Two Drilling Covenants Implied in Oil and Gas Leases

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TWO DRILLING COVENANTS IMPLIED IN OIL AND GAS LEASES*

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One of the striking features of the law of oil and gas is the willingness of courts to impose upon operators drilling obligations not expressed in the mineral lease, the usual instrument for securing oil and gas development. The technique for imposing these obligations is to read into the lease certain covenants respecting the drilling of wells. Among the various covenants thus implied in the lease, of special interest to a landowner-lessee in a new field are the covenants to develop and to protect the premises. In substance these covenants require the lessee to exercise due diligence in drilling wells to prevent drainage from the leasehold and to develop a known producing formation. These two implied covenants by no means exhaust the list of lessee's implied duties: among other obligations, the lessee must use due diligence in producing and marketing the product, in conducting all operations on the premises, in exploring for further producing formations, and in drilling an initial test well. The latter covenant arises under certain older forms of leases but not under the “unless” type lease. It is misleading, however, to enumerate these duties as distinct and separate obligations, for in substance they are merely specific applications of a more general duty imposed on the lessee by a great majority of oil-producing jurisdictions. This general duty requires the lessee to operate the premises in the manner of an ordinary prudent operator having regard for the interests of both lessor and lessee. The most recent addition to the list of oil-producing states, North Dakota, applies this standard of conduct to the operations of lessees.

In considering these implied covenants, this paper will take up each covenant separately, treating first the nature of the duty, then the elements of a cause of action for breach of the duty, and finally, the remedies for breach.

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1. Brewster v. Lanyon Zinc Co., 140 Fed. 801 (8th Cir. 1905) (per Van Devanter, J.). A few states have adopted a standard based upon the good faith of the lessee. For a thorough discussion of the two standards, see Merrill, Covenants Implied in Oil and Gas Leases §§ 118-145 (1940). This fine book will hereafter be cited simply as Merrill.

2. Herman Hanson Oil Syndicate v. Bentz, 77 N. D. 20, 40 N. W. 2d 304 (1949).
Protection From Drainage

One of the specific applications of the general duty of the lessee to operate the premises in an ordinary prudent fashion is the duty to use due diligence to protect the leasehold from drainage. This obligation is frequently referred to as the implied covenant to drill offset wells, or more briefly, to offset. The duty arises from the peculiar physical qualities of fluid hydrocarbons, which migrate within a reservoir toward the point of lowest pressure. Contrary to the understanding of judges of an earlier day, oil and gas in their natural state do not roam about underground; it is only when the strata has been penetrated and the reservoir pressure accordingly reduced that movement will occur. It is theoretically possible in certain oil fields to produce nearly all the recoverable oil in place from a single well. This capacity for migration, often referred to by early decisions as the "fugacious nature" of petroleum, led to the adoption of "the rule of capture." 3

The rule of capture is actually one of non-liability for producing oil that has migrated from another’s land. In the early days of the oil business, when a landowner came to court complaining of a neighbor taking his oil, the court’s reply was, "go and do likewise." The remedy for drainage was self-help. 4 The rule has been criticized for encouraging wasteful development methods, but under the common-law ad hoc method of resolving disputes, no other solution seemed possible. 5 Of course, legislative and administrative regulations have seriously curtailed the operation of the rule of capture; most oil-producing states now prohibit drilling within certain distances of property lines. 6 Nevertheless, the rule of capture remains the basis of the lessee’s duty to protect from drainage. 7 If a well on one tract of land is causing the migration of oil or gas from an adjoining tract, the remedy of the owner of the tract being drained is to drill an offset well. After the execution of an oil and gas lease upon the tract, the lessor can no longer exercise this remedy: the exclusive right to operate the premises belongs to the lessee. The lessor’s only recourse is against the operator. Thus the courts say that an oil and gas lease contains an implied promise by the lessee

5. That other remedies are now available, see Hardwicke, The Rule of Capture, 13 Texas L. Rev. 391 (1935).
7. Merrill §§ 93-94.
to drill offset wells. The basis for raising this promise, which is rarely made explicit in the written agreement, is that the parties, being aware of the above facts, necessarily contemplated protection of the premises by the person having the exclusive right to drill on the land.8

What, then, are the elements of a cause of action for breach of the implied protection covenant? In essence, the lessor must show that drainage has occurred and that an offset well would be profitable, and the burden of proof of these two elements is on the lessor.9 With regard to the first element of the cause of action, a number of courts have stated that the drainage must be substantial, although that word is not too well defined.10 What these cases reflect, I think, is concern over imposing liability on an operator where the evidence tends to be somewhat speculative and indefinite and the loss of oil or gas is relatively slight. The evidence in drainage cases is almost always something less than exact; the quantity of petroleum being drained away often can be established only in terms of maximum and minimum figures. By requiring proof of substantial drainage, the courts can minimize the effect of the inexactitude of the evidence.

Proof of drainage, however, does not automatically result in liability of the lessee, for the latter is not an insurer. Rather, his duty is to take such steps as an ordinary prudent operator would take to prevent the drainage, i.e., he must drill an offset well if an ordinary prudent operator would do so. The courts have generally agreed that this standard does not require the drilling of a non-commercial offset well.11 In other words, to establish a breach of covenant, the lessor must show, in addition to substantial loss of


10. See cases cited notes 8 and 9 supra.


Professor Merrill has argued that the Oklahoma cases make a distinction between equitable relief and damages as the remedy for breach of covenant. Where cancellation of the lease is sought, the lessor is said to have
oil by drainage, that an offset well would produce oil in paying quantities. The phrase "production in paying quantities" does not have the same meaning in this context as it does in connection with the habendum clause of the lease. In the habendum clause, paying production, which is necessary to keep a lease alive after the primary term, means production sufficient to yield a profit after current operating expenses are paid. This formula ignores the original cost of drilling, completing and equipping the well. As used in connection with breach of implied covenants, however, paying production means sufficient recovery of oil or gas to repay the cost of drilling, equipping and operating the well over the life of the well. In addition, there are a number of cases indicating that the lessee is also entitled to a reasonable profit on the investment.

The requirement that the drainage be substantial and that the offset well produce in paying quantities may be interrelated in some cases. For example, the Louisiana Supreme Court has stated: "The question, then, is whether plaintiffs [the lessors] have discharged the burden of showing that the location of the wells upon the adjacent premises is such that they drain from their premises a quantity of oil sufficient to justify the lessees in going to the expense of drilling offset wells in order to save the oil or distillate for the mutual benefit of the lessors and lessees." Clarity of thought is probably promoted by keeping distinct the element of substantial drainage and proof of a probability of a commercial well. It is quite possible that substantial drainage could occur and yet an offset well would not produce in paying quantities. Yet it cannot be denied that in many cases these two elements will ride or fall together: if there is slight drainage it will frequently be true that the quantity of oil in place is also too slight for commercial production.

the burden of proving that an offset well would be a commercial producer. But where damages are sought, the lessor is said to make out a case without such proof. See Merrill, Permitted Drainage — The Sellers Case and Local Law, 4 Okla. L. Rev. 58 (1951). If this is the Oklahoma law, it is not the law elsewhere, absent drainage caused by the lessee's own activities on adjoining land.

17. This seems to be the situation in Poindexter v. Lion Oil & Ref. Co., 205 Ark. 978, 167 S. W. 2d 492 (1943).
18. Where there is insubstantial drainage, but sufficient oil in place
In rare instances, jurisdictions adhering to the ordinary prudent operator test have dispensed with the necessity of showing that an offset well will produce petroleum in paying quantities. In one case, the lessee was held liable without such proof because the delay in drilling the offset well permitted a sufficient amount of oil to migrate, which, if captured by the lessee, would have made the well pay out. Actually, what this case holds, and correctly so, is that the plaintiff must prove that an offset would probably have been a commercial well if drilled when it ought to have been. Another case departing from the commercial well requirement is less readily explained. In Poindexter v. Lion Oil and Ref. Co., the plaintiff's land was located on the southern flank of a water-drive field in which the field-wide drainage (which is up-structure) was to the north. Apparently, the migration of plaintiff's oil was due both to local drainage caused by adjacent wells and to field drainage, which is always present in a water-drive field. The defendant declined to drill an offset on two grounds: (1) that plaintiff's land was on the edge of the field and would produce no oil at all, and (2) in the alternative, if any oil were present, field drainage would cause it to migrate away before enough could be produced to pay for the well. The trial court found that oil did exist beneath plaintiff's land and that adjacent wells "have a tendency to drain oil from under the lands" involved in the suit. But cancellation of the lease was denied because it was found further that an offset well would not produce in paying quantities. The Supreme Court of Arkansas reversed this judgment and entered a decree cancelling the lease if the defendant failed to commence an offset well within six months. The basis of this decision is obscure, for the court purports to follow the ordinary prudent operator test, yet fails to overrule the trial court's finding of fact that an offset well would not pay out. The opinion ignores a vital distinction between field drainage and local drainage. A lessor is entitled to protection against both, of course, but only if the protection can be given without loss to the lessee. The lessor should be required to prove not only that the value of the oil in place exceeds the cost of drilling but also that this oil will be produced through the offset well. If field drainage will deplete the plaintiff's oil or gas deposit before the offset has paid out, no breach of the protection covenant has occurred, for prudent operation does not require vain struggles against the inevitable.


\[20\] 205 Ark. 978, 167 S. W. 2d 942 (1943).
One further point should be noted with regard to the question of the offset well as a commercial producer. It is doubtful that an operator who owns a working interest subject to outstanding oil payments and overriding royalties can defend on the ground that he cannot make a profit on the offset well because of the reduced working interest he owns. The bargain struck between the plaintiff-lessor and the original lessee, requiring the lessee to offset if he could make a commercial well on the then working interest, which is usually seven-eighths, should not be defeated by subsequent transactions foreign to the lessor.21

Having considered some of the problems presented by the second element of a cause of action for breach of the offset covenant — proof of the probability of making a commercial well — let us return to the first element of the cause of action, that of drainage, which has been the subject matter of two interesting cases arising in Illinois. In the first case to come up, Ramsey v. Carter Oil Co.,22 the lessor sought an injunction in the federal district court to prevent the lessee from converting one of four wells on a forty acre tract into a gas injection well. The lessee proved that radically declining production was due to loss of reservoir pressure and that repressuring methods would increase production so much that the remaining three wells would produce substantially more oil than four would produce in the absence of repressuring. It is not clear whether the lessee proved also that a failure to adopt repressuring would result in the ultimate loss of otherwise recoverable oil, but we may infer that it did, such being an accepted engineering fact. The lessee proved (and the lessee conceded) that abandonment of the well as a producer would result in substantial migration of oil away from the land. To counteract this evidence the lessee pointed to the fact that total production would be increased by a repressuring program, without producing from the fourth well, and proved further that migration of oil to the plaintiff's land from nearby leases to be included in the repressuring program would be substantially equal to the oil lost by the plaintiff. Nevertheless, the federal district judge granted the injunction in an opinion that seems to turn primarily on the nature of the lessor's property interest in the oil in the ground. The court reasoned that since the lessor owned the oil in place, he was entitled to have it remain there until it could be produced without drainage. The reasoning is false because the assump-

tion is false: without repressuring, the oil remaining in the ground when primary production ceased would be lost forever. While recognizing the prudent operator test, the court misapplied it, failing to recognize that the duty of the lessee is to take such steps as a reasonably prudent operator would take to prevent drainage. That drainage will occur is beside the point under the prudent operator test if the repressuring operations result in greater ultimate recovery of oil from the leasehold. Moreover, with such increased recovery, the lessor suffers no damage from the drainage.

The district court also rejected the lessee's contention that no breach of covenant results if as much oil migrates to the leasehold as away from it. As an independent question, this is more perplexing than the first, but it is immaterial to the decision if one adopts the view that repressuring to increase total production despite some drainage is prudent management. Accordingly, consideration of the cross-drainage point will be postponed.

The Ramsey case was affirmed by the Court of Appeals for the Seventh Circuit in an opinion that adds little to that of the district court. Shortly after this decision, it would appear, the Carter Oil Company filed a declaratory judgment action in the state court to determine the identical question with respect to another of its leases in the area. In this case, styled Carter Oil Co. v. Dees, the tract also was forty acres in size and had four producing wells on it, one of which the lessee wanted again to convert to an injection well. In fact, it appeared that the land in the Dees case was a quarter to half a mile from the land in the Ramsey case and was the tract that was to have been drained by the Ramsey tract. It also appeared that this drainage away from the land would be replaced by drainage to the land from other tracts. The Illinois court, declining to follow the federal decision, held that conversion of the well, although resulting in drainage, was not a breach of the protection covenant where repressuring operations resulted in an increase in the total recovery. The precise holding of the opinion is not clear, in that the court failed to specify whether the increased production or the equalization of the drainage was decisive. In other words there is a question whether the court would have denied the injunction

23. 172 F. 2d 622 (7th Cir.), cert. denied, 337 U. S. 958 (1949).
25. In one part of the opinion the court seems to distinguish Ramsey v. Carter Oil Co., 74 F. Supp. 481 (E.D. Ill. 1947), aff'd., 172 F. 2d 622 (7th Cir.), cert. denied, 337 U. S. 958 (1949) on the ground that the evidence there did not establish that the drainage to and fro would be substantially the same, whereas here such fact was stipulated. I do not believe, however, that this distinction is decisive in the case.
upon proof only of increased total recovery, or whether it would require in addition proof that the drainage away from the tract would be equalled by drainage to the tract. It could be contended and there is language in the Dees opinion to suggest that the ordinary prudent operator test is satisfied if the operations on the premises will result in increased production of oil. This argument is sound; the implied offset covenant is nothing more than a specific application of the general standard of conduct governing lessees. The lessee is not compelled to drill a non-commercial offset well, because it is imprudent to drill a well that will not pay out. Similarly the lessee should not be compelled to continue operation of an offset well, when converting it to an input well, at the expense of some loss of oil by drainage, will result in greater ultimate recovery and greater income for both lessee and lessor. It is true that the increased production may not be shared ratably by all landowners in the field, since some may obtain increased production without having to sacrifice a producing well. But absent unit operation of the field, by voluntary agreement or legislative and administrative compulsion, this windfall cannot be avoided. Secondary recovery operations should not be inhibited by the courts because the increased production is not always shared ratably; after all, every landowner will get more oil with the secondary recovery operations than without them.

The facts in the Ramsey and Dees cases suggest an interesting problem that was not discussed in either opinion. The question is this: is the duty of the lessee affected by the fact that the drainage is caused by lessee's operations on neighboring tracts? The courts have taken three separate positions on this question. Some cases ignore the fact that the defendant lessee is the operator of the draining tracts and apply the ordinary rules of liability. Other cases specifically point out the defendant's operations and hold that they have no effect on the duty he owes to prevent drainage. Perhaps

26. Professor Merrill regards the Ramsey and Dees cases as distinguishable and seems to approve the decision in each. Merrill, Implied Covenants and Secondary Recovery, 4 Okla. L. Rev. 177 (1951). As is apparent from the text, I cannot agree with this conclusion, which restricts secondary recovery operations to the situation where drainage away from the tract is replaced by drainage to the tract.


28. Myers v. Shell Pet. Corp., supra, could stand for the more narrow proposition that the lessee's duty remains unaffected only where the draining wells do not produce in paying quantities.
the strongest case in this group is *Hutchins v. Humble Oil & Ref. Co.*, for there the lessee owned not only the seven-eighths working interest in the adjoining tract but also the one-eighth royalty. If a court will ever require a higher standard of conduct from a lessee than that of prudent management, it should be in this situation, where the operator has every incentive to take the oil from land in which he owns the fee rather than from land in which he owns a mere working interest. The *Hutchins* case was followed in *Tidewater Associated Oil Co. v. Stott*, but the decision there may be put on more narrow grounds. The lessee had unitized many of his leases in a Texas gas field in order to engage in recycling operations. The plaintiff-lessee had refused to join in the unit agreement. The effect of the recycling process was to drive wet gas away from the plaintiff’s land and to replace it with dry gas of less value. The plaintiff sued for breach of the protection covenant. He conceded that a prudent operator would not drill another well on the land without unitization, but he contended that the prudent operator rule did not apply. He urged the court to impose a heavier burden upon the lessee because its operations were causing the drainage. The court rejected the argument stating that the law of Texas did not impose any greater burden on the lessee because his operations resulted in drainage. But the court went on to say that any duty the lessee owed to the lessor was discharged when the latter was offered participation in the unit upon the same basis as other royalty owners, a basis which the court found to be fair. Despite the language of the court that the ordinary prudent operator test was unaffected by adjacent operations of the lessee, the case could be read as holding that the protection covenant is not breached by unit operations resulting in

(1921); *Hutchins v. Humble Oil & Ref. Co.*, 161 S. W. 2d 571 (Tex. Civ. App. 1942) (error ref’d, w.o.m.); cf. *Tidewater Associated Oil Co. v. Stott*, 159 F. 2d 174 (5th Cir. 1946), *cert. denied*, 331 U. S. 817 (1947); *Hood v. Southern Prod. Co.*, 206 La. 642, 19 So. 2d 336 (1944) (claim of a lessor who refused to pool his land when government restrictions prevented drilling on tracts the size of the leasehold rejected). The Arkansas court in the *Blair* case made clear its rejection of the greater burden doctrine: “The practical test is to be found in this question: Are the outside wells on the ... [adjoining tracts operated by lessee] draining the ... [plaintiff’s tract] to such an extent that, if the wells on the ... [adjoining] tracts were operated by a third party, appellee, as lessee of ... [plaintiff’s] tract, would find it good management to put down protection wells to save its own leased territory from exhaustion?” *Blair v. Clear Creek Oil & Gas Co.*, *supra* at 309, 230 S. W. at 288-289.

30. 159 F. 2d 174 (5th Cir. 1946).
31. This concession is explained by the differences in the allowable production granted a well that returned the dry gas to the formation and one that did not.
drainage from a lessor's land if the lessor is offered an opportunity to join in a fair unit agreement.

It is interesting to contrast the attitude of the Fifth Circuit in the *Stott* case with that of the Seventh Circuit in the *Ramsey* case. In both, the operator proposed to engage in operations leading to greater conservation of natural resources, which operations would cause drainage from the complaining lessors' lands. *Ramsey* held the proposed activity to be a breach of covenant despite proof of increased total recovery, while *Stott* found no breach despite proof of decreased total recovery from the lessor's land. One can only speculate what the Seventh Circuit's reaction would have been if the Carter Oil Company had been able to unitize its leases and had offered the landowner an opportunity to join in the unit agreement on a fair basis.

The third group of cases to consider the effect on the prudent operator test of adjacent operations by the lessee — and the largest group by numerical count — takes the position that the lessee's actions place a higher burden upon him. It is not altogether clear just what practical consequence follows from this increased duty. Some courts have held that where the lessee is doing the draining, a breach of covenant may be shown without proof that an offset well would pay out. Others hold that an express covenant which might otherwise negative the existence of the implied protection covenant is set at naught where the lessee is responsible for the migration. One case took the latter position but nevertheless required proof that the offset would be a commercial well.

It is a fair question to ask why drainage by lessee's adjacent wells should be opprobriously labelled "fraudulent" and the

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35. Hartman Ranch Co. v. Associated Oil Co., supra note 32. The plaintiff overcame the burden, with some to spare; he recovered a jury verdict, a judgment, an affirmance on appeal (and collection?) of $593,700 damages.

lessee obliged to drill an offset well at a loss. It is not hard to imagine cases where the first well to be drilled comes in as a poor producer and a second well, located across a property line as an offset, would not pay out. There may be oil enough for just one commercial well. Why then should the operator be forced to drill a second well at a loss solely because he owns the first, when he would have no such obligation if some other person had drilled the first well? To impose such an obligation is to hand over a mere gratuity to the adjoining landowner.

Of course, it must be recognized that lessees will be less inclined to offset a well on adjoining premises which they operate. But a remedy is always available to a landowner who can show substantial drainage and the probability of securing commercial production. This remedy should be protection enough.

One further point should be observed in connection with the element of drainage in a cause of action for breach of the protection covenant—the matter of cross-drainage. Some cases have suggested that if the migration of petroleum away from the tract is equalled or exceeded by migration to the tract, no cause of action for breach of covenant exists.\footnote{37} Other cases make the somewhat similar point that the protection covenant is not breached, although drainage exists, if the lessee has produced or will produce a quantity of oil equal to that originally in place.\footnote{38} In other words some courts say that if the current drainage to the tract equals the current drainage away from the tract, so that no net loss of oil is occurring, there is no breach of covenant, and other cases say that the duty of the lessee is satisfied if he has produced all of the recoverable oil originally in place. Thus the fact that there is some drainage to the tract and some away from it has no bearing on breach of the protection covenant.

It is difficult to understand the theory of these decisions. If the land is being subjected to substantial drainage which could be prevented by the drilling of a well that would produce oil in paying quantities, the failure to drill the well should be regarded as a breach

\footnote{37} Only one case seems to be a square holding: Central Kentucky Nat. Gas Co. v. Williams, 249 Ky. 242, 60 S. W. 2d 580 (1937). In other cases such facts are the basis for an alternative holding or are mentioned by the court as a factor in the decision: Carter Oil Co. v. Dees, 340 Ill. App. 449, 92 N. E. 2d 519 (4th Dist. 1950); Hutchins v. Humble Oil & Ref. Co., 161 S. W. 2d 571 (Tex. Civ. App. 1942) (error ref'd, w.o.m.). See also Ramsey v. Carter Oil Co., 74 F. Supp. 481 (E.D. Ill. 1947), aff'd, 172. F. 2d 622 (7th Cir.) cert. denied, 337 U. S. 958 (1949).

\footnote{38} See Culbertson v. Iola Portland Cement Co., 87 Kan. 529, 125 Pac. 81 (1912); Louisiana Gas Lands v. Burrow, 197 La. 275, 1 So. 2d 518 (1941).
of covenant. Under the rule of capture, a landowner is entitled to produce the oil that migrates to his land without liability to adjacent landowners. If he can get the oil, it is his. An ordinary prudent operator would surely take all the oil he could profitably produce, and this includes oil migrating to the tract as well as oil migrating away from the tract. Under the rule of capture, it is simply not true that a royalty owner suffers no pecuniary loss if cross drainage results in no net loss of oil or if he has received or will receive royalty on all the oil originally in place. He suffers the loss of royalty on the oil being drained away if it could be produced profitably. It would seem, therefore, that prudent operation requires an effort to obtain all oil or gas, from whatever source, that can be produced at a profit.39

Before turning to the relief lessors may obtain for breach of the protection covenant, we may notice briefly two matters bearing on the right to maintain an action. In those states where cancellation of the lease is recognized as a remedy for breach of an implied covenant, notice of breach and demand for performance are treated as prerequisites to the maintenance of a suit.40 This view seems to have been adopted in North Dakota.41 In Kentucky, a statute has been construed to make notice and demand a prerequisite for both an action for damages and an action for cancellation.42 But in the absence of such a statute, it has been held that the remedy of damages should be distinguished from the remedy of cancellation, notice and demand being necessary only if suit is for the latter relief.43 This view has the approval of one well-known writer.44 Many modern lease forms, however, expressly provide for notice and demand as a prerequisite for any action for breach of covenant and for a stipulated period of time within which to comply with the covenants.

The delay rental clause has also caused difficulty in suits for

39. In the situation where the royalty owner owns the land to which the oil is migrating, the courts have properly held that no injury occurs from the failure to offset. Indian Territory Illuminating Oil Co. v. Rosamond, 190 Okla. 46, 120 P. 2d 349 (1941); Pinchback v. Gulf Oil Corp., 242 S. W. 2d 242 (Tex. Civ. App. 1951) (error ref'd, n.r.e.).
41. Herman Hanson Oil Syndicate v. Bentz, 77 N. D. 20, 40 N. W. 2d 304 (1949).
43. General Crude Oil Co. v. Harris, 101 S. W. 2d 1098 (Tex. Civ. App. 1937) (error dism'd.).
44. A. W. Walker, Jr. in 2 Cases on Oil and Gas 651 (1949).
breach of the protection covenant. A number of courts regard acceptance of delay rental after notice of breach as a waiver of the cause of action. Others take the position that the delay rental clause confers only the right to defer drilling an exploratory well and is not intended to affect the implied offset covenant. The question is yet to be decided in North Dakota; accordingly a lessor who discovers that drainage is taking place while the lease is being held by the payment of delay rentals would best protect himself by giving notice of the breach and demanding the drilling of an offset well and thereafter refusing a tender of delay rentals at the next anniversary date.

REMEDIES FOR BREACH OF THE PROTECTION COVENANT

The courts have recognized three different remedies for breach of the protection covenant. A few courts have granted outright cancellation of the lease. Others have denied outright cancellation, but have granted a conditional decree of cancellation; that is, they have ordered the lessee to drill an offset well within a given time or suffer cancellation of the lease. If there is a producing well on the tract, the decree normally excepts the well from the cancellation order. Still other courts have refused to declare a forfeiture of the lease and have restricted relief to damages.

The remedy for breach of the offset covenant is yet to be decided in North Dakota. In the only reported case involving an implied covenant in an oil and gas lease, Herman Hanson Oil Syndicate v. Bents, the Supreme Court of that state recognized the availability of forfeiture for breach of an implied covenant, after notice of breach of the protection covenant.
and demand for performance plus a reasonable time for compliance. But the covenant in issue there was in the nature of an implied duty to drill an initial well, not an implied covenant to drill an offset well. In the former situation damages are not ascertainable, while in the latter they usually are. It appears, therefore, that the question of a remedy for breach of the offset covenant is still an open question there.

Where damages will provide complete relief, forfeiture in equity should be denied. The forfeiture remedy seems to have originated in the early days of the industry when damages could not be ascertained. The only protection that could be afforded a lessor was the opportunity to drill his own offset well. The reasoning that supported the implication of a protection covenant in the first place also supported the cancellation of the lease for breach of the covenant. In effect, the courts said that the moving object of the lease to the lessor was royalties, and these could be obtained only by a rescission of the contract, which left the lessor free to go on the land and by drilling exercise his common-law remedy of self-help against the drainage. With the development of more precise means for measuring volume of oil in the ground and the amount of drainage taking place,\textsuperscript{53}\ the reasons for granting cancellation of the lease appear less often. Damages can be fairly accurately established in most cases by expert testimony. The remedy at law being adequate, there is little justification for resort to forfeiture in equity.

Among those jurisdictions in which damages are regarded as the appropriate remedy for breach of the protection covenant, disagreement has developed with respect to the proper measure of damages. A number of cases award as damages the royalty on all the oil or gas that was drained away plus interest.\textsuperscript{54} A better damage rule is to allow recovery of royalty on the oil or gas that would have been produced from an offset well timely drilled plus interest.\textsuperscript{55} In other words, the lessor's recovery is measured by the oil that an

\textsuperscript{53} See, e.g., Elliff v. Texon Drilling Co., 146 Tex. 575, 210 S. W. 2d 558 (1948).

\textsuperscript{54} Blair v. Clear Creek Oil & Gas Co., 148 Ark. 301, 230 S. W. 238 (1921); Hartman Ranch Co. v. Associated Oil Co., 10 Cal. 2d 232, 73 P. 2d 1163 (1937); Bush Oil Co. v. Beverly-Lincoln Land Co., 69 Cal. App. 2d 246, 158 P. 2d 754 (2d Dist. 1945); Powers v. Bridgeport Oil Co., 238 Ill. 397, 87 N. E. 381 (1909); Central Kentucky Nat. Gas Co. v. Williams, 249 Ky. 242, 60 S. W. 2d 580 (1933). In all of these cases the lessee was operating the draining wells, so the use of this measure of damages may be restricted to such facts.

\textsuperscript{55} Webb v. Graf, 289 Ky. 644, 159 S. W. 2d 433 (1942); Texas Pacific Coal & Oil Co. v. Barker, 117 Tex. 418, 6 S. W. 2d 1031 (1928); see Walker, \textit{Property Interests Created by Lease}, 11 Texas L. Rev. 399, 436 (1933).
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offset well would have produced starting from the time when the well ought to have been in production. Royalty on the oil drained away is not the most accurate measure of damages because the lessee does not undertake to prevent all drainage. He is obligated merely to use due diligence to prevent drainage. The most the lessee—or the lessor for that matter—can do about drainage is to sink a protection well. Therefore, all the lessor is out of pocket for breach of this duty is the royalty on the oil this well would have produced.

THE COVENANT OF REASONABLE DEVELOPMENT

It is customary for judges and writers to lump together all questions of further drilling by the lessee, except the question of drilling protection wells, under the general heading of the covenant of reasonable development. The duty to use due diligence in drilling additional wells may better be examined, however, by keeping two distinct types of cases in mind. In one kind of case, the lessor seeks the drilling of additional wells in a known producing horizon. This duty will be called the covenant of reasonable development. In the other type of case, the lessor seeks the drilling of further test wells; that is, he seeks further drilling to discover additional producing strata. This duty will be called the covenant of further exploration. The difference between the two covenants is substantial. Three kinds of injuries may be inflicted on the lessor by breach of the covenant of reasonable development. First, there may be enough wells on the land to produce all the oil or gas in place over a period of time, but the existing wells may be too few in number to produce the minerals fast enough. The lessor is deprived of the use of capital represented by the minerals remaining in the ground. Second, there may be too few wells to produce all the minerals in place. Without more wells, all the recoverable oil or gas in place will never be obtained. The lessor is hurt because he is not receiving royalty on oil that could be produced if more wells were drilled. Third, there may be too few wells to produce the recoverable oil in place, and through loss of reservoir energy or for other cause, some oil may be permanently lost. The injury suffered by the lessor in this


57. In General Crude Oil Co. v. Harris, 101 S. W. 2d 1098 (Tex. Civ. App. 1937) (error dism'd) lessor recovered damages for breach of the reasonable development covenant where lessee failed to drill additional wells promptly. The land was high on the structure of a water-drive field and consequently failure to produce resulted in permanent loss of oil, for such production would have been replaced by drainage from down structure.
kind of case is the permanent loss of oil that could have been recovered from additional wells and is similar to the injury suffered from breach of the covenant to drill offset wells.

The injury inflicted upon the lessor by breach of the covenant of further exploration is quite different from the three injuries just listed. The lessor does not suffer from the failure of the lessee to recover known deposits of oil or gas; he complains of the failure of the lessee to take steps to ascertain whether any other deposits of oil and gas underlay the land. The exploration covenant is analogous to the covenant that was implied in the old no-term or long-term leases to drill an initial test well, except that the duty to explore arises after one producing formation has been discovered. In this type of case, the lessor does not know whether or not he is, in fact, losing any royalties, and he cannot find out so long as the lessee keeps the lease but refuses to test for other producing formations.

A hypothetical illustration will demonstrate the difference between the covenant of reasonable development and the covenant of further exploration. \( R \) leases a half section to \( E \) in 1928. Shortly thereafter shallow production is obtained in the northeast forty acres. The lessee drills four wells on this forty acres and settles down to a modestly profitable operation. In 1950, when the four shallow wells are still producing in paying quantities, an operator on land to the south and west makes a good discovery in a deeper formation. Is \( R \) then entitled to an additional well although he is unable to prove that such well would produce in paying quantities? Conceding that \( E \) has fully developed the northeast forty acres, some courts would nevertheless require additional drilling on the southwest portion of the tract. In quantitative terms, \( R \) can show no injury; he certainly has no cause of action with respect to the number of wells on the forty acres; but \( R \) is being injured by the prolonged inactivity on the southwest portion of his land. A number of cases regard the lessee as holding this portion of the land for purely speculative purposes and grant the lessor relief in the form of a conditional decree of cancellation.

58. The leading case on the covenant of further exploration is Sauder v. Mid-Continent Pet. Corp., 292 U. S. 272 (1934). There the defendant held a lease, executed in 1916 for a ten year term, on the east one-half of a section of land and on the southeast quarter of the southwest quarter of the same section. In November of 1921 and January of 1922, two offset wells were drilled on the latter 40 acres. At the time of trial, a period of seventeen years had expired without drilling ever having taken place on the 320 acres. The lessor gave notice of breach of covenant and thereafter brought suit to cancel the lease. At the trial, defendants' experts testified that it was their opinion that an ordinary prudent operator would not drill an additional well although there was present in the area a deeper, potentially oil-bearing formation. The
In a newly discovered oil or gas field, the covenant of further exploration has little significance; accordingly only the covenant of reasonable development of a known producing strata will be considered here. Under the modern oil and gas lease, with a short primary term and a thereafter clause and with the "unless" delay rental clause, the lessee has no obligation to drill an initial well. He can keep his lease alive during the primary term by the tender of the stipulated delay rentals. However, to extend the life of the lease beyond the primary term it is necessary for the lessee to secure production during the term, or shortly thereafter by operations in progress before the term ends. Drilling operations in the exploration for oil or gas during the primary term are a substitute for the payment of delay rentals. If such operations end in failure, resumption of the payment of delay rentals will continue the lease in force. These matters are disposed of by express provisions in the lease instrument, and the implied covenant of reasonable development has no bearing upon them. But if the drilling operations result in the discovery of oil or gas, the ordinary lease is silent as to the further activity by the lessee. At this point the implied covenant of reasonable development takes command and becomes the arbiter of disputes arising between lessor and lessee.

The courts are in general agreement that after the discovery of oil or gas upon the leasehold, the lessee is obliged to use due diligence to develop the premises fully.59 An early case puts the rule and the reason for it succinctly:

trial judge "was unable to decide the question of the likelihood that additional wells on the Sauder tract would produce oil or gas in paying quantities." Nevertheless, the Supreme Court held the lessee guilty of breach of covenant and ordered the lease cancelled as to the untested half-section of land. Mr. Justice Roberts stated: "The production of oil on a small portion of the leased tract cannot justify the lessee's holding the balance indefinitely and depriving the lessor not only of the expected royalty from production pursuant to the lease, but of the privilege of making some other arrangement for availing himself of the mineral content of the land." Sauder v. Mid-Continent Pet. Corp., supra at 281.

This principle has been adopted in a number of other cases. See, e.g., Humble Oil & Ref. Co. v. Romero, 194 F. 2d 383 (5th Cir. 1952); Doss Oil Royalty Co. v. Texas Co., 192 Okla. 359, 137 P. 2d 934 (1943); Colpitt v. Tull, 204 Okla. 289, 228 P. 2d 1000 (1950); cf. Trust Co. of Chicago v. Samedan Oil Corp., 192 F. 2d 282 (10th Cir. 1951).

Texas, however, seems to reject the principle, regarding the covenant of further exploration and the covenant of reasonable development as identical, with breach of covenant depending in both instances upon proof that the additional well would probably be profitable. Fort Worth Bank v. McLean, 245 S. W. 2d 309 (Tex. Civ. App. 1951) (error ref'd., n.r.e.).


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“Manifestly, it was contemplated by the parties that, if the test well showed these minerals in paying quantities, the lessee would proceed to drill and operate other wells so long as the business proved to be profitable. From the nature of the contract, the subject-matter thereof, and the situation of the parties... there is an implied obligation on the part of the lessee to use reasonable diligence to develop the unused premises so long as the enterprise could be carried on at a profit...”

Despite contentions to the contrary, it is clear that this duty arises during the primary term; indeed, it arises when the first producing well is brought in upon the leasehold. Even in the absence of production on the leasehold, the duty of reasonable development may arise. There is authority that the lessee is under the duty to reasonably develop when production on adjoining tracts indicates that the land is in a proven field. The two cases supporting this proposition involve leases being held by a producing gas well on land in the vicinity of wells producing oil from deeper formations. There is a question whether the duty would arise if the lease were being held by delay rentals instead of production. The lessee's argument would be that the lease expressly provides for drilling to be excused by the payment of rentals; to imply a covenant of reasonable development when delay rentals have been paid is in flat contradiction with the express terms of the lease. On the other hand, the lessor could point to the cases holding that the duty to drill an offset well exists despite the delay rental clause. From these cases he could argue that the rental provision excludes the duty to drill a wildcat well, but not the duty to drill an offset well or a development well in a proven formation. This question is not likely to arise frequently, first because the protection covenant can normally be invoked if there is nearby production and second because a lessee will

95 (1943), decision adhered to on rehearing, 156 Kan. 722, 137 P. 2d 139 (1943); State ex rel. Shell Pet. Corp. v. Worden, 44 N. M. 400, 103 P. 2d 124 (1940).


Even states that hold acceptance of delay rentals to constitute waiver of a cause of action on the protection covenant recognize that the delay rental clause does not permit the lessee to excuse failure to drill a protection well by tender of rentals that is refused. Deep Rock Oil Co. v. Bilby, 199 Okla. 430, 186 P. 2d 823 (1947).
TWO DRILLING COVENANTS

normally be willing to drill in a proven field. But there may be instances of a lessee's reluctance to drill, as where he is also the operator of the adjoining wells.

The elements of a cause of action for breach of the covenant of reasonable development of a known producing horizon are very difficult to isolate. The courts seem to prefer to keep their language general, stating that a breach occurs if the lessee fails to use due diligence to develop the premises or fails to drill as many wells to develop the property as would a reasonably prudent operator under the same or similar circumstances. Testimony by experts that in their opinion a reasonably prudent operator would or would not drill more wells is admissible. More specifically, the lessor is usually required to prove that an additional well would probably be profitable to the lessee. As in drainage cases, there is no breach of covenant unless a reasonably prudent operator would drill; and such an operator drills only if he will probably make a profit. Other factors that are considered in determining whether the lessee has breached the reasonable development covenant are such general economic conditions as the price of oil or gas and the market demand. The cases suggest that the covenant is satisfied if existing production meets or exceeds the market demand. This position is sound: if no more oil or gas can be marketed from the land, the lessor suffers no damage from lack of another well. Moreover, in these circumstances, another well usually would not produce oil or gas in paying quantities.

One interesting question that arises in connection with the covenant of reasonable development is whether a reasonably prudent operator would drill additional wells if the existing wells are

64. See, e.g., Genuso v. Magnolia Pet. Co., 203 La. 559, 14 So. 2d 445 (1943), where plaintiff offered no expert testimony and defendant offered that of one witness only, an employee, who stated that in his opinion a reasonably prudent operator would not drill another well. The court sustained judgment for the defendant on the basis of the uncontradicted opinion of the expert.

65. See the quotation from Daughtee v. Ohio Oil Co. at note 60, supra; see also Berry v. Wondra, 173 Kan. 273, 246 P. 2d 282 (1952); Myers v. Shell Pet. Corp., 153 Kan. 287, 110 P. 2d 810 (1941); George v. Franklin, 219 Ky. 377, 292 S. W. 1093 (1927); Texas Pacific Coal & Oil Co. v. Barker, 117 Tex. 418, 6 S. W. 2d 1031 (1928); Senter v. Shanafelt, 233 S. W. 2d 202 (Tex. Civ. App. 1950). In Gruy v. Reiter Foster Oil Corp., 150 S. W. 2d 842, 844 (Tex. Civ. App. 1941), the court defined paying quantities which the lessor must prove will be produced by a development well as "such an amount of oil . . . that would equal the cost of drilling and equipping such well, the cost of producing and marketing the oil, and yield to the operator a reasonable profit in addition."

sufficient in number to obtain, over a period of time, all the recoverable oil in place. This question has not always been distinguished from the question whether the additional wells would be profitable. It is obvious that the drilling of an additional well under these circumstances will usually cut down the over-all profit of the lessee upon the entire lease, since more money will have to be spent to get the same amount of oil or gas. This profit-cutting does not necessarily mean, however, that the additional well might not itself be profitable. One court has held that where the existing wells had produced all the recoverable oil originally in place but were still flowing because of drainage to the tract, reasonable development does not require the drilling of additional wells. As applied to the facts of that case, this proposition may be sound. The drainage appeared to be local and not substantial. Applied to other situations, the proposition is doubtful. For example, in the East Texas oil field, tracts on the eastern flank of the field have produced many times over the oil that was originally in place, due to the fact that in a water-drive field, there is field-wide drainage up-structure. Thus when oil is removed high on the structure it is replaced by oil draining from lower parts of the structure. That the existing wells have recovered all the oil originally in place should not be treated as compliance with the covenant of reasonable development if the lessee, because of field drainage, could make a reasonable profit on another well.

Taking out the factor of field drainage, there remains the question of whether the covenant is breached if the existing wells will capture all the recoverable oil in place. The Supreme Court of Arkansas recently had occasion to consider this question in the case of Smart v. Crow. The lessor sought to cancel the lease on four undrilled well sites of ten acres each, contending that reasonable development required one well per ten acres. The total leasehold consisted of 150 acres upon which the lessee had drilled twelve producing wells. Defendants' experts testified that in their opinion the existing wells would "eventually recover practically all the oil obtainable from the entire 150 acres." The Chancellor, in good equity tradition, split the difference, cancelling the lease as to two well sites and upholding it as two others. While the opinion is not entirely clear, apparently the Chancellor found that as to two well sites the oil in place would be recovered by the existing wells, while as to two others it would not. On appeal by the lessors only, the high court affirmed, holding the Chancellor's findings not to be contrary

68. 220 Ark. 141, 246 S. W. 2d 432 (1952).
to the evidence. In affirming, the court necessarily held also that the reasonable development covenant is not breached if existing wells will produce all the recoverable oil, since that was the sole defense raised by the lessee as to the two well sites for which cancellation was denied.

The question was more thoroughly considered by the Kentucky Court of Appeals in *Union Gas and Oil Co. v. Fyffe.* The lessee had drilled two gas wells under a lease providing for a fixed royalty of $100 per year on wells producing gas used off the premises. The lessor demanded further drilling and sued for breach of the covenant of reasonable development. The lessee's evidence established that the existing wells would exhaust all the gas under the land within a reasonable period of time. The court held that such proof satisfied the duty to develop reasonably. To illustrate its holding the court supposed this situation: a lease providing for royalty of $100 per year on producing gas wells; a supply of gas that could be produced in ten years with one well or in one year with ten wells; wells costing $3,000 apiece to drill. Upon these facts, said the court, one well on the tract is reasonable development, because it makes no difference to the lessee whether he gets his $1,000 in one year or ten years while it makes a great difference to the lessee whether his drilling costs over the life of the lease are $3,000 or $30,000. The difficulty with this argument, and with the rule adopted by the Arkansas and Kentucky courts, is that it overlooks an injury to the lessor. In the very illustration above, the lessor will lose the interest on a full $1,000 for a nine-year period; he will obtain interest on only $100 the second year, $200 the third, and so forth. Perhaps we need not be too concerned about the lessor's loss of interest on a thousand dollars only. But in other cases the loss of interest can be quite serious. For example, suppose that the total recoverable oil in the ground is worth $400,000. The lessor's share of this sum, assuming the royalty reserved to be one-eighth, is $50,000. Assume further that one well would exhaust the oil in thirty years and that two wells would exhaust it in fifteen years. If only one well is drilled on the leasehold, the lessor is deprived of the interest on $25,000 for fifteen years. At four per cent, this sum amounts to $15,000.

I do not suggest that the lessor's loss of interest alone makes out a case of breach of covenant. I do submit, however, that if more wells can be drilled without injury to the reservoir, and without violating the state conservation regulations, and at a profit to the

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69. 219 Ky. 640, 294 S. W. 176 (1927).
lessee, then failure to drill is a breach of covenant. It is true that forcing the lessee to drill more wells will cut down his profit, but there is some point between too few wells and too many wells at which the lessee may operate at a profit and the lessor may have faster production.

A final question should be considered in connection with breach of the covenant of reasonable development. To what extent is the ordinary prudent operator test affected by the fact that the operator owns a lease not only on the land in question but also upon substantial acreage in the field. Two cases that have considered the problem give conflicting answers. In *Union Gas and Oil Co. v. Pyffe*, the Kentucky high court took the position that the total acreage of the lessee in the field could be considered as a unit, and if the lessor's land had received its fair proportion of the total number of wells drilled, there was no breach of covenant. Implicit in this decision, is the requirement that the total acreage has been or is being developed in an ordinary prudent manner. The effect of this position is to shift attention from the particular leasehold in question to the aggregate holdings of the lessee. To show a breach, the lessor must show either that the lessee failed to develop his total holdings reasonably or that the lessor's land did not receive fair treatment as compared to the total acreage. Ten years later, in *Amerada Pet. Co. v. Doering*, the lessee urged the same rule upon the Court of Appeals for the Fifth Circuit, contending "... that they had a right to proceed with ratably and proportionate development of the whole block," aggregating 75,000 acres. The court rejected this argument and held that the plaintiff's lease was entirely independent of the other leases and that reasonable development depended upon what was done on the plaintiff's land. Having drilled only one gas well on the land between March, 1934, and December, 1934, when suit was filed, the lessee was ordered to drill an additional well in 90 days or forfeit the lease.

It is not easy to say which of these views represents the better solution to a complicated problem. The Fifth Circuit is undoubtedly correct in saying that breach of covenant is usually determined by what the lessee has or has not done on the specific land in question. Yet it is equally true that after bringing in a discovery well, an operator holding leases on a substantial portion of the field must plan a development program that will apportion its drilling activities ratably among all its lessors and at the same time define the

70. 219 Ky. 640, 294 S. W. 176 (1927).
71. 93 F. 2d 540 (5th Cir. 1937).
boundary of the field and otherwise obtain the kind of information essential to the proper exploitation of the field. The balancing of the interests of lessor and lessee under these circumstances is a difficult task, but fortunately time itself takes care of the problem as drilling progresses and wells become more numerous.

**Remedies for Breach of the Reasonable Development Covenant**

As in protection covenant cases, the courts have recognized three separate remedies for breach of the covenant of reasonable development. In some cases, the lease has been cancelled outright, save for a small area surrounding the existing producing wells. In other cases a more moderate decree has been entered, cancelling the lease if a specified number of wells were not drilled within a fixed period. Lastly, some courts take the position that damages are the appropriate remedy for breach of the covenant unless this legal remedy is inadequate. Again I suggest that in many cases, damages can be ascertained within reasonable bounds of accuracy. Working in a proven field, experts are now able in many instances to determine the volume of oil and gas in place, the probable production from a well and the duration of such production. Where these facts are available to the lessor, forfeiture should be denied and proof of damages required.

The remedy of damages, however, suffers from the objection that an appropriate measure has never been thoroughly worked out by the courts. In one type of case, the measure of damages causes no difficulty. Where the failure to drill development wells has resulted in the permanent loss of otherwise recoverable oil, the proper measure of full compensation to the lessor is the value of the royalty oil lost plus interest. The damage here is the same as that caused by breach of the offset covenant. Where, however, the breach results in no permanent loss of oil and the action is either for failure to produce the oil fast enough or for failure to produce all of it, the royalty rule is not an exact measurement of the lessor's loss since the oil not produced remains in the ground. By giving the lessor royalty on such oil or gas, the courts are awarding

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double damages, since the lessor will also collect the royalty when the oil is eventually produced.

One early case observed this objection to the royalty rule of damages and suggested that a better measure of damages is the interest on the sum that would have been paid the lessor if no breach had occurred. In short this court viewed the injury as the wrongful withholding from the lessor of the use of the capital represented by the oil remaining in the ground. This view was pressed on the Texas Supreme Court in two cases, but was rejected as it has been by other courts. The Texas court was not entirely unaware of the difficulties involved in awarding as damages the value of the royalty on the oil that would have been produced if the development wells had been drilled and suggested that the lessee might be relieved in equity from paying royalty on the oil already paid for, if and when produced. So far as I can discover neither a Texas court nor any other court has ever put this suggestion into effect.

Thus no court has succeeded in working out an entirely satisfactory measure of damages for breach of the development covenant. The royalty rule overcompensates the lessor because he has not lost the value of oil remaining in the ground and still capable of being produced. The lessor's injury, rather, is the loss of use of the capital represented by the oil that could have been produced but wasn't, which loss is compensated by the payment of interest. But the interest rule is very complex to administer. For what period should interest be given? What effect has fluctuation in the price of oil? How can multiplicity of suits be avoided? These difficulties and others have persuaded the majority of the courts to adopt the royalty measure of damages despite the objections to it.

**CONCLUSION**

The covenants to protect from drainage and to reasonably develop are the primary protection afforded by courts to landowners in new oil and gas fields. The moving consideration to a landowner for the execution of a mineral lease is the receipt of royalties. This consideration can be realized only if the courts require operators to develop the premises not only with their own interests in mind

76. Texas Pacific Coal & Oil Co. v. Barker, 117 Tex. 418, 6 S. W. 2d 1031 (1928); Freeport Sulphur Co. v. American Sulphur Royalty Co., 117 Tex. 439, 6 S. W. 2d 1039 (1928).
77. Daughetee v. Ohio Oil Co., 263 Ill. 518, 105 N. E. 308 (1914); Midland Gas Corp. v. Reffitt, 286 Ky. 11, 149 S. W. 2d 537 (1941).
but also with regard for interests of the lessor. Once the lessor establishes an injury — from permanent loss of recoverable minerals or loss of interest on capital represented by unproduced minerals — the primary inquiry should then be concerned with whether this injury could have been avoided by the exercise of due diligence on the part of the lessee. And this inquiry, in turn, should depend upon whether a well could have been drilled at reasonable profit to the lessee. If the landowner has suffered injury and if the drilling of a well would cure the injury and also return a profit on the investment to the operator, courts should not hesitate to impose on the operator a duty to drill and to grant relief to the landowner for breach of this duty.