SUMMARY FOR PAPER #8
Saturday, October 3, 2009 (1:20 P.M.)

KEEPING LEASES ALIVE IN THE ERA OF HORIZONTAL DRILLING AND HYDRAULIC FRACTURING:

Are the Old Workhorses (Shut-In,Continuous Operations and Pooling Provisions) Up to the Task?

by

Professor Bruce M. Kramer

1. INTRODUCTION

The oil and gas industry, specifically that part of the industry that is responsible for the development and use of written agreements, has not been terribly responsive to judicial opinions, changes in industry custom and practice or common sense when it comes to adjusting widely used forms and/or provisions. A few examples will suffice to illustrate this basic thesis. The concept that when people execute an oil and gas lease that utilizes an "unless" type delay rental clause they create a fee simple determinable estate in the lessee and a possibility of reverter in the lessor has been around for close to 100 years. The notion that "unless" leases would automatically terminate upon the failure, accidental or otherwise, of the lessee to either commence a well or make a timely and accurate delay rental payment has likewise been around for nearly a century. Yet during my recent sojourn through thousands of oil and gas leases executed by the majors, the large independents and the "mom and pop" oil companies, I have still found a large percentage of them which continue to use that form, notwithstanding the "gotcha" implications of somebody making a mistake and being a day late or a dollar short. The use of the "paid-up" lease is still not universally accepted even as the era of the 10-year primary term lease has been replaced by the one- or two-year primary term lease.

Likewise, even though horizontal drilling and hydraulic fracturing techniques have been around for 50 years or so, the oil and gas lease's "savings" provisions have not been modified to deal with different circumstances that may arise from the use of such techniques on these provisions that were originally developed to deal with circumstances that are no longer relevant and which do not cover the needs of the parties given the nature of the new "shale" plays and "tight sands" development. I propose to look at a number of the more widely-used savings provisions and raise some issues as to how the industry and its attorneys may take a proactive stance to avoid what the old Midas Muffler man used to say on TV: "You can pay me now or you can pay me later; It's your choice."

A second example of the industry's complacency in the light of changed circumstances is the continued inclusion of various savings provisions in leases located in states such as Oklahoma which have adopted the "discovery" rule for habendum clauses. At least since 1958, the Oklahoma Supreme Court has made it crystal clear that in order to satisfy the terms of an habendum clause that requires the lessee to achieve production or production in paying quantities in order to enter the secondary term, all that is required of the lessee is that it discover hydrocarbons in paying quantities and engage in a diligent effort to market those hydrocarbons. *McVicker v. Horn, Robinson & Nathan*, 1958 OK 49, 322 P.2d 410, 8 O.&G.R. 951; *State ex rel. Commissioners of the Land Office v. Carter Oil Co. of West Virginia*, 1958 OK 259, 336 P.2d 1086, 10 O.&G.R. 790. The need for savings clauses in Oklahoma and similar jurisdictions would be to deal with the singular event that there is no discovery of hydrocarbons at the end of the primary term or that there is no longer a common source of supply that is capable of producing hydrocarbons because it has been exhausted. One would hope that Oklahoma oil and gas leases would reflect the limited utility of savings provisions to deal with those two circumstances. Instead Oklahoma leases are chock full of standard savings provisions that at least for a number of years had created some consternation with the Oklahoma oil and gas industry following the Court of Civil Appeals decision in *Fisher v. Grace Petroleum Corp.*, 1991 OK CIV APP 112, 830 P.2d 1380, 118 O.&G.R. 491, *cert. denied*. As Dean Eugene Kuntz said in his Discussion Note in the OIL AND GAS REPORTER:

> The holding of the court that the leases terminated can be justified only if the finding of the trial court that the well did not "produce in paying quantities" for a twelve-month period was supported by evidence that the well was not capable of producing in paying quantities during that time. 118 O.&G.R. at 508-09.

It wasn't until 1994 that the Oklahoma Supreme Court in a herculean effort attempted to give meaning to standard savings clauses that don't mesh with the capable of producing definition that is applied to the habendum clause. In *Pack v. Santa Fe Minerals*, 1994 OK 23, 869 P.2d 323, 128 O.&G.R. 550, the court interpreted a cessation of production clause and a shut-in clause in light of the adoption of the "discovery" rule. Good drafting by Oklahoma oil and gas attorneys could have prevented this by tailoring leasehold "savings" clauses to deal with the unique Oklahoma rules relating to lease termination in general and habendum clause interpretation specifically.

2. THE POOLING CLAUSE

The pooling clause which authorizes the lessee to pool the lessor's interest has been a staple provision in oil and gas leases for many decades. PATRICK H. MARTIN & BRUCE M. KRAMER, WILLIAMS & MEYERS OIL AND GAS LAW § 669 (2009) [hereinafter Williams & Meyers]; BRUCE M. KRAMER & PATRICK H. MARTIN, THE LAW OF POOLING & UNITIZATION § 8.01 (3d ed. 2009) [hereinafter Kramer & Martin]. Most oil and gas leases outside of the Rocky Mountain area contain "pooling" clauses which limit the lessee's power to "unitize" the lease into a fieldwide or partial fieldwide unit without getting the further consent of the lessor. The absence of such a clause authorizing unitization can create some problems for a party seeking to utilize hydraulic fracturing techniques, notwithstanding the Texas Supreme Court's recent decision in *Coastal Oil & Gas Corp. v. Garza Energy Trust*, 268 S.W.3d 1 (Tex. 2008).

For example, the following pooling and unitization clause used in North Dakota might help resolve some of the issues relating to cross-boundary hydraulic fracturing operations:

Lessee shall have the right to unitize, pool, or combine all or any part of the above described lands as to one or more of the formations thereunder with other lands in the same general area by entering into a cooperative or unit plan of development or operation approved by any governmental authority and, from time to time, with like approval, to modify, change or terminate any such plan or agreement, and, in such event, the terms, conditions and provisions of this lease shall be deemed modified to conform to the terms, conditions, and provisions of such approved cooperative unit of development or operation. . . *Sotrana-Texas Corp. v. Mogen*, 551 F. Supp. 433, 434, 77 O.&G.R. 320 (D.N.D. 1982).

In *Coastal Oil*, Coastal formed a unit that combined 7.357 acres from its fee-owned acreage on Share 12 with 72.643 acres from its Share 13 leasehold, in part to be able to drill an additional well on Share 12. Notwithstanding a pooling clause that gave the lessee broad discretion the jury in Coastal Oil found that the pooling was in bad faith and awarded damages. While under the facts it would have been unlikely that Coastal would have unitized the Share 12 and Share 13 acreage when it first proposed to hydraulically frac the well on Share 12 that allegedly crossed the boundary line to Share 13, if the lessee had a clause such as the one reproduced above it could have avoided the trespass issues entirely by unitizing the leases that would be affected by the proposed fracing operation.

Note, however, that the pooling and unitization clause reproduced above has a reasonably common requirement that before one can unitize the "unit plan of development or operation" must be approved by "any governmental authority." This type of governmental approval language is common in the Rocky Mountain and undoubtedly was included because of the large amount of federal oil and gas resources in the area. WILLIAMS & MEYERS, at § 669.7. This condition precedent to unitization is probably not warranted where only fee lands are concerned and will certainly add substantial transaction costs to the effort since the unit operator will have to seek approval from the relevant state conservation agency of the voluntary unitization. While almost all states give statutory authority to their state conservation agencies to approve voluntary unitization agreements they require that there be notice and a public hearing before an approval will be granted. KRAMER & MARTIN, at § 17.03 provides a listing of the state voluntary unitization statutes. Where time may be of the essence, including a governmental approval provision in the pooling and unitization clause may defeat the purpose of encouraging unitization to deal with cross-boundary fracing operations. In addition, the inclusion of a unitization clause will also give the lessee more flexibility in dealing with horizontal drilling operations, both in terms of surface and sub-surface operations.

It has been common for a long time for pooling clauses to have acreage provisions that limit the power of the lessee to pool. It is becoming increasingly common for pooling clauses to have "anti-dilution" clauses so as to prevent the lessor's royalty from being pooled in a way that diminishes its value. In *Browning Oil Co. v. Luecke*, 38 S.W.3d 625, 149 O.&G.R. 127 (Tex.App.—Austin 2000), an anti-dilution clause made it impossible to create a horizontal pooled

unit according to the lessee. The court correctly showed no sympathy for the lessee being placed in a dilemma of its own making and found that the lessee could only pool subject to the restrictions contained in the lease.

Such clauses, especially acreage limitations, create substantial problems because many states have yet to come up with an appropriate spacing regulatory scheme for horizontal wells or fields that require hydraulic fracturing for primary production. The use of language "prescribed or permitted" by the relevant state conservation agency has been a hindrance in the use of the pooling power where the relevant pooling rules are flexible and may allow for the drilling of infill wells. *Jones v. Killingsworth*, 403 S.W.2d 325, 24 O.&G.R. 508 (Tex. 1966). Notwithstanding a restrictive reading of the term "prescribed or permitted" oil and gas leases continue to have such language contained therein creating substantial problems for lessees who want to pool leases into a horizontal drilling unit.

3. THE CONTINUOUS OPERATIONS CLAUSE

There are many forms of continuous operations clauses. Some are general in nature meaning that the only condition precedent to its applicability is that some type of operations is ongoing. Other types of continuous operations clauses tend to fall under other categories such as a cessation of production clause or a dry hole clause. Such clauses have specific conditions precedent such as the drilling of a dry hole, the cessation of production from an existing well, the drilling of a well at the end of the primary term or any combination thereof. These clauses require that the specific condition precedent or triggering event actually occur before the lease may be saved. An excellent example of how these specific clauses may not cover the situation on the ground is reflected in *Sunac Petroleum Corp. v. Parkes*, 416 S.W.2d 798, 26 O.&G.R. 689 (Tex. 1967). The lease had a pooling clause, limited to gas wells and a dry hole and cessation of production clause. Unfortunately for the lessee/assignor who retained an overriding royalty interest, the lease was pooled shortly before the end of the primary term and a productive oil well was drilled off of the leasehold acreage. Since the well was productive the dry hole savings clause was inapplicable and since no well had ceased production the cessation of production savings clause was also inapplicable. The pooling clause was also ineffective to hold the lease into the secondary term because an oil well was drilled.

The lesson of *Sunac Petroleum* is the need to draft continuous operations clauses that have the most general condition precedent. Such a clause would use the term operations and not drilling operations because in the case of hydraulic fracturing some might argue that hydraulic fracturing operations even if needed to establish initial or primary production from a well would be a completion operation and not a drilling operation. There should be no condition precedent other than the lack of production in paying quantities at the onset or any time after the secondary term has been entered into.

An additional issue that has been recently explored is the concept that merely engaging in operations or drilling operations may not be sufficient. A recent opinion, *BP American Production Co. v. Marshall*, 288 S.W.3d 430 (Tex.App.—San Antonio 2008) highlights a judicial predisposition to require good faith on behalf of the operator even if it is engaging in physical operations on the

ground. What is even more interesting about the Marshall opinion is that Texas, as a general matter, does not imply a covenant of good faith between contracting parties as many states do following Justice Cardozo's lead in *Wood v. Lucy Lady Duff Gordon*. In *Marshall*, the court unfortunately does not give us the specific language of the continuous operations clause but merely labels it a "standard 'sixty-day' clause" that requires the lessee to be engaged in drilling or reworking operations with no cessation of more than sixty days. A well is spudded shortly before the end of the primary term and total depth is reached on September 22, 1980. That formation is non-productive so BP moves up the well to a secondary objective. Its efforts in that formation are also fruitless. Within 60 days of this second "dry hole" BP takes steps to test a formation higher up in the wellbore. These efforts also turn out to be fruitless. A farmout well is not drilled until April 13, 1981. In instructing the jury as to whether or not the "savings" provision applied, the court defined "operations" as "any and all actual acts, work, or operations in which a reasonable prudent operator, under the same or similar circumstances, would engage in a good faith effort to cause a well or wells to produce oil and gas in paying quantities."

Most of the savings provisions that I have seen do not contain an express good faith requirement as to the operations. The jury answered the question by concluding that the actual operations undertaken by BP to reach the last of the formations was not done in good faith but merely done to maintain the lease into the secondary term. While many of us have assumed that such a good faith requirement was involved, in *Marshall*, the operator is exposed to a second guessing by experts who will, after the fact, determine that such operations were not designed to achieve production in paying quantities. I am not sure that a drafting solution is possible to this issue but it might be better if the continuous operations clause tried to define what constitutes good faith so that the jury instruction would follow that language rather than the court's more general language as used in *Marshall*.

4. SHUT-IN GAS ROYALTY CLAUSE

Shut-in gas royalty clauses were primarily designed to deal with the fact that natural gas could not be marketed simultaneously with production because of the need for post-production facilities, including pipelines, compressors, dehydrators and or processors. While many shut-in gas royalty clauses have, as a condition precedent to its application, the requirement that the well be capable of producing in paying quantities, courts will impose such a requirement even if no express language so requires. *Tucker v. Hugoton Energy Corp.*, 855 P.2d 929, 125 O.&G.R. 301 (Kan. 1993). The issue of what constitutes a well capable of producing in paying quantities is not only a shut-in gas royalty clause issue but may arise in the context of the habendum clause as well. The term "capable of producing" may be implied in the standard habendum clause as it is in Oklahoma, Montana and several other jurisdictions, or it may be part of the express clause as it was in *Anadarko Petroleum Corp. v. Thompson*, 94 S.W.3d 550 (Tex. 2002).

Because courts may borrow the definition of "capable of producing" from the habendum clause cases, it may behoove the drafter of a shut-in gas royalty clause to attempt to define the term to deal with the circumstances that horizontal drilling and hydraulic fracturing operations bring to the table. Some of the problems may be caused by the following language used in *Thompson* to describe when a well is capable of producing:

> [T]he 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. Conversely, 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. *Thompson*, 94 S.W.3d at 558. See also *Hydrocarbon Management, Inc. v. Tracker Exploration, Inc.*, 861 S.W.2d 427, 433-34, 126 O.&G.R. 316 (Tex.App.—Amarillo 1993, no writ).

What happens to a well that needs a frac job and thus is required to be shut in or a well for which a new lateral line may be added likewise requiring the well to be shut in. Applying the *Thompson* definition of "capable of producing" may not lead to the desired result from the operator's perspective. A drafting solution defining the reasons why a well may be shut-in, including down time for additional well bore operations that may impact the ability of the well to produce might be appropriate.

In *Blackmon v. XTO Energy, Inc.*, 276 S.W.3d 600 (Tex.App.—Waco 2008), the lessor argued unsuccessfully that a lease terminated because it was incapable of producing in paying quantities where the well was shut in for 15 months. The cause of the shut-in was the increased presence of carbon dioxide in the natural gas stream so that the purchaser rejected any proffered gas until such time as the carbon dioxide was removed. It took 15 months because the operator had to install an amine processing plant. The lessor's claim was that there was no market if the valve was turned "on" since no one would accept the gas stream with the high carbon dioxide content. Therefore, the well was no longer capable of producing in paying quantities. While doing so in the context of a habendum clause that contained the language "capable of producing," the analysis is the same for the shut-in gas royalty clause. The shut-in gas royalty clause was not directly implicated since the operator did not tender any such payments during the period the well was shut-in. In analyzing *Thompson*, the court expands somewhat on what constitutes a well capable of producing in paying quantities. As long as the upstream equipment and/or facilities are operational, including the wellbore and the Christmas tree, the well will be capable of producing in paying quantities even where a downstream "post-production" facility must be installed in order to actually market the natural gas. The key issue for defining a well capable of producing is one where the raw gas stream is ready to flow through the Christmas tree but cannot because of issues downstream of that point.

The *Blackmon* court also highlights the way that parties can successfully draft around the fee simple determinable/automatic termination rule when it comes to both the habendum clause and the shut-in gas royalty clause. It is conventional wisdom that failure to make a timely and accurate shut-in gas royalty payment in the secondary term automatically terminates the lease. *Freeman v. Magnolia Petroleum Co.*, 141 Tex. 274, 171 S.W.2d 339 (1943). But the *Freeman* rule is not a rule of law like the Rule Against Perpetuities but merely a rule that follows from the express language of the lease. In *Blackmon*, the combination of a habendum clause using the term capable of producing and a shut-in gas royalty clause that used promissory, not limitational, language combined to make the shut-in gas royalty clause a condition, not a limitation. Because the habendum clause

had been satisfied by merely having the well capable of producing in paying quantities, the breach of the shut-in gas royalty clause would only lead to an action for breach of contract damages for non-payment, not a decree finding that the lease had automatically terminated.