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IT'S THE SECONDARY
TERM - DO YOU KNOW
WHERE YOUR LEASE IS?

Charles C. Steincamp

IT'S THE SECONDARY TERM - DO YOU KNOW WHERE YOUR LEASE IS?

Oil and gas leases have been structured since time immemorial into a primary or fixed term followed by a secondary term that is dependent on the conduct of the lessee for its duration. The lessee must either produce oil or gas from the lease or fit within one of the various "excuse" clauses contained in the lease.

During the secondary term of a standard oil and gas lease the lessee is operating under the portion of the lease known as the habendum clause. This paper will focus on the issues surrounding operations in the secondary term.

Habendum Clause

The habendum clause contained in the common forms of oil and gas leases are all drafted as a special limitation on the grant.¹ The lease lasts during the primary term and "as long

¹ *Haby v. Stanolind Oil and Gas Company*, 228 F.2d 298 (5th Cir. 1955); *Dethloff v. Zeigler Coal Company*, 412 N.E. 2d 526 (Ill. 1980), *cert. denied* 451 U.S. 910 (1981); *Noel Estates, Inc. v. Murray*, 65 S. 2d 886 (La. 1953); *Peckham v. Dunning*, 125 NYS 2d 895 (NY Sup. Ct. 1953); *Hannah v. Shorts*, 125 N.E. 2d 338 (Oh. 1955); *Brown v. Haight*, 255 A.2d 508 (Pa. 1969); *Watson v. Rochmill*, 155 S.W. 2d 783 (Tx. 1941); *McCullough Oil Inc. v. Rezek*, 346 S.E. 2d 788 (W.Va. 1986); *Stewart v. Amerada Hess Corporation*, 604 P. 2d 854 (Ok. 1979); *Reese Enterprises, Inc. v. Larson*, 553 P.2d 885 (Kan. 1976); *Reynolds v. McNeill*, 236 S.W. 2d 723 (Ar. 1951); *Turner v. Reynolds Metal Company*, 721 S.W. 2d 626 (Ar. 1986).

thereafter as oil and gas, or either of them, is produced²

This limitation means that the lessee is not required to do anything, however, if he fails to satisfy the terms of the lease it will terminate under its own terms. This automatic termination puts the burden on the lessee to be diligent in his efforts to maintain his lease.

Paying Quantities

Even though not written into the lease, Courts in almost every producing state engraft upon the requirement of production in the habendum clause a further requirement that the production be “paying quantities.”³ Courts have developed two approaches to determine whether a well is in fact producing “paying quantities.” Under the arithmetic test the question becomes when viewed objectively “will the lease produce a profit, however small, over operating expenses after eliminating the initial costs of drilling and equipping the well or wells on the lease which are required to prepare the lease for production.”⁴ If the lease does not produce “paying quantities” based on this objective test then the lease expires under its own terms. The second test is known as the prudent operator test. In using that test, Courts first perform an objective

² Producers 88 1- 43B Oil and Gas Lease Form.

³ *Turner v. Reynolds Metal Company*, 721 S.W. 2d 626 (Ark. 1986); *Barnard v. Gibson*, 224 P.2d 90 (Ca. 1950); *Adolf v. Stearns*, 64 P.2d 372 (Kan. 1984); *Cumberland Contracting Company v. Coffey*, 405 S.W. 2d 553 (Kt 1966); *Michigan Wisconsin Pipeline Company v. Michigan National Bank*, 3024 N.W. 2d 541 (1982); *Henry v. Clay*, 274 P.2d 545 (Ok. 1954); *Garcia v. King*, 164 S.W. 2d 509 (Tx. 1942); LSA-R.S. 31:124(La. Civil Code requiring the same).

⁴ *Wrestler v. Colt*, 644 P. 2d 1342 (Ks. App. 1982); *Garcia v. King*, 164 S.W. 2d 509 (Tx. 1942); *Superior Oil Company v. Devon Corporation*, 458 F. Supp. 1063 (D.Ne. 1978); *Gypsy Oil Company v. Marsh*, 248 P. 329 (Ok. 1926).

analysis of whether the lease is in fact producing in paying quantities over expenses, then, only in the event it is not, the court turns to whether a prudent operator would continue to produce the well in spite of the fact that it is not producing in commercial quantities. The leading case concerning the prudent operator test is the case of *Clifton v. Koontz*.⁵ The Texas court in that case stated “in determining paying quantities, in accordance with the above standard, the trial court necessarily must take into consideration all matters which would influence a reasonable and prudent operator. Some of these factors are: the depletion of the reservoir and the price for which the lessee is able to sell his produce, the relative profitableness of other wells in the area, the operating and marketing costs of the lease, his net profit, the lease provisions, a reasonable period of time under the circumstances, and whether or not the lessee is holding the lease merely for speculative purposes.” This formulation has been adopted by a number of courts.⁶

Accounting

However, even in jurisdictions that have strictly adopted the objective test there are still a host of issues concerning the application of that test. The typical rule with regard to includible expenses is that includible costs include all direct costs encountered whether paid or accrued in operating the lease as a prudent operator. These direct costs include labor, trucking, transportation expenses, replacement and repair of equipment, taxes, license and permit fees, operator’s time on the lease, maintenance and repair of roads, entrances and gates, and expenses

⁵ *Clifton v. Koontz*, 325 S.W. 2d 684 (Tx. 1959).

⁶ *Webb v. Hardage Corporation*, 471 So. 2d 889 (La. App. 2d Cir. 1985); *Michigan Wisconsin Pipeline Company v. Michigan National Bank*, 324 N.W. 2d 541 (Mi. 1982); *Barby v. Singer*, 648 P.2d 14 (Ok. 1982).

encountered in compliance with state laws which require the plugging of abandoned wells in prevention of pollution.⁷ In addition to direct costs there are still questions concerning inclusions of more indirect costs. One of these items is the overhead costs of the operator.⁸ Courts have taken divergent views concerning inclusion of overhead. Another item of dispute is depreciation. Some courts hold that depreciation should be included as an operating expense.⁹ However, the general rule is that depreciation should not be considered as an expense in determining the profitability of production to the extent that depreciation relates to the initial investment of drilling the well.¹⁰ However, there are some courts that have distinguished between depreciation of the original investment and depreciation of the production equipment.¹¹

A further difficulty in the paying quantities determination is the appropriate accounting period to be used in making the paying quantities determination. Most courts have held that a reasonable period of time should be used to determine whether the well is producing in paying quantities. The determination of a reasonable period of time typically results in the application in

⁷ *Reese Enterprises, Inc. v. Lawson*, 553 P.2d 885 (Ka. 1976); *Ross Explorations, Inc. v. Freedom Energy, Inc.*, 8 S.W. 3d 511 (Ar. 2000); *Garcia v. King*, 164 S.W. 2d 509 (Tx. 1942).

⁸ Compare and contrast *Skelly Oil Company v. Archer*, 356 S.W. 2d 774 (Tx. 1961), (Items of overhead charges which can be traceable to the actual expense of production should be considered.); *United Central Oil Corporation v. Helm*, 11 F.2d 760 (5th Cir. 1926), (Overhead charges should be considered.); *Mason v. Ladd Petroleum Corporation*, 630 P.2d 1283 (Ok. 1981), (Administrative overhead and district expenses should not be considered.)

⁹ *Transport Oil Company v. Exeter Oil Company*, 191 P.2d 129 (Ca. 1948).

¹⁰ *Clifton v. Koontz*, 325 S.W. 2d 684 (Tx. 1959). *Ross Explorations, Inc. v. Freedom Energy, Inc.*, 8 S.W. 3d 511 (Ar. 2000); *Texaco, Inc. v. Fox*, 618 P.2d 844 (Ka. 1980).

¹¹ *Whitaker v. Texaco, Inc.*, 283 F.2d 169 (10th Cir. 1960); *Stewart v. Amerada Hess Corporation*, 604 P. 2d 854 (Ok. 1979).

practice if not by admission of the court of the prudent operator test.¹²

Other Excuses

Operations Clause

Some habendum clauses refer to various operations on the premises as an alternative means of extending the life of the lease. Typically such clauses are appended to the end of the habendum clause. A common lease form provides “. . . or the premises are being developed or operated.”¹³ Courts have generally given these clauses effect by applying a prudent operator type standard. Where operations are conducted diligently and in good faith Courts have typically upheld the lease.¹⁴

Dry Hole Clause

The issues involved in the dry hole clause are first the determination as to whether the dry hole clause operates into the secondary term or whether it is limited by its terms to the primary

¹² *Texaco, Inc. v. Fox*, 618 P.2d 844 (Ka. 1980), (“The better rule precludes the use of a rigid fixed term for determination of profitability and uses a reasonable time depending upon the circumstances of each case, taking into consideration sufficient time to reflect the current production status of the lease and thus to provide the information which a prudent operator would take into account in whether to continue or to abandon the operation.”); *Clifton v. Koontz*, 305 S.W. 2d 782 (Tx. Civ. App. 1957); *Transport Oil Company v. Exeter Oil Company*, 191 P.2d 129 (Ca. 1948).

¹³ Producers 88 1-43B Oil and Gas Lease Form.

¹⁴ *Pardue v. Mark*, 279 S.W. 2d 594 (Tx. Cir. App. 1955); *Prowant v. Sealy*, 187 P. 235 (Okl. 1920); *Adolph v. Stearns*, 684 P.2d 372 (Kan. 1984).

term.¹⁵ Some clauses by their terms have been held to extend even into the secondary term. For example in the case of *Stanoland Oil and Gas Company v. Newman Brothers Drilling Company*.¹⁶ The lease contained the following dry hole provision: “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 60 days thereafter, or (if it be within the primary term) commences or resumes the payment or tender of rentals. . .”. The Texas court held that the lease was preserved by new drilling operations commenced within 60 days after the completion of a dry hole, even though the dry hole itself was completed after the expiration of the primary term. This rule has been followed by several jurisdictions.¹⁷

Cessation of Production Clause

Typical cessation of production clauses provide for the commencement of new operations within a certain time or for the resumption of rental payments by the lessee if the cessation occurs during the primary term. The courts have used the test of whether the cessation is

¹⁵ . See *Long v. Magnolia Petroleum Company*, 89 N.W. 2d 245 (Ne. 1958).

¹⁶ *Stanoland Oil and Gas Company v. Newman Brothers Drilling Company*. 305 S.W. 2d 169 (Tx. 1957).

¹⁷ *Harper v. Hudson Gas and Oil Corporation*, 189 F. Supp. 781 (W.D. of La. 1960) Aff. 299 F.2d 238 (5th Cir. 1962). (Dry hole was completed after the expiration of the primary term and within 60 days thereafter a portion of the lease hole was included in a compulsory unit with premises on which there was located a producing well.). *Owens v. Superior Oil Company*, 730 P.2d 458 (N.M. 1986), (Lease was preserved by pooling the leasehold with other premises and by engaging in further drilling off the lease but on the pool deck which resulted in production.); *Somer v. Harris Trust and Savings Bank*, 566 P.2d 775 (Ka. 1977).

permanent and not merely temporary.¹⁸ The kinds of evidence relevant to the question of whether the cessation is temporary or permanent typically are (1) the period of times that the cessation has persisted; (2) the intent of the operator; and (3) the cause of the cessation.¹⁹ These issues tend to devolve into an application of the prudent operator standard.

Shut In Royalty

The operation of gas wells involves unique considerations due to the nature of the product that are not inherent in the production of oil. First and foremost, because gas is not amenable to transportation other than by pipeline, issues then arise as to the lessee's ability to maintain an oil and gas lease in the event no pipeline is available with which to market his gas. Some states hold that discovery of paying quantities of gas is equivalent to "production in paying quantities." These states are West Virginia, Montana, Wyoming and Oklahoma. In these states, a shut in royalty clause is not necessary in an oil and gas lease so long as the lessee acts as a prudent operator finding market for the production. However, a number of states require marketing of gas at the end of the primary term in order to preserve the lease. These states are Texas, Louisiana, New Mexico, and Kansas. Some states such as North Dakota and Arkansas have not clearly ruled on the issue of whether actual marketing of gas is required to extend the lease beyond the primary term.

In the states not requiring marketing in order to extend the lease beyond the primary term,

¹⁸ *Kelwood Farms, Inc. v. Ritchie*, 571 P.2d 338 (Ka. 1977).

¹⁹ *Wrestler v. Colt*, 644 P. 2d 1342 (Ks. App. 1982); *Reynolds v. McNeill*, 236 S.W. 2d 723 (Ar. 1951); *Watson v. Rochmill*, 155 S.W. 2d 783 (Tx. 1941); *Amoco Production Company v. Braslau*, 561 S.W. 2d 805 (Tx. 1978); *Cotner v. Warren*, 330 P.2d 217 (Ok. 1958).

the lease will not terminate as long as the lessee diligently searches for a market. However, in those states where marketing is required, failure to pay shut in royalty in a timely manner or to market gas will cause the lease to terminate.²⁰ In addition, failure to pay shut in royalty in the proper manner will result in lease termination.²¹ In addition, courts have interpreted shut in royalty provisions to be applicable only when there is no market for the gas from a given well. In the case of *Tucker v. Hugoton Energy Corporation*, 855 P.2d 929 (Kan. 1993) a broad form of shut in royalty clause did not permit the lessee to shut in production in an effort to negotiate a better gas contract with his purchaser and the lease was terminated.

Conclusion

We are all bound by the whims of some long ago lessee that structured oil and gas leases. Little has changed since the 1800's in the overall form of the oil and gas lease. As a result of decisions made long ago oil and gas operators must be extremely diligent to either market oil and gas in paying quantities or assure themselves that they are within one of the “excuses” in the lease. Unfortunately, a new cottage industry has sprung up with the revival of prices seeking to cancel oil and gas leases that are in the secondary term.²² So the question is: “It’s the secondary term: Do you know where your lease is?”

²⁰ *Osborne v. Rogers*, 261 S.W.2d 311 (Tx. 1953); *Pray v. Premier Petroleum*, 662 P.2d 255 (Kan. 1983).

²¹ *Amber Oil and Gas Company v. Bratton*, 711 S.W. 2d 741 (Tx. App. 1986), (Lessee accidentally paid shut in royalty to the wrong party and the lease terminated.)

²² *National Gas Pipeline Company v. Pool*, 30 S.W. 3d 618 (Tx. App. 2000), (1937 lease held by production, two new wells drilled in 1996, suit filed 1998, asserting lease terminated due to interruptions in production for brief periods in 1959, 1960, 1961, 1963, 1964, and 1969.)