LEASE SAVINGS CLAUSES AND EQUITABLE DOCTRINES:

PRODUCTION IN PAYING QUANTITIES, CESSATION OF PRODUCTION, SHUT-IN ROYALTIES, RATIFICATION AND REVIVOR

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I. Introduction

As the past two years have shown, during economic downturns exploration and production of oil, gas and other minerals slows significantly. Drilling rig counts plummet because oil and gas prices plummet. Lessees begin considering the most cost-effective ways to hold on to their leases, which does not always mean drilling and production. As a result, many lessees find themselves facing lease termination claims from their lessors. Such claims are based on a variety of circumstances and often require analysis of the interaction between the habendum clause and many different types of savings clauses and equitable defenses to termination. This article by no means encompasses all lease preservation and maintenance issues that can conceivably arise in today's legal climate. It examines the complexities of the phrase "production in paying quantities" and how such phrase affects the application of the habendum clause, cessation of production clause and shut-in royalty clause in an oil and gas lease. In addition, the paper addresses the doctrines of ratification and revivor, two of the last resorts available to hold a lease in the secondary term. Suffice it to say that in this author's opinion, if you are faced with having to rely upon a savings provision or equitable defense to maintain your lease, the odds of being forced to go to the Texas Supreme Court are high given the complexities of the law and factual issues that can arise. Of course, for lessees these days, that may not be such a bad option aside from the legal fees.

II. Production in Paying Quantities

In order to discuss the interaction between the habendum, cessation of production and shut-in royalty clauses, one needs to understand the phrase "production in paying quantities." The definition of "produced" within the meaning of the habendum clause was first addressed by the Texas Supreme Court in *Garcia v. King*.[1] In that case, the lease contained a basic habendum clause providing that the lease would continue for the specified primary term "and as long thereafter as oil gas or other mineral is ***produced*** from said land hereunder. . ." The Court was faced with the issue of whether "produced" meant "production in paying quantities" as the lessor argued, or whether, as the lessee contended, it meant only that sufficient oil need be produced to be susceptible of division. Ultimately the Court agreed with the lessor's definition, stating that "the very purpose of the landowner executing the lease is to have the oil and gas on the leased premises produced and marketed so that he may receive his royalty therefrom, and the purpose of the lessee is to discover and produce oil and gas in such quantities as will yield him a profit."[2]

The question that arose next was: What is meant by the phrase "production in paying quantities?" Through the Courts' opinions in *Garcia v. King* and *Clifton v. Koontz,* a two pronged test evolved that courts have since used to determine whether a well is producing in paying quantities: (1) Did the lease yield a profit over a reasonable period of time after deducting operating and marketing costs?; and (2) Would a reasonably prudent operator continue to operate the well in the manner in which it was being operated for the purpose of making a profit and not merely for speculation?[3] A finding of production in paying quantities can be made as a matter of law if the lessee can show a profit was made from the subject well.[4]

[1] *Garcia v. King,* 139 Tex. 578, 164 S.W.2d 509 (1942).

[2] *Id.* at 510-11.

[3] *See Pshigoda v. Texaco, Inc.,* 703 S.W.2d 416, 418 (Tex.App. – Amarillo 1986, writ ref'd n.r.e.); *Duncan Land & Exploration, Inc. v. Littlepage,* 984 S.W.2d 318, 331 (Tex.App. – Ft. Worth 1998, pet. denied); *Grinnell v. Munson,* 137 S.W.3d 706, 715 (Tex.App. – San Antonio 2004, no pet. h.).

[4] *See Evans v. Gulf Oil Corp.,* 840 S.W.2d 500, 503 (Tex.App. – Corpus Christi 1992, writ denied).

Otherwise, the issue involves multiple questions of fact depending upon the circumstances, as discussed in more detail below.

The *Garcia* Court laid the foundation for the first prong in their quantification of "profit":

> If a well pays a profit, even small, over operating expenses, it produces in paying quantities, though it may never repay its costs, and the enterprise as a whole may prove unprofitable.[5]

The Court addressed the issue further at the conclusion of the opinion, which would later be rephrased as the second prong of the test:

> The object of the contract was to secure development of the property for the mutual benefit of the parties. It was contemplated that this would be done during the primary period of the contract. So far as lessees were concerned, the object in providing for a continuation of the lease for an indefinite time after the expiration of the primary period was to allow the lessees to reap the full fruits of the investments made by them in developing the property. Obviously, if the lease could no longer be operated at a profit, there were no fruits for them to reap. The lessors should not be required to suffer a continuation of the lease after the expiration of the primary period merely for speculation purposes on the part of the lessees. Since the lease was no longer yielding a profit to the lessees at the termination of the primary period, the object sought to be accomplished by the continuation thereof had ceased, and the lease had terminated.[6]

[5] *Garcia,* 164 S.W.2d at 512.

[6] *Id.* at 512-13.

In *Clifton v. Koontz,* the Court considered a similar habendum clause and added to the analysis, holding that "there can be no limit as to time, whether it be days, weeks, or months, to be taken into consideration in determining the question of whether paying production from the lease has ceased."[7] Referring to a marginal well, the Court stated, that "the standard by which paying quantities is determined is whether or not under all the relevant circumstances a reasonably prudent operator would, for the purpose of making a profit and not merely for speculation, continue to operate a well in the manner in which the well in question was operated."[8]

The *Clifton* Court then set the standard for all subsequent courts who consider the issue, stating that an analysis of all factors that would be considered by a reasonably prudent operator in continuing to operate the well for profit must be made. The Court listed a nonexclusive list of factors throughout the opinion, including (1) reservoir depletion, (2) sales price, (3) whether other wells in the area are profitable, (4) operating and marketing costs, (5) net profit, (6) lease terms, (7) a reasonable period of time given the circumstances, (8) whether the lease is being held only for speculative purposes; (9) and proration rules adopted by the Texas Railroad Commission. The ability to market the product is also a necessary consideration, which requires some showing by the lessee that some facilities exist in a nearby locale that would furnish a profitable market for the lessee.[9]

Each of these factors present questions of fact determined on a case-by-case basis. One of the more common factors litigated is the issue of what is encompassed in "operating and marketing costs." Through a series of cases, courts

[7] 160 Tex. 82, 325 S.W.2d 684, 690 (1959).

[8] *Id.* at 691.

[9] *See id.*

have determined that in general, capital expenses such as drilling and equipping the well[10] or reworking expenses[11], are not included, but the following types of expenses are considered operating and marketing costs:

- Out-of-pocket lifting expenses and fixed or periodic expenditures in the daily operation of the well[12];
- Taxes, labor, repairs[13];
- Overhead directly related to production, as opposed to overhead that continues whether or not the well is producing[14]; and
- Depreciation on salvable equipment, meaning depreciation on equipment used in production and marketing of minerals, and not the typical "bookkeeping entry of depreciation";[15]

A decision out of the Fourth Court of Appeals tends to indicate that estimates of such costs are sufficient to raise a fact issue as to production in paying quantities. In *Grinnell v. Munson,* the lessor's expert relied upon monthly production and lifting costs of other wells in the county producing from similar depths, rather than actual expenses incurred by the lessee for operating the subject well.[16] Applying these estimated expenses to the actual revenues of the subject wells using 1999 oil prices, the expert opined that the revenues did not exceed expenses, and "that a reasonable prudent operator, having knowledge of present and projected crude oil prices and present and projected future production on the [subject leases] could not reasonably expect to receive profits and would only hold the leases for speculative purposes."[17] The lessee responded that it conducts its business as a "stripper operation" incurring lower costs than typical operators. In addition, the lessee argued that had the lessor's expert used 2000 oil prices or an average price for the prior three years, the revenues would have been greater. Plus, the lessee presented evidence that 5 million barrels of oil remain in place, and therefore, a reasonably prudent operator with knowledge of present and projected oil prices would continue operating the wells. The court determined that a fact issue existed based on the conflicting evidence.[18]

A. *Capable of* Production in Paying Quantities

A different analysis is presented by lease forms that add the language "and as long thereafter as gas is ***or can be*** produced" to the habendum clause. As held by the Texas Supreme Court in *Anadarko Petroleum Corp. v. Thompson,* such a clause does not require actual or constructive production to maintain the lease into the secondary term.[19] In *Thompson*, Anadarko's predecessors in interest had operated the subject well since 1936, and during two separate periods of 61 days and 91 days, the production ceased while the gas purchaser conducted pipeline repairs. The Court reiterated the law that under a basic habendum clause that provides "as long as oil or gas is produced," the lease automatically terminates if during the secondary term actual production ceases.[20] However, under the language of

[10] *Id.* at 692;

[11] *Pshigoda,* 703 S.W.2d at 418-19; *see also Peacock v. Schroeder,* 846 S.W.2d 905, n. 2 (Tex.App. – San Antonio 1993, no writ); *Abraxus Petroleum Corp. v. Hornburg,* 20 S.W.3d 741, 756 (Tex.App. – El Paso 2000, no pet. h.).

[12] *Pshigoda*, 703 S.W.2d at 418.

[13] *Skelly Oil Co. v. Archer* , 163 Tex. 92, 356 S.W.2d 774, 781 (1961).

[14] *Ladd Petroleum Corp. v. Eagle Oil & Gas Co,* 695 S.W.2d 99, 108 (Tex.App. – Ft. Worth 1985, writ ref'd n.r.e.); *Bomar Oil & Gas, Inc. v. Lloyd,* 2009 WL 2136404, *7 (Tex.App. – Waco July 15, 2009) *aff'd as modified on reh'g,* 298 S.W.3d 832.

[15] *Skelly Oil Co.*, 356 S.W.2d at 781.

[16] 137 S.W.3d 706, 715 (Tex.App. – San Antonio 2004, no pet. h.).

[17] *Id.*

[18] See i*d.* at 715-16.

[19] 94 S.W.3d 550 (Tex. 2003).

[20] *Id.* at 554.

the habendum clause at issue, Anadarko argued that a well not actually producing but that is ***capable*** of production would continue the lease. The subject well was always capable of production. Anadarko asserted further that savings provisions, such as the 60 day cessation of production clause, were not triggered until the subject well was determined to be ***incapable*** of production. The lessor, Thompson, argued that such an interpretation of the habendum clause would render the cessation of production clause meaningless and is contrary to Texas law. Rejecting Thompson's arguments, the Court held that the cases interpreting a basic habendum clause are not controlling, because by including the language "is *or can be* produced" in the habendum clause, "the parties intended that a well actually produce gas, *or be capable of producing gas*, to sustain the lease."[21] With respect to the cessation of production clause, the Court, therefore, held that it "only applies if a well holding the leases ceases to be *capable of producing gas.*"[22] Thompson argued further that Anadarko's interpretation would permit a lessee to hold a lease indefinitely with only a well that was capable of production and not actual production, but the Court reasoned that the implied covenant to manage and administer the lease and market the gas, provides sufficient protection against such a situation.[23]

Having interpreted the meaning of the habendum clause, the Court was left with the issue of what "capable of production" means. The Court considered the case of *Hydrocarbon Mgmt., Inc. v. Tracker Exploration, Inc.,* 861 S.W.2d 427 (Tex.App. – Amarillo 1993, no writ) in which the Seventh Court of Appeals defined the phrase "capable of producing in paying quantities" to mean "a well that will produce in paying quantities if the well is turned 'on,' and it begins flowing, without additional equipment or repair."[24] The *Thompson* Court approved of the definition and applied it to the context of the subject habendum clause, holding that "a well is ***capable of production*** if it is capable of producing in paying quantities without additional equipment or repairs."[25]

On rehearing, the Court clarified that its holding does not extinguish the requirement for "production in paying quantities" that there still must be facilities near enough to the well for it to be economically feasible to connect the well for marketing the production at a profit. In fact, the Court held that such requirement also applies to determining if a well is "capable of producing in paying quantities." The Court found that the subject well was connected to pipeline facilities, and even though it ceased producing for two separate periods because of pipeline repairs, it was still capable of producing in paying quantities.[26] The Court does not address the apparent conflict between its definition of "capable of producing in paying quantities", requiring the well be able to flow without additional equipment or repair, and the fact that the subject well apparently could not flow because of pipeline repairs.

In *Blackmon v. XTO Energy, Inc.,* XTO succeeded to a lease held by a gas well that had ceased producing because the gas purchaser refused to continue taking the gas due to a high CO_2 content. Almost a year-and-a-half after production ceased, an amine plant was installed to remove the CO_2 and production continued. The Blackmons argued that the lease terminated because the well was not capable of producing in paying quantities during the time it was turned off.[27] Addressing the *Thompson* and *Hydrocarbon Mgmt.* Courts' definition of "capable of production in paying

[21] *Id.* at 555.
[22] *Id.* at 555-56.
[23] *See id.* at 557.
[24] *See id.* at 557-58.
[25] *Id.* at 558 (emphasis added).
[26] *See id.* at 559.
[27] 276 S.W.3d 600, 602-03 (Tex.App. – Waco 2008, no pet. h.).

quantities," the Blackmons asserted that the well did not meet the definition, because as a result of the CO_2 content, the well needed additional equipment and repairs to produce "marketable gas."[28] The Tenth Court of Appeals disagreed stating that the "focus is on whether the well is capable of producing gas in a marketable *quantity*, not a marketable *quality*."[29] The court held further that the reference in the definition to "additional equipment or repairs" refers to "equipment or repairs necessary for ***raw gas*** to flow from the wellhead when the switch is turned 'on' rather than on equipment installed downline to refine the raw product to marketable form."[30] In addition, the court relied upon the treatment of post-production costs in calculating royalties, stating that a royalty interest is not charged with costs associated with "production", but it is charged with post-production costs associated with marketing of the gas. In that regard the amine plant was installed downstream of the wellhead and was needed to "render the gas of marketable quality." It was therefore, not equipment necessary to enable gas to flow from the well when it is turned on.[31] The subject well was found to be capable of producing significant volumes of raw gas at the wellhead - it just was not marketable without being processed.

The *Blackmon* case could be used to argue that a well shut-in due to pipeline repairs, such as the well in *Thompson*, is not capable of production in paying quantities, because pipeline equipment is "necessary for raw gas to flow from the wellhead when the switch is turned 'on.'" In response, however, the lessee could rely upon the temporary cessation of production doctrine and cases such as *Krabbe v. Anadarko Petroleum Corp.,* discussed below.

In *AFE Oil & Gas, L.L.C. v. Armentrout*, the Second Court of Appeals considered whether a Barnett Shale well was capable of producing in paying quantities.[32] During the relevant time period of nonproduction, the subject well was acid perforated, which did not result in production, and the well had not yet been fraced. The evidence presented to the jury, included expert testimony that Barnett Shale wells will not produce without fracture stimulation, and that after an acid perforation was done on the subject well, the well would not flow on its own and was incapable of production at the time. Further, in a letter from one of the working interest owners in the well, it was represented that the gas purchaser would not purchase the gas form the well without a gas sample, and to obtain the gas sample the well needed to be fraced.[33] The lessee's expert testified that the acid perforation was sufficient to "break the formation" and if the well had been turned on it would have flowed. The expert also relied upon daily operations reports indicating the well was showing "very little" gas, that the well was flowing, and that there was 240 lbs casing pressure on August 3, 330 lbs on August 6 and 750 lbs on October 27, 2003.[34] Based on the evidence, though somewhat conflicting, the court affirmed the jury's verdict stating "that the evidence at trial was at least some evidence that the well was not capable of producing at the time that the well was shut in and shut in royalties were paid."[35]

III. Cessation of Production

A. Total Cessation of Production

In the event the evidence supports a finding of total cessation of production, there is no need to conduct the two-pronged analysis of production in paying quantities.

[28] *See id.* at 603.
[29] *Id.* (emphasis in original).
[30] *Id.* (emphasis added).
[31] *See id.* at 604.

[32] 2008 WL 623980 (Tex.App. – Ft. Worth, March 6, 2008)
[33] *See id.* at *3-4.
[34] *See id.* at *5-6.
[35] *Id.* at *5.

Though seemingly obvious, a total cessation occurs when a well ceases to produce ***any*** quantity of minerals.[36] As one court put it:

> A total, physical cessation of production conveys an unambiguous message: either a well is in need of reworking or repair, or it has permanently drained the reservoir. In either case, it is more reasonable in such circumstances to expect the operator to take immediate action or suffer termination of the lease.[37]

In terms of temporary cessation, however, the two-pronged production in paying quantities analysis must first be conducted.

In *Cannon v. Sun-Key Oil Co., Inc.,* at issue was the continuing validity of a 1973 oil and gas lease covering 6,518 acres, which included 6,043.79 acres of land known as the "Parkey Ranch." The leased acreage was divided up into eleven individual units. In 1978, the lessee completed a well on one of the units that covered 352 acres. In 1994, the well was shut down in connection with the lessee's decision to build a pipeline, and when the well was turned back on it would not produce. After a little more than a year of operations to fix the well, it finally resumed production. In August 1997, Cannon purchased an interest in the land covered by the lease, and thereafter, filed suit to terminate the lease due to cessation of production during the time period the well was shut down.[38]

Cannon submitted the issue of "cessation of production in paying quantities" to the jury, which determined that the second prong of the "production in paying quantities" test was not met (*i.e.*, a reasonably prudent operator would continue operating the well for profit and not mere speculation) and found the lease terminated. Sun-Key appealed the finding, which Cannon responded to by asserting that the lease alternatively terminated due to total cessation of production, and therefore, the production in paying quantities analysis does not apply. However, the Court noted that while Cannon asserted such a theory in the alternative in his petition, he only submitted to the jury the question of whether the well ceased to produce in paying quantities. As such, the court held that Cannon waived the total cessation of production issue.[39] The court went on to reverse the jury's finding that the well ceased to produce in paying quantities based on lack of evidence in support of same. Cannon was not done. He came back a couple of years later with a fellow interest owner in the lease, Moncrief Minerals Partnership, asserting essentially the same claims as before, but focusing on the total cessation of production theory.[40] Though res judicata barred any claims brought by Cannon that accrued prior to the date of the previous judgment, such defense did not act as a bar to Moncrief. Moncrief filed a motion for partial summary judgment on the issue of total cessation of production for a period of 20 months. Sun-Key did not file a response to the motion, but instead filed its own cross-motion on its defense of adverse possession. The trial court granted Moncrief's motion and entered a declaration in favor of both Moncrief and Cannon that the lease terminated. On appeal, the court upheld the finding, because Sun-Key did not file a response to Moncrief's motion. As to the judgment in favor of Cannon, Sun-Key did not raise the issue on appeal, and therefore, that judgment was affirmed as well.[41]

[36] *Cannon v. Sun-Key Oil Co., Inc.,* 117 S.W.3d 416, 421 (Tex.App. – Eastland 2003, pet. denied).
[37] *Ridenour v. Herrington,* 47 S.W.3d 117, 122 (Tex.App. – Waco 2001, pet. denied).
[38] *Cannon,* 117 S.W.3d at 418-19.
[39] *See id.* at 421-22.
[40] *See Sun-Key Oil Co., Inc. v. Cannon,* 2009 WL 62071 (Tex.App. – Eastland, March 12, 2009).
[41] *See id.* at *2-3.

B. Temporary Cessation of Production

A standard oil and gas lease will contain some variation of a cessation of production clause that defines what constitutes a temporary cessation of production, and under what circumstances the lessee can hold the lease despite such temporary cessation. In the event the lease is silent on the subject, courts have long implied such a clause into the lease in order to address what is considered to be a common occurrence in the industry.[42] However, as discussed above, whether the clause is express or implied it is not triggered until the well holding the lease ceases to produce in paying quantities, or depending on the habendum clause at issue, ceases to be capable of producing in paying quantities.[43]

In order to prove temporary cessation, a lessee must show that the cessation was the result of a sudden stoppage of the well or some mechanical breakdown of the production equipment. Unless a specific time period is expressed in the lease (typically 60, 90 or 120 days), the lessee is afforded a reasonable time to remedy the failure and resume production.[44] What constitutes a reasonable time depends on the facts of the case at hand, but the lessee must act with diligence in restoring production.[45] Courts have also added a requirement that the cessation be "unforeseen and unavoidable."[46]

[42] *See Krabbe v. Anadarko Petroleum Corp.,* 46 S.W.3d 308, 315 (Tex.App. – Amarillo 2001, pet. denied); *Moore v. Jet Stream Investments, Ltd.,* 261 S.W.3d 412, 425 (Tex.App. – Texarkana 2008, pet. denied); *Sun Operating P'ship v. Holt,* 984 S.W.2d 277, 281-82 (Tex.App. – Amarillo 1998, pet. denied).

[43] *See Ridenour,* 47 S.W.3d at 121; *Anadarko Petroleum Corp v. Thompson,* 94 S.W.3d at 555-56;

[44] *See Watson v. Rochmill,* 155 S.W.2d 783, 784 (1941); *Krabbe,* 46 S.W.3d at 315.

[45] *See Krabbe,* 46 S.W.3d at 315-16.

[46] *Scarborough v. New Domain Oil & Gas Co.,* 276 S.W. 331, 336 (Tex.Civ.App. – El Paso 1925, writ dism'd w.o.j.)

The majority of cases involve situations in which the courts find a temporary cessation has occurred. For instance, in *Scarborough v. New Domain Oil & Gas Co.,* casing in a gas well collapsed, killing the well, and the lessee diligently attempted to repair the well and resume production of gas, but to no avail. During the lessee's attempts to restore production of gas, the lessee drilled and completed an oil well as a producer. The court held that "the cause of cessation of production was thereafter necessarily unforeseen and unavoidable, and where the lessees in good faith used reasonable diligence to resume production, and at great outlay of money, and did, within a reasonable time, in view of the conditions disclosed by the record, resume production, a forfeiture for temporary cessation of production without fault of lessees should not be allowed as a matter of law."[47] Despite the ultimate total cessation of production from the gas well, the court considered the situation to be a temporary cessation of production in light of the restoration of production through the newly completed oil well. Under this holding, "restoration of production" is not necessarily well-specific.

Likewise, temporary cessation of production was found in cases in which production ceased because two lawsuits were filed and an obstruction in a gas line required the construction of a new line, *Midwest Oil Corp. v. Winsauer,* 323 S.W.2d 944 (1959); the occurrence of pressure differentials between the wells and pipeline requiring installation of compressors even though the lessee waited two months to begin the repair work, *Cobb v. Natural Gas Pipeline Co. of Am.,* 897 F.2d 1307, 1312 (5th Cir. 1990); and the two month negotiation of a new gas purchase contract coupled with the fact that the purchaser disconnected the lease requiring installation of a gas compressor for reconnection, and the theft of electric pump motors from the lease, *Casey v. Western Oil & Gas, Inc.,*

[47] *Id.*

611 S.W.2d 676, 679 (Tex.Civ.App. – Eastland 1980, writ ref'd n.r.e.).

An interesting scenario was addressed by the Seventh Court of Appeals in *Krabbe v. Anadarko Petroleum Corp.,* involving two wells, the Rockwell 1-102 and Rockwell B1R, that Anadarko operated under a lease that did not contain any kind of savings provision. The gas from the two wells was sold to Cabot Corporation who transported the gas via two different pipelines to its Turkey Creek processing plant. The gas from Rockwell 1-102 was transported through the Masterson Loop line controlled by Westar Transmission Company ("Westar") and later by Cabot. The Rockwell B1R gas was transported on a pipeline leased from Anadarko's predecessor, Panhandle Eastern Pipeline Company. The Rockwell 1-102 gas was purchased under a twenty-year gas purchase contract executed in 1964 between Westar and Panhandle Eastern Exploration Company ("PEEC"). In 1984, Westar and PEEC renegotiated the 1964 gas purchase contract, but thereafter, Cabot purchased Westar and refused to honor the new terms. A dispute arose resulting in PEEC filing suit against Cabot, and a settlement not being finalized until January 1987. During that time, production from the Rockwell 1-102 ceased for a period of 19 months. The Rockwell B1R well continued to produce, but for a period of 92 days the B1R did not produce, because Cabot was making repairs to its Turkey Creek processing plant. Later, for a period of 61 days Cabot again shut down the plant, and the B1R well did not produce.[48] In addressing the temporary cessation of production doctrine, the Seventh Court of Appeals held that the evidence proved that Anadarko did not intend for the wells to cease producing and that during the 92 day and 61 day periods of no production from the B1R well, Anadarko diligently attempted to have Cabot resume its acceptance of gas from the Rockwell 1-102 under the 1964 contract, and that Anadarko did not know that the Turkey Creek plant would shut down and fail to take the usual quantities from the Rockwell B1R. The court affirmed the trial court's determination from the evidence that Anadarko acted diligently by waiting for the Turkey Creek plant to resume accepting the gas, rather than reworking the Panhandle pipeline to circumvent the plant.[49]

In contrast, there are very few cases refusing to find a temporary cessation of production. For instance, a lessee's decision not to produce a well because of poor economic conditions was held not to be a "mechanical breakdown" or other condition that prevented operation of the well, and coupled with the fact that the well did not produce for over two years was determined not to fall within the temporary cessation of production doctrine.[50] This holding is in line with the principle that lack of a market is no excuse for failure to produce.[51]

In *Bradley v. Avery,* the lessee failed to meet its burden of proof as to temporary cessation based on the trial court's finding that the cause of the cessation was "uncertain."[52] An interesting note about that case is that the court appears to apply the temporary cessation of production doctrine despite the fact that the express language of the habendum clause provided the lease would continue "so long as Lessee shall continue to produce oil and gas . . . ***but the failure of Lessee to continue production without interruption from any such wells . . . shall terminate this Lease . . .***"[53]

Also, in *Nafco Oil & Gas, Inc. v. Tartan Res. Corp.,* top lessees filed suit to have the underlying lease terminated for

48 *See Krabbe,* 46 S.W.3d at 311-13.

49 *See id.* at 317-18.

50 *See Watson v. Rochmill,* 155 S.W.2d at 783-84.

51 *See Gulf Oil Corp. v. Reid,* 161 Tex. 51, 337 S.W.2d 267, 279 (1960).

52 746 S.W.2d 341 (Tex.App. – Austin 1988, no writ).

53 *Id.* at 343 (emphasis added).

lack of production.[54] With respect to a certain gas well that ceased producing for eight months after which the lessee renewed production from the well, the court found that the reason for the cessation of production was depletion of the reservoir. Though the lessee recompleted the well eight months later in a different sand, the court held that the particular sand was known to the lessee as early as ten months before, and therefore, the recompletion work could have been performed ten months earlier. The lessee's decision to wait to recomplete the well was solely based on economics, which the court held was insufficient to support a finding of temporary cessation.[55]

It is these types of decisions that the Texas Supreme Court referenced in *Ridge Oil Co. v. Guinn Investments, Inc.,* in which the Court expanded the temporary cessation of production doctrine.[56] In that case, Guinn and Ridge were co-lessees of a 1937 oil and gas lease covering two contiguous 160 acre tracts. Guinn held the lessee interest on one tract and Ridge on the other. The only producing wells were operated by Ridge on its 160 acre tract, and under well-established law, those two wells held the entire lease. When Guinn refused to sell out to Ridge, Ridge orchestrated a plan to terminate the lease and obtain new leases on both tracts. Ridge directed its pumper to shut off electricity to the two wells for 90 days, which Ridge was advised by its attorney would terminate the lease. During the 90 day period, Ridge obtained a new lease from the mineral owners under its 160 acre tract, as well as a new lease from a portion of the mineral owners under the Guinn tract. Guinn filed suit, claiming among other things, that the temporary cessation of production clause applied precluding termination of the 1937 lease. The trial court disagreed finding the lease terminated. The court of appeals reversed finding the temporary cessation of production doctrine applied.[57]

On review, the Supreme Court stated, "[t]he central question before us today is whether there was a temporary cessation of production under the facts of this case."[58] However, the Court never made a finding on that issue. Instead the Court held that Ridge's procurement of a new lease covering the Ridge tract acted as a **total** cessation of production as to that tract alone as of the effective date of the new lease. From that point on, the 1937 lease covered only Guinn's tract, however Guinn no longer received the benefit of the two wells holding its lease. Accordingly, the Court held that the 1937 lease terminated on the same date, for lack of production.[59]

With respect to the temporary cessation of production doctrine, the only thing the Court did was address prior holdings on the topic and expand its application without any reference to or application to the facts of the case at hand. The Court stated that the doctrine applies in a "wide variety of circumstances," and is not limited to circumstances in which production ceased due to a "sudden stoppage" or "mechanical breakdown" that was unforeseeable. The Court stated further that "foreseeability and avoidability are not essential elements of the temporary cessation of production doctrine."[60] Though arguably dicta, the Court has laid the groundwork for lessees to argue a broader application of the doctrine in the future.

IV. Shut-in Royalty Clauses

Oftentimes, a lessee coming up on the end of the primary term of its lease drills a well and obtains production despite the lack of any gathering lines or facilities to get the well's production to market. The

[54] 522 S.W.2d 703 (Tex.Civ.App. – Corpus Christi 1975, writ ref'd n.r.e.).
[55] *See id.* at 709.
[56] 148 S.W.3d 143 (Tex. 2004).
[57] *See id.* at 147-49.
[58] *Id.* at 151.
[59] *Id.* at 152-53.
[60] *Id.* at 151-52.

general rule in Texas is that unless expressly provided otherwise in the lease, a lessee does not have a reasonable time within which to find a market after shutting in a well.[61] Of course, the work of laying gathering lines and constructing the necessary facilities to get the product to market can extend the lease under a continuous operations clause; however, to provide another avenue to the lessee to hold the lease, the shut-in royalty clause was created. The shut-in royalty clause is triggered in the event the lessee is operating a well that is shut-in, but capable of producing oil or gas in paying quantities. In that instance, the lessee can pay the lessor a specified dollar amount in order to extend the lease, and such payment acts as constructive production for purposes of the habendum clause.[62] For the most part, courts have applied the clauses strictly, requiring timely payments of the shut-in royalty and a showing that the subject well is actually capable of production in paying quantities.

A. Requirement that well be capable of production in paying quantities.

In *Hydrocarbon Mgmt., Inc. v. Tracker Exploration, Inc.,* the Seventh Court of Appeals considered two leases with primary terms of five years expiring May 26, 1981. The leases contained a shut-in royalty clause that provided the lessee with the option to pay an annual shut-in royalty in the event gas from any well or wells capable of producing gas is not sold or being used off the leased premises. One well held both leases, but ceased production during the secondary term on May 25, 1989 due to mechanical difficulties. The successor lessee, Hydrocarbon, attempted to turn on the well on July 3, 1989, but it would not flow. The well did not produce again until December 1989. The lessors and owners of top leases on the land sought to terminate the leases, and in response, Hydrocarbon attempted to rely upon the savings provisions in the leases, including the shut-in royalty clause.[63]

The Seventh Court stated that a proper application of a shut-in royalty clause requires proof of two things: (1) the well must be capable of producing in paying quantities at the time it is shut-in; and (2) lack of a market for the well's production.[64] The court then set forth the issue for resolution as follows:

> In order to satisfy the shut-in royalty clause and hold the leases, it must be established that gas from a well, capable of producing gas, is not being sold or used. Thus, appellees [lessors], as part of their burden of proof in attempting to terminate the leases, must negate the clause by establishing that the well was either not capable of producing in paying quantities, or that no market existed for the gas, or both.[65]

It is assumed the court intended to say "or that ***a*** market existed for the gas," as proving that no market existed would support the shut-in. In any event, the evidence showed that once the well resumed production in December 1989 it continued to produce and the gas was being purchased. Based on that evidence, the court determined that "because a market apparently existed for the gas, in order to

[61] *See Garcia v. King,* 337 S.W.2d at 270.

[62] *See Hydrocarbon Mgmt, Inc.,* 861 S.W.2d at 432-33.

[63] *See id.* at 430-32. Interestingly, nowhere in the opinion does the court state that Hydrocarbon actually tendered a shut-in royalty payment, but presumably it did, otherwise the court would likely have dealt with the issue more pointedly.

[64] *See id.* at 432-33.

[65] *Id.* at 433. The reference "or both" does not fit with the court's holding that negation of either element is sufficient to defeat application of the shut-in royalty clause.

negate the shut-in clause, appellees must have produced sufficient evidence that the well was not capable of producing in paying quantities."[66] This statement suggests the lessors had to negate both elements to prevent application of the shut-in royalty clause, which conflicts with the court's statement quoted above that the lessors had to negate one or the other element. Having found that the second element was not met, arguably the shut-in royalty clause was not triggered.

With respect to the first prong of its test, the evidence presented showed the well stopped producing on May 25th and did not resume production until December due to a variety of mechanical issues that Hydrocarbon worked diligently to remedy.[67] The court set forth its definition of "capable of production in paying quantities" which was subsequently approved and adopted by the *Thompson* Court, as discussed above:

> We believe that the phrase "capable of production in paying quantities" means a well that will produce in paying quantities if the well is turned "on," and it begins flowing, without additional equipment or repair. Conversely, a well would not be capable of producing in paying quantities if the well switch were turned "on," and the well did not flow, because of mechanical problems or because the well needs rods, tubing, or pumping equipment.[68]

Due to the multiple mechanical problems with the well, the court found that it was not capable of producing in paying quantities, and therefore, could not have been properly shut-in by the lessee. Accordingly, the court held that the shut-in royalty clause was not applicable to save the lease.[69]

[66] *Id.*
[67] *See id*.
[68] *Id.* at 433-34.
[69] *See id.* at 435.

In a recent unpublished opinion, the Tenth Court of Appeals considered the temporal question of whether the determination that a well is capable of producing in paying quantities is to be made at the time the well is shut-in or at the end of the primary term for proper application of a shut-in royalty clause. In *Chesapeake Exploration Ltd. P'ship v. Corine Inc.*, Chesapeake was the lessee under an oil and gas lease to which Corine succeeded to the lessor interest.[70] The lease had a primary term that expired September 2003. No drilling or production was conducted during the primary term. The Colmer well was drilled and completed on adjacent property in March 2002 and shut in a few days later. The Corine lease was then pooled into the Colmer Gas Unit on which the Colmer well was the only existing well. No further activity occurred on the Colmer well until September 2004 after the Corine lease expired. Corine obtained partial summary judgment on its claim that the lease terminated for lack of any well capable of producing in paying quantities on the lease or unit.[71]

On appeal, Chesapeake relied upon the lease's shut-in royalty clause arguing that the trial court failed to make a determination of whether the Colmer well was capable of producing in paying quantities at the time it was shut-in. Corine contended the time for such determination is at the end of the lease's primary term. The subject shut-in royalty clause provided:

> If at the end of the primary term or any time thereafter one or more wells on the leased premises or lands pooled therewith are capable of producing oil or gas or other substances covered hereby in paying quantities, but such well or wells are either shut in or production therefrom is not being sold by

[70] 2007 WL 2447293 (Tex.App. – Waco Aug. 29 2007)
[71] *See id.* at *1.

> Lessee, such well or wells shall nevertheless be deemed to be producing in paying quantities for the purpose of maintaining the lease.[72]

The parties agreed that shut-in royalty payments were to begin at the end of the primary term. Chesapeake relied upon the holdings in *Hydrocarbon Mgmt.* and *Duke v. Sun Oil* (discussed below in Section IV(C)) that the time for determining whether a well is capable of production in paying quantities is at the time it is shut-in. The Tenth Court distinguished both cases on the ground that the subject wells in each case were shut in during the secondary term and not the primary term, and further distinguished the *Hydrocarbon Mgmt.* case because the court there was not deciding the temporal issue, but was determining the meaning of the phrase "capable of producing in paying quantities." In addition, because the Corine lease was paid up, nothing was needed to continue the lease during the primary term, such as shut-in royalty payments. Further, the express language of the subject clause, "If at the end of the primary term. . .," required the determination to be made "at the end of the primary term."[73] Chesapeake argued that language simply expressed that shut-in royalty payments are excused until the end of the primary term, but the court rejected that argument stating that the "phrase cannot be used to determine the timing of shut in royalty payments and then ignored to determine the timing of when a well is capable of production in paying quantities."[74] The court then addressed Chesapeake's alternative argument that fact issues remained as to whether the well was actually capable of production in paying quantities at the end of the primary term, holding that all of the evidence proved that the well lacked the necessary equipment necessary for the well to produce in paying quantities at the end of the primary term.[75]

B. Timeliness of payments.

One of the earliest examples of a shut-in royalty clause was addressed by the Texas Supreme Court in *Freeman v. Magnolia Petroleum Co.,* and provided: "a royalty of $50.00 per year on each gas well from which gas only is produced while gas therefrom is not sold or used off the premises, and while said royalty is so paid, said well shall be held to be a producing well under [the habendum clause]."[76] In that case, the lessee drilled and completed a gas well before the end of the primary term that produced large quantities of gas, none of which was ever sold or used off the leased premises. The primary term ended on April 7, 1940, and the lessee did not pay the shut-in royalty until over four months later. The lessor declined the royalty and sought to terminate the lease for untimely payment. The Lessee contended the shut-in royalty could be paid anytime during the year following the expiration of the primary term. The Court held that the shut-in royalty clause must be interpreted in conjunction with the habendum clause:

> Here the parties agreed that if no gas was being produced on April 7, 1940, the lease should terminate. They further agreed that a gas well from which gas was not being sold or used off the premises was a producing well provided a royalty of fifty dollars was paid. Clearly, then, if the fifty dollars was not paid on or before April 7, 1940, gas was not being produced from the premises on that date, and the lease terminated for nonproduction. That is precisely what the contracting parties said should follow, and they were privileged to define what they meant by the phrase "producing

[72] *Id.* at *2.
[73] *Id.* at *2-3.
[74] *Id.* at n. 3.
[75] *See id.* at *3.
[76] 141 Tex. 274, 171 S.W.2d 339, 341 (1943).

> well." If [lessee] had wanted to prevent lapsation of the lease for nonproduction, they could easily have done so by paying the fifty dollars on or before the last day of the primary term. They could thus have met the condition which they imposed upon themselves when they accepted assignment of the lease. For their failure to do so they have only themselves to blame. The lease lapsed as a matter of law when they so failed, and it could not be revived by their attempt to perform the condition more than four months after the contract said it should be performed.[77]

The Court addressed the issue again in *Gulf Oil Co. v. Reid,* which involved a five year lease terminating December 9, 1948 containing a similar shut-in royalty clause.[78] A few days before the end of the primary term, Gulf began drilling its first well completing it on January 18, 1949 after expiration of the primary term. Though the well was capable of producing gas in paying quantities, Gulf shut in the well immediately due to lack of marketing facilities. On February 19, 1949, Gulf tendered the requisite shut-in royalty payment to Reid, but it was rejected. On June 7, 1949, Gulf contracted with a pipeline company to purchase the gas, and by November 22, 1949, the gathering lines were laid and connected and the well produced in paying quantities from that date forward.[79] Gulf asserted it had a reasonable time after shutting in the well to pay the shut-in royalty. The Court disagreed relying on its prior holding in *Freeman*, which the Court stated involved "similar facts, practically the only distinction being that in *Freeman* the discovery well had been brought in a few months prior to the end of the primary term."[80] The Court reiterated that the shut-in royalty must be paid on or before the date the well is shut in, because on the date the well is shut-in, no gas is being produced, actually or constructively, to continue the lease under the habendum clause.[81]

In *Hastings v. Pichinson,* two leases were at issue, both of which were effective February 9, 1958 for a one-year primary term.[82] Both leases also contained a shut-in royalty clause that precluded preservation of the leases through payment of shut-in royalties after January 9, 1960. The Hastings lease covered 188.74 acres of land and the Hastings-Cary lease covered 273.4 acres of land out of the same survey. A gas well was completed on the Hastings lease in May 1958, but no pipeline was available to market the gas. The lessee began making the requisite monthly shut-in royalty payments, and on September 18, 1958, pooled the two leases with a third tract. After the primary term of the two leases expired on February 9, 1959, the lessee contracted with a gas purchaser who began taking the gas on April 1, 1960. Shut-in royalty payments were made up through January 9, 1960. Thereafter, the lessee made a shut-in royalty payment on March 16, 1960 covering the month of February, and another payment on May 28, 1960 covering the month of March. The lessors accepted the payment for February but rejected the one for March.[83] The court held that after January 9, 1960, the lease could continue only through actual production, and the lessors' acceptance of the shut-in royalty payments after that date was technically not a shut-in royalty payment since "the contract declared against that."

> For us to write about shut-in royalty after January 9, 1960, we need to improvise a clause not found in the lease at all. It is one thing to excuse

[77] *Id.* at 342.
[78] 161 Tex. 51, 337 S.W.2d 267 (1960).
[79] *See id.* at 268.
[80] *Id.* at 271.
[81] *See id.*
[82] 370 S.W.2d 1 (Tex.Civ.App. – San Antonio 1963, no writ).
[83] *See id.* at 2-3.

> compliance, it is another to make a different contract for the parties. . . In other words, the leases terminated on January 9, 1960, and shut-in royalty was not authorized after that date.[84]

The court went on to hold that the doctrine of revivor acted to affirm the Hastings lease due to the lessor's execution of a subsequent oil-only lease, in which the lessors acknowledged the existence of the Hastings lease as to gas. However, since there was no subsequent recognition of the validity of the Hastings-Cary lease, revivor did not apply and that lease terminated effective January 9, 1960 for non-production.[85]

The Seventh Court of Appeals considered a different twist on the issue in *Steeple Oil & Gas Corp. v. J. D. Amend*.[86] The subject lease was for a six month primary term ending October 9, 1957, "and as long thereafter as oil and gas are produced from said land and land with which said land is pooled hereunder." A gas well was completed within the primary term that was capable of producing gas in paying quantities, but it was immediately shut-in. No other well was completed on the leased premises. The lease contained what the court called a "permissive shut-in clause", which contained the standard language but couched in terms of "lessee ***may*** pay as royalty $640.00 per well per year . . ."[87] The lessee tendered its first shut-in royalty payment on September 24, 1957 with a receipt stating that it covered the shut-in royalty period of August 9, 1957 to August 9, 1958.[88] The lessee tendered the next shut-in royalty payment on September 22, 1958, which was rejected by the lessor.

Distinguishing *Reid,* the court stated that the issue in the case is not whether the royalty was paid at or before the date the well was shut-in, but "whether the parties themselves may set an anniversary date for the payment of the 'production' or 'shut-in' after the 'shut-in' has taken place."[89] The court held that the lessee's initial payment receipt expressly covering the shut-in period of August 9, 1957 to August 9, 1958 and the lessor's acceptance of same, constituted an agreement by the parties to set an anniversary date of August 9th on which subsequent annual payments were due. Accordingly, the lessor was within his rights to reject the second payment made more than a month after the agreed upon anniversary date.[90] The lessee also argued the 60-day cessation of production clause applied to permit the late shut-in royalty payment, but the court relied upon *Reid* finding that there had been no production marketed prior to the shut-in, thus the provision did not apply.[91]

The issue of whether a timely payment of shut-in royalties mistakenly made to the wrong party would nevertheless continue the lease was addressed in *Amber Oil & Gas Co. v. Bratton*.[92] In that case the lessee, Amber Oil & Gas Co., completed a gas well within the primary term, but shut it in for lack of market. The subject lease was executed by the Kilcoynes, as lessors, and Lillis, as lessee in 1975. Three years later, Lillis assigned the lease to Amber, but no notice of the assignment was given to the Kilcoynes. In 1979, the Kilcoynes deeded one-half of the surface and minerals to the Brattons, who later gave written notice to Lillis of their purchase from the Kilcoynes. No finding was made as to whether Amber

[84] *Id.* at 4.
[85] *See id.* at 5; Refer also to Section V, below, regarding the doctrines of revivor and ratification.
[86] 337 S.W.2d 809 (Tex.Civ.App. – Amarillo 1960, writ ref'd n.r.e.).
[87] *Id.* at 810.
[88] *Id.* at 811.
[89] *Id.* at 810-11.
[90] *See id.* at 811.
[91] *See id.* at 813.
[92] 711 S.W.2d 741 (Tex.App. – Austin 1986, no writ).

received a copy of this notice. Amber later hired Lillis who was shown to have signed Railroad Commission forms as Amber's "authorized representative." Amber tendered shut-in royalty payments to the Kilcoynes for many years, but did not pay the Brattons their one-half share of the royalties until 1984 when Amber tendered shut-in royalties for 1984 and the previous three years. The Brattons refused the payment and contended the lease terminated as to their one-half interest.[93]

The subject lease contained a standard shut-in royalty provision requiring the annual payment of $150.00 royalty in order for the shut-in gas well to be deemed to be producing in paying quantities. Relying upon the law to the effect that mistaken payment of delay rentals terminates a lease, the court held that the same reasoning applies for mistaken payment of shut-in royalties. In that regard, the Court stated:

> Because payment of shut-in royalty is a substitute for production which keeps the lease in effect, failure to make a timely shut-in payment is the equivalent of cessation of production, and the lease automatically terminates. The rule is generally applied rigidly against the lessee because time is of the essence in an oil and gas lease.[94]

[93] *See id.* at 742-43.

[94] *Id.* at 743. The court's use of the term "cessation of production" should not be construed as coming within the definition of a cessation of production clause. As discussed below in Section IV(C), when the lessee never sold or used the oil or gas off the leased premises prior to shutting the well in, the cessation of production clause would not be triggered. In other words, Amber's failure to pay shut-in royalties should not be considered the equivalent of cessation of production, since Amber never marketed the gas before shutting the well in. Instead, it should be deemed that there was no production from the well within the meaning of the lease provisions as of the end of the primary term.

C. Interaction with cessation of production clause.

In *Shell Oil Co. v. Goodroe*, the subject lease effective August 5, 1935 contained a basic habendum clause providing a five year primary term and "as long thereafter as either oil, gas, sulphur or any other mineral is produced from said land by lessee."[95] Shell drilled and completed a gas well that produced in paying quantities until it was shut in during the secondary term on July 25, 1944 because of insufficient pressure to flow into the gas purchaser's pipeline, which was the only available market in the area. Shell attempted to fix the problem, but was unable and on October 16, 1944, paid the required shut-in royalty to the lessors for the period of July 25, 1944 to July 25, 1945, which they accepted and cashed. Eight months later, the lessors asserted that the lease had terminated. In response, Shell tendered the shut-in royalty for the next one year period, but lessors refused the payment and returned the checks.[96] The applicable shut-in royalty provision provided that "where such gas is not so sold or used lessee shall pay to lessor $50.00 per annum as royalty from each of such wells and while such royalty is so paid such well shall be held to be a producing well under [the habendum clause]."[97] The lease also contained a 90 day cessation of production clause that read:

> It is specially agreed that in the event oil, gas, sulphur or other minerals is being produced or is obtained from said premises after the expiration of the primary term hereof and said production shall for any reason cease or terminate, lessee shall have the right at any time within ninety (90) days from the cessation of such production to

[95] 197 S.W.2d 395 (Tex.Civ.App. – Texarkana 1946, writ ref'd n.r.e.).

[96] *See id.* at 397-98.

[97] *Id.* at 398.

resume drilling or mining operations in an effort to make said leased premises again produce oil, gas, sulphur or other minerals, in which event this lease shall remain in force so long as such operations are continuously prosecuted, as defined in the preceding paragraph, and if they result in production of oil, gas sulphur or other minerals, so long thereafter as oil, gas, sulphur or other minerals is produced from the premises.[98]

The lessors relied upon *Freeman,* in arguing the lease terminated because Shell failed to timely pay the shut-in royalty. The Sixth Court of Appeals distinguished *Freeman,* stating that the instant case involved a well that ceased producing during the secondary term, whereas the *Freeman* well never produced after it was completed in the primary term. As such, the court stated that Shell could essentially stack the shut-in royalty clause onto the 90 day cessation of production clause, and tender payment of the shut-in royalty within the 90 day period.[99] The court held further that Shell's tender of the second shut-in royalty payment also continued the lease, however, the lessors' refusal of such tender and execution of a top lease to a third party effectively repudiated the lease and relieved Shell of its obligations to make such tender until the dispute was settled.[100]

The Texas Supreme Court addressed the issue in *Reid*, which contained a shut-in royalty clause requiring payment of $50.00 "per well per year" and a 60 day cessation of production clause.[101] Based on *Goodroe,* Gulf argued alternatively that it could stack the shut-in royalty clause onto the 60 day cessation of production clause, the latter of which applied because a significant amount of gas was flared and a number of barrels of condensate were obtained before the well was shut in. The Court disagreed, distinguishing *Goodroe* on the basis that Shell actually marketed gas and condensate from the subject well before it ceased production, and Shell made the shut-in royalty payment, which was accepted, within the 90-day period under the cessation of production clause. Gulf, on the other hand, did not sell or use any of the gas or condensate before shutting in the well, and therefore, "there was no production from the well within the meaning of the lease provisions."

It follows, that since there had been no production, there could not be a cessation of production, and thus the 60-day clause is not available to [Gulf] to extend the term of the lease or to delay the tender of the royalty payment.[102]

A couple of years later, the Supreme Court revisited its *Reid* opinion in analyzing an almost identical fact pattern in *Skelly Oil Co. v. Harris*.[103] The *Skelly Oil* lease contained the same type of shut-in royalty clause as the *Reid* lease, however, the *Skelly Oil* Court came to a different conclusion due to the difference in the 60-day cessation of production clauses between the two leases. The *Skelly Oil* 60-day clause included the following provision:

If at the expiration of the primary term, oil, gas or other mineral is not being produced on said land, or on acreage pooled therewith, but Lessee is then engaged in drilling or reworking operations thereon. . .the lease shall remain in force ***so long as operations are prosecuted with no cessation of more than sixty (60) consecutive days, and if they result in the production of oil, gas or other mineral, so long***

98 *Id.*

99 *See id.*

100 *See id.* at 400.

101 *See Reid,* 337 S.W.2d at n.1.

102 *Id.* at 271.

103 352 S.W.2d 950 (Tex. 1962).

> ***thereafter as oil, gas or other mineral is produced from said land or acreage pooled therewith*. . .[104]

In contrast, the *Reid* 60-day clause provided:

> If, at the expiration of the primary term, oil, gas or other mineral is not being produced from the land then covered hereby, but Lessee is then engaged in operations for drilling or reworking operations on some part of the and hereunder, this lease shall not terminate if Lessee does not allow more than sixty ***(60) days to elapse between the abandonment of one well and the commencement of drilling or reworking operations on another until production is obtained***.[105]

The *Reid* Court determined this provision did not apply because there was no question that Gulf shut-in the well for lack of market and not for purposes of abandoning the well.[106] The *Skelly Oil* Court, on the other hand, determined that the language of its cessation of production clause continued the lease, such that the shut-in royalty clause was not even triggered. Because the lessee had begun drilling the subject well before expiration of the primary term, had completed the well during the secondary term and upon shutting in the well continued diligently to connect the well to a pipeline after which it produced in paying quantities without cessation, the foregoing language of the 60-day clause applied to hold the lease.[107]

In *Duke v. Sun Oil Co.*, the Fifth Circuit considered a similar fact pattern and lease provisions as that in *Skelly Oil,* except the lessee had tendered a shut-in royalty payment during the 60 day time period provided in the cessation of production clause after the subject well was shut in.[108] The 60 day clause at issue was made part of the habendum clause and provided the lease would continue as long after the primary term "as Lessee shall conduct drilling or reworking operations thereon with no cessation of more than sixty consecutive days until production results, and if production results, so long as any such mineral is produced."[109] The Fifth Circuit distinguished *Reid* for the same reason the *Skelly Oil* Court did, and took *Skelly Oil* a step further. The Court held that based on the language of the 60 day clause, the lessee had two options available to continue the lease: "within 60 days (1) he commences drilling, reworking operations, or (2) production results." Such "production" could be actual or constructive, meaning the lessee had 60 days from the date the subject well was shut-in to pay the requisite shut-in royalty.[110]

In *Marifarms Oil & Gas, Inc. v. Westhoff*, the Second Court of Appeals used some loose language in construing the shut-in royalty clause at issue, which language may cause confusion in this area.[111] At issue was what the court identified as a "90-day shut-in well clause" that provided the lessee may pay an annual royalty and upon payment, "it shall be considered under all provisions of the lease that gas is being produced in paying quantities for one year from the date of payment."[112] The court did not set forth the exact language of the "shut-in well clause," but based on the limited description provided, it is assumed the 90-day provision required the lessee to tender the requisite shut-in royalty payment within 90 days of shutting the well in. The lease also contained a 60-day cessation of production

[104] *Id.* at n. 1. (emphasis added)
[105] *Reid,* 337 S.W.2d at n.1. (emphasis added).
[106] *See id.* at 271-72.
[107] *See Skelly Oil Co.,* 352 S.W.2d at 954.
[108] 320 F.2d 853 (5th Cir. 1963).
[109] *Id.* at 857.
[110] *See id.* at 861.
[111] 802 S.W.2d 123 (Tex.App. – Ft. Worth 1991, no writ).
[112] *Id.* at 125.

clause. The subject well was shut-in for 84 days, and accordingly, the court held that the cessation of production clause did not apply; only the shut-in royalty clause controlled the outcome. The court referenced *Freeman* for the proposition that advance payment of the shut-in royalty (presumably before the end of the 90 day period) is required to keep the lease alive. Accordingly, the court said the only "question remaining concerns the timeliness of that advance payment." Yet, later in the same paragraph the court recites the fact that "[n]o shut-in royalty was ever paid by the parties before us." [113] The discussion should begin and end there, but before coming to that conclusion, the court loosely discussed the holdings of *Goodroe, Reid* and *Duke* resulting in unnecessary confusion of those cases.

The court began with its reading of *Goodroe* as standing for the blanket rule "that if a lease contained both a cessation of production clause and a shut-in royalty provision, then to preserve the lease, it was necessary to make the shut-in royalty payment within the time period stated in the cessation of production clause."[114] Of course, as discussed above, the *Goodroe* court came to such holding by distinguishing the *Freeman* case and finding that Shell shut in the well during the secondary term and marketed the gas and condensate prior thereto. These two facts taken together triggered the 90 day cessation of production clause and the lessee was then permitted to stack the shut-in royalty clause on top taking advantage of the 90 day time period. The *Marifarms Oil & Gas* court's language suggests a lessee can rely on the cessation of production clause even if the well was shut in immediately during the primary term without any marketing of the oil or gas, which is incorrect.

The court then characterized the *Reid* decision as having "pulled in the reins even stronger deciding that even where the shut-in royalty payment was made one month after the well was shut-in, it did not continue the lease."[115] In reality, the Supreme Court did not tighten the reins, but merely reiterated its prior holding in *Freeman* and affirmed the *Goodroe* holding based on the distinguishable facts presented there. While the *Marifarms Oil & Gas* court referenced the *Reid* Court's treatment of *Goodroe,* it failed to recognize the reason for such treatment.[116]

Finally, the court referenced the Fifth Circuit's opinion in *Duke v. Sun Oil Co.,* stating that the *Duke* Court followed "the reasoning in *Goodroe* holding again that the shut-in royalty payment must be paid within the time given in the cessation of production clause else the lease terminates."[117] The Fifth Circuit, however, never mentioned the *Goodroe* case, but rather primarily relied upon the specific language of the lease at issue and the holding in *Skelly Oil*. Moreover, none of the aforementioned opinions involved a 90-day "shut-in well" provision. Practitioners should be careful when affirmatively using the *Marifarms Oil and Gas* opinion, or more likely, in responding to its application in your case.

V. Ratification and Revivor

The general statement of the doctrines of revivor and ratification are well-settled in Texas law. Over the years, many legal scholars have provided their analysis of these doctrines and how they have been referred to interchangeably by earlier courts.[118] It appears now that courts have

113 *Id.* at 125-26.
114 *Id.* at 126.

115 *Id.*
116 *Id.* at 126.
117 *Id.*
118 *See e.g.,* Elizabeth N. Miller, *Lease Preservation and Maintenance: The Defenses of Estoppel, Revivor and Ratification,* 7th Annual Advanced Oil, Gas & Energy Resources Law Course, Sept. 1989; Jesse R. Pierce & William R. Burns, *Termination of Oil, Gas and Mineral Leases: Savings Clauses and Defensive Doctrines,* 26th Annual Advanced Oil, Gas & Energy Resources Law Course, Sept. 2008.

the doctrines clarified and understood. Accordingly, this article will discuss the most recent cases in an effort to bring the doctrines current for readers.

Revivor applies to a lifeless deed or lease that terminated under its own terms. The deed or lease is deemed to be revived by the subsequent execution of a formal document, even to a third person, which expressly recognizes in clear language the validity of the lifeless deed or lease.[119] "The subsequent formal document must make a sufficient reference to the lease to revive it."[120] Revivor is treated as "the granting of a new estate in land."[121] Ratification, on the other hand, requires the same subsequent execution of a formal document, but one that recognizes the validity of a deed or lease that was void from the outset.[122] Both doctrines are affirmative defenses that must be pled.

In *Cannon v. Sun-Key Oil Co., Inc.,* discussed above in Section III(A), as an affirmative defense to Cannon's lease termination claim, Sun-Key Oil asserted revivor.[123]

After stating the elements of revivor, the Eleventh Court of Appeals cited Williams & Meyers for the proposition that "because revivor grants a new estate in land, the estate 'should not be held to have been granted without a showing of intent to grant it."[124] Sun-Key relied upon five separate documents in support of its defense of revivor. The first two documents were letters from Cannon's attorney, Durham, to Sun-Key dated October 23, 1997 and December 10, 1997. In the letters, Durham referred to the Special Warranty Deed under which Cannon received title to the land, stating that the Deed conveyed ½ of the oil, gas and other minerals in the land and that Cannon was entitled to receive the benefits of "Grantee's Mineral Estate" effective August 28, 1997. The Court held that this language and reference to "Grantee's Mineral Estate" was not sufficient for revivor, as it "did not refer to any leases, much less recognize the validity of any leases." In his letters, Durham also demanded that Sun-Key "take appropriate action as required by law, applicable mineral leases and other documents pertaining to the property to protect Mr. Cannon's livestock from [their] well sites, pipelines, etc." Though the letter refers to "applicable mineral leases," the Court held that this language "did not recognize that there were, in fact, any applicable leases."[125]

The next two documents Sun-Key relied upon were a December 5, 1997 and January 26, 1998 letter from Cannon notifying Sun-Key that he had purchased the surface and mineral estates in the Parkey Ranch. Cannon also requested that the lessee change its records to reflect that royalties were to be paid to him and that the lessee's well locations were causing risks to his livestock, property and people. The January 26, 1998 letter followed up on the fact that the lessee had not corrected the deficiencies in the well sites to protect Cannon's livestock and property. The Court held that because these letters did not reference any oil and gas leases or recognize the validity of any leases, they did not support revivor.[126]

The final document Sun-Key relied upon was the August 28, 1997 Special Warranty Deed itself. The Deed provided that it was subject to "all valid and subsisting, outstanding and duly recorded oil and gas leases, which are vested in

[119] *See Wright v. E.P. Operating. Ltd. P'ship.,* 978 S.W.2d 684, 688 (Tex.App. – Eastland 1998, pet. denied); *Westbrook v. Atlantic Richfield Co.,* 502 S.W.2d 551, 555-56 (Tex. 1974).
[120] *Cannon,* 117 S.W.3d at 420.
[121] *Wright,* 978 S.W.2d at 688.
[122] *See Bradley v. Avery,* 746 S.W.2d 341 (Tex.App. – Austin 1988, no writ).
[123] *Cannon,* 117 S.W.3d at 418-19.
[124] *Id.* at 420

[125] *Id.*
[126] *See id.* at 420-21.

parties other than Grantor as of the date hereof." The Court held that this language was insufficient to support revivor because "the deed did not identify any valid and subsisting leases, nor did it refer to any specific leases."[127] In conclusion, the Court held:

> The letters and deed did not refer to the Lease, much less contain language showing an intent to grant a new estate in the 352 acres. They did not contain language to the effect that the property was subject to the lease. They did not recognize the clear language of validity of the Lease. They did not revive the Lease.[128]

In *Sun-Key Oil Co., Inc. v. Whealy,* 2006 WL 3114466 (Tex.App. – Ft. Worth Nov. 2, 2006), the Second Court of Appeals considered the doctrine of ratification. In that case, Sun-Key was the lessee under a November 1, 1999 oil and gas lease with the Grays covering approximately 312.1 acres of land ("the Gray lease"), but the Court determined that the description of the land in the lease was insufficient "to allow the property conveyed in the lease to be identified with reasonable certainty." Therefore, the Court held the Gray lease was void as it did not comply with the statute of frauds.[129] After execution of the lease, on August 3, 2001, Whealy received title to 148.525 acres of land covered by the same survey in which the leased land was located from the Benjamin Bernard Udd and Dovie G. Udd Living Trust, to whom the Grays had previously conveyed the tract. On April 6, 2005, the Grays executed a mineral deed to Whealy covering the 148.525 acre tract and made the deed "subject to" the Gray lease. The Grays reserved a nonparticipating royalty interest in the event the Gray lease was later deemed to be cancelled or forfeited. On that same day, Whealy filed her Petition asserting that the Gray lease was void due to the insufficient description of the land. Thereafter on September 28, 2005, Sun-Key and the Grays executed an Amendment to the Gray Lease in order to correct the defect in the legal description of the land, and provided that the amendment was to be retroactively effective to the date of the original lease.[130]

In response to Whealy's claim that the Gray lease was void, Sun-Key argued that Whealy was prevented from denying the lease's validity under the doctrine of "revivor" because Whealy accepted the mineral deed from the Grays "subject to" the Gray lease. The Court noted that since the Gray lease was void from the beginning, Sun-Key was actually arguing the doctrine of ratification and not revivor, because Sun-Key was attempting to breathe life into an inoperative or invalid lease. Nevertheless, the Court held that Whealy could not ratify the Gray lease because as of the date of the deed, the lease still contained the invalid description of the land, and such defect was not remedied by the deed. Regarding the amendment executed by the Grays and Sun-Key, the Court held that such amendment was ineffective because at the time the Grays executed the amendment they owned only a nonparticipating royalty interest and Whealy owned the executive right.[131]

VI. Conclusion

As shown above, the legal landscape concerning lease preservation can be confusing, even to appellate courts. The reason being, every case presents different factual scenarios that courts do their best to fit within existing law. More and more lessors are becoming educated about their leases and what requirements are placed on their lessee to hold the lease. Therefore, it is incumbent upon lessees to

[127] *Id.* at 421.
[128] *Id.*
[129] *Id.* at *4.
[130] *See id.*
[131] *See id.* at *4-5.

pay close attention to the language of their leases, and determine what specific action is appropriate and necessary to preserve a lease.