

Chapter 23
KEEPING YOUR LEASE ALIVE IN GOOD TIMES
AND IN BAD

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§ 23.01 Introduction *

The oil and gas lease is the central document in oil and gas development. By issuing a lease, the mineral owner transfers the right to explore for and develop its minerals to the lessee. Both parties expect to make a profit from the transaction, but their means for achieving this end may be different. The lessor wishes to maximize the upfront bonus and royalty to be paid, minimize the length of the primary term, and require diligent development of the leasehold once production has been obtained. The lessee, on the other hand, seeks the right to develop for the agreed upon term, without the *obligation* to develop during such term, and, once production is obtained, to maintain the lease for so long as it can do so at a profit, without interference from the lessor. This chapter will focus on these conflicting goals.

A great deal has been written about lease maintenance issues during the last twenty years,¹ primarily during periods of industry downturns. This may be coincidental, or it may be a reflection that maintaining lease inventory is particularly difficult in periods of weak market conditions when financial challenges prevent lessors from drilling and developing their leases to the extent desired (or required). At the time this chapter was written, the industry was experiencing another downturn, with uneconomic wells shut in, drilling in certain areas all but stopped, and royalty payments greatly diminished—all precursors to lease challenges down the road. But it should also be noted that lease maintenance issues are not unique to industry depressions, as evidenced by the widespread top leasing activities and lease busting attempts that characterized the last boom, and it is likely that the short primary terms of many of the leases currently being issued will require prompt drilling activity to hold onto such leases, whether under boom or bust conditions.²

* Cite as Kendor P. Jones & Jennifer L. McDowell, “Keeping Your Lease Alive in Good Times and in Bad,” 55 *Rocky Mt. Min. L. Inst.* 23-1 (2009).

¹Gregory R. Danielson, “Lease Maintenance and the Development of Coalbed Methane,” 46 *Rocky Mt. Min. L. Inst.* 8-1 (2000); Bruce M. Kramer, “Lease Maintenance for the Twenty-First Century: Old Oil and Gas Law Doesn’t Die, It Just Fades Away,” 41 *Rocky Mt. Min. L. Inst.* 15-1 (1995); Thomas P. Battle, “Lease Maintenance in the Face of Curtailed/Depressed Markets,” 32 *Rocky Mt. Min. L. Inst.* 14-1 (1986); William P. Pearce, “Keeping Oil and Gas Leases Alive: A Review of Both the Mineral Lessee’s Obligations and Possible Ways to Keep Leases in Effect,” *Problems and Opportunities During Hard Times in the Minerals Industry* 8-1 (Rocky Mt. Min. L. Fdn. 1986).

²See Joshua Starnes, “To Retain Leases, Shale Operators Keep on Drilling,” *Platts Gas Daily*, June 25, 2009.

Early leases were typically for a fixed term of up to 20 years, sometimes with an option to renew for a second fixed term.³ In the early 1900s, the modern day habendum clause developed with a relatively short primary term followed by an indefinite secondary term that required the lessee to perform certain activities during both the primary and secondary terms to keep the lease alive.⁴ The habendum clause means what it says, i.e., without production in paying quantities (or the commencement of operations to obtain production) at the end of the primary term, the lease terminates.⁵

All jurisdictions, except Oklahoma and Louisiana, treat the habendum clause as creating a fee simple determinable that terminates automatically upon the failure of one or more of the conditions on which it is based.⁶ Equitable remedies, such as waiver and estoppel, are generally not available to avoid termination.⁷

To ameliorate the harshness of the automatic termination rule, lessees have drafted oil and gas leases that include savings clauses, which serve as substitutes for actual production and are designed to keep the lease alive absent production during the primary term (delay rental clause), preserve the lease into the secondary term (commencement of operations, pooling, and force majeure clauses), and maintain the lease during the secondary term if production is not obtained from the initial well or ceases thereafter or if the product is not immediately marketed (dry hole, cessation of production, and shut-in royalty clauses). Certain savings clauses can be utilized during both the primary and secondary terms (e.g., dry hole, cessation of production and shut-in royalty clauses) to preserve the lease. The fail-safe clause is one that requires a notice of default and a reasonable period of time to cure the default before the lease is terminated.

³The lease under which America's first well was drilled, the Drake well in 1859, provided for a "term of 15 years, with the privilege of renewal for the same term." See Leslie Moses, "The Evolution and Development of the Oil and Gas Lease," 2 Sw. Legal Fdn. Oil & Gas Institute 1, 7 (1951).

⁴Martin & Kramer, 3 Williams & Meyers Oil and Gas Law §§ 601-601.5 (2008) (Williams and Meyers).

⁵Gulf Oil Corp. v. Reid, 337 S.W.2d 267, 269 (Tex. 1960); Woodside v. Lee, 81 N.W.2d 745, 746 (N.D. 1957).

⁶See, e.g., Texas Co. v. Davis, 254 S.W. 304, 309 (Tex. 1923). Oklahoma has rejected the fee simple determinable interpretation of the habendum clause. See Stewart v. Amerada Hess Corp., 604 P.2d 854, 858 (Okla. 1979).

⁷See Duke v. Sun Oil Co., 320 F.2d 853, 865, n.19 (5th Cir. 1963) and Phillips Petroleum Co. v. Curtis, 182 F.2d 122 (10th Cir. 1950). But see Jicarilla Apache Tribe v. Andrus, 687 F.2d 1324 (10th Cir. 1982) and Humble Oil & Refining Co. v. Harrison, 205 S.W.2d 355 (Tex. 1947).

Even if production has been obtained, either from a well on the leased premises or on lands pooled therewith, and the lease has been extended beyond the primary term, the lessee cannot relax since almost all jurisdictions hold that there is an implied covenant of further development that requires the lessee to act with reasonable diligence in developing the lease, as would a prudent operator under similar circumstances, in order to keep the lease alive as to the undeveloped leasehold.⁸ Court-imposed remedies for breach of this implied covenant to develop vary, from an award of damages to conditional or immediate cancellation of the lease as to the undeveloped portion of the lands.

Sections 23.02 to 23.04 of this chapter analyze the various types of savings clauses that can be used during the life of the lease and discuss court decisions that have interpreted such clauses and have expanded or narrowed their scope, while section 23.05 addresses the implied covenant to develop the leasehold once production has been obtained and reviews current industry practices for unconventional gas plays that may alter the way the courts view this implied covenant.

§ 23.02 Preserving the Lease During the Primary Term

[1] Delay Rentals

Many modern oil and gas leases are “paid up” leases, which means that the mineral owner is given an up-front payment, equivalent to the rentals payable for the entire primary term, instead of receiving yearly rental payments throughout the primary term. If the lease is not paid up, then the lessee must pay the mineral owner annual rental payments in compliance with the lease terms or risk having the lease automatically terminate. These annual payments are called “delay rentals” because payment of the rental keeps the lease alive and allows the lessee to delay drilling a well for another year. Of course, the lessee can extend the lease by drilling or commencing operations, which has the small added benefit of avoiding the delay rental payments (normally, not that significant).

Most modern leases contain an “unless” form of delay rental clause, which provides that if there is not a producing well on the leased premises or on lands pooled therewith, or if operations have not been commenced to drill a well on the premises or on lands pooled therewith, the lease will automatically terminate *unless* on or before the first anniversary date of the lease the lessee pays the specified rental in the specified manner, thereby deferring commencement of drilling operations for another 12

⁸ See *Superior Oil Co. v. Devon Corp.*, 604 F.2d 1063, 1068 (8th Cir. 1979).

months.⁹ The “unless” rental clause is so worded that although the lessee may defer drilling and extend the lease by paying delay rentals, there is no obligation to drill or requirement to pay. If the lessee chooses not to pay or drill, the lease automatically terminates. In contrast, under the alternative form of an “or” delay rental clause, which is still widely used in the West Coast and Appalachian states, the lessee is obligated to either drill a well, pay delay rentals, or surrender the lease. If the lessee does not surrender the lease and it fails to either drill or pay, the lease is not automatically terminated, but the lessee is subject to a breach of contract action for its failure to make the delay rental payment.¹⁰

All states, even Oklahoma, require strict compliance with the delay rental provision.¹¹ Tardiness in paying rentals is inexcusable, even when dire circumstances exist.¹²

Importantly, a delay rental clause will not keep the lease alive when (1) operations lead to a dry hole or production ceases during the primary term and (2) there is no provision in the lease for a return to payment of delay rentals.¹³ Even if there is a provision allowing for the return to rental payments, it may be unclear when such payments are due. For example, *Superior Oil Co. v. Stanolind Oil & Gas Co.*,¹⁴ involved a dispute as to whether, after a dry hole was drilled in the primary term, the delay rentals were due prior to the anniversary of the lease or the anniversary of the dry hole. The Superior lease provided:

Should the first well drilled on the above described lands be a dry hole, then and in that event if a second well is not commenced on said land within twelve months thereafter, this lease shall terminate as to both parties, unless

⁹See *Schwartzberger v. Hunt Trust Estate*, 244 N.W.2d 711 (N.D. 1976), and *Phillips Petroleum Co. v. Curtis*, 182 F.2d 122 (10th Cir. 1950) for an analysis of the “unless” lease.

¹⁰See *Warner v. Haught, Inc.*, 329 S.E.2d 88 (W.Va. 1985) and *Butler v. Nepple*, 354 P.2d 239 (Cal. 1960).

¹¹See *Phillips Petroleum Co. v. Curtis*, 182 F.2d 122 (10th Cir. 1950); *Danne v. Texaco Exploration & Prod., Inc.*, 883 P.2d 210 (Okla. App. 1994).

¹²See *Ford v. Cochran*, 223 S.W. 1041 (Tex. App. 1920) (no excuse for missing payment to be with sick relative). *But see Borth v. Gulf Oil Exploration and Production Co.*, 313 N.W.2d 706 (N.D. 1981) (equitable adjustment made by reducing the leasehold by the percentages that rentals actually paid bore to rentals required to be paid); and *Humble Oil & Refining Co. v. Harrison*, 205 S.W.2d 355 (Tex. 1947) (lessor estopped to assert lease was terminated by erroneous delay rental payment because of an ambiguous mineral deed).

¹³*Davis v. Laster*, 138 So.2d 558, 562 (La. 1962) (“rental payments . . . are designed only to grant the privilege of deferring commencement of drilling operations”). *But see Colby v. Sun Oil Co.*, 288 S.W.2d 221 (Tex. App. 1956) (completion of dry hole precludes further rental payments, thereby making the leasehold indefeasible during the primary term).

¹⁴230 S.W.2d 346 (Tex. App. 1950), *aff’d*, 240 S.W.2d 281 (Tex. 1951).

the lessee on or before the expiration of said twelve months, shall resume the payment of rentals in the same amount and in the same manner as hereinbefore provided.^{14.1}

The Texas Court of Appeals affirmed the trial court's finding that the lease unambiguously required that after the dry hole was drilled, delay rentals be paid on the anniversary date of the dry hole, not on the anniversary of the date that the parties entered into the lease. In affirming the court of appeals, a majority of the Texas Supreme Court found the lease to be ambiguous as to when rental was due, but reasoned that Superior's predecessor-in-interest had paid the delay rentals on the anniversary date of the dry hole for the three years previous to Superior acquiring the lease, and that Superior had knowledge of these payments.

Bankruptcy is no relief from the harsh rule. An oil and gas lease will terminate automatically when a bankruptcy trustee fails to make a timely delay rental payment and neither the Bankruptcy Code nor the bankruptcy court can prevent such termination.¹⁵

[2] Obtaining Production

Production during the primary term preserves the lease. But what does the term "production" mean? The courts have held that the word "produce" as used in the habendum clause of an oil and gas lease is synonymous with the phrase "producing in paying quantities."¹⁶ A well is producing in paying quantities if the production is sufficient to pay the lessee a profit, even small, over the operating and marketing expenses, although the cost of drilling may never be repaid.¹⁷ The majority of states require actual production (also referred to as discovery, plus marketing).¹⁸ A few states, Oklahoma being the leading example, are discovery jurisdictions and only require that the well be capable of producing in paying quantities.¹⁹ Even the Oklahoma courts' patience has its limits, however, and in a 2006

^{14.1}*Id.* at 348.

¹⁵*In re Trigg*, 630 F.2d 1370 (10th Cir. 1980). *See also In re J.H. Land & Cattle Co. Inc.*, 8 B.R. 237, 239 (W.D. Okla. 1981) (debtor-lessor allowed to reject 11 leases and grant new leases on more advantageous terms under "business judgment test").

¹⁶*Garcia v. King*, 164 S.W.2d 509, 511-512 (Tex. 1942).

¹⁷*Id.*

¹⁸*Gulf Oil Corp. v. Reid*, 337 S.W.2d 267, 269-270 (Tex. 1960) (must be actual production and marketing to have production in paying quantities). *See also Davis v. Cramer*, 808 P.2d 358, 363 (Colo. 1991) (implied covenant to market applies during primary term and the lease expired because lessee did not pay shut-in royalties or market production during the primary term).

¹⁹*Pack v. Santa Fe Minerals*, 869 P.2d 323, 326 (Okla. 1994).

decision, *Geyer Bros. Equipment Co. v. Standard Resources, LLC*,²⁰ the Oklahoma Court of Appeals ruled that the lease expired even though the well was capable of producing in paying quantities. The Geyer lessee had failed to produce or market the gas for over 20 years after drilling the well. Although there was no pipeline to service the well, the lessee made no efforts to obtain a pipeline and waited five years after being locked out from entering the property before attempting to assert its rights. In the end, the court ruled that the lease terminated because the lessee had failed to market the gas for an unreasonable period.

Specific lease terms can lead to unusual results. For example, in determining the production required to continue a lease during the secondary term, Texas courts have recognized a distinction between the typical “production in paying quantities” habendum clause and one that provides that the lease continues as long as gas “is or can be produced.” In the latter situation, the courts have held that the lease will continue so long as the well is actually producing *or* is capable of producing gas.²¹ A well is “capable of production,” at least in the eyes of the Texas courts, if the well is turned on and product can flow without “additional equipment or repairs.”²²

In a 2008 decision, *Blackmon v. XTO Energy, Inc.*,²³ the Texas Court of Appeals held that when deciding if a well is “capable of producing,” the issue to be decided is whether the well is capable of producing gas in marketable *quantities*, not in marketable *quality*. The plaintiffs argued that the well at issue was not producing in paying quantities because it produced gas that was unmarketable in its raw state and additional equipment was required in order to market the gas. The court held that the required additional equipment was part of the processing function, not the production function, and that the evidence conclusively established that the well was capable of producing in paying quantities because the raw

²⁰140 P.3d 563, 567 (Okla. App. 2006).

²¹See *Grinnell v. Munson*, 137 S.W.3d 706 (Tex. App. 2004).

²²*Anadarko Petroleum Corp. v. Thompson*, 94 S.W.3d 550, 558 (Tex. 2002) (quoting *Hydrocarbon Mgt., Inc. v. Tracker Exploration, Inc.*, 861 S.W.2d 427, 433-434 (Tex. App. 1993) (“a well would not be capable of producing in paying quantities if the well switch were turned ‘on,’ and the well did not flow, because of mechanical problems or because the well needs rods, tubing, or pumping equipment”)).

²³276 S.W.3d 600, 603 (Tex. App. 2008).

gas was capable of flowing from the wellhead in a marketable quantity, regardless of whether the processing equipment was installed.²⁴

The lessor has the burden of proving that the lease is not producing in paying quantities.²⁵ To prove that a lease is not producing in paying quantities, the lessor must show both that the lease operated at a loss over a reasonable period of time and that a reasonably prudent operator would not continue operating under the circumstances.²⁶ The court will examine the facts and circumstances of each case, and compelling equitable considerations may save an oil and gas lease from termination even with unprofitable operations. For example, in *Barby v. Singer*,²⁷ the Oklahoma Supreme Court held that the prospect of impending federal legislation, the Natural Gas Policy Act, that might result in an increase in the price of natural gas was equitable consideration for preserving the lease. But in *Smith v. Marshall Oil Corporation*,²⁸ the same court held that there were not compelling circumstances that justified the continuation of the leases in the face of a cessation of production when the operator testified at trial that during the three-year time period in question, “I produced them when I felt like producing them. And I turned them off when I felt like turning them off.”^{28.1} The court noted that the operator had deliberately ceased production hoping that oil and gas prices would rise, but stated that “[f]luctuating market prices do not rise to the level of equitable consideration, . . . [or excuse a] failure to produce in paying quantities.”²⁹

²⁴See also *Chesapeake Exploration, Ltd. v. Corine Inc.*, 2007 WL 2447293 (Tex. App. August 29, 2007) and *Wheeler & Lemaster Oil & Gas Co. v. Henley*, 398 S.W.2d 475 (Ky. 1965).

²⁵*Coyle v. North American Oil Consol.*, 9 So.2d 473, 479 (La. 1942); *Cox v. Cardinal Drilling Company*, 188 So.2d 667, 672 (La. App. 1966).

²⁶*Dreher v. Cassidy Ltd. Partnership*, 99 S.W.3d 267, 269 (Tex. App. 2003); *Pshigoda v. Texaco, Inc.*, 703 S.W.2d 416, 418-419 (Tex. App. 1986). Cf. *Positron Energy Resources, Inc. v. Weckbacher*, 2009 WL 690583 (Ohio App. March 12, 2009) (burden shifts to lessee when it seeks a declaratory judgment that the lease is valid).

²⁷648 P.2d 14 (Okla. 1982).

²⁸85 P.3d 830 (Okla. 2004).

^{28.1}*Id.* at 835.

²⁹*Id.* at 836. See also *Somont Oil Co., Inc. v. A & G Drilling, Inc.*, 49 P.3d 598, 606 (Mont. 2002) (in determining whether production had ceased temporarily, the district court erred by improperly allowing the jury to consider oil and gas prices, economic factors, and the lessee's financial condition).

The “reasonable time” period must be broad enough to provide an accurate picture of the lease activity.³⁰ The revenue considered is the working interest revenue prior to the payment of overriding royalties, production payments, or other burdens, except for the lessor’s royalty.³¹ Expenses deducted are “lifting expenses,” which are costs associated with producing the oil and gas after the well has been drilled and are the ordinary, periodic, direct operating expenses associated with the lease. One-time expenses, such as drilling, equipping, and reworking costs, are capital expenditures and are not to be considered in determining whether a lease is producing in paying quantities.³² Even if the strict arithmetic test is not satisfied, the lease may survive if a reasonably prudent operator would have continued to operate the well.³³

Should the court also consider industry conditions in establishing the length of the period to be considered? The Tenth Circuit did in *Denker v. Mid-Continent Petroleum Corp.*,³⁴ a depression-era case.

[3] Coalbed Methane Wells

The industry has been anxiously waiting for a court ruling on whether the dewatering of coalbed methane wells constitutes production. To the surprise of many, the issue has not been adjudicated to date. Perhaps one explanation for this is that many of the coalbed methane leases recently issued specifically provide that production includes the dewatering process.

For federal leases, agency-wide regulations do not exist regarding dewatering and production. However, at least some Bureau of Land Management jurisdictions will grant an initial paying well determination which will serve to extend the lease as held by production if it appears that

³⁰Wood v. Axis Energy Corp., 899 So.2d 138, 145 (La. App. 2005) (12 months prior to shut-in); Pshigoda v. Texaco, Inc., 703 S.W.2d 416, 418-419 (Tex. App. 1986) (court correctly submitted two time periods for jury’s consideration—two years prior to filing and 17 months between filing and trial).

³¹Hininger v. Kaiser, 738 P.2d 137, 140 (Okla. 1987); Clifton v. Koontz, 325 S.W.2d 684, 690-91 (Tex. 1959).

³²Wood v. Axis Energy Corp., 899 So.2d 138, 145 (La. App. 2005); Smith v. Marshall Oil Corp., 85 P.3d 830 (Okla. 2004); Avien Corp. v. First Nat. Oil, Inc., 79 P.3d 223 (Kan. App. 2003); Abraxas Petroleum Corp. v. Hornburg, 20 S.W.3d 741 (Tex. App. 2000).

³³Clifton v. Koontz, 325 S.W.2d 684 (Tex. 1959); T.W. Phillips Gas and Oil Co. v. Jedlicka, 964 A.2d 13 (Pa. App. 2008) (lessee’s good faith is key to determination, not an objective determination whether revenues exceeded expenses each year).

³⁴56 F.2d 725 (10th Cir. 1932). See also 3 Williams & Meyers, *supra* note 4, § 604.6(c) (“The lessee has a fairly strong argument for holding the lease by nonpaying production during a period when temporary depression prevents paying production.”).

a prudent operator would continue to operate the coalbed methane well in expectation of improving the well's performance.³⁵

Beyond the dewatering/production question, coalbed methane wells present unique issues as to whether the well is even capable of production. For example, in *Levin v. Maw Oil and Gas, LLC*,³⁶ the issue before the trial court was whether a coalbed methane well that was not connected to either a dewatering system or a gathering system was capable of production. The court held that the well had to be connected to both systems in order to be capable of production.

§ 23.03 Preserving the Lease into the Secondary Term

[1] Commencement of Operations

Most modern oil and gas leases provide that a lease will not terminate if the lessee “commences operations for the drilling of a well on the leased lands or on acreage pooled therewith” by the end of the primary term. There are frequent disagreements between lessors and lessees as to what actions constitute commencement of operations. In fact, the courts cannot agree whether a regulatory agency's approval of an application to drill is required for operations to have commenced.³⁷ Texas courts have defined “commencement of operations” as requiring a bona fide intent to proceed thereafter with diligence toward the completion of a producing well.³⁸

In determining whether operations have indeed commenced, the courts consider the specific language of the lease and the facts and circumstances of each case. Substantial surface operations will be sufficient, provided that the preliminary operations are continued and the well is spud. For example, in *Breaux v. Apache Oil Corp.*,³⁹ the court found that the lessee had commenced operations by completing a board road and turnaround to the well location by the end of the primary term, even though equipment was not moved to the site and drilling operations were not commenced until two days after the primary term ended. Similarly, in *Petersen v. Robinson*

³⁵ See e.g., Colorado BLM, Notice to Lessee/Operators NTL-CO-88-2, “Paying Well Determinations and Venting, and Flaring Applications on Jurisdictional Coal Bed Methane Wells” (1988).

³⁶ No. 07 CV 166 (D. Ct. Miami County, Kan., 2007) (decision pending, Kansas Supreme Court Docket No. 100132).

³⁷ Compare *Bunnell Farms Co. v. Samuel Gary, Jr. & Assoc.*, 47 P.3d 804 (Kan. App. 2002), with *Gray v. Helmerich & Payne, Inc.*, 834 S.W.2d 579 (Tex. App. 1992).

³⁸ *Bell v. Mitchell Energy Corp.*, 553 S.W.2d 626, 632 (Tex. App. 1977) (citing *Peterson v. Robinson Oil & Gas Company*, 356 S.W.2d 217, 220 (Tex. App. 1962)).

³⁹ 240 So.2d 589 (La. App 1970).

Oil & Gas Co.,⁴⁰ the court found that drilling operations had commenced because the lessee had hired a contractor, hired a surveyor, completed the survey, staked the well, moved the maintainer onto location, and begun to level the well location.⁴¹

Some courts have distinguished “commence drilling operations” and “commence to drill a well” from “commence operations for the drilling of a well,” holding that the former require the lessee to penetrate the ground with a drill bit prior to the end of the primary term. For example, in *Hall v. JFW, Inc.*,⁴² the court found that, even though the well location was staked, elevation survey completed, drilling contractor hired, drilling pits dug, location leveled, and water well dug, drilling had not commenced because actual drilling had not started.⁴³ By contrast, in *Bunnell Farms Co. v. Samuel Gary, Jr. & Assoc.*,⁴⁴ the contractor had drilled 51 feet and had set and cemented casing on the last day of the primary term. A larger rig was moved onto the premises two days after the expiration of the primary term and the well was completed. The lessor argued that drilling had not commenced before the end of the primary term because the original drilling rig was too small to complete the well. The court held that to extend the lease into the secondary term, drilling was required to be commenced but not completed and that the drilling in the instant case was sufficient to commence operations.

As with all contracts, the specific lease language is crucial to the determination of whether the lessee’s actions have extended the lease beyond the primary term. For example, in *Petroleum Energy, Inc. v. Mid-America Petroleum, Inc.*,⁴⁵ the court found that drilling operations had commenced when the dirt contractor prepared the site for drilling because the lease provided that “operations shall be deemed to be commenced when the first material is placed on the leased premises or when the first work, other than surveying or staking the location, is done thereon which is necessary for such operations. . . .”^{45.1} In *Veritas Energy, LLC v. Brayton*

⁴⁰ 356 S.W.2d 217 (Tex. App. 1962).

⁴¹ See also *Vickers v. Peaker*, 300 S.W. 2d 29, 32 (Ark. 1957).

⁴² 893 P.2d 837, 842 (Kan. 1995).

⁴³ See also *Solberg v. Sunburst Oil & Gas Co.*, 235 P. 761 (Mont. 1925). But see *LeBar v. Haynie*, 552 P.2d 1107 (Wyo. 1976) (“commence to drill a well” may be satisfied if preliminary commencement activities are not mere pretenses or a holding device).

⁴⁴ 47 P.3d 804 (Kan. App. 2002).

⁴⁵ 775 F. Supp. 1420 (D. Kan. 1991).

^{45.1} *Id.* at 1423

Operating Corp.,⁴⁶ on the other hand, operations were found not to have commenced by backdragging of grass because the lease defined operations as “for and any of the following: drilling, testing, completing, reworking, recompleting, deepening, plugging back or repairing of a well in search for or in an endeavor to obtain production of oil, gas, sulphur or other minerals. . . .”^{46.1}

The lessee is relieved of the requirement to comply with the commencement of operations clause if the lessor’s actions prevent him from taking such action.⁴⁷ Once operations are commenced, however, the lessee is required to diligently continue such operations in good faith.⁴⁸ Does this requirement extend to completing the well? In the few cases dealing with the requirement of diligent completion, the applicable standard appears to combine an objective standard of diligence and a subjective standard of good faith.⁴⁹ Availability of equipment may come into play in applying this standard. In the recent past, frac proponents, mud, tubulars, completion rigs, and the like were in short supply, and the most diligent of operators had a hard time completing a well.

[2] Pooling/Unitization

“Pooling” refers to the integration of small tracts and fractional interests into a single spacing unit for the purpose of having sufficient acreage to receive a well drilling permit and for the sharing of production by the interest owners in the pooled unit.⁵⁰ “Unitization,” on the other hand, refers to the joining together of mineral or leasehold interests covering all or part of a common source of supply.⁵¹ While both pooling and

⁴⁶2008 WL 384169 (Tex. App. February 14, 2008) (memorandum opinion).

^{46.1}*Id.*

⁴⁷*See* Pinnacle Gas Resources v. Diamond Cross Properties, LLC, 201 P.3d 160 (Mont. 2009) (lessor’s counsel notified lessee that it had not satisfied statutory notice requirements and it would be a trespasser if it entered onto the leasehold); and Greer v. Carter Oil Co., 25 N.E. 2d 805 (Ill. 1940) (lessor who brought suit to invalidate lease estopped from claiming term had expired). *Cf.* Stone v. Devon Energy Production Company, 181 P.3d 936 (Wyo. 2008) (assignee breached clause requiring it to make a reassignment offer six months prior to the end of primary term, but the well was drilled within the six month period, so the assignor suffered no damages).

⁴⁸*Sword v. Rains*, 575 F.2d 810 (10th Cir. 1978); *LeBar v. Haynie*, 552 P.2d 1107, 1111 (Wyo. 1976).

⁴⁹*See* 3 Williams & Meyers, *supra* note 4, § 618.3. *See also* Exxon Corporation v. Emerald Oil & Gas Company, L.C., 2009 WL 795668 (Tex. March 27, 2009) and Simpson v. Stanolind Oil & Gas Co., 210 F.2d 640, 642 (10th Cir. 1954).

⁵⁰Kramer and Martin, *The Law of Pooling and Unitization* § 1.02 (2008) (Kramer and Martin).

⁵¹*Id.*

unitization are methods to be used to allow for the orderly and efficient development/conservation of the underlying oil and gas resources, pooling is accomplished in order to drill a single well, while the primary function of unit operations is to maximize production by efficiently draining the reservoir, utilizing the best engineering techniques that are economically feasible.⁵²

Pooling may be either voluntary or “forced” under statutes in most producing states (except Kansas) authorizing compulsory pooling. Voluntary pooling may be accomplished by the execution of a pooling agreement among the interest owners or by the lessee’s recording of a declaration of pooling under the pooling clause of the lease.⁵³

If a lease contains a pooling clause and the lessee complies strictly with the terms of such clause, then production from the pooled acreage will act as constructive production to preserve the lease into the secondary term. Certain courts have interpreted the pooling clause as granting very broad pooling authority to the lessee and others have interpreted the pooling clause strictly.⁵⁴ All jurisdictions that have addressed the matter apply a standard of good faith to the exercise of the pooling clause. This recognizes that the pooling clause tends to favor the interests of the lessee more than those of the lessor.⁵⁵ Pooling after production has been obtained does not, by itself, constitute bad faith,⁵⁶ nor does pooling just before the expiration of the primary term.⁵⁷

Absent a clause to the contrary, when a lease lies partially within and partly outside a unit, unit production will maintain the lease in its entirety, regardless of the location of the well.⁵⁸ This is true regardless of whether the pooled unit has resulted from the exercise of the pooling clause or

⁵²*Id.*

⁵³See Pearce, *supra* note 1, footnotes 230-233, for typical pooling clauses and pooling statutes.

⁵⁴Compare Phillips Petroleum Co. v. Peterson, 218 F.2d 926, 933 (10th Cir. 1954) with Jones v. Killingsworth, 403 S.W.2d 325 (Tex. 1966). See also Sunac Petroleum Corp. v. Parkes, 416 S.W.2d 798 (Tex. 1967) (clause allowing pooling for gas purposes only inoperative when oil well drilled).

⁵⁵See Amoco Production Co. v. Underwood, 558 S.W.2d 509 (Tex. App. 1977); Southwest Gas Producing Co. v. Seale, 191 So.2d 115 (Miss. 1966); and Imes v. Globe Oil & Refining Co., 84 P.2d 1106 (Okla. 1938).

⁵⁶Gillham v. Jenkins, 244 P.2d 291, 293 (Okla. 1952); Kaszar v. Meridian Oil & Gas Enterprises Inc., 499 N.E. 2d 3 (Ohio App. 1985).

⁵⁷Boone v. Kerr-McGee Oil Indus., 217 F.2d 63, 65 (10th Cir. 1954). *But see* Wilcox v. Shell Oil Co., 76 So.2d 416 (La. 1954).

⁵⁸Kramer and Martin, § 20.02[1].

from creation of the unit by the state conservation agency.⁵⁹ The lessor can seek additional development of the acreage outside of the unit through the implied covenant to develop (see § 23.05) or by including a Pugh clause in the lease.⁶⁰ Several states have enacted statutory Pugh clauses that provide that the term of a lease extended by production in a pooled unit shall not extend to lands outside of the unit.⁶¹

Lessees with leases that are beyond their primary term but are held by production from older fields may face challenges as a result of emerging resource plays that overlap these mature producing fields, as evidenced by the recently decided *Cambridge Production, Inc. v. Geodyne Nominee Corp.*^{61.1} In *Cambridge*, the top lessor sought termination of 44 oil and gas leases (the Section 33 leases) covering Section 33, Block M-1, H&GN Ry. Survey, Hemphill County, Texas. At the end of the primary terms of the Section 33 leases, there was no production on Section 33. However, the Section 33 leases had been pooled with Section 39, on which a producing well, the Prater 1-39, had been completed in the interval between 14,364 feet and 14,372 feet. The Designation of Pooling erroneously identified the pooled depths for the well as between 14,634 feet and 14,929 feet. Even though they were not entitled to royalties from the Prater 1-39 well because of the erroneous unit designation, the lessors were paid and accepted royalties on production from such well for 20 years. On cross motions for summary judgment, the trial court held in favor of the lessees, declaring that the Section 33 leases and the unit designations creating the Prater Unit were in full force and effect. The court of appeals affirmed, ruling that the defense of quasi estoppel^{61.2} applied since the lessors had accepted the benefit of revenues from production to which they were not entitled, and to repudiate the Section 33 leases would be asserting a right inconsistent with the benefits they had previously accepted. The court cited the holding in *Atkinson Gas Co. v. Albrecht*,^{61.3} among others, in support of its position, although in that case the court had refused to apply the doctrine of quasi estoppel since the lessor, prior to accepting the

⁵⁹*Id.* See also *Hunter Co. v. Shell Oil Co.*, 31 So.2d 10 (La. 1947).

⁶⁰See, e.g., *Jones v. Bronco Oil & Gas Co.*, 446 So.2d 611 (Ala. 1984).

⁶¹See, e.g., Ark. Code Ann. § 15-73-201(a) and N.D.C.C. § 38-08-09.8.

^{61.1}2009 WL 1813143 (Tex. App. June 23, 2009).

^{61.2}Quasi estoppel, unlike equitable estoppel, does not require proof of a false statement or detrimental reliance. “Rather, it precludes a party from accepting the benefits of a transaction and then taking a subsequent inconsistent position to avoid corresponding obligations or effects.” *Id.* at *6.

^{61.3}878 S.W.2d 236 (Tex. App. 1994).

royalty payment, had consistently maintained the position that the lease had terminated due to cessation of production.^{61.4}

[3] Force Majeure

The force-majeure clause was developed to address circumstances that would otherwise cause the lease to terminate.⁶² While the theory of force majeure has existed for many years and embodied the concept that a party could be relieved of its obligations if its performance was prevented by causes beyond its control, such as acts of God, its scope and application are now dependent upon the specific language of the force-majeure clause in the lease.⁶³ Whether the force-majeure clause extends the lease term set forth in the habendum clause is also dependent upon the language of the two clauses.⁶⁴ The force-majeure clause will excuse nonperformance only when caused by circumstances beyond the reasonable control of the lessee or when the event was unforeseeable at the time the parties entered into the lease.⁶⁵

The impossibility to comply with the lease must arise out of the nature of the act to be done, not the lessee's inability to perform the act. For example, in *Erickson v. Dart Oil & Gas Corp.*,⁶⁶ the Michigan Court of Appeals ruled that the force-majeure clause did not excuse the lessee's nonperformance, which was due to delays in receiving drilling permits. The court found that the delays were foreseeable and that "[w]here governmental action is alleged to be the cause of delay, the parties to the lease are presumed to have contracted with knowledge of any preexisting law that could have caused delay."⁶⁷ The parties are presumed to know

^{61.4}See also *Scilly v. Bramer*, 85 A.2d 592, 594 (Pa. Super. 1952) and *Kyle v. Wadley*, 24 F. Supp. 884, 888 (W.D. La. 1938) where the courts held that the mere acceptance of royalties did not preclude the lessor from canceling the leases for failure to develop.

⁶²See e.g., *Baldwin v. Blue Stem Oil Co.*, 189 P. 920 (Kan. 1920).

⁶³*Sun Operating Limited Partnership v. Holt*, 984 S.W.2d 277, 283 (Tex. App. 1998) (lessee not required to avoid, remove, or overcome the effects of force majeure unless clause so requires); and *Moore v. Jet Stream Investments, Ltd.*, 261 S.W.3d 412, 422 (Tex. App. 2008) (unless the lease provides otherwise, due diligence is not required to remedy force majeure).

⁶⁴Compare *Sun Operating Limited Partnership v. Holt*, 984 S.W.2d 277, 286 (Tex. App. 1998) with *Gulf Oil Corp. v. Southland Royalty Co.*, 496 S.W.2d 547, 552 (Tex. 1973).

⁶⁵*Hydrocarbon Management, Inc. v. Tracker Exploration, Inc.*, 861 S.W.2d 427, 435-46 (Tex. App. 1993). *But see* *Perlman v. Pioneer Ltd. P'ship*, 918 F.2d 1244, 1248 (5th Cir. 1990) (court erred when it interpreted the clause to require that the event be unforeseeable or beyond plaintiff's control).

⁶⁶474 N.W.2d 150 (Mich. App. 1991).

⁶⁷*Id.* at 155.

the regulatory agency's requirements when they enter into the lease. If the regulation is within the control of the lessee, the force-majeure clause does not protect the lessee. The force-majeure clause has been found inapplicable when delays were caused by the lessee's failure to comply with the Texas Railroad Commission's financial assurance requirements and when a well was shut in by the Texas Railroad Commission due to lessee's failure to timely file production reports.⁶⁸ Similarly, in *Perlman v. Pioneer Limited Partnership*,⁶⁹ the court ruled that studies required by Wyoming state officials before permits would be issued did not excuse the lessee's failure to perform.

The force-majeure clause does not serve to extend the lease when the lessee is in bankruptcy,⁷⁰ although at least one Texas court has found that the force-majeure clause is extended by involuntary bankruptcy.⁷¹

§ 23.04 Maintaining the Lease During the Secondary Term

[1] Dry Hole and Cessation of Production Clauses

Many leases combine the dry hole clause with the cessation of production clause (e.g., "if lessee should drill a dry hole, or if after production is obtained, production ceases from any cause, this lease shall not expire if lessee commences additional drilling or reworking operations within sixty days thereafter and they result in production being obtained"). What constitutes a "dry hole" and when does production "cease" for these purposes? Compare the mechanical analysis of the Texas Supreme Court in *Sunac Petroleum Corp. v. Parkes*⁷² with that of the Wyoming Supreme Court in *LeBar v. Haynie*.⁷³ In *Sunac*, the lessee pooled the lands in question with other lands for gas purposes only three days before the primary term was to expire. The following day, drilling operations were commenced on land within the pooled unit, but not on the 160 acres covered by the lease. The well was completed as an oil well. Sixty-eight days after the expiration of the primary term of the lease and 13 days after the completion of the oil well, a second well was commenced, this time

⁶⁸ See, e.g., *Moore v. Jet Stream Investments, Ltd.*, 261 S.W.3d 412, 421 (Tex. App. 2008); *Atkinson Gas Co. v. Albrecht*, 878 S.W.2d 236, 241-242 (Tex. App. 1994).

⁶⁹ 918 F.2d 1244, 1248 (5th Cir. 1990).

⁷⁰ See *Champlin Petroleum Co. v. Mingo Oil Producers*, 628 F. Supp. 557, 560-561 (D.Wyo. 1986); *Webb v. Hardage Corp.*, 471 So.2d 889 (La. App. 1985). See also *Morton Valley Oil & Gas, Inc. v. Nelson*, 1998 WL 34193636 (Tex. App. Mar. 5, 1998) (unreported); and *In re Trigg*, 630 F.2d 1370 (10th Cir. 1980).

⁷¹ *Gilbert v. Smedley*, 612 S.W.2d 270 (Tex. App. 1981).

⁷² 416 S.W.2d 798 (Tex. 1967).

⁷³ 552 P.2d 1107 (Wyo. 1976).

on the particular 160 acres in question. It was completed as a producing oil well. The court reviewed the applicable provisions of the lease⁷⁴ and concluded that (1) the first well did not save the lease since it was an oil well and the pooling clause only applied to gas units, (2) the well could not be considered a dry hole for purposes of the 60-day provision since it was a producer, and (3) there had not been a cessation of production from the well triggering that provision.⁷⁵ In *LeBar*, the well at issue was drilled over the end of the primary term to a depth of 6,744 feet. On July 13, 1973, casing was run and the rig was released. One month later, another rig was moved upon the well, the well was deepened to 7,115 feet, commercial production was discovered, and the well was completed as a producer on October 2, 1973. The lessors argued that the well had been completed as a dry hole and that the subsequent operations were really a re-entry and re-deepening of the once-completed well after the lease had expired. The court upheld the finding of the trial court that the well was completed on October 2, not July 13, even though a total of 96 days elapsed between the date on which drilling was commenced and the well was completed as a producer.⁷⁶

Where a lease does not contain a cessation of production clause, in an effort to mitigate against the harshness of automatic termination, courts have developed the temporary cessation of production doctrine, reasoning that the parties must have contemplated that temporary interruptions in production would occur from time to time due to mechanical breakdowns, reworking operations, and similar problems. The lessee seeking the doctrine's protection carries the burden of demonstrating that the cessation is "temporary" and not permanent, so the outcome hinges on the particular facts of each case and can lead to some unusual results. For example, in *Ridge Oil Company, Inc. v. Guinn Investments, Inc.*,⁷⁷ two lessees, Ridge and Guinn, obtained working interests under a single 1937 lease through assignments. Ridge shut in the only two producing wells, both located on its tract, for approximately 90 days with the express intent of terminating the 1937 lease. With certain of the mineral owners, Ridge

⁷⁴"If prior to discovery of oil and gas on said land Lessee should drill a dry hole or holes thereon, or if after discovery of oil and gas 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. . . ." *Sunac*, 416 S.W.2d at 800.

⁷⁵See also *Rogers v. Osborn*, 261 S.W.2d 311 (Tex. 1953), where the court also strictly construed the savings clause language in finding that the lease had terminated.

⁷⁶The court observed: "[T]his writer believes that he may personally opine, without serious damage to the law, that prudence would always dictate testing of all possible production horizons in unproven areas." *LeBar*, 552 P.2d at 1113.

⁷⁷148 S.W.3d 143 (Tex. 2004).

then took a new lease that covered both tracts. Guinn argued that the lease had not terminated as to its tract because the cessation of production on the Ridge tract was temporary. The court held that when the mineral owners in the Ridge tract executed new leases with Ridge, they effectively terminated the 1937 lease as to the tract, and production by Ridge from the Ridge tract was thereafter performed under the new lease, not the old one, and the cessation of production from the Ridge tract had thereby become permanent as to the old lease.

Similarly, in *Duncan Land & Exploration, Inc. v. Littlepage*,⁷⁸ the Texas Railroad Commission had ordered a well shut in for testing to determine if the well was producing “sour gas” in excess of allowable limits. The shut-in period extended for over six months while three separate tests were conducted, the last of which conclusively showed that the well was in compliance. Despite the existence of the shut-in order, the lessee periodically produced the well during the shut-in period. The lease contained a provision that it would terminate if no commercial production was obtained from the tract in excess of 90 days. The lessor sought to terminate the lease on the basis that the production from the well in violation of the Railroad Commission’s order did not constitute production that satisfied the 90-day clause. The court held that the lease had not terminated. It noted that the lessee had “to endure the Railroad Commission’s plodding efforts . . . (and that) he was mired in a complex Catch-22 situation that was largely out of his control . . . either violate the shut-in order and keep his lease or abide by the order and lose the lease.”⁷⁹ It concluded that the lessor should not be able to “bootstrap himself onto the Railroad Commission’s inherently public powers to take advantage of [Lessee] in connection with their inherently private lease.”⁸⁰

The following factors have been considered in determining whether the cessation of production was “temporary”:

- (1) The cessation period.⁸¹
- (2) The cause of the cessation. It was thought that the Texas courts limited the application of the doctrine to a sudden stoppage of the well or some mechanical breakdown of the equipment used

⁷⁸984 S.W.2d 318 (Tex. App. 1998).

⁷⁹*Id.* at 329.

⁸⁰*Id.* at 330.

⁸¹*Compare* *Saulsberry v. Siegel*, 252 S.W.2d 834 (Ark. 1952) with *Logan v. Blaxton*, 71 So.2d 675 (La. App. 1954).

in connection therewith.⁸² But in *Ridge Oil Co., Inc. v. Guinn Investments, Inc.*,⁸³ the Texas Supreme Court adopted a much more liberal standard, holding that the temporary cessation of production doctrine applies in a wide variety of circumstances.

(3) The lessee's diligence in attempting to restore production.⁸⁴

A lessee might be better off if the lease does not contain an express provision covering the cessation of production. For example, in *Samano v. Sun Oil Co.*,⁸⁵ the court held that the 60-day limitation period in the habendum clause applied to the secondary term, and the lease terminated because of a 73-day cessation of production. But in *Pack v. Santa Fe Minerals*,⁸⁶ even though the habendum clause limited cessation of production to 60 days, the court held that the lease did not terminate when the lessees had shut in the wells in excess of such period so that they could overproduce in the winter months without violating their allowables since the wells were capable of production at all times.

[2] Shut-In Royalties

Certain states equate "production" with actual production and marketing, while others hold that the term "produced" means "capable of producing in paying quantities" and does not include marketing of the product.⁸⁷ Most modern leases therefore contain a clause providing that the lease will be maintained by the payment of shut-in royalty while there is a gas well on the premises but gas is not being sold or used.⁸⁸ A typical clause reads as follows:

Where gas from a gas well is not sold or used, lessee may pay as royalty \$640 per well within 45 days after the expiration of each one-year period during which

⁸² See, e.g., *Watson v. Rochmill*, 155 S.W.2d 783 (Tex. 1941) and *Somont Oil Company v. A & G Drilling, Inc.*, 49 P.3d 598 (Mont. 2002) (adopting the Texas test).

⁸³ 148 S.W.3d 143, 152 (Tex. 2004),

⁸⁴ See *Locke v. Palmore*, 215 S.W.2d 544 (Ky. 1948) (lease terminated when lessee capped the well and did nothing further); and *Gillespie v. Wagoner*, 190 N.E.2d 765 (Ill. 1963) (financial difficulties no excuse for lack of diligence). But see *Natural Gas Pipeline Co. v. Pool*, 124 S.W.3d 188 (Tex. 2003) (even if the lease expired because production had ceased, the lessees regained their leaseholds by adverse possession for the statutory 10-year period).

⁸⁵ 621 S.W.2d 580 (Tex. 1981). See also *Sun Operating Ltd. P'ship v. Holt*, 984 S.W.2d 277 (Tex. App. 1998).

⁸⁶ 869 P.2d 323 (Okla. 1994).

⁸⁷ Compare *Freeman v. Magnolia Petroleum Co.*, 171 S.W.2d 339 (Tex. 1943), with *Pack v. Santa Fe Minerals*, 869 P.2d 323 (Okla. 1994).

⁸⁸ See *Tucker v. Hugoton Energy Corp.*, 855 P.2d 929 (Kan. 1993).

such well is shut-in and, while such payment is made, it will be considered that gas is being produced within the meaning of the habendum clause.”

It should be noted that many contemporary leases now limit the time period during which the lease may be maintained by the payment of shut-in royalties.

Shut-in royalties may be made only if the well is capable of producing in paying quantities at the time it is shut in.⁸⁹ If the lease does not provide a grace period for payment of the shut-in royalty, the courts have held that no reasonable time is inferred and that payment must be made before the well is shut in or before the end of the primary term, whichever is later.⁹⁰ Most modern leases, however, provide for a grace period in which to make the payment after the well is shut in, even if the payment is made after the expiration of the primary term.⁹¹

The remedies for the failure to make timely payment of shut-in royalty vary with the states. In Texas, the remedy is termination of the lease.⁹² In Oklahoma, the lessee is liable for breach of contract.⁹³

Most shut-in clauses are limited to gas wells. In such a case, if the well is capable of producing hydrocarbons in addition to gas, e.g., distillate or condensate, the well cannot be shut in.⁹⁴

Whether a lessee is permitted to shut in a well because of depressed market conditions will depend on the language of the shut-in royalty clause. In an earlier day, if there was any market for gas there was frequently only one purchaser for such gas. Today there is not likely to be a “lack of market,” but a lack of an acceptable market. The Kansas Supreme Court has held that the lessee is required to sell into such a depressed market and is not allowed to wait for conditions to improve.⁹⁵ Other courts have been more tolerant.⁹⁶ A shut-in royalty clause that permits the lessee to shut in

⁸⁹Hydrocarbon Management, Inc. v. Tracker Exploration, Inc., 861 S.W.2d 427, 433 (Tex. App. 1993).

⁹⁰Gulf Oil Corp. v. Reid, 337 S.W.2d 267 (Tex. 1960).

⁹¹See Union Oil Co. v. Ogden, 278 S.W.2d 246 (Tex. App. 1955).

⁹²Gulf Oil Corp. v. Reid, 337 S.W.2d 267, 272 (Tex. 1960).

⁹³Danne v. Texaco Exploration and Production Inc., 883 P.2d 210, 215 (Okla. App. 1994).

⁹⁴See Vernon v. Union Oil Company of California, 270 F.2d 441 (5th Cir. 1959) (gas cannot be stored or transported like oil).

⁹⁵Tucker v. Hugoton Energy Corp., 855 P.2d 929, 936 (Kan. 1993).

⁹⁶See, e.g., McDowell v. PG&E Resources Co., 658 So.2d 779 (La. App.1995), and Johnson v. Phinney, 287 F.2d 544 (5th Cir. 1961).

a well when it is the “lessee’s good faith judgment that it is unadvisable to produce and sell such products for the time being is recommended.”⁹⁷

[3] Notice Requirement

The ultimate savings clause is a provision in a lease requiring the lessor to put the lessee on notice of a default before taking any action to terminate the lease.

- (1) A “notice-and-demand clause”⁹⁸ requires the lessor to notify the lessee in writing, specifying the default and providing the lessee with a period of time after receipt of such notice in which to remedy or commence to remedy the breach. The service of the notice is a condition precedent to the beginning of any action by the lessor, and the action cannot be brought until the lapse of the specified period without action by the lessee.
- (2) A “notice-before-forfeiture clause”⁹⁹ requires the lessor to notify the lessee in writing of the breach and provides for a period of time during which the lessee may cure or begin to cure the breach. But, after the lapse of the specified period without cure, the lease is terminated without further action by the lessor.

⁹⁷ 3 Williams and Meyers, *supra* note 4, § 632.4. See also Nancy J. Forbis, “The Shut-In Royalty Clause: Balancing the Interests of Lessors and Lessees,” 67 Tex. L. Rev. 1129, 1151 (1989) (“By interpreting the ‘lack of market’ provision of the typical shut-in clause to mean a lack of a *reasonable* market, courts could allow lessees to shut in wells when the prevailing market prices do not economically justify operation of the wells.”) (emphasis added).

⁹⁸ For example:

In the event Lessor considers that Lessee has failed to comply with any obligation hereunder, express or implied, Lessor shall notify Lessee in writing specifying in what respects Lessor claims Lessee has breached this lease. The service of such notice and the lapse of sixty days without Lessee’s meeting or commencing to meet the alleged breaches shall be a condition precedent to any action by Lessor for any cause.

See, e.g., *Ridl v. EP Operating Ltd. P’ship*, 553 N.W.2d 784, 789, n.6 (N.D. 1996).

⁹⁹ Should the lessee so far fail in the compliance with the conditions of this lease as to justify a forfeiture thereof, no forfeiture shall be declared unless lessor shall first notify lessee in writing specifying the exact nature of the default, and unless lessee shall fail to remedy such default within ninety days from date of receipt of said notice.

4 Williams & Myers, *supra* note 4, § 682.1.

- (3) A “judicial-ascertainment clause”¹⁰⁰ goes even further to protect the lessee, providing that the lease may not be declared terminated unless the lessor has proved the breach in court and then, after final judgment, the lessee has been given a reasonable time to comply. Two courts have held that the clause violates public policy,¹⁰¹ but most courts have sustained and applied the clause.¹⁰²

§ 23.05 Keeping the Lease Alive by Developing the Leasehold

[1] Express Covenant to Develop

Many leases contain an express covenant to develop the leasehold after production has been obtained. In such a case, the express covenant obviates the need for an implied covenant.¹⁰³ This issue was squarely presented in a 2009 Texas Supreme Court decision, *Exxon Corporation v. Emerald Oil & Gas Company*.¹⁰⁴ The leases at issue had development causes requiring Exxon to “prosecute diligently a continuous drilling and development program until [the tracts are] fully developed for oil and gas,”^{104.1} and provided that the tracts were deemed to be “fully developed” when “at least one (1) well has been drilled and completed in each horizon or stratum capable of producing [oil or gas] in paying quantities for a specified number of acres.”^{104.2} The plaintiff royalty owners claimed that Exxon failed to fully develop two productive zones in violation of the development clauses. The court noted that the plaintiffs conceded that Exxon had complied with the spacing requirements and drilled the requisite number of wells per acre. The court held that evidence that further development potential existed when Exxon abandoned the

¹⁰⁰This lease shall never be forfeited, cancelled or terminated for failure by lessee to perform in whole or in part any of [its express or] implied obligations . . . unless there shall first be a final judicial ascertainment that such obligation . . . exists . . . and that lessee is in default. Upon such final determination, lessee is hereby given a reasonable time thereafter to comply with such obligation. . . .

Willingham v. Bryson, 294 S.W.2d 421, 422 (Tex. Civ. App. 1956).

¹⁰¹*Wellman v. Energy Resources, Inc.*, 557 S.E.2d 254, 259-62 (W. Va. 2001) and *Frick-Reid Supply Corp. v. Meers*, 52 S.W.2d 115, 118 (Tex. App. 1932).

¹⁰²See 4 Williams and Meyers, *supra* note 4, § 682.1.

¹⁰³See *Gulf Production Co. v. Kishi*, 103 S.W.2d 965, 968 (Tex. 1937) (“[t]he implied covenant arises only out of necessity and in the absence of an express stipulation with respect to development of the leased premises.”). See also *Lundin/Weber Co. LLC v. Brea Oil Co., Inc.*, 117 Cal. App. 4th 427, 432-33 (Cal. App. 2004); and *Sundheim v. Reef Oil Corp.*, 806 P.2d 503, 509-510 (Mont. 1991).

¹⁰⁴2009 WL 795668 (Tex. March 27, 2009)

^{104.1}*Id.* at *4.

^{104.2}*Id.* at *5.

leasehold in 1991 was not evidence that Exxon had failed to comply with the parties' agreement embodied in the leases' development clauses and that Exxon's compliance with its express obligations relieved it from a duty to comply with any implied obligations.¹⁰⁵

In *BB Energy, LP v. Devon Energy Production Company, LP*,¹⁰⁶ the issue presented was whether an express development covenant applied. Each of the leases involved had a primary term of five years and contained an addendum. Paragraph 17 of the addendum was comprised of the following two sentences:

In the event a portion or portions of the leased premises is pooled or unitized with other lands so as to form a pooled unit or units, operations on, completion of a well upon, or production from such unit or units will not maintain this lease in force as to that portion of the leased premises not included in such unit or units. This lease may be maintained in force as to any portion of the leased premises covered hereby and not included in such unit or units in any manner provided for herein; provided however, that if at the end of the primary term . . . Lessee is then engaged in drilling or reworking operations on the leased premises or on acreage pooled therewith . . . this lease shall remain in full force and effect as to all non-unitized acreage so long as Lessee commences drilling operations on the leased premises or on acreage pooled therewith within ninety (90) days of the completion of such well as a producer or dry hole and conducts continuous operations thereon with no cessation of longer than ninety (90) days between the completion of drilling or reworking operations on a well and the commencement of such operations for the next succeeding well.^{106.1}

The plaintiff contended that the first sentence of Paragraph 17 was a Pugh clause which was intended to limit the effect of production on portions of land that are pooled with other lands and that the second sentence constituted a "continuous development" clause that applied even if no portion of the leased premises had been pooled with other lands. It argued that the leases had terminated as to the undeveloped lands because the defendant had failed to comply with this continuous development requirement. The court rejected the plaintiff's argument and held that the continuous development obligation of the second sentence of Paragraph 17 did not apply if the leased lands had never been pooled as contemplated by the first sentence.

¹⁰⁵The leases included a 50% royalty obligation and stringent disclosure, surrender and development clauses. During the term of the agreement, Exxon drilled 121 wells and produced at least 15 million barrels of oil and more than 65 billion cubic feet of gas, resulting in the payment of more than \$43 million in royalties.

¹⁰⁶2008 WL 2164583 (N.D. Tex. May 23, 2008).

^{106.1}*Id.* at *3.

[2] Implied Covenant for Further Development

Absent an express covenant, the courts have fashioned an implied covenant to further develop which applies after production has been obtained. The rationale for the implied covenant is to prevent the lessee from holding the balance of the leased tract indefinitely, thus depriving the lessor of royalties and the opportunity to make other arrangements.¹⁰⁷ The time element is an important factor.¹⁰⁸

The lessor has the burden of providing legally sufficient evidence to support a finding that the implied covenant to further develop has been breached.¹⁰⁹ The lessor must also prove that there is a reasonable expectation that further development would yield a profit for the lessee.¹¹⁰

In *Slaaten v. Amerada Hess Corp.*,¹¹¹ the court identified several factors relevant to a determination of whether the lessee has breached the implied covenant to further develop, including (1) the quantity of oil and gas likely to be found; (2) market conditions and prevailing prices; (3) operations on adjacent lands; (4) the drainage characteristics of the reservoir; (5) the cost of drilling, equipping, and operating the wells; (6) transportation and storage costs; (7) the willingness of another operator to drill on the tract in question; (8) the attitude of the lessee towards further development; and (9) the elapsed time since drilling operations were last conducted. These are questions of fact, and appellate courts will apply the clearly erroneous standard in their review of the trial court's decision.¹¹²

[a] Development of Deeper Formations

The implied covenant to develop applies to undeveloped deeper formations. But lessors generally have not been successful in establishing that such depths could be profitably drilled and/or that the lessee acted

¹⁰⁷ *Sauder v. Mid-Continent Petroleum Corp.*, 292 U.S. 272, 281 (1934); *Superior Oil Co. v. Devon Corp.*, 604 F.2d 1063, 1069 (8th Cir. 1979).

¹⁰⁸ *Temple v. Continental Oil Co.*, 328 P.2d 358, 360 (Kan. 1958) (“fulfillment of this obligation might require the drilling of several wells, despite the fact that one well alone might ultimately drain the entire reservoir given unlimited time”).

¹⁰⁹ *Grayson v. Crescendo Resources, L.P.*, 104 S.W.3d 736, 741 (Tex. App. 2003); *Whitham Farms, LLC v. City of Longmont*, 97 P.3d 135, 138 (Colo. App. 2003); *Sanders v. Birmingham*, 522 P.2d 959, 965 (Kan. 1974).

¹¹⁰ *Superior Oil Co. v. Devon Corp.*, 604 F.2d 1063, 1068 (8th Cir. 1979); *Clifton v. Koontz*, 325 S.W.2d 684, 695 (Tex. 1959).

¹¹¹ 459 N.W.2d 765, 769 (N.D. 1990) (citations omitted).

¹¹² *Id.* at 769-770. See also *Edmundson Brothers Partnership v. Montex Drilling Company*, 731 So.2d 1049, 1055 (La. App. 1999) (evidence supported finding that a single well in 10 years did not develop adjacent 1,196 acre lease; lessors were entitled to an award for lost leasing opportunities).

imprudently in not developing such horizons.¹¹³ In *Lundin/Weber Company LLC v. Brea Oil Company Inc.*,¹¹⁴ defendant Brea was lessee under two leases issued in 1926 and 1995. The leases expressly required the drilling of oil and gas wells by Brea, and Brea was in compliance with these provisions. However, plaintiff Lundin/Weber contended that Brea should drill additional wells below 3,000 feet. The court examined the provisions of both leases and found that the 1926 lease required the lessee to drill 10 new wells each year for the first four years to a depth of 1,000 feet, while the 1995 lease contained a three-month continuous development clause, but limited this obligation to one oil well per 10 acres and one gas well per 160 acres. The court held that these provisions constituted express limitations on Brea's obligation to develop and, since Brea had complied with its express obligations, the "court should not insert obligations in direct conflict with the limitation expressed by the parties."¹¹⁵

Similarly, in *Blythe v. Sohio Petroleum Company*,¹¹⁶ a total of 51 wells had been drilled to exploit the shallow zones, 24 of which were producers. Later, interest in the possibilities of oil and gas being found in commercial quantities in the deeper formations had intensified. The court noted that the lands covered by the Blythe lease were very complex from a geological standpoint, the most useful and accurate method for locating possible oil traps were through seismic, the lessor had denied the lessee permission to conduct seismic operations on the lease, and a wildcat well drilled to the deeper formations would have been quite expensive. It also noted that none of the five wells within a radius of five miles of the leased lands that were drilled to the deeper formations had been productive. The court upheld the trial court's finding that the defendant had not acted in bad faith by not undertaking the expensive and risky drilling operation.

[b] Statutory Requirements to Develop

Several states have statutory requirements as to further development. The Kansas Deep Horizons Act implies in all oil and gas leases a covenant "to reasonably explore and to develop the minerals which are the subject

¹¹³ See, e.g., *Atlantic Richfield Co. v. Gruy*, 720 S.W.2d 121 (Tex. App. 1986), and *Blythe v. Sohio Petroleum Company*, 271 F.2d 861 (10th Cir. 1959).

¹¹⁴ 117 Cal. App. 4th 427 (Cal. App. 2004).

¹¹⁵ *Id.* at 436.

¹¹⁶ 271 F.2d 861 (10th Cir. 1959).

of such lease.”¹¹⁷ Louisiana law requires the mineral lessee to develop the property as a reasonably prudent operator for the mutual benefit of itself and the lessor.¹¹⁸ The obligation of further development also is well settled in Louisiana case law.¹¹⁹ North Dakota law provides that when a lease covers lands partially within and partially without a unit, unit production may not be deemed production from the leased lands lying outside the unit area after two years from the date of the unitization order or the expiration of the primary term of the lease, whichever is the later date, and, after such date, the lease as to the affected lands may be maintained only in accordance with the lease terms.¹²⁰

[c] Notice Requirement

Most jurisdictions require that written notice of the asserted breach of the implied covenant to develop be provided to the lessee and that the lessee be given a reasonable time for performance before the courts will entertain an action for damages or cancellation of the lease.¹²¹ In *Superior Oil Company v. Devon Corporation*,¹²² plaintiff Superior Oil Company had taken a lease in 1949 from defendants’ predecessors-in-interest covering 3,440 acres in Banner County, Nebraska. Oil was discovered and produced on the leasehold within the primary term. In 1961, that portion of the leasehold on which oil was being produced was unitized. After 1961, there was no further drilling on the lease by Superior. In 1976, the successors of the original lessors executed top leases on certain of the undeveloped tracts covered by the Superior lease, and an oil well was

¹¹⁷K.S.A. 55-223. See *Lewis v. Kansas Production Co., Inc.*, 199 P.3d 180 (Kan. App. 2009), where the court found that the lessee had breached the covenant to develop the deeper formations, but that an appropriate remedy under the Deep Horizons Act was conditional cancellation of the lease and the grant of a reasonable time for the lessee to drill a well.

¹¹⁸La.R.S. § 31:122.

¹¹⁹See, e.g., *Carter v. Arkansas-Louisiana Gas Co.*, 36 So.2d 26, 28 (La. 1948). See also *Rathborne Land Co., L.L.C. v. Ascent Energy, Inc.*, 2008 WL 5427751 (E.D. La. December 31, 2008), where the court found that the failure to join in seismic surveys, pursue farmouts, or release lands held by a well having no meaningful production violated the prudent operator rule.

¹²⁰N.D.C.C. § 38-08-09.8.

¹²¹See, e.g., *St. Luke’s United Methodist Church v. CNG Development Co.*, 663 S.E.2d 639 (W. Va. 2008); *Robinson v. Continental Oil Co.*, 255 F. Supp. 61, 64 (D.Kan. 1966); and *Sapp v. Massey*, 358 S.W.2d 490, 493 (Ky. 1962). Louisiana requires such notice by statute and computes damages from the time written notice was received by the lessee. La. R.S. 31:136. *But see* *Crain v. Hill Resources, Inc.*, 972 P.2d 1179, 1181 (Okla. App. 1998); and *North York Land Associates v. Byron Oil Industries, Inc.*, 695 P.2d 1188, 1192 (Colo. App. 1984).

¹²²604 F.2d 1063 (8th Cir. 1979).

successfully completed on one of the tracts in February 1977. Superior sued to quiet its title to the entire leasehold and for breach of contract, conversion, and trespass. The trial court found that Superior had breached the implied covenant of further development and that no further demand was necessary by the successor lessors to obtain a cancellation of the Superior lease outside of the unit. The Eighth Circuit agreed with the trial court that Superior had failed to prudently develop the leasehold, but it found that the trial court had erred in ordering the cancellation of the Superior lease where no notice or demand had been served on the lessee prior to the execution of the top leases. It rejected the trial court's rationale that equity required cancellation absent notice and demand because the lease had gone undeveloped for an unreasonable period of time and held that a rule requiring notice and demand "is consistent with due process and with the law's abhorrence of forfeitures."¹²³ In contrast to the holding in *Superior*, in *North York Land Associates v. Byron Oil Industries Inc.*,¹²⁴ the Colorado Court of Appeals upheld the trial court's finding that, while the lessee was not obligated to develop the leasehold outside the 80 acres within the pooled area because the evidence indicated that such development would not be profitable, it could not hold the undeveloped land merely for speculation. It also agreed that notice and demand were not required because the lessee's responses to verbal demands "created a reasonable belief in [lessor] that further demands short of a lawsuit would have been futile."¹²⁵

The remedies awarded for breach of the implied covenant to develop vary. The "lost royalty" rule awards the lessor the royalty that it would have received had the lessee developed the leasehold as a reasonably prudent operator.¹²⁶ Some courts have awarded lessors damages for lost leasing opportunities.¹²⁷ If monetary damages are insufficient, partial cancellation of the lease may be appropriate, to apply only to the lands that the court has found should have been developed. This was the remedy approved by the West Virginia Supreme Court in *St. Luke's United Methodist Church v. CNG Development Company*.¹²⁸ In *St. Luke's*, the court reversed the trial court's holding that partial cancellation or partial recession of an oil

¹²³ *Id.*

¹²⁴ 695 P.2d 1188 (Colo. App. 1984).

¹²⁵ *Id.* at 1192.

¹²⁶ See, e.g., *Howerton v. Kansas Natural Gas Co.*, 108 P. 813 (Kan. 1910).

¹²⁷ See, e.g., *Edmundson Brothers P'ship v. Montex Drilling Co.*, 731 So.2d 1049, 1065-1066 (La. App. 1999).

¹²⁸ 663 S.E.2d 639 (W. Va. 2008)

and gas lease for a breach of the implied covenant to develop were not appropriate remedies where monetary damages are available, although it ordered the trial court to enter a provisional decree which would cancel the lease as to the undeveloped acreage if an exploratory well was not drilled within a reasonable period of time, finding that the plaintiff had sought injunctive relief to prevent the defendant from drilling additional wells in order to protect a top lease of the undeveloped acreage issued by the plaintiff. Total lease cancellation is also a remedy, but this is done only in extreme circumstances.¹²⁹

[3] Implied Covenant of Further Exploration

Certain jurisdictions have recognized, either through case law or by statute, the implied covenant to explore further, which was first proposed in 1956.¹³⁰ Under this proposed covenant, a lessor is not required to prove that further exploration would be profitable to the lessee, but the lessee is required to either explore the undeveloped acreage, both laterally and vertically, or return it to the lessor. Colorado courts have recognized this implied covenant.¹³¹ Arkansas courts may have adopted it.¹³² Kansas has codified a covenant to explore further,¹³³ as has Louisiana.¹³⁴ However, Oklahoma and Texas have rejected such a covenant.¹³⁵ In the famous case of *Clifton v. Koontz*,¹³⁶ the Texas Supreme Court categorically rejected the proposition, stating that:

We hold that there is no implied covenant to explore as distinguished from the implied covenant to conduct additional development after production in paying quantities has been obtained. . . . This theory [of a duty to explore] is untenable and is diametrically opposed to our established “prudent operator” rule where expectation of profit is an essential element.¹³⁷

¹²⁹ See, e.g., *Waseco Chemical & Supply Co. v. Bayou State Oil Corp.*, 371 So.2d 305, 307 (La. App. 1979).

¹³⁰ C.J. Meyers, “The Implied Covenant of Exploration,” 34 Tex. L. Rev. 553 (1956).

¹³¹ See *North York Land Associates v. Byron Oil Indus., Inc.*, 695 P.2d 1188, 1191 (Colo. App. 1984), and *Gillette v. Pepper Tank Co.*, 694 P.2d 369, 372 (Colo. App. 1984).

¹³² See *Byrd v. Bradham*, 655 S.W.2d 366 (Ark. 1983) (declined to follow on other grounds); and *Skelly Oil Co. v. Scoggins*, 329 S.W.2d 424 (Ark. 1959).

¹³³ Kan. Stat. Ann. §§ 55-223 - 224.

¹³⁴ Commentary to La.R.S. 31:122.

¹³⁵ See *Sun Exploration & Prod. Co. v. Jackson*, 783 S.W.2d 202 (Tex. 1989) and *Mitchell v. Amerada Hess Corp.*, 638 P.2d 441 (Okla. 1981).

¹³⁶ 325 S.W.2d 684 (Tex. 1959).

¹³⁷ *Id.* at 696-697.

Other courts have reserved judgment on whether such a covenant exists. For example, in *Lundin/Weber Company LLC v. Brea*,¹³⁸ the court found that the defendant had satisfied the express covenant to develop and that, therefore, “we leave for another day the more fundamental question whether, and to what extent, California courts will imply a covenant of further exploration when such a covenant would not conflict with the express terms of the oil and gas lease.”¹³⁹

Whether or not a court recognizes the implied covenant to further explore, continued inactivity is likely to lead to a day of reckoning. As the court stated in *Blake v. Texas Co.*:¹⁴⁰ “The defendant cannot forever choose to delay further development and at the same time prevent others from drilling. Should the total time of inactivity measured in years become unconscionable in and of itself, the plaintiffs will be entitled to oust the ‘dog in the manger.’”¹⁴¹

[4] Unconventional Gas Plays¹⁴²

It remains to be determined how the courts will apply the implied covenants of further development and of further exploration to unconventional gas plays. An exploratory well followed by development or step-out wells is not the norm in shale or other unconventional gas plays where there may be greater reservoir continuity and/or uniformity and where an operator may drill a series of delineation wells, strat tests, or pilot wells and shoot seismic before it begins to “develop” the field. A good argument can be made that mechanical/engineering/completion risks have replaced geological risks with these plays. Also, determining the correct drainage pattern to be used to maximize the ultimate recovery of the resource in these plays involves an analysis of well performance over possibly an extended period of time. It will be interesting to see what development obligations the courts will impose on lessees while they are conducting this type of analysis.¹⁴³

138117 Cal. App. 4th 427 (Cal. App. 2004).

139*Id.* at 437.

140123 F. Supp. 73, 80 (D.C. Okla. 1954).

141*Id.* at 80.

142The authors wish to express their appreciation to James J. O’Malley, Land Director-U.S. Onshore Exploration for Anadarko Petroleum Corporation, for his assistance with this subsection.

143See, e.g., *Blythe v. Sohio Petroleum Co.*, 271 F.2d 861 (10th Cir. 1959).

§ 23.06 Conclusion

Unlike other basic industry documents, such as the Model Form Operating Agreement, there is no “standard” form of oil and gas lease, although at least half of them are designated “Producers 88.” The terms of printed lease forms can vary substantially, and, particularly in competitive areas, lease brokers are not always careful about the forms they use and/or the terms they will accept in an addendum to the lease prepared by the lessor. Lessors are becoming increasingly sophisticated and knowledgeable as to modifications they might seek in the lessee’s lease form, thanks in part to advice they receive from organizations such as the National Association of Royalty Owners. Lessor-friendly clauses such as those providing for cost-free royalties, favored nations reopeners covering bonus and royalty payments,¹⁴⁴ continuous development operations once production is obtained, and/or immediate termination at the lessor’s option for the lessee’s default are becoming the norm in leases covering “hot” plays.

But lessors are not alone in wanting to substantially alter the traditional lease form. Lessees increasingly seek to tailor the form to fit the particular play or concept they are chasing, and they may seek to include lease provisions that go beyond the traditional savings clauses, such as “kickers” that, upon payment of a predetermined additional bonus by the lessee, automatically extend the lease or a right of first refusal allowing the lessee to match any bona fide offers the lessor receives for a new lease prior to the end of the primary term, coupled with more traditional provisions requiring notice of default with reasonable cure periods.

In this dynamic environment, lessees will be put to the test by their lessors and/or by their top-leasing competitors, and they will need to be nimble and creative in negotiating their lease savings clauses and their development obligations if they wish to protect their most precious asset, their lease inventory.

¹⁴⁴Companies operating in Louisiana have informed the authors of threatened litigation alleging fraud and misrepresentation by lessees who got into a play early and were able to negotiate bonus and royalty payments that proved to be below market once the frenzy hit.