Defining “Production in Paying Quantities”: A Survey of Habendum Clause Cases Throughout the United States

Presented to the
North Dakota Law Review Energy Law Symposium
Bismarck, North Dakota

By:
Zachary M. Wallen
Steptoe & Johnson PLLC
zachary.wallen@steptoe-johnson.com

© 2015 Steptoe & Johnson PLLC All Rights Reserved
Disclaimer

- Views and comments stated in this presentation are solely those of the presenter and are NOT:
  - Views of presenter’s firm
  - Views of any of any clients of presenter’s firm
  - Legal Advice as to any specific matter
Introduction

• So what is a habendum clause?
• In the oil and gas leasing context, it defines the type of interest and rights granted to the lessee—particularly as to term.
  – Primary Term
  – Secondary Term
Term of an Oil and Gas Lease

• Primary

• Secondary
  – so long thereafter as oil or gas is produced (in paying quantities); or
  – so long thereafter as oil or gas can be produced (in paying quantities; or
  – so long thereafter as oil or gas can be found (in paying quantities; or
  – so long thereafter as oil or gas is discovered (in paying quantities
Plain meaning of those terms? Right?

- Produced means produced? Produced in Paying Quantities means PPQ?
  - Rarely
  - Terms of Art
    - Meaning product of case law
Two Fundamental Questions:

• What constitutes “production”?

• What constitutes “paying quantities?”
Analytical Approach

• Individuality of forums ➔ state-by-state analysis of case law
Mid-continent States
Garcia v. King
164 S.W.2d 509 (Tex. 1942)

• Facts and Procedural History
• Analysis
  – Look to other decisions
  – Production must be in production in paying quantities
  – Key Question: “not only amount of production, but also the ability to market the product at a profit.”
Clifton v. Koontz
325 S.W.2d 684 (Tex. 1959)

• Facts

• Analysis
  – When does marginal well produce in paying quantities?
  – Would a reasonably prudent operator continue to operate the well?
    • Factor test → all factors that would influence reasonably prudent operator
    • Does not factor in depreciation
• Facts
  – Capped well

• Analysis and Holding
  – Expands on *Garcia v. King*
  – Paying Quantities includes ability to market at a profit
  – Did not happen → lease terminated
• Facts
  – Habendum clause allowed for the capability of production to sustain the lease

• Analysis and Holding
  – Court defined capability of production
    • Well that will produce in paying quantities if “turned ‘on’”
Oklahoma Key Theme

- Capability of Production
McVicker v. Horn, Robinson & Nathan
322 P.2d 410 (Okla. 1958)

• Facts
  – Completed well, but not connected to pipeline
  – Lessee’s argument: Well *could* produce gas

• Analysis and Holding
  – Immediate marketing not required for production
  – Caveat: Reasonable probability of success required
• Capability rule confirmed in Pack v. Santa Fe Minerals, 869 P.2d 323 (Okla. 1994)
• Lease OK in primary term “as long as the well remained capable of producing in paying quantities, regardless of any marketing of the product.”
Mason v. Ladd Petroleum
630 P.2d 1283 (Okla. 1981)

• Facts
  – Centered around meaning of “production”

• Analysis and Holding
  – Production = Production in Paying Quantities
  – Deductable expenses are those connected with lifting or producing
Kansas
Tate v. Stanolind Oil & Gas Company
240 P.2d 465 (Kan. 1952)

• Kansas is an actual production state
• Production “distinct from mere exploration or discovery of oil” during primary term
• Facts
  – “Free flow” only

• Analysis and Holding
  – Rejects Lessee’s good faith determination
  – Objective, mathematical computation
  – Operating Costs > Gross Income → Lease expired
Louisiana

• Outlier in two regards:
  – Mathematical test
  – Codified by statute
• “Objective Standard”
• Courts compared Royalties paid to Lessor versus maintenance costs of operating the leasehold
Green v. Standard Oil Company of Louisiana
84 So. 211 (La. 1920)

• Facts
  – Well that produced so little oil would ordinarily have been abandoned
  – Lessee had other neighboring wells

• Analysis and Holding
  – Lease expired
  – Must develop with reasonable diligence or give up lease
• Essentially, codified existing LA common law
• Relevant Code Sections:
Eastern States

**Marcellus Shale area:** New research shows an estimated 500 trillion cubic feet of natural gas lies within the rock.

**Devonian Black Shale Succession:** The Marcellus Shale comprises part of this large formation.
Eastern States

• Early developers of oil and gas law
  – But generally, a gap in the dates of decisions
• Recurring Theme:
  – Good-faith determination by the Lessee
Marcellus Shale Formation
Young v. Forest Oil Company
45 A.121 (Pa. 1899)

• Facts
  – PPQ lease
  – Lessee drilled five wells, but refused to drill any more
  – Lessor argued that areas of 53 acre tract lacked wells
    → therefore not production in paying quantities

• Analysis and Holding
  – When does a well produce in paying quantities?
    • When it “pays a profit, even a small one over operating expenses, even though it may never repay its cost, and the operation as a whole may result in a loss.”
  – Lease upheld → good faith determination of Lessee
Marcellus Shale Boom

• What will PA courts do?
  – Follow *Young v. Forest Oil*?
  – Adopt objective standard?
T.W. Phillips Gas and Oil Company v. Jedlicka
42 A.3d 261 (Pa. 2012)

• Facts
  – Lessors and Lessees in conflict over plan to drill new wells under 1928 lease

• Arguments
  – Lessor: Existing well sustained loss in 1959 → lease expired
  – Lessees: Continuous good faith effort to turn a profit

• Holding: Good faith standard over reasonable period of time → Lease upheld
Kentucky
• Facts
  – Lessee sought to abandon lease
  – Lessors claimed obligated payment of rental or drilling of wells

• Holding
  – Abandoning lease OK
  – Good faith judgment of operator
Reynolds v. White Plains Oil & Gas Co.  
250 S.W. 975 (Ky. Ct. App. 1923)

• Facts
  – One barrel of oil every other day
  – “So long thereafter as oil and gas are produced or operations are continued thereon”

• Holding
  – Lease good; decision to terminate rests with good faith determination of Lessee
  – Refused to construe production as production in paying quantities
Enfield v. Woods
248 S.W. 842 (Ky. Ct. App. 1923)

• Facts
  – “Mere scum of oil”

• Argument
  – Lessee: No requirement of PPQ; only production

• Holding
  – No PPQ requirement, but “production must be tangible and substantial, but it need not be great”
  – Standard: Profitable operation
  – Lease expired
Other Kentucky Cases

• Sale of gas not required
  – But reasonable efforts are
  – Reiterated in 2000
South Penn Oil Co. v. Snodgrass
76 S.E. 961 (W. Va. 1912)

• Facts
  – “As long thereafter as oil or gas or either of them is produced therefrom”
  – Well drilled on last day of primary term
  – Lessors sought to terminate lease

• Analysis and Holding
  – Habendum clause exists to allow skillful operator to recoup costs
  – Lessor well within rights under contract to wait to drill
  – Lease upheld
Goodwin v. Wright
255 S.E.2d 924 (W. Va. 1979)

• Facts
  – Rental payments ceased, but house gas continued

• Analysis and Holding
  – Paying production required $\rightarrow$ commercially profitable
    • Enough that Lessor receives a royalty payment
  – Free gas to Lessor not enough
  – Lease expired
Midwestern States

- North Dakota
- South Dakota
- Minnesota
- Wisconsin
- Michigan
- Nebraska
- Iowa
- Illinois
- Indiana
- Ohio
- Kansas
- Missouri
North Dakota
Olson v. Schwartz
345 N.W.2d 33 (N.D. 1984)

• Facts
  – Similar to Young v. Forest Oil
  – Allegation that Lessee didn’t fully develop leasehold acreage → termination

• Analysis and Holding
  – Production in paying quantities (albeit small)
  – No abandonment where well with PPQ
  – No breach of implied covenant to develop
• Facts
  – Another case alleging that Lessee didn’t adequately develop leased acreage

• Analysis and Holding
  – Centers around district court analysis
  – But two key points on habendum clauses:
    • Only one well
    • FN → Production generally means PPQ
Another Cessation of Production case

However, noted that “found in paying quantities” synonymous with “produced in paying quantities”
Gillespie v. Ohio Oil Company
102 N.E. 1043 (Ill. 1913)

• Facts
  – Well drilled < week before end of primary term
  – Well produced very little oil—”so small as to make the venture unprofitable”

• Holding
  – Satisfied the strict letter of the lease
  – Lease upheld
Post-Gillespie decisions: A distancing...

  - Lease terms didn’t include PPQ language
  - Only production was flared off gas
  - Court read habendum clause in tandem with shut-in clause to require PPQ
  - Distinguished Gillespie

  - Pumped well until filled pit; no proceeds from sale of oil
  - Court relied on intent of parties (profit), and deemed lease expired
  - Declined to expressly overrule Gillespie
Tedrow v. Shaffer
155 N.E. 510 (Ohio Ct. App. 1926)

• Facts
  – PPQ lease with ten year primary term
  – Lessee pumped small amount of oil from well; then paid delay rentals for seven years
  – Assigned lease, and assignee resumed pumping oil from well on last day of lease

• Holding
  – Must produce oil in paying quantities for “substantial or reasonable time” → Last day not enough
  – Lease expired
Other Ohio Cases

• American Energy Services, Inc. v. Lekan (598 N.E. 2d 1315 (Ohio Ct. App. 1992))—Actual, not just potential production, required

• Litton v. Geisler (76 N.E.2d 741, (Ohio Ct. App. 1945))—”Reasonable pecuniary return in excess of cost of production”

• Blausey v. Stein (400 N.E.2d 408 (Ohio 1980))—deferred to Lessee’s good faith judgment; costs factored into PPQ determination does not include labor costs
Lough v. Coal Oil, Inc.  
266 Cal. Rptr. 611 (Cal. Ct. App. 1990)

• Facts
  – “So long thereafter as . . . [hydrocarbons were produced] therefrom.”
  – Lessor showed that Lessee sustained multiple multi-year periods of losses

• Holding
  – Lease terminated due to failure to produce in paying quantities
Montana
• Facts
  – Amended habendum clause: “as long as oil or gas was produced and the lessee exercises reasonable diligence in development”
  – Original well had significant gas flow, but not sold

• Analysis and Holding
  – Discovery of oil enough in primary term
  – Secondary term requires reasonable diligence and production in paying quantities
Nevada
Nevada Statutory Law

Maralex Resources, Inc. v. Gilbreath
76 P.3d. 626 (N.M. 2003)

• Facts
  – Well drilled under 1959 lease produced through 1990
  – Drop in pressure → Lessee fixed after several month shut-in

• Analysis and Holding
  – Cites Clifton v. Koontz → infers PPQ
  – Shut-in clause only operative when well capable of producing gas
  – Lease terminated when production ceased
Well is a commercial producer when it pay a profit to the lessee over operating expenses—even if the profit is small and costs of development may never be recovered.

Champion Ventures, Inc. v. Dunn, 567 P.2d 724, 728 (Wyo. 1977)
Conclusion...
Questions?

Zachary M. Wallen
Steptoe & Johnson PLLC
304.933.8168
zachary.wallen@steptoe-johnson.com