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THE SHUT-IN ROYALTY CLAUSE IN AN OIL AND GAS LEASE†

by

Wilmer D. Masterson, Jr.*

I. INTRODUCTION

IN CONSTRUING a shut-in royalty provision in an oil and gas lease, one must start with the usual rule that a written instrument is to be construed as meaning what it says, and that if this meaning is clear and unambiguous, parole evidence is not admissible to prove that the parties intended something else—except, of course, in a direct attack upon the instrument, as, for example, a suit to reform it. While often paying lip service to this rule, the courts, rightly or wrongly, have even more often distorted logical, grammatical meanings in order to reach a result which it appeared the parties would have intended if the problem before the court had occurred to them when they were preparing the instrument in question.

Thus, in South Penn Oil Co. v. Snodgrass¹ the court held that discovery of oil constituted sufficient production to continue a lease beyond its primary term and said that to hold otherwise would "accord too much force and effect to the letter of the contract and do violence to its spirit." ² (Emphasis added.) The use of this phrase, "do violence to its spirit," sounds like an unusual rule for construing contracts. Nevertheless, the tendency of courts to decide cases on this basis is evident in the following statement by Mr. A. W. Walker, Jr.³ "The clauses in the modern oil and gas lease have been evolved through many years of trial and error and after a great amount of litigation and judicial construction. Revisions of the basic clauses of oil and gas leases should be made with great care and only by persons familiar with the evolutionary development of modern forms."

In considering cases involving what constitutes production under an oil and gas lease, Mr. James Sperling has said: "If ever the old

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¹ 71 W. Va. 438, 76 S.E. 961 (1912).
² 76 S.E. at 968.
³ Defects and Ambiguities in Oil and Gas Leases, 28 Texas L. Rev. 895, 909 (1950).
adage 'hard cases make poor law' needs support, it may be found in the decisions in the field of oil and gas law.'”

Mr. Frank Scurlock said that some courts have held a shut-in well does not constitute production sufficient to meet the habendum clause and added that “... courts in other jurisdictions avoided that result by rewriting, in effect, the lease contracts or by giving such a strained construction to the language of the leases that their judgments were incompatible with the actual terms of the lease.”

Generally speaking, it may be said that in a given case, if a lessee has held, or attempted to hold a lease in effect beyond its primary term without engaging in drilling or production activity, the courts will have a tendency to look for some reason why the lease has terminated. Conversely, if the lessee has spent and continues to spend large sums in drilling or related activity, the courts will have a tendency to look for some way to uphold the lease.

One not familiar with the evolution of oil and gas leases might wonder why a lessee, who usually is the one who writes or selects the lease form used, does not make it “ironclad” against termination. The answer is that in the early days of oil and gas law, around the turn of the century and continuing until about 1920, and to some extent still continuing, the more “ironclad” a lessee made an oil and gas lease against termination, the more ways courts found to look through the language of the lease and interpret it according to its spirit, which is another way the courts have of saying according to the way lessees customarily behave, or in the court’s opinion should behave. The result has been that leases have been made more and more favorable to lessors, sometimes with disastrous results to the lessees.

In analyzing the present law and predicting what it will be in

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4 Habendum Clause as Affected by Shut-In, Commence Drilling, Continued Drilling and Other Clauses, Southwestern Legal Foundation Ninth Annual Inst. on Oil & Gas L. & Tax 1, § (1958).

5 Practical and Legal Problems in Delay Rental and Shut-In Royalty Payments, Southwestern Legal Foundation Fourth Annual Inst. on Oil & Gas L. & Tax 17, 39-40 (1953). For other discussions of this topic, see Hardwicke, Problems Arising out of Royalty Clauses in Oil and Gas Leases in Texas, 29 Texas L. Rev. 790 (1951); Maxwell, Oil and Gas Lessee's Rights on Failure to Obtain Production During the Primary Term or to Maintain Production Thereafter, Third Rocky Mt. Mineral L. Inst. 133 (1957); Moses, Problems in Connection with Shut-In Gas Royalty Provisions in Oil and Gas Leases, 23 Tul. L. Rev. 374 (1949), 27 Tul. L. Rev. 478 (1953).

6 That courts do not always find such a way is illustrated by Haby v. Stanolind Oil and Gas Co., 228 F.2d 298 (5th Cir. 1955), 3 Oil & Gas Rep. 1019; Continental Oil Co. v. Boston-Texas Land Trust, 221 F.2d 124 (5th Cir. 1955), 4 Oil & Gas Rep. 669; Skelly Oil Co. v. Wickham, 202 F.2d 442 (10th Cir. 1953), 2 Oil & Gas Rep. 519; Rogers v. Osborn, 152 Tex. 540, 261 S.W.2d 311 (1953), 2 Oil & Gas Rep. 304; Woodson Oil Co. v. Pruett, 281 S.W.2d 159 (Tex. Civ. App. 1955) error ref. n.r.e., 4 Oil & Gas Rep. 1995.
future shut-in royalty cases, the above rules and tendencies will be considered.

II. CONTINUING THE LEASE IN EFFECT IN THE ABSENCE OF A SHUT-IN CLAUSE

A. During the Primary Term

1. Delay Rentals

The early leases provided for a designated term during which the lessee could hold the lease in effect without doing anything. This was ideal for the lessee. The only difficulty was that the courts refused to give literal effect to such a lease, unless the fixed term was for a short period (a year or less), and sometimes even refused to give effect to a short-term lease. The courts usually gave abandonment as the reason for either cancelling such a lease, or holding that it had terminated by its own terms, reasoning that the main purpose the lease was executed was to give the lessee the right to drill wells and, if they produced, to produce therefrom. Thus it was held that if a lessee did not commence drilling within what the court considered to be a reasonable time, the lessee lost his lease by abandonment.

These holdings made it evident to lessees that they had to include something in the lease compelling them to do something periodically in lieu of drilling or producing. The "something" decided upon was a delay rental—a sum of money to be paid periodically during the primary term in lieu of drilling or producing. While the periods elapsing between such payments at first varied (and still do to some extent), the customary period between such payments became one year. The courts tacitly approved delays of such length and it is now settled that a court will not find abandonment of a lease with a primary term of ten years or less where the lessee, in order to keep the lease in effect, must pay a delay rental at least once each year during the primary term of the lease, and where the lease is being held in effect by delay-rental payments.

2. Effect of Dry Hole

As the delay-rental payment was to take the place of exploration, leases customarily authorized a lessee to continue the lease in effect by such payments only until a well was commenced or drilled. This arrangement proved unsatisfactory to the lessee because once a well was drilled or commenced, the lessee was not authorized to return to delay-rental payments and was faced with the alternative of con-
continuing drilling operations or running the risk of abandonment. To cover this situation, the dry-hole clause came into being. In its original form, it authorized a return to delay rentals if during the primary term a dry hole was drilled. This dry-hole clause was found too restrictive in that it failed to cover a situation where during the primary term a producing well was drilled but production ceased. The clause was expanded to cover such a situation. However, a defect which usually is still present in printed forms is that they do not authorize a return to delay rentals if the well is not dry, but never produces.

3. Effect of a Well Producing or Not Producing in Paying Quantities During the Primary Term

In considering the question of whether the production of a well is in paying quantities or not, there is a very important distinction between production during the primary term and production at the end of and after the primary term. This is because the habendum clause, the clause providing that the lease shall be in effect for a designated number of years and as long thereafter as production continues, does not become effective until the last day of the primary term. In other words, isolating the habendum clause from all other clauses, the lessee could do or fail to do anything he pleased during the primary term without danger of losing the lease.

Even isolating this clause, however, there remained the constant danger of abandonment. As stated, one way which was provided to avoid this danger was to reactivate the delay-rental provision when the well was dry or production had ceased. This is not necessary when there is actual production. Thus, during the primary term, production, whether or not in paying quantities, suffices to avoid abandonment and, under most leases, renders a return to delay rentals unnecessary.7

Two words of caution are in order: (1) the production may be so small that the well will be treated as dry, or production may diminish to such an extent that the court will treat it as having ceased and the dry-hole clause may be so worded that if the well is so treated, automatic termination occurs at the next delay-rental anniversary date unless the delay rental is paid; and (2) the lessors

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7 Long v. Magnolia Petroleum Co., 166 Neb. 410, 89 N.W.2d 245 (1958), 9 Oil & Gas Rep. 41; Murphy v. Garfield, 98 Okla. 273, 225 Pac. 676 (1924). By analogy, this rule is supported by cases holding that once a well has been drilled, lessee is not required to do anything for the remainder of the primary term, unless, of course, the lease includes an applicable terminal shut-in clause requiring a return to delay rentals. Baker v. Huffman, 176 Kan. 534, 271 P.2d 276 (1954), 3 Oil & Gas Rep. 1662; Sohio Petroleum Co. v. V.S. & P.R.R., 222 La. 383, 62 So. 2d 615 (1952), 2 Oil & Gas Rep. 178.
become accustomed to receiving at a minimum the amount of the annual delay rental and if royalty from production is less than this amount the lessee loses one of his most important intangible assets—the good will of the lessor.

4. Effect of Shut-In Well Which Is or Is Not Capable of Producing Gas in Paying Quantities

If a well principally capable of producing gas is completed, it must, under government regulations in most producing states, be shut in unless there is an available pipeline and an available market. Query: When such a well is shut in during the primary term, is the delay-rental clause reactivated? The answer to this question under most lease forms is no, because production never started and hence did not cease and because the well is not a dry hole. It should be stressed that returning to delay rentals has no legal effect unless the lease authorizes such return. Such action might create an estoppel or a ratification, but a careful lessee cannot safely assume that it will. If a lessee who completes a shut-in well during the primary term is not required to return to delay rentals, can he safely do nothing for the rest of the primary term? The answer is yes, qualified in two possible ways: (1) there may be a shut-in royalty clause which renders the lessee personally liable for shut-in royalties; and (2) if the lessee does nothing, he again faces the spectre of abandonment.

In summary, during the primary term of a usual oil and gas lease, failure to pay shut-in royalty will not in itself cause an oil and gas lease to terminate. At most, the lessee may possibly be personally liable for such payments, depending upon the wording of the lease in question.

B. After the Primary Term

1. The Habendum Clause—What Constitutes Production?

The usual habendum clause provides that the lease will remain in effect for a designated number of years and as long thereafter as production continues. Query: What constitutes production as used in this clause? More specifically, within the scope of this discussion, does a shut-in well capable of producing gas in paying quantities constitute such production? Logically, the answer is no. Production means actually taking oil or gas from the well in a captive state either to market or to storage. The majority rule supports this logical definition. However, in Montana, Oklahoma, and West Vir-

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ginia, the present rule is that discovery of oil or gas, at least if capable of being produced in paying quantities, equals production under the habendum clause, at least if the lease in question does not include a shut-in royalty clause. Even in states professing to follow the logical, strict rule, the court's "bark" is apt to be in lieu of any "bite" where the lessee has diligently searched for and has found a market for the gas by the time the case comes to trial. A typical example is *Tate v. Stanolind Oil & Gas Co.*,¹⁰ where the Kansas Supreme Court stated in cold and unrelenting language that a shut-in well did not meet the habendum, but held that the lessee nevertheless had a reasonable time beyond the primary term in which to find a market by reason of a lease provision which the court admitted had no application to the facts before it.

In summary, while a diligent lessee with a shut-in well and no shut-in royalty provision should not surrender without a fight, his situation is vastly improved if his lease has a shut-in royalty provision and if he complies with it. To put it another way, if he has a shut-in provision and fails to comply with it, he cannot hope for the "spirit treatment" sometimes accorded a shut-in well in the absence of such a provision.¹¹

2. The Dry-Hole Clause, Including the Commence-Drilling Clause and the Continuous-Drilling Clause

The inclusion of this clause in lease forms and why, under most of them, the lease does not authorize a return to delay rentals where a well capable of producing is shut in, has been previously discussed. The importance of this matter justifies repeating that under most lease forms an attorney cannot safely advise his client that he can return to delay rentals where the client has a shut-in well capable of producing gas in paying quantities.

III. THE USE OF THE SHUT-IN ROYALTY CLAUSE

A. Reasons for its Inclusion

The principal reason for including a shut-in clause is to give a lessee a way to continue a lease upon which there is a shut-in well

⁹ Panhandle Eastern Pipe Line Co. v. Isaacson, 255 F.2d 669 (10th Cir. 1958) (Okla.); Bristol v. Colorado Oil and Gas Corp., 225 F.2d 894 (10th Cir. 1955) (Okla.), 5 Oil & Gas Rep. 50; Fey v. A. A. Oil Corp., 129 Mont. 300, 285 P.2d 578 (1955), 4 Oil & Gas Rep. 1324; McVickers v. Horn, —Okla.——, 322 F.2d 410 (1958), 8 Oil & Gas Rep. 951; South Penn Oil Co. v. Snodgrass, 71 W. Va. 438, 76 S.E. 961 (1912); see also Union Oil Co. v. Touchet, 229 La. 316, 86 So. 2d 50 (1956), 5 Oil & Gas Rep. 1177. Cf. Smith v. Sun Oil Co., 172 La. 615, 135 So. 15 (1931). Possibly the rule as applied in one or more of these cases would not apply when there is no pipe line and no market and no reasonable expectation that these will exist within a reasonable time.


beyond its primary term. In some jurisdictions, at least part of the
time, such a well will be treated as producing. However, in most
jurisdictions (and there is a risk in all jurisdictions), such a well will
not be treated as producing. It was to cover this situation that the
shut-in clause was developed during the 1930's. This provision was
not then considered necessary as to oil wells, because oil could be
produced and marketed in many ways. It was necessary as to gas
wells because gas can be produced only when there is a pipeline from
the well to a market.

While the principal reason was as stated above, another reason for
this clause is that it gives the lessee a way to avoid abandonment
where the shut-in well is completed prior to the beginning of the last
year of the primary term, and where the dry-hole clause does not
authorize a return to delay rentals.

B. Importance of Whether Well Will Produce Only
Gas, Gas and Condensate, Oil and Gas, or Only Oil

The shut-in clause in its initial form authorized shut-in payments
only when the well in question was capable of producing only gas.
In fact, many and possibly a majority of lease forms in use today
so provide. Such questions as the following arise: (1) What is the
reason for limiting this clause to wells capable only of producing
gas? (2) What kind of a well is capable only of producing gas
within the meaning of this clause? The first of these questions can
be definitely answered; the second cannot be. However, the answer
to the first may shed light on how the second should be answered.

Until about 1930, in most producing states gas was considered
relatively unimportant as compared with oil. Further, until about
that time, a well was considered as either an oil well or a gas well.
If the well would produce oil, it was customary to produce it even
though large quantities of gas came up with the oil and were wasted
into the air.

If the well would not produce oil, but would produce gas, the dis-
appointed lessee would either "give up" or try to find a market. If
the gas was produced with a liquid content, or through distillation
the gas could be liquefied, customarily no effort was made to utilize
both the gas and the liquid. Either the gas was utilized in its wet
form as gas, or gas in large quantities was allowed to escape and only
the liquid was utilized for either gasoline or carbon black. This back-
ground may explain the customary royalties prior to about 1930.

Customarily, the royalty for oil was measured by and based upon

\[12\] See note 9 supra and accompanying text.
a free one eighth of gross production. That is, the lessor was entitled either to said free one eighth in kind or to its market value. The royalty payable for gas from wells was usually a fixed amount of money per annum, varying from fifty to three hundred dollars per well per annum. This royalty provision referred to wells capable of producing only gas for the simple reason that any well was thought of as either a well capable only of producing gas or as an oil well.

As might be expected, questions also arose as to whether a lessee with a shut-in well capable of producing gas could continue his lease beyond its primary term by paying the stipulated amount per well. The argument in favor of the lessee was that the lessor should not be concerned with whether there was actual production when he was receiving exactly what he would receive if the well or wells in question were producing. The argument on the other side was that the terms of the lease simply did not authorize continuing the lease in effect beyond the primary term by means of such payments, and that the only way to continue the lease was by actual production. The cases split on this question.5

By about 1931, lessors were producing from oil wells along with the oil a vaporous substance or a gas which could be vaporized. This substance or substances needed little and often no treatment to be converted into gasoline. This substance became known as casinghead gas because at that time it was customarily produced from the space between the tubing and the casing.4

The inevitable question arose as to whether this substance was gas and thus governed by the fixed amount of the gas royalty, which actually would result in no payment by lessee to lessor for this substance, or whether it was oil, thus entitling lessor to one eighth thereof. In a pioneer Texas case,15 through somewhat tenuous reasoning as to reservations and exceptions, it was held that this substance was oil and thus that the oil-royalty clause in a modified way was applicable.

In a case several years later,16 a Texas court was called upon to determine the rights of the parties to liquid which came up either as gas in a liquid form or as gas which was thereafter liquefied. The deed provision which caused the conflict read as follows: "'All of our

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13 See United States v. Brown, 15 F.2d 561 (D.C. Okla. 1926); 2 Summers, Oil and Gas § 299 (perm. ed 1938); Comment, Clauses in Oil and Gas Leases Providing for the Payment of an Annual Sum as Royalty on a Nonproducing Gas Well, 24 Texas L. Rev. 478 (1946).
14 See appendix to the court's opinion in Reynolds v. McMan Oil & Gas Co., 11 S.W.2d 778, 787 (Tex. Comm. App. 1928).
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rights, title and interest, ownership and claim, both present and prospective, in all natural gas in and under the following tract . . . .” The court held the owner of the gas owned this substance, saying:

The term "all natural gas" would include all the substances that come from the well as gas, and that regardless of whether such gas be wet or dry. It is undisputed in the evidence that the term "natural gas" includes numerous elements or component parts . . . which were in gaseous form when they came from the wells.18

A short time later a Texas court was called upon to pass upon a lessor's contention that a liquid like that involved in the case just discussed was governed by the gas-royalty clause, the oil-royalty clause, or the clause providing for a royalty for gas produced from an oil well.19 A majority of the court concluded the substance was gas, and hence the fixed gas-royalty provision controlled. A dissenting justice well illustrates the problems inherent in this fickle substance—now it's gas, now it's liquid, and vice versa—in these words: "Certainly, no court would hold as a matter of law that the gasoline manufactured from gas out of an oil well is oil, but that the gasoline manufactured from gas out of a gas well is not oil."20 This statement seems contrary to the holding of the majority in the very case in which it was made.

The preceding discussion leads to the following conclusions: (1) the shut-in royalty clause initially referred to wells capable of producing only gas because this clause grew out of the old gas-royalty clause, which in turn was worded at a time when a well was considered either an oil well or a well capable of producing only gas, there being no middle ground; and (2) if a well is capable of producing only gas, the "gas only" shut-in clause applies, even though liquids are extracted from the gas either by natural condensation after the gas leaves the well or through distillation.

This leaves the following problems: (1) suppose the liquid substance produced with the gas was gas while in the reservoir but liquefied while en route to the mouth of the well; (2) suppose the liquid substance was commingled with the gas while in the reservoir; and

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20 Lone Star Gas Co. v. Harris, supra note 19, at 670.
(3) suppose gas or the liquid substance in question is produced from an oil well. 

In considering these problems, it is important to bear in mind that the same basic problems are involved as were involved in the earlier cases concerning whether the fixed gas-royalty provision or the one-eighth oil-royalty provision controlled. As it is now customary to provide for a one-eighth royalty on both oil and gas, the royalty question is usually relatively unimportant. The question of whether the well is an oil well, a well capable of producing only gas, or some other type of well, is now important in determining whether the "gas only" shut-in royalty clause is applicable.

Unfortunately, the cases do not justify answers to the above three problems. By analogy to the earlier cases, however, particularly the Harris and Stine cases, a strong argument could be made that a well capable of producing "gas only" includes a well capable of producing gas and the liquid substance referred to above, often called distillate or condensate and referred to in the Stine case as wet gas. Of course the argument in favor of this view is stronger where the substance was gas while in place than when it was liquid at that time. As a practical matter, again because of the fickle nature of this substance, expert testimony will probably differ in many if not in all cases as to when the liquid became a liquid, including testimony to the effect that no one can do more than speculate on this matter.

Consideration should be given to the spirit of this provision (as was done by the court in the Snodgrass case). This provision was included to give a lessee a way to continue his lease beyond the primary term when he had a shut-in gas well. Under conservation laws and practices, a well capable of producing both gas and condensate must be shut in until the gas can be marketed, even though when production starts the condensate will or may be more valuable than the gas. Under this view, the answer to the first two problems posed would be that a well of either type (gas while in place or liquid commingled with gas in place) would be a well capable of producing only gas. The argument on the other side is that a well capable of producing only gas means a gas unmixed with any liquid, and that this meaning should not be changed by looking for the spirit of the shut-in clause.

The third problem raised above concerned gas or condensate produced from an oil well. Again looking to the spirit of the shut-in

21 See note 20 supra.
22 See note 16 supra.
23 See note 14 supra.
clause, it could be argued that if the well must be shut in because of the gas produced along with the oil, the shut-in clause should apply. However, because of the customary and well-established difference between an oil well and a gas well, this argument would be weaker than that applicable to the first two problems.

The above discussion has been of "gas only" shut-in clauses. Whatever be the correct answers to the problems discussed, certainly anyone drafting a lease form should consider making the shut-in provision broad enough to include gas and condensate, distillate, and any other liquefiable or liquefied substances. The provision is as fair to a lessee as is a "gas only" provision because in each instance it is to cover a situation where the lessee has no choice but to shut in the well.

Admittedly, the suggested provision might be broad enough to include a well which produces oil and gas. The provision has intentionally been made ambiguous in this respect to emphasize the importance of expressly deciding whether the clause should apply to a combination oil and gas well. If it is intended so to apply, the provision should be clarified by expressly referring to a well capable of producing oil, gas, etc. If the provision is not intended to refer to such a well, such intention should be clearly expressed. In considering how broad this clause should be, one must bear in mind the increasing tendency of conservation agencies to require a well to be shut in until all substances capable of being produced from it can be utilized.

In this connection there is the question of whether a shut-in clause should provide that it is applicable to wells capable of producing in paying quantities. The answer is no. In the first place, the majority rule is that even if the habendum clause requires merely production, by implication such production must be in paying quantities. By the same implication, the shut-in royalty provision refers only to wells capable of producing in paying quantities.

The author believes that the implication requiring production of paying quantities is unfair to the lessee for several reasons, one of which is the frequent difficulty in determining when a well is so producing. The usual reason given for the rule is to prevent a lessee from holding the lease for speculative purposes. The possibility of

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speculation could effectively be met by implying a covenant against holding for speculative purposes.

It appears to be fair to a lessor for the habendum clause expressly to provide the following: "and as long thereafter as oil, gas, or other mineral, whether or not such oil, gas, or other mineral is produced in paying quantities, is produced," etc. If such a provision is used, a similar one should be included in the shut-in clause.

C. Effect of Shut-In Clause on Implied Covenants

A complete answer to the argument that a shut-in clause is unfair to a lessor because it would allow a lessee to hold a lease forever without producing, is that the lessee owes a duty to be diligent in searching for a market. Breach of this duty possibly renders the lessee liable for damages or cancellation or both, or an alternative decree. Similarly, the shut-in well does not excuse the lessee from the usual implied covenants to develop further, to offset, and otherwise to conduct himself as would a reasonable and prudent lessee under the same or similar circumstances.

D. Examples of Shut-In Provisions

In considering the material discussed and to be discussed, it will be helpful to look at several more or less typical shut-in provisions. Four such provisions are as follows:

(1) Where gas is not 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—and while said royalty is so paid or tendered this lease shall be held as a producing lease.

(2) While there is a gas well on this lease, or an acreage pooled therewith, but gas is not being sold or used, Lessee may pay as royalty at monthly intervals a sum equal to one-twelfth of the amount of annual rental payable in lieu of drilling operations under the primary term on the number of acres subject to this lease at the time such payment is made, and if such payment is made or tendered, it will be considered that gas is being produced from this lease in paying quantities.

(3) The royalties to be paid by lessee are: "... on gas ... a royalty of $50 per year on each gas well from which gas only is produced while gas therefrom is not sold or used off the premises, and while said royalty is so paid, said well shall be held to be a producing well . . . ."

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28 Amerada Petroleum Co. v. Doering, 93 F.2d 540 (5th Cir. 1937), 114 A.L.R. 1385.
27 This clause is commonly found in commercial forms which are in general use throughout the industry.
26 Ibid.
29 This clause was before the Court in Freeman v. Magnolia Petroleum Co., 141 Tex. 274, 171 S.W.2d 339 (1943).
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(4) ... [I]f at any time while there is a gas well or wells on the above land (and for the purpose of this clause (e) the term "gas well" shall include wells capable of producing natural gas, condensate, distillate or any gaseous substance and wells classified as gas wells by any governmental authority) such well or wells are shut in, and if this lease is not continued in force by some other provision hereof, then it shall nevertheless continue in force for a period of ninety (90) days from the date such well or wells are shut in, and before the expiration of any such ninety-day (90-day) period, lessee or any assignee hereunder may pay or tender an advance annual royalty equal to the amount of delay rentals provided for in this lease for the acreage then held under this lease by the party making such payment or tender, and if such payment or tender is made, this lease shall continue in force and it shall be considered that gas is being produced from the leased premises in paying quantities within the meaning of paragraph 2 hereof for one (1) year from the date such well or wells are shut in, and in like manner subsequent advance annual royalty payments may be made or tendered and this lease shall continue in force and it will be considered that gas is being produced from the leased premises in paying quantities within the meaning of said paragraph 2 during any annual period for which such royalty is so paid or tendered; such advance royalty may be paid or tendered in the same manner as provided herein for the payment or tender of delay rentals; royalty accruing to the owners thereof on any production from the leased premises during any annual period for which advance royalty is paid may be credited against such advance payment.30

E. Parties Entitled to Payment and Methods of Payment

1. As Between the Owner of the Right to Bonus and Delay Rental on One Side and the Owner of Royalty on the Other

Suppose A owning all of the minerals conveys a right to one half of royalties payable under present and future oil and gas leases to B. Suppose further that C owns a valid oil and gas lease upon the interests of both A and B. He desires to make a shut-in payment and desires to know whether he should pay all of it to A or one half to A and one half to B.

The answer to this question depends upon whether the shut-in payment is a bonus or delay rental on one side or a royalty on the other. The only case which has discussed this problem concluded the payment was royalty and hence payable to the royalty owners.31 However, in that case the payment was designated as royalty in the

30 This provision was in the lease involved in Long v. Magnolia Petroleum Co., 166 Neb. 410, 89 N.W.2d 241, 251 (1958), 9 Oil & Gas Rep. 41.

shut-in provision, and further, the principal clause before the court was a minimum-royalty clause.

Suppose the clause in question provides “payable as bonus” or is silent as to which it is. An examination of several analogous problems may be helpful. A royalty payable from production in excess of one eighth has been held to be royalty in Texas32 (after dictum to the contrary in earlier cases) and has been held to be bonus in Oklahoma. A minimum royalty has been held to be royalty.33 On the other hand, a production payment, that is, a right to a fractional amount of production until the lessor has received a designated amount of money, has been held to be bonus.34

Of course, if the one with the power to lease desires such a payment or its equivalent to go to the one entitled to bonus, he could phrase the clause in the form of a conditional production payment, bearing in mind the duty of the owner to act reasonably as to the royalty owner.

No attempt shall be made to predict how this payment will be judicially labeled. The only safe procedure at present is to advise the client that the question is open and that either the parties should execute an instrument with words of grant providing how this payment should be made or an overpayment should be made. Thus in the last posed hypothetical question, in the absence of a clarifying instrument, this writer would advise the client to pay the entire shut-in payment to A and to pay an amount equalling one half thereof to B. This assumes the payment should be made; whether it should or not will be further discussed below.

2. When, if Ever, Can Payment be Made to the Depository Bank?

Customarily, the delay-rental provision in an oil and gas lease gives a lessee a choice between paying a delay rental to the lessor or to his credit in a depository bank designated in the lease. It is not customary to provide for payment of royalties from production to a depository bank. Of course, a mistake in such a royalty payment would not cause the lease to terminate, as it would be the production and not the royalty payments which would be continuing the lease in effect.

A shut-in royalty clause may or may not be terminal in the sense that a failure to pay shut-ins may possibly terminate the lease. As

32 Griffith v. Taylor, —Tex.—, 291 S.W.2d 673 (1956), 5 Oil & Gas Rep. 1371.
34 Morris v. First Nat'l Bank, 249 S.W.2d 269 (Tex. Civ. App. 1952) error ref. n.r.e., 1 Oil & Gas Rep. 1371.
35 State Nat'l Bank v. Morgan, 133 Tex. 109, 143 S.W.2d 717 (1940).
has been and will be further discussed, this will usually depend upon whether the shut-in payment is being relied upon to continue the lease in effect beyond its primary term. If the shut-in payment is terminal, the same care as to timely and correct payment must be used as in paying delay rentals. Thus, shut-in payments should be made directly to the parties entitled to them unless the lease expressly authorizes payment to their credit in a named depository bank. Of course, if a payment is made to a depository bank under a lease not authorizing this procedure and if the person entitled thereto withdraws it, there is always the possibility of precluding relief to the lessor upon the ground of estoppel or some similar doctrine.36

3. Importance of a Legal Tender

Usually the delay-rental clause authorizes the lessee to pay delay rentals by the check of lessee. This authorization would probably not extend to shut-in payments unless the lease expressly authorized such payment in this manner. "Probably" is used because conceivably a court might hold that the shut-in payment is sufficiently like a delay-rental payment so as to make applicable provisions as to delay-rental payments. This statement applies to the preceding subdivision as well as to the present one. Of course, if the person entitled to the shut-in payment accepts and cashes the check, he would usually be held to have waived the manner of payment.37

In drafting a shut-in provision, the questions just mentioned should be avoided by expressly authorizing payments by check either to the lessor or to his credit in a named depository bank.

F. Shut-In Clause Problems During the Primary Term

1. Is the Lessee Personally Liable for Said Payments During the Primary Term?

The question of personal liability for shut-in payments during the primary term depends upon the wording of the shut-in clause in the particular lease in question. Some forms say "may pay." Under these there would be no personal liability. Others say "shall pay"
or "shall be obligated to pay." Under these there would probably be personal liability unless and until the lease was released.

2. When, if Ever, Will a Failure to Pay Shut-In Royalty Result in Termination Prior to Expiration of the Primary Term?

As stated above, the reason the shut-in clause first appeared in oil and gas lease forms was to give the lessee a way to continue his lease in effect beyond the primary term when he had a shut-in well. However, such provisions are uniformly applicable during the primary term. The reason this provision was considered unimportant during the primary term was because the lessee attempted to avoid abandonment during that period by providing for delay-rental payments in the absence of drilling and by providing for a return to delay rentals where the well drilled was a dry hole or where production ceased. This latter provision does not literally apply where a well capable of producing is drilled during the primary term, but has never produced—a shut-in gas well being the usual well of this type. Thus, even during the primary term the shut-in provision when applicable can serve the useful purpose of avoiding abandonment when the delay-rental provision is inapplicable and when nothing else is being done to avoid abandonment.

What about a situation where during the primary term a well is producing but not in paying quantities? As stated earlier, the majority rule is that a habendum clause in a usual form ("and as long thereafter," etc.) requires that production be in paying quantities. However, the habendum clause does not become applicable until the end of the primary term. Thus, any production during the primary term, whether or not in paying quantities, is sufficient to continue the lease in effect without the necessity of paying delay rentals or shut-in royalties.38

Repetition of two words of warning is in order: (1) the production may be in such small quantities that the court will consider the well a dry hole; and (2) if royalties from production do not equal or exceed delay rentals, lessors may become dissatisfied and seek ways to terminate or have the lease terminated.

Further attention shall now be given to whether failure to pay shut-ins can ever cause automatic termination of the lease prior to the expiration of its primary term. As stated above, such failure may result in termination by abandonment. While it would be possible so to word a shut-in provision as to make it terminal, the

38 See note 7 supra.
author has never seen one and doubts that there has ever been one so worded.

As stated under a preceding subdivision, the shut-in clause sometimes is in the form of a promise to pay. In this latter form it may create liability upon the part of the lessee. This, however, is far from automatic termination. In fact, the existence of personal liability might in itself avoid abandonment. It is interesting in this connection to compare the shut-in clause with the provisions of the dry-hole clause authorizing a return to delay rentals in designated instances. In some lease forms the provision is, in effect, as follows: "If the first well drilled is a dry hole, or if production ceases, this lease shall terminate unless . . . ." This is clearly a terminal provision. In other lease forms negative language is used, to wit: "If the first well drilled is a dry hole or if production ceases this lease shall not terminate if . . . ." At least one case raised the question of whether such a negative provision was terminal, but found it unnecessary to decide how the question should be answered. 39

In summary, aside from abandonment, a failure to pay either a permissive or obligatory shut-in during the primary term will not cause the lease to terminate unless the shut-in clause expressly provides otherwise.

3. Times for Payments

Some lease forms, as does the shut-in clause in the fourth example above, expressly provide times for payment. Unfortunately, many do not. However, during the primary term, the times for payment are relatively unimportant because a failure to pay or a late payment will not (except for possible abandonment) cause the lease to terminate. In this respect there is a vast and important difference between shut-in payments during the primary term and shut-in payments relied upon to continue a lease in effect beyond the primary term, a matter considered below.

G. Shut-In Problems at and After End of Primary Term

1. Necessity of Timely and Correct Payment to Avoid Lease Termination

As before indicated (aside from abandonment questions), regardless of what may be the correct anniversary date for shut-in payments and regardless of whether they are permissive or obligatory,

if the lessee pays a shut-in royalty in the correct amount and to the parties entitled thereto at any time before the primary term ends, this payment will continue the lease in effect beyond the primary term. What is the correct time? Here there may be a difference between a permissive shut-in and an obligatory one. Arguably, even if the payment is obligatory, payments for which the lessee became liable for designated years or other periods provided for in a given lease, prior to the period running at the end of the primary term, would not be necessary in order to continue the lease in effect beyond the primary term, payment for the period running at the end of the primary term being sufficient. To be safe, however, a lessee should pay all accumulated shut-in payments while the lease is within its primary term. On the other hand, if the shut-in clause is permissive, it is sufficient to pay the first shut-in at any time before the primary term ends. In either event, unless the lease very clearly allows payment of shut-in royalty after the primary term, the first payment should be made before the primary term ends. In this connection one case held that if a lease includes the customary provision that if production ceased the lessee would have a designated time to resume operations, lessee had a right to commence shut-in payments within that period.

Query: What are the anniversary dates for payments of shut-in royalties after expiration of the primary term? The answer to this question, of course, depends upon the terms of the lease involved. In the absence of a clear lease provision, anniversary dates should be based upon the date the well was shut in; in no event, however, should there be a time lapse of more than a year if the payment is on an annual basis (or of one month if on a monthly basis) between the time the last shut-in payment was made within the primary term and the time of the next payment. For example, assume that an oil and gas lease was executed August 2, 1948, for a primary term of ten years with a permissive annual shut-in clause which failed to designate times for payment, that a shut-in well capable of producing gas in paying quantities was completed on September 15, 1949, and that the first shut-in payment was made on August 1, 1958. To

41 Union Oil Co. v. Ogden, 278 S.W.2d 246 (Tex. Civ. App. 1955) error ref. n.r.e., 4 Oil & Gas Rep. 1394. Another rule stated and applied in this case was that even though literally the shut-in clause did not apply because it was made to apply only where production ceased, nevertheless, based upon the intention of the parties, it did apply. For a discussion of what constitutes production under the habendum clause of an oil and gas lease, see Discussion Note, 4 Oil & Gas Rep. 1400 (1955). This case also sets forth a minimum-royalty provision which is well worded.
be safe the next shut-in payment should be made on or before September 15, 1958, and thereafter on or before September 15 of each year.

Of course, there is a possible risk in paying a shut-in royalty in advance when there is no provision for advance payments. The problem is similar, though not so easily answered, as that presented when a delay rental is paid under circumstances where there is no obligation to pay rentals, such as where there is production, even though the primary term has not ended. Where the lease is silent as to times for payments, it is submitted that the courts should hold that by implication advance shut-in payments are authorized. Overemphasis cannot be given the importance of analyzing the provisions of the lease involved for an answer to this question. Of course, the lease provision should be clearly drawn to cover this problem as is the provision in the fourth example of a shut-in clause set forth above.

2. Effect of Spasmodic Production in Connection With Drilling Other Wells

This question has been so thoroughly discussed in an article by Mr. A. W. Walker, Jr.42 that no further discussion is needed herein, except for the observation that this problem should be covered in the shut-in clause. It is so covered in the fourth example given above.

H. Miscellaneous Considerations

The question of whether or not to apportion royalties arises when the fee title to leased land later becomes divided. The view of the vast majority is that when a lessor conveys a part of the leased premises to another, the latter will receive all royalty from wells in the conveyed tract and none from wells located elsewhere. This is known as the rule of nonapportionment. Under the same rule, if shut-in royalty is payable as royalty, payment should be made to the persons owning the land upon which the shut-in well is located. Sometimes, however, royalty rights are apportioned. This can occur through use of an entirety clause, a community lease, voluntary pooling, or compulsory pooling.43 To the extent, if any, that shut-in

42 Comment, Clauses in Oil and Gas Leases Providing for the Payment of an Annual Sum as Royalty on a Nonproducing Gas Well, 24 Texas L. Rev. 478 (1946).
43 Hoffman, Voluntary Pooling and Unitization (1933); Hardwicke and Hardwicke, Jr., Apportionment of Royalty to Separate Tracts: the Entirety Clause and the Community Lease, 32 Texas L. Rev. 660 (1954); Masterson, Division Order Problems Created by Apportionment of Royalty, 10 Okla. L. Rev. 289 (1957); O'Quin, Separately Owned Tracts Under Single Lease as Affected by Entirety Clause and Related Provisions, South-
payments are royalty payments, the problems presented are identical
to those presented in connection with paying royalties from pro-
duction, which problems have been considered in articles previously
indicated.44

Again, to the extent shut-in royalties are royalties, the lease form
in question in a given case should be carefully examined to ascer-
tain whether the amount thereof has been or can be cut down (1)
by a partial surrender of leased premises, (2) by the fact that the
well is located upon a tract less than the entire leased premises (this
having been caused by an assignment of the lease as to only a part
of leased premises), or (3) by a conveyance by lessor of only a part
of the land.

The effect of a shut-in well upon a term royalty or mineral in-
terest also warrants consideration. Suppose that A owns a one-half
mineral interest in lot 1 for ten years from August 1, 1948, and
as long thereafter as production continues. Suppose that A’s inter-
est is covered by a valid oil and gas lease on which the primary
term ended July 1, 1958, and that on this date there was a shut-in
well capable of producing gas in paying quantities with the lease
being held in effect by shut-in payments. Query: Will this well
continue the term interest in effect? This question is vitally impor-
tant to A. It is also important to the lessee because the answer will
determine how to make future correct shut-in payments. As might
be expected, in states holding that a shut-in well is one which is
producing within the meaning of the lease habendum clause, a shut-
in well capable of producing in paying quantities will continue a
mineral or royalty interest in effect for a designated time and as
long thereafter as production continues. This same result has been
reached where the tract in which the term interest exists has been
validly pooled with another tract upon which the well is located.45
The cases involving such pooled tracts do not discuss the problem
of how shut-in payments should be made after pooling.

States in which actual production is required to meet the haben-
dum clause hold that a shut-in well will not continue in effect a
term mineral or royalty interest of the type under discussion.46 Thus,

44 See note 43 supra.
45 Panhandle Eastern Pipe Line Co. v. Isaacson, 255 F.2d 669 (10th Cir. 1958) (Okla.); Union Oil Co. v. Touchet, 229 La. 316, 86 So. 2d 50 (1956), 5 Oil & Gas Rep. 1177.
the owner of the term interest may lose it even though an oil and gas lease is in effect and being held by shut-in payments, or in some other manner, when the primary term of the term interest ends. To remedy this situation, which usually is unfair to the term owner, it is suggested that the instrument creating the term interest should include a provision as follows: "As cumulative to all other provisions herein, if at any time while this interest is in effect there is a valid oil and gas lease or leases covering said interest, this interest shall remain in effect for as long as said lease or leases, or any of them, remains in effect." This provision gives the owner of the term interest the benefit of the shut-in clause in existing leases, as well as all other clauses in the lease which operate to continue it in effect."

Finally, in the event it appears that any drilling well, before or after the primary term, will for any reason be shut in, the file upon this property should be resubmitted for an opinion as to what action should be taken in connection with that well.

47 As to term interests generally, see Cantwell, Term Royalty, Southwestern Legal Foundation Seventh Annual Inst. on Oil & Gas L. & Tax 339 (1956).