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COMMENTS

EXTENDING THE TEXAS OIL AND GAS LEASE BY THE HABENDUM, DRY HOLE, AND SHUT-IN ROYALTY CLAUSES

Rarely has the law recognized an interest in realty as ephemeral as that of the usual oil and gas lease. From the moment the lease is executed, the parties thereto are aware that this interest may terminate at almost any time. As the lease nears or passes the end of the primary term, the lessor and the lessee, knowing the slightest inadvertence may extinguish this interest, become acutely conscious of its fragility. To protect his interest, it is essential that the lessee know what activities are required of him and at what time he must conduct these activities. The purpose herein will be to explore the requisite activities and appropriate timing necessary to extend and continue the lease beyond the primary term, the approach being limited to the habendum, dry hole, and shut-in gas royalty clauses of the lease. The basic clause, of course, is the habendum. However, as it is modified substantially by the dry hole and shut-in royalty clauses, it seems proper that they be considered together.

I. THE HABENDUM CLAUSE

The modern habendum clause of an oil and gas lease commonly provides that the lessee's interest is vested for a definite term of years—called the primary term—and as long thereafter as oil and gas, or either of them, is produced.¹ A literal construction of the habendum clause would require no activity by the lessee in order to sustain the lease during the primary term, as this clause purports to vest unconditionally in the lessee certain mineral rights for a term of years. However, because the doctrine of abandonment is said to operate as an unwritten special limitation on the lessee's interest, some action by him has been regarded as essential to the continuance of the lease during this fixed term.² To circumvent abandonment, the typical lease contains a delay rental clause whereby the lessee may perpetuate the lease during the primary term without

¹ For a discussion of the history of the evolution of the habendum clause as well as the remainder of the contemporary lease see 2 Summers, *Oil & Gas* § 281-307 (perm. ed. 1959); Veasley, *The Law of Oil & Gas*, IV, 19 *Mich. L. Rev.* 161 (1920); Walker, *The Nature of the Property Interests Created by an Oil and Gas Lease in Texas*, 7 *Texas L. Rev.* 1 (1928); Comment, 11 *Sw. L.J.* 340, 342 (1957).

² *Texas Co. v. Davis*, 115 *Tex.* 321, 254 *S.W.* 304 (1923); see Masterson, *The Shut-in Royalty Clause in an Oil & Gas Lease*, 12 *Sw. L.J.* 459, 461 (1958).

conducting drilling operations by the annual payment of "delay rentals" to the lessor.³ Since this Comment will treat primarily the problem of extending the lease beyond the primary term, the necessary elements of activity by a lessee during the primary term will be considered only as they incidentally affect the paramount problem.

A. *Production That Will Extend The Term*

The fundamental characteristic of the extended term is the necessity of production as the prerequisite for maintaining the leasehold estate. Under Texas law, this leasehold estate is defined as a determinable fee in the oil and gas with the "thereafter" or "production" clause operating as a special limitation upon the estate.⁴ Production, therefore, is a condition precedent to the extension of the lessee's interest beyond the primary term.⁵ Determining if the condition is satisfied would seem to be relatively simple, yet an analysis of the cases reveals ambiguity in terminology and problems created by judicial interpretation.

When the lease form merely provides that oil and gas shall be "produced" and neglects to define this word elsewhere in the instrument, judicial construction of the lease becomes necessary. According to the minority view, "produced" does not mean "produced in paying quantities."⁶ The production, however, must be capable of division,⁷ *i.e.*, it must be tangible and substantial, and there must be more than a mere showing of oil and gas.⁸ Until *Garcia v. King*⁹ Texas recognized the minority rule.¹⁰ However, in the *Garcia* case the Texas Supreme Court committed the state to the view that "produced" means "produced in paying quantities,"

³ See Masterson, A 1952 Survey of Basic Oil and Gas Law, 6 Sw. L.J. 1 (1952); Scurlock, Practical and Legal Problems in Delay Rental and Shut-in Royalty Payments, Southwestern Legal Foundation 4th Annual Inst. on Oil & Gas L. & Tax. 17 (1953).

⁴ Haby v. Stanolind Oil & Gas Co., 228 F.2d 298 (5th Cir. 1955); Stephens County v. Mid-Kansas Oil & Gas Co., 113 Tex. 160, 254 S.W. 290 (1923); Caruthers v. Leonard, 254 S.W. 779 (Tex. Comm. App. 1923).

⁵ Watson v. Rochmill, 137 Tex. 565, 155 S.W.2d 783 (1941); Waggoner Estate v. Sigler Oil Co., 118 Tex. 509, 19 S.W.2d 27 (1929); Morrison v. Swaim, 220 S.W.2d 493 (Tex. Civ. App. 1949) error ref. n.r.e.; Stanolind Oil & Gas Co. v. Barnhill, 107 S.W.2d 746 (Tex. Civ. App. 1937) error ref.

⁶ Gillespie v. Ohio Oil Co., 260 Ill. 169, 102 N.E. 1043 (1913); Enfield v. Woods, 198 Ky. 328, 248 S.W. 842 (1923); cf. Eastern Oil Co. v. Coulehan, 65 W. Va. 531, 64 S.E. 836 (1909). Oklahoma formerly followed this interpretation. Roach v. Junction Oil & Gas Co., 72 Okla. 213, 179 Pac. 934 (1919). But see Woodruff v. Brady, 181 Okla. 105, 72 P.2d 709 (1937).

⁷ Adams v. Bennett, 282 S.W. 909 (Tex. Civ. App. 1926) error dism.

⁸ Enfield v. Woods, 198 Ky. 328, 248 S.W. 842 (1923); McCraw Oil & Gas Co. v. Kennedy, 65 W. Va. 595, 64 S.E. 1027 (1909).

⁹ 139 Tex. 578, 164 S.W.2d 509 (1942).

¹⁰ Adams v. Bennett, 282 S.W. 909 (Tex. Civ. App. 1926) error dism.

thereby abrogating a criterion of relative certainty for one of uncertainty.¹¹ The court's reasoning was that the

object of the contract was to secure development of the property for the mutual benefit of the parties. . . . So far as the lessees were concerned, the . . . continuation of the lease for an indefinite time after the expiration of the primary period was to allow the lessees to reap the full fruits of the investments made by them in developing the property. Obviously, if the lease could no longer be operated at a profit, there were no fruits for them to reap. The lessors should not be required to suffer a continuation of the lease after the expiration of the primary period merely for speculation purposes on the part of the lessees.¹²

While this interpretation has precipitated considerable litigation, such litigation has failed to resolve all the problems emanating from this decision.

B. *Paying Quantities Defined*

Now that the term "produced" has a qualified meaning, *viz.*, produced in paying quantities, what is the definition of paying quantities? The generally accepted rule as to what constitutes production in "paying quantities" has often been stated to mean that the lessee must produce in such quantities as will enable him to make a profit over and above the cost of operating the well, although the cost of drilling and equipping the well may never be repaid.¹³

The recent Texas Supreme Court decision of *Clifton v. Koontz*¹⁴ has contributed toward an articulation of the various factors to be considered in applying the test of paying quantities. Here, a lease, covering 350 acres, was executed by the plaintiff in 1940. In 1949 during the primary term of the lease, the lessee drilled and produced an "associated" (with oil) gas well. Other than its acidization in

¹¹ *Garcia v. King*, 139 Tex. 578, 164 S.W.2d 509 (1942). See also *Continental Oil Co. v. Boston-Texas Land Trust*, 221 F.2d 124 (5th Cir. 1955); *West v. Continental Oil Co.*, 91 F. Supp. 505 (S.D. Tex. 1950), *aff'd*, 194 F.2d 869 (5th Cir. 1952); *Clifton v. Koontz*, ___Tex. ___, 325 S.W.2d 684 (1959); *Holchak v. Clark*, 284 S.W.2d 399 (Tex. Civ. App. 1955) error ref. Accord: *Benedum-Trees Oil Co. v. Davis*, 107 F.2d 981 (6th Cir. 1939), cert. denied, 310 U.S. 634 (1940); *Reynolds v. White Plains Oil & Gas Co.*, 199 Ky. 243, 250 S.W. 975 (1923); *Berthelote v. Loy Oil Co.*, 95 Mont. 434, 28 P.2d 187 (1933); *Woodruff v. Brady*, 181 Okla. 105, 72 P.2d 709 (1937); Comment, *supra* note 1, at 342.

¹² *Garcia v. King*, *supra* note 11, at 512, 513. For a criticism of this interpretation see Brown, *The Law of Oil and Gas Leases* § 5.02 (1958); Williams, *Primary Term and Delay Rental Provisions*, *Southwestern Legal Foundation 2d Annual Inst. on Oil & Gas L. & Tax.* 93, 107 (1951).

¹³ *Henry v. Clay*, 274 P.2d 545 (Okla. 1954); *Walden v. Potts*, 194 Okla. 453, 152 P.2d 923 (1944); *Gypsy Oil Co. v. Marsh*, 121 Okla. 135, 248 Pac. 329 (1926); *Young v. Forest Oil Co.*, 194 Pa. 243, 45 Atl. 121 (1899); *Clifton v. Koontz*, ___Tex. ___, 325 S.W.2d 684 (1959); *Garcia v. King*, 139 Tex. 578, 164 S.W.2d 509 (1942).

¹⁴ *Supra* note 13.

1950, no other drilling or reworking operations were conducted until September 12, 1956, when the defendant, who acquired his lease interest in June, 1956, by assignment, successfully reworked the well by "sand fracturing," thereby increasing production 1800 per cent. The plaintiff claimed that the lease had terminated since the lessee failed to maintain production from the well in paying quantities. The trial court found, and the court of civil appeals concurred,¹⁵ that the well continuously produced in paying quantities. In affirming the lower courts the supreme court concluded that the evidence supported the trial court's findings. Where possible and applicable, the importance of this decision will be considered in the development of this general principle.

1. *Income from Lease*

If it be assumed that the ultimate application of the "paying quantities" test only requires one to look to an accounting record of the lease in question, then, before "operating expenses" can be classified, the income portion of this account must be ascertained.¹⁶ However, the income accounting record for the lease may prove deceptive since actual income or sale of the oil or gas is immaterial—the crucial item being actual production, whether sold or not.¹⁷ Thus, the court should consider not only the amount of oil or gas sold, but also that in storage at the time of the trial.¹⁸ In *Clifton v. Koontz*¹⁹ there was testimony that two to three months were required to accumulate a tank of oil before a sale could be made; hence, an actual bookkeeping net loss to the lessee was shown for two consecutive months. The court, in repudiating this ostensible bookkeeping loss, apparently considered (although not expressly stated) the amount of unsold oil that was stored. This view would buttress the supreme court's affirmance on the basis that the evidence supported the trial court's verdict.

2. *Period of Time*

An additional problem in defining the scope of the term "paying quantities" is "over what period of time should . . . [operations] be considered in determining whether the lease is now producing in

¹⁵ *Clifton v. Koontz*, 305 S.W.2d 782 (Tex. Civ. App. 1957).

¹⁶ For a thorough discussion of these accounting problems see Cage, *Production in Paying Quantities: Technical Problems Involved*, Southwestern Legal Foundation 10th Annual Inst. on Oil & Gas L. & Tax. 61 (1959).

¹⁷ *Sullivan and Garnett v. James*, 308 S.W.2d 891 (Tex. Civ. App. 1957) error ref. n.r.e.; *Cowden v. General Crude Oil Co.*, 217 S.W.2d 109 (Tex. Civ. App. 1948) error ref. n.r.e.

¹⁸ *Henry v. Clay*, 274 P.2d 545 (Okla. 1954).

¹⁹ ___Tex. ___, 325 S.W.2d 684 (1959).

paying quantities."²⁰ *Clifton v. Koontz*²¹ clearly delineates the issue. Here, the plaintiffs based their contention that the well had ceased to produce in paying quantities upon the showing that for the period of time from June, 1955, through September, 1956, the income from the lease was \$3,250, and that the total expense of operations during the same period was \$3,466.16; thus, a loss of \$216.16 for the sixteen-month period was sustained. During this period, however, some months showed a gain and some a loss. For instance, the months of July, August, and September of 1956 showed a total net loss of \$372.37. It was undisputed that reworking operations, which resulted in an 1800 per cent increase of production, were commenced on September 12, 1956, and that under the terms of the lease the lessee had a right to engage in such operations, provided that production had not ceased more than sixty days prior to the commencement of the operations. Therefore, it would seem that the small operating loss occurring during the sixty-day period prior to commencement of reworking operations was not material to the main issue. If this is true, the lessee operated at a profit of \$111.25 for a period of time beginning in June of 1955 and continuing through July 12, 1956, the beginning of the sixty-day period. The record further shows that a loss occurred during the months of April and May, 1956, that for the year 1954, a profit was earned each month, and that the aggregate profit was the sum of \$1,575.00; that in 1955 the operations were profitable during nine months of the year, with a net profit of \$894.00 for the year; and that for the first six months' period of 1956, the lease was operated at a profit of \$145.00.

The court was thus faced with three separate periods in which "paying quantities" might be determined: (1) the original sixteen-month period, June, 1955, through September, 1956, chosen by the plaintiff; (2) this same sixteen-month period reduced by the "sixty-day clause" to a fourteen-month period, June, 1955, through July 12, 1956; and (3) the two consecutive months of April and May, 1956. In period (1) there was a net operating loss to the lessee of \$216.00. In period (2) there was a net profit of \$111.25. In period (3) there was a net loss. The court concluded that the lease did not cease producing in "paying quantities." The choice of the appropriate measuring period appears crucial, and the court apparently was of the view that this choice must be decided on an *ad hoc* basis:

²⁰ Cage, *supra* note 16, at 82.

²¹ —Tex.—, 325 S.W.2d 684 (1959).

We again emphasize that there can be no limit as to time, whether it be days, weeks, or months, to be taken into consideration in determining the question of whether paying production from the lease has ceased.²²

The lease in question contained a sixty-day *continuous drilling* clause which provided that if production should cease for any cause after discovery the lease would not terminate if the lessee commenced additional drilling or reworking operations within sixty days.²³ Under the present facts the lessee did in fact commence additional reworking on September 12, 1956. Because of these reworking operations, it was concluded that if production had in fact ceased on July 12, 1956, this clause would give the lessee a sixty-day period of grace in which to commence further operations. Since the lessee did commence reworking on September 12, 1956, this sixty-day period reduced the original period chosen by the plaintiff by sixty days. By such construction of the lease contract, the status of production after July 12, 1956, becomes irrelevant and the original period of sixteen months chosen by the plaintiffs, in which there was a loss, is reduced to a fourteen-month period in which there was a *net profit*.

All lessors seeking to cancel the lease should not assume that they will necessarily be confronted with this interpretation. The lease in question must contain such a clause, and for it to be applicable, it may be necessary that the lessee actually commence reworking operations or additional drilling.²⁴ If the sixty-day *continuous drilling* clause had not been applicable, the court would have been faced with a sixteen-month period in which there was a net loss. Had the court in such a situation held that the lessee had not ceased to produce in paying quantities, the opinion would necessarily have given extremely favorable treatment to lessees. In addition, such an interpretation would have almost nullified the concept of paying quantities. However, since the opinion must be construed within its facts, the only issue as to a period of *substantial* duration before the court was the second period, *i.e.*, the reduced period of fourteen months in which the record showed a *net profit*. Since there was a net profit to the lessee over the fourteen-month period considered by the court, the case is limited authority on the question of the precise period determinative of the status of production in paying quantities. The court was, however, required to dispose of the third period, *i.e.*, the months of April and May, 1956, which was the only

²² Supra note 21, at 690.

²³ See discussion pp. 377-80 *infra*.

²⁴ See discussion p. 387 *infra*.

remaining period that reflected a net operating loss. It did so by abandoning the accounting approach to the problem, choosing instead to direct the paying quantities test toward a more liberal course. Relying upon two cases²⁵ dealing not with the test of paying quantities but with a temporary cessation of production, the court proclaims that there are numerous reasons which may justify a temporary cessation of production. As the problem before the court was not the temporary cessation of production but the failure to continue production in paying quantities, the reliance on these cases indicates the court's willingness to extend their reasoning to encompass the test of paying quantities. The adoption and favorable application of these temporary cessation of production cases greatly ameliorates the harshness of the paying quantities requirement²⁶ and considerably reduces the significance of the problem of the appropriate period in which to determine paying quantities.

Other Texas cases have not seriously considered the propriety of the period of time which will properly reflect paying quantities. For instance, in *Garcia v. King*²⁷ the lessee on November 15, 1938, entered into a contract with one Juarez. Juarez was to operate the lease, which then had six shallow producing wells, and receive as his compensation the entire production attributable to the seven-eighths working interest. This contract continued for eight months, *i.e.*, until July 15, 1939. However, the primary term had ended February 6, 1939. The court concluded that the eight-month period was sufficient to show no production in paying quantities. As production in "paying quantities" does not seem to be necessary during the primary term,²⁸ except as a condition precedent to extending the term, it would seem that the proper period for determining paying quantities should not begin until the last day of the primary term. It might, therefore, be argued that *Garcia v. King*²⁹ represents approval of a five and one-half month accounting period, *i.e.*, the period beyond the primary term. Apparently, the period actually considered by the court was eight months. The case of *Sullivan and Garnett v. James*³⁰ concluded without question that "paying quantities" might be determined with propriety over a six-month period.

The question as to the appropriate period in which to determine

²⁵ *Midwest Oil Corp. v. Winsauer*, ___Tex. ___, 323 S.W.2d 944 (1959); *Texas Pac. Coal & Oil Co. v. Bratton*, 239 S.W. 688 (Tex. Civ. App. 1921).

²⁶ This point is more fully developed pp. 379-80 *infra*.

²⁷ 139 Tex. 578, 164 S.W.2d 509 (1942).

²⁸ *Baker v. Huffman*, 176 Kan. 554, 271 P.2d 276 (1954); *Long v. Magnolia Petroleum Co.*, 166 Neb. 410, 89 N.W.2d 245 (1958); *Murphy v. Garfield Oil Co.*, 98 Okla. 273, 225 Pac. 676 (1923).

²⁹ 139 Tex. 578, 164 S.W.2d 509 (1942).

³⁰ 308 S.W.2d 891 (Tex. Civ. App. 1957) error ref. n.r.e.

"paying quantities" according to a mechanical criterion remains unanswered, and rightly so. Because of the multiplicity of factors that may effect the profitableness of the oil and gas venture, an immutable period would work many hardships not contemplated by the parties to the lease. Flexibility, geared to appropriate accounting procedures, seems to be the correct approach even though some certainty may be sacrificed. The *Clifton* decision, if properly construed, will adequately chart future decisions toward an elastic definition of an appropriate accounting period.

3. *Operating Expenses Defined*

A proper determination of "operating expenses" depends largely upon sound accounting methods.³¹ Paying quantities is a term sufficiently pliable to entertain almost any proper accounting theory.³² It is submitted that the lessee should be given reasonable latitude in determining these factors so long as there is no clear abuse. It would seem that pumpers' salaries, fuel costs, and clearing costs are properly classified as operating expense items since they relate directly to "lifting the oil."³³ Difficulty, however, may arise in distinguishing what may be classed as capital expenditures. It was stated in an early Texas case that "the expenses necessarily incurred in the equipment of an oil well should not be taken into account in determining whether or not production therefrom is in paying quantities."³⁴ This language is consistent with the principle enunciated in *Clifton v. Koontz*,³⁵ i.e., the lessee must have a profit over and above "operating expenses." Therefore, expenditures made for acquisition and retention of the lease (e.g., bonus, delay rentals, and title curative matters) and the costs of drilling, both tangible and intangible, and equipping the wells should be treated as capital expenditures and thus not considered in determining whether there is production in paying quantities.³⁶

³¹ For a broad discussion of these problems see Smith and Brock, *Accounting for Oil and Gas Producers* 268 (1959).

³² Although a proper accounting theory would seemingly require the matching of expense with revenue, Herwitz and Trautmann, *Materials on Accounting* 89 (3d ed. 1959), it should not be assumed that an immutable accounting theory has been judicially adopted. The problem will, of course, be largely one of evidence, and as such, the astute lessee will do well to consider keeping his marginal wells on a cash accounting basis. As the *Clifton* decision indicates that a loss for a short period may be immaterial to the continuation of the lease, a cash accounting basis would allow the lessee to place high expenses into a shorter period of time.

³³ *Noel Estate v. Murray*, 223 La. 387, 65 So. 2d 886, 2 O. & G. Rep. 951 (1953); *Henry v. Clay*, 274 P.2d 545 (Okla. 1954); *Gypsy Oil Co. v. Marsh*, 121 Okla. 135, 248 Pac. 329 (1926).

³⁴ *Texas Pac. Coal & Oil Co. v. Bruce*, 233 S.W. 535, 539 (Tex. Civ. App. 1921).

³⁵ —Tex.—, 325 S.W.2d 684 (1959).

³⁶ Compare *Hanks v. Magnolia Petroleum Co.*, 14 S.W.2d 348 (Tex. Civ. App. 1928),

In *Clifton v. Koontz*³⁷ it was urged that depreciation should be considered as an expense item. The court correctly concluded that if the original investment itself was not considered, then depreciation on this investment should likewise be excluded. However, this rule must be qualified by the court's language: "We do not have before us the question of whether or not depreciation on *producing* equipment should be charged as an operating expense, and therefore, do not decide the question." (Emphasis added.)³⁸

The question of whether administrative expenses may be classified as an "operating expense" remains unlitigated.³⁹ It would appear that as these items only indirectly affect the lease they should be excluded in applying the test. By excluding such items altogether, many problems will be obviated.

The contention was made in the *Clifton* case that an outstanding eight per cent overriding royalty should be excluded from the total income in applying the "paying quantities" criterion. This was repudiated by the court which stated: "The entire income attributable to the contractual working interest created by the original lease is to be considered."⁴⁰ Therefore, in determining total income, the lessor must look to the original leasing arrangement. If the lessor reserved additional royalty or an "overriding royalty" including a reserved production payment, the "runs" attributable to this interest would be excluded in computing the lessee's lease income.⁴¹

Where more than one lease is being operated by the lessee and one operating expense is common to all the leases, the problem of allocation arises. In *Sullivan and Garnett v. James*⁴² the lessee had allocated expenses among several properties on a per-well basis. Later, he argued that these expenses should be allocated to each well according to the proportion of income produced by each well, thus reducing the

aff'd, 24 S.W.2d 5 (Tex. Comm. App. 1930). But see *Archer v. Skelly Oil Co.*, 314 S.W.2d 655 (Tex. Civ. App. 1958) where the court voluntarily stated that the cost of pipeline to market gas should be included as an operating expense. The supreme court sustained the opinion in sending the case back to the trial court but stated in a per curiam opinion at 317 S.W.2d 47 (1958): "The holding that the cost of construction of a pipeline for marketing the gas should be included in determining whether the well or wells in question were producing oil in paying quantities is not before us, and we express no opinion thereon."

³⁷ ___Tex. ___, 325 S.W.2d 684 (1959).

³⁸ *Clifton v. Koontz*, supra note 37, at 692.

³⁹ See *Cage*, supra note 16; Comment, 12 Okla. L. Rev. 179, 182 (1958). Complete agreement as to its treatment does not exist even among accountants. See Smith and Brock, op. cit. supra note 31, at 275.

⁴⁰ *Clifton v. Koontz*, ___Tex. ___, 325 S.W.2d 684, 693 (1959); see *Transport Oil Co. v. Exeter Oil Co.*, 84 Cal. App. 2d 616, 191 P.2d 129 (1948); *Vance v. Hurley*, 215 La. 805, 41 So. 2d 724 (1949).

⁴¹ Compare *Vance v. Hurley*, supra note 40.

⁴² 308 S.W.2d 891 (Tex. Civ. App. 1957) error ref. n.r.e.

expense of his marginal wells. This tenuous argument was summarily rejected. It would appear that a sound accounting procedure again would be the proper course for a lessee; hence, a reasonable allocation consistent with his accounting procedure would appear acceptable to the court.

4. *Who Determines "Paying Quantities"*

The above discussion was centered on the ramifications of the term "paying quantities" as though it were a mechanical test which could be applied, as the court in *Sullivan and Garnett v. James*⁴³ seems to indicate, in the following manner:

From these figures, by simply adding up the receipts on the one hand and the expenditures on the other, the difference would readily determine profit or loss.

However, the application of this criterion may not determine the question in such an unmitigated fashion. Some courts have held that the presentation of evidence according to basic accounting facts would be sufficient.⁴⁴ In earlier Texas cases it was established that the technical aspects of the "paying quantities" test would not be given exclusive consideration. In *Masterson v. Amarillo Oil Co.*,⁴⁵ for instance, it was stated that "what amounts to oil and gas in paying quantities is a matter to be determined exclusively by the lessee acting in good faith."⁴⁶ Later cases held that the judgment of either party is not conclusive in determining paying quantities.⁴⁷ It was stated in *Clifton v. Koontz*:

In the case of a marginal well, such as we have here, the standard by which paying quantities is determined is whether or not under all the relevant circumstances a reasonably prudent operator would, for the purpose of making a profit and not merely for speculation, continue to operate a well in the manner in which the well in question was operated.

In determining paying quantities, in accordance with the above stan-

⁴³ Id. at 893.

⁴⁴ *McLeon v. Wells*, 207 Ark. 303, 180 S.W.2d 325 (1944); *Elliott v. Crystal Springs Oil Co.*, 106 Kan. 248, 187 Pac. 692 (1920); *Rockcastle Gas Co. v. Horn*, 241 Ky. 398, 44 S.W.2d 273 (1931); *Smith v. Sun Oil Co.*, 172 La. 655, 135 So. 15 (1931).

⁴⁵ 253 S.W. 908 (Tex. Civ. App. 1923) error dism.

⁴⁶ *Masterson v. Amarillo Oil Co.*, supra note 45, at 915; *Nystel v. Thomas*, 42 S.W.2d 168 (Tex. Civ. App. 1931); *Bouldin v. Gulf Prod. Co.*, 5 S.W.2d 1019 (Tex. Civ. App. 1928) error dism.; *Texas Pac. Coal & Oil Co. v. Bruce*, 233 S.W. 535 (Tex. Civ. App. 1921); accord, *Denker v. Mid-Continent Petroleum Corp.*, 56 F.2d 725 (10th Cir. 1932); *Bay State Petroleum Corp. v. Penn Lubricating Co.*, 121 Ky. 637, 87 S.W. 1102 (1905); *Gypsy Oil Co. v. Marsh*, 121 Okla. 135, 248 Pac. 329 (1926); *Young v. Forest Oil Co.*, 194 Pa. 243, 45 Atl. 121 (1899); *South Penn Oil Co. v. Snodgrass*, 71 W. Va. 438, 76 S.E. 961 (1912).

⁴⁷ *Stephenson v. Little*, 12 S.W.2d 196 (Tex. Comm. App. 1929); *Walker*, supra note 1, at 514.

dard, the trial court necessarily must take into consideration all matters which would influence a reasonable and prudent operator. Some of the factors are: The depletion of the reservoir and the price for which the lessee is able to sell his produce, the relative profitability of other wells in the area, the operating and marketing costs of the lease, his net profit, the lease provisions, a reasonable period of time under the circumstances, and whether or not the lessee is holding the lease merely for speculative purposes.⁴⁸

This emphatic language clearly shows that an objective accounting standard will not be conclusive. The court, however, does not discuss the earlier "good faith" rule, but seems to promulgate a new standard, *i.e.*, the "prudent operator" standard.⁴⁹ The two are not necessarily identical. Under the "good faith" rule the test is a subjective one, *i.e.*, what was this lessee's intent. Under the "prudent operator" test the particular lessee's intent would be immaterial and the question would be determined by what a mythical third person, the "prudent operator," would do under identical circumstances. Intent of the lessee, however, is not completely ignored, for if he seeks to hold the lease for speculative purposes only, the lease is jeopardized because such conduct shows no regard for the lessor's rights; thus, the lessee is not acting as a "prudent operator."

Since the burden of proof is upon the one attacking the lease to show an absence of production in paying quantities and presumably to show a failure of the lessee to act as a prudent operator,⁵⁰ such person will have a difficult task so long as the lessee acts reasonably. It seems that the "paying quantities" test is now both objective and subjective. The objective standard will, of course, be the accounting record and the subjective standard, the "prudent operator" rule. The liberality granted by the *Clifton* decision seems more than justified when it is remembered that the parties to the lease did not stipulate that production should be in paying quantities.⁵¹

C. Equitable Considerations

Heretofore it has been assumed that the habendum clause required actual production in some measurable quantity. The question may

⁴⁸ ___Tex. ___, 325 S.W.2d 684, 691 (1959). In addition, the opinion indicates that Texas Railroad Commission orders are to be considered. But see *Haby v. Stanolind Oil & Gas Co.*, 228 F.2d 298 (5th Cir. 1956). Compare *Butler v. Jenkins Oil Corp.*, 128 Tex. 356, 97 S.W.2d 46 (Tex. Comm. App. 1936) dealing with construction of an overriding royalty.

⁴⁹ See *Henry v. Clay*, 274 P.2d 545 (Okla. 1954). Compare the "prudent operator" test with respect to the covenant to drill offset wells. *Texas Pac. Coal & Oil Co. v. Barker*, 117 Tex. 418, 6 S.W.2d 1031 (1928).

⁵⁰ *Mitchell v. Perkins*, 266 S.W.2d 451 (Tex. Civ. App. 1953), rev'd on other grounds, 153 Tex. 379, 268 S.W.2d 909 (1954).

⁵¹ *Garcia v. King*, 139 Tex. 378, 164 S.W.2d 509 (1942).

arise whether this rule would apply should the lessee complete a gas well capable of producing in paying quantities during the primary term but be unable to find a market for this gas before the primary term expires. Some jurisdictions have declared that no termination occurs if the lessee equips the well and markets the gas within a reasonable time.⁵² These decisions are predicated upon equitable considerations⁵³ and upon the concept that "discovery" alone vests an interest in the lessee.⁵⁴ The proposition that "discovery" within the primary term, followed by diligent operations, is the equivalent of producing in paying quantities seems to be unequivocally denied in Texas.⁵⁵

In *Stanolind Oil & Gas Co. v. Barnhill*⁵⁶ a lessee invested approximately \$35,000 in completing a gas well during the second year of a five-year primary term, but a market was not obtained until a few months after the term expired. It was the lessee's contention that discovery alone would continue the lease beyond the primary term. The Texas court held that since the lease was not "producing in paying quantities" on the day the primary term expired, the lease had terminated. The court properly justified its conclusion by reiterating the rule that the lessee holds a determinable fee, which determines according to the original grant; and, further, that it is not the duty of the courts to make contracts for the parties.⁵⁷

However, in *Union Oil Co. v. Ogden*⁵⁸ the court under similar facts reached the conclusion that the lease had not expired since the "lessee should have a reasonable time to market the gas." This was further defined "as the reasonable time it would take appellant to lay a line from its well to the only available market." It should be noted, however, that here the market was only one-half mile away, whereas in other cases considering the point, it appeared that there was no available market. The *Union Oil Co.* case seems to represent a limited exception to the general rule requiring actual

⁵² *Bristol v. Colorado Oil & Gas Corp.*, 225 F.2d 894 (10th Cir. 1955); *Christianson v. Champlin Ref. Co.*, 169 F.2d 207 (10th Cir. 1948); *Tate v. Stanolind Oil & Gas Co.*, 172 Kan. 351, 240 P.2d 465 (1952); *Pennagrade Oil & Gas Co. v. Martin*, 211 Ky. 137, 277 S.W. 302 (1925); *Parks v. Sinai Oil & Gas Co.*, 83 Okla. 295, 201 Pac. 517 (1921); *Roach v. Junction Oil & Gas Co.*, 72 Okla. 213, 179 Pac. 934 (1919).

⁵³ *Strange v. Hicks*, 78 Okla. 1, 188 Pac. 347 (1920).

⁵⁴ *South Penn Oil Co. v. Snodgrass*, 71 W. Va. 438, 76 S.E. 961 (1912); *Eastern Oil Co. v. Coulehan*, 65 W. Va. 531, 64 S.E. 836 (1909).

⁵⁵ *Holchak v. Clark*, 284 S.W.2d 399 (Tex. Civ. App. 1955) error ref.

⁵⁶ 107 S.W.2d 746 (Tex. Civ. App. 1937) error ref.

⁵⁷ Other Texas cases have sustained this view. See *Watson v. Rochmill*, 137 Tex. 565, 155 S.W.2d 783 (1941); *Francis v. Pritchett*, 278 S.W.2d 288 (Tex. Civ. App. 1955) error ref.; *Giles v. McKanna*, 200 S.W.2d 709 (Tex. Civ. App. 1947) error ref. n.r.e.; *Cox v. Miller*, 184 S.W.2d 323 (Tex. Civ. App. 1944) error ref.

⁵⁸ 278 S.W.2d 246 (Tex. Civ. App. 1955) error ref. n.r.e.

production to continue the lease beyond the primary term, the exception being that sufficient time is allowed the lessee, who has completed a gas well within the primary term, diligently to construct a line from his well to market, provided there is a reasonably accessible market.⁵⁹ This problem may, of course, be obviated by a properly worded shut-in royalty clause.⁶⁰

II. THE HABENDUM CLAUSE AS MODIFIED BY THE TYPICAL DRY HOLE AND SHUT-IN ROYALTY CLAUSES

The habendum clause of the oil and gas lease is significantly modified by the "dry hole" clause. A typical dry hole clause reads:

If prior to discovery of oil, gas or other mineral on said land or on acreage pooled therewith lessee should drill a dry hole or holes thereon, or if after discovery of oil, gas or other mineral, the production thereof should cease from any cause, this lease shall not terminate if lessee commences additional drilling or reworking 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 reworking on or before the rental paying date next ensuing after the expiration of sixty days from date of completion of dry hole or cessation of production. If at the expiration of the primary term, oil, gas or other mineral is not being produced on said land, or on acreage pooled therewith, but lessee is then engaged in drilling or reworking operations thereon or shall have completed a dry hole thereon within sixty (60) days prior to the end of the primary term, the lease shall remain in force so long as operations are prosecuted with no cessation of more than sixty (60) consecutive days, and if they result in the production of oil, gas or other minerals, so long thereafter as oil, gas or other mineral is produced from said land or acreage pooled therewith.⁶¹

Because of the complexity and numerous variations of this clause, many novel problems have arisen. Although the clause may also affect operations during the primary term, these problems will be considered only as they relate to continuance of the lease beyond the primary term.⁶² Ignoring the language dealing with delay rentals, it may be noted that the "dry hole" clause has been divided into two distinct divisions.⁶³ The first part of this clause is known as

⁵⁹ Brown, *supra* note 12, at 75; Comment, *supra* note 1, at 345.

⁶⁰ See Masterson, *supra* note 2.

⁶¹ For examples of differently worded dry hole clauses see Brown, *supra* note 12, at 175.

⁶² For a discussion of these problems during the primary term see Berman, *Dry Hole, Drilling Operations, and 30 Day - 60 Day Drilling Operation Clauses*, 38 *Texas L. Rev.* 270 (1960); Braly, *Problems Presented By Operations During the Primary Term of an Oil and Gas Lease*, *Southwestern Legal Foundation 6th Annual Inst. on Oil & Gas L. & Tax.* 189 (1955).

⁶³ Discussion Note, 7 *O. & G. Rep.* 1511 (1956).

the *continuous drilling* clause and was inserted originally to cover a situation where, after the primary term, production ceased for some short period. The latter part of the clause is known as the *commence drilling* clause. It was created to provide relief from the stringent application of the habendum clause in the situation where a well was being drilled at the end of the primary term. The clause originally was designed to keep the lease alive long enough to permit completion of this well beyond the primary term. It would be impossible to exhaust all the possible fact situations that might arise under this clause. However, at the present time the fact situations presented by prior litigation fall into the following groups, and this grouping will perhaps elucidate some of the nebulous areas which exist in extending the lease.

A. Cessation Of Production After The Primary Term

The majority view is that complete and permanent cessation of production after the primary term automatically terminates the lease under the habendum clause.⁶⁴ This view is one of literal construction in which equitable rules against forfeiture are inapplicable.⁶⁵ Thus, the fact of cessation caused by unavoidable delay, an act of God, or financial difficulty of the lessee is immaterial.⁶⁶ Temporary cessation of production, however, for the purpose of improving or repairing the well does not result in termination.⁶⁷ This rule is not based upon equitable principles,⁶⁸ but upon a theory of construction that the parties to the lease did not intend it to terminate because of a temporary interruption of production caused by attempts to improve or repair the well.⁶⁹ Whether a particular cessation is considered temporary or permanent must be determined by looking to the reason for the cessation as well as the time element involved.⁷⁰

In order for the parties to the lease to be assured of the exact

⁶⁴ *Watson v. Rochmill*, 137 Tex. 565, 155 S.W.2d 783 (1941); *Waggoner Estate v. Sigler Oil Co.*, 118 Tex. 509, 19 S.W.2d 27 (1929); *Francis v. Pritchett*, 278 S.W.2d 288 (Tex. Civ. App. 1955) error ref.; *Shell Oil Co. v. Goodroe*, 197 S.W.2d 395 (Tex. Civ. App. 1946) error ref. n.r.e.; *Flato v. Weil*, 4 S.W.2d 992 (Tex. Civ. App. 1928); *Stephenson v. Calliham*, 289 S.W. 158 (Tex. Civ. App. 1926).

⁶⁵ *Flato v. Weil*, supra note 64; *Stephenson v. Calliham*, supra note 64.

⁶⁶ *McLean v. Kishi*, 173 S.W. 502 (Tex. Civ. App. 1915); *Walker*, *The Nature of the Property Interests Created by an Oil and Gas Lease in Texas*, 8 Texas L. Rev. 483, 516 (1930).

⁶⁷ *Francis v. Pritchett*, 278 S.W.2d 288 (Tex. Civ. App. 1955) error ref.; *Giles v. McKanna*, 200 S.W.2d 709 (Tex. Civ. App. 1947) error ref. n.r.e.; *Scarborough v. New Domain Oil & Gas Co.*, 276 S.W. 331 (Tex. Civ. App. 1925) error dism.

⁶⁸ *Contra*, *Cotner v. Warren*, 330 P.2d 217 (Okla. 1958).

⁶⁹ See *Scarborough v. New Domain Oil & Gas Co.*, 276 S.W. 331 (Tex. Civ. App. 1925) error dism. See also Discussion Note, 9 O. & G. Rep. 712 (1958).

⁷⁰ *Midwest Oil Corp. v. Winsauer*, ___Tex. ___, 323 S.W.2d 944 (1959); *Watson v. Rochmill*, 137 Tex. 565, 155 S.W.2d 783 (1941); *Adams v. Bennett*, 282 S.W. 909 (Tex. Civ. App. 1926) error dism.

period to be allowed for temporary cessation, modern lease forms now expressly provide that should production cease from any cause, the lease will not terminate if the lessee commences additional drilling or reworking operations within sixty days. Two cases arising in Texas have held that the general rule allowing a temporary cessation of production is abrogated by the express terms of the lease, and that a temporary cessation which exceeds the arbitrary sixty-day period terminates the lease.⁷¹ However, if the production never attained the status of "paying quantities," then there can be no cessation within the meaning of the clause.⁷²

Assume that production does not completely cease but does cease to the extent that the lease is not producing in "paying quantities." Does the express dry hole clause become applicable and define the period in which this production may legitimately cease? The petitioner in *Clifton v. Koontz*⁷³ urged that because production had ceased in paying quantities the sixty-day clause became applicable, and since there was a lack of paying quantities for more than a sixty-day period, the lease terminated. The supreme court, however, pointed out that since it found that production in paying quantities had not ceased, the sixty-day clause was inapplicable. Although the reliance upon the temporary cessation of production cases prevented the application of the sixty-day clause, it was indicated that should there be a finding⁷⁴ of cessation of production in paying quantities the sixty-day clause would become applicable; and the lessee would only have a sixty-day period in which to restore production to a paying quantities status. However, the clause might not benefit the lessee who is sued for termination of the lease on the basis of failure to produce in paying quantities when he has done nothing which would qualify as "reworking or additional drilling operations."⁷⁵

This portion of the decision, possibly the most untenable portion, arguably overrules by implication prior Texas authority. The basic assumption that the cases relating to temporary cessation of production are applicable to cessation in paying quantities appears sound.

⁷¹ *Haby v. Stanolind Oil & Gas Co.*, 228 F.2d 298 (5th Cir. 1955); *Woodson Oil Co. v. Pruett*, 281 S.W.2d 159 (Tex. Civ. App. 1955) error ref. n.r.e.

⁷² *Gulf Oil Corp. v. Reid*, ___Tex.____, 337 S.W.2d 267 (1960).

⁷³ ___Tex.____, 325 S.W.2d 684 (1959). The answer to this question depends on whether the lease extends automatically to the end of this 60 day period and may be continued only by appropriate operations, or whether the lease terminates at the beginning of this 60 day period only to be revived by conducting the appropriate activity within this period. See p. 387 *infra*.

⁷⁴ This decision fails to indicate how such a finding would be possible. The court could make this finding in a situation where the lessee's activity would come within the conduct which justifies a temporary cessation of production.

⁷⁵ See discussion p. 387 *infra*.

If, however, this body of law is to be considered controlling in part, then it should, unless a material reason exists to the contrary, be controlling *in toto*. The court was apparently oblivious of, or else failed to understand *Woodson Oil Co. v. Pruett*⁷⁶ which held that the sixty-day *continuous* clause defined the allowable period of a justifiable cessation of production. The *Clifton* case concluded that the sixty-day *continuous* clause was inapplicable because production in paying quantities never ceased. The reason ascribed by the court for its finding that paying quantities had not ceased was that the temporary cessation of production cases justify a cessation in paying quantities for a short duration, and therefore the sixty-day period was not yet applicable. Under this reasoning it is hard to see when the sixty-day clause would ever be applicable. Logically, under this decision, it would not become definitive of the period allowed for a temporary cessation of paying quantities until the expiration of the time allowed under the temporary cessation of production cases, which might be several months. At the expiration of this period, it would appear, the lessee could then add the sixty-day clause and urge his justification for a cessation of production in paying quantities for a substantial period of time.

B. Lessee Engaged At End Of Primary Term
In Drilling Or Reworking Operations

The *commence drilling* clause allows the lessee to continue the lease beyond the primary term without production if he has complied with the requirements of "drilling or reworking operations" before the end of the primary term.⁷⁷ In the absence of such a clause the habendum would require the termination of the lease.⁷⁸

The lessee, to be engaged in drilling operations, need not be actually spudding in the well.⁷⁹ If substantial preparations to drill are being made, e.g., hauling material to the drillsite,⁸⁰ making and clearing a location,⁸¹ digging of slush pits and a water supply,⁸² the lease

⁷⁶ 281 S.W.2d 159 (Tex. Civ. App. 1955) error ref. n.r.e.

⁷⁷ *St. Louis Royalty Co. v. Continental Oil Co.*, 193 F.2d 773 (5th Cir. 1952); *Stanolind Oil & Gas Co. v. Newman Bros. Drilling Co.*, 175 Tex. 489, 305 S.W.2d 169 (1957).

⁷⁸ *Perkins v. Saunders*, 109 Kan. 372, 198 Pac. 954 (1921); *Fagan v. Burns*, 247 Mich. 674, 226 N.W. 653 (1929). *Contra Lester v. Mid-South Oil Co.*, 296 Fed. 661 (6th Cir. 1924); *Simpson v. Buckner*, 247 Ky. 564, 57 S.W.2d 464 (1933); *McLain v. Harper*, 206 Okla. 437, 244 P.2d 301 (1952).

⁷⁹ *Brown*, supra note 12, at 127.

⁸⁰ *Guleke v. Humble Oil & Ref. Co.*, 126 S.W.2d 38 (Tex. Civ. App. 1939); *Terry v. Texas Co.*, 228 S.W. 1019 (Tex. Civ. App. 1921). Compare *Forney v. Ward*, 62 S.W. 108 (Tex. Civ. App. 1901).

⁸¹ *Whelan v. R. Lacy, Inc.*, 251 S.W.2d 175 (Tex. Civ. App. 1952) error ref. n.r.e.; *Wheelock v. Batte*, 225 S.W.2d 591 (Tex. Civ. App. 1949) error ref. n.r.e.

⁸² *McCallister v. Texas Co.*, 223 S.W. 859 (Tex. Civ. App. 1920) error ref.

continues beyond the primary term. It has recently been held that re-entering an abandoned hole will satisfy this requirement.⁸³ The courts do not always look solely to these objective factors, however, and the rule has been qualified to require good faith on the part of the lessee evidenced by diligent prosecution of the drilling operations.⁸⁴ Although the issue of what constitutes commencement of drilling is fairly settled, some question remains as to when drilling may be said to have ceased which would be material in determining the time for commencement of a second well should the first be a failure.⁸⁵ The court of civil appeals in *Reid v. Gulf Oil Corp.*⁸⁶ stated what may be considered a proper theory for answering this question, *i.e.*, "the term 'drilling operations' was intended to embrace all of the physical and mechanical aspects of bringing about the production of oil or gas in paying quantities." This same court held that negotiations with third persons to install pipeline facilities for marketing of gas constituted "drilling" operations. The supreme court seemingly approved the theory but disagreed with its application and held as a matter of law that negotiations only could not constitute "drilling" since the term requires that the lessee be physically or manually conducting activities.⁸⁷

The dry hole clause also allows "reworking operations" to continue the lease. In *Rogers v. Osborn*⁸⁸ it was held that the "bleeding" of a completed well will continue the lease in effect, but the court did not find it necessary to determine whether it was relying on the word "drilling" or the word "reworking." In *Texas Co. v. Leach*⁸⁹ operations consisting of relogging the derrick, pulling the tubing, repairing the fuel lines, and repairing roads and bridges so that equipment could be moved, constituted "reworking operations." As long as these operations are continued by the lessee in good faith, few problems will arise.⁹⁰

Once the required activity is actually begun the clause typically provides that it shall be continued without cessation of more than sixty days. One Texas case has held that for this limitation period to commence to run the cessation of operations must be complete.⁹¹ If the lease fails to provide a definite period allowing cessation of

⁸³ *Kothmann v. Boley*, 156 Tex. 56, 308 S.W.2d 1 (1957).

⁸⁴ *Whelan v. R. Lacy, Inc.*, 251 S.W.2d 175 (Tex. Civ. App. 1952) error ref. n.r.e.; *Street v. Masterson*, 277 S.W. 407 (Tex. Civ. App. 1925).

⁸⁵ *Fields v. Stanolind Oil & Gas Co.*, 233 F.2d 625 (5th Cir. 1956).

⁸⁶ 323 S.W.2d 107, 115 (Tex. Civ. App. 1959).

⁸⁷ *Gulf Oil Corp. v. Reid*, ___Tex. ___, 337 S.W.2d 267 (1960).

⁸⁸ 152 Tex. 540, 261 S.W.2d 311 (1953).

⁸⁹ 219 La. 613, 53 So. 2d 786 (1951).

⁹⁰ See Discussion Note, 5 O. & G. Rep. 1370 (1954).

⁹¹ *Phillips Petroleum Co. v. Rudd*, 226 S.W.2d 464 (Tex. Civ. App. 1949).

operations, then the common-law standard of "due diligence" will determine the period allowed.⁹²

1. *Activity Sufficient to Carry Lease Beyond the Primary Term Results in Dry Hole*

If the activity in which the lessee was engaged at the end of the primary term results in production in paying quantities, the lease will endure so long as such production continues.⁹³ Should the drilling result in a dry hole, the question presented is whether or not the lessee may continue his lease by additional activity.

It has been stated that the dry hole provision is applicable only to "completed" wells.⁹⁴ Thus, it becomes essential under many circumstances to define "completed" and "dry hole," as well as determining the time the well was completed as a dry hole. Clearly, some wells simply cannot be considered as dry holes, e.g., a well producing oil or gas in less than paying quantities.⁹⁵ Nor can a shut-in gas well with a capacity to produce one million cubic feet of gas per day be classified as a dry hole.⁹⁶ Articulating an exact definition of the term, however, cannot be done with any accuracy. The term "completed" has been defined as "a well drilled to the extent that either oil or gas has been found, or is not likely to be found in paying quantities, by drilling deeper, or drilled to that reasonable depth at which the product in paying quantity was usually proven or disproven to exist in that particular locality."⁹⁷

a. *No Discovery During Primary Term*

The recent supreme court case of *Stanolind Oil & Gas Co. v. Newman Bros. Drilling Co.*⁹⁸ supplies a thorough analysis of the problems in this area. The action was one to determine the ownership of the leasehold estate covering an undivided one-half interest in the minerals. Two identical leases were in question. The leases were kept in force during the primary term by the payment of delay rentals. A well was commenced on the land prior to the expiration of the primary terms and was completed as a dry hole after the end

⁹² Reid v. Gulf Oil Corp., 323 S.W.2d 107 (Tex. Civ. App. 1959), aff'd, ___Tex.____, 337 S.W.2d 267 (1960); Stephenson v. Calliham, 289 S.W. 158 (Tex. Civ. App. 1926).

⁹³ Clifton v. Koontz, ___Tex.____, 325 S.W.2d 684 (1959).

⁹⁴ Braly, supra note 62.

⁹⁵ Murphy v. Garfield Oil Co., 98 Okla. 273, 225 Pac. 676 (1923).

⁹⁶ Cox v. Miller, 184 S.W.2d 323 (Tex. Civ. App. 1944) error ref. It was stated: "The terms 'dry hole' and a well 'producing gas in paying quantities' are not necessarily the converse of each other."

⁹⁷ Braly, supra note 62, at 208. See also Berryman v. Sinclair Prairie Oil Co., 164 F.2d 734 (10th Cir. 1947).

⁹⁸ 157 Tex. 489, 305 S.W.2d 169 (1957).

of those terms. A second well was commenced fifty days after the completion of the dry hole and was completed as a producer. The lease contained a dry hole clause similar to that set out above, except that the *commence drilling* clause contained a thirty-day limitation. By virtue of the *commence drilling* clause the well being drilled at the end of the primary term continued the lease until completion of the well as a dry hole. Since this clause would only allow a cessation of operations for thirty days and as the second well was begun some fifty days later, it was urged by the lessee that the sixty-day provision of the *continuous drilling* clause was applicable, and, therefore, the lease was still in effect. The court concluded that the *commence* and *continuous drilling* clauses may be cumulatively employed by the lessee seeking to extend the lease, provided such clauses are operative.

b. *Discovery During Primary Period*

Rogers v. Osborn,⁹⁹ another supreme court decision, emphasizes the difficulty created by the dry hole clause. The facts illustrated that before the primary term expired on September 21, 1947, the first well was commenced on May 15, 1947, and that at the expiration of the term the lessee was engaged in "reworking" operations on this well. After the primary term the lessee drilled and completed as a producer a second well, but discontinued activity on the first well. The trial court found that the first well was not dry. On appeal the supreme court held the *continuous drilling* clause inapplicable because the first well was neither a dry hole nor a producing well from which it could be said that production had ceased, thus denying the lessee the cumulative effect of the *Stanolind Oil & Gas Co. v. Newman Bros.* case. It was held that the *commence drilling* clause standing alone required that production result from continuous prosecution of the operations in which the lessee was engaged at the expiration of the primary term and did not include new operations commenced after the primary term expired.¹⁰⁰

The impact of this case is to require that a lessee must ultimately obtain production in paying quantities from the *very well* being drilled or reworked at the end of the primary term (provided, of course, the lessee is depending solely on these operations to continue the lease beyond the primary term) when the lease contains no *continuous* clause or when the *continuous* clause is inapplicable.

The *continuous drilling* clause will be held inapplicable when, as

⁹⁹ 152 Tex. 540, 261 S.W.2d 311 (1953).

¹⁰⁰ Accord *Skelly Oil Co. v. Wickham*, 202 F.2d 442 (10th Cir. 1953).

in the *Rogers* case, there is a finding that the well being drilled is not a dry hole. Furthermore, the clause will be inapplicable if there is "discovery" during the primary term.¹⁰¹ A definition of discovery has not been promulgated by the courts, but it would probably include production in any quantity as well as the discovery of gas in paying quantities which has not been produced.

The result when the lease does not contain a *continuous drilling* clause may be seen in *Skelly Oil Co. v. Wickham*.¹⁰² There the lessee relied on the *commence drilling* clause to carry the lease beyond the primary term, but as he failed to obtain production from this very operation, it was held that the lease terminated. The same result would undoubtedly prevail in Texas.

2. Lessee Completes Gas Well Without Available Market

Most modern leases provide that in the situation where the lessee, within the primary term, completes a gas well capable of producing in paying quantities,¹⁰³ but due to lack of a market or for various other reasons the well cannot be produced, the lease may be perpetuated for specified periods by the tender of "shut-in" royalty payments.¹⁰⁴ The "shut-in" clause typically stipulates that production will be deemed in paying quantities when the appropriate payment has been made. It is not the purpose of this Comment to examine in detail the shut-in royalty clause, but merely to discuss the more important decisions as they relate to continuing the lease beyond the primary term.

The case of *Freeman v. Magnolia Petroleum Co.*¹⁰⁵ seems to epitomize the treatment this clause will receive from the Texas Supreme Court. There a gas well was drilled on a lease and completed near the end but before the expiration of the primary term. The shut-in royalty payment was not made until shortly after the expiration date of the primary term. The court concluded that the lease expired at the end of the primary term because there was no production from the leased premises at that time. In other words, the constructive production allowed by the payment of the shut-in royalty will not arise until actual payment is tendered. If there is

¹⁰¹ *Continental Oil Co. v. Boston-Texas Land Trust*, 221 F.2d 124 (5th Cir. 1955). This result could be altered by a deletion of the first phrase in this clause, i.e., "If prior to discovery. . ."

¹⁰² 202 F.2d 442 (10th Cir. 1953).

¹⁰³ See *Vernon v. Union Oil Co.*, 270 F.2d 441 (5th Cir. 1959), which construes the word "gas only" that is used in some shut-in clauses.

¹⁰⁴ *Masterson*, supra note 2; Walker, *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).

¹⁰⁵ 141 Tex. 278, 171 S.W.2d 339 (1943).

no other lease provision to allow the lessee to continue the lease, the payment must be made during the primary term as the rule contemplates that the payment must be tendered while the lease is in effect.

If the gas well is commenced just prior to the end of the primary term and completed after the primary term with no available market, to what extent will the dry hole clause determine the time allowed in which the lessee may tender the shut-in payment? In *Shell Oil Co. v. Goodroe*¹⁰⁶ the lessee completed an oil well in 1938, during the primary term of the lease, which produced oil for a time in paying quantities. However, because of conservation, it was later shut down and recompleted as a gas well which produced gas in paying quantities beyond the primary term. On July 25, 1944, the well was shut in because of a decline in pressure, and on October 16, 1944, some eighty-two days later, the lessee tendered and the lessor accepted a shut-in royalty payment which purported to cover the period from July 25, 1944, to July 25, 1945. The lease contained a *continuous drilling* clause as discussed above but stated that if "production shall for any reason cease or terminate, lessee shall have the right at any time within 90 days from the cessation of such production to resume drilling or mining operations in an effort to make said leased premises again produce. . . ." The lessee did not resume drilling or mining operations within the prescribed 90 day period. The court held that as the shut-in payment was made within the 90 day period allowed by the *continuous* clause of the lease, the lease was therefore still in effect. It was also stated that the acceptance of the shut-in payment by the lessors estopped them from contesting the effectiveness of the payment.

In the very recent case of *Reid v. Gulf Oil Corp.*,¹⁰⁷ the problem presented in *Shell Oil Co. v. Goodroe*¹⁰⁸ was further developed. The lessee commenced a well on November 29, 1948. The primary term ended December 9, 1948, and drilling continued until December 23, 1948. By January 15, 1949, testing was completed and the well was shut in as one capable of producing gas in paying quantities. On January 18, 1949, the well's bottom hole pressure was tested. On February 15, 1949, the lessee tendered a shut-in royalty payment covering one year from January 15, 1949, but the lessor refused to accept it and asserted that the lease terminated on the date the well was shut in. The lease contained a *continuous* clause similar to those

¹⁰⁶ 197 S.W.2d 395 (Tex. Civ. App. 1946) error ref. n.r.e.

¹⁰⁷ 323 S.W.2d 107 (Tex. Civ. App. 1959), aff'd, ___Tex. ___, 337 S.W.2d 267 (1960).

¹⁰⁸ 197 S.W.2d 395 (Tex. Civ. App. 1946) error ref. n.r.e.

discussed above but the *commence* clause was worded somewhat differently. It stated:

If at the expiration of the primary term . . . Lessee is then engaged in operations for drilling or reworking operations . . . this lease shall not terminate if Lessee does not allow more than sixty (60) days to elapse between the *abandonment* of one well and the commencement of drilling or reworking operations on another until production is obtained. (Emphasis added.)

Since there was no production from the leased premises at the expiration of the primary term, the lease would automatically terminate according to the habendum clause.¹⁰⁹ In order to extend the lease the lessee necessarily had to assert the effectiveness of some savings clause of the lease, in this instance the payment of shut-in royalty. No dispute existed, however, as to the actual payment of the shut-in royalty. Thus, the basic issue was whether the shut-in payment was timely.

The fundamental premise of the decision is that the shut-in payment must be made at a time when the lease is in effect. This premise emanates from *Freeman v. Magnolia Petroleum Co.*,¹¹⁰ the rationale being that the constructive production created by the clause begins only from the time the payment is actually tendered.

Relying on this concept, the court of civil appeals repudiated the lessee's contention that he should be allowed a reasonable time in which to make the shut-in payment.¹¹¹ The court then scrutinized the dry hole clause of the lease for some basis on which to extend the lease to the time of the shut-in payment. It was concluded that the *continuous* clause was inapplicable since production did not cease if production never *began* in paying quantities. The only other alternative was the *commence* clause. Although this clause would extend the lease beyond the primary term by the continuance of drilling operations commenced during the primary term, because of its particular wording, *i.e.*, *abandonment*, it was not definitive of the period allowed for cessation of operations. As the clause clearly did not define the period for prosecution of these drilling operations, the court said that the period would be determined by common-law standards of due diligence. It was stated that the installation of marketing facilities, which remained to be done at the time the well was shut in, was classifiable as a "drilling" operation.¹¹² Concluding that

¹⁰⁹ *Stanolind Oil & Gas Co. v. Barnhill*, 107 S.W.2d 746 (Tex. Civ. App. 1937) error ref.

¹¹⁰ 141 Tex. 274, 171 S.W.2d 339 (1943).

¹¹¹ *Reid v. Gulf Oil Corp.*, 323 S.W.2d 107 (Tex. Civ. App. 1959).

¹¹² See discussion pp. 380-81 *supra*.

the lessee still had some "drilling" remaining to be done when the well was shut in, the court remanded to determine what period should be allowed the lessee to conduct this further activity. If the trial court should conclude that the proper period was at least thirty-days, then the shut-in royalty payment would have been tendered while the lease was in effect and the lease would have been continued. It should be noted that the case was remanded to determine a *period of time*, not whether further *activities* were in fact conducted.

The Supreme Court of Texas agreed with the court of civil appeals that the lessee does not have a reasonable time for making a shut-in royalty payment when a gas well is completed and shut in beyond the primary term.¹¹³ The court also affirmed the lower court's holding that there could be no cessation of production if production never began in paying quantities. The court did disagree, however, as to the definition of "drilling operations." It stated that as a matter of law negotiations with third parties to lay and install a pipeline did not constitute "drilling operations," since the term "operations" contemplates physical or manual activity by the lessee. Since nothing remained for the lessee to do in the way of drilling operations, the shut-in payment was not tendered at a time while the lease was in effect and therefore the lease had terminated.

These cases evolve the interesting question of whether the usual sixty-day period of the *continuous*¹¹⁴ and *commence* clauses operate to extend the lease automatically for this limited period of time regardless of whether there is a resumption of the required activity before the end of this period, or whether the lease terminates upon the cessation of production or drilling activity only to be revived by later conduct required by the lease within this period. The answer to this question remains speculative.

Both cases assume that the lease continues to the end of the stated sixty-day period and, therefore, any activity which would extend the lease, *e.g.*, payment of shut-in royalty, may be made during this period and the lease will be continued regardless of the resumption of the required activity. In both cases emphasis was placed on whether the shut-in royalty was tendered during the proper *time period* and *not* upon the future resumption of drilling or reworking activity. Because of the element of estoppel, the strength of *Shell Oil Co. v. Goodroe*¹¹⁵ on this point is abated. *Gulf Oil Corp. v.*

¹¹³ *Gulf Oil Corp. v. Reid*, ___Tex.___, 337 S.W.2d 267 (1960).

¹¹⁴ Normally, the *continuous* clause will have no application as it usually refers to "dry holes" or "cessation" of production.

¹¹⁵ 197 S.W.2d 395 (Tex. Civ. App. 1946) error ref. n.r.e.

*Reid*¹¹⁶ cannot be considered as authority for the proposition that the lease extends automatically for the usual sixty-day period. It is significant, however, that the court does not repudiate this theory but merely finds it inapplicable under the special terms of this particular lease. It is believed the holding is of limited application, *i.e.*, its result may be circumvented by (1) using a lease form which does not limit the period allowed for cessation of operations to situations where the first well must be *abandoned*, (2) if the lease form does use the language of *abandonment* then the lessee should tender his shut-in payment while he is still conducting *physical activity* which might be classifiable as drilling operations, and (3) redrafting the shut-in clause using express language that payment may be made within a definite period after the well is shut in.

The holding that there is no reasonable time in which to make a shut-in payment once the lease has expired is justified on the basis of *Freeman v. Magnolia Petroleum Co.*¹¹⁷ Nevertheless, this result could lead to very technical and inequitable results. Should the lease be of the form used in *Gulf Oil Corp. v. Reid*¹¹⁸ and should it later be ruled by the supreme court that the lessee has no right or privilege to make a shut-in payment until the well is in fact shut in, then a logical conclusion would require that the lease could not be continued by a shut-in payment since the right to pay the shut-in payment did not arise until the well was shut in and once the well was shut in the lease expired. Since the payment could not theoretically be made at the precise moment of shutting in the well, the payment would be too late.

This issue of these cases, *i.e.*, may shut-in royalty payments be made during the extended sixty-day period of the *commence-continuous* clauses and the lease be continued without further drilling or reworking activity, and the larger problem of whether the lease extends automatically for this sixty-day period in all situations, has not been unequivocally settled. The cases do indicate that the lease is continued in effect for the full length of the period (usually sixty days) allowed for cessation of activities. It has been assumed in some cases that the extension of the lease for this stated period was automatic¹¹⁹ and it is believed this theory will prevail. The liberal interpretation approach of *Stanolind Oil & Gas Co. v. Newman Bros.*

¹¹⁶ ___Tex.___, 337 S.W.2d 267 (1960).

¹¹⁷ 141 Tex. 274, 171 S.W.2d 339 (1943).

¹¹⁸ ___Tex.___, 337 S.W.2d 267 (1960).

¹¹⁹ *McQueen v. Sun Oil Co.*, 213 F.2d 889 (6th Cir. 1954); *Woodson Oil Co. v. Pruett*, 281 S.W.2d 159 (Tex. Civ. App. 1955) error ref. n.r.e.

*Drilling Co.*¹²⁰ may be applied to buttress this position. There the court, when faced with a situation demanding termination of the lease under the *commence* clause, found that the *continuous* clause could be read into the *commence* clause. Thus, a court may also be able to go outside the shut-in clause and interpret some other clause as an aid to extending the lease, *e.g.*, the dry hole clause.

By a complete adoption of this theory a lessee would be enabled during this extended period to conduct such activity, other than additional drilling or reworking, as would continue the lease, *e.g.*, payment of shut-in royalty or perhaps pooling or unitization. Commitment to this theory would also mean that the lessee would have the benefit of this sixty-day period in applying the paying quantities test, *i.e.*, if a lessor should assert that over a period chosen by him the accounting record revealed a net loss to the lessee, as in *Clifton v. Koontz*,¹²¹ then the period would automatically be shortened by this sixty-day period without additional activity.

III. CONCLUSION

The ultimate standard for determining the rights and obligations flowing from the oil and gas lease transaction obviously is the oil and gas lease instrument. Since each clause of the lease is dependent upon and often substantially modified by the other clauses of the lease, an accurate interpretation of the lease relationship demands that each clause be considered in context and that the interrelationship of the clauses be carefully considered. Regrettably, one must recognize that many people who enter into oil and gas leases fail to appreciate the single significance of this basic instrument, choosing rather to submit abjectly to the use of standard forms which often fall short of the actual expectations and intentions of the parties. When one recognizes the many contingencies which may arise and drafts the lease instrument accordingly, then the unnecessary problems and expensive litigation exemplified in this Comment will be avoided.

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¹²⁰ 157 Tex. 489, 305 S.W.2d 169 (1957).

¹²¹ —Tex.—, 325 S.W.2d 684 (1959).