Energy Alert

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# Maintaining Your Lease When There's Nowhere to Send Your Oil

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## Key Points:

- Industry analysts are forecasting that the surplus of oil produced over oil needed may soon exceed available storage. Producers that were already reducing production due to low prices are now feeling pressure to completely shut in wells, raising the risk of lease termination.
- Several provisions in oil and gas leases may mitigate this risk, including shut-in royalty clauses, cessation of production clauses, and force majeure clauses.
- Producers should also understand how the analysis of production in paying quantities is impacted by shutting in production.

While the decimation of global demand for oil resulting from the coronavirus crisis, coupled with the glut in supply arising from the Organization of the Petroleum Exporting Countries ("OPEC")-Russia price war, has caused a devastating collapse in the price of oil, the fallout from this confluence of events now presents yet another challenge for United States (U.S.) producers. Industry analysts are now forecasting that the surplus of oil produced over oil needed may soon exceed available storage. Producers that were already reducing production due to low prices are now feeling pressure to completely shut in wells. *See, e.g.*, this article. This situation presents still another issue for producers: the risk of lease termination resulting from the shutting in of such production. This alert discusses several issues producers should consider in analyzing their leases for termination risk.

## Shut-in Royalty Payments

Under some leases, the payment of shut-in royalty can operate to maintain the lease in this situation. While shut-in royalty is typically thought of in the context of gas production, most industry form leases actually do not limit the applicability of this clause to only gas production or gas wells. Many custom leases, however, expressly limit this option to only apply to wells classified as gas wells. In between, some clauses apply so long as there is gas production associated with the oil production or even so long as the well is "capable of producing gas." The shut-in royalty clause should be at the top of the list of lease provisions producers should review in order to determine if the payment of shut-in royalty is an option under these circumstances.

## Cessation of Production Clauses / Temporary Cessation of Production Doctrine

If paying shut-in royalty is not an option, the lessee may nevertheless get a short-term reprieve from lease termination via the “cessation of production” clause found in most modern lease forms. This clause commonly provides that if production ceases from any cause, the lease will not expire if the lessee commences additional drilling or reworking operations within a specified number of days thereafter (typically 60–90 days), and diligently prosecutes such operations, resulting in the restoration of production. Thus, the operator could only shut in the well for the limited period of time specified in this clause and then would have to recommence operations and production in order to maintain the lease.

If the lease does not contain a cessation of production clause, the lessee may nevertheless be protected by the common law “temporary cessation of production” doctrine. This doctrine allows the lessee to avoid lease termination by establishing that the cessation of production is only temporary. In making this determination, the court looks at three factors: (1) the duration of the cessation period, (2) the cause of the cessation and (3) the lessee’s diligence in attempting to restore production. Historically, this doctrine was only applied when the cessation resulted from a mechanical breakdown or other condition in connection with the well or equipment. *See, e.g., Watson v. Rochmill*, 155 S.W. 2d 783, 784 (Tex. 1941). More recently, however, the Texas Supreme Court has recognized that the doctrine has been broadened to apply in a wide variety of circumstances. *See Ridge Oil Company Inc. v. Guinn Investments, Inc.*, 148 S.W.3d 143 (Tex. 2004). Indeed, the doctrine has been applied in at least one situation somewhat analogous to this one. In *Casey v. Western Oil & Gas, Inc.*, production ceased because a gas sales agreement had expired and the purchaser had disconnected the lease, but production was restored after the operator negotiated a new gas sales agreement. The court held that this cessation was temporary and that the lease was therefore maintained in force during the cessation. 611 S.W.2d 676 (Tex. Civ. App. – Eastland 1980, writ ref’d n.r.e.). Because the lessee’s diligence in attempting to restore production is a factor in the analysis, a lessee wishing to rely on this doctrine should continue using its best commercial efforts to find alternative outlets for oil sales while the well is shut in.

## Production in Paying Quantities

Assuming that (a) shut-in royalty payments are not applicable and (b) the total cessation of production does not terminate the lease under the analysis described in the preceding section, the lessee must still maintain production in paying quantities to avoid the risk of lease termination. In the absence of specific language in the lease defining what constitutes production in paying quantities, this issue turns on the relevant state law on production in paying quantities.

Fortunately for the operator, Texas and a few other producing states take into account subjective “reasonableness” and “reasonably prudent operator” standards as a part of the paying quantities analysis. In 1959, the Texas Supreme Court set forth the now well-established two-part test of paying quantities. *See Clifton v. Koontz*, 325 S.W.2d 684 (Tex. 1959). First, the lessee may satisfy the test by showing that a well makes a profit, however small, over operating expenses, even though it may never repay its costs. *Id.* at 690-691. This objective profitability test must be measured over a reasonable period of time under the circumstances. *Id.* at 690 ("We again emphasize that there can be no limit as to time, whether it be days, weeks, or months, to be taken into consideration in determining the question of whether paying production from the lease has ceased."); *see also BP America Production Company v. Laddex, Ltd.*, 513 S.W.3d 476, 483 (Tex. 2017). If production in paying quantities is not satisfied under the objective profitability test, Texas has a second subjective prong of the paying quantities test—i.e., the test is satisfied if a reasonably prudent operator would, for the purpose of making a profit and not merely for speculation, continue to operate the well in the manner in which the well is operated. *Clifton*, 325 S.W.2d at 691. North Dakota has also adopted this same two-part test. *Fleck v. Missouri River Royalty Corp*., 872 N.W. 2d 329 (N.D. 2015). Louisiana also includes a reasonably prudent operator standard in this analysis. La. Rev. Stat. 31:124 ("It is considered to be in paying quantities when production under the lease is sufficient to induce a reasonably prudent operator to continue production in an effort to secure a return on his investment or to minimize any loss.").

In this context, the extraordinary events that have led to the storage capacity issue should certainly be taken into account in evaluating what is a reasonable period of time over which profitability should be measured as well as whether a reasonably prudent operator would continue to operate the well. The longer the present conditions continue, however, the more difficult it will become to argue that the well is profitable over a reasonable period of time, or that a reasonably prudent operator would continue to operate the well with the expectation of making a profit and not merely for speculation.

**Force Majeure**

Operators should also analyze the *force majeure* clauses of their leases. Some industry-friendly forms contain a very broad, lessee-friendly *force majeure* provision. For example, we are familiar with one form that specifically includes the inability to obtain a satisfactory market for production or the failure of purchasers or carriers to take or transport such production as events that will preclude lease termination. However, most *force majeure* clauses are much narrower, and many even expressly exclude market conditions as an element of *force majeure*. Where *force majeure* clauses are vague or do not specifically either include or exclude market conditions or pandemics, we can expect to see a body of litigation in this area in the coming years. Even if the pandemic constitutes a *force majeure* event, lessors will argue that the pandemic was not the direct cause of wells being shut in, while lawyers for producers will likely craft some creative "domino effect" arguments to advocate that the drop in global demand caused by the virus was a material factor in the supply glut, beyond the control of the lessee, and that the lease should not be terminated in such unprecedented circumstances.

## Notice Requirements

Some industry-friendly lease forms contain notice provisions requiring the lessor to notify the lessee in writing, specifying the alleged event of default and providing the lessee with a period of time after receipt of such notice in which to remedy the breach. The service of the notice is often a condition precedent to an action by the lessor to terminate the lease. Such a clause is obviously quite favorable to the lessee in buying additional time to secure an outlet for its production.

## Lease Amendments

If, after going through the foregoing analysis, an operator still concludes that it is at high risk of losing its lease by shutting in the well, the operator should consider proactively negotiating with their lessors to amend or extend their leases. On the one hand, the lessor will likely demand some consideration or other concession (such as amending other lease terms of concern to the lessor) in return. On the other hand, as a royalty owner, the lessor has a common interest with the lessee in waiting for higher oil prices to sell the production, so may be willing to negotiate a reasonable solution to maintain the lease in effect—particularly if the operator has maintained good relations with the lessor in the past.

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