



Implied Duty of Reasonable Development

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Colorado Courts have recently taken positive steps to clarify the implied duty of reasonable development with respect to oil and gas leases.

One such example is reflected in Northern Colorado Royalties, LLC and Broe Land Acquisitions II, LLC, v. CDM Oil & Gas Ltd., d/b/a CDM Oil & Gas Company, Colorado Court of Appeals, Case Nos. 08CA0749 & 08CA1568, announced June 25, 2009, in an unpublished opinion.¹

Plaintiffs Northern Colorado Royalties, LLC and Broe Land Acquisitions II, LLC (collectively, "Broe"), sued defendant CDM Oil & Gas Ltd. ("CDM") to have its oil and gas lease equitably terminated. Broe claimed CDM breached the implied duty of reasonable development because no drilling took place for 22 years after the first producing well was drilled. The trial court entered judgment in favor of CDM, and following appeal, the Colorado Court of Appeals affirmed.

Broe owned the surface and mineral estates in a 211-acre parcel in Weld County, Colorado, that was subject to a 1983 oil and gas lease acquired by CDM ("Property"). The lease contained a 3 year primary term, and was to remain in effect thereafter for so long as oil or gas was produced. The lease also granted a 16.5% royalty to the lessor, Broe. The last producing well drilled under the lease was the Windsor I-35 Well ("Well"), drilled in 1984. From 1988-2002, CDM conducted a number of development activities on the leasehold, including the 2002 reestablishment of production from the Codell Formation, thereby allowing commingling of production with the already producing Niobrara Formation.

¹ See also, *Ed Orr v. Noble Energy, Inc.*, Weld County District Court, State of Colorado, 2006 CV 259, January 6, 2009 (Honorable Daniel S. Maus).

In October 2005, Broe threatened to file an action for trespass and damages if CDM attempted to drill on the Property, contending the lease had terminated for CDM's alleged breach of the implied covenant of reasonable development. Broe made no demand for development of the leasehold oil and gas interests. CDM responded by contending that the lease was valid.


Broe made additional claims that any effort by CDM to drill would be a trespass, and ultimately filed an action under C.R.C.P. 57 alleging CDM had breached the implied covenant of reasonable development in the oil and gas lease. Notwithstanding such demands, CDM planned to drill on the Property in September, 2006.

After a two day trial, the trial court ruled in favor of CDM, finding that a reasonably prudent operator would not have drilled additional wells during the time period specified by Broe because it would have been uneconomical to do so. Similar to other cases involving implied covenants of development, the trial court considered: (1) available reserves; (2) rate of return; (3) product prices; (4) operating costs; and (5) capital costs associated with drilling and completion expenses. Ultimately the court agreed with CDM's experts that development would have only been profitable by mid-2006, the time that CDM intended to develop. Broe appealed, asserting that the trial court erred in a number of ways; however, Broe's primary argument was that the court erred in determining whether CDM acted as a prudent operator.

Colorado Courts have generally determined that an oil and gas operator has an implied covenant to reasonably develop the mineral rights covered by an oil and gas lease, and that the lessee must proceed with such development with reasonable diligence for the mutual profit or common benefit of the parties. *Gillette v. Pepper Tank Co.*, 694 P.2d 369, 373 (Colo. App. 1984). With regard to implied covenants in oil and gas leases, the general rule is that "the lessor has the burden of proof to show that the lessee did not act in good faith and as a reasonably prudent, similarly situated business [person]." *Whitham Farms, LLC v. City of Longmont*, 97 P.3d 135, 137 - 138 (Colo. Ct. App. 2003). The terms of the lease govern the rights and obligations between the parties. *See Davis v. Cramer*, 808 P.2d 358, 359 (Colo. 1991) ("[t]here is no standard oil and gas lease, and each lease must be construed to give effect to the particular wording that has been agreed to by the parties"). The implied covenant of reasonable development requires a determination that additional development will be profitable. This determination rests on proof that, more probably than not, production of oil and gas will be found in paying quantities. *Gillette* at 372. Moreover, the standard in Colorado is for the

lessor to make a demand on the lessee to fulfill the implied covenant. *See North York Land Assocs. V. Byron Oil Indus., Inc.*, 695 P.2d 1188, 1192 (Colo.App. 1984). The absence of a demand is a factor in determining whether there has been unreasonable delay in fulfilling the implied covenant. *See Davis v. Cramer*, 837 P.2d 218, 224 (Colo.App. 1992).

Based on its application of the facts to the foregoing Colorado law, the Colorado Court of Appeals found that CDM proceeded with reasonable diligence in developing the Property. The record supported the trial court's finding that additional drilling would not have been profitable until mid-2006, as evidenced by new permits and wells drilled, and that prior to 2005 few wells were drilled in the area. Equally important was that Broe and its predecessors failed to make a demand on CDM to develop, which is a factor in evaluating whether there has been unreasonable delay in fulfilling the implied covenant of reasonable development. *Davis v. Cramer*, 837 P.2d 218, 224 (Colo.App. 1992). The court therefore affirmed the trial court's decision that CDM had not violated the implied covenant of reasonable development.



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