempts to limit the lessee's obligation to market:

> [N]othing herein contained shall obligate lessee to produce, save, sell or otherwise dispose of any gas from said land unless such gas well shall be of commercial quality and quantity and a commercially profitable market therefor shall exist at the well when produced.[140]

Most lessors enter into a lease with the expectation that if there is production of any of the leased substances, they will get royalty payments on such production. Most royalty clauses, however, do not fulfill that expectation because the royalty is payable only when the products are marketed. A typical royalty clause reads as follows:

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135. Eggleson v. McCasland, 98 F. Supp. 693 (E.D. Okla. 1951) (dictum).
136. Christianson v. Champlin Refining Co., 169 F.2d 207 (10th Cir. 1948).
137. Brewster v. Lanyon Zinc Co., 140 F. 801 (8th Cir. 1905).
138. E. BROWN, 2 THE LAW OF OIL AND GAS LEASES § 16.02 (1973).
139. In some states (notably Oklahoma), there has been some confusion as to termination of the lease under the "habendum" clause and the implied covenant to market. *See* H. WILLIAMS & C. MEYERS, 5 OIL AND GAS LAW 395 (1972). The habendum clause of an oil and gas lease customarily provides that the lease will continue in full force and effect beyond the primary term so long as substances are produced from the leased lands. The lease also normally provides that, if production is frustrated by a lack of market, the lessee is protected against forfeiture.
140. Husky Oil lease clause 2(b). Although this clause is an attempt to limit the lessor's implied obligation to market, it might well be sustained on the basis that the lessee's obligations under this clause are the same as would be implied by a court.

> The lessee reserves unto . . . (hereinafter called the "Royalty Owner") a gross royalty of Twelve and One-Half percent (12½%) of the leased substances produced and *marketed*[141] from the said lands.[142]

In most cases, the lessee will be just as desirous of finding a market for the product as the lessor. Circumstances can arise, however, in which the lessee may be unable or unwilling to market the production, and may be quite content to keep the lease alive by paying a shut in royalty.[143] Such a royalty will be substantially less than the royalty on production that is marketed.[144] This may prove to be quite unsatisfactory to the lessor. In such a case the lessor may have grounds to bring an action for breach of the implied covenant to market the production.

The various aspects of the implied covenant to market will now be considered in the context of the Canadian leases.

B. *Private Leases*

1. The Duty to Market Production

There appears to be no reason of policy or law which should prohibit the implication of such a covenant in Canada. One Canadian writer has suggested "that the obligation to market is the one major area in which Canadian courts might be prepared to imply a covenant."[145]

Most of the problems that have arisen in connection with the implied covenant to market have been concerned with gas sales. Crude oil sales are relatively straight-forward. Oil production can be easily stored on the surface and can be transported to market in a variety of ways. The pricing provisions in such contracts are straight-forward and based on the price prevailing in the particular field, for the particular quality of oil as set by

141. Emphasis added.
142. Petrofina Canada Ltd. lease, clause 3.
143. Often a well may be brought into production, but due to the lack of a market, it may not be economical for the lessee to produce from that well. In order to keep the lease alive the lessee is entitled to make a payment to the lessor called a "shut in royalty".

Canadian courts have been uniformly strict in construing the shut in royalty provisions in oil and gas leases. *See* Shell Oil v. Gibbard, [1961] S.C.R. 725; Canadian Superior Oil v. Kanstrup, [1964] 47 D.L.R. 2d 1 (S.C.C.). The recent Supreme Court of Canada decision in Cull v. Canadian Oil Ltd., 20 D.L.R. 3d 360, may be evidence of a less harsh approach to the interpretation of lease provisions (including the shut in royalty clause).

144. The standard Canadian shut in royalty payment is a sum equal to the delay rental payment, which in monetary terms is usually $1.00 per acre leased per year. The normal production royalty payment is 12½ percent (or ⅛) of the proceeds realized by the sale of substances produced. (There are some exceptions to this general formula, a minimum price might be set for gas or a fixed price for such incidental minerals as sulphur).
145. J. BALLEM, THE OIL AND GAS LEASE IN CANADA 183 (1973).

the purchaser at the date of delivery.[146] Given the present need for crude oil, its ease of transportation and the pricing system, the marketing of oil should not be difficult for the lessee.

Gas purchase contracts, on the other hand, have evolved into long and complicated documents. The reason is that financing and satutory requirements demand commitment of a minimum quantity and quality of gas reserves as a prerequisite for extension of pipelines into a new production area. The necessity for proven reserves and the long-term nature of the contract are the cause of most of the problems in connection with the implied obligation to market.

For instance, a lessee may hold leases over several tracts of land. He may combine these leases in order to establish the necessary gas reserves for contract purposes, and yet he may only produce the actual volume from one tract. The result of this is that "[t]he unhappy lessor finds himself in a position where his reserves help the lessee establish favourable contract volumes but are not sold, with the result he obtains no royalty."[147] This problem has already arisen and been dealt with in the United States on the basis of the implied covenant to market.[148] Such a factual situation could conceivably arise in Canada and should be dealt with on the same basis.

2. The Lessee as Marketing Agent for the Lessor According to Trade Usage

Whether an agency relationship arises depends on the nature of the contract between the lessor and lessee. It has been suggested that if the lessor is allowed to take a share of the production in kind, then the oil allocated to him is under his control and he has the obligation to market it.[149] This being so, no agency relationship will arise. Few leases in Canada provide for delivery in kind,[150] however, so that in the majority of cases the lessee will be obliged to market any production.

Trade usage may also bear upon the issue of which party pays any treatment and transportation costs on production that is marketed. In most

146. For example, Imperial Oil Ltd. provides in their crude oil purchase contract that the price to be paid for a barrel of oil "shall be the Purchaser's designated price for the grade of crude oil delivered fom the field at the time and place of commencement of each delivery on the opening gauge measurement of such delivery."

147. J. Ballem, The Oil and Gas Lease in Canada 183 (1973).

148. *See* Foster v. Atlantic Refining Co., 329 F.2d 485 (5th Cir. 1964). In this case the lessee produced and marketed proportionately more gas from adjacent land. The court held the implied covenant had been breached even though more gas could not be marketed. Damages were assessed on what the lessee should have produced from the plaintiff's land had he struck a fair balance between the two leases.

149. *See* H. Williams & C. Meyers, 5 Oil and Gas Law 394 (1972).

150. The Hudson's Bay Oil and Gas Co. lease, clause 3(E), does allow for a royalty in kind in these terms:

> [T]he lessor may from time to time, upon thirty (30) days' notice to the lessee, elect to take the gross royalty share of the crude oil produced and saved from the said lands in kind . . . .

cases, however, the lease will have express stipulations on these points. A typical lease will state the obligation in this manner:

> The lessor's interest in the leased substances, or the royalties payable thereon, shall bear one-eighth of the costs of transportation, storage off the said lands and other such necessary costs incurred in delivering the leased substances to market.[151]

Where such an express provision is inserted, there is no room to resort to trade usage.[152] It thus appears that in Canada there is little likelihood of implying an obligation on the lessee to prepare the product for market and to bear such costs.

3. The Duty to Act with Reasonable Diligence and to Market Production Within a Reasonable Time

It has already been pointed out that the prudent operator test governs this issue. As each case depends entirely on its own facts, it is impossible to forecast what amounts to a reasonable time.[153] This will be something for the Canadian courts alone to ascertain if they choose to imply a covenant to market production.

4. The Duty to Get the Best Obtainable Price

The payment of royalties is generally expressed in terms of a percentage of the "current market value" of the products sold. Crude oil royalties are generally paid to the lessee on the basis of the posted field price. Payment of royalties to the lessor based on this price would in most cases[154] satisfy this aspect of the lessee's obligation to market. As crude oil purchase contracts are determinable on 30 days' notice,[155] the ascertainment of the "current market value" of the products is a relatively easy process. Gas purchase

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151. Sun Oil Co. lease, clause 4(d). Other leases, however, may not be so precise with regard to treatment costs. The Shell Canada lease, clause 2(b) states (*inter alia*):

> As royalty the lessee covenants and agrees:
> . . . .
> (b) to pay to the lessor on gas and casinghead gas produced from the said lands (1) when sold by the lessee, one eighth of the amount realized by the lessee, computed at the mouth of the well.

The expression "computed at the mouth of the well" suggests that the company takes the price at which the gas was sold and computes it back to the well head by deducting processing and transportation costs.

152. Various regulatory agencies, such as Oil and Gas Conservation Boards, are also involved in setting standards for the processing and transportation of the products. Such standards would also preclude a resort to trade usage.

153. *See* Bjornson, Boyd, Bredin, Brown, MacWilliam, *Problems in Development of Leased Lands*, 4 ALTA. L. REV. 302, 319 (1965).

154. An exception could arise if the posted field price was less than the market price for similar crude oil produced. This type of pricing should rarely arise in view of the governmental regulation of such prices.

155. See Imperial Oil Ltd. Crude Oil Purchase Contract, clause 4 (f):

> . . . this Agreement shall continue from month to month from the date

contracts, however, are of much longer duration. This makes it extremely difficult to compute the "current market value" of the production from the gas field.

A considerable controversy has arisen in connection with long-term gas purchase contracts and the expressions "market value" and "market price." This debate has raised two major problems, both of which are unresolved in Canada:[156] (1) Is there a difference between market value and market price? (2) At what time is the market value or market price to be ascertained? The resolution of these problems will depend on the particular contract and applicable pricing legislation.[157] Any general solution offered must of necessity be extremely broad. It is suggested, however, that a lessee would be advised to insert a price escalation clause into the gas purchase contract that would get the best price for the gas marketed over the life of the contract. Such a clause would have to be tailored to suit the particular field and external market factors.[158] After inserting such a clause, the lessee could argue that he was acting as a prudent operator seeking the best obtainable price for the minerals to be marketed.

5. Express Covenants to Market

One Canadian writer has stated that:

> The issue of marketing is of such importance to the lessor that he would be well advised to insist upon an express covenant imposing some duty on the lessee to use due diligence in obtaining a market for any production encountered in the demised premises.[159]

It appears that the interests of both the lessor and lessee demand that there should be some express provision concerning the lessee's obligation to market. Yet, most leases are silent on this point. It is conceded that conservation legislation and a reasonably well-regulated pricing structure will fill in some of the gaps. Nevertheless, there are some demonstrable situations in Canada in which a covenant to market could be implied.

C. *Crown Leases*

None of the Crown leases employed in Canada contain an express stipulation that the production is to be marketed. Legislation[160] governing

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hereof provided that either the Vendor or the Purchaser may at any time cancel this agreement by 30 days' notice of writing.

156. Rae, *Royalty Clauses in Soil and Gas Leases,* 4 ALTA. L. REV. 323, 327 (1965).

157. *See* The Gas Utilities Act, R.S.A. 1970, c. 158, § 6. The Public Utilities Board can fix the field price for gas.

158. *See* Taylor, *Escalation Clauses in Gas Purchase Contracts,* 3 ALTA. L. REV. 255 (1964).

159. J. BALLEM, THE OIL AND GAS LEASE IN CANADA 183 (1973).

160. *See* Oil & Gas Land Regulations S.O.R./61-253 Reg. 63 (Canada); Mines & Minerals Act, R.S.A. 1970, c. 238, §157 (Alberta); Petroleum & Natural Gas Act, Stat. B.C. 1965, c. 33, § 77 (British Columbia); Petroleum & Natural Gas Regulations 1969, O.C. 8/69 Regs. 43, 55 (Saskatchewan).

such leases merely states that they shall continue in existence as long as there is paying production. It is most unlikely, but not inconceivable, that there could be production under a Crown lease without marketing. In this situation a covenant to market could be implied.

VII. Conclusion

The context in which the Canadian oil and gas industry operates differs substantially from that in which the doctrine of implied covenants originally developed in the United States. The influences on the development of the doctrine in Canada are different. The lessee's control and administration of the lessor's interest is a primary concern; prompt and immediate development is less important. Such differences do not, however, deny implied covenants a significant role in oil and gas leases.

The doctrine has already molded the form of the express covenants concerning exploration, operation of wells, and protection from drainage. Despite the extent of express provisions, covenants have been implied in these areas and will likely be implied in the future. Express provision is largely absent in the areas of additional development and marketing, and accordingly it appears that these are particularly fertile areas for the implication of obligations. Although patterns of landholdings and conservation legislation may discourage appropriate litigation, they do not preclude implied obligations.

An important conclusion of this article is that Crown leases recognize and respect the doctrine of implied covenants. In varying degrees the Crown has sought to render its reliance upon the doctrine unnecessary, but it is evident that the Crown will not hesitate to invoke it.