ARE WE THERE YET?

An Examination of the Commencement & Termination of an Oil and Gas Lease

Peter E. Hosey &
Jordan Smith
Jackson Walker L.L.P.
112 E. Pecan, Suite 2400
San Antonio, Texas 78205
(210) 978-7700
phosey@jw.com
sjsmith@jw.com

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THE INTEREST CONVEYED BY AN OIL AND GAS LEASE

- An oil and gas lease creates a fee simple determinable estate, by making the conveyance of the mineral estate subject to a special limitation
- A conveys Blackacre to B “for so long as” B shall use Blackacre for a particular purpose
  - B receives defeasible estate in the minerals
  - A retains a possibility of reverter

Requirements for Conveyance

Tex. Prop. Code § 5.021

“A conveyance of an estate of inheritance, a freehold, or an estate for more than one year, in land and tenements, must be in writing and must be subscribed and delivered by the conveyor or by the conveyor’s agent authorized in writing.”
Jones v. Bevier

- Lessor executed and delivered to the lessee an oil and gas lease, which lessee recorded. The lessor never received the payment of a bonus.
- Held: The lease was supported by nonmonetary consideration in the form of an affirmative drilling obligation, which was sufficient to overcome the claim by lessor that there was a lack of consideration.

DELIVERY

Requirements for Delivery:

1. **Surrender of Control.** Surrender of possession (either actual or constructive) of the conveyance instrument to the grantee/lessee

2. **Intent for Instrument to be Effective.** Grantor must intend for the conveyance instrument to take effect immediately

- Whether delivery has occurred is a question of fact
- What constitutes delivery is a question of law
Actual vs. Constructive Delivery

**Actual Delivery** – Grantor physically delivers the conveyance instrument to the grantee for the purpose of conveying title.

**Constructive Delivery** – Grantor takes an affirmative action to allow Grantee to obtain possession of the executed deed with the intent that the deed be immediately delivered.

Conditional Delivery

- Actual possession of instrument is relinquished, but there is no intent to make a present conveyance (i.e., grantor intends that the lease become effective upon lessee’s payment of the bonus and authorizes an agent to hold the conveyance until such time as the purchase price has been paid).

- Grantor should expressly state the condition in the document or at the very least be clear on the conditional status of the physical delivery of the instrument.

- *Pelican Oil Co. v. Edson Petroleum Co.*
  - Lease was not effective where purchaser failed to make the bonus payment within the time required under the oral agreement with the mineral owner.
Acceptance is key.

- Acceptance may be implied
- Acceptance may be presumed in certain circumstances:
  - Recordation of the lease is prima facie evidence of acceptance by the grantee.
  - Possession of the deed by the grantee also raises the presumption from that day that the instrument has been delivered and accepted.

Enforceability of Offer Sheets and Letter Agreements

- An oil and gas lease must contain the following “essential terms” to be enforceable:
  1. Term of the lease;
  2. The commencement date;
  3. Description of the lease premises;
  4. Time and amount of payments in lieu of drilling operations; and
  5. Amount and manner of payment for produced hydrocarbons.

- Oakrock Exploration Co. v. Killam
  - Mineral owners and Oakrock signed a letter agreement agreeing to enter into an oil and gas lease. The agreement described the acreage, the bonus amount, the royalty and the duration of the primary term.
  - Notably, the agreement also called for an oil and gas lease to be negotiated and prepared by the lessors’ attorney.
TOP LEASING

• Top leasing occurs when the lessor under an existing oil and gas lease, who has retained the possibility of reverter in the mineral estate, grants a second lease covering the same land to another lessee with the intention that the second lease (the “top lease”) become effective upon termination of the first lease (the “bottom lease”).

• The key to drafting top leases is to take one of two approaches:
  
  (i) carefully draft a conveyance of a future leasehold interest in the mineral estate to avoid application of the RAP; or
  
  (ii) make a present conveyance of a determinable fee interest in the grantor’s possibility of reverter (an estate not subject to the RAP).

COVENANTS, CONDITIONS, & SPECIAL LIMITATIONS

• Covenant – a promise to do or refrain from doing something
  
  • Breach of covenant = liability for damages, not termination of the lease

• Condition of termination – requires lessee to do or refrain from doing something
  
  • Breach of condition = termination (if the remedy is clearly expressed in the lease)

• Special Limitation – expressed as a limitation on the estate granted
  
  • Triggering of limitation = automatic termination
TERMINATION
DURING THE PRIMARY TERM

• The habendum clause typically states:
  • “Subject to the other provisions contained herein, this lease shall be for a term of three years from the effective date (the ‘primary term’), and as long thereafter as oil, gas or other mineral is produced from the lease premises or land pooled therewith.”

• Depending on the language of the lease, termination can occur during the primary term due to:
  • Failure to commence drilling operations within a stated time (actual spudding of the well is generally not required)
  • Failure to pay delay rentals (does not apply to paid-up leases)
  • Failure to abide by express conditions contained within the lease if clearly stated

• Delay rental provisions are strictly enforced by the courts (timely and proper payment by the lessee is required)

Production in Paying Quantities

• Production must be “produced and marketed” to hold a lease in effect past the primary term; production in “paying quantities” is required

• To prevail on a claim that a lease has terminated due to lack of production in paying quantities, a Plaintiff must prove that:
  (a) operating expenses exceed operating revenues over a reasonable period of time (question of law); and
  (b) a reasonably prudent operator would continue to operate the well in the manner in which it had been operated with the expectation of making a profit (question of fact).
Termination Due to a “Permanent” Cessation of Production

- An oil and gas lease will terminate upon the permanent cessation of production.
- Temporary cessation of production doctrine – the lessee has a reasonable amount of time to restore production when production ceases (common law).
  - A court will consider:
    (a) what caused the cessation of production;
    (b) how long the cessation occurred; and
    (c) what efforts the lessee undertook to restore production.
  - “foreseeability and avoidability are not essential elements of the [temporary cessation of production] doctrine.” (Ridge Oil Co. v. Guinn (Tex. 2004))
- Time stated in the operations clause (60, 90 or 180 days) will control over “reasonable amount of time” under common law.

Avoiding Termination: Savings Clauses

- Serve as substitutes for or excuse a lack of production and prevent a lease from terminating (constructive production)
  - Dry hole clause
  - Cessation of production clause
  - Drilling operations clause
  - Pooling and unitization
  - Force Majeure provisions
- Dry Hole/Cessation of Production/Operations Provision Example:
  - “If prior to discovery of oil or gas on said land lessee should drill a dry hole or holes thereon, or if after discovery of oil or gas the production thereof should cease from any cause, this lease shall not terminate if lessee commences additional drilling or reworking operations within sixty (60) days thereafter or if it be within the primary term commences or resumes the payment or tender of delay rentals on or before the rental paying date next ensuing after the expiration of three months from the date of completion of the dry hole or cessation of production. If all the expiration of the primary term oil, gas or other mineral is not being produced on said land but lessee is then engaged in drilling or reworking operations thereon, the lease shall remain in force so long as operations are prosecuted with no cessation of more than thirty (30) consecutive days, and if they result in the production of oil, gas or other minerals so long thereafter as oil, gas or other mineral is produced from said land.”
**DRY HOLE CLAUSE**

- “If prior to discovery of oil or gas on said land lessee should drill a dry hole or holes thereon, … this lease shall not terminate if lessee commences additional drilling or reworking operations within sixty (60) days thereafter or (if it be within the primary term) commences or resumes the payment or tender of delay rentals on or before the rental paying date next ensuing after the expiration of three months from the date of completion of the dry hole or cessation of production.”

- Allows the lessee to keep a lease in effect following the drilling of a dry hole if lessee commences drilling operations for a subsequent well within a stated period or resumes the payment of delay rentals.

- Lessee must have completed a well which qualifies as a “dry hole” (i.e., the well is not productive of oil or gas).
  - A well which is capable of producing oil or gas but is simply not capable of producing oil or gas in paying quantities does not constitute a dry hole.

**CESSATION OF PRODUCTION CLAUSE**

- “… if after discovery of oil or gas, the production thereof should cease from any cause, this lease shall not terminate if lessee commences additional drilling or reworking operations within sixty (60) days thereafter or (if it be within the primary term) commences or resumes the payment or tender of delay rentals on or before the rental paying date next ensuing after the expiration of three months from the date of completion of the dry hole or cessation of production.”

- Keeps a lease in effect for a certain period of time after a well that has been producing oil or gas ceases to flow.

- The time stated in the cessation of production clause will replace the “reasonable amount of time” permitted under the common law temporary cessation of production doctrine.
DRILLING OPERATIONS CLAUSE

• “If at the expiration of the primary term oil, gas or other mineral is not being produced on said land but lessee is then engaged in drilling or reworking operations thereon, the lease shall remain in force so long as operations are prosecuted with no cessation of more than thirty (30) consecutive days, and if they result in the production of oil, gas or other minerals so long thereafter as oil, gas or other mineral is produced from said land.

• Functions as constructive production if lessee is engaged in drilling or reworking operations

• To constitute “drilling operations”, Texas courts require actual manual operations on the lease premises or land pooled therewith which are preliminary to the actual work of drilling

Continuous Operations Clause vs. Well Completion Clause

• “Well completion” clause (think stud poker) – operations only permitted on specific well when the lease does not expressly allow for operations on other wells

• “Continuous operations” clause (think five card draw) – operations can be conducted on one or more wells as long as the operations are conducted continuously
PAYMENT OF SHUT-IN ROYALTIES

- Permits a lessee to keep an oil and gas lease in effect in the absence of production by paying the lessor an agreed upon shut-in royalty while the lessee seeks a market for gas that is capable of being produced from a well on the lease premises.
  - There must be a well that is capable of producing gas in paying quantities.
- Strictly construed by courts – failure to timely and properly pay shut-in royalties typically results in the automatic termination of the lease.

FORCE MAJEURE PROVISIONS

- If a force majeure event occurs, lessee’s obligations under the lease are suspended.
- Under the common law, force majeure applied when performance became impossible or impracticable due to forces beyond lessee’s control or events which were unforeseeable.
- Depending on the language of the force majeure provision, a force majeure event may or may not have to be outside of lessee’s control or unforeseeable.
- Caution - some leases require notice be provided to the lessor; others may limit the total time of suspension due to force majeure.
EXPRESS CONDITIONS

• In most oil and gas leases, the affirmative obligations of the lessee, such as the obligation to pay royalties, are stated as covenants, rather than special limitations or conditions of termination.
• However, any such provision can result in termination of the lease if the lease expressly allows for forfeiture as a remedy.
• Continuous development and retained acreage clauses may result in only partial termination of a lease.

DEFENSES

• Quasi-estoppel – prevents a lessor from arguing that a lease is invalid or has terminated when the lessor has accepted benefits from the lease, such as royalties
• Title by limitations – adverse possession of the mineral estate after a lease has terminated, results in a new determinable fee estate in the lessee on the same terms as the terminated lease (Natural Gas Pipeline Co. v. Pool)
• Revivor – a subsequent grant of the mineral leasehold estate following termination of a lease
  • Applies when a subsequent instrument executed by the mineral owner (a) makes a specific reference to a terminated lease and (b) clearly acknowledges the validity of that lease
• Waiver – the intentional relinquishment of a known right or intentional conduct inconsistent with claiming that right
  • Not a defense to lease termination claim based on a special limitation
• Ratification – a subsequent written affirmation may bind a mineral owner to an otherwise voidable lease
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