

# 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?

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## I. 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. There are in existence many standard form oil and gas leases, joint operating agreements, unit agreements, and unit operating agreements.<sup>1</sup> Yet, litigation over terms contained in such agreements remains unabated. Language contained in written instruments, including model forms, may be judicially construed in a way that makes the existing language irrelevant or confusing at best. Yet, for the most part, the oil and gas industry has not been proactive in dealing with changes that may render existing agreements or provisions ineffective to prevent litigation regarding the meaning of the terms and provisions contained therein. The fact that the *Manual of Oil and Gas Terms* is now in its 14th edition and covers over 1,500 pages<sup>2</sup> is an excellent reflection that “the times they are a changin’.”

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1. The American Association of Petroleum Landmen has published four versions of its Form 610—Model Form Operating Agreement. The first was in 1956, the second in 1977, the third in 1982, and the fourth in 1999. The American Petroleum Institute has published three versions of its Model Form of Unit Agreement and Model Form of Unit Operating Agreement, the first in 1957, the second in 1961, the third in 1970, and the fourth in 1993. The Rocky Mountain Mineral Law Foundation has published several versions of its Form 2 Unit Operating Agreement. There has not been a widely used oil and gas lease form, although there are plenty of lease forms that have been used over the years. See generally Edwin M. Cage, *The Modern Oil and Gas Lease—A Facelift for Old 88*, 31 INST. ON OIL & GAS L. & TAX’N 177 (1980); Thomas W. Lynch, *The “Perfect” Oil and Gas Lease: An Oxymoron*, 40 ROCKY MTN. MIN. L. INST. 3-1 (1994); Leslie Moses, *The Evolution and Development of the Oil and Gas Lease*, 2 INST. ON OIL & GAS L. & TAX’N 1 (1951); Milam Randolph Pharo & Gregory R. Danielson, *The Perfect Oil and Gas Lease: Why Bother!*, 50 ROCKY MTN. MIN. L. INST. 19-1 (2004); A.W. Walker, Jr., *Defects and Ambiguities in Oil and Gas Leases*, 28 TEX. L. REV. 895 (1949).

2. PATRICK H. MARTIN & BRUCE M. KRAMER, WILLIAMS & MEYERS: MANUAL OF OIL AND GAS TERMS (14th ed. 2009).

A few concrete examples will suffice to illustrate this basic thesis. The concept that an oil and gas lease that utilizes an “unless” type delay-rental clause creates an automatically terminating fee simple determinable estate in the lessee and a possibility of reverter in the lessor has been around for nearly a century.<sup>3</sup> The ramifications of a mistaken or late payment may be substantial.<sup>4</sup> Yet, for most of the latter part of the twentieth century, the basic “unless” form delay rental payment lease was not modified to eliminate the possibility that a lease might end during its primary term due to a late or mistaken payment.<sup>5</sup> The emergence of the “paid-up” lease form—in which the annual delay rental payments are paid at the execution of the lease—did not begin to show up until relatively recently and only in a minority of leases.<sup>6</sup> The use of the “paid-up” lease is still not universally accepted, even as the era of the ten-year primary term lease has been replaced by the era of the one or two-year primary term lease.

A second example of the industry’s complacency in the light of changed circumstances concerns the continued inclusion of various savings provisions in leases located in states such as Oklahoma that have adopted the “discovery” rule for habendum clauses.<sup>7</sup> Since 1958, the Oklahoma Supreme Court has made it crystal clear that in order to satisfy the terms of the standard habendum clause, which requires the lessee to achieve production or production in paying quantities in order to enter the secondary term of the lease, 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.<sup>8</sup> Thus, the many savings provisions, which are relevant in the “discovery plus marketing” jurisdictions to keep a lease alive without actual production and marketing of hydrocarbons, would appear to be irrelevant in a “discovery” jurisdiction.

The need for savings clauses in Oklahoma and similar jurisdictions may arise in order to deal with two events: the lack of discovery of hydrocarbons in paying quantities prior to the end of the primary term or

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3. 3 PATRICK H. MARTIN & BRUCE M. KRAMER, WILLIAMS & MEYERS: OIL AND GAS LAW § 606 (2009) [hereinafter 3 WILLIAMS & MEYERS]; see also Bruce M. Kramer, *The Temporary Cessation Doctrine: A Practical Response to an Ideological Dilemma*, 43 BAYLOR L. REV. 519 (1991) [hereinafter *Temporary Cessation*].

4. See, e.g., Phillips Petroleum Co. v. Curtis, 182 F.2d 122, 127 (10th Cir. 1950) (applying Oklahoma law). See generally Mitchell v. Simms, 63 S.W.2d 671 (Tex. Comm’n App. 1933).

5. Over the past 15 years, I have reviewed thousands of oil and gas leases that have been executed by the majors, the large independents, and the “mom and pop” oil companies as part of class action royalty litigation.

6. For an example of a “paid-up” delay rental clause, see 3 WILLIAMS & MEYERS, *supra* note 3, §§ 605.4, 606.4 n.13.

7. *Id.* § 604.1 (listing Montana, Oklahoma and West Virginia as adopting the “discovery” rule).

8. See, e.g., State *ex rel.* Comm’rs of the Land Office v. Carter Oil Co. of W. Va., 336 P.2d 1086, 1094-95 (Okla. 1959); *McVicker v. Horn, Robinson & Nathan*, 322 P.2d 410, 413-14 (Okla. 1958).

the exhaustion of recoverable hydrocarbons from a discovered formation. Most oil and gas lease savings provisions are drafted to deal with the lack of production of hydrocarbons either at the end of the primary term or during the secondary term.<sup>9</sup> One would hope that Oklahoma oil and gas leases would reflect the limited applicability of savings provisions to deal with those two circumstances. Instead, Oklahoma leases are chock full of standard savings provisions that, for a number of years, created substantial consternation with the Oklahoma oil and gas industry following the decision of the Court of Civil Appeals in *Fisher v. Grace Petroleum Corp.*<sup>10</sup> As Dean Eugene Kuntz said in his “Discussion Note” in the *Oil and Gas Reporter*:

The holding of the court that the leases in this case 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.<sup>11</sup>

It was not until 1994 that the Oklahoma Supreme Court, in a herculean effort, attempted to give meaning to standard savings clauses that did not mesh with the “capable of producing hydrocarbons in paying quantities” definition that the earlier Oklahoma court applied to the habendum clause. In *Pack v. Santa Fe Minerals*,<sup>12</sup> the court interpreted standard cessation of production and shut-in gas royalty clauses in light of the “discovery” rule.<sup>13</sup> Even though the language of the clause was appropriate in a “discovery plus marketing” jurisdiction to keep a lease alive in the secondary term, in a “discovery” jurisdiction it seemingly created impediments to the maintenance of the lease in the secondary term beyond those created by the habendum clause. The Oklahoma Supreme Court, however, interpreted the savings provisions as only being triggered by the lack of discovery of hydrocarbons in paying quantities as opposed to the lack of discovery and marketing of hydrocarbons in paying quantities.<sup>14</sup> By doing so, the court gave meaning to the express clauses without modifying the Oklahoma “discovery” definition for habendum clauses. 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.<sup>15</sup>

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9. See *Temporary Cessation*, *supra* note 3, at 529, 545.

10. 830 P.2d 1380 (Okla. Civ. App. 1991).

11. Eugene O. Kuntz, *Discussion Note*, in 118 O. & G.R. 508, 508 (1994).

12. 869 P.2d 323 (Okla. 1994).

13. *Id.* at 327-29.

14. See *id.* at 326-28.

15. Besides adopting the “discovery” rule, Oklahoma has interpreted the habendum clause of the lease as creating a fee simple subject to a condition subsequent estate rather than a fee simple determinable estate. *Temporary Cessation*, *supra* note 3, at 521 n.5, 550. This interpretation means that the lease does not automatically terminate upon the failure to comply with a limitation and allows equitable defenses to be raised in a suit asserting lease termination. *Stewart v. Amerada Hess*

## II. LEASEHOLD POOLING CLAUSES

The pooling clause, which authorizes the lessee to pool the lessor's interest without her further consent, has been a staple provision in oil and gas leases for many decades.<sup>16</sup> In the Mid-Continent region, most clauses limit the lessee's ability to pool leasehold acreage into a drilling or spacing unit as set forth in the relevant state conservation agency rules or regulations. In the Rocky Mountain region, such clauses often give the lessee the additional power to unitize the leasehold acreage into a fieldwide or partial fieldwide unit.<sup>17</sup> It is axiomatic that without a pooling or unitization clause, the lessee must receive the consent of the lessor in order to pool or unitize the lessor's interest.<sup>18</sup> The Texas Supreme Court has succinctly stated the general rule that: "Absent express authority, a lessee has no power to pool interests in the estate retained by the lessor with those of other lessors."<sup>19</sup> There is some disagreement in the cases as to whether pooling clauses should be narrowly or liberally construed. A number of decisions note that because pooling provisions deal with future, unknown events, they are drafted using general language and should be liberally construed to carry out the overall purposes of the pooling clause. As one Texas Court of Appeals decision concluded:

Anticipatory provisions in leases for the commitment by the lessee of such leases to unitization, of necessity must be in general terms. Neither the lessor nor the lessee has any way of knowing at the time the lease is taken the facts with respect to which it will be necessary for the lessee to apply his power. It is not practicable for the lessee to await the ascertainment of such facts. He knows from experience that because of the possibility of many changes in ownership of the lessor's interest as time goes on, it may be difficult to effect an agreement if the right to unitize is not included in the lease itself.<sup>20</sup>

Yet, there is also language in some Texas cases that requires strict compliance with the express terms of the pooling clause if the pooling is to be valid.<sup>21</sup> One way to reconcile these two seemingly inconsistent posi-

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Corp., 604 P.2d 854, 858 (Okla. 1979).

16. 4 PATRICK H. MARTIN & BRUCE M. KRAMER, WILLIAMS & MEYERS: OIL AND GAS LAW § 669 (2009) [hereinafter 4 WILLIAMS & MEYERS]; BRUCE M. KRAMER & PATRICK H. MARTIN, THE LAW OF POOLING AND UNITIZATION § 8.01 (3d ed. 2009) [hereinafter LAW OF POOLING].

17. For examples of various types of pooling clauses, see LAW OF POOLING, *supra* note 16, § 8.02 and 4 WILLIAMS & MEYERS, *supra* note 16, §§ 669.1-669.32.

18. See, e.g., Phillips Petroleum Co. v. Petersen, 218 F.2d 926, 934 (10th Cir. 1954); Se. Pipe Line Co. v. Tichacek, 997 S.W.2d 166, 170 (Tex. 1999).

19. Jones v. Killingsworth, 403 S.W.2d 325, 328 (Tex. 1965) (citing Brown v. Smith, 174 S.W.2d 43 (Tex. 1943)).

20. Expando Prod. Co. v. Marshall, 407 S.W.2d 254, 260 (Tex. Civ. App. 1966) (quoting Tiller v. Fields, 301 S.W.2d 185 (Tex. Civ. App. 1957); see also Young v. Amoco Prod. Co., 610 F. Supp. 1479, 1484 (E.D. Tex. 1985); Mengden v. Peninsula Prod. Co., 544 S.W.2d 643, 647 (Tex. 1976); Sabre Oil & Gas Corp. v. Gibson, 72 S.W.3d 812, 816 (Tex. App. 2002); Texaco, Inc. v. Lettermann, 343 S.W.2d 726, 732 (Tex. Civ. App. 1961).

21. See, e.g., Tittizer v. Union Gas Corp., 171 S.W.3d 857, 861 (Tex. 2005); Se. Pipe Line Co.,

tions is to state that strict compliance with express conditions precedent to the exercise of the pooling or unitization power is required; however, the language of the pooling clause should not be narrowly construed when such language uses general or broad terms to describe the nature of the power granted.<sup>22</sup>

The absence of clauses authorizing unitization can create 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*.<sup>23</sup> Cross-boundary hydraulic fracturing operations create substantial issues, as did secondary and tertiary recovery-injection programs in their day, because such operations are likely to have ramifications well beyond the spacing or pooled unit boundary lines.<sup>24</sup> Because pooling clauses often include acreage limitations tied to the state conservation agency's spacing or drilling rules, such clauses may not be utilized in circumstances in which the fracturing or injection operations will go beyond the boundary lines of the applicable spacing or drilling unit.<sup>25</sup>

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 . . . .<sup>26</sup>

When an operator wants to engage in a hydraulic fracturing operation that is likely to cross the boundary lines of the spacing or drilling unit, a

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997 S.W.2d at 171; *Browning Oil Co. v. Luecke*, 38 S.W.3d 625, 640 (Tex. App. 2000); *Circle Dot Ranch, Inc. v. Sidwell Oil & Gas, Inc.*, 891 S.W.2d 342, 346 (Tex. App. 1995); *Humble Oil & Ref. Co. v. Kunkel*, 366 S.W.2d 236, 239 (Tex. Civ. App. 1963). For other cases adopting a narrow interpretation, see generally *Mallett v. Union Oil and Gas Corp.*, 94 So. 2d 16 (La. 1957); *Wilcox v. Shell Oil Co.*, 76 So. 2d 416 (La. 1954).

22. *Compare Tittizer*, 171 S.W.2d at 861 (stating lessee must strictly comply with the requirement of filing a unit declaration), *with HS Res., Inc. v. Wingate*, 327 F.3d 432, 442 (5th Cir. 2003) (noting that the interpretation of anti-dilution and acreage limitation provisions of pooling clauses are governed by standard canons of construction).

23. 268 S.W.3d 1 (Tex. 2008).

24. *See, e.g., Mowrer v. Ashland Oil & Ref. Co.*, 518 F.2d 659, 660-61 (7th Cir. 1975) (applying Indiana law); *Young v. Ethyl Corp.*, 521 F.2d 771, 772 (8th Cir. 1975); *Greyhound Leasing & Fin. Corp. v. Joiner City Unit*, 444 F.2d 439, 440 (10th Cir. 1971) (applying Oklahoma law); *Snyder Ranches, Inc. v. Oil Conservation Comm'n of N.M.*, 798 P.2d 587, 588 (N.M. 1990); *Baumgartner v. Gulf Oil Co.*, 168 N.W.2d 510, 511-13 (Neb. 1969); *Boyce v. Dundee Healdton Sand Unit*, 560 P.2d 234, 235 (Okla. Civ. App. 1975); *R.R. Comm'n v. Manziel*, 361 S.W.2d 560, 561-65 (Tex. 1962).

25. For examples of areal restrictions on the size of the pooled unit, see 4 WILLIAMS & MEYERS, *supra* note 16, §§ 669.7, 669.10.

26. *Sotrana-Tex. Corp. v. Mogen*, 551 F. Supp. 433, 434 (D.N.D. 1982).

clause like the one reproduced above might give the lessee the opportunity to avoid the uncertainty of litigation in resolving the cross-boundary fracing liability rules. While in *Garza* the Texas Supreme Court essentially immunized the operator from trespass liability under most, if not all, circumstances involving cross-boundary fracing operations, it is not clear that other state supreme courts will adopt its rationale. In *Garza*, Coastal formed a standard pooled unit that combined 7.357 acres from its fee-owned acreage on Share 12 with 72.643 acres from its lease-owned acreage on Share 13, in part, to be able to drill an additional well on Share 12.<sup>27</sup> Notwithstanding a pooling clause that gave the lessee broad discretion to pool, the jury in *Garza* found that the pooling was in bad faith and awarded damages.<sup>28</sup> 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 frac hydraulically the well on Share 12 that crossed the boundary line onto Share 13. However, if the lessee had a clause such as the one reproduced above, it could have avoided the trespass issue entirely by unitizing the Share 12 and Share 13 acreage into a partial-fieldwide unit. The operator may also have avoided the bad faith pooling verdict by unitizing rather than pooling the acreage in question. When a single operator has leases on adjacent acreage, the ability to unitize rather than to pool would be most advantageous in dealing with proposed hydraulic fracing on injection operations.

The pooling and unitization clause reproduced above, however, has a reasonably common requirement that, before one can unitize, the “unit plan of development or operation” must be approved by “any governmental authority.”<sup>29</sup> This type of governmental-approval language is common in the Rocky Mountain area where there are substantial federal and/or state oil and gas leases.<sup>30</sup> This condition precedent to unitization is probably not warranted when only private or fee lands are concerned. Including such language in a private oil and gas lease will certainly add substantial transactional costs to the unitization effort because the unit operator will have to seek approval from the state conservation agency for the voluntary unitization. While almost all states provide for such an approval process,<sup>31</sup> many require that there be notice and a public hearing before such an approval will be granted. When 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 and/or injection operations. Furthermore, the ability to unitize all or a portion of a

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27. *Garza*, 268 S.W.3d at 21.

28. *Id.* at 8.

29. See *supra* text accompanying note 26.

30. 4 WILLIAMS & MEYERS, *supra* note 16, § 669.7.

31. LAW OF POOLING, *supra* note 16, § 17.03.

common source of supply will provide the lessee with greater flexibility in dealing with horizontal drilling operations, both in terms of surface and sub-surface operations.

Parties should also avoid using a common pooling clause which limits the lessee's ability to pool to an area that may be "prescribe[d] or permit[ted]" by the governmental authority having jurisdiction over spacing or drilling.<sup>32</sup> Such language was narrowly interpreted in *Jones v. Killingsworth*<sup>33</sup> to invalidate a pooling of acreage for a 160-acre pooled unit when the Railroad Commission rules permitted a 160-acre unit but prescribed a unit of only 80 acres.<sup>34</sup> Because spacing, drilling and/or proration units relating to horizontally-drilled wells may have variable acreage requirements depending on individual circumstances, a pooling clause using the prescribed or permitted language may limit the lessee's ability to pool to the smallest amount of acreage prescribed by the state conservation agency. Because state conservation agencies are increasingly allowing variable spacing and drilling unit sizes, a pooling clause should not be drafted that creates an ambiguity as to the areal limits of the voluntarily-pooled unit.<sup>35</sup>

The difficulty of not having a pooling or unitization clause that is written with horizontal wells in mind is illustrated in *Browning Oil Co. v. Luecke*.<sup>36</sup> The lease contained a pooling clause that had been amended several times after its execution because it contained various constraints on the pooling power. One of the amendments to the pooling clause added the following anti-dilution provision: "Notwithstanding paragraph number four (4) hereof, if any pooled unit is created with respect to any well drilled on the land covered hereby, at least sixty percent (60%) of such pooled unit shall consist of the land covered hereby."<sup>37</sup> Another provision allowed the lessor's lands to be pooled even if the lands constituted less than 60% of the pooled unit when all of the lessor's lands were included in the unit or such non-lessor lands were needed to comply with established field rules.<sup>38</sup>

The lessee wanted to drill two horizontal wells.<sup>39</sup> It unsuccessfully sought to amend the pooling clause to deal with the horizontally-configured pooled units.<sup>40</sup> One of the horizontal wells crossed through

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32. See *id.* § 8.05.

33. 403 S.W.2d 325 (Tex. 1966).

34. *Id.* at 327.

35. See *Atl. Richfield Co. v. Hilton*, 437 S.W.2d 347, 351 (Tex. Civ. App. 1969).

36. 38 S.W.3d 625 (Tex. App. 2000). See generally Stephen Taylor Dennis, *Browning Oil Co. v. Luecke: Has Texas Illuminated a Dark Distinction Between Vertical and Horizontal Drilling*, 34 ST. MARY'S L.J. 215 (2002).

37. *Browning Oil*, 38 S.W.3d at 637.

38. *Id.*

39. *Id.* at 638.

40. *Id.*

seven tracts of land.<sup>41</sup> That well crossed through one of the three tracts of land subject to the lease.<sup>42</sup> The vertical well bore and a portion of the horizontal well bore were located on the lessor's tract.<sup>43</sup> A second horizontal well crossed the other two tracts included within the lessor's lease although the vertical portion of the well was not physically located on the lessor's tracts.<sup>44</sup> The lessee essentially conceded that the two proposed pooled units did not comply with the anti-dilution provisions of the pooling clause.

As noted above, in Texas a lessee purporting to act pursuant to the pooling power contained in a lease must strictly comply with any conditions precedent to the exercise of that power.<sup>45</sup> Having conceded that the horizontal-pooled unit configurations violated the anti-dilution provision, the lessee tried to argue that a reasonable and prudent operator would not have pooled the acreage for the horizontal wells using the 80-acre spacing patterns that the Railroad Commission had adopted.<sup>46</sup> The court easily rejected the assertion that an express limitation contained in the pooling clause might be avoided by claiming that following the express limitation would violate the reasonable and prudent operator standard.<sup>47</sup> The standard of conduct between the lessor and lessee is created and defined by the written language of the lease. The fact that the lessee wants to engage in activities that it believes will be reasonable and prudent cannot excuse the breach of the express language requiring that the lessor's interests not be diluted beyond an agreed-to percentage by the lessee's exercise of the pooling power.

The trial court measured damages based on the traditional rules for the owner of a drill site tract whose interests have been improperly pooled. That measure of damages would be an undiluted royalty on all production coming through the well bore that is located on the leased tract.<sup>48</sup> Because the second horizontal well crossed two of the three tracts under lease, in theory, the lessor would have received a "double royalty" based on the illegal pooling. In rejecting this recovery, the court articulated the reasons why a different damages rule should apply to wrongful pooling of royalty interests as applied to horizontal and to not vertical wells. It stated:

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41. *Id.*

42. *Id.*

43. *Id.*

44. *Id.* at 638-39.

45. *Id.* at 640 (citing *Se. Pipe Line Co. v. Tichacek*, 997 S.W.2d 166, 170 (Tex. 1999); *Jones v. Killingsworth*, 403 S.W.2d 325, 327-28 (Tex. 1965); *Pampell Interests, Inc. v. Wolle*, 797 S.W.2d 392, 394 (Tex. App. 1990)).

46. *Browning*, 38 S.W. 3d at 641-42.

47. *Id.*

48. *Id.* at 645. The wrongfully pooled tract is treated as never having been pooled so that the owner would be entitled, under the rule of capture, to 100% of the production or, in this case, 100% of the leasehold royalty. The general rule has been brought into question as it applies to vertical wells in *Wagner & Brown Ltd. v. Sheppard*, 282 S.W.3d 419, 428-30 (Tex. 2008).

Horizontal wells can extend across several tracts of land in a linear configuration to accommodate the length of the horizontal drainhole. Consequently, all the tracts are not contiguous. Several tracts of land may separate the penetration point of the drainhole from the terminus point. And each of the tracts traversed by the horizontal drainhole is considered a drillsite tract, which likely includes underlying fractures that are being drained by the wellbore. Thus, each point along the drainhole is contributing to production from isolated fractures, and no one drillsite is naturally draining minerals from all of the penetrated tracts. Even though the rule of capture and other principles of oil and gas law would afford the Lueckes royalties on all production if a vertical well were drilled on their land without valid pooling, these principles have no application in the case of horizontal wells that contain multiple drillsites on tracts owned by multiple owners.

Absent the ability to naturally drain neighboring tracts, the Lueckes are not entitled to production from other lessors' tracts unless there has been a cross-conveyance of property interests. Because the purported units were invalid, there has been no cross-conveyance of interests, and the Lueckes are not entitled to royalties on production from lands they do not own.<sup>49</sup>

While minimizing the damages awarded to a lessor whose interests have been invalidly pooled, the court clearly re-emphasized the general principle that any restrictions on the power to pool granted in the lease to the lessor will be strictly enforced.

Anti-dilution provisions, such as the one used in *Browning Oil*, are becoming more common as lessors seek to prevent their royalty income from being diluted by having only a small portion of their leasehold committed to a pooled unit. Because of the nature of horizontally-pooled units, however, pooled units may legitimately encompass numerous leases, each of which may be contributing a reasonably small area in order that the lateral or horizontal well segment maximizes the recovery from the formation. The existence of anti-dilution provisions will create disincentives for the voluntary pooling of horizontal well units and may encourage the use of the compulsory pooling powers given to the state conservation agencies in every major producing state except for Kansas. The general rule is that a lessee who goes through the compulsory-pooling procedure is not constrained by any restrictions on its voluntary pooling power that may be contained in the leasehold pooling clause.<sup>50</sup>

Anti-dilution provisions may also be avoided using other leasehold provisions. For example, in *Sabre Oil & Gas Corp. v. Gibson*,<sup>51</sup> the lessee was authorized by the lease to execute partial assignments of the

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49. *Browning Oil*, 38 S.W.3d at 646.

50. See *Egeland v. Cont'l Res., Inc.*, 616 S.W.2d 861, 866 (N.D. 2000). See generally LAW OF POOLING, *supra* note 16, § 9.06.

51. 72 S.W.3d 812 (Tex. App. 2002).

leasehold acreage.<sup>52</sup> A partial assignee then pooled all of the acreage that had been partially assigned into a pooled unit with non-leasehold acreage.<sup>53</sup> The court reconciled the anti-dilution provisions of the lease with the partial assignment provisions by allowing the pooling of all of a partially-assigned portion of the lease.<sup>54</sup> Likewise, the leasehold provision allowing the lessee to surrender all or a portion of the leasehold estate may be used by a lessee to overcome an anti-dilution provision.<sup>55</sup> The lessee may surrender all non-pooled portions of the lease and, thus, comply with an anti-dilution provision requiring that all of the leasehold acreage be pooled.<sup>56</sup>

One other matter relating to the pooling clause that will constrain the lessee's exercise of the pooling power is the duty imposed by the courts that the power be exercised under a duty of good faith and fair dealing.<sup>57</sup> In *Garza*, the Texas Supreme Court would not have disturbed the jury's finding that the pooling was in bad faith had it not been for the admission of racially-charged memos that prejudiced the jury.<sup>58</sup> The evidence of bad faith that supported the jury verdict was that Coastal included in the pooled unit substantial acreage from its Share 12 fee-owned lands while it should have only included a single acre in order to avoid the Railroad Commission's restrictions on the drilling of one of its new wells.<sup>59</sup> Further evidence of bad faith was shown by Coastal's failure to include Share 13 acreage in a pooled unit with one of the Share 12 wells.<sup>60</sup>

The duty owed by a lessee in exercising the pooling power that otherwise complies with the provisions of the pooling clause first arose in a series of cases in the 1950s in which the lessee pooled acreage immediately prior to the end of the primary term.<sup>61</sup> The use of the term "fair dealing" as an additional constraint on the power to pool was added by the Mississippi Supreme Court in *Southwest Gas Producing Co. v. Seale*.<sup>62</sup> In Texas, the fair dealing portion of the duty has largely been dropped, thus, requiring the lessee to exercise its express-pooling power in good faith.<sup>63</sup> The good faith and/or fair dealing duty has also

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52. *Id.* at 817-18.

53. *Id.* at 814.

54. *Id.* at 816-17.

55. *See id.* at 818.

56. *See HS Res., Inc. v. Wingate*, 327 F.3d 432, 442-43 (5th Cir. 2003).

57. *See* 3 WILLIAMS & MEYERS, *supra* note 3, § 670.2.

58. *Coastal Oil & Gas Corp. v. Garza Energy Trust*, 268 S.W.3d 1, 23-24 (Tex. 2008).

59. *Id.* at 21.

60. *Id.*

61. *See, e.g., Boone v. Kerr-McGee Indus., Inc.*, 217 F.2d 63, 64 (10th Cir. 1954); *In re Little Nick Oil Co.*, 258 P.2d 1184, 1185-86 (Okla. 1953).

62. 191 So. 2d 115, 121 (Miss. 1966).

63. *See Se. Pipe Line Co. v. Tichacek*, 997 S.W.2d 166, 170 (Tex. 1999); *Circle Dot Ranch, Inc. v. Sidwell Oil & Gas, Inc.*, 891 S.W.2d 342, 346 (Tex. App. 1995); *Elliott v. Davis*, 553 S.W.2d 223, 226 (Tex. Civ. App. 1977).

been expressly applied to unitization clauses.<sup>64</sup> What constitutes good faith and/or fair dealing will be quite fact-specific but as *Garza* indicates, pooling in a way that benefits the lessee and dilutes the interest of the lessor may be in bad faith, even in the absence of any anti-dilution restrictions in the pooling clause.<sup>65</sup> Because of the fact-specific nature of the inquiry, a lessee's decision to pool may be second-guessed by a jury that has the benefit of hindsight regarding any particular choices made by the lessee. The pooling decisions finding bad faith when the lessee pools shortly before the end of the primary term reflect that kind of uncertainty, given the fact that most pooling clauses do not have a time restriction on when they may be exercised.<sup>66</sup> Another factor that must be considered when engaging in pooling or unitizing even when the lessee has complied with any of the express condition precedents is whether the pooling or unitizing is being done in order to hold leases which might otherwise expire. A number of cases have found such efforts to be in bad faith, largely from the perspective of the drill-site tract owner whose interest is being diluted.<sup>67</sup>

### III. LEASEHOLD SAVINGS PROVISIONS

#### A. Some Introductory Principles

There are many types or forms of leasehold savings clauses. The goal of these types of clauses is to prevent the lease from automatically terminating in its secondary term in those jurisdictions that require discovery and marketing to satisfy the terms of the habendum clause. There are also many types of short-hand names for such clauses including thirty-day clauses, sixty-day clauses, continuous-drilling operations clauses, continuous-operations clauses, drilling-operations clauses, dry hole clauses, shut-in gas royalty clauses, and cessation of production clauses.<sup>68</sup> Some of the clauses are general in nature, while others deal with specific conditions, events, or circumstances. As noted briefly above, in states that require the marketing of hydrocarbons in the secondary term in order to satisfy the habendum clause, lessees need to have provisions included in the lease that prevent the automatic termi-

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64. See, e.g., *Froholm v. Cox*, 934 F.2d 959, 962 (8th Cir. 1991); *Amoco Prod. Co. v. Heimann*, 904 F.2d 1405, 1411-12 (10th Cir. 1990).

65. See *Garza*, 268 S.W. 3d at 21.

66. See 4 WILLIAMS & MEYERS, *supra* note 16, § 670.1. See generally *McDonald v. Grande Corp.*, 214 So. 2d 795 (La. Ct. App. 1968); *Skelly Oil Co. v. Harris*, 352 S.W.2d 950 (Tex. 1962).

67. See, e.g., *Circle Dot Ranch, Inc. v. Sidwell Oil & Gas, Inc.*, 891 S.W.2d 342, 346 (Tex. App. 1995); *Amoco Prod. Co. v. Underwood*, 558 S.W.2d 509, 513 (Tex. Civ. App. 1977).

68. See generally 3 WILLIAMS & MEYERS, *supra* note 3, §§ 613.1-613.7, 615.1-615.7, 617, 624-26. The labeling may be outcome-determinative if courts do not carefully parse the exact language of the clause involved. See generally *Skelly Oil Co. v. Wickham*, 202 F.2d 442 (10th Cir. 1953); *Griffin v. Crutcher-Tufts Corp.*, 500 So. 2d 1008 (Ala. 1986); *Rogers v. Osborn*, 261 S.W.2d 311 (Tex. 1953).

nation of the lease in the event that production has not been secured or when production ceases.<sup>69</sup>

Savings provisions, just like pooling clauses, may contain limits or conditions precedent to their applicability. Specific savings provisions often bear the label of the condition precedent that must occur before they can prevent the lease from terminating in the secondary term. Such provisions may also have time limits as to when certain activities must occur or how frequently those activities must take place. As the following example shows, these conditions precedent and time constraints may be combined in a single provision:

If prior to the discovery of oil or gas on said land Lessee should drill a dry hole or holes thereon, or if after discovery of oil or 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. . . . If at the expiration of the primary term oil, gas or other mineral is not being produced on said land but Lessee is then engaged in drilling or re-working operations thereon, this lease shall remain in force so long as operations are prosecuted with no cessation of more than thirty (30) consecutive days, and if they result in the production of oil, gas or other minerals so long thereafter as oil, gas, or other mineral is produced from said land.<sup>70</sup>

The drafters of this clause clearly had the intent of covering all of the possible scenarios dealing with the potential termination of the lease either at the end of the primary term or in the secondary term. The first clause contains several different savings provisions. When there has not been a discovery but the lessee drills a dry hole or holes, after the drilling of such a hole or holes, the lessee has sixty days to commence additional drilling or reworking operations so the lease will not terminate. The first clause also provides that when there has been production from a well which ceases, the lease can be maintained by the same commencement of additional drilling or reworking operations within sixty days of the cessation of production. The second clause deals with the singular circumstance in which production has not been achieved when the primary term is ending, but the lessee is then engaged in drilling or re-working operations. In this instance, the lease will likewise not terminate so long as such operations do not cease for a period in excess of thirty days. It is important to note that the second clause does not use the modifier "additional" in describing what type of drilling operations are sufficient to keep the lease alive. This may be important given a factual scenario in which new wells are commenced.<sup>71</sup>

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69. 3 WILLIAMS & MEYERS, *supra* note 3, § 604.

70. Sunac Petroleum Corp. v. Parkes, 416 S.W.2d 798, 800 (Tex. 1967). For other cases interpreting similar clauses, see *Skelly Oil*, 352 S.W.2d 950; *Stanolind Oil & Gas Co. v. Newman Brothers Drilling Co.*, 305 S.W.2d 169 (Tex. 1957); and *Rogers v. Osborn*, 261 S.W.2d 311 (Tex. 1953).

71. See *Rogers*, 261 S.W.2d at 313.

Savings provisions are cumulative in nature.<sup>72</sup> Thus, a lessee who is actively drilling a well at the end of the primary term gets to keep the lease alive under the second clause so long as operations take place at least one day every thirty days. If that drilling operation is unsuccessful, then the lessee has sixty days to commence additional drilling or reworking operations to keep the lease alive.<sup>73</sup>

Notwithstanding the seemingly complete coverage provided by the above-cited savings provision, it proved inadequate to deal with the factual scenario in *Sunac Petroleum Corp. v. Parkes*.<sup>74</sup> In *Sunac*, the lease, despite the savings provision given above, also contained a pooling clause that restricted the lessee's power to pool to gas wells.<sup>75</sup> The 160-acre lease was pooled into a 640-acre gas unit three days prior to the end of the primary term.<sup>76</sup> Drilling operations were ongoing within the unit but not on the land subject to the lease. Thus, under the second clause of the savings provision, as well as the pooling clause, the lease was extended into the secondary term. The well was successfully completed as a producing oil well.<sup>77</sup> The lessee then drilled a second well on the 160-acre leasehold tract thirteen days after the completion of the oil well and sixty-eight days after the end of the primary term.<sup>78</sup> A majority of the Texas Supreme Court parsed the language of the savings provision and found that the lease terminated because none of the savings provisions were applicable.<sup>79</sup> While there were drilling operations ongoing, because the lessee was not authorized to pool for an oil well, the second clause in the savings provision that specifically dealt with operations in existence when the primary term expired did not apply.<sup>80</sup> Likewise, there were no "additional" drilling or reworking operations on the oil well. The drilling of the well on the lease occurred more than sixty days after the end of the primary term. The oil well was not a "dry hole" under the first clause of the lease because it produced marketable hydrocarbons.<sup>81</sup> Likewise, there was no cessation of production that would

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72. *Sunac*, 416 S.W.2d at 801-02; see *Stanolind Oil*, 305 S.W.2d at 172-73.

73. *Stanolind Oil*, 305 S.W.2d at 173.

74. 416 S.W.2d 798, 798 (Tex. 1967).

75. *Id.* at 800.

76. *Id.* at 799-800.

77. *Id.* at 800.

78. *Id.* This lawsuit was brought by the original lessee of the 160-acre tract who had assigned it to Sunac and reserved an overriding royalty interest. Because of the legal issues raised by the factual scenario, the original lessor and Sunac executed a second lease of the tract. If the first lease terminated, then Parkes, the assignor, lost its overriding royalty interest. 2 PATRICK H. MARTIN & BRUCE M. KRAMER, WILLIAMS & MEYERS: OIL AND GAS LAW § 418.2 n.2 (2009).

79. *Sunac*, 416 S.W.2d at 802.

80. *Id.*

81. Justice Hamilton, in dissent, would equate the drilling of a producing oil well on lands pooled for gas well purposes only as the functional equivalent of a dry hole because the pooled acreage was not receiving its pro rata share of production. See *id.* at 807-08 (Hamilton, J., dissenting). If treated as a dry hole, then the first clause of the savings provision would apply, and the lessee would have sixty days from the completion of the dry hole to engage in "additional drilling or reworking" operations. *Id.* at 807.

also allow the lessee to commence additional operations within sixty days of the cessation in order to keep the lease alive.

The lesson of *Sunac* is the need to draft savings provisions that do not have specific conditions precedent or have very general conditions precedent in order to avoid having the lease terminate under an unanticipated set of facts. The more “terms of art” used, such as drilling operations, cessation of production, completion, and the like, the more likely it is that uncertainty and/or litigation will follow. For example, if a savings provision requires that a well must be commenced within sixty days of the completion of a prior well, when does the clock start ticking? Is it at the time that total depth is reached and the drilling rig is removed from the premises? Is it at the time that casing is set? Is it at the time that the reservoir is perforated? Is it at the time that the fracing operations are concluded? Is it at the time that the well is capable of producing hydrocarbons? Is it at the time that the well is connected to the tank battery or pipe line? Is it at the time that the well physically produces hydrocarbons? In such circumstances, if the parties desire to use a term such as completion, it behooves them to define the term within the savings provision and not allow a dispute to arise afterward that will be resolved by a judge or jury.

### B. Commencement Clauses

Similar issues arise when the term “commence” is used in savings clauses.<sup>82</sup> The jurisprudence relating to how courts define that term ranges from “clear” to “fuzzy.” The clearest definition of when a well is commenced would require spudding or the entry of a drill bit into the ground.<sup>83</sup> The fuzziest definition is an ad hoc one, based on all of the relevant circumstances. This appears to be the road followed by a goodly number of courts.<sup>84</sup> Kansas appears to take a middle ground that does not require the actual spudding of an oil and gas well but does require an irrevocable commitment to drill to be in place before the primary term ends in order to have commenced operations or commenced the drilling of a well.<sup>85</sup>

In several of these “commencement” cases the court adds a requirement or two that the operations conducted by the lessee either be

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82. Commencement language is also typically found in delay rental clauses in which the lessee must either pay the delay rental or commence the drilling of the well prior to the anniversary date in order to avoid the automatic termination of the lease in most jurisdictions. *See, e.g.*, 3 WILLIAMS & MEYERS, *supra* note 3, § 605 (“If no well be commenced . . .”).

83. *See, e.g.*, LA. REV. STAT. ANN. § 31:30 (2000); Michigan Oil Co., 71 I.D. 263 (1964), 1964 WL 8990.

84. *See* 3 WILLIAMS & MEYERS, *supra* note 3, § 618.1.

85. *See* 1 DAVID E. PIERCE, KANSAS OIL & GAS HANDBOOK § 9.34 (1986); *see also* Petroleum Energy, Inc. v. Mid-America Petroleum, Inc., 775 F. Supp. 1420, 1425 (D. Kan. 1991); Hall v. JFW, Inc., 893 P.2d 837, 840 (Kan. Ct. App. 1995).

made in “good faith” or with “due diligence” in order to satisfy the express provision. The requirement that the operations commence with due diligence is often the result of express language.<sup>86</sup> The requirement that the operations, whatever they may involve physically, must also be undertaken in good faith, first arose in the 1940s and 1950s.<sup>87</sup> One recurring factual scenario that illustrates the ad hoc nature of decisions that accompany a good faith standard arises when a lessee has actually spudded a well but with a rig or equipment that is not capable of reaching the depths needed to produce from the expected reservoirs. In *Geier-Jackson, Inc. v. James*,<sup>88</sup> the court concluded that the actions of the lessee did not comply with the good faith and diligence necessary to meet the requirements of the commencement and operations clauses of a lease. The court reached this decision because the lessee lacked a good faith intent to pursue with good faith diligence the drilling of a well to such a depth as would likely encounter hydrocarbons.<sup>89</sup> But, in *Bunnell Farms Co. v. Samuel Gary, Jr. & Associates*,<sup>90</sup> the court found that the physical commencement of drilling operations by a rig incapable of drilling to the target depth where oil and gas could be encountered did constitute a good faith commencement of operations so as to keep the lease alive.<sup>91</sup> Whenever the court adds a good faith element to a particular contractual standard, greater uncertainty and the increased likelihood of litigation will necessarily follow. The cases dealing with how one proves good faith or bad faith are very fact-specific and inconsistent in results.<sup>92</sup>

As with other issues, it would be better for the parties to define what constitutes operations or commencement of drilling operations to avoid the kind of uncertainty that case law has provided. For example, in *Petroleum Energy, Inc. v. Mid-America Petroleum, Inc.*,<sup>93</sup> the parties defined commencement as: “Drilling operations or mining 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 stak-

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86. In *Skelly Oil Co. v. Wickham*, 202 F.2d 442 (10th Cir. 1953), the commencement provision stated: “If the lessee shall commence to drill a well within the term of this lease . . . the lessee shall have the right to drill such well to completion with reasonable diligence and dispatch . . .” *Id.* at 443.

87. See, e.g., *Haddock v. McClendon*, 266 S.W.2d 74, 77-78 (Ark. 1954); *Wilcox v. West*, 114 P.2d 39, 44 (Cal. Ct. App. 1941); *Ill. Mid-Continent Co. v. Tennis*, 102 N.E.2d 390, 394 (Ind. Ct. App. 1951); *Jones v. Moore*, 338 P.2d 872, 875 (Okla. 1959); *Bain v. Portable Drilling Corp.*, 198 P.2d 207, 210 (Okla. 1948); *Petersen v. Robinson Oil & Gas Co.*, 356 S.W.2d 217, 220 (Tex. Civ. App. 1962).

88. 160 F. Supp. 524 (E.D. Tex. 1958); see also *Int’l Oil & Gas Corp., GFS BLM-1966-39* (May 24, 1966); *Hondo Oil & Gas Co.*, A-30216 (Jan. 11, 1965).

89. *Geier-Jackson*, 160 F. Supp. at 529-30.

90. 47 P.3d 804 (Kan. Ct. App. 2002); accord *Exxon Corp. v. Crosby B Miss. Res., Ltd.*, 154 F.3d 202, 207 (5th Cir. 1998) (deciding that a small truck-mounted drilling rig that begins drilling prior to end of primary term is sufficient to keep lease alive).

91. *Bunnell Farms Co.*, 47 P.3d at 807.

92. See 3 EUGENE KUNTZ, A TREATISE ON THE LAW OF OIL AND GAS § 32.3(c) (1989) (referencing list of cases involving good faith).

93. 775 F. Supp. 1420 (D. Kan. 1991).

ing the location, is done thereon which is necessary for such operations.”<sup>94</sup> Such a definition makes clear what operations, other than the actual spudding of the well, will keep the lease alive and avoid litigation like that which occurred in *Veritas Energy, L.L.C. v. Brayton Operating Corp.*<sup>95</sup> In *Veritas Energy*, the court found that a lessee had not commenced operations when, a week prior to the end of the primary term, it hired a “dirt work” company that used a backhoe to “back-drag” grass along a proposed new road to access the drill site.<sup>96</sup> Using a clause such as the one provided above would more clearly make such preliminary efforts insufficient to meet the commencement requirement of a savings clause.

Two cases have dealt with the problem that while drilling operations have clearly begun prior to the end of the primary term, none of the actual operations have taken place on the leased premises because either horizontal or slant wells were being drilled. The earlier case, *A & M Oil, Inc. v. Miller*,<sup>97</sup> dealt with a slant hole being drilled by the lessee prior to the end of the primary term. The savings provision stated:

Notwithstanding anything in this lease contained to the contrary, it is expressly agreed that if lessee shall commence operations for drilling at any time while this lease is in force, this lease shall remain in force and its terms shall continue so long as such operations are prosecuted.<sup>98</sup>

Even though the court applied the canon of construction which construes leases against the lessee,<sup>99</sup> it did not find in the above-quoted savings provision a requirement that the operations physically take place on the respective leased premises. The lessee had both taken preliminary steps towards commencing a well and had exercised due diligence in pursuing the completion of the well. That was sufficient for the court. It stated: “We cannot agree with the landowners in their assertion that A & M must conduct some physical activity on the leased property in order to commence drilling operations. The leases are unambiguous and cannot be read to require physical entry.”<sup>100</sup>

A more recent decision reached the same result but did so in a way that created some doctrinal difficulty. In *Manzano Oil Corp. v. Chesapeake Operating, Inc.*,<sup>101</sup> a top lessee sought to take advantage of the fact that a horizontal well was commenced off of the leasehold acreage

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94. *Id.* at 1423.

95. No. 13-06-061-CV, 2008 WL 384169 (Tex. App. Feb. 14, 2008).

96. *Id.* at 4-5.

97. 715 P.2d 1295 (Kan. Ct. App. 1986).

98. *Id.* at 1296.

99. See *Jackson v. Farmer*, 594 P.2d 177, 183 (Kan. 1979) (explaining canon of construction that construes leases against lessee); Bruce M. Kramer, *The Sisyphian Task of Interpreting Mineral Deeds and Leases: An Encyclopedia of Canons of Construction*, 24 TEX. TECH L. REV. 1, 105-17 (1994) (discussing canon of construction construing leases against lessee).

100. *A & M Oil*, 715 P.2d at 1297.

101. 178 F. Supp. 2d 1217 (D.N.M. 2001).

to claim that a well had not been commenced prior to the end of the primary term. Chesapeake entered into a three-year primary term lease with Howay.<sup>102</sup> Because of municipal regulations, Chesapeake needed a variance in order to drill a well on a surface location within the boundaries of the lease.<sup>103</sup> Instead of seeking a variance, Chesapeake purchased an adjacent three-acre parcel from which it began to drill a deviated well.<sup>104</sup> The well was spudded on the adjacent tract prior to the end of the primary term but the well bore did not enter the leasehold estate until after the end of the primary term.<sup>105</sup> The lateral section of the proposed horizontal well was to be entirely within the boundaries of the leasehold estate.<sup>106</sup>

The court rejected the top lessees' claim that, because there was no activity on or beneath the surface of the described leasehold estate, the savings provision allowing the lessee to complete a well that had been commenced but not completed in the primary term, was not triggered.<sup>107</sup> There was also a pooling clause in the lease, but there is no evidence that the lessee voluntarily pooled the three-acre tract with the leasehold acreage.<sup>108</sup> There is likewise no mention that the state conservation agency force pooled the leasehold acreage with the adjacent three-acre tract.

The court's reliance on the pooling clause to conclude that operations may be commenced off the leasehold tract and satisfy the savings provision is not supported by the language of the lease. While no one would argue with the conclusion that operations occurring within a validly-pooled unit are attributable to all of the leases that have been pooled, without pooling, the court ignores the lease language that refers to operations "thereon" that would indicate that the operations must be on the leasehold. While the reliance on the pooling clause may be misplaced, the ultimate decision is supportable given the court's statement that the lease contemplated the drilling of a horizontal well.<sup>109</sup> Lessors should be aware that, given the nature of horizontal well bores, physical

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102. *Id.* at 1218.

103. For a discussion of local regulation of oil and gas operations, see Bruce M. Kramer, *Local Regulation of Oil and Gas Operations: Don't All Homeowners Want a Pumpjack in Their Backyard*, 41 ROCKY MTN. MIN. L. INST. 213 (2004); Bruce M. Kramer, *The Pit and the Pendulum: Local Government Regulation of Oil and Gas Activities Returns From the Grave*, 50 INST. ON OIL & GAS L. & TAX'N 4-1 (1999).

104. *Manzano Oil*, 178 F. Supp. 2d. at 1218-19.

105. *Id.* at 1219.

106. *Id.* at 1218-19.

107. The savings provision stated:

[I]f at the expiration of the primary term there is no well upon said land capable of producing oil or gas, but lessee has commenced operations for drilling or reworking thereon this lease shall remain in force so long as operations are prosecuted with no cessation of more than 60 consecutive days . . . .

*Id.* at 1219.

108. *Id.* at 1219-20.

109. *See id.* at 1220.

operations within the boundaries of the lease may take place well after the actual drilling has commenced. The fact that the spudding and drilling prior to the end of the primary term has not occurred on the leasehold estate should not prevent the savings clause of the lease from being triggered. There was a 1966 Louisiana State Lease form providing that directional-drilling operations were deemed to be commenced “on the leased premises when the drill stem penetrates beneath the surface of the leased premises.”<sup>110</sup> Obviously, under that type of clause, the results in *A & M Oil* and *Manzano Oil* would be different. From a lessee’s perspective, including language in the savings clause that refers to actions designed to bottom a well on the leased premises, would reinforce those results.<sup>111</sup>

A proper use of a pooling clause that allows a lessee to engage in operations off the lease in the drilling of a horizontal well is exemplified by *Pioneer Natural Resources USA, Inc. v. W.L. Ranch, Inc.*<sup>112</sup> In that case, the lease contained a pooling clause and an operations clause.<sup>113</sup> Prior to the end of the primary term, the lessee pooled the leasehold acreage to form a horizontal well-pooled unit.<sup>114</sup> Nine days prior to the end of the primary term, the vertical portion of the well bore was spudded off the leased premises.<sup>115</sup> The horizontal or lateral well bore did not cross the boundary line of the plaintiff’s tract until the primary term had expired.<sup>116</sup> Because the pooling clause expressly stated that operations anywhere on lands pooled with the leased lands shall constitute operations on the leased lands, the court had no difficulty finding that the operations conducted by the lessee satisfied the terms of the operations savings provision.<sup>117</sup>

While the *Pioneer* court suggested that there might be a conflict between the pooling clause and the operations savings provision which solely referred to operations on said lands, there really was no conflict. Under the express terms of a pooling clause, all operations on pooled lands are treated as if they occurred on the leased premises. As such, a lessee complies with the operations savings provision, and production from the pooled unit well maintains the lease until it ceases producing.<sup>118</sup>

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110. 3 WILLIAMS & MEYERS, *supra* note 3, § 605.2 (directional well).

111. *See id.* § 605.2.

112. 127 S.W.3d 900 (Tex. App. 2004).

113. *Id.* at 903, 905.

114. *Id.* at 904.

115. *Id.*

116. *Id.*

117. *Id.* at 906.

118. *See* Southland Royalty Co. v. Humble Oil & Refining Co., 249 S.W.2d 914, 916 (Tex. 1952). *See generally* LAW OF POOLING, *supra* note 16, § 20.03.

### C. Operations Clauses

This subsection will focus not so much on the condition precedent to the savings clause, such as the cessation of production or the drilling of a dry hole, but on the actions that must be taken by the operator in order to keep a lease alive. These actions typically use such terms as “drilling operations,” “operations,” “re-working operations,” or “additional operations.” These terms are infrequently defined by the lease although a substantial body of law exists regarding these various terms.<sup>119</sup> This body of law, however, consists largely of judicial decisions by state courts in the Mid-Continent region. Because many of the leasing and drilling activities created by the new shale plays will take place in jurisdictions which have “immature” oil and gas jurisprudence, how courts in those jurisdictions will interpret standard-form savings provisions is hard to predict. Either by express language or implication, the operations may have to take place on the leased premises. As shown above in *A & M Oil* and *Manzano Oil*, the courts have ignored any express reference to the leased premises and have found that operations that take place off of the leased premises but are designed to produce from the leased premises satisfy the applicable savings provision.

An Arizona statute dealing with the lease of state lands for oil and gas development defines drilling operations as:

[A]ny work or actual physical or mechanical operations undertaken or commenced in good faith for the purpose of bringing about the production of oil or gas in paying quantities, including the preparation of drill sites, followed diligently and in reasonable due course by the mobilization of a drilling rig and other necessary structures for the drilling of an oil or gas well and by actual drilling in the ground.<sup>120</sup>

What is interesting about the definition is the inclusion of the term “good faith” to define a drilling operation. The same Arizona statute, when it defines “reworking operations,” does not include “good faith” as an element of such operations. That definition states: “‘Reworking operations’ means work performed at any depth on a well after its initial completion in an effort to secure production where there has been none, or to restore production that has ceased or to increase production.”<sup>121</sup>

In *Rogers v. Osborn*,<sup>122</sup> the Texas Supreme Court noted the following definition of “reworking operations” that was included in the jury instruction although it eschewed adopting that definition as a general rule:

[T]he term ‘re-working operations,’ . . . means actual work or operations which have theretofore been done, being done over, and being done in

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119. See 3 WILLIAMS & MEYERS, *supra* note 3, §§ 617, 618, 621, 622.

120. ARIZ. REV. STAT. ANN. § 27-551(4) (2000).

121. *Id.* § 27-551(10).

122. 261 S.W.2d 311 (Tex. 1953).

good faith endeavor to cause a well to produce oil and gas or oil or gas in paying quantities as an ordinarily competent operator would do in the same or similar circumstances.<sup>123</sup>

The express language of the leasehold savings provision, however, makes no reference to good faith; rather, it only requires the lessee to be “engaged in drilling or re-working operations.”<sup>124</sup> While hydraulic fracturing operations have been carried out since the 1950s, express references to such operations are rare in most model lease forms.<sup>125</sup> In one case, the court clearly found that an operator engaged in a hydraulic fracturing operation was engaged in a reworking operation, but that case involved a joint-operating agreement and not an oil and gas lease.<sup>126</sup> But whether or not hydraulic fracturing would constitute a “drilling” operation or a “reworking” operation should not be left for a court to divine. Instead, savings provisions should be drafted so that hydraulic fracturing is specifically mentioned as the type of operation that would trigger the maintenance of a lease without actual production.

The more generic term “operation” is “not a term of art with a clearly understood definition.”<sup>127</sup> It is a term that should be defined in the oil and gas lease. For example, the following definition appears to cover most of the activities that people understand to be “operations”: “[D]rilling, 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, excavating a mine, production of oil, gas, sulphur or other mineral, whether or not in paying quantities.”<sup>128</sup> Notwithstanding this very broad definition, it still does not expressly mention hydraulic fracturing or other types of operations that may occur when horizontal drilling is involved. In applying this definition, a Texas Court of Appeals found that certain minimum surface activities—including back dragging a backhoe in order to delineate the location of the access road to the well site—was not an operation that triggered the application of the savings provision.<sup>129</sup> The court found that other activities, including the hiring of a geophysicist and a geoscientist for the evaluation of the 3-D seismic data and the preparation of an estimated well cost document, were clearly not opera-

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123. *Id.* at 313-14.

124. *Id.* at 313.

125. See Bruce M. Kramer, *Coastal Oil & Gas Corp. v. Garza Energy Trust: Some New Paradigms for the Rule of Capture and Implied Covenant Jurisprudence*, 30 ENERGY & MIN. L. INST. (forthcoming 2009).

126. See *Texstar N. Am., Inc. v. Ladd Petroleum Corp.*, 809 S.W.2d 672, 674, 677 (Tex. App. 1991).

127. MARTIN & KRAMER, *supra* note 2, at 659.

128. *Veritas Energy L.L.C. v. Brayton Operating Corp.*, No. 13-06-061-CV, 2008 WL 384169, at \*1 (Tex. App. Feb. 14, 2008). A similar definition can be found in the lease involved in *Ice Bros., Inc. v. Bannowsky*, 840 S.W.2d 57, 58 (Tex. App. 1992).

129. *Veritas Energy*, 2008 WL 384169, at \*6.

tions as defined by the agreement.<sup>130</sup> But there are cases that suggest that road clearing activities may constitute operations under such a savings provision.<sup>131</sup>

The issue of whether the operations undertaken by the lessee have to be undertaken in good faith in order to keep a lease alive were explored in depth in *BP America Production Co. v. Marshall*.<sup>132</sup> The lease in *Marshall* contained the following savings provision:

If prior to discovery and production of oil, gas or other mineral on said land or on acreage pooled therewith, Lessee should drill a dry hole or holes thereon, or after discovery and production of oil, gas or other mineral, the production thereof should cease from any cause, this lease shall not terminate if Lessee commences operations for drilling or reworking within sixty (60) days thereafter. . . . If at the expiration of the primary term, oil, gas or other mineral is not being produced on said land, or on acreage pooled therewith, but Lessee is then engaged in drilling or reworking operations thereon . . . the lease shall remain in force so long as operations on said well or for drilling or reworking any additional well are prosecuted with no cessation of more than sixty (60) consecutive days, and if they result in the production of oil, gas or other mineral . . . .<sup>133</sup>

The court describes this provision as not allowing the lease to expire, “so long as the lessee was engaged in drilling or reworking operations designed to produce paying quantities of oil or gas with no cessation of such work for more than sixty days.”<sup>134</sup> There is no express language in the savings provision requiring that such drilling or reworking operations be done in good faith.

As with many lease-termination cases, the lessee’s operations occur within days or weeks of the end of the primary term. In *Marshall*, BP spudded a well on the lease fewer than two weeks prior to the end of the primary term.<sup>135</sup> Internal BP documentation showed that the geologists believed that there would be hydrocarbons in the Lower Wilcox Formation but that a secondary objective of the drilling would be the Middle Wilcox.<sup>136</sup> There was no evidence showing that BP considered the Upper Wilcox as a potential source of hydrocarbons. Texas is one of the

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130. *Id.* at \*4-5 n.3. For other cases defining “operations” or “drilling operations” as requiring some type of physical activity on the drillsite, see *Ridge Oil Co. v. Guinn Inv., Inc.*, 148 S.W.3d 143, 158-60 (Tex. 2004); *Gulf Oil Corp. v. Reid*, 337 S.W.2d 267, 270 (Tex. 1960).

131. See, e.g., *Gray v. Helmerich & Payne, Inc.*, 834 S.W.2d 579, 580, 582 (Tex. App. 1992); *Petersen v. Robinson Oil & Gas Co.*, 356 S.W.2d 217, 219 (Tex. Civ. App. 1962); *Whelan v. R. Lacy, Inc.*, 251 S.W.2d 175, 176-77 (Tex. Civ. App. 1952).

132. 288 S.W.3d 430 (Tex. App. 2008).

133. The *Marshall* opinion does not provide the express leasehold language. The author obtained from Michael Homeyer and Jeanmarie Tade of BP America Production a copy of the *Marshall* lease which is on file with the author. The author would like to thank Mr. Homeyer and Ms. Tade for providing that copy. The savings provision is part of the form lease used by the parties who did add specific provisions to the lease including an anti-dilution provision to the pooling clause. The language of the form savings provisions is similar to the language used in the *Sunac* case described earlier *supra* at text accompanying notes 74 to 81.

134. 288 S.W.3d at 438.

135. *Id.*

136. *Id.*

few states that does not, as a general matter, imply a covenant of good faith between contracting parties.<sup>137</sup> Notwithstanding this lack of an implied covenant of good faith, the trial court gave the following definition in its jury instruction: "Operations . . . [are] 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."<sup>138</sup> This instruction contains both an objective element, namely that the operations are those that would be conducted by the reasonable and prudent operator, and a subjective element, namely that the operations be carried out in good faith.

The drilling operations that were commenced prior to the end of the primary term continued through September 22, 1980, and ended with the determination that the Lower Wilcox was not hydrocarbon-productive.<sup>139</sup> BP then moved up the well bore to the Middle Wilcox. Physical operations continued through mid-January 1981, although evidence from BP's files suggested that the Middle Wilcox was deemed to be unproductive sometime in mid-December 1980.<sup>140</sup> Under the terms of the savings provision, the date that operations cease is critical because the lessee has sixty days from that date to engage in other operations in order to avoid the lease from terminating for failure to produce hydrocarbons in the secondary term.

BP was clearly aware of its need to engage in further operations within sixty days. It sought to farm out the acreage to a third party who would be required to drill a well on the Marshall lease.<sup>141</sup> Delays, however, were incurred in the consummation of the farmout agreement, so BP began reworking operations of the existing well bore, designed to test the Upper Wilcox formation, on February 2, 1981.<sup>142</sup> Physical operations continued through March 5, 1981, and were likewise fruitless.<sup>143</sup> The farmout agreement was executed and the farmee spudded a new well on April 13, 1981.<sup>144</sup> Thus, the key issue was whether the operations relating to the testing of the Upper Wilcox extended the sixty-day

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137. See *Subaru of Am., Inc. v. David McDavid Nissan, Inc.*, 84 S.W.3d 212, 225 (Tex. 2002); *El Paso Natural Gas Co. v. Minco Oil & Gas, Inc.*, 8 S.W.3d 309, 312-13 (Tex. 1999).

138. *BP Am.*, 288 S.W.3d at 440 (internal quotations omitted). The court imposes both the reasonable prudent operator and good faith standards on the lessee even though few leasehold savings provisions use either of those terms to define what the lessee must do in order to keep a lease alive. Could an operator make a decision to try and find hydrocarbons even if a reasonably prudent operator would not? Likewise, could an operator make a decision to try and keep a lease alive even though it would be in the lessor's best interests to have the lease terminate so that it may be re-leased for more substantial economic benefits?

139. *Id.* at 438.

140. *Id.* at 448-49. Plaintiff's expert witness asserted that BP knew that the well was a dry hole on December 4, 1980. *Id.*

141. *Id.* at 439.

142. *Id.*

143. *Id.*

144. *Id.*

period which would encompass the farmee's drilling operations.<sup>145</sup> The jury, given the instruction quoted above, found that operations ceased on December 4, 1980, and were not re-instituted until April 13, 1981, when the farmee spudded its well.<sup>146</sup>

The evidence of bad faith was provided by two of the plaintiffs' experts. One was a reservoir engineer who did not actually participate in the drilling of the well, and the other was a former engineer/employee of the operator who worked on the well.<sup>147</sup> It was his conclusion that the operator acted unreasonably and imprudently because the chance of the Upper Wilcox Formation being productive was "so remote that it was not a warranted test."<sup>148</sup> He likewise opined that the operations were not done in good faith and that the good faith operations ceased on December 4, 1980: the date the operator knew that the Middle Wilcox was not a productive formation.<sup>149</sup>

Nowhere in the opinion does the court state the basis for imposing an implied covenant of good faith to the contractual savings provisions to which the parties agreed. While the actual savings provision does require operations that are designed to eventually produce in paying quantities, the clause says nothing about whether such operations must be undertaken in good faith. As with the commencement cases discussed above, in which the courts have imposed an implied duty or covenant of good faith, the results tend to be unpredictable.

In *Utley v. Marathon Oil Co.*,<sup>150</sup> a lessor sought to terminate a lease because there was neither production in paying quantities nor continuous operations in the secondary term. A well had been commenced during the last weeks of the primary term.<sup>151</sup> The target depth was reached in March 1979 and other operations, which the lessor agreed met the leasehold savings provision requirement, took place through April 16, 1979.<sup>152</sup> The lessor then alleged that no operations were undertaken in good faith until September 24, 1979, when Marathon engaged in completion work that led to the well producing in paying quantities.<sup>153</sup> As in *Marshall*, the lessee tested a different formation from the original targeted formation in the April through September period. Utley's experts said that the operations undertaken to test the Cotton Valley Lime Formation were speculative at best and non-prudent.<sup>154</sup> One of Marathon's

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145. *Id.* at 440.

146. *Id.*

147. *Id.* at 448-49.

148. *Id.* at 450.

149. *Id.*

150. 31 S.W.3d 274 (Tex. App. 2000). The author was an expert witness on behalf of Marathon Oil at the trial.

151. *Id.* at 276.

152. *Id.* at 275.

153. *Id.*

154. *Id.* at 276.

activities was the hydraulic fracturing of the Cotton Valley Lime Formation in order to produce natural gas.<sup>155</sup> The jury was instructed “that operations means actual work done in a good faith endeavor to cause a well to produce oil and/or gas in paying quantities.”<sup>156</sup> Because no party objected to the jury instruction, the court accepted it as the law of the case but also noted that a number of earlier decisions had likewise included a good faith element into a jury instruction on whether the lessee had complied with the relevant leasehold savings clause.<sup>157</sup> In a battle of the experts, the court is not going to second-guess the jury as to whether or not operations were undertaken in good faith to keep the lease alive. In *Marshall*, the jury believed the lessor’s experts, while in *Utley* the jury believed the lessee’s experts. This is the type of uncertainty that adding the good faith element compounds in lease-termination litigation.

There may be factual scenarios in which the good faith element benefits the operator. In *Guleke v. Humble Oil & Refining Co.*,<sup>158</sup> the court added a good faith element to the express savings provision that allowed the lease to continue into the secondary term if the lessee was engaged in drilling or re-working operations.<sup>159</sup> The lessee had not actually spudded the well prior to the end of the primary term but had entered upon the land, made a location for the well, and moved material for the derrick structure and the well bore onto the site. This was sufficient according to the court to constitute drilling operations and, thus, keep the lease alive.<sup>160</sup>

The key issue in many of the cases appears to be the requirement that some type of physical or actual activity take place on the leased premises in order to constitute a drilling or reworking operation.<sup>161</sup> Again, with horizontal drilling, one needs to make sure that operations that take place off the leasehold premises are included, otherwise the lessee may lose its lease. For example, if the vertical portion of the well bore needs to be reworked and the horizontal or lateral section is shut-in, the reworking operations will not necessarily be on the leased premises. Careful attention needs to be paid to encompassing operations that take place off of the leasehold premises in order to avoid losing the benefit of leasehold savings provisions. As with the term “commencement,” the term “operations” may not include preliminary activities un-

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155. *Id.* at 277.

156. *Id.* at 278 (emphasis omitted).

157. *See, e.g.*, *Rogers v. Osborn*, 261 S.W.2d 311 (Tex. 1953); *Cox v. Stowers*, 786 S.W.2d 102, 104-05 (Tex. App. 1990); *Phillips Petroleum Co. v. Rudd*, 226 S.W.2d 464, 466 (Tex. Civ. App. 1949).

158. 126 S.W.2d 38 (Tex. Civ. App. 1939).

159. *Id.* at 41-42.

160. *Id.* at 42.

161. *See, e.g.*, *Sheffield v. Exxon Corp.*, 424 So. 2d 1297, 1303 (Ala. 1983); *Jardell v. Hillin Oil Co.*, 485 So. 2d 919, 924-25 (La. 1986); *Hoyt v. Cont'l Oil Co.*, 606 P.2d 560, 564 (Okla. 1980); 21st Century Inv. Co. v. Pine, 734 P.2d 834, 839 (Okla. Civ. App. 1986).

dertaken by the lessee such as staking a well site, obtaining a drilling permit, and negotiating a surface damages agreement.<sup>162</sup>

Further consideration must also be given to the fact that the modifier “drilling” may have unintended consequences when used in such clauses. For example, if one needs to be engaged in “drilling operations” at the end of the primary term in order to keep a lease alive, would hydraulic fracturing operations necessarily be treated as drilling operations? Clearly, in tight sands and shale reservoirs, hydraulic fracturing operations are treated as a necessary step in achieving primary production. Yet, for other purposes, such as a casing-point election in a joint-operating agreement, hydraulic fracturing operations would be treated as a “completion” operation and not as part of the “drilling” operation. Courts have construed the term “drilling” operation to be more than just operations physically boring a hole into the ground. By encompassing operations needed to achieve production, such as the laying of pipeline, hydraulic fracturing would constitute a drilling operation.<sup>163</sup> Conversely, some courts have narrowly defined what a drilling operation is by excluding from the definition operations that would be considered re-working operations.<sup>164</sup> By including the modifier “drilling,” the lessee may inadvertently cause the lease to terminate when hydraulic fracturing occurs in the secondary term of a lease.

#### *D. Shut-in Gas Royalty Clauses*

Shut-in gas royalty clauses were primarily designed to deal with the obvious fact that natural gas could not be marketed simultaneously with the completion of the well because of the need for post-production facilities, including pipelines, compressors, dehydrators, and/or processing facilities.<sup>165</sup> Shut-in clauses vary in length, but as with other savings provisions, they normally contain express condition precedents before they may be used by the lessee to extend a lease.<sup>166</sup> While some shut-in clauses have an express condition precedent that the well being shut-in be capable of producing in paying quantities, most do not.<sup>167</sup> Notwithstanding the lack of express language, courts and commentators have almost universally agreed that such a condition precedent should be im-

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162. *Ridge Oil Co., Inc. v. Guinn Invs., Inc.*, 148 S.W.3d 143, 157 (Tex. 2004). The *Ridge Oil* case lists a number of the cases that have tried to determine whether the lessee's activities satisfy the requirement that “operations” or “drilling operations” be conducted in order to avoid the termination of the lease. *See id.* at 158-60.

163. *See Gulf Oil Corp. v. Reid*, 337 S.W.2d 267, 282-83 (Tex. 1960).

164. *See Bargsley v. Pryor Petroleum Corp.*, 196 S.W.3d 823, 226-27 (Tex. App. 2006).

165. 3 WILLIAMS & MEYERS, *supra* note 3, § 631; Robert Beck, *Shutting-In: For What Reasons and For How Long?*, 33 WASHBURN L.J. 749 (1994).

166. *See* 3 WILLIAMS & MEYERS, *supra* note 3, § 632.1-632.16.

167. *Id.* § 632.3; 4 EUGENE KUNTZ, A TREATISE ON THE LAW OF OIL AND GAS § 46.4(e) (1990).

plied.<sup>168</sup> Thus, a well which needed further testing and procedures in order to determine whether it would be capable of producing in paying quantities would not be kept alive by the payment of shut-in royalties.<sup>169</sup> Similarly, when wells are shut-in because of the high costs of dewatering, a court will not allow the leases to be kept alive by the payment of shut-in royalties, especially when the lessee in its marketing brochure noted that the wells were marginal producers with high operational costs.<sup>170</sup> One of the earliest cases implying the condition precedent of a well being capable of producing in paying quantities involved what appears to be a clear case of fraud when the lessees knew that the well was dry but tried to put a “fast one” over on the lessor by tendering shut-in gas royalty payments in order to keep the lease alive.<sup>171</sup>

What happens when a shut-in gas royalty payment is made, which under the terms of the provision is to be treated as production for a year and early in that year it becomes evident that the well is no longer capable of producing in paying quantities? An early Oklahoma case, *Probst v. Hughes*,<sup>172</sup> suggests that the lease would be maintained for the entire year because that is what the express language provides after the payment is made.<sup>173</sup> There is language, however, in a more recent New Mexico Supreme Court decision that suggests that the condition precedent of the well being capable of producing in paying quantities must be met at all times for the lease to be kept alive.<sup>174</sup>

The issue of whether a well is capable of producing in paying quantities in order to satisfy the express or implied condition precedent of a shut-in gas royalty clause is critical in the era of horizontal drilling, hydraulic fracturing, and single well pads holding multiple wells. Because most clauses do not define the term “capable of producing in paying quantities,” it may behoove the drafter of an oil and gas lease to attempt to define that term to avoid the definitions that have been applied to date in both the shut-in gas royalty and habendum clause contexts.<sup>175</sup>

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168. See, e.g., *Griffin v. Crutcher-Tufts Corp.*, 500 So. 2d 1008, 1011-12 (Ala. 1986); *Pray v. Premier Petroleum, Inc.*, 662 P.2d 255, 257-58 (Kan. 1983); *Taylor v. Kimbell*, 54 So. 2d 1, 3 (La. 1951); *Maralex Res., Inc. v. Gilbreath*, 76 P.3d 626, 636-37 (N.M. 2003); *Hydrocarbon Mgmt., Inc. v. Tracker Exploration, Inc.*, 861 S.W.2d 427, 437 (Tex. App. 1993); 3 WILLIAMS & MEYERS, *supra* note 3, § 632.3 n.3 (listing cases discussing implied conditions precedent); Leslie Moses, *Problems in Connection with Shut-in Gas Royalty Provisions in Oil and Gas Leases*, 23 TUL. L. REV. 374, 376 (1949); A.W. Walker, Jr., *Clauses in Oil and Gas Leases Providing for the Payment of an Annual Sum as Royalty on a Nonproducing Gas Well*, 24 TEX. L. REV. 478, 478 n.5 (1945).

169. *Webb v. Hardage Corp.*, 471 So. 2d 889, 892 (La. Ct. App. 1985).

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

171. *Kidd v. Hoggett*, 331 S.W.2d 515, 519 (Tex. Civ. App. 1959).

172. 286 P. 875 (Okla. 1930).

173. *Id.* at 877.

174. See *Maralex Res., Inc. v. Gilbreath*, 76 P.3d 626, 630 (N.M. 2003).

175. Some jurisdictions, notably Oklahoma and Montana, define the typical language of a habendum clause as merely requiring that the well be capable of producing oil or gas as opposed to actually producing and marketing oil or gas. See 3 WILLIAMS & MEYERS, *supra* note 3, § 604. Furthermore, even in states that require actual marketing, a court may interpret habendum clauses that use the term “capable” in a way that will impact shut-in gas royalty clause jurisprudence. See, e.g.,

Should the same calculation that is made in the habendum clause cases be applied in the shut-in gas royalty clause context? For example, should post-production costs be used to determine whether a well is deemed to meet the “capable of producing in paying quantities” standard? At least two courts refused to allow a lessor to include transportation costs in figuring out whether the well was capable of producing and, thus, eligible for shut-in gas royalty payments.<sup>176</sup>

In *Hydrocarbon Management, Inc. v. Tracker Exploration Co.*,<sup>177</sup> the Texas Court of Appeals provided the following definition of when a well is capable of producing in paying quantities for the purpose of satisfying the condition precedent of a shut-in gas royalty clause:

We believe that 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. 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, or pumping equipment.<sup>178</sup>

This rather simplistic definition was applied by the Texas Supreme Court in a habendum clause case involving the express language “capable of producing in paying quantities.”<sup>179</sup> This application gave added weight to a definition that would prevent many lessees from using a shut-in gas royalty clause in circumstances likely to arise in this new era of horizontal drilling and hydraulic fracturing operations.

The New Mexico Supreme Court followed *Hydrocarbon Management* in *Maralex Resources, Inc. v. Gilbreath*.<sup>180</sup> In *Maralex*, a well that had been producing for nearly thirty years suddenly stopped producing.<sup>181</sup> The lessee closed off the valve to the pipeline in order to build up pressure in the hopes of regaining production. After this failed, the lessee took several months in order to re-work the well, which led to a resumption of production about ninety days after the cessation of production.<sup>182</sup> The lessee argued that, based on an earlier New Mexico Supreme Court decision,<sup>183</sup> as long as there are hydrocarbons to be produced, the well is capable of producing even when additional reworking operations must take place before actual production can be obtained—stating that such a test only applies when a well does not totally cease

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Anadarko Petroleum Corp. v. Thompson, 94 S.W.3d 550, 556-57 (Tex. 2002).

176. See Pray v. Premier Petroleum, Inc., 662 P.2d 255, 259 (Kan. 1983); Young v. Dixie Oil Co., 647 S.W.2d 235, 237 (Tenn. Ct. App. 1982).

177. 861 S.W.2d 417 (Tex. App. 1993).

178. *Id.* at 433-34.

179. *Anadarko Petroleum*, 94 S.W.3d at 557-58.

180. 76 P.3d 626 (N.M. 2003).

181. *Id.* at 628.

182. *Id.* at 628-29.

183. Greer v. Salmon, 479 P.2d 294, 299 (N.M. 1970).

production.<sup>184</sup> It merely stated that *Clifton v. Koontz*<sup>185</sup> only applies when there is marginal production, not a case in which the well stops producing entirely.<sup>186</sup> The *Maralex* court distinguished the earlier case by noting that in that case the parties stipulated that the well was capable of producing, while in the *Maralex* case the parties were contesting that issue.<sup>187</sup> What makes *Maralex* a difficult case is the fact that even though the well was put back into production within three months after producing for many years, the court nevertheless found that the well was incapable of producing as a matter of law.<sup>188</sup> The court specifically rejected application of the habendum clause definition of production in paying quantities—which looks at both an arithmetic calculation and an objective standard to determine whether a reasonable and prudent operator would continue total, albeit temporary, cessation of production.<sup>189</sup> But, the “production in paying quantities” concept has a temporal element, namely that calculations are made over a period of time, including periods when there may be no production.<sup>190</sup> In fact, the Texas Court of Appeals applied the *Clifton* test to determine whether a shut-in gas royalty clause was triggered by a lack of production under a uranium lease.<sup>191</sup> The *Maralex* court should have asked questions about whether there were still hydrocarbons left in the formation that could eventually be produced in paying quantities. Instead, it relied on the *Hydrocarbon Management* definition to preclude the use of the shut-in gas royalty clause by the lessee.

In *Blackmon v. XTO Energy, Inc.*,<sup>192</sup> the lessor argued unsuccessfully that a lease terminated because it was incapable of producing in paying quantities when the well had been shut in for fifteen months.<sup>193</sup> 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 and met contractual standards.<sup>194</sup> The lessee took fifteen months in order to build an amine processing plant to remove the carbon dioxide.<sup>195</sup> The shut-in gas royalty clause was not implicated because the lessee never tendered a shut-

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184. *Clifton v. Koontz*, 325 S.W.2d 684, 689 (Tex. 1959). See generally 3 WILLIAMS & MEYERS, *supra* note 3, §§ 604.5-604.6.

185. 325 S.W.2d 684 (Tex. 1959).

186. *Maralex*, 76 P.3d at 634.

187. *Id.*

188. *Id.*

189. *Id.*

190. 3 WILLIAMS & MEYERS, *supra* note 3, § 604.5; see also *Ballanfonte v. Kimbell*, 373 S.W.2d 119, 120 (Tex. Civ. App. 1963).

191. *Everest Exploration, Inc. v. URI, Inc.*, 131 S.W.3d 138, 142, (Tex. App. 2004).

192. 276 S.W.3d 600 (Tex. App. 2008).

193. *Id.* at 602.

194. *Id.* at 602-03.

195. *Id.*

in gas royalty payment.<sup>196</sup> The lessor's claim of lease termination was based on the *Hydrocarbon Management* definition that had been applied by the Texas Supreme Court in a habendum clause situation.<sup>197</sup> Under the lessor's theory, if the valve at the Christmas tree was turned on, there would not be any production because no pipeline would accept the natural gas stream with a heavy concentration of carbon dioxide.<sup>198</sup> A strict reading of the *Hydrocarbon Management* definition would support the lessor's claim, but in *Blackmon*, the court took a more expansive view of when a well is capable of producing in paying quantities. As long as the upstream equipment and/or facilities are operational, including the well bore and the Christmas tree, the well would be capable of producing in paying quantities even when a downstream "post-production" facility must be installed in order to market the gas.<sup>199</sup> The key issue according to the *Blackmon* court for defining a well capable of producing in paying quantities is one in which the raw gas stream is ready to flow through a Christmas tree but cannot because of issues downstream of that point.<sup>200</sup> This would not necessarily help the lessee in *Maralex* because the reason for the lack of production was upstream of the Christmas tree but it might help out the operator who shuts in a well in order to use the vertical component of the well to drill a new lateral/horizontal well bore. Again the drafter of a shut-in gas royalty clause will have to develop new language to deal with the issue of what constitutes a well capable of producing in paying quantities to avoid the harsh result in *Maralex* and *Hydrocarbon Management*.

#### IV. CONCLUSION

Oil and gas lease savings provisions have been around for over 100 years. By and large they have not changed much over the past fifty years. Re-drafting savings provisions to deal with the current technologies will save substantial litigation expenses over both the short and long-term. With courts increasingly requiring that operators act in good faith, leasehold savings provisions need to be carefully drafted so the uncertainty caused by the "Monday-morning quarterbacking" of decisions made years earlier inherent in a good faith analysis will be minimized. The clearer the activities are that must be undertaken in order to avoid lease termination, the better. Nonetheless, drafters should not try and repeat the error of *Sunac* because undoubtedly there will be new technologies and factual scenarios that cannot be predicted. Therefore,

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196. *Id.* at 606.

197. *Anadarko Petroleum Corp. v. Thompson*, 94 S.W.3d 550, 558 (Tex. 2002) (quoting the *Hydrocarbon Management* definition).

198. *See generally Blackmon*, 276 S.W.3d at 600.

199. *Id.* at 603-04.

200. *Id.* at 603-08.

having general savings provisions will still be required if leases are to be maintained in the absence of production in paying quantities in the secondary term.