



REAL ESTATE CENTER

Termination of an Oil and Gas Lease

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Technical Report 601

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Reprinted September 2001
Revised December 1996

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Summary

The downturn in the oil and gas industry has caused mineral owners to examine the issues associated with the termination of an oil and gas lease. A lease can terminate either during its primary or secondary term. Termination during the primary term arises solely from the failure of the operator to pay delay rentals as required by the lease. On the other hand, there are four ways a lease may terminate during the secondary term; three are listed in an unaltered Producers 88 form: failure to produce in paying quantities, cessation of production and operations, and failure to tender shut-in royalties when due.

The fourth way is unrelated to the written provisions of the lease. It entails the breach of the implied covenant to reasonably develop the leased premises. If the operator fails to develop the leased premises fully, the lease may terminate.

After termination, the mineral owner in Texas no longer has any liability to plug the well. The owner has no rights to any equipment left on the leased premises unless:

- the mineral owner negotiated takeover privileges before the lease was signed,
- a reasonable time has elapsed since the lease terminated or
- the mineral owner can prove the owner abandoned the equipment.

Termination must be based on the language used in the lease document as it is critical in resolving issues.

Energy companies eagerly pursued mineral owners in the late 1970s and early 1980s to lease their mineral interests. Oil prices were at an all-time high and the potential income generated by an outstanding oil well was at the back of everyone's mind.

Economic conditions changed, however. The price of oil dropped drastically, causing many wells to be plugged and abandoned. Some operators continued to operate marginal wells in anticipation of higher oil prices. Other operators abandoned leases, leaving the equipment and casing in place.

As a result of the downturn in the oil and gas industry, mineral owners began to question at what point an oil and gas lease terminates, their liability for plugging an abandoned well and their rights to equipment and casing left on the leased premises.

The answer to these questions depends upon the wording of the oil and gas lease, the relevant case law construing the lease provisions and the rules and regulations of the administrative agencies having jurisdiction over the state's oil and gas production.

Because of the variations in the provisions that may be negotiated by mineral owners before a lease is signed, this report is based on an unaltered Producers 88 lease form with no addendum. Likewise, this report is based solely on Texas law where the issues have been resolved. Other states may vary, assuming the issues have been decided.

Conditions and Covenants

Understanding the difference between a lease covenant and a lease condition is critical in determining when an oil and gas lease terminates. For instance, the breach of a covenant gives rise to a suit for damages while the breach of a condition terminates the lease automatically. There are only two possible conditions in an oil and gas lease—one for failing to pay delay rentals during the primary term, the other for failing to pay shut-in royalties during the secondary term.

Because of the harsh consequences for breaching a condition, oil companies have eliminated all conditions in revised oil, gas and mineral lease forms commencing in December 1979. These forms are easily

recognized by noting the date in the upper lefthand corner of the lease. Typically, it will state "Producers 88" followed by a date in parenthesis, such as (7/69) or (4/76). When the date is (12/79) or later, payment of delay rentals and shut-in royalties is not a condition.

Excluding the two conditions, the rest of the agreements drafted in an oil and gas lease are covenants. For example, the operator's promise to pay royalties (except shut-in royalties), to pay surface damages and to clean up the wellsite and repair roads are all covenants. The mineral owner's sole remedy for their breach is to sue the operator for damages. They are not grounds for terminating the lease.

Also, critical in determining a lease's termination is understanding how the longevity of the lease is both stated and calculated.

Primary Term and Delay Rentals

The lease is divided into two terms or phases. The first term is called the *primary term*. It has a fixed duration as set forth in paragraph 2 of the lease. Generally, it is a negotiated two to five years. Otherwise, the predrafted Producers 88 lease form contains a ten-year term.

The primary term is divided into annual events commencing with the effective date of the lease. On each anniversary date that production or operations are not occurring, the operator must tender a delay rental to keep the lease in force for another year. Delay rentals are defined as a payment for the privilege of deferring drilling operations for another year.

If the right to receive the delay rental payment is divided between two or more people (owned by cotenants), the oil company may pay all the delay rentals to one cotenant to fulfill its obligation under the lease.

The failure to tender a delay rental when required terminates the lease on lease forms prior to 12/79.

Delay Rentals and Grace Periods

Delay rentals are not required when production or operations are occurring on an anniversary date or have ceased within 90 days thereof. A grace period allows the operator a certain time after operations or

production ceases to do nothing and yet not lose the lease. Grace periods may range from 60 to 180 days, depending upon the lease. Ninety days is typical, which is used throughout this report.

Delay Rentals and Shut-in Wells

A shut-in well during the primary term also relieves the operator from having to pay delay rentals. The shut-in provisions of the lease, somewhat similar to grace periods, allow the operator to maintain the lease without having to conduct actual operations. Unlike grace periods, shut-ins do not automatically follow the cessation of operations. Shut-ins occur where a well has been completed but for some reason cannot be produced. Generally, shut-ins follow the completion of a gas well awaiting a pipeline.

The important fact is that a shut-in well is classified as a producing well for lease purposes. Thus, no delay rentals are required during the primary term when a well is shut in because production is constructively taking place.

Delay Rentals and Force Majeure

A force majeure also relieves the operator from having to pay delay rentals. A force majeure is defined as an event, reasonably beyond the control of the operator, that prohibits operations from commencing or continuing. Flooding, fires or other acts of God are good examples. The Texas Railroad Commission's enjoining a well's operations also is a force majeure.

A force majeure temporarily halts the lease term, which has the effect of extending the lease until the force majeure is removed. Thus, if an operator is forced to suspend drilling operations during the primary term because of a force majeure, no delay rentals would be due on an anniversary date occurring during the force majeure.

Delay Rentals and Paid-Up Leases

Some leases require no delay rentals. These are known as paid-up leases. Paid-up leases require all the delay rentals to be paid in advance at the commencement of the lease. Consequently, the primary term of a paid-up lease cannot be cut short for the failure to pay annual delay rentals.

Secondary Term and the Habendum Clause

Once the primary term ends, there must be actual production or operations occurring at that time to extend the lease into its secondary term. If there are none, then the lease will terminate with three exceptions:

- Drilling operations or production from a well ceased within 90 days of the end of the primary term. Here, because of the grace period, the lease terminates 90 days after operations cease and not at the end of the primary term. However, the operator must renew drilling or reworking operations before the end of the 90-day grace period or lose the lease.
- A well is shut in. A shut-in well constitutes a producing well as explained earlier. Thus, the lease lasts for so long as the shut-in continues and shut-in royalties are paid.
- A force majeure caused an extension of the primary term.

The secondary term, unlike the primary term, does not have a definite longevity. Instead, the secondary term lasts so long as production or operations continue. When they cease, so does the lease after the grace period expires.

The length of the secondary term is dependent upon the wording of paragraph 2 of the Producers 88 lease. This is known as the habendum clause. Most habendum clauses state that the lease will last "for so long as production continues." Others state "for so long as operations continue." Texas courts have defined the phrase "for so long as production continues" to mean for so long as the well produces in "paying quantities."

Calculating Paying Quantities

Because some energy companies have continued to operate marginal wells, the Texas courts have developed a formula for calculating paying quantities.

The formula requires certain charges and expenses to be deducted from the well's revenue. If the resulting figure is negative, the well is not producing in paying quantities. If there is more than one well in the lease, the paying-quantities test applies to all

the lease wells as a whole and not separately to individual wells.

The expenses deductible from revenue include royalty payments, administrative and overhead charges traceable to producing and marketing of the production, treating and transportation charges, charges for labor and repairs, depreciation of salvageable production equipment, expenses for installing pipeline facilities, electric bills for production operations and taxes.

Nondeductible expenses include the original costs of drilling, completing and equipping the well, reworking expenses, depreciation of original investment and overriding royalties.

The courts have been less than consistent in establishing the length of time over which the paying-quantities test applies. Obviously, the length of time depends on the circumstances in each case. So far, the courts have examined a minimum of six months and a maximum of 17 months.

If the paying-quantities test cannot be met, the lease does not terminate automatically. The courts must decide whether a reasonably prudent operator would, for the purpose of making a profit and not merely for speculation, continue to operate the well or wells situated on the lease.

A different picture emerges for leases based on the language "for so long as operations continue." Here, the lease itself defines operations as ". . . an endeavor to obtain production of oil, gas, sulfur or other minerals, *whether or not in paying quantities.*" However, it is unclear whether this language removes such leases from the paying-quantities test or not.

Cessation of Production or Operations

Another way a lease can terminate during the secondary term is by cessation of production. The cessation-of-production provisions provide that, unless the operators renew operations or productions within 90 days after they cease, the lease terminates. The 90-day period corresponds to the grace period of the lease.

The operator of each well in Texas must file monthly production reports with the Texas Railroad Commission. Mineral own-

ers wishing to ascertain whether 90 days have transpired without production may obtain copies of the monthly reports. However, there is no public source available for ascertaining whether other operations such as reworking or recompleting a well have occurred.

Payment of Shut-in Royalties

A third way an oil and gas lease can terminate during the secondary term is failing to tender shut-in royalties as they come due on lease forms prior to 12/79. If all the wells on a lease are shut in during or at the end of the primary term, the first shut-in royalty will be due 90 days after the end of the primary term and on each subsequent anniversary date thereafter until production resumes. If all the wells are shut in during the secondary term, the first shut-in royalty is due 90 days after the shutin and on each subsequent anniversary date thereafter until production is restored.

The shut-in provisions apply only when all the wells on the lease or on acres pooled with the lease are shut in. If all but one well is shut in, the shut-in provisions do not apply.

Recently, there has been a tendency among mineral owners to place a limitation on how long a shutin may last, i.e., no more than two years beyond the end of the primary term or two years in the aggregate. When the imposed time limit expires, the operator must produce or lose the lease.

A recent case dealing with shut-in royalties in Texas held that the shut-in royalties must not only be paid on time but also to the correct parties. In this case, two mineral owners, X and Y, each owned one half of the royalties. A well was shut in and the operator tendered all the shut-in royalties to X. The courts held the lease terminated as to Y's interest resulting from the improper tender.

To correct this problem, newer lease forms published in the 1980s give the oil company to same privilege it has for payment of delay rentals. If the right to

receive shut-in royalties is divided between two or more people (owned by cotenants), the oil company may pay all the shut-in royalties to one cotenant to fulfill its obligation under the lease.

There is a relationship between the paying-quantities test, the cessation-of-production test and the shut-in provisions. The paying-quantities test applies when the operator continues to produce or operate the lease with no interruption exceeding 90 days. The cessation-of-production test applies any time there is a cessation of more than 90 days between production, reworking or other operations regardless of whether or not the well or wells are producing in paying quantities. A shut-in well always constitutes production or operations. Thus, neither of the two prior tests applies to a situation where all the wells on a lease are shut in. However, only a well or wells capable of producing in paying quantities may be shut in according to the provisions of an oil and gas lease.

Implied Covenants

Another way the lease may terminate during the secondary term is by the operator's violation of an implied covenant. As the name indicates, these covenants are not written nor referenced in the lease. They are merely implied by law. The most applicable to the termination of the lease during the secondary term is the implied covenant of reasonable development. Issues surrounding implied covenants are quite voluminous and therefore are not included in this report.

Liability for Plugging Well

The question of who is liable for the cost of plugging a well often arises. Assume that an operator abandons a well during the secondary term. Production and operations cease for 90 consecutive days, terminating the lease. Is the mineral owner liable for the plugging cost? The answer is no. A recent change in the Texas Railroad Commission's regulations relieves the mineral owner from

any plugging costs except where the mineral owner explicitly agrees to do so.

Rights to Abandoned Equipment and Casing

What about the equipment and casing left on the property after the lease expires? Does it become the property of the mineral owner? Again, the answer is generally no unless:

- the lease states that it does,
- a reasonable time has elapsed since the lease terminated or
- the mineral owner can prove the operator abandoned the equipment and casing.

Generally, there are no provisions in a Producers 88 lease form giving the mineral owner the right to assume control of the unremoved equipment and casing. In fact, most oil and gas leases state the operator has the right to remove equipment and casing "at any time" after the lease expires. Thus, if the mineral owner did not negotiate take-over privileges and attach them to the oil and gas lease, the mineral owner may never have any rights to the equipment and casing.

However, Texas courts have **not** construed the relevant provisions of the oil and gas lease literally. The courts have held that the term "at any time" means within a reasonable period of time. The operator's failure to remove the equipment and casing within a reasonable time after the lease expires results in a forfeiture.

The next question is what is a reasonable time. Texas courts have held that the issue is a mixed question of law and facts and depends on the surrounding circumstances. What is deemed reasonable in one case may

be wholly inadequate under different circumstances. So far, the Texas courts have found from 19 months to four years to be a reasonable time for the operator to remove the equipment and casing.

The mineral owner need not address the issue of a reasonable time if abandonment can be proven. However, abandonment is a legal term meaning the operator relinquished the property with the intent of terminating ownership. Although the relinquishment can easily be proven, the intent of the operator cannot. Mere nonuse and the passage of time alone do not constitute abandonment. For example, the Texas courts have held the nonuse of an easement for 22 years was insufficient proof of abandonment.

Under any circumstance, the mineral owner still may not have an absolute right to the equipment and casing if there are perfected mechanic's and materialman's liens existing against the equipment and casing. Perfected creditors take priority over the mineral owner's claim to the property.

Conclusion

This report reviews the ways a conventional oil and gas lease can terminate. As noted, different rules apply to the primary and secondary terms of the lease. There may be other ways a lease may terminate if clauses were negotiated by the mineral owner prior to signing the lease. Likewise, a suit for the breach of an implied covenant can terminate a lease. However, the latter two means are beyond the scope of the report.

This information is in no way intended to substitute for the advice of legal counsel. Persons with specific questions may want to consult an attorney.