TWELVE LESSOR/LESSEE ISSUS TO CONSIDER WHEN NAVIGATING THE "NEW NORMAL"

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Introduction

Operators across the nation are scrutinizing their leases in a wide-spread effort to navigate historic low oil prices, takeaway curtailment and storage shortages, issues introduced by the COVID-19 pandemic, and a host of associated issues.

These circumstances present a variety of complex lease maintenance issues. Most leases obtained during the shale boom are in their secondary terms, held either by production in paying quantities, shut-in provisions, operations clause, or continuous development provisions. Each introduce a unique analysis, and each is susceptible to significant strategic challenges in the face of low commodity prices along with transportation and storage issues.

This article briefly mentions twelve issues that may arise in lessor/lessee relationships relative to these unusual circumstances. While focus is on Texas law, many of these principles apply across jurisdictions.

1. Lease by Lease Analysis

While checklists and general rules may be helpful, when it comes to analyzing lease maintenance issues there is no-one-size-fits-all solution. Over the last several years, courts have repeatedly emphasized an individualized approach to interpreting oil and gas leases.[1]

In addition, the recent Texas Supreme Court case, *Murphy v. Adams*[2] illustrates that fact-specific "surrounding circumstances" evidence can sometimes lead to deviations from the industry's customary understanding of a given word or phrase. In that case, due to admissible "surrounding circumstances" evidence, the phrase "offset well" did not refer to a well that would actually protect from drainage, but instead referred to a well drilled anywhere on the leased premises.

Many modern leases contain custom definitions for words or phrases like "operations," "drilling," or "reworking." Similarly, some modern leases contain provisions governing the evaluation of production in paying quantities and offset obligations. Those custom definitions and provisions generally control. As a result, any strategy or analysis of the impact of these unusual circumstances on lease maintenance or obligations must involve a lease-by-lease analysis.

2. Continuous Development Obligations

Many leases granted over the last decade are currently held by a continuous development provision. These provisions vary widely in specifying when and how a lease may be held by continuous development, such as when a well is "completed" or "abandoned," and when the next

[1] ***See, e.g.,*** *Tro-X, L.P. v. Anadarko Petroleum Corp.*, 548 S.W.3d 458, 466 (Tex. 2018).
[2] 560 S.W.3d 105 (Tex. 2018).

well is "commenced."[3] In addition, some provisions allow for "banking" of time saved between wells, and recent cases demonstrate the complexities those calculations can introduce.[4]

Lessees seeking to slow down capital expenditures yet continue to maintain continuous development operations through this downturn should carefully examine their leases to ensure that such decisions do not inadvertently break a continuous development deadline.

3. Retained Acreage/Separate Lease Clause

Many companies will inevitably suspend certain continuous development programs. When continuous development ceases, this generally triggers a retained acreage provision that provides for an automatic termination of some portion of leased acreage.

Lessees considering allowing continuous development to cease should analyze the timing and extent of a potential partial release. Retained acreage provisions widely vary and small changes in wording can sometimes lead to drastically different results in terms of the quantity of acreage retained and released.[5] Additionally, some provisions call for a one-time termination, while others call for partial terminations on a "rolling" basis.[6]

Lessees considering shutting in some wells should evaluate whether production or operations on remaining wells will be sufficient to hold the shut-in production units. Retained acreage clauses are often paired with a "separate lease" clause, generally providing that, after the end of both the primary term and continuous development, each remaining production unit must be held by its own production and/or operations.

4. Production in Paying Quantities

Most leases continue during their primary tern so long as there is "production in paying quantities."[7] To determine whether there is "production in paying quantities" Texas courts apply a two-pronged test.[8] Under the first prong, the court will determine whether the well is making *any* profit, no matter how small.[9] Simple math reflects that reduced oil prices can negatively impact this test.

Under the second prong, a court determines "whether or not under all the 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 well in question was operated."[10] If this downturn is prolonged, some lessors may argue certain leases are being held merely out of speculation. However, if reduced commodity prices are only temporary, lessees will

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[3] ***See, e.g.***, *Endeavor Energy Res., L.P. v. Energen Res. Corp.*, 563 S.W.3d 449, 452 (Tex. App.—Eastland 2018, pet. filed); *HJSA No. 3, Ltd. P'ship*, 587 S.W.3d at 873.
[4] ***See, e.g.***, *Endeavor Energy Res., L.P.*, 563 S.W.3d at 452.
[5] ***Compare*** *XOG Operating, LLC v. Chesapeake Expl. Ltd. P'ship*, 554 S.W.3d 607, 609 (Tex. 2018) with *Discovery Operating, Inc.*, 554 S.W.3d at 590.
[6] ***See, e.g.***, *Chesapeake Expl., LLC v. Energen Res. Corp.*, 445 S.W.3d 878, 881 (Tex. App.—El Paso 2014, no pet.); *Apache Deepwater, LLC v. Double Eagle Dev., LLC*, 557 S.W.3d 650, 656 (Tex. App.—El Paso 2017, pet. denied).
[7] ***See, e.g.***, *Clifton v. Koontz*, 325 S.W.2d 684 (Tex. 1959).
[8] ***Id.***
[9] ***See Garcia v. King***, 139 Tex. 578, 583, 164 S.W.2d 509, 511-12 (1942).
[10] ***Koontz***, 325 S.W.2d at 691.

likely argue that arithmetic and prudent operator tests should both be analyzed over a period of time that factors in a period of higher prices.

5. Minimum Royalties

Some leases require payment of "minimum royalties." With the drop in oil prices, coupled with the inability of some operators to market all of their production, lessees may need to evaluate whether royalty payments drop below a threshold that would require payment of minimum royalties. While failure to make minimum royalty payments may merely provide the lessor with a breach of lease claim, some clauses also provide the lessor with the option to terminate the lease.

6. Force Majeure

A flurry of client alerts and LinkedIn posts over the last few months have contemplated that COVID-19 and/or the market downturn may give rise to reliance on force majeure provisions. Force majeure provisions introduce a large variety of potential issues. Only a few are mentioned here.

One significant issue is whether the event or condition at issue qualifies as "force majeure" under the lease. Many provisions provide a specific list of events or conditions that qualify, as well as catch-all language.[11] These lists and catch-all phrases vary widely and must be analyzed on a case-by-case basis. Some commentators have pondered whether COVID-19 could be considered an "Act of God" – a phrase sometimes listed in force majeure provisions.

Another critical issue is determining whether the lease requires the event or condition to be unforeseeable or preventable. In the 2018 case *TEC Olmos v. Conocophillips*,[12] Texas' First Court of Appeals in Houston held that an economic downturn did not qualify as a force majeure event under the catch-all phrase, because that catch-all only applied to unforeseeable events. The court reasoned that the lessee "did not and cannot" prove that an economic downturn is unforeseeable because "*fluctuations in the oil and gas market are foreseeable as a matter of law*."[13] One may ask, is the current downturn, paired with a global pandemic, unique enough to call for a different conclusion?

An additional issue that may arise is whether the force majeure provision suspends both obligations and conditions in the lease. Generally, lessees are not under an obligation to maintain a lease. However, many force majeure provisions only mention the suspension of obligations. In those circumstances, a force majeure provision may not suspend conditions necessary to maintain the lease.

7. Shut-in royalties

With oil prices recently dipping briefly into negative prices (and as of the date of this article resting in the low $30 range), some lessees may be evaluating whether it is prudent to shut-in some or all wells in certain leases or fields. Care should be taken in evaluating shut-in provisions. Being

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[11] *See, e.g.*, *TEC Olmos, LLC v. Conocophillips Co.*, 555 S.W.3d 176, 182 (Tex. App.—Houston [1st Dist.] 2018, pet filed).

[12] 555 S.W.3d 176 (Tex. App.—Houston [1st Dist.] 2018).

[13] *Id.*

a matter of contract, shut-in provisions widely vary. Common variables include (i) the specific circumstances triggering the shut-in royalty clause, (ii) when and how the payments must be tendered, and (iii) the consequence of failing to make timely payments.

A failure to timely and properly pay a shut-in payment, or shutting in a well that does qualify under a specific shut-in provision, may result in lease termination. The shutting in of oil wells in response to these unprecedented times raises numerous potential questions. For instance, while shut-in provisions traditionally only contemplate shut-in gas wells, many also cover oil wells. In addition, many provisions require a "lack of market," or similar condition precedent.[14] Whether depressed markets or curtailed takeaway capacity qualify under a specific shut-in provision should be carefully evaluated.

8. Regulatory Orders

With the decrease in prices and the threat of limited storage capacity, some are looking for the Texas Railroad Commission to intervene. In March of 2020, Pioneer Natural Resources filed a petition with the Commission, requesting the re-institution of market demand prorationing limits, with the aim of curtailing State and global supply.[15] The Railroad Commission ultimately declined to institute market demand prorationing limits.

In New Mexico, on the other hand, the New Mexico State Land Office announced emergency rulemaking to give relief to the oil and gas industry by allowing wells to be shut-in on certain leases covering state-owned minerals.[16] Oklahoma's energy regulator, similarly, entered an emergency order allowing producers to shut-in well sin certain circumstances.[17]

Regulatory action, while impactful, may or may not help lessees perpetuate their leases. While many force majeure clauses specifically make reference to regulatory orders, some courts have been hesitant to find that regulatory action triggers force majeure provisions when the effects of the regulatory order could have been avoided by the lessee.[18]

9. Cessation of Production/Continuous Operations Clauses

Most modern oil and gas leases contain "cessation clauses," which provide that if production were to cease, the lease may be maintained by commencing production, drilling or reworking operations within a certain period of time — often 60 to 90 days.[19] Whether such a clause could provide a basis to cease production during a time of low prices and/or storage constraints will depend on the express terms of the lease.

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[14] Smith & Weaver, 1 *Texas Law of Oil and Gas* §4.5 (2019).

[15] Mella McEwan, *Parsley, Pioneer ask RRC for market demand hearing*, MIDLAND REPORTER-TELEGRAM, March 30, 2020, https://www.mrt.com/business/oil/article/Parsley-Pioneer-call-for-market-demand-hearing-15167419.php.

[16] Associated Press, New Mexico Land Office Approves Emergency Oil and Gas Rule, U.S. NEWS, April 22, 2020, https://www.usnews.com/news/best-states/new-mexico/articles/2020-04-22/new-mexico-land-office-approves-emergency-oil-and-gas-rule.

[17] Liz Hampton, *Reeling Oklahoma oil producers win right to keep leases while wells shut*, REUTERS, April 22, 2020.

[18] *See, e.g.*, *Red River Res., Inc. v. Wickford, Inc.*, 443 B.R. 74, 84 (E.D. Tex. 2010) (stating that a severance order "will only qualify as a force majeure event when compliance with the RRC regulation violated was outside the control of the lessee.").

[19] 3 Williams & Meyers, Oil and Gas Law § 615, 616 (2019).

Most cessation clauses make no reference to any required cause of cessation, or indicate that they broadly apply to cessation "from any cause."[20] However, it should be noted that in certain cases disputes may arise regarding whether a voluntary cessation of production is permitted under the express language of the provision at issue, particularly where the voluntary cessation is for reasons other than to work on the well or associated facilities.[21]

10. Offset Obligations

Lessees must remain prepared to respond to express or implied offset obligations. In Texas, in order to establish a breach of the implied covenant to protect against drainage a lessor must prove (1) substantial drainage from the leased premises, and (2) a reasonable prudent operator would have acted to prevent the drainage which ordinarily means there is a reasonable expectation of profit from drilling an offset well.[22] Of course, a drilling project is less likely to be profitable during depressed commodity prices.

However, it must be noted that many leases contain express offset provisions that do not condition the obligations on an expectation of profit, and some expressly waive the condition altogether.[23] For instance, some express offset provisions provide that if a well is drilled within a certain number of feet from the leased premises, then drainage is "deemed" to exist, triggering an obligation to either drill an offset well, execute a partial release, or pay compensatory royalties.[24]

11. Volume Commitments and Pipeline Capacity Limitations

Many operators have entered into midstream contracts within minimum volume commitments.[25] Under these agreements, if the operator fails to deliver the agreed-upon volume, the operator may be required to pay shortfall fees or deficiency fees.[26] In the current market, curtailing production could, in some circumstances, result in significant volume deficiency fees.

12. Potential Impacts on Royalty Calculation

In Texas, many royalty provisions allow a lessee to deduct or "net back" a share of certain post-production expenses when calculating royalties.[27] When commodity prices fall low enough, deductions can actually result in a negative net number for royalty valuation purposes, sometimes referred to as a "negative royalty." There are many unanswered questions relating to so-called negative royalties, including the proper method of calculating royalty obligations both during the period when deductions resulted in a negative net value, and how what effect (if any) that may have once positive net values return.

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[20] *Id.*

[21] *See, e.g.,* Williams & Meyers, Oil and Gas Law § 615 (2019) (discussing whether a voluntary cessation can trigger a cessation of production provision.).

[22] *Kerr-McGee Corp. v. Helton,* 133 S.W.3d 245, 253 (Tex. 2004); *Coastal Oil & Gas Corp. v. Garza Energy Tr.,* 268 S.W.3d 1, 17 (Tex. 2008); *Amoco Prod. Co. v. Alexander*, 622 S.W.2d 563 (Tex. 1981).

[23] Austin Brister and Ana Navarrete, *Four Recent Drainage and Offset Cases: A Texas Litigation Trend?*, 33-4 Texas Oil and Gas Law Journal 01 (2019).

[24] *See, e.g., Bell v. Chesapeake Energy*, No. 04-18-00129-CV, 2019 Tex. App. LEXIS 1978, 2019 WL 1139584 (Tex. App.—San Antonio Mar. 13, 2019, pet. pending).

[25] Patrick A. Jackson, *Do MVC's in Midstream Contracts Give Rise to Administrative-Expense Claims in Oil and Gas Cases*?, AM. BANKR. INST. J. 26 (2016).

[26] *Id.*

[27] *See, e.g., Heritage Res., Inc. v. NationsBank, Co.,* 939 S.W.2d 118 (Tex. 1996).