The Quick and the Dead: Production Related Savings Events for Oil and Gas Leases

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Nature of the Interest Created by an Oil and Gas Lease

Texas

– *Stephens County v. Mid-Kansas Oil & Gas Co.*

• “[a]t common law, a grant of land for such a term and for such use and purpose-and no other-created the estate called a base, qualified or determinable, fee. . . .” 254 S.W. 290, 296 (Tex. 1923).Id.

– The Supreme Court of Texas has since clarified this position by declaring that a lease automatically terminates upon cessation of production after the primary term.
Nature of the Interest Created by an Oil and Gas Lease

Oklahoma

– *Herbert J. Danne v. Texaco Exploration and Production Inc.*, -

• 883 P.2d 210 (Okla. 1994).

• The Court of Appeals held the oil and gas lease does not transfer or convey an actual interest in the leased premises, as the Texas courts concluded, but rather transfers the right to explore and mine the leased premises.

– “In the primary term, before hydrocarbons are discovered, the lessee has the right to explore for a fixed period of time.

• Once oil and gas are produced from the subject tract, thereby extending the lease into the secondary term, “the lessee has proved a valuable asset and has established a right to develop that asset.”
Effect of Cessation of Production

• Oklahoma - Danne - Oklahoma does not, take the view that habendum clauses are special limitations; rather, Oklahoma views the habendum clause as an estate on condition subsequent creating only a right of entry in the grantor.

• Texas - Stephens - the Texas courts have concluded that the oil and gas lease will terminate when oil or gas ceases to be produced in paying quantities.
Temporary Cessation Doctrine

• Texas’ equitable remedy for an Inequitable Effect of the Determinable Estate

• The question: whether temporary cessation of production from the premises would result in the termination of the oil and gas lease?

• The Solution: A temporary cessation of production should not result in a forfeiture, or termination, of the lease, if the cessation of production were “unforeseen and unavoidable” and if “the lessees in good faith used reasonable diligence to resume production, within a reasonable time

• Emphasis in Texas on temporary cessation of production stoppage due to mechanical or other unforeseeable issues
Temporary Cessation Doctrine

- Oklahoma and Temporary Cessation of Production
- A lease continues in force unless the period of cessation, viewed in the light of all the circumstances is for an unreasonable time.
- *Townsend v. Creekmore-Rooney Co.*, 332 P.2d 35 (Okla. 1958). “[t]he lease terminates by its own provisions when oil or gas are no longer produced after the primary term, except where there are equitable considerations which justify a temporary cessation of production.”
Cessation of Production Clauses v. Temporary Cessation Doctrine

Both Texas and Oklahoma follow the view that an express lease term dealing with temporary cessation eliminates the application of any common law rule.
Temporary Cessation - Colorado

• Although Colorado has not explicitly adopted the “temporary cessation of production doctrine,” it has addressed the issue of whether a lease should terminate for failure of production. The determination turns on the relevant lease provisions, the circumstances of the individual case, and considerations of equity. See Mountain States Oil Corp. v. Sandoval, 125 P.2d 964, 967 (Colo. 1942).

Temporary Cessation - Colorado

• In *North York Land Assoc. v. Byron Oil Industries., Inc.*, leased acreage was considered as two separate portions, the pooled area and the non-pooled area. Although a well was producing on the pooled area, the non-pooled area had not been produced or explored for a number of years. Court determined that the lease should be cancelled as to the non-pooled area. “Production of oil on a small portion of the leased tract cannot justify the lessee’s holding the balance indefinitely, depriving the lessor not only of the expected royalty, but of the privilege of making some other arrangement.”
Temporary Cessation - Kansas

• The Kansas Supreme court has consistently held that where the primary term of an oil and gas lease has expired and its terms are being continued pursuant to the “thereafter clause” by continued production of oil or gas, all rights under it terminate when production in paying quantities ceases. Tate v. Stanolind Oil & Gas Co., 240 P.2d 465 (Kan. 1952); Brack v. McDowell, 320 P.2d 1056 (Kan. 1958); Wagner v. Sunray Mid-Continent Oil Co., 318 P.2d 1039 (Kan. 1957)

• If there is a halt in production at an oil leasehold, the burden is upon the lessee to prove that the cessation is temporary and not permanent. . . . Whether the cessation of production is temporary or permanent is a question of fact to be determined by the trial court. Eichman v. Leavell Res. Corp., 876 P.2d 171, 174 (Kan. Ct. App. 1994).
There are three factors relevant to whether a cessation is temporary or permanent: (1) the period of time cessation has persisted; (2) the intent of the operator; and (3) the cause of cessation. In general, no one of these elements can be isolated and held to be decisive.

In *Reese Enterprises, Inc. v. Lawson*, 553 P.2d 885 (Kan. 1976), while court found an eighteen month period of unprofitable operation sufficient to terminate an oil and gas lease under a “thereafter” clause that provided that continuation of the lease was dependent upon production in paying quantities, the time factor was case specific.
Temporary Cessation - Kansas

- In *Welsh v. Trivestoco Energy Co.*, 221 P.3d 609 (Kan. Ct. App. 2009). The court held an express contractual provision that addresses temporary cessation supersedes any generally applicable doctrines, and thus, a lessee “cannot invoke the doctrine of temporary cessation to avoid complying with a specific provision in the lease that addresses temporary cessation of production.

- In *Baker v. Hugoton Production Company*, 320 P.2d 772 (Kan. 1958) The court considered the effect of pooling on cessation issues. Ten gas-drilling units included all of the land covered by the lease. Gas was being produced from seven of those units, containing 2,950 acres, but not the other three, which contained 680 acres. Production on the seven units, or any one of them, perpetuated the lease on all of the units where the lease had granted an interest in the entire 3,630 acres.
Temporary Cessation – West Virginia

• Sult v. A. Hochstetter Oil Co., 61 S.E. 307, 308–10 (W.Va. 1908). An oil and gas lessee acquires a mere “license, conferred by the contract of lease, an incident of which is the right to sever the minerals, a part of the corpus of the land.” This interest is a unique right fit for equity jurisdiction.

• Court held that lapses in production and their duration are facts relevant to but not determinative of lease termination.

• No period of nonproduction will terminate a lease automatically if such would contradict the intent of the leasing parties as evidenced by their conduct.
Temporary Cessation – West Virginia

• *Bryan v. Big Two Mile Gas Co.*, factors to be considered in determining whether the cessation is “temporary” include the length of time without production, the cause of the delay, and whether the lessee exercised reasonable diligence to resume production.

• A cessation of production will automatically terminate a lease unless it is excused under the “temporary cessation of production” doctrine.
Temporary Cessation – West Virginia

• A “temporary” cessation of production is excusable if it is (1) not unreasonably protracted, (2) incidental to the normal operation of the lease, and (3) if it can be said that the possibility of such a period of cessation would be contemplated by objectively reasonable parties to such a lease.

• Cessation from 1979–80 was an excusable cessation while a cessation from 1987-90 was sufficiently long to cause a forfeiture of the lease.
Temporary Cessation - Ohio


- Courts universally recognize the proposition that a mere temporary cessation in the production of a gas or oil well will not terminate the lease under a habendum clause of an oil and gas lease where the owner of the lease exercises reasonable diligence and good faith in attempting to resume production of the well.

- Critical factor to reasonableness is the length of time the well is out of production. . . . Additionally, all attendant circumstances must be taken into account.

- In *Wagner*, two to three years was considered too long a period to permit the lease to stay in force, whereas in *Barrett v. Dorr*, 212 N.E.2d 29 (Ind. Ct. App. 1965), cited favorably by the *Wagner* court, a one-year cessation with some activity toward bringing the well into production was considered reasonable.
In *Whitmer v. Mack*, 1981 Ohio App. LEXIS 12337 (1981), the court held a three year period with no production was fatal to a lease, even though the lessee resumed operation after that time. The lease terminated automatically, by its own terms, when production ceased.
Temporary Cessation – North Dakota

• North Dakota adheres to the general rule that, where the lease has been extended beyond its primary term by production, a temporary cessation of production will not automatically terminate an oil and gas lease.

• In Feland v. Placid Oil Co., 171 N.W.2d 829 (N.D. 1969), the Court reasoned: “since there are various justifiable causes for the slowing up, or temporary cessation, of production, it would be harsh and inequitable to automatically terminate a lease in all cases of cessation.” This rule holds true whether the habendum clause creates a defeasible-term interest or not.
Temporary Cessation – North Dakota

• Whether the cessation is temporary or permanent is a question of fact. In making that determination the factors adopted by the North Dakota Supreme Court in *Greenfield v. Thill*, *are those* from the decision of the Kansas court in *Wagner v. Sunray Mid-Continent Oil Co.*
Nature of Shut in Payments

Texas - *Amber Oil and Gas Co. v. Bratton*

– Shut in royalties are, “periodic payments for the privilege of deferring explorations and production after the primary term.”

711 S.W.2d 741 (Tex. App. 1986)
Nature of Shut in Payments

Oklahoma - *Gard v. Kaiser*,

– A shut in royalty clause “allows the continuance of the lease, without actual production and marketing of the shut-in product by the *substitution of the stipulated payment for the royalties* 582 P. 2d 1311 (Okla. 1978).
When Shut in Clauses Apply

Texas

*Hydrocarbon Management v. Tracker Exploration, Inc.*

- “for a well to be maintained by the payment of shut-in royalties, it must be capable of producing gas in paying quantities at the time it is shut-in.
- The phrase capable of production in paying quantities means a well that will produce in paying quantities if the well is turned “on,” and it begins flowing, without additional equipment or repair.”
When Shut in Clauses Apply

Oklahoma

_Fisher v. Grace Petroleum Corp._

- The courts in Oklahoma have concluded a well cannot be shut-in or a lease preserved by the shut-in royalty provision unless the well is actually capable of production in paying quantities.

Failure to Make Timely Payment

Oklahoma

*Roye Realty & Developing, Inc., v. Watson*

“[n]either nonpayment of shut-in royalty after the end of the primary term, nor the failure to secure actual production prior to the end of the shut-in royalty period will terminate the lease if the lessee is acting as a reasonably prudent lessee under the circumstances in securing actual production.”
Failure to Make Timely Payment

Amber Oil and Gas Co [B]ecause payments of a shut-in royalty is a substitute for production which keeps the lease in effect, failure to make a timely shut in payment is the equivalent of cessation of production and the lease terminates.

– However, Texas Courts have shown some flexibility in what is considered timely payment

• General Rule: shut-in payments must be paid on or before the date that the well was going to be shut-in
• Exception where a cessation of production clause applies
• Exception for express clause making a well capable of production the substitute performance
Shut In Clauses - Kansas

Levin v. Maw Oil & Gas

• A well generally qualifies as shut-in under Kansas law when it is physically complete and capable of producing in paying quantities, even if it has not actually produced in paying quantities in the past.

• A well not yet connected to a pipeline does not necessarily prevent it from being accurately described as shut-in.

• Question of fact and the factors to be considered “are those that affect the properties and potential of the well itself, rather than the likely success of any processing or transport of product that remains to be attempted or accomplished.”
Shut In Clauses - Kansas

Mineral Deeds

*Dewell v. Federal Land Bank*,

- Where a lease is extended through a valid exercise of the shut in provision, the rights of a third party under a separate mineral deed that also has conditions linked to production are not also extended.

- The payment of shut-in royalties is not the equivalent of production under any other contract. 380 P.2d 379 (Kan. 1963).
Shut In Clauses - Colorado

• Ties evaluation of shut in clauses to general law regarding implied covenants

• A shut-in royalty is “constructive production” by allowing the lessee to extend his lease past the primary term without marketing product,

• Where commercial discovery has been made during the primary term, thereby satisfying the habendum clause, the shut-in clause is not necessary to extend the lease beyond its primary term and does not operate as a special limitation to extend the term of the lease. The lease will be extended with or without the shut-in clause subject only to forfeiture for failure to comply with the implied covenant to market.
Shut In Clauses - Colorado

• Parties may choose to insert a shut-in royalty clause to provide “an additional special limitation,” requiring payment of the shut-in royalty if gas is not marketed.

• Duty to market has been held to apply during primary term. Therefore, payment of shut-in royalties, if used, may be necessary both before and after the primary term expires if a well capable of production is shut-in.
Pooled Lease

*O’Hara v. Coltrin* addressed shut ins on pooled leases:

- Lease allowed pooling and provided that well on pooled acreage that was not part of the lease was sufficient to maintain the lease as to the entire leased premises.

- Two wells were drilled on pooled land, but not on the leasehold, and were subsequently shut-in.

- The court found that the shut-in clause should be combined with the pooling clause, such that the payments continued the lease in full force and effect.

Shut In Clauses – West Virginia

No Shut In Cases per se

– Howell v. Appalachian Energy, Inc., dealt with tender of a shut in payment that was not expressly provided for in the lease.

• Wells were non-productive for 8 years, lessors notified lessees of abandonment claim

• Lessee responded by tendering a check for a shut-in payment, even though no shut-in clause in the lease, argued that tender of shut-in payment showed intent not to abandon.
Shut In Clauses – West Virginia

• Court rejected Lessee’s argument and found 8 years of non production and non payment determinative.

• *Howell* case implies that West Virginia courts would evaluate the application of a shut-in clause to preserve a lease in the secondary term by appropriate payment under a shut in clause. 519 S.E.2d 423 (W.Va. 1991).
Shut In Clauses - Ohio

Courts have generally held that [a] shut-in royalty clause modifies the habendum clause so that the lease may be preserved between the time of discovery of the product and marketing of same.

Wuenschel v. Northwood Energy Corp.

- Lessors sought forfeiture of lease alleging that wells were not productive.
- gas production had stopped for repairs to a leaking pipeline; oil production had continued.
- Held, no shut in obligation because oil was produced
Shut In Clauses - Ohio

*Moore v. Adams* - tardy payment of shut in after five years of non production will not hold the lease

*Morrison v. Petro Evaluation Services*- on suit for payment of shut ins, held that lessees actions showed intent not to abandon, so shut in payments were due
The use of cessation clauses in contemporary leases and contemporary courts comfort with forfeiture likely means that temporary cessation doctrine will not expand and will likely be narrowed.

Shut in clauses should never be treated as an afterthought or boilerplate in either lease negotiation or lease administration.

Questions?