Chapter 25

Held By Production Leases:
When Are They Actually Held?

J. Thomas Lane
Bowles Rice LLP
Charleston, West Virginia

Britt A. Freund
Bowles Rice LLP
Canonsburg, Pennsylvania

J. Breton McNab
Bowles Rice LLP
Parkersburg, West Virginia

Synopsis

§ 25.01. Introduction ...........................................................................964
[1] — The Oil and Gas Lease Term Clause ..................................966
[2] — Nature of an Oil and Gas Leasehold Estate ......................968
  [a] — Inchoate Estate During Primary Term ..................969
  [b] — Vested or Determinate Estate .................................970
[3] — The Meaning of “Production”............................................971

§ 25.02. Held By Production ............................................................972
  General Considerations ....................................................972
[2] — Free Gas .............................................................................974
[4] — Profitability in Depressed Markets .................................979
[5] — Production from Shallow Formations Only .................981

§ 25.03. Cessation of Production .....................................................982
[1] — Temporary Cessation of Production .................................983
  [a] — Length of Time for Cessation ........................................984
  [b] — The Reason for the Cessation ........................................985
  [c] — The Diligence of the Lessee ...........................................986
[2] — Cessation Due to Price or Depressed Markets .................988
[3] — Other “Savings” Events and Special Provisions ...............995
  [a] — Cessation Clause with Grace Period .........................995
  [b] — Operations Clause .......................................................995
  [c] — Pooling and Unitization Provisions .............................997
    [i] — Pugh Clause .............................................................998
    [ii] — Retained Acreage Clause ........................................999
§ 25.01. Introduction.

The 21st century, in its relatively short span of 15 years, has seen remarkable change in the energy sector, and every resource from renewables to coal to oil and gas has been affected. Incredible discoveries and new technologies for the development and production of both oil and gas have resulted in the large scale displacement of coal for energy power generation, and, for the first time in our lifetimes, we have gained independence from reliance on foreign oil. Enhanced air quality regulations have influenced closure of coal-fired power plants so that in 2015, use of gas has exceeded coal in electric power generation for the first time. No one would have forecast any of this in the year 2000.

If we look back to the turn of the century, the Nymex price of gas was $2.36. Indeed, this price was not much different than the average wellhead price of gas from 1985 to 2000, $2.01. This relatively long period of stable but low prices resulted in demand for natural gas catching up with supply and a stagnation in new drilling. Suggestion was made in some quarters that gas resources were being depleted. In the cyclical gas business, demand appeared to outpace supply, and gas prices spiked to $8.90 in December 2000. Prices settled back and reached a low of $2.19 in September 2001, but then averaged about $3 in 2002. Starting in 2003, however, average prices jumped to $7 and climbed to an all-time high of $13.42 in October 2005. The sustained high price levels from 2003 to 2010 were unprecedented in the history of

the gas industry, and, at these prices, the gas business was good and a surge in drilling of new conventional wells occurred.

During this period, a small Texas company, Mitchell Energy, employed a “slickwater” hydraulic fracture technique in the Barnett Shale formation in Texas. The “slickwater,” likened to water and dish soap, was highly successful and provided the first glimpse of the forthcoming revolution in shale gas plays. Shortly after, in 2004, Range Resources used a similar hydraulic fracturing technique in its Renz Well in Washington County, Pennsylvania, and found similar success. Back in Texas, Devon Energy, with expertise in horizontal drilling, acquired Mitchell Energy and drilled horizontal wells into the Barnett shale with multi-stage hydraulic fracturing completions, again with high success. Following suit again, Range Resources began drilling horizontal wells in 2007 in Washington County. Range’s successes were not made public until 2008; however, as rumors spread and ultimately the news of this success became known, a fervor for property to develop quickly emerged, and the competition for acreage caused lease prices to escalate from historical prices of $1 per acre to $500 per acre, then to $1,000 per acre, and then to as much as $10,000 and more per acre. These prices were staggering, and the magnitude of the investment, both in lease acquisition and development costs, set dramatically new levels. In some cases, the significant investment in lease acquisition has driven the new development necessary to hold leases.

In many cases, producers have acquired acreage by purchasing existing leases, which were developed with shallow wells many years ago. Again, the acquisition costs have set unprecedented new levels, and, thus, the value of these leases is high. Buyers assume in each instance that the leases are “held by production.” But are they? Stated more specifically, has there been “production” sufficient to extend the term of these old leases or might there have been a cessation or a lack of profitable production which might have caused termination? Looking forward, the boom in new drilling has resulted

in a glut of gas on the market and a corresponding drop in prices to the $2 range. Assuming a lease was valid when wells were drilled, what analysis might apply with depressed gas prices and an inability to operate profitably? This chapter explores the requirements for extending the term of an oil and gas lease and the hidden dangers which may cause termination, sometimes unexpectedly.

[1] — The Oil and Gas Lease Term Clause.

From the early days of the oil and gas industry, a standard oil and gas lease has adhered to certain common terms, and one of the core provisions has always been the term clause, which will provide for a “primary term,” a finite period stated in days, months or years, and an “extended” or “secondary” term, which will be an indefinite period lasting as long as oil or gas are produced from the leased premises. In its simplest form, an oil and gas lease will provide: “This lease shall have a term of ten years from the date hereof and as long thereafter as oil and gas, or either, are produced from the leased premises.” The fixed term of years — in this example, 10 years — is the “primary term,” and, if production is obtained, the period “thereafter” is the “extended” or “secondary” term. This term clause will be coupled with a rent clause, which provides for rent, historically in periodic payments, to be made during and to cover the primary term and a royalty clause to provide for payments after production is obtained and during the extended term.

Thus, a primary term allows the lessee a finite period to evaluate the property, arrange for financing as necessary, obtain drilling permits and authorizations, and possibly acquire surrounding acreage that can be supported with the pipeline infrastructure. To extend the lease during the primary term, the lessee must either pay rent or drill a well and obtain production of oil or gas. In order to propel the lease from the primary term to the extended term, a well must be drilled and, generally, production obtained. Thereafter, the lease will be extended so long as oil or gas is produced. Hence, a lease extended by production is “held by production,” or, in common parlance, “HBP.” The secondary or extended term, or sometimes

---

3  *Williams & Meyers, Oil and Gas Law* 601.4 at 9-10 (1985).
the “thereafter” term, can continue for an indefinite period of time beyond the primary term’s expiration, and, during this time, the lessee can continue producing from one or possibly more wells for as long as operations are economic or profitable.

While these lease provisions may seem simple and straightforward — either pay rent or produce oil or gas — there are few areas of the law more replete with litigation than the term and royalty clauses of oil and gas leases. Indeed, the case law over many years has resulted in the drafting of lease terms with increasing sophistication, almost universally, to expand the acts, which, if taken by an oil and gas lessee, will extend the term.

Accordingly, a modern lease might provide as an example:

“This Lease shall remain in force for a primary term of **Five (5) years** from __________ __________, 2015 the effective date, and shall continue beyond the primary term as to the entirety of the Leasehold if any of the following is satisfied: (i) operations are conducted on the Leasehold or lands pooled/unitized therewith in search of oil, gas, or their constituents, or (ii) a well deemed by Lessee to be capable of production is located on the Leasehold or lands pooled/unitized therewith, or (iii) oil or gas, or their constituents, are produced from the Leasehold or lands pooled/unitized therewith, or (iv) if the Leasehold or lands pooled/unitized therewith is used for the underground storage of gas, or for the protection of stored gas, or (v) if prescribed payments are made, or (vi) if Lessee’s operations are delayed, postponed or interrupted as a result of any coal, stone or other mining or mining related operation under any existing and effective lease, permit or authorization covering such operations on the leased premises or on other lands affecting the leased premises, such delay will automatically extend the primary or secondary term of this oil and gas lease without additional compensation or performance by Lessee for a period of time equal to any such delay, postponement or interruption.

---

4 *Id.*
If there is any dispute concerning the extension of this Lease beyond the primary term by reason of any of the alternative mechanisms specified herein, the payment to the Lessor of the prescribed payments provided below shall be conclusive evidence that the Lease has been extended beyond the primary term.”

In turn, this clause will be coupled with a “shut in” clause, which expressly allows the cessation of production, but extension of the lease term by payment of “shut in” rent. In short, a modern lease will provide for an expansive list of acts which might extend the term of a lease. In oil and gas law, like any area of contract interpretation, the cardinal rule of interpretation universally applied is that a contract will be enforced as written. So, while many of the terms of a modern lease have not been tested, this cardinal rule will be the starting point for any challenge. This chapter will focus on the terms of older, less sophisticated leases.


The oil and gas lease, like any other lease, creates an estate in land of limited duration. Ownership of the land, which in almost all states includes oil and gas, remains in the landowner/lessor so long as the minerals remain in place. Unlike commercial and residential leases, however, oil and gas leases, like other mineral leases, contemplate that the lessee will take part of the estate, the oil and gas, and thereby diminish the reversion, which the owner has when the lease terminates.

The motivation for the owner in entering an oil and gas lease, generally, is to earn income from valuable resources, which the owner lacks the expertise and resources to develop on his own. This major premise often rises to the forefront in disputes over the term of oil and gas leases, and a recognition is generally given to the fact that the basic purpose of an oil and gas lease is to earn income, both to the lessee and to the lessor, and this can occur only if there is development.5 From this basic premise, and absent express provisions,

Held by Production leases

Courts have generally inferred implied covenants that property be developed and that the minerals be marketed in a fashion that benefits both parties.

To the extent that an oil and gas lease “grants” the oil and gas, or the right to develop the oil and gas, for a term of years, and this grant is coupled with detailed operating rights and obligations, most jurisdictions treat the lease as both a conveyance of rights in real property from the lessor to the lessee and as a contract between the lessor and the lessee.

[a] — Inchoate Estate During Primary Term.

During the primary term, or at least until development occurs, the nature of the estate is viewed in many jurisdictions as creating a license or an option and is often characterized as an inchoate right, which may blossom into a fee simple determinable, while others classify it as a profit a prendre.

---


8 Hite, 13 A.3d 942; Goodwin, 163 W. Va. 264.

9 See, e.g., Eastern Oil Co. v. Coulehan, 65 W. Va. 531, 64 S.E. 836 (1909) (“In this state and in Pennsylvania such leases are generally treated as mere licenses vesting no estate; the title thereto, both as to the period of years and the term thereafter remaining inchoate and contingent on the finding of oil and gas.”); Smith v. Root, 66 W. Va. 633, 66 S.E. 1005 (1910) (“It simply gave them the exclusive right to make exploration upon the land for oil and gas. Their right was simply an inchoate right, not a vested estate in the land.”); Parish Fork Oil Co. v. Bridgewater Gas Co., 51 W. Va. 583, 591 (1902) (“Until oil is discovered in paying quantities, the lessee acquires no title under such lease.”); Hite, 13 A.3d 942 (“[T]he title conveyed is inchoate and initially for the purpose of exploration and development. If development during the primary term is unsuccessful, no estate vests in the lessee.”); Lowther Oil Co. v. Miller-Sibley Oil Co.; Urpman v. Lowther Oil Co., 53 W. Va. 501 (1903); see also footnotes 1 through 4 above.

10 See, e.g., Snyder Bros. v. Peoples Natural Gas Co., 450 Pa. Super. 371, 378 (1996) (“[T]he interest granted to lessee is a fee simple determinable; the lessor retains a reversionary interest.”); Luckel v. White, 819 S.W.2d 459, 464 (Tex. 1991) (“In Texas, a typical oil and gas lease actually conveys the mineral estate (less those portions expressly reserved, such as royalty) as a determinable fee.”).

11 See, e.g., Rich v. Doneghey, 71 Okla. 204, 206 (1918) (“The right . . . is an incorporeal hereditament; or more specifically, as designated in the ancient French, a profit a prendre, analogous to a profit to hunt and fish on the land of another.”).
[b] — Vested or Determinate Estate

When development occurs, and especially when oil or gas is discovered, courts generally hold that the oil and gas lease becomes a vested estate.\(^{12}\) In doing so, there is a recognition of the investment made by the lessee, and inherent in the concept of “vesting” is the fact that courts will not allow the estate to be easily lost, unless the condition, “production,” is not met. The West Virginia Supreme Court described the nature of the traditional oil and gas leasehold term as follows:

A habendum clause in an oil and gas lease (or other mineral lease) providing for a short primary term and a secondary term for ‘so long as’ production in paying quantities or operations therefor continue, or similar language, conveys a “determinable” interest, that is, an interest subject to a special limitation. Such an interest automatically terminates by its own terms upon the cessation of production or operations during the secondary term.\(^{13}\)

Thus, the “habendum” or “term” clause in an oil and gas lease serves to define and limit the duration of the term of the estate conveyed.\(^{14}\) So long as the condition, “production,” is met, though, the term will continue for an indefinite time.\(^{15}\)

Traditional wells in the eastern United States can produce for very long periods — 70 and 80 years and more and counting — and during this time the lease is not only the central, but typically the only, operating document between the parties. What may be unique to the oil and gas industry is the fact that, until recent years, compelling reasons for modification of original leases have rarely occurred. Thus, when development of the Marcellus and Utica formations is proposed, and horizontal wells are to be drilled under leases held by old production, dual questions will exist: first, has the lease


\(^{15}\) 3 Williams & Meyers, *Oil and Gas Law* § 601.4 at 9-10.
actually been held by production, and, second, are the terms of the lease adequate for the development which is anticipated? This chapter addresses the first question only.


The term “production” would seem to be straightforward and mean, literally, that oil or gas are being produced from the lease premises; however, early case law, particularly in West Virginia, allowed a more relaxed standard, at least in order to propel the term from the primary term to the extended term. These early cases addressed the question whether an oil and gas lease could be extended beyond the primary term in instances where the operator commenced drilling operations but failed to establish production before the end of the primary term. Thus, in the first early case, a well was commenced within the primary terms, and gas in “paying quantities” was discovered, but the lessee was unable to put the well into production. The court nevertheless held that the term was extended. In later cases, the same facts were addressed; however, the lessee was unable to show that the discovery was in paying quantities. Again, the court held the term continued. In a different vein, the lessee in *Eastern Oil Co. v. Coulehan* drilled a well and was nearing completion on a Saturday. The primary term expired on Sunday, and the lessor prevented working on the Sabbath. The court held the lessor’s interference served to extend the term. These cases each recognize the substantial investment made by the operator and the “gross injustice” that might occur if the lease was not extended. Collectively, these cases establish the principle that if there has been “substantial compliance” with the lease by discovering oil or gas, the lease term will be extended so long as the operator has a “reasonable basis for the expectation of profitable returns” and is diligently seeking to produce, even though the literal condition that

---

16 Barbour-Stedman & Co. v. Tompkins, 81 W. Va. 116, 93 S.E. 1038 (1917).
19 Id.
“production” exists is not met.\textsuperscript{21} Diligence, in turn, is tested by the facts and circumstances of each case.\textsuperscript{22}

\section*{§ 25.02. Held By Production.}

In the majority of producing states, actual production of oil and gas is required for the lease to extend into the secondary term.\textsuperscript{23} As discussed above, a few states, like West Virginia, allow the discovery of oil and gas without production at the end of the primary term to extend the lease. So long as the lessee is diligently seeking to obtain production, these states similarly adhere to the requirement that there be production to continue to the term of the lease.\textsuperscript{24} The question then becomes what kind of production will be necessary. At most, a typical oil and gas lease might provide that the production be “in paying quantities,” but seldom will a lease say more.


The courts have, with limited exceptions,\textsuperscript{25} addressed the question of the type of “production” necessary to extend the term of a lease by holding that to continue the term of the lease, production must be in paying quantities; that is, the production must be “commercial” or “profitable.”\textsuperscript{26} According

\begin{flushleft}
\textsuperscript{21} Also see, Gazin, 367 P.2d at 1013, “where the court held that when a well, capable of producing in paying quantity, was drilled within the primary term, the term was extended so long as the lessee exercised “reasonable diligence in seeking and obtaining a satisfactory market within a reasonable time under the facts and circumstances.”

\textsuperscript{22} Bryan, 577 S.E.2d at 269-270.

\textsuperscript{23} See also Baldwin v. Blue Stem Oil Co., 189 P. 920 (Kan. 1920); Standard Oil & Gas Co. v. Barnhill, 107 S.W.2d 746 (Tex. Civ. App. 1937); Hanna v. Shots, 163 Ohio St. 144, 125 N.E. 338 (Ohio 1955), at Syl. Pt. 2.

\textsuperscript{24} Parish Fork Co., 51 W. Va. 583.

\textsuperscript{25} Gillespie v. Ohio Oil Co., 260 Ill. 169, 102 N.E. 1043; McGraw Oil & Gas Co. v. Kennedy, 65 W. Va. 595, 64 S.E. 1027 (1909); South Penn Oil Co., 71 W. Va. 438 (1912).

\textsuperscript{26} Swiss Oil Corp. v. Riggsby 252 Ky. 374, 67 S.W.2d 30 (1933); Kerr v. Hillenberg, 373 P.2d 66 (Okla. 1962); Young v. Forest Oil Co., 194 Pa. 243, 45 A. 121 (1899) (small profit); Benedum-Trees Oil Co. v. Davi, CA 6 Tenn. 107 F.2d 981 (1939), cert. den. 310 U.S. 634, 84 L. Ed. 1404, 60 S. Ct. 1076 (apparently applying Tennessee law, reasonable return); Garcia v King, 139 Tex. 578, 164 S.W.2d 509 (1942) (small profit); Patton v. Rogers, Tex. Civ. App. 417 S.W.2d 470 (1967), error ref n r e (small profit); Lowther Oil Co., 53 W. Va. 501 (1903) (small profit); Barbour, Stedman & Co., 81 W. Va. 116 (1917).
\end{flushleft}
to one court: "'Produced,' 'produced in paying quantity,' and 'found in paying quantities' must mean about the same thing, else substance will be subordinated to shadow or mere technicality." Profitability, in turn, is measured by net profits from operations, that is, the income from sales must exceed the cost of operations without regard to the capital cost of drilling a well. Thus, a well that may never recover the cost of drilling is nevertheless considered profitable if it has net profits from ongoing operations.

Varying factors can lead courts to apply the requirement of "paying quantities" in different ways. In a very general context, many decisions hold that "paying quantities" is determined from the subjective viewpoint and judgment of the lessee or operator when exercised in good faith. Thus, the "prevailing rule seems to be that [the] phrase 'paying quantities' is to be construed from the standpoint of the lessee, and by his judgment if exercised in good faith." The Texas Supreme Court announced a "paying quantities" definition that recognizes a prudent operator standard in this way:

[T]he 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 . . . .

These cases would suggest that while much may be left to the lessee’s viewpoint, a close examination indicates that operations must either achieve, or have a reasonable expectation of achieving, a net profit. Therefore, if a well, or operations under a lease, pays a profit, however small, over operating expenses, it is considered to be producing in paying quantities, even if operations do not recover capital costs of lease acquisition, development and drilling. In cases of marginal operations, courts will generally show deference

27 South Penn Oil Co., 71 W. Va. 438; see also, Clifton v. Koontz, 160 Tex. 82, 325 S.W.2d 684 (1959).
31 Clifton, 160 Tex. 82, 325 S.W.2d 684.
to a lessee’s judgment and take into consideration any other matter that a reasonably prudent operator would consider in continuing with operations.


It is common for an oil and gas lease to provide that the lessor may take gas from a well for domestic purposes at no charge. If that is all that occurs, and there is no commercial sale of oil or gas, the question is whether producing free gas for a landowner will constitute “production.”

In the West Virginia case of Goodwin v. Wright, the lessor prevailed in a suit to set aside an oil and gas lease where, although a well on the property provided free gas to the lessor, no production had been marketed and sold from the property and no royalties paid to the lessor by the lessee in over four years. The court based its decision on the rationale that the purpose of an oil and gas lease is for the production of the minerals “in the ordinary sense of the term,” which results in royalty to the lessor. In holding that production must be in paying quantities, the court stated the following with regard to the free gas:

> From a reading of the entire instrument it is evident that the royalty provision is a primary matter, while the free gas, like the provision for burying lines below plow depth, is a secondary matter.

While it might seem axiomatic that a lessor who utilizes free gas by connecting to the lessee’s well would waive, or otherwise be precluded from raising, the issue that the lease has terminated for lack of production, the Goodwin court held there was no estoppel preventing the lessor from challenging the lease. The court reasoned that the lessor had both the right to free gas and the right to have the lease terminate at the end of its term. As to the primary obligation to produce in paying quantities, the court clarified

---

32 Goodwin, 163 W. Va. at 265.
33 Id.
34 Id. at 69, 927 (citing Metz v. Doss, 114 Ill. App. 2d 195, 252 N.E.2d 410 (1969), where the Illinois court held that a lessor, by taking free gas, is not estopped from challenging the lease, and that furnishing free gas to a lessor does not constitute “production,” which will keep the lease in effect).
that paying quantities meant “commercial” production, which generates net profits to the lessee and royalty income to the lessor.

This rule has been followed generally where the issue has been raised.\(^{35}\)


Where challenges have been specific to the issue of profitability, courts are more stringent in applying a direct economic analysis of operating costs to determine whether operations have been profitable, although questions may exist over the period of time to consider and the appropriate items of cost to include.

Stated most simply, the Texas court in *Sullivan and Garnett v. James*\(^{36}\) concluded that with the use of the operator’s own numbers, “by simply adding up the receipts on the one hand and the expenditures on the other, the difference would readily determine the profit or loss.”\(^{37}\)

In an Ohio case,\(^{38}\) proof was offered that gross receipts from operations were $2,887, and the court calculated operating costs as $3,741, including the sum of $2,887 as the value attributed to the lessee’s labor. The lessee in that case performed all labor himself, and, on appeal, the court held it was improper to attribute a cost not actually incurred, stating: “[t]he fact that a lessee can keep operating costs at a minimum should inure to his benefit in a determination of whether a well produces in paying quantities.”\(^{39}\) Thus, when the attributed, or estimated, cost of the lessor’s labor was eliminated from the equation, the operations were profitable.

In *Imperial Colliery Co. v. Oxy USA Inc.*,\(^{40}\) a robust examination was made of the issue of paying quantities in the context of a large lease entered in 1944 with 14 producing wells. The lessee in that case had internal memoranda


\(^{37}\) Id. at 893.

\(^{38}\) Blausey, 61 Ohio St.2d 264.

\(^{39}\) Id.; 400 N.E.2d at 410.

\(^{40}\) Imperial Colliery Co. v. Oxy USA Inc., 912 F.2d 696 (4th Cir. 1990).
indicating losses from operations began in 1978. OXY was unable to provide complete accounting for operations for any year after 1978 and, absent complete records of costs, the lessor offered expert testimony to establish the missing cost items and provided an operating model demonstrating that operations, in each year from 1978 to the time suit was filed in 1985, were conducted at a loss. The court followed the general rule that “paying quantities” is measured by “operating costs” and not the cost of drilling or other capital expense, and found that under any analysis the lease as a whole operated at a loss from 1978 to 1985 when suit was filed. Accordingly, the condition that production occur profitably was not met, and the lease was held to terminate. As part of its decision, the court held that the lease as a whole must operate profitably and refuted a contention that the term would have been extended if any single well out of the 14 wells could have been shown to be profitable.

These cases demonstrate that, while great deference will be given to the judgment of the operator, the question of paying quantities, or profitability, can be a hard economic analysis that compares current income with current expenses. In these cases, the questions will likely devolve into an analysis of those costs that should be considered, and these are “largely a matter of expert and technical knowledge.”41 Specific costs, such as the lessee’s own labor or the efficiencies employed by an operator, will be important, as seen in the Ohio cases above. Looking beyond these items, costs such as “taxes, overhead charges, labor, repairs, depreciation on salvageable equipment” have been approved,42 although depreciation, generally, has been disapproved as an operating expense.43 “Marketing” costs are generally stated to be operating expenses,44 while “re-working” costs have been specifically held to be “analogous, and closely related, to the initial drilling expenses.”45 Further,

42 Skelly Oil Co. v. Archer, 356 S.W.2d 774, 781 (Tex. 1961).
43 Clifton, 160 Tex. 82, 325 S.W.2d 684.
such expenses are “a one time, single expense item” that should be treated as a capital expense rather than an operating cost.\(^{46}\)

An interesting twist on the profitability analysis is seen in the Ohio case of *Weisant v. Follett*,\(^ {47}\) where the lessee “shackled” wells on the leased premises in question with a large number of other wells and used a single power plant for pumping. The lessor, in attempting to prove that operations were not “paying,” urged that the test should be whether the cost of operating the three wells on the leased premises should be made as if they were operated alone. The court was persuaded by the fact that the method of operation was customary in the area, and that the lessor who lived on the property was familiar with it. Accordingly, the court found that “it may be assumed” that in entering the lease, the lessor understood that the lessee “would have the right to pump oil in this manner.”\(^ {48}\) Moreover, the court recognized the “large expenditure in the drilling of wells and in the developing of the lease,” finding that it would be “unjust” to require a test for profitability “not in general use, and which, if generally applied, would put an end to the operation of thousands of wells in this territory by lessees who have developed them.”\(^ {49}\)

A series of Texas cases\(^ {50}\) developed the following two-pronged test for profitability:

(1) does the production yield a profit after deducting operating and marketing costs . . . and (2) would a prudent operator continue, for profit and not for speculation, to operate the well as it has been operated.

Following this test of profitability, the court in *Pshigoda v. Texaco*\(^ {51}\) added:

---

\(^{46}\) *Id.*


\(^{48}\) *Id.* at 383.

\(^{49}\) *Id.*

\(^{50}\) *Garcia*, 139 Tex. 578; *Clifton*, 160 Tex. 82, 325 S.W.2d 684; *Skelly Oil Co.*, 163 Tex. 336; *Pshigoda*, 703 S.W.2d 416.

\(^{51}\) *Pshigoda*, 703 S.W.2d 416.
Central to the [analysis] is the philosophy that fixed or periodic cash expenditures incurred in the daily operation of a well (sometimes called out-of-pocket lifting expenses) are to be classified as operating expenses, while one time investment expenses, such as drilling and equipping costs are to be treated as capital expenditures.

In considering the question of “paying” production, a question may exist with respect to the time period for testing profitability. General guidance on this issue is provided in Clifton v. Koontz, where the court rejected the lessor’s contention that a cessation-in-production clause providing a 60-day grace period defined the period for examination of profitable operations, and held that where production never ceased, “the 60-day clause is not definitive of the period over which the trier of the facts must determine whether a lease is producing in paying quantities.” 52 The court stated:

There can be no arbitrary period for determining the question of whether or not a lease has terminated for the additional reason the [sic] there are various causes for slowing up of production, or a temporary cessation of production, which the courts have held to be justifiable. . . . We again emphasize 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. . . . 53

In the end, the Koontz court concluded that the factor for consideration is “a reasonable period of time under the circumstances.” 54 In the Pshigoda case, the lessor urged that a single period of 23-1/2 months prior to the litigation should have been considered and, although perhaps moot, based on other decisions in the case, the court affirmed the consideration by the court of an additional 17-month period, reasoning that “the time frames adopted by the trial court are reasonable.” 55

---

52 Clifton, 160 Tex. at 88, 325 S.W.2d at 690.
53 Id.
54 Id. at 88; 325 S.W.2d at 691.
55 Pshigoda, 703 S.W.2d at 419; see also Ballanfonte v. Kimbell, 373 S.W.2d 119 (Tex. Civ. App. 1963), where a 13-month period was approved.

The introduction to this chapter describes the fluctuation in gas prices in the 21st century starting at a little above $2.00, rising to all-time highs in 2005 and falling back to the $2.00 and below range. Development during this time reached unparalleled highs and, with inflation operating costs, have certainly increased. Of all expenses an operator might encounter today, however, transportation and pipeline access costs have seen the most dramatic increase. Thus, with a glut of gas, low prices and high operating costs, some operators may find it difficult to operate profitably.

Our research shows that gas prices in the Dominion system at South Point were $1.41 in May 2015, and that the following might represent operations in central Appalachia, at least for those operators on the Dominion transportation system:

<table>
<thead>
<tr>
<th>Inside FERC Dominion South Point Index May 2015 (as published)</th>
<th>Per Dth</th>
<th>$1.41</th>
</tr>
</thead>
<tbody>
<tr>
<td>Royalty Interest (depends on lease before or after transport)</td>
<td>-12.5%</td>
<td>($0.18)</td>
</tr>
<tr>
<td>Overriding royalty (if payable)</td>
<td>0.03125</td>
<td>($0.04)</td>
</tr>
<tr>
<td>WV County Tax (% varies by county)</td>
<td>2.0%</td>
<td>($0.03)</td>
</tr>
<tr>
<td>Gathering (assumed percentage - fee structure varies)</td>
<td>10.5%</td>
<td>($0.15)</td>
</tr>
<tr>
<td>Processing (assumed percentage cost - fee structure varies)</td>
<td>0.5%</td>
<td>($0.01)</td>
</tr>
<tr>
<td>Firm transportation (fixed fee per Dth)</td>
<td></td>
<td>($0.57)</td>
</tr>
<tr>
<td>Marketing fee (varies, assumed 3.5%)</td>
<td>-$0.05</td>
<td>($0.04)</td>
</tr>
<tr>
<td>WV Severance Tax (calculated iss 15% safe harbor transport credit)</td>
<td>-5.00%</td>
<td>($0.06)</td>
</tr>
<tr>
<td>WV Workers Comp. Severance Tax (fixed - $0.047/MCF)</td>
<td>-$0.047</td>
<td>($0.05)</td>
</tr>
<tr>
<td>Operating cost (varies assumed $1.35 per Dth)</td>
<td>-$1.35</td>
<td>($1.35)</td>
</tr>
<tr>
<td>Operator loss per Dth</td>
<td></td>
<td>($1.07)</td>
</tr>
</tbody>
</table>

The chart graphically illustrates conditions in a depressed market and the potential that an operator with substantial investment in drilling and development might find it impossible to operate at a profit, particularly under the hard economic analysis of cases such as Imperial Colliery. If we harken back to certain core principles applied by the courts, indicating that the requirement of production is satisfied if the operator has a “reasonable basis
for the expectation of profitable return,”56 and if we take into account the universal proposition that operations must be assessed from the perspective of the operator using good faith judgment, it would seem the market forces, particularly temporary ones, which are beyond the operator’s control and any diligence he or she might exercise, should result in a tempered requirement of “paying quantities.”

In one of the few cases to address this question, the Tenth Circuit Court of Appeals considered an oil and gas lease that was operated profitably until a depression in the oil market caused prices to drop and operations under the lease to occur at a loss. The lease in that case provided that the term would continue as long as oil or gas were “produced.” Absent the qualification “in paying quantities,” the court, first, “assumed without deciding, that ‘in paying quantities’” was an implied qualification of ‘production.’ It then refuted the lessor’s claim that the lease expired for failure to produce in paying quantities, holding:

We are of the opinion that the parties, when they used such phrase [produced in paying quantities], contemplated normal conditions and not the unusual conditions to which we have referred, and intended that the question of whether the requirements thereof were being met should be determined in the light of such normal conditions; and that if the wells would produce a profit over operating expenses under normal conditions and the [lessee] is willing to continue to operate them at a loss believing in good faith that normal conditions will return and the wells will ultimately produce a profit over operating expenses, it cannot be said that the wells are not producing oil in paying quantities within the meaning of the lease.

The reasoning of the federal court in this case, which was decided under Oklahoma law, is unique, but sound. Considering the scenario in the east, the general principles articulated by the Ohio, Pennsylvania and West Virginia courts, which allow deference to the good faith judgment of a lessee, which recognize the significant investments made, which recognize the ‘reasonable

56 Barbour, Stedman & Co, 93 S.E. at 1040; see also, supra, Section 25.02[c].
expectations’ of producers, and which are often tailored to unique facts, would seem to compel the same result if a similar challenge were made in one of these states.


Acquisitions in recent years of older leases that are ‘held by production’ typically involve leases where production has occurred from shallow wells only, so that over the life of the leases, there has been no development of deeper horizons. The question as to the potential partial termination of deep formations, or correspondingly, the question whether shallow production will hold deep formations, has been answered in Ohio and Pennsylvania.\(^57\)

In the Ohio instance, the landowners challenged whether the production of 15 wells from the Germantown Sand Formation under two leases — the Burton Lease and Miller Lease — also held the “deep rights.” The basis for the challenge was that a previous assignment of shallow rights excepted and reserved the deep rights, and, in that case, the deep rights or formation had never been developed. Accordingly, the question raised was whether continued production from the shallow formations with no development as to the deep formations continued to hold the deep formations.\(^58\) The Fourth District Court of Appeals of Ohio began by examining the granting and habendum clauses under Ohio oil and gas contract law as set forth in *Harris v. Ohio Oil Co.*, 57 Ohio St. 118, 48 N.E. 602 (1897).\(^59\) The granting clauses in each of the leases at issue covered “all the oil and gas in and under” the tracts.\(^60\) The Miller Lease provided “for the term of two years from the date hereof and as much longer as oil or gas is founded in paying quantities,” and


\(^{58}\) *Marshall*, at §§ 1-4.

\(^{59}\) *Id.* at §§ 10-13.

\(^{60}\) *Id.* § 12.
the Burton Lease provided “for the term of one years [sic] from the date hereof and as much longer as oil or gas is found in paying quantities.”61 The court determined that the crux of the case was whether the production in paying quantities from the shallow wells held the “deep rights” or whether the 1960 assignment severed the original oil and gas leases and created two separate and distinct leases in which the implied covenant to reasonably develop applied separately to both the shallow and deep formations.62 Ultimately, the court affirmed the decision of the trial court that the 1960 assignment of the shallow rights did not create separate and distinct leaseholds, but, rather, that the production in “paying quantities” from the shallow formations held all depths and all formations covered by the original oil and gas leases.63

A similar decision was reached in Pennsylvania64 and, given the similarity in laws in the eastern states, it is submitted that each would reach the same result.

§ 25.03. Cessation of Production.

The literal habendum clause language that the term will continue “so long as oil or gas are produced” creates a “determinable estate,” that is, one based on a condition, which, if not met, causes the lease to automatically terminate.65 No action for termination to occur is required by either the lessee or lessor.66 The termination results in an automatic reversion of all oil and gas rights to the lessor.67 Once terminated, a lease may not be revived by production or other physical act,68 and an effort to resume production by a

61 Id.
62 Id. at ¶ 13.
63 Id. at ¶¶ 16-21.
67 See, e.g., Bryan, 213 W. Va. at 113, 577 S.E.2d at 261.
lessee, or, more accurately, a former lessee, will at least in one jurisdiction constitute a trespass.\textsuperscript{69} According to the West Virginia court:

As with the lack of production (or under some mineral leases, the lack of operations) at the end of the primary term, an oil and gas lease (or other mineral lease) automatically terminates immediately upon the cessation of production during the secondary term, unless there is a cessation of production clause . . . , or in the absence of such a clause, unless the cessation of production is only ‘temporary.’

Some leases may contain express provisions that contemplate temporary cessation, and these may contain grace periods for the resumption of production. Where a lease does not contain such a provision, courts, in recognition of the substantial investment normally made in oil and gas development and the nature of both the operations and the markets, nearly always recognize that events in the normal course, many beyond the operator’s control, may cause production to cease. The harsh result of losing a lease and the investment made has led courts to carve out a relaxation of the requirement of production by recognizing a ‘temporary cessation in production’ doctrine.

\textbf{[1] — Temporary Cessation of Production.}

The temporary cessation doctrine recognizes that cessations in production can result from a variety of causes, and, under this doctrine, the term of a lease will continue during the cessation so long as the cause is justified, the length of time is reasonable and, perhaps most importantly, the operator is diligent in seeking to restore production. According to one court:

Courts universally recognize the proposition that a mere temporary \textit{cessation} in the production of gas or oil \textbf{will not terminate the lease} under a habendum clause of an oil and gas lease \textbf{where the owner of the lease exercises reasonable diligence and good faith in attempting to resume production of the well}. A critical factor in determining the reasonableness of the operator’s conduct is the length of time the well is out of production. Additionally, \textbf{in determining}

\footnote{\textit{Bryan}, 213 W. Va. at 121, 577 S.E.2d at 269.}
the reasonableness of the lease owner’s conduct, all attendant circumstances must be taken into account.\textsuperscript{70}

Perhaps the most extensive discussion of this doctrine and the nature of an oil and gas lease are seen in the West Virginia case of \textit{McCullough Oil, Inc. v. Rezek},\textsuperscript{71} where the court offered the following:

In the absence of a cessation of production clause, the courts in virtually all jurisdictions addressing the issue have developed a “temporary” cessation of production doctrine, whereby a mere “temporary” cessation of production during the secondary term for equipment repairs or technical problems, reworking operations, lack of a market, etc., does not result in an automatic termination of the lease, as these types of delays are normally not protracted and are incidental to the normal operation of the lease; they must, therefore, have been contemplated by the parties to be excusable. \textit{See Anderson v. Schaffner}, 90 W. Va. 225, 229, 110 S.E. 566, 567 (1922). \textit{See also annot.}, 100 A.L.R.2d 885 (1965 and Later Case Service). Factors to be considered in deciding whether a cessation of production is “temporary” include the length of time without production, the cause of the delay and whether the lessee exercised reasonable diligence to resume production. [further citations omitted].\textsuperscript{72}

Hence, whether the cessation was temporary or permanent in nature is dependent on multiple factors, including the length of time, the cause of the cessation and the diligence of a lessee, all of which are usually questions of fact.\textsuperscript{73}

\textbf{[a] — Length of Time for Cessation.}

Clearly, the longer the cessation of production, the more likely it will be considered a permanent abandonment of the leasehold.

\begin{footnotes}
\item[71] \textit{McCullough Oil, Inc.}, 176 W. Va. 643, 346 S.E.2d at 794.
\item[72] \textit{Id.}, 346 S.E.2d 788 (footnote 5).
\item[73] \textit{Bryan}, 213 W. Va. at 118, 577 S.E.2d at 266.
\end{footnotes}
“A review of the reported cases reflects that while courts tend to hold the cessation of production temporary when the time periods are short, lessees have, for the most part, been held not to have proceeded diligently when the cessation from production exists for two years or more.”74

In West Virginia, a statutory presumption of abandonment occurs if no production occurs for two years. This statute provides:

There is a rebuttable legal presumption that the failure of a [lessee] to produce and sell or produce and use for its own purpose for a period of greater than twenty-four months . . . oil and/or gas produced from such leased premises constitutes an intention to abandon any oil and/or gas well . . . on said leased premises.75

The length of time, though, can be much less than two years, as demonstrated in the West Virginia case of Bryan v. Big Two Mile Gas Co., where a cessation due to a faulty meter was found to exist for about four months. Evidence that the operator could have replaced the malfunctioning meter in a “matter of days” was held to be a sufficient basis for the jury to conclude that the cessation was unexcused and that the lease terminated. In at least one Arkansas case, a cessation of more than four years was considered temporary.76 The length of time without production, then, is almost always considered, along with other factors in determining whether the cessation is excused.77

[b] — The Reason for the Cessation.

The second consideration on the issue of a “temporary” cessation is the reason for the cessation. The “reasons” for cessation can vary and may

---

74 Wagner, 8 Ohio App.3d at 94, 456 N.E.2d at 526 (emphasis added).
76 Saulsberry v. Siegel, 252 S.W.2d 835 (Ark. 1952) (Wells were destroyed by fire and took four years to repair. Additionally, Lessors did not claim the lease terminated during the four years the wells were not producing but, rather, made the claim approximately 20 years later.).
77 McCullough Oil, Inc., 176 W. Va. 638, 346 S.E.2d at 788 (1986); Wagner, 8 Ohio App.3d at 93, 456 N.E.2d at 526.
include, among other things, the need for equipment or technical repairs, reworking operations, pipeline constraints or simply a lack of market for production. One West Virginia court indicated that a temporary cessation is excusable when “the reason for the period of cessation is incidental to the normal operation of the lease . . . .”78 When cessation results from circumstances beyond the lessee’s control, though, a longer cessation is more likely to be considered temporary than if the circumstances were within the lessee’s control as a prudent operator.79 Thus, it is expected and reasonable that a well may need to be taken out of production temporarily, but there is a direct correlation between the length of the cessation, the reason for it and the diligence of the operator in remedying the problem.

The reasonableness of the time of the cessation can be measured by the length of time it might take to fix a problem. Thus, in Bryan v. Big Two Mile Gas Co., a four-month cessation was not excused when the evidence demonstrated that the malfunctioning equipment could have been replaced in a “matter of days.”80

[c] — The Diligence of the Lessee.

The third, and perhaps most important, consideration in testing whether a cessation is temporary is the diligence of the operator in restoring production. If a lessee is slow to act, acts in bad faith or otherwise does not meet the standard of a diligent, prudent operator, the cessation is more likely to be treated as permanent.81 In Wagner v. Smith, the Ohio court considered all three factors where a lessee failed to produce for three years due to water in the borehole, resulting in a failure of the well to produce. However, the court’s holding was largely based on the lessee’s lack of diligence, in that the evidence indicated that the lessee did not discover the well defect until six months after production had ceased, and repairs were not undertaken.

78 Bryan, 213 W. Va. at 118, 577 S.E.2d at 266.
80 Bryan, 213 W. Va. at 118, 577 S.E.2d at 266.
81 Wagner, 8 Ohio App.3d at 94, 456 N.E.2d at 526.
Held by Production leases

for another year after that.\textsuperscript{82} The Wagner court, accordingly, overturned the trial court and held:

[I]n light of the totality of circumstances, that appellee did not proceed with the diligence required in respect to the rights of the lessors and that the cessation of production was for an unreasonable length of time and, thus, was more than a ‘temporary’ cessation of production.

Pennsylvania, unlike West Virginia, Ohio, New York and Kentucky, has no case recognizing the temporary cessation of production doctrine.\textsuperscript{83} However, a period of cessation, followed by a renewal of production, has been held to result in a tenancy at will.\textsuperscript{84} Thus, in Pennsylvania, when a leasehold ceases production but the lessee revives operations thereon, a tenancy at will occurs rather than an automatic termination, so that the lessee is not liable for trespass, and the lessor must then notify the lessee of its desire to terminate the lease. A similar result can occur in other states, such as Kentucky, where a lessee drilled a well, but abandoned its lease for lack of production, only then to re-enter the property with the acquiescence of the lessor and begin operations again.\textsuperscript{85} In such an instance, although subject to the will, and

\textsuperscript{82} Id. at 93, 456 N.E.2d at 526.
\textsuperscript{83} The issue of “temporary cessation” was referenced once by the Pennsylvania Supreme Court in Cole v. Philadelphia Co., 26 A.2d 920 (Pa. 1942), when the court rejected a producer’s argument that “temporary cessation” constituted “abandonment” of the lease. Cole, 26 A.2d at 923. The landowner in Cole sued to recover unpaid royalties. Id. at 921. The producer defended the suit on the grounds that he had “abandoned” the lease prior to that time by temporarily disconnecting the well. Id. The Cole panel opined that “[a] cessation of operations for a short time does not signify the same intention of abandonment.” Id. Remarkably, outside of the Cole opinion, there does not appear to be another Pennsylvania appellate court that has even addressed the issue of “temporary cessation.”
\textsuperscript{84} Heasley, 2012 Pa. Super. 151, 52 A.3d 341; see also, Cassell, 193 Pa. 359 (holding that the moment an oil and gas lessee stops producing from the property, the lessor has the right to terminate the lessee’s tenancy, and if the lessee holds over, it is as a tenant at will).
\textsuperscript{85} Bay State Petroleum Co. v. Penn Lubricating Co., 121 Ky. 637, 87 S.W. 1102 (1905); see also, Bryan, 577 S.E.2d 258, 266 (containing dicta that a holdover tenancy may arise if the lessor were to accept payments or acquiesce in the continued use of the land by the operator).
possibly the knowledge, of the lessor, the lessee was allowed to continue to operate the property without being liable for trespass.

[2] — Cessation Due to Price or Depressed Markets.

As this chapter is written, many areas of the country, particularly the eastern mineral-producing states, are seeing all-time high prices of natural gas fall to all-time lows and an oversupply condition which will likely not end any time soon. In this cyclical gas marketplace, producing gas profitably in certain areas might be difficult. Our discussion above at Section 25.02, particularly in the example given with prices at $1.41 per dth, indicates that production at a profit in some areas might be difficult to impossible, given the depressed market, and this might occur despite the diligent efforts of the operator. The question this presents is whether an operator, who, despite best efforts cannot operate profitably, can cease production in hopes that market conditions will improve.

Unfortunately, no case could be found that squarely addresses this question and provides guidance on the ability of an operator to invoke the temporary cessation in production doctrine and keep a lease in effect without “production,” when confronted with the alternative of either operating at a loss or shutting-in. This dilemma pivots on the question of whether courts will show deference to an operator’s diligence, good faith judgment and “reasonable expectations” or whether a court might take a more hard line approach and find that, so long as a market exists, a lease will remain in effect only so long as profitable production occurs, or, stated another way, might a court hold that the temporary cessation of production doctrine does not apply if there is a market, albeit at a loss.

An analytically related situation presents itself where a market for natural gas exists, but the lessee’s best economic judgment is that total economic return from the well may be maximized by voluntarily shutting-in the well for a period of time until the market for natural gas improves and it may

86 Introduction and Section 25.02[4].
reasonably be expected that prices for natural gas will increase. Does the lessee have discretion under an oil and gas lease to make the decision to shut-in a well and not market gas where a market, albeit a poor one that could earn a slight profit, is available? Under the typical habendum clause, there is no easy answer to this question.

Again, we are not aware of a reported case that squarely addresses the situation in which a lessee has voluntarily capped production during the secondary term of an oil and gas lease because of dissatisfaction with the price the gas is bringing, although the well is still capable of producing and could, in fact, yield a slim profit under existing conditions. However, the few reported cases, which involve similar conditions or touch upon related issues, have inconsistent results, but most suggest that a lessee has a certain amount of discretion in rejecting unfavorable sales contracts and in shutting-in wells under certain circumstances.

The least favorable result from the operator perspective is Hutchinson v. McCue,\(^8\) where the Fourth Circuit Court of Appeals held that a lease terminated where a lessee, after drilling and producing from two wells, ceased making deliveries of gas from the wells under an existing sales contract, shut-in the producing wells, and attempted to negotiate a long-term contract at a better price. Although such a contract was ultimately negotiated and a third well was drilled, a variety of problems prevented the sale of any gas under the second contract until approximately eight months after the expiration of the 10-year primary term of the lease and five years after production ceased. Without production, no rentals or royalties whatsoever were paid after the original sale contract was terminated and, more importantly, after expiration of the primary term of the lease.

The majority in Hutchinson, over the vigorous dissent of Judge Parker, concluded that the lessee had failed to operate the premises with the diligence and efficiency required of the lessee. Given that much of the majority’s analysis focused on the fact that the lessor received no benefit from the lease after the wells were shut-in, it is unclear whether the majority would have reached the same conclusion had the lessee been paying shut-in

\(^8\) Hutchinson v. McCue, 101 F.2d 111 (4th Cir.) cert. denied 308 U.S. 564 (1939).
royalties in accordance with the terms of a shut-in royalty provision or had
the lessee demonstrated that operations under the available market would
have been at a loss. In any event, the court in this case did not consider the
“reasonable expectations” of the operator, and the court noted that although
market conditions were bad, the court concluded that the “evidence offers no
sufficient explanation” why sales were curtailed by the operator.89

Additionally, at least one Illinois court has expressly held that the fact of
a depressed market cannot be used to justify nonproduction as a depressed
market does not prevent the operation of a well.90 That court found that the
market conditions could not justify the nonproduction because “the depressed
price of oil was not contracted against” in the lease.91 Other courts have
similarly held that “fluctuations” in market prices may not excuse a lessee’s
failure to produce in paying quantities,92 though such a market state may
justify cessation for a reasonable time.93

89 The majority’s ruling in Hutchinson has been criticized as wrongly decided, both
explicitly, see Weaver, “Implied Covenants in Oil and Gas Law Under Federal Energy Price
Regulation,” 34 Vand. L. Rev. 1473, 1517 n.164 (1981), and implicitly, see Pierce, “Lessee/
Lessor Relations in a Turbulent Gas Market,” 38th Inst. on Oil & Gas L. & Tax’n, Ch. 8
(Matthew Bender & Co. 1987).
91 Id.
92 See, e.g., Smith v. Marshall Oil Corp., 85 P.3d 830, 834 (Okla. 2004). In Smith, the
lessee “offered no compelling equitable considerations” that would justify his decision not to
produce; rather, the court noted, the lessee testified that he “deliberately ceased production,
hoping oil and gas prices would rise.” Id. at 835. The court reiterated that this was the
lessee’s “mere ‘hope.’” That court explicitly stated that “[f]luctuating market prices do not
rise to the level of an equitable consideration [which may save a lease from termination even
with unprofitable well operations], or an excuse for [a lessee’s] failure to produce in paying
quantities.” Id. at 836.
93 Collins v. Mt. Pleasant Oil & Gas Co., 118 P. 54, 56 (Kan. 1911). In Collins, the lessee
claimed that the wells would have been profitable if the price of oil had remained where it
was when the lease was made, but that the price fell from $1.16 to 28 cents per barrel, and
that the wells could not operate at a profit at those prevailing rates. Id. at 55. The lessee’s
failure to operate for five years due to impossibility of operating “on a paying basis,” despite
diligent efforts to find a market for oil, was found to constitute abandonment of the well,
thus cancelling the lease. Id. at 56.
In *Gazin v. Pan American Petroleum Corporation*, the Supreme Court of Oklahoma considered an action by a lessor seeking to cancel a lease on the alternative grounds that either the lease expired by its own terms or that the lessee had unreasonably delayed the marketing of gas from the well in question. The lease was for a primary term of five years, required the commencement of a well within one year or the payment of delay rentals, and contained the ordinary habendum clause language that the lease would continue in effect for as long as either oil or gas was produced. The lease was executed in May 1954; a gas well capable of producing more than 20 Mcf of gas was completed in October 1956; and shut-in and appropriate delay rentals were paid and accepted during the primary term of the lease. However, no contract for the sale of gas was made until April 1960, some 11 months after the expiration of the primary term of the lease, facts very similar to *Hutchinson v. McCue*.

The Supreme Court of Oklahoma first rejected the lessor’s contention that the lease had expired by its own terms, since there was a well capable of production and the lessee had timely paid the delay rentals due under the lease. Turning to the lessor’s contention that the lessee had breached the implied covenant to market, the court observed that the lease contained no express marketing requirement; therefore, a requirement to market within a reasonable time would be imposed as part of the implied covenant.

The court next noted that, while earlier Oklahoma cases had held that the implied covenant to market did not require the expenditure of considerable sums of money for equipment or pipeline to market the gas, in this case only a nominal sum would have been required since the gas could have been marketed under a contract with a pipeline company whose pipeline was less than one mile from the well. Accordingly, the simple question before the court was whether the lessee could permissibly refuse to enter into a sales contract with a potential, willing buyer while gas was being shut-in and not marketed.

The pipeline company’s initial proposed contract provided that the pipeline company could purchase the gas “as and when needed and required” at the price of $0.10 per Mcf (and later $0.11 per Mcf, pursuant to an escalator

---

provision). The court’s opinion further indicates that the lessee knew from its own experience, and from that of other producers in the area, that the pipeline was purchasing a minimal amount of gas under similar contracts.

After completion of the well, the lessee had also contacted another potential purchaser whose line was located some 18 miles away. This potential purchaser was offering an initial price of $0.15 per Mcf, provided that the lessee could establish reserves in excess of 40 billion cubic feet. Armed with this offer, the lessee continued its negotiations with the first pipeline company and was eventually able to negotiate a contract with the first pipeline company at a price of $0.15 per Mcf, which obligated the pipeline to take or pay for five percent of the proven reserves of every well under the dedicated tract upon the establishment of proven reserves of 20 billion cubic feet of gas. The requisite reserves were established in January 1960, and the contract was executed in April 1960.

The Oklahoma Supreme Court upheld the trial court’s finding that the lessee had proceeded with due diligence in seeking and obtaining a satisfactory market within a reasonable time under the facts and circumstances of the case. Indeed, there can be little question but that the lessee conferred a substantial benefit upon the lessor, as well as upon itself, by virtue of its action in rejecting the available contract offer and keeping the wells shut-in, pending the negotiation of a more favorable contract. At the very least, this case stands for the proposition that a lessee may reject the first purchase offer with which it is presented where there exists a reasonable prospect of obtaining a more favorable sales arrangement.

Another case in which a court has explicitly held that a lessee has complied with its implied covenant to market, even though the lessee refused to market gas, is Poafpybitty v. Skelly Oil Co.95 Here, the lessors brought an action for waste and breach of the implied covenant to market against a lessee that was flaring casinghead gas instead of marketing the gas. Despite continuing negotiations for the sale of the gas, the lessee refused to enter into a contract for its sale on the grounds that (1) a better price could be obtained if the same purchaser had the opportunity to buy gas—well gas, as well as

casinghead gas—and (2) there were rumors that another pipeline company might be entering the area and offering a higher price for casinghead gas in the near future.

The Supreme Court of Oklahoma sustained the trial court’s ruling that, as a matter of law, the evidence indicated that the lessee had complied with its implied duty to find a market for casinghead gas, insofar as the lessee had complied with the normal procedures and practices within the industry in seeking a market. Although, in *Poafpybitty*, the lessors apparently did not seek cancellation of the lease but merely damages, the case holds that a lessee has not violated the implied covenant to market where it has complied with the normal practices and procedures of the industry in seeking to market its gas and has rejected sales offers in the hope and expectation that a better market could be obtained.

While there are other cases that hold that a lessee need not accept the first gas purchase offer with which it is presented, there are no reported cases that squarely uphold the right of a lessee to shut-in wells already put on line in the absence of express contractual authority to do so. However, in the case of *Nordan-Lawton Oil and Gas Corp. of Texas v. Miller*, the court upheld the decision of a lessee to shut-in two wells under a gas lease rather than produce the gas where there was a contract in effect pursuant to which gas from the wells could have been marketed. Sales from the wells would have resulted in a downward revision in estimated field reserves and a corresponding decrease in the purchaser’s take obligation. Deliveries were being made from two other wells under the lease, so there was no question of production sufficient to sustain the lease. However, the court did reject the lessor’s contention that failure to market the gas from the two shut-in wells was, under the circumstances, a breach of the implied covenants to develop and market. In refusing to attach any significance to the lessor’s evidence

---

96 *E.g.*, *Sword v. Rains*, 575 F.2d 810 (10th Cir. 1978) (held lease did not terminate although no gas was delivered until some ten months after the expiration of the primary term; test is whether the lessee has acted with due diligence in marketing the gas under the circumstances).

that it would have been better to have negotiated a shorter term contract at a lesser price so as to produce more gas on a current basis, the court observed:

Thus, the general rule in this regard applicable here is that whatever shortcomings in the lessee’s conduct may be revealed by hindsight, a covenant is not breached if, under the circumstances, an ordinary prudent operator might have followed the same course. Such a course has been followed here.\textsuperscript{98}

The lessor apparently did not appeal the district court’s findings and conclusions on this point.\textsuperscript{99}

Although the foregoing cases suggest that a lessee has discretion to reject initial sales offers where there is at least a reasonable expectation that a better contract can be secured and to shut-in wells where to produce gas from such wells would be economically unwise, not every case has looked as favorably upon a lessee who foregoes existing marketing opportunities in the reasonable expectation of securing a better market as seen in *Hutchinson v. McCue*.\textsuperscript{100}

From a theoretical perspective, though, it would seem that a lessee should be accorded substantial discretion to shut-in wells for a period of time where the lessee has a reasonable expectation that total economic return from the wells can be maximized after shut-in. Essentially, the duty owed by the lessee to the lessor is the duty of good faith and fair dealing, which inheres in every contract.\textsuperscript{100} From this duty of good faith, fair dealing and cooperation springs the obligation imposed on every lessee to conduct operations as an ordinary, reasonable, and prudent operator would, so as to effectuate the purposes of the lease agreement.\textsuperscript{101} Thus, commentators are virtually unanimous in the view that a lessee should be afforded discretion to shut-in a well where an

\textsuperscript{98} *Id.* at 137-38.

\textsuperscript{99} *Nordan-Lawton*, 403 F.2d at 946-47, n.1.

\textsuperscript{100} See, e.g., *Triangle Mining Co. v. Stauffer Chem. Co.*, 753 F.2d 734 (9th Cir. 1985).

\textsuperscript{101} See, e.g., *Piney Woods Country Life School v. Shell Oil Co.*, 539, 957 (S.D. Miss. 1982), aff’d, 726 F.2d 225 (5th Cir. 1984), *reh. denied* 750 F.2d 69 (5th Cir. 1984), *cert. denied*, 471 U.S. 1005 (1985) (failure to procure price renegotiation clause in contract for sale of gas does not represent breach of duty to secure highest price for gas; lessee acted with care and diligence required by ordinary, prudent lessee).
operator of ordinary prudence might do so, giving due consideration to the interests of both lessor and lessee, even in the absence of express contractual authority to do so.\textsuperscript{102} In these cases, it is submitted that the temporary cessation in production doctrine should apply, and that the “diligence” of the operator should be tested by his efforts to seek a market that ultimately benefits both parties.

\textbf{[3] — Other “Savings” Events and Special Provisions.}

\textbf{[a] — Cessation Clause with Grace Period.}

In lieu of the risks of automatic termination or conversion to a tenancy at will, many leases have express provisions that contemplate cessations and provide a grace period to restore production. In those cases, the grace period has been held to define the period in which a cessation might occur without termination of the lease. According to the West Virginia Supreme Court:

where an oil and gas lease (or other mineral lease) contains a cessation of production clause applicable to the secondary term, the lease terminates automatically at the end of the ‘grace period’ provided by such clause, unless production or operations are resumed within the grace period.\textsuperscript{103}

\textbf{[b] — Operations Clause.}

An operations clause is commonly used to allow for the lease to continue, absent production, provided that drilling operations are in progress. A typical operations clause provides:

If, at the expiration of the primary term, Lessee is conducting operations for drilling a new well or reworking an old well, or if, after the expiration of the primary term, production on this lease should


\textsuperscript{103} \textit{McCullough Oil, Inc.}, 176 W. Va. at 645, 346 S.E.2d at 795.
cease, this lease nevertheless shall continue as long as said operations continue or additional operations are had, which additional operations shall be deemed to be had where not more than sixty (60) days elapse between abandonment of operations on one well and commencement of operations on another well, and if production is discovered, this lease shall continue as long thereafter as oil, gas or other mineral is produced and as long as additional operations are had.\footnote{Fields v. Stanolind Oil & Gas Co., 233 F.2d 625 (5th Cir. 1956).}

Thus, an operations clause serves to make drilling operations a condition, in addition to production, which will extend the term. A key factor in determining whether the lessee’s operations have been sufficient to maintain a lease past its primary term is often the demonstrated good or bad faith of the lessee in proceeding to bring a well to completion.\footnote{See, e.g., Pemco Gas, Inc. v. Bernardi, 5 Pa. D. & C.3d 85, 92 (1977) (‘‘…actual drilling is not necessary and . . . physical acts normally required to be done prior to the commencement of actual drilling, if done in good faith, are sufficient’’); Butler v. Nepple, 354 P.2d 239, 242-243 (Ca. 1960) (cited in Pemco Gas, 5 Pa. D. & C.3d at 96) (‘‘[T]he commencement of drilling operations . . . must be something more than a pretense, i.e., must be done with the bona fide intention to follow it with actual drilling operations prosecuted with reasonable diligence.’’); True Oil Co. v. W. R. Gibson, Jr., 392 P.2d 795, 799-801 (Wyo. 1964) (cited in Pemco Gas, 5 Pa. D. & C.3d at 96) (holding that the lessee ‘‘did not have a bona fide and unconditional good-faith intention to complete the well’’ because its intentions were ‘‘qualified and contingent upon the success of its negotiations’’ over a farm-out agreement); Geier-Jackson, Inc. v. W. B. James, 160 F. Supp. 524, 530 (E.D. Texas 1958) (cited in Pemco Gas, 5 Pa. D. & C.3d at 96) (‘‘[Lessee]’s intent to drill must have been unqualified. An intent to drill on the happening of certain contingencies such as favorable information gained from the drilling of [another] well or the making of favorable financial arrangements for drilling by the [lessee] . . . would not be sufficient.’’); Duffield v. Russell, 10 Ohio C.D. 472, 19 Ohio C.C. 266 (Ohio Cir. Ct. 1899) (affirmed without comment by Supreme Court of Ohio, 65 Ohio St. 605, 63 N. E. 1127 (1902) (held that staking out the well and purchasing timber on the last day of the primary term with a bone fide intention to drill the well was commencement of operations); Kaszar v. Meridian Oil & Gas Enterprises, Inc., 27 Ohio App. 3d 6, 499 N.E.2d 3 (11th Dist. 1985) (cert. denied by Supreme Court of Ohio in Case No. 85-1371) (held the surveying and staking out of the well site, as well as filing documents with the SEC constituted commencement of operations); but see Gisinger v. Hart, 115 Ohio App. 115, 184 N.E.2d 240 (4th Dist. 1961) (holding that where the secondary term called for ‘‘as much longer as oil and gas is produced in paying quantities’’ that lease terminated at the end of the primary term since nothing occurred on the tract until 10 days before the expiration of the primary term and the attempt to drill only four days before the expiration of
court has defined good faith in this context as the lessee’s “bona fide intention to proceed thereafter [preliminary operations] with diligence toward the completion of the well.”


In today’s world, where multi-well pads are used to produce large geographic areas of land by way of horizontal wells that generally transect multiple tracts, the ability of a lessee to pool leaseholds is, in most cases, a necessity. Without the lessor’s approval, or a compulsory pooling statute, a lessee generally cannot affect the lessor’s rights under the lease by pooled or unitized operations.

An express pooling and unitization provision in a lease will generally provide (i) that production (or operations) from anywhere on the unit shall be treated as if it were on the leasehold property, and (ii) that the lessor will be paid royalty in relation to the amount of leased acreage to the total acreage in the unit. It is the first purpose that we focus on here; namely, a pooling clause’s express modification of the traditional habendum of a lease to allow for production from non-leasehold acreage to hold the lease.

Once a leasehold is combined with other properties pursuant to a pooling and unitization clause, then production from a well drilled anywhere within the unit will generally serve to continue the entire leasehold (or only the acreage so unitized ((discussed below in the context of a “Pugh clause”)) under the secondary term). Importantly, though, a lessee has a duty of fair dealing or good faith in its exercise of the pooling power.

the primary term, because it would have been highly unlikely to have “production in paying quantities” at the end of the term so as to extend it, even though the lessors had interfered with lessees in the days right before expiration of the primary term.).

107 A unitization provision may vary from a pooling provision, in that it is generally applicable in the context of secondary recovery activities, which may encompass an entire oil and gas field; however, for our purposes, such distinction is not important, as a unitization clause will generally also modify the habendum to allow for continuation of the lease without actual operations on the leasehold itself.

[i] — Pugh Clause.

From the lessor’s perspective, a lessee may have too much power under a general pooling and unitization provision. To the extent that the lessor may wish to limit the discretion the lessee has to extend the lease or to affect the lessor’s royalty, a pooling variation commonly known as the “Pugh Clause” appears as a compromise of the lessee’s pooling and unitization powers. There are infinite iterations of a Pugh clause, including a traditional Pugh clause, which contemplates a vertical separation only, and a horizontal clause, which contemplates a horizontal separation of the leasehold. Following is an example of a standard version that is applicable both vertically and horizontally:

In the event the leased premises shall be separated or divided into two or more horizons, levels or formations by assignments, or shall be pooled or unitized with other premises, in whole or in part, by agreement or governmental order, such event or events shall constitute a severance of the leased premises, and thereafter the acreage, or horizons, or the acreage and horizons so separated, or the acreage, or horizons, or the acreage and horizons included in each separate pool or unit and the acreage, or horizons, or the acreage and horizons not included within any pool or unit each shall be treated as though covered by a separate lease containing the provisions and stipulations of this instrument.¹⁰⁹

Thus, the above-quoted clause would have the effect of limiting the acreage/formation that could be held by production from the unit to only those included in the unit. A Pugh clause then still allows a lessee to hold leasehold property by production from other lands, but limits the effect of activities under the pooling clause to only that part of the leasehold included in the pooled unit.

[ii] — Retained Acreage Clause.

A retained acreage clause is a cousin to a Pugh clause, in that it, too, will limit the extent of the property that can be affected by drilling operations/production under the lease. Generally, a retained acreage provision is coupled with express drilling obligations, sometimes referred to as a continuous drilling program. Following is an example of a retained acreage clause:

Upon cessation of continuous drilling operations, except as provided above, this lease and all rights hereunder shall automatically terminate as to all lands covered hereby, SAVE and EXCEPT, as to each well then capable of producing oil and gas in paying quantities together with ___ acres allocated thereto as of the date of such termination, and shall further terminate as to all depths below 100 feet below the total depth in a well located on each such unit, or as to all depths below which the base of the deepest producing formation in each such well, whichever is greater.\(^\text{110}\)

A retained acreage provision, like a pooling provision, affects the operation of the habendum clause. However, the retained acreage provision could cause a limitation on the leasehold acreage (or depths/ formations) that will be held by production according to the quantity and/or depths of the wells drilled.

Thus, pooling and unitization provisions can operate to hold a lease without actual production from the leasehold. Limitations on the pooling power in the form of a Pugh clause and/or an express drilling requirement, coupled with a retained acreage clause, can change the make-up of the leasehold by causing acreage (or depths/formations) to be released from the held-by production lease.

[d] — Reworking Clause.

As discussed above, most of the producing states recognize the temporary cessation of production doctrine; however, there is a lack of certainty for a

If after discovery of oil, gas or other mineral, the production thereof should cease from any cause, this lease shall not terminate if lessee commences additional drilling or reworking operations within sixty days thereafter, or if it be within the primary term, commences or resumes the payment or tender of rentals, or commences operations for drilling or reworking on or before the rental paying date next ensuing after the expiration of sixty days from date of . . . cessation of production.111

Under the above clause, it is highly unlikely that a lease would be held to have terminated for lack of production, provided that drilling or reworking operations commenced within 60 days. Such a provision will substitute for the reasonableness of an operator’s diligence under the cessation of production doctrine. However, a potential pitfall for fixing a definite time where cessation is excused is that it may entirely replace the doctrine, which, depending on the facts and the leanings of the court, could have the opposite result of its intent to preserve the lease.112


It is common for a lessee to complete a well capable of producing in paying quantities but be unable to produce the well for lack of pipeline infrastructure or a market.113 Although a few states, like West Virginia, recognize discovery of natural gas as enough to continue a lease beyond the

111 Roberts v. Corum, 236 Miss. 809, 112 So. 2d 550 (1959).
112 See Samano v. Sun Oil Co., 621 S.W.2d 580 (Tex. 1981) (holding that a lease terminated under a 60-day cessation of production clause when there were no operations for 73 days after production stopped); see also McCullough Oil, Inc., 176 W. Va. 638, 346 S.E.2d 788.
113 See Derosa v. Hess Ohio Resources LLC, 2014 WL 4249861 (S. D. Ohio 2014) (Slip Copy) (holding that shut-in royalty payments held the acreage within the pooled unit until the gas could be marketed; however, the acreage outside of the pooled unit was not held by the shut-in royalty provision and amounted to a failure of reasonable development, resulting in a termination of those acres outside the pooled unit.).
primary term, most require production. Additionally, even where a lease may be extended by discovery or otherwise, under an implied duty to market, a lessor may assert a termination if a well remains shut-in.\(^{114}\) Further, when a lease is extended by way of an operations clause (discussed above) in lieu of actual production, there will inevitably be a passage of time, once the well is drilled, before completion of the well and the marketing of the natural gas. To avoid this issue, most oil and gas leases contain a shut-in royalty provision along the lines of the following:

In the event that production of oil, gas, or their constituents is interrupted and not marketed for a period of twelve months, and there is no producing well on the Leasehold, Lessee shall thereafter, as Royalty for constructive production, pay a Shut-in Royalty equal in amount and frequency to the annual Delay Rental payment until such time as production is re-established (or lessee surrenders the Lease) and this Lease shall remain in full force and effect.\(^{115}\)

The effect of a shut-in provision is to provide a substitute for production in satisfaction of the habendum clause and in avoidance of an automatic termination for lack of actual production. Thus, as a precursor to a well qualifying for shut-in status, generally such a well must first be completed and capable of producing in paying quantities.\(^{116}\)

An underlying issue, even where the period of shut-in is limited and expressly stated in the lease, is the length of time that shut-in payments can operate to relieve a lessee from its implied obligation to market production from the property.\(^{117}\) Another common issue is whether shut-in royalty

\(^{114}\) 3 Williams & Meyers, *Oil and Gas Law* § 631.

\(^{115}\) Taken from an Appalachian Lease form.

\(^{116}\) 3 Williams & Meyers, *Oil and Gas Law* § 632 at footnote 3.

\(^{117}\) A complete answer to the argument that a shut-in clause is unfair to a lessor because it would allow a lessee to hold a lease forever without producing, is that the lessee owes a duty to be diligent in searching for a market; for a breach of which he is liable possibly for damages, cancellation or an alternative decree. Similarly the shut-in well does not excuse the lessee from the usual implied covenants to further develop, to offset and to otherwise conduct himself as would a reasonable and prudent lessee under the same or similar circumstances.
payments can maintain a lease where there is no production for reasons other than a lack of the ability to market. Generally speaking, if the shut-in royalty clause does not limit its application to a lack of a market, the clause should be applied to whatever is the cause of the shut-in, so long as the operator acts in good faith and complies with its other express and implied duties.\textsuperscript{118}

[f] — *Force Majeure.*

Most modern oil and gas leases contain a *force majeure* clause, which allows the lessee to preserve the lease when forces beyond its control keep it from developing the oil and gas property. If other clauses do not cover a contingency under which production ceases, then a *force majeure* provision can step in to remedy a failure to produce and sell gas due to unforeseen circumstances. Although many variations of a *force majeure* clause can be found, the following is a straightforward provision that provides for a majority of *force majeure* situations:

If, after production has been obtained, operations under this lease are delayed, interrupted or prevented by acts of God, fire, riots, wars, strikes, inability to obtain equipment due to governmental order or action, or by failure of carriers to transport equipment, or by regulation of State or Federal action, this lease shall not terminate or be forfeited and no right of damages shall exist against lessee by reason thereof, provided operations are commenced or resumed within a reasonable time after removal of such cause or causes. If at any time within three months prior to the expiration of the primary term of this lease, production has not been obtained and the commencement or continuance of operations for the drilling of a well on said lands is delayed or prevented by any of the causes

\begin{footnotesize}

\textsuperscript{118} But see, Tucker v. Hugoton Energy Corp., 855 P.2d 929 (Kan. 1993) (holding that shut-in royalty clause could not be used to hold a lease where a market for the gas did exist, but for a very low price).

\end{footnotesize}
mentioned in this paragraph, the said primary term and all other terms of this lease may be extended for successive periods of time while such cause or causes exist, by continuing the payment or tender of delay rentals in the manner and amount and for the periods of time as provided in Paragraphs _____ of this lease for deferment of the commencement of drilling operations during the said primary term.\textsuperscript{119}

Although there is not a lot of case law concerning the construction and effect of a \textit{force majeure} clause in the context of an oil and gas lease, generally it appears that courts will give them a narrow construction and application.\textsuperscript{120}

\textbf{[g] — Non-Forfeiture Provision.}

In spite of the limitations that may be found in the habendum clauses of the type discussed herein, it is not uncommon to see savings provisions in “thereafter” oil and gas leases such as notice-and-demand clauses or judicial-ascertainment and non-abandonment clauses.\textsuperscript{121} The aim of these non-forfeiture provisions is essentially to avoid an automatic termination of the leasehold. An example of one such clause reads:

After discovery of oil, gas or other minerals upon said premises, the title to all minerals in and upon and underlying the surface of the land described in this lease shall remain and be vested in lessee and shall not revert to lessor nor end until there is a complete, absolute and intentional abandonment by lessee of each and all of the purposes, either express or implied, of this lease and every part and parcel of

\begin{itemize}
\item \textsuperscript{119} Lamczyk v. Allen, 8 Ill.2d 547, 134 N.E.2d 753 (1956).
\item \textsuperscript{121} Conny Farms Ltd. v. Ball Resources, Inc., 2011 Ohio 5472 (7th Dist.) (“Conny Farms I”) (held that judicial ascertainment clauses within oil and gas leases are unenforceable as against public policy.). But in New Hope Community Church v. Patriot Energy Partners LLC, 2013 Ohio 5882, 6 N.E.3d 70 (7th Dist. 2013) (Same court did not extend \textit{Conny Farms} and held that arbitration clause was valid and not against public policy.).
\end{itemize}
the lands described herein. Such abandonment is the only manner by which lessee’s title to such minerals can be ended and title to said minerals be reinvested in lessor.122

Closely related to the above non-forfeiture provision is a judicial-ascertainment provision, except that judicial ascertainment provides that a lease will not be terminated until final determination of such by a court, and then, after judgment, may even provide that the lessee will have a reasonable opportunity to cure the breach and avoid the termination. Another related clause, a notice-and-demand provision, on the other hand, is drafted so as to require a lessor to provide notice and an opportunity to cure its breach prior to an action for forfeiture or otherwise.

There is an inconsistency, however, between non-forfeiture–type provisions and the limitation found in a habendum clause. This inconsistency may be a difficult hurdle to overcome for a lessee wishing to revive an oil and gas lease that terminated for lack of production.123 Although courts are reticent to forfeit a real property interest, such as a vested oil and gas leasehold, they also are generally not inclined to allow a contractual expression to trump a habendum clause that clearly indicates the lease ends when production stops. In some cases, the court held that “judicial-ascertainment” clauses are void as against public policy.124

§ 25.04. Alternative Lease Forms.

To this point, the focus of this chapter has been on the traditional oil and gas lease habendum clause, which limits the duration of the secondary

122 Freeman v. Magnolia Petroleum Co., 141 Tex. 274, 171 S.W.2d 339 (1943).
123 In Freeman, the Texas court held that the leasehold estate automatically terminated where no production had occurred, even though a well, capable of production, had been drilled. The provision quoted was “held to contemplate a discovery and production of gas in paying quantities in order thereby to vest title to the minerals” in lessees. Freeman, 141 Tex. at 274, 171 S.W.2d at 339. See also, Preston v. Lambert, 489 S.W.2d 955, 44 (Tex. Civ. App.–Eastland 1973); Lynch v. Southern Coast Drilling Co., 442 S.W.2d 804 (Tex. Civ. App.–San Antonio 1969). But see, Whelan v. Shell Oil Co., 212 S.W.2d 991 (Tex. Civ. App.–Texarkana 1948) (placing some weight on this clause in holding a lease had not been terminated by abandonment).
term to a period for which there is production of oil and/or gas. There are many variations on this traditional form that may alter the production requirement.\textsuperscript{125} A few key variations will now be examined.

**[1] — Flat-rate Royalty Leases.**

A flat-rate royalty lease requires royalty of a flat sum; generally per month, quarter or year and per each well drilled on the property or per acre leased. Under a flat-rate royalty lease, the royalty is \textit{not} related to the amount of oil or gas produced. Flat-rate royalty leases are now somewhat archaic, since many states, such as West Virginia and Pennsylvania, have enacted statutes that require a volumetric royalty.\textsuperscript{126} Nonetheless, a flat-rate royalty lease, if still in effect, will most likely be one that is held by production. Following is an example of a typical flat-rate royalty provision:

[Lessee] to pay seventy-five dollars each three months in advance for the gas from each and every gas well drilled on said premises, the product from which is marketed and used off the premises . . . while the gas from said well is so marketed and used.\textsuperscript{127}

Since, under a flat-rate royalty lease, the lessor’s royalty is merely based on a well’s existence on the property and not on its level of production, it makes no difference to the lessor how much natural gas is produced from the leasehold. In a well-established line of cases in West Virginia, flat-rate royalty leases are distinguished from the “usual” oil and gas lease (production lease), in that, even with a “thereafter” habendum clause, production of oil

\textsuperscript{125} The many variations of the traditional “thereafter” habendum clause that have additional or different requirements from production are too numerous to examine in detail here, but may include, \textit{e.g.}: (i) production “by the lessee”; (ii) enumeration of substances that will continue the lease; (iii) a quantity requirement; (iv) production coupled with payments; (v) operations on the premises (discussed above); (vi) continuous drilling program, etc.

\textsuperscript{126} Guarantee of Minimum Royalties, 58 Pa. Cons. Stat. § 33 (1979); Permits not to be on flat well royalty leases, W. Va. Code § 22-6-8 (1994). These minimum royalty statutes are generally only applicable as to wells drilled or reworked after the effective dates of the laws.

\textsuperscript{127} From a lease form like the lease at issue in Wellman v. Bobcat Oil and Gas Inc., 2013 WL 1878927 (W. 4th C. W. Va. 2013).
and gas in paying quantities is not expressly required to extend a flat-rate royalty lease beyond the primary term.128

In *Bruen v. Columbia Gas Transmission Corporation*, the court stated in its only syllabus point:

If an oil and gas lease contains a clause to continue the lease for a term ‘so long thereafter as oil or gas is produced,’ but also provides for ‘flat-rate’ rental payments, then quantity of production is not relevant to the expiration of the term of the lease if such ‘flat-rate’ rental payments have been made by the lessee.129

In a recent case, *Wellman v. Bobcat Oil and Gas Inc.*130 the U. S. Court of Appeals for the Fourth Circuit issued an opinion affirming the U. S. District Court’s decision that, as a matter of West Virginia law, a flat-rate royalty lease with a “thereafter” habendum was not forfeited when, by undisputed evidence, there were long periods of time where no oil or gas was produced from the wells on the property. Further, the court held that, even though the lessor asserted that some quarterly flat-rate royalty payments were late or missed altogether, such payments were a contractual obligation, and the lessor’s subsequent acceptance of payments thereafter acted to ratify the contractual agreement.131 The *Bobcat* court based its decision on *Bruen* and also noted that West Virginia has long expressed a “general disfavor of forfeitures in contractual matters within the context of oil and gas lease rental clauses . . . .”132

In Pennsylvania, though, a flat-rate royalty lease with a “thereafter” habendum clause may not necessarily be treated differently than a production

---

129 *Bruen v. Columbia Gas Transmission Corp.*, 188 W. Va. at 730, 426 S.E.2d at 522; see also *McGraw Oil & Gas Co.*, 65 W. Va. 595, 64 S.E. 1027.
130 2013 WL 1878927 (W. Va. 2013).
131 *Id.* at 6.
132 *Id.* (quoting from *Warner v. Haught, Inc.*, 329 S.E.2d 88, 95 (W. Va. 1985)).
royalty lease. Pennsylvania, like West Virginia, has an established line of cases that distinguish production royalty from flat-rate royalty leases for habendum purposes. In *T. W. Phillips Gas and Oil Co. v. Komar,* the Pennsylvania Supreme Court affirmed that the lease at issue remained in effect, despite the fact that there was no production from the property, and stated:

Where a lessor’s compensation is subject to the volume of production, the period of active production of oil or gas is the measure of the duration of the lease. Where lessor’s compensation is a definite and fixed amount unrelated to the volume of production, the duration of the lease is not measured by the length of time the mineral is actually extracted and marketed, but by the time during which the lease provides that the lessor shall receive the fixed rental. . . .

227 A.2d. at 165.134

More recently, in *Heasley v. KSM Energy, Inc.,* a Pennsylvania superior court applied the rule announced in the *Phillips* case to a “thereafter” lease with a flat-rate royalty, but with the opposite result. The *Heasley* court reasoned that the royalty in *Heasley* differed from *Phillips,* in that “[t]he provisions of the *Phillips* lease agreement required the lessor be paid quarterly, regardless of production.” However, the *Heasley* court found that the royalty clause under its review required payments for the period during which “. . . the gas from said well is used.” The *Heasley* court reasoned that, by this language, and under the habendum clause, the lease “remained in effect only so long as production continued. When production

---

134  The *Phillips* court discussing Pennsylvania case law, namely *Cassell v. Crothers,* 193 Pa. 359, 44 A. 446 (1899) (standing for the rule that under a “percentage” royalty, a lease term ends when production ceases), and *Summerville v. Apollo Gas Co.,* 207 Pa. 334, 56 A. 876 (1904) (standing for the rule that where royalty is not tied to production a lease term is dependent only on the duration that lessor is to receive payments).
136  *Id.* at 346 (emphasis added).
137  *Id.*
ceased, the lease became an at-will tenancy, subject to termination by the
lessor at any time.”138

A delay rental, which is payable during the primary term of an oil and
gas lease as consideration for foregoing operations, is similar to a flat-rate
royalty in that it is a fixed sum payable in lieu of operations and/or production.
In a fairly uncommon lease form, an attempt is made to allow for the lease to
be extended under a modified habendum that allows for not only production
and or operations, but rental payments as well, to continue the lease into the
secondary term. Although, generally speaking, parties to a contract are free
to negotiate agreements as they see fit, under at least one Pennsylvania case
(and conceptually in line with oil and gas jurisprudence from many other
jurisdictions),139 payments alone under such a modified habendum clause
were held invalid to continue a lease into the secondary term.

In Hite v. Falcon Partners, the habendum clause read as follows:

“Lessee has the right to enter upon the Property to drill for oil and
gas at any time within one (1) year from the date hereof and as
long thereafter as oil or gas or either of them is produced from the
Property, or as operations continue for the production of oil or gas,

138 Id. at 347.
139 An early oil and gas lease form, known as the “no-term” lease, allowed a lessee
to either commence drilling operations or pay the lessor a rental to continue the lease
with no fixed term. The “no-term” lease was heavily attacked, and multiple jurisdictions
refused to enforce them. See 3 Williams & Meyers, Oil and Gas Law § 601. The amount
of litigation involving the perpetual nature of the “no-term” lease undoubtedly led to its
disuse. Nonetheless, even some modern oil and gas leases are subject to attack for provisions
that could lead to a perpetual primary term. Recently, in a class action lawsuit styled Clyde
Hupp, v. Beck Energy Corp., the Common Pleas Court of Monroe County, Ohio, sustained
plaintiff’s motion for summary judgment with regard to a form of oil and gas lease that the
plaintiff class lessor’s claim violates public policy due to language that grants the lessee a
“unilateral” right to perpetually postpone drilling by payment of rentals. See SMJ Monroe
County Case No. 2011-345. However, the 7th District Court of Appeals of Ohio reversed this
decision, finding the lease was not perpetual in nature. Hupp v. Beck Energy Corp. 2014-
Ohio-4255, 20 N.E.3d 732 (7th Dist. 2014) (The Supreme Court of Ohio has accepted this
appeal. 141 Ohio St. 3d 1454).
or as Lessee shall continue to pay Lessors two ($2.00) dollars per acre as delayed rentals, or until all oil and gas has been removed from the Property, whichever shall last occur.”

In *Hite*, the Pennsylvania superior court affirmed the trial court’s holding that the lease had expired at the end of the primary term in spite of the fact that payments continued to be made. The court’s opinion discusses the history of oil and gas lease agreements and the creation of the “thereafter” habendum clause in concluding:

[T]he terms of the leases limited the privilege of foregoing production through the payment of delay rental to the one year primary term . . . . [Lessee] was permitted to delay production during the year long primary term of the leases by the tendering of a delay rental payment, but when that primary term ended and [Lessee] failed to commence production, the agreements expired.

The court’s holding in *Hite* was largely based on the rationale that the primary term of an oil and gas lease creates in a lessor an inchoate right that vests upon the occurrence of production of the oil and gas. Thus, without production, the lease could not be extended beyond the fixed one-year period, even though the parties contracted for payments to do so. The court further noted that “a lease will not be construed to create a perpetual term unless the intention is expressed in clear and unequivocal terms.” It stands to reason that holdings such as the one in *Hite* are also predicated on a public policy, which is applicable in most producing regions and stresses the importance of the efficient and prolific development of natural resources.

---

140 *Hite*, 13 A.3d at 943.
141 *Id.* at 950.
142 *Id.* at 949.
143 *Id.* at 947-48 (citing the order of the lower court, which quoted Sterle v. Galiardi Coal & Coke Co., 168 Pa. Super. 254, 257–58, 77 A.2d 669, 672 (1951)). But see, Ball v. Ball, 137 Misc. 69, 244 N.Y.S. 300, 302 (Sup. Ct. 1930) (holding that payments could extend the lease beyond a one-year term under language indicating that the lease extends for “as much longer as the rent for failure to commence operation is paid”).
A different approach to a “no terms” lease was adopted in West Virginia when the court held that the payment of delay rent will cover the term for which the payment was made—quarterly in those cases—but the lessor could give notice and demand drilling, in which case the lease would terminate unless a well was thereafter drilled within a reasonable time.144


In the Appalachian Basin, it is not uncommon for a habendum clause to contain an additional provision for storage of non-native gas to extend the lease. The “dual purpose” lease is one that grants the lessee the right to store gas within the leased premises and contains an habendum clause that expressly allows for storage activity to continue the lease. There are several variations of the dual-purpose habendum clause. The following is an example from a case out of Pennsylvania involving the continued validity of production rights:

It is agreed that this lease shall remain in force for the term of ten (10) years . . . and as long thereafter as the above described land, or any portion thereof, or any other land pooled or unitized therewith . . . is operated by the Lessee in the search for or production of oil or gas or as long as gas is being stored, held in storage, or withdrawn from the premises by Lessee. It is agreed that the cessation of production from wells on the leased premises or upon other land unitized therewith, after the expiration of the original term, shall not terminate this lease whether the pooling units have been dissolved or not, if the land is used for the storage of gas prior to the plugging and abandonment of wells from which oil or gas has been produced. It is understood that a well need not be drilled on the premises to permit the storage of gas, and it is agreed that the Lessee shall be the sole judge as to whether gas is being stored within the leased premises and that its determination shall be final and conclusive.145

In *Jacobs v. CNG Transmission Corp.*, the courts, after an interplay between federal and state courts, held that either production or storage of gas under the dual-purpose lease could hold the entire lease, that the delay rental payment “was not necessary to preserve the lessee’s future right to drill,” but that the lessee had an implied obligation to develop the property for the benefit of both itself and the lessors.146 A companion case, also from the same federal District Court for the Western District of Pennsylvania, *Penneco Pipeline Corp. v. Dominion Transmission, Inc.*, involved the same issue regarding the secondary term of multiple dual-purpose oil and gas leases.147 Although the habendum clause in the leases at issue in *Jacobs* and *Penneco* were nearly identical, the judge of this federal district court, applying Pennsylvania law in both cases, issued competing opinions.

The primary issue in *Jacobs* and *Penneco* was whether oil and gas leases that provided for production or storage to extend leaseholds for habendum purposes continued in their secondary terms when there had been no production of gas for decades. Importantly, in *Jacobs*, the Third Circuit Court of Appeals certified two questions to the Pennsylvania Supreme Court: 1) whether a court must first find a lease to be ambiguous before deciding whether the production and storage rights are severable, and 2) whether Pennsylvania recognizes an implied covenant to produce under a mineral lease.148 The Pennsylvania Supreme Court did not address the questions specifically in light of the *Jacobs* facts but, based on the Pennsylvania Supreme Court’s opinion, the federal district court in both *Jacobs* and *Penneco* found that the habendum language in the dual-purpose leases at

---


issue granted both production and storage rights to be held in entirety, and they were not intended to be severable.

Whether the production and storage rights are severable is an important step in the analysis of the issue of what leasehold rights are “held.” In an instructive case out of the state of Kansas, Rook v. James E. Russell Petroleum, Inc., the Kansas Supreme Court held that the production and storage rights under the dual-purpose lease before that court had been severed, and that the production rights were abandoned and terminated in spite of the fact that storage operations were ongoing and subsisting.149

The basis for terminating production rights under a dual-purpose lease is generally going to be premised on the implied covenant to develop. Indeed, on remand of Jacobs, the district court, even though finding that the production and storage rights were not intended to be severed, nevertheless held that the lease had terminated because of the lessee’s failure to produce and sell gas.150 At the crux of the Jacobs court’s holding was the court’s application of Pennsylvania law to require a lessee to produce oil and gas (thereby generating royalty payments) to maintain a leasehold, as opposed to making mere rental payments for storage, which the court likened to delay rental payments that are unable to extend a lease beyond the primary term.151

In contrast, in the Penneco decision (issued by a different judge), the federal district court held that storage payments without production of oil and gas were sufficient to maintain oil and gas leaseholds.152 Importantly, in Penneco, unlike Jacobs, the court did not find an implied covenant to develop, applicable since the lessor under the dual-purpose lease could be compensated by production royalties or storage rental payments.153 Further, the magisterial judge in Penneco found that the rationale of Jacobs, namely

---

151 Jacobs, 332 F. Supp. 2d. at 786.
153 Id. at *19 (“. . . payment of compensation under the alternative gas storage provisions of the leases precludes the application of an implied covenant to develop and produce oil and gas . . . .”).
that there was an implied covenant which required production, was not applicable since the case law cited by Jacobs involved production-only leases rather than dual purpose leases.\textsuperscript{154}

Thus, in Pennsylvania, even after recent and extensive litigation and several lengthy opinions on the issue of whether storage operations alone can hold an oil and gas leasehold under a modified “thereafter” habendum clause, the law on the issue is less than clear. Additionally, there are virtually no cases on the issue from the other states in the Appalachian Basin and very little guidance from outside the region. However, considering the value of large contiguous acreage in today’s world of long lateral horizontal well development, production rights under storage fields that may be operated pursuant to dual-purpose leases almost certainly will be an issue of further litigation. To that end, and in light of the little judicial guidance available, it would seem that whether the dual-purpose lease is held by production could be raised under a myriad of different fact patterns. For example, some potential variables include: (i) whether the language in a dual-purpose lease contemplates production or storage versus production and storage; (ii) whether storage operations have been ongoing; (iii) whether there has never been production from the leasehold or there was production that ceased; (iv) whether the production rights were ever assigned or are even assignable; and, perhaps most importantly, (v) whether the production and storage rights are severable.

\textbf{§ 25.05. Conclusion.}

In conclusion, we have attempted in this chapter to describe the nature of the oil and gas leases and the unique term clause universally found in them. Given the magnitude of investment in oil and gas development today, mostly under leases, issues surrounding the term clause will certainly continue to be developed. We hope this chapter provides a good reference source on issues extant today, as the principles and decisions summarized should guide the outcome of future cases.

\textsuperscript{154} \textit{Id.} at *25.