



## Chapter 6

# The Termination Clauses of The Lease: The Delay Rental Clause

## THE TERMINATION CLAUSES OF THE LEASE

Oil and gas leases become a company's most valuable asset. Most oil companies do not own real estate nor do they own the building where their offices are located. Most oil companies do not own the drilling rigs, a fleet of cars, pipelines or a refinery. A legitimate oil company can exist without any of those items. Take away the pieces of paper called "Oil and Gas Leases" and you have different outcome.

As with any asset, this most valuable asset for the oil company can be lost. The word used in the oil and gas lease for this loss is *terminate*. The word terminate is never a good word and refers to what will happen to the oil and gas lease (the company's asset) if the lease administrator or lessee fails to meet the lease obligations associated with the lease.

For most unaltered oil and gas leases, termination can occur either during or after the primary term. Although, there is a hand full of causes for the termination during the secondary term, only one cause would result in the lease termination during the primary term of a non-paid up lease. That cause would be the failure of the lease administrator to pay the delay rental payment as required by the lease.

Four causes would result in the termination of the lease during the secondary term. They are as follows:

1. The lease would terminate if the lessee fails to produce a well in *paying quantities*.
2. The lease would terminate if either the production of a well or operations ceased.
3. The lease would terminate if the lessee fails to make a proper shut-in royalty payment.
4. The lease would terminate if the lessee fails to meet the implied covenant for the reasonable develop of the lease.

The fourth cause is different from the first three in that it becomes a breach of a lease covenant. As the name suggests, covenants are not a written part of the oil and gas lease, "they are merely implied by law" and the implied covenant that is "the most applicable to the termination of the lease during the secondary term is the implied covenant of reasonable development."<sup>1</sup>

In this section of the study all four causes for termination will be covered. They are found in the following:

## **The Delay Rental Clause**

Paid-up Leases

Delay Rental Leases

Meeting the Conditions of Commencing Operations

Meeting the Conditions of Paying the Delay Rental

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## **FOOTNOTES:**

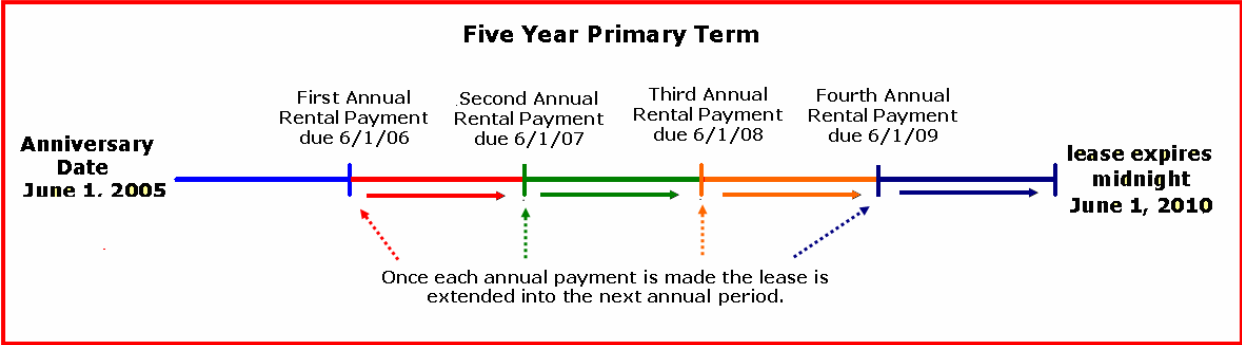
<sup>1</sup>Termination of an Oil and Gas Lease, Real Estate Center, Technical Report 601, Judon Fambrough.

# Delay Rental Clause

## Delay Rental Clause

This lease shall terminate on July 1<sup>st</sup> 20 07 unless on or before said date the Lessee either (a) commences operations for the drilling of a well on the land, or on acreage pooled therewith, in search of oil, gas or other minerals and thereafter continues such operation and drilling to completion or abandonment; or (b) pays to the lessor a rental of One Dollars (\$ 1.00 ) per acre for all or that part of the land which Lessee elects to continue to hold hereunder, which payment shall maintain Lessee's right in effect as to such land without drilling operations for one year from the date last above mentioned; and Lessee may continue to maintain the right granted without drilling operations for successive twelve month's periods (during the primary term) by paying Lessor, on or before the beginning of such respective periods One Dollars (\$ 1.00 ) per acre for all or that part of the land held hereunder. If the lessee shall commence to drill a well or commence reworking operations on an existing well within the term of this lease or any extension thereof, or on acreage pooled therewith, the lessee shall have the right to drill such well to completion or complete reworking operations with reasonable diligence and dispatch, and if oil or gas, or either of them, be found in paying quantities, this lease shall continue and be in force with like effect as if such well had been completed within the term of years first mentioned.

Most mineral owners who sign an oil and gas lease want the oil company to drill a well. For most, the sooner the well is drilled the better. Oil companies, on the other hand, may not be ready to begin operations within the first, second or third year of the lease. Although oil companies want to drill wells they must be strategic about the venture. So, in an attempt to accommodate both lessor and lessee, today's non-paid up leases are segregated into equal annual periods. Each of these periods begins on the anniversary date of the lease. During each of the annual periods, the oil



company has the right, but not the obligation to begin the drilling of a well.

In those cases where operations have not begun, a delay rental payment must be made to the lessor either on or before the anniversary date of the lease. This payment is the only vehicle that can perpetuate the lease into the next annual period. This payment also allows the company another year in which they have the right but not the obligation to begin drilling.

## PAID-UP LEASES

Many companies prefer to use a lease form that has done away with the need to make annual delay rental payments. The necessity for these payments has not gone away because they actually become part of the bonus payment offered to the lessor and are made all at once - at the time the lease is taken. This type of lease, called a *paid-up lease*, ensures that the lease will not be terminated because of any rental payment oversight.

## DELAY RENTAL LEASES

If a company chooses to use something other than a paid-up lease form, the lease requires *annual* delay rentals. Since these are annual rental payments and are to be made prior to the next ensuing 12-month period, the first annual rental is made to the lessor at the time the lease is signed and is usually incorporated into the bonus payment.

There are two types of annual delay rental clauses used today. One is called the "unless" clause and the other is the "or" clause. The delay rental lease form, used in our example, uses the *unless* clause. Simply put, when this language is used the lease will terminate on the anniversary date of the lease *unless* one of the following things has taken place.

- a. Operations have commenced.
- b. A delay rental payment has been tendered to the lessor.
- c. Other portions of the lease provide for the third condition - that being a well is actually producing in paying quantities or a shut-in

**Notice the word, "Terminate"**

**Delay Rental Clause**

**Notice the word, "unless"**

This lease shall **terminate** on July 1<sup>st</sup> 20 07 **unless** on or before said date the Lessee either (a) commences operations for the drilling of a well on the land, or on acreage pooled therewith, in search of oil, gas or other minerals and thereafter continues such operation and drilling to completion or abandonment; or (b) pays to the lessor a rental of One Dollars (\$ 1.00 ) per acre for all or that part of the land which Lessee elects to continue to hold hereunder, which payment shall maintain Lessee's right in effect as to such land without drilling operations for one year from the date last above mentioned; ...

payment has been made on or before the anniversary date of the lease.

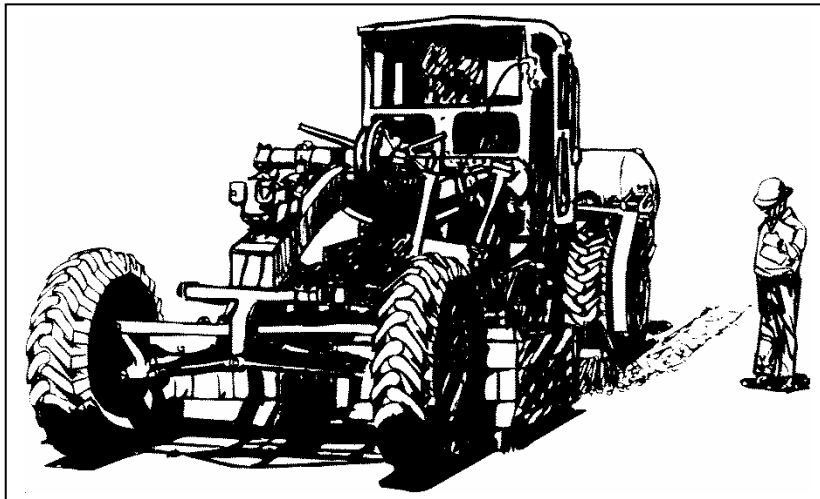
The words as set out in this clause create, what is known as a *condition of title*. A condition of title simply means that in order for the lease to be maintained into the next annual period of the lease, certain *conditions* must have been met. Most states hold that such language is to be strictly interrupted and unless the lessee has complied with the terms, the lease will terminate automatically by its own terms.<sup>2</sup>

## MEETING THE CONDITION OF COMMENCING OPERATIONS

The question is often asked, "What does commencing operations really mean?" If a company simply staked a location, filed a permit to drill a well or had someone on the premises digging a hole with a shovel, would that qualify as commencing operations?

Or is drilling the only way to satisfy this condition?

Although, some leases define operations as actual drilling with a rig capable of drilling to total depth,<sup>3</sup> apart from this language, generally, courts have found that commencing operations can be something less than actual drilling. Moving dirt in order to build a road or a location or some sort of physical operations *would* qualify as commencing operations. Whatever the activity, it must be demonstrated that the company has an *irrevocable commitment* to finish the task of drilling the well.<sup>4</sup>



Some leases actually define operations. In these cases, the definition must be literally followed and the lessee becomes limited in their interpretation of "operations". If the definition is limited in its scope, the constraints placed on the lessee are also limited. Leases that do not attempt to define operations are more liberally upheld in the favor of the lessee.

A lease using the term “commence a well” is much different than a lease using the term, “commence operations to drill a well” or “commence operations”. It is very important to properly identify the language in the lease. The language of the lease will determine what activity needs to take place on the specified date.

Example:

Read the following language and determine what activity needs to take place on the specified date.

**This lease shall terminate on July 1, 2008, unless on or before said date Lessee completes drilling operations for the drilling of a well on the land, or on acreage pooled therewith, in search of oil, gas or other minerals.**

In this example, the lessee has limited operations to not only mean drilling, but also the *completion* of the drilling operations either on or before July 1, 2008.

## MEETING THE CONDITION OF PAYING A DELAY RENTAL

If the commencement of drilling is not achieved, the lessee must make delay rental payments in order to keep the lease active. Failure to make these payments, on or before the due date, will result in the termination of the lease.

Most states would enforce a stringent compliance with the paying of delay rentals. States will permit few excuses, if any, and will not allow “honest” mistakes or an inadvertent error made on the part of the lessee. Because the language in the lease has created a *condition*, the condition must be met or the lease terminates. An Oklahoma District Court in *Latham v. Continental Oil Co.*, 558 F. Supp. 731 (W.D. Okla. 1980), stated, “Intention, good faith, or a mistake on the part of the lessee generally are not material and will not excuse the lessee's failure to strictly comply with said lease condition.”

Excuses that are not allowed and will cause the termination of the lease:

1. A rental payment made after the due date
2. A rental payment made with less than the full amount due
3. A rental payment sent to the wrong payee

### **Example 1:**

Your company had a rental payment that is due on January 22<sup>nd</sup>. One week prior to this date, many of your company's employees went home sick with a severe case of the flu. Your lease administrator was one of those employees and did not return to work until January 23<sup>rd</sup>. Realizing that the rental payment had been missed, the employee immediately had a rental check processed and placed in overnight mail.

Even though it was not the lease administrator's fault that they became ill, the *conditions* as set out in the clause were not met. The payment was late and the lease would terminate despite your company's efforts to correct the error.

In light of this, many companies have a policy in place whereby rental obligations are reviewed ninety (90) days prior to the obligation date. The actual payment is in the mail at least sixty (60) days prior to the obligation date.

### **Example 2:**

Your company has a very large rental obligation due on March 12<sup>th</sup> for \$1,112.58. Your lease administrator reviewed the obligation ninety (90) prior to the due date and had the payment approved sixty (60) days prior to the due date. When the check request was submitted the employee made a typographical error and requested \$1,111.58. There was a \$1 error which was not caught prior to the mailing of the check. In this case, the *conditions* as set out in the clause were not met. Unless the error was corrected prior to the anniversary date, the lease would terminate.

### **Example 3:**

Your company has a very important oil and gas lease with a rental obligation due in sixty days. Your lease administrator reviewed the obligation last month and received the approval for the payment last week. The check, in the amount of \$640.00 was sent yesterday to the 1<sup>st</sup> National Bank of Tulsa, Oklahoma f/o/a Jackson Wilson. The problem is the payment should have been sent to the 1<sup>st</sup> National Bank of Oklahoma City, Oklahoma f/o/a Jackson Wilson. The files contained the appropriate bank address and location and if the error is not corrected prior to the anniversary date, the lease will have terminated. On the other hand, if the check was addressed to the proper bank but the mail service delivered the check to the wrong bank, in Oklahoma, the lease would not be terminated.

#### Example 4:

Your lessor, Peggy Smith owns an 80% severed mineral interest in a 120-acre tract of land (or 80% of the 120-acre tract = 96 net acres). Six months after she signed a lease with your company, she conveyed "a 25% interest" to her sister, Janice Smith. This document was sent to your company several months ago.

A delay rental payment is due in May of this year. How should your company pay rentals? Did Peggy Smith convey a full 25% (30 acres) of the whole, leaving her with 66 acres? Or did she convey 25% (24 acres) of her 80%, leaving her with 72 acres?

	25% of the whole	25% of her 80%
Peggy	\$66	\$72
Janice	<u>\$30</u>	<u>\$24</u>
	\$96	\$96

The total gross rentals for these 96 net acres would be \$96.00. If your company paid Peggy Smith as if the conveyance was a full 25% of the whole, then Janice Smith would receive \$30 and Peggy Smith would receive \$66. If your company paid Peggy Smith as if the conveyance was 25% of her 80% then Janice Smith would receive \$24 and Peggy Smith would receive \$72.

What would happen if she conveyed 25% of her 80% leaving her with 72 acres but you pay rentals based on your belief that she conveyed 25% of the whole and that she now owns 66 acres? If you underpaid Peggy would that portion of the lease terminate? Very likely, "Yes".

Because the conveyance appears to be ambiguous, a court could attribute fault to Peggy Smith. There is no guarantee that the courts would regard Peggy's conveyance as ambiguous and no oil company wants a court deciding the disposition of their assets.

- One way of dealing with this problem is to seek Ratifications from both Peggy and Janice. If the lease administrator had reviewed this lease obligation ninety days prior to the May due date there would be plenty of time to circulate the Ratifications.

Failing that, your company should overpay both Peggy and Janice. When in doubt, always overpay rather than to guess incorrectly and underpay.

### **Example 5:**

Last year your company acquired an oil and gas lease from a mineral owner named Ralph Carry. The landman who prepared the lease failed to enter a lease date at the top of the lease. The lease was not notarized until May 11<sup>th</sup> and was not recorded until May 25<sup>th</sup>.

Your company's lease administrator had been working on a department project that had captured most of her time for the past two months. On May 7<sup>th</sup> she realized that a rental payment was due. A hand written note in the file stated that the lease date, "although missing was believed to be May 5<sup>th</sup>".

She immediately mailed a rental payment to Ralph Carry postmarked May 7<sup>th</sup>. Did the lease terminate?

If the rental clause specifically stated that the lease would terminate on May 5<sup>th</sup> then the payment would be late and the lease is terminated. In cases where the date is missing at the top of the lease and no date appears in the rental clause, the rental due date becomes the date of execution or acknowledgment. In this case the lease would not have terminated.

### **Example 6:**

Given the same facts as seen in the last example except the lease was dated May 5<sup>th</sup>, notarized May 11<sup>th</sup> and recorded May 25<sup>th</sup>.

The payment was mailed May 7<sup>th</sup> to Ralph Carry's depository bank and deposited into his bank account. There it sat for 45 days. On April 24<sup>th</sup> Mr. Carry returned the money and demanded that your company release the lease. Did the lease terminate?

In order to answer this question, one should know that a depository bank is generally regarded as the lessor's agent. As an agent they do not have the ability or authority to determine if one payment is proper and another payment is improper. Their job and task is simply to deposit any funds sent to the account. In this case, Ralph Carry was correct in refunding the payment and demanding a release of the lease.

**Example 7:**

Your company is preparing rental checks and must send a payment on a lease that was signed by Thomas Perrault as guardian of Dennis Perrault, a minor child.

The lease was signed 3 years ago when Dennis was 16. Since you know that Dennis is now of adult age, should your company make the check payable to Dennis Perrault, an adult or continue to make the payment to Thomas Perrault as guardian of Dennis Perrault, a minor child?

Since Dennis has become 18 years of age, he is legally an adult and must be treated as one under the law. When a lease is taken involving a minor, the birth date of the minor is necessary so that the obligations can be paid correctly once the minor becomes an adult. Some companies would require a notice releasing Thomas Perrault from the guardianship. A Ratification and Rental Division Order prepared by your company and sent for signatures would serve the same purpose.

**Example 8:**

Your company owns a lease that covers a very large tract of land. A \$25,000 rental payment is due on July 31<sup>st</sup> of this year.

Your lease administrator has circulated the rental obligation for approval. However, the President of your company denied the payment because a rig is scheduled to begin drilling on the lease July 1<sup>st</sup>.

If your company fails to make the rental payment will the lease be in jeopardy of termination?

Depending on the language in the rental clause, your company most often will have the right to miss the rental *if operations have begun* prior to July 31<sup>st</sup>. This is an item that should be monitored closely. Rigs have been known to be delayed or canceled completely.

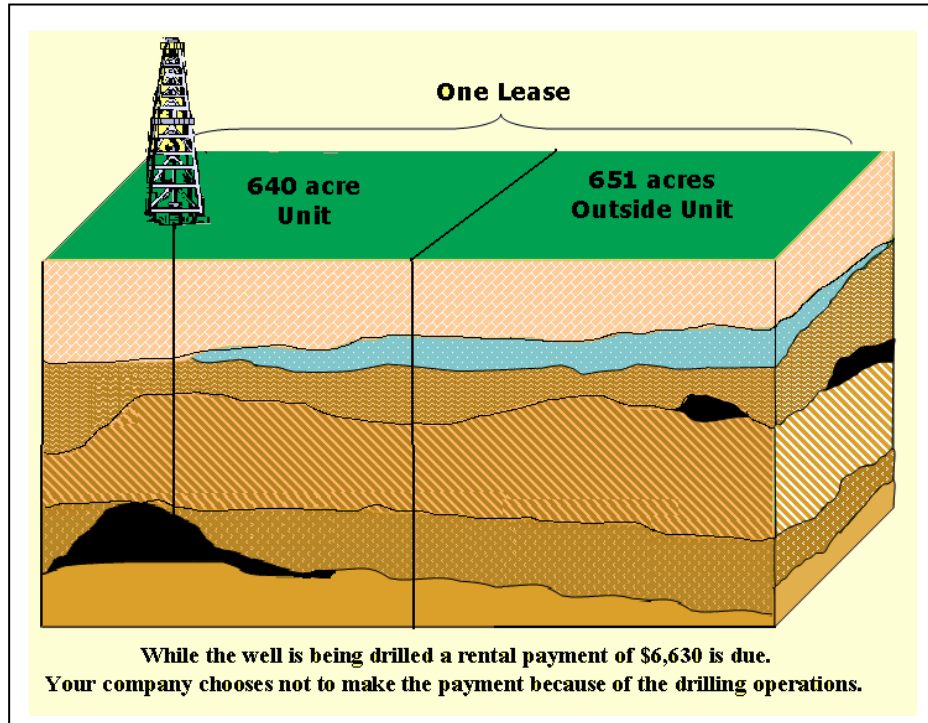
Obviously, this lease is a very important asset to your company and a prudent lease administrator should be prepared to save the lease if some twist should occur.

**Example 9:**

Your company owns a lease that covers 1,291 acres. A 640 acre spacing unit has been formed on the W/2 of the lease and drilling a well takes place inside this unit boundary during the primary term of the lease.

While the well is being drilled a rental payment of \$6,630 is due. Your company chooses not to make the payment because of the current operation

on the lease. The mineral owner complains telling you that you have violated the terms of the lease; that only half of the lease is inside the unit boundary and that a rental payment should have been made. Is he correct?



The answer will depend on two issues.

- First, did the lease contain Pugh Clause language that would necessitate a rental payment on the 651 acres outside the unit? If there was no such language, the drilling of the well on the west 640 acres would hold all lands covered in the lease and no payment should be made. On the other hand, pugh clause language might say,

“drilling operations shall continue this lease in force and effect during or after the primary term only as to the lands covered hereby which are included in such unit.”

If this were the case, a rental payment should be made on the lands outside the unit.

- Secondly, was it determined that the well was capable of producing in paying quantities. If the well turned out to be a dry hole, your company will most likely be obligated to make a rental payment on the remaining days in the lease year. If a situation like this occurs and it becomes unclear on how to pay the rental, the best rule of thumb is always – overpay rather than risk underpayment.

## CAN THE LEASE BE REVIVED ONCE AN ERROR IS MADE?

In answering this question, much caution should be used. As already expressed, courts have not allowed a great deal of latitude when errors have been made on the part of the lessee. Because the delay rental clause expresses a conditional element that must be fulfilled, if the condition is not met, the lease will terminate automatically.

- If the lessor accepts a late payment or payment less than the full amount, courts have viewed this as “inconsistent” with having the lease terminate and, therefore, might allow the lease to continue.<sup>5</sup>

For three years a company inadvertently underpaid the delay rentals to a lessor. The payment should have been \$80 for 80 net acres owned but the payment was sent in the amount of \$60. The lessor cashed each of the three checks. Ultimately, the lessor demanded the termination of the lease on the grounds that underpayment had been made. The North Dakota Supreme Court found that the acceptance by the lessor of the partial payment “validated the lease as to the 60 acres...and invalidated the lease as to the 20 acres.” *Borth v. Gulf Oil Exploration and Production Co.*, 313 N.W.2d 706 (N.D. 1981)

- In cases where the lessor desires to have the lease revived, “the only cure for making a faulty delay rental payment is ratification, more correctly called reviving the expired lease. *Reserve Petroleum Company v. Hodge*, 147 Tex. 115, 213 S.W.2d 456 (1948), 7 A.L.R. 2d 288.” Lessor<sup>6</sup> A ratification or reviver is signed by the Lessor and may contain words such as,

“In all respects, the Lease is hereby revived so that this Lease shall be deemed in full force and effect and the undersigned does hereby lease, grant, demise, ratify and confirm the Lease and all of its terms and conditions.”

- If the delay rental clause has been modified to include language such as:

“If Lessee shall, on or before any anniversary date, make a bona fide attempt to pay or deposit rental to a Lessor entitled thereto according to Lessor's records or to a Lessor who, prior to such attempted payment or deposit, has given Lessee notice, in accordance with subsequent provisions of this lease, of his right to receive rental, and if such payment or deposit shall be ineffective or erroneous in any regard, Lessee shall be unconditionally obligated to pay to such Lessor the rental properly payable for the rental period involved, and this lease shall not terminate but shall

be maintained in the same manner as if such erroneous or ineffective rental payment or deposit had been properly made, provided that the erroneous or ineffective rental payment or deposit be corrected within thirty (30) days after receipt by Lessee of written notice from such Lessor of such error accompanied by such instruments as are necessary to enable Lessee to make proper payment to Lessor.<sup>7</sup>

## **EXCUSES THAT MIGHT BE ALLOWED BY A COURT**

Excuses that might be allowed and may not cause the termination of the lease vary to some degree from state to state:

Texas courts have permitted the following excuses:

- Confusion or ambiguity caused by the lessor
- Repudiation of the lease by the lessor<sup>8</sup>

Kansas courts have permitted the following excuses:

- Lessor is attacking the lessee
- Payment sent on time but lost in mail<sup>9</sup>

Oklahoma courts have permitted the following excuses:

- Checks mailed on or before the anniversary date but delivered after the date
- A clerical error on behalf of a depository bank
- An improper payment made by an independent party over which the lessee has no control
- The mail service delivering check to the wrong bank<sup>10</sup>

## THE DIFFERENCE BETWEEN THE “UNLESS” CLAUSE AND THE “OR” CLAUSE

There are two types of delay rental clauses used today. One is called the

**Notice the word, “Terminate”**

**Delay Rental “Unless” Clause**

**Notice the word, “unless”**

This lease shall **terminate** on July 1<sup>st</sup> 20 07 **unless** on or before said date the Lessee either (a) commences operations for the drilling of a well on the land, or on acreage pooled therewith, in search of oil, gas or other minerals and thereafter continues such operation and drilling to completion or abandonment; or (b) pays to the lessor a rental of One Dollars (\$ 1.00 ) per acre for all or that part of the land which Lessee elects to continue to hold hereunder, which payment shall maintain Lessee’s right in effect as to such land without drilling operations for one year from the date last above mentioned; ...

“unless” clause and the other is the “or” clause.

The language in the “unless” clause creates a *condition of title* that must be met. If not, the lease will automatically terminate upon a certain date. This is the most common lease used today.

**Notice the word “or”**

**Delay Rental “Or” Clause**

**ABC Oil Company agrees to commence operations on said premises within one year from this date, or thereafter to pay to (lessor) one dollar per acre per year annually until a well is drilled, or the property hereby granted is conveyed to the lessor.**

The language in the “or” clause is different from that in the “unless” clause. This language does not create a condition, it creates a *covenant*. Covenant

simply means an agreement or a contract. If one party breaks the agreement, the other party is free to file a suit.

The word terminate is not used in this clause nor does the wording create a specific *condition* that must be met. With this type of lease, the lessee has simply *agreed* to one of the following:

1. Commence operations
2. pay rentals
3. surrender the lease

If the lessee fails to do any of the three, the lessor may bring a suit against the lessee in order to recover rentals.

## **FOOTNOTES:**

<sup>1</sup>Termination of an Oil and Gas Lease, Real Estate Center, Technical Report 601, Judon Fambrough.

<sup>2</sup>Oil and Gas Law 2001: Nationwide Comparison of Laws on Leasing, Exploration and Production, George A. Snell, III.

<sup>3</sup>A Comparative Review of Oil and Gas Law in Texas, Oklahoma, Arkansas, New Mexico, Mississippi & Louisiana, Landman Oil & Gas law, Special Section, December 2002, George Snell, Timothy Dowd, Tom Daily, Gregory Nibert, John McDonald and Richard Revels, p. 93.

<sup>4</sup>An Introduction to Kansas Oil & Gas Law, David E. Pierce, University School of Law, 1988, P. 69.

<sup>5</sup>South Texas College of Law, Student Bar Association, Oil and Gas Outline, Professor Strausser, 2004 [www.stcl.edu/students/sba/outlines](http://www.stcl.edu/students/sba/outlines).

<sup>6</sup>A Comparative Review of Oil and Gas Law in Texas, Oklahoma, Arkansas, New Mexico, Mississippi & Louisiana, Landman Oil & Gas law, Special Section, December 2002, George Snell, Timothy Dowd, Tom Daily, Gregory Nibert, John McDonald and Richard Revels, p. 95.

<sup>7</sup>A Comparative Review of Oil and Gas Law in Texas, Oklahoma, Arkansas, New Mexico, Mississippi & Louisiana, Landman Oil & Gas law, Special Section, December 2002, George Snell, Timothy Dowd, Tom Daily, Gregory Nibert, John McDonald and Richard Revels, p. 95.

<sup>8</sup>A Comparative Review of Oil and Gas Law in Texas, Oklahoma, Arkansas, New Mexico, Mississippi & Louisiana, Landman Oil & Gas law, Special Section, December 2002, George Snell, Timothy Dowd, Tom Daily, Gregory Nibert, John McDonald and Richard Revels, p. 95.

<sup>9</sup>An Introduction to Kansas Oil & Gas Law, David E. Pierce, University School of Law, 1988, P. 72.

<sup>10</sup>A Comparative Review of Oil and Gas Law in Texas, Oklahoma, Arkansas, New Mexico, Mississippi & Louisiana, Landman Oil & Gas law, Special Section, December 2002, George Snell, Timothy Dowd, Tom Daily, Gregory Nibert, John McDonald and Richard Revels, p. 95.