Money for Nothing — Shut-In
Royalty Clauses in Oil and Gas Leases

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§ 15.01  Introduction.

Shut-in clauses are well known to all parties in the natural gas industry. The typical shut in clause permits the lessee of a gas well to shut in the well in return for making payment of a contractually specified amount to the lessor. The primary purpose of the shut-in clause is to permit the lessee to hold onto its lease despite the fact that the well is not producing in paying quantities.

Although simple in concept, shut-in clauses have been frequently litigated. The issues litigated depend on the language of the specific lease and the facts of each case. Certain issues, however, resurface with regularity. For example, many cases involve claims by lessors seeking to invalidate a lease on a shut-in well based on the claim that the well is not capable of producing in paying quantities. Other frequently litigated issues are whether the acceptance of shut-in payments estops the lessor from seeking termination of the lease; whether failure to make shut-in payments automatically terminates the lease or merely entitles the lessor to recover breach of contract damages; when shut-in payments are required to be made; and who the proper parties are to receive the payments.

The Eastern Mineral Law Foundation last addressed the interpretation and operation of shut-in clauses in 1984.1 This chapter will focus primarily

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on the shut-in clause cases litigated since 1984 and suggest drafting solutions to avoid those problems. Because any contract drafter knows that litigants can crawl through the narrowest of cracks in any contract, this article will also discuss current or likely future issues involving the interpretation or operation of shut-in clauses.

§ 15.02. Typical Shut-In Royalty Clauses.

There is no uniform shut-in clause and slight differences in language have led to different results in the reported cases. Moreover, the shut-in clause cannot be read in isolation but rather must be read in the context of the entire lease. Those disclaimers aside, the following are examples of typical shut-in clauses:

A. Where gas from any well or wells capable of producing gas, . . . is not sold or used during or after the primary term and this lease is not otherwise maintained in effect, Lessee may pay or tender as shut-in royalty to the party or parties shown by Lessee’s records to be entitled to receive royalties on actual production of gas . . . payable annually on or before the end of each twelve-month period during which said gas is not sold or used and this lease is not otherwise maintained in force, and if such shut-in royalty is so paid or tendered and while Lessee’s right to pay or tender same is accruing, it shall be considered that gas is being produced in paying quantities, and this lease shall remain in force . . . . During any period while Lessee’s right to pay or tender any shut-in royalty is accruing, Lessee may commence or resume operations or production and this lease shall remain in force as though shut-in royalty had been duly paid down to such commencement or resumption.2

B. If at any time after the expiration of the primary term of this lease, there is any gas well on land covered hereby, which is capable of producing in paying quantities, but is shut in for

a period of 90 days, either before or after production therefrom, and the production is not being sold or used and such lease acreage is not being held by any other terms or provisions hereof, Lessee agrees to pay or tender to the mineral owners entitled to receive same, a royalty, which shall be a sum equal to one dollar per acre for all that part of the premises included in the unit of said shut-in well. Such payment shall be made on or before 90 days after expiration of the 90 days from the date the well is shut in. This shut-in royalty shall have the effect of holding the lease as to said lands for one year from the date the well is shut in.3

C. LESSEE shall be obligated to pay or tender to LESSOR within 60 days after any such well is shut in and each anniversary thereafter, as royalty, an amount equal to $300 per year it being the intention of the parties that this lease shall remain in full force and effect for 60 days after shutting in any well without payment.4

D. If Lessee obtains production of minerals on said land or on land with which the lease premises or any portion thereof has been posted, and if, during the life of this lease either before or after the expiration of the primary term, all such production is shut in by reason of force majeure or the lack either of a market at the well or wells or of an available pipeline outlet in the field, this lease shall not terminate but shall continue in effect during such shut-in period as though production were actually being obtained on the premises . . ., and, during the month of January of each year immediately succeeding any year in which a shut-in period occurred when all such production was so shut in, Lessee shall pay or tender, by check or draft of Lessee, to the royalty owners as royalty.

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for each full calendar month in the preceding calendar year that this lease was continued in force solely and exclusively by reason of the foregoing provisions of this paragraph. The owners of the royalty as of the date of such payment shall be entitled thereto in proportion to their ownership of the royalty. The provision of this paragraph shall be recurring at all times during the life of this lease. Nothing in this paragraph contained shall abridge the right of Lessee to otherwise maintain this lease in force and effect under its other provisions, and for any part of a shut-in period that this lease is otherwise being maintained in force and effect no shut-in royalty shall be due. 5

§ 15.03. Purpose of Shut-In Royalty Clauses.

The primary purpose of an oil and gas lease is to encourage the diligent production and marketing of the minerals from the well. The parties expect the lessee to earn revenues from the oil and gas produced while the lessor profits from its ownership of the estate. To accommodate the contracting parties' expectations, modern habendum clauses in oil and gas leases generally provide that the lease terminates upon the expiration of the primary term unless there is production. Specifically, the typical habendum clause of a modern oil and gas lease provides that the lease shall endure for a fixed number of years (the primary term), and as long thereafter as oil, gas or other minerals are produced in paying quantities. 6 There are a number of variant forms, but the following is an example of a typical habendum clause:

Subject to the other provisions herein contained, this lease shall be for a period of five years from this date (called “primary term”) and as long thereafter as (1) oil, gas, sulphur, or other mineral is produced from said land hereunder or from


6 3 Williams, Oil and Gas Law § 603, p. 20 (1992) [Hereafter cited as __ Williams § __, p. ___.].
land pooled therewith, or (2) it is maintained in force in any other manner herein provided.  

The modern habendum clause, such as the one above, “with its short primary term and its ‘thereafter’ provision, is designed to measure the duration of the oil and gas lease by its primary objective, the production of oil or gas.” The lessor is assured that the oil or gas will be produced from the well, resulting in a royalty, or the lease will terminate at the end of the primary term. The lessee is assured a fixed period of time for obtaining production and for maintaining the lease as long as production in paying quantities continues.

The problem with this rationale arises when the well, although capable of production in paying quantities, is not producing, and thus the lessor is not receiving a production royalty. To address this dilemma, shut-in royalty clauses were first developed and incorporated in oil and gas leases in the 1930s. Their purpose was (and is) to protect against automatic termination of a lease when a well is drilled and no market exists for the gas. The shut-in clause provides relief from actual production and marketing requirements by permitting lessees, who have discovered oil or gas, to extend or maintain the lease by payment of a fixed money royalty in lieu of an actual production royalty.

Although shut-in royalty clauses are premised on the assumption that the lease would terminate upon the expiration of the primary term, absent some actual production and marketing to extend the lease into the secondary term, this assumption is not correct in all states. There are well-defined majority and minority views on whether production is required to extend a lease beyond its primary term.

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8 3 Williams § 604, p.41.
9 Id.
10 Id.
11 Because oil can be taken from the ground and stored in tanks while awaiting shipment by rail or truck to a market, shut-in royalty cases are typically confined to gas which can only be stored in the station in which it is found and transported to a market through a pipeline. See e.g., 2 Summers, Oil and Gas § 299, p. 222-23 (1959 and Supp. 1995) [Hereafter cited as __ Summers § ___, p.___.].
12 Id.
[1] — The Majority View — Actual Production and Marketing Are Required to Extend and Maintain the Lease.

In a majority of states, including California, Colorado, Illinois, Indiana, Kansas, Louisiana, Michigan, New York, Ohio, Pennsylvania, Tennessee and Texas, “production” — as that term is used in the habendum clause of an oil and gas lease — requires actual production and marketing to extend the lease beyond its primary term. The shut-in royalty clause modifies the habendum clause by providing for shut-in payments (or in some clauses, the existence of a shut-in well) as substitute or constructive production which will extend or maintain the lease.

13 Lough v. Coal Oil, Inc., 266 Cal. Rptr. 611, 615 (Cal. Int. App. Ct. 1990)(explaining that the “so long thereafter” habendum clause creates a determinable fee that terminates upon the occurrence of a specified event with no notice required).
14 Davis v. Cramer, 793 P.2d 605 (Colo. Int. App. Ct. 1990), rev’d on other grounds, 808 P.2d 358 (Colo. 1991)(construing the shut-in royalty clause as a special limitation so that shut-in payments were required to maintain the lease in force); Eitel v. Alford, 257 P.2d 955 (Colo. 1953)(requiring production to extend a lease beyond the primary term).
18 Landry v. Flaitz, 157 So. 2d 892 (La. 1963); Lelong v. Richardson, 126 So. 2d 819 (La. Int. App. Ct. 1961)(quoted in Acquisitions, Inc. v. Frontier Explorations, Inc., 432 So. 2d 1095, 1098 (La. Int. App. Ct. 1983) for stating that a lease will terminate under the habendum clause if the lessee is unable to produce gas after the primary term).
22 Cassel v. Crothers, 44 A. 446 (Pa. 1899).
Under the typical shut-in clause, as construed in majority-view jurisdictions, where a well is shut in and the lessee fails to pay the shut-in royalty as provided for in the lease, the lease automatically terminates. The shut-in royalty clause operates as a special limitation to the lease, and as a result, “a failure to make the required shut-in gas royalty payments will result in the automatic termination of the lease if the lease is not held pursuant to the provisions of another clause in the lease.”

For example, in *Amber Oil and Gas Co. v. Bratton*, the court recognized that “[i]n the absence of actual production, an oil and gas lease will not continue in effect beyond the primary term unless a timely payment of shut-in royalties is made.”

The lease creates a fee simple determinable or defeasible *profit-a-prende* in the lessee, which terminates upon the cessation of production in paying quantities. The payment of a shut-in royalty acts as a substitute for production which enables the lessee to extend or maintain the lease. Under these circumstances, the “failure to make a timely shut-in payment is the equivalent of cessation of production, and the lease automatically terminates.”

This basic rule must be viewed as a rule of construction (albeit one that can be overcome only with clearly expressed language.) Nevertheless, if the *mere existence* shut-in clause is worded so that the mere existence of a shut-in well extends the lease, and if the payment of shut-in royalty is expressed as a covenant (*i.e.*, promise to pay), then failure to pay the shut-in royalty should be construed as the breach of a promise giving rise only to damages, not lease termination.

The proper tendering of shut-in royalty payments does not permit the lessee to maintain the lease indefinitely. The lessee must still comply with the implied covenant to diligently market the gas. In *American Energy*
Services, Inc. v. Lekan, the lessee completed and shut in a well in September, 1973. Since that time, the well was never connected to a gas gathering line for purposes of production and marketing. Instead, the lessee tendered shut-in royalties to the record owners of the land every year for a total of 17 years.

The court determined that the potential for production was insufficient to maintain a lease beyond the primary term. According to the court, “[t]he law of Ohio requires that potential production be translated into actual production.” However, where the lessee is unable to produce and market the gas, the payment of a shut-in royalty preserves the lease until such time as the gas can be produced and marketed.

Although a shut-in royalty provision is a savings clause, the court noted that “it certainly does not negate the duty to use due diligence to sell the production.” The court explained that in addition to the requirement of production, every lease, unless it is specifically excluded, contains an implied covenant that the lessee will market the gas produced from the well with due diligence. Furthermore, the implied covenant is not eliminated by the shut-in royalty clause.

The remedy for a breach of the implied covenant to market typically is damages when the grounds for forfeiture are specified in the lease. However, forfeiture will be granted “when necessary to do justice to the parties,” even though the lease provides specific grounds for forfeiture. In Lekan, the court held that in order to “do justice to all of the parties” it was declaring a forfeiture of the lease, because the lessee demonstrated a

30 Id. at 1318-19.
31 Id. at 1320.
32 Id. at 1322.
33 Id.
34 Id. at 1321.
35 Id. at 1322.
36 Id.
37 Id. (quoting from Ionno v. Glen-Gery Corp., 443 N.E.2d 504 (Ohio 1983)). See Beer v. Griffith, 399 N.E.2d 1227 (Ohio 1980)(noting that where a lessee has violated an implied covenant and legal remedies are inadequate, forfeiture of the oil and gas lease, in whole or in part, is an appropriate remedy).
complete disregard for the rights of the lessor by shutting in the well immediately upon completion and failing to produce and market the gas at any time during the 17-year period.\(^{38}\)

**[a] — Louisiana’s Statutory Notice and Delay Requirement.**

Louisiana has modified by statute the majority view as it pertains to royalty payments. Before the adoption of the present provisions of the Louisiana Mineral Code, the failure to properly tender shut-in payments would result in the automatic termination of the oil and gas lease.\(^{39}\) However, the Mineral Code has all but eliminated the remedy of cancellation for the improper payment of shut-in royalties by expressly disfavoring cancellation and requiring written notice of default.\(^{40}\)

Specifically, the Mineral Code requires written notice of default and a period of delay to allow time for the lessee to cure the default as a prerequisite to a judicial demand for damages or dissolution of a lease due to the lessee’s failure to make timely or proper royalty payments.\(^{41}\) As for the cancellation of the lease, the Mineral Code provides:

\[\text{[i]n a case where notice of failure to pay royalties is required, dissolution should be granted only if the conduct of the lessee, either in failing to pay originally or in failing to pay in response to the required notice, is such that the remedy of damages is inadequate to do justice.}\(^{42}\)

In *Acquisitions, Inc. v. Frontier Explorations, Inc.*,\(^ {43}\) the court determined that the shut-in payment was a royalty. Accordingly, notices


\(^{39}\) *See* *Acquisitions, Inc. v. Frontier Explorations, Inc.*, 432 So. 2d 1095, 1098 (La. Int. App. Ct. 1983).

\(^{40}\) *Id.* at 1100. The emphasis is on royalties because the statutory notice and delay requirements do not apply to rental payments.


\(^{42}\) *Id.* at § 31.141.

of nonpayment of the shut-in royalties and following delays were required pursuant to the Mineral Code. Because the lessee tendered payment of all the delinquent shut-in royalties before the statutory 30-day delay period expired, the remedy of cancellation was no longer available to the lessors.44

Louisiana has further neutralized the harsh effects of the majority view by requiring the lessor to give notice to the lessee of a breach of the lease and provide an opportunity for the lessee to correct the breach before the lease terminates. This same result can be achieved in the other majority view states by inserting in the lease a notice before termination clause that is expressly drafted to apply to the failure to pay shut-in royalties properly.45 However, the lessee should not rely in bad faith on such clauses to avoid tendering shut-in royalties on a timely basis. Presumably, an oil and gas lease and all provisions contained therein, including the shut-in royalty clause, impose on each party an implied duty of good faith and fair dealing in its performance and enforcement of the lease.46 This duty requires that neither party do anything that will injure the right of the other to receive the benefits of the agreement.47 The courts may not be willing to honor notice before termination clauses in such situations where the lessee has deliberately refused to tender proper shut-in payments. Moreover, notice before termination clauses should not be used in those states where the failure to properly tender a shut-in royalty payment would not result in automatic termination of the lease. Such clause could create a right of termination that the lessor would not have otherwise had.


The minority view holds that the mere existence of a well capable of production is sufficient to extend or maintain an oil and gas lease beyond the primary term, provided that the lessee is reasonably diligent in its

44 Id. at 1101-02.
45 See Lowe, Shut-In Royalty Payments, at 18-34 and 18-35 (providing an excellent example of a notice before termination clause).
47 Id.
marketing efforts. In these minority view states, which include Kentucky, Oklahoma, and West Virginia, the lease will not automatically terminate at the end of the primary term if the lessee has not commenced production. In other words, the mere existence of a shut-in well capable of production in paying quantities is sufficient to perpetuate the lease beyond the primary term. Although the need for a shut-in royalty clause is not as acute, shut-in royalty clauses are nevertheless found in leases in these states. Because it often takes years for lessees to develop a sufficient number of producing wells to justify connection to a pipeline, lessees in these states have found that shut-in royalty clauses provide a convenient safeguard to ensure lease extension and maintenance throughout extended periods of lease development.

As in the case of the majority view, the minority view is a rule of construction, not a rule of law, that is difficult to overcome, absent express language to the contrary. There is no reason why a shut-in clause could not be drafted so as to result in automatic lease termination in the absence of a timely and proper payment.

Roye Realty & Developing, Inc. v. Watson, provides an excellent illustration of the minority view. The plaintiffs claimed that the lease had terminated, because the lessee failed to make a timely payment of the

48 See e.g., Pack v. Santa Fe Minerals, a Div. of Santa Fe Int’l Corp., 869 P.2d 323 (Okla. 1994)(noting that a shut-in royalty clause is not required to extend or maintain an oil or gas lease after a commercial discovery satisfies the habendum clause).
49 Greene v. Coffey, 689 S.W.2d 603 (Ky. Int. App. Ct. 1985)(referring to the Hutchinson case); Hutchinson v. Schneeberger, 374 S.W.2d 483 (Ky. 1964)(holding that “a lessee who in good faith is prosecuting work for development with reasonable diligence will be protected against cancellation of his lease”); Pennagrade Oil & Gas Co. v. Martin, 277 S.W. 302 (Ky. 1925)(holding that a delay in marketing did not result in an abandonment of the lease).
first shut-in royalty at the end of the primary term. The court explained that under Oklahoma law, an oil and gas lease cannot be canceled for failure on the part of the lessee to pay royalties unless the lease specifically provides otherwise. Moreover, even when a lease contains a shut-in royalty clause, discovery of minerals in paying quantities during the primary term is sufficient to extend the lease into the secondary term. The court explained:

[N]either nonpayment of shut-in royalty after the end of the primary term, nor the failure to secure actual production prior to the end of the shut-in royalty period will terminate the lease if the lessee is acting as a reasonably prudent lessee under the circumstances in securing actual production.

The court found no provision in the lease specifically granting the lessor the right to declare forfeiture of the lease due to the failure of the lessee to pay shut-in royalties. Because the lessee had discovered gas in paying quantities, the court held that the lessee had presented prima facie evidence of a valid oil and gas lease.

Danne v. Texaco Exploration and Production, Inc., provides another example of the application of the minority view. In Danne, the plaintiffs sought termination of the lease, because the lessee failed to diligently market the gas and tender shut-in royalty payments for four years after the well was shut in. The court emphasized (in an opinion that arguably misconstrues prior precedent) that Oklahoma does not take the view that habendum clauses are special limitations which automatically terminate upon the happening of a condition; rather, Oklahoma regards the habendum clause as a condition subsequent creating only a right of entry in the lessor.

53 Id. at 823.
54 Id.
56 Id. at 824.
57 Id.
59 Id. at 212.
The lessor must bring a separate forfeiture action to terminate the lease.\(^{60}\) Once the lessee has discovered gas in paying quantities, no automatic termination can be tolerated because the lessee has established a right to develop the gas. Moreover, the lessee must be given a reasonable opportunity to develop the gas without the unreasonable fear of forfeiture.\(^{61}\)

Although the lease did not automatically terminate, the plaintiff in Danne claimed that the lease should be terminated because the lessee failed to make shut-in payments as directed by the terms of the lease. The court declared that, “"[u]nless 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."\(^{62}\) The shut-in royalty clause provided:

> During any period (whether before or after expiration of the primary term hereof) when gas is not being sold or used and the well or wells are shut-in and there is no current production of oil or operations on said leased premises sufficient to keep this lease in force, Lessee shall pay or tender a royalty of One Dollar ($1.00) per year per net royalty acre retained hereunder, such payment or tender to be made, on or before the anniversary date of this lease next ensuing after the expiration of ninety (90) days from the date such well is shut in and thereafter on the anniversary date of this lease during

\(^{60}\) Id. at 213. Oklahoma has a strong policy against forfeiture of estates which has been codified at 23 O.S. 1971 § 2. It clearly requires courts to avoid forfeiture by giving consideration to compelling equitable circumstances. Id. at 214 (quoting excerpts from Stewart v. Amerada Hess Corp., 604 P.2d 854, 858 (Okla. 1979)). However, “[i]n Oklahoma it is settled that, absent third party error, a lease will automatically terminate by its own terms due to lessee’s failure to pay delay rental payments [in the primary term].” Duer v. Hoover & Bracken Energies, Inc., 753 P.2d 395, 398 (Okla. Int. App. Ct. 1986)(emphasis added). If the lessee fails to discover gas during the primary term, the estate created under the lease is not forfeited per se; it simply ceases to exist by its own terms. Danne, 883 P.2d at 214. The public policy against forfeiture is not offended because automatic termination in this situation does not divest the lessee of valuable assets. See Id.

\(^{61}\) Danne, 883 P.2d at 214.

\(^{62}\) Id. at 215. See Pack v. Santa Fe Minerals, a Div. of Santa Fe Int'l Corp., 869 P.2d 323, 330 (Okla. 1994)(holding that “failure to pay shut-in royalties in and of itself does not operate to cause a termination of the lease”).
the period such well is shut in, or to the royalty owners or the royalty owners' credit in the rental depository bank hereinafter designated. When such payment or tender is made it will be considered that gas is being produced within the meaning of the entire lease.63

Although the shut in clause required that royalties be paid annually to the lessor when a producing well is shut in, the court held that the lessee’s failure to timely tender shut-in royalties did not result in automatic forfeiture of the lease because the lease did not expressly state that a forfeiture is mandated under these circumstances.64 Note the strength of the minority-rule of construction: the clause specifically stated that the lease would be considered as production when such payment or tender is made. . . . “ Arguably, this expressly states that the shut-in payment must be paid to save the lease. This could certainly be the result in majority-view jurisdictions.

However, even under the minority view, forfeiture may still result if a separate action is brought and it is demonstrated that the lessee failed to market the gas with due diligence. Under either the majority or the minority view, there is an implied covenant to market with due diligence in every oil and gas lease.65 The lessee has a “reasonable time,” which is dependent on the facts and circumstances of each case, to obtain a market and begin producing the gas.66 In Danne, the lessee maintained that the well was

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63 Danne, 883 P.2d at 215.
64 Id.
65 Id. at 217. See Pack, 869 P.2d at 330 (stating the longstanding rule that oil and gas leases contain an implied covenant to market the product).
66 Danne, 883 P.2d at 217; Pack, 869 P.2d at 330. In Pack, the Oklahoma Supreme Court quoted from one of its earlier decisions:

In other words in the absence of the specific clause requiring marketing within the primary term fixed in the lease, the completion of a well, as provided therein, capable of producing oil or gas in paying quantities will extend such term, provided that within a reasonable time the actual length of which must of necessity depend upon the facts and circumstances of each case, a market is obtained and oil or gas is produced and sold from such well. In such event if the producing and marketing thereof in such quantities from the well so completed is continued, the lease will extend until the economic exhaustion of the product.

Id.
shut in by mistake, but acknowledged that during the first two years of the shut-in, a purchaser for the casinghead gas had a meter at the well and could have purchased the gas at spot-market prices. Because the lessee failed to market the gas to a readily available purchaser, the Danne court upheld the trial court’s decision to terminate the lease based on the lessee’s failure to diligently market the gas. 67

[a] — The Express Language of the Shut-In Royalty Clause Could Override the Benefits of the Minority View.

Although the common law in the minority of states does not impose automatic termination upon the failure to pay shut-in royalties, a poorly drafted shut-in royalty clause could extinguish the protections of the common law.

In Blaser Farms, Inc. v. Anadarko Petroleum Corp., 68 the well was shut in during the primary term, and shut-in payments were tendered and accepted by the lessor for two years. The third yearly payment, which was payable after the expiration of the primary term, was not timely tendered, and the lessor subsequently rejected the lessee’s tardy tender. 69 Because of the language used in the shut-in clause, the court declared that the shut-in royalty clause operated as a special limitation. 70

67 Danne, 883 P.2d at 217.
69 Id. at 261.
70 Id. at 261. The relevant portion of the shut-in royalty clause states:

Notwithstanding anything in this lease to the contrary, it is expressly agreed that if the Lessee shall commence drilling operations within the primary term of this lease or upon a consolidated gas unit of which this lease is a part and shall complete a well capable of producing gas in paying quantities, this lease shall remain in force and its term shall continue only in the event either (a) pipeline connections are made within one (1) year from the date the well is completed and shut-in; or (b) in the event pipeline connections have not been made within said one (1) year, the Lessee shall pay or tender to the Lessor a royalty being referred to as substitute royalty in the amount of $3.00 per acre, per year; or (c) if pipeline connections are not made within two (2) years from date the well is shut in, then the Lessee
However, the court also emphasized that “under Oklahoma law such provisions do not operate exactly like common law defeasible estates. Oklahoma permits the application of ameliorating equitable considerations in these substitute royalty cases notwithstanding their facial similarity to defeasible estates created by special limitation language.”71 In this case the lessee had successfully connected the well to a pipeline three months after the shut-in payment was due and the lessee incurred significant costs in doing so.72 The court found these equitable circumstances sufficient to prevent the automatic termination of the lease.73

§ 1.04. Scope of the Shut-In Royalty Clause.

[1] — The Shut-In Well Must Be Capable of Producing in Paying Quantities.

Generally, a shut-in well can be defined as broadly as “one or more wells where gas is not sold or used.” However, courts have consistently required that a shut-in well be capable of production in “paying quantities,” even though the shut-in royalty clause makes no mention of capacity for paying production.74 Paying quantities has been defined as a profit to the

shall pay or tender to the Lessor a royalty hereafter referred to as substitute royalty in the amount of $5.00 per acre, per year.

Id. at 262-63.

72 Id. at 262.

73 Id. at 264.

74 See Pack v. Santa Fe Minerals, a Div.of Santa Fe Int’l Corp., 869 P.2d 323 (Okla. 1994)(stating that “[t]his Court has long held that the terms ‘produced’ and ‘produced in paying quantities’ have substantially the same meaning”); Hydrocarbon Management, Inc. v. Tracker Exploration, Inc., 861 S.W.2d 427 (Tex. Int. App. Ct. 1993)(ruling that the shut-in royalty clause “must be capable of producing gas in paying quantities at the time it is shut-in” even though the clause makes no mention of capacity for paying production); Tucker v. Hugoton Energy Corp., 855 P.2d 929 (Kan. 1993)(noting that “[a]lthough the phrase ‘in paying quantities’ may not appear in oil and gas leases, it implicitly is a part of the habendum clause.”); West Bay Exploration Co. v. Amoco Prod. Co., 384 N.W.2d 407 (Mich. Int. App. Ct. 1986)(construing the term “production” “to mean production in paying quantities sufficient to yield a return in excess of operating costs”), vacated on other grounds, 389 N.W.2d 865 (Mich. 1986), remanded, 399 N.W.2d 549 (Mich. Int. App. Ct. 1986)(affirming the original decision); Griffin v. Crutcher-Tufts Corp., 500 So. 2d 1008 (Ala. 1986)(“Clearly, the tender of shut-in royalty payments will not keep a lease alive unless the well that was shut in is capable of production in
lessee, however small, over operating and marketing expenses, even if drilling and equipment costs might never be recovered.  

[a] — Where the Well Is Shut In After Production.

*Hydrocarbon Management, Inc. v. Tracker Exploration, Inc.*, illustrates the analysis the courts perform to determine whether a shut-in well is capable of production in paying quantities. In *Hydrocarbon*, the lease had been extended into its secondary term when the well stopped producing for over six months due to mechanical difficulties.

The court emphasized that for a well to be maintained by the shut-in royalty clause, it must be capable of production in paying quantities at the time the well is shut in, regardless of whether the clause mentions capacity for paying production. The court defined paying quantities as a profit, however small, “over the operating and marketing expenses, although the cost of drilling the well may never be repaid.” More importantly, “paying quantities” means that once the well is turned “on,” it will begin flowing without additional equipment or repair.

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75 Tucker, 855 P.2d at 935-36 (stating that “‘in paying quantities’ means 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 though the undertaking as a whole may thus result in a loss to the lessee’’); *Hydrocarbon Management*, 861 S.W.2d at 434 (explaining that the shut-in well must be capable of producing a profit although the drilling expenses might never be recovered); *James Energy Co. v. HCG Energy Corp.*, 847 P.2d 333, 339 (Okla. 1992)(defining “production in paying quantities” as the capability to yield a return in excess of “lifting expenses,” even though the lessee may never recover the cost of drilling and completing the well); *Lough v. Coal Oil, Inc.*, 266 Cal. Rptr. 611, 616-17 (Cal. Int. App. Ct. 1990)(defining “paying quantities” as proceeds which are sufficient to exceed the ongoing operating costs, and the initial drilling and equipment costs are excluded from the calculation).


77 *Id.* at 430-31.

78 *Id.* at 432-33.

79 *Id.* at 434.

80 *Id.* at 433-34.
concluded that the well was not capable of production in paying quantities, because the well was shut down due to mechanical problems. Therefore, the lease could not have been maintained by the shut-in royalty clause. 81

Likewise, in *Griffin v. Crutcher-Tufts Corp.*, 82 the court held that “the tender of shut-in royalty payments will not keep a lease alive unless the well that was shut in is capable of production in commercial quantities.”83 The gas well in *Griffin* was not capable of production in commercial quantities because the casing which supported the well had collapsed and that collapse prohibited any further production.84

If the lessor wants the shut-in royalty clause to extend and maintain the lease during a shut-in period due to mechanical problems, the drafters should include “mechanical failure” as an express reason for shutting-in the well.85 With the proper language, the shut-in royalty clause can provide considerable flexibility in dealing with the circumstances that at first glance seem to implicate the cessation of production clause or the *force majeure* clause.

[b] — Where the Well is Shut in Upon Completion Without Ever Producing.

The determination of whether a well is capable of production in paying quantities is more difficult when the well is shut in after completion, without ever producing. In *Webb v. Hardage Corp.*, 86 the court held that a lease would not be preserved under a shut-in royalty clause, unless the well’s capacity to produce was determined at the time the well was shut in.

81 *Id.* at 435.
82 *Griffin v. Crutcher-Tufts Corp.*, 500 So. 2d 1008 (Ala. 1986).
83 *Id.* at 1012.
84 *Id.* at 1011-12.
85 *But see* Norman v. Apache Corp., 19 F.3d 1017, 1027 (5th Cir. 1994)(stating that the legal meaning of shut-in “refers to the closing of valves ‘when production at a well capable of producing in paying quantities is temporarily halted to repair or clean the well, to allow reservoir pressure to build, or for lack of market.’”); P. M. Drilling, Inc. v. Groce, 792 S.W. 2d 717, 723 (Tenn. Int. App. Ct. 1990)(interpreting “shut-in” to mean “closed down temporarily for repairs, cleaning out, building up pressure, lack of market, etc.”).
In *Webb*, the lessee drilled three shallow wells before the primary term expired. The only testing performed to determine the production potential of the wells was simply igniting the gas and observing the flares for several hours. After the wells were flared, they were shut in because of a lack of market for the gas.87 The initial potential test required by the Louisiana Department of Conservation for classifying the well and authorizing the lessee to market the product was not performed.88 The lessors filed an action seeking the termination of the leases because the wells were not capable of production in paying quantities.89

Generally, an oil and gas lessor bears the burden of proving the propriety of terminating an oil and gas lease.90 However, the court declared that the circumstances presented in this case require an exception to that general rule:

A lessee cannot place the burden of proving the propriety of cancellation on the lessor by simply alleging that a well that has never been placed into actual production is capable of producing in paying quantities. Rather, the lessee must prove by a preponderance of the evidence that prior to the expiration of the primary term . . . a well was completed and surface tested to the extent that the well was at that time demonstratively capable of producing in paying quantities.91

Although other evidence of production potential may be considered — such as the history of other wells in the same zone or field, flaring of the wells, or logs and core samples — actual surface testing is the most definitive indicator of production capability. Without actual surface testing, the status of the well would be uncertain while the well is shut in.92 The court held that “[a] lessee should not be able to rely on the shut-in clause to hold a lease beyond its primary term where the well’s capacity to produce

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87 *Id.* at 890.
88 *Id.* at 892.
89 *Id.* at 891.
90 *Id.* at 892.
91 *Id.*
92 *Id.*
in paying quantities cannot be determined until further testing and procedures are carried out at some later date.”\textsuperscript{93} Because there was insufficient evidence to demonstrate that the wells were capable of production in paying quantities at the time the wells were shut in, the lease was not extended beyond the primary term under its shut-in royalty clause.\textsuperscript{94}


According to Professor Howard Williams, “[i]nsufficient attention has been given in the drafting of shut-in royalty clauses to the question of whether the clause should specify permissible grounds for shutting-in of a well on which shut-in royalty may be paid.”\textsuperscript{95} Most shut-in royalty clauses do not specifically designate the reasons for the shut-in. Instead, they provide for the payment of a shut-in royalty when there is a gas well on the premises, “but gas is not being sold or used.” This type of clause is generally thought to provide the lessee with the maximum flexibility, because it seemingly does not require a specific justification for the shut-in. Moreover, this type of clause is most susceptible to an interpretation allowing the lessee to shut in a well in order to secure an acceptable price.\textsuperscript{96}

However, in \textit{Tucker v. Hugoton Energy Corp.},\textsuperscript{97} the Kansas Supreme Court held that the shut-in royalty clause applies only when \textit{no} market exists for the gas.\textsuperscript{98} The wells involved in this case suffered from mechanical difficulties and production ceased. The wells remained shut in for over three years and throughout that time shut-in royalty payments were properly tendered and accepted by the lessors. After the three-year shut-in period, the lessee, fearing that the leases had expired because the

\textsuperscript{93} \textit{Id.} at 893.
\textsuperscript{94} \textit{Id.}
\textsuperscript{95} 3 Williams § 632.4, p. 411-12.
\textsuperscript{96} A comprehensive analysis of the permissible reasons for shutting-in a well can be found in Robert E. Beck, “Shutting In: For What Reasons And For How Long,” 33 \textit{Washburn L. J.} 749 (1994).
\textsuperscript{97} \textit{Tucker v. Hugoton Energy Corp.}, 855 P.2d 929 (Kan. 1993).
\textsuperscript{98} \textit{Id.} at 936.
wells were not capable of producing gas in paying quantities, executed new leases for the same wells. The defendant in this case was the successor in interest to the original lessees and an action was brought by the lessor to terminate the original leases.\textsuperscript{99}

The plaintiff argued that the shut-in clause could not be invoked when there was a market for the gas. The original lessee had invoked the shut-in royalty clause because the limited market and the price being paid for the gas\textsuperscript{100} would make it impossible to recover the costs of repair.

Despite the fact that the shut-in clause did not contain a “no-market requirement,” the court held that a well could only be shut in if no market existed for the gas.\textsuperscript{101} The court explained:

\begin{quote}
[t]here is a mutual interest between the lessor and lessee when no market for the gas exists. However, once a market for gas is secured, that mutual interest no longer exists because the lessor’s interest is in securing royalty payments from production, while the lessee’s interest is divided between receiving revenues and minimizing expenses associated with that production.\textsuperscript{102}
\end{quote}

The court concluded that because there was a limited market available for the gas at the time of shut-in, even though it was a market at a low price, the shut-in clause was improperly invoked and the lease terminated.\textsuperscript{103}

\begin{itemize}
\item \textsuperscript{99} \textit{Id.} at 933.
\item \textsuperscript{100} \textit{Id.} at 935.
\item \textsuperscript{101} \textit{Id.} at 936. The shut-in royalty clause provided:

\begin{quote}
Where gas from a well or wells, capable of producing gas only, is not sold or used for a period of one year, Lessee shall pay or tender, as royalty, an amount equal to the delay rental as provided in paragraph (5) hereof, payable annually at the end of each year during which such gas is not sold or used, and while said royalty is so paid or tendered this lease shall be held as a producing property under paragraph numbered two hereof. \textit{Id.} at 934.
\end{quote}

\item \textsuperscript{102} \textit{Id.} at 936.
\item \textsuperscript{103} \textit{Id.}
\end{itemize}
The *Tucker* case has been described as “perhaps the most alarming case of 1993,” because it forces lessees to sell gas in unfavorable markets.\(^{104}\) According to Professor John Lowe:

The case appears flatly wrong, both as a matter of the facts of the case (the shut-in clause did not limit the reasons for shut-in) and as a matter of policy (it is not in the interest of either lessor or lessee that sales take place whatever may be the market conditions).\(^{105}\)

The *Tucker* case is also contrary to the views advocated by the notable oil and gas scholars Professor Eugene Kuntz and Professor Howard Williams. Kuntz believes “[i]f the clause does not specify want of a market as the necessary cause of shutting in a gas well, there is no reason to read such a provision into the clause.”\(^{106}\) Williams also favors the expansive interpretation of a non-committal shut-in royalty clause, and cautions that if the clause makes any reference to the permissible reasons for shutting-in the well, the reference should conclude with a catch-all phrase such as the “lessee’s good faith judgment that it is unadvisable to produce and sell such products for the time being.”\(^{107}\)

The court in *Tucker*, however, may have reached the right result for the wrong reason. The facts strongly suggest that the court could have terminated the lease on the ground that the wells in question were incapable of producing gas in paying quantities. Because a well that is shut-in for mechanical reasons may not satisfy the “capable of production in paying quantities” requirement for a shut-in well, lessees should consider including mechanical problems as a permissible reason for shutting in a well.\(^{108}\)

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\(^{106}\) 4 Kuntz § 46.4(c), p. 17.

\(^{107}\) 3 Williams § 632.4, p. 412.

\(^{108}\) Compare Hydrocarbon Management, Inc. v. Tracker Exploration, Inc., 861 S.W.2d 427 (Tex. Int. App. Ct. 1993)(declaring that the shut-in royalty payment could not extend the lease because of the existence of mechanical problems) *with* Greer v. Salmon, 479 P.2d 294 (N.M. 1970)(allowing the payment of shut-in royalty to maintain the lease due to a ruptured flow line, even though the shut-in clause was silent as to the permissible reasons for shutting-in).

[a] — “Gas Only” or “Gas Well.”

Most shut-in royalty provisions apply only to “gas wells” or wells capable of producing “gas only”, with no mention in the lease of oil, sulfur, liquid condensate such as casinghead gas and other liquefied hydrocarbons or other minerals. This limitation results historically because of the slight likelihood that an oil well would need to be shut in for lack of a market. Due to the inherent physical nature of natural gas, it, unlike oil, cannot be produced and stored in tanks or transported in trucks or railroad cars. The only available storage for the gas is the underground stratum in which it is found.109

In some situations, the distinction between a “gas well” and an oil well is unclear. For example, an “oil well” may also be capable of producing “associated” or “casinghead” gas. The use of a shut-in royalty provision for a “gas well” or “gas only” well may be precluded under these circumstances.110 The well drafted shut-in royalty provision will apply to both oil and gas, or at least to any well capable of producing gas, regardless of its classification as either an “oil well” or a “gas well.”

[b] — The Effect of the Pooling Clause on the Shut-In Royalty Clause.

Many leases give the lessee the power to enter into a pooling agreement which combines the lands of the lessor with the lands of other landowners to form a common drilling unit. The problem that arises by the pooling of leases is whether a shut-in well on one lease in the unit will satisfy the shut-in royalty clauses of the other leases in the unit.

This situation arose in Asberry v. Saint Joseph Petroleum, Div. of Beaver Engineering, Inc.,111 where the lessors contend that the lease had expired at the end of the primary term and refused to accept shut-in payments. During the primary term of the lease, the lessee had completed

109 2 Summers § 299, p. 222-23.
110 See Duke v. Sun Oil Co., 320 F.2d 853 (5th Cir. 1963).
a well capable of producing in paying quantities on the property adjacent to the leasehold. The lessee then pooled a portion of the leasehold with the adjacent land on which the shut-in well was drilled. The pooling was done before the primary term expired. The lessee made timely shut-in payments.

The court explained that where a portion of the leasehold is included within a pooled unit, the weight of authority has held that production within the unit during the primary term of the lease will extend and maintain the portion of the lease that is excluded from the unit, as well as the portion which is included. In addition, this interpretation was consistent with the express language of the pooling provision. The court gave effect to the pooling provision and held that the lessee completed and shut in a well within the primary term. Because the lessee properly tendered shut-in payments and continued its efforts to market the gas, the lease was extended and maintained beyond the primary term.

Although the weight of authority holds that production anywhere within the pooled acreage maintains all leases that may be wholly or partly in the unit, the prudent lessee may want to include in the shut-in royalty clause some reference to the completion and shutting in of a well located on a portion of the unit other than the leasehold in question. For example, the shut-in royalty clause could provide: “If lessee obtains production of minerals on said land or on land with which the lease premises or any portion thereof has been pooled . . .” or “. . . [W]hile there is a gas well

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112 Id. at 414.
113 Id. at 415.
114 Id. See Perry v. Nicor Exploration, 738 S.W.2d 414, 415 (Ark. 1987); Mesa Petroleum Co. v. Scheib, 726 F.2d 614, 615 (10th Cir. 1984).
115 Ashberry, 653 S.W.2d at 415. The pooling provision provided: The entire acreage so pooled into a tract or unit shall be treated, for all purposes except the payment of royalties on production from the pooled unit, as if it were included in the lease. 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.
116 Id. (emphasis added).
on this lease or on acreage pooled therewith . . .” 118 Absent such a reference, the lessee relies at his peril on shut-in payments for a unit well which is not located on the leasehold.

§ 15.05. Administration of the Shut-In Clause: Payment Issues.

[1] — Time When the Shut-In Royalty Payment Must Be Tendered.

A recurring and troublesome problem associated with the shut-in royalty clause is the determination of the proper time for tendering the shut-in royalty payment. The problem is difficult with respect to both the initial shut-in payment and all subsequent payments. Further difficulties may arise when the other lease provisions or the conduct of the parties have the effect of establishing the date when the shut-in payment must be made or change the date that was otherwise established.

There is no simple answer to the question of when shut-in royalties must be paid because the answer varies depending upon the shut-in clause. Some clauses require initial payment prior to the shutting in of a well, some require payment within a specified time period after a well is shut-in, some require payment on or before the lease anniversary date following the shutting in of a well, and worst of all, some clauses are silent on this question. The consequences of an untimely shut-in royalty payment are not as important in states like Kentucky, Oklahoma and West Virginia, which have adopted the minority view requiring only capability of gas production to maintain the lease. Under the minority view, the lease should not terminate upon inadequate payment or a failure to timely tender shut-in royalties unless the shut-in clause clearly indicates otherwise. 119 However, in a majority of states where there must be actual or constructive gas production in order to extend or maintain the lease beyond the primary term, the time when the shut-in royalty payments must be tendered is critically important.

119 E.g., Pack v. Santa Fe Minerals, a Div. of Santa Fe Int’l Corp., 869 P.2d 323, 330 (Okla. 1994) (commenting that “the failure to pay shut-in royalties in and of itself does not operate to cause a termination of the lease”).
[a] — When Is a Well “Shut In”?

In some circumstances, it may be uncertain when a well is shut in for purposes of calculating when the shut-in royalty must be paid. When a well has been producing, but production is later terminated, few would dispute that the well was shut in on the date that the control valves were turned to the “off” position and the production ceased.\textsuperscript{120} The calculation is more difficult when the well is shut in immediately upon completion, before any actual production. Lessees often make the assumption that the well is shut in once the completion unit has left the well site.\textsuperscript{121} However, the courts consider a well shut in once all steps necessary to make it capable of producing oil or gas in paying quantities, short of connection to a pipeline, have been taken.\textsuperscript{122} This will usually occur before the time the completion rig is removed from the site.\textsuperscript{123} Therefore, lessees who are required to tender shut-in royalties on or before the date of the shut-in, should err on the side of caution and tender the shut-in payment at or before the time the tests on the well reveal that it is capable of producing in paying quantities.\textsuperscript{124}

[b] — Where the Shut-In Clause Does Not Specify a Time for Payment.

If the lease does not specify when shut-in royalty payments must be tendered, it should be assumed that they are due in advance of the shut-in.\textsuperscript{125} Otherwise, in majority view jurisdictions, the lease may terminate because there is neither actual production nor constructive production necessary to extend and maintain the lease beyond its primary term.\textsuperscript{126} For example, in \textit{Blaser Farms, Inc. v. Anadarko Petroleum Corp.}, the shut-in provision failed to state a date upon which the royalties were due. After determining that the failure to make the required shut-in royalty

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{120} Lowe, \textit{Shut-In Royalty Payments}, at 18-27.
\item \textsuperscript{121} \textit{Id}.
\item \textsuperscript{122} Hoyt v. Continental Oil Co., 606 P.2d 560 (Okla. 1980).
\item \textsuperscript{123} Lowe, \textit{Shut-In Royalty Payments}, at 18-27.
\item \textsuperscript{124} \textit{Id}.
\item \textsuperscript{125} \textit{See e.g.}, Freeman v. Magnolia Petroleum Co., 171 S.W.2d 339 (Tex. 1943).
\item \textsuperscript{126} \textit{Id}. at 342.
\end{enumerate}
\end{footnotesize}
payments would result in automatic termination of the lease, the court held that the royalty payments had to be made in advance of the shut-in period.\textsuperscript{127}

The better approach when drafting shut-in provisions is to clearly specify when the payment is due, and the period for which the payment extends and maintains the lease. This eliminates the uncertainty and corresponding threat of ultimate lease termination. The leases which specifically address these issues generally require that the initial shut-in payment be made on or before one of the following: a specified date,\textsuperscript{128} the anniversary date of the lease,\textsuperscript{129} or the passage of a specified period of time.\textsuperscript{130} The shut-in royalty provisions should also specify when the subsequent payments must be tendered, such as annually, semi-annually, monthly or on specific dates.

[c] — Conduct of Lessee Establishing the Shut-In Period.

Although the date a well is shut in or the date a shut-in royalty is paid will normally determine the anniversary date for future shut-in royalty payments, it has been held that the period of payment specified on a shut-in royalty receipt is controlling as to the period of time covered by the

\textsuperscript{127} Blaser Farms, Inc. v. Anadarko Petroleum Corp., 893 F.2d 259, 263 (10th Cir. 1990).
\textsuperscript{128} See Acquisitions, Inc. v. Frontier Explorations, 432 So. 2d 1095, 1101 (La. Int. App. Ct. 1983)(providing that “during the month of January of each year immediately succeeding any year in which a shut-in period occurred when all such production was shut-in, Lessee shall pay or tender . . . for each full calendar month in the preceding calendar year that this lease was continued in force . . . ”).
\textsuperscript{129} See Lapeze v. Amoco Prod. Co., 655 F. Supp. 1, 3 n.7 (M.D. La. 1987), aff’d 842 F.2d 132 (5th Cir. 1988)(providing that the payment must be made on or before “the expiration date of the primary term and each anniversary date thereof shall be considered as a fixed rental paying date . . . ”).
\textsuperscript{130} See Currey v. TNG, Inc., 410 S.E.2d 415, 416 (W. Va. 1991)(providing that “LESSEE shall be obligated to pay or tender to LESSOR within sixty (60) days after any such well is shut in and each anniversary thereafter . . . ”). Most contemporary oil and gas leases incorporate this type of provision requiring the shut-in payment for a period that has already occurred, rather than an advance payment. The underlying purpose for such a provision is to provide the lessee with an administrative grace period for properly tendering the payment. Lowe, \textit{Shut-In Royalty Payments}, at 18-28.
payment. In *Mayers v. Sanchez-O’Brien Minerals Corp.*, the lessee drilled a well that was capable of producing gas in paying quantities, but was shut in upon completion on July 8, 1978. According to the terms of the lease, the lessee had 90 days, or until October 6, 1978, to tender the required shut-in royalties to the lessor. On August 10, 1978, the lessee paid the shut-in royalties with checks accompanied by receipts. Both the checks and the receipts stated that the payments were for the twelve-month period beginning October 6, 1978. The court held that the period stated by the lessee on the checks and the receipts, which ran from the end of the 90-day grace period to pay shut-in royalties rather than the earlier date actual payment was made, established the anniversary date for future shut-in payments.

[2] — Who is Entitled to Receive Payment?

[a] — Whether the Payment is a Royalty or Delay Rental.

When discussing shut-in royalty clauses in an oil and gas lease, one question that often arises relates to the nature of the payment tendered in accordance with the shut-in clause. The determination of whether to make shut-in payments to those entitled to the royalty payments under the lease, or to those entitled to the delay rental payments, is often difficult and confusing. The issue usually arises in disputes between non-participating royalty owners, who would be entitled to their share of the royalties paid on production, and the lessor who executed the lease and is entitled to any rents paid under the lease.

132 *Id.* at 706.
133 *Id.* at 708.
134 A nonparticipating royalty is “[a]n expense-free interest in oil or gas, as, if and when produced. The prefix ‘nonparticipating’ indicates the interest does not share in bonus or rental, nor in the right to execute leases or to explore and develop.” 8 Williams and Meyers, *Manual of Oil and Gas Terms*, at 788. On the other hand, a participating royalty “is a royalty interest, independent of a subsisting lease, if any, which shares in some other lease benefits than gross production, such as bonus, rental, or the right to join in the execution of leases.” *Id.* at 876.
The classification of the shut-in payment as a “delay rental” or as a “royalty” is dependent on the underlying purpose of the payment. A royalty payment is a certain proportion of the minerals found or the production per well, while a delay rental is a “payment to the lessor for the privilege of deferring the commencement of drilling operations or the commencement of production during the primary term of the lease.”

This fundamental distinction was addressed in the landmark case on this issue, *Morriss v. First National Bank of Mission*. The *Morriss* court held that the shut-in payments were the equivalent of production under the habendum clause, and therefore were royalties. In addition, the court placed considerable emphasis on the fact that the lease described the shut-in payments as “royalties.”

Whether shut-in payments were to be treated as “rental” or “royalty” was discussed in *Acquisitions, Inc. v. Frontier Explorations, Inc.* The lessors brought an action seeking the termination of an oil and gas lease based upon the lessee’s failure to make shut-in payments pursuant to the lease. Because the Louisiana Mineral Code requires notice of the nonpayment of royalties or delay rentals to allow the lessee an opportunity to tender the royalty payment, the court had to determine whether the shut-in payment was royalty or rental.

The court noted that prior to the adoption of the current provisions of the Louisiana Mineral Code, the failure to properly tender shut-in payments resulted in the automatic termination of the oil and gas lease. Noting that the shut-in payment was constructive production under the lease, the

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138 *Id.* at 275. The court stated:

When the parties prepare a finely wrought instrument and use terms of legal distinction, their classifications should be given great weight as the intentional expression of their purpose . . . . To hold that the parties meant rent or bonus when they said royalty, when no mistake is urged, would be to attribute a carelessness to the parties not otherwise found in the lease. *Id.*

140 *Id.* at 1096.
141 *Id.* at 1098.
court ruled it was a royalty that must be paid to both the participating and nonparticipating royalty owners.\textsuperscript{142}

This rationale has since been incorporated in the definition of a royalty under the Louisiana Mineral Code. It includes within its definition payments that are classified as constructive production, such as shut-in royalty payments.\textsuperscript{143} Because the shut-in payments in \textit{Acquisitions, Inc.} served as constructive production to maintain the lease and the lease specifically designated the payments as royalties, the court held that the shut-in payments were royalties, requiring notice to the lessee with an opportunity to cure.\textsuperscript{144}

There are leases which define the shut-in payment as a “rental” resulting in a contradiction between the function of the lease and the specific language of the leases. However, the courts generally attach little significance to whether a shut-in payment is labeled “rental” or “royalty.” It is the intention of the parties that is most important.\textsuperscript{145} For example, in \textit{Acquisitions, Inc.}, the court stated that while the “designation alone is not dispositive of the question of whether these payments were royalties or rentals, the parties’ choice of words does help identify their intent in constructing the shut-in provision.”\textsuperscript{146} Although the intention of the parties is most important, the conservative course of action is to pay both those entitled to royalties and those entitled to rentals in this situation. The risk of automatic termination is too great to do otherwise.

\textbf{[b] — Importance of Tendering Payment to the Proper Parties.}

Once the shut-in payment has been properly classified, those entitled to payment must be identified. It is very important when drafting shut-in

\begin{footnotesize}\begin{enumerate}
\item \textsuperscript{142} \textit{Id.} at 1097-99.
\item \textsuperscript{143} \textit{Id.} at 1100 (quoting La. R.C. § 31:213(5) and the comment that follows).
\item \textsuperscript{144} \textit{Id.} at 1101.
\item \textsuperscript{146} \textit{Acquisitions, Inc.}, 432 So. 2d at 1101.
\end{enumerate}\end{footnotesize}
royalty clauses to clearly identify those entitled to receive payments, because payment mistakenly tendered to the wrong person can result in the automatic termination of the lease.

In *Amber Oil and Gas Co. v. Bratton*, 147 Amber was assigned rights under an oil and gas lease. Neither Amber nor its assignor gave the lessor notice of the transfer of ownership. Later, the lessor deeded the surface and one-half of the minerals to Bratton. Because Bratton was unaware that the lease had been assigned, he gave written notice of his purchase of the surface and one-half of the minerals to Amber’s assignor. 148

Amber proceeded to drill a gas well which was shut in because no market existed. Pursuant to the shut-in clause, Amber paid shut-in royalties for several years. However, it paid the entire amount to the original lessor. 149

The court noted that in the majority of states, the shut-in royalty is a substitute for production. The failure to timely tender the shut-in payment is the equivalent of a cessation of production, and results in the automatic termination of the lease. The court held that shut-in royalties were not timely paid to Bratton, and therefore the lease had automatically terminated. 150

The death of a royalty recipient could further complicate the question of who is entitled to receive the shut-in royalty payment. Many oil and gas leases provide that upon the death of a rental or royalty recipient, the lessee may make payments to the decedent’s estate until proper evidence of the identity of his successors can be furnished. This protects the lessee from the possibility of losing the lease for failing to make payments to the proper parties. 151

This issue arose in *Lapeze v. Amoco Production Co.*, 152 where the plaintiffs, who were the successors-in-interest to a deceased lessor, sued

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148 *Id.* at 742.
149 *Id.* at 743.
150 *Id.* at 743-44.
151 *See* 4 Williams § 697.8, p. 551-52.
to have a lease declared to have terminated automatically because the lessee had failed to tender the shut-in payments to the proper parties.

The original lease provided that the payments were to be made to the “Lessor” “Eugene Shilling” or deposited to his credit in the Livingston State Bank, and that Shilling’s death would not terminate or affect the lessee’s right to continue to deposit the shut-in payments at the Livingston Bank. In addition, the lease contained a change of ownership provision stating that regardless of any actual or constructive change of ownership, the lessee would not be bound thereby until furnished with a certified copy of a recorded instrument or judgment evidencing the change.

Upon the death of Eugene Shilling, his heirs and the lessee entered into an amendment of the lease, which corrected the property description, increased the royalty, and reaffirmed the remainder of the original lease. Although the amendment to the lease made no mention of a change of ownership, the lessee was aware that the plaintiffs had succeeded to the interest of Eugene Shilling. Thereafter, Amoco continued to tender shut-in payments to the Livingston State Bank to the credit of Eugene Shilling.

Without addressing whether the plaintiffs would have prevailed had the shut-in payments been improperly tendered, the court concluded that

153 *Id.* at 134.
154 *Id.* The change of ownership provision in the lease stated:

All provisions hereof shall inure to the benefit of and bind the successors and assigns (in whole or in part) of Lessor and Lessee (whether by sale, inheritance, assignment, sublease or otherwise), but regardless of any actual or constructive notice thereof, no change in the ownership of the land or any interest therein or change in the capacity or status of Lessor or any other owner of rights hereunder, whether resulting from sale or any other transfer, inheritance, interdiction, emancipation, obtainment of majority or otherwise, shall impose any additional burden on Lessee or be binding on Lessee for making any payments hereunder unless, at least forty-five (45) days before any such payment is due, the record owner of this lease shall have been furnished with certified copies of recorded instruments or judgments evidencing such sale, transfer or inheritance, or with evidence of such change in status or capacity of Lessor or other party owning rights hereunder. *Id.*

155 *Id.* at 133.
156 *Id.*
the change of ownership clause in the lease controlled. Under the lease, Amoco was not bound by plaintiffs’ oral assertion of ownership, nor by its own actions to amend the lease. According to the court, the lessee’s better course in such a situation would be to comply with the literal terms of the lease, regardless of any actual or constructive knowledge to the contrary, because “'[t]he lessee is protected when he relies on failure to furnish proof of change of ownership, but is not protected when he relies on anything else.’”157


The amount of the shut-in royalty payment varies considerably among the shut-in provisions that have appeared in reported cases. The variations in amount include a fixed amount over a specified period of time,158 a fixed amount per well,159 a fixed amount per acre,160 or an amount equal to the delay rental provided for in the lease.161 Because an error in the amount of payment can result in the termination of the lease, the shut-in

157 Id. at 135 (quoting Bond, “Delay Rental Instructions,” 140 Okla. L. Rev: 475 (1961)).
158 See Plymouth Fertilizer Co. v. Balmer, 488 N.E.2d 1129, 1136 (Ind. Int. App. Ct. 1986)(permitting the lessee under the terms of the lease to cap the well and continue the lease by the payment of $50.00 per year).
159 See Frost Nat’l Bank v. Matthews, 713 S.W.2d 365, 368 (Tex. Int. App. Ct. 1986)(stating that “Lessee may pay or tender . . . the sum of Two Hundred Fifty and No/100 (($250.00)) Dollars, per well . . . .”); Doty v. Key Oil, Inc., 404 N.E.2d 346, 347 (Ill. Int. App. Ct. 1980)(providing that “lessee or any assignee hereunder may pay or tender an advance annual royalty payment of Fifty Dollars (($50.00)) for each such well . . . .”).
160 See Cali-Ken Petroleum Co. v. Slaven, 754 S.W.2d 64, 66 n.2 (Tenn. Int. App. Ct. 1988)(requiring that lessee “shall pay or tender . . . $1.00 per acre per annum”); West Bay Exploration Co. v. Amoco Prod. Co., 384 N.W.2d 407, 409 (Mich. Int. App. Ct. 1986)(“Lessee agrees to pay or tender . . . a sum equal to One Dollar (($1.00)) per acre for all that part of the premises included in the unit of said shut-in well.”), vacated on other grounds, 389 N.W.2d 865 (Mich. 1986), remanded 399 N.W.2d 549 (Mich. Int. App. Ct. 1986)(affirming the original decision).
161 See Tucker v. Hugoton Energy Corp., 855 P.2d 929, 934 (Kan. 1993)(providing that the “lessee may pay or tender . . . an amount equal to the delay rental as provided in paragraph (5) hereof . . . .”); Fisher v. Grace Petroleum Corp., 830 P.2d 1380, 1384 n.2 (Okla. Int. App. Ct. 1991)(stating that the “lessee may pay or tender an advance annual royalty equal to the amount of delay rentals provided for in this lease . . . .”).
royalty provision should set forth, in an understandable fashion, the calculation or the fixed amount of the shut-in royalty payment. Obviously when in doubt as to the amount due, lessees should err on the side of an overpayment in majority-view jurisdictions.

[a] — Including a Proportionate Reduction Clause.

In addition, the shut-in royalty clause should include a proportionate reduction provision, whereby each party entitled to the royalty receives only the percentage due in accordance with their fraction of interest in the minerals. For example, the shut-in clause found in Acquisitions, Inc. v. Frontier Explorations, Inc. states that “[t]he owners of the royalty as of the date of such payment shall be entitled thereto in proportion to their ownership of the royalty.”162 If the shut-in clause does not contain such a provision, each party entitled to the royalty may claim the entire amount specified in the clause.


In order to avoid any dispute as to the appropriate manner of payment, it is recommended that the shut-in clause provides that the royalty “be paid by check or draft of the lessee or any assignee mailed or delivered to the persons entitled to such [royalty] payment or to a depository bank.”163 When the shut-in royalty clause is silent as to the manner of payment, the most conservative course of action is to tender the payment in cash or by certified check.164 Many oil and gas lessees make the dangerous assumption that shut-in royalties can be paid in the same manner as delay rentals. However, unless the lease specifically provides that the payments

163 3 Williams § 635, p. 497. See e.g., TSB Exco, Inc. v. E.N. Smith, III Energy Corp., 818 S.W.2d 417, 421 (Tex. Int. App. Ct. 1991)(“Regardless of the legal meaning of payment, the parties to an oil and gas lease are free to define what may constitute payment for the purposes of that lease.”).
164 See Duke v. Sun Oil Co., 320 F.2d 853, 861 (5th Cir. 1963 (commenting that “in the absence of an express agreement, the delivery of a check to the payee is merely a conditional payment which does not become absolute until the check is actually paid by the drawee bank”).

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may be made in the same manner provided for the payment of delay rentals, that assumption could result in automatic termination of the lease.\textsuperscript{165}

A dispute over the manner of payment arose in \textit{TSB Exco, Inc. v. E.N. Smith, III Energy Corp.},\textsuperscript{166} where the court had to decide whether the timely tender of a check was effective to extend the lease under its extension clause which provided only for the “payment” of a sum of money. Both the delay rental and royalty clauses of the lease provided that the payment “may be made by check or draft of Lessee delivered or mailed to the authorized depository bank or to Lessor . . . on or before such date for payment, and the payment or tender will be deemed made when the check or draft is so delivered or mailed.”\textsuperscript{167} However, the extension provision merely called for the “payment to Lessor” without describing how the payment was to be made.\textsuperscript{168} The lessee delivered checks to the lessors at their personal residences to extend the term of the lease. The lessors refused to accept the checks and contended that the lease had expired.\textsuperscript{169}

The court recognized that in contracts requiring the payment of money, there was precedent for requiring cash, as opposed to a check which would not constitute legal tender unless there was an agreement to the contrary. In addition, there was precedent for allowing payment by check when it was demonstrated that there were sufficient funds in the bank account to cover the check.\textsuperscript{170}

The court opted for the “modern and better rule” by adopting the Restatement (Second) of Contracts section 249, which states:

\begin{quote}
Where the payment or offer of money is made a condition of an obligor’s duty, payment or offer of payment in any manner current in the ordinary course of business satisfies the requirement unless the obligee demands payment in legal
\end{quote}

\textsuperscript{165} See Lowe, \textit{Shut-In Royalty Payments}, at 18-33.
\textsuperscript{167} \textit{Id}. at 419.
\textsuperscript{168} \textit{Id}.
\textsuperscript{169} \textit{Id}.
\textsuperscript{170} \textit{Id}. at 420.
tender and gives any extension of time reasonably necessary to procure it.171

Because checks are used for payment of oil and gas lease obligations in the ordinary course of business and the lessor did not make a demand for cash, the lessees timely and proper delivery of the check constituted payment within the meaning of the extension provision in the lease.172


There is limited authority dealing directly with whether a lessor is estopped from denying the validity of an oil and gas lease by the acceptance of an improper shut-in royalty payment. In the vast majority of cases that present situations where the question of estoppel might have been raised, the courts do not discuss the subject.173 Nevertheless, in majority-view states where failure to timely tender shut-in royalty payments results in automatic termination of the lease, the weight of authority holds that once the oil and gas lease has automatically terminated, it cannot be revived under any circumstances.174 Accordingly, the doctrine of estoppel would seem to be inapplicable in majority-view states. However, in West Bay Exploration Co. v. Amoco Production Co.,175 a Michigan court nevertheless considered the lessees’ equitable estoppel claim,176 even though Michigan adheres to the majority view in which the lease automatically terminates without actual or constructive production, and

171 Id. (quoting Restatement (Second) of Contracts § 249 (1981)).
172 Id. at 421.
173 See 3 Williams § 634.3, p. 487 and n.4 (discussing cases where estoppel by acceptance was applicable, but never discussed).
174 See 3 Kuntz, § 46.5(g), p. 55 (quoting from Greer v. Salmon, 479 P.2d 294, 300 (N.M. 1970)).
176 In order to prove its equitable estoppel claim, the lessees had to demonstrate “(1) a party by representations, admissions or silence induces another party to believe facts; (2) the other party detrimentally relies and acts on this belief; and (3) the other party will be prejudiced if the first party is allowed to deny the existence of the facts.” Id. at 411.
constructive production requires timely payment of shut-in royalties.\textsuperscript{177} The lessees contended that the lessors should be estopped from claiming termination of the lease, because the lessors accepted an untimely shut-in royalty payment.\textsuperscript{178} Instead of outrightly rejecting the applicability of an estoppel claim in this context, the court held that the element of detrimental reliance was lacking, because the lessees “had the highest degree of expertise and sophistication regarding the interpretation of an oil and gas lease.”\textsuperscript{179} Of course as a practical matter, under this interpretation, the court may as well have rejected the estoppel theory outright because it would seem highly unlikely that a trial court would ever find that a lessee (a party who would ordinarily be presumed to have oil and gas expertise and sophistication) relied to its detriment on an improper payment, at least in the absence of some further investment in the property, perceived as relying to its detriment.

Under the minority view which does not require the payment of shut-in royalties, the doctrine of estoppel could be a valid defense for the gas producer. Its viability can be seen in \textit{Danne v. Texaco Exploration and Production Inc.},\textsuperscript{180} where an Oklahoma Court of Appeals held that the untimely acceptance of shut-in royalty payments by the lessors affirmed the existence of the lease and estopped the lessors from denying the lessee’s claim of title.\textsuperscript{181} In \textit{Danne}, the lessee tendered, and some of the lessors accepted, untimely shut-in royalty payments. Because Oklahoma adheres to the minority view in which the oil and gas leases do not expire automatically by their terms, the court held that the lessors’ acceptance of shut-in royalty payments constituted a waiver of the breach of the lease. The lessors were thereby estopped from seeking cancellation of the lease.\textsuperscript{182}

\begin{thebibliography}{9}
\bibitem{177} See \textit{Id.} at 411.
\bibitem{178} \textit{Id.}
\bibitem{179} \textit{Id.} at 411.
\bibitem{181} \textit{Id.} at 216.
\bibitem{182} \textit{Id.} at 215-16.
\end{thebibliography}
The court did recognize that had the lease automatically terminated by the failure to timely tender shut-in payments, the acceptance of the royalty would not estop the lessor from asserting lease cancellation.\textsuperscript{183}

\textbf{[6] — Whether Defaulting Lessee Can Be Liable in Conversion.}

Lessees who continue to market or use the gas after the lease has terminated, without the permission of the owners, may be liable for conversion. In \textit{Plymouth Fertilizer Co. v. Balmer},\textsuperscript{184} the plaintiffs, after allowing 10 years to pass without receiving shut-in payments or actual production royalties, recorded a termination affidavit, which returned clear title in the mineral interests to the plaintiffs.\textsuperscript{185} The defendant had reason to believe that the affidavit was filed, and that it reserved in the plaintiffs the interest in the gas.\textsuperscript{186} Thereafter, the lessees assigned all their rights to Beulah Moore, who was the owner of the surface real estate and an interest in the gas for domestic use only. The defendant succeeded to Moore’s interest, and without notice to the plaintiffs, began removing gas from the well for use as fuel in the defendant’s manufacturing process.\textsuperscript{187}

The court held that the lease had expired due to the lessees’ failure to tender shut-in payments. In addition, the court declared the lease abandoned, because the shut-in payments were not made and the lessees never made any serious attempts to market the gas.\textsuperscript{188} Therefore, the lessees had no interest in the gas to assign to Beulah Moore, because the right to produce the gas had reverted back to the plaintiffs. Because the

\textsuperscript{183} \textit{Id.} at 215. In the words of Professor Kuntz, the court declared “[i]f a lessee should continue to make royalty payments to the lessor after the lease has terminated according to its own terms, the receipt of such payments will not work an estoppel against the lessor, and such lessor may nevertheless assert that the lease has terminated.” \textit{Id.} (quoting 3 Kuntz § 43.2 ((1989))) (internal quotations omitted).


\textsuperscript{185} \textit{Id.} at 1132.

\textsuperscript{186} \textit{Id.} at 1132-33.


\textsuperscript{188} \textit{Id.} at 1136-37.
plaintiffs were the owners of the mineral estate, the court held that the defendant converted the gas, and found him liable for the gross value also known as the well head valve, of the gas taken.\(^{189}\) Although punitive damages were not awarded in the case, lessees that fraudulently, wantonly or recklessly disregard another’s rights by conversion can be ordered to pay punitive damages.

\textbf{§ 15.06 Conclusion.}

The United States natural gas market has undergone a fundamental transformation in the last 10 to 15 years, from the stability and predictability of long-term sales contracts to the continual price renegotiation and volatility associated with today’s “spot market.”\(^{190}\) Since the inception of the spot market in the mid-1980s, gas prices have plummeted and sent the industry spiraling into the midst of a depression. In addition, the deregulation of the natural gas industry under the Natural Gas Policy Act of 1978\(^ {191} \) resulted in an oversupply of gas which contributed to the falling market price.

In the face of today’s depressed oil and gas market, the shut-in royalty clause will remain especially important, because gas producers will continue to shut in an increasing number of wells to avoid selling the gas under current market conditions. Shut-in litigation is also likely to increase as lessors, unsatisfied with the often nominal shut-in royalty payment, seek to terminate the leases in the hopes of renegotiating with other producers. The stakes are too high for the gas producer not to closely examine the lease in question to ensure that the well is shut-in properly. Should the lessee exceed the scope of the shut-in clause or fail to make a proper shut-in payment, the entire lease could automatically terminate.

\(^{189}\) \textit{Id.} at 1140 (stating that “[n]atural gas is property which can be converted if, as it was in the present case, it was extracted and consumed without the knowledge and consent of the owner”).
