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BREAKFAST SERIES *for*

Surface and Mineral Owners

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- DATE:** Aug 21, 2018
- TOPIC:** **Are We There Yet? The Start and Finish of An Oil and Gas Lease**
- LOCATION:** **San Antonio Petroleum Club**
8620 N New Braunfels, Suite 700
San Antonio, TX 78217-6363
P 210.824.9014, F 210.829.5443
- TIME:** 7:30 AM Breakfast - 8:00 AM Presenters - 8:50 AM Questions & Answers
- INTRODUCTIONS:** **E.O. (Trey) Scott, III, Trinity Mineral Management, Ltd.**
- PRESENTERS:** **Peter E. Hosey, Jackson Walker, L.L.P.**
Are We There Yet? The Start and Finish of An Oil and Gas Lease
- Commencement of an Oil and Gas Lease
 - Conveyed Interest
 - Creation
 - The End of the Beginning
 - Termination of an Oil and Gas Lease
 - Understanding the Issues
 - Primary Term
 - Outside the Primary Term
 - Savings Clauses
 - Express Conditions
 - Avoiding Termination Claims

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Mr. Hosey is also currently an Adjunct Professor of Law at St. Mary's University School of Law, teaching Texas Land Titles. Mr. Hosey was named a San Antonio "Best Lawyer" by Scene in S.A. (2007-2009) and a "Super Lawyer" (2009-2011) by Thomson Reuters and has been named a "Who's Who in Energy (2012- 2014). In 2011, he was named an "Outstanding Lawyer" by the San Antonio Business Journal.

Since 1998, Mr. Hosey has served on the Joint Editorial Board for the development of the Texas Title Examinations Standards established by the Real Property, Probate and Trust Law and Oil, Gas and Energy Resources Law Sections of the State Bar of Texas, which are published in the Texas Property Code.

Mr. Hosey is a frequent lecturer around the State of Texas at various CLE sponsored events concerning oil and gas issues, land titles, title insurance and other real estate related topics. He has also written articles for the Section Report of the Oil, Gas and Energy Resources Law Section of the State Bar of Texas, *Texas Lawyer* magazine, and wrote such presentations such as:

- "Follow the Money!" Oil and Gas Leases and Division Orders,
- "To Whom it May Concern" - Title To The Title Opinion and the Duty of the Examiner, Title To Uranium and Other Minerals (Still Crazy After All These Years),
- "Are We There Yet?" The Start and Finish of an Oil and Gas Lease, "What am I Missing?" What Title Examiners Sometimes Overlook,
- "What Am I Still Missing?" Mineral Title Examination and Due Diligence: Additional Selected Pitfalls and Problems,
- "Come Out, Come Out Wherever You Are:" Constructive Notice of Unrecorded Agreements in Oil and Gas Titles, Quench My Thirst: Water Rights in the Context of Water Treatment Technologies, which was co-written with Jesse Lotay.

Mr. Hosey is a member of the San Antonio Bar Association, the American Bar Association, the State Bar of Texas, the College of the State Bar of Texas, and the Council of the Oil, Gas and Energy Resources Law Section of the State Bar of Texas. He is the Immediate Past Chair of the Oil, Gas and Energy Resources Law Section of the State Bar of Texas, A Life Sustaining Fellow of the Texas Bar Foundation and is the 2013 Distinguished Graduate of St Mary's University School of Law.

ARE WE THERE YET?

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

**Trinity Profitable Mineral
Management Seminar**

Petroleum Club
San Antonio, Texas
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ARE WE THERE YET !?!



MATT GROENING

THE INTEREST CONVEYED BY AN OIL AND GAS LEASE

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

Requirements for Conveyance

Tex. Prop. Code § 5.021

"A conveyance of an estate of inheritance, a freehold, or an estate for more than one year, in land and tenements, must be in writing and must be subscribed and delivered by the conveyor or by the conveyor's agent authorized in writing."



Consideration

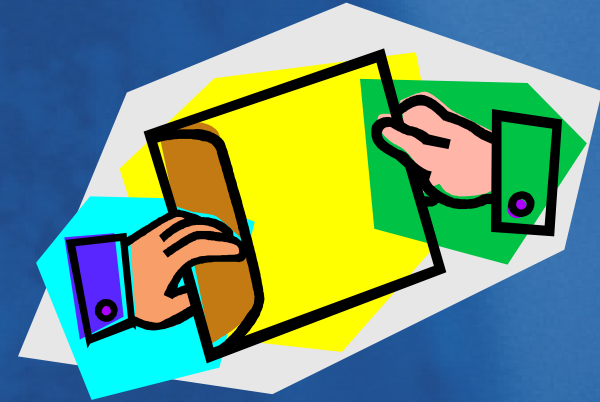
(Payment of Bonus Not Required)



Jones v. Bevier

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

DELIVERY



Requirements for Delivery:

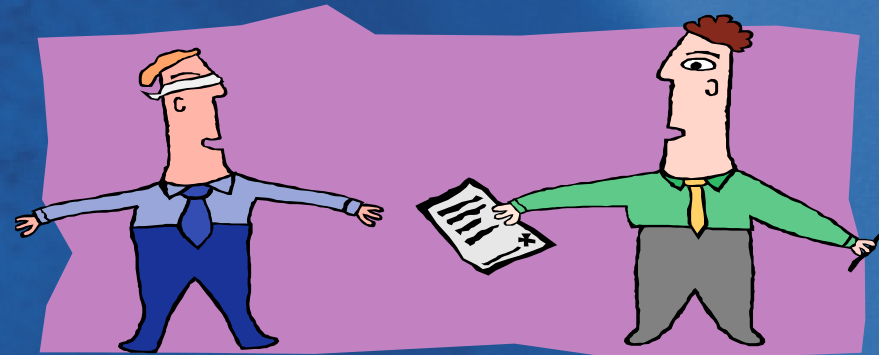
1. Surrender of Control. Surrender of possession (either actual or constructive) of the conveyance instrument to the grantee/lessee
2. Intent for Instrument to be Effective. Grantor must intend for the conveyance instrument to take effect immediately
 - Whether delivery has occurred is a question of fact
 - What constitutes delivery is a question of law

ACTUAL VS. CONSTRUCTIVE DELIVERY

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

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

Conditional Delivery



- Actual possession of instrument is relinquished, but there is no intent to make a present conveyance (i.e., grantor intends that the lease become effective upon lessee's payment of the bonus and authorizes an agent to hold the conveyance until such time as the purchase price has been paid).
- Grantor should expressly state the condition in the document or at the very least be clear on the conditional status of the physical delivery of the instrument.
- *Pelican Oil Co. v. Edson Petroleum Co.*
 - Lease was not effective where purchaser failed to make the bonus payment within the time required under the oral agreement with the mineral owner.

Acceptance is key.



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



Enforceability of Offer Sheets and Letter Agreements

- An oil and gas lease must contain the following “essential terms” to be enforceable:
 1. Term of the lease;
 2. The commencement date;
 3. Description of the lease premises;
 4. Time and amount of payments in lieu of drilling operations; and
 5. Amount and manner of payment for produced hydrocarbons.
- *Oakrock Exploration Co. v. Killam*
 - Mineral owners and Oakrock signed a letter agreement agreeing to enter into an oil and gas lease. The agreement described the acreage, the bonus amount, the royalty and the duration of the primary term.
 - Notably, the agreement also called for an oil and gas lease to be negotiated and prepared by the lessors' attorney.

TOP LEASING

- Top leasing occurs when the lessor under an existing oil and gas lease, who has retained the possibility of reverter in the mineral estate, grants a second lease covering the same land to another lessee with the intention that the second lease (the "top lease") become effective upon termination of the first lease (the "bottom lease").
- The key to drafting top leases is to take one of two approaches:
 - (i) carefully draft a conveyance of a future leasehold interest in the mineral estate to avoid application of the RAP; or
 - (ii) make a present conveyance of a determinable fee interest in the grantor's possibility of reverter (an estate not subject to the RAP).

COVENANTS, CONDITIONS, & SPECIAL LIMITATIONS

- Covenant – a promise to do or refrain from doing something
 - Breach of covenant = liability for damages, not termination of the lease
- Condition of termination – requires lessee to do or refrain from doing something
 - Breach of condition = termination (if the remedy is clearly expressed in the lease)
- Special Limitation – expressed as a limitation on the estate granted
 - Triggering of limitation = automatic termination

TERMINATION DURING THE PRIMARY TERM

- The habendum clause typically states:
 - *"Subject to the other provisions contained herein, this lease shall be for a term of three years from the effective date (the 'primary term'), and as long thereafter as oil, gas or other mineral is produced from the lease premises or land pooled therewith."*
- Depending on the language of the lease, termination can occur during the primary term due to:
 - Failure to commence drilling operations within a stated time (actual spudding of the well is generally not required)
 - Failure to pay delay rentals (does not apply to paid-up leases)
 - Failure to abide by express conditions contained within the lease if clearly stated
- Delay rental provisions are strictly enforced by the courts (timely and proper payment by the lessee is required)

Production in Paying Quantities



- Production must be “produced and marketed” to hold a lease in effect past the primary term; production in “paying quantities” is required
- To prevail on a claim that a lease has terminated due to lack of production in paying quantities, the plaintiff must prove:
 - 1) Whether the well pays a profit, even small, over operating expenses without a limit in time, whether it be days, weeks or months; and
 - 2) If not, whether under all of the relevant circumstances a reasonably prudent operator would, for purposes of making a profit and not merely for speculation, continue to operate the well as it had been operated. [*BPAmerica Production Company v. Laddex, Ltd.*, 513 S.W.3d 475 (Tex. 2017)]

Termination Due to a “Permanent” Cessation of Production

- An oil and gas lease will terminate upon the permanent cessation of production.
- **Temporary cessation of production doctrine** – the lessee has a reasonable amount of time to restore production when production ceases (common law).
 - A court will consider:
 - (a) what caused the cessation of production;
 - (b) how long the cessation occurred; and
 - (c) what efforts the lessee undertook to restore production.
 - “foreseeability and avoidability are not essential elements of the [temporary cessation of production] doctrine.” [*Ridge Oil Co., Inc. v. Guinn Investments, Inc.* 148 S.W.3d 143 (Tex. 2004)]
- Time stated in the operations clause (60, 90 or 180 days) will control over “reasonable amount of time” under common law.

Avoiding Termination: Savings Clauses

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



DRY HOLE CLAUSE



- “If prior to discovery of oil or gas on said land lessee should drill a dry hole or holes thereon, ... this lease shall not terminate if lessee commences additional drilling or reworking operations within sixty (60) days thereafter or (if it be within the primary term) commences or resumes the payment or tender of delay rentals on or before the rental paying date next ensuing after the expiration of three months from the date of completion of the dry hole or cessation of production.”
- Allows the lessee to keep a lease in effect following the drilling of a dry hole if lessee commences drilling operations for a subsequent well within a stated period or resumes the payment of delay rentals
- Lessee must have completed a well which qualifies as a “dry hole” (i.e., the well is not productive of oil or gas).
 - A well which is capable of producing oil or gas but is simply not capable of producing oil or gas in paying quantities does not constitute a dry hole

CESSATION OF PRODUCTION CLAUSE

- “... if after discovery of oil or gas, the production thereof should cease from any cause, this lease shall not terminate if lessee *commences* additional drilling or reworking operations within sixty (60) days thereafter or (if it be within the primary term) commences or resumes the payment or tender of delay rentals on or before the rental paying date next ensuing after the expiration of three months from the date of completion of the dry hole or cessation of production.”
- Keeps a lease in effect for a certain period of time after a well that has been producing oil or gas ceases to flow.
- The time stated in the cessation of production clause will replace the “reasonable amount of time” permitted under the common law temporary cessation of production doctrine.





DRILLING OPERATIONS CLAUSE

- “If at the expiration of the primary term oil, gas or other mineral is not being produced on said land but lessee is then engaged in drilling or reworking operations thereon, the lease shall remain in force so long as operations are prosecuted with no cessation of more than thirty (30) consecutive days, and if they result in the production of oil, gas or other minerals so long thereafter as oil, gas or other mineral is produced from said land.
- Functions as constructive production if lessee is engaged in drilling or reworking operations
- To constitute “drilling operations”, Texas courts require actual manual operations on the lease premises or land pooled therewith which are preliminary to the actual work of drilling

Continuous Operations Clause

VS.

Well Completion Clause

- “Well completion” clause (think stud poker) – operations only permitted on specific well when the lease does not expressly allow for operations on other wells
- “Continuous operations” clause (think five card draw) – operations can be conducted on one or more wells as long as the operations are conducted continuously

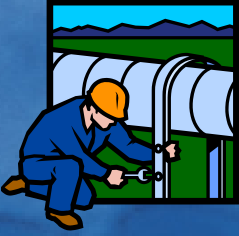




PAYMENT OF SHUT-IN ROYALTIES



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



FORCE MAJEURE PROVISIONS

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



EXPRESS CONDITIONS

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

DEFENSES



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

ARE WE THERE YET !?!



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THE START AND FINISH OF AN OIL AND GAS LEASE**

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BACKGROUND, EDUCATION AND PRACTICE

Peter E. Hosey is a Partner in the San Antonio, Texas office of Jackson Walker L.L.P. He received a Bachelor of Arts degree from The University of Texas at El Paso in 1976, and is a 1979 graduate of St. Mary's University School of Law. He practices primarily in the areas of oil, gas and mineral law, title and transactional matters, real estate law, business law, and international business law. Since 1998, he has served on the Joint Editorial Board for the development of the Texas Title Examinations Standards established by the Real Property, Probate and Trust Law and Oil, Gas and Energy Resources Law Sections of the State Bar of Texas, which are published in the Texas Property Code. He is a member of the San Antonio Bar Association (has been several times as President and Treasurer of the Natural Resources Committee of the San Antonio Bar Association), a member of the American Bar Association and the State Bar of Texas. He is also a member of the College of the State Bar of Texas. Mr. Hosey is a frequent lecturer around the State of Texas at various CLE sponsored events concerning oil and gas issues, land titles, title insurance and other real estate related topics, including writing articles for and speaking at the 50th Annual Rocky Mountain Mineral Law Institute in 2004, the 23rd, the 29th, the 32nd and 33rd Annual Advanced Oil, Gas and Energy Resources Law Course in 2005, 2011, 2014 and 2015 and the 33rd, 35th, 37th and 43rd Annual Ernest E. Smith Oil, Gas and Mineral Law Institutes in 2007, 2009, 2017. Mr. Hosey has also written articles for the Section Report of the Oil, Gas and Energy Resources Law Section of the State Bar of Texas (December 2008 and June 2011) and wrote an article in the November 14, 2011, edition of the *Texas Lawyer* magazine on representing land owners in oil and gas leasing transactions. He also wrote "*Follow the Money!*" *Oil and Gas Leases and Division Orders, "To Whom it May Concern" - Title To The Title Opinion and the Duty of the Examiner, Title To Uranium and Other Minerals (Still Crazy After All These Years), "Are We There Yet?" The Start and Finish of an Oil and Gas Lease, "What am I Missing?" What Title Examiners Sometimes Overlook, "What Am I Still Missing?" Mineral Title Examination and Due Diligence: Additional Selected Pitfalls and Problems, "Come Out, Come Out Wherever You Are:" Constructive Notice of Unrecorded Agreements in Oil and Gas Titles, Quench My Thirst: Water Rights in the Context of Water Treatment Technologies*, which was co-written with Jesse Lotay and published in the Oil, Gas and Energy Resources Law Section Report, Winter 2013, and updated in Fall 2017, and "*Where There is a Well There is a Way:*" *Out Tract Title Issues Regarding Horizontal Wells*. He is a member of the Council of the Oil, Gas and Energy Resources Law Section of the State Bar of Texas. He is currently an Adjunct Professor of Law at St. Mary's University School of Law, teaching Texas Land Titles. Mr. Hosey was named a San Antonio "Best Lawyer" by *Scene in S.A.* (2007-2009) and a "Super Lawyer" (2009-2011) by Thomson Reuters and has been named a "Who's Who in Energy (2012-2014). In 2011, he was named an "Outstanding Lawyer" by the *San Antonio Business Journal*. Mr. Hosey is the Immediate Past Chair of the Oil, Gas and Energy Resources Law Section of the State Bar of Texas, A Life Sustaining Fellow of the Texas Bar Foundation and is the 2013 Distinguished Graduate of St Mary's University School of Law.

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BACKGROUND, EDUCATION AND PRACTICE

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SUMMARY OF CONTENTS

I.	COMMENCEMENT OF AN OIL AND GAS LEASE	1
A.	Introduction	1
B.	The Interest Conveyed by an Oil and Gas Lease.....	1
1.	The Fee Simple Determinable Estate	2
2.	The Rule in Texas	3
C.	The Creation of the Oil and Gas Lease.....	3
1.	Statute of Frauds.....	3
2.	Bonus.....	3
3.	Delivery and Acceptance	4
a.	Actual and Constructive Delivery	4
b.	Conditional Delivery	5
c.	Acceptance	7
4.	Offer Sheets and Letter Agreements.....	7
5.	Top Leases.....	9
D.	The End of the Beginning.....	10
II.	TERMINATION OF AN OIL & GAS LEASE	10
A.	Understanding Lease Termination Issues	10
B.	Termination During the Primary Term	11
1.	Commencement of Drilling Operations	11
a.	Payment of Delay Rentals	11
C.	Termination at the End of the Primary Term or During the Secondary Term	12
1.	Lack of Production in Paying Quantities	13
2.	Permanent Cessation of Production.....	14
D.	Savings Clauses	15
1.	Dry Hole, Cessation of Production and Drilling Operations Provisions	15
a.	Dry Hole Clause	16
b.	Cessation of Production Clause.....	17
c.	Drilling Operations Clause.....	17
2.	Shut-in Royalty Provisions.....	19
3.	Force Majeure Provisions.....	20
E.	Termination Resulting From an Express Condition.....	20
F.	Avoiding Termination Claims	21
1.	Waiver	21
2.	Ratification	22
3.	Quasi-Estoppel & Equitable Estoppel.....	22
4.	Statute of Limitations	23
5.	Revivor	23
III.	CONCLUSION.....	24

ARE WE THERE YET?*

I. COMMENCEMENT OF AN OIL AND GAS LEASE

A. Introduction

In this paper, we will focus on when an oil and gas lease starts and ends. In order to answer these questions, we must know what it is and how it works.

We all know that the oil and gas industry is cyclical, subject to many factors, including the price of hydrocarbons, regulatory changes and the success or failure of drilling operations. This is the reality within which oil and gas leases are negotiated.

Although a lease typically covers all minerals where the granting clause includes “oil, gas and other minerals,”¹ our focus will be upon the operation, production and sale of oil and gas.

The lessor wishes to maximize the value of the bonus, the royalty and its bargaining position with regard to the minerals to be leased, the duration of the lease and the surface to be encumbered (where the lessor is also the surface owner). The lessee prefers to pay no more than the negotiations require, nor to include any more onerous terms in the oil and gas lease than it must. Timing in these negotiations is critical.

It is essential for the parties to the lease to know when the real property rights in the

substances covered by the lease become vested in the lessee and when the leasehold interest held by the lessee terminates so that the underlying mineral estate is no longer encumbered by the lease. That which occurs in between will not be covered in this paper, unless such events affect the continuation of the lease.

Our journey begins with the creation of the oil and gas lease through the execution by the lessor of a written document containing the identity of the lessor and the lessee, a description of the leased premises, the essential terms and delivery of the executed instrument to the lessee. The oil and gas lease may last forever. Thus far, none has.

Time does not permit, nor does space allow, a discussion of all of the potential contingencies which could occur. This is not an examination of all of the lease terms which can be created, the breach of which may result in the termination of an oil and gas lease.

The parties to an oil and gas lease should always pay particular attention to the terms and provisions of the lease as written. Although the death of an oil and gas lease may be sudden and without warning, some defenses do exist. Where the lease is held to have expired, these judgments generally do not terminate the lease, but rather confirm that the lease has already expired.

B. The Interest Conveyed by an Oil and Gas Lease

Since the 1920s, the Texas Supreme Court has held that an oil and gas lease conveys a fee simple determinable estate to the minerals in place in the acreage described as a result of the language of the habendum

* Many thanks to Brenda Eckert and Eve Searls for their diligence and hard work in the preparation of this paper.

¹ For a discussion of the meaning of “and other minerals” under Texas law, please see this author’s article entitled “*Title to Uranium and Other Minerals (Still Crazy After All These Years)*” published in the Oil, Gas and Energy Resources Law Section Report, December 2008.

clause of the typical lease.² Although the document is called a “lease,” it does not create a landlord-tenant relationship. A fee simple determinable estate is subject to a special limitation, the duration of which may be perpetual if the special limitation never occurs. However, the estate will automatically terminate by operation of law upon the occurrence of the breach of the special limitation.

1. The Fee Simple Determinable Estate

Under the common law, a special limitation creates a fee simple determinable estate in which A conveys Blackacre to B, “for so long as” B shall use Blackacre for a particular purpose. The instant that Blackacre is no longer used for such purpose, by operation of law the estate terminates and vests in the grantor, or grantor’s successors, as a result of the limitation of the grant. The automatic reversion to the grantor of the title to the estate granted is not a forfeiture, but is the result of the “possibility of reverter” retained by the grantor upon the execution and delivery of the fee simple determinable conveyance.³

The fee simple determinable estate is distinguished from the fee simple absolute estate in that the determinable estate is subject to defeasance. The fee simple determinable estate is an exception to the common law rule requiring as a prerequisite, the filing of an action to recover land. A

determinable fee estate is also distinguishable from the fee simple estate subject to a condition subsequent.⁴ The conveyance of a fee simple estate subject to a condition subsequent requires the grantor to take an affirmative action, or to make an actual re-entry in order to terminate the granted estate. The termination of a fee simple estate subject to a condition subsequent is not automatic, but vests in the grantor the power of termination or a right of entry. Today the grantor would bring an action to recover the land without the need for actual prior entry.⁵

In the case of a fee simple estate subject to a condition subsequent, the grantor must know of the termination of the estate in order to bring an action for the recovery of the fee simple title. In the case of a fee simple determinable interest, the grantor need not know of the termination of the estate as a result of the occurrence of the breach of the special limitation in order to become vested with fee simple absolute. Moreover, since the estate reverts to the grantor instantaneously upon the occurrence of the limitation by operation of law, the grantor may not waive its right to terminate the fee simple determinable estate.⁶ The fee simple determinable estate terminates upon the terms of the grant through the habendum clause as a consequence of the limitation of the estate granted. The fee simple estate upon a condition subsequent must be forfeited.⁷

² *Stephens County v. Mid-Kansas Oil & Gas Co.*, 113 Tex. 160, 173, 254 S.W. 290, 295 (1923). See generally, A.W. Walker, Jr., *Fee Simple Ownership of Oil and Gas in Texas*, 6 TEX. L. REV. 125 (1928); A.W. Walker, Jr., *The Nature of the Property Interests Created by an Oil and Gas Lease in Texas*, 8 TEX. L. REV. 483 (1930).

³ FRED A. LANGE & ALOYSIUS A. LEOPOLD, 3 TEXAS PRACTICE: LAND TITLES AND TITLE EXAMINATION § 331, at 602–03 (2d ed. 1992).

⁴ However, see Section II.E, *infra*, discussing conditions subsequent contained in provisions other than the granting clause.

⁵ FRED A. LANGE & ALOYSIUS A. LEOPOLD, 3 TEXAS PRACTICE: LAND TITLES AND TITLE EXAMINATION § 341, at 702–13 (2d ed. 1992).

⁶ However, see Section II.F, *infra*, discussing Texas courts’ application of defenses to termination claims.

⁷ CORNELIUS J. MOYNIHAN, INTRODUCTION TO THE LAW OF REAL PROPERTY, 36–37, 103–06 (1962).

2. The Rule in Texas

Although early Texas cases held that the leasehold estate granted a possessory interest, they did not always interpret the leasehold estate as a fee simple determinable estate.⁸ However, in *Stephens County v. Mid-Kansas Oil & Gas Co.*,⁹ the Supreme Court of Texas held that the typical oil and gas lease conveyed to the lessee the ownership of oil and gas in place for so long as oil or gas was produced in paying quantities. Although the leasehold interest was held to be a fee simple interest (theoretically the estate could continue indefinitely due to the language of the habendum clause “so long as”), the interest conveyed was determined to be a defeasible fee interest. Upon cessation of production in the secondary term, the leasehold estate would terminate. The court arrived at its decision by ascertaining the intent of the parties as stated in the specific language of the habendum clause of the lease. The same result is reached in leases containing a habendum clause using the words, “so long thereafter as.”

No new estates have been created since the promulgation of the Statute of Uses in 1536.¹⁰

C. The Creation of the Oil and Gas Lease

1. Statute of Frauds

The oil and gas lease is a conveyance of a real property interest and is therefore subject to the Statute of Frauds. It must be in

⁸ *Texas Co. v. Daugherty*, 107 Tex. 226, 227–28, 176 S.W. 717, 718–19 (1915).

⁹ 113 Tex. 160, 254 S.W. 290 (1923).

¹⁰ For a more comprehensive analysis of these issues see Bruce M. Kramer, *The Temporary Cessation Doctrine: A Practical Response to an Ideological Dilemma*, 43 BAYLOR L. REV. 519 (1991), and MOYNIHAN, *supra*, at 35-36, 95-100.

writing and subscribed to and delivered by the grantor or the grantor’s agent.¹¹ It need not be acknowledged or recorded to be effective, but it must be executed and delivered.¹² The instrument must also properly describe the acreage covered by the lease and contain the essential terms of the agreement.¹³

2. Bonus

The well settled rule in Texas has been that consideration is not necessary to support the validity of a deed.¹⁴ This rule also applies to oil and gas leases. In *Jones v. Bevier*,¹⁵ the lessor executed and delivered to the lessee an oil and gas lease. The lessee recorded the instrument but failed to pay any bonus for the lease. In fact, the lessor never requested the payment of a bonus. The lessor sued to cancel the lease as being ineffective for lack of consideration. The court ruled in favor of the lessee, stating that an oil and gas lease is the conveyance of a determinable fee interest in the oil, gas and other minerals in and under the acreage described in the lease.¹⁶ It is a conveyance of land and therefore requires no consideration. As a result, the nonpayment of the bonus was immaterial. The court held that the lease was not a mere option, but a present grant of an interest in real property.¹⁷

The court further held that in the event that consideration was required, consideration

¹¹ TEX. PROP. CODE ANN. § 5.021 (West 2014).

¹² *Thornton v. Rains*, 157 Tex. 65, 66–67, 299 S.W.2d 287, 288 (1957).

¹³ For a further discussion of property descriptions in real property documents, see *Texas Title Examination Standards*, TEX. PROP. CODE ANN., Tit. 2, App., ch. 5 (West Supp. 2015).

¹⁴ *Baker v. Westcott*, 73 Tex. 129, 133, 11 S.W. 157, 159 (1889).

¹⁵ 59 S.W.2d 945 (Tex. Civ. App.—Beaumont 1933, writ ref’d).

¹⁶ *Bevier*, 59 S.W.2d at 948.

¹⁷ *Bevier*, *Id.*

had in fact been exchanged as the recited consideration of, “One Dollar in Hand Paid,” was sufficient.¹⁸ It did not matter whether this money was ever paid to the lessor. The court further stated that the lease was, in any event, supported by nonmonetary consideration in the form of an affirmative drilling obligation.¹⁹ It cited the offset provision as proof that in accepting the lease the lessee had obligated itself to drill, finding that prior to the execution and delivery of the instrument, no such legal obligation existed.²⁰

3. Delivery and Acceptance

a. Actual and Constructive Delivery

Although in writing and executed by the grantor, no conveyance (including an oil and gas lease) is effective to transfer title until it is delivered. Delivery is a formality essential to the effectiveness of any conveyance, regardless whether it is recorded.²¹ Title is not transferred until the conveyance instrument is executed and delivered.²²

Delivery requires a showing that the instrument was placed in the permanent control of the grantee by the grantor and that the grantor intended for the instrument to operate as a conveyance.²³ Whether delivery has occurred is a question of fact, what constitutes delivery is a question of law.²⁴

Delivery may be accomplished by actual delivery, where the conveyance is physically delivered to the grantee by the grantor for the purpose of conveying title, or by constructive delivery, where actual delivery is not possible, but the grantor takes some action permitting the grantee to obtain possession of the executed instrument.

Delivery does not require physical delivery of the conveyance to the grantee. Although each case would stand upon its own facts, there must be proof of an intention on the part of the grantor that the instrument be delivered and such other acts sufficient to show delivery.²⁵ It is the intention of the grantor that controls, even though the grantee may not be aware of the execution and delivery of the instrument.²⁶

The recording of a deed for record raises a rebuttable presumption that the instrument has been delivered and is effective as a conveyance that has been accepted by the grantee.²⁷ Since delivery is a question of the intention of the grantor, the presumption may be rebutted by showing that, (1) the deed was delivered or recorded for a different purpose, (2) that fraud, accident or mistake accompanied the delivery, or (3) that the grantor had no intention of divesting himself of title.²⁸

Once a deed has been executed and delivered and is effective as a conveyance, the subsequent return of the deed to the grantor has no effect upon the conveyance.²⁹

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *Id.*

²¹ *Dikes v. Miller*, 24 Tex. 417, 423 (1859).

²² *Stephens County Museum, Inc. v. Swenson*, 517 S.W.2d 257, 262 (Tex. 1974).

²³ *Ragland v. Kelner*, 148 Tex. 132, 135, 221 S.W.2d 357, 359 (1949).

²⁴ *Id.*

²⁵ *Smith v. Smith*, 607 S.W.2d 617, 620 (Tex. Civ. App.—Waco 1980, no writ).

²⁶ *Ragland*, 148 Tex. at 135.

²⁷ *Texas Title Examination Standards*, TEX. PROP. CODE ANN., Tit. 2, App., ch. 4 (West Supp. 2015).

²⁸ *Stephens County Museum, Inc. v. Swenson*, 517 S.W.2d 257, 261 (Tex. 1974).

²⁹ *Phoenix Ins. Co. v. Neal*, 56 S.W. 91, 93 (Austin 1900, no writ).

Where multiple grantors have executed an instrument intending that it convey title, delivery is nevertheless ineffective as to any nonconsenting co-grantors.³⁰ As a result, the lessee must confirm that the document has been executed and delivered by all lessors therein named in order for the leasehold estate to be fully conveyed.

A deed to a grantee who is deceased is void since no grantee exists. A void instrument passes no title.³¹ A deed must also be delivered prior to the death of the grantor, related back to the grantor's lifetime.³²

b. Conditional Delivery

Delivery may also be conditional, where the grantor intends that the conveyance be effective upon payment of the purchase price and authorizes an agent, typically a title company acting as the escrow agent, to hold the conveyance until such time as the purchase price has been paid. In real estate closings today, subject to the instructions of the parties, the documents are generally not physically delivered by the grantor to the grantee, but are delivered by the title company recording the instrument in favor of the grantee for the purpose of conveying the interest therein stated, upon the payment of the purchase price.

Although oil and gas transactions are not escrowed through title companies, historically oil and gas leases were conditionally delivered through a bank to become effective upon the payment of the draft made payable to the lessor. Today, bonus payments can be made either through check, wire transfer, or given the amount of

today's bonus payments, by armored car. The lease is either delivered to the landman as agent for the lessee, or to an actual employee of the lessee for the purpose of vesting the leasehold title in the lessee upon the payment of the consideration or bonus.

Where an instrument is delivered into escrow under an escrow agreement or through the instructions contained in a letter agreement between the parties, although not dependent upon physical delivery, the legal title passes to the grantee only upon compliance with the conditions of the escrow arrangement.³³

In the event that the instrument is delivered contrary to the instructions contained within the escrow agreement, no delivery has occurred, and no title has passed.³⁴ Oil and gas lessees should take care to satisfy the terms of any agreement with the lessor regarding the execution, delivery and payment of the bonus.

Although the payment of a bonus to the lessor is not a condition to the conveyance of the leased substances to the lessee, lessors will insist upon it. The payment of the bonus in exchange for the execution and delivery of the lease should be made a condition to the effectiveness of the instrument.

In *Pelican Oil & Gas Company v. Edson Petroleum Company*,³⁵ the Stones (lessors) and Pelican (lessee) had agreed to the payment of the bonus pursuant to the tendering of a draft deposited with a

³⁰ North v. North, 2 S.W.2d 481, 483 (Tex. Civ. App.—Waco 1927, no writ).

³¹ Vineyard v. Heard, 167 S.W. 22, 25–26 (Tex. Civ. App.—San Antonio 1914), *aff'd*, 212 S.W. 489 (Tex. Comm'n App. 1919).

³² Davis v. Bond, 158 S.W.2d 297 (Tex. 1942).

³³ Sheldon v. Stagg, 169 S.W.2d 550, 552 (Tex. Civ. App.—Amarillo 1943, writ ref'd w.o.m.).

³⁴ Binford v. Snyder, 144 Tex. 134, 143–144, 189 S.W.2d 471, 475–76 (1945); Alamo Lumber Co. v. Lawyers Title Ins. Corp., 439 S.W.2d 423, 426 (Tex. Civ. App.—San Antonio 1969, writ ref'd n.r.e.).

³⁵ 123 S.W.2d 696 (Tex. Civ. App.—Texarkana 1939, no writ).

Shreveport bank.³⁶ The funds were to be transferred to the lessors' account at a local Texas bank within four days of the execution of the lease. The lease was executed on July 11, 1935. The draft was paid by the Shreveport bank within the four day period, however the proceeds were not credited at the Texas bank to the account of the lessors until July 17. This was two days after the date upon which it had been agreed that the bonus monies must be deposited in the account of the lessor. On July 17, the oil and gas lease was recorded. The lessors were informed on July 16 that the bonus monies had not been credited to their account. On that same day they executed and delivered a lease to another lessee who immediately recorded the second lease. The second lessee executed an assignment to a third party. This assignment was recorded prior to the recording of the Pelican lease. The second lease was subsequently assigned to Edson Petroleum, and the lessors refused the bonus payment credited to them by Pelican on July 17.

Upon execution, the original lease had been physically delivered to an agent for Pelican and thereby to Pelican itself with the understanding that it would not take effect unless the bonus monies were timely deposited into the account of the lessor at the local bank. The court held that although physical delivery to the lessee had occurred, it was not an unconditional delivery, since the lessor did not intend that the lease become effective upon the loss of control of the lease to Pelican through its agent.³⁷ The court held that to complete a delivery so that the conveyance becomes effective, although the instrument is placed within the control of the grantee, it must be done by the grantor

with the intention that it shall become operative as a conveyance.³⁸

Although the Pelican lease was physically given to the lessee through its agent, the agreement was that the agent would take the lease to the bank which would hold it and deliver it to the lessee only upon the bonus monies being timely credited to the account of the lessor. This was not accomplished. As a result, the delivery never became effective; therefore, the Pelican lease never became operative.³⁹ Since the lease never took effect as a result of the lack of delivery, the court deemed it unnecessary to discuss whether the junior lessee was an innocent purchaser.⁴⁰

A conveyance document which passes into the possession of the grantee without the intention of the grantor that it pass title is wholly inoperative and passes no title. A subsequent purchaser from the grantee who has paid value and is without knowledge of these facts cannot rely on the doctrine of bona fide purchaser. Such a deed delivered without the consent of the grantor is void and has no more effect to pass title than if it were a forgery.⁴¹

However, where a grantor through gross negligence permits the deed to be delivered so as to cause the grantee to believe that it was genuine and in reliance thereon acted to his detriment, the doctrine of equitable estoppel would apply.⁴²

In *Jones*, no consideration was required or paid, and the lease became effective upon actual delivery. In *Pelican*, the delivery was ineffective as a result of the lessee's failure

³⁶ *Id.* at 697.

³⁷ *Id.* at 698.

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ *Binford v. Snyder*, 144 Tex. 134, 144, 189 S.W.2d 471, 476 (1945).

⁴² *Id.*

to fully comply with the agreement for the delivery of the lease, notwithstanding the attempt to pay the bonus. Without delivery, the lease never took effect.

Lessors should not deliver an executed oil and gas lease to the lessee without either the contemporaneous payment of the bonus, or under a conditional delivery through written instructions to the lessee or a third-party escrow that delivery shall be ineffective and the oil and gas lease shall not become operative until such conditions have been fully satisfied. Lessees should be careful to strictly comply with the conditions of delivery.

c. Acceptance

Although delivered, a conveyance is not effective until it is accepted by the grantee.⁴³ Such acceptance may be express, or it may be implied.⁴⁴ The payment of the consideration to the grantee as expressed in the instrument creates the presumption of acceptance,⁴⁵ as does possession of the deed by the grantee.⁴⁶ The recordation of the conveyance creates prima facie evidence of acceptance by the grantee, although the presumption may be overcome.⁴⁷

In order to determine the date of delivery and thereby the effectiveness of the instrument, the instrument may specifically state a date upon which it shall become effective. Also, possession of the deed by

the grantee raises the presumption that the instrument has been delivered and was accepted on the date when possession began.⁴⁸ Where a conflict exists between the effectiveness of the instrument on the date of the instrument or on the date of the acknowledgement of the instrument, the courts are divided, although they favor the date of the instrument as controlling.⁴⁹ The parties are free to contract to make the conveyance effective at any time, whether before or after the date of actual delivery, the date of the instrument or the date of the acknowledgment, if these dates are different.⁵⁰

4. Offer Sheets and Letter Agreements

Sometimes specific terms of a lease may be contained in an offer sheet. Typically, these offer sheets are signed by the lessee and submitted to the lessor detailing certain essential terms of the lease, such as the bonus, royalty, the duration of the primary term and the acreage to be covered, with the remaining terms to be negotiated. The lessor is asked to sign the term sheet and return it, although not all of the terms of the lease are stated in the term sheet.

In the case of *Oakrock Exploration Company v. Killam*,⁵¹ Oakrock sought to enter into an agreement with the landowners covering a 154-acre tract in Zapata County. An agreement was signed on March 7 by Oakrock and all of the landowners. It described the acreage, the bonus, the royalty and the duration of the primary term. It called for an oil and gas lease to be negotiated and prepared by the lessors'

⁴³ *Aguilar v. Sinton*, 501 S.W.3d 730 (Tex. App. – El Paso, 2016, pet. denied)

⁴⁴ *Robert Burns Concrete Contractors, Inc. v. Norman*, 561 S.W.2d 614, 618 (Tex. Civ. App.—Tyler 1978, writ ref'd n.r.e.).

⁴⁵ *Phillips v. Anderson*, 93 S.W.2d 171, 175 (Tex. Civ. App.—Austin 1936, no writ).

⁴⁶ *Fox v. Lewis*, 344 S.W.2d 731, 741 (Tex. Civ. App.—Austin 1961, writ ref'd n.r.e.).

⁴⁷ *Martin v. Uvalde Sav. & Loan Ass'n*, 773 S.W.2d 808, 812 (Tex. App.—San Antonio 1989, no writ).

⁴⁸ *Fox*, 344 S.W.2d at 741.

⁴⁹ *Wilson v. Curry*, 151 S.W.2d 356, 358 (Tex. Civ. App.—Fort Worth 1941, writ dismissed).

⁵⁰ *Cox v. Payne*, 107 Tex. 115, 118–19, 174 S.W. 817, 818–19 (1915).

⁵¹ 87 S.W.3d 685 (Tex. App.—San Antonio 2002, pet. denied).

attorney. Under the terms of the agreement, the lessors were also to be paid an additional \$50 per acre until such time as the release of a prior lease covering the acreage had been obtained through the bankruptcy court. This release was subsequently acquired. The new lease was prepared by the lessors' attorney as envisioned by the agreement. The lease was signed by the members of one of the ownership groups (Ramirez). Ramirez was paid the bonus and delivered the executed lease to Oakrock. In the interim, Killam began negotiations with the other ownership group (Martinez) who failed to sign the Oakrock lease, but who had signed the March 7 agreement. Martinez subsequently signed a lease with Killam. Oakrock sued Killam for breach of contract, tortious interference and upon other theories with regard to the Martinez mineral interest.

The court held that the dispositive issue in the case was whether the March 7 agreement executed between the ownership groups and Oakrock was enforceable.⁵² In order to be enforceable, the agreement must contain the essential terms required for contractual formation. It must contain an offer which must be accepted in strict compliance with the terms of the offer, and there must be a meeting of the minds between the parties, including execution of the contract and delivery of the document with the intention that it be binding. The court held that whether the agreement is legally enforceable is a question of law.⁵³

Although the March 7 agreement must contain the essential elements of an oil and gas lease in order to be enforceable, the duty to develop the premises, protect the leasehold and manage and administer the lease would be implied.⁵⁴ The court required the agreement to state the

commencement date and duration of the lease, time and amount of payments in lieu of drilling operations and the amount and manner of payment for produced hydrocarbons.⁵⁵ Obviously, the land to be leased must also be described with reasonable certainty as the agreement is subject to the Statute of Frauds.⁵⁶ The character, extent and duration of the rights to the oil and gas in place are essential terms and must also be disclosed in the agreement in order for it to be enforceable.

The court found that the March 7 letter agreement lacked these essential terms and was not enforceable as a matter of law.⁵⁷ Accordingly, the Martinez ownership group was free to lease its interest in the 154 acres to Killam for a much higher bonus and upon better terms as those previously offered by Oakrock.

Although in *Oakrock* the March 7 letter agreement was not enforceable, had it contained the essential terms required by the court and satisfied the Statute of Frauds, it would have been binding upon the lessors and the lessee. In order to avoid this result, the parties should be careful to expressly state that the agreement does not contain the essential terms of the lease but is merely a basis upon which the parties shall negotiate in good faith, and until such time as a mutually-acceptable oil and gas lease has been executed and delivered, the parties shall not be bound thereby, nor shall any interest in the minerals be conveyed. Although term sheets generally do not contain the essential elements of an oil and gas lease, parties should take care to avoid such uncertainty.

⁵² *Killam*, 87 S.W.3d at 690–91.

⁵³ *Id.* at 690.

⁵⁴ *Id.* at 690–91.

⁵⁵ *Id.*

⁵⁶ *Texas Title Examination Standards*, TEX. PROP. CODE ANN., Tit. 2, App., ch. 5 (West Supp. 2015).

⁵⁷ *Killam*, 87 S.W.3d at 691.

5. Top Leases

The conveyance of a top lease occurs when the lessor under an existing oil and gas lease, who has retained the possibility of reverter in the mineral estate, grants a second lease covering the same land to another lessee with the intention that the second lease (the “top lease”) become effective upon termination of the first lease (the “bottom lease”). Top leasing has been a common practice in Texas for many years, but drafting such leases is riddled with potential pitfalls about which every practitioner should be aware.

To avoid clouding the title of the bottom lessee and to prevent the primary term of the top lease from commencing while the bottom lease is still in effect, the effectiveness of a top lease must be conditioned on the termination of the bottom lease. Such top leases, however, have been held to violate the Rule Against Perpetuities (RAP), because they create a future interest (a springing executory interest) in the top lessee which may not vest within the time required by the RAP.⁵⁸ The RAP requires that all interests must vest, if at all, within twenty-one (21) years after the death of some life or lives in being at the time of the creation of the interest. If the top lease is not properly drafted to avoid violation of the RAP, the conveyance is void *ab initio*. The rule applies only to the vesting of estates or interests, not vesting of possession. Accordingly, the rule is not applicable to present interests or future interests which vest at their creation, regardless whether the grantee has a present right to possession.

⁵⁸ See *Hamman v. Bright & Co.*, 924 S.W.2d 168, 172-73 (Tex. App.—Amarillo 1996, writ granted w.r.m.) (concluding that top leases which were expressly “made subject to, and specifically designated to commence after and subsequent to the expiration of, the bottom leases” violated RAP and were, therefore, void *ab initio* as a matter of law)(emphasis in original).

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

First, the lessor may choose to convey the top lease as a springing executory interest to become effective upon termination of the bottom lease. However, if this approach is taken, language should be added that such conveyance will become null and void if the interest has not vested in the top lessee within twenty-one years from the date of its execution, or such other date which is not in violation of the RAP.

Alternatively, the lessor can make a present conveyance of a determinable fee interest in the lessor’s possibility of reverter. A conveyance of a determinable fee interest in the lessor’s possibility of reverter is a presently vested interest which is not subject to the application of the RAP⁵⁹ and conveys to the top lessee the right to develop the mineral estate upon termination of the bottom lease, with a possibility of reverter retained in favor of the lessor. In the recent case of *BP America Production Company v. Laddex, Ltd.*⁶⁰, the court held that the top lease in question was a present conveyance of a vested interest that did not violate the RAP. Any such conveyance should make clear that the top lease is a present conveyance of a partial interest in the lessor’s possibility of reverter in connection with a determinable fee of the mineral estate. Further, the top lease should make clear that the primary term will commence upon the top lessee’s obtaining possession of

⁵⁹ *Mahan v. Brader*, 242 S.W.2d 941, 945 (Tex. Civ. App.—Fort Worth 1951, no writ).

⁶⁰ *BP America Production Co. v. Laddex, Ltd.* 513 S.W.3d 476 (Tex. 2017).

the mineral estate, rather than commencing upon the date of the conveyance.

D. The End of the Beginning

We have learned what an oil and gas lease is, the estate that it conveys and the legal requirements necessary for it to become effective. We have discussed how the parties may be bound through an agreement which satisfies the Statute of Frauds and contains all of the essential terms of an oil and gas lease. We know to take care in top leasing over existing leases. Having been created, now let us examine the circumstances under which the oil and gas lease may terminate.

II. TERMINATION OF AN OIL & GAS LEASE

A. Understanding Lease Termination Issues

As previously discussed, the key to understanding lease termination issues is to have an appreciation of the life span of an oil and gas lease and the nature of the fee simple determinable estate created by an oil and gas lease.⁶¹ Texas courts have long

recognized the well-established principal that oil and gas leases are both a conveyance and a contract. Rules of property law and general rules of contract construction are used to interpret them. It is also true that the rules of contract law would not be used to supplant the nature of the oil and gas lease as a conveyance of real property and the application of property law concepts.

Of utmost importance in analyzing lease termination claims is to have an appreciation of the difference among covenants, conditions subsequent, and special limitations.⁶² A covenant is a promise to do or refrain from doing something. If the lessee breaches a covenant, he would be liable to the lessor for damages, but such a breach would not result in termination of the lease. A condition subsequent creates a right of reentry in the lessor if triggered. If the lessee breaches a condition of termination, the lessor can terminate the lease but must make an affirmative act of reentry to do so.⁶³ Finally, the occurrence of a breach of the special limitation results in the automatic termination of the mineral leasehold estate and an automatic reversion to the lessor.

Texas courts have struggled with these important distinctions which highlight the interplay between principals of property and

⁶¹ Please note that there exist poorly drafted oil and gas leases which purport to convey a fee simple absolute estate, although it is clear that the parties intended for the conveyance to be for the exploration of oil and gas purposes only. Where an oil and gas lease makes a general conveyance but contains a provision setting forth a specific purpose for the conveyance and the lessee stops using the land for the stated purpose, the estate granted automatically terminates and reverts to the lessor. *Texas Co. v. Davis*, 113 Tex. 321, 331, 254 S.W. 304, 306 (1923) (“The grant was not of an absolute fee. The estate conveyed, on condition subsequent, was a determinable fee, inasmuch as the land might always produce minerals in paying quantities, causing the grant to endure forever, and inasmuch as the intent is unquestionable that the land was to be used for no other purpose than the drill for and produce the minerals, and that the grant was to be enjoyed

only while the work of mineral exploration and production was carried on.”)

⁶² *Blackmon v. XTO Energy, Inc.*, 276 S.W.3d 600, 605 (Tex. App.—Waco 2008, no pet.) (providing a summary of the effects of each type of qualification within an oil and gas lease). For an in-depth discussion of these concepts, see A.W. Walker, Jr., *The Nature of the Property Interests Created by an Oil and Gas Lease in Texas*, 8 TEX. L. REV. 483, 483–84 (1930).

⁶³ *Vinson Minerals, Ltd. v. XTO Energy, Inc.*, 335 S.W.3d 344, 354 (Tex. App.—Fort Worth 2010, pet. denied) (“Upon breach of a condition subsequent, the lessor must elect between seeking damages or forfeiture; the lease is not automatically terminated upon breach.”)

contract law. These distinctions are subtle and are not always easy to discern from the language of the lease. For a brief discussion of the distinctions among these concepts, please refer to Section II.E, *infra*.

B. Termination During the Primary Term

The habendum clause sets forth the primary term which establishes the time that the lease can remain in effect after delivery to the lessee absent production in paying quantities. This is typically three to five years, although longer and shorter primary terms have been negotiated. The habendum clause also allows the lease to remain in effect past the primary term if there is sufficient production. The typical habendum clause states: “[s]ubject to the other provisions contained herein, this lease shall be for a term of [three] years from the effective date (the ‘primary term’) and as long thereafter as oil, gas or other mineral is produced from the lease premises or land pooled therewith.”

A lease may terminate prior to the end of the primary term if the lease requires that drilling operations be commenced within a certain time after the effective date of the lease. The typical form leases used in Texas during most of the twentieth century contained “drilling and delay rental” clauses which required the lessee to engage in drilling operations within a certain period or, alternatively, pay the lessor annual delay rentals for the right to maintain the lease in effect throughout the primary term.⁶⁴

⁶⁴ A typical drilling and delay rentals clause states: “If drilling operations for a well are not commenced on the lease premises or land pooled therewith within one year of the effective date of this lease, this lease shall terminate, *unless* on or before the anniversary date, lessee shall pay or tender to lessor the amount of \$[_____] (herein called ‘delay rentals’), which shall cover the privilege of deferring commencement of drilling operations for one year. In like manner and upon

Because the use of the word “unless” creates a special limitation on the mineral leasehold estate, failure to commence drilling operations or timely and properly pay the delay rental will result in automatic termination of the lease.⁶⁵

1. Commencement of Drilling Operations

The requirement that the lessee commence drilling operations can generally be satisfied if the lessee has engaged in some activity on the lease premises related to drilling activities and diligently proceeds with those activities in good faith until a well is completed. Spudding the well is generally not required.⁶⁶ Ultimately, determining whether the lessee has commenced drilling activities is a question of fact. Texas cases have broadly interpreted these provisions to allow for most types of preparatory work to qualify as the commencement of lessee’s drilling operations.

a. Payment of Delay Rentals

Delay rentals can only keep a lease in effect during the primary term and cannot be used as a substitute for production during the secondary term. Delay rental provisions are strictly interpreted by Texas courts.⁶⁷

like payments or tenders annually, lessee may further defer commencement of drilling a well on the lease premises for successive one year periods during the primary term.”

⁶⁵ Cox v. Miller, 184 S.W.2d 323, 327 (Tex. Civ. App.—Eastland 1944, writ ref’d) (noting that the use of an “unless” lease in Texas does not create a forfeiture provision through the use of a condition subsequent “but is a limitation upon the lessee’s estate, marking the limit of the estate granted”).

⁶⁶ Please note that there may be instances in which the language of the lease requires the “commencement of drilling,” rather than the “commencement of drilling operations,” in which case actual spudding may then be required.

⁶⁷ Young v. Jones, 222 S.W. 691, 694 (Tex. Civ. App.—El Paso 1920, no writ) (stating that the

Accordingly, under an “unless” delay rental provision, if the lessee does not pay the correct amount to the proper party by the time stated in the lease, the lease will terminate.⁶⁸ Even if the lessee’s underpayment is due to a good faith mistake, this will typically not excuse termination.⁶⁹ However, where the improper payment of delay rentals is due to some fault on the part of the lessor, the lease will not terminate.⁷⁰ In addition, if the lease contains language allowing for substantial performance or bona fide efforts by the lessee in order to comply with its delay rental payment obligation, Texas courts have not interpreted these provisions as harshly against lessees.⁷¹

Many oil and gas leases in use today are “paid-up” leases which provide the lessee with the option, but not the obligation, to commence drilling operations within the

strict construction of these delay rental provisions is due to the fact that time is of the essence in oil and gas leases).

⁶⁸ *Id.* at 695 (holding that lessee’s tender of \$73.29 as delay rental, rather than the \$76.25 that was owed, terminated the lease).

⁶⁹ *Coker v. Benjamin*, 83 S.W.2d 373, 377–78 (Tex. Civ. App.—Beaumont 1935, no writ) (holding that the lessee’s failure to pay the proper amount of \$75 semiannually was entirely due to the lessee’s own negligence, and because the lessor was not at fault, the lease automatically terminated).

⁷⁰ *See Humble Oil & Refining Co. v. Harrison*, 146 Tex. 216, 223–26, 205 S.W.2d 355, 359–361 (1947) (determining that underpayment was excused due to ambiguity created by lessors in a subsequent deed allocating such payments); *Meier v. Suntext Oil & Gas Co.*, 413 S.W.2d 944, 949 (Tex. Civ. App.—Amarillo 1967, no writ) (concluding that lessee did not fail to make a proper delay rental payment because it had not been provided with a copy of the deed to the subsequent grantee).

⁷¹ *See Kincaid v. Gulf Oil Corp.*, 675 S.W.2d 250, 256–57 (Tex. App.—San Antonio 1984, writ ref’d n.r.e.) (excusing improper payment of a delay rental to the wrong lessor where the lease allowed for the lessee to make a “bona fide attempt” to pay the delay rental).

primary term.⁷² Consequently, paid-up leases do not contain commencement of drilling operations and delay rental clauses requiring the lessee to pay the lessor a sum certain in the absence of drilling operations or production from the lease premises during the primary term. In a paid-up lease, the lessee is essentially buying out this option by paying an increased bonus amount upon execution of the lease. The recent boom in Texas shale plays, such as the Eagle Ford Shale, the Barnett Shale, the Permian Basin and the Haynesville/Bossier Shale, has resulted in increased competition among developers and some of the highest bonus payments in history (upwards of \$20,000 per acre in some cases in the Permian Basin – circa 2018).

Exploration and development companies often require that paid-up leases be used in order to alleviate the administrative burdens of ensuring delay rental payments are timely and properly paid and to provide greater flexibility in coordinating drilling operations when competition for drilling rigs is high.

C. Termination at the End of the Primary Term or During the Secondary Term

An oil and gas lease will terminate at the end of the primary term if the lessee is not producing oil or gas and has not complied with one of the savings provisions in the oil and gas lease which either excuses production or serves as a substitute for lack of production. Even where a lease is held by production into the secondary term, the lease is susceptible to termination if a special limitation is triggered. A special limitation will be triggered if there is a lack of production in paying quantities or after a

⁷² The General Land Office’s form leases for state lands include drilling and delay rental provisions. *See* 31 TEX. ADMIN. CODE § 9.33 (West 2014) (Gen. Land Office, Delay Rental Payments).

period of production in paying quantities, production permanently ceases or ceases beyond the time allowed in the applicable savings clause.

1. Lack of Production in Paying Quantities

Texas follows the majority rule that mere discovery of oil or gas is insufficient to hold a lease in effect past the primary term. Rather, a lessee must have produced and marketed the oil or gas.⁷³ Texas courts have established that production from the lease must be “in paying quantities” in order to maintain an oil and gas lease in effect. Even where the habendum clause of a lease uses only the word “production,” production must still be in paying quantities in order to keep the lease in effect during the secondary term.⁷⁴

The issue of paying quantities is a question of fact for the jury and the burden is on the lessor to prove a lack of production in paying quantities in order to terminate the lease. The plaintiff must show that (1) operating expenses exceed revenues; and (2) if not, that, under the all of the relevant circumstances, a reasonably prudent

operator would for purposes of making a profit and not merely for speculation continue to operate the well as it had been operated. There can be no limit as to time, whether it be days, weeks or months in determining the question whether paying production from the lease ceased.⁷⁵

If the “well pays a profit, even small, over operating and marketing expenses, it produces in paying quantities, even though it may never repay its costs and the enterprise as a whole may prove unprofitable.”⁷⁶ When performing this calculation, only operating and marketing costs are taken into account.⁷⁷ Operating and marketing costs may include pumping costs, taxes, overhead, labor attributable to maintaining the well, repairs, depreciation on salvable equipment and other similar expenses. These are sometimes referred to as out-of-pocket lifting expenses, which can generally be described as fixed or periodic expenses incurred in operating a well. Capital investment expenditures such as drilling and reworking costs and lease acquisition costs, however, are not considered in this calculation.⁷⁸

If the plaintiff is unsuccessful in showing that operating revenues from a well exceed operating expenses, a court will next consider “whether under all relevant circumstances a reasonably prudent operator would, for the purpose of making a profit and not merely for speculation, continue to operate a well in the manner in which the

⁷³ Stanolind Oil & Gas Co. v. Barnhill, 107 S.W.2d 746, 749 (Tex. Civ. App.—Amarillo 1937, writ ref’d) (holding that the lease terminated at the end of the primary term for lack of a market, despite the fact that lessee had drilled a well capable of producing 7 million cubic feet of sour gas per day and was making reasonable efforts to market the gas); Cox v. Miller, 184 S.W.2d 323, 327 (Tex. Civ. App.—Eastland 1944, writ ref’d) (“Where the real consideration for a lease is a part of the oil or gas produced, or its proceeds, the lessee’s obligation to ‘produce’ oil or gas in order to prevent termination of an ‘unless’ lease is not discharged merely by drilling or by discovering oil or gas with potential production in paying quantities, but the lessee is further required to operate the well and market the product within a reasonable time.”)

⁷⁴ Garcia v. King, 139 Tex. 578, 583, 164 S.W.2d 509, 511–12 (1942); Cox, 184 S.W.2d at 327.

⁷⁵ Clifton v. Koontz, 325 S.W.2d 684, 690–91 (Tex. 1959); BP America Prod. Co. v. Laddex, Ltd., 513 S.W.3d 476 (Tex. 2017).

⁷⁶ Garcia, 164 S.W.2d at 511–12.

⁷⁷ Skelly Oil Co. v. Archer, 356 S.W.2d 774, 781–82 (Tex. 1961), *rev’d in part on other grounds*, 356 S.W.2d at 782 (Tex. 1962); Pshigoda v. Texaco, Inc., 703 S.W.2d 416, 418 (Tex. App.—Amarillo 1986, writ ref’d n.r.e.).

⁷⁸ Pshigoda, 703 S.W.2d at 418–19.

well in question was operated.”⁷⁹ This is commonly referred to as the “reasonably prudent operator test.” This second prong is the subjective portion of the paying quantities analysis.⁸⁰

The two prong analysis is inapplicable in the event of total cessation of production which is a separate grounds for lease termination. It is different from cessation of production in paying quantities. A total cessation of production clause will result in automatic termination of the lease, regardless of the reasonableness of the actions of the lessee, unless another lease savings clause applies.⁸¹

2. Permanent Cessation of Production

If a lessee has been producing oil or gas in paying quantities but the well ceases to permanently produce oil or gas, the lease will terminate.⁸² The two-prong “paying quantities” analysis described in *BP America Production Company v. Laddex, Ltd.* does not apply to claims that there has been a total cessation of production.⁸³

⁷⁹ *BP American Production Company v. Laddex, Ltd.* 513 S.W.3d 476 at 481; *Clifton*, 325 S.W.2d at 691.

⁸⁰ *Clifton*, (noting that factors to consider include, “[t]he depletion of the reservoir and the price for which the lessee is able to sell his produce, the relative profitableness of other wells in the area, the operating and marketing costs of the lease, his net profit, the lease provisions, a reasonable period of time under the circumstances, and whether or not the lessee is holding the lease merely for speculative purposes”).

⁸¹ *BP America Production Company v. Red Deer Resources, LLC*, 526 S.W.3d 389 (Tex. 2017).

⁸² *Anadarko Petroleum Corp. v. Thompson*, 94 S.W.3d 550, 554 (Tex. 2002); *Amoco Prod. Co. v. Braslau*, 561 S.W.2d 805, 808 (Tex. 1978).

⁸³ *BP America Production Company v. Laddex, Ltd.* 513 S.W.3d 476 (Tex. 2017); *Cannon v. Sun-Key Oil Co., Inc.*, 117 S.W.3d 416, 421 (Tex. App.—Eastland 2003, pet. denied) (holding that the plaintiff-lessor waived its claim for termination

in the absence of a savings provision in the lease delineating under what circumstances and in what timeframe production must be restored,⁸⁴ Texas courts will apply the common law temporary cessation of production doctrine to determine whether a lease has terminated due to lack of production.⁸⁵ Under the temporary cessation of production doctrine, the lessee is given a reasonable time to restore production when production ceases due to mechanical breakdown or other production problems which are inherent in the production of oil and gas.⁸⁶ Early cases appeared to limit the application of the doctrine to mechanical breakdowns or other instances where the cessation was “necessarily unforeseen or unavoidable.”⁸⁷ The Supreme Court has stated, however, that “foreseeability and avoidability are not essential elements of the

due to total cessation of production by submitting to the jury only the issue of termination due to lack of production in paying quantities); *see also* *Bachler v. Rosenthal*, 798 S.W.2d 646, 650 (Tex. App.—Austin 1990, writ denied) (withdrawing and reversing its previous opinion which had upheld the trial court’s application of the two-prong “paying quantities” analysis to a total cessation of production claim); *Wainwright v. Wainwright*, 359 S.W.2d 628, 630 (Tex. Civ. App.—Fort Worth 1962, writ ref’d n.r.e.) (refusing to apply the analysis announced in *Clifton v. Koontz* to a permanent cessation of production claim).

⁸⁴ Please refer to Section II.D(1)(b), *infra*, for a discussion of express cessation of production provisions.

⁸⁵ *Ridge Oil Co., Inc. v. Guinn Investments, Inc.*, 148 S.W.3d 143, 147 (Tex. 2004).

⁸⁶ *Watson v. Rochmill*, 137 Tex. 565, 567, 155 S.W.2d 783, 784 (1941) (applying the temporary cessation doctrine to prevent automatic termination of the leases “due to sudden stoppage of the well or some mechanical breakdown of the equipment used in connection” with the well).

⁸⁷ *Scarborough v. New Domain Oil & Gas Co.*, 276 S.W. 331, 336 (Tex. Civ. App.—El Paso 1925, writ dism’d w.o.j.).

[temporary cessation of production] doctrine.”⁸⁸

When applying the temporary cessation of production doctrine, a court will consider (a) what caused the cessation of production, (b) how long the cessation continued, and (c) what efforts the lessee undertook to restore production.

The common law temporary cessation of production doctrine does not apply when the lease contains an operations provision which sets forth a time limitation within which drilling or reworking operations must be conducted by the lessee (60 or 90 days is typical), as discussed in Section II.D(1), *infra*.⁸⁹

D. Savings Clauses

An oil and gas lease will terminate at the end of the primary term if the lessee is not producing oil or gas from the lease premises or land pooled therewith⁹⁰ and the lessee has not complied with one of the various savings provisions in the lease which either excuses, or serves as a substitute for, lack of production. Each of these savings provisions, if triggered and complied with by the lessee, will keep an oil and gas lease in effect despite either a lack of production

at the end of the primary term or a cessation of production during either the primary or secondary term.

Production at the end of the primary term may not exist for a number of reasons: (i) a well has not been completed by lessee; (ii) oil or gas has been discovered but has not yet been produced; (iii) any or all of the wells drilled resulted in dry holes; or (iv) production was once obtained but has ceased. The plaintiff bears the burden of proof to show that there is no production from the lease premises and that the lessee has not complied with the various savings clauses contained in the lease.⁹¹

1. Dry Hole, Cessation of Production and Drilling Operations Provisions

Most oil and gas leases contain a single paragraph which includes three separate, but interrelated, savings clauses: (i) the drilling operations clause, (ii) the dry hole clause and (iii) the cessation of production clause. These savings clauses are often collectively referred to as the “operations” provision of an oil and gas lease. Although the language of these savings provisions vary from lease to lease, a typical operations provision reads as follows:

“If prior to discovery of oil or gas on said land lessee should drill a dry hole or holes thereon, or if after discovery of oil or gas the production thereof should cease from any cause, this lease shall not terminate if lessee commences additional drilling or reworking operations within sixty (60) days thereafter or (if it be within the primary term) commences or resumes the payment or tender of delay rentals on or before the

⁸⁸ *Ridge Oil Co.*, 148 S.W.3d at 152 (quoting *Guinn Investments v. Ridge Oil Co.*, 73 S.W.3d 523, 532 (Tex. App.—Fort Worth 2002), *rev'd on other grounds*, 148 S.W.3d 143 (Tex. 2004)).

⁸⁹ *Samano v. Sun Oil Co.*, 621 S.W.2d 580, 581–84 (Tex. 1981); *Sun Operating Ltd. P'ship v. Holt*, 984 S.W.2d 277, 282 (Tex. App.—Amarillo 1998, *pet. denied*).

⁹⁰ A pooling provision in an oil and gas lease can also function as savings clause where there is no actual production from the lease premises but from the land pooled therewith. However, if the lessee fails to comply with the pooling requirements of the lease in designating the pooled unit, the unit may be ineffective, and the lease may terminate. *Jones v. Killingsworth*, 403 S.W.2d 325, 332–33 (Tex. 1965).

⁹¹ *Hydrocarbon Mgt., Inc. v. Tracker Exploration, Inc.*, 861 S.W.2d 427, 431 (Tex. App.—Amarillo 1993, *no writ*); *Morrison v. Swaim*, 220 S.W.2d 493, 495 (Tex. Civ. App.—Eastland 1949, *writ ref'd n.r.e.*).

rental paying date next ensuing after the expiration of three months from the date of completion of the dry hole or cessation of production. If at the expiration of the primary term oil, gas or other mineral is not being produced on said land but lessee is then engaged in drilling or reworking operations thereon, the lease shall remain in force so long as operations are prosecuted with no cessation of more than thirty (30) consecutive days, and if they result in the production of oil, gas or other minerals so long thereafter as oil, gas or other mineral is produced from said land.”⁹²

The first sentence contains the dry hole and cessation of production clauses and only applies when (i) a dry hole is drilled prior to the discovery of oil or gas, or (ii) where production ceases following the discovery of oil or gas.

The second sentence is the drilling operations clause. This provision keeps a non-productive lease in effect past the primary term if, prior to the end of the primary term, the lessee timely commences drilling or reworking operations in an effort to either obtain or restore production and diligently pursues those operations without a cessation in those drilling or reworking operations for a certain period of time.

a. Dry Hole Clause

The dry hole clause allows the lessee to keep a lease in effect following the drilling of a dry hole but requires the lessee to commence drilling operations for a subsequent well within a stated period or resume the payment of delay rentals where

⁹² This form of operations provisions is often referred to as a “thirty day-sixty day” clause and has been discussed, with minor variations in the language used, in a number of Texas cases. See, e.g., *Stanolind Oil & Gas Co. v. Newman Bros. Drilling Co.*, 305 S.W.2d 169 (Tex. 1957); *Rogers v. Osborn*, 261 S.W.2d 311 (Tex. 1953).

delay rentals are required (if the dry hole is drilled during the primary term). The policy behind this savings provision acknowledges the speculative nature of oil and gas exploration and affords the lessee additional time to drill in a different location in an attempt to obtain production.”⁹³

To avail itself to the protection of this savings provision, the lessee must have completed a well which qualifies as a “dry hole” (i.e., the well is not productive of oil or gas). A well which is capable of producing oil or gas but is simply not capable of producing oil or gas in paying quantities does not constitute a dry hole for purposes of triggering this savings provision.⁹⁴ In addition, where a unit is pooled for the production of gas only, but a well producing oil rather than gas is drilled, the lessee cannot rely on the dry hole clause to hold a lease in effect during the secondary term where pooling is allowed for gas wells only.⁹⁵

A properly drafted dry hole clause should provide the lessee with adequate time to either commence drilling operations on a subsequent well or resume the payment of

⁹³ See *Stanolind*, 305 S.W.2d at 174 (noting that the “primary purpose [of the dry hole provision] is to give a lessee who has incurred the expense of drilling a well an opportunity to save his lease. . . .”)

⁹⁴ See *Rogers*, 261 S.W.2d at 312–14 (concluding that a well which produced some gas and was occasionally bled to remove trace oil and waste did not constitute a dry hole); *Cox v. Miller*, 184 S.W.2d 323, 328 (Tex. Civ. App.—Eastland 1944, writ ref’d) (“The terms ‘dry hole’ and a well ‘producing gas in paying quantities’ are not necessarily the converse of the other.”)

⁹⁵ *Sunac Petroleum Corp. v. Parkes*, 416 S.W.2d 798, 802 (Tex. 1967) (concluding that a lease which permitted the lessee to pool the gas leasehold estate could not rely on the dry hole provision to prolong the lease during the secondary term when an oil well, rather than a gas well, was completed on other acreage pooled with the lease premises).

delay rentals if the dry hole is drilled during the primary term and delay rentals are required.

b. Cessation of Production Clause

The cessation of production clause will keep a lease in effect for a certain period of time after a well that has been producing oil or gas ceases to flow. The lessee must either commence reworking or drilling operations on the well, begin drilling a new well, or, if the cessation occurs during the primary term, resume the payment of delay rentals where delay rentals are required.

As discussed in Section II.C(2), *supra*, cessation of production provisions supplant the common law temporary cessation of production doctrine, which would otherwise apply in the absence of an express cessation of production clause in the lease. Therefore, rather than the lessee having a “reasonable time” to obtain production from the well, the language of the cessation of production clause will require the lessee to engage in drilling or reworking operations within a certain period to keep the lease in effect.

c. Drilling Operations Clause

A drilling operations clause will keep a non-productive lease in effect into or during the secondary term if, while the lease is still in effect, the lessee timely commences drilling or reworking operations in an effort to either obtain or restore production and diligently pursues those operations without a cessation in those drilling or reworking operations for a certain period.⁹⁶

⁹⁶ *Whelan v. R. Lacey, Inc.*, 251 S.W.2d 175, 176–77 (Tex. Civ. App.—Texarkana 1951, writ ref’d n.r.e.) (holding a that a lessee complies with the drilling operations provision if it begins work that is preliminary to the start of actual drilling). In *Whelan*, the primary term ended on April 21, 1946, but the lease was kept in effect by activities

Depending upon how the drilling operations provision is drafted, it may be interpreted as either a “continuous operations” provision or a “well completion” provision. It is important for lessees to appreciate the distinction between these two types of provisions.

Under a “continuous operations” provision, drilling operations conducted on any well located on the lease premises or land pooled therewith will keep the lease in effect in the absence of production. It is not limited to operations conducted on the specific well being drilled or reworked at the end of the primary term.⁹⁷ Accordingly, the lease will remain in effect so long as operations are continuously conducted on any well.

A “well completion” provision, however, is a much more limited drilling operations clause. This type of operations clause allows the lessee to continue drilling operations until the specific well being

preparatory to the actual spudding of the well, where those activities were conducted diligently and in good faith by the lessee. *Id.* at 176.

⁹⁷ The following is an example of a continuous operations provision: “If at the end of the primary term oil or gas is not being produced on the lease premises, or land pooled therewith, but lessee is then engaged in drilling or reworking operations thereon, or if prior to the discovery and production of oil or gas on the lease premises, or land pooled therewith, lessee should drill a dry hole or holes thereon, or if after the discovery and production of oil or gas on the lease premises, or land pooled therewith, the production thereof should cease from any cause, and this lease is not being otherwise maintained in force, this lease shall nonetheless remain in force so long as operations, whether on the same well or on different wells successively are prosecuted with due diligence with no cessation of operations of more than sixty (60) consecutive days, and if they result in production of oil or gas, so long thereafter as oil or gas is produced in paying quantities from the lease premises, or land pooled therewith, subject to the other provisions of this lease.”

drilled at the end of the primary term is complete, but does not permit the lessee to hold the lease in effect by engaging in subsequent drilling operations on other wells.⁹⁸ If the well in question results in a dry hole, the lease will terminate, unless held in effect by some other savings provision.⁹⁹

⁹⁸ *Rogers v. Osborn*, 261 S.W.2d 311, 315 (Tex. 1953) (holding that a lease which excluded the word “additional” from the drilling operations provision limited the application of that provision to the specific well for which operations were being conducted at the end of the primary term). In *Rogers*, the operations provision provided: “If prior to discovery of oil or gas on said land Lessee should drill a dry hole or holes thereon, or if after discovery of oil or gas the production thereof should cease from any cause, this lease shall not terminate if lessee commences *additional* drilling or reworking operations within sixty (60) days thereafter or (if it be within the primary term) commences or resumes the payment or tender of rentals on or before the rental paying date next ensuing after the expiration of three months from date of completion of dry hole, or cessation of production. If at the expiration of the primary term oil, gas or other mineral is not being produced on said land but lessee is then engaged in drilling or re-working operations thereon, this lease shall remain in force so long as operations are prosecuted with no cessation of more than thirty (30) consecutive days, and if they result in the production of oil, gas or other mineral so long thereafter as oil, gas or other mineral is produced from said land...” *Id.* at 313 (emphasis added). The Court interpreted the second sentence, the drilling operations clause, by comparing it with the language of the first sentence, which contains the dry hole and cessation of production clauses. *Id.* at 315. The Court reasoned that by excluding the word “additional” from the drilling operations clause, the parties intended for that clause to be limited to operations conducted on a specific well. *Id.*

⁹⁹ *Id.* (“This sentence means that if production results from the continuous prosecution of the very operations being engaged in by the lessees upon the expiration of the primary term, the lease is good.”)

Accordingly, a “continuous operations” provision is analogous to playing five card draw in poker, while a “well completion” provision is the equivalent of playing five card stud. All lessees will want the ability to pull additional cards from the deck if they don’t like the hand that is dealt, but “well completion” provisions do not provide lessees with that option.

Under each of these savings clauses contained in the operations provision, commencing and/or continuously pursuing drilling operations will be required to perpetuate the lease past the time period stated in the lease, especially during the secondary term when the lessee no longer has the option to pay delay rentals. Not surprisingly, the majority of lease termination cases deal with one or more of the following issues: (i) whether the lessee’s actions constituted “drilling”¹⁰⁰ or

¹⁰⁰ To constitute “drilling operations,” Texas courts require actual manual operations on the lease premises by the lessee which are preliminary to the actual work of drilling. *See Whelan v. R. Lacey, Inc.*, 251 S.W.2d 175, 176 (Tex. Civ. App.—Texarkana 1951, writ ref’d n.r.e.) (holding that the preparation of a drilling location and moving a drilling rig on site were actual operations preparatory to drilling sufficient to hold the lease in effect). The Eastland Court of Appeals has held that the following activities do not constitute “drilling operations” as matter of law: long-stroking the existing well, laying a pipeline to gas wells, performing electrical work, maintaining electrical power, replacing a tank, keeping the equipment on the wells, and installing, checking, and repairing flow lines. *Bargsley v. Pryor Petroleum Corp.*, 196 S.W.3d 823, 826 (Tex. App.—Eastland 2006, pet. denied). *See, e.g., Ridge Oil Co. v. Guinn Investments, Inc.*, 148 S.W.3d 143, 158 (Tex. 2004) (“Even assuming that the stake was driven into the well site during this interval, and taking into account the fact that [the lessee] obtained a drilling permit . . . and was attempting to pay surface damages, this does not raise a fact question as to whether ‘operations were being carried on’ sufficient to sustain the lease.”); *Veritas Energy v. Brayton Operating, Corp.*,

“reworking”¹⁰¹ operations; (ii) whether drilling or reworking operations were properly “commenced”;¹⁰² (iii) whether the lessee’s drilling operations were prosecuted with reasonable diligence;¹⁰³ and (iv) whether the lessee continuously conducted its drilling operations in good faith without cessation for more than the requisite period of time allowed by the lease.¹⁰⁴

For practitioners drafting oil and gas leases or litigating lease termination claims, the three most important aspects of an operations provision to consider are: (i) determining what constitutes “drilling operations,” which may be specifically

defined, (ii) determining the period in which the lessee must commence drilling operations and (iii) determining the date that triggers termination of the lease if the lessee fails to continuously pursue its drilling activities.

2. Shut-in Royalty Provisions

A shut-in royalty clause permits a lessee to keep an oil and gas lease in effect in the absence of production by paying the lessor an agreed upon shut-in royalty while the lessee seeks a market for gas that is capable of being produced from a well on the lease premises.¹⁰⁵ For the shut-in royalty provision to apply, there must be a well that is capable of producing gas in paying quantities.¹⁰⁶ The well may be shut-in due to the lessee’s inability to get the gas to an available market. Like the payment of delay rentals discussed above, courts strictly construe shut-in royalty provisions, such that the failure to timely and properly pay shut-in royalties typically results in the automatic termination of the lease.¹⁰⁷ However, the

No. 13-06-061-CV, 2008 WL 384169, at *5 (Tex. App.—Corpus Christi Feb. 14, 2008, pet. denied) (mem. op.) (“Although Tucker stated that he intended to drill a well, we cannot conclude that the mere back dragging of grass with a back hoe on the last day of the primary term, apparently to mark the location of a road, was ‘drilling’ or was ‘for drilling’ a well. This minimal activity does not constitute ‘operations’ within the meaning of the lease provisions and did not serve to extend the Miner Lease beyond its primary term.”)

¹⁰¹ See *Cox v. Stowers*, 786 S.W.2d 102, 105 (Tex. App.—Amarillo 1990, no writ) (“We conclude that the term ‘reworking operations,’ as used in the instant clause, means any and all actual acts, work or operations in which an ordinarily competent operator, under the same or similar circumstances, would engage in a good faith effort to cause a well or wells to produce oil or gas in paying quantities.”) In applying this standard, the court in *Stowers* held that the lease was held in effect by the lessee repeatedly injecting fluids and shutting in the well over a period of approximately 15 months. *Id.* at 106.

¹⁰² See *Whelan*, 251 S.W.2d at 176.

¹⁰³ See *Ridge Oil Co.*, 148 S.W.3d at 158 (approving in dicta that “in examining the lapse of time between discontinuance of operations at the site of the first hole and commencement of drilling at the second site, ‘the question is one of reasonable diligence of operations.’” (quoting *Pardue v. Mark*, 279 S.W.2d 594, 596 (Tex. Civ. App.—Fort Worth 1955, no writ)).

¹⁰⁴ *Whelan*, 251 S.W.2d at 176.

¹⁰⁵ A typical shut-in royalty provision states: “If, at the end of the primary term, or at any time or times thereafter, there is located on the lease premises, or on land pooled therewith, a well capable of producing gas in paying quantities, but the gas is not being sold due to lack of market, and this lease is not being otherwise maintained in force, lessee shall pay or tender by check or draft of lessee, as royalty, at annual intervals, a sum of \$[_.] per net acre to the parties who at the time of such payment would be entitled to receive royalties hereunder and if such payment is made or tendered, it will be considered that gas is being produced from the lease premises in paying quantities during any period for which such payment is made.”

¹⁰⁶ *BP America Production Company v. Red Deer Resources, LLC*, 526 S.W.3d 389 (Tex. 2017).

¹⁰⁷ *Amber Oil & Gas Co. v. Bratton*, 711 S.W.2d 741, 744 (Tex. App.—Austin 1986, no writ) (holding that the lease terminated automatically when the lessee failed to properly pay shut-in royalties); *Gulf Oil Corp. v. Reid*, 337 S.W.2d 267, 272 (Tex. 1960) (holding that the oil and gas

failure to pay shut-in royalties may not result in automatic termination of the lease if the language of the shut-in royalty provision creates a covenant, rather than a special limitation on the mineral leasehold estate or a condition of termination.¹⁰⁸

3. Force Majeure Provisions

Force majeure provisions are generally designed to excuse a lessee's noncompliance with its production, or other performance obligations due to forces beyond its control or events which were unforeseeable at the time the parties executed the oil and gas lease.¹⁰⁹ The lessee bears the burden of

lease terminated where there was no production or tender of shut-in royalty for a period of thirty-two days following the capping of the well); *Freeman v. Magnolia Petroleum Co.*, 141 Tex. 274, 279, 171 S.W.2d 339, 342 (1943) (holding that lessee's failure to timely pay shut-in royalties was a condition which automatically terminated the lease, and the lease "could not be revived by [lessee's] attempt to perform the condition more than four months after the contract said it should be performed").

¹⁰⁸ *See, e.g., Blackmon v. XTO Energy, Inc.*, 276 S.W.3d 600, 607 (Tex. App.—Waco 2008, no pet.) (holding that the shut-in royalty provision was a covenant to make shut-in royalty payments, rather than a condition or special limitation, and therefore, the lease would not terminate due to lessee's failure to make proper payments).

¹⁰⁹ *See Hydrocarbon Mgmt., Inc. v. Tracker Exploration, Inc.*, 861 S.W.2d 427, 436–37 (Tex. App.—Amarillo 1993, no writ) (holding that lessee could not avail itself to protection under the force majeure clause because it was within lessee's control to reduce production below the well's allowable and avoid the Railroad Commission's ordering the well shut-in); *Atkinson Gas Co. v. Albrecht*, 878 S.W.2d 236, 241–42 (Tex. App.—Corpus Christi 1994, writ denied) (holding that lessee could not rely on force majeure provision when the RRC ordered the well shut-in due to lessee's failure to timely file production reports, because compliance with the regulations was entirely within its control); *but see Frost Nat'l Bank v. Matthews*, 713 S.W.2d 365, 367 (Tex. App.—Texarkana 1986, writ ref'd n.r.e.) (concluding that the force

proof to establish that a lease has not terminated due to the occurrence of a force majeure event.¹¹⁰ Because Texas courts strictly construe these provisions, it is important for lessees to specifically describe which circumstances will constitute force majeure events, such as floods, fires, wars, riots, damage to third-party pipelines, strikes by employees, and state and federal laws and regulations.¹¹¹

Riders to oil and gas leases may require the lessee to provide the lessor with notice of the occurrence and subsequent termination of a force majeure event in order to avail itself to the protection of the force majeure clause. In addition, more lessor-friendly force majeure clauses may also limit the total time that a lessee can rely on force majeure events to excuse a lack of production or other performance, even if the force majeure event is completely out of the lessee's control.

E. Termination Resulting From an Express Condition

In addition to the triggering of a special limitation on the mineral leasehold estate, termination can also result from other provisions contained within the lease which

majeure clause prevented termination of the lease because the shut-in order issued by the Railroad Commission was due to overproduction by the previous operator, which was outside of the assignee-operator's control).

¹¹⁰ *Kodiak 1981 Drilling P'ship v. Delhi Gas Pipeline Corp.*, 736 S.W.2d 715, 723 (Tex. App.—San Antonio 1987, writ ref'd n.r.e.).

¹¹¹ *See, e.g., Sun Operating P'ship v. Holt*, 984 S.W.2d 277, 282–84 (Tex. App.—Amarillo 1998, pet. denied) (discussing application of force majeure due to pipeline repairs); *Moore v. Jet Stream Inv., Ltd.*, 261 S.W.3d 412, 419–22 (Tex. App.—Texarkana 2008, pet. denied) (refusing to allow lessee to avail itself to the force majeure provision due to the Railroad Commission's amending its regulations to require all operators to post a P-5 Certificate of Financial Assurance).

expressly state that the lease will terminate if the lessee fails to comply with a stated condition. In most oil and gas leases, the other affirmative obligations of the lessee, such as the obligation to pay royalties, are drafted as covenants made by the lessee, rather than special limitations on the leasehold estate or conditions of termination.¹¹²

Negotiated oil and gas leases more favorable to the lessor, however, may contain express provisions stating that the lessee's failure to abide by the stated obligation will result in termination of the lease.¹¹³ Some lease provisions, such as continuous development and retained acreage clauses, whether couched in terms of condition or special limitation, may result in only partial termination of the lease if not satisfied.¹¹⁴ In order to transform a covenant into a condition of termination, the lease must clearly and unequivocally state that lessee's

failure to comply with the obligation will result in termination of the lease.¹¹⁵ If the language is unclear as to whether it creates a covenant, rather than a special limitation or a condition, a court will construe the provision as a covenant to avoid termination of the lease.¹¹⁶

F. Avoiding Termination Claims

Defenses may generally not be used to overcome termination of an oil and gas lease due to the occurrence of a breach of the special limitation. However, despite an oil and gas lease being a conveyance of a fee simple determinable estate in the leased substances which automatically terminates upon the occurrence of the breach of the special limitation, lessees have sometimes successfully asserted defenses to lease termination claims.

1. Waiver

Waiver is defined as the intentional relinquishment of a known right or intentional conduct inconsistent with

¹¹² See *Blackmon v. XTO Energy, Inc.*, 276 S.W.3d 600, 606 (Tex. App.—Waco 2008, no pet.) (holding that the language of the shut-in royalty provision created a covenant, rather than a condition of termination or a special limitation).

¹¹³ See *Freeman v. Magnolia Petroleum Co.*, 141 Tex. 274, 279, 171 S.W.2d 339, 342 (1943) (holding that lessee's failure to timely pay shut-in royalties was a condition which allowed for termination of the lease as a matter of law); *Vinson Minerals, Ltd. v. XTO Energy, Inc.*, 335 S.W.3d 344, 354 (Tex. App.—Fort Worth 2010, pet. denied) (acknowledging that under certain circumstances, the language of the royalty provision can create a condition of termination, allowing for termination by the lessor).

¹¹⁴ Cf. *ConocoPhillips Co. v. Vaquillas Unproven Minerals*, No. 04-15-00066-CV, 2015 Tex. App. LEXIS 8194 (Tex. App.—San Antonio August 5, 2015, pet. granted, judgment vacated w.r.m.) (showing the issues that can arise when tying a retained acreage provision to the size of units provided by Railroad Commission of Texas field rules. Conoco was permitted to retain 40-acre gas units, set forth by the RRC special field rules, which was "different" from the 640-acre gas units initially set forth in the retained acreage clause.).

¹¹⁵ See *Hitzelberger v. Samedan Oil Corp.*, 948 S.W.2d 497, 510 (Tex. App.—Waco 1997, writ denied) (concluding that the lease expressly provided that the lessee's failure to timely pay royalties terminated the lease).

¹¹⁶ *W.T. Waggoner Estate v. Sigler Oil Co.*, 118 Tex. 509, 523, 19 S.W.2d 27, 31 (1929) ("In case of doubt as to the true construction of a clause in a lease, it should be held to be a covenant, and not a condition or limitation, as the law does not favor forfeitures.") (internal citations omitted); cf. *Rogers v. Ricane Enterprises, Inc.*, 884 S.W.2d 763, 767 (Tex. 1994) (refusing to imply a special limitation to an assignment based on the language contained within the lease); *Colby v. Sun Oil Co.*, 288 S.W.2d 221, 225 (Tex. Civ. App.—Galveston 1956, writ ref'd n.r.e.) (noting that the general rule that oil and gas leases are usually construed more strongly against the lessee and in favor of the lessor does not apply to the construction of forfeiture provisions).

claiming that right.¹¹⁷ “Waiver is essentially unilateral in its character; it results as a legal consequence from some act or conduct of the party against whom it operates; no act of the party in whose favor it is made is necessary to complete it. It need not be founded upon a new agreement or be supported by consideration; nor is it essential that it be based upon an estoppel.”¹¹⁸ An oil and gas lease that terminates due to a breach of the special limitation cannot be overcome by a claim of waiver by the lessor because the lessor has no “right” which he can waive once the lease has terminated. Rather, the lessor immediately becomes vested with title and, therefore, has no time within which to waive the automatic defeasance of the mineral estate.

2. Ratification

Unlike revival, ratification does not effect a present conveyance of a terminated lease, but binds a mineral owner to an otherwise defective, voidable lease which was previously executed. Ratification cannot be used as a defense to a lease that has terminated, although courts have often incorrectly used the term “ratification” in this context.¹¹⁹ Neither can ratification be asserted to save a top lease that is void ab initio for being in violation of the Rule Against Perpetuities.¹²⁰

¹¹⁷ Sun Exploration & Prod. Co. v. Benton, 728 S.W.2d 35 (Tex. 1987).

¹¹⁸ Giddings v. Giddings, 701 S.W.2d 284, 289 (Tex. App.—Austin 1985, writ ref’d n.r.e.).

¹¹⁹ See, e.g., Bradley v. Avery, 746 S.W.2d 341, 343 (Tex. App.—Austin 1988, no writ)(rebuking the trial court’s determination that the lessor’s execution of division orders following termination of the lease resulted in a ratification of the lease).

¹²⁰ Hamman v. Bright & Co., 924 S.W.2d 168, 174 (Tex. App.—Amarillo 1996, writ granted w.r.m.).

3. Quasi-Estoppel & Equitable Estoppel

Traditionally, the doctrine of quasi-estoppel has been applied in oil and gas cases when a lessor accepts the benefits from an agreement, such as royalty payments, and then argues that the agreement is invalid or has terminated.¹²¹ As stated by one Texas court, “the doctrine applies when it would be unconscionable to allow a person to maintain a position inconsistent with one in which he acquiesced, or of which he accepted a benefit.”¹²² Quasi-estoppel can preclude the exercise of a contractual forfeiture provision.¹²³ However, the

¹²¹ Cambridge Prod., Inc. v. Geodyne Nominee Corp., 292 S.W.3d 725, 732 (Tex. App.—Amarillo 2009, pet. denied) (applying quasi-estoppel to hold that a defeasible fee simple determinable did not terminate despite the condition of termination having occurred because the lessors accepted royalties from unit production). In *Cambridge*, a top lessee sued for termination of the bottom lease, claiming an amended unit designation filed by the bottom lessee almost sixteen years after the primary term of the bottom lease and almost nine years after the mineral owners granted the top lease, which amended designation increased the description of the depth of the formation; bottom lessee claimed it was to correct a scrivener’s error. *Id.* at 725–32. The Amarillo Court of Appeals held that the top lessee could have no greater rights than the mineral owners it was claiming under, which mineral owners would be estopped under theory of quasi-estoppel, to assert termination of the bottom lease due to their acceptance of royalties from the productive unit well located on a different tract within the pooled unit. *Id.* at 725–32.

¹²² Atkinson Gas Co. v. Albrecht, 878 S.W.2d 236, 240 (Tex. App.—Corpus Christi 1994, writ denied).

¹²³ See, e.g., Young v. Amoco Prod. Co., 610 F. Supp. 1479, 1488 (E.D. Tex. 1985), *aff’d*, 786 F.2d 1161 (5th Cir. 1986) (holding that plaintiffs were estopped to contend that leases had expired when they continued to accept royalties); Mulvey v. Mobil Producing Tex. & N.M. Inc., 147 S.W.3d 594, 608 (Tex. App.—Corpus Christi 2004, pet. denied) (holding that plaintiff was estopped from contesting validity of farmout

benefits accepted must be derived from the same agreement which a party is seeking to terminate for the doctrine to apply.¹²⁴

Equitable estoppel is less often seen in the oil and gas lease context, as it requires the plaintiff to prove that the other party made a false statement knowing that the plaintiff would rely on that statement and that the plaintiff did rely on the false statement to its detriment.

4. Statute of Limitations

Under the Texas Supreme Court's decision in *Natural Gas Pipeline Company v. Pool*,¹²⁵ a lessee of an otherwise terminated lease may be able to successfully assert the affirmative defense of title by limitations if the lessor does not bring his lease termination claim within the requisite limitations period.¹²⁶ Like the claim of revivor discussed below, adverse possession of the mineral estate acknowledges that the lease terminated at a certain point, but that a new determinable fee estate can be obtained on the same terms as the terminated lease by

when it benefitted financially from that agreement).

¹²⁴ See *Cole v. Anadarko Petroleum Corp.*, 331 S.W.3d 30 (Tex. App.—Eastland 2010, pet. denied) (mineral and surface owners were not estopped under theory of quasi-estoppel from claiming that a surface lease terminated as a result of Anadarko's failure to timely pay annual rentals due to their acceptance of royalties from minerals produced from a pooled unit which included some, but not all, of the owners' acreage on which Anadarko's surface operations were being conducted).

¹²⁵ 124 S.W.3d 188 (Tex. 2003).

¹²⁶ *Id.* at 197–99 (“The lessees’ possession of the mineral estates in the cases before us today was adverse, and all the requirements of the three-, five-, and ten-year statutes of limitations were met.”)

satisfying the requirements of adverse possession.¹²⁷

5. Revivor

Revivor is not technically an equitable defense to termination, because it creates a subsequent grant of the mineral leasehold estate following termination of a lease. The doctrine of revival including words of grant applies when a subsequent instrument executed by the mineral owner (a) makes a specific reference to a terminated lease and (b) clearly acknowledges the validity of that lease.¹²⁸ Revival effects a present grant of the lease referenced in the reviving instrument, which lease had previously terminated as a matter of law. The lessee-defendant has the burden to prove that an otherwise terminated lease has been revived.¹²⁹ When these elements are satisfied, revivor has been held to occur by the subsequent execution of mineral deeds, letter agreements and other similar instruments.¹³⁰ However, revival of a

¹²⁷ *Natural Gas Pipeline Company v. Pool* at 199 (“The lessees acquired the same interest that they adversely and peaceably possessed, that is, the oil and gas leasehold estates as defined by the original leases.”)

¹²⁸ *Humble Oil & Ref. Co. v. Clark*, 126 Tex. 262, 266, 87 S.W.2d 471, 473 (Tex. 1935) (delivering mineral deeds which referenced a specific oil and gas lease and stated that “this sale is made subject to the terms of said lease” resulted in a revival of the lease which had terminated due to lessee’s failure to pay delay rentals); *Loeffler v. King*, 149 Tex. 626, 236 S.W.2d 772 (Tex. 1951) (delivering deed which stated that the property was “under an Oil and Gas Lease” was sufficient to revive the lease which had terminated due to lack of production in paying quantities).

¹²⁹ *Cannon v. Sun-Key Oil Co., Inc.*, 117 S.W.3d 416, 419 (Tex. App.—Eastland 2003, pet. denied).

¹³⁰ *Brannon v. Gulf States Energy Corp.*, 562 S.W.2d 219, 222 (Tex. 1977) (“We consider the letter and the check relating to ‘lease rentals’ as contractual in nature because late payment and acceptance of annual rentals provided for in an oil and gas lease

terminated oil and gas lease will not occur when the language used in the subsequent instrument does not clearly refer to a specific lease and recognize the validity of that lease.¹³¹

III. CONCLUSION

Well, we're finally here. Our often-referenced oil and gas lease has been created and then terminated. Whether examining title, operating acreage, or purchasing land, it is important to know if the minerals under a particular tract are subject to an oil and gas lease. Sometimes we must determine whether a lease has become effective, but more often than not the issue is whether an existing lease has terminated. Generally, the facts which would indicate whether an oil and gas lease has terminated are not apparent from an examination of the real property records.

An oil and gas lease is a conveyance of a real property interest (a fee simple determinable estate). It is subject to the Statute of Frauds and must therefore be in writing, executed by the lessor, describe the leased premises with reasonable certainty, and contain words of present grant and other essential terms. It must be delivered to the lessee, or to a third party under instructions about which there must be strict compliance. An oil and gas lease does not require consideration in order to be effective, although the possibility of negotiating one without it is a mere operator's pipe dream.

has the effect of reviving the lease as though it had never terminated.”)

¹³¹ *Westbrook v. Atlantic Richfield Co.*, 502 S.W.2d 551, 556 (Tex. 1973) (holding that revival did not occur because the subsequently executed agreements did not recognize the validity of a specific lease); *Sun-Key Oil.*, 117 S.W.3d at 420–21 (refusing to hold that a revival occurred in the absence of language in subsequent deeds that those conveyances were made subject to the lease).

The lease must be accepted by the lessee. The lessee should also be careful when obtaining a top lease so as not to run afoul of the Rule Against Perpetuities.

Once effective, the lessee must be careful to comply with all of the terms of the lease, particularly those of condition or special limitation, lest the lease be lost. Even during the primary term (that safe time during which the obligation to utilize the leased premises for the purposes required under the habendum clause may be abated), the lessee should make sure that the lease terms are satisfied (e.g., delay rental payments, drilling obligations, if any). Continuing the lease during the primary term is hazardous enough. In the secondary term, failure to comply with the terms of the lease will often prove fatal.

We have discussed the implied savings provisions where no express terms are contained in the lease, (e.g. the temporary cessation of production doctrine). We have also discussed express savings provisions in leases. Although we do not talk about every clause of condition or limitation which may be included in a lease, the reader should now have an understanding of the nature of the termination issues and the defenses that may be available in limited cases.

We have discussed the ways in which oil and gas leases can terminate, during either the primary or secondary term. Whether due to failure to properly pay the lessor or lack of operations or production, the lessee may find that the lease has already terminated according to its terms even though the lessee has been diligent in attempting to satisfy the lease provisions.

Whether the lease has terminated usually depends upon the facts and circumstances surrounding these events. As a result, the outcome of these determinations is rarely predictable. Although the lessee has some

defenses available in these cases, an adverse judgment will usually involve the confirmation of the prior termination of the lease by operation of law, without the lessee being able to rectify the situation absent the execution and delivery of a new lease (words of present grant) and the payment of another bonus. If production has already been established, the lessee will find itself dreaming of the days of the old lease. Both lessor and lessee must always know the answer to the question:

ARE WE THERE YET?

TABLE OF AUTHORITIES

FEDERAL CASES

Young v. Amoco Prod. Co.,
610 F. Supp. 1479 (E.D. Tex. 1985), *aff'd*, 786 F.2d 1161 (5th Cir. 1986)23

STATE CASES

Aguilar v. Sinton,
501 S.W. 3d 730 (Tex. App. – El Paso 2016, pet. denied)7

Alamo Lumber Co. v. Lawyers Title Insurance Corp.,
439 S.W.2d 423 (Tex. Civ. App.—San Antonio 1969, writ ref’d n.r.e.)5

Amber Oil & Gas Co. v. Bratton,
711 S.W.2d 741 (Tex. App.—Austin 1986, no writ)20

Amoco Prod. Co. v. Braslau,
561 S.W.2d 805 (Tex. 1978)14

Anadarko Petroleum Corp. v. Thompson,
94 S.W.3d 550 (Tex. 2002)14

Atkinson Gas Co. v. Albrecht,
878 S.W.2d 236 (Tex. App.—Corpus Christi 1994, writ denied)20, 23

Bachler v. Rosenthal,
798 S.W.2d 646 (Tex. App.—Austin 1990, writ denied)14

Baker v. Westcott,
73 Tex. 129, 11 S.W. 157 (1889)3

Bargsley v. Pryor Petroleum Corp.,
196 S.W.3d 823 (Tex. App.—Eastland 2006, pet. denied)19

Binford v. Snyder,
144 Tex. 134, 189 S.W.2d 471 (1945)5, 7

Blackmon v. XTO Energy, Inc.,
276 S.W.3d 600 (Tex. App.—Waco 2008, no pet.)11, 20, 21

BP America Production Company v. Laddex, Ltd.,
513 S.W.3d 476 (Tex. 2017)10, 14

BP America Production Company v. Red Deer Resources LLC,
526 S.W.3d 389 (Tex. 2017)14, 20

Bradley v. Avery,
746 S.W.2d 341 (Tex. App.—Austin 1988, no writ)22

Brannon v. Gulf States Energy Corp.,
562 S.W.2d 219 (Tex. 1977)24

Cambridge Prod., Inc. v. Geodyne Nominee Corp.,
292 S.W.3d 725 (Tex. App.—Amarillo 2009, pet. denied)23

<i>Cannon v. Sun-Key Oil Co., Inc.</i> , 117 S.W.3d 416 (Tex. App.—Eastland 2003, pet. denied)	14, 24
<i>Clifton v. Koontz</i> , 325 S.W.2d 684 (Tex. 1959)	13, 14, 15
<i>Coker v. Benjamin</i> , 83 S.W.2d 373 (Tex. Civ. App.—Beaumont 1935, no writ).....	12
<i>Colby v. Sun Oil Co.</i> , 288 S.W.2d 221 (Tex. Civ. App.—Galveston 1956, writ ref'd n.r.e.)	22
<i>Cole v. Anadarko Petroleum Corp.</i> , 331 S.W.3d 30 (Tex. App.—Eastland 2010, pet. denied)	23, 24
<i>ConocoPhillips Co. v. Vaquillas Unproven Minerals</i> , No. 04-15-00066-CV, 2015 Tex. App. LEXIS 8194 (Tex. App.—San Antonio August 5, 2015, pet. granted, judgm't vacated w.r.m.).....	21
<i>Cox v. Miller</i> , 184 S.W.2d 323 (Tex. Civ. App.—Eastland 1944, writ ref'd).....	11, 13, 17
<i>Cox v. Payne</i> , 107 Tex. 115, 174 S.W. 817 (1915)	7
<i>Cox v. Stowers</i> , 786 S.W.2d 102 (Tex. App.—Amarillo 1990, no writ).....	19
<i>Davis v. Bond</i> , 158 S.W.2d 297 (Tex. 1942)	5
<i>Dikes v. Miller</i> , 24 Tex. 417 (1859)	4
<i>Fox v. Lewis</i> , 344 S.W.2d 731 (Tex. Civ. App.—Austin 1961, writ ref'd n.r.e.).....	7
<i>Freeman v. Magnolia Petroleum Co.</i> , 141 Tex. 274, 171 S.W.2d 339 (1943)	20, 21
<i>Frost National Bank v. Matthews</i> , 713 S.W.2d 365 (Tex. App.—Texarkana 1986, writ ref'd n.r.e.)	21
<i>Garcia v. King</i> , 139 Tex. 578, 164 S.W.2d 509 (1942)	13, 14
<i>Giddings v. Giddings</i> , 701 S.W.2d 284 (Tex. App.—Austin 1985, writ ref'd n.r.e.).....	22
<i>Guinn Investments, Inc. v. Ridge Oil Co., Inc.</i> , 73 S.W.3d 523 (Tex. App.—Fort Worth 2002), <i>rev'd on other grounds</i> , 148 S.W.3d 143 (Tex. 2004)	15
<i>Gulf Oil Corp. v. Reid</i> , 337 S.W.2d 267 (Tex. 1960)	20

<i>Hamman v. Bright & Co.</i> , 924 S.W.2d 168 (Tex. App.—Amarillo 1996, writ granted w.r.m.)	9, 23
<i>Hitzelberger v. Samedan Oil Corp.</i> , 948 S.W.2d 497 (Tex. App.—Waco 1997, writ denied)	22
<i>Humble Oil & Refining Co. v. Harrison</i> , 146 Tex. 216, 205 S.W.2d 355 (1947)	12
<i>Humble Oil & Refining Co. v. Clark</i> , 87 S.W.2d 471 (Tex. 1935)	24
<i>Hydrocarbon Mgt., Inc. v. Tracker Exploration, Inc.</i> , 861 S.W.2d 427 (Tex. App.—Amarillo 1993, no writ).....	16, 20
<i>Jones v. Bevier</i> , 59 S.W.2d 945 (Tex. Civ. App.—Beaumont 1933, writ ref'd)	3, 4, 7
<i>Jones v. Killingsworth</i> , 403 S.W.2d 325 (Tex. 1965)	15
<i>Kincaid v. Gulf Oil Corp.</i> , 675 S.W.2d 250 (Tex. App.—San Antonio 1984, writ ref'd n.r.e.)	12
<i>Kodiak 1981 Drilling Partnership v. Delphi Gas Pipeline Corp.</i> , 736 S.W.2d 715 (Tex. App.—San Antonio 1987, writ ref'd n.r.e.)	21
<i>Loeffler v. King</i> , 149 Tex. 626, 236 S.W.2d 772 (Tex. 1951)	24
<i>Mahan v. Brader</i> , 242 S.W.2d 941 (Tex. Civ. App.—Fort Worth 1951, no writ)	10
<i>Martin v. Uvalde Sav. & Loan Association</i> , 773 S.W.2d 808 (Tex. App.—San Antonio 1989, no writ).....	7
<i>Meier v. Suntex Oil & Gas Co.</i> , 413 S.W.2d 944 (Tex. Civ. App.—Amarillo 1967, no writ).....	12
<i>Moore v. Jet Stream Investment, Ltd.</i> , 261 S.W.3d 412 (Tex. App.—Texarkana 2008, pet. denied)	21
<i>Morrison v. Swaim</i> , 220 S.W.2d 493 (Tex. Civ. App.—Eastland 1949, writ ref'd n.r.e.).....	16
<i>Mulvey v. Mobil Producing Tex. & N.M. Inc.</i> , 147 S.W.3d 594 (Tex. App.—Corpus Christi 2004, pet. denied).....	23
<i>Natural Gas Pipeline, Co. v. Pool</i> , 124 S.W.3d 188 (Tex. 2003)	23, 24
<i>North v. North</i> , 2 S.W.2d 481 (Tex. Civ. App.—Waco 1927, no writ)	5
<i>Oakrock Exploration Co. v. Killam</i> , 87 S.W.3d 685 (Tex. App.—San Antonio 2002, pet. denied).....	8, 9

<i>Pardue v. Mark</i> , 279 S.W.2d 584 (Tex. Civ. App.—Fort Worth 1955, no writ)	19
<i>Pelican Oil & Gas Company v. Edson Petroleum Company</i> , 123 S.W.2d 696 (Tex. Civ. App.—Texarkana 1939, no writ)	6, 7
<i>Phillips v. Anderson</i> , 93 S.W.2d 171 (Tex. Civ. App.—Austin 1936, no writ).....	7
<i>Phoenix Insurance Co. v. Neal</i> , 56 S.W. 91 (Austin 1900, no writ).....	5
<i>Pshigoda v. Texaco, Inc.</i> , 703 S.W.2d 416 (Tex. App.—Amarillo 1986, writ ref'd n.r.e.).....	14
<i>Ragland v. Kelner</i> , 148 Tex. 132, 221 S.W.2d 357 (1949)	4
<i>Ridge Oil Co., Inc. v. Guinn Investments, Inc.</i> , 148 S.W.3d 143 (Tex. 2004)	15, 19
<i>Robert Burns Concrete Contractors, Inc. v. Norman</i> , 561 S.W.2d 614 (Tex. Civ. App.—Tyler 1978, writ ref'd n.r.e.).....	7
<i>Rogers v. Osborn</i> , 261 S.W.2d 311 (Tex. 1953)	16, 17, 18
<i>Rogers v. Ricane Enterprises, Inc.</i> , 884 S.W.2d 763 (Tex. 1994)	22
<i>Samano v. Sun Oil Co.</i> , 621 S.W.2d 580 (Tex. 1981)	15
<i>Scarborough v. New Domain Oil & Gas Co.</i> , 276 S.W. 331 (Tex. Civ. App.—El Paso 1925, writ dism'd w.o.j.)	15
<i>Sheldon v. Stagg</i> , 169 S.W.2d 550 (Tex. Civ. App.—Amarillo 1943, writ ref'd w.o.m.)	5
<i>Skelly Oil Co. v. Archer</i> , 356 S.W.2d 774 (Tex. 1961), <i>rev'd in part on other grounds</i> , 356 S.W.2d at 782 (Tex. 1962)	14
<i>Smith v. Smith</i> , 607 S.W.2d 617 (Tex. Civ. App.—Waco 1980, no writ)	4
<i>Stanolind Oil & Gas Co. v. Barnhill</i> , 107 S.W.2d 746 (Tex. Civ. App.—Amarillo 1937, writ ref'd)	13
<i>Stanolind Oil & Gas Co. v. Newman Brothers Drilling Co.</i> , 305 S.W.2d 169 (Tex. 1957)	16, 17
<i>Stephens County Museum, Inc. v. Swenson</i> , 517 S.W.2d 257 (Tex. 1974)	4, 5
<i>Stephens County v. Mid-Kansas Oil & Gas Co.</i> , 113 Tex. 160, 254 S.W. 290 (1923)	2, 3

<i>Sun Exploration & Prod. Co. v. Benton</i> , 728 S.W.2d 35 (Tex. 1987)	22
<i>Sun Operating Partnership v. Holt</i> , 984 S.W.2d 277 (Tex. App.—Amarillo 1998, pet. denied).....	15, 21
<i>Sunac Petroleum Corp. v. Parkes</i> , 416 S.W.2d 798 (Tex. 1967)	17
<i>Texas Co. v. Daugherty</i> , 107 Tex. 226, 176 S.W. 717 (1915)	3
<i>Texas Co. v. Davis</i> , 113 Tex. 321, 254 S.W. 304 (1923)	10
<i>Thornton v. Rains</i> , 157 Tex. 65, 299 S.W.2d 287 (1957)	3
<i>Veritas Energy v. Brayton Operating, Corp.</i> , No. 13-06-061-CV, 2008 WL. 384169 (Tex. App.—Corpus Christi Feb. 14, 2008, pet. denied) (mem. op.).....	19
<i>Vineyard v. Heard</i> , 167 S.W. 22 (Tex. Civ. App.—San Antonio 1914), <i>aff'd</i> 212 S.W. 489 (Tex. Comm'n App. 1919).....	5
<i>Vinson Minerals, Ltd. v. XTO Energy, Inc.</i> , 335 S.W.3d 344, 354 (Tex. App.—Fort Worth 2010, pet. denied)	11, 21
<i>W.T. Waggoner Estate v. Sigler Oil Co.</i> , 118 Tex. 509, 19 S.W.2d 27 (1929)	22
<i>Wainwright v. Wainwright</i> , 359 S.W.2d 628 (Tex. Civ. App.—Fort Worth 1962, writ ref'd n.r.e.).....	15
<i>Watson v. Rochmill</i> , 137 Tex. 565, 155 S.W.2d 783 (1941)	15
<i>Westbrook v. Atlantic Richfield Co.</i> , 502 S.W.2d 551 (Tex. 1973)	24
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<i>Wilson v. Curry</i> , 151 S.W.2d 356 (Tex. Civ. App.—Fort Worth 1941, writ dismiss'd)	7
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