

STATE OF KANSAS

Office of the Attorney General

1st Floor, State Capitol Bldg. (913) 296-2215 Topeka, Kansas 66612

Curt T. Schneider
Attorney General

November 15, 1976

ATTORNEY GENERAL OPINION NO. 76- 342

The Honorable J. C. Tillotson
State Senator
109 South State
Norton, Kansas 67654

Re: Oil and Gas--Leases--Conditions

Synopsis: House Bill No. 3038, if enacted, would authorize partial termination of natural gas leases for breach of a condition imposed on such leases by the bill itself, and thus, if enacted, could not constitutionally be applied to any lease executed prior to the effective date of such law.

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Dear Senator Tillotson:

You inquire concerning House Bill No. 3038, introduced by Representative Farrar, which is being studied by the Special Committee on the Judiciary which you chair.

Section 1 of the bill purports to authorize termination of natural gas leases under certain circumstances. Specifically, it provides that "[w]henever a natural gas lease permits the production of natural gas from all subsurface zones" and surface access for that purpose, the holder of the fee interest in the surface may be entitled to a judicial decree terminating production rights under the lease "from any subsurface zone not presently or previously brought into production," as well as the "rights of entry or occupation as to all or some" of the surface, if the court finds, among other facts, that 1) the lease was executed more than 25 years prior to commencement of the action; 2) that the lessee is not or has not previously during that period "made any effort to commence production of natural gas from such subsurface zone or zones; and 3) that termination will not interfere with the lessee's existing production

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rights in other subsurface zones which are not the subject of the termination action.

You advise that the question has been raised whether the bill, if enacted, would operate as an impairment of existing contractual lease obligations.

In Kansas, absent express provisions in the lease, there is an implied covenant by the lessee to undertake prudent development of the leased tract. The broad general outline of this duty was described in *Stamper v. Jones*, 188 Kan. 626, 364 P.2d 972 (1961) thus:

"There is an implied covenant . . . that the tract will be prudently developed, and where the existence of oil in paying quantities is made apparent, it is the duty of the lessee to continue the development of the property and to put down as many wells as may be reasonably necessary to secure the oil for the common advantage of both the lessor and the lessee.

A lessee, under the implied covenant to develop an oil and gas lease, is required to use reasonable diligence in doing what would be expected of an operator of ordinary prudence, in the furtherance of the interests of both the lessor and lessee. Under this rule neither the lessor nor the lessee of an oil and gas lease is the sole judge of what constitutes prudent development of the tract.

A lessor who alleges breach of the implied covenant to develop has the burden of showing, by substantial evidence, that the covenant has been breached. He must prove that the lessee has not acted with reasonable diligence under the facts and circumstances of the particular situation at the time." [Citations omitted.]
188 Kan. at 631.

The diligence which the lessee must demonstrate is to be measured by a number of considerations. In *Fischer v. Magnolia Petroleum Co.*, 156 Kan. 367, 133 P.2d 95 (1943), the court stated thus:

"It has generally been recognized that in determining whether there is prudent development under the lease there are various

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pertinent factors to be considered -- all the facts and circumstances which would affect the reasonableness of an ordinarily prudent operator's position in connection with development of the particular tract involved In *Brewster v. Lanyon Zinc Co.*, . . . [140 Fed. 801], the circuit court of appeals said:

"Whether or not in any particular instance such diligence is exercised depends upon a variety of circumstances, such as the quantity of oil and gas capable of being produced from the premises, as indicated by prior exploration and development, the local market or demand therefor or the means of transporting them to market, the extent and results of the operations, if any, on adjacent lands, the character of the natural reservoir -- whether such as to permit the drainage of a large area by each well -- and the usages of the business." [Citations omitted.]

The costs of drilling, equipment and operation of wells, costs of transportation and storage, prevailing prices, and general market conditions as influenced by supply and demand or by governmental resolution or both must be considered.

There are many Kansas cases concerning the lessee's implied covenant to develop, and it would unduly lengthen this opinion to attempt to canvass even a few selected cases here. See, 3 Summers, *Oil and Gas* § 464 (2nd ed.) The extent of the lessee's duty is determined essentially by a standard of reasonableness. In *Berry v. Wondra*, 173 Kan. 273, 246 P.2d 282 (1952), the court quoted from *Merrill on Covenants Implied in Oil and Gas Leases*, § 57 (2nd ed.) thus:

"Where oil or gas is discovered in paying quantities, and, as is usually the case, there are no express provisions governing the drilling of additional wells, it is held uniformly that there is an implied covenant to drill as many wells as are reasonably necessary to develop the premises and to secure the oil or gas for the mutual benefit of the lessor and the lessee."

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This bill is distinctive in that it provides a ground for termination by the lessor which, in many instances, may be certainly unrelated to the lessee's entire satisfaction of all implied covenants to develop and market production from the leasehold. The lessee may, with extraordinary diligence, completed an ample number of wells on the tract and acted in all respects as a prudent operator. No Kansas case holds that it is a measure of the prudent operator standards that, absent express provision in the lease, the lessee shall develop every subsurface zone or horizon in the leasehold. Reasonable development of the leasehold might well be accomplished without production from every separate subsurface zone or horizon. Thus, the effect of the bill is to permit termination of the lessee's rights at the instance of the lessor for grounds which would not legally support such action prior to enactment of the bill.

In *Oil Fork Development Co. v. Huddleston*, 202 Ky. 261, 259 S.W. 334 (1924), the court considered a 1920 Kentucky statute which was enacted to prevent the courts from implying a covenant to develop in an oil and gas lease contrary to express provisions therein for delay in drilling by payment of rental. The lease at issue in the case was executed in 1919, and the 1920 statute was raised as a defense to forfeiture. The court refused to apply the statute, stating thus:

"The answer proceeds on the theory that section 3 is controlling, and that the completion of the nonproductive well automatically extended the lease for a period of 12 months without further payment of rentals. The lease was executed prior to the enactment of the statute, and though the statute purports to apply to existing leases, the question is: Is it valid when so applied? Article 1, § 10, federal Constitution, provides that no state shall pass any law impairing the obligation of contracts. The obligation of contracts is impaired by a statute which alters its terms by imposing new conditions, or dispensing with conditions, or which adds new duties or rights, or releases or lessens any part of the contract obligation, or substantially defeats its end. . . . There was no statute of similar import in force when the lease was executed. . . . The statute not only lessens the lessee's obligation, but confers


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new rights and privileges wholly inconsistent with the contract, and very prejudicial to the lessors. It follows that the statute is invalid as applied to the lease in question." 259 S.W. at 335.

Section 1 of the bill does not authorize partial termination of a lease for breach of any implied covenant to develop. Rather, regardless of how extensive the lessee's development of the leasehold has been, the bill authorizes termination as to any subsurface zone or horizon which has not been placed in production. Thus, production from each subsurface zone or horizon is made a condition of the lease, not by express agreement of the parties and not by implication, but by statute.

Clearly, enactment of this bill would operate to impair contractual obligations under leases executed prior to its effective date. It would permit a lessor to compel termination of a lease as to one or more subsurface zones or horizons, notwithstanding the lessee had breached no express or implied covenant with the lessor; the ground of any termination order entered under the bill would necessarily be a breach of a condition imposed by the bill itself, *i.e.*, production from every subsurface zone under the leasehold within twenty-five years from its execution. Interposition of such a condition by statute clearly constitutes an abridgement of existing contractual obligations. Thus, in my judgment, the bill could not constitutionally be applied to enforce termination of any lease executed prior to the enactment and effective date of the bill.

Yours very truly


CURT T. SCHNEIDER
Attorney General

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