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Measure of Damages for Breach of Implied Covenants in Oil and Gas Lease to Develop and Protect From Drainage

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MEASURE OF DAMAGES FOR BREACH OF IMPLIED COVENANTS IN OIL AND GAS LEASE TO DEVELOP AND PROTECT FROM DRAINAGE. — After the discovery of oil by the lessee under an oil and gas lease by the terms of which the compensation of the lessor is to be a share of the oil produced, in the absence of an express covenant as to further development of the premises, the courts will imply a covenant on the part of the lessee to protect the lines of the leased premises from drainage by wells on near-by lands, and will also imply a covenant to develop the leasehold with reasonable diligence for the mutual benefit of both parties.[1] In case of the breach of either of these covenants it has often been said that the lessor has an action for damages[2] though the cases are few where a lessor has attempted to recover such damages. In the cases which have been decided by courts of last resort the question as to the proper measure of damages for breach of these covenants has proved troublesome.

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another company, an interstate commerce transaction? It is of course beyond the scope of this note to do more than briefly point out the line of argument. There is an *interstate transportation of an ordinary article of commerce* by one person for another, under an agreement by which a service is to be performed upon that article in another state for another person. Why isn't that interstate commerce? If there had been a sale of the article by the Torpedo Co. to the Oil Co. and then such an interstate transportation by the former for the latter it would clearly be interstate commerce. See 2 WILLOUGHBY, CONSTITUTION, § 302; PRENTICE AND EGAN, THE COMMERCE CLAUSE OF THE FEDERAL CONSTITUTION, 43 *et seq;* JUDSON, INTERSTATE COMMERCE, 3 ed. § 7. But the actual, practical effect of the transaction is the same as if there had been a technical sale. Besides, a sale of the thing transported between states is not necessary to constitute an interstate commerce transaction. Butler Bros. Shoe Co. *v.* United States Rubber Co., 156 Fed. 1. See also International Text Book Co. *v.* Pigg, 217 U. S. 91, 54 L. Ed. 678, 27 L. R. A. (N. S.) 493, where the court, quoting with approval from the last named case, says: "all interstate commerce is not salés of goods. Importation into one state from another is the indispensable element, *the test,* of interstate commerce, and *every negotiation, contract, trade* and *dealing* between citizens of different states *which contemplates and causes such importation,* whether it be goods, persons, or information, is a transaction of interstate commerce." See also to the same effect City of Kansas City *v.* Seaman, 99 Kan. 143, 160 Pac. 1139, L. R. A. 1917B 341.

[1] Brewster *v.* Lanyon Zinc Co., 140 Fed. 801; Poe *v.* Ulrey, 233 Ill. 56, 84 N. E. 46; Ulrey *v.* Keith, 237 Ill. 284, 86 N. E. 696; Culbertson *v.* Iola Portland Cement Co., 87 Kan. 529, 125 Pac. 81; Harris *v.* Ohio Oil Co., 57 O. St. 118, 48 N. E. 502; Coffinberry *v.* Sun Oil Co., 68 O. St. 488, 67 N E. 1069; Indiana Oil, Gas & Development Co. *v.* McCrory, 42 Okla. 136, 140 Pac. 610; McGraw Oil Co. *v.* Kennedy, 65 W. Va. 595, 64 S. E. 1027; Hall *v.* South Penn Oil Co., 71 W. Va. 82, 76 S. E. 124.

[2] Doddridge County Oil & Gas Co. *v.* Smith, 154 Fed. 970; Brewster *v.* Lanyon Zinc Co., 140 Fed. 801; Poe *v.* Ulrey, 233 Ill., 56 N. E. 46; Carr *v.* Huntington Light & Fuel Co., 33 Ind. App. 1, 70 N. E. 552; Harris *v.* Ohio Oil Co., 57 O. St. 118, 48 N. E. 502; Ammons *v.* South Penn Oil Co., 47 W. Va. 610, 35 S. E. 1004; Jennings *v.* Southern Carbon Co., 73 W. Va. 215, 80 S. E. 368; Phillips *v.* Hamilton, 17 Wyo. 41, 95 Pac. 846.

On principle, if an action is brought for breach of the implied covenant to protect the leased land from drainage by drilling wells to offset those on other property near enough to drain the leasehold, the plaintiff ought to recover what he has lost by such breach, that is, the value of the oil he would have received had the covenant been performed by the lessee. In *Kleppner* v. *Lemon*,[3] recovery was allowed on substantially this basis. This seems to be the only case decided by a court of last resort where damages have been allowed for breach of covenant to protect the leased land from drainage of oil. The question recently arose in West Virginia in the case of *Steele* v. *American Oil Development Co*,[4] but as the case was reversed on other grounds, the court did not discuss the proper measure of damages. However, throughout the opinion it appears to assume the rule of damages suggested would be correct.

Clearly the lessor ought to have a remedy for breach of this implied covenant. It is quite certain the oil drained from the land is not replaced to any great extent by inflowing oil from adjoining territory, particularly where, as in many cases, wells are operated on all sides of a leasehold. There is, therefore, truly a substantial loss to the lessor. It may be difficult to prove the extent of the drainage with sufficient definiteness to sustain a verdict for damages but it would seem a skilful lawyer should be able to secure and introduce evidence upon which a jury could make at least as accurate a guess as to the amount of damages as they can make from the evidence commonly before them in a great number of other cases. The court should only require the best evidence that can be produced and this should be sufficient if it fairly tends to support the verdict.[5]

In at least two cases damages have been allowed for breach of the covenant to develop the premises reasonably.[6] In *Bradford Oil Co.* v. *Blair, supra,* the lease contained an express covenant to develop the leasehold and damages were allowed for its breach. It would seem the same measure of damages should be applied whether the covenant be express or implied. The jury was directed to find how much more oil the plaintiff ought to have received than he did receive, its value, and from such value deduct

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[3] 197 Pa. St. 430, 47 Atl. 353; on rehearing 198 Pa. St. 581, 48 Atl. 483.

[4] 92 S. W. 410 (W. Va. 1917).

[5] But see Duffield *v.* Rosenzweig, 144 Pa. St. 520, 23 Atl. 4.

[6] Bradford Oil Co. *v.* Blair, 113 Pa. St. 83, 4 Atl. 218; Daughetee *v.* Ohio Oil Co., 151 Ill. App. 107, 181 Ill. App. 135; affirmed 263 Ill. 518, 105 N. E. 308.

the cost of producing what he ought to have received at the time and under the circumstances and with the appliances then known and upon such balance allow interest. Why the cost of production should be deducted is hard to perceive since the lessor was entitled to one eighth of the oil and apparently did not bear any of the cost of production. Perhaps the court thought that since the original lease had been forfeited in this case, the lessor himself would be compelled to put down wells to get the oil beneath his land, and hence would have to bear the cost of production. This seems unsound for if he did so he would get all the oil instead of a royalty and if the amount of oil was considerable he could make another lesse. In *Daughetee* v. *Ohio Oil Co., supra,* the action was for breach of an implied covenant to develop. The court approved an instruction which in substance said that in arriving at a verdict the jury should subtract from the quantity of oil which they found should have been produced from the premises during the period stated, the quantity actually produced and saved, and allow the plaintiff one eighth the value of the difference at the market price during the period in question. In *Guffey Petroleum Co.* v. *Jeff Chaison Townsite Co.,*[7] the lower court applied a similar rule of damages but on appeal the case was reversed without consideration of the measure of damages.

It is submitted that the measure of damages applied in these cases is not sound because the result is to give to the lessor the value of his share of the oil that ought to have been produced by the lessee, though the oil is not lost as in the case of drainage, but is still beneath his land and may subsequently be produced and turned over to the lessor by way of royalty, either under the original or under a subsequent lease. It is true that oil is of a vagrant character but in the absence of drainage it is reasonable to presume that approximately the same amount of oil remains under the land at all times even if not made up of the same molecules. This objection to the measure of damages was pointed out by the Supreme Court of Appeals of West Virginia in *Grass* v. *Big Creek Development Co.,*[8] where the court said of the lessors: "So far as disclosed, they have lost nothing more than interest on the value of productions obtainable had defendant exercised that degree of diligence we havê suggested as due under certain conditions and circumstances." Judge Poffenbarger in his con-

[7] 48 Tex. Civ. App. 555, 107 S. W. 609.
[8] 75 W. Va. 719, 732, 84 S. E. 750.

curring opinion insisted that no right of action whatever should be allowed in such a case. If such a covenant is implied then it is submitted on its breach there is no substantial damage capable of proof except the loss of interest on the money the lessor should have received from the sale of his share of the oil.

Where leased land contains gas but no oil or where part of each are produced and saved, there may be some difference in the measure of damages so far as the gas is concerned. If a lease provides for payment of a royalty on the amount of gas taken from the premises, then the rule of damages for breach of an implied covenant to protect from drainage should be similar to that applied where there is a breach of covenant to protect from drainage of oil and one case has so held.[9] Most leases provide for the payment of a fixed yearly sum for each gas well. This would simply relieve the jury from the duty of determining how much gas should have been produced by the lessee. However, the jury would have to find, not how much gas had thus been lost by drainage, but how many wells the lessor should have drilled and how many years' rental was lost because of the lessee's breach. In case of an implied covenant to develop the premises diligently it would not be easy in most cases to prove a breach of the covenant since a lessee is not bound to put down many wells to develop for gas,[10] the drainage being from a great area and if wells are close together the lives of such wells are very much shortened. No case has been found where damages have been allowed for such a breach, but in *Howerton* v. *Kansas Natural Gas Co.*,[11] the court stated the damages would be the sum the plaintiff has lost or may lose by the failure of the defendant to complete the number of producing wells reasonably necessary to develop the resources of the leased land and to protect its lines. It seems the court meant he was entitled to the sum fixed per year for each year the wells that ought to have been drilled produced gas in paying quantities. If so, in so far as there was no drainage the same objection can be made here as was made above in the case of breach of covenant to develop for oil. The lessor would lose only the use of the money he should have received.

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[9] Culbertson *v.* Iola Portland Cement Co., 87 Kan. 529, 125 Pac. 81.
[10] McGraw Oil Co. *v.* Kennedy, 65 W. Va. 595, 64 S. E. 1027.
[11] 82 Kan. 367, 108 Pac. 813.