Title:	**MAINTAINING THE OIL & GAS LEASE BEYOND THE PRIMARY TERM**
Date:	**November 7, 2008**
Location:	**Oklahoma City, Oklahoma**
Program:	**The Eugene Kuntz Conference on Natural Resources Law and Policy 2008**
Sponsor:	**University of Oklahoma College of Law and the Oklahoma Bar Association Mineral Law Section**
Duration:	**One Hour**

Maintaining the Oil and Gas Lease Beyond the Primary Term

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The Eugene Kuntz Conference on Natural Resources Law and Policy 2008

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I. INTRODUCTION

When oil prices rise, scrutiny of the continuing validity of oil and gas leases will also rise. When a mineral interest is subject to an oil and gas lease, increased oil and gas values redound to the lessee that owns the right to develop the mineral interest and retain up to 7/8ths of the production value. Although the mineral owner will share in increased values through royalty, 8/8ths is better than 1/8th. When oil prices are low, mineral owners, and their would-be top lessee surrogates, will pay scant attention to the intricacies of lease maintenance. Some royalty is better than no royalty and there will be no cadre of top lessees desiring to pursue the hostile takeover of a marginal property.

However, once a half-barrel-a-day well becomes capable of generating over $20,000 in annual revenue, folks take note and look back at the well's history while keeping close track of how the well is currently being operated. This article reviews the principles that affect the continuing "life" of the oil and gas lease.

II. THE PRODUCTION REQUIREMENT: SATISFYING THE HABENDUM CLAUSE

It is odd that something as potentially valuable as an oil and gas lease has built into it provisions causing it to terminate because of events beyond the control of the lessee, such as the market price for oil or gas.[1] The habendum clause of the lease conditions its continuing validity on the event of "production," which courts uniformly interpret to mean "production in paying

[1]*See generally*, David E. Pierce, *Incorporating a Century of Oil and Gas Jurisprudence Into the "Modern" Oil and Gas Lease*, 33 WASHBURN L. J. 786, 801 (1994).

quantities."[2]

The habendum clause sets the stage for evaluating the current status of a lease: Is there production in paying quantities? If not, the analysis shifts to searching for an applicable "savings clause" which may excuse a failure to satisfy the habendum clause production requirement.[3] If a savings clause is not available, the lease will terminate unless the lessee can establish a recognized equitable basis for delaying termination under Oklahoma's habendum clause jurisprudence.[4]

A. Do Savings Clauses Narrow or Broaden the Operation of the Habendum Clause?

An important conceptual and contractual inquiry under any oil and gas lease is whether a savings clause imposes *new conditions* that must be satisfied *in addition to* the basic production requirement under the habendum clause. Conceptually, savings clauses are designed to *broaden* the habendum clause by specifying events that will continue the lease or interest in effect, even though the terms of the habendum clause cannot be satisfied. This means if you satisfy the habendum clause a savings clause is unnecessary to extend the lease term.

For example, in *Pack v. Santa Fe Minerals* the lessor argued the cessation of production clause imposed a more demanding "production" requirement than that imposed by the habendum clause.[5] The lessor argued that "production" under the cessation clause meant a cessation of actual

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[2]Stewart v. Amerada Hess Corp., 604 P.2d 854, 857 (Okla. 1979) ("The term 'produced', when used in a 'thereafter' provision of the habendum clause, denotes in law production in paying quantities.").

[3]The court in *Pack v. Santa Fe Minerals* characterizes the cessation of production clause in the oil and gas leases as "a saving clause" that is designed to address situations where the lease is not otherwise extended by the habendum clause. Pack v. Santa Fe Minerals, 869 P.2d 323, 328 (Okla. 1994).

[4]*See, e.g.*, Smith v. Marshall Oil Corp., 85 P.3d 830, 834 (Okla.2004) ("In determining whether a failure to produce in paying quantities suffices to terminate a lease, we examine the facts and circumstances of the cessation on a case-by-case basis. . . . Indeed, we have held that 'compelling equitable considerations' may save a lease from termination even with unprofitable well operations.").

[5]The cessation clause states:

> If, after the expiration of the primary term of this lease, production on the leased premises shall cease from any cause, this lease shall not terminate provided lessee resumes operations for drilling a well within sixty (60) days from such cessation, and this lease shall remain in force during the prosecution of such operations and, if production results therefrom, then as long as production continues.

production *and marketing* of oil and gas.[6] The court rejects this argument and holds that "production" for purposes of the cessation clause means the same as "production" under the habendum clause: a well *capable* of producing in paying quantities. Because the wells in *Pack* were at all times capable of producing in paying quantities, the cessation clause was never triggered.[7]

The court in *Pack* applies a similar analysis to the shut-in royalty clause noting: "the failure to pay shut-in royalties in and of itself does not operate to cause a termination of the lease."[8] Although the lessor may have a contractual right to payment of the sums due, failure to make payment will not terminate the lease. Instead, termination of the lease will be governed by the lessee's failure to market for an unreasonable period of time.[9]

Contractually, however, it is possible that under certain facts the lessee's failure to comply with the details of a savings clause could terminate the lease – even though the conditions imposed by the habendum clause are otherwise being met. For example, the cessation clause might define "production" to require the actual extraction and marketing of oil or gas. The clause could go further and impose, as an express condition to the continuing duration of the lease, that the lessee resume production and marketing within 90 days from the cessation.

However, the cases are clear that Oklahoma courts will not arrive at such a conclusion interpreting the most commonly-encountered lease language regarding shut-in royalties and cessations of production. To *narrow* the scope of the habendum clause the language contained in a savings clause must be explicit. For example, in *Commissioners of the Land Office v. Carter Oil Company of West Virginia*,[10] the court notes that if the lessor desired to require actual production at the end of the primary term to maintain the lease, it must do so with "a specific clause requiring

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Pack, 869 P.2d at 327.

[6]The lessors in *Pack* argued the lessee must "continually market the gas from the well, and any cessation of such marketing for a period of sixty days or more would result in termination of the lease." 869 P.2d at 327.

[7]*Pack*, 869 P.2d at 328 ("The term 'production' as used in the cessation of production clause must mean the same as that term means in the habendum clause.").

[8]*Id.* at 330.

[9]As noted in subsection III.B. of this article, Oklahoma courts apply the "Doctrine of Temporary Cessation" to determine when a failure to produce and market from a lease capable of producing in paying quantities justifies termination of the lease. *Pack*, 869 P.2d at 330.

[10]336 P.2d 1086 (Okla. 1958).

marketing within the primary term . . . ."[11]

B. The Oklahoma "Discovery" Rule Regarding "Production"

Actual physical production and marketing from a well is not required to maintain an Oklahoma oil and gas lease beyond the primary term.[12] Instead, "discovery" of oil or gas in a well that is "capable" of producing in paying quantities will maintain the lease for an appropriate period of time.[13] This "capability" rule recognizes the reality that it may not be possible to immediately produce a well to achieve actual physical production of oil or gas.[14] However, like other judicial default rules, this one can be changed by express terms requiring actual production.

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[11]*Id.* at 1095. The court also notes:

> [I]n absence of a specified provision requiring the marketing thereof within such [primary] term the lessee has a reasonable time, depending upon the facts and circumstances of each case, in which to find a market and run the product so found and thereby comply with the implied covenant to market.

Id.

[12]McVicker v. Horn, Robinson & Nathan, 322 P.2d 410, 414 (Okla. 1958) (gas well completed on May 1, 1954, lease primary term expired October 31, 1954, gas was not marketed from the well until after a gas contract was obtained on November 30, 1955); Gard v. Kaiser, 582 P.2d 1311, 1313 (Okla. 1978) ("Oklahoma . . . has consistently taken the position that 'produced' does not include marketing.").

[13]Quoting Professor Kuntz, the Oklahoma Supreme Court, in *Gard v. Kaiser*, observes:

> "In a jurisdiction where marketing is not required as a part of the production and a commercial discovery of gas will satisfy the habendum clause, the shut-in gas royalty clause is not required as an additional special limitation to extend the term of the lease. The lease is extended with or without the shut-in gas royalty clause, subject to forfeiture for failure to comply with the implied obligation to market the product."

Gard v. Kaiser, 582 P.2d 1311, 1313 (Okla. 1978).

[14]In the *McVicker* case the court quotes the following passage: "'in the very nature of the oil business . . . a reasonable time must intervene between the completion of the drilling operations resulting in production and the ability to market and sell the product of a well." McVicker v. Horn, Robinson & Nathan, 322 P.2d 410, 413 (Okla. 1958) (quoting Christianson v. Champlin Refining Co., 169 F.2d 207, 210 (10th Cir. 1948)).

C. Commencement or Completion: When Must the "Production" be Achieved?

Habendum clauses can be classified as being either of the "commencement" type or the "completion" type. The critical inquiry is: *What must be accomplished by the end of the primary term of the lease?* Under a "commencement" form of lease the lessee is required, prior to the end of the primary term, to take the action necessary to *begin the drilling process* on a well.[15] Under a "completion" form of lease, the drilling process must be *completed* to such an extent that you know you have a well capable of producing in paying quantities -- prior to the end of the primary term.

Most modern lease forms contain two "commencement" clauses. One is found within the drilling/delay rental clause of the lease and gives the lessee the option of either paying delay rental or commencing drilling operations. For example, one frequently-encountered form provides:

> If ***operations for drilling are not commenced*** on said land . . . on or before one year from the date hereof, the Lease shall terminate as to both parties, unless on or before such anniversary date Lessee shall pay or tender to Lessor . . . the sum of_____ Dollars . . . .[16]

The second "commencement" clause addresses what must take place to extend the lease beyond the primary term when it is no longer possible to continue the lease by the payment of delay rental.[17] Building on the example above, the same lease form provides:

> If at the expiration of the primary term, oil, gas or other hydrocarbons are not being produced on said land, or on acreage pooled therewith, ***but Lessee is then engaged in drilling or re-working operations thereon***, or shall have completed a dry hole

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[15]Absent express language requiring production by the end of the primary term, commencement of drilling during the primary term, followed by diligent completion of a well capable of producing in paying quantities in the secondary term, will maintain the lease in effect under the habendum clause. *See, e.g.*, Simons v. McDaniel, 7 P.2d 419, 420-21 (Okla. 1932) ("[W]e hold that the grant to lessee plaintiff of the right to commence a well at any time within the term fixed by the lease contract, by necessary legal implication, carried with it the right to complete the well after the period fixed for commencement had expired, subject, however, to abandonment of that right by failure to proceed in good faith and with diligence.").

[16]JOHN S. LOWE, ET AL., FORMS MANUAL TO ACCOMPANY CASES AND MATERIALS ON OIL AND GAS LAW 148 (5th ed. 2008) (A.A.P.L. For 675 Oil and Gas Lease, ¶ 5, lines 1-7) (emphasis added).

[17]*See, e.g.*, Wilds v. Universal Resources Corp., 662 P.2d 303, 305 (Okla. 1983) ("Unless changed by contract a commencement clause of an oil and gas lease has been generally interpreted to mean that operations for the drilling of a well and not the actual drilling must be commenced prior to the end of the primary term with good faith intention of completing the operation [with due diligence].").

> thereon within sixty (60) days prior to the end of the primary term, the Lease shall remain in force ***so long as operations are prosecuted*** with no cessation of more than sixty (60) consecutive days, and if they result in the production of oil, gas or other hydrocarbons, so long thereafter as oil, gas or other hydrocarbons are produced from said land, or acreage pooled therewith.[18]

Clauses addressing the drilling that must take place before the end of the primary term are often labeled "operations" or "completion" clauses because they assume drilling operations were "commenced" before the end of the primary term. Therefore, the clause allows the lessee to continue its drilling "operations" to "completion." This language should not be confused with what Oklahoma courts define as a "completion" form of habendum clause.

Under the completion form of habendum clause the lease will terminate unless a well capable of producing in paying quantities has been "completed" on the land as of the end of the primary term. One form of lease used by the Oklahoma State Land Office contains the following completion form of habendum clause:

> The lessor . . . does hereby demise, grant, lease, and let unto the lessee for the term of five years from the date hereof, and as long thereafter as oil or gas or either of them is produced in paying quantities . . . .
>
> . . . .
>
> [A]nd provided further that unless a producing well in paying quantities of oil or gas is ***completed on the above described premises within five years*** from the date hereon this lease shall be void.[19]

This language was analyzed by the Oklahoma Supreme Court in *Commissioners of the Land Office v. Carter Oil Company of West Virginia*,[20] where the court notes:

> The State leases are "completion" leases. In other words, to comply therewith the well must have been ***completed within the primary term*** to extend the lease.[21]
>
> Thus to extend the fixed term in "completion" leases and acquire a limited estate in the land covered thereby the lessee must have ***found oil or gas upon the premises in paying quantities by completing a well thereon prior to the expiration of such***

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[18]*Id.* (¶ 6, lines 36-42) (emphasis added).

[19]Commissioners of the Land Office v. Carter Oil Company of West Virginia, 336 P.2d 1086, 1089 (Okla. 1958).

[20]336 P.2d 1086 (Okla. 1958).

[21]*Id.* at 1090 (emphasis added).

fixed term.[22]

The benefit the lessee receives under a "commencement" form of habendum clause is the lessee can continue operations beyond the primary term in an effort to ultimately discover oil or gas in paying quantities in the well they are drilling.[23] The issue posed in the *Carter Oil* case was whether Oklahoma would apply its "discovery" habendum clause analysis to a lease with a completion form of habendum clause. The State Lands Commissioners contended that to have a "completed" well as required by its completion lease clause, oil and gas must be both discovered in paying quantities *and actually marketed.*[24] The Supreme Court rejects the Commissioners' argument and holds that a discovery of oil or gas, in paying quantities, prior to the end of the primary term, will satisfy even a "completion" form of habendum clause.[25]

The facts in *Carter Oil* aptly illustrate the point. The lessee completed a gas well capable of producing in paying quantities prior to the end of the primary term, which was April 11, 1955.[26] The well was located 12 miles from the nearest pipeline and the lessee was unable to negotiate an acceptable gas sales agreement until March 19, 1956.[27] The court found the lessee "exercised the utmost diligence in seeking a market . . . ."[28] The lease did not contain a shut-in royalty or other

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[22]*Id.* at 1094 (emphasis added).

[23]The Supreme Court discusses this concept in *Carter Oil* stating:

> This court has held that in every grant there passes by implication that which is reasonably necessary to the enjoyment of the thing granted. [citations omitted]
>
> The last cited cases are authority for the rule that the grant to a lessee "of the right to commence a well at anytime within the term fixed by the lease contract", . . . by necessary legal implication carried with it the right to complete the well after the period fixed for commencement had expired, subject however, to abandonment of that right by failure to proceed in food faith and with diligence.

Carter Oil, 336 P.2d at 1094.

[24]*Id.* at 1093.

[25]*Id.* at 1094.

[26]*Id.* at 1091.

[27]*Id.* at 1092.

[28]*Id.* at 1092 & 1096.

express savings clause.[29] Nevertheless, the lease was maintained, under the habendum clause, because a well capable of producing in paying quantities was completed before the end of the primary term. In that situation it is proper to imply the additional right to delay marketing while the lessee is diligently seeking, in good faith, a market for the gas.[30]

D. The "Paying Quantities" Requirement

The Oklahoma Supreme Court, in *Smith v. Marshall Oil Corporation*,[31] describes the basic paying quantities requirement as follows:

> "Production in paying quantities" is a term defined by Oklahoma case law to mean "production of quantities of oil and gas sufficient to yield a profit to the lessee over operating expenses, even though the drilling costs or equipping costs are never recovered, and even if the undertaking as a whole may result in a loss to the lessee." . . . . The phrase denotes a return in excess of "lifting expenses," costs associated with lifting the oil from the ground after the well has been drilled.[32]

The process requires analysis of four issues: (1) revenue that must be credited to the lease; (2) "lifting expenses" that must be deducted from lease revenue; (3) the accounting period during which revenue and expenses must be compared; and (4) if expenses exceed revenue, whether there are "compelling equitable considerations" that justify refusing to cancel the lease. Often the most important issue will be selection of the accounting period.

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[29]*Id.* at 1096 ("The Texas Company lease [covering another part of the pooled area] contained a shut-in gas well clause which is not in the State leases.").

[30]The court reasons as follows:

> [I]n every grant there passes by implication that which is reasonably necessary to the enjoyment of the thing granted.

336 P.2d at 1094.

> To effectuate the right granted, the completion of a well producing oil or gas in paying quantities within the primary term where there is no specific requirement that the product be marketed in that period, it is equitable and just that the lessee have a reasonable time, under the circumstances existing in the particular case, in which to find a market and run production therefrom.

336 P.2d at 1095.

[31]85 P.3d 830 (Okla. 2004).

[32]*Id.* at 833 (quoting Hininger v. Kaiser, 738 P.2d 137, 140 (Okla. 1987)).

1. Accounting Period During Which Revenue and Expenses are Compared

Establishing the accounting period over which revenue and expenses will be compared often determines the paying quantities issue. The mineral owner will select a snap-shot of time during which revenue has failed to keep pace with expenses. The lessee will seek a longer period of time that tends to average costs and commodity prices. In *Barby v. Singer* the Oklahoma Supreme Court instructs that "the appropriate time period is not measured in days, weeks or months, but by a time appropriate under all of the facts and circumstances of each case."[33] The Oklahoma Court of Appeals, in *Fisher v. Grace Petroleum Corp.*,[34] explains the *Barby* "facts and circumstances" analysis by adopting the analysis of Professor Kuntz:

> The better rule precludes the use of a rigid fixed term for determination of profitability and uses a reasonable time depending upon the circumstances of each case, taking into consideration sufficient time to reflect the current production status of the lease and thus to "provide the information which a prudent operator would take into account in whether to continue or abandon operation."[35]

The Oklahoma Supreme Court's most recent opportunity to apply this analysis was in *Smith v. Marshall Oil Corporation*.[36] The oil and gas leases were obtained by Smith in 1987 and 1988; production was obtained in paying quantities, extending the leases into their secondary terms for several years. Production dwindled with expenses exceeding revenue for the years 1996, 1997, and 1998. Production ceased in 1998[37] and was not regained until April 1999 when Marshall Oil, a top lessee, reworked the wells on the leased land. There was no dispute concerning the items to be included as current revenue and current expenses.[38] There was $9,495.77 in lease revenue and

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[33]648 P.2d 14, 16-17 (Okla. 1982).

[34]830 P.2d 1380 (Okla. Ct. App. 1991).

[35]*Id.* at 1386.

[36]86 P.3d 830 (Okla. 2004). This analysis of *Smith* is taken from an earlier Kuntz Conference paper I presented in 2004 titled "Effective Top Leasing and Mysteries of the Habendum Clause" beginning at page 5.

[37]"Smith quit using electricity in January 1998." *Smith*, 85 P.3d at 835.

[38]The court observes:

> Smith failed to produce any evidence to support his assertion that the wells were at all times capable of producing in paying quantities, other than his personal belief to that effect. The record establishes that Smith's lifting expenses, which by his own admission understate his actual costs due to insufficient record-keeping, far exceed any return, when the wells actually were producing.

$52,355.00 in expenses. Although the court does not address how the accounting period was determined, the court apparently looked back to the first year production revenue failed to keep pace with production expenses: 1996. The accounting period ended with the date Marshall Oil regained production from the property.

It would seem that in picking an accounting period to provide a prudent operator with the information they need to decide whether to abandon the lease, the court should include some of the "good" times with the "bad." What would the balance sheet have looked like if the accounting period ran from 1988 to 1998? Perhaps a reasonable accounting period would have been three years before the three years of negative cash flow: 1993, 1994, and 1995 in addition to the losing years of 1996, 1997, and 1998. This provides a more objective basis for a prudent operator's future market expectations. The accounting period will always be one of the intangibles in the equation that can change the result.[39] The accounting period becomes even more important to the outcome because it appears Oklahoma courts cannot consider fluctuating prices as an equitable consideration. As the court in *Smith* observes: "Fluctuating market prices do not rise to the level of an equitable consideration, or an excuse for Smith's failure to produce in paying quantities."[40] I think it is

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Smith, 85 P.3d at 835.

[39]Consider the approach followed in Kansas, where whatever equitable considerations the court plans to apply must be encompassed by the selection of an accounting period:

> [I]t is generally accepted that profitability on an oil and gas lease should be determined over a relatively long period of time in order to expose the operation to the leveling influences of time. The arbitrary use of a short period of time while a well is down for a workover is obviously untenable. On the other hand, the use of an unreasonably long period would entail using past glories of flush production to determine a lease's present condition, which would give a distorted result not reflective of the current status of the lease. The better rule precludes the use of a rigid fixed term for determination of profitability and uses a reasonable time depending upon the circumstances of each case, taking into consideration sufficient time to reflect the current production status of the lease and thus to "provide the information which a prudent operator would take into account in whether to continue or to abandon the operation."

Texaco, Inc. v. Fox, 618 P.2d 844, 848 (Kan. 1980) (quoting KUNTZ ON OIL AND GAS LAW § 26.7(u), at 368-69). In *Texaco* the trial court used a 13-year period but then proceeded to require profitable production for *each year* of the 13-year period. The Supreme Court reverses rejecting the year-by-year profitability requirement, but also rejects a single comparison for the 13-year period as being an unreasonably long period to compare revenue and expenses. *Id.* at 847-48.

[40]Smith v. Marshall Oil Corp., 85 P.3d 830, 836 (Okla. 2004).

arguable that given the appropriate set of facts,[41] fluctuating market prices, particularly wildly fluctuating prices, could be relevant "compelling equitable considerations."

2. Revenue Credited to the Lease

All revenue derived from the lease is considered. Therefore, the value of 8/8ths of the production will be used to determine the revenue side of the paying quantities equation. This includes the shares of production attributed to royalty[42] and overriding royalty.[43]

3. Expenses that Must be Deducted from Revenue

The Oklahoma Supreme Court addresses the expense issue in *Stewart v. Amerada Hess Corporation*.[44] The court explains the basic rules as follows:

> The cost of drilling a producing well – i.e. the expense incurred before oil is actually lifted from the ground – is not an item to be considered in computing production in "paying quantities." The lifting of oil which marks the commencement of [the] production stage is coincidental with the completion of a well. At that stage, critical here, only those expenses which are ***directly related to lifting operations*** can be included in determining if Amerada's lease remained in force beyond its primary term.[45]

What the court characterizes as "lifting expenses" include: "costs of operating the pumps, pumpers'

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[41]Recall that in *Smith* the lessee deliberately ceased production because he was awaiting $30/barrel oil. As it turns out, the reason he ceased production was because it was unprofitable at current prices. Nothing was done for three years until a top lessee obtained production from the leased land that ultimately triggered the lawsuit. *Smith*, 85 P.3d at 835-36. These facts have affected the context of the court's statement regarding "fluctuating market prices."

[42]The court in *Stewart v. Amerada Hess Corporation*, 604 P.2d 654 (Okla. 1979), lists "royalties payable to the lessor" as an expense item, which assumes revenue associated with royalty will be included, and then deducted as an expense. 604 P.2d at 857, n.11. Some states simply treat royalty as a "wash," not counting it as revenue or expense. The practical result is the same as including royalty as revenue and then deducting it as an expense.

[43]Overriding royalty was the focus of the court's opinion in *Hininger v. Kaiser*, 738 P.2d 137 (Okla. 1987), where the issue was whether production values attributed to overriding royalty should be deducted as an expense in the same manner the landowner's royalty is deducted. This assumes revenues attributed to overriding royalty will be credited to the lease as revenue.

[44]604 P.2d 854 (Okla. 1979).

[45]*Id.* at 857 (emphasis added).

salaries, costs of supervision, gross production taxes, royalties payable to the lessor, electricity, telephone, repairs and other incidental lifting expenses."[46]

The expense at issue in *Stewart* was "[d]epreciation of equipment used in lifting operations . . . ."[47] Reasoning that "production-related equipment does have value that is being reduced through its continued operation"[48] the court holds:

> [D]epreciation should be mandatorily included as an item of lifting expense in determining whether there is production in "paying quantities." The base and the period of depreciation should be determined by reference to currently prevailing accounting standards.[49]

Therefore, although the initial cost of equipping the well is not an expense item, some of that production-related equipment will be subject to a depreciation charge applying "prevailing accounting standards."

In *Mason v. Ladd Petroleum Corporation*[50] the court affirms the trial judge's finding that "casing, tubing, and Christmas tree were not directly related to lifting costs" and therefore depreciation on those items should not be chargeable as lifting costs.[51] The court also holds the mere presence of "a line heater and low pressure separator" on the leased land, but not being used to operate wells on the lease, should not be considered in calculating depreciation.[52]

The *Mason* case also addresses "district expenses" which are a product of the internal accounting practices of larger operators designed to allocate all their employees and facilities to particular operations. The court holds these expenses should not be included as "lifting expenses" noting "the absurdity of determining a well to be a non-producer in the hands of a corporate giant, yet a producer in the hands of a single leasehold owner-operator who is unfettered by such attendant complexities."[53] The court also rejects, as a "lifting expense," "administrative overhead" which the

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[46]*Id.* at 857, n.11.

[47]*Id.* at 857.

[48]*Id.*

[49]*Id.* at 857-58.

[50]630 P.2d 1283 (Okla. 1981).

[51]*Id.* at 1286.

[52]*Id.*

[53]*Id.* at 1285.

trial judge defined as "'the indirect expense attributable to the cost of accounting, interest, postage, office supplies, telephone, depreciation of office equipment, and all other indirect expense of the oil company regarding production."[54]

In the process of addressing "administrative overhead" the court in *Mason* also addresses charges made under a joint operating agreement. For example, the "Accounting Procedure Joint Operations" form, commonly known as the "COPAS," which is attached to the A.A.P.L. Form 610-1989 Model Form Operating Agreement as Exhibit C,[55] addresses "Direct Charges" in section II "for the Joint Operations" and in Section III addresses "Overhead." The 2005 version of the COPAS states: "As compensation for costs not specifically identified as chargeable to the Joint Account to Section II (*Direct Charges*), the Operator shall charge the Joint Account in accordance with this Section III."[56] Section III then lists various types of activities included in the stated "overhead rates" to include items such as: "administration, accounting and auditing" and "supervision not directly charged under Section II.2 (*Labor*), among other forms of arguably "indirect" expenses.[57] The COPAS provides for either a "Fixed Rate Basis" to collect Overhead or a "Percentage Basis."[58] The Fixed Rate Basis is the most common election and provides for a stated amount to be charged each month at either a "Drilling Well Rate" or a "Producing Well Rate."[59]

Because a working interest owner must pay the stated charge each month, the issue arises whether a readily identifiable sum paid to an operator for "Overhead" is an expense item in the paying quantities equation. The court in *Mason* offers the following guidance:

> The fact that operators under a joint operating agreement generally treat such expenses as chargeable *inter se*, does not, as plaintiff contends, establish a basis for including them as chargeable expenses in determining whether a well is a producer, both because no joint operating agreement was here involved, and because even if there were, such expenses would still be too indirectly and too remotely related to

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[54]*Id.* at 1286.

[55]A.A.P.L. 610-1989 Model Form Operating Agreement, p. 2, Article II, line 69, reproduced in JOHN S. LOWE, ET AL., FORMS MANUAL TO ACCOMPANY CASES AND MATERIALS ON OIL AND GAS LAW 277 (5th ed. 2008).

[56]COPAS 2005 Accounting Procedure Recommended by COPAS, Inc., Exhibit "C" Accounting Procedure Joint Operations, p. 8, Section III, lines 54-55, reproduced in JOHN S. LOWE, ET AL., FORMS MANUAL TO ACCOMPANY CASES AND MATERIALS ON OIL AND GAS LAW 320 (5th ed. 2008).

[57]*Id.* at p. 8, lines 64 & 65; p. 9, line 3.

[58]*Id.* at p. 9, lines 18-19.

[59]*Id.* at p. 9, lines 51-57.

lifting costs.[60]

This *dicta* clearly indicates that the Oklahoma Supreme Court will not automatically accept an overhead charge as an expense item.[61] Instead, the court will examine individual expenses and determine whether they are directly related to the operation of the wells at issue to constitute "lifting expenses."

The *dicta* status of the statements in *Mason* were resolved by the holding of the court in *Hininger v. Kaiser*.[62] The expenses at issue in *Hininger* are "joint interest billings directly attributable to the Hininger 7A well" and "this sum represented administrative expenses for supervision and accounting to working interest owners."[63] The court holds that these particular administrative expenses are not lifting expenses. The court also holds the characterization of an expense under a "Joint Operating Agreement" "will have no effect on what expenses are, or are not to be, deducted as lifting costs."[64]

The apparent concern of the court in *Hininger* is that a lease having the same exact expenses owned by a single lessee would not require an operating agreement and therefore would not delineate a specific charge for overhead or administrative expenses. However, with the same lease, with the same expenses, but having a 10% non-operating working interest owner obligated to pay the operator a fixed overhead charge under their Operating Agreement, a different result might obtain – if the court considered the overhead charge as an expense. This is most likely the context of the following statement by the court:

> If the mineral owners' argument is accepted [that joint billings for administrative expenses are lifting costs], the result would inevitably be that small working interest owners would be faced with having to deduct administrative expenses from production proceeds [because they will be charged the expense as a non-operator],

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[60]Mason v. Ladd Petroleum Corp., 630 P.2d 1283, 1286 (Okla. 1981).

[61]The statement is *dicta* because the court notes "no joint operating agreement was here involved," but it is fairly strong *dicta* because the court goes on to note that in any event such a charge would be "too indirectly and too remotely related to lifting costs." *Id.* The expenses the court actually addresses as "indirect" are the same sort of expenses expressly encompassed by the COPAS definition of items included in "overhead." COPAS 2005 Accounting Procedure Recommended by COPAS, Inc., Exhibit "C" Accounting Procedure Joint Operations, Section III, p. 8, lines 54-66, p. 9, lines 1-11, reproduced in JOHN S. LOWE, ET AL., FORMS MANUAL TO ACCOMPANY CASES AND MATERIALS ON OIL AND GAS LAW 320-21 (5th ed. 2008).

[62]738 P.2d 137 (Okla. 1987).

[63]*Id.* at 141.

[64]*Id.*

> while large corporations or operators would evade such deductions based largely on simplicity versus complexity in accounting procedures.[65]

The court in *Hiniger* also makes it clear that although amounts attributable to overriding royalty are included as revenue, there will not be a corresponding deduction as a lifting expense.[66] The court notes: "Overriding royalties, like costs of drilling, are part of the capital investment instead of part of the lifting costs."[67] The court follows the analysis of Professor Kuntz quoting as follows:

> *[I]ncome attributable to the working interest as originally created* is taken into account, and only the lessors's royalty or other share of production is excluded. Thus, *the share of production attributable to any outstanding royalty interest will not be excluded but will be taken into account in determining income.*[68]

Therefore, all revenue from royalty, overriding royalty, and working interest will be counted but only royalty will be treated as a lifting expense.

4. "Compelling Equitable Considerations"

Once revenue and lifting expenses are compared over the selected accounting period, if revenue exceeds lifting expenses, the inquiry is at an end, the lessee wins, the paying quantities requirement is met. However, if lifting expenses exceed revenue, the analysis must proceed to a fourth inquiry: whether there are any "compelling equitable considerations" that justify the court to refuse cancelling the lease, even though it is not presently capable of producing in paying quantities. The court in *Stewart* holds cancellation is appropriate only when the lease is "not producing in paying quantities ***and there are no compelling equitable considerations to justify continued production from the unprofitable well operations***."[69] The court explains the basis for equitable considerations by noting that in Oklahoma once paying quantities are obtained, lease termination for an inability to continue paying production is in the nature of a forfeiture instead of a special limitation on the grant.[70]

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[65]*Id.*

[66]*Id.* at 140.

[67]*Id.*

[68]*Id.* (quoting "2 E. Kuntz, 'Law of Oil & Gas', p. 273, § 26.7(1) (1964)") (emphasis by the court).

[69]Stewart v. Amerada Hess Corp., 604 P.2d 854, 858 (Okla. 1979) (emphasis added).

[70]*Id.* The court explains:

In *Smith v. Marshall Oil Corporation*[71] the court surveys the types of events that might constitute "compelling equitable considerations" which includes a wide range of lease- and *lessee*-specific information relevant to ascertain whether the court should spare the lease from termination.[72] The analysis is highly fact-specific and conducted on a case-by-case basis.[73] As the court observes: "Indeed, we have held that 'compelling equitable considerations' may save a lease from termination even with unprofitable well operations."[74] The court's survey of possible "compelling equitable considerations" includes: (1) whether the period of cessation or negative cash flow from the lease was "reasonable"; (2) whether the cessation was voluntary;[75] (3) an impending event that may result in higher prices, such as passage of the Natural Gas Policy Act; (4) problems in gaining access to a pipeline to transport production; (5) attempts to resolve conflicts with partners.

The court concludes:

> Smith offered no compelling equitable concerns to justify this. Instead, Smith testified he deliberately ceased production, hoping oil and gas prices would rise. However, he had no factual support for this, and testified it was his mere "hope."[76]

Smith testified he had "decided to wait until they [oil prices] rose to $30.00 a barrel."[77] Notably, the court responds stating: "Fluctuating market prices do not rise to the level of an equitable consideration, or an excuse for Smith's failure to produce in paying quantities."[78]

> Our law is firmly settled that the result in each case must depend upon the circumstances that surround cessation. Our view is no doubt influenced in part by the strong policy of our statutory law against forfeiture of estates.

Stewart, 604 P.2d at 858.

[71]85 P.3d 830 (Okla. 2004).

[72]This analysis of *Smith* is taken from an earlier Kuntz Conference paper I presented in 2004 titled "Effective Top Leasing and Mysteries of the Habendum Clause" beginning at page 7.

[73]*Smith*, 85 P.3d at 834.

[74]*Id.*

[75]The court was particularly unimpressed with Smith's testimony that "he turned the wells on when he wanted to, and turned them off when he wanted to." *Id.*

[76]*Id.* at 835.

[77]*Id.* at 836.

[78]*Id.*

The "equitable considerations" analysis is perhaps best illustrated by the court's holding in *Barby v. Singer*.[79] The accounting period for considering revenue and lifting costs was held to run from February 1978 to the date suit was filed, April 18, 1979.[80] If the actual revenue received during this time period was used, it would result in a negative cash flow. However, in the process of considering the surrounding circumstances, the court evaluates whether the prospect of Congress passing the Natural Gas Policy Act of 1978, and the resulting higher gas prices, would be an "equitable consideration" a prudent operator would have factored in to retain the losing lease. Evidence was offered to establish that a prudent operator would factor this in as a basis for retaining the unprofitable lease – for legitimate purposes instead of merely for speculation.[81] Although this alone would seem to be an adequate basis for refusing termination of the lease, the court concludes noting:

> The Natural Gas Policy Act was adopted by Congress, effective as of December 1, 1978. Appellees filed an application to qualify the Barby 1-12 as a "stripper" well, resulting in a price increase for the gas produced, retroactive to December 1, 1978, The trial court held that the retroactive price increase was properly to be taken into consideration in determining the well's profitability. We agree. . . . The fact the production income was received retroactively does not convert it into something other than what it is, production income. . . .
>
> The undisputed evidence before the trial court shows that if the increase in the price of natural gas is applied retroactively to the production income from the well, the well produced a profit each month during the test period. Having so determined, it is unnecessary to consider other specifications of error set forth in the briefs.[82]

It would seem that even if the NGPA did not provide for the retroactive price adjustment, the prospect of future higher gas prices for this stripper well would alone be an "equitable consideration." Under the facts, a prudent operator during the selected accounting period would not plug their well, and abandon their lease, until they knew the impact of a bill (which seemed to everyone to have a good chance of passing) which would provide gas price incentives to keep wells, like the Barby 1-12, profitable to operate.

The underlying basis for Oklahoma's "compelling equitable considerations" analysis is Okla. Stat. Tit. 23, § 2 which provides:

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[79]648 P.2d 14 (Okla. 1982).

[80]*Id.* at 16.

[81]*Id.* at 17.

[82]*Id.* at 18.

> Whenever, by the terms of an obligation, a party thereto incurs a forfeiture, or a loss in the nature of a forfeiture, by reason of his failure to comply with its provisions, he may be relieved therefrom, upon making full compensation to the other party, except in case of a grossly negligent, willful or fraudulent breach of duty.[83]

Although the full factual and legal contours of this provision have not been literally applied, the Oklahoma Supreme Court has consistently relied on this section to avoid applying any sort of "fee simple determinable" or "special limitation" analysis to the habendum clause once the lessee has achieved a lease capable of producing in paying quantities.[84]

E. Forfeiture vs. Special Limitation on the Grant: Leases, Defeasible Interests, and Assignments

1. The Oil and Gas Lease

With regard to the oil and gas lease, the Oklahoma Supreme Court has held that once a lessee completes a well capable of producing in paying quantities on the leased land, the lessee obtains rights in the lease that can generally be lost only through a forfeiture analysis. Although the lease may specify it will continue in effect only "so long as" it is capable of producing in paying quantities, this classic fee simple determinable language will not give rise to automatic termination of the lease. Instead, the lessor has the burden of establishing that under the circumstances the equities dictate that termination (cancellation) is the appropriate remedy.[85] The court in *Stewart v.*

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[83]OKLA. STAT. tit. 23, § 2 (1987).

[84]*E.g.*, Pack v. Santa Fe Minerals, 869 P.2d 323, 326-27 (Okla. 1994).

[85]The Oklahoma Court of Appeals, in *Danne v. Texaco Exploration and Production Inc.*, 883 P.2d 210 (Okla. Ct. App. 1994), characterizes the estate created in such cases as similar to "an estate on condition subsequent creating only a right of entry in the gantor" for which "the grantor must bring an action to cause forfeiture of the estate." *Id.* at 213. However, prior to the lessee discovering production in paying quantities, a fee simple determinable analysis will be used to terminate the lease for failure to pay delay rentals. The court explains:

> In the primary term, before hydrocarbons are discovered, the lessee has the right to explore for a fixed period of time. If he fails to discover hydrocarbons within the enumerated period, he must either buy more time (through payment of something like delay rental) of lose the lease when the term has expired. When the time runs out on the primary term, the estate is not forfeited, it simply ceases to exist by its own terms, a simple terminable estate. Automatic termination of the lease at this stage of exploration does not divest the lessee of valuable assets, since no assets have yet been proved.

Danne, 883 P.2d at 214.

Amerada Hess Corporation[86] explains the lessee's unique status noting:

> The 'thereafter' clause is hence not ever to be regarded as akin in effect to the common-law conditional limitation or determinable fee estate. The occurrence of the limiting event or condition does not automatically effect an end to the right. Rather, the clause is to be regarded as fixing the life of a lease instead of providing a means of terminating it in advance of the time at which it would otherwise expire. In short, the lease continues in existence so long as interruption of producing in paying quantities does not extend for a period longer than reasonable or justifiable in light of all the circumstances involved. But under *no* circumstances will cessation of production in paying quantities *ipso facto* deprive the lessee of his extended-term estate.[87]

This broad statement in *Stewart* is accurate when applied to the typical language found in the habendum clause. However, the court has taken a different approach when evaluating lessee compliance with the cessation of production clause. For example, in *Hoyt v. Continental Oil Company*,[88] the lease contained a cessation of production clause which stated the "lease shall not terminate provided . . . lessee resumes operations for drilling . . . within sixty days."[89] When the court found that the lessee failed to act within the 60-day time frame, it applied a special limitation analysis instead of a forfeiture analysis.[90] Noting that the temporary cessation "doctrine" would allow a "reasonable time" to take action, the court holds that "[w]here the parties have bargained for an agreed on time period for a temporary cessation clause that provision will control over the

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[86]604 P.2d 854 (Okla. 1979).

[87]*Id.* at 858 (emphasis by the court).

[88]606 P.2d 560 (Okla. 1980).

[89]*Id.* at 562.

[90]The court reasoned as follows:

> After the primary term, the effect of the cessation of production clause is to modify the habendum clause and to extend or preserve the lease while the lessee resumes operations designed to restore production. If the lessee fails to resume operations within the 60-day period provided in this clause neither the cessation of production clause or the habendum clause is satisfied ***and the lease terminates upon the expiration of the given time period.***

Hoyt, 606 P.2d at 563 (emphasis added).

common law doctrine . . . ."[91]

This means the parties – by contract – can reimpose a special limitation analysis. However, the contract language must be express and explicit.[92] When parties have sought to apply a similar analysis to common forms of shut-in royalty clauses, the courts have uniformly rejected a special limitation analysis and instead applied a forfeiture analysis.[93] This means a failure to pay shut-in royalties as required by the shut-in royalty clause will not result in automatic termination.[94]

Classifying the lessee's failure to act as giving rise to either a forfeiture or an automatic termination also impacts whether there must be demand by the lessor, followed by lessee inaction, before seeking cancellation. For example, in *James Energy Company v. HCG Energy Corporation*,[95] the lessee failed to make shut-in royalty payments in a timely manner.[96] The facts indicate HCG's predecessor completed a gas well capable of producing gas in paying quantities during the primary term of the lease and attempted to market the gas, but was unsuccessful. The trial court refused to cancel HCG's leases because the lessors failed to give the lessee notice demanding diligent marketing of the gas.[97] Affirming the trial court's holding, the Oklahoma Supreme Court states:

> In Oklahoma, the duty to produce and market is an implied covenant unless specifically stated in the lease. . . . An action to cancel an oil and gas lease is an action in equity. . . . It was long ago established that "the *lessor* must demand that an implied covenant be complied with before a court of equity will grant a forfeiture."[98]

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[91]*Hoyt*, 606 P.2d at 563. *See also* French v. Tenneco Oil Co., 725 P.2d 275, 277 (Okla. 1986) (noting that if the clause requires "drilling," no other operation will satisfy the clause).

[92]Danne v. Texaco Exploration and Production Inc., 883 P.2d 210, 215 (Okla. Ct. App. 1994) ("Unless a lease clearly provides for forfeiture of the lessee's estate upon failure to make timely payment, the lessor's grounds for relief lay only in contract law.").

[93]*E.g.*, Gard v. Kaiser, 582 P.2d 1311, 1314-15 (Okla. 1978) ("We further conclude in this case that shut-in gas provisions are not to be construed as limitations or conditions which would affect termination of the leases.").

[94]*Id.*

[95]847 P.2d 333 (Okla. 1992).

[96]*Id.* at 336.

[97]*Id.* at 337.

[98]*Id.* at 338 (emphasis by the court; citations omitted).

The court also notes that the demand must come from ***the lessor***, the owner of the mineral interest at issue: "the lessor, not a stranger to the lease such as James Energy [a top lessee], must make demand on the lessee to comply with the implied covenants."[99] Also, the demand must explicitly seek compliance with the implied covenant to market; a general claim that the lease has terminated is not an appropriate demand because it does not provide the lessee with an opportunity to pursue marketing.[100]

Contrast the demand requirement in *James*, when a forfeiture analysis is being applied, with situations where a special limitation analysis is used. In *Fisher v. Grace Petroleum Corporation*[101] the lessee failed to comply with the express terms of the lease cessation of production clause. The court holds the leases automatically terminated when they ceased producing in paying quantities and the lessee failed to take the action required to regain production under the cessation clauses of the leases.[102] The lessee objected arguing no demand had been made by the lessor for the lessee to act. Holding demand was not required in this situation, the court notes:

> This action, however, is brought to quiet title because Appellees' leases have expired by their own terms for failure to produce in paying quantities or pursuant to the temporary cessation provisions, thus clouding Appellee's title. The action includes a cause of action for damages suffered by Appellees for Appellants' breach of duty regarding the marketing of gas from the Morlan No. 1-25 well. . . .
>
> Because the subject leases have expired by their own terms, we find that demand for compliance and an opportunity to cure were not required. Nor was such demand required to preserve Appellees' claim for damages for Appellants' failure to diligently and prudently market because an action for damages is not an equitable action.[103]

If automatic termination is permissible under the particular clause at issue, such as a delay rental clause or an appropriately worded cessation clause, demand is not required. If a forfeiture analysis is applied, demand and an opportunity to cure are required.

The forfeiture/automatic termination analysis also applies when evaluating whether the lessor's acceptance of royalties or other payments can give rise to an estoppel. In *Danne v. Texaco*

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[99] *Id.*

[100] *Id.* As the court explains: "Claiming an interest in the well hardly rises to the level of demand notice to market."

[101] 830 P.2d 1380 (Okla. Ct. App. 1991).

[102] *Id.* at 1386-87.

[103] *Id.* at 1389-90.

Exploration and Production Inc.[104] the court observes: "When a lease does not expire automatically, however, the lessor's acceptance of benefits may estop the lessor from asserting lease termination." In *Danne* the court held the lease did not terminate automatically and therefore an action to terminate the lease through forfeiture was required. However, because two of the lessors accepted lease benefits (shut-in royalties and royalties) before bringing their action, "they are now estopped from denying Texaco's title."[105] However, for the third lessor who accepted no lease benefits, they were entitled to cancellation because the court found that although the lease was capable of producing in paying quantities at all times, Texaco failed to act with due diligence to market the gas.[106]

2. Defeasible Term Interests

The Oklahoma Supreme Court, in a 5/4 decision in *Ludwig v. William K. Warren Foundation*,[107] indicates it will take a traditional property-based special limitation analysis when evaluating compliance with the habendum clause of a defeasible term mineral interest. The deed conveyed the mineral interest "for a period of 20 years from December 22, 1961 and as long thereafter as oil and/or gas or other minerals [were] produced from the land herein described."[108] Production was timely obtained extending the grant past its primary term up until the time the well ceased producing. A new well was promptly drilled to re-establish production.[109] The grantor, owner of the possibility of reverter, claimed the grantee's rights in the mineral interest terminated once production ceased.[110]

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[104]883 P.2d 210 (Okla. Ct. App. 1994).

[105]*Id.* at 218.

[106]*Id.* Texaco was in a gas contract dispute with its purchaser and mistakenly shut-in gas from the Helen Danne No. 1 well thinking it was subject to the contract at issue. Instead, the well had been previously released from the contract in 1988 and therefore was available for marketing at any time. The well remained shut-in for two years. *Id.* at 212-13. Query: isn't this a situation that can be remedied with money damages instead of cancellation? Nevertheless, even after running it through a full forfeiture analysis to consider the equities, the court grants cancellation as the remedy. Note the parallels with the delay rental clause in this situation where the lessee fumbles a payment. However, we are at the proven production stage of the lease where forfeitures are to be generally avoided.

[107]809 P.2d 660 (Okla. 1990).

[108]*Id.* at 661.

[109]Although not addressed in the opinion, it appears the court is treating the loss of production as a temporary cessation as opposed to a permanent cessation.

[110]*Id.*

Although the court recognizes that if this were an oil and gas ***lease*** it would be maintained under the temporary cessation doctrine,[111] the court rather summarily holds no such relief will be recognized under a defeasible term mineral interest.[112] The dissent acknowledges the conveyance in this case is fundamentally different from an oil and gas lease, but argues that when it comes to temporary cessations the same sort of practical relief should be afforded to defeasible interests that has been fashioned for oil and gas lessees.[113]

Some of the mysteries of the *Ludwig* case are explored by the North Dakota Supreme Court in *Greenfield v. Thill*,[114] where the court notes that two prior Oklahoma Supreme Court cases, *Beatty v. Baxter*[115] and *Postier v. Postier*,[116] were not analyzed. The court in *Greenfield* observes:

> [T]he *Ludwig* majority inexplicably fails to address the clear holdings in *Beatty* and *Postier* that a temporary cessation of production does not automatically terminate a royalty interest or a defeasible-term interest. With little discussion, and without any explicit determination whether the cessation was permanent or temporary, the court upheld the determination that the interest was extinguished by the termination of production. The dissent concluded that the temporary cessation rule from lease cases should apply . . . , but curiously failed to cite the prior holdings in *Beatty* and *Postier* to support that conclusion.[117]

The rationale for the court's approach in *Ludwig* is best explained by examining its analysis in *Fransen v. Eckhardt*.[118] In *Fransen* the court holds that in order to satisfy the "production" requirement under the habendum clause of a defeasible term mineral interest, there must be ***actual***

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[111]*Id.*

[112]The court merely observes that a special limitation does not trigger a forfeiture analysis and does not consider any of the realities that gave rise to the temporary cessation analysis under the oil and gas lease. *Id.* at 663.

[113]*Ludwig*, 809 P.2d at 664 (Doolin, J., dissenting)/

[114]521 N.W.2d 87 (N.D. 1994).

[115]258 P.2d 626 (Okla. 1953).

[116]296 P.2d 138 (Okla. 1956).

[117]*Greenfield*, 521 N.D. at 91.

[118]711 P.2d 926 (Okla. 1985).

production and marketing at the end of the primary term.[119] In *Fransen* a gas well had been completed, tested, and was in the process of being connected to a pipeline when the primary term ended. Although the well was clearly "capable" of producing in paying quantities, the production requirement was not met and the term interest expired. As the court states: "The requirement for production in paying quantities is not satisfied until the gas is reduced to possession and the parties receive financial benefits from the production."[120]

The driving force behind the court's refusal to treat defeasible term interests the same as oil and gas leases is the desire to eliminate defeasible interests at the earliest possible time to reunite the interest with the holder of the possibility of reverter. The court in *Fransen* reasons as follows:

> The purpose of a term interest is to prevent title complication by unifying the title from time to time. The advantage of title unification, in the absence of production or in the presence of exhaustion of oil and gas reserves, is important for several reasons. There is no way to determine with certainty whether the resources are exhausted. Other investors who believe that other mineral deposits may be present may want to purchase the mineral interest. Because prospective purchasers of surface interests frequently want the mineral rights included, outstanding mineral interests place practical hindrances, on and depress the price of, subsequent sales. The mineral owner owes certain duties to the perpetual royalty owner. Ultimate title unification provides certainty and extinguishes these problem obligations.[121]

Adopting what the court characterizes as "the Kuntz rationale," it holds that "production means actual enjoyment of tangible economic benefits which result from marketing."[122]

In the latest edition of the Hemingway treatise, it is noted: "*Ludwig* seems incorrect. The courts should apply the same view of 'production' in defeasible-term deeds that they apply to oil and gas leases."[123] I disagree with this observation. The defeasible term conveyance and the oil and gas lease are fundamentally different documents and the interpretation of each should be guided by a search for the presumed intent of the parties. If such an interpretive analysis results in the same, or different, interpretive conclusion, so be it. As the court aptly notes in *Fransen*, the relationships and expectations under these two documents are very different. If the holder of a defeasible interest does not like this result, they should demand terms in their defeasible term interests that are more akin

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[119] *Id.* at 927.

[120] *Id.*

[121] *Id.* at 931.

[122] *Id.*

[123] OWEN L. ANDERSON, ET AL., HEMINGWAY OIL AND GAS LAW AND TAXATION 264, n.77 (4th ed. 2004).

to those found in oil and gas leases, such as: an expanded habendum clause ("is or can be produced"), commencement and completion clauses, dry hole clause, cessation clause, shut-in royalty clause, pooling clause, and force majeure clause.

3. Assignments

Two facts regarding assignments should be noted: (1) the continuing life of the assigned interest is dependent upon the validity of the oil and gas lease; and (2) assignments frequently create a second layer of covenants, conditions, and special limitations that must be accounted for by the assignee. For this discussion, the second fact should be highlighted. Throughout this article the focus has been on what the lessee must do to keep the lease alive. This same sort of relationship can be created between a lessee and their assignee by the lessee/assignor imposing additional, or more demanding, performance obligations on their assignee.

The lesson in this area, like that in the foregoing section on defeasible interests, is the Oklahoma Supreme Court may decide not to apply oil and gas lease (lessor/lessee) jurisprudence to evaluate these assignment (lessee/lessee) relationships. For example, in *XAE Corp. v. SMR Property Management Co.*,[124] the court refuses to import oil and gas lease "implied covenant" jurisprudence to interpret rights under an overriding royalty.[125] As with the defeasible interests, commentators are divided on whether overriding royalty jurisprudence should mirror oil and gas lease jurisprudence, or go its own way depending upon the intent of the parties involved.[126]

III. ADDITIONAL SAVINGS CLAUSES

A. Shut-In Royalty Clause

Because of Oklahoma's "capability" approach to the habendum clause, and the forfeiture analysis it applies when a lease ceases being capable of producing in paying quantities, a shut-in royalty clause is not essential. This then raises the issue whether a lessee is better off with, or without, a shut-in clause in their lease. As noted in the *Danne* case in the prior section of this article, the acceptance of shut-in royalty by a lessor can serve an estoppel function.[127] The clause provides

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[124]968 P.2d 1201 (Okla. 1998).

[125]*Id.* at 1204 ("This Court has said that, unless expressly assumed, implied covenants of an oil and gas lease do not extend to lease assignments with reservation of overriding royalty.").

[126]*See* David E. Pierce, *Exploring the Origins of Royalty Disputes*, 23 PETROLEUM ACCOUNTING AND FINANCIAL MANAGEMENT JOURNAL 72, 106 (2004) (contrasting Professor Owen Anderson's desire to achieve a degree of uniformity in analysis by applying oil and gas lease jurisprudence to the overriding royalty with Professor Pierce's emphasis on contract interpretation without concern for uniform outcomes).

[127]*See supra* text accompanying notes 104-06.

a degree of certainty, when it is complied with by the lessee.

However, the most important inquiry is whether the presence of a shut-in clause will narrow benefits the lessee would have under Oklahoma's lessee-friendly interpretation of the habendum clause. These issues are addressed in section II.A. of this article.[128] The goal, from the ***lessee's perspective***, is to ensure that any savings clause is truly that: something that *supplements* the habendum clause without restricting the benefits available to a lessee under the habendum clause had they not had a savings clause. The goal, from the ***lessor's perspective***, is to treat specific events (e.g., inability to market, cessation of production) as being governed solely by a specific clause, without having any sort of overarching habendum clause protection.

The most frequently encountered forms of shut-in royalty clauses have been interpreted by Oklahoma courts to supplement, as opposed to restrict, the benefits under the habendum clause. The issue was squarely presented in *Gard v. Kaiser*[129] where the lessee failed to timely pay shut-in royalty under three leases which covered the same well location.[130] The issue was whether the express terms of the shut-in royalty clauses required automatic termination of the leases for failure to pay shut-in royalty. The express terms contained language which arguably could be interpreted as a special limitation on the grant. For example, the phrases "***may*** pay" and "***if*** such payment or tender is made it will be considered that gas is being produced within the meaning of [the habendum clause]," suggest that payment is optional, but necessary to maintain the lease. Another clause used the covenant-like language "shall pay" but then made extension of the lease dependent upon "when such payment . . . is made."[131]

The court begins its analysis by quoting Professor Kuntz to establish "the Oklahoma rule":

> "In a jurisdiction where marketing is not required as a part of the production and a commercial discovery of gas will satisfy the habendum clause, the shut-in gas royalty clause is not required as an additional special limitation to extend the term of the lease. The lease is extended with or without the shut-in gas royalty clause, subject to forfeiture for failure to comply with the implied obligation to market the product."[132]

The court concludes: "in this case shut-in provisions are not to be construed as limitations or

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[128]*See supra* text accompanying notes 5-11.

[129]582 P.2d 1311 (Okla. 1978).

[130]*Id.* at 1312.

[131]*Id.*

[132]*Id.* at 1313 (quoting 4 Kuntz, The Law of Oil and Gas § 46.3).

conditions which would affect termination of the leases."[133] Therefore, the court refuses to "construe language of the leases to operate to terminate a shut-in gas well during a period lessee is diligently seeking a market."[134] The court's reference to "this case" accounts for the possibility that the parties may, "through the addition of very carefully prepared, very explicit language,"[135] create a special limitation in the shut-in clause that takes precedence over the habendum clause.[136]

The Oklahoma Supreme Court had another opportunity to address the effect of a shut-in clause on the habendum clause in *Pack v. Santa Fe Minerals*.[137] In *Pack* the lessee was producing the bulk of its annual gas allowable in the winter months and then reducing production during the summer months to such an extent that revenue, during the summer months, did not exceed expenses.[138] The lessors argued this triggered the cessation clause and the shut-in royalty clause. Regarding the shut-in royalty claim, the court holds "the failure to pay shut-in royalties in and of itself does not operate to cause a termination of the lease."[139] The court notes that is it not the failure to pay shut-in royalties, but rather "the failure to comply with the implied covenant to market which

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[133]*Id.* at 1314-15.

[134]*Id.* at 1314.

[135]As suggested by Professor Merrill in an article the court quotes. *Gard*, 582 P.2d at 1314.

[136]The court in *Danne v. Texaco Exploration and Production Co.*, 883 P.2d 210, 215 (Okla. Ct. App. 1994), collects the cases for the proposition that the frequently encountered shut-in royalty clause terms do not provide for automatic termination. The court states: "Unless a lease clearly provides for forfeiture of the lessee's estate upon failure to make timely payment, the lessor's grounds for relief lay only in contract law." The court seems to be making the distinction between a ***contract*** remedy, which requires a forfeiture analysis – to *avoid* a forfeiture, and a ***property*** remedy, which avoids a forfeiture analysis by characterizing the event as a special limitation on the grant with no intervening equitable considerations. In *Danne* the shut-in clauses indicated the lessee "***shall*** pay" the royalty but then state: "***When*** such payment or tender is made it will be considered that gas is being produced within the meaning of the entire lease." *Danne*, 883 P.2d at 215 (emphasis added). The latter statement suggests only when the payment is made will it be considered capable of producing. These two conflicting terms, "shall" and "when," allow for a court to apply the preference for a condition subsequent instead of a determinable analysis, which would also provide the lessee with the benefit of a forfeiture analysis.

[137]869 P.2d 323 (Okla. 1984).

[138]*Id.* at 325-26.

[139]*Id.* at 330.

results in lease cancellation."[140] The court concludes the lessors failed to carry their burden of proving their lessee failed to use reasonable diligence in operation of the well.[141]

B. Cessation of Production (Judicial Doctrine and Contractual Clause)

The cessation doctrine recognizes it would be inconsistent with the logical expectations of the parties to a lease to hold that "*any cessation* of production [in the paying quantities sense of the term], however slight or short, would put an end to the lease."[142] Instead, Oklahoma courts reject a literal requirement of continuous production and instead focus on the circumstances giving rise to the cessation.[143]

If the cessation of production, under the circumstances, is for an unreasonable period of time – which indicates a lack of diligence on the part of the lessee – the lease can be cancelled. For example, in *Hunter v. Clarkson*[144] the lessee voluntarily ceased producing for a five-month period, for no apparent reason. The court concludes the five-month cessation was an unreasonable time because it was without cause or justification. Under these facts the court holds the trial court

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[140]*Id.*

[141]*Id.* at 331.

[142]Stewart v. Amerada Hess Corp., 604 P.2d 854, 858 (Okla. 1979) (emphasis by the court).

[143]*Id.* The court in *Jath Oil Co. v. Branch*, 490 P.2d 1086 (Okla. 1971), describes the reasoning as follows:

> The very nature of the oil and gas producing operation, considered in relation to the purpose of an oil and gas lease to portend monetary benefits to lessor and lessee, makes it clear that lessor and lessee could not have intended that the lessee, to prevent lease termination must produce every minute of every day. Continuous production may damage the oil and gas reservoir. Operating hazards or mechanical breakdowns may cause interruptions frequently.
>
> These and other considerations have prompted us to announce the rule that a lessor and lessee did not intend that a temporary cessation of production, after the primary term, terminate the lease and that a temporary cessation is one that does not extend for an unreasonable time under the particular circumstances of each case.

Id. at 1090.

[144]428 P.2d 210 (Okla. 1967).

properly cancelled the lease.[145]

The cessation of production clause, in an oil and gas lease, was the focus of the Oklahoma Supreme Court in *Hoyt v. Continental Oil Company*.[146] The clause stated: "'If after expiration of the primary term . . . production . . . shall cease . . . (the) lease shall not terminate provided . . . lessee resumes operations for drilling . . . within sixty days.'"[147] Although the physical extraction of production from the well never ceased totally, the volume of production was such that it had not produced in paying quantities for twelve months prior to filing suit.[148] The landowner claimed the lease terminated after sixty days of non-paying production because during the sixty-day period the lessee failed to resume "operations for drilling" as required by the cessation clause.[149] The lessee claimed the clause only applies to a total cessation of production and, in any event, the lease was still capable of producing in paying quantities once the lessee took action to complete its well in a different formation.[150]

The court first holds the cessation clause is triggered when the lease ceases to produce in paying quantities – even though it may continue to physically produce oil or gas.[151] Second, where the lease is in its secondary term, the cessation clause modifies the habendum clause by specifying that specific action must be taken (resume "operations for drilling"), within a specified time ("within sixty days" from the cessation of production in paying quantities), or the lease will automatically terminate. In this situation the cessation clause displaces "the common law doctrine of temporary cessation allowing a 'reasonable time' for resumption of drilling operations."[152] The final point made by the court is that unless the well is currently completed in a targeted zone, and currently capable of producing in paying quantities, the lease will not be maintained by the habendum clause or a shut-in royalty clause.[153]

The Oklahoma Supreme Court focuses on the following clause in *French v. Tenneco Oil*

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[145] *Id.* at 212-13.

[146] 606 P.2d 560 (Okla. 1980).

[147] *Id.* at 562.

[148] *Id.*

[149] *Id.* at 563.

[150] *Id.* at 562-63.

[151] *Id.* at 563.

[152] *Id.*

[153] *Id.* at 564.

Co.:[154]

> "If, after the expiration of the primary term of the lease, production on the leased premises shall cease from any cause, this lease shall not terminate provided lessee resumes operations for drilling a well within sixty days from such cessation, and this lease shall remain in full force during the prosecution of such operations, and, if production results therefrom, then as long as production continues."[155]

Production in paying quantities ceased for four months and the lessee failed to take action within sixty days. The court explains the operation of this clause as follows:

> [T]he lessee has, under the contract here considered, 60 days to restore production in paying quantities by means the lessee determines to be advantageous under the circumstances. Restoration of production in paying quantities within that period obviates the need to drill, but to preserve the lease, where that production is not restored within the specified period, drilling operations must be commenced within sixty days.[156]

Because the lessee failed to regain production during the 60-day period, and also failed to commence drilling operations within the 60-day period, the lease terminated. Unless production is regained during the 60-day period, the only way the lessee can maintain the lease is by commencement of drilling operations.[157]

Following the decisions in *Hoyt* and *French*, the Oklahoma Court of Appeals addresses the interaction of the cessation clause and the habendum clause in *Fisher v. Grace Petroleum Corporation*.[158] The clauses, and facts, in *Fisher* were similar to those in *Hoyt* and *French*: the lease had not produced in paying quantities for a 12-month period and the court found the lessee failed to take action, as required by the cessation clauses, to maintain the leases.[159] However, in discussing the relationship of the cessation clause to the habendum clause, the court goes beyond the facts before it and states:

> Capability alone does not operate to suspend the application of this temporary

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[154]725 P.2d 275 (Okla. 1986).

[155]*Id.* at 275-76.

[156]*Id.* at 277.

[157]*Id.* (quoting Kuntz, Oil & Gas § 47.5 Vol. 4, p. 134 (1972)).

[158]830 P.2d 1380 (Okla. Ct. App. 1991).

[159]*Id.* at 1385-86.

> cessation clause which operates when a well ceases production in paying quantities for any cause for longer than the provided time. To hold physical capability alone is sufficient to maintain the lease would render temporary cessation clauses superfluous and would allow lessees to hold on to leases indefinitely. ***The flip side of Appellants' argument is that the temporary cessation clause only applies to a well incapable of production in paying quantities. This construction would create an absurdity*** . . . ."[160]

The Court of Appeals' "absurdity" became law in *Pack v. Santa Fe Minerals*[161] where it held that "production," as the term is used in the cessation clause, means a lease ***capable*** of producing in paying quantities.[162] Therefore, if the lease satisfies the capability requirement of the habendum clause, as was the case in *Pack*, there is no need to result to the cessation or other savings clauses. The court distinguishes its holdings in *Hoyt* and *French* noting that in each of those cases the leases were ***not*** capable of producing in paying quantities and therefore did not satisfy the habendum clause terms. Therefore, the only way to maintain the leases was through compliance with the terms of the cessation clause.[163]

The Texas Supreme Court, in *Anadarko Petroleum Corporation v. Thompson*,[164] interpreting the effect of a "can be produced" habendum clause, rejects the *Fisher* analysis, and adopts the *Pack* analysis, that the cessation clause is designed to supplement, not restrict, the habendum clause.[165] The court summarizes its analysis as follows:

> [W]e hold that a well actually producing or capable of producing gas sustains this particular lease under the habendum clause. We also hold that the cessation-of-production clause only applies if the lease would otherwise terminate under the habendum clause.[166]

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[160] *Id.* at 1388 (emphasis added).

[161] 869 P.2d 323 (Okla. 1994).

[162] *Id.* at 328 ("The term 'production' as used in the cessation of production clause must mean the same as that term means in the habendum clause.").

[163] *Id.* at 329.

[164] 94 S.W.3d 550 (Tex. 2002).

[165] *Id.* at 557.

[166] *Id.*

The court in *Hunthauser Holdings, LLC v. Loesch*,[167] applying Kansas law to a "can be produced" habendum clause, concludes it requires an Oklahoma-type capability analysis.[168] In a subsequent order the court adopts a *Pack* analysis noting: "When read together, the habendum and cessation of production clauses can only reasonably be interpreted to require the lessee to resume drilling operations within sixty days from the date on which the Stanco #1 well ceases to produce ***or be capable of production***."[169]

The most recent case to deal with a cessation problem addresses it in the context of a well that is capable of producing in paying quantities. In *Geyer Brothers Equipment Co. v. Standard Resources, L.L.C.*[170] the lease contained a savings clause which provides:

> If after discovery of oil or gas on said leased land . . . the production thereof should cease from any cause after the primary term, this lease shall not terminate if Lessee commences additional drilling or re-working operations within ninety (90) days from date of cessation of production or from completion of dry hole. If oil or gas shall be discovered and produced as a result of such operations at or after the expiration of the primary term of this lease, this lease shall continue in force so long as oil or gas is produced from the leased premises . . . .

To analyze the issues the court focused on the primary term of two leases that expired in 1999. The only well on the property had been drilled in 1985 and was declared to be a "shut-in" gas well; the parties agreed the well was capable of producing in paying quantities. No production had been obtained from the leased land from November 1984 to April 1999; there were no ongoing drilling or reworking operations at the time the primary term expired in March 1999.[171] The defendant successfully reworked the well in May 1999, which gave rise to the dispute.

In 2003 Geyer Brothers, the lessee claiming their leases were still in effect, argued as an "equitable consideration" that the failure to produce for 15 years was "due to the absence of a

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[167]Case No. Civ.A. 00-1154-MLB, 2003 WL 21981969 (D. Kan. May 1, 2003).

[168]*Id.* at *4-5.

[169]Hunthauser Holdings, LLC v. Loesch, Case No. Civ.A. 00-1154-MLB, 2003 WL 21981961, at *3 (D. Kan. June 10, 2003) (emphasis added).

[170]140 P.3d 563 (Okla. Ct. App. 2006).

[171]*Id.* at 565. *See also* Jath Oil Co. v. Branch, 490 P.2d 1086 (Okla. 1971) (lease cancelled for cessation lasting over two years when lessee had opportunities to resume production but failed to act). *Contrast* Cotner v. Warren, 330 P.2d 217 (1958) (lease not cancelled for failure to produce during 6-month period because co-tenants were at odds but lessee was diligent in trying to resolve the problem); Kerr v. Hillenberg, 373 P.2d 66 (1962) (persistent and good faith efforts to resolve operational problems avoided cancellation).

pipeline to the leasehold" and later due to disputes concerning the validity of its leases. The trial court granted summary judgment holding the Geyer Brothers' leases had expired at the end of their primary terms. The Court of Appeals affirms this portion of the trial court's judgment applying what it describes as "an implied covenant to market" analysis but in the context of a temporary cessation. The "cessation" analysis was necessary because the parties agreed the well was capable of producing in paying quantities; apparently the well was tested when it was completed, and again in 1992 and 1998.[172]

Conceptually, the well "produced" and then ceased producing, triggering the cessation of production clause. However, note that the court focuses its attention on the cessation *doctrine* instead of the cessation *clause*. The court does not focus on the 90-day drilling/re-working requirements in the clause, but rather focuses on a habendum clause analysis with "equitable considerations." This is an example where the court treats this as a temporary cessation, governed by the temporary cessation doctrine, instead of the sort of permanent cessation that would trigger mandatory drilling or re-working to preserve the lease. Consistent with the Supreme Court's approach in *Pack*, this seems logical since an inability to market would not justify new drilling or re-working of a well already capable of producing in paying quantities.

Applying a temporary cessation analysis, a cessation for a "reasonable time" is acceptable and will not terminate the lease. However, if the cessation extends beyond a reasonable time, meaning the lessee has failed to exercise the diligence required to produce and market gas for an unacceptable period, the lease will terminate. The lessor has the burden of proving the lessee failed to "'use reasonable diligence in the operation of the well . . . .'"[173]

Although absence of a pipeline to transport production is an "equitable consideration," in this case the lessee presented no evidence to suggest it had attempted to secure a market for the shut-in gas. Once the lessor presented facts to suggest a lack of diligence, the lessee had the burden of responding to demonstrate a reasonable basis for its inaction. The lessee failed to do that in this case and their leases were deemed to have expired at the end of their primary terms. Summary judgment on the lease termination issue was proper.[174]

IV. ACREAGE HELD BY PRODUCTION

The most frequently-encountered form of oil and gas lease provides that production under the habendum clause, or activities in compliance with a savings clause, will perpetuate all land encompassed by the granting clause of the lease. Typically the area of influence will be expanded with a pooling clause which extends the lease whenever a portion of it is included within a pooled

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[172] *Id.* at 566 n.1.

[173] *Id.* at 567.

[174] *Id.*

area – even though the well may not be physically located on the leased land.[175]

Lessors, recognizing the inherent limitations in using implied covenants to ensure development of all leased acreage, negotiate for express clauses to address the acreage held by production. These include "retained acreage" clauses, "continuous development" clauses, and "Pugh" clauses. Lessors in Oklahoma are also assisted by a "statutory Pugh" clause found at 52 Oklahoma Statutes § 87.1. Each of these devices is designed to give back leased acreage to the lessor when the lessee has failed to pursue development of the acreage within a defined period of time. To varying degrees these are the "use-it-or-lose-it" provisions designed to create well-defined events in which undeveloped lease acreage will revert to the lessor.

A. Oklahoma's Statutory Pugh Clause

Oklahoma's statutory Pugh clause states:

> In case of a spacing unit of one hundred sixty (160) acres or more, no oil and/or gas leasehold interest outside the spacing unit involved may be held by production from the spacing unit more than ninety (90) days beyond expiration of the primary term of the lease.[176]

The origin and purpose of this provision is explained by the Oklahoma Court of Appeals in *Siniard v. Davis*,[177] where the court notes:

> Section 87.1(b) has the purpose of preventing production from a unit from satisfying the habendum clause of any lease for more than ninety days beyond the expiration of the primary term as to acreage outside of the unit when a part of the leased premises is included in a unit of 160 acres or more. Prior to enactment of the statutory Pugh clause or in the absence of a Pugh clause in an oil and gas lease, when a part of the leased premises was included in a drilling unit, production from the unit satisfied the habendum clause of the lease as to the part of the leased premises included in the unit and also as to the part of the leased premises outside of the unit.[178]

The Oklahoma Supreme Court, in *Wickham v. Gulf Oil Corporation*,[179] traces the statutory

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[175]Trawick v. Castleberry, 275 P.2d 292 (Okla. 1953).

[176]OKLA. STAT. ANN. tit. 52, § 87.1(b) (West Supp. 2007).

[177]678 P.2d 1197 (Okla. Ct. App. 1984).

[178]*Id.* at 1200-01.

[179]623 P.2d 613 (Okla. 1981).

history of § 87.1(b) and notes this language was added to the pooling statute by an enactment on May 27, 1977. In *Wickham* a lease coverng 2,552 acres, "scattered over nine miles in nine sections,"[180] was executed on November 8, 1967 with a ten-year primary term that would end on November 8, 1977.[181] The lessees created a 640-acre drilling and spacing unit, commenced drilling on the pooled acreage prior to November 8, 1977, and completed a well capable of producing in paying quantities after November 8, 1977 pursuant to a completion clause in the lease.[182] The lessors asserted that as to the 1,912 leased acres not encompassed by the drilling and spacing unit, the lease terminated 90 days following expiration of the November 8, 1977 primary term – pursuant to § 87.1(b).[183]

The court first describes the effect of the statutory Pugh clause:

> As a result of Section 87.1(b), leased lands lying outside of the spacing unit would no longer be held by production over ninety days beyond the expiration of the primary term of the lease – a departure from the previous law that the production of oil and gas in commercial quantities from any part of the leased premises during the primary term extended the lease not only as to the acreage committed to the drilling and spacing unit but also as to the lands lying outside of the unit area.[184]

The court rejects the lessors' argument by holding: (1) § 87.1(b) will not be given retroactive effect; and (2) the dates for determining retroactive effect are the date of enactment, May 27, 1977,

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[180] *Id.* at 614.

[181] *Id.*

[182] *Id.* The court notes the lease gave the lessees: "'the right to drill to completion with reasonable diligence and dispatch (1) any well commenced within the terms of this lease . . .'" and that "'[i]f oil, gas or any other minerals . . . be found in paying quantities in any such well, this lease shall continue and be in force with like effect as if such well had been completed within the [primary term] . . . .'" *Id.*

[183] *Wickham*, 623 P.2d at 614-15.

[184] *Id.* at 616. In *Trawick v. Castleberry*, 275 P.2d 292 (Okla. 1953), the court states the basic rule that production from a pooled area containing a portion of the leased acreage will perpetuate the lease as to all the leased acreage. The pooling clause in *Trawick* provided: "'*If production is found on the pooled acreage, it shall be treated as if production is had from this lease, whether the well or wells be located on the premises covered by this lease or not.*'" 275 P.2d at 293 (emphasis by the court). In *Trawick*, 7 of the 80 leased acres were included in the pooled area; the well for the pooled unit was not located on the 7 acres. *Id.* The court holds the 73 acres that did not participate in production from the pooled area were nevertheless held by the terms of the pooling clause and pooled production attributed to 7 acres of the leased land. *Id.* at 293-94.

and the effective date of the lease, in this case November 8, 1967. Because the lease was entered into prior to the May 27, 1977 enactment date, the statutory Pugh provisions do not apply the this lease.[185]

B. Contractual Clauses Limiting Acreage Held By Production

In its original form, the Pugh clause was designed to limit the effect of pooling so that acreage not participating in pooled production at the end of the primary term would automatically revert to the lessor/mineral owner. As noted in the Hemingway treatise: "According to the express provisions of the usual pooling clause, production or operations anywhere upon unit lands are deemed to be production or operations from all lands within the unit."[186] The Pugh clause seeks to change this situation.

The extent to which the situation is changed, is a matter of contract. For example, in *Rist v. Westhoma Oil Company*,[187] the issue was whether a pooled area should be limited to the shallow depths from which the well was producing. The lease had been assigned resulting in one lessee owning the lease rights above sea level and another lessee, Westhoma, owning rights below sea level.[188] The lessee owning rights above sea level formed a pooled unit and obtained production prior to the end of the primary term. The pooling clause also included a Pugh clause, which stated: "this lease, insofar as it covers any tract or tracts not included in a consolidation . . . shall terminate at the expiration of the primary term hereof . . . ."[189]

The lessor contended this Pugh language had a "horizontal" effect in addition to its uncontested areal effect.[190] Therefore, not only would acreage ***outside*** the pooled area terminate, but also any deeper geologic horizons that had not been developed by the end of the primary term ***within*** the pooled area. The court rejects the lessor's argument noting the granting clause grants to the lessee all rights, at all depths, within the leased area. Absent express language indicating a limitation as to "depth, levels or strata" the court will not imply one that runs counter to the granting

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[185] *Wickham*, 623 P.2d at 616.

[186] OWEN L. ANDERSON, ET AL., HEMINGWAY OIL AND GAS LAW AND TAXATION 395 (4th ed. 2004).

[187] 385 P.2d 791 (Okla. 1963).

[188] *Id.* at 793.

[189] *Id.* at 795.

[190] The court uses the terms "vertical" and "horizontal" to describe the areal (vertical) effect and the depth (horizontal) effect. *Id.* at 794.

clause and other portions of the pooling clause.[191] However, the court notes that the 10th Circuit, in a case from a Kansas federal district court, considering identical lease language under similar facts, held the Pugh clause had a horizontal effect and terminated the deeper horizons within the pooled area.[192]

Clauses sometimes confused with a Pugh clause are the "retained acreage" and "continuous development" clauses. The "retained acreage" clause terminates the lease as to all acreage not part of a pooled area or drilling or production unit associated with a particular well.[193] The continuous development clause continues the lease in effect, beyond the primary term, so long as the lessee is meeting the drilling program specified in the clause. Once the lessee fails to satisfy the drilling schedule, the clause operates as a "retained acreage" clause returning to the lessor any acreage that is not associated with a producing well.[194] The major guide in this area is that the parties to the lease can provide for whatever mix of rights they desire to govern the acreage that will be perpetuated beyond the primary term and the express conditions that will be attached regarding development of retained acreage.

V. CONCLUSION

The observations made in this article are as relevant with $100/barrel oil as they are with $10/barrel oil. As the price of oil increases, what would otherwise be marginal operations can become profitable – for the moment. Even with record oil prices during the past several months, the market has experienced $50/barrel price swings. Inevitably this will create the same sort of "habendum clause auditing," by mineral owners and their potential top lessees, that went on when oil prices first emerged from the $25/barrel level.

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[191] *Id.* at 795.

[192] *Id.* at 794 (discussing *Rogers v. Westhoma Oil Co.*, 291 F.2d 726 (10th Cir. 1961)).

[193] *See generally* OWEN L. ANDERSON, ET AL., HEMINGWAY OIL AND GAS LAW AND TAXATION 397 (4th ed. 2004).

[194] *Id.* at 397-98.

The Eugene Kuntz Conference on Natural Resources Law and Policy 2008

Maintaining the Oil & Gas Lease Beyond the Primary Term

The Eugene Kuntz Conference
November 7, 2008
Presented by:
David E. Pierce

1

Introduction

- Half-barrel-a-day well now capable of generating over $20,000/year in revenue.
- $50/barrel price swings over a period of months.
- Lessee gets the upside benefit.
- Lessor gets benefits associated with their 1/8th royalty.
- 8/8ths is better than 1/8th.

2

Satisfying the Habendum Clause

- Lessees lack control over the duration of their oil and gas leases.
- Two major variables that determine the duration of any oil and gas lease:

  (1) Geology.

  (2) Price of oil and gas.

3

The Basics

- "**Production**" under the lease habendum clause means **production in *paying quantities***.
- The basic inquiry: is there production in paying quantities?
- If not: is there a savings clause that excuses production in paying quantities?

4

The Not-So-Basic

- Do savings clauses narrow or broaden the operation of the habendum clause?
- Does the savings clause at issue merely supplement the habendum clause? or
- Does the savings clause limit the effect of the habendum clause?

5

The Not-So-Basic

- **Shut-in royalty clause**: does not limit the effect of the habendum clause.
- Failure to comply with shut-in royalty clause will not terminate lease if the habendum clause is being satisfied.
- **Cessation of production clause**: does not limit the effect of the habendum clause.
- "Production" under the cessation clause means the same as "production" under the habendum clause.

6

The Not-So-Basic

- **Article pages 30-31.**
- Court of Appeals' *dicta* in ***Fisher v. Grace Petroleum Corp.*** impliedly rejected by Supreme Court in ***Pack v. Santa Fe Minerals***.
- Point is made by the Texas Supreme Court in ***Anadarko Petroleum Corp. v. Thompson***.

7

The Not-So-Basic

- However, it is possible, through express and explicit language, to limit the effect of the habendum clause with a savings clause.
- **Article page 3.** E.g. ***Commissioners of Land Office v. Carter Oil Company of W.V.*** (express clause requiring actual marketing at the end of the primary term).

8

The Basics

- **The Oklahoma "discovery" rule.**
- Actual physical production and marketing from a well is not required to maintain lease beyond the primary term.
- "Discovery" of oil or gas in a well that is "capable" of producing in paying quantities will suffice to extend the lease.

9

The Basics

- Must the well resulting in the discovery be **completed** before the primary term, or will **commencement** during the primary term, followed by completion in due course, suffice?
- Absent express language stating otherwise, ***commencement*** will suffice.

10

The Basics

- **Article page 5.** Often the matter is addressed in a "commencement" clause.
- "Commencement," absent language providing otherwise, means "***operations*** for the drilling of a well and ***not the actual drilling*** must be commenced prior to the end of the primary term with good faith intention of completing the operation [with due diligence.]" ***Wilds v. Universal Resources Corp.***

11

The Basics

- ***Commencement* can be changed to *completion* by contract:** "[P]rovided further that unless a producing well in paying quantities of oil or gas is ***completed on the above described premises within five years from the date hereon this lease shall be void***."

12

The Not-So-Basic

- Under a lease with a ***completion*** form of habendum clause, must there also be ***actual marketing*** from the lease at the end of the primary term?
- **No.** Nothing in the clause to change the capability rule. **Article page 7.**

13

The Basics

- **What is "paying quantities"?**
- Production of enough oil and gas from the lease to yield a profit over operating expenses – even though the drilling costs and equipping costs are never recovered.
- Revenue exceeds "lifting expenses" over a court-selected accounting period.
- **Article page 8.**

14

The Basics

- **Four paying quantities issues:**

  (1) ***Revenue*** credited to the lease;

  (2) ***"Lifting Expenses"*** to be deducted;

  (3) ***Accounting Period*** during which the two are compared; and

  (4) ***If*** Expenses exceed Revenue, can the situation be justified due to ***"Compelling Equitable Considerations"***?

15

The Not-So-Basic

- **Determining the proper accounting period.**
- Appropriate time period to provide a prudent operator with the information they need to decide whether to keep the lease.
- **Article pages 9-10.** Professor Kuntz's analysis.
- Need some of the "good" with the "bad."

16

The Not-So-Basic

- **Importance of selecting an appropriate accounting period:**
- "Fluctuating market prices do not rise to the level of an equitable consideration, or an excuse for Smith's failure to produce in paying quantities." ***Smith v. Marshall Oil Corp.***
- ***How should courts account for "fluctuating market prices"?***
- Selection of the accounting period.

17

The Basics

- **Revenue credited to the lease:**
- ***All revenue derived from the lease (8/8ths) is credited to the lessee.***
- Include amounts credited to the royalty owner; the landowner's royalty will be deducted in the next step in the equation.
- **Article page 11.**

18

The Basics

- **Expenses that must be deducted:**
- Expenses before oil is actually lifted from the ground are ***not*** included.
- Expenses ***directly related to lifting operations*** are included.
- Royalty is an expense.
- Overriding royalty is ***not*** an expense.
- **Article pages 11-15.**

19

The Basics

- **"Lifting expenses" include:** "costs of operating the pumps, pumpers' salaries, costs of supervision, gross production taxes, royalties payable to the lessor, electricity, telephone, repairs and other incidental lifting expenses."
- **Also includes:** "[d]epreciation of equipment used in lifting operations" as determined applying "currently prevailing accounting standards."

20

The Basics

- **Held *not* to be "lifting expenses":**
- Casing, tubing, and Christmas tree.
- Equipment on lease but not being used to produce oil or gas.
- "District expenses" allocated to a lease as an internal accounting function.
- "Administrative overhead" as an indirect charge against the operation.

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The Not-So-Basic

- **Amounts charged under JOA as an overhead charge is not a lifting expense.**
- **COPAS overhead charges.** Fact that it may be an expense between operator and nonoperator does not turn such indirect expenses into a direct expense.

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The Not-So-Basic

- If **revenue exceeds lifting expenses**, the analysis is over, the lease continues.
- If **lifting expenses exceed revenue**, the analysis proceeds to the final issue:
- ***Are there any "compelling equitable considerations" that "justify continued production from the unprofitable well operations." Stewart v. Amerada Hess***

23

The Not-So-Basic

- The analysis is highly fact-specific and conducted on a case-by-case basis.
- **Article page 16-18.**
- Focus on the nature of the event and how the lessee responded to the event.
- Oklahoma's forfeiture statute. **Okla. Stat. tit. 23, § 2. Have the terms of this statute ever been applied literally?**

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The Not-So-Basic

- **Oil and gas lease:** once a well is completed that is capable of producing in paying quantities, termination of the lessee's leasehold interest employs a forfeiture analysis as opposed to a special limitation analysis.
- Classic fee simple determinable language will not be given its property-based effect; instead apply a contract-based analysis.

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The Not-So-Basic

- **Could this state of affairs be changed by express and explicit lease language?**
- **Yes.** Effect of frequently-encountered form of cessation clause when the lease is not otherwise capable of producing in paying quantities. ***Hoyt v. Continental Oil Co.***

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The Not-So-Basic

- **Demand requirement.** Once a contract analysis is applied to the habendum clause (as opposed to a special limitation analysis), it sets the stage for demand and cure concepts that are associated with contract law.
- Duty to produce and market from a capable well is an implied covenant requiring the lessor to demand performance before equity will grant a forfeiture. **Article pages 20-22.**

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The Not-So-Basic

- **Forfeiture vs. Special Limitation and the estoppel defense.**
- Lessor acceptance of royalties or other payments can give rise to an estoppel under a forfeiture analysis – but not a special limitation analysis.
- **Article page 22.**

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The Not-So-Basic

- **Oil and gas "lease" rules will not be applied to defeasible term interests.**
- ***Ludwig v. William K. Warren Foundation***
- Not clear whether this was a temporary or permanent cessation situation (court does not analyze this issue).
- **No cessation of production doctrine will be applied to defeasible term interests.**

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The Not-So-Basic

- ***Ludwig*** analyzed by the North Dakota Supreme Court in ***Greenfield v. Thill***.
- **Article pages 22-24.**
- No analysis by the Ludwig court of its prior rulings in ***Beatty v. Baxter*** and ***Postier v. Postier***.

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The Not-So-Basic

- Court's probable rationale in ***Ludwig*** revealed in ***Fransen v. Eckhardt*** (decided 5 years before ***Ludwig***).
- To satisfy the habendum clause of a defeasible term mineral interest, you must have ***actual production and marketing*** at the end of the primary term.
- Refuse to apply the "capability" rule used for oil and gas leases.

31

The Not-So-Basic

- **The rationale motivating the court to reject rules applied to the oil and gas lease:**
- The desire to eliminate defeasible interests at the earliest possible time to reunite the interest with the holder of the possibility of reverter.
- **Article page 24.**

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The Not-So-Basic

- **The Hemingway (4th ed.) treatise:** "*Ludwig* seems incorrect. The courts should apply the same view of 'production' in defeasible-term deeds that they apply to oil and gas leases."
- I disagree. These are fundamentally different documents creating differing relationships. Interpretation should be guided by the probable intent of the parties.

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The Not-So-Basic

- If you are drafting a defeasible term interest, and you want it to continue in effect similar to an oil and gas lease, then it will need clauses such as: an expanded habendum clause ("is or can be produced"), commencement and completion clauses, dry hole clause, cessation clause, shut-in royalty clause, pooling clause, and force majeure clause.

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The Not-So-Basic

- Assignments of interests in the oil and gas lease can create a second layer of covenants, conditions, and special limitations that must be accounted for by the assignee.
- **The lesson:** draft with the assumption that oil and gas lease jurisprudence may not apply to the assignor/assignee relationship. **Article page 25.**

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The Basics

- **Shut-in royalty clause principles.**
- Must have a well "capable" of producing in paying quantities.
- Frequently-encountered form can only operate when the lease is already being maintained by the habendum clause (because there must be a well "capable" of producing).

36

The Basics

- **Shut-in royalty clause principles.**
- Failure to properly pay shut-in royalty can give rise to a contractual obligation to pay, but will not terminate the lease – assuming the lease is capable of producing.
- **Article pages 26-28.**

37

The Not-So-Basic

- It is clear under conventional oil and gas leases the well must be capable of producing (completed, tested, ready to operate) in order to qualify as a shut-in well.
- Problem with unconventional coalbed methane wells where operations are being conducted under a partially modified lease form.

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The Not-So-Basic

- Several wells may be drilled into the coal seam but not completed until the dewatering and gas production system is installed for the wells in the area.
- Goal is to complete and begin flowing all wells at the same time.
- You generally commit to completing a coalbed methane well the moment you drill the hole.

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The Basics

- **Cessation of Production *Doctrine***
- Well can cease producing in paying quantities and, if a temporary cessation, the lessee will have a reasonable period of time to regain production in paying quantities.
- Failure to act, or the cessation is otherwise for an unreasonable period of time, the lease can be cancelled.

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The Not-So-Basic

- **Cessation of Production *Clause***
- "Cessation" occurs when the lease ceases producing in paying quantities – even though physical production continues from the well without interruption.
- When the well is no longer capable of producing under the habendum clause, the terms of the cessation clause define what must be done to maintain the lease.

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The Not-So-Basic

- **Cessation of Production *Clause***
- ***Geyer Brothers Equipment Co. v. Standard Resources, L.L.C.***
- Cessation clause, ***well capable of producing in paying quantities***, shut-in for 15 years, apply a temporary cessation forfeiture analysis to conclude: lessor carried their burden of proving lessee failed to "use reasonable diligence in the operation of the well . . . ."

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The Not-So-Basic

- Practical effect of the cessation **clause** under the ***Pack*** and ***Geyer*** cases: it applies only to **permanent** cessations that would not otherwise be encompassed by the temporary cessation doctrine.
- If the lease is capable of producing in paying quantities when the cessation occurs, then the lessee will have a reasonable period of time to respond, under the cessation **doctrine**.

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The Not-So-Basic

- If the well is ***not*** capable of producing in paying quantities at the time of the cessation, then the cessation **clause** will apply.
- The clause in ***Geyer*** applied to a cessation of production "from **any cause** . . . ."
- "Production" however, means it must cease to be **capable** of producing in paying quantities. **Article pages 32-34.**

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The Basics

- **Acreage held by production.**
- Production anywhere on the leased land will maintain all the leased land – absent special language in the lease providing otherwise.
- Area held by production can be expanded through pooling.

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The Basics

- **Acreage held by production.**
- Lessors, recognizing the inherent difficulties with relying upon implied covenants, seek to limit the acreage held by production.
- Pooling: Pugh clause.
- Continuous development clause.
- Retained acreage clause.
- Areal dimension and depth dimension.

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The Basics

- **Acreage held by production.**
- **Oklahoma's statutory Pugh clause:**
- "In case of a spacing unit of one hundred sixty (160) acres or more, no oil and/or gas leasehold interest outside the spacing unit involved may be held by production from the spacing unit more than ninety (90) days beyond expiration of the primary term of the lease."

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The Not-So-Basic

- **Acreage held by production.**
- The Oklahoma statutory Pugh clause applies to leases entered into after it took effect on May 27, 1977.
- Leases entered into prior to that date will not be affected by the clause.
- **Article page 36.**

48

The Not-So-Basic

- ***Horizontal* Pugh Clause?**
- ***Rist v. Westhoma Oil Co.***
- "this lease, insofar as it covers any tract or tracts not included in a consolidation . . . shall terminate at the expiration of the primary term hereof . . . ."
- "Tract" refers to the entire piece of acreage, as to all depths.

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The Basics

- The parties can agree to about anything they desire, so long as the intended effect is clearly stated in the governing document.
- To the extent the express, explicit terms of the document do not clearly modify the "norm," the norm will most likely constitute the default rule.

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The Eugene Kuntz Conference on Natural Resources Law and Policy 2008