

Lease Termination Issues

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Low Prices for an Extended Period May Mean Trouble

U.S. Oil Prices¹

| | |
|------|---------|
| 1/97 | \$21.76 |
| 7/97 | \$15.89 |
| 1/98 | \$13.48 |
| 7/98 | \$10.46 |
| 1/99 | \$ 8.59 |
| 4/99 | \$12.94 |
| 9/99 | \$21.74 |

U.S. Gas Prices²

| | | |
|---------|---------------------|--------|
| 1/11/99 | KATY HUB | \$1.85 |
| 1/11/99 | NEW YORK CITY GATE | \$2.87 |
| 1998 | US WELLHEAD AVERAGE | \$1.96 |
| 1997 | “ | \$2.32 |
| 1996 | “ | \$2.17 |
| 1995 | “ | \$1.55 |
| 1994 | “ | \$1.85 |
| 1993 | “ | \$2.04 |

1998 U.S. Oil and Gas Statistics

9.2 MM BBL/D (6.2 MMBBL/D Crude)

Down from 11.18 MM BBL/D in 1972

Plus 9.7 MM BBL/D imported

18.9 TCF/YR

21.3 TCF Consumed (3.0 TCF imported from Canada)

76% of U.S. oil wells produce 10 BBls or less per day, accounting for 14 percent of U.S. oil production. 140,000 wells were plugged and abandoned in 1998.

¹ Domestic First Purchase Price. Source: Energy Information Agency
<http://www.eia.doe.gov/pub/energy.overview/monthly.energy/mer9-11>

² Source: Energy Information Agency
<http://www.eia.doe.gov/pub/energy.overview/monthly.energy/mer9-11>

Habendum Clause

“Subject to the other provisions herein contained, this Lease shall be for a term of _____ years from this date (called “primary term”) and as long thereafter as oil and gas or other hydrocarbons are being produced from said land or land with which said land is pooled hereunder.”

What Maintains a Lease?

Delay rentals—During the primary term

Production—During the secondary term

Constructive Production—At any time

Producing Lease Termination Variables

Terms of the Habendum Clause

Nature of the Leasehold Interest

Applicability of Savings Clauses

Availability of Savings Doctrines

Terms of the Habendum Clause

What constitutes “production”?

“In paying quantities”

Other

Meaning of “Production”

Majority Rule – Actual Production which is marketed.

Illinois

Kansas

Louisiana

Michigan

Mississippi

New York

Ohio

Texas

Minority Rule – Capable of Production.

Kentucky

Montana

Oklahoma

West Virginia

“In Paying Quantities”

Many leases specifically require.

Implied in many states but not in all.

E.g., *Coyle v. North American Oil Consolidated*, 201 La. 99, 9 So.2d 473 (1942).

Meaning:

lessee's subjective view;

objective view: marginal profitability to a reasonably prudent operator;

marginal profitability if sufficient to provide "serious consideration" to the lessor. *Noel Estate v. Murray*, 223 La. 387, 65 So.2d 886 (1953).

Lease Termination: The Texas "Litmus Test"

Have operating revenues been greater than operating costs over a reasonable period of time? *Clifton v. Koontz*, 325 S.W.2d 684 (Tex. 1959).

If so, then the lease is producing in paying quantities.

If not, then apply the legal test.

"In Paying Quantities" (Majority View)

Operating revenues must be greater than operating costs over a reasonable time.

Operating revenues = sales revenues attributable to the working interest (including ORRI but not landowner's royalty). What about take-or pay benefits?

Operating costs = actual and direct costs of producing and marketing. What about clean-up, depreciation, administrative overhead?

Reasonable time = at least a year

Lease Termination: The Texas "Legal Test"

If a lease fails the litmus test, would a reasonable prudent operator, motivated by profit and not by speculation, nonetheless continue to operate the lease in the manner in which it is being operated? *Clifton v. Koontz*, 325 S.W.2d 684 (Tex. 1959).

Louisiana "Production": Louisiana Mineral Code Article 124

When a mineral lease is being maintained by production of oil or gas, the production must be in paying quantities. It is considered to be in paying quantities when production allocable to the total original right of the lessee to share in production under the lease is sufficient to induce a reasonably prudent operator to continue production in an effort to secure a return on his investment or to minimize any loss.

Louisiana "Paying Quantities"

"Serious consideration" is an evidentiary standard, not a legal requirement.

If royalty is small compared to bonus or other payments, then the court looks to see if the lessee is acting as a reasonable prudent operator. La.M.C. Art. 125.

Query whether this step is different from the Texas analysis? See *Edmunson Bros. Partnership v. Montex Drilling Co.*, 731 So.2d 1049 (La.App.--3d Cir.1999).

Nature of the Lease Interest

Determined in part by the ownership theory embraced by the jurisdiction

Ownership or non-ownership

Leads to categorization of the lease as corporeal or incorporeal hereditament:

Estate in land

Profit aprendre

Irrevocable license

Contract

Nature of the Lease Interest: Ownership In Place Theory

Mineral owner owns oil and gas in place in the soil, as well as the exclusive right to search, develop and produce from the land.

Mineral owner has fee simple absolute estate in the minerals, but subject to the rule of capture:

Arkansas, Colorado, Kansas, Maryland, Michigan, Mississippi, Montana, New Mexico, North Dakota, Pennsylvania, Tennessee, Texas, Washington and West Virginia

Lease creates a fee simple determinable interest (generally). E.g., *Stephens County v. Mid-Kansas Oil & Gas Co.*, 254 S.W. 290 (1923).

Nature of the Lease Interest: Non-Ownership/Exclusive Right-To-Take Theory

Mineral owner owns the exclusive right to search for, develop, produce and market from the land, but does not own the oil or gas itself until he/she captures it.

Mineral owner has *profit a prendre*, generally:

Alabama, California, Illinois, Indiana, Kentucky, Louisiana, New York, Ohio, Oklahoma and Wyoming.

Lease owner has profit a prendre, license or contract. E.g., La. M.C. Arts. 114, 116, a "hybrid institution."

Effect of the Nature of the Lease on Lease Termination

Non-Ownership theory and classification as an incorporeal hereditament (profit or license) is more likely to support lease termination by abandonment, cancellation or forfeiture.

But non-ownership theory is also more likely to cause the leasehold to be classified as an interest subject to a condition subsequent (rather than as a determinable interest) and to make equitable doctrines available to save the lease.

***Stewart v. Amerada Hess Corp.*, 604 P.2d 854, 858 (Okla.1979).**

“The “thereafter” clause is hence not ever to be regarded as akin in effect to the common-law conditional limitation or determinable fee estate. The occurrence of the limiting event or condition does not automatically effect an end to the right. Rather, the clause is to be regarded as fixing the life of a lease instead of providing a means of terminating it in advance of the time at which it would otherwise expire. In short, the lease continues in existence so long as interruption of production in paying quantities does not extend for a period longer than reasonable or justifiable in light of all the circumstances involved. But under *no* circumstances will cessation of production in paying quantities Ipso facto deprive the lessee of his extended-term estate.”

***Pack v. Santa Fe Minerals, Inc.*, 869 P.2d 323, 327 (Okla.1994).**

“the lease continues in existence so long as the interruption of production in paying quantities does not extend for a period longer than reasonable or justifiable in light of the circumstances involved. ‘But under *no* circumstances will cessation of production in paying quantities ipso facto deprive the lessee of his extended-term estate.’ A decree of lease cancellation may be rendered where the record shows that the well in suit was not producing in paying quantities and there are no compelling equitable considerations to justify continued production from the unprofitable well operations.”
(Emphasis in original) (Citations omitted).

***Watson v. Rochmill*, 155 S.W.2d 783, 784 (Tex. 1941).**

“[i]t appears to be very well settled that under the terms of the lease, upon cessation of production after termination of the primary term, the lease automatically terminated.”

***Stanolind v. Barnhill*, 107 S.W.2d 746, 748 (Tex. App.—Amarillo 1933)**

“The lease did not exist. The term had closed, and the interest they procured by the lease was gone. It is not a question of forfeiture for failure to continue to develop the land.... [Lessee] did not contract for a term which would depend upon the possibility of

procuring a market for the product at some date subsequent to its express date of expiration.”

Louisiana Lease Termination

Failure to “produce” is an express resolutive condition that causes termination. La. M.C. Arts. 124, 133.

Louisiana courts often talk about “canceling” leases for failure to produce in paying quantities. See, e.g., *Edmunson Bros. Partnership v. Montex Drilling Co.*, 731 So.2d 1049, 1058 (La.App.--3d Cir. 1999).

Savings Clauses: Constructive Production

Lease provisions that provide for substitutes for “production”

Constructive Production Clauses

Dry hole, operations, cessation of production

Pooling/unitization

Shut-in Royalty

Force majeure

Cessation of Production Clause

“6. . . . if after the discovery of oil, gas or other hydrocarbons, the production thereof should cease from any cause, this Lease shall not terminate if Lessee commences additional drilling or re-working operations within sixty (60) days thereafter, or if it be within the primary term, commences or resumes the payment or tender of rentals or commences operations for drilling or re-working on or before the rental paying date next ensuing after the expiration of sixty (60) days from the date of . . . cessation of production”

Meaning of “Drilling or Reworking Operations”

“Reworking” includes “any and all actual acts, work or operations in which an ordinarily competent operator, under the same or similar circumstances, would engage in a good faith effort or cause a well or wells to produce oil or gas in paying quantities.” *Cox v. Stowers*, 786 S.W.2d 102, 105 (Tex.App.—Amarillo 1990).

Where “operations for drilling” are required to maintain a lease that has ceased to produce, reworking or operations other than drilling will not suffice. *French v. Tenneco Oil Co.*, 725 P.2d 275 (Okla. 1986).

“Mere gathering of geological or geophysical information is not intended to suffice” La. M.C. Comment, Art. 39.

Pooling Clause

“Lessee . . . is hereby given the right and power to voluntarily pool . . . the acreage covered by this Lease . . . with other . . . leases Operations for drilling on or production of oil or gas from any part of

the pooled unit . . . shall be considered as operations for drilling on or production of oil or gas from the land covered by this Lease. . . . For . . . computing the royalties . . . there shall be allocated to the land covered by this Lease and included in said unit a pro rata portion of the oil and gas . . . produced from the pooled unit. . . . [A]llocation shall be on an acreage basis. . . . Royalties . . . shall be computed on the portion . . . so allocated to the land covered by this Lease and included in the unit just as though such production were from such land.”

Pooling Clause Limitations

Must pool while lease is still in force.

Must act in good faith by reference to the purposes of the pooling clause.

Must strictly comply with the terms of the lease pooling clause. *Jones v. Killingsworth*, 403 S.W.2d 325 (Tex.1965). *Wilcox v. Shell Oil Co.*, 76 So.2d 416 (La. 1954).

Shut-In Royalty Clause

“While there is a gas well on this Lease, or on acreage pooled therewith, but gas is not being sold or used Lessee shall pay or tender annually at the end of each yearly period during which such gas is not sold or used, as royalty, an amount equal to the delay rental provided for in paragraph 5 hereof, and while said royalty is so paid or tendered this Lease shall be held as a producing Lease under paragraph 2 hereof.”

Hydrocarbon Management, Inc. v. Tracker Exploration, Inc., 861 S.W.2d 427, 126 O&GR 316 (Tex.App.—Amarillo 1993)

“[F]or a well to be maintained by the payment of shut-in royalties, it must be capable of producing gas in paying quantities at the time it is shut-in even though the shut-in royalty clause makes no mention of capacity for paying production. * * * ‘Capable of production in paying quantities’ means a well that will produce in paying quantities if the well is turned ‘on,’ and it begins flowing, without additional equipment or repair. Conversely, a well would not be capable of producing in paying quantities if the well switch were turned “on,” and the well did not flow, because of mechanical problems or because the well needs rods, tubing, or pumping equipment.” See also *Taylor v. Kimbell*, 219 La. 731, 54 So.2d 1 (1951).

When May a Well Be “Shut-In”?

A few courts say that the clause cannot be invoked where a market exists, even though it is a market at a low price. *Tucker v. Hugoton Energy Corp.*, 253 Kan. 373, 855 P.2d 929 (1993).

Watch out for limiting lease terms:

E.g. “gas well,” “producing gas only.”

E.g. “where there is no market available.”

Effect of Improper Shut-In Payment

Oklahoma: Lease continues as long as it is capable of production in paying quantities. *Gard v. Kaiser*, 582 P.2d 1311 (Okla. 1978).

Louisiana: Lease continues after failure to pay shut-in “royalty” pending written notice and dissolution pursuant to La. M.C. Arts. 137, 141. *Acquisitions, Inc. v. Frontier Explorations, Inc.*, 432 So.2d 1095 (La.App. 1983). But see also the comment to La. M.C. Art. 123, suggesting that a failure to pay shut-in “rental” will cause lease termination.

Texas: What does the clause make the “constructive production”?
Gulf Oil Corp. v. Reid, 337 S.W.2d 267 (Tex. 1960).

If “proper payment,” lease terminates.

If “existence of a shut-in well,” lease should not terminate.

Force Majeure Clause

“Should Lessee be prevented from complying with any express or implied covenant of this Lease, from conducting drilling, or reworking operations thereon or from producing oil or gas or other hydrocarbons therefrom by reason of scarcity of, or inability to obtain or to use equipment or material, or by operation of force majeure, or because of any federal or state law or any order, rule or regulation of a governmental authority, then while so prevented, Lessee’s obligations to comply with such covenant shall be suspended, . . . and this Lease shall be extended while and so long as Lessee is prevented by any such cause from conducting drilling or reworking operations on, or from producing oil or gas or other hydrocarbons from the leased premises”

Force Majeure Clause Limitations

The terms of the clause:

How is force majeure defined?

Notice required?

What performance is excused?

What remedy does the clause provide?

Common law requirements:

Beyond the parties’ control (or contemplation).

But see *Denker v. Midcontinent Pet. Corp.*, 56 F.2d 725 (10th Cir. 1932).

Efforts to overcome. *Haby v. Stanolind Oil and Gas Co.*, 228 F.2d 298 (5th Cir. 1955).

Causation.

Savings Doctrines

Temporary Cessation of Production Doctrine

Equity

Estoppel

Waiver

Laches

Ratification

Revivor

Temporary Cessation of Production Doctrine

A lease will not terminate because production ceases if the cessation is temporary, not permanent.

Factors:

Duration of the cessation;

Effort of the lessee;

Cause of the cessation.

Temporary Cessation of Production Doctrine Limitations

Must have a complete cessation.

May be limited to “necessarily unforeseen and unavoidable” causes resulting in “sudden stoppage of the well or some mechanical breakdown of the equipment used in connection therewith, *or the like.*” *Scarborough v. New Domain*, 276 S.W. 331 (Tex. Civ.App.—El Paso 1925); *Watson v. Rochmill*, 155 S.W.2d 783 (Tex. 1941).

Lease cessation of production clause may obviate. See, e.g., *Samano v. Sun Oil Co.*, 621 S.W.2d 580 (Tex. 1981).

Equitable Principles that May Save a Lease

Waiver - One cannot enforce rights that one has explicitly or implicitly released.

Estoppel - One cannot enforce rights that one has led another to believe reasonably one will not enforce where the other has changed position in reliance.

Laches - One may lose the right to enforce rights by waiting too long.

Ratification - One may confirm the validity of a voidable instrument explicitly or implicitly.

Revivor - An agreement that has terminated will be enforced if the parties act as if it is still valid.

What Does It Take to Trigger Equity?

Something more required than continued acceptance of royalties. *Watson v. Rochmill*, 155 S.W.2d 783, 137 A.L.R. 1032 (Tex.1941); *Woodruff v. Brady*, 72 P.2d 709, 113 A.L.R. 391 (Okla.1937). Nor is execution of division order enough. *Bradley v. Avery*, 746 S.W.2d 341 (Tex.App.—Austin 1988).

Loeffler v. King, 236 S.W.2d 772 (Tex. 1951) (deed conveyed royalty in land, stipulating it was subject to an oil and gas lease).

Shell Oil Co. v. Goodroe, 197 S.W.2d 395 (Tex.Civ.App.—Texarkana 1946, error ref. n.r.e.) (lessor repudiated lease by granting top lease and demanding release).

“Equity” Louisiana Style

“Only if there has been some mutual error or a good faith attempt to meet the condition necessary for maintenance of the contract with failure to do so being beyond the control of the lessee or the lessor has in some manner led the lessee to believe that the lease is still in existence and should therefore be prohibited from denying it, should any leniency be exercised When a resolutive condition occurs, the contract is simply at an end.” La.M.C. Art. 133 (Comment).

Limitations on Equity

Out of your control:

Applicability depends on lessor’s actions;

Court must apply.

Subject to many defenses:

Clean hands, etc.

Unpredictable -

“Equity is a roguish thing. For Law we have a measure, know what to trust to; Equity is according to the conscience of him that is Chancellor, and as that is larger or narrower, so is Equity.”
John Selden, 1584-1654.

What You Can Do to Prevent Lease Termination

Understand your rights and exposures.

Know how property and equitable concepts apply to oil and gas leases in your jurisdiction.

Know how court-devised doctrines and lease savings clauses are applied in your jurisdiction.

Know the terms of your lease clauses.

Track your revenues and costs.

Maintain your position.

Keep good relations with your lessors.

Keep producing.

Improve your position.

Cut costs. Look for better deals.

Get ratifications (with words of grant) or new leases. *Westbrook v. Atlantic Richfield Co.*, 592 S.W.2d 551 (Tex.1973).

Consider modification of habendum or savings clauses.

Some Other Papers

Frank Scurlock, "Practical and Legal Problems in Delay Rental and Shut-In Royalty Payments," 4th Oil and Gas Inst. 17 (1953).

Richard C. Maxwell, "Oil and Gas Lessee's Rights on Failure to Obtain Production During the Primary Term or to Maintain Production Thereafter," 3 Rocky Mtn. Min. L. Inst. 133 (1957).

William B. Browder, Jr., "Estoppel, Waiver, and Ratification Affecting Mineral and Leasehold Rights," 10 Rocky Mtn Min. L. Inst. 139 (1965).

John S. Lowe, "Shut-In Royalty Payments," 5 Eastern Min. L. Inst. 18-34 (1984).

Thomas P. Battle, "Lease Maintenance in the Face of Curtailed/Depressed Markets," 32 Rocky Mtn. Min. L. Inst. 14-1 (1986).

William P. Pearce, "Keeping Oil and Gas Leases Alive: A Review of Both the Lessee's Obligations and Possible Ways to Keep Leases in Effect," RMMLF Special Institute on Problems and Opportunities During Hard Times in the Minerals Industry 8-1 (May 1986).

Bruce M. Kramer, "The Temporary Cessation Doctrine: A Practical Response to an Ideological Dilemma," 43 Baylor L. Rev. 519 (1991).

Bruce M. Kramer, "Lease Maintenance for the Twenty-First Century: Old Oil and Gas Law Doesn't Die, It Just Fades Away," 41 Rocky Mt. Min. L. Inst. 15-1 (1995).

Donald G. Sinex, "Lease Maintenance and Shut-In Royalty Issues," *Landman* (Nov./Dec. 1998) 23.

Rick G. Strange, "Production in Paying Quantities," *Landman* (May/June 1999) 51.

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