Maintaining oil and gas leases during secondary terms

Energy Alert

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Due to today's low cost environment, oil and gas production on many leases is being halted. [1] While this may save immediate costs, it can have long-term consequences, as lessees may inadvertently forfeit leased acreage, breach their supply contracts, or both.

Many articles address how lessees can preserve a lease into its secondary term, but today, many lessees find themselves already beyond this point. Given these circumstances, this article assumes that a lease is already in its secondary term and highlights several relevant lease interpretation issues.

First, the article examines what constitutes paying quantities as background for what savings clauses replace. Next, the article examines savings clauses, turning first to shut-in clauses, next to cessation of production, then to force majeure, and finally to pooling. The article then examines possibilities concerning midstream contracts and closes with a discussion on finance concerns.

1. Paying quantities

Modern oil and gas leases tend to continue during the secondary term for as long as the lease can produce oil and gas.[2] Even where the habendum clause only uses the word "produce" nearly all states read "production" to mean "production in paying quantities." [3]

States diverge, however, on what "production in paying quantities" means in this context. A majority of states, including Texas, Louisiana, and New Mexico require actual, physical production and marketing.[4] The minority view, generally holds that the lease may be held by a well capable of producing so long as the operator diligently seeks a market.[5]

Where actual, physical production and marketing is required, either because the lease expressly says so or a court reads this into "produce," states almost universally agree a well produces in paying quantities when it "pays a profit, even a small one, over the operating expenses."[6] Still, varieties exist. One variety concerns the inputs for how to calculate profit less expenses. For example, states differ with regards to what constitutes an "operating expense."[7] Another variety concerns marginal wells. Texas, for example, asks whether a reasonable prudent operator would continue to operate a marginal well for "the purpose of making a profit and not merely for speculation" in the same manner in which the well was operated. [8] What a reasonably prudent operator would do is a fact intensive question that may involve the price at which the lessee can sell the produce and the relative profitableness of other wells in the area, both as measured over a reasonable period of time.[9]

2. Shut-in royalty

Most modern oil and gas leases contain a shut in clause, although many variations exist.[10] They also tend to be limited to gas wells.[11] Functionally, these clauses allow the lessee to maintain their lease by substituting actual production through payments when a well that is capable of production is not producing.[12] Despite the varieties in the clauses, common issues emerge, such as the following three.[13] First, what does it mean to shut in a well? Second, which leases can be maintained through shut-in payments? Third, what limitations do these provisions include, particularly in light of today's market conditions?

First, shutting in a well "does not refer to any particular type of engineering operation but refers to the absence of current production."[14] To "shut in" a well means to alter its legal status.

Second, to support shut-in payments, the well must generally be capable of production at the time the well stops producing.[15] What "capable of production" means varies by state and lease. For example, in Texas, a well is "capable of producing" if it is not producing because there is no available market, or when the well can be turned on and begin flowing without additional equipment or repair.[16] In Kansas, however, a well is "shut in" when it is sufficiently complete to be capable of producing, even if it has not actually produced in paying quantities in the past.[17]

Third, lessees looking to shut in wells due to market conditions are encouraged to examine (1) whether the lease allows this, either through lease language or judicial doctrine; (2) if allowed, whether payments are considered covenants or conditions of the lease; and (3) how are payments calculated.

It is unclear whether a lessee can rely on a shut-in provision to maintain its lease while lessee waits for market conditions to improve, assuming (1) a market does exist, although prices may be lower than desired, and (2) there is no lease language that would otherwise allow this.[18] Some states are more tolerant of decisions not to sell into a depressed market than others.[19] Lessees are encouraged to read their lease for provisions that leave the decision of whether to shut in up to the lessee's good faith judgment. [20] However, even where shut-in payments are allowed, the lessee's implied duty to market with diligence likely remains. [21] If violated, this could independently terminate the lease in many states, although in Texas it is the rare case where money damages would not be an adequate remedy.[22]

A missed payment may also automatically terminate the lease or give rise to a breach of contract claim. Which remedy applies depends on whether the payment is a condition or covenant of the lease. Payment is a condition when the payment itself is the constructive production. Payment is a covenant when a well capable of producing satisfies constructive production. States also vary on how they interpret conditional language. In Texas, when conditional, missed payments can trigger forfeiture regardless of express language to this effect.[23] But in Oklahoma, where the capacity to produce holds the lease for purposes of the habendum clause, failing to properly tender payment would not terminate the lease unless a lease "clearly provides for forfeiture…upon failure to make timely payment."[24]

Besides timing, payments can be missed due to the payment of an insufficient amount. Pugh clauses affect payment calculations. Pugh clauses provide that acreage on the lease which is properly pooled during the primary term, survives into the secondary term whereas the other, non-pooled, non-productive acreage is released.[25] Pugh clauses redetermine the acreage on which a shut-in payment is due, or where shut-in payments are due on a per well basis, may redetermine how many wells count towards shut-in royalties.[26]

3. Cessation of production

Cessation of production clauses and the temporary cessation of production doctrine allow lessees to hold their leases for a limited time when the lease's holding wells become incapable of production. [27] Unlike shut-in clauses, which may or may not be in the lease, cessation of production protection is generally available, however to what extent may depend on whether the lease has a cessation clause.

When a lease contains a cessation styled clause, the court's temporary cessation doctrine may be unavailable. For example, in Texas, the temporary cessation doctrine did not apply when the lease contained a provision "in the habendum clause [that expressed] a time limitation within which continued drilling or reworking operations must be conducted."[28] An absence of such time limitation or cessation style clause, may be to the lessees detriment: a Texas court held a lease terminated after the lease ceased production "without regard to the reasonableness of the operator's actions." [29]

The cessation of production doctrine generally offers protection "when a lease, though not producing, is one that a reasonable prudent operator would continue to hold."[30] Evidence to show what a prudent operator would do may involve (1) what ceased production; (2) how long it lasted; and (3) what the lessee did to restore production. Of these inquiries, what caused the cessation may be the most limiting. For example, Texas extends its protection wider than mere mechanical failures but appears to stop short of extending it for "market based interruptions." [31]

4. Force majeure

Unless the lease contains a force majeure clause, the remedy offered by it is unavailable, though jurisdictions may still recognize impossibility and frustration of purpose.[32] Force majeure clauses allow the lease to continue by way of constructive production when performance is interrupted by a cause that is outside the parties control even if the event might be foreseeable.[33] These clauses have tended to become so specific that their contours "dictate the application, effect, and scope of force majeure." [34]

What is considered outside a party's control could be a purchaser being unable to take production if the lease does not require the lessee to find another purchaser.[35] It may also be a rule or regulation of the government which prevents the lessee from complying with lease covenants.[36] In today's markets, when downstream servicers are unable to take delivery, force majeure could offer a means to maintain leases.

5. Pooling

The pooling clause expands the area from which "production" may be achieved and as such may be a mechanism to continue a lease.[37] However, lessees with leases already into their secondary term are encouraged to be cautious when pooling acreage. The two questions courts generally ask when parties pool is (1) whether the lease allows it, and (2) whether the exercise was proper.[38] The later analysis tends to involve a question of good and bad faith.[39]

6. Midstream considerations

Most companies have long-term midstream agreements that include gathering, processing or marketing arrangements – possibly all three. These agreements may include commitments to deliver a fixed quantity or volume of product. Failing to satisfy this threshold often triggers a penalty, even if the level of production is sufficient to satisfy the lease. Accordingly, producers may advise their midstream counterparts to discuss suspending commitments or restructuring their agreements.

Alternatively, difficulties faced by midstream companies may present lessees the opportunity to rely on force majeure provisions. Midstream companies may impose restrictions on producers due to restrictions placed on them by downstream servicers. These downstream restrictions may translate into a "force majeure" situation as being an event outside its control. Nevertheless, it is critical to examine all agreements and leases carefully to determine if such protection is possible.

7. Finance concerns

Although there is usually no "continuous operation" requirement under a reserve based loan or other credit facility that an E&P borrower is required to comply, the entire structure of credit facility should be reviewed prior to any program to shut in wells; despite the lack of "continuous operation" requirements, there are various covenants in current credit facilities that taken together as a whole could be implicated by such a program. Attention to an E&P borrower's covenants, including notification obligations in the event of a material adverse change, should also be assessed. The decrease in revenue from production should be evaluated in light of any revenue based financial covenants and any covenants regarding hedging price risk for the E&P borrower's production.

8. Conclusion

Despite today's low cost environment, lessees do have solutions that allow them to halt production while maintaining their lease. The first step in identifying these solutions is for lessees to have a firm understanding of their leases and any restrictions in their credit facilities. After better identifying the mechanisms that trigger penalties and forfeitures, lessees are better prepared to forecast future operations, given the constraints of their lease and credit facilities.

Learn more about the implications of these issues by contacting any of the authors.

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[1] Russell Gold, Benoit Faucon, Rebecca Elliott, *Thirst for Oil Vanishes, Leaving Industry in Chaos*, Wall Street J. (Apr. 14, 2020), https://www.wsj.com/articles/thirst-for-oil-vanishes-leaving-industry-in-chaos-11586873801; Patti Domm, *US Oil Production Plunges as the Industry Retrenches, and More Cuts are Expected After a Price Crash*, CNBC (Apr. 22, 2020), https://www.cnbc.com/2020/04/22/us-oil-production-plunges-as-the-industry-retrenches-and-more-cuts-are-expected-after-a-price-crash.html.

[2] Alex Ritchie, *A Reexamination and Reformulation of the Habendum Clause Paying Quantities Standard Under Oil and Gas Leases*, 3 Oil & Gas, Nat. Res. & Energy J. 981–82 (2017).

[3] John S. Lowe, Owen L. Anderson et al, Cases and Materials on Oil and Gas Law 264 (7th ed. 2018).

[4] *See e.g.*, Clifton v. Koontz, 325 S.W.2d 684 (Tex. 1959) ("The term 'paying quantities' involves not only the amount of production, but also the ability to market the product (gas) at a profit."). La. Rev. Stat. Ann § 31:124 (2020); Maralex Resources, Inc. v. Gilbreath, 76 P.3d 626, 630 (N.M. 2003).

[5] *See e.g.*, Pack v Santa Fe Minerals, Div. of Santa Fe Int'l Corp., 869 P.2d 323 (Okla. 1994). Howell v. Appalachian Energy, Inc., 519 S.E.2d 423 (W. Va. 1999); Kevin Abbott and John Boyd II, *Money for Nothing – Shut-in Royalty Clauses in Oil and Gas Leases*, 16 E. Min. L. Inst. Ch. 15 (1997).

[6] *See generally* Jessica McDonald and Zachary Wallen, *Defining "Production in Paying Quantities": A Survey of Habendum Clause Cases Throughout the United States*, 90 N.D. L. Rev. 383, 388 (2014); *see also* Young v. Forest Oil Co., 45 A. 121, 123 (Pa. 1899); Garcia v. King, 164 S.W.2d 509, 510 (Tex. 1942); West v. Russell, 90 Cal. Rptr. 772 (Cal.App. 1970); 2 Eugene Kuntz, A Treatise of Law of Oil and Gas, § 26.7(d) (Matthew Bender, Rev. Ed.).

[7] *See e.g.*, Clifton v Koontz, 325 S.W.2d 684 (Tex. 1959) ("We are of the opinion that the trial court correctly excluded depreciation as an operating expense in determining whether and when production in paying quantities ceased"); West v. Russell, 90 Cal. Rptr. 772 (Cal.App. 1970) (indicating that "depreciation and other items of cost incident to the owned rig could properly be charged as overhead expenses in determining net profit").

[8] *See e.g.*, Clifton v. Koontz, 325 S.W.2d 684 (Tex. 1959).

[9] *Id*.

[10] 4 Eugene Kuntz, A Treatise of Law of Oil and Gas, § 46.1 (Matthew Bender, Rev. Ed.); Patrick H. Martin and Bruce M. Kramer, Williams and Meyers, Oil and Gas Law, § 632.4 (LexisNexis Matthew Bender 2019).
[11] Kendor P. Jones & Jennifer L. McDowell, *Keeping Your Lease Alive in Good Times and in Bad*, 55 Rocky Mt. Min. L. Inst. 23-1, 23-20 (2009).

[12] Lowe, Anderson, et al, *supra* note 3, at 274.

[13] 4 Eugene Kuntz, A Treatise of Law of Oil and Gas, § 46.1 (Matthew Bender, Rev. Ed.)
[14] *Id*. at § 46.4(b).

[15] R. Neal Pierce, Katerina E. Milenkovski, Ryan S. Bundy, *The Quick and the Dead: Cessation of Production and Shut-Ins During the Secondary Term of an Oil and Gas Lease*, 88 N.D. L. Rev. 727 (2012); *see e.g.*, Hydrocarbon Management, Inc. v. Tracker Exploration, Inc., 861 S.W.2d 427, 433 (Tex. App. 1993).

[16] Anadarko v. Thompson, 94 S.W.3d 550, 557 (Tex. 2010); Hydrocabon Mgmt. v. Tracker Exp., Inc. 861 S.W.2d 427, 430-31 (Tex. App. 1993).

[17] Levin v. Maw Oil & Gas, LLC, 234 P.3d 805 (Kan. 2010).

[18] Lowe, Anderson, et al., *supra* note 3, at 281 (raising the question of whether a lessee can shut in a well and wait for better market prices but not expansively answering. Instead, the authors describe Tucker v. Hugoton Energy Corp., a Kansas case, as appearing to “conclude that the clause could not be invoked where any market, even a market at a low price and on poor terms, was available for gas. 855 P.2d 929 (Kan. 1983). However, the authors then clarify that the Kansas court has since distanced itself from the view in Levin v. Maw Oil & Gas, LLC, 234 P.3d 805 (Kan. 2010)); *see also* Jones & McDowell, *supra* note 11, at 23-20; Anadarko, 94 S.W.3d at 558 (noting a well is capable of production if it is shut-in because there is no available market).

[19] See, e.g., McDowell v. PG&E Resources Co., 658 So.2d 779 (La. Ct. App.1995) (“what constitutes a reasonable time for obtaining a market, of necessity, will be measured by the operator’s exercise of due diligence under the circumstances”); *see also* Jones & McDowell, *supra* note 11, at 23-20.

[20] William and Meyers, *supra* note 10, at § 632.4.

[21] Danne v. Texaco Exploration and Production, Inc., 883 P.2d 210, 215 (Okla. Civ. App. 1994) (“[F]orfeiture can result if an action is brought and it is demonstrated that the lessee either failed to produce in paying quantities or failed to market the product with due diligence in breach of the implied covenant to market the product”); *see also* Pack v. Santa Fe Minerals, a Div. of Santa Fe Int’l Corp., 869 P.2d 323 (Okla. 1994)

[22] Lowe, Anderson, et al, *supra* note 3, at 355 (citing Davis v. Cramer, 837 P.2d 218, 225 (Colo. App. 1992); Crain v. Hill Resources, 972 P.2d 1179 (Okla.Civ.App. 1998); Robins v. Chevron U.S.A., Inc., 785 P.2d 1010, 1016 (Kan. 1990); Anadarko Petroleum Corp. v. Thompson, 94 S.W.3d 550, 560 (Tex. 2002)).

[23] Freeman v. Magnolia Petroleum Co., 171 S.W.2d 339 (Tex. 1943).

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

[25] 4 Kuntz, *supra* note 10, § 48.4.

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

[27] 4 Kuntz, *supra* note 10, at § 47.3; Anadarko v. Thompson, 94 S.W.3d 550, 557 (Tex. 2010).

[28] Sun Operating Ltd. Partnership v. Holt, 984 S.W.2d 277, 282 (Tex. App. 1998).

[29] Ridenour v Herrington, 47 S.W.3d 117, 122 (Tex. App. 2001)

[30] Lowe, Anderson, et al, *supra* note 3, at 283.

[31] Natural Gas Pipeline Co. v. Pool, 124 S.W.3d 188, 206 (Tex. 2003) (Jefferson, J., dissenting).

[32] Lowe, Anderson, et al, *supra* note 3, at 301 ("American contract law does not recognize a force majeure doctrine…though jurisdictions generally recognize the doctrines of impossibility of performance, frustration of purpose, and perhaps commercial impracticability as defenses to contract breach claims.")

[33] Jones & McDowell, *supra* note 11, at 23-15; Sun Operating Ltd Partnership v. Holt, 984 S.W.2d 227, 282–83 (Tex. App. 1998).

[34] Holt, 984 S.W.2d at 282–83.

[35] *See generally id*.

[36] *See generally* Moore v. Jet Stream Investments, Ltd., 261 S.W.3d 412 (Tex. App. 2008); Schroeder v Songa, 1997 WL 428472 (Tex. App. 1997, not designated for publication).

[37] Lowe, Anderson, et al, *supra* note 3, at 273.

[38] 4 Kuntz, *supra* note 10, at § 48.3.

[39] Lowe, Anderson, et al, *supra* note 3, at 307–19.

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