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Contractual Time Gap Clauses in Oil and Gas Leases in Texas

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NOTES

Contractual Time Gap Clauses in Oil and Gas Leases in Texas

Lessee of a pooled tract of land extended an oil and gas lease past the primary term by drilling operations in compliance with a commence-continuous drilling clause. These operations were continued until gas, in paying quantities, was discovered and the well completed. No shut-in royalty was paid, but forty-one days later actual production in paying quantities commenced and continued. The commence-continuous drilling clause permitted the lease to remain in effect past the expiration of the primary term, if at such time Lessee was then engaged in drilling or reworking operations, even though no production had resulted. It further provided that the lease would continue as long as operations did not cease for more than sixty consecutive days, and that if such operations resulted in production of oil, gas, or other mineral, then as long as that production lasted. Lessors contended that the sixty-day clause had no application after Lessee had completed a well capable of production in paying quantities but rather, that it was a saving clause which held the lease open during intervals between temporary cessation and resumption of drilling or reworking operations. *Held*: A consolidated commence-continuous drilling clause which continues an oil and gas lease in force after the end of the primary term provided no more than sixty days elapse before resumption of drilling or reworking operations[1] is effective to establish a sixty-day contractual period after completion within which to commence production in paying quantities. *Skelly Oil Co. v. Harris*, — Tex. —, 352 S.W.2d 950 (1962).[2]

I. General Background

A gas well presents a peculiar problem for a lessee in continuing his lease during the time span between completion of a well and its production. Because it is a light vapor, gas cannot be economically stored at the well, and, consequently, it must remain in the strata

[1] The fact that the lease in *Harris* related cessation to "operations" distinguishes it from the clause used in Gulf Oil Corp. v. Reid, 161 Tex. 88, 337 S.W.2d 267 (1960), where cessation was connected with "abandonment." See note 4 *infra*.

[2] Lessors further contended that since drilling and production were not on the originally leased acreage, but merely within a pooled area, the two provisions in the commence-continuous clause had no effect. In rejecting this argument, the court held, in view of the pooling language of the lease, that the entire acreage pooled into a unit should be treated for all purposes as if it were included in the lease.

until it can be delivered into a pipeline—a process that often takes several months.[3]

The Texas courts have treated the lessee harshly in dealing with this time interval. Upon completion of a well, no reasonable time for marketing is implied,[4] thereby creating a serious problem for the lessee in maintaining his lease. A well completed during the primary term presents a question the Texas courts have never directly answered, *viz.*, whether the lease expires upon capping or at the end of the primary term.[5] However if the habendum clause[6] extends the

[3] Noel, *Shut-In Gas Well Payments*, Sw. Leg. Found. 12th Inst. on Oil & Gas L. & Tax. 171, 175-76 (1961).

[4] Gulf Oil Corp. v. Reid, 161 Tex. 88, 337 S.W.2d 267 (1960); Freeman v. Magnolia Petroleum Co., 141 Tex. 278, 171 S.W.2d 339 (1943); Shell Oil Co. v. Goodroe, 197 S.W.2d 395 (Tex. Civ. App. 1946) *error ref. n.r.e.;* Stanolind Oil & Gas Co. v. Barnhill, 107 S.W.2d 746 (Tex. Civ. App. 1937) *error ref.* The *Reid* case set forth basic Texas law: under a lease containing ordinary habendum and shut-in royalty clauses, when the initial well is properly completed as a producer after the end of the primary term, but when no immediate production results and a time gap ensues before shut-in royalty is tendered, a fatal time gap occurs in the post-primary term aspect of the habendum clause.

[5] No decision has directly determined this point. A proper analysis of the question requires that a distinction be drawn between the two types of shut-in royalty clauses, *i.e.*, the "*may* pay" and the "*must* pay" provisions. Since the latter constitutes an obligation to pay upon capping, it creates a royalty on each non-producing gas well. During the primary term, therefore, failure to pay does not terminate the lease, since non-payment of royalties only effects a debt obligation. The lease is not forfeited unless expressly so stated. See, *e.g.*, Freeman v. Magnolia Petroleum Co., *supra* note 4, in which the supreme court suggested that the lease in question was preserved during the entire primary term without payment of a shut-in royalty (obligatory type), but held that the lease was terminated at the end of the primary term, since no shut-in royalty was tendered. However, the value of the case as precedent is limited because the lease was held in force until the end of the primary term by a clause which provided that the obligation to pay delay rentals was excused if operations ceased during the final year of the primary term.

The more common "*may* pay" shut-in royalty clause poses more difficulty. It is not an ordinary royalty since the lessee is under no obligation; rather, he has a privilege in lieu of production as required by the habendum clause. See Walker, *Clauses in Oil and Gas Lease Providing for the Payment of an Annual Sum as Royalty on a Nonproducing Gas Well*, 24 Texas L. Rev. 478 (1946), where the writer states:

> Since the habendum clause does not require production until the expiration of the primary term it can be urged that the Lessee is not required to make any royalty payments under this clause upon nonproducing wells during the primary term, and that it is only necessary that he make the initial royalty payment immediately prior to the expiration of that term in order to hold the lease thereafter. On the other hand, it is possible that the courts may adopt the construction that the Lessee cannot take advantage of this clause upon the expiration of the primary term unless he has elected to comply with this clause from the time the nonproducing gas well is first completed, and has faithfully made all annual payments thereafter throughout the balance of the primary term. In view of the uncertainty as to how this clause will be interpreted the cautious Lessee should commence making payments annually in advance as soon as the well is capped for want of market if he desires to be certain that he will be able to take advantage of this clause upon the expiration of the primary term. *Id.* at 481.

A shut-in royalty does not modify the special limitation implied in Texas, which prohibits holding for speculative purposes. Amerada Petroleum Corp. v. Doering, 93 F.2d 540 (5th Cir. 1937). Therefore, regardless of whether the lease is extended to the full extent of the primary term, it can be, though rarely is, cancelled earlier if the lessor can demonstrate that the lessee has violated the implied special limitation to explore, develop, and lease past the primary term into its secondary period, it is well settled that the lease shall terminate upon cessation of production in paying quantities.[7] Consequently, the lessee in such a situation is forced to resort to one of the two methods for preserving his lease: (1) he can pay a shut-in royalty,[8] if the lease so provides, prior to the shutting-in, and the life of the lease will be extended for a fixed period of time (typically one year);[9] (2) the lessee and the lessor

produce. See, *e.g.*, Waggoner Estate v. Sigler Oil Co., 118 Tex. 509, 19 S.W.2d 27 (1929); Texas Co. v. Davis, 113 Tex. 321, 255 S.W. 601 (1923); Gay v. Grinnan, 218 S.W.2d 1021 (Tex. Civ. App. 1949) *error ref. n.r.e.*

[6] The habendum clause is the basic clause which determines the time period of the lease. It "consists of two parts, the primary term . . . which is for a definite time . . . and the secondary term . . . which is of indefinite duration." Sullivan, Oil and Gas Law 96 (1956). An example of a typical habendum clause is: "It is agreed that this lease shall remain in force for a term of ______ years from this date, said term being hereinafter called "Primary Term" and as long thereafter as oil and gas or either of them is produced from said land by Lessee." *Id.* at 95.

[7] Gulf Oil Corp. v. Reid, 161 Tex. 88, 337 S.W.2d 267 (1960); Freeman v. Magnolia Petroleum Co., 141 Tex. 278, 171 S.W.2d 339 (1943); Watson v. Rochmill, 137 Tex. 565, 155 S.W.2d 783 (1941); Woodson Oil Co. v. Pruett, 281 S.W.2d 159 (Tex. Civ. App. 1955) *error ref. n.r.e.* See also 3 Williams, Oil and Gas Law 41-42 (1962), in which the author states: "Logically, cessation of production in the secondary term had the identical effect under the habendum clause as lack of production at the end of the primary term." *But see* Clifton v. Koontz, 160 Tex. 82, 325 S.W.2d 684 (1959), discussed in text accompanying note 28 *infra*, for a recent construction of "production in paying quantities."

[8] In Williams, Maxwell, & Myers, Cases on Oil and Gas 249 (1956), an example of such a clause is given: "The royalties to be paid by Lessee are: . . . a royalty of $________ 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 . . . ." In a footnote, the authors state:

> Payment or tender of the shut-in gas well royalty will not keep a lease alive unless the well which was shut-in is capable of production of gas in commercial quantities. Ketchum v. Chartiers Oil Co., 121 W. Va. 503, 5 S.E.2d 414 (1939); United States v. Brown, 15 S.E.2d 565 (N.D. Okla. 1926). The shut-in gas well royalty clause does not modify the implied covenant to use reasonable diligence in marketing the gas [Risinger v. Arkansas-Louisiana Gas Co., 189 La. 101, 3 So.2d 289 (1941)] and to develop the premises with reasonable diligence [Amerada Petroleum Corp. v. Doering, 93 F.2d 540 (5th Cir. 1937)]. *Id.* at 252 n.35.

[9] The major obstacle to the use of this method is timely tender. "One of the most critical problems presented by recent cases is in calculation of the exact time when shut-in gas well payments must be made to achieve their desired effect. The particular lease provisions are of primary importance." Noel, *supra* note 3, at 197. As a general proposition, for a shut-in royalty to be effective it must be tendered while the lease is in effect. Otherwise, a time gap results which is fatal to the lessee. See, *e.g.*, Freeman v. Magnolia Petroleum Co., 141 Tex. 278, 171 S.W.2d 339 (1943).

Special consideration should be given the case where a well is completed during the primary term. If the lease is allowed to extend past completion until the end of the primary term (or some other fixed period) the shut-in royalty may be withheld until immediately prior to the term's expiration. In such a situation, the two types of shut-in royalties become of primary interest. Under the *must* pay shut-in clause, it appears that the payment reverts back to the time of capping regardless of when actual payment was made, as long as made prior to termination of the primary term. However, there is a sound argument that the *may* pay clause establishes the anniversary date at the moment of payment, although the cautious lessee should tender the shut-in royalty as soon as the well is capped. If, however, the courts should refuse to extend the lease past completion during the primary term, the general rule applies, and the shut-in royalty must be tendered prior to capping.

can expressly agree in the lease to extend it past completion for a given period,[10] during which time the lease may be extended by the commencement of either actual or constructive production.[11] However, until the instant case, the Texas Supreme Court, in *Gulf Oil Corp. v. Reid,* had cast doubt upon the effectiveness of a contractual time gap clause.[12]

A majority of the jurisdictions[13] facing the problem have approached it differently than Texas. The Kansas Supreme Court in *Tate v. Stanolind Oil & Gas Co.*[14] held that a "commence" clause[15] implies a reasonable time within which to find a market and thus permits a valid completion after the end of the primary term.[16] However, the court refused to recognize a reasonable extension period grounded solely upon the habendum clause and, like Texas,[17] held that under the habendum clause alone, actual production in paying quantities at the expiration of the primary term was necessary to prevent termination. A third approach is exemplified by the rule

[10] See text accompanying note 30 *infra* for an example of a contractual time gap clause.

[11] The usual construction given the shut-in gas royalty clause equates the payment of a shut-in royalty with actual production (constructive production), at least for the period of time during which the shut-in clause operates. Therefore, for purposes of preservation of the lease, identical treatment is given to both actual and constructive production.

[12] See notes 24-27 *infra* and accompanying text.

[13] Bristol v. Colorado Oil & Gas Corp., 255 F.2d 894 (10th Cir. 1955) (Colo. law); Christianson v. Champlin Ref. Co., 169 F.2d 207 (10th Cir. 1948) (Kan. law); Tate v. Stanolind Oil & Gas Co., 172 Kan. 351, 240 P.2d 465 (1952); Carroll Oil & Gas Co. v. Skaggs, 231 Ky. 284, 21 S.W.2d 445 (1929); Fey v. A. A. Oil Corp., 129 Mont. 300, 285 P.2d 578 (1955); McVicker v. Horn, 322 P.2d 410 (Okla. 1958); Union Oil Co. v. Ogden, 278 S.W.2d 246 (Tex. Civ. App. 1955) *error ref. n.r.e.;* McGraw Oil & Gas Co. v. Kennedy, 65 W. Va. 595, 64 S.E. 1027 (1909).

[14] 172 Kan. 351, 240 P.2d 465 (1952).

[15] The clause in the *Tate* case read as follows:

> If the Lessee shall commence to drill a well within the term of this lease or any extension thereof, the Lessee shall have the right to drill such well to completion with reasonable diligence and dispatch, and if oil or gas, or either of them, be found in paying quantities, this lease shall continue and be in force with the like effect as if the well had been completed within the term of years herein first mentioned. *Id.* at 469.

Such a clause is known as "commence drilling" or "operating" clause; it serves to continue the lease after the expiration of the primary term only as to the particular wells which were commenced within that term. This type of clause should be distinguished from the "continuous drilling" clause which allows the lease to continue in effect when a dry hole has been completed subsequent to the primary term and drilling or reworking operations are resumed on another well within the cessation period. Sullivan, *op. cit. supra* note 6, at 102-03; 3 Williams, *op. cit. supra* note 7, at 296-97.

[16] Noel, *supra* note 3, at 205-06, quoting from *Tate,* 240 P.2d at 469:

> Obviously if on completion of drilling operations oil or gas is found in paying quantities, the lessee, under this clause, is not expressly required to produce or market the oil or gas immediately. And, of course, that might be wholly impossible. He would, however, be required to do so within a reasonable time.

[17] Garcia v. King, 139 Tex. 578, 164 S.W.2d 509 (1942); Stanolind Oil & Gas Co. v. Barnhill, 107 S.W.2d 746 (Tex. Civ. App. 1937) *error ref.* See also 2 Summers, Oil and Gas §§ 299-300 (2d ed. 1954).

in West Virginia,[18] where the habendum clause is construed so that the mere discovery (as opposed to production) of gas in paying quantities without more implies a reasonable time in which to market.[19]

II. GULF OIL CORP. v. REID—TEXAS PRECEDENT

Consideration of *Gulf Oil Corp. v. Reid*[20] is a prerequisite to a full appreciation of Texas' unique position in the time gap area. In that case, a well was commenced on November 29, 1948; the primary term expired on December 9, 1948; the well was completed on January 18, 1949; and a shut-in royalty was tendered on February 15, 1949. In addition to the habendum clause, the lease contained three special limitation clauses which affected its duration: (1) a continuous (dry-hole) clause which allowed a sixty-day cessation period if production ceased;[21] (2) a commence-continuous clause which provided for a like period between the abandonment of the well and the commencement of drilling or reworking operations on another;[22] and (3) a shut-in royalty clause which permitted a payment of fifty dollars per year per well in lieu of actual production, if tender of the royalty was made while the lease was in existence.[23]

[18] Bristol v. Colorado Oil & Gas Corp., 255 F.2d 894 (10th Cir. 1955) (Colo. law); Christianson v. Champlin Ref. Co., 169 F.2d 207 (10th Cir. 1948) (Kan. law); Fey v. A. A. Oil Corp., 129 Mont. 300, 285 P.2d 578 (1955); State v. Carter Oil Co., 336 P.2d 1086 (Okla. 1959); McVicker v. Horn, 322 P.2d 410 (Okla. 1958); McCutcheon v. Enon Oil & Gas Co., 102 W. Va. 345, 135 S.E. 238 (1926); 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). See also 2 Summers, *op. cit. supra* note 17, at § 300; 3 Williams, *op. cit. supra* note 7, at § 604.1.

[19] *But see* Simons v. McDaniel, 154 Okla. 168, 7 P.2d 419 (1932), 10 Texas L. Rev. 518 (1932). Lessee had commenced drilling operations during the primary term but at the expiration of same had failed to discover oil, gas, or other minerals. The Oklahoma court, under the sole auspices of the habendum clause, granted any lessee who commenced a well during the primary term the right to complete it as long as he continued to operate diligently.

[20] 161 Tex. 88, 337 S.W.2d 267 (1960).

[21] If cessation of production occurs at any time after the expiration, then this lease shall not terminate if Lessee, until production is again procured, does not allow more than sixty (60) days to elapse between the cessation of production and the commencement of additional drilling or reworking operations in a bona fide effort to again obtain production, and successive attempts may be made so long as not more than sixty (60) days are allowed to elapse between completion or abandonment of operations on another until production is again obtained. *Id.* at 269 n.1.

[22] If, at the expiration of the primary term, oil, gas or other mineral is not being produced from the land then covered hereby, but Lessee is then engaged in operations for drilling or reworking operations on some part of the land hereunder, 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. *Ibid.*

[23] "Where gas from a well producing gas only is not sold or used, Lessee may pay as royalty Fifty Dollars ($50) per well per year, and upon such payment it will be considered

The Texas Supreme Court held that the tender of the shut-in royalty was ineffective because the lease had terminated prior to the time of tender. The continuous clause was precluded from operating, since there had never been production. In light of the fact that the well was capped, and obviously not abandoned, the commence-continuous clause was also denied application. The court,[24] however, was not clear as to whether it overruled or distinguished *Shell Oil Co. v. Goodroe,*[25] in which payment of a shut-in royalty eighty-one days after capping was held to be valid. The lease in the latter case contained a clause which permitted the resumption of operations within ninety days after cessation of production. From the vague treatment of the *Goodroe* case, question arose as to the permissibility of a contractual time gap clause in Texas.[26] However, it is important to note that in the *Reid* case the court did not reject the line of reasoning employed in the earlier decision of *Stanolind Oil & Gas Co. v. Newman Bros.*[27] In that case, the Texas Supreme Court had recognized that a habendum clause must yield to any and all modifying provisions which affected the duration of the lease.

The underlying reasoning of the *Reid* case appears inconsistent with the approach taken in *Clifton v. Koontz,*[28] which was decided by the same court a few months earlier. Although refusing to imply a reasonable time after completion of the well in *Reid,* the court in

that gas is being produced within the meaning of Paragraph 2 [habendum clause] hereof." *Ibid.*

[24] Justice Culver, writing for the majority, said:

> Actually the only case Gulf relies on as supporting its position is that of Shell Oil Co. v. Goodroe, Tex. Civ. App., 197 S.W.2d 395 (wr. ref. n.r.e.). There the tender of "shut-in" royalty was not made before Shell had capped and shut-in the gas well. The case is distinguished, however, on several grounds. In the first place gas and condensate had been marketed from the well and the "shut-in" royalty payment was tendered within the 90-day period after production had ceased in compliance with the terms of the lease. In the second place, the royalty payment was not only tendered, but was accepted by the Lessors and therefore the decision, we think, has little bearing on the problem presented here. *Id.* at 271.

[25] 197 S.W.2d 395 (Tex. Civ. App. 1946) *error ref. n.r.e.* This case involved a well on a lease which produced gas during the primary term and for years thereafter until the well was shut-in for lack of market. The lessee subsequently paid a shut-in royalty in accordance with a continuous drilling clause in the lease. The court held that this payment continued the lease in force. The case for the lessee was strengthened, however, by the fact that the lessor accepted the payment and thereby estopped himself from asserting termination of the lease.

[26] See Discussion Notes, 15 Oil & Gas Rep. 659 (1961). *Contra,* 3 Williams, *op. cit. supra* note 7, at 290.

[27] 157 Tex. 489, 305 S.W.2d 169 (1957).

[28] 160 Tex. 82, 325 S.W.2d 684 (1959). The Supreme Court of Texas held that production in paying quantities is a question of fact to be determined by application of a reasonable and prudent operator standard. This case overruled Garcia v. King, 139 Tex. 578, 164 S.W.2d 509 (1942), in which the court held that production was in paying quantities if enough oil or gas was produced to cover operating and marketing expenses and to provide small profit to the lessee.

Koontz, through application of a "reasonable, prudent operator" test, avoided the necessity of requiring uninterrupted production in paying quantities as a requisite for continued duration of the lease under the habendum clause.

III. THE HARRIS CASE AND ITS EFFECTS

Although no shut-in royalty was paid in the principal case, the court held that actual production forty-one days after completion of the well was sufficient to preserve the lease. The commence-continuous drilling clause[29] was held to allow a sixty-day interval for both temporary and final cessation of well operations. This, in essence, meant that the clause had three applications: (1) when the cessation was a temporary discontinuance of operations, necessitated by repairs, tests, *et cetera,* sixty days were permitted within which to resume operations; (2) when the termination was final and the well was a dry hole, the clause permitted sixty days within which to commence additional drilling and reworking operations; (3) most important, when the final discontinuance was the result of a completed and capped well, then sixty days would be allowed within which to produce, either actually or constructively. If the lease in the *Harris* case is considered from the standpoint of the interested parties and the draftsmen, it is unlikely that more than the first two applications were intended. Nevertheless, the holding should remove any doubts concerning the validity of a contractual time gap clause in Texas.

The principal case apparently has a two-fold effect on Texas law. (1) It removes the doubt cast by the *Reid* decision upon the effectiveness of a contractual time gap after completion of a well. In the future, every carefully drawn oil and gas lease should contain a clause which, in substance, provides: "In the event of completion of a well, either during or subsequent to the primary term, the lessee shall have — days in which to produce or to pay a shut-in royalty."[30] No longer need a lessee face the uncertainty of clauses similar to those used in both the *Harris* and the *Reid* cases. (2) By allowing

[29] 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 mineral, so long thereafter as oil, gas or other mineral is produced from said lands or acreage pooled therewith. 352 S.W.2d at 951 n.1.

[30] See 3 Williams, *op. cit. supra* note 7, at §§ 630(17), 633.3; Discussion Notes, 15 Oil & Gas Rep. 659 (1961).