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Damages and the Oil and Gas Lease—A Probable Missouri Approach

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ments. This arrangement removes the attorney's incentive for having the entire award lumped. It is commendable that Missouri has adopted this construction.[81] Under the Illinois statute allowing commutation when "for the best interests of the parties,"[82] the Illinois court could also easily reach this result and reduce the excessive number of lump sum cases with which it has had to deal.

Of course not all states can follow this recommended construction. Some commissions are limited by express statutory prohibitions against making lump awards to attorneys,[83] or else the act requires agreement by both parties to any commutation.[84] In these instances only further legislation can free the courts from the shackles of the present statutory provisions. It is regrettable that some lawyers have exploited a system which is vital to the welfare of the industrial class and that they have been accused of ambulance-chasing and appropriating payments intended for indigent families. It would seem that the profession itself, as well as the courts and legislatures, should be interested in correcting the situation.

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DAMAGES AND THE OIL AND GAS LEASE— A PROBABLE MISSOURI APPROACH

I

In most litigation the careful practitioner will "hew to the line," but in the field of damages apparently the inclination of the most assiduous is to let the "chips fall where they may." As a result, the theory upon which liability in a tort action is built may be most meticulously woven, while an exorbitant claim for damages, devoid of a measurement theory, may be presented to the court in the sanguine expectation that the jury will award a small portion of the plaintiff's request. This procedure seems to be particularly characteristic where the case involves damages that are uncertain and indefinite. Curiously enough, however, in one situation where damages are admittedly very uncertain, con-

81. Wims v. Hercules Contracting Co. (Mo. App. 1939) 123 S. W. (2d) 225.
82. Ill. Smith-Hurd Ann. Stats. (1935) c. 48, sec. 146.
83. N. J. Rev. Stats. (1937) sec. 34, 15-25; Vt. Pub. Laws (1933) sec. 6532.
84. Mass. Gen. Laws (1932) c. 152, sec. 48; Neb. Comp. Stats. (1929) sec. 48-140; Minn. Mason's Stats. (1927) sec. 4285.

fusion occurs, not because the litigants fail to adopt a theory, but rather because of ignorance as to which of several theories they should follow.

In these cases, the harm for which redress is sought arises where a lessee of an oil and gas lease fails to drill a well.[1] The covenant to drill, which forms all or a major part of the consideration for the lease, is either expressly stated or will readily be implied as a necessary part of the lease.[2] Since self-help is not an available remedy,[3] the aggrieved lessor's recourse is in the courts.[4] In a particular case the lessor may be given the equitable relief of forfeiture[5] or specific performance,[6] but the difficult problem of the appropriate measure of damages is presented when the lessor sues for pecuniary compensation.

The lessor must, of course, show a breach[7] and substantial evidence and proof of damages.[8] Courts agree that such proof can be shown most reliably by expert oil operators and geologists.[9] Thus, where there is the requisite substantial evidence, courts will let a case go to the jury, but there is no unanimity as to the measure of damages the jury is required to apply.

Some courts, rather arbitrarily, limit the measure to the cost of drilling.[10] The reason assigned for so shackling the jury is

1. Where the drilling contract that is breached is simply one of hire under which the defendant agreed to drill on land owned or leased by the plaintiff, it is generally agreed that damages are the difference between the cost of drilling and the contract price. North Healdton Oil and Gas Co. v. Skelley (1916) 59 Okla. 128, 158 Pac. 1180; Covington Oil Co. v. Jones (Tex. Civ. App. 1922) 244 S. W. 287; Thuss, *Texas Oil and Gas* (1935) sec. 231.

2. Crain v. Pure Oil Co. (C. C. A. 8, 1928) 25 F. (2d) 824; Waggoner Estate v. Sigler Oil Co. (1929) 118 Tex. 509, 19 S. W. (2d) 27; Note (1939) 27 Cal. L. Rev. 314.

3. O'Neil v. Sun Co. (1909) 58 Tex. Civ. App. 167, 123 S. W. 172.

4. For a discussion of these cases by jurisdiction, see McCormick, *Damages* (1935) 113, n. 55.

5. 2 Summers, *Oil and Gas Law* (2d ed. 1938) 400, sec. 431.

6. Waggoner Estate v. Sigler Oil Co. (1929) 118 Tex. 509, 19 S. W. (2d) 27; Thuss, op. cit. supra, note 1, sec. 154.

7. Warfield Natural Gas Co. v. Allen (1933) 248 Ky. 646, 59 S. W. (2d) 534, 91 A. L. R. 890; Goodwin v. Standard Oil Co. of La. (C. C. A. 8, 1923) 290 Fed. 92.

8. Central Kentucky Natural Gas Co. v. Williams (1933) 249 Ky. 242, 60 S. W. (2d) 580; Stanolind Oil & Gas Co. v. Kimmel (C. C. A. 10, 1934) 68 F. (2d) 520; 2 Summers, op. cit. supra, note 5, at 404, sec. 433.

9. Daughetee v. Ohio Oil Co. (1914) 263 Ill. 518, 105 N. E. 308; Julian Petroleum Corp. v. Courtney Petroleum Co. (C. C. A. 9, 1927) 22 F. (2d) 360; Comment (1930) 39 Yale L. J. 431.

10. Brown v. Homestake Exploration Corp. (1934) 98 Mont. 305, 39 P. (2d) 168; Okmulgee Producing & Refining Co. v. Baugh (1925) 111 Okla. 203, 239 Pac. 900; All-American Oil and Gas Co. v. Connellee (C. C. A. 5, 1925) 3 F. (2d) 107; Eysenback v. Cardinal Petroleum Co. (1925) 110 Okla. 12, 236 Pac. 10. Contra: Atlantic Oil Producing Co. v. Masterson (C. C. A. 5, 1929) 30 F. (2d) 481 (nominal damages).

that any other measure of damages would be too speculative and uncertain. The analogy of a building contract, where the defendant in event of a breach must pay the construction cost, has been tendered in defense of this formula.[11] The answer seems to be, however, that this is not a contract for hire,[12] but rather a contract given in consideration for a lease in which the lessor reserves the right to potential royalties.

More truly compensatory is the measure of damages which awards the lessor the value of royalties he would have received had the covenant to drill not been breached.[13] Such a measure properly gives the plaintiff the benefit of his bargain and adequate protection against loss from drainage by nearby wells. While the damages are necessarily uncertain, expert testimony should remove the jury's verdict from the realm of supposition and conjecture.[14] However, the courts which adopt this measure of damages seem to be effecting a marked departure from the rather arbitrary distinction often maintained between the certainty of damages required in contract cases and the leniency permitted in tort cases. Apparently disregarding any such distinction and approving a lost royalties measure, the Illinois Supreme Court[15] has ruled that:

> The unliquidated damages growing either out of breach of contract or the commission of a tort are seldom susceptible of exact measurement. If such exactness were required, the law of damages would be of little practical value.

A West Virginia decision[16] imposed a refinement on the lost royalties measure. Because the oil remained in the ground, the court felt that to allow a lessor royalties on oil not produced would in effect award him double compensation. As a result, the lessor was given the interest on the royalty money he should have received. The Supreme Court of Texas in *Texas Pacific Coal & Oil Co. v. Barker*[17] considered this West Virginia rule at length, and, in rejecting it, called attention to the fact that it

11. See 2 Summers, op. cit. supra, note 5, at 412, sec. 434.
12. See note 1, supra.
13. Julian Petroleum Corp. v. Courtney Petroleum Co. (C. C. A. 9, 1927) 22 F. (2d) 360; Daughetee v. Ohio Oil Co. (1914) 263 Ill. 518, 105 N. E. 308; Guardian Trust Co. v. Brothers (Tex. Civ. App. 1933) 59 S. W. (2d) 343; Fallis v. Julian Petroleum Corp. (1930) 108 Cal. App. 599, 292 Pac. 168.
14. See note 9, supra.
15. Daughetee v. Ohio Oil Co. (1914) 263 Ill. 518, 526, 105 N. E. 308.
16. Grass v. Big Creek Development Co. (1915) 75 W. Va. 719, 84 S. E. 750, L. R. A. 1915E. 1057.
17. (1928) 117 Tex. 418, 6 S. W. (2d) 1031, 60 A. L. R. 936.

would be impossible to determine for how long a period interest should be allowed. The lessee's remedy, it was ruled, lay in an equitable action if and when he produced the oil upon which royalties had been paid.

A case may arise where the plaintiff is the owner or holds leases on acreage surrounding the leased property. In this fact situation it has been held that the proper measure of damages is the diminution in value of the plaintiff's leases resulting from the defendant's breach of contract.[18] While this measure is open to the lack-of-certainty criticism, it would seem that here also a fairly definite award of damages could be adduced from expert testimony. One compelling virtue of this measure lies in its ready applicability to leases in unproven or "wild cat" territory.

It has also been suggested that the lessor's damages should be the value of the lease at the time it was granted to the lessee.[19] This measure, however, "runs counter to a fundamental concept of the law of damages, namely, that they are awarded as compensation for the injury suffered, and not to restore the consideration paid."[20]

Still another measure of damages has been promulgated by a federal circuit court in *Hoffer Oil Corp. v. Carpenter*.[21] Meeting the demand for certainty of damages with the statement that "where the cause and existence of damages has been established with requisite certainty, recovery will not be denied because such damages are difficult of ascertainment,"[22] the court held that the appropriate measure of damages was "the value of the services rendered in obtaining [geological] information."[23] This case is particularly interesting because, although speculative wildcat property was involved, the court expressly refused to follow the definite cost of drilling theory for a measure which it felt was more truly compensatory. In adopting this theory, the courts disregarded the rule of the Oklahoma state courts[24] on the

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18. Sanzenbacher v. Howard-Clay Oil Co. (C. C. A. 8, 1922) 283 Fed. 13; Cotherman v. Oriental Oil Co. (Tex. Civ. App. 1925) 272 S. W. 616, where plaintiff's lease was forfeited as a result of defendant's breach of contract.

19. Henry Oil Co. v. Head (Tex. Civ. App. 1914) 163 S. W. 311.

20. Hoffer Oil Corp. v. Carpenter (C. C. A. 10, 1929) 34 F. (2d) 589, 591.

21. (C. C. A. 10, 1929) 34 F. (2d) 589. Discussed in comment (1930) 39 Yale L. J. 431. Accord: Bu-Vi-Bar Petroleum Corp. v. Krow (1930) 40 F. (2d) 488; (1931) 47 F. (2d) 1065.

22. Hoffer Oil Corp. v. Carpenter (C. C. A. 10, 1929) 34 F. (2d) 589, 592.

23. Id. at 593.

24. The cost of drilling measure. Eysenbach v. Cardinal Petroleum Co. (1925) 110 Okla. 12, 236 Pac. 10; Okmulgee Producing & Refining Co. v. Baugh (1925) 111 Okla. 203, 239 Pac. 900.

grounds that "the measure of damages for breach of contract is a question of general jurisprudence."[25] This liberty, however, is probably now denied the federal courts under the recent decision in *Erie R. R. v. Tompkins.*[26]

II

Academic interest is always inspired by an unsettled field of the law, but this abysmal confusion in the field of damages is not without its practical significance. The lessor, who has an actionable claim against his lessee for breach of covenant, may find his right to recover dwindle into a Pyrrhic victory if, by chance, he pleads the improper measure of damages. In *Guardian Trust Co. v. Brothers*[27] the appellants put the following question: "Was the reasonable cost of drilling the well the correct measure of damages for the breach of the contract? If it was not, the plaintiffs, under their pleadings, were not entitled to recover." The court then found that the cost of drilling was not correct and affirmed a judgment awarding the plaintiffs nominal damages. Hence, in both the pleading and trial stages, it is exceedingly important that the litigant know, if possible, what measure his jurisdiction considers "correct."

It is, of course, difficult to know what theory of damages should be pleaded in oil and gas cases until the court of the particular state has announced which measure it considers appropriate. No decision has been found in which any court of Missouri considered the problem, but Missouri's increased activity in oil[28] makes a solution imminent.

The measure of damages which the Missouri courts will probably adopt is not entirely speculative; this is because of the compelling similarity between the problems under an oil and gas lease and those under a lease for solid minerals. This analogy has been recognized and consistently followed in Illinois. The Supreme Court of that state in the leading case of *Daughetee v. Ohio Oil Co.*[29] espoused the lost royalties rule in the case of an oil and gas lease and consistently applied the same measure in *Stoddard v. Illinois Improvement and Ballast Co.,*[30] where a

25. Bu-Vi-Bar Petroleum Corp. v. Krow (1930) 40 F. (2d) 488, 493.
26. (1938) 304 U. S. 64.
27. (Tex. Civ. App. 1933) 59 S. W. (2d) 343, 345.
28. (June 15, 1939) 38 Oil and Gas Journal, No. 5, p. 106; (June 22, 1939) 38 Oil and Gas Journal, No. 6, p. 97; (July 6, 1939) 38 Oil and Gas Journal, No. 8, p. 59; St. Louis Post-Dispatch, Mar. 2, 1939, p. 12a: 2 (Oil bill in Missouri House); McQueen and Greene, 25 *Geology of Northwestern Missouri* (2d series 1938) 47 ff.
29. (1914) 263 Ill. 518, 105 N. E. 308.
30. (1916) 275 Ill. 199, 113 N. E. 913. Cf. Walker v. Tucker (1873) 70 Ill. 527, 543 (lease of coal properties).

lease of quarrying property was involved. The Missouri courts have considered the problems arising under solid mineral leases and have indicated, it is believed, their probable approach to oil and gas lease cases.

Where the lessee has violated his obligation to develop mineral properties, the Supreme Court has shown no hesitency to declare forfeiture of the lease.[31] In *Oliver v. Goetz*[32] forfeiture was allowed, although not provided for in the lease, since the lessee's inactivity was depriving the lessor of royalties, the agreed consideration. It was admitted in *Brooks v. Gaffin*[33] that other courts might construe lease provisions as covenants and give damages for their breach; but it was established that the Missouri rule was to hold such provisions as conditions subsequent and allow forfeiture. This rather liberal use of equitable relief, however, may have been limited by a more recent decision[34] which suggests that the right to forfeiture must be expressly reserved.

The Missouri courts have shown the same disposition to grant relief to the aggrieved lessor when pecuniary remuneration was sought for the lessee's breach of covenants to prospect or develop property covered by zinc,[35] coal,[36] and iron ore[37] leases. All these cases, however, awarded specific damages that were provided for in the leases. Although these cases have little probative value in indicating what the courts will do when facing the typical suit under an oil and gas lease, they do indicate that the courts are ready to hold an objecting lessee to his bargain.

A more illuminating case on the specific problem under consideration is *Ragland v. Conqueror Zinc Co.*[38] The defendant, claiming to be the lessee of certain property, agreed to assign the lease to the plaintiff, reserving a royalty of twenty per cent, if the plaintiff's exploration showed minerals in paying quantities. The defendant, however, was unable to deliver a valid lease and, after finding remunerative deposits of zinc, the plaintiff brought this action to recover damages measured by the "worth"

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31. Oliver v. Goetz (1894) 125 Mo. 370, 28 S. W. 441; Kirk v. Mattier (1897) 140 Mo. 23, 41 S. W. 252; Brooks v. Gaffin (1905) 192 Mo. 228, 90 S. W. 808; Smith v. Eagle Coal and Mercantile Co. (1913) 170 Mo. App. 27, 155 S. W. 886; Ace Mining and Milling Co. v. R. U. Mining Co. (Mo. 1922) 247 S. W. 172.
32. (1894) 125 Mo. 370, 28 S. W. 441.
33. (1905) 192 Mo. 228, 90 S. W. 808.
34. (1913) 170 Mo. App. 27, 155 S. W. 886.
35. Leon v. Barnsdall Zinc Co. (1925) 309 Mo. 276, 274 S. W. 699.
36. Lennox v. Vandalia Coal Co. (1896) 66 Mo. App. 560.
37. Clark v. Midland Blast Furnace (1886) 21 Mo. App. 58.
38. (1909) 136 Mo. App. 631, 118 S. W. 1194.

of the lease to him. The court found that "the profits which plaintiff might have realized from a continuance of their mining contract would be too uncertain and speculative as a basis for recovery"[39] and approved an instruction which allowed the plaintiff only his prospecting expenses. Although the plaintiff successfully established that his cause of action was not "speculative" and stood ready to prove the full extent of his damages, the court felt the evidence would be of such a nature that it should not be considered by the jury. It seems clear, however, that the evidence which the plaintiff wished to adduce was exactly the type used to prove damages in jurisdictions which adopt a lost royalties measure in oil and gas cases. The strictness of the *Ragland* case is emphasized by the fact that, in almost an identical situation, the Iowa Supreme Court ruled that the plaintiff was entitled to prove and recover "the value of the privilege" he would have held under the lease.[40] While the *Ragland* case is not a direct authority, it seems to weight the scales against an adoption of the lost royalties measure of damages in Missouri. This conclusion is also supported by non-lease cases where the Missouri courts have refused substantial recovery because the damages were speculative.[41]

As indicated above, the forfeiture cases[42] suggest that Missouri courts are inclined to construe mineral leases in favor of the lessor, which seems proper since such leases very often are contracts of adhesion.[43] On the other hand, the courts have shown a hesitancy to accept other than a specific measure of damages. It would seem to follow then, that of the prevalent theories of recovery, the cost of drilling measure will probably be adopted in Missouri. This measure does, in a very arbitrary way, grant relief to the lessor and at the same time has the virtue of being definite and calculable. In addition, an enunciation in *Simons v. Wittman*[44] might prove to be a handy hook upon which to hang an argument for the cost of drilling. There a building contract had been breached; and it was found that, where the price had been paid in advance, the proper damages were the value of the completed building. As has been indicated,[45] this analogy has

39. Id. at 636, 118 S. W. at 1196.
40. Chambers v. Brown (1886) 69 Iowa 213, 28 N. W. 561.
41. Sloan v. Paramore (1914) 181 Mo. App. 611, 164 S. W. 662; Weber Implement Co. v. Acme Harvesting Mach. Co. (1916) 268 Mo. 363, 187 S. W. 874.
42. See notes 31-34, supra.
43. But see Note (1939) 27 Cal. L. Rev. 314.
44. (1905) 113 Mo. App. 357, 88 S. W. 791.
45. See note 11, supra.

been successfully invoked in support of the cost of drilling measure.

There is language in *United Real Estate Co. v. McDonald*[46] which indicates that the Missouri Supreme Court might follow the rule adopted by a federal court,[47] and award the lessor the decrease in value of his leases where he owns property contiguous to that of the lessee. In the *United Real Estate Co.* case, a grantee had contracted to construct certain buildings on his property. For breach of this contract, the court held the proper award of damages would be the difference in the value of the grantor's land with and without construction of the buildings.

Except for the *United Real Estate Co.* case, the past record of the Missouri courts has been one requiring a demonstration of certain damages. While this bespeaks the probable adoption of the cost of drilling rule in oil and gas lease cases, it might be preferable if the courts which are not bound by direct precedent, were to adopt the lost royalties measure. In the overwhelming number of cases, the purpose of the lease is the "mutually profitable production of oil, gas or other valuable minerals."[48] The only value contemplated by the lessor is the value of the royalties and, when no oil has been produced, the proper compensation is not the lessee's cost of performance—the cost of drilling—but the value of the royalties he should have received.

The ingrafted argument against this measure is that the damages are too speculative and indefinite. While the history of the law of damages reflects the constant fear of an unbridled jury, it would seem that under carefully admitted expert evidence and accurate, succinct instructions neither the lessor nor the lessee should fear the judgment of "twelve reasonable men."

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46. (1897) 140 Mo. 605, 41 S. W. 913.

47. Sanzenbacher v. Howard-Clay Oil Co. (1922) 283 Fed. 13. See note 18, supra.

48. Texas Co. v. Davis (1923) 113 Tex. 321, 333, 254 S. W. 304.