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A Survey of Oil and Gas Law in Montana as it Relates to the Oil and Gas Lease

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I

It requires some knowledge of science to understand that oil and gas in the earth are not found in underground lakes or pools. Although it is not uncommon to refer to such accumulations as "pools," this has reference to a concentration of oil and gas at a particular place in the sub-surface and not to the physical characteristics of the accumulation itself. It is also accepted terminology to refer to the containing space of such accumulations as a reservoir. Although an underground reservoir is a container of fluids, it has properties which differentiate it from surface reservoirs. An oil and gas reservoir has been defined as "a body of porous and permeable rock in which oil [or gas] has accumulated in sufficient quantity to permit its commercial recovery."[1] In other words, oil is found in the minute pore spaces of sandstone or in the small seams in limestones that have been formed by the dilute acids in underground waters. These small pores or seams are connected so that the oil and gas are capable of moving through what appears to be a solid mass of compact rock.

However, oil and gas do not move about indiscriminately in the subsurface. Although courts have taken judicial notice of their fugacious character,[2] scientific evidence has demonstrated

[1]American Petroleum Institute, Standards of Allocation of Oil Production 19 (1942).

[2]In the case of Westmoreland and Cambria Natural Gas Co. v. DeWitt, 130 Pa. St. 235, 18 A. 724, 725 (1889), the court observed: "Water and oil and still more strongly gas, may be classed by themselves, if the analogy be not too fanciful, as minerals ferae naturae. In common with animals, and unlike other animals, they have the power and the tendency to escape without the volition of the owner."

In the Montana case of Toomey v. State Board of Land Commissioners, 106 Mont. 547, 562, 81 P. 2d 407 (1938), the court stated: "The gas thereunder is considered *ferae naturae* and is capable of being reduced the fallacy of this popular misconception.[3] Oil and gas reservoirs are not found throughout the areal extent of the sub-surface. They have been formed in certain areas because of the movements of the earth's crust which has resulted in folds or faults of what previously was a horizontal bed of porous and permeable rock. An inverted soup bowl on a table provides an apt example. The protrusion has been effected without puncturing the impermeable top layer or cover, and consequently, as the oil and gas accumulate in this reservoir or trap, they are immobilized there until such time as the containing rock is penetrated by a well.

Oil, as it exists in the earth, has no inherent energy, that is, it is incapable of producing itself even after the reservoir has been penetrated by a well. The propulsive force is provided by gas in solution in the oil[4] or at the crest of the reservoir, or by water which lies below the accumulation of oil in the reservoir rock. In either case, an area of lower pressure is created at the point where the well penetrates the reservoir and the expansion of the gas or water, or both, serves to push the oil towards the bottom of the well. There are no artificial boundary lines in sub-surface reservoirs. And there is nothing in the nature of oil within a reservoir which permits an identification of the oil at the surface of the earth as coming from some particular part of the reservoir.

An awareness of these factors is indispensable to an understanding of the peculiarities of oil and gas law: 1. That oil and gas are found in underground reservoirs of porous and permeable rock; 2. That prior to a penetration of the reservoir by a well, the oil and gas are in a state of equilibrium and do not move about within the reservoir; 3. That there are no underground barriers in the sub-surface to differentiate diverse ownership interests that exist on the surface; and 4. That in moving toward an area of lower pressure in the resrevoir, oil and gas may cross boundary lines that have been established on the surface, but when reduced to possession at the surface there is no way of identifying the oil as having originated beneath a specific surface tract.[5]

to the ownership of the party who captures it. The gas, as shown by geological experience, is highly fugitive in character. . . ."

[3]Hager, Practical Oil Geology (New York: McGraw-Hill Book Co., Inc., 1951); Interstate Oil Compact Commission, Oil and Gas Production (Norman, Oklahoma: University of Oklahoma Press, 1951).

[4]Just as gas is in solution in a bottle of seltzer water or ginger ale.

[5]The danger of generalization is to over-simplify the problem and to ignore the qualifications and exceptions. For a detailed treatment, see Sullivan, Handbook of Oil and Gas Law, 1-38 (1955).

II

The nature of oil and gas as minerals was recognized at an early date in the oil producing jurisdictions.[6] However, there was also judicial recognition of the fact that they were to be distinguished from metallic substances[7] and that the classification was based in some instances upon the division of matter into animal, vegetable and mineral.[8] The Supreme Court of Montana stated as early as 1922 that "oil is a mineral" and "an oil well is a mine."[9] The importance of the classification lies in the fact that some of the rules applicable to minerals may be applied by analogy to oil and gas.[10] However, the analogy is imperfect and misleading because of the dissimilarity between oil and gas and other minerals, particularly solid minerals.

When the question of ownership of oil and gas in place first arose, judicial recognition was taken of this dissimilarity and of the fugacious character of oil and gas.[11] The Montana Supreme Court has emphasized this tendency of oil and gas to move laterally within the formation when a pressure differential is created by the penetration of a well into the structure.[12] Because of this, and the fact that little more was known of the behavior underground of oil and gas when ownership disputes were first presented to the courts, analogies to substances that were similar in nature or behavior were applied.[13] Thus, they were compared to solid minerals and the theory of ownership in place was enunciated.[14] In other words, oil and gas are a part of the land

[6]Poe v. Ulrey, 233 Ill. 56, 84 N. E. 46 (1908); Silver v. Bush, 213 Pa. St. 195, 62 A. 832 (1906); Brown v. Spilman, 155 U.S. 665, 15 S.Ct. 245, 39 L.Ed. 304 (1895).

[7]Poe v. Ulrey, note 6, supra.

[8]Silver v. Bush, note 6, supra.

[9]Mid-Northern Oil Co. v. Walker, 65 Mont. 414, 427, 211 P. 353 (1922), and see Rice Oil Co. v. Toole County, 86 Mont. 427, 431, 284 P. 145. (1930)—"Oil is a mineral and the process of extracting it from the rocks is mining."

[10]In Re Hume's Estate, ... Mont. ......, 272 P. 2d 999 (1954)—the grant of "an undivided . . . interest in and to all of the oil, gas and other minerals in and under and that may be produced from the following described lands . . ." construed as a mineral deed which divided the ownership of the minerals from the ownership of the surface estate.

[11]Westmoreland and Cambria Natural Gas Co. v. DeWitt, 130 Pa. St. 235, 18 A. 724 (1889).

[12]Williard v. Federal Surety Co., 91 Mont. 465, 472, 8 P.2d 633 (1932)—they are "part of it [the land] as long as they are on or in it, or subject to his [the landowner's] control." And see Toomey v. State Board of Land Commissioners, 106 Mont. 547, 81 P.2d 407 (1938)—gas.

[13]For a discussion of the various theories and the basis for the analogies, see Summers, The Modern Theory and Practical Application of Statutes for the Conservation of Oil and Gas, 13 TULANE L. REV. 1, 7 (1938).

[14]Texas Co. v. Daugherty, 107 Tex. 234, 176 S.W. 717 (1915). For a further discussion and citation to states adopting this theory, see Sullivan, Handbook of Oil and Gas Law, 42 (1955).

and ownership of the land includes ownership of oil and gas in place. They were compared to underground percolating waters and the qualified theory of ownership was declared.[15] In other words, oil and gas are fugacious minerals and ownership of the land includes the exclusive right to drill thereon and acquire ownership in the oil and gas by reducing them to possession. They were compared to wild animals and the no-ownership theory was proposed.[16] In other words, oil and gas are owned by no one until reduced to possession; they are minerals ferae naturae.

Montana has adopted the theory of ownership in place insofar as the interest of the landowner is concerned.[17] In the case of *Gas Products Co.* v. *Rankin,* the Supreme Court approved as a general rule that: "Both petroleum and gas, as long as they remain in the ground, are a part of the realty. They belong to the owner of the land, and are a part of it as long as they are on it or in it, or subject to his control. When they escape and go into other lands, or come under another's control, the title of the former owner is gone."[18] The Supreme Court of Montana continued by stating: ". . . we subscribe to and declare this to be the doctrine applicable in Montana. We can see no distinction between the owner's property rights to minerals in his land and those pertaining to gas taken from the land and reduced to possession."[19] There is some doubt as to the application of this sweeping generality since the case of *Toomey* v. *State Board of Land Commissioners* wherein the court stated: "There is no actual ownership of gas in situ."[20] However, a determination as to ownership was not essential to the decision in the latter case and, consequently, the forcefulness of the statement is considerably weakened.

The ownership theory coupled with judicial recognition of

[15]Rich v. Doneghey, 71 Okla. 204, 177 P. 86 (1918) ; and see Ohio Oil Co. v. Indiana, 177 U.S. 190, 20 S.Ct. 576, 44 L. Ed. 729 (1900).

[16]Townsend v. State, 147 Ind. 624, 47 N.E. 19 (1897) ; but see criticism in Manufacturers Gas and Oil Co. v. Indiana Natural Gas and Oil Co., 155 Ind. 461, 57 N.E. 912 (1900).

[17]Gas Products Co. v. Rankin, 63 Mont. 372, 207 P. 993, 24 A.L.R. 294 (1924) ; Homestake Exploration Corp. v. Schoregge, 81 Mont. 604, 264 P. 388 (1928) ; Broderick v. Stevenson Consol. Oil Co., 88 Mont. 34, 290 P. 244 (1930) ; Williard v. Federal Surety Co., 91 Mont. 465, 8 P.2d 633 (1932).

[18]Gas Products Co. v. Rankin, note 17, supra at page 393, citing Lanyon Zinc Co. v. Freeman, 68 Kan. 691, 75 P. 995 (1904).

[19]Gas Products Co. v. Rankin, note 17, supra at page 393.

[20]106 Mont. 547, 563, 81 P.2d 407 (1938). Contrast this position with that of Oklahoma which is one of the non-ownership (exclusive right to drill theory) states (Rich v. Doneghey, note 15, supra) but where there is absolute ownership of gas in place by statute (Oklahoma Stat. Ann. 52-231).

the fugitive nature of oil and gas is the basis for the anachronism of title to produced oil or gas. Thus it has been declared that oil and gas "... when produced on the surface ... become personal property and belong to the owner of the well.'"[21] This has also been declared to be the rule in Montana by the Supreme Court.[22] But what of the oil that has drained through the subsurface to neighboring land and that has been produced through a well located thereon? The Montana Supreme Court recognizes the Rule of Capture, namely: "... when [oil or gas] escape and go into other lands, or come under another's control, the title of the former owner is gone ...'"[23] The doctrine was first enunciated in a Pennsylvania case[24] and has been modified considerably by conservation regulations which fix the location, and in some cases, the limitations upon production of wells.[25] It has been responsible, however, for the application of the doctrine of self-help to oil operations, i.e., the Offset Drilling Rule.[26] This also has been modified by conservation regulations.

The theory of ownership applicable to landowner's rights has not been applied in fixing the nature of the lessee's interest. In this respect, Montana departs from other ownership states, particularly Texas, where the execution of a lease effects the conveyance of a determinable fee to an undivided seven-eights interest in the oil and gas in place to the lessee.[27] In Montana there is no conveyance of title; there is merely the grant of a right to go on and explore, and, if oil and gas is found, to acquire title thereto as personal property under the terms of the lease.[28]

[21]Note 18, supra.

[22]Note 19, supra; and see Broderick v. Stevenson Consol. Oil Co., 88 Mont. 34, 290 P. 244 (1930).

[23]Note 18, supra. In Toomey v. State Board of Land Commissioners, note 20, supra, the court stated (at page 563): "The gas underlying state lands may be brought to the surface on adjacent lands, and, conversely, gas brought to the surface on state lands may actually drain from adjoining lands. Each landowner over a gas structure has coequal rights to reduce the gas to his possession, but he who first reduces the gas to possession on his lands is the owner thereof."

[24]Westmoreland and Cambria Natural Gas Co. v. DeWitt, note 11, supra.

[25]See Walker, Property Rights in Oil and Gas and Their Effect Upon Police Regulation of Production, 16 Tex. L. Rev. 370 (1938); Shank, Present Status of the Law of Capture, Sixth Annual Institute on Oil and Gas Law and Taxation (1955).

[26]"What, then, can the neighbor do? Nothing; only go and do likewise. He must protect his own oil and gas." Barnard v. Monongahela Natural Gas Co., 216 Pa. 362, 65 A. 801, 802 (1907).

[27]Stephens County v. Mid-Kansas Oil and Gas Co., 113 Tex. 160, 254 S.W. 290, 29 A.L.R. 566 (1923).

[28]Broderick v. Stevenson Consol. Oil Co., 88 Mont. 34, 290 P. 244 (1930).

It creates a "privilege a prendre,"[29] a present property right[30] which is "an interest in land although incorporeal."[31]

III

The oil and gas lease is undoubtedly the most complex and most extensively interpreted short form of legal instrument ever drafted. There is no standard form of lease[32] although it is common to refer to an oil and gas lease as a "Producers 88." All oil leases have certain basic elements but there are variations in terminology, and therefore in operative effect, even within this common framework. Thus in the evolution of contemporary lease forms, the drilling obligation of the lessee served as a convenient basis for the classification of the rights acquired. Where the lessee promised either to drill a well or to pay delay rentals, an "or" lease resulted.[33] Where the lessee did not promise either to drill or pay but the lease would terminate within a specified period unless he did one or the other, an "unless" lease resulted.[34] It is impossible, therefore, to state principles of uniform application to all oil and gas leases without qualification as to the particular clause in issue and the detailed provisions thereof.

An oil and gas lease of the "or" type has been construed as an option contract which vests no title in the lessee until the substances are reduced to possession and which is not a grant of any estate in the land.[35] But in the case of *Homestake Exploration Corporation* v. *Schoregge*,[36] the court stated: "The contract is one of lease . . . not a mere option, as stated in the decision of this court in *Thomas* v. *Standard Development Co.* . . ." An oil and gas lease of the "unless" type has been construed as ". . . a lease, but in the nature of an optional contract, as it does not require the lessee to perform any act nor give rise to a right of action on default under its terms, but merely grants to the lessee

[29]Homestake Exploration Corp. v. Schoregge, 81 Mont. 604, 615, 264 P. 388 (1928)—"Until actual discovery of oil, the interest of the lessee in the land is inchoate."

[30]Williard v. Federal Surety Co., 91 Mont. 465, 8 P.2d 633 (1932).

[31]*Ibid* at page 473.

[32]Fagg v. Texas Co., 57 S.W. 2d 84 (Tex. Civ. App. 1933)—specific performance of an agreement to execute a Form 88 lease denied.

[33]For a detailed discussion of the form and operative effect of "or" leases, see Sullivan, Handbook of Oil and Gas Law, 109 (1955); see also Thomas v. Standard Development Co., 70 Mont. 156, 224 P. 870 (1924).

[34]For a detailed discussion of the form and operative effect of "unless" leases, see Sullivan, Handbook of Oil and Gas Law, 107 (1955); see also Abell v. Bishop, 86 Mont. 478, 284 P. 525 (1930).

[35]Thomas v. Standard Development Co., note 33, supra. But see notes 28-31 supra wherein the interest of the lessee has been construed to be an interest in land in the nature of a profit a prendre.

[36]81 Mont. 604, 614, 264 P. 388 (1928).

the privilege of drilling, paying, or terminating the lease at its option.'"[37] Nonetheless, as noted previously[38] the right acquired by an oil and gas lessee is a present property interest in the nature of a profit a prendre.

In the evolution of oil and gas law, the nature of the subject matter and the dependence of the landowner upon operations by the lessee for realization of benefits under the lease led to the formulation of distinctive canons of construction, namely:

1. The lease is to be construed most strongly against the lessee and in favor of the lessor;
2. It will be construed to promote development and prevent delay;
3. Forfeitures will be favored where there is an express provision therefor in the lease.[39]

The Montana Supreme Court has declared that the rules of construction applicable to leases generally, do not apply to oil and gas leases because of the nature of the subject matter.[40] Therefore, the lease will be strictly construed against the lessee and in favor of the lessor,[41] forfeitures are favored,[42] and time is of the essence although not so specified in the instrument.[43] The intention of the parties must be gathered from a consideration of the entire instrument and not some isolated provision thereof.[44] Where there is a conflict between the written and printed portions of the lease, the former will control.[45] The fact that the provisions of the lease are burdensome or improvident is not a sufficient grounds for avoiding the lease.[46]

IV

A granting clause which provides that the lessor "has leased, and let, and by these presents does grant, lease, and let unto the

[37]McNamer Realty Co. v. Sunburst Oil and Gas Co., 76 Mont. 332, 344, 247 P. 166 (1926). And see Covey v. Sunburst Oil and Gas Co., 72 Mont. 383, 233 P. 909 (1925), cert. den. 268 U.S. 698; McDaniel v. Hager-Stevenson Oil Co., 75 Mont. 356, 243 P. 582 (1926).
[38]See notes 28-31, supra and the corresponding discussion in the text.
[39]Sullivan, Handbook on Oil and Gas Law 83 (1955).
[40]Solberg v. Sunburst Oil and Gas Co., 76 Mont. 254, 246 P. 168 (1926).
[41]Thomas v. Standard Development Co., 70 Mont. 156, 224 P. 870 (1924); Solberg v. Sunburst Oil and Gas Co., 73 Mont. 94, 235 P. 761 (1925); McDaniel v. Hager-Stevenson Oil Co., 75 Mont. 356, 243 P. 582 (1926); Bowes v. Republic Oil Co., 78 Mont. 134, 252 P. 800 (1927).
[42]Bowes v. Republic Oil Co., note 41, supra; Abell v. Bishop, 86 Mont. 478, 284 P. 525 (1930); Stanolind Oil and Gas Co. v. Guertzger, 100 F.2d 299 (C.C.A. Mont. 1938).
[43]Solberg v. Sunburst Oil and Gas Co., note 40, supra; McDaniel v. Hager-Stevenson Oil Co., note 41, supra.
[44]Bowes v. Republic Oil Co., note 41, supra; Krutzfeld v. Stevenson, 86 Mont. 463, 284 P. 553 (1930).
[45]Daley v. Torrey, 69 Mont. 599, 233 P. 498 (1924).
[46]Hinerman v. Baldwin, 67 Mont. 417, 215 P. 1103 (1923).

lessee . . . all the oil and gas and hydrocarbons and other minerals, in and under the following described land . . ." invests the lessee with a present property right in the nature of a profit a prendre.[47] It is a lease and not a license where exclusive rights are given and the name by which the instrument is identified does not control.[48]

The habendum clause fixes the term or duration of the lease. A conventional provision provides that the lease shall continue "for a term of five years and so long thereafter as oil and gas or either of them is produced from said land by the lessee."[49] Under such a provision there are actually two periods of limitation and not one. The first period is for the fixed term of five years, called the primary term, and the second is measured by the continuance of production after the primary term has expired, called the "thereafter" period.

The purpose of the habendum clause is to fix the period beyond which the lease cannot continue in the absence of production and the circumstances under which termination will take place in the event of production.[50] Thus, production within the primary term must be obtained if the lease is to continue thereafter.[51] Some courts have sought to avoid the harshness of termination in such cases through exceptions under the circumstances of the particular cases.[52] However, in a Montana case the basis for extension of the lease beyond the primary term without production was the application of general contract rules of construction to

[47]Homestake Exploration Co. v. Schoregge, 81 Mont. 604, 264 P. 388 (1928), quoting with approval at page 614 from Veasey on Oil and Gas, 18 Mich. L. Rev. 773: ". . . but by his lease, regardless of the form of granting clause, he [the owner of the fee] does not intend to convey the oil and gas in place or any interest therein. . . . By a lease of this description the lessee is vested with a present property right in the leased premises, namely, to search for oil and gas under the conditions of the lease and to appropriate them as personal property, if found, yielding the stipulated royalty. This is a right to take a profit from the lands of another, and within the common law classification may be regarded as a profit a prendre."

[48]Herigstad v. Hardrock Oil Co., 101 Mont. 22, 52 P.2d 171 (1935)—federal exploration permit assigned by "operating agreement."

[49]Berthelote v. Loy, 95 Mont. 434 442, 28 P.2d 187 (1933).

[50]See Veasey, The Habendum Clause, 19 Mich. L. Rev. 161 (1920) ; Sullivan, Handbook of Oil and Gas Law, 95 et seq. (1955).

[51]J. J. Fagan & Co. v. Burns, 247 Mich., 674, 226 N.W. 653, 67 A.L.R. 522 (1929) ; Galloway v. Kroeger, 169 Okla. 645, 34 P.2d 250 (1934) ; Stanolind Oil and Gas Co. v. Barnhill, 107 S.W.2d 746 (Tex. Civ. App. 1937).

[52]Freeman v. Magnolia Petroleum Co., 141 Tex. 339, 171 S.W.2d 339 (1943)—finding but not producing gas within primary term; Stahl v. Van Vleck, 53 Oh. St. 136, 41 N.E. 35 (1895)—interference by lessor; Saulsberry v. Siegal, 221 Ark. 152, 252 S.W. 2d 834 (1952).

the oil and gas lease.[53] If the resumption of drilling eight months after the well was commenced is to be construed as diligent operation, the result of the case is commendable. But it is unfortunate that the distinction in purpose and operative effect between the habendum clause and the development clause has been disregarded.[54] In one other case, the Montana Supreme Court has decided that discovery of gas within the primary term is sufficient to continue the lease and that production was not necessary where there was no present market.[55]

Production within the meaning of this clause means production in paying quantities.[56] This has been construed by the Montana Supreme Court to mean "such an amount of production as would pay a small profit over the cost of operation of the well, excluding from consideration the initial cost of bringing the well into production."[57] Although production must normally be by the lessee or those in privity with him,[58] the Montana Supreme Court has held that the drilling of a producing well by a wilful trespasser will enure to the benefit of the lessee.[59] To preclude termination of the lease where a well has been commenced and is being drilled with diligence at the end of the primary term, a so-called "commencement clause" has been inserted in conventional lease forms.[60] Other clauses are frequently inserted to cover other contingencies, such as the cessation of production during the "thereafter" period where the lessee continuously prosecutes drilling or reworking operations in an effort to restore production.[61]

Oil and gas leases are often classified according to type of

[53]Consolidated Gas Co. v. Rieckhoff, 116 Mont. 1, 5, 151 P.2d 588 (1944) —"While there may be some features of oil and gas leases which inject new considerations in the rule of construction of contracts, we think that in this instance the ordinary rule of contract must apply. There is no question but what the development clause, if it is given effect, modifies the term clause. . . ."

[54]For an analysis of the development clause see text at note 62 infra.

[55]Steven v. Potlatch Oil and Ref. Co., 80 Mont. 239, 260 P. 119 (1927).

[56]Bertholote v. Loy Oil Co., 95 Mont. 434, 28 P.2d 187 (1933); and see Sunburst Oil and Ref. Co. v. Callender, 84 Mont. 178, 274 P. 834 (1929).

[57]*Ibid* at page 448. That the royalty payable to the lessor is a part of the operating expenses and must be deducted in determining whether the well is producing in paying quantities, see Indiana Natural Gas & Oil Co. v. Wilhelm, 44 Ind. App. 100, 86 N.E. 86 (1908).

[58]The habendum clause specifies that it must be "by the lessee." In the absence of this phrase the rule is still operative, see Batete v. Adams, 229 S.W. 930 (Tex. Civ. App. 1921).

[59]Rieckhoff v. Consolidated Gas Co., 123 Mont. 555, 217 P.2d 1076 (1950).

[60]For an example of such a clause and a case upholding the validity of the provision as an extension beyond the primary term, see Bain v. Portable Drilling Corp., 200 Okla. 569, 198 P.2d 207 (1948).

[61]See Sullivan, Handbook of Oil and Gas Law 102 et seq. (1925) for the form and operative effect of such clauses.

development clause, or drilling and delay rental clause as it is sometimes called. One type, called the "or" clause, obligates the lessee to drill a well within a specified period, usually one year, or pay a stipulated sum called a "delay rental."[62] Failure to drill or pay gives the lessor the option to forfeit the lease even though the primary term has not expired.[63] The other type, called the "unless" clause is used most frequently and does not obligate the lessee to either drill or pay.[64] Failure to do either, however, will result in the automatic termination of the lease inasmuch as this is a clause of special limitation.[65] As such, it expires by its own terms, without the necessity of intervention by the lessor as in the case of the "or" clause.[66]

Actual drilling is not necessary to constitute commencing a well.[67] However, where the lessee expressly contracts to "commence drilling operations," the work done as a preliminary to actual drilling is not sufficient; the well must be actually spudded in, that is, the drill must actually penetrate the ground.[68] The failure to object to the drilling of a well on structure but on adjoining premises, pursuant to an express drilling clause but after the primary term has expired, does not constitute a waiver of the right to forfeit or create an estoppel against the lessor-owner of other lands.[69]

In the absence of commencing a well, a condition precedent to the continuance of the lease under the "unless" clause is the payment of the stipulated delay rental.[70] Payment by check is sufficient where there is an established course of dealing[71] but payment by telegraph which is not the usual mode between the parties does not constitute payment until it has been received by

[62]For an example of such a clause, see Thomas v. Standard Development Co., 70 Mont. 156, 224 P. 870 (1924).

[63]McDaniel v. Hager-Stevenson Oil Co., 75 Mont. 356, 243 P. 582 (1926).

[64]". . . if no well be commenced on said land within one year from date of this lease, this lease shall terminate as to both parties, unless the lessee on or before that date shall pay or tender to the lessor, or to the lessor's credit in the First National Bank at Shelby, Montana . . . one hundred and sixty dollars ($160) which shall operate as rental and cover the privilege of deferring the commencement of the well for twelve months from date." McNamer Realty Co. v. Sunburst Oil and Gas Co., 76 Mont. 332, 337, 247 P. 166 (1926).

[65]Williard v. Campbell, 91 Mont. 493, 11 P.2d 782 (1932).

[66]McDaniel v. Hager-Stevenson Oil Co., 75 Mont. 356, 243 P. 582 (1926).

[67]Cromwell v. Lewis, 98 Okla. 53, 223 P. 671 (1924).

[68]Solberg v. Sunburst Oil and Gas Co., 73 Mont. 94, 235 P. 761 (1925); and see Consolidated Gas Co. v. Rieckhoff, 116 Mont. 1, 151 P.2d 588 (1944)—drilling to 50 feet and lapse of eight months when drilling resumed after expiration of primary term, held sufficient to continue lease into "thereafter" period.

[69]Bowes v. Republic Oil Co., 78 Mont. 134, 252 P. 800 (1927).

[70]Abell v. Bishop, 86 Mont. 478, 284 P. 525 (1930).

[71]Saling v. Flesch ,85 Mont. 106, 277 P. 612 (1929).

the lessor or the designated depository.[72] The payment must be free from any condition which the lessor is not bound to accept.[73] In ascertaining the date upon which payment must be made the usual rule is to exclude the first day and include the last[74] but the rule is not applicable where the parties have construed the obligation otherwise.[75] Acceptance of late payments will constitute a "waiver of the power to declare a forfeiture"[76] and the obligation to pay may be modified by an executed oral agreement between the parties.[77] Where a bank is designated as the depository for delay rental payments, it becomes the agent of the lessor but its authority is limited to the receipt of payments and they must be in cash unless a custom has become established to the contrary.[78]

The royalty clause constitutes the principal affirmative covenant of the oil and gas lease. Royalty is defined as the "share of the product or profit paid to the owner of the property."[79] Because of the differences in oil, gas, and casinghead gas, early lease forms provided for a threefold computation of royalty payable to the lessor.[80] Conventional lease forms provide for a uniform rate of one-eighth for all three substances. Royalty oil, that is the share of the lessor in the oil produced, is personal property.[81] An interest in royalty in place, as distinguished from a mineral interest, has been construed as personal property.[82] They are analogous, however, to rent as it was defined at common law in that they issue out of the land leased and are a payment in return for the privilege of occupying the premises. In their

[72]Abell v. Bishop, note 70, supra.

[73]Thomas v. Standard Development Co., 70 Mont. 156, 224 P. 870 (1924) —"or" lease.

[74]White v. Dennis, 220 S.W. 161 (Tex. Civ. App. 1920).

[75]Abell v. Bishop, 86 Mont. 478, 284 P. 525 (1930).

[76]Nadeau v. Texas Co., 104 Mont. 558, 69 P.2d 506, 111 A.L.R. 874 (1937); and see Saling v. Fesch, 85 Mont. 106, 277 P. 612 (1929)—acceptance of check before due date and retention for long period thereafter will prevent lessor from contending that lease had terminated because sublessee had entered stop payment order. But a good faith tender made after the due date will not extend the lease, Abell v. Bishop, note 75, supra.

[77]Griffith v. Cedar Creek Oil and Gas Co., 91 Mont. 553, 8 P.2d 1071 (1932).

[78]Abell v. Bishop, note 75, supra.

[79]Homestake Exploration Corp. v. Schoregge, 81 Mont. 604, 264 P. 388 (1928); and see Hinerman v. Baldwin, 67 Mont. 417, 215 P. 1103 (1923); Marias River Syndicate v. Big West Oil Co., 98 Mont. 254, 38 P.2d 599 (1934).

[80]For an example of such a royalty clause, see Cedar Creek Oil and Gas Co. v. Archer, 112 Mont. 477, 484, 117 P.2d 265 (1941).

[81]Gas Products Co. v. Rankin, note 17 supra; Homestake Exploration Corp. v. Schoregge, note 29 supra.

[82]Rist v. Toole County, 117 Mont. 426, 159 P.2d 340, 162 A.L.R. 406 (1945).

nature, then, royalty interests in place are real property[83] as distinguished from interests in royalty oil produced which are personal property.

The term "royalty" has an established meaning and a landowner who contracts with respect thereto cannot plead ignorance and mistake of such meaning in an effort to cancel the lease.[84] The acceptance of royalty payments after breach of other covenants in the lease does not constitute a waiver of the right to forfeit the lease.[85] A provision that the lease may be shut-in if "by reason of there being no profitable market for its output, there shall be no royalty" will relieve the lessee from making any royalty payment and the lease continues in effect under the thereafter clause.[86]

In addition to the foregoing principal clauses, a number of miscellaneous provisions have been construed by the Montana Supreme Court. A notice clause is inserted in the oil and gas lease to prevent termination of the lease for breach of some express or implied obligation therein.[87] It does not apply to limitations in the lease as a rule unless the terms of the notice clause are so broad as to include "any terms or conditions."[88] The clause requires notice of default and proof of failure to perform before the question of diligence in drilling a well may be litigated.[89] A provision in the lease that the lessee will pay for all damages to growing crops, fences, etc. adds nothing to the general liability of the lessee to the lessor.[90] Surrender clauses were inserted initially to allow a lessee under an "or" type lease to terminate his liability for delay rental payments prior to the end of the primary term.[91] A forfeiture clause was inserted to give a corresponding right of termination to the lessor.[92] Surrender clauses are inserted in "unless" type leases to give the lessee the right of partial surrender. If the lease is supported by consideration, the

[83]For a discussion, see Blake, Oil Royalties; A Suggested Criterion, 13 Miss. L. J. 307 (1941); Levy, Oil Royalties: A Distinct Species of Property, 11 So. Calif. L. Rev. 319 (1938).
[84]Hinerman v. Baldwin, 67 Mont. 417, 215 P. 1103 (1923).
[85]Stanolind Oil and Gas Co. v. Guertzgen, 100 F.2d 299 (C.C.A. Mont., 1938).
[86]Steven v. Potlatch Oil and Ref. Co., 80 Mont. 239, 260 P. 119 (1927).
[87]For an example of such a clause see Stimson v. Tarrant, 43 F. Supp. 657 (D.C. Mont. 1941), affirmed 132 F.2d 363, cert. den. 319 U.S. 751.
[88]*Ibid.*, and see Stranhan v. Independent Natural Gas Co., 98 Mont. 597, 41 P.2d 39 (1934).
[89]Consolidated Gas Co. v. Rieckhoff, 116 Mont. 1, 151 P.2d 588 (1944).
[90]Franz Corp. v. Fifer, 295 F. 106 (C.C.A. Mont. 1924)—use of leased premises as base for operations on adjoining tracts.
[91]Thomas v. Standard Development Co., 70 Mont. 156, 224 P. 870 (1924).
[92]McDaniel v. Hager-Stevenson Oil Co., 75 Mont. 356, 243 P. 582 (1926).

presence of such a clause does not affect the mutuality of the lease.[93]

V

The doctrine of implied covenants in oil and gas leases is analogous to the implied obligations that exist in the law of landlord and tenant. It was conceived to secure to the lessee the moving consideration for the execution of the early oil leases, that is, production from which royalties were paid. Because of the nature of the subject matter and the impossibility of ascertaining the characteristics of the reservoir at the time the lease is executed, conventional lease forms rarely contain provision for the drilling of test wells, the development of the premises after production is secured initially, the protection of the premises against drainage to producing wells on adjacent tracts, or the operation of producing wells and the marketing of the products therefrom. The omission is an intentional one, the existence and extent of the obligations being left to implication.[94]

The implied covenant to drill a test well was recognized in the case of *Berthelote* v. *Loy Oil Co.*[95] Inasmuch as the obligations of implied covenants are not applicable where the parties have expressly fixed their obligations by contract,[96] the option to pay delay rentals under an unless lease abrogates the obligation to drill a test well. However, the Montana Supreme Court has held that the doctrine is inapplicable in some cases:

"In view of the fact that no allegations appear in any of the pleadings asserting the payment of rentals, we must treat the case as though none were paid; and the lease, so far as we are here concerned, is in the same condition as though it contained no delay-rental provision."[97]

The implied covenant to develop the property was also recognized in the *Berthelote* case.[98] Before the duty arises it must be established that the additional wells will produce in paying quantities. The meaning of the term "paying quantities" when

[93]Hinerman v. Baldwin, 67 Mont. 417, 215 P. 1103 (1923).

[94]"Where, as here, a lease is granted for a nominal initial consideration, and the lessee agrees to pay in return therefor a share of the oil or gas produced from the land, it is apparent that the principal consideration for the grant is the promise of the lessee to pay the royalty. The payment of the royalty is, however, contingent upon production. Where the real purpose is thus disclosed but the lease does not contain in itself express provisions creating duties in the lessee to do such acts as were necessary for the accomplishment of that purpose, the law implies them." Berthelote v. Loy Oil Co., 95 Mont. 434, 445, 28 P.2d 187 (1933).

[95]95 Mont. 434 ,28 P.2d 187 (1933).

[96]Southwestern Oil Co. v. McDaniel, 71 Okla. 142, 175 P. 920 (1918).

[97]Berthelote v. Loy Oil Co., 95 Mont. 434, 455, 28 P.2d 187 (1933).

[98]Note 95, supra.

used in connection with this implied covenant is to be distinguished from the interpretation of it when used in the "thereafter" provision of the habendum clause. It does not mean a profit, however small, in excess of the cost of operation, but:

> ". . . when used in connection with the implied covenant to drill additional wells, it should include, rather than exclude, the cost of drilling operations."[99]

The implied covenant to protect the property from drainage by the drilling of offset wells was recognized in the case of *Severson* v. *Barstow*.[100] However, the duty does not arise until drainage occurs and will not be enforced if there is no outlet for the product from the offset wells when they are drilled:

> "There being no possible market for the gas when produced, the drilling of a number of additional wells would not protect this land in this respect, for each well, when drilled, would have to be capped and the drainage would continue as theretofore. . . . The failure of the lessees to drill offset wells cannot be deemed a breach of this implied covenant, unless or until it is shown that there would be a market for the gas produced from such wells."[101]

The implied covenant to operate and market the product requires that the lessee use reasonable diligence in the operation of the well and in seeking to find an outlet for the production therefrom.[102] Where the implied covenants have been breached, the lessor may secure a cancellation of the lease:

> "These implied covenants are conditions of the lease . . . and upon the plain and substantial breach thereof the lease became terminated and no longer of any force or effect, although still appearing on the records as an effective disposal of oil and gas under the leased lands."[103]

Partial cancellation has been ordered where the lessee has discharged the duty as to a part of the tract but is in default as to the remainder.[104]

[99]Note 97, supra at page 452.
[100]103 Mont. 526, 63 P.2d 1022 (1936).
[101]Severson v. Barstow, 103 Mont. 526, 533, 63 P.2d 1022 (1936).
[102]Severson v. Barstow, 103 Mont. 526, 63 P.2d 1022 (1936), and see the discussion in Berthelote v. Loy Oil Co., note 97, supra, and in Sunburst Oil and Ref. Co. v. Callender, 84 Mont. 178, 274 P. 834 (1929).
[103]Berthelote v. Loy Oil Co., note 97, supra, at page 446.
[104]Severson v. Barstow, note 102, supra—implied covenant to develop.

VI

Oil and gas leases may terminate in a variety of ways under the provisions of the lease: non-payment of delay rentals under an "unless" lease,[105] expiration of the primary term without having secured production,[106] cessation of production after the expiration of the primary term, surrender in accordance with the terms of a surrender clause in the lease, failure to drill additional wells where the lease specifies termination as the penalty,[107] and by judicial proceedings.

Cancellation by a court of equity necessitates that the petitioner be free from fault, that is, come into equity with clean hands.[108] The action to forfeit is equitable in nature as distinguished from the statutory remedy of securing the release of record of a terminated lease.[109]

At the common law no damages were recoverable for the failure of a lessee to release of record an oil and gas lease that had terminated.[110] However, by statute in Montana the lessee or his successor must release a forfeited lease of record within sixty days.[111] If he refuses or neglects to do so, the landowner may bring an action to compel the release and recover statutory damages in the amount of one hundred dollars plus all costs, reasonable attorney's fees, and any other damages that can be established.[112]

CONCLUSION

Despite a long history of production, Montana has had relatively meager litigation in the field of oil and gas law. In the resolution of problems that will arise with an increase in leasing, exploratory activity, and production, it has available the results of a trial and error method pursued by the more prolific produc-

[105]Abell v. Bishop, 86 Mont. 478, 284 P. 525 (1930).

[106]Consolidated Gas Co. v. Rieckhoff, 116 Mont. 1, 151 P.2d 588 (1944)—but here the court construed the development clause as modifying the habendum clause and commencing a well during the primary term was sufficient to continue the lease in effect into the "thereafter" period.

[107]Ellingson v. Shaw, 114 Mont. 550, 138 P.2d 947 (1943)—but lease also provided for the retention of stipulated acreage around each producing well.

[108]Covey v. Sunburst Oil and Gas Co., 72 Mont. 383, 233 P. 909, cert. den. 268 U.S. 698.

[109]McNamer v. Sunburst Oil and Gas Co., 76 Mont. 332, 247 P. 166 (1926).

[110]Hasquet v. Big West Oil Co., 29 F.2d 78 (C.C.A. Mont. 1928).

[111]Revised Code of Montana (1947) 73-114.

[112]*Ibid.*, Sec. 115; for an interpretation of the meaning and effect of the statute, see Solberg v. Sunburst Oil and Gas Co. 70 Mont. 177, 225 P. 612 (1924); 73 Mont. 94, 235 P. 761 (1925); 76 Mont. 254, 246 P. 168 (1926); Steven v. Potlatch Oil and Refining Co., 80 Mont. 239, 260 P. 119 (1927); Berthelote v. Loy Oil Co., 95 Mont. 434, 28 P. 2d 187 (1933).

ing states. But in the evolution of a separate jurisprudence on oil and gas, the cases may be distinguished on the basis of a clearly recognizable time sequence—before 1900, the era of definition and comparative ignorance of how oil occurs and reacts when a well penetrates the reservoir; between 1900 and 1932—the era of scientific awareness of the nature of petroleum and petroleum reservoirs and the emergence of the conventional "unless" lease; from 1932 to the present—the era of conservation. With an increase in understanding of the nature of the substance and how it occurs, the basis for some of the earlier decisions in other jurisdictions is questionable and no longer persuasive. The classification of the producing states on the basis of the theories of ownership of oil and gas in place is also illusory inasmuch as the same results have been forthcoming to similar problems in many instances despite this fundamental cleavage. In the formulation of a sound jurisprudence on oil and gas law, Montana is in the position of being restricted by few questionable precedents and able to profit by the experience of her sister producing states.