2014 Edition

Printed in Denver, Colorado
UNITED STATES OF AMERICA

www.petroleumeducationworkshops.com

1 (303) 663-0397

Introduction

The oil and gas lease is, without question, the foundation of every oil and gas exploration and production company. It can be said, with a great deal of certainty, that these simple pieces of paper are, indeed, the greatest assets a company can own.

One might argue that the *production* from a great discovery well is a far greater asset than an oil and gas lease. Someone might even argue that the geologic *knowledge* gained from a multi-million dollar seismic shoot is a much greater asset than a simple piece of paper called an oil and gas lease. The argument might suggest that the discovery well is projected to produce millions of dollars and the seismic data has revealed a field worth tens of millions of dollars. However, both are worthless to a company unless that company has gained the *leasehold right* to the tracts of land. This process takes place through the oil and gas lease.

With this in mind, the role of the oil and gas personnel who oversee and manage these simple pieces of paper becomes paramount for the success of the oil and gas company. These people have been hired not as data input personnel but rather as the *guardians of the company assets*. Their responsibility goes far beyond shuffling paper and capturing information into a computer system. Their job is as an analyst, overseer, maintainer, and guardian of these assets. For the company to realize its maximum success those who oversee the leases must also succeed. A part of that success will come as a result of mastering the oil and gas lease.

The Pugh Clause

During the latter part of the twentieth century and into the twenty-first century, the oil and gas industry witnessed a vast increase of lessors adding *divisible* language in their leases. Such language is more commonly known as Pugh clause language. This added language would require a partial termination or division of lands located outside a formed unit. Pugh clause language can provide for either a *horizontal* or *vertical* termination or severance of the lands.

Today, there exists some confusion over the definition of either a horizontal or a vertical pugh clause or severance. It appears that different organizations in the industry define these differently.

The following illustrations have been adapted from the definitions as set out by the National Association of Royalty Owners and the Schlumberger Oilfield Glossary.

- Horizontal Pugh Clause – refers to depths, geologic horizons or structures beneath the surface of the earth that will be terminated. A horizontal severance happens between two subsurface strata.
- Vertical Pugh Clause – refers to a defined portion of lands located outside a formed unit, such as the Northwest quarter of the lease or any of those lands being outside of the producing unit boundary.

Clearly, major problems can and would exist if two individuals from the same company defined pugh language differently from one another. What might be the affect if a lease administrator told a landman that the lease contained a horizontal pugh clause when, in fact, the landman defined horizontal pugh differently than the lease administrator? To avoid such confusion, it is suggested that different language be used. Instead of horizontal pugh, the term depth pugh can be used. Instead of vertical pugh, the term surface pugh can be used.

Statutory Pugh Clause

A hand full of states, including Oklahoma, North Dakota, Mississippi and Arkansas, have established what is known as *statutory pugh clause* rulings.

The Oklahoma statutory pugh clause applies to leases that were executed after May 25, 1977 and only apply to leases that have been included in a

spacing unit containing 160 acres or more. In such a case, those lands falling outside the drilling and spacing unit will, by state statute, automatically expire 90 days after the primary term of the lease.

The North Dakota statutory pugh clause N.D.C.C. section 38-08-09.8 applies to leases that have been committed to a compulsory unit that have lands inside the unit boundary and lands outside the unit boundary. Unit operations and unit production allocated to the lease may not be deemed operations on or production from the lease as to the lands covered by the lease lying outside the unit area after two years from the effective date of the order of the commission creating and approving the unit or the expiration of the primary term of the lease, whichever is the later date. After the later date, the lease as to lands outside the unit area may be maintained in force and effect only in accordance with the terms and provisions contained in the lease.

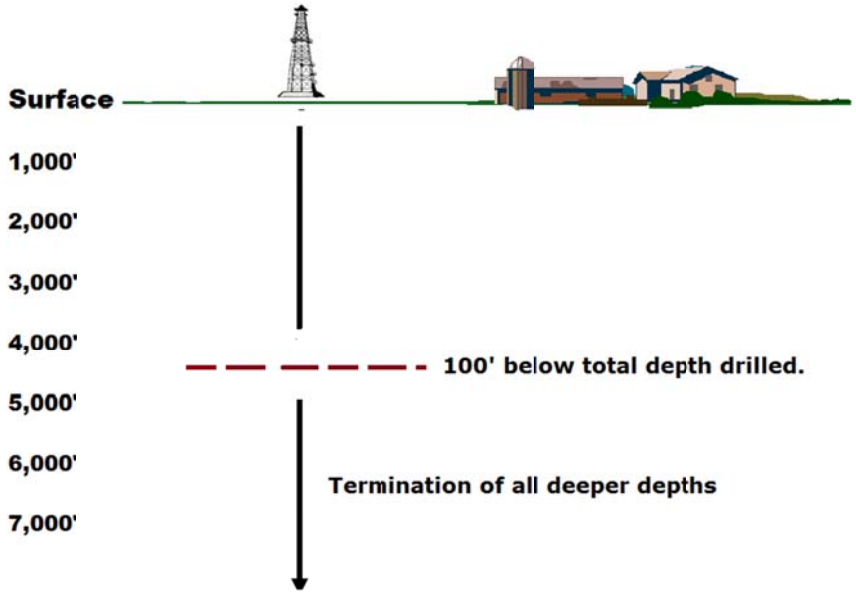
Mississippi provides that if an oil and gas lease contains lands partially within and partly outside a compulsory field-wide unit, production from the unit shall not hold the lands outside the unit. The exception to the rule applies if the lessee commences drilling activities on the land outside the unit within one year from the date of the determination of the unit or before the end of the primary term of the lease, whichever is a longer period of time.

The Arkansas Pugh clause statute applies to oil and gas leases that were executed on or after July 4, 1983. Drilling operations or production from lands falling within a pooled unit shall maintain the lease only as to the lands where the production occurs. Those leased lands falling outside the sections or pooling unit will not be extended into the secondary term of the lease. There is an exception to this rule also. The rule does not apply when drilling operations have commenced on any part or lands in sections or pooling units under the lease within one year after the expiration of the primary term, or within one year after the completion of a well on any part of lands in sections or pooling units under the lease.

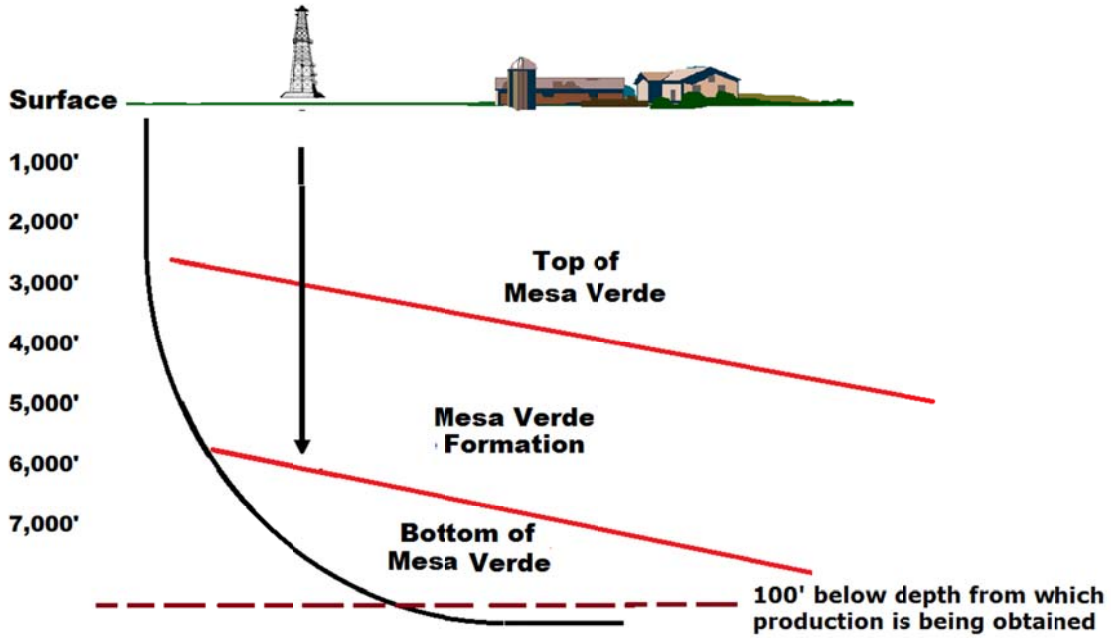
Louisiana does not have a statutory pugh clause. They do require, however, that all state leases, which have been executed after August 1, 1991, contain a type of pugh clause. The language in this clause permits the lessee to maintain lands outside a unit for two additional years past the primary term of the lease, if the lessee submits rental payments during the two year term.

Different types of Depth Pugh Clause Language

"this Lease shall terminate as to all depths down to a depth of 100 feet below the total depth drilled in each producing well."

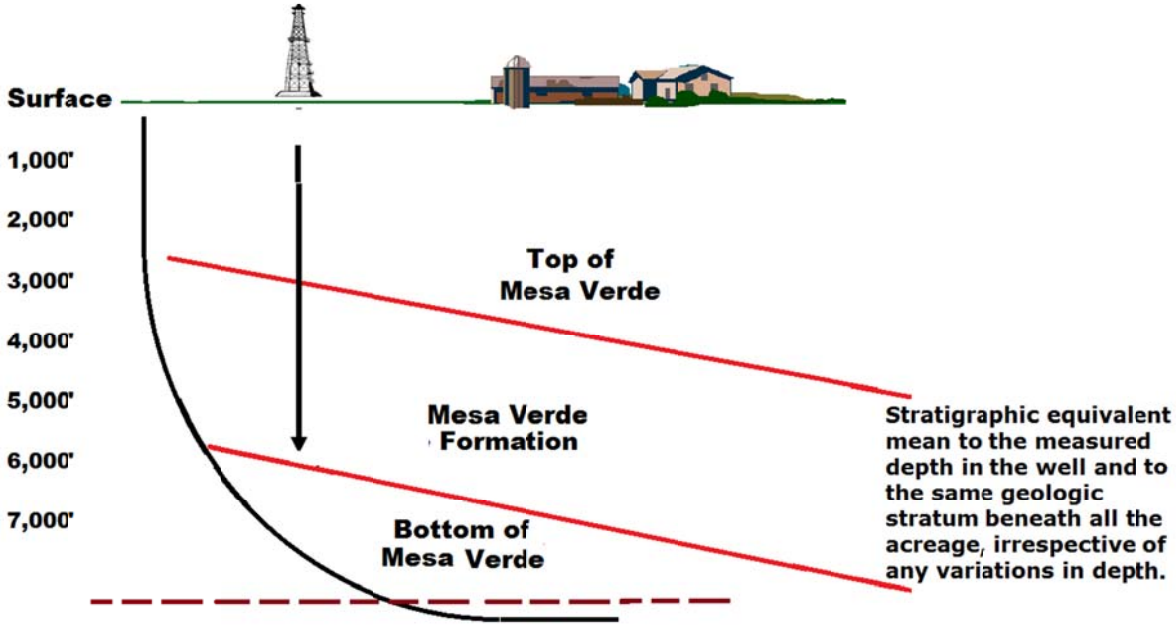


"Two years from the date of production from the lease premises is first established, if this Lease is then in full force and effect, it shall terminate as to all depths 100 feet below the greatest depth from which production is being obtained on the lease premises or lands pooled with the lease premises."



Stratigraphic Equivalent

"It is understood and agreed that two(2) years following the expiration of the primary term of this lease or the expiration of any extension or renewal of the primary term, whichever occurs last, Lessee shall release the leased premises as to all rights lying below one hundred (100) feet below either (1) the deepest depth drilled in any well drilled on the leased premises or on lands pooled therewith; or (2) the stratigraphic equivalent of the base of the deepest formation producing or capable of producing in any well drilled on the leased premises or on lands pooled therewith, whichever is the deepest."



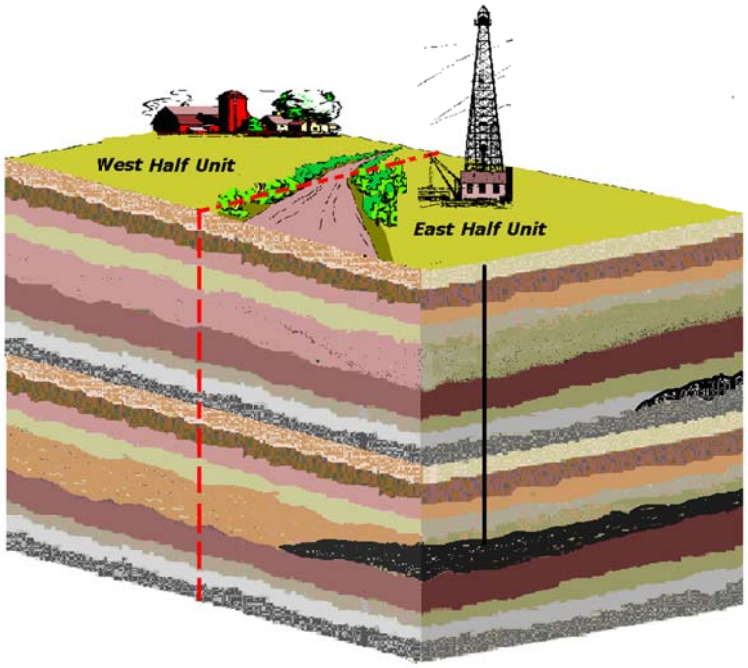
SCENARIO #5

THE PUGH CLAUSE
AND THE
JACKIE LEWIS LEASE

Assume that your company leased a 320-acre tract of land from Jackie Lewis. At the time she leased she added the following Pugh Clause language in her lease:

> "If, . . . a drilling and/or production unit be created and established, pooling and combining a portion of the lands covered by this lease with other lands, lease or leases in the vicinity thereof, then drilling or production 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, . . . it being expressly agreed that drilling or production operations shall not maintain this lease . . . as to any of the land covered hereby which are not included in such unit."

Assume that your company divided the leased acreage into two 160 acre drilling and production units (as shown). Your company also drilled a producing well on the eastern unit. No activity has occurred in the western unit and the lease is now past its primary term.



Recently, Jackie Lewis demanded that the western acres be released.

Assume you took Jackie's demand letter to your land manager. After reviewing all of the facts and reading the pugh clause in the lease, the land manager says to you, "There is no way under God's heaven that we will release the western half of her lease!"

Read the Pugh language carefully and determine who is correct, Jackie Lewis or your Land Manager. What language in the pugh clause can you use to defend your position? How you would respond in this scenario? What should you do?

_____
_____
_____
_____

Answer to scenario #5 - The Pugh Clause and the Jackie Lewis Lease:

Contracts will often have "conditional" clauses. In this case, Jackie added a conditional Pugh Clause to her lease. What this means is that ***if*** *the conditions of the clause are met* **then** the oil company must release her lease. Jackie is saying the conditions were met and the W/2 must be released. Your land manger is saying the Pugh clause conditions were not met and you should not release the W/2 lands.

Take another look at the conditional language in the Pugh clause. It begins with the word **"IF".** Here is where you find the conditions. The language then adds the word **"THEN".** If the **"IF"** conditions are met, then the **"THEN"** must take place of the releasing of the W/2 lands.

The **"IF"** language says,

> **"If** a drilling and/or production unit be created and established, pooling and combining a portion of the lands covered by this lease with other lands, lease or leases in the vicinity thereof, THEN…"

You should ask yourself the question, were these conditions met? Was a drilling unit created and established? The answer is YES. Was a portion of Jackie's lease pooled with or combined with other lands or leases in the vicinity? What is the answer to this question? **If** the answer is yes, **then** you must release the W/2 lands.

From the scenario, this condition of the pugh clause was not met. No portion of Jackie's lease was pooled with other leases or lands. This is what your land manager is seeing. Because this condition was not met, he does not think you should release the W/2 lands.

Royalty

A royalty interest is a “cost free” percentage out of the production from an oil or gas well. Cost free means that royalty owners would not pay any of the costs associated with drilling a well or any of the monthly operating costs associated with the well.

The word "royalty," as used in connection with oil and gas leases, conveyances, and reservations, has a definite meaning in its popular sense. It means a share of the products, or proceeds therefrom, reserved to the owner of land for permitting another to use the property. *McCullough v. Almach*, 188 Okla. 434 (Okla. 1941).

The Landowner’s Royalty – This royalty is established at the time the mineral owner negotiates the oil and gas lease and becomes the fractional percentage of production that would go to the owner. Just as an author of a bestselling novel would receive royalty checks based on the sales of his or her book, this royalty owner would receive a royalty payment based on the production of a producing well. Originally, the standard royalty rate paid the mineral owner was 1/8th of all production. Over the years, royalty rates have increased. In some parts of the country, many landowners have negotiated very high royalties, some with sophisticated consequences.

The Escalating royalty: With this language, the royalty rate would, at some point, increase. In the following example, the before payout royalty would increase once the well reached payout.

> “The royalties payable to the Lessor under this lease shall be on a well by well basis and on a Before Pay Out (BPO) and After Pay Out (APO) basis.” As to each and every well completed as a producer on the leased premises or on lands pooled therewith, the royalties paid to Lessor shall be one-eighth (1/8) BPO and one-fifth (1/5) APO.

The Sliding Scale Royalty: The North Dakota Industrial Commission (NDIC) has approved 640 acre spacing for the minimum size Bakken well. The operator, however, can apply for and receive 1,280 acre spacing for their unit sizes. Some attorneys, representing their mineral owner clients, are insisting on “sliding scale royalty” language when the spacing becomes greater than the minimum 640 permitted by the NDIC.

> The result of such added language can be significant. For instance, assume the lessor negotiated a 18.75% royalty with a sliding scale royalty increase of 35% if the unit size increased from 640 acres to

1280 acres. The result would be (18.75% X 1.35% = 25.3125% royalty).

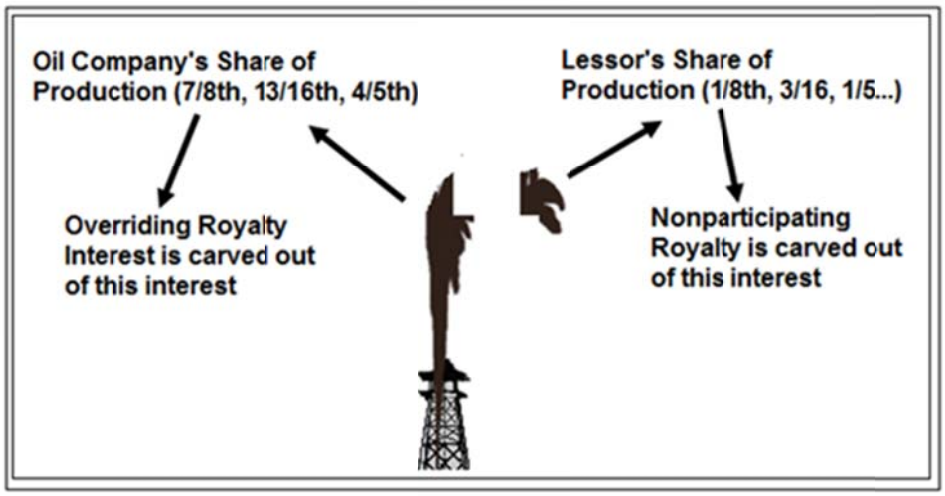
Overriding Royalty – This royalty is a cost free royalty and typically is established by the lessee who agrees to carve out a fractional portion in his share of the production and give it to a third party. Because it is carved out of the working interest owner's leasehold interest, it will terminate when the lease terminates. An override is often created in order to compensate a party who has helped to develop a drilling project or by an oil company when they assign either all or a portion of their leases to another company.

Nonparticipating Royalty Interest (NPRI) – Mineral owners can convey either all or a part of their *royalty* interest in a tract of land to a non-mineral owner. It is often assumed that this transaction cannot take place prior to the creation of the oil and gas lease since no true "royalty" exists prior to the lease. Most states would reject this thought and allow a conveyance or reservation of royalty to take place before the lease has been executed. An exception to this is seen in Oklahoma courts, where a conveyance of a "royalty" interest prior to a lease is treated as a conveyance of a mineral interest, unless the conveyance is stated as a specific percentage of production (1/24th of 3/16th royalty). *Melton v. Sneed,* 188 Okla. 388, 109 P.2d 509 (1940). *John S. Lowe, Oil and Gas Law in a Nutshell (4th ed. 2003; H. Williams & C. Meyers, Oil and Gas Law (13th ed. 2006).*

Once the royalty is severed from the mineral owner, it can be referred to as a *nonparticipating royalty* and will contain some distinguishing characteristics.

1) Nonparticipating owners have no right to explore for or remove the minerals from the land.
2) They have no ingress or egress rights.
3) They have no right to grant an oil and gas lease.
4) They have no right to share in the bonus or delay rental payments.

If the language in all deeds that created a nonparticipating royalty interest described these distinguishing characteristics similarly, there would be no confusion. However, deeds are often difficult to interpret. There have been times that a deed designated as a "mineral deed" actually conveyed royalty, and times when a deed entitled "royalty deed" actually conveyed minerals. Such royalty conveyances or reservations are often deemed to be ambiguous; therefore, the lease administrator must look to the intent of the parties as found on the face of the deed. *Mitchell v Hannah*, 208 P.2d 812 (MT 1949). *Stokes v Tutvet*, 328 P.2d 1096 at 1101-1104 (MT 1958) and *Proctor v Werk*, 714 P.2d 171, 173 (MT 1986).



What does the language in the deed mean?

"Mineral," "Mineral Interest," or "Mineral Acres"

At first glance, the lease administrator would assume that words such as *"mineral," "mineral interest,"* or *"mineral acres"* would be describing a mineral interest. Under the Rules of Construction, if the conveyance or reservation used such words but later referenced other characteristics that would describe a royalty interest, these later characteristics might very well convey or reserve a royalty interest instead of a mineral interest.

"In, on, and under"

When such language is used, courts have most often determined that the interest being conveyed or reserved is still *in, on, and under the land*; and therefore, would be describing a mineral interest.

"In, on, and under and that which may be produced"

This language is often used to create a mineral interest, since it refers to that which is yet to be produced. According to Williams and Meyers, *Oil and Gas Law*, when this phrase stands alone, it will create a mineral interest.

"Produced and saved"

When these words are used in a conveyance or reservation, they would be describing minerals that have been taken from the land and would, therefore, be considered a royalty interest.

"The right to share in profits, a portion of all royalty, incomes, rentals"

Most states would see this language as conveying or reserving a mineral interest.

"The right to Nonparticipating in bonus, rentals, and executive rights"

States do not appear to be consistent when such contradictory language is used. Since the royalty owner is the party who has no right to receive bonus, rentals, or executive rights, some courts would see this language as creating a mineral interest.

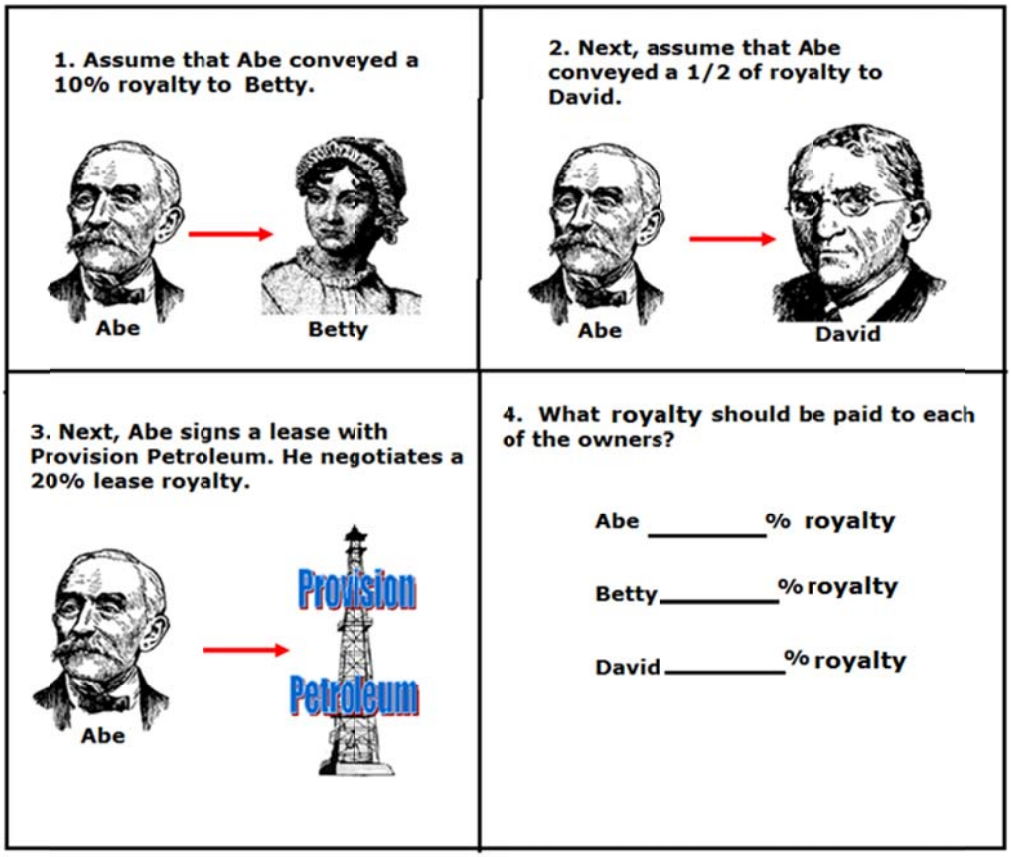
"A 1/24th royalty interest" vs. "a 1/24th of royalty interest"

Would a deed conveying a 1/24th royalty interest convey a full 1/24th of 8/8ths of the royalty under the tract of land or a 1/24th of the royalty rate found in the oil and gas lease?

In most states, a conveyance or reservation of "1/24th royalty interest" without any additional limitation would be a full 1/24th of 8/8ths of the royalty under the tract of land.

On the other hand, a conveyance or reservation that simply added the word "of" would limit the amount being conveyed or reserved by the percentage of royalty negotiated in the lease. If the negotiated lease royalty was 1/8th, the conveyed royalty would be 1/24th of 1/8th.

Issue 1:



Answer: Abe negotiated a great royalty rate of 20%; however, he will receive none of that royalty. He conveyed a full 10% royalty to Betty, leaving him with 10%. When he conveyed ½ *of* royalty to David, David would have received 1/2 of the royalty negotiated in the lease, leaving Abe with nothing.

Oklahoma courts have ruled that any such conveyance made prior to an oil and gas lease, unless the conveyance is stated as a specific percentage of production (1/24th of 3/16th royalty), would create a mineral interest. *John S. Lowe, Oil and Gas Law in a Nutshell (4th ed. 2003; H. Williams & C. Meyers, Oil and Gas Law (13th ed. 2006).*

Montana appears to draw a distinction between a royalty conveyed prior to leasing and one that was conveyed subsequent to leasing. The Montana Supreme Court ruled that a royalty conveyed prior to leasing (defined as a "nonparticipating royalty") is not reducible by a later lease royalty, and a conveyance of royalty after leasing (defined as a "landowners royalty"), is reducible by the lease royalty rate. The prior conveys a much larger share of production than the latter.

A Kentucky court ruled that when a conveyance containing a reservation of royalty, "1/16 royalty interest in all the oil and gas now being produced or which may hereafter be produced," would be a full 1/16th royalty out of 8/8th production and not 1/16th of the lease royalty. They further found that this interest would be consistent on any current or future oil and gas leases. *Kavanaugh v. Clay,* 275 S.W.2d 938, 939 (Ky. Ct. App. 1955).

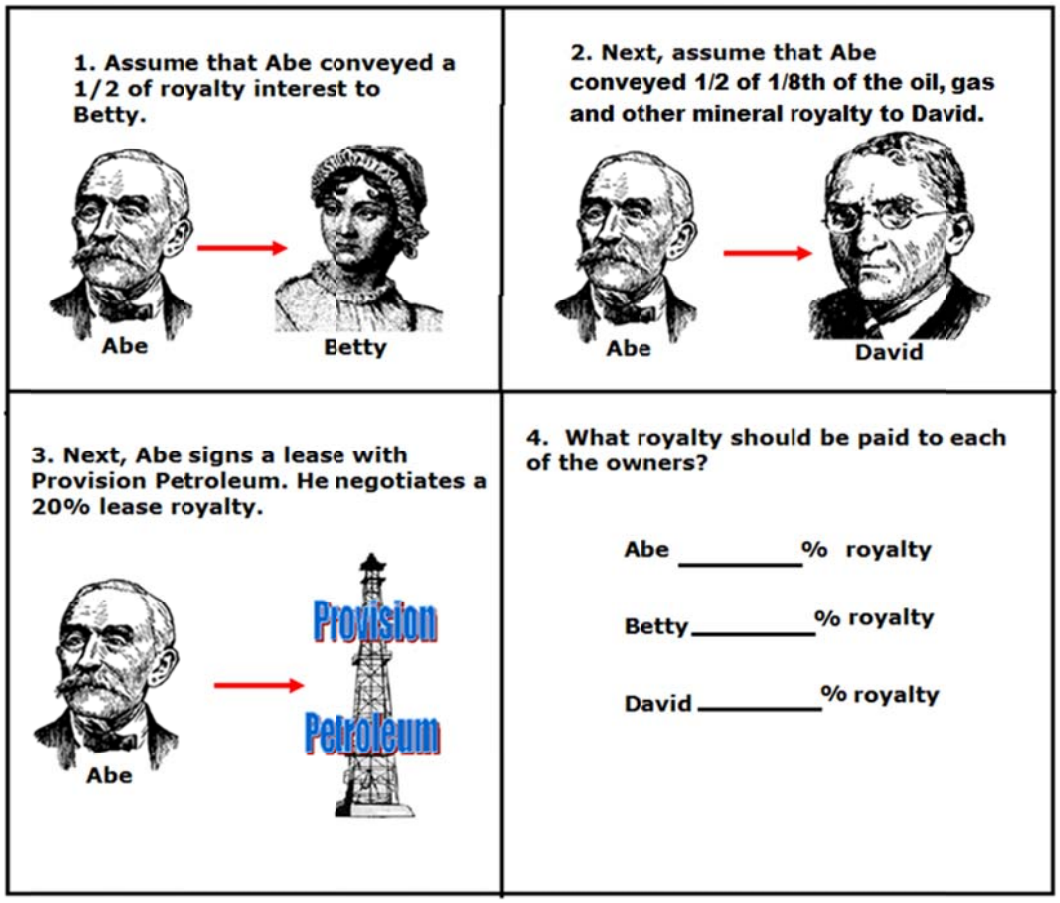
"A 1/2 of 1/8th of royalty interest"

Assume a deed granted "1/2 of 1/8th of the oil, gas, and other mineral royalty that may be produced from said land." Also assume that the negotiated lease royalty rate was 1/8$^{th.}$ What royalty has been conveyed?

- 1/2 of 1/8th, or
- 1/2 of 1/8th of the negotiated 1/8th royalty rate?

Several courts have ruled that the grant was 1/2 of 1/8th of the amount negotiated in the lease or 1/2 of 1/8th of the 12.5% royalty rate. *Harriss v. Ritter,* 279 S.W.2d 845 (Tex.1955), *Palmer v. Lide,* 567 S.W2d 295 (Ark.1978), *Corbin v. Moser,* 403 P.2d 800 (Kan.1065).

Issue 2:



Answer: Betty would receive a full 10% royalty or 1/2 of the negotiated 20% royalty. David would receive 1/2 of 1/8th (1/16th) of the 20% negotiated royalty or 1/2 X 1/8th X 20% = 1.25% royalty. Abe would receive what is left over or 8.75% royalty.

"A 1/2 nonparticipating royalty interest"

Would this language convey 1/2 of 8/8ths of all production, or 1/2 of the royalty rate found in the oil and gas lease?

Although it is possible to convey 1/2 of all royalty production, such a conveyance would become an almost impossible burden for an oil company to bear. The likelihood that the oil company would walk away is great. In an attempt to determine the intent of the instrument, a number of courts ruled that an abnormally large fraction indicated intent to convey minerals.

A Mississippi Supreme Court examined a conveyance entitled "Non-participating Royalty" but contained the following grant:

"1/2 of the whole of any oil, gas or other minerals, on, under, or that

may be produced… the royalty herein described shall be delivered or paid to purchaser out of and deducted from royalty reserved to lessor in said lease."

The court determined that the royalty conveyed was 50% of the lease royalty rather than a full 50% of all production. *Payne v. Campbell* 164 So.2d 780 (Miss.1964).

The Perpetual or Non-perpetual Nature of the NPRI

Generally, a nonparticipating royalty can be created for a certain period of time or in a perpetual manner. The following language would create a non-perpetual royalty:

Kansas is a state where it appears impossible to create a perpetual royalty. The courts ruled that royalty "consists of a share in the oil and gas produced *under existing leases*, but a royalty interest does not consist of a perpetual interest in the oil and gas as they lie in the ground. On the expiration of the existing leases the right of the owner of the royalty expires." The court held that a nonparticipating royalty is a "contractual obligation." Once the oil and gas lease terminates, the royalty obligation also terminates. *Bellport v. Harrison,* 255 P.52 (Kan.1951).

KNOW ALL MEN BY THESE PRESENTS:

That Helen Anderson, "Grantor," for and in consideration of love and affection, has granted, sold, conveyed and assigned, to my three children,

RAYMOND ANDERSON, an undivided 1 ½% royalty;
to DONALD ANDERSON, an undivided 1 ½% royalty;
and to JACKIE TALLMAN, an undivided 1 ½% royalty interest

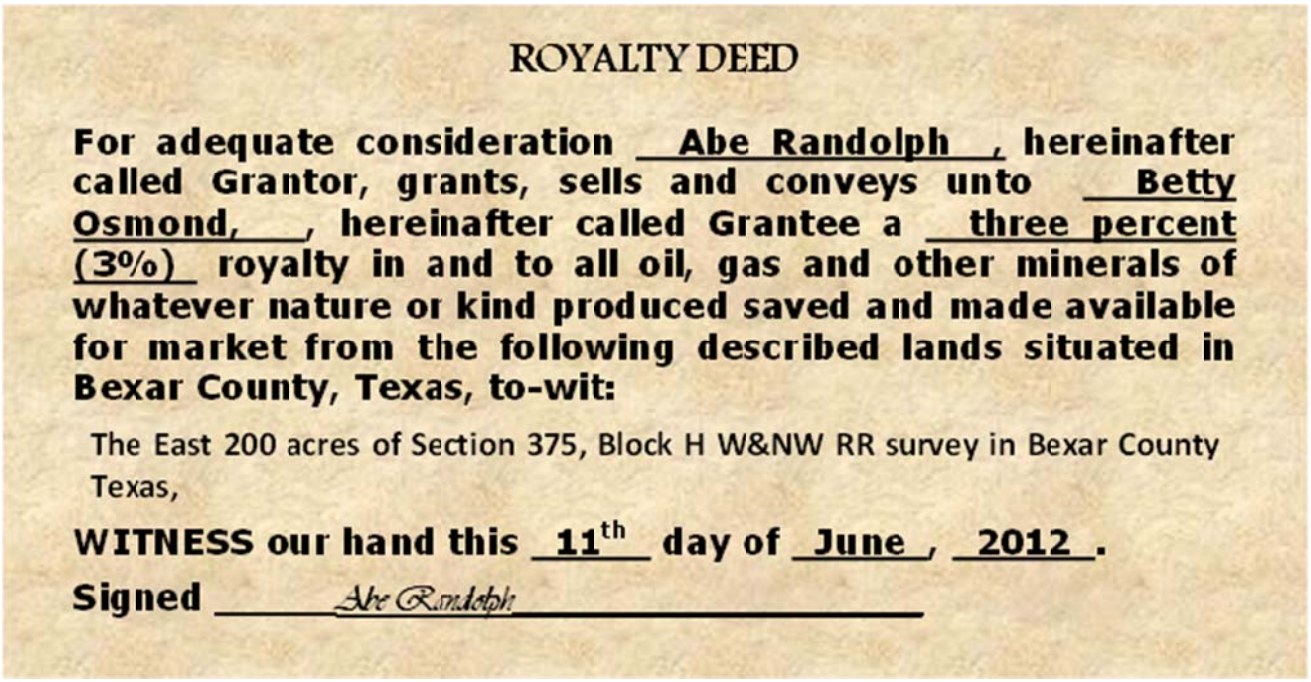
In and to the oil and gas from the following lands:

Township 38 North, Range 55 West, 6th P.M.
Section 35: NWNW, W2SW

For and during the natural lifetime of each grantee.

Issue 1:

Assume that Abe Randolph owned an undivided 50% of the minerals in the 200 acre tract of land located in Bexar County, Texas. He leased his mineral interest to Provision Petroleum and negotiated a 3/16th lease royalty. Subsequently, he conveyed an NPRI to Betty Osmond in the following Royalty Deed. After examining the deed determine what interest Betty is receiving?



ROYALTY DEED

For adequate consideration Abe Randolph, hereinafter called Grantor, grants, sells and conveys unto Betty Osmond, hereinafter called Grantee a three percent (3%) royalty in and to all oil, gas and other minerals of whatever nature or kind produced saved and made available for market from the following described lands situated in Bexar County, Texas, to-wit:

The East 200 acres of Section 375, Block H W&NW RR survey in Bexar County Texas,

WITNESS our hand this 11th day of June, 2012.

Signed Abe Randolph

- a full 3% NPRI
- 3% X 50% (Abe only owned 50% of the minerals in the land)
- 3% X 3/16th lease royalty
- 3% X 50% X 3/*16th*

Answer: Abe gave Betty a 3% royalty interest "from the *following described lands*." He DID NOT give her a 3% royalty out of his 50% mineral interest or 3% of his royalty. This 3% would not be reduced by his royalty rate; therefore, the answer is a full 3% NPRI. Abe would receive (3/16th X .50) – 3% NPRI = 6.375 Royalty.

Issue 2:

Assume that after conveying the 3% NPRI to Betty, Abe conveyed a 50% mineral interest to David Davis on the following Mineral Deed. After examining the deed, determine what royalty David should receive out of the 3/16th royalty negotiated in Abe's lease with Provision Petroleum.

MINERAL DEED

KNOW ALL MEN BY THESE PRESENTS THAT

Abe Randolph hereinafter called Grantor, for and in consideration of the sum of One and no/100 --------Dollars each in hand paid and other good and valuable consideration, the receipt of which is hereby acknowledged, do hereby grant, bargain, sell, convey, transfer and deliver unto David Davis, hereinafter called Grantee, an undivided fifty percent (50%) interest in and to all of the oil, gas, casinghead gas, coal, clay, uranium, potash and other minerals, known or unknown, in and under and that may be produced from the following described lands situated in Bexar County, Texas, to-wit:

The East 200 acres of Section 375, Block H W&NW RR survey in Bexar County Texas,

WITNESS our hand this 10th day of August, 2012.

Signed *Abe Randolph*

- 18.75%
- 18.75% X 50% (50% of Abe's royalty)
- 18.75% X an undivided 50% interest in the lands
- 18.75% X an undivided 50% interest less a 3% NPRI

Answer: David received a full 50% of the mineral estate because the conveyance was granting the interest from the described lands rather than 50% of Abe's interest. The interest David received is also burdened by the previous NPRI owned by Betty; therefore, his royalty interest would be 18.75% X an undivided 50% interest in the lands less Betty's 3% NPRI.

Issue 3:

Instead of the language used in Scenario 2, Abe conveyed the following to David from this Mineral Deed. Prior to this deed, Abe had conveyed the 3% NPRI to Betty but HAD NOT negotiated an oil and gas lease. Six months after receiving this interest from Abe, David negotiated his own lease with Provision Petroleum and received a 3/16th royalty rate. What royalty would David be entitled to from the entire tract of land?

MINERAL DEED

KNOW ALL MEN BY THESE PRESENTS THAT

Abe Randolph hereinafter called Grantor, for and in consideration of the sum of One and no/100 --------Dollars each in hand paid and other good and valuable consideration, the receipt of which is hereby acknowledged, do hereby grant, bargain, sell, convey, transfer and deliver unto David Davis, hereinafter called Grantee an undivided twenty-five percent (25%) interest in and to all of the oil, gas, casinghead gas, coal, clay, uranium, potash and other minerals, known or unknown, in and under and that may be produced from the following described lands situated in Bexar County, Texas, to-wit:

The East 200 acres of Section 375, Block H W&NW RR survey in Bexar County Texas,

WITNESS our hand this 10th day of August, 2012.

Signed *Abe Randolph*

- ☐ A full 18.75%
- ☐ 18.75% X 25%
- ☐ 18.75% X 50% X 25%
- ☐ 18.75% X 25% less 3%
- ☐ 18.75% X 25% less 1.5%

Answer: David received a full 25% of the mineral estate. The interest David received is also burdened by the previous NPRI owned by Betty, but since David only received half of Abe's interest he is only burdened by half of the NPRI. The other half of the NPRI burdens Abe. (18.75% X 25% X 1.5%)

The Shut in Clause

Failing to properly make a shut-in royalty payment is another way that the oil and gas lease can terminate during the secondary term of the oil and gas lease.

During any period (whether before or after expiration of the primary term hereof) when gas from any well or wells on the premises capable of producing gas in commercial quantities is not sold or used and the well or wells are shut in and there is not current production of oil or no operations on said leased premises sufficient to keep this lease in force, lessee shall pay or tender a royalty of One Dollar ($1.00) per year per net acre retained hereunder, such payment or tender to be made, on or before the anniversary date of this lease next ensuing after the expiration of ninety (90) days from the date such well is shut in and thereafter on the anniversary date of this lease during the period such well is shut in, to the royalty owners. When such payment or tender is made it will be considered that gas

As stated in the lease language, a shut-in payment can be made during either the primary or secondary term of the lease. Such a payment made during the primary term will take the place of any rental payment that is due. A lessee would not send the lessor both a rental payment and a shut-in payment for the same period of time.

This payment will also relieve the lessee from having to conduct actual operations during the secondary term.

Purpose of the Shut-in Clause

In order to understand the purpose of the shut-in clause one should travel back in time. The oil boom came about as a result of the invention of the automobile. Because the gasoline that powered this invention came from the oil in a producing well and not from natural gas, the natural gas was originally not considered as valuable. Many companies just did not produce the gas. In some cases, gas was flared and thus lost forever. Once the tremendous value of natural gas was realized, oil companies began to explore for and develop natural gas fields. In doing so, there was a unique problem that existed - transporting the gas to the marketplace.

It was this problem that gave way to the "shut-in royalty clause" as we know it today.

Transporting oil to the market place was an easy matter. Oil is found in a liquid state. It could be pumped out of the ground and placed into tanks. A truck would back up to the tank, unload the oil and then drive it to the marketplace.

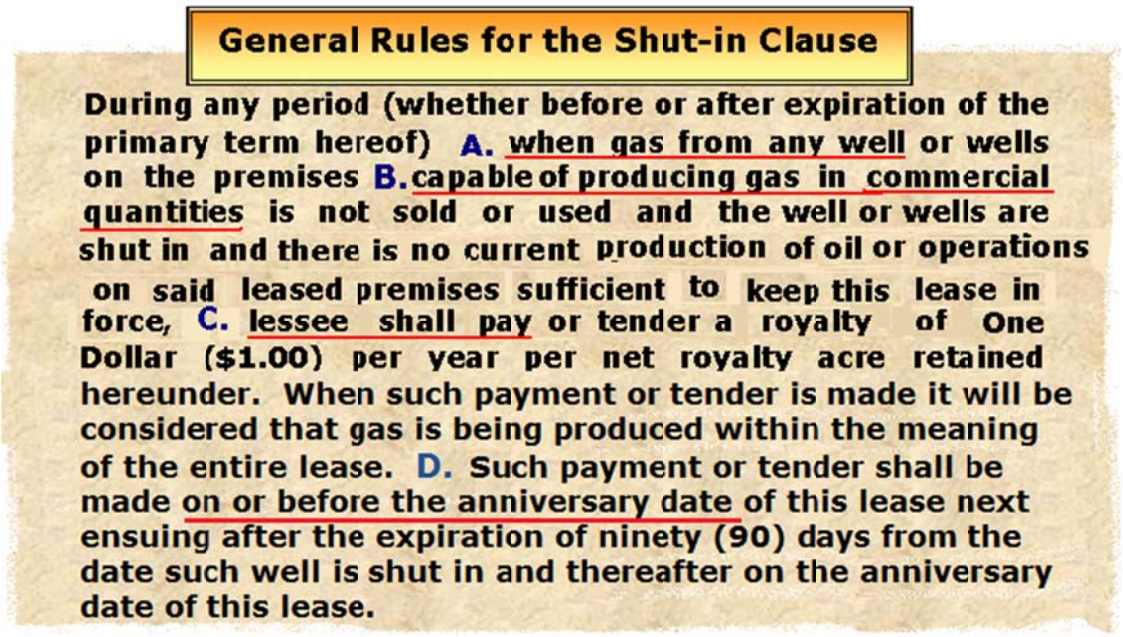
Because gas is not in a liquid state, rather a gaseous state, it could not be pumped out of the ground and placed into some sort of tank. The only realistic way to transport this gas to the marketplace was through a pipeline.

When companies first began to see the value in natural gas, there were no pipelines. Although there are numerous pipelines in existence today, when a company first completes a well, the line needed to flow the gas from the wellhead and into the pipeline does not exist. Building that line takes time.

Remember the Habendum Clause? The lease clearly states that at the expiration date of the primary term, *the lease will automatically terminate unless there is actual production from a well*. Having a well *capable* of production and having *actual production* are two different matters. This language became the bigger part of the issue facing oil companies. They might have drilled the well and reached a very productive natural gas zone capable of producing millions of dollars in revenue; however, if no pipeline existed in the area or there were not refineries in which to handle the gas, the well would not be capable of *actual production*.

General Rules Surrounding the Shut-in Clause

A. Traditionally, the shut-in payment is limited to gas wells. The following shut in clause limits itself to only gas wells.
B. These wells must be capable of producing gas in paying quantities.
C. Failure to make the proper shut-in payment when the payment is justified, in some states, will result in the termination of the lease.
D. If the shut-in clause does not specify the time that the shut-in payment is due, the payment should be made before or at the time the well is shut in.



When can a Well be Shut-In?

The Shut-In Royalty Clause was established to protect the lessee against loss of the lease when production became either impossible or unadvisable. In cases like this, the shut-in royalty provides for a payment to be made to the lessor as a substitute for any *actual payment out of production*.

This clause gives the lessee the right to *temporarily* stop the production of gas from a well. This temporary non-production is limited in its scope.

However, a well can be shut-in…

1. When transporting gas is impossible
2. When there is a lack of a market

Defining Lack of Market

Courts have defined lack of market in two ways:

1. There is no market available
2. There is no reasonable market

Production can be shut-in for what is referred to as "a lack of a market". This term has been defined by the courts in two ways:

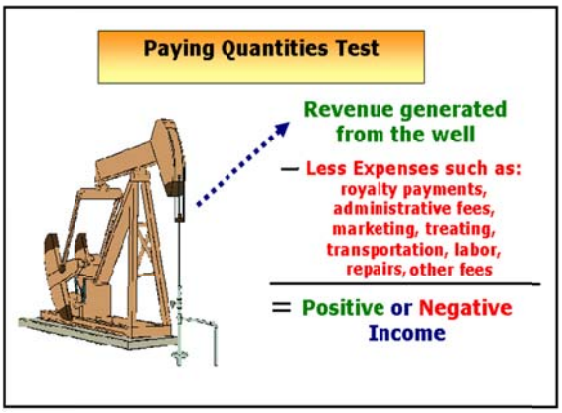
1. There is no market available for the gas. In other words, the purchaser of the gas does not have either the ability to or capacity to buy any more of the gas capable of being produced. Thus, the well must be shut-in.
2. There is simply a lack of a reasonable market for the gas. In other words, the purchaser has the ability to transport the gas and refine the gas but the purchaser is offering to pay unreasonable prices for the gas.

In a case like this, can a company shut the gas in until the price becomes more economic or until they can find a better price for the gas? This question has involved many courts and different courts have answered the question differently. Oklahoma courts have said, "Yes." A lessee can, in fact, shut a well in if they are trying to find a more marketable price for gas. Kansas courts have said, "No".

The important issue here is that a lessee may be at risk of losing an important lease, if the reason for shutting the well in was determined to be illegitimate. Even in Oklahoma, a company would be at risk of losing the lease, if the well had been shut-in seven years because they could not find a better price for the gas. Such reasoning would most likely be considered illegitimate.

How is Paying Quantities Determined?

A shut-in well must be capable of producing gas in commercial (paying) quantities. This term becomes a very important term in understanding issues surrounding a legitimate well and appears numerous times throughout the lease.



The following formula is a simplified version of what this test looks like:

In this example, if the outcome is a negative income, the well does not meet the paying quantities test. If the outcome is a positive income, the well does meet the paying

quantities test.

Two Questions:

1. A very marginal well has been producing in paying quantities for the last six months but failed to make a profit during the last two months. Does this well meet the paying quantities test?
2. Does the test apply to an individual well on a well-by-well basis or, if there are multiple wells located on the same lease; does the test apply to all the wells as if they were one?

Answer: Courts have been inconsistent in establishing a standard length of time that would help meet the "paying quantities" test. Instead, on a case by case basis, they have attempted to decide whether a reasonable prudent operator would continue to operate the shut in well.

Secondly, the paying quantities test would apply to all wells located on the same lease as if they were one.

The Use of the Words "shall, must, or may"

The shut-in clause example states, "Lessee *shall* pay or tender a royalty of $1 per year per net acre retained hereunder..." Other leases might use the word "Lessee *must* pay" or "Lessee *may* pay". What would be the difference with the different words?

The words "*shall"* and "*must"* are virtually identical in meaning, however, the word "*shall"* is usually considered to be the more formal of the two words and is used often in contracts and/or similar documents. "*Shall"* is derived from *sceal* meaning to owe. The word "*shall"*, as used in the shut-in language in the lease example means that the oil company has a duty to make the shut-in payment. With that being said, words must be read in context to the entire contract in order to determine if the word is creating a condition or a covenant.

Assume the shut-in language read in its entirety,

> "Lessee shall be obligated to pay or to tender to Lessor, on or before the anniversary date of this lease following the shutting-in of such well, and annually thereafter, while such well is so shut-in, a royalty payment in the sum of $100 per well."

Has this language created a covenant to pay or a condition to pay? Is the obligation simply a promise or is it tied to language that would create a condition that would cause termination of the lease? In contracts, words must be read in context to the entire contract in order to determine if it

means that an obligation is optional or if the obligation is mandatory. Is the obligation a covenant or a condition?

Many see the word "*may"* and believe that an oil company would have a choice in making the shut-in payment or may be exempt from complying with the provision of the lease. The word "*may"* can, in fact, have the meaning of a conditional obligation when read in context with the entire document. Assume the shut-in provision read,

> "Lessee *may* pay or tender a royalty of $1 per year per net acre retained hereunder. When such payment or tender is made *it will be considered* that gas is being produced within the meaning of the entire lease."

In this example, the provision stated that the lessee *"may"* make the payment which suggests that the lessee has a choice or a promise of a possibility to act. However, the provision also stated that when the payment is made *it would be considered* as if gas is being produced. Therefore, if the payment was not made, it could be argued that gas was not being produced. According to the habendum clause, if oil or gas is not produced the lease would not continue into the "thereafter" phase of the lease and the lease would terminate.

Language Limiting the Length of Time for a Shut-in

Often a lessor will add language limiting the length of time that a well or wells can be shut-in. Such language might read:

> "After the end of the primary term, this lease may not be maintained in force solely by reason of the shut-in royalty payments, as provided heretofore, for any *one shut-in period of more than three (3) years*, or, from *time to time, for shorter periods which exceed three (3) cumulative years."*
>
> or "no more than two years beyond the end of the primary term or two years in the aggregate."

Once the time limit obligation has been met on such a lease, unless there is actual production in paying quantities, the lease will terminate.

The Amount Due for a Shut-in Payment

Traditionally, the shut-in amount due is $1 per year, per net mineral acre owned by the lessor. However, today's leases can contain a variety of dollar amounts. If the payment is based on $1 per net mineral acre owned and

the lessor owned a undivided 25% mineral interest in a lease covering 160 acres, the shut-in payment would be 160 X 25% X $1.00 = $40.00. Some state leases require a shut-in payment of $1,600 per year per well. In a case like this, the payment is not based on net acres owned, rather on wells drilled.

Correct Payment to the Correct Owners

A Texas court established that shut-in payments must not only be made on time and in the correct amount but must also be made to the correct parties.

Assume that your company has leased Peggy Smith on an lease form that contained the following shut in royalty clause. Read the following issues and determine if your lease with Peggy Smith has terminated.

> During any period (whether before or after expiration of the primary term hereof) when gas from any well or wells on the premises capable of producing gas in commercial quantities is not sold or used and the well or wells are shut in and there is no current production of oil or no operations on said leased premises sufficient to keep this lease in force, lessee shall pay or tender a royalty on One Dollar ($1.00) per year per net acre retained hereunder, such payment or tender to be made, on or before the anniversary date of this lease next ensuing after the expiration of ninety (90) days from the date such well is shut in and thereafter on the anniversary date of this lease during the period such well is shut in, to the royalty owners. When such payment or tender is made it will be considered that gas is being produced within the meaning of this lease.

Issue 1: Assume your company has produced both oil and gas from the lease. A few months ago the price of gas dropped to $2.00 an Mcf. This is far below your company's break-even point to make money. A decision was made not to produce gas until the price rises to an economic level. Several months later, Peggy Smith contends that the lease has been terminated because no shut-in payment has been received. In order to keep this lease in effect, should your company have made shut-in payments to Peggy Smith?

_____
_____

Issue 2: Assume that your company has drilled three gas wells on Peggy Smith's lease. The last well drilled has been shut-in but the other two wells are producing. According to the terms of the lease, are you obligated to pay shut-in royalty for this well?

_____
_____
_____

Issue 3: Assume your company drilled one gas well on Peggy Smith's lease. This well has been shut-in but your company is drilling a second well. According to the terms of the lease, are you obligated to pay shut-in royalty for the shut-in well?

_____
_____
_____

Issue 4: Assume your company must make a shut in payment on the Peggy Smith lease. According to the terms of the shut-in royalty clause, the lessee needs to pay "a royalty of One Dollar ($1.00) per year per net acre" in order for the lease to be held under a shut-in period. The problem is that Peggy Smith, who owns the full mineral interest in and to the lands under lease, conveyed to her daughter Margie Smith, a 3/16 nonparticipating royalty.

When your company made their shut-in royalty payment, they sent a check of $1.00 per net mineral acre to Peggy Smith. Peggy returned the check with a letter stating that the lease was void because your company had failed to make proper royalty payments to Margie Smith. Should your company have paid Margie instead of Peggy? Is the lease terminated?

_____
_____
_____

Issue 5: Assume that your company drilled a gas well in a very productive natural gas field on the Peggy Smith lease. Unfortunately, there is no pipeline in the area; therefore the gas is unable to be marketed. There are plans to build a pipeline but it will take 2 years to build and your lease

expires in 18 months. Also assume that the Peggy Smith lease contained no shut-in provision. Will your lease expire?

_____
_____
_____

ISSUE 6: Assume that after your company acquired the Peggy Smith lease a mistake was made when your lease administrator input the lease information into your computer system. The legal description on Peggy's lease was input incorrectly and her lease was included in an area that was currently producing. Therefore, the lease appeared to be held by production from another well. A year later, your company drilled a well in an area that contained Peggy's lease and the well was shut-in for 18 months while a pipeline was constructed. During the 18-month shut-in period no shut-in payment was made because the computer system indicated that the lease was HBP by the other producing well. Read the language in Peggy's lease and determine if the lease has terminated or if you can quickly make a shut-in payment to Peggy.

_____
_____
_____

Answers to shut in questions:

ISSUE 1: The Shut-in Royalty Clause states "During any period…when gas is not being sold or used and the well is shut in ***and there is no current production of oil***…lessee shall pay a royalty of One Dollar per year per net acre." In other words, if there is oil production that production will hold the lease and your company would not be obligated to make a shut-in payment.

On the other hand, if no oil is being produced, and all of the other conditions exist that would demand a shut-in payment, that payment must be made. If your company fails to make this payment, the lease will be in breach of the condition as stated in the lease. In Oklahoma, the Oklahoma Court of Appeals has held that a failure to make shut-in payments will not by itself cause the lease to terminate unless the lease so provides.

Issue 2: The terms of the lease indicate that you must make the shut in payment if any one well or several wells are shut in. In this case, two of the three wells are producing so no shut in payment would be due.

Issue 3: According to the terms found in this shut in clause, no payment will be necessary because your company has operations in place.

Issue 4: First, you must define n*on-participating royalty* and *production royalty*. A non-participating royalty indicates that the owner does not share in any *lease bonus* or *delay rental payments*, or in the *right to execute the lease.* They would, instead, be entitled to payments out of production. The question is, does the shut in payment come out of production?

Is *shut-in royalty* the same as *production royalty?* Traditionally, *shut-in royalty* and *production royalty* have been classified differently from one another and the shut in royalty is paid to the same owners who would receive any delay rental payments. However, the Peggy Smith lease clearly states that the payment is to go to the "royalty owners". This could lend itself to some ambiguity and Peggy might feel she has a valid point. Apart from having Peggy and her daughter Margie set out in writing how the payment should be made, many oil companies would pay both Peggy and Margie.

Issue 5: Yes

Issue 6: The language in the lease appears to be a conditional shut-in provision. It says that if such payment is made, it will be considered that gas is being produced. In other words, if no payment is made it is as if no gas is being produced and the habendum clause indicates that the lease can only be carried into the thereafter period if oil or gas is being produced. It appears that you have lost the lease.

The Granting or Reserving of "Royalty Acres"

The lease administrator must make a distinction between the term "royalty acre" and "mineral acre." Because royalty acre is not often used today, when it does appear, confusion may follow. Usually, it can be seen in older instruments when the standard lease royalty was 1/8th.

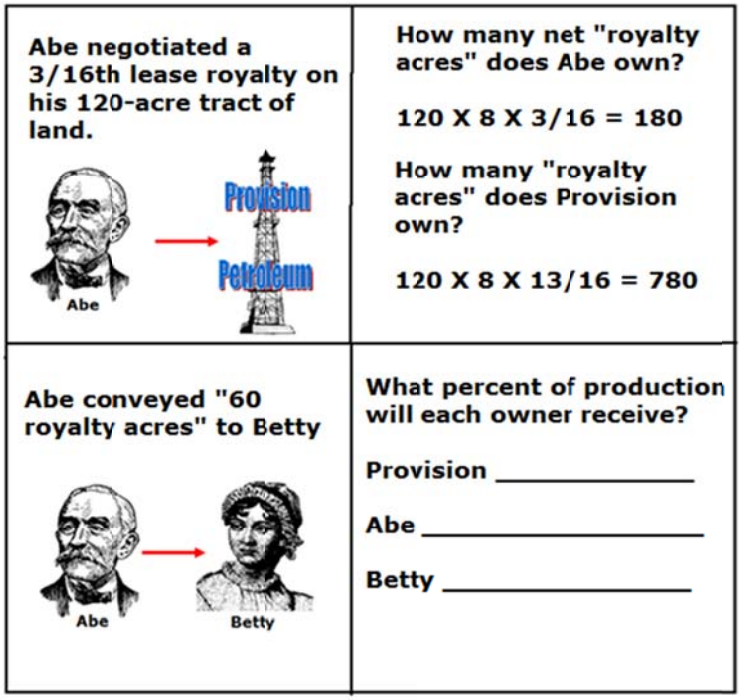
With that being said, there would be a total of 8 royalty acres in one mineral acre. With a 1/8th royalty lease, the oil company would receive 7 of these royalty acres and the landowner would receive 1 of them. Owning a one *net royalty acre* would give a person the right to receive a 1/8th royalty on that one acre with 7/8th going to the oil company.

Issue 1: Assume Abe owned a 100-acre tract of land under a 1/8th royalty lease. This would equal 800 royalty acres (100 X 8). The oil company would be entitled to 700 royalty acres and Abe would be entitled to 100 royalty acres. Calculating royalty acres is based on the number of acres in the tract of land X 8; multiplied by the percentage of royalty in a lease (100 acres X 8 X 1/8th = 100 royalty acres going to Abe).

If Abe had negotiated a 3/16th lease the outcome would be 100 X 8 X 3/16 = 150 royalty acres going to Abe. The oil company would receive 100 X 8 X 13/16 = 650 royalty acres.

Issue 2: Assume that Abe owned a second tract of land of 120 acres and he negotiated a 3/16ths royalty with Provision Petroleum. How many net royalty acres does he own? Also, assume that Abe conveyed "60 royalty acres" to Betty. What percent of production will each owner receive?

NOTE: Betty was conveyed 60 "royalty acres," not 60 mineral acres. If she had been conveyed mineral acres she would have received 50% of the minerals in the



120-acre tract of land. With royalty acres the outcome will be different.

ANSWER: Total royalty acres (120 X 8 = 960)

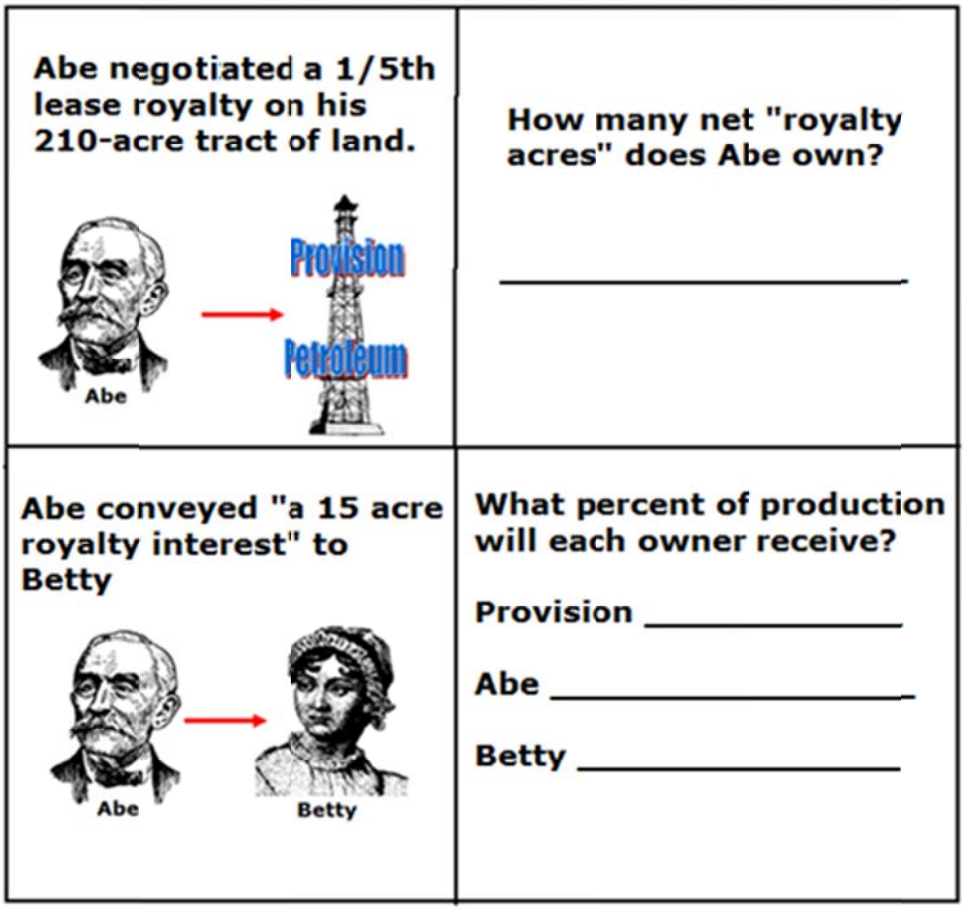
Royalty acres going to Abe and Betty (120 X 8 X 3/16 = 180. This gives Abe and Betty a 18.75% of all production 180/960 = 18.75%.)

Royalty acres going to Provision Petroleum (120 X 8 X 13/16 = 780. This gives Provision an 81.25% of all production 780/960 = 81.25%.)

Royalty acres going to Betty (60 / 180 X 3/16 = 6.25% royalty from all production).

Royalty acres going to Abe (120 / 180 X 3/16 = 12.5% royalty from all production).

Issue 3: Assume that Abe owned a 210-acre tract of land and negotiated a 1/5th royalty with Provision Petroleum. Subsequent to the lease, he conveyed "a 15 royalty acre interest" to Betty. Answer the following questions:



Answer: Total royalty acres (210 X 8 = 1680)

Royalty acres going to Abe and Betty (210 X 8 X 1/5 = 336)

Royalty acres going to Provision Petroleum (210 X 8 X 4/5 = 1344. This gives Provision 80% of all production 1344/1680 = 80%.)

Royalty acres going to Betty (15 / 336 X 1/5 = .89285% royalty from all production).

Royalty acres going to Abe (321 / 336 X 1/5 = 19.10715% royalty from all production).

Issue 4: Assume your company has acquired a lease with the following language: Also assume the lessor has leased 120 mineral acres to your company and, according to the terms of the lease, has negotiated a 3/16th royalty. A shut-in payment is due. What amount of shit-in payment should be paid to the lessor?

- ☐ $120.00
- ☐ $150.00
- ☐ $180.00

During any period (whether before or after expiration of the primary term hereof) when gas from any well or wells on the premises capable of producing gas in commercial quantities is not sold or used and the well or wells are shut in and there is no current production of oil or no operations on said leased premises sufficient to keep this lease in force, **lessee shall pay or tender a royalty on One Dollar ($1.00) per year per net royalty acre retained hereunder**, such payment or tender to be made, on or before the anniversary date of this lease next ensuing …

Issue 5: Assume the previous lease did not have a 3/16ths royalty but rather a 1/5 royalty and the lease covered a 233 acre tract of land; however, the mineral owner, under the lease, only owned an undivided 25% of the minerals. What shut-in payment should be made to the lessor?

- ☐ $233.00
- ☐ $116.50
- ☐ $58.25

- ☐ $93.20

Issue 6: Assume your company owns a 24.45 acre lease that contains a 3/16th royalty rate. The lessor owns 100% of the minerals. A shut-in payment is due. The lease says the following, "Lessee shall pay or tender a shut-in royalty of $5.00 per year per net royalty acre retained hereunder…" What shut-in payment should be made to the lessor?

- ☐ $36.67
- ☐ $183.38
- ☐ $122.25
- ☐ $24.45

Issue 7: What would the answer be if the lease said the following, "Lessee shall pay or tender a shut-in royalty of $5.00 per year per net mineral acre retained hereunder…" What shut-in payment should be made to the lessor?

- ☐ $36.67
- ☐ $183.38
- ☐ $122.25
- ☐ $24.45

Answers:

Scenario 4 - $180.00

Scenario 5: $93.20

Scenario 6: $183.38

Scenario 7: $122.25